Ukraine
Ministry of Finance/
Business Development Fund

Data Collection Survey on SME Policies and Loans in Ukraine

Final Report

March 2021

Japan International Cooperation Agency (JICA)

Japan Economic Research Institute Inc.

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List of Abbreviations

AMC	Asset Management Company
API	Application Programming Interface
ATM	Automatic Teller Machine
BDF	Business Development Fund
BIS	Bank for International Settlements
B/S	Balance Sheet
CAR	Capital Adequacy Ratio
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
DGF	Deposit Guarantee Fund
DIY	Do It Yourself
DX	Digital Transformation
EBITDA	Earnings before interest, taxes, depreciation, and amortization
EBRD	European Bank for Reconstruction and Development
EFF	Extended Fund Facility
EIB	European Investment Bank
ESMS	Environmental and Social Management System
EU	European Union
EUR	Euro
GDP	Gross Domestic Product
GOU	Government of Ukraine
GUF	German-Ukrainian Fund
IFCPO	International Financial Cooperation Project Office
IFI	International Financial Institution
IT	Information Technology
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
JPY	Japanese Yen
KfW	Kreditanstalt für Wiederaufbau
KYC	Know Your Customer
LCR	Liquidity Coverage Ratio
SME	Small and Medium-sized Enterprise
SMEDO	SME Development Office
MOF	Ministry of Finance
MSME	Micro, Small and Medium-sized Enterprise
NBU	National Bank of Ukraine
NCSSM	National Commission for Securities and Stock Market
NPL	Non-Performing Loan
ODA	Official Development Assistance
OECD	The Organisation for Economic Co-operation and Development
PFI	Participating Financial Institution
PIU	Project Implementation Unit
P/L	Profit & Loss
POS	Point of Sale
PSD2	Payment Service Directive Two
R&D	Research & Development
ROA	Return on Assets
ROE	Return on Equity
SCRFSM	State Commission for Regulation of Financial Services Market
SUV	Sport Utility Vehicle

TA	Technical Assistance
TSL	Two-Step Loan
UAH	Ukrainian Hryvnia
UIRD	Ukrainian Index of Retail Deposit Rate
UNDP	United Nations Development Programme
USAID	U.S. Agency for International Development
US$	U.S. dollar
VC	Venture Capital
WIPO	World Intellectual Property Organization

1. Current Situation and Challenges of SMEs in Ukraine

1.1 Development Plan of Ukrainian Government and Position of SME Promotion in Development Policies

In view of the high position of the country's SMEs in the economy and society, the Government of Ukraine has previously formulated the strategy for the development of SMEs of Ukraine in the wake of the Strategy for Sustainable Development of Ukraine 2020 (Presidential Decree No. 5 of Ukraine dated 12 January 2015). Specifically, there are *the Business Development and Support of SMEs in Ukraine* (Parliamentary Resolution No. 1090-VII dated 13 April 2016) and *the Strategy for SME Development in Ukraine until 2020* (Directive No. 504 of the Cabinet of Ministers dated 24 May 2017).

At first, the basic policies for promoting entrepreneurship and economic growth are defined in *the Business Development and Support of SMEs in Ukraine*. Then, based on the Parliamentary Resolution, *the Strategy for SME Development in Ukraine until 2020* suggests that the strategy for SME development of Ukraine is reflected by the government's major strategies and policy documents, including the Strategy for Sustainable Development of Ukraine 2020 (Presidential Decree No. 5 dated 12 January 2015), the Association Agreement between the EU/its member states and Ukraine (ratified by Decree No. 1678-VII dated 16 September 2014), etc., and the government intends to coordinate the work of relevant government agencies in order to implement balanced and comprehensive policies for business development. The Directive also confirms that SME policies are strategically related to the Strategy for High-Tech Development until 2025, the Ukraine Export Strategy: roadmap for the strategic development of trade in 2017-2021, the Strategy for the Combined Promotion of Industry until 2025, the National Energy Strategy until 2035, the 2015-30 Sustainable Development Goals, and the Reform Programme of the National Supervisory System. Moreover, while recognizing the serious challenges facing the national economy and SMEs, the government is committed to developing competitive SMEs in the future, in line with the EU Small Business Act and the European Commission (EC) / OECD SME Policy Index.

At present, the National Economic Strategy of Ukraine 2030 is being discussed within the Government of Ukraine, and the direction of the SME development strategy is also being discussed during the policy consultations. Therefore, no new strategic document has been prepared to replace *the Strategy for SME Development in Ukraine until 2020*. However, the government is most likely to continue to work within the framework of the EU Small Business Act.

In general, SME policies are heterogeneous and pluralistic from country to country, and it is difficult to objectively categorize them, but for example, according to a previous study (Atsutaro Yamanaka, "Economic Internationalization and Small and Medium Enterprises in the World," in Fujita and Fujii (eds.), *Economic Internationalization and Small and Medium Enterprises*, 1976), SME policies can be categorized into six types: (i) industrialized country type (A-type Britain, B-type continental Europe, C-type United States, D-type Japan), (ii) developing countries type, and (iii) socialist countries type. If we classify Ukraine's SME policy according to these types, we can see that historically it has been regarded as a socialist country type in the process of transition to a market economy, but at the moment it has entered the process of policy formation of the orthodox continental European type. Therefore, when considering policy-based finance for SMEs, it is important to be consistent with the objectives of EU Small Business Act and to be careful not to design a system that is overly protectionist.

Currently, in the international evaluation of the country's SME policy, for example, *SME Policy: Index Eastern Partner Countries 2020* (OECD, et al., 2020), the evaluation items A (Institutional and regulatory framework, Business environment, Bankruptcy and second chance), B (Entrepreneurship education and entrepreneurship by women, SME skills), C (Access to finance), D (Government procurement, Standards and regulations, Internationalization), and E (Business development services, Innovation policies, Green economy), except for B (Entrepreneurship education and entrepreneurship by women) and D (Standards and regulations), are below the average for eastern European countries (EaP countries). However, there is a general trend of improvement compared to 2016. *The 2019 SBA (Small Business Act for Europe) Fact Sheet* by the EC also points out that "administrative response" has improved to the EU average level, although items such as "internationalization" and "second chance" are rated low.

Table 1-1 International Evaluation on Ukrainian SME Policies

Pillar	Dimension	UKR 2020	UKR 2016	EaP average 2020	*UKR 2020 (2016 methodology)*
A	Institutional and regulatory framework	**3.50**	2.45	3.74	3.50
	Operational environment	**3.55**	3.81	3.92	3.89
	Bankruptcy and second chance	**2.56**	2.05	2.85	2.38
B	Entrepreneurial learning / Women's entrepreneurship	**3.98**	2.25	3.58	n.a.
	SME skills	**3.19**	2.56	3.36	n.a.
C	Access to finance	**3.31**	3.22	3.57	3.23
D	Public procurement	**3.17**	2.73	3.49	3.17
	Standards and regulations	**3.55**	4.34	3.43	3.81
	Internationalisation	**2.64**	1.63	2.96	3.02
E	Business development services	**2.90**	1.84	3.53	2.90
	Innovation policy	**2.28**	1.86	2.92	2.35
	Green economy	**2.54**	1.22	2.77	2.54

Note: EaP (Eastern Partner) countries include Armenia, Azerbaijan, Belarus, Georgia, Republic of Moldova, and Ukraine.
Sources: *SME Policy: Index Eastern Partner Countries 2020* (OECD, et al., 2020).

On the other hand, the support policy for "start-ups" aiming at rapid growth is aimed at encouraging the creation of industries and innovations that do not yet exist in the world, which is different from the traditional "SME support" for micro enterprises that do not intend to grow or for SMEs aiming at stable growth. The government's efforts to improve the start-up environment to date have received some international recognition. For example, according to *the Global Entrepreneurship Index 2018* (The Global Entrepreneurship and Development Institute, Washington, D.C., US), the country ranks 73th out of 137 countries in the world in terms of its entrepreneurial environment. The country's rank is higher than Vietnam (87th), where the IT industry has been on the rise in recent years with an increasing number of young IT engineers.

Also, the government aimed to continuously work to improve the regulatory environment to create an appropriate business environment and to be ranked in the top 20 in the World Bank's ranking of *Doing Business* (Directive No. 1406 of the Cabinet of Ministers dated 16 December 2015). Ukraine is ranked at 64^{th} in the ranking as of 2020.

1.2 Definition of SME and SME Strategy, Policies, and Measures

The Government of Ukraine has defined "SMEs" as those with an annual average number of employees of less than 250 and a turnover of less than EUR50 million, in order to be consistent with EU statistics on SMEs.

Table 1-2 Legal Definition of SMEs in Ukraine

	Micro	Small	Medium	Large
Employment	≦ 10 employees	≦ 50 employees	All enterprises that do not fall into the category of small or large enterprises	≧ 250 employees
Annual income	≦ EUR 2 million	≦ EUR 10 million		≧ EUR 50 million

Sources: Article 55 of the Commercial Code (22 March 2012), *SME Policy: Index Eastern Partner Countries 2020* (OECD, et al., 2020).

Specific measures include *the Action Plan for the Implementation of the SME Development Strategy by 2020* (Order No. 292 of the Cabinet of Ministers dated 10 May 2018). The action plan includes a total of 35 items in six categories, including (i) creating an environment for SME development, (ii) improving SMEs' access to finance, (iii) simplifying the SME tax system, (iv) fostering an entrepreneurial culture and developing corporate skills, (v) strengthening SME competitiveness and innovation, and (vi) organizational support and strategic implementation mechanisms. For each measure, an action plan, timeline, organization in charge, and performance indicators are provided.

On the basis of (vi) above, in November 2018, the Small and Medium Enterprise Development Office (SMEDO) was established under the Ministry of Economic Development and Trade, which has become the implementing agency of the Ukrainian SME policy measures. In addition, if we focus on the above (ii) improving of SMEs' access to finance, the details of the measures are shown in the table below.

Table 1-3 Measures for improving SMEs' access to finance under *the Action Plan for the Implementation of the SME Development Strategy by 2020*

Measures	Action	Timeframe	Responsible	Performance indicators
Direction 2: Improve SME access to finance				
7. Enhance SME financing by commercial banks	1) Develop proposals for effective implementation of credit guarantee schemes for SMEs by commercial banks, including portfolio credit guarantees schemes with respect to the best international practice	4Q-2018	• Ministry of Economic Development and Trade • Ministry of Finance • National Bank (by consent)	Proposals are submitted to the Cabinet of Ministers of Ukraine.
	2) Facilitate implementation of partial credit guarantee scheme for SMEs by financial institutions through the pilot program with the German-Ukrainian Fund	-	• State Statistics Service • Ministry of Economic Development and Trade	Partial credit guaranty scheme is implemented and available at financial institutions.

8. Enhancing the use of promissory notes	1) Raise SME awareness about using bills of exchange and promissory notes	On-going	• National Commission for Securities and Stock Market (by consent) • Ministry of Finance • National Bank (by consent)	The relevant informational events are conducted, including distribution of information and analytical materials; forums, trainings, round tables are held.
	2) Develop and submit the Draft Law of Ukraine "On Amending the Law of Ukraine 'On Circulation of Promissory Notes in Ukraine'" for consideration by the Cabinet of Ministers to comply with the Geneva Conventions on Bills of Exchange and Promissory Notes	4Q-2018	-	The Draft Law is adopted by the CMU and submitted to the Parliament.
9. Enhancing financing by non-banking financial institutions	To support the process of consideration of the Draft Law of Ukraine "On Credit Unions" (registration No 6405) by the Parliament	Until the Law is passed	• National Commission for State Regulation of Financial Services Markets (by consent) • Ministry of Finance • National Bank (by consent)	The Law is adopted.
10. Bridge SME financing gap through factoring services	Develop and submit the Draft Law “Amending certain provisions of the Civil Code of Ukraine in regards to Financial Services” for consideration by the Cabinet of Ministers of Ukraine	2Q-2019	• National Commission for State Regulation of Financial Services Markets (by consent)	The Draft Law is adopted by the CMU and submitted to the Parliament.

Source: *The Action Plan for the Implementation of the SME Development Strategy by 2020* (Order No. 292 of the Cabinet of Ministers dated 10 May 2018).

1.3 Current Situation and Challenges of SMEs

In general, there is a precondition for policy discussion on SME support that SMEs play a quantitatively and qualitatively important role in a country's economy and society. At this point, in quantitative terms, the number of SMEs in the total number of businesses is 99.8% (of which 96% are micro enterprises), the number of employees in SMEs is 63% of total number of employees, and the percentage of SMEs’ value added is 49% (2018).

In addition, SMEs are expected to play a role in competition & innovation, creating growth industries, revitalizing local economies, meeting diversifying needs, promoting the social division of labor, etc. From this qualitative perspective, a notable recent trend is the rise of the IT industry and the expectations of agricultural SMEs.

The percentage of the number of businesses in the domestic IT industry in Ukraine has increased from 5% in 2015 to 9% in 2018. The IT industry currently has about 200,000 software developers. VC investments for IT start-ups are about US$300 million per year (2018). Exports of IT services (system development, R&D, etc.) are US$3.6 billion per year (2017, 3.4% of GDP). It is estimated that there are 4,000 IT companies in the country, many of which are SMEs that are eligible for policy support, and these 4,000 companies include a certain number of so-called “start-ups” that are expected to be catalysts for competition & innovation and the creation of a growth industry.

The agricultural SMEs have been also considered to be important for stimulating the local economies in the agricultural country Ukraine. In 2018, the agricultural sector accounted for 10.1% of GDP and 5.9% of the total number of employees, with 76,300 businesses operating in the sector. The agricultural sector also accounted for 33.9% of total exports (2017).

On the other hand, if we focus on the actual business challenges faced by SMEs in the country, they vary depending on the type of industry, business conditions, size, growth aspirations, etc., but the lack of all kinds of management resources such as people, goods, money, and information is a problem. In particular, "access to finance" is one of the most critical business challenges, which is indicated in the above-mentioned *Action Plan for the Implementation of the SME Development Strategy by 2020*. The assessment of financial matters (Getting Credit) in the World Bank's *Doing Business 2020: Ukraine* focuses on the progress in developing institutions that support finance, including legal rights, credit information penetration, credit information registration coverage, and credit information agency coverage. The country ranks 37th in the world's country rankings, in line with the average of European and Central Asian countries. However, there are glimpses of a situation in which the actual "access to finance" does not improve immediately, even if institutional improvements are made. In addition, the recent debate on financial support for SMEs has been heightened by the debate on emergency measures to deal with the impact of the spread of the new corona epidemic.

2. Current Situation and Challenges of Banking Sector in Ukraine

2.1 Overview of Financial Sector and Outline of Banking Sector

Prior to the collapse of the former Soviet Union, the Ukrainian financial sector was an economic system called planned economy, and its purpose was to provide government fiscal funds; however, after Ukraine's independence in 1991, the financial system was developed and has been in place ever since. As of the end of September 2020, there are 74 banks operating in the country, including five state-owned banks, 34 foreign banks (including 23 fully foreign-owned banks) and 35 private banks. State-owned banks have the majority of the banking sector, accounting for 58.0% of total assets, with the top 10 banks, including state-owned banks, accounting for 80.4%.

According to the World Bank's *Financial Inclusion Indicators* (2019), there has been a certain improvement in the bank account ownership rate of 63% of citizens aged 15 years and older, 61% of their digital payment usage, 51% of their salary and other bank transfers, and 88% of SME's holding of formal financial institution accounts (as of 2017). However, the number of bank outlets (at the end of June 2020) is 7,580 nationwide, which are concentrated in urban areas such as Kyiv with 1,056 outlets (13.9% of the total). The number of bank outlets per 100,000 people in the country is 18, while in Kyiv the number is 36. The banking infrastructure has been becoming pervasive, with 34,700 ATMs and 352,000 POS in the country.

Table 2-1 Top 10 Banks in Ukraine (Total Assets)

	Name of Bank	Attribute	Total Assets（billion UAH）	Share (%)
1	PrivatBank	State-owned	600.1	27.6
2	Oschadbank	State-owned	266.3	12.3
3	Ukreximbank	State-owned	226.6	10.4
4	Ukrgasbank	State-owned	165.6	7.6
5	Raiffeisen Bank Aval	Foreign	109.2	5.0
6	ALFA-BANK	Foreign	101.6	4.7
7	FUIB	Private	80.5	3.7
8	Ukrsibbank	Foreign	69.5	3.2
9	Sberbank	Foreign	66.5	3.1
10	OPT Bank	Foreign	60.7	2.8
		Total of Top 10	1,746.6	80.4
		Total	2,172.0	100.0

Note: data as of the end of September 2020.
Source: Prepared by JICA Survey Team, based on NBU Statistics website.

If we take a general view on the recent history of the banking sector, in 1994-1995, the National Bank of Ukraine (NBU) tightened banking regulations in line with the BIS standards, and introduced a new currency, the hryvnia (UAH), in 1996 to stabilize the currency. In 2004, after the EU's eastern enlargement, the Orange Revolution occurred and Ukraine moved closer to the EU. Many local banks were acquired by foreign banks, and the private banks were gradually recapitalized. However, the global financial crisis in 2008, the Crimean Crisis and Eastern Ukraine Conflict in 2014-15, etc. led to the banking sector once again being burdened with large amounts of non-performing loans, and as of end-September 2020, the overall NPL ratio for the banking sector stood at 45.6% (based on the NBU standard). The NPL ratio varies by attribute: 61.9% for state-owned banks (79.2% for Privatbank), 30.7% for foreign banks, and 16.8% for private banks.

It should be noted that the Crimean Crisis and Eastern Ukraine Conflict severely disrupted the country's financial system. This was a major blow to the country's economy, as the east of Ukraine was home to basic industries such as the steel industry. As a result, economic growth was negative in 2014-15 (0.0% in 2013, -6.6% in 2014, -9.8% in 2015, and then 2.4% in 2016), which put downward pressure on the home currency and caused foreign exchange reserves to bottom out, making the dollar-peg system unsustainable, leading to a falling hryvnia currency (real effective rate to US dollar, percent change at end of period: -20.9% in 2014, -11.2% in 2015, +0.2% in 2016) and high inflation (CPI; period average: 12.1% in 2014, 48.7% in 2015, 13.9% in 2016). In 2015, the IMF approved $17.5 billion of Extended Fund Facility (EFF), and the resulting massive amount of non-performing loans in the banking sector can be described as a negative legacy of that history.

Afterwards, while the capital adequacy ratio of the banking sector as a whole has risen from 12.3 percent at the end of 2015 to 21.9 percent at the end of June 2020, lifting and stabilizing to the level seen around 2010, the domestic Credit-to-GDP ratio has been constrained to about 40 percent or less since 2017.

Table 2-2 Recent Trends of Key Financial Indicators

Financial Indicators	2011	2012	2013	2014	2015
No. of Banks (incl. foreign banks)	176 (53)	176 (53)	179 (49)	163 (51)	119 (41)
Incl. No. of banks not in compliance with the supervisory standards	11	6	5	34	11
Incl. Top 10 banks' share (%)	52.8	52.7	53.6	59.7	64.7
Credit-to-GDP Ratio (%)	61.2	57.8	60.9	66.8	51.2
Loan-deposit Ratio (%)	163.2	143.5	223.7	152.4	158.8
NPL Ratio (NBU standard, %)	14.3	16.5	14.0	19.0	28.0
CAR (risk-weighted base, %)	18.9	18.1	18.3	15.6	12.3
ROA (%)	-0.8	0.5	0.3	-4.1	-5.5

	2016	2017	2018	2019	2020/6
No. of Banks (incl. foreign banks)	100 (41)	84 (39)	78 (37)	75 (35)	75 (34)
Incl. No. of banks not in compliance with the supervisory standards	39	32	20	8	0
Incl. Top 10 banks' share (%)	72.2	75.7	76.9	78.8	78.9
Credit-to-GDP Ratio (%)	42.1	39.5	30.4	24.5	-
Loan-deposit Ratio (%)	127.3	84.6	118.8	92.7	113.3
NPL Ratio (NBU standard, %)	30.5	54.5	52.9	48.4	48.5
CAR (risk-weighted base, %)	12.7	16.1	16.2	19.7	21.9
ROA (%)	-12.3	-2.0	1.2	4.3	3.1

Note: Strict new standards for the definition of non-performing loans have been applied since February 2017, in line with international standards (NBU Resolution No. 351, June 2016). At the end of 2014 and 2015, the NPL ratio (international standard) was 32.0% and 44.3% respectively (IMF estimate).

Source: Prepared by JICA Survey Team, based on NBU Statistics website, IMF Country Report No.20/197 (June 2020), etc.

2.2 Current Situation and Challenges of Banking Sector's Relevant Systems, Policies, etc.

In Ukraine, the NBU is the main authority for banking regulation and supervision. The Ministry of Finance (MOF) has a say in state-owned banks as a shareholder, and it has taken a leading role in the restructuring of financial institutions. However, because large banks also provide securities services under a universal banking system (excluding insurance services), the National Commission for Securities and Stock Market (NCSSM), in addition to the NBU, has regulatory authority over these services. In 2016, the State Commission for Regulation of the Financial Services Market (SCRFSM), in addition to the NCSSM, supervised the operations of financial services other than banking services. The Financial Stability Council (NBU Governor, NBU Deputy Governor, Minister of Finance, Deputy Minister of Finance, Chairman of the NCSSM, Chairman of the Deposit Guarantee Fund (DGF), and others, totally nine members. Mostly held quarterly) has been established to advise the NBU in order to identify and resolve problems at an early stage.

The NBU's independence as a central bank has been in the spotlight since 1 July 2020, when former Governor Smoliy resigned while complaining of systematic political pressure. Kristalina Georgieva, Managing Director of the IMF, in a press release on 14 July, expressed that "the independence of the NBU is in Ukraine's interest and is a precondition for the IMF-supported programme". An IMF's analysis (2016) suggests that there is a negative correlation between the independence of the central bank and the Consumer Price Index (CPI), but in Ukraine, under an IMF-supported programme, it is also indicated that a degree of independence is maintained while the CPI is suppressed.

As of 12 October 2020, the organization of the NBU is divided between five Deputy Governors, each of whom is responsible for their respective departments under the supervision of Governor Kyrylo Shevchenko. Banking supervision is mainly overseen by the Banking Supervision Department, under the jurisdiction of the Deputy Governor (Central Bank Law, Article 7 and 55-60 of the Law on the National Bank of Ukraine), in collaboration with the Banking Inspection Department, Financial Monitoring Department and Related Parties Monitoring Office. In addition, the Financial Stability Department, which reports directly to the Deputy Governor, is responsible for prudential regulation.

The NBU's banking supervision includes regular on-site inspections by the staff in charge (on-site inspections), systems analysis and internal monitoring of banks (daily, weekly, 10 days, and monthly) (off-site inspections), as well as audits by “the special team" (annually for large banks and biennially for small and medium-sized banks). The capital adequacy requirements are regulated by the inspection standards in accordance with the Basel Principles (Basel II and partly III) under the Article 35 of the Law on Banks and Banking.

