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POLICY BRIEF FOR THE EUROPEAN COMMISSION: RECOMMENDATIONS FOR ENHANCING FINANCING MECHANISMS FOR UKRAINE'S RECOVERY

May 2024

Statement of the Ministry of Economy of Ukraine on the Ukraine Investment Framework

The launch of the Ukraine Investment Framework (UIF), a key component of the Ukraine Facility supported by the European Union, marks a significant milestone in expanding available financing for businesses. With a dedicated budget of €9.3 billion, the UIF aims to improve Ukraine's business financing landscape.

The UIF offers several benefits to Ukrainian businesses, including reduced collateral requirements for loans, grants and blended financing options. Technical assistance will also be available to help companies prepare applications and refine projects.

We are continuing to work with the European Commission, IFIs and DFIs to launch and implement the UIF. At the Steering Board meeting in April, the strategic guidelines of the programme were agreed upon, and the top-ups of the existing IFIs instruments are to be announced at the Ukraine Recovery Conference in Berlin. We are now also starting discussions on the second phase of the UIF, during which new instruments should also be launched.

However, it will take the joint efforts of the Ukrainian government, business and international partners to realise the full potential of the UIF.

The economic reforms and incentives are designed to benefit businesses. However, it is the entrepreneurs, whether large corporations, small or medium-sized enterprises, or startups, who can truly translate these reforms and incentives into real economic recovery and growth.

A key task for the Government is to improve Ukraine's business environment. In our recent RDNA3 report, we set out our priorities for promoting business development and attracting investments. This is a comprehensive list of measures that together should create the necessary conditions for economic growth. These include providing financial incentives (grants, loans and guarantees), addressing general infrastructure needs, strengthening capacity and improving the quality of the human capital.

The implementation of the Ukraine Plan will also contribute to improving the business environment. It foresees structural reforms in the public sector, a range of economic reforms aimed at developing the business climate and entrepreneurship, and steps to develop priority sectors that can drive rapid economic growth.

The Plan takes into account more than 130 proposals from the business community, identified after several months of work in sectoral groups. In addition, together with business representatives, we have identified steps to facilitate the implementation of the UIF, in particular with a view to improving the programmes of the international financial institutions, as well as development finance institutions and agencies, that will be involved in the programme.

We commend the ongoing policy and technical dialogue between all stakeholders, which has enabled the Government to improve policies and navigate IFIs programs to meet real business needs.

The Ministry of Economy of Ukraine would like to acknowledge the valuable contribution from the Kyiv School of Economics in preparing this Policy Brief on recommendations for enhancing financing mechanisms for Ukraine's recovery.

Deputy Minister of Economy of Ukraine **VOLODYMYR KUZYO**

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Introduction

Following Russia's full-scale invasion in February 2022, Ukraine experienced significant challenges, including GDP contraction (-29% in 2022), population displacement (3.7 mln IDPs and 6.3 mln stay abroad), disrupted logistics, and damage to energy infrastructure. While some risks were mitigated in 2023 and the economy grew (real GDP grew by 5.3% y-o-y), Ukraine remains reliant on external financing, with only $42bn of budget needs met for 2024. The annual requirement, as long as the war persists, is approximately estimated at an additional $40 billion/year. While there might be some reduction in this amount, it cannot be halved, and substantial external support, likely tens of billions of US dollars, will still be necessary.

To reduce this dependence and sustain reform momentum, private sector investment must become the primary driver of recovery. Pillar II of the Ukraine Facility outlines the establishment of a dedicated EUR 9.3 billion specific Ukraine Investment Framework aimed to mobilize investments for the reconstruction and modernization of Ukraine. This framework aims to mitigate the risks associated with financing programs for private and public projects in key economic sectors. The mechanism implies providing guarantees (for a maximum amount to EUR 7.8bn) and EUR 1.5 billion designated for blending operations and grants, and technical assistance to support the implementation of the Ukraine Plan.

- at least 15% of the guarantees are earmarked for small and medium enterprises;
- at least 20% of overall investment (Pillar I and Pillar II) is dedicated to green projects;
- 25% of Ukraine Guarantee is earmarked for European Investment Bank (EIB) sovereign and non-commercial sub-sovereign operations.
- It's important to note that these allocations do not preclude each other.