With regard to the resolution of banks' non-performing loans, the Deposit Guarantee Fund (DGF) currently acts as receiver for member banks in the event of their failure and carries out the liquidation process (recovery and sale of assets held, including non-performing loans). State-owned banks except Oschadbank are member banks of the DGF. When a state-owned bank fails, the DGF acts as receiver and carries out the liquidation process. In fact, when the state-owned Rodovid Bank failed, the DGF acted as receiver and is now carrying out the liquidation process. Until now, state-owned banks have had to face the risk of prosecution if they sell their non-performing loans for less than the book value of their state assets. On the other hand, the DGF Law stipulates that the assets of a failed bank (which are already state assets) held by the DGF in its capacity as receiver may be sold at less than book value. The Government therefore sought to amend the DGF Law to provide that if the DGF receives remuneration and sells on behalf of a state-owned bank assets held by the bank (state assets), the assets are deemed to be in the custody of the DGF and may be sold at less than book value. However, the World Bank opposed this proposal on the grounds that it would be a departure from the original mandate of the DGF (liquidation of failed banks as receiver), and argued that a separate public credit resolution agency should be established to deal with the situation. As a result, such an amendment of the DGF Law failed to materialize. The Ministerial Resolution No. 281, adopted on 15 April 2020, allows state-owned banks to dispose of state assets at below-book value through Dutch auctions, etc. However, state-owned banks, which want to sell their assets at a higher price, have no incentive to use Dutch auctions or asset sale platforms, which are expected to sell at extremely low prices below the actual fair value of the assets, and the disposal of non-performing loans has not progressed.

Oschadbank, a state-owned bank, is not a member bank of the DGF and the deposit guarantee is handled directly by the state (blanket guarantee). According to the interview with the NBU, in the context of the reform of state-owned banks, there should not be special treatment of state-owned banks, and during this year it is intended to bring Oschadbank into the DGF system in the same way as private banks. In the meantime, while no specific plan has been formulated at this time, the establishment of a public credit resolution agency for dealing with non-performing loans of state-owned banks is being also considered within the government. Systemic risk is addressed by the NBU in cooperation with the MOF and DGF. The definition of non-performing loans has been tightened since February 2017, with a corresponding culling of small and medium-sized financial institutions. The NBU provides resident supervisors to financial institutions as needed, and can provide liquidity supplements and loans for a period of two years to troubled banks. Troubled banks are dealt with in two ways: (i) the NBU provides liquidity, and if business conditions do not improve, they are sent to DGF (liquidation); or (ii) the NBU takes control of the bank in the short term and either restructures or finds investors, or otherwise liquidates the bank.

It should be noted that Privatbank, the former largest private bank with a significantly high ratio of non-performing loans, was nationalized on 18 December 2016, with a capital injection of 116.8 billion hryvnias (delivered in full by the end of February 2017 in exchange for government bonds and new shares of the bank). At the time, the bank was perceived as an important bank with a 35% share of retail deposits and as much as 60% of small payments, and with the world's first customer authentication system, and the decision was made that it wouldn’t be easy to fail the bank.

Table 2-3 Organizational Outline of Ukrainian Deposit Guarantee Fund (DGF)

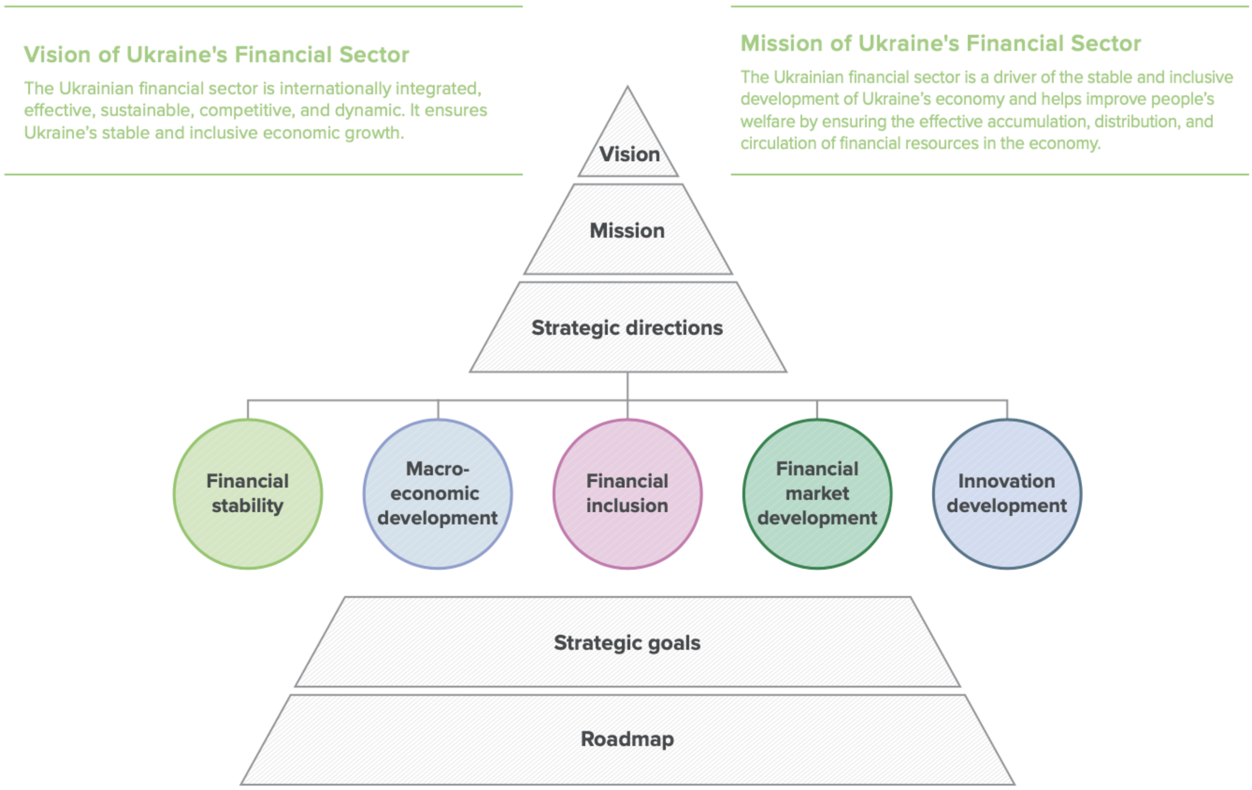
Items	Contents
Legal base for establishment	・Presidential Decree (1998): decided direction on establishment ・Law on Deposit Guarantee Fund (2010): establishment ・Law on Households Deposit Guarantee System (2012): given power of resolution of banks, including disposing the assets of failed banks
Business	・Resolution of banks, including disposing the assets of failed banks ・Participation in bank inspection requested by NBU
No. of staff	Approximately 400
Rules of operations	・Payment amount is up to UAH200,000 for a bank. ・The order of payment for the portion exceeding the said limit is (i) insured deposits up to UAH200,000, (ii) wages and pensions, and (iii) fund borrowings, followed by the fourth order of payment.
Results	・44 billion UAH deposit refunds (2001-2012) ・80 billion UAH, payoffs for 1.5 million depositors (2014-2016) ・The banks were liquidated in 2014-2016 and the number of the banks turned to be 84, and the total assets taken over (book value) was UAH450 billion (its market value was about a quarter of its book value)
Financial assistance	Total financial assistance of UAH72 billion. The breakdown is: (i) UAH20.5 billion borrowed from the NBU in 2014-2016 (with an interest rate of 12% per annum), and (ii) UAH51 billion from the government budget (MOF).
Technical assistance	TA has been received by the IMF, U.S. Department of the Treasury, European Bank for Reconstruction and Development (EBRD), and others. A team of six experts from the U.S. Department of the Treasury has been accepted for a two-year term, with plans to increase the number of experts in the future.

Source: Prepared by JICA Survey Team, based on Completion Report on JICA Banking Sector Survey Project in Ukraine (February 2017).

On the other hand, one notable recent development is a move to amend the law on the resale of agricultural land. If the resale of farmland is allowed, financial institutions will be able to take farmland as collateral, which is expected to expand credit limits. The concrete legislation is the enactment of the Land Turnover Law (Law No. 552-IX). Under this law, individuals will be able to resell up to 100 ha of farmland from 1 July 2021, and corporations will be able to do so from 2024. If farmland becomes collateral, it could lead to an expansion of loans for agriculture. However, in order to achieve transparency and efficiency in the market for the resale of agricultural land after 1 July 2021, it is critical to apply the laws and regulations pertaining to the registration system of agricultural land, resale procedures, etc. (Law No. 554-IX dated 13 April 2020 and Law No. 340-IX dated 5 December 2019, Draft Law No. 2194 and No. 2195).

In addition, the formulation of policies for the development of fintech has been paid attention. In accordance with the government's strategy paper *Strategy of Ukrainian Financial Sector Development until 2025* (see below), NBU has taken five strategic directions such as (i) financial stability, (ii) macroeconomic development, (iii) financial inclusion, (iv) financial market development, and (v) innovation development. Innovation development refers to the open architecture of financial markets, the development of fintech markets, digital technologies, regulatory platforms, SupTech/RegTech development, and the development of the e-economy. The NBU intends to make the most use of digital technologies for realizing the above-mentioned (i)-(iv). In particular, with regard to the FinTech market, the NBU has *FinTech 2025 Development Strategy* and has already created a regulatory sandbox system, while working with the expert committee within the NBU and tech companies. Recent legislative developments include Law on Currency and Currency Transactions (February

2019) and Law on Electric Trust Services (November 2018). NBU has discussed the introduction of the European payment services directive two (PSD2), which promotes open banking and allows services providers (e.g., fintechs) to obtain users' bank account information via APIs. However, the environment for crowdfunding is still underdeveloped, although it has been identified as one performance indicator. Some fintechs also point out problems such as excessive regulation, lack of laws and regulations (e.g., video-based KYC customer identification), and low financial literacy among the public.



Source: MOF, NBU, National Commission for the State Regulation of Financial Services Markets, and DGF, *Strategy of Ukrainian Financial Sector Development until 2025.*

Figure 2-1 Vision and Mission of Ukrainian Banking Sector

2.3 Bank Utilization and Loan Purposes by Business Size/Industry in Ukraine

According to the NBU statistics (end of June 2020) on the financial institutions' outstanding loans by the size of the loan recipient companies (non-financial institutions) in Ukraine, the total amount is 761,426 million hryvnias (100.0%). Of this, 223,901 million hryvnias (29.4%) to large enterprises, 213,139 million hryvnias (28.0%) to medium enterprises, 78,511 million hryvnias (10.3%) to small enterprises, 165,058 million hryvnias (21.7%) to small businesses, and 80,817 million hryvnias (10.6%) unclassified. Thus, 60.0% (456,708 million hryvnias) of the total corporate lending are SME loans.

If we look at the recent trends of outstanding loans to SMEs over time, SME loans have remained steady while loans to large enterprises have been sluggish. However, if we check the SME loans by dividing them into micro, small, and medium enterprises, loans to small enterprises and loans to medium enterprises fell by -21.9% and -13.0% year-on-year at the end of December 2019 respectively, while loans to micro enterprises increased by

14.5% at the end of December 2018, and 28.0% at the end of December 2019. There are glimpses of a new strategy by banks to expand micro business lending with higher margins, while being aimed at generating revenues.

Table 2-4 Recent Trends of Outstanding Loans to SMEs

(Unit: million UAH)

	Corporate Loans	SMEs				Large enterprises	Unclassified
			Micro	Small	Medium		
2017/12	829,932	33,513	112,939	111,054	209,521	310,948	85,470
2018/12 (YoY)	859,740 (+3.6%)	436,299 (+0.6%)	129,325 (14.5%)	94,485 (-14.9%)	212,490 (+1.4%)	310,066 (-0.3%)	113,375 -
2019/12 (YoY)	744,648 (-13.4%)	424,090 (-2.8%)	165,500 (+28.0%)	73,807 (-21.9%)	184,783 (-13.0%)	234,658 (-24.3%)	85,900 -
2020/6 (YoY)	761,426 (+2.3%)	456,708 (+7.7%)	165,058 (-0.3%)	78,511 (+6.4%)	213,139 (+15.3%)	223,901 (-4.6%)	80,817 -

Source: Prepared by JICA Survey Team, based on NBU Statistics website.

The table below shows the outstanding loans to SMEs (as of end-June 2020) broken down by loan term and currency, respectively. The ratio of short-term loans of one year or less to medium-to-long-term loans of more than one year is 50/50. Small enterprises (65.5%) and micro businesses (35.8%) have the largest and smallest share of medium-to-long-term loans of more than one year, which are considered to be mainly for equipment loans. On the other hand, by currency, the proportion of loans to SMEs denominated in foreign currencies is 38.6%. About half of each medium enterprises and small enterprises is borrowed in foreign currencies, which suggests that they are financing their capital investment with foreign currency loans. A monthly review of the relevant data since the end of 2017 shows a similar trend, with the proportion of medium-to-long-term loans to SMEs remaining in the range of approximately 46%-55% and the proportion in foreign currency ranging from 37%-42%. The proportion of medium-to-long-term loans to large enterprise loans account for 52.3% of the total outstanding loans to large enterprises, and 56.5% are denominated in foreign currency (as of end-June 2020). The proportion of foreign currency-dominated loans to large enterprises is at a relatively high level, comparing to that of SMEs.

Table 2-5 Outstanding Loans to SMEs by Loan Term (end of June 2020)

Size of borrowers (million UAH)	Term	1 year or less	1-5 year	5 year or more
SME	456,708 (100.0%)	231,663 (50.7%)	134,553 (29.5%)	90,494 (19.8%)
Medium	213,139 (100.0%)	98,678 (46.2%)	67,234 (31.6%)	47,227 (22.2%)
Small	78,511 (100.0%)	27,061 (34.5%)	27,969 (35.6%)	23,484 (29.9%)
Micro	165,058 (100.0%)	105,924 (64.2%)	39,351 (23.8%)	19,783 (12.0%)

Source: Prepared by JICA Survey Team, based on NBU Statistics website.

Table 2-6 Outstanding Loans to SMEs by Currency (end of June 2020)

Size of borrowers (million UAH) Currency		Home Currency	Foreign Currency
SME	456,708 (100.0%)	280,417 (61.4%)	176,292 (38.6%)
Medium	213,139 (100.0%)	105,924 (49.7%)	107,215 (50.3%)
Small	78,511 (100.0%)	42,616 (54.3%)	35,895 (45.7%)
Micro	165,058 (100.0%)	131,876 (79.9%)	33,182 (20.1%)

Source: Prepared by JICA Survey Team, based on NBU Statistics website.

The interest rate terms on corporate loans averaged 10.1% in June 2020. By currency, the interest rate is 10.8% in home currency and 5.1% in foreign currency. By size of borrower, the average interest rate is 8.4% for large enterprises (8.8% in home currency and 4.8% in foreign currency), 12.8% for medium-sized enterprises (14.3% in home currency and 5.0% in foreign currency), 16.1% for small enterprises (17.5% in home currency and 6.5% in foreign currency), and 12.1-15.6% for micro enterprises (17.8-19.2% in home currency and 5.1-8.1% in foreign currency). The smaller the size of the enterprise, the higher the interest rate spread.

The recent trends pertaining to loan rates by company size show that while UAH-denominated loan rates for large enterprises have fallen significantly from an annual average of 17.7% in December 2018 to an average of 8.8% in June 2020 in line with the decline of the NBU's policy rates, UAH-denominated loan rates for SMEs have not fallen by much. Although the background is not necessarily clear from the NBU published data, one reason is the higher risk premium on SME loans, and according to the analysis of the NBU's Financial Stability Department, another reason is that the UAH-denominated lending to large companies, including overnight loans and 3-week short-term loans, has the overwhelmingly large proportion of short-term working capital loans that are sensitive to a decline of the NBU policy rate.

Table 2-7 Recent Trends of Loan Interest Rates by Company Size

(Unit: %)

Period	NBU's policy rates (end of period)	Average loan interest rates (period average)	Micro (Turnover: EUR 50,000 or less)		Micro (Turnover: EUR 50,000 - 500,000)		Micro (Turnover: EUR 500,000 – 2,000,000)		Small enterprises		Medium enterprises		Large enterprises	
			UAH	Foreign	UAH	Foreign	UAH	Foreign	UAH	Foreign	UAH	Foreign	UAH	Foreign
2017.12	14.5	14.1	18.0	5.4	19.8	7.9	19.0	7.6	17.6	7.4	16.8	8.6	15.5	5.4
2018.12	18.0	16.9	19.5	7.5	20.4	7.8	19.6	6.9	19.5	7.2	18.2	7.5	17.7	5.2
2019.12	13.5	13.5	19.2	6.0	19.9	5.4	20.2	6.9	19.5	6.6	18.4	7.1	14.3	4.2
2020.1	11.0	11.9	20.7	7.3	20.0	8.1	20.2	8.1	19.7	7.5	17.7	6.2	12.4	3.7
2020.2	11.0	11.7	33.5	5.7	20.3	7.9	19.4	6.6	19.0	6.8	16.9	6.3	10.5	4.3
2020.3	10.0	12.9	19.6	7.9	19.1	6.7	18.6	7.6	18.4	7.3	16.9	6.5	12.4	4.8
2020.4	8.0	12.2	20.4	7.0	18.8	6.6	18.7	6.1	18.4	6.5	16.6	5.7	12.2	4.1
2020.5	8.0	11.0	18.3	6.4	19.6	7.4	18.6	6.8	18.5	6.4	15.5	5.9	9.9	4.2
2020.6	6.0	10.1	17.8	5.1	19.2	6.7	17.8	8.1	17.5	6.5	14.3	5.0	8.8	4.8

Source: Prepared by JICA Survey Team, based on NBU Statistics website.

On the other hand, recent loan disbursements by company size and currency (flow-based statistics) show that in the first half of 2020, loan disbursements in foreign currency decreased overall by 20.4% y-o-y, because the outlook for the home currency hryvnia is uncertain, although loan disbursements in foreign currency increased for part of medium enterprises and micro enterprises.

Table 2-8 Recent Trends of Loan Amount (Flow) by Company Size and Currency

(Unit: billion UAH)

Period	Total flow of corporate loans		Micro (Turnover: EUR 50,000 or less)		Micro (Turnover: EUR 50,000 - 500,000)		Micro (Turnover: EUR 500,000 – 2,000,000)		Small		Medium		Large	
	UAH	Foreign	UAH	Foreign	UAH	Foreign	UAH	Foreign	UAH	Foreign	UAH	Foreign	UAH	Foreign
2018.1-12	1,892.7	358.5	12.3	10.1	29.4	2.8	38.4	3.5	109.1	20.7	387.4	49.4	1,154.1	239.7
2019.1-12	2,098.6	571.6	17.8	14.7	51.2	11.1	49.1	15.7	144.3	22.3	397.0	57.3	1,234.6	390.7
(YoY)	(+10.9%)	(+59.5%)	(+44.6%)	(+45.3%)	(+74.0%)	(+300.0%)	(+28.1%)	(+355.0%)	(+32.3%)	(+7.8%)	(+2.5%)	(+16.1%)	(+7.0%)	(+63.0%)
2020.1-6	1,076.9	191.5	5.8	3.5	16.4	1.8	19.4	2.2	65.3	7.9	151.1	28.3	753.9	123.5
(YoY)	(+7.7%)	(-20.4%)	(-18.4%)	(-53.5%)	(+2.1%)	(-13.7%)	(-13.8%)	(+60.0%)	(+5.6%)	(-24.2%)	(-34.5%)	(+20.3%)	(+35.8%)	(-25.5%)

Source: Prepared by JICA Survey Team, based on NBU Statistics website.

In terms of outstanding loans to corporations (including large corporate loans) (at the end of October 2020) by region and sector, 49.8% are concentrated in Kyiv and Kyiv Oblast, followed by 23.0% in Dnipropetrovsk Oblast and 4.2% in Kharkiv Oblast. In order of share by sector, the following sectors are in order of share: wholesale/retail trade & motorcycle/bicycle repair 36.0%; manufacturing 23.1%; electricity/gas & air conditioning supply 8.9%; agriculture, forestry & fisheries 8.8%; real estate 7.1%; transport 5.3%; construction 2.8%; Administrative & support services 1.5%; Professional services 1.4%; and finance & insurance 1.3%.

Detailed data on outstanding corporate loans (including large corporate loans) (at the end of October 2020) by loan purpose are not available in the loan statistics, but they are categorized as commercial real estate loans and other loans, which comprise 3.3% and 96.7% of the total, respectively.

2.4 Overview of SME Finance

In general, external financing for SMEs is typically structured to rely on loans. When looking at the current state of SME financing in a country, it is desirable to examine it from multiple perspectives: (i) the degree of quantitative sufficiency, (ii) the appropriateness of credit terms and conditions (whether interest rate spreads and collateral conditions are commensurate with the credit risk of each firm), and (iii) the diversity of financing channels. (cf. Adachi & Osawa, The Bank of Japan Working Paper: Current Situation and Challenges of Leading Medium-sized Enterprises and SMEs, July 2000)

First of all, in terms of quantitative sufficiency, it is necessary to check on the progress of financial inclusion in order to grasp SME financing in Ukraine. According to the World Bank's *Financial Inclusion Indicators* (2019), there has been a certain improvement in the bank account ownership rate of 63% of citizens aged 15 years and older, 61% of their digital payment usage, 51% of their salary and other bank transfers, and 88% of SME's holding of formal financial institution accounts (as of 2017). However, only 17% of SME borrowed from financial institutions (as of 2013), and the domestic Credit-to-GDP ratio has stagnated at 24.5% (2019).

If we focus on the actual funding gap (potential funding demand - funding supply) for MSMEs (micro, small and medium enterprises) in the IFC's data of *MSME Finance Gap 2017* (updated data for FY2018/19), the funding gap for MSMEs (360,000 businesses surveyed) is at US$33.1 billion (36% of GDP), plus an estimated US$35.1 billion (39% of GDP) in potential funding demand in the informal MSME sector. This suggests that there is significant room for improvement.

The bank interviews suggest that bank services have not been able to keep up with the latent demand for home currency-denominated medium-to-long-term loans for capital investment, and this is due to the banks' difficulties in raising funds. Some of the eight banks investigated in this survey have high loan-to-deposit ratios of between 100% and 110%, and they are working to meet the home currency medium-to-long-term loan demand of their SME customers within that range by obtaining funds from international donors and IFIs.

Secondly, while there are no objective indicators of the suitability of credit conditions, other than data on interest rates level from NBU statistics, the interviews with business managers, officers of international donors and SME advisors in international donors' programs and references (*SME Policy: Index Eastern Partner Countries 2020* (OECD, et al., 2020), and others) suggest that the problem of high interest rates has been identified by enterprises as the biggest management challenge faced by SME managers. The banks are trying to overcome this situation by making their operations more efficient through digitalization and other means. In addition, it cannot be denied that "lack of collateral" may be one of the major barriers for unexperienced micro enterprises, entrepreneurs and SMEs who do not have real estate to borrow from banks.