This initiative aims to enable Ukrainian and international companies to more easily secure funding for projects in Ukraine, thereby increasing investment in Ukrainian enterprises. However, the main channel for funding inflows are International Financial Institutions (IFIs), either directly or with intermediation of Ukrainian banks. We believe their historical approach to financing companies and projects in Ukraine needs updating and improvement to become more efficient and flexible in meeting the needs of Ukrainian businesses.

[1] The Ukraine Facility is the European Union's financial assistance programme for Ukraine. During the period of 2024-2027, EUR 50 billion from the EU will be allocated to finance the state budget, stimulate investment, and provide technical support in the implementation of the program.
https://ec.europa.eu/commission/presscorner/detail/bg/qanda_23_3353

IFIs framework in Pillar II

International Financial Institutions (IFIs) with a track record of operating in Ukraine adhere to established procedures and requirements for potential applicants. Ukrainian businesses seeking financing must meet compliance standards, which include demonstrating enough cash flow to service interest expenses on the borrowings, a history of capital creation, and considerations regarding their reputation as a main prerequisites. Moreover, the due diligence process is typically lengthy, especially for new applicants, often spanning up from several months to years. Moreover, IFIs tend to steer clear of sectors with extensive regulation, such as construction and extraction industries.

One significant challenge is that many IFIs lack well-developed regional networks, leading them to primarily engage with larger funding recipients. Consequently, smaller potential partners and projects often go unnoticed. Consequently, these factors significantly limit the pool of potential recipients of IFI funding, as IFIs provide loans to companies with a minimum ticket size of $ 10 million. However, IFIs can also collaborate with local banks to support SME lending. It's worth noting that the usual financing limits for local banks range from 2.5 to 5 million EUR. This creates a significant gap between financing programs offered by local banks and direct IFI cooperation with Ukrainian businesses for projects valued at 5 - 10 million EUR, which represent an important segment of Ukrainian businesses.

At the same time, IFIs backed by the EU Commission are expected to play a pivotal role in implementing recovery projects through various means, including grants, portfolio guaranties, risk-sharing arrangements, and project financing.

Investment guarantees are crucial for mitigating risks and attracting additional funds from Ukrainian banks and IFIs. It's estimated that this approach could potentially mobilize investments of up to EUR 40 billion through various financing mechanisms. It incentivises partners to supplement European guarantees with their own financing, thereby multiplying the amount available for lending to Ukrainian businesses. Additionally, a combination of loans and grants, known as blended instruments, should help reduce the cost of blended financing. Technical assistance financing is also proposed to support businesses in preparing and submitting their projects.

To accelerate the receipt of funding through Pillar II, the EU is expected to provide an initial wave of support by topping up existing IFIs programs (up to 30% of total guarantee capacity or EUR 2.34 billion).This will expand available financing limits for IFIs, enabling them to lend more to businesses meeting their standards and increasing coverage within these limits. However, this is unlikely to reduce finance-raising costs for Ukrainian companies, especially those unable to work with IFIs directly. Moreover, these mechanisms do not facilitate financing for investment projects beyond current IFI limits, such as those in early implementation stages (pre-feasibility or feasibility studies).

Current state of financing for businesses

Challenges in Ukraine's Business Recovery Funding

Ukrainian businesses predominantly rely on two funding sources: loans from domestic banks, amounting to $110.8 billion issued since March 2022 (including refinancing of existing debt programs, resulting in a substantially lower net inflow of financing), and funding from International Financial Institutions (IFIs) for the private sector, totaling over $5 billion during the same period to address urgent needs.

Despite the significant role played by Ukrainian banks, they struggle with limitations in providing independent, long-term financing at favorable rates, essential for successful investment projects. As of February 2024, the weighted average lending rates for non-financial corporations stand at 15.9%, with rates varying across enterprises, particularly affecting small businesses, which face a rate of 22%.

The Government of Ukraine initiated the "Affordable Loans 5-7-9%" program, primarily focusing on small and medium enterprises (SMEs) in agriculture, trade, and services. Managed through Ukrainian banks and partially supported by international aid, the program's available financing and scope fall short of meeting full recovery needs. From March 2022 to December 2023, project financing under this program totaled around $4.3 billion, accounting for 40% of total net corporate banking loan portfolio. Investment projects accounted for only 6%, with a significant 82% directed towards agriculture, trade, and services.

Private investment remains limited since the onset of the full-scale invasion, with new investment projects totaling $1.7 billion over the period. Potential investors grapple with unavoidable military risks, especially in projects involving extensive construction. Moreover, many Ukrainian businesses struggle to provide collateral for loans.

Needs assessment

The World Bank in the third Rapid Damage and Needs Assessment (RDNA3) estimates that the direct damage to assets and infrastructure in Ukraine is $152 billion, with housing, transport, energy, and agriculture being the most affected sectors. The estimated cost for recovery and reconstruction stands at $486 billion.

In-depth analysis by the Kyiv School of Economics (KSE) has identified significant funding gaps in proposed recovery investment projects, highlighting the need for financial support for small and medium enterprises and large national projects. Sectors with a high multiplier effect on the broader economy and substantial export capabilities include agriculture, energy, transport, green steel, and critical materials. The total amount of investments (for the development of these sectors) needed to achieve the strategic goals of the Government of Ukraine is estimated at $292 billion over the next 10 years. As of May 2024, companies in Ukraine, both state-owned and private, have submitted applications for over 830 projects amounting to $148billion. Of the announced projects, only 28% are ready for implementation. Thus, there is a significant deficit of new projects totaling $144 billion, with the largest gaps being in the energy sector (-$72.2 billion), transport (-$27.8 billion), and the agro-industrial complex (-$27.1 billion).

Insurance of war-related risks

According to projections from the European Bank for Reconstruction and Development (EBRD), prolonged conflict or fragile ceasefire agreements in Ukraine may prompt investors to seek increased insurance coverage for risks related to war. Different estimates suggest that up to 80% of expected foreign direct investment (FDI) and other private investments may need to be secured by insurance. However, investors might not have the capacity to fully cover these costs, resulting in a substantial funding gap. Additionally, higher insurance premiums could further limit the scope of potential projects.
This will particularly impact capital-intensive projects with long implementation periods, such as energy, processing industries, extraction of critical materials, green metallurgy, and other complex projects.

[2] https://ukraine.un.org/sites/default/files/2024-02/UA%20RDNA3%20report%20EN.pdf
[3] https://kse.ua/wp-content/uploads/2023/12/INVESTMENT-OPPORTUNITIES-IN-UKRAINE.pdf

Challenges to current framework in the context of needs

Historically,IFIs have played a key role in facilitating investments in Ukraine. However, given the sharp increase in recovery needs, their approach to partnerships needs to adapt.

- Businesses often cannot afford the lengthy time frame required for full due diligence processes.
- Moreover, sectors that are crucial for driving recovery are heavily regulated, making them less attractive to IFIs.
- While grants and blending programs with Ukrainian banks can help reduce blended lending rates, and guarantees can lower collateral requirements, the availability of these programs is very limited, and interest rates remain high.
- Project financing requirements are typically met only by well-established businesses, leaving fewer opportunities for startups.
- Additionally, IFIs tend to work with projects valued over 10 million EUR, creating a financing gap for projects in the 5 to 10 million EUR range, as Ukrainian banks typically finance projects valued between 2.5 and 5 million EUR.
- Before the war in Ukraine, there was a limited number of companies capable of working directly with IFIs. The war has further reduced their numbers, and there is a lack of mechanisms for project financing necessary for the emergence and development of new companies.

Discussion Forum with Businesses, Government, and IFIs

KSE engaged in a dialogue with the Ukrainian Government, businesses, and IFIs to explore ways to enhance the financing of Ukrainian enterprises during the war. The primary focus was on bolstering institutional capacity for funding viable projects, as Ukrainian businesses navigate financial, structural, and human capital challenges.

Local SMEs struggle to access equity financing and are often overlooked by Development Financial Institutions (DFIs) due to high funding thresholds and bankability issues related to governance and transparency of business models and capital formation. DFIs mainly promote their debt instruments, sidelining equity financing needs. To bridge this gap, the solution would be to enable SME access to equity financing by supporting local private equity managers with DFI commitments. These managers can expand deal flow in underserved segments, helping SMEs grow and meet DFI standards for bankability and environmental, social, and governance (ESG) compliance. Boosting investment infrastructure and increasing DFI-backed funds will directly enhance SME development in Ukraine.

This issue is especially acute for tech startups who need equity financing, not loans. Private equity and venture funds could alleviate this problem, if they were supported by IFIs in programs similar to what is currently implemented with bank guarantees and blended instruments. Engaging more private equity funds would open more options for pre-bankable projects and startups and allow them to grow and reach the necessary maturity for bankability.
For private manufacturing companies displaced by occupation, establishing new facilities requires time and investment. If financed through loans, producers face months of interest expenses before achieving their first sales and positive net cash flows, especially with increased logistic costs. Implementing negotiated grace periods on interest payments could ease this burden.