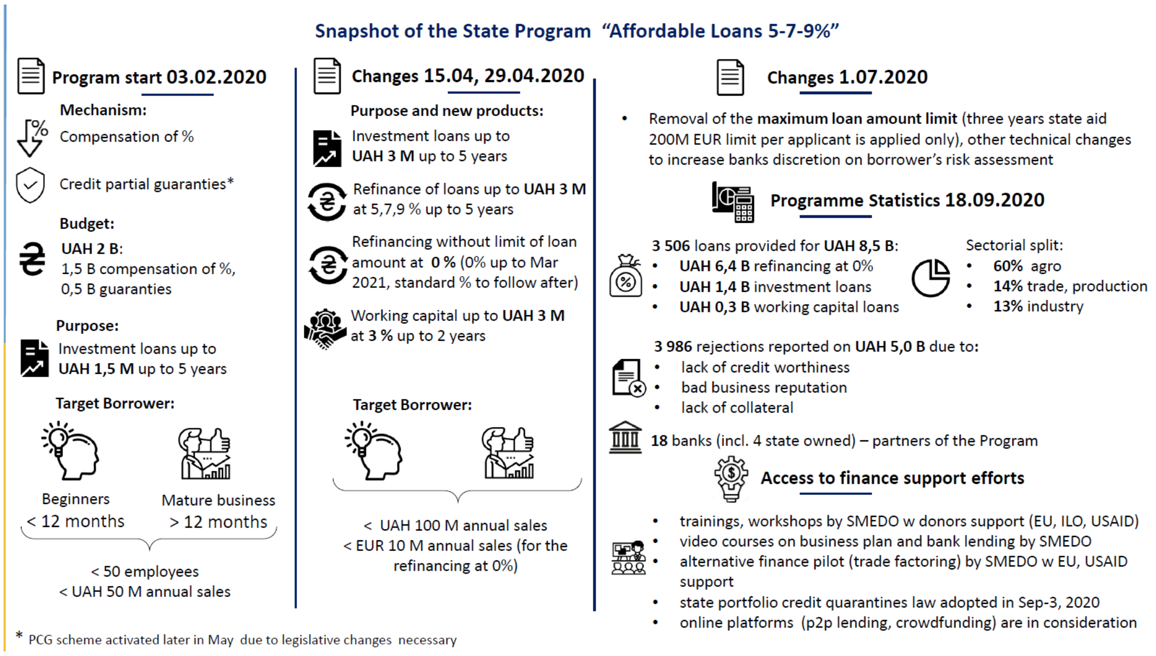
Third, with regard to the diversity of financial channels, alternative financial services other than bank loans, such as leasing, venture capital, factoring, etc. are still developing, which makes bank loans almost the only option for many SMEs to obtain external financing.

For example, after the enactment of Law on Leasing (1997) and Law on Financial Leasing (2003), the leasing industry gradually developed, and domestic leasing balances reached 1% of GDP in 2000, mainly in the agricultural and transportation sectors. Around 1994-2003, more than 60 leasing companies, mostly bank-owned leasing companies, were established. Since then, it has been affected by the financial crisis (2008-2009) and the depreciation of the hryvnia currency due to the Crimean Crisis and Eastern Ukraine Conflict, etc. At the end of 2019, the domestic leasing balance reached 55.3 billion hryvnias (up 17% from the previous year), which is about 7.2% of GDP. There are about 280 finance companies dealing in leasing. However, the sectoral breakdown of leases is mostly for agriculture and transport, and general-purpose equipment and machinery is not widely used. It is well known that the lease rates are more expensive than the interest rates on loans.

In addition, if we look at recent investments by venture capitals, there are currently 50 member institutions in the Ukrainian VC & PE Association, with $509.9 million, 111 deals in VC investments in 2019 (up 51% year-on-year), and $6.1 million, 21 deals in angel investments (up 578% year-on-year). The sectoral breakdown of VC investment was concentrated in software $272.4 million (18 deals) and online services $163.1 million (17 deals). The total of VC and angel investment was $516 million (about 14.6 billion hryvnias in home currency terms), or only 0.4% of GDP. However, by 2019, two unicorn companies were born in Ukraine (privately held startups with a company valuation of more than $1 billion); i.e., Grammarly (digital writing support) and GitLab (DevOps platform for quality continuous delivery in software development and operations).

In Ukraine, under an environment where access to finance is difficult for SMEs as mentioned above, the Business Development Fund (BDF) under the MOF is the public institution responsible for SME policy finance. It is a non-profit financial institution established in 1999 as German-Ukrainian Fund (GUF) by NBU (31.25%), MOF (31.25%), and KfW (37.5%), and its purpose is to provide policy finance to MSMEs in Ukraine. Currently, BDF has implemented the Micro-lending Program, the MSME Lending Support Program in Priority Areas, the SME Lending Support Program in Rural Area and the SME Investments Support Program, with the help of long-term on-lending loans from KfW and the EU's grant to cover the foreign exchange risk of SME loans (EUR5 million). As of end-October 2020, BDF had disbursed 163,513 loans with a total value of EUR838.1 million to MSMEs (Source: BDF, *Description of activities in the field of SME financing*, October 2020). The total cumulative amount of approximately EUR838.1 million in these four loans programs is around 6% of the total outstanding loans to MSMEs of 456,708 million hryvnias (end-June 2020) (approximately EUR13,800 million) in Ukraine. Also, among about 1.6 million SMEs in the country, about 160,000 businesses have received loans under these programs to date, which means that about 10% of all SMEs in the country have benefited from these programs. In addition to loans, BDF has also been dealing with the "FinancEast Program" (interest subsidized by KfW and EU support with a budget of EUR9.5 million).

In addition, in response to the economic downturn caused by the spread of corona infection and other factors, the government is implementing a state support program called "Affordable Loans 5-7-9%" (interest subsidies and credit guarantee by the Ukrainian government with a total of 2 billion hryvnias) from February 2020. The loan is for equipment financing with a term of up to five years, with interest rates of 5, 7 or 9% depending on the term. Micro enterprises and part of small enterprises with a turnover of less than 100 million hryvnias (approx. EUR3 million) are eligible for the program. 3,506 loans of 8.5 billion hryvnias (approx. EUR 256 million) have been disbursed through 20 banks, including four state-owned banks (as of 18 September 2020), and the sectoral breakdown is as follows: agriculture 60%; wholesale, retail & production 14%; and industry 13%.



Source: SMEDO (September 2020).

Figure 2-2 State Support Program "Affordable Loans 5-7-9%"

3. Current Situation and Challenges of SME loans by State-owned and Private Banks

3.1 Organizational Structure (branch network, business areas, shareholder composition, etc.)

The eight BDF partner banks investigated in this survey are Ukrgasbank, Oschadbank (these are two state-owned banks), KredoBank, Creditwest Bank Ukraine, Bank Lviv, ProCredit Bank, Megabank, and Piraeus Bank (these are six foreign banks). Based on interviews with each bank and submitted documents, the following table summarizes the organizational structure (including management and financial condition).

The eight banks included in the survey range from Oschadbank, the second largest bank in terms of total assets in the country, to Creditwest Bank Ukraine, the 48th largest bank, with a difference of about 140 times. Also, the foreign banks include four 100% foreign-owned banks, which vary widely in terms of strategies, branch network, business areas, staffing, etc.

3.2 Management and Financial Condition

The eight BDF partner banks under investigation are not currently in material breach of the NBU's prudential regulations. The prudential regulations include regulatory minimum capital (UAH200 million), capital adequacy ratio (no less than 10%), short-term liquidity (no less than 60%), maximum credit risk exposure regulation (no more than 25% of regulatory capital), leverage ratio (total credit risk exposure is no more than 800% of regulatory capital), etc. and separately FX position (no more than 10%) and Liquidity Coverage Ratio (LCR; no less than 100%) are also monitored by the NBU.

According to the interview with NBU, although there are currently seven or eight banks at risk of violating prudential regulations in the banking sector as a whole, they all comply with such basic regulations as capital adequacy and liquidity. Typical violations include concentrations of credit in certain sectors or groups of companies, and we will need to keep an eye on it.

At the moment, there are no critical concerns about the management and financial condition of those eight BDF partner banks under investigation. The indicators on those banks' financial soundness such as capital adequacy (capital adequacy ratio), asset quality (NPL ratio), profitability (ROA, ROE, etc.), and liquidity (current ratio, etc.) do not show any outliers compared to the average for the domestic banking sector as a whole. However, there is a fair amount of variation in the capital adequacy ratio, ROA and other indicators, depending on the attributes of the bank, its management strategy and policy, and its staffing structure, with a few banks reporting a loss in the last three fiscal years due to their low profitability and large amount of loan loss provisions.

3.3 Position of SME Lending in Business Strategy, Situation of SME Loans and Implementation System

According to the bank interviews, all of the banks emphasize SME lending as part of their business strategy, with a majority share of outstanding loans to SMEs for them except a few top-tier banks. This reflects the reality that since 2012 the government has defined "SMEs" as those with an average of less than 250 employees and a turnover of less than EUR50 million per year, which now account for 99.8% of the total number of companies in the country. According to the NBU statistics (end of June 2020), domestic banks have outstanding corporate loans of 761,426 million hryvnias, of which 60.0% is to SMEs. However, if we look at the eight BDF partner banks surveyed individually, their key customer targets vary from micro, small enterprises to medium enterprises, depending on the different marketing structure and strategies of each bank.

On the other hand, in order for the banks to implement their SME lending strategies, depending on their key customer targets, they basically need to build up their know-how of SME lending/screening/management, improve the efficiency of their lending workflow (modification of credit decision models, use of IT, introduction of credit scoring model, etc.), and strengthen their management support skills, in which each bank has made efforts on its own by utilizing external consulting firms.

Table 3-1 Organizational Structure of BDF Partner Banks

No.	Name of Bank	Type of Bank	Year of Establishment	HQ Location	Major Shareholders	No. of Branches	(included No. in Kyiv)	No. of Employees	(Included No. of Business Loan Officers)	Total Asset (mil hryvnias)	Share of Assets in Ukrainian Banking Sector (%)	Loans (mil hryvnias)	(included SME loans, mil hryvnias)	SME loans disbursed in FY2019 (mil hryvnias)	No. of disbursed SME loans in FY2019	Ratio of Loans to Deposits (%)	CAR (%)	NPL Ratio (%)	ROA (%)	ROE (%)	Average Liquidity Ratio (%)	Rating (rating company)
1	Ukrgasbank	State-owned	1993	Kyiv	MOF (95%)	248	32	4,300	85	148,003	9.3	45,505	5,750	1,785	2,177	35.0	13.5	13.0	0.6	10.5	72.3	B (FitchRatings: outlook stable)
2	Oschadbank	State-owned	1999	Kyiv	MOF (100%)	2,319	223	2,900	1,600	224,716	12.6	68,273	31,000	4,300	3,200	37.8	16.3	39.0	1.5	12.0	12.9	B (FitchRatings: long-term, outlook stable); b3 (Moody's: baseline credit assesment)
3	KredoBank	Foreign (100%)	1990	Lviv	PKO Bank Polski S.A., Poland (100%)	88	14	2,010	1,075	23,089	1.4	14,040	2,092	2,242	2,292	87.9	14.2	6.3	2.5	18.7	30.4	uaAAA (Standard-Rating and Expert-Rating)
4	Creditwest Bank Ukraine	Foreign (100%)	2006	Kyiv	JSC «Altinbas Holding Anonim Sirketi» (Altınbaş Holding INC.) (100%)	1	0	86	13	1,623	0.1	1,287	615	974	705	32.0	18.1	9.0	0.8	3.0	15.9	BB- (JCR Eurasia Rating: Long-Term International Credit rating); uaAA+ (IBI Rating: Long-Term National Credit rating)
5	Bank Lviv	Foreign (Private with foreign capital)	1990	Lviv	responsAbility Participations AG, Switzerland (51%), LLC New Progress Holding, Ukraine (39%), LLC Frontmost Limited, Cyprus (10%) * Margeir Petursson (Iceland), controller of LLC New Progress Holding and LLC Frontmost Limited, indirectly owing 49% shares of the Bank.	21	1	342	54	3,598	0.2	2,320	2,110	1,687	1,080	100.6	16.3	3.4	1.2	10.7	26.1	uaA (IBI-Rating: evolving outlook)
6	ProCredit Bank	Foreign (100%)	2001	Kyiv	ProCredit Holding AG&Co. KGaA (100%)	8	4	300	n.a	25,355	1.2	18,331	18,307	n.a	n.a	105.1	20.6	3.6	2.6	12.7	11.6	B (FitchRating: Long-term foreign currency IDR; Stable)
7	Megabank	Foregin (Private with foreign capital)	1990	Kharkiv	V.G.Subotin (65.54%), EBRD (13.22%), KfW (13.22%), IFC (5.30%), other legal entities & individuals (2.73%)	153	3	1,163	187	8,997	0.6	7,258	5,268	2,813	384	112.8	11.1	7.5	0.4	5.0	73.3	uaAA (Expert-Rating)
8	Piraeus Bank	Foreign (100%)	2007	Kyiv	PIRAEUS BANK SA (99.99%)	17	7	334	15	3,197	0.2	1,408	609	252	98	65.3	30.1	3.8	0.0	0.0	52.0	uaAA (Standard-Rating: long-term credit rating)

Note: 1 EUR = 33.8 UAH (as of 26 Nov 2020)

Sources: Internal documents of BDF partner banks (data as of end-June 2020) (Oct-Nov 2020), NBU statistics.

3.4 Selection Criteria for Lending Target, Screening Criteria/Process/System, Prospect and Challenges on SME Lending (including Challenges of Each Bank)

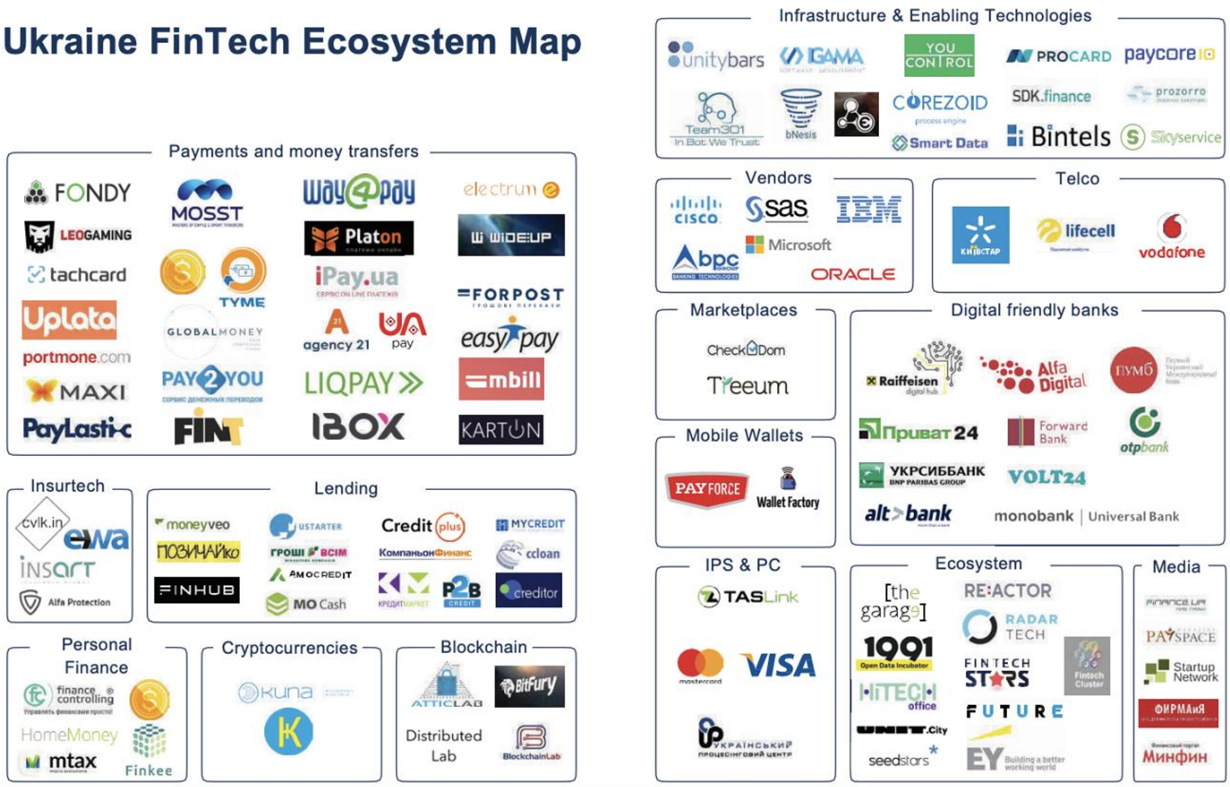
If we look at the internal lending practices of Ukrainian banks, their screening systems are orthodox, and there are some common features as shown in the table below. With regard to collateral conditions, the practice of requiring real and movable collateral equivalent to 75-150% of the loan amount, depending on the credit risk of the loan applicant and type of loan product (short-term working capital loans, mid-to-long-term loans for capital investment), is common, and this practice is reasonable because of the environment in which the disposal of collateral properties takes time and it is costly. In addition, as an advanced agricultural lending practice in Ukraine, the crop receipt has become a financial instrument that enables farmers to use their future crops as collateral to access financing to buy inputs such as seeds and fertilizer.

Table 3-2 Screening System within Ukrainian Banks

Items	Contents
Organizational Structure	Head Office: Loan Department, Credit Committee Branches: Loan officers Loan officers are in charge of credit appraisal and post-lending management, while the back office is responsible for loan repayment administration and the legal department is responsible for collecting delinquent loans.
Screening Method	i) A comprehensive evaluation of financial and non-financial factors to determine repayment capacity; ii) credit history check; and iii) collateral evaluation. In the case of a micro enterprise, physical collateral tends to be insufficient, in which a personal guarantee (family, relatives, friends, etc. of the CEO) is requested.
Screening Documents	i) Customer's basic information, ii) Credit history, iii) Financial information (B/S, P/L: CAR, current ratio, profits, Debt/EBITDA ratio, etc.), iv) Transaction record with the Bank, v) Summary of the investment plan for the application, vi) Projected future cash flow, vii) Collateral/Guarantor, etc.
KYC	The KYC process (customer verification) for accepting loan applications from new customers is based on an official uniform code.
Credit Scoring	In order to improve the efficiency of lending operations for micro and small enterprises, the banks have introduced a system that comprehensively evaluates financial and non-financial factors on a scale of 100 (scorecard based on the judgment of the bank's in-house experts or statistical analysis).

Source: Prepared by JICA Survey Team, based on interviews with BDF partner banks.

On the other hand, a regulatory sandbox system has been created under the NBU's *FinTech 2025 Development Strategy* to promote the use of technologies such as open APIs, instant payments 24/7, blockchain and digital currencies. The Cornell SC Johnson College of Business, INSEAD and WIPO's *Global Innovation Index* (2020) ranks Ukraine 45th in the world, and Ukraine has been particularly well regarded in the areas of knowledge/technology and human resources/research. New forms of finance using digital technology, such as neobanks (e.g., monobank) and online lending platforms (e.g., Treeum), have also emerged. In addition, domestic fintech is in its infancy. There are about 100 domestic fintech companies, half of which were established in the last three years. In this environment, Ukraine's banks, especially small and medium-sized local private banks, which have not been IT-enabled, need to rapidly digitize (and even more so, DX digital transformation) in conjunction with fintechs and change their business models accordingly in order to expand SME lending in the future.



Source: UNIT.City, USAID (2019).

Figure 3-1 Overview of Ukrainian Fintech Ecosystem

4. Current Situation and Challenges of SME Sector

4.1 Distribution of SMEs (by Sector/Area)

Since it is difficult to capture the image of SMEs only by the size of the enterprise, which is defined by the law, another axis is sometimes added to classify them as a group of SMEs. In this regard, in Ukraine, depending on the business conditions of enterprises, there are the following categories: “subsistence businesses”, “freelancers” (journalists, writers, designers, photographers and other freelancers), “stuck-in-middle companies” (companies aiming at a stable management with a certain size of business), “innovative growing companies” (startups by entrepreneurs who are aiming at high growth, and growing SMEs), and “pseudo self-employed”. The following table summarizes the formal size classification based on the laws and the actual classification.

Table 4-1 Classification of Ukrainian SMEs

Size classification / Actual classification		Single entrepreneurs	Micro enterprise	Small enterprises	Medium enterprises
		0-10 employees Turnover≦€2 million		10-50 employees Turnover≦€10 million	51-250 employees Turnover≦€50 million
		1,506,916 (95.9%)		52,821 (3.4%)	9,500 (0.6%)
Subsistence businesses	(57%)	A	A		
Freelancers		B			
Stuck-in-middle companies	(4%)			C	C
Innovative growing companies	(39%)		D	D	D
Pseudo self-employed		E			

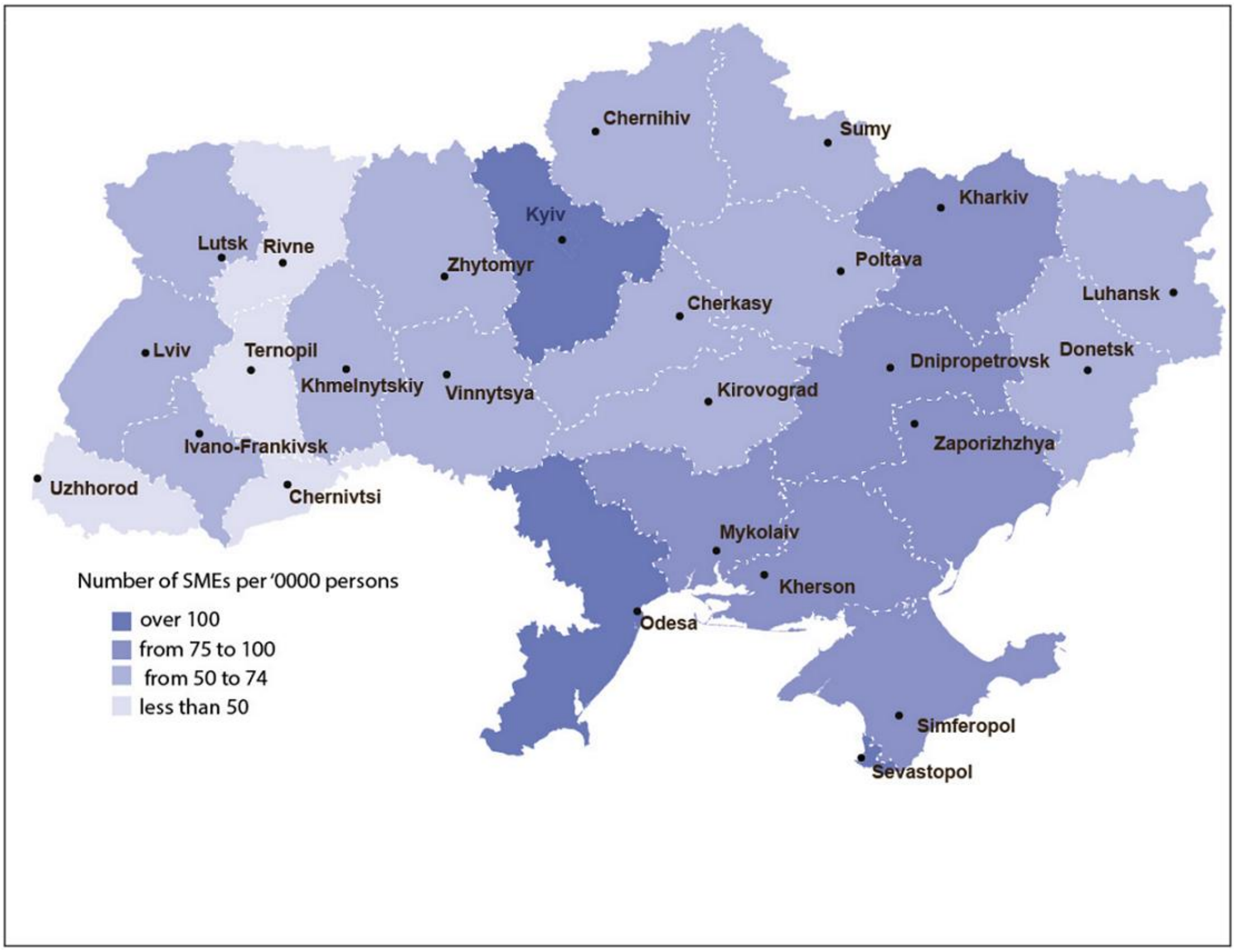
Note:

- The scope is non-financial business economy, and it excludes agriculture, forestry, fishery industry, and education and health industry.
- Experts estimate that the number of single entrepreneurs accounts for 77% of all SMEs (= about 1.2 million businesses), half of which are subsistence businesses & freelancers (= about 0.6 million businesses) and the other half are pseudo-self-entrepreneurs (= about 0.6 million businesses). If so, micro enterprises are about 19% of all SMEs (= 0.3 million businesses)
- A: micro enterprises & individual entrepreneurs, B: freelancers, C: SMEs, D: startups & growing SMEs, E: pseudo self-employed.

Sources: Prepared by JICA Survey Team, based on European Commission (2020) *2019 SBA Fact Sheet*, BE Berlin Economics GmbH (2014) *Towards a modern SME policy in Ukraine*.

In terms of the number of SMEs by sector (2017), 51.4% of the total number of SMEs belongs to the wholesale and retail trade. This is followed by the information industry (11.0%), professional services (7.9%), manufacturing (7.8%), real estate (5.9%), transportation (5.7%), hotels (3.9%), construction (3.3%), and management services (3.1%).

The regional dispersion of SMEs (2014) shows that they are concentrated in economically developed regions such as Kyiv and Odessa Oblast.



Source: BE Berlin Economics GmbH (2014) *Towards a modern SME policy in Ukraine*.

Figure 4-1 Regional Distribution of Ukrainian SMEs

4.2 Challenges faced by SMEs and Their Challenges on Financing

In general, the management issues of SMEs vary depending on the type of industry, business conditions, size, growth aspirations, etc., but the lack of all kinds of management resources such as people, goods, money, and information is a problem.

Notably in Ukraine, in *the 2019 SBA (Small Business Act for Europe) Fact Sheet* by the European Commission (EC), evaluation sub-items such as "second chances" and "internationalization" score significantly lower than the EU average. Firstly, "second chances" is an assessment axis that assesses whether entrepreneurs can quickly try again if their business fails as a result of good faith and rational decisions, and the assessment sub-items include (i) the establishment of a framework for liquidation (Index 0-16: 8.5 points in Ukraine, EU average 11.73 points), (ii) the time required for the liquidation process (Ukraine 2.9 years, EU average 2.01 years), and ii) the cost of liquidation (cost of debt collection divided by debtor's assets) (Ukraine 40.5%, EU average 10.43%). Secondly, the score for "internationalization" is significantly lower, including information, various procedures, and cooperation of border agencies, which imply that SMEs are struggling to access international markets in comparison to EU countries.

SMEs' challenges in financing vary according to the type of industry, business conditions, size, growth aspirations, etc., and thus the JICA Survey Team classifies SMEs as follows, based on the Table 4-1 Classification of Ukrainian SMEs. First of all, if we exclude “pseudo self-employed” and “freelancers”, which do not fit in with the SME policy, the main SME segments are considered to be [A] micro enterprises and single entrepreneurs (about 900,000 businesses), [C] SMEs (about 60,000 businesses), and [D] start-ups and growing SMEs (estimated to be less than 10,000 businesses).

The core segment of the country's SMEs is the [C] SMEs (approximately 60,000 companies, legally defined as those with 10-250 employees and a turnover of EUR2-50 million). This group represents only about 4% of the total number of enterprises in Ukraine, but it accounts for 27.3% of the number of employees and 31.7% of the value added. This group has received financial support from the EBRD, KfW and others over the years. However, according to the IFC’s data in *MSME Finance Gap 2017 (data updated 2018/19)*, the country's formal MSME finance gap is US$33.1 billion (36% of GDP), of which the SME finance gap excluding micro enterprises is US$29.3 billion. The certain level of additional funding demands may be recognized even now.

[A] micro enterprises and single entrepreneurs (approximately 900,000 businesses, legally defined as those with less than 10 employees and a turnover of less than EUR2 million) are classified as “micro enterprises” with a potential financing gap of $3.8 billion according to the IFC data. Their main financing needs are likely to be for small-scale working capital, which requires speedy loan approvals. In addition, some of those enterprises with high growth aspirations may invest in equipment to grow from a micro enterprise to a small or medium-sized enterprise, and there is a certain level of demand for medium- to long-term funds for equipment. At present, bank loan is not a realistic option for newly established micro enterprises in Ukraine.

[D] start-ups and growing SMEs (estimated to be less than 10,000) are made by entrepreneurs and are one of the keys to the future development of the Ukrainian economy. An example of industry sector that has received a lot of attention recently is the IT industry, which has about 200,000 software developers. Because the funding needs are mainly equity financing, VC investments for IT start-ups have grown to about $340 million per year (2018) (cf. $40 million in 2014, $130 million in 2015, $90 million in 2016, $260 million in 2017). However, it is expected that further development of the IT industry will require further risk money from business angels and VCs in the future.

4.3 Summery of Previous Surveys and Results of Interviews

According to interviews with bank staff, SME advisors affiliated with SMEDO, and founders of a business managers’ group, the challenge for SMEs is the lack of resources such as people, goods, money, and information. But the first issue is about people. In other words, many inexperienced SME managers and entrepreneurs lack basic business skills such as business modelling and planning, which undeniably leads to problems in obtaining loans from banks.

As for the difficulty of getting bank loans, its high interest rates are recognized as an obstacle to SME management. Even if SMEs are able to borrow a bank loan, there are concerns that the heavy burden on repayments of principal and interest will make cash flow management tight. In many cases, especially in a situation where the home currency continues to depreciate, foreign-dominated loans have increased the interest cost.

If we look at agriculture, manufacturing, restaurants, hotels and energy efficiency businesses, which are the main targets of BDF's financing, SMEs in these sectors need capital investments continuously to expand their business in the medium-to-long-term, and bank loans are almost the only option for external financing for this purpose. The banks are aware of the potential demand for this type of capital equipment financing, but they should examine each loan application on a case-by-case basis and make an economically rational decision, taking comprehensively into account the capital investment plan, outlook of the industry, and others.

"Internationalization" is the key for medium-sized enterprises. In the domestic business environment, they face difficulties in accessing international markets due to inadequate systems for "internationalization", in terms of access to information, procedures, and cooperation with border agencies, etc.

Another challenge for SMEs is the relatively low level of salaries. Looking at trends over the past five years, the average monthly salary in June 2020 was 11,579 hryvnias (approximately EUR349), a 169% increase over the same month in 2015. However, it is difficult to get an accurate picture due to the lack of data by the size of the companies in which they work, but the JICA survey team’s interviews suggest that there is a certain disparity in the level of salaries between employees of small and large companies.

On the other hand, if we check the recent actual condition of business operations based on the NBU's *Business Outlook Survey* (2Q of 2020), including before and after the spread of the corona infection, we can see that the business conditions of Ukrainian companies are deteriorating. The managers who responded to the questionnaire (691 valid responses: 28.8% of small enterprises, 39.4% of medium-sized enterprises and 31.8% of large enterprises) are pessimistic about the growth of their companies, while expecting high inflation and depreciation of the national currency in the future.

In terms of points to note, firstly, the sales outlook for the next 12 months is -34.1% (10.4% in Q1 2020). Second, the Business Outlook Index is at 90.8% (110.5% in Q1 2020), which is weak across industries and employee sizes. Third, the Consumer Price Index is expected to rise by 7.0% (5.1% in Q1 2020). Fourth, the exchange rate is expected to be 28.28 hryvnias per dollar (26.01 hryvnias in Q1 2020). On the other hand, the percentage of respondents with future borrowing needs has increased from 36.5% in Q1of 2020 to 39.6% in the current quarter (Q2 of 2020). In particular, it is noted that the industries with the strongest borrowing needs are in the energy and water supply industry, medium-sized firms, and exporting firms. Also, the index, which is calculated by subtracting the percentage of firms that reported that borrowing has become more difficult from the percentage of firms that reported that borrowing has become easier, has increased. The number of respondents planning to borrow has decreased, but they still prefer to take out a hryvnia-denominated loan. As a whole, the results indicate that the obstacles to business operations are lack of demand, lack of working capital and the unstable political climate.

5. Situation of Other Donors' Assistance for SME Promotion

5.1 European Union (EU)

EU support to Ukraine reflects Ukraine's strategic importance for the EU in the context of the European Neighbourhood Policy (ENP) and contributes to economic stabilization and economic development in the country by addressing short and medium-term external borrowing needs.

The EU's macro-financial support to Ukraine (capped at EUR1 billion) was signed in September 2018 with the relevant memorandum of understanding, in which conditions for structural reforms, including improved public financial management, governance and corruption eradication, reform of state-owned enterprises and reduction of non-performing loans of banks, were set out. In May 2020, a loan facility of EUR500 million was approved as part of the fourth macro-financial assistance (MFA IV) programme, aimed at stabilizing the economy and accelerating reforms, and macro-fiscal support of EUR1.2 billion was also adopted, of which EUR600 million was disbursed by end-2020.

One of the activities related to supporting SMEs is a comprehensive SME development initiative called EU4Business. The results for the past 2009-2017 are shown in the figure below. The number of SMEs using loans is 1,043 with a cumulative total value of EUR188.8 million (2009-2017). There are currently 21 projects in the project portfolio (2018), 17 operational and 4 completed, of which 10 are related to financial access, 10 operational and 0 completed. In addition, in October 2019, the EU and EBRD announced the launch of a new SME-supported fund, the EU4Business-TERD Credit Line, under the initiative. The fund has a size of EUR120 million and will be handled by Raiffeisen Bank Aval, ProCredit Bank and OTP Bank.

Table 5-1 Past Results of EU4Business (2009-2017)

	2009-15	2016-17	2009-2017
No. of enterprises supported with advisory services	306	354	660
No. of enterprises which received loans	557	486	1,043
Total value of loans disbursed (Euro)	103,921,541	84,889,419	188,810,961
No. of new jobs created	1,865	4,022	5,887
No. of jobs supported and sustained (advisory and financial projects)	20,318	8,722	29,040

Source: EU4Business, *Investing in SMEs in the Eastern Partnership Ukraine Country Report* (June 2018).

The EU handles the FX Risk Losses Compensation Program (i.e., guarantee service to cover losses caused by foreign exchange risk) using the grant budget, and in Ukraine it operates under an agreement with KfW with a grant budget of EUR5 million. The role of this guarantee service (which is not a fee-based service) comes into play when the home currency is weakening, as it has been in recent years in Ukraine.

5.2 KfW

Recognizing the importance of SMEs in the Ukrainian economy and the difficulty of accessing capital investment funds for SMEs, KfW has been implementing various programs in the past. A prime example is the German-Ukrainian Fund (GUF) (currently BDF), which was established in 1999 in collaboration with MOF and NBU. BDF as the implementation agency has been implementing loan programmes for MSMEs, such as the Micro-lending Program, the MSME Lending Support Program in Priority Areas, the SME Lending Support

Program in Rural Area, and the SME Investments Support Program. It has so far disbursed 163,513 loans to MSMEs for a total amount of EUR838.1 million.

It should be noted that the entire amount of KfW's grant (donation) was taken over by MOF and NBU at the beginning of 2020, and KfW has already terminated its technical assistance (TA) and concessionary rights at the general meeting of investors. The reason for this is that 20 years have passed since the KfW began its work at BDF, and in a situation where a diverse range of donors are already active in Ukraine, KfW has concluded that it has had played a significant role. Going forward, KfW intends to concentrate on its core business of lending and, according to the interview with KfW, it is considering a new large-scale TSL scheme using the BDF.

On the other hand, recognizing the importance of modernizing the vocational training system for sustainable economic growth and increased competitiveness in international markets, KfW is also making efforts to reform the vocational training system and improve its infrastructure (e.g., setting up a vocational training system in line with market needs and investing in the necessary buildings and equipment, etc.).

5.3 Other Donors (EBRD, EIB, World Bank, IMF, etc.)

According to the EBRD website, the EBRD is the largest institutional investor in Ukraine, committing to 460 projects in the country so far, totalling over EUR14.54 billion. In 2019, the EBRD as a whole has invested EUR1.1 billion through 51 projects and this amount is the largest for a single recipient country. Of these, within the EU4Business initiative, the EBRD has contributed EUR40 million out of a total of EUR350 million.

19 MSME finance-related projects were conducted by the EBRD since 1998, beginning from the Ukraine SME Credit Line II, launched in May 1998, to the FIF-DCFTA-Bank Lviv SME Facility, launched in May 2020. BDF was responsible for the implementation of SME-1 (fund size: EUR100 million) and SME-2 (EUR68 million), which have already been completed. In October 2019, the EBRD also announced the launch of the aforementioned SME support fund “the EU4Business-TERD Credit Line”, in collaboration with the EU.

In support of diversifying the country's SME finance, in February 2019, the EBRD granted a loan 324 million hryvnias (about EUR10 million) to a leasing company called OTP Leasing for the operation of leasing services for SMEs. In addition, the EU provided the same leasing company with a grant of EUR1 million.

According to the EBRD's *Ukraine Country Strategy 2018-2023*, the EBRD's priority strategic targets are: promoting public sector privatization to strengthen competitiveness and governance; creating a level playing field by supporting best-practice companies; energy security; restoring the financial system by strengthening the banking sector and developing capital markets and non-banks; and economic integration by promoting trade and investment and entrenching EU regulations. The largest programme in relation to this is the SME Competitiveness Program, which includes energy conservation, export market development, incentives, funding support for commercial banks, etc. In the future, the EBRD is likely to consider support that does not need budgeting such as a guarantee, as it is unable to provide loans on the same concessional terms as other donors.

What needs to change? *(Section 2)*	Can it be changed? *(Section 3)*	What can the Bank do?	Strategic Priorities (2018-2023)	What we want to see in 2023
• Privatisation in key sectors needs to be revived • Strategically-important SOEs and municipal companies need to undergo restructuring and commercialisation • State's share in the banking sector should be reduced • Banks with state participation to operate under proper corporate governance and on commercial basis • .	• Association Agreement with EU, including DCFTA continue to serve as an additional anchor/incentive for reforms • Some progress made under external pressure to accelerate reforms • Strong pro-reform push from progressively-minded lawmakers, politicians, civil society. • Plans to gradually privatise state-owned banks have been approved	• Strong record in supporting privatisation and commercialisation of SOEs, utilities in particular, through investment and advisory • Experience in preparing state-owned banks for privatisation through restructuring • Proven track record in corporate governance improvements at the client level (provisions of debt and equity financing) and high-level policy engagement • Track-record in supporting sector consolidation	**Promote privatisation and commercialisation in the public sector to increase competitiveness and foster good governance**	• Increased private sector participation across sectors • Commercialisation and restructuring of selected public sector entities • Modern public sector procurement system implemented • Improved productivity across sectors • Improved public governance and business climate
• Rule of law, property rights in particular, to be vigorously applied • Competition, level playing field should be enforced • Corruption, shadow economy, illicit trade should be tackled • Corporate governance needs to be improved • Business climate needs to be conducive to investment & growth • Innovation and modernisation should be encouraged • Land reform is key for private business • Value-chains need to be developed • High value-added production needs to increase as share of economy • Skills to match the economy's needs	• Anti-corruption legislation adopted and anti-corruption bodies put in place, but serious challenges remain and tangible progress remains elusive • Public administration and civil service reforms are underway albeit impeded by vested interests • Competition laws broadly in line with EU, but enforcement lacks • Business Ombudsman in place • Education reform and nascent labour policies to improve skills	• Excellent track-record in supporting companies in productivity improvements through investment and ASB • Solid experience in policy engagemen in support of business climate improvement • Experience in corporate governance improvements at the project level and high-level policy engagement • Experience in private sector skills governance • Expertise in private procurement	**Promote rule of law, competition and level playing field in the private sector by supporting best practice companies**	• Increased competition through entry, reduced corruption and informal sector activities • Improved skills and employability of disadvantaged groups

What needs to change? *(Section 2)*	Can it be changed? *(Section 3)*	What can the Bank do?	Strategic Priorities (2018-2023)	What we want to see in 2023
• Energy markets need to develop • Production needs to increase to underpin extensive connectivity by surety of supply • Diversification of energy sources to be augmented by increase in renewable energy • Energy efficiency across sectors needs to improve • Sustainability of municipal services should be enhanced	• Secondary legislation to implement EU's Third Energy Package passed • Independent regulator operational • New Waste Strategy in place • National Energy Efficiency Strategy adopted	• Expertise in energy market reform • Proven ability to support best practice production • Proven ability to support best practice energy generation • GET instruments available • Solid experience in cross-sectoral energy efficiency (direct and intermediated financing) and sustainable municipal services • Sustainable scheme to support renewable energy	**Strengthen energy security by supporting effective regulation, market liberalisation, diversification and increase of production, and energy efficiency**	• Sustainable energy market structure & improved energy connectivity • Increased resource efficiency & use of renewable energy
• Commercial banks need to be induced into lending • NPLs need to be settled, their share in the portfolios needs to decline to acceptable industry norms • Local currency transactions should become prevalent • Capital markets need to be consolidated to develop beyond the current nascent state • Insurance and leasing need to be developed	• Clean-up and consolidation of underperforming banks underway • Out-of-court NPL restructuring mechanism in place, although with limited effect to-date • Banks adopt tougher credit practices • Hryvna stabilisation measures have stemmed from further dollarization • Some progress in reducing the number of exchanges • Microeconomic and geopolitical situation deter private equity	• Experience in NPL resolution • Existing mechanisms for supporting private banks • Ability to support non-bank financial institutions of sufficient size and bankability as opportunities arise • Strong experience in local currency finance via capital market instruments • Proven expertise in capital markets institutional consolidation	**Enhance resilience of the financial system by strengthening the banking sector, and in parallel developing capital markets and other non-bank finance**	• Stable and efficient banking sector • Increased variety of non-banking financial channels and the use thereof
• Domestic infrastructure gaps needs to be narrowed; cross-border corridors developed • "Soft infrastructure", including logistics, need to improve • Quality inbound FDI needs to be encouraged, overcoming risk perception • Complexity of exports needs to increase	• Openness to FDI flows comparable to regional averages • Work on methodology for various transportation dues underway • Concession legislation to be approved by the Parliament • Highly developed gas transit connectivity infrastructure • DCFTA as an inducement to improve quality and operational practices to comply with EU standards • Adoption of Transport and Export strategies (the latter in progress)	• Solid track-record in transport infrastructure finance on both sovereign and commercial bases • Experience in supporting private operators in PPPs, logistics, freight • Experience in assisting exporters, DCFTA-minded companies • Well-positioned to support FDI through brand-recognition, preferred lender status • Availability of TFP for PFIs and their export-oriented clients	**Improve integration by facilitating trade and investment, expanding infrastructure links, and supporting convergence with EU standards**	• Improved connectivity through enhanced infrastructure • Increased trade and investment flows

Source: *EBRD Ukraine Country Strategy 2018-2023*

Figure 5-1 EBRD's Priority Strategy in Ukraine

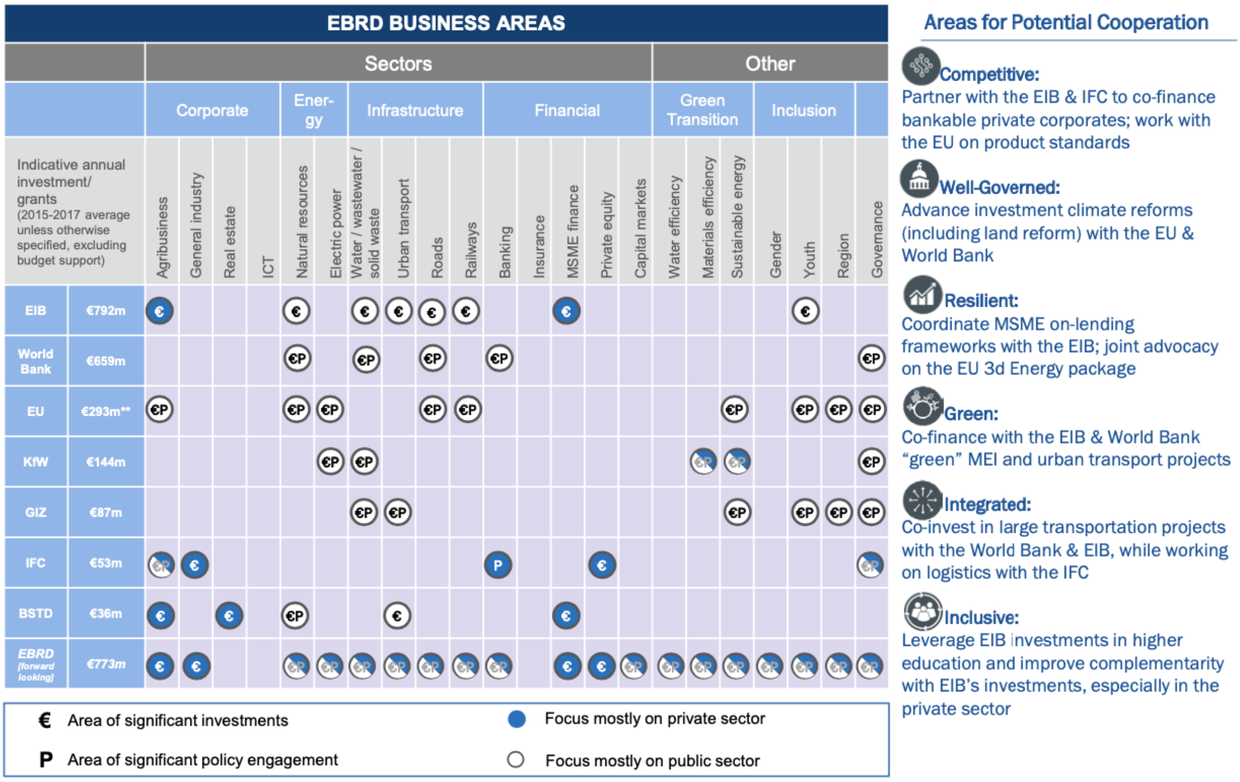
Since 2017, the EIB has been operating an EU-supported credit guarantee programme for SMEs, addressing the problem of collateral shortages in SME finance (with a 70% guarantee ratio). The four banks involved are Raiffeisen Bank Aval, Oschadbank, Ukrgasbank, and ProCredit Bank.