Enterprises focused on extraction and critical materials must invest heavily in geological research, inventory confirmation, and engineering development during pre-project stages. Utilizing funds designated for technical assistance under Pillar II for surveying, analysis, and feasibility studies could reduce project risks and enhance the profitability in the long term.
Partner banks working together with IFIs on guarantee programs noted that a broader scope of target sectors is needed, as the narrow set of sectors could reduce flexibility when fast decision making is required in the war environment.

IFIs highlighted the need for further reforms and policies to foster market competitiveness and improve the quality of the investments projects, represented by Ukrainian Businesses. Limited information and ambiguous requirements for accessing bank loans were also concerns. Defense risks have impacted leasing solutions, previously an effective means of financing equipment purchases.

At the same time, IFIs plan to expand their existing programs and continue supporting Ukrainian businesses, particularly small and medium enterprises (SMEs).

- Risk-sharing programs. The EBRD and IFC (and other IFIs) have introduced risk-sharing programs, with partner banks covering 50% to 80% of financing, allowing Ukrainian companies to receive financing without adding extra burdens on collateral. Banks can lend without a significant rise in reserves for these loans or a notable impact on risk-weighted assets.
- Grants and technical assistance are additional areas of IFIs' involvement. However, businesses seeking IFIs' programs face extended due diligence and strict eligibility criteria.
- Insurance coverage for war-related risks, specifically freight, property, and inventory insurance, could bolster business financing. This could involve leveraging donor funds and the Multilateral Investment Guarantee Agency (MIGA).
- Enhancing training and consulting for Ukrainian enterprises in project planning, legal structuring, and transparent reporting would improve their bankability and increase the likelihood of financing approval.
- Promoting easier access to bank financing through the "Affordable Loans 5-7-9%" program is essential, along with showcasing successful SMEs financed through this initiative and IFIs' consulting support.

Conclusion and Considerations for EU

In conclusion, a successful recovery in Ukraine will necessitate further reforms and changes in the business environment, which is the focus of the Ukraine facility approved by the EU. Ukrainian businesses will need to adapt to European markets and rules to remain competitive. However, our analysis has primarily focused on the framework of International Financial Institutions (IFIs), as their involvement will be crucial.

Therefore, we urge the EU Commission to consider the following recommendations:

1. Increase the availability of grants or tools to reduce effective interest rates through introducing blending instruments. While the tools in IFI's proposals address the collateral issue, they do not tackle the problem of high interest rates. It's important to develop and deploy de-risking instruments and financial support mechanisms to enhance interest rate affordability across all sectors.
2. To provide special funding programs/grants for private companies to bolster the resilience of critical infrastructure against war-related risks, including acquiring emergency equipment to sustain services in sectors such as telecommunications, energy, and medical services.
3. Implement specialized initiatives for SMEs operating in de-occupied regions and areas with high shelling risks.
4. Introduce specialized financing initiatives for industrial parks to facilitate business return, including compensation for interest rates, connection to engineering networks, and special tax regimes.
5. Develop project financing to fund industrial projects at the initial stages, for both SMEs and large national projects, which could include grace interest periods.
6. Create a support system for startups to encourage innovation and growth by engaging private equity and venture funds, specifically in the tech sector.
7. Promote project finance and development finance to stimulate equity investments and support capital and working capital needs.
8. Involve more international and domestic financial institutions, as well as credit agencies, to diversify funding sources.
9. Extend the financing limits of IFIs to cover the gap between local banks (projects of 2.5 - 5 million EUR) and IFIs (projects over 10 million EUR), enabling funding for projects valued at 5 - 10 million EUR.
10. Enhance technical assistance and financing support for feasibility studies, specifically for critical materials and extraction industries, to ensure projects are investment-ready. Introduce measures to guarantee that technical assistance benefits the recipients, rather than serving as an additional income stream for IFIs.
11. Include Export Credit Agencies into the scope of Pillar II to facilitate the insurance coverage.
12. Enforce a no-refinancing policy under Pillar II to ensure financing is directed towards new projects rather than refinancing existing credit lines.

Without these measures, there is a risk that Pillar 2 will not achieve its goal of engaging IFIs to drive Ukraine's recovery.

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