The World Bank has supported a total of $14 billion and 70 projects in Ukraine since the country joined the World Bank in 1992. It is currently implementing the Country Partnership Framework for Ukraine for FY2017-21, which aims to achieve an economic recovery that benefits the entire population and focuses on market efficiency, fiscal and financial stability, and improving social services for the Ukrainian people. At present, the portfolio in Ukraine includes eight investment operations with a loan of $2.32 billion (including the $148 million Clean Technology Fund). In addition, in the 2000s, there were loan programs "MSME Credit Line", "Municipality Credit Line" and "Access to Financial Services Project" in which BDF was the implementing agency, with 66 loans and EUR43.8 million of proven track record.

In line with the purpose of its establishment, the IMF monitors Ukraine's exchange rate policy and provides loans when the balance of payments has deteriorated significantly, while contributing to the promotion of Ukraine's international trade, increasing employment and national income, and stabilizing the exchange rate. It should be noted that the most recent consultation with Ukraine was held for the Stand-by Arrangement ended in May 2020, and subsequently the Board of Governors approved $5 billion in financial assistance at its June meeting, and the first installment loan (tranche) of $2.1 billion has already been disbursed.

USAID is building on its strengths to support the overall financial sector by raising the bar and creating an investment fund for SMEs. Recent projects include the Financial Sector Transformation Project (2016-2020), a technical assistance (TA) to improve financial services, legislative support, training and IT implementation, and the WesternNIS Enterprise Fund (1994-2023), an equity investment fund for SME ($150 million) aimed at private sector development. Characteristically, among the projects to improve financial services, USAID has strengthened the Ukrainian leasing company association, resulting in a leasing market of $919.5 million in 2019, doubling from $420 million in 2017. In addition, there are on-going projects, such as the Competitive Economy Program (2018-2023), the Competitive Law and Policy for Ukraine (2016-2024), and other support to boost the industrial competitiveness of SMEs.

As a whole, an overview of the support activities by international organizations in Ukraine is described in the figure below. If we look at the area of SME finance, the EBRD and EIB have taken the lead in terms of the scale of inputs as shown in the figure below.



Source: *EBRD Ukraine Country Strategy 2018-2023*

Figure 5-2 Complementary Relations of International Organizations in EBRD Business Areas

6. Relationship of Japanese Companies Operating in Ukraine with the Local SMEs

Remote interviews with 12 Japanese companies operating in Ukraine were conducted between October 2 and 27, 2020, for collecting the information on their strategies, issues and challenges of local SMEs they have come to know through businesses, their financial transactions with local banks, expectations on JICA's TSL, etc. The results of these interviews are summarized below.

1. Purposes and Basic Strategies of the Operations in Ukraine

Company	Backgrounds and Purposes	Overview of Business Operations and Basic Policies
Company A, Pharmaceutical	Started the import/sales operation in Ukraine in 1993 and acquired the local company in 2011. Sells the product imported from Austria to wholesalers, hospitals and specialists. Has a back office function and also covers Belarus and Moldova from Kyiv.	▪ Customers include government (procurement by Ministry of Health and international organizations such as UNDP, accounting for 30-40% of the total sales) and local wholesalers. Demands from hospitals include those from medical specialists. ▪ Ukraine is well located to cover the whole CIS area.
Company B, Farming Materials/ Equipment	Used to be a local company but a Japanese trading/investment company, which has been importing pesticides using its local subsidiary since 90s, has acquired 51% in Nov 2018 with a view to expending its business to the downstream business.	▪ Since the establishment in 2009, selling farming materials such as pesticides, seeds and fertilizers, and started to deal with farming equipment in 2012. Annual sales is JPY13bn, with the top share in pesticide market. ▪ 360 employees (with 1 Japanese sent from the parent company in Japan).
Company C, Construction Machinery Distributor	▪ Established in 2013 as a subsidiary of Japanese trading/investment company for the sales/repairs of construction machinery for mining sector. ▪ Official dealer of a Japanese construction machinery and forklift. ▪ Based in Kyiv and has branches in Kryvyi Rih and Kremenchuk with iron ore mines. ▪ 360 employees, half of which work for service/maintenance and the rest is for management, business development and back office.	▪ Business includes 1) sales/repair of construction machinery from Japan (60%) and 2) sales of industrial vehicles from Europe (40%) ▪ 80% of 1) is for sales and after service for the mining sector, for which Caterpillar, Volvo JCB (UK) lead the market and Japanese brands face tough competitions. No presence of Japanese constructors, and urban development/construction companies are mainly from Turkey and China with machinery brought from their own countries. ▪ For 2), sales of new forklifts also face tough competitions, as there is no official inspection/maintenance program to be provided by official dealers. Rental/lease (40% of sales) is limited to maximum 1 year service without local license for leasing business.
Company D, Farming Production	▪ Farming production company, 100% owned by a Japanese company, established in 1984 and dealing with IT vendor, mobile reuse, e-sports businesses, etc. ▪ Produce wheat, corn, etc., using 2,500ha of farmland, drying/storage facility with 16,000t capacity and 135 employees.	Buys grains from about 30 farmers and farming production companies and export to Middle East (UAE), North Africa (Egypt, Tunisia, etc.) and Bangladesh, along with the own products.
Company E, Automobile Distributor	Established in Jul 2004, with 100% ownership of a Japanese trading/investment company. Under the European HQ in Belgium and selling mainly SUVs imported from Japan.	▪ 150 employees (4,000 employees if 35 affiliated dealers are included). 90% of the dealers are SMEs, which are typically located in the regions with 20-30 employees and selling 200 units/year (around USD 8mn). ▪ Top 5-6 dealers account for 30% of the whole market and 70% is sold by SMEs. ▪ Number of customers (including maintenance): Around 70,000 (30% corporate, 70% individuals) ▪ Annual sales: 15,000 units (No.2 with 15% market share, following Renault). Small market compared to the population, due to relatively low income level compared to the price of a new car.
Company F, Automobile Distributor	100% owned by Japanese trading/ investment company. 9 affiliated dealers without any ownership, with a typical size of 20-30 employees each. Started the business relationship in 2005 for the oldest one.	▪ Mainly selling SUVs (with 3 major models plus build-to-order models), with an annual sales of 600-800 unites (i.e. 6-7 unites per dealer per month). ▪ Main customers are relatively higher income class with foreign currency incomes. Sales grow during UAH depreciates but is recently stagnant due to the appreciation trend. ▪ Used car market is 6-8 times larger than the new car market, but not easy for the distributors with low market share for the new cars.

Company G, Electronics Distributor	Came to Ukraine 20 years ago and established a subsidiary 10 years ago. With 50 employees, deal with home electronics (80%) and electric materials/equipment for the commercial users (construction companies and electric constructors, 20%). 50 employees. Products are manufactured in Malaysia and China, transported to the ports in Europe and sold in Ukraine.	▪ Main products: dry cells (#1 market share), headphones (#3), white goods (#4-5), fixed-line telephones, TV cameras, etc. ▪ Also doing business through the distributors in Azerbaijan, Uzbekistan and Georgia.
Company H, Trading & Investment	Established in 1997 and functions as the sales representatives office.	Major businesses include air terminal project through ODA, selling filter materials in line with the Kyoto Protocol, medical equipment for hospitals, farming machinery/equipment, etc. On the trading side, dealing with chemical products, titanium, iron ore, enriched uranium, dairy products, building materials, pulp, farming materials, food, hydrogen fuel, materials for renewable energy (solar panels, inverters, IPP-related items), etc.
Company I, Trading & Investment	Manage 3 business fields (automobile, construction machinery, agro-related business) and 5 companies. Has a branch status and can do businesses on its own account.	Kyiv branch focuses on electric power infrastructure and commodities (e.g. iron). Share the concern with the competitors about the local FX regulations as a potential obstacle to expanding the trade going forward.
Company J, Automobile Distributor	Established in Apr 2016 through 100% acquisition of local dealer network by a Japanese trading/investment company. Has 50 employees, but not an SME as the annual sales exceeds €50 million.	▪ Sold 2,500 units in 2019 out of 90,000 for the whole market. SUV accounts for 90%, and 30% for corporate customers. ▪ 60% of the new cars are SUVs for which Toyota leads the market, followed by Renault, Nissan, Mazda, KIA and Hyundai. For pickup trucks, share 30% pies each with Toyota, followed by VW, Ford and Nissan.
Company K, Trading & Investment	Opened the representative office in 1991 and functions as a liaison office.	▪ Main business has been automobile distribution since end-90s. Established a sales company with 100% ownership, to which HQ in Japan has sent 2 Japanese staff members. Automobile sales accounts for 90% of overall sales. ▪ Also deals with commodity exports, import/sales of Japanese tires (from the sales company in Poland), public works (JICA, EBRD, and approaching EIB). Non-automobile businesses account for 10% altogether, half of which is agricultural products.
Company L, Electric Tools Distributor	▪ Long-established Japanese brand, with sales branches in 50 countries and after-service and sales coverage in 170 countries. Ukraine is covered from Bucharest. ▪ Established the sales company in Ukraine in 2005 (from the representative office established in 2003). 47 employees, 250 corporate customers and 452 shops and 100 repair stores dealing with the brand.	▪ Sold €12 million in 2019 (155,000 units), of which 80% is imported from China and Romania, 20% from Japan and UK. ▪ Production of grinders are shifting to Romania, where the batteries are manufactured with a 'zero-emission' target. ▪ Price of the products range from €100 to €1,500. Among the end users, corporate customers account for 60-70%, individuals 30-40%. The latter (DIY needs) is expanding due to the COVID situation. ▪ Market share is around 10%, following Chinese brands and Karcher from Germany. ▪ Dealing with cash sales only. ▪ Potential demands include wide variety of businesses and activities, such as horticulture, cement production, hotels/ restaurants, power supply, solar energy, railways, agriculture, cleaning, food processing, gardening, green space management, camping and tourist bus operations.

2. Business Relations with Local SMEs

While the exposure of Japanese companies to the local SMEs varies by product, sector and type of business, most of the companies, unless they intentionally avoid due to the nature of the business, have business transactions with local SMEs more or less.

For the automobile distributors, majority of the affiliated dealers are SMEs with limited number of branches (one to several) and staff (up to a couple of dozens), with a few exception of larger scale dealers as a part of local conglomerates. In the case of construction machinery, purchasers also include SMEs, as in the case of forklifts sold to local SMEs (typically middle-sized ones) in logistics, beverage and food processing industries, which accounts for about 40% of total sales (acc. To construction machinery distributor).

Japanese companies operating in the agro-related sector, as one of the leading industries in Ukraine, have farmers and agricultural corporations among their customers, which typically have 20-1,000 employees and 1,000-3,000ha (middle-sized in the local standard) of farm lands (acc. to farming materials/equipment trading and farming production companies). Smaller farmers than this range tend to buy the materials from smaller-scale local wholesalers, not from the foreign companies including the ones interviewed in this survey (acc. to farming materials/equipment trading company).

For the electronics, customers include middle-sized retail stores (with the floor space of around 2,000m^2), online shops, small-scale hardware stores, wholesalers and constructors, which are mostly classified as SMEs with exceptions of large retailers/wholesalers. The credit sale is a common practice, for which 30-45 days (90 days in the longest case) are allowed for accounts receivable, depending on the deposit.

For pharmaceuticals, direct customers are relatively large-scale private wholesalers, while their clients include SMEs (i.e. local retail chains). Also some SMEs are included in the wholesalers in the case of government procurement.

In the case of Japanese '*shosha*' (trading and investment companies), the relationship with local SMEs varies from total avoidance to a variety of transaction for agro-products, processed food (e.g. sunflower oil), chemical products, textiles, etc.

3. Identified Challenges for the Local SMEs

While the issues vary by sector, common challenges identified through the interviews can be categorized into the followings.

a) Cash Flow Problems

It turned out through the interviews that many SMEs face this problem. The most typical case is the fund shortage resulting from the time gap between purchase and sales, for which the working capital demand comes in, but cannot be met by the banks due to their risk averse attitude as well as to the high interest rate. While some of the SMEs are suffering from the COVID situation in their payments (acc. to the pharmaceutical company), exporting companies who earn foreign currencies can still afford capital expenditures (acc. to the construction machinery distributor).

b) Difficulties in Financing Due to the Weak Financial Conditions

Some of the interviewee companies also pointed out the weakening financial conditions of SMEs as their customers. Automobile dealers, especially, are still struggling with the repayment burden of their past investments made before the Lehman Shock, when the automobile sales hit the historical high at 620 thousand units in 2008. In this situation, many dealers hesitate to make new investments due to the constraints in financing, and some of them ask for financial support to their suppliers.

c) Transparency of the Company Management

Not a few interviewees casted a doubt on the transparency of the corporate management. The doubt ranged from those on the reliability of SMEs' financial data to the practice of bribing the tax authority to avoid taxes, which undermine the credibility of the company through distorting the corporate culture and resulting attitudes.

d) Relatively Low Value Added in the Products

One of the critical challenges pointed out for the manufacturing companies was how to add values to their products for export competitiveness. Some of the interviewees pointed out the low level of processing and quality in the case of agro-related industry as one of the leading sector in Ukraine. It was also raised by one of the trading companies dealing with sunflower oil that 'French style' high value-added products with relatively limited farmland could be one of the solutions.

e) Difficulty in Hiring Workers

Ukraine recently tends to be a net supplier of the quality IT workers to the rest of Europe, due partly to the low salary level within the country, which makes it difficult for the local SMEs to keep good quality labor (acc. to the electronics company). This is somehow related to the change in the domestic labor market, which used to supply an amount of engineers and technicians but is shifting younger generation toward IT sector. Eventually, a large number of senior labor is stuck in the low value-added sectors with limited contribution to Ukrainian economy.

As a result of these constraints, after all, many of the local SMEs seem to face difficulty in operating with a well-designed long-term vision.

4. Relationship with the Local Financial Institutions

Most of the interviewee companies have no borrowings from the local banks, as they tend to finance from their headquarters in Japan. Local bank transactions are limited to remittance, FX, foreign currency deposit and salary accounts for the employees, mainly with foreign and foreign-affiliated banks such as Crédit Agricole, Citibank, Raiffeisen, Deutsche, ING, ODP, BNP Paribas, UkrSibbank (BNP Paribas Group), with an exception of Ukreximbank ('Export-Import Bank') for a farm production company and a trading company. Reasons for such selection included credibility, ability to provide information, FX transaction capability and consistency with the headquarters' bank transactions.

Loan transactions were limited to bank guarantees (by Citibank for the pharmaceutical company), roll-over of the overnight lending (for the farming material/equipment trading company at the lending rate of around 4%) and short-term loan (by Ukreximbank for the farming production company), while there was a company (farming production company) planning to finance from international donor organizations such as EBRD.

5. Local Financing Needs and Sources

As mentioned above, majority of SMEs' demand for finance is related to the working capital. Among automobile distributors, there was a case of consignment in which the dealers do not have to bear the financial burden of inventories, but other distributors with limited financial capacity mentioned their expectation on the reduction of bank borrowing burdens (e.g. high interest rate, documentation for loan application, etc.).

Among the financing needs for capital expenditures included those for;

- acquiring farmlands (as the land acquisition will be gradually liberalized in 2021 through 2024), farming equipment/machinery, storage facilities ('elevators'), spreaders ($200,000-300,000/unit) and irrigation facilities for the agro-related sector
- logistics/call centers and IT-related investments for the electronics sector
- shop renovation, land acquisition (for a new shop), transport vehicles (including used ones) for the freight companies carrying cars for sale and automobiles for commercial use in the case of automobile distributors
- production line for textile, paper, snacks, sunflower oil, sugar, poultry feed, etc. in the case of manufacturing companies

For these purposes, lease is also available, but given the level of the leasing fee which is generally higher than the loan interest rate, most of the interviewees mentioned the long-term financial source with lower interest rate will be helpful for the local SMEs.

6. Identified Problems for the Local Financing

Most of the interviewees had limited idea about what kind of transactions and relationship their SME clients have with the local banks.

Their general understanding includes such factors as high interest rate, absence of credit guarantee mechanism for the borrowers in short of collaterals and resulting low priority of using bank finance. Also from the viewpoint of general public, trust in commercial banks is not very high (therefore they tend to save in dollar cash) and the number of banks is still thought to be too large.

They also understand there is no such relationships as the 'main bank system' in Japan (acc. to one of the trading and investment companies). As mentioned above, lease is available as an alternative to loans, but the fee level is not so competitive against the loan interest rate, which makes some of the automobile distributors start thinking about cultivating automobile leasing market for SME clients.

Venture capitals and private equities are emerging as alternative sources for risk capitals, especially in IT sector, but have not been recognized in other businesses such as biomedical and healthcare (acc. to pharmaceutical company).

7. Others (Expectations on JICA's TSL, etc.)

Given that the loan interest rate is still high (at around 15% p.a.) even in the downward trend for the local interest rates, many of the interviewees responded positively to the idea of JICA's TSL if the product is attractive enough with long-term and low interest features for the uses in 5 mentioned above.

Once the TSL is in place, benefits for Japanese companies operating in Ukraine can be two-folded; one is the expansion of their businesses with local SMEs taking sub-loans, and the other is the possible purchase of their products and services by local SMEs using sub-loans.

The former shall include production line for the food processing companies, facilities and equipment for renewable energies, while the latter shall stimulate the potential demand for motor vehicles, farming machinery/materials, electric tools, in line with the expectations of the interviewee companies. In that context, it may be possible for these Japanese companies to recommend JICA's TSL to their clients in purchasing their products. On the other hand, a concern has been raised by one of the interviewees (trading and investment company) that the sub-loan may not necessarily be used for expensive Japanese products from the viewpoint of SMEs, meaning TSL does not necessarily benefit Japanese companies operating in Ukraine.

For the loan condition, specific expectations have not been heard from the interviewees, while they said the demand can be expected as long as the interest rate (desirably fixed) in home currency is low enough compared to the local market rate, and the tenor is long enough to limit the repayment burden.

7. Lending Schemes for SMEs Managed by Ukrainian Government (BDF)

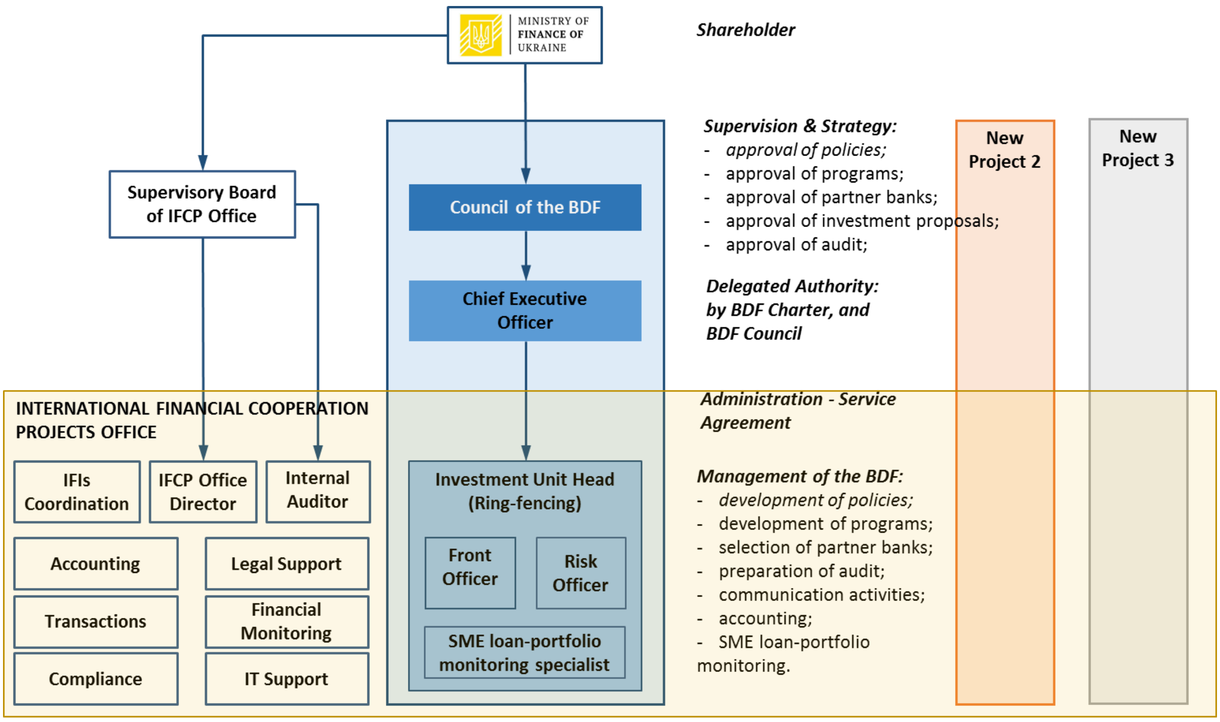
7.1 Operations, Fund Flows and Institutional Arrangements

1. Organizational Structure Around BDF

BDF (Business Development Fund) was initially established in 1999 as German-Ukrainian Fund (GUF) under the joint ownership of NBU, MOF and KfW, and regarded as a non-profit financial institution under the supervision of NBU with a full ownership of MOF as of today. Currently, there is an ongoing discussion within MOF on merging BDF with IFCPO (International Financial Cooperation Projects Office, established to manage a wide range of programs from international finance projects to government-funded projects such as 5-7-9 program), but has not been concluded (including the specific timing) as of the end-October 2020.

As of now, BDF has only 3 staff members including the Executive Director, and given that the daily operations are already outsourced to IFCPO, there likely to be no substantial changes in the legal status, roles and operations of the organization after the possible merger of BDF and IFCPO.

Current organizational structure of BDF and the relevant entities, as well as the governance structure, is shown below.

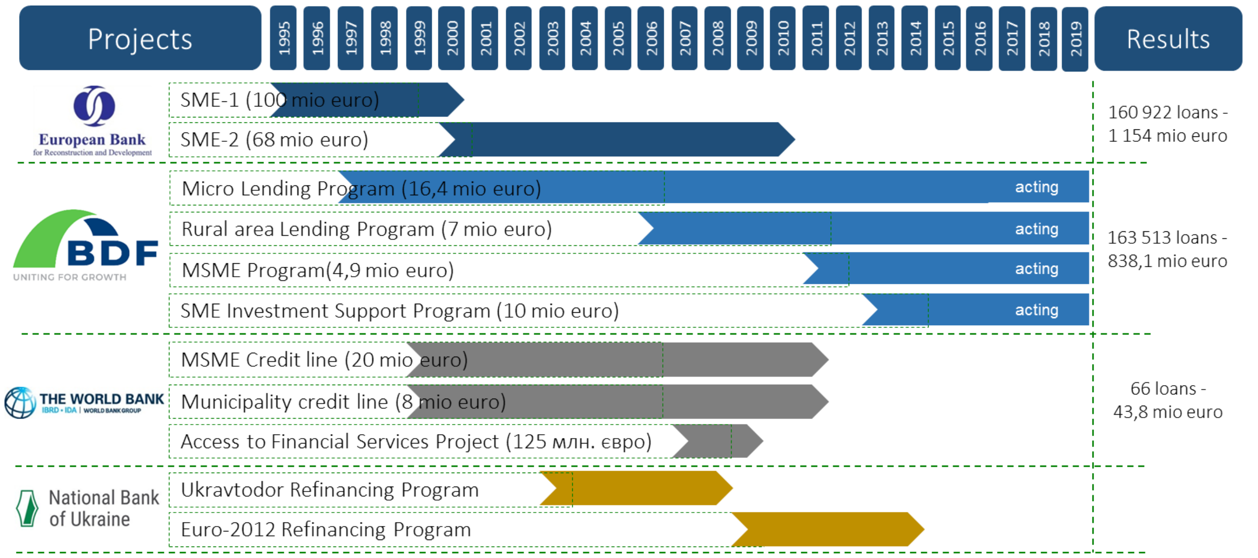


Source: BDF

Figure 7-1 Governance Structure of BDF

2. Projects Being Executed/Scheduled by BDF

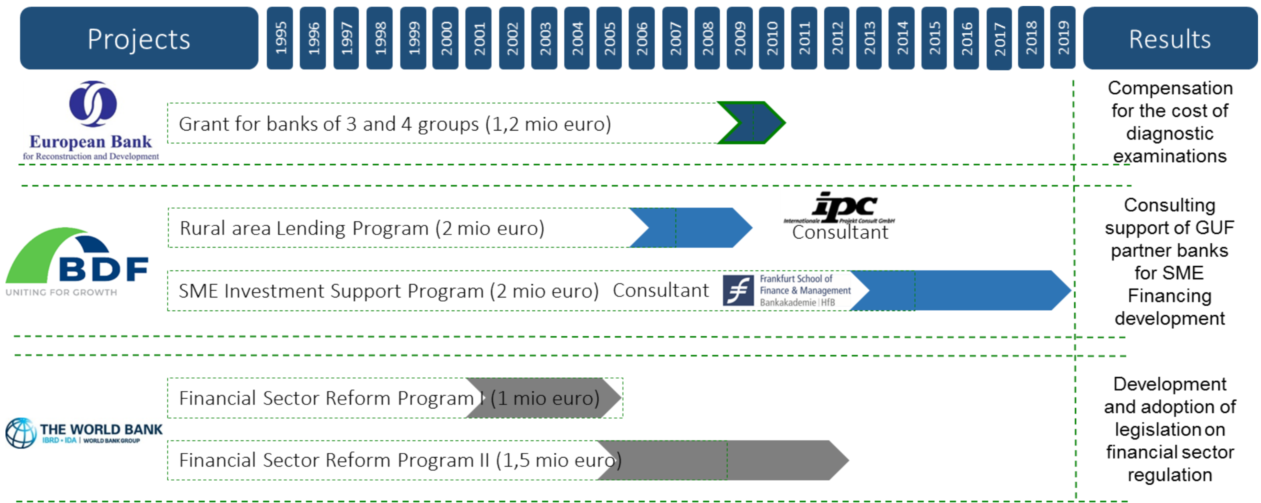
Loan and technical assistance (TA) projects that was/have been managed and are being scheduled by BDF are shown in Figure 7-2 and 7-3 in a time sequence, and the detailed information on the latest ones are shown in Table 7-1. These programs are roughly divided into those using the capital of BDF, those financed by KfW and those funded by Ukrainian government's own budget. Also depending on the fund usage and the borrowers' nature, 4 lending programs (Micro-lending Program, MSME Lending Support Program in Priority Areas, SME Lending Support Program in Rural Areas, SME Investments Support Program) and 2 subsidy programs (FinancEast Program, Affordable Loans 5-7-9%) are in place. They will be joined by a new lending program, SME Energy Efficiency Projects Support Program (for financing energy saving investments) starting in 2021.



Source: BDF

Figure 7-2 Loan Projects Executed by BDF

Note: 4 programs with the status 'acting' correspond to No.1~4 in Table 7-1. Other programs have been completed and the loan outstanding balances are already zero.



Source: BDF

Figure 7-3 TA Project Executed by BDF

Table 7-1 Projects Being Executed/Scheduled by BDF

No	Project Title	Donor Name/ GOU	Lending or Non-Lending	Budget Amount	Status (completed/ on-going/ planned)	Implement-ation Period (*1)	Outline of the Project	Condition of Loan (in case of lending program)
1	Micro-lending Program	from BDF's equity	Lending	€18mn	on-going	1996-	Financial Support of micro and small enterprises Business activities, % of CAPEX (capital expenditure) in total loan amount: No requirements	Financed from BDF's equity BDF→PFI: currency €, interest rate 2.5-4.5% p.a., maturity - 5yrs, grace period/repayment - standard schedule or at the end of the loan maturity PFI→final borrower (incl. sub-loan amount): currency € or UAH, interest rate - market rate, maturity - 5yrs, grace period can be provided by the partner bank, maximum loan amount - €250,000
2	MSME Lending Support Program in priority areas	from BDF's equity	Lending	UAH161.7mn	on-going	2011-	Financial Support of MSMEs in national currency Business activities: agriculture, manufacturing, hotels & restaurants, green tourism, energy efficiency % of CAPEX: No requirements	Financed from BDF's equity BDF→PFI: currency UAH, interest rate - floating rate based on UIRD, maturity - 5yrs(*2), grace period/ repayment - standard schedule or at the end of the loan maturity PFI→final borrower (incl. sub-loan amount): currency UAH, interest rate - UIRD+5%, maturity - 5yrs, grace period can be provided by the partner bank, maximum loan amount - €100,000
3	SME Lending Support Program in rural area	KfW loan	Lending	€6mn	on-going	2006-46	Financial Support of small and medium-size enterprises from cities with up to 100,000 inhabitants Business activities, % of CAPEX: No requirements	Donor→BDF: interest rate - 0.75%, maturity - 40yrs, grace period - 10yrs, Front end fee - 0.25% BDF→PFI: currency €, interest rate - 2.8%, maturity - 5yrs, grace period/repayment - standard schedule or at the end of the loan maturity PFI→final borrower (incl. sub-loan amount): currency € or UAH, interest rate - market rate, maturity - 5yrs, grace period can be provided by the partner bank, maximum loan amount - €250,000
4	SME Investments Support Program	KfW loan in combination with FX Losses Compensation Grant from EU in the amount of €5mn	Lending	€10mn+€5mn for FX Losses Compensation	on-going	2012-52, 2017-30	Financial Support of small and medium-size enterprises' investments projects Business activities: agriculture, manufacturing, hotels & restaurants, energy efficiency % of CAPEX: 60% or more	Donor→BDF: interest rate - 0.75%, maturity - 40yrs, grace period - 10yrs, Front end fee - 0.25% BDF→PFI: currency UAH, interest rate - UIRD x 0.9, maturity – 6yrs, repayment - after each 2yrs period PFI→final borrower (incl. sub-loan amount): currency UAH, interest rate - UIRD x 1.1, maturity - 6yrs, grace period can be provided by the partner bank, maximum loan amount - €250,000

5	SME Energy Efficiency Projects Support Program	KfW loan in combination with FX Losses Compensation Grant from EU in the amount of €5mn	Lending	€7mn+€5mn for FX Losses Compensation	planned	2021-61, 2017-30	Financial Support of small and medium-size enterprises' energy efficiency projects Business activities: energy efficiency % of CAPEX: No requirements	Donor→BDF: interest rate - 2.0%(*3), maturity - 40yrs, grace period - 10yrs, Front end fee - 0.25% BDF→PFI: currency UAH, interest rate - UIRD x0.9, maturity - 6yrs, repayment - after each 2yrs period PFI→final borrower (incl. sub-loan amount): currency UAH, interest rate - UIRD x1.1, maturity - 6yrs, grace period can be provided by the partner bank, maximum loan amount - €500,000
6	FinancEast Program	Financial contribution of the EU through KfW	Subsidy	€9.5mn	on-going	2019-22	Subsidy for compensation of 50% of the investments costs (without VAT) of SMEs located in Lugansk and Donetsk regions under control of GOU Business activities, % of CAPEX: No requirements	Maximum amount of subsidy - €150,000
7	Affordable Loans 5-7-9%	GOU	Subsidy	UAH1.5bn for 2020	on-going	2020-30	Subsidy for interest rate compensation to the level 5%, 7%, 9% p.a. Business activities, % of CAPEX: No requirements	---
8				UAH0.5bn for 2021			Credit guarantees in the amount of 50% (for existing SMEs) of 80% (for start-ups) from loan amount Business activities, % of CAPEX: No requirements	---

(*1) End year for the implementation period stands for the timing by when all sub-loans are collected by PFIs and repaid to KfW through Ukrainian government. While the outstanding balance of the PFIs' borrowings from BDF keeps decreasing as the Ukrainian government's repayment to KfW goes on, PFIs can recycle the collected loans for the new lending on a revolving basis within the available fund. Two separate terms in the implementation period column refer to the period for the loan (first one) and the period for the FX hedging facility (second one).

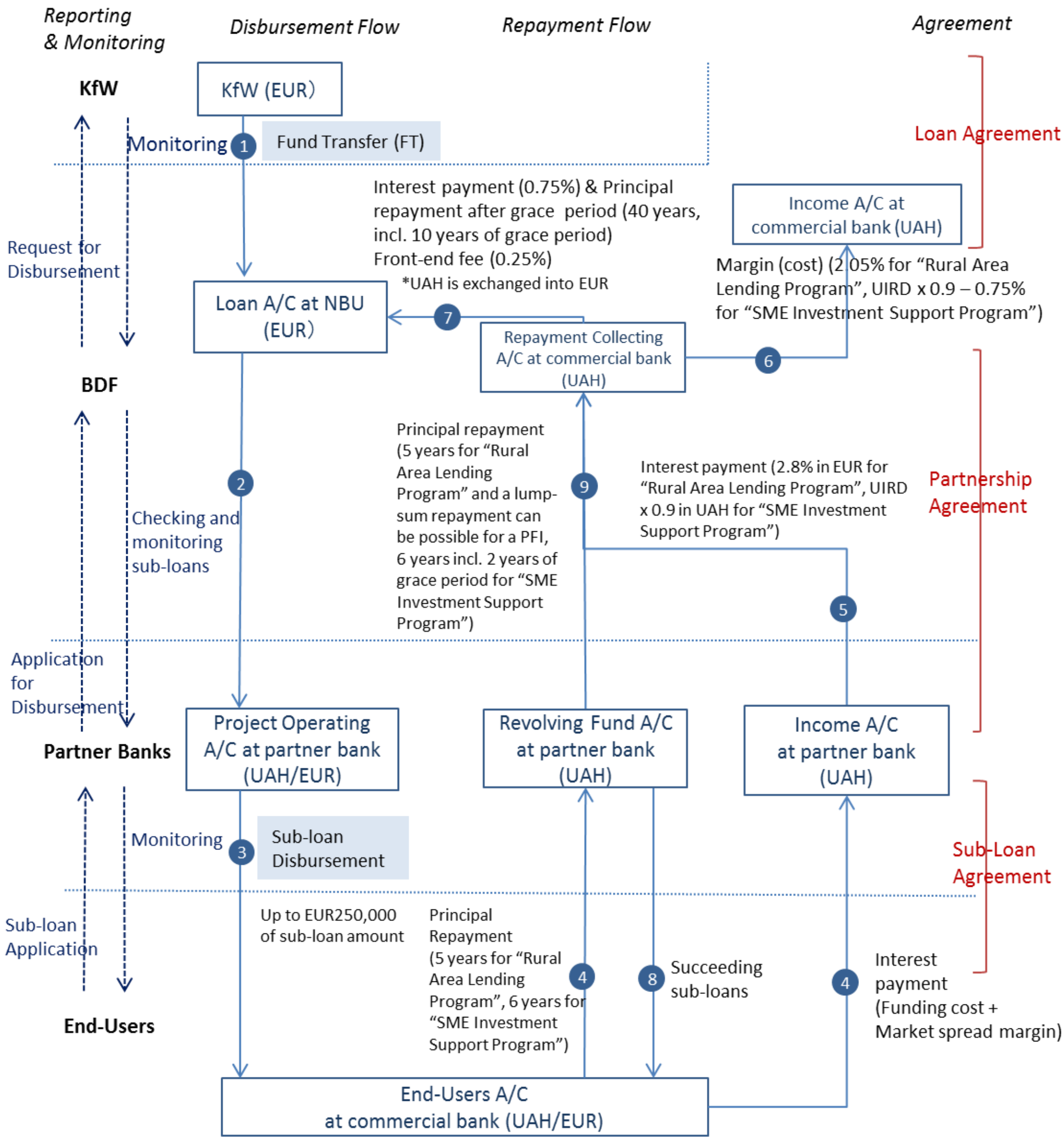
(*2) Same terms for the funding and lending by PFIs are based on the agreement with KfW, which somehow limits the availability of the fund for the revolving use.

(*3) Different interest rate from other KfW programs is a result of the revision of the applied interest rate by KfW.

Source: BDF

3. Loan Operation

Administrative flow for KfW-funded programs ('Rural Area Lending Program' amd 'SME Investment Support Program') has been visualized as shown below, based on the information provided by BDF. Funds from KfW are transferred to the Partner Banks through NBU to be disbursed to the SMEs as end-borrowers.



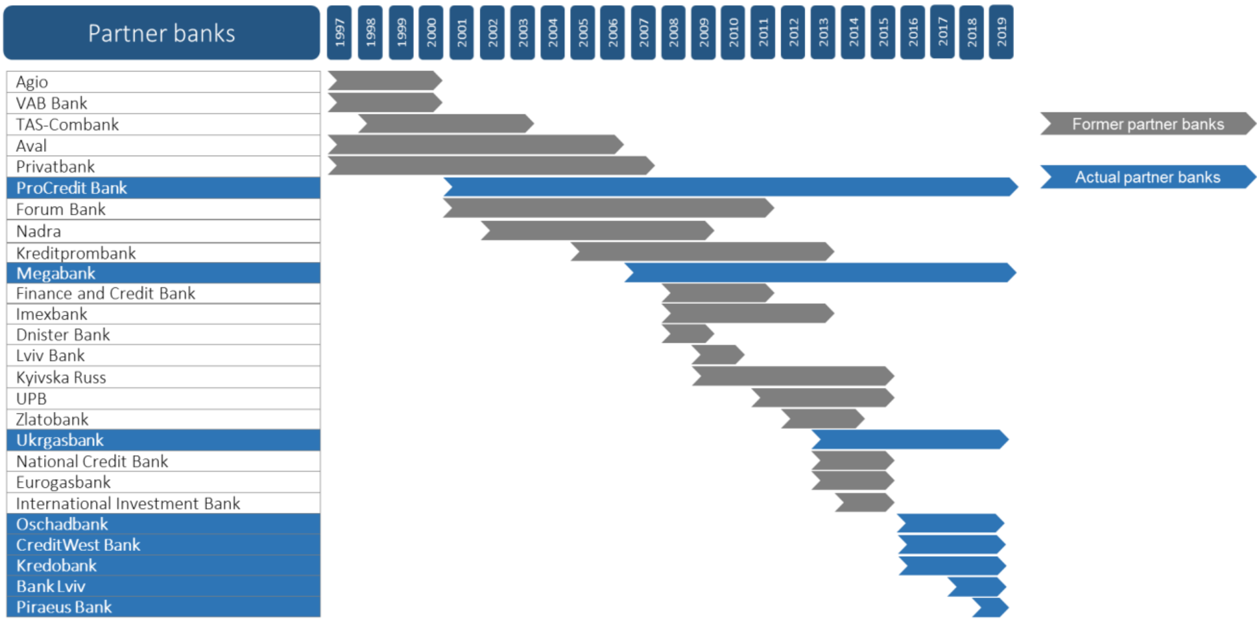
Note 1: The Figure shows the fund flow in such KfW's loan programs as "Rural Area Lending Program" and "SME Investment Support Program". In case of "SME Investment Support Program", the loan program is implemented together with FX Losses Compensation Grant by EU (EUR5 million of budget). On the other hand, both "Micro Lending Program" and "MSME Program" are the equity investments by KfW, where PFI can flexibly chose its repayment schedule to BDF, including "a lump-sum repayment on the date of loan maturity".
2: UIRD (Ukrainian Index of Retail Deposit Rates) 3 month = 8.08% (as of 28 October 2020).

Sources: Survey Team based on the information provided by BDF

Figure 7-4 Administrative Flow for the Loan Operation

4. Selection of the Partner Banks

Commercial banks selected as Partner Banks for the lending programs provided through BDF are shown below, of which 8 banks (ProCredit Bank, Megabank, Ukrgasbank, Oschadbank, CreditWest Bank, Kredobank, Bank Lviv and Piraeus Bank) are serving for the on-going programs.

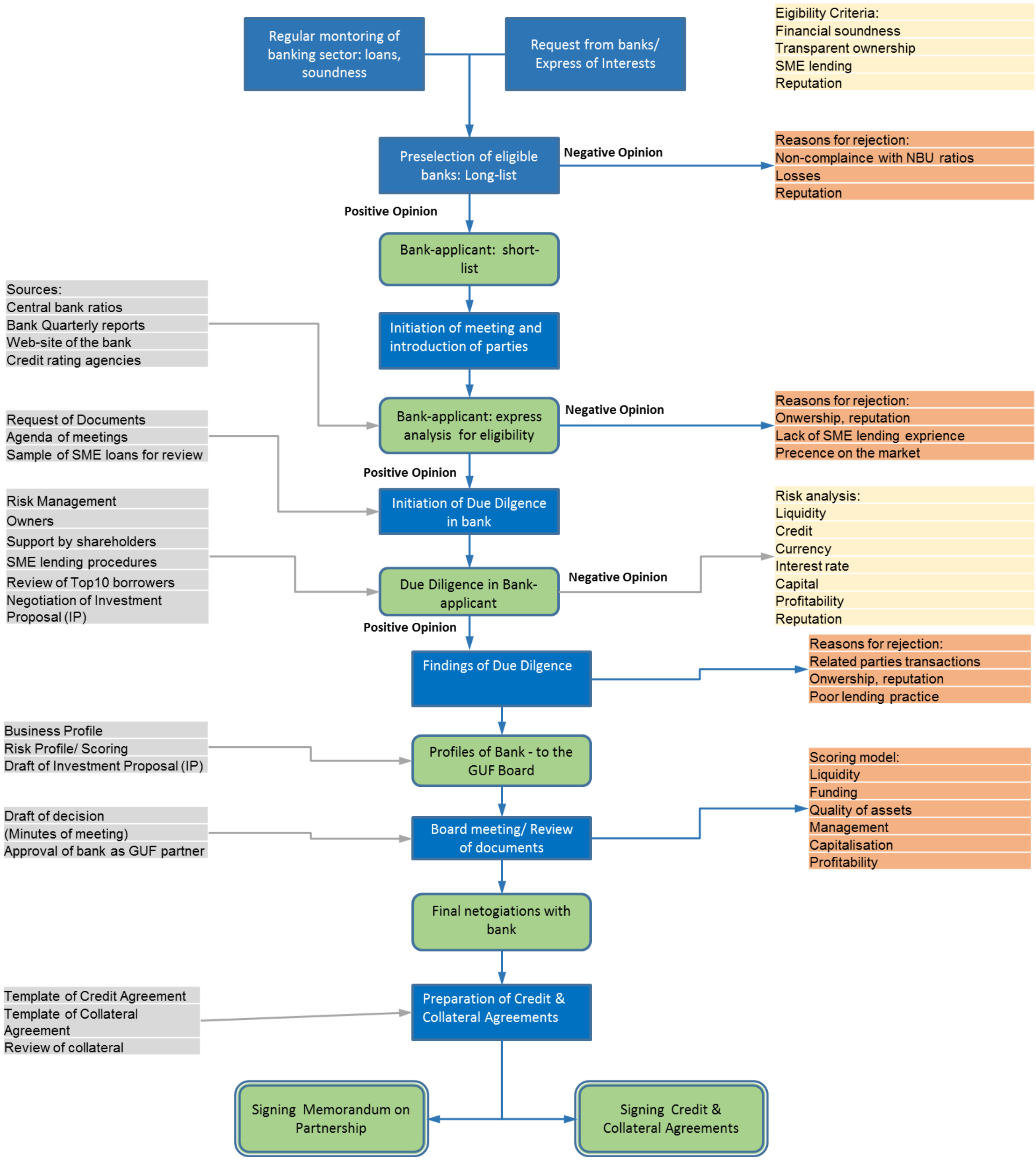


Source: BDF

Figure 7-5 Past and Present Partner Banks

Criteria and procedures for the selection of Partner Bank are shown below. In the selection process, BDF first does the screening from the viewpoints of financial health, transparency of ownership, loan capability and reputations, by checking compliance to the prudential regulations by NBU, negative reputations, capacity for SME finance, credit concentrations to subsidiaries and affiliated companies, positioning in SME finance market, etc. to reject inappropriate banks. Also on the final stage, BDF applies the original scoring criteria, in which the banks are classified into 5 categories (‘Very Good’, ‘Good’, ‘Satisfactory’, ‘Poor’, ‘Default’) and the lowest two categories are rejected. According to BDF, eight Partner Banks for the ongoing programs are classified as either ‘Very Good’ or ‘Good’.

The scoring model consists of financial health (with a weight of 70%) and management/financing (30%), and the former includes capital adequacy (20%), credit/asset (25%), profitability/efficiency (10%) and liquidity (15%). This method can be characterized by; 1) higher weight for the financial factors, 2) use of original indicators different from NBU’s operational indicators (disclosed in public on a quarterly basis), 3) focus on the management and financing activities for the non-financial part, while skipping conventional evaluation items such as the strategies and track records of SME finance, experiences in policy lending programs, branch network, credit appraisal capabilities, etc. and 4) extra point (1 on top of the 0~5 scale score) for the state-owned banks and foreign banks.



Source: BDF

Figure 7-6 Selection Procedure for the Partner Banks

Table 7-2 Qualification Criteria for BDF Partner Banks

Evaluation Items		Criteria	Unit
A. Overall Evaluation Factors			
1)	Financial soundness	signs warning something bad	None or Yes
2)	Transparent ownership	Untransparent ownership	None or Yes
3)	SME Lending	Unexperienced SME lending practice	None or Yes
4)	Reputation	bad reputation	None or Yes
B. Pre-selection for preparing a long-list (reasons for rejection)			
1)	Non-compliance with NBU ratios	non-compliance	None or Yes
2)	Reputation	bad reputation	None of Yes
C. Bank application (reasons for rejection)			
1)	Ownership, Reputation	untransparent ownership, bad reputation	None or Yes
2)	Lack of SME lending experience	lack of expereince	None or Yes
3)	Presence on the market	too small presence	None or Yes
D. Due Diligence in applicant bank (risk analysis)			
1)	Liquidity	signs warning something bad	None or Yes
2)	Credit	signs warning something bad	None or Yes
3)	Currency	signs warning something bad	None or Yes
4)	Interest rate	signs warning something bad	None or Yes
5)	Capital	signs warning something bad	None or Yes
6)	Profitability	signs warning something bad	None or Yes
7)	Reputation	bad reputation	None or Yes
E. Findings of Due Diligence (reason for rejection)			
1)	Related-parties transactions	Excessive credit exposure to related parties (no more than 25 percent; NBU Prudential Ratio R9)	None or Yes
2)	Ownership, Reputation	untransparent ownership, bad reputation	None or Yes
3)	Poor lending practice	poor lending practice	None or Yes
F. Board Meeting / Review of documents (scoring model: I-II (Very Good), III-IV (Good), V-VI (Satisfactory), VII-VIII (Poor), and IX (Default))			
1)	Liquidity (15%)	liquidity ratio, coverage of liquidity buffer, violation of currency position limits, clienets' credit / client' fund ratio	%, No.
2)	Resource base (15%)	dependence of NBU's resources, share of term funds of other banks, dynamics of clienets funds (quarterly), term fund / funds ratio, individual funds / liabilities ratio	%
3)	Credit activity and asset quality (25%)	compliance with the NBU's credit ratios, dynamics of credits for clients (quartely), credits with pass due for 90+ days / credits ratio, share of top 10 groups in credit portfolio, other securities / total assets ratio	%, other
4)	Capitalization (20%)	CAR, statutory capital / regulatory capital, sahreholders support potential, dynamics of regulatory capital (quarterly)	%, other
5)	Management and ratings (15%)	staff rotation during 6 months, management experience assessment, prudential sanctions, credit scores	others
6)	Profitability and efficiency (10%)	ROA, cost-to-income ratio (CIR), spread between market interest rate and rate for 3-month bank deposit in home currency, net interest margin (NIM)	%

Table 7-3 Scoring Criteria for BDF Partner Banks

Measures	Formula	Standard Value	Unit	Scale: 0-5						Weight (%)
Financial Soundness										**70.00**
Capitalization (No.4)										20.00
Capital adequacy ratio (CAR)	Capital Base / Risk-Weighted Assets (NBU Prudential Ratio R2; Minimum CAR = 10%)	21.91	%	Minimum CAR-2	Miinimum CAR-1	Minimum CAR+0	Minimum CAR+1	Minimum CAR+2	Minimum CAR+≧2	10.00
Statutory capital to regulatory capital ratio	Statutory Capital / Regulatory Capital	n.a	%	>120	110~120	105~110	100~105	90~100	<90	2.00
Shareholders support potential	Shareholders support potential	n.a	other	Shareholders are insolvent	Problematic conditions of shareholders	The condition of shareholders is uncertain; Statutory Capital is stable in current year	The condition of shareholders is uncertain; + Statutory Capital is stable in current year	Shareholders are solvent; Statutory Capital is stable in current year	The condition of shareholders is strong; + Statutory Capital is stable in current year	4.00
Dynamics of regulatory capital (quarterly)	Regulatory Capital / Regulatory Capital at the end of Previous Quarter (increase or decrease rate)	n.a	%	<-10	From -10 to -5	From -5 to 0	0~1	1~5	>5	4.00
Credit Activity and Asset Quality (No.3)										25.00
Compliance with NBU's credit ratios	No. of violation(s) or nearly violation(s) against NBU's prudential ratios on credit risks (NBU Prudential Ratio R7, R8, and R9)	n.a	No.	>2	1>	temporary pemission to violate	2 ratios close to threshold	2 ratios close to threshold	OK	6.25
Dynamics of credits for clients (quarterly)	Loans for Clients / Loans for Clients at the end of Previous Quarter (increase or decrease rate)	n.a	%	<-10	From -15 to -10	From -5 to 0	0~1 or >10	1~5	>5	3.75
Credit with pass due for 90+ days to credit ratio	Loans with Pass Due for 90+ Days / Total Loans	45.62	%	>30	20~30	15~20	10~15	5~10	<5	6.25
Share of top 10 groups in credit portfolio	Loans to Top 10 Groups / Total Loans	n.a	%	>65	55~65	45~55	35~45	25~35	<25	6.25
Other securities to total assets ratio	Other Securities / Total Assets	n.a	%	>10	7~10	5~7	3~5	1~3	<1	2.50
Profitability and Efficiency (No.6)										10.00
Return on Assets (ROA)	Profit before tax / Average Total Asset	3.42	%	<-1	0~-1	0~0.25	0.25~0.5	0.5~1	>1	3.50
Cost-to-income ratio (CIR)	Noninterest Expenses / Gross Income	56.67	%	>100	85~100	70~85	60~70 or <30	55~60	<55	3.50
Spread between market rate of bank deposits and the bank's rate for 3-month deposit in home currency	Market Rate of Bank Deposits - The Bank's Rate for 3-month Deposit in Home Currency	n.a	%	>3	2~3	1~2	0~1	0~-2	<-2	1.50
Net Interest Margin (NIM)	(Interest Received - Interest Paid) / Interest Earning Assets	n.a	%	<1	1~2	2~3	3~4 or >10	4~5	>5	1.50
Liquidity (No.1)										15.00
Compliance with the liquidity ratio	Liquid Assets / Total Assets (i.e., short-term liquidity ratio of no less than 60%; NBU Prudential Ratio R6)	89.68	%	<55	55~60	60~65	65~70	>90	70~90	6.00
Coverage of liquidity buffer (LCR, all currency)	High-quality Liquid Assets / Total Net Cash Flow (LCR, all currency of no less than 100 percent)	n.a	%	>100	100~105	105~110	110~120	>150	120-150	4.50
Violation of currency position limits	Total long open FX position (no more than 10 percent, NBU's regulation L13-1), Total short open FX position (no more than 10 percent, NBU's regulation L13-2)	n.a	other	2 limits significantly	1 significantly, 2 not significantly	2 limits not significantly	1 limit significantly	1 limit not significantly	No	2.25
Clients credit to clients' fund ratio	Loans / Deposits (i.e., loan-to-deposit ratio)	n.a	%	>140	130~140	120~130	110~120	100~110 or <80	80~100	2.25
Management & Funding Sources										**30.00**
Management and Ratings (No.5)										15.00
Staff rotation during 6 months (Board & Council)	No. of rotated management members during recent 6 months	n.a	No.	>3	CEO, Deputy CEO, Head of Council	3	2	1	stable	3.00
Management experience assessment	Unexperienced or unskilled management members	n.a	No.	>3	CEO, Deputy CEO, Head of Council	3	2	Secondary positions rotations	No	4.50
Prudential sanctions	None or yes (sanction of >UAH1 mil, warnign letter, fianncial recovery program, others)	n.a	other	Recognition as problematic	Other significant measures	Financial recovery program	Warnig letter	Sanctions >1 million UAH	No	5.25
Credit scores	Rating(s) from international or local rating agency (RA)	n.a	other	No score / D	C-CC-CCC from International RA or B from Local RA	B from International RA or BB from Local RA	BB from International RA or BBB from Local RA	BBB from International RA or A-AAA from Local RA	A-AAA from International RA	2.25
Resource Base (No.2)										15.00
Dependence of NBU's resources	Funds from NBU / Total Funds	n.a	%	>20	15~20	10~15	5~10	1~5	<1	5.25
Share of term funds of other banks	Term Funds of Other Banks / Total Funds	n.a	%	>25	20~25	15~20	5~15	1~5	<1	1.50
Dynamics of clients funds (quarterly)	Deposits / Deposits at the end of Previous Quarter (increase or decrease rate)	n.a	%	<-15	From -15 to -10	From -10 to -5	From -5 to 0	1~5	>5	5.25
Term funds to funds ratio	Term Funds / Total Funds	n.a	%	>70	60~70	50~60	50~55	40~50	<40	1.50
Individuals funds to liabilities ratio	Deposits and Other Individual Funds / Liabilities	n.a	%	>70	60~70	50~60	40~50	30~40	<30	1.50
Total										**100.00**

Note: No.1~No.6 by the items in the column 'Measures' correspond to the numbers in 'F. Board Meeting / Review of documents (scoring model: I-II (Very Good), III-IV (Good), V-VI (Satisfactory), VII-VIII (Poor), and IX (Default))' as one of the categories for the evaluation items in Table 7-2. Items in the categories A~E in Table 7-2 can be answered in simple Yes and No, while the evaluation for F, based on more detailed financial data, is applied to the candidate banks that have passed the initial screening through the criteria in A~E.

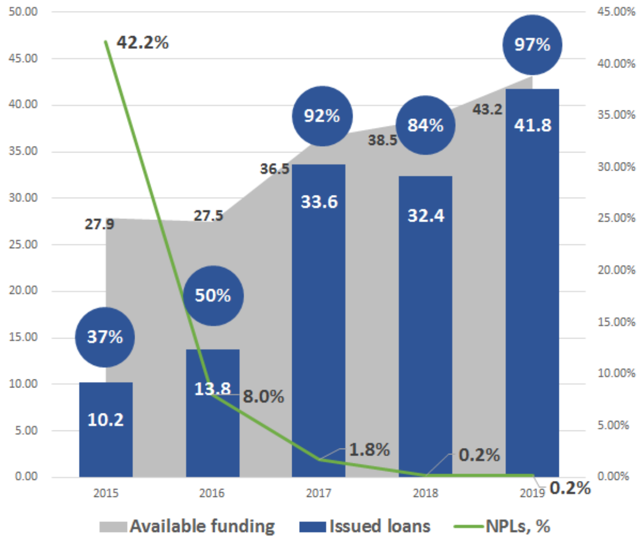
Sources: BDF, "Description of activities in the field of SME financing", p.8-11 (October 2020), BDF, "Technical Procedure for Scoring the Credit Risk of A Partner Bank", NBU Statistics (November 2020)

7.2 Track Records, Loan Conditions and Impacts

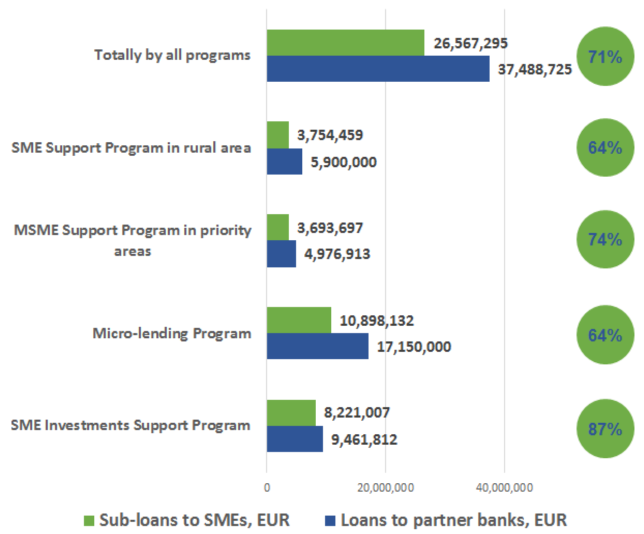
Summary results and impacts of the ongoing programs are shown in Figure 7-7, based on the data prepared by BDF.

It is clear from '1) Loan Disbursement from BDF to the Partner Banks (€ million) and NPL Ratio (%)' that the disbursed amount as a percentage of the available funding has been increasing (from 37% in 2015 to 97% in

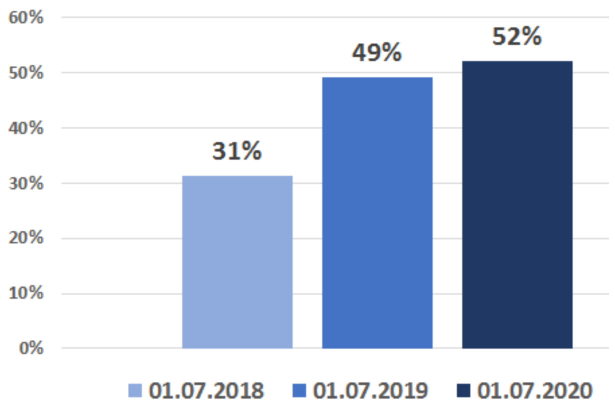
2019), while the NPL ratio has been decreasing[1], suggesting that the effort for appropriate and efficient use of fund is being materialized after the initial turbulent period. In addition, the increasing share of capital expenditures as the sub-loan usage observed in '3) Share of Capital Expenditures in SME Sub- Loans (%)' shows that a greater part of the fund is used for longer-term purposes to improve productivity as well as to increase the capacity of the borrower companies. Also the sector of the end-borrowers are getting more diversified towards industrial sectors (e.g. manufacturing), although agro-related sectors are still dominant.



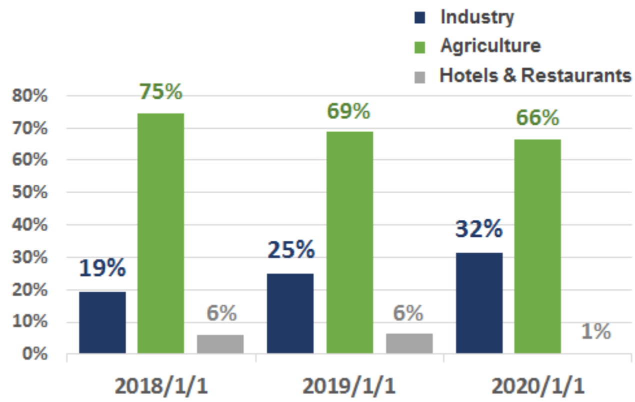
1) Loan Disbursement from BDF to the Partner Banks (€ million) and NPL Ratio (%)



2) Loan Disbursement from the Partner Banks to SMEs by Program (€ million)



3) Share of Capital Expenditures in SME Sub-Loans (%)



4) Sector Breakdown of SME Sub-Loans (%)

Source: BDF

<u>Figure 7-7 Loan Track Records of BDF Loans through Partner Banks</u>

[1] NPL ratio is calculated for the BDF-funded part only. Sharp decline from 2015 (42.2%) to 2016 (8.0%) is a result of writing off the NPL through the fund financed by the government bond issues for this purpose.

8. Necessity of Cooperation for SME Loan Project

In general, there is an issue about how to solve the high transaction costs associated with the “information asymmetry” of SME finance in order to enhance SME finance. There are three theoretical solutions: (i) society as a whole absorbs the cost (the government pays for it as a policy cost), (ii) lenders solve the problem (accumulation of know-how within financial institutions, use of information technology, etc.), and (iii) borrowers bear the cost (high interest rates commensurate with the high cost). (cf. Yabushita & Bushimata, Introduction of SME Finance, September 2002)

When forming a loan scheme for SMEs from a perspective of SME policy, it falls under (i) above. When verifying its necessity and appropriateness, it is necessary to rigorously confirm the following three points: “SMEs play an important role in the economy and society”, “Actual funding demand for the enterprises to be supported funds is reasonably recognized”, and “Immediate improvement in (ii) and (iii) above would be difficult.”

Based on the discussion so far, these three points can be considered as follows.

First, with regard to "SMEs play an important economic and social role", in quantitative terms, the number of SMEs in the total number of businesses is 99.8% (of which 96% are microenterprises), 63% in the number of employees and 49% in the value added (2018). If we look at the "SMEs" (approximately 60,000 companies, legally defined as those with 10-250 employees and a turnover of EUR2-50 million), excluding micro enterprises, their number is only about 4% of the total, but they alone account for 27.3% of the number of employees and 31.7% of the value added. In addition, SMEs are expected to play a role in competition and innovation, creating growth industries, revitalizing local economies, meeting diversified needs and promoting the social division of labour. From this qualitative perspective, we can see the rise of the IT industry and the expectations of agricultural SMEs.

Secondly, with regard to "a reasonable recognition of the real funding demand of the companies eligible for support", firstly, if we look at the real funding gap of MSMEs (micro enterprises and SMEs) (potential funding demand - funding supply) in the IFC’s data of *MSME Finance Gap 2017* (data updated in 2018/19), the country's MSME (360,000 businesses surveyed) has a funding gap of $33.1 billion (36% of GDP). Of the MSME financing gap of $33.1 billion, the SME financing gap, excluding micro enterprises, is $29.3 billion, so there is a reasonable amount of potential funding demand. In addition, according to the interviews with the eight BDF partner banks, if the JICA-TSL for SMEs is realized, the total amount of sub-loans that could be disbursed by the eight banks is expected to be at a certain level for the next 1-2 years ahead.

Thirdly, with regard to “it is difficult for lenders to solve the problem (accumulation of know-how within financial institutions, use of IT, etc.) and for borrowers to bear the burden (high interest rates commensurate with high costs)”, in the country's SME finance, extremely high level of loan interest rates has been a huge issue among SME borrowers. For the purpose of facilitating SME financing, it is absolutely necessary for banks to improve operational efficiency through the use of IT. But due to a lack of know-how and investment budget, it is difficult to expect dramatic improvements in a short period of time.

Summing up the SME financing in Ukraine, the Strategy for Sustainable Development of Ukraine 2020

(Presidential Decree No. 5 of Ukraine dated 12 January 2015) marked the beginning of the process of shaping the SME policies in accordance with the EU model. This led to the development of the infrastructure supporting the lending practices of banks (credit information systems, credit guarantee programmes, etc.) and the regulatory environment for banks, while banks, including the major state-owned banks, have begun to focus on SME business strategies, accumulating SME screening know-how and making certain improvements and efficiencies in their SME lending operations. However, there is still room for further improvement in business operations through the use of scoring models and fintechs. On the other hand, SMEs, as borrowers, face the challenge of a lack of management skills, including the preparation of bank loan applications, due to the high proportion of micro enterprises (95.9% of the total number of enterprises in the country). Also, it is difficult for SMEs to develop profitable capital investment plans by utilizing bank loans with high interest rates, although bank loan is almost the only external financing option for SMEs. The problems of SME financing are compounded by the banks as lenders, the infrastructure and financial environment surrounding the banks, and SMEs as borrowers, and there are no quick solutions. So, governments around the world are implementing SME policy finance, and also in Ukraine, the BDF, established in 1999, has been providing SME policy finance with the support of the EU, EBRD and other donors. However, at present the size of the Ukrainian banking sector is absolutely small in relation to the size and growth potential of the national economy, so policy finance has a significant role to play in further developing the Ukrainian SME sector.

Then, in view of the need for SME loan project, assuming the JICA-TSL scheme, the following table summarizes the three options for support extracted from the whole of the Ukrainian SME sector, their respective financial needs, the constraints on JICA-TSL, and solution approaches.

In this context, considering that the banking sector in Ukraine is not able to adequately meet the potential demand for medium-to-long-term home currency-denominated loans for capital investment, the Survey Team would propose to focus on [C] SMEs (approximately 60,000 businesses) whose financing needs are consistent with the traditional JICA-TSL scheme, as the corporate segment that should be the main target of JICA-TSL. However, with regard to the eligibility of end-users for TSL, judging from the economic and social importance of supporting micro businesses in the national economy, and from the perspective of ensuring smooth operations by not placing undue constraints on the selection of end-users by PFIs, the proposal is not limited to [C] SMEs (small, medium enterprises) but also to [A] micro businesses (micro enterprises, single entrepreneurs).

Table 8-1 Financial Needs, Constraints of JICA-TSL and Solution Approaches by Target Options for Support

Target for support	Expected main financial needs	Constraints of JICA-TSL	Solution approaches
[C] SMEs	・Short-term working capital loans (1 year or less), speedy ・Medium- and long-term equipment loans (about 3-7 years)	・Success of TSL depends largely on PFI selection because PFIs are responsible for finding, selection, screening, etc. of end-borrowers.	・Appropriate selection of PFIs (Comprehensive and objective evaluation , based on financial soundness, governance and management system, capacity to implement TSL project, etc. ・Utilization of fintechs to improve the lending operational efficiency, and financial institutions' rebuilding of business model for it

[A] micro enterprises and single entrepreneurs	・Small-scale short-term working capital loans, speedy(1 year or less) ・Medium- and long-term working capital loans for stabilizing management (about 5 years) ・Partially, medium- and long-term equipment loans (about 3-7 years)	・Policy-based finance to supplement the supply of medium- and long-term capital investment loans (the basic concept of “supplementary financing” that does not squeeze on the private sector). ・Subsequent reporting that is difficult for micro businesses to deal with (e.g., dealing with ex-post onsite management by the implementing agency and PFI, reporting on equipment completion, submitting copies of receipts, recording assets in the account books). ・Success of TSL depends largely on PFI selection because PFIs are responsible for finding, selection, screening, etc. of end-borrowers.	・Modifications of system design (whether or not to add short-term and medium- and long-term working capital loans) ・Simplification of the TSL reporting obligation ・Appropriate selection of PFIs (in particular, paying attention to the capacity of microbusiness lending operations) ・Utilization of fintechs to improve the operational efficiency of microbusiness lending, and financial institutions’ rebuilding of business model for it
[D] startups and growing SMEs	・Equity investment (angels, VC investments)	・Lack of function to make equity investments. ・Risk money with high-risk and high-return would not fit in the policy-based finance.	・Provision of unsecured, unguaranteed “capital loans” (5 years or less) that are subordinated to other debts with a lump-sum repayment on the date of loan maturity (Reference example: “Special Program to Strengthen Capital to Support Challenges” by Japan Finance Corporation)

Source: Prepared by JICA Survey Team, based on the interviews with BDF partner banks, etc.

9. Possible Cooperation by JICA

9.1 Necessity for the Financial Support and Its Delivery Measures

Needs for financial support by JICA have been identified through the interviews with 8 Partner Banks for the programs managed by BDF with the support from KfW; 2 state-owned banks (Ukrgasbank, Oschadbank) and 6 foreign banks (KredoBank, CreditWest Bank, Bank Lviv, ProCredit Bank, Megabank, Piraeus Bank). Specifically 6 items, desired size of the funding, tenor, grace period, disbursement currency, usage (whether it is for capital expenditures or working capitals) and spread margin are included. (c.f. Appendix, p.16 'Banks' Request on JICA SME-TSL')

According to the responses, desired loan conditions are rather similar for the maximum loan amount per customer (up to €1 million) and tenor (up to 7 years[2], except for a bank that requested 10 years), but the responses varied for the grace period (6 months to no upper limits), disbursement currency (home currency, € and $) and the share of working capital in a disbursement (below 20% to no limitation). The spread margin to be added on top of their cost of funding from BDF was concentrated to the range 5-7%.

For the tenor, generally 5 years, and 7 years depending on the loan size and financial conditions of the borrowers, seem to be reasonable for the loan to a single SME in comparison with JICA-funded TSL programs in other countries.

For the working capital share on the other hand, the range from 40% to 100% seems to be a bit too high. Given, however, that there was no specific request for the pure use as the working capital, there seems to be a general understanding that JICA's TSL is being designed for financing capital investments of SMEs in Ukraine.

As for the spread margin, the decision at each PFI shall be made considering the funding cost from JICA plus the operational cost at MOF and BDF. For ensuring the competitiveness of JICA's TSL sub-loan vis-à-vis the local loan products, the spread margin needs to be carefully designed considering the financial market environment at the time of finalizing the loan conditions.

Funding amounts for the 8 partner banks totals at €104～148 million (c.f. Appendix, p.15 'Potential Funding Demand for JICA SME-TSL'), which already exceeds the initial assumption by JICA before this survey started. On the other hand, it implies that a certain level of demand for fund by the local SMEs is already there waiting for the program by JICA.

Figure 9-1 illustrates the proposed administrative flows of JICA's TSL, provided the existing TSL programs in Ukraine as introduced in the previous chapter. Basic ideas behind the design are also listed below. In the figure as well as for the rest of this report, financial institutions that are called 'Partner Banks' in KfW-funded programs, shall be called 'PFI (Participating Financial Institution)', as in JICA's TSL programs in other countries.

- Executing Agency: Request BDF to be an executing agency for managing the operations, as in other TSL programs funded by KfW.

[2] BDF also suggested 7 years for the capital investment part, while recommending 3 years for the working capital part.

- Fund Flow: JICA fund shall be provided to PFIs through BDF, as in other TSL programs funded by KfW. Disbursement method from JICA to BDF, such as 'Advance Method' in which PFIs request disbursements based on the fund demand projection for the next 3 or 6 months, or 'Special Account Method' in which the injections to a BDF's account are requested on a demand-basis, shall be decided based on JICA's policy as well as on the request from BDF based on its experiences.

- Currency for disbursement (BDF→PFI): While the disbursement currency(ies) shall be decided based on the discussion by Japanese and Ukrainian governments, the Survey Team recommends that UAH or EUR shall be used, as in KfW-funded TSL programs.

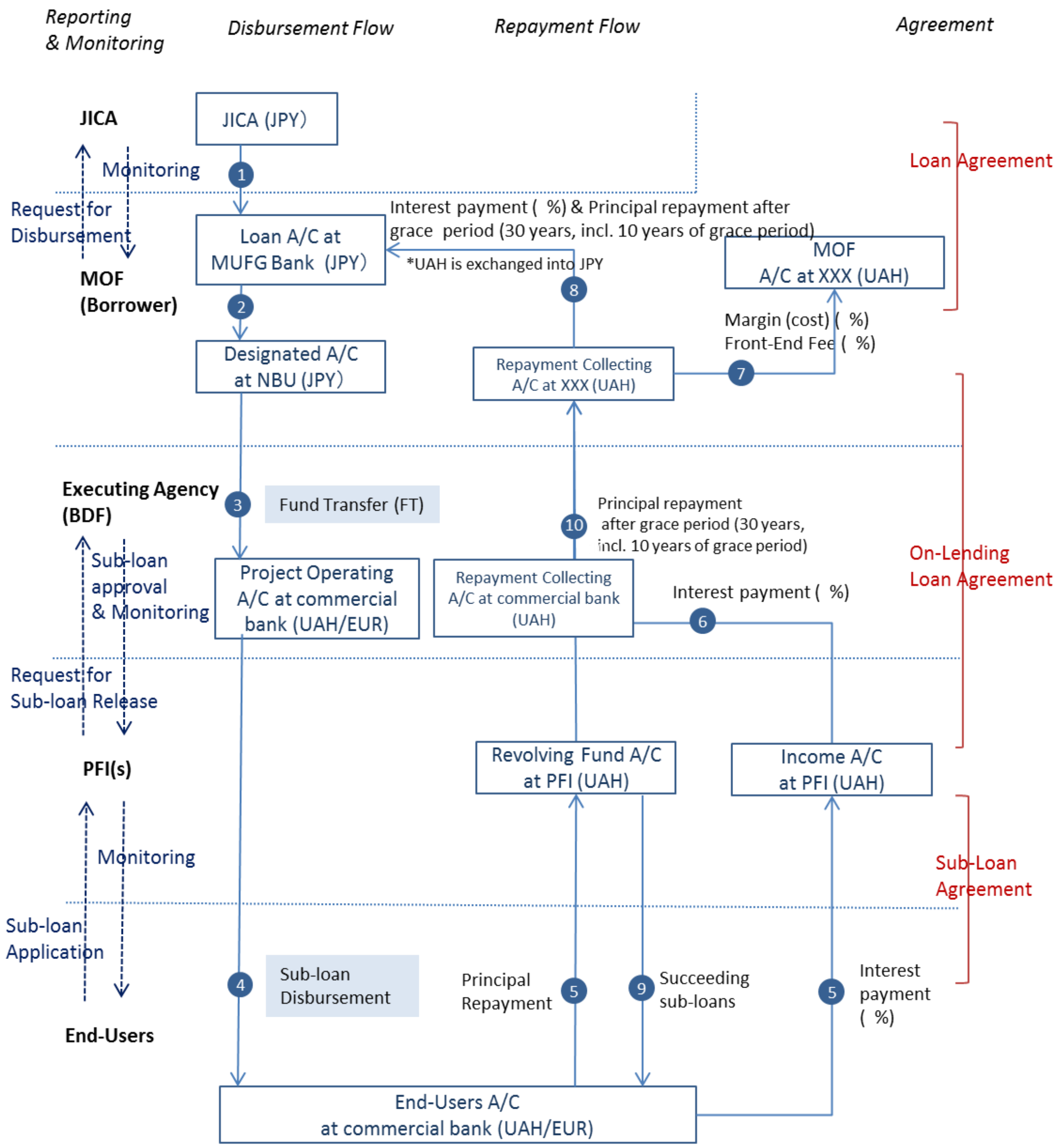
- Relevant bank accounts in Ukraine: Designated Account for receiving funds from the Loan Account in Japan, as well as the Project Operating Account for pooling the fund since the conversion from JPY to UAH or EUR until the disbursements to PFIs, shall be necessary. Banks for these purposes shall be selected by BDF.

- Disbursement request from PFI to BDF: To be in line with the conventional procedure for JICA's TSL programs, BDF shall check if the end-users who cleared the credit examination by PFIs are qualified for the TSL sub-loan and the submitted documents have no problems, the final approval for which shall be made by the Council. On this front, however, BDF requests for the similar procedure to the one under KfW-funded programs, in which BDF disburses a loan to eligible Partner Banks and conducts ex-post off- and on-site monitoring of sub-loan projects. This is based on their concern on the competitiveness of JICA's TSL product (in terms of the administrative burden and processing time) vis-à-vis existing loan programs funded by KfW as well as other IFIs (international financial institutions).

- Principal repayment and interest payment: PFI shall make the payments to MOF through BDF in the disbursement currency, as in the KfW-funded TSL programs. MOF's repayments to JICA shall take place after conversion from the received currency into JPY in the case of JPY loan.

- Management of the Revolving Fund: Each PFI shall manage the allocated fund until the repayment to MOF, meaning the fund repaid by the end-borrowers can be recycled for the loans to other customers.[3]

[3] Since PFIs' repayments to MOF shall be made in line with the schedule of MOF's repayments to JICA, it is less practical to assume that the fund repaid by PFIs stays at MOF for a long time.



Note 1: The disbursement between JICA and MOF will be "Advance Procedure", receiving a fund from JICA according to 3 or 6-month project financial forecast.
2: Regarding on-lending currency (MOF→PFI), the loan currency for GOU will be JPY. The currency disbursed from MOF to PFI will be in UAH. The exchange risk of transferring JPY to UAH will be taken by GOU.
3: All the interest rates in the Figure are tentatively mentioned, which will be discussed later between JICA and MOF/BDF.

Source: Survey Team based on the information provided by BDF.

Figure 9-1 Proposed Administrative Flow for JICA's TSL Operation

Term Sheet reflecting the loan conditions assumed as of this moment is shown in Table 9-1. While most of the conditions for the loans from MOF to PFIs and sub-loans from PFIs to the end-users shall be specified after the G to G loan conditions are finalized, sub-loan conditions also require the inputs from BDF, PFI candidate banks and KfW, for the conditions to be reasonable to the end-users and PFIs. Some of the key features of the design are listed below.

- End users: No restriction as long as the company is identified as an SME according to the definition in Ukraine and NOT listed on the negative list by the government.
- Area coverage: It is recommended to make it the whole country.
- Fund usage for sub-loans: Capital expenditure, with an exception of the working capitals accompanying the running cost of the invested facilities/equipment (e.g. costs for setting, fuels, consulting fees) up to a particular share of the loan amount (e.g. 20%[4]).
- Maximum amount for sub-loans: While the on-going KfW-funded programs adopt the upper limit of € 250,000, with an exception of the SME Energy Efficiency Projects Support Program (up to €500,000) starting this year, some of the Partner Banks responded to this survey interviews that the upper limit needs to be raised to €1,000,000[5]. Given that the EU standard is applied for the definition of SMEs, sizes of the capital investment may vary depending on the size of the end-borrower. For the investments in single machinery/vehicle, ceiling for the loan amount in existing programs is likely to be high enough in most cases, while for the investments in larger-scale factories/stores, it may necessarily not. After all, if JICA puts greater emphasis on financing micro/small companies' investments in relatively smaller items, similar level of the upper limit as the existing programs can be sought, while the higher level becomes necessary if larger investments by medium-size borrowers are also covered by the program.
- Share of the self-financing portion of sub-loan borrowers: Maximum share of sub-loan finance can be 100% as long as the amount is below the upper limit of the sub-loan amount. Self-financed portion for ensuring the discipline of the borrowers shall not necessarily by the requirement, as the quality of the potential borrowers is understood to be above a certain level from the asset quality for the on-going TSL programs.
- Interest rate for sub-loans: Needs to be competitive enough vis-à-vis the market loan interest rate.
- Credit appraisal for sub-loans: Relies on each PFI's criteria for the evaluation of collaterals, guarantees, repayment capacity, etc.
- Currency for sub-loans: UAH or EUR.
- Others: Those who have taken loans from other donors' projects are also eligible for this sub-loan. Also the second-time borrowing is possible as long as the first one is fully repaid, while the use for refinancing is not allowed.

[4] Generally applied number for JICA TSL programs focusing on financing capital investments. Given that the loans are used for the capital expenditures for enhancing efficiency and/or capacity, certain amount of working capital is required for covering initial running cost but should not be a substantial portion of the loan amount.

[5] For the maximum sub-loan amount per borrower, BDF requests €500,000 as a base line, with a later option to increase up to € 1,000,000 should there be justified demand from partner banks, provided appropriate prior review and approval arrangements.

Table 9-1 Term Sheet for JICA's TSL (Tentative Proposal)

Condition	Suggested Option(s)	Notes
Loan Conditions (JICA – GOU*)		
Currency	USD or JPY (undecided)	
Total Amount	(undecided)	
Tenor	20-30 years? (undecided)	
Grace Period	10yrs (undecided)	
Base Interest Rate	Fixed rate or floating	0.01% for Consulting Services
Repayment Cycle	Semi-annually?	
Interest Payment Cycle	Semi-annually?	
On-lending Conditions (GOU – PFI)		
Currency	UHA or EUR	
Total on-lending amount	Depending on each PFI's funding needs	
Tenor	Same as loan conditions	
Grace Period	Same as loan conditions	
Base Interest Rate	JICA loan interest rate + spread to cover BDF's operating cost for this program	On-lending interest rate is subject to 1) JICA's loan interest rate, 2) FX cost for currency conversion and 3) BDF's operating cost, but needs to be low enough to be competitive against, or at least the same level as, the existing programs.
Repayment Cycle	Before loan repayment	
Interest Payment Cycle	Before interest payment of the loan	
Sub-Loan Conditions (PFI – End-borrower)		
Currency	UHA or EUR	Potential end-borrowers' demand is greater for UHA
Sub-Loan Amount	Up to EUR500,000?	No need for financial contribution by the end-borrower to the sub-project
Tenor	Up to 7yrs?	
Grace Period	Up to 3yrs?	
End-user Interest Rate	On-lending rate + up to 5% margin	Interest margin for PFIs ranges from 1.65% to 4.72% in the existing TSL programs
Repayment Cycle	Depends on end-user sub-loan agreement	
Interest Payment Cycle	Depending on end-user sub-loan agreement	
Loan Usage	Capital investment: min 80% Working capital: max 20%	
Collateral(s)	Determined by each PFI	
Guarantor(s)	Determined by each PFI	
Borrowers' Eligibility		
Company Size	'SME' under GOU's definition	
Location	Nationwide	

(*) GOU = Government of Ukraine
Source: Survey Team

9.2 Necessity of Technical Cooperation and Its Proposed Outline

As for the proposal for technical cooperation to maximize the effect of the TSL project, judging from the fact that BDF hasn't experienced in implementing a JICA-TSL project, the first suggestion would be to provide JICA-TSL management support to the BDF. Specifically, the following is assumed to implement.

(i) Support for the operation and management of the TSL project: general management of the TSL project, monitoring and management of the sub-loans, preparation of progress reports to JICA;

(ii) Support for capacity building on TSL project implementation: promotion of understanding of TSL structure and administrative procedures through seminars, preparation for TSL sub-loans disbursement, day-to-day practices in TSL project implementation using operation manuals, preparation for meetings of Steering Committee, etc. (preparation of proposals and related documents), preparation of PFI orientation and documentation on TSL management;

(iii) Support for public relations activities: marketing activities, various partnerships with stakeholders to promote understanding of TSL among SMEs; and

(iv) Support for capacity building of TSL projects monitoring: monitoring of projects using operational and effectiveness indicators (preparation, analysis and updating of data for the indicators, preparation and revision of project monitoring forms and sub-loan implementation procedures, and preparation of reports to JICA and auditing agency (e.g. formatting and revising the annual report and collecting the necessary documents).

Secondly, for PFIs, a broad consulting or practical training program on SME targeting strategies could be implemented. According to the interviews with eight BDF partner banks and the questionnaire survey with them, in recent years, many Ukrainian banks, including state-owned banks, have adopted a business strategy of shifting the target of their loan customer from large companies to SMEs, despite the huge amount of non-performing loans, and in order to reduce the high transaction costs of SME financing, they need to accumulate know-how in SME lending/screening and management, improve the efficiency of the lending process (e.g., revising the credit decision-making model, utilizing IT, digital transformation, promoting collaboration with fintechs, modifying a credit scoring model, etc.), develop SME-focused loan products, and strengthen management support capacity. There is also a growing recognition that a new banking model needs to be rebuilt for this purpose.

In particular, as the NBU is trying to foster the domestic fintech industry with its *FinTech 2025 Development Strategy*, there is a discussion on strategic responses such as the ecosystem approach to SME finance, and how banks can work together with fintech to improve the SME financial services has become a major theme. Considering that nearly 96% of domestic SMEs are micro enterprises, the use of fintech in the domain of microbusiness financial services (e.g., client accounting and cash management, KYC client verification, client deposit and withdrawal data analysis, credit scoring, digitalization of customer relations processes such as credit management, etc.) are potentially in great need of support, including human resource development.

Thirdly, the needs for cooperation on SME management practices could be considered for SME end-users and/or the government/BDS providers. In this regard, according to SMEDO and officers of international organizations who understand SME managers and entrepreneurs through their projects, they lack the skills required for bank loan application, such as the ability to prepare the documents required to be submitted to the banks when applying for a loan, financial management skills, and the ability to explain their financial situation. There is a great demand for support measures to be taken in this aspect. It is an important skill for SME managers and entrepreneurs that can be directly related to obtaining bank loans, which is an area that should not be overlooked in the JICA-TSL as a SME loan scheme. However, the preparation of loan application materials and loan repayment management should be supported by the loan officers of banks as the lenders as necessary, and improving their support skills would be the most effective and sustainable approach.

The JICA Survey Team would propose the following realistic and effective technical cooperation (included in the TSL Consulting Services), based on the discussions with relevant organizations and BDF partner banks in terms of actual needs for support, while fully considering the assumed major scope of this TSL scheme and resources of Japanese side.

Table 9-2 Proposal on Technical Cooperation (for BDF and PFIs)

	Category	Contents
1	Background	Firstly, JICA SME-TSL project will be the first case in Ukraine. Secondly, PFIs selected among 8 BDF partner banks have shown their good performances in their previous banking operations as well as similar BDF's SME financing schemes. But still, the high level of loan interest rates is one of the major issues among Ukrainian SMEs. In a short-term, policy-based financing programs such as JICA TSL are quite necessary, but in a longer-term, there is further room for improving their SME-focused strategies and the operational efficiency in SME lending so that the banks could significantly and sustainably enhance SME lending in Ukraine.
2	Objectives	A: To assist PIU for implementing JICA-TSL scheme for SMEs B: To assist PFIs for improving their SME-focused strategies and operations
3	Scope	<u>A: Management for the operation of TSL project</u> A-1: Assistance for PIU's overall management A-2: Capacity building of PIU A-3: Institutional development of BDF as the leading provider of SME policy finance in Ukraine <u>B: Capacity building of PFIs</u> B-1: Improving of SME-focused strategies and the operational efficiency utilizing digital transformation B-2: Strengthening of skills to design financial products based on deep understanding on typical business types of SMEs and agriculture/ agri-businesses B-3: Improving of business support skills for SME customers, including support for loan application documentation and business plan-making

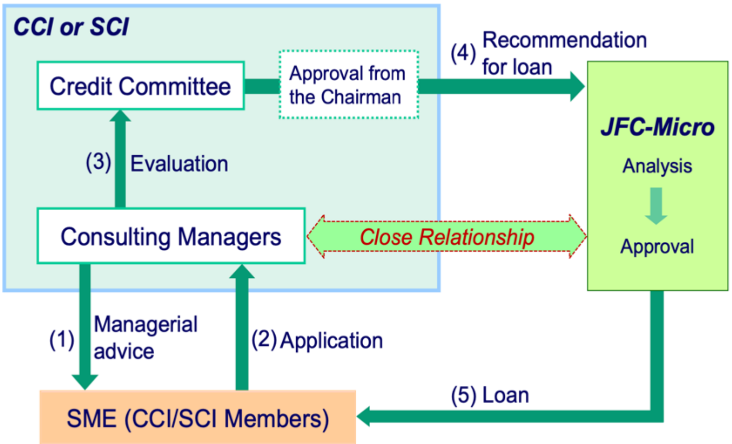
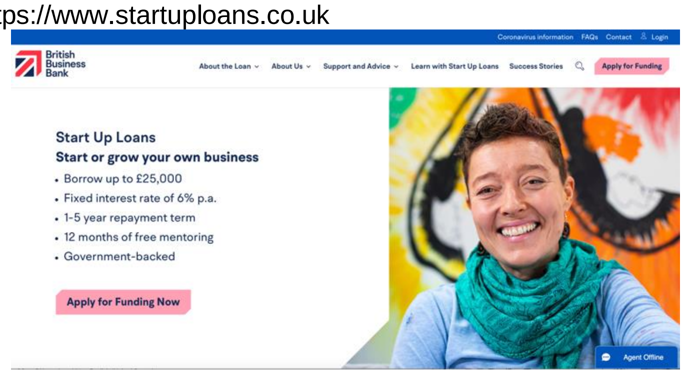
4	Activities as Consulting Services	A: Management consulting for the smooth operation of TSL project A-1: Day-to-day assistance for PIU's overall management A-2: Seminars/lectures and follow-ups for PIU in terms of TSL procedures, project monitoring, JICA reporting, ESMS policies, etc. A-3: Advise on the improvement of BDF's strategic planning, enhancement of corporate governance and streamlining the organizational structure of BDF, designing of new financial instruments as well as auxiliary services to support SMEs, etc. B: Trainings for PFIs (online & offline combined trainings on a quarterly basis) B-1: Collective seminars/webinars and customized trainings on SME-focused strategies, SME credit risk management, and the digital transformation for upgrading SME banking services B-2: Collective seminars/webinars on design of financial products for SME/agriculture customers and industry analysis (including typical SMEs' business types and agriculture/agri-business) B-3: Collective seminars/webinars on business support for SME customers, including support for loan application documentation and business plan -making
5	Reports/Documents	Overall Consulting Services Inception Report Project Completion Report Project Management Monthly Progress Report Quarterly Progress Report Annual Progress Report TSL Operation Implementation Manual
6	Term	3 years (since the start of TSL project)
7	Staffing	International Consultants (20MM/year) Team Leader (4MM/year) TSL Expert (4MM/year) SME Banking & Fintech Expert (4MM/year) Agricultural Banking Expert (4MM/year) SME Business Support Expert (4MM/year) National Consultants (30MM/year) Deputy Leader (6MM/year) TSL Expert (6MM/year) SME Banking & Fintech Expert (6MM/year) Agricultural Banking Expert (6MM/year) SME Business Support Expert (6MM/year)

Source: Prepared by JICA Survey Team, based on the interviews with SMEDO, BDF partner banks, international donors, etc.

In addition, with regard to technical cooperation for SMEDO, we focus on the importance of creating the environment necessary for smooth financing of micro enterprises, and propose the following technical cooperation (grant) that can be expected to have a synergistic effect with JICA-TSL.

Table 9-3 Proposal on Technical Cooperation (for SMEDO)

	Category	Contents
1	Background	The Ukrainian SME sector is made up of 1.5 million "micro enterprises and single entrepreneurs" (0-10 employees and Turnover≦€2 million), which is 95.9% of the total number of SMEs. Many inexperienced micro business managers lack basic business skills for their business growth such as business planning and financial management, which undeniably leads to problems in obtaining loans from banks. In this respect, SMEDO has significantly recognized the necessity of establishing a platform where micro business managers can improve their management skills so that they will be able to grow through smoothly and timely obtaining necessary loans from banks. Given a present situation where micro enterprises have faced difficulties in getting bank loans, it is highly expected that SMEDO will take an initiative to establish a collaboration mechanism among banks, BDS providers and micro enterprises in Ukraine.
2	Objectives	To assist SMEDO for establishing a collaboration mechanism among banks, BDS providers and micro enterprises
3	Scope	A-1: Drafting a concept paper on a SMEDO-led collaboration mechanism among banks, BDS providers and micro enterprises A-2: Starting the implementation of such a collaboration mechanism in Ukraine A-3: Business mentoring operations at SMEDO
4	Activities as Consulting Services	A-1: Assistance for drafting a concept paper on a SMEDO-led collaboration mechanism among banks, BDS providers and micro enterprises, which includes the following services; data collection on relevant benchmarking cases (e.g., JFC's "MARUKEI" Loan with free 6-month management advise (since 1973), "Startup Loan" by British Business Financial Services with free 12-month mentoring within the web-based platform (since 2013), and other similar schemes around the world), internal discussion and consensus-making within SMEDO, drafting a concept paper and its decision-making, designing a digital platform for the collaboration mechanism, and cost estimation & budgeting preparation for the implementation (e.g., time-charge based personnel expenses for partner BDS providers, usage fees for digital platform) [1st Year] A-2: Assistance for starting the implementation of such a collaboration mechanism in Ukraine, which includes the following services; negotiation with potential partners such as banks, BDS providers (including business consultants, web-based accounting services providers, fintechs on small business financial management, etc.), advertising and selection of partner BDS providers and bank(s), contract signing procedures with those partners, and organizing online seminars for those partner BDS providers and partner bank(s) [1st-2nd Year] A-3: Assistance for the business mentoring operations at SMEDO, which includes the following services; business mentoring activity, matching between micro enterprises and bank(s), and operational assistance for the partner BDS providers and partner bank(s) [2nd-3rd Year]

		Note 1. "MARUKEI" Loan (Managerial Improvement Loan) by Japan Finance Corporation (JFC)-Micro Taro Morita, 18 November 2010, Presentation on "MARUKEI" Loan https://slideplayer.com/slide/5681203/  *CCI = Chamber of Commerce & Industry **SCI = Society of Commerce and Industry Note 2. "Startup Loan" by British Business Financial Services (wholly-owned subsidiary company of British Business Bank) https://www.startuploans.co.uk 
5	Reports/Documents	Inception Report Concept Paper on a SMEDO-led collaboration mechanism in Ukraine Quarterly Progress Report Annual Progress Report Project Completion Report
6	Term	3 years
7	Staffing	<u>International Consultants (12MM/year)</u> Team Leader (4MM/year) SME Policy Lending & Business Support Expert (4MM/year) Agricultural Banking & Business Management Expert (4MM/year) <u>National Consultants (18MM/year)</u> Deputy Leader (6MM/year) SME Banking & Business Support Expert (6MM/year) Agricultural Banking & Business Management Expert (6MM/year)

Source: Prepared by JICA Survey Team, based on the interviews with SMEDO, BDF partner banks, international donors, etc.