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PUTTING IN PLACE THE CONDITIONS TO SET UP A CREDIT GUARANTEE SCHEME FOR AGRIBUSINESS SMEs IN UKRAINE

Pre-feasibility Study

Project Summary
March 2016

OECD Eurasia
Competitiveness Programme

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PUTTING IN PLACE THE CONDITIONS TO SET UP A CREDIT GUARANTEE SCHEME FOR AGRIBUSINESS SMEs IN UKRAINE

The project *Putting in Place the Conditions to Set up a Credit Guarantee Scheme for Agribusiness SMEs in Ukraine* (CGS project) emerges out of the OECD Sector Competitiveness Strategy for Ukraine, which identified high-potential sectors in the Ukrainian economy and competency-based barriers that were hindering their development. Agribusiness is a key sector identified in this work, and access to finance for agribusiness SMEs was identified as a major constraint hampering the sector's development. Within the frame of the CGS project, the OECD designed an instrument to guarantee a proportion of loans to agribusiness SMEs of 100-2000 hectares. The scheme was designed on the basis of a pilot covering four Oblasts (Cherkassy, Vinnytsia, Poltava, and Kharkiv), before being scaled up as results are revealed. This project was launched in September 2013 and concluded in February 2016. It was fully **financed by the Government of Sweden**.

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GLOSSARY

Agribusiness	Agribusiness represents a comprehensive value chain that covers all aspects of agricultural production (*e.g.* farming, seed and other agricultural inputs, crop production, post-harvest handling, and animal husbandry), processing, and distribution (e.g. wholesaling, retail sales to final consumers) (FAO, 2010; OECD, 2008).
Agricultural SMEs	In this report, agricultural small and medium-sized enterprises (SMEs) refer to enterprises farming 100-2000 hectares of land.
Counter-guarantee	A counter-guarantee is a form of back-to-back guarantee given to a CGS by either the state or international organisations, in exchange for a fee, to cover a portion of the potential losses when guarantees are paid out. It is as a supplementary risk-sharing mechanism.
Farmers	In this report, "farmers" refers to land-based agricultural SMEs.
Leverage ratio	Leverage ratio refers to the "multiplier effect" – the size of the scheme's guarantee portfolio relative to the size of its fund.
Moral hazard	Moral hazard describes a situation in which agents do not bear the full cost of their actions and are thus more likely to take such actions. It is particularly an issue when a party undertakes a risky action knowing that it is protected against the risk and that others will share/bear the cost.
Pari passu basis	*Pari passu* refers to loans, bonds or classes of shares that have equal rights of payment, or equal seniority.
Primary features	In this report, primary features are defined as those aspects which constitute the basic concept of the CGS. Broadly, they are the policy decisions – here, they are taken as mission, target and type of CGS.
Secondary features	In this report, secondary features are defined as all other design features of the CGS. These include coverage rate, pricing, legal form and procedures for guarantee application and claims payout. They are defined based on the specific institutional and market environment, international best practice, and projections of the financial model.
Small and medium-sized enterprises (SMEs)	In 2012, the State Statistics Service of Ukraine started to classify small- and medium-sized enterprises (SMEs) largely in-line with the EU definition – the exception being that it excludes a balance-sheet criterion. SMEs are now defined as enterprises with under 250 employees and generating under EUR 50 million in annual turnover.

EXECUTIVE SUMMARY

The design of a Credit Guarantee Scheme (CGS) in Ukraine is an initiative supported by a Task Force composed of representatives of the Ministry of Agrarian Policy and Food, the Ministry of Economic Development and Trade, the Ministry of Finance, and the National Bank of Ukraine (NBU). The present pre-feasibility study assesses the feasibility, desirability, and next steps related to the establishment of a CGS in Ukraine, which will aim at facilitating access to credit for specific segments of agricultural small and medium-sized enterprises (SMEs) – initially land-based SMEs. The report defines the main primary features of a CGS based on international practice and desk research, presents initial best-fit scenarios for Ukraine, and develops a methodology to select the most suitable partner banks for the scheme. The main goal of the work underlying the pre-feasibility study is to establish a common understanding of the CGS concept among key stakeholders – namely, the Ukrainian government, regulatory bodies, commercial banks, international donors, and targeted beneficiaries, and to assess the desirability and feasibility of implementing such a scheme in the Ukrainian context.

This context is particularly difficult in important respects, being characterised by high levels of macroeconomic and political uncertainty, a need for structural reforms in the agricultural sector, weak institutions, and a high risk of corruption. For these reasons, the design and implementation of the scheme must be adapted to Ukraine's realities. An incremental approach, allowing space to pilot certain arrangements and then modify or upscale them as warranted, would seem necessary.

The analysis is based on interviews with the scheme's potential stakeholders in Ukraine, as well as desk research looking at international practices and the current environment in Ukraine. The main findings confirm significant interest in such a scheme, since, if implemented under the right conditions, it could generate direct benefits to agricultural borrowers. In addition, the CGS set-up could contribute to improving local commercial banks' understanding of the target segments and the technologies and methodologies required to appraise and extend credit to them. Ultimately, it is expected that a CGS could increase the banks' appeal for this underserved market and their willingness to lend to this group over the long term.

Initial recommendations are provided on the scheme's institutional structure and primary features. It is proposed that the mission of the scheme be to increase access to finance in Ukraine's agricultural sector, and the target segment should be farms sized 100-2000 hectares (ha) initially in the Cherkassy, Vinnytsia, Poltava, and Kharkiv regions. It is proposed that the CGS be a public/private legal entity seeded with international donor funds, registered in accordance with the "Law of Ukraine on Financial Services and State Regulation of Financial Services", and that it should provide individual guarantees. In addition, a method is suggested for carefully screening potential partner banks.

The secondary features of the scheme and its processes (such as risk-management techniques) will be developed in the project's feasibility study and its technical report – based on market analysis, international good practices, and elaboration of the scheme's financial model.

The content summarised in this project report was discussed at the project's first, second, and third Task Force meetings held in Kyiv in June 2014, October 2014, and February 2015 respectively. Members of the Task Force, including representatives of the government and the National Bank of Ukraine, provided feedback on the analysis and raised issues that will be further addressed in the following stages of the project.

1. INTRODUCTION

1.1 Rationale for the project

1.1.1 Agricultural development in Ukraine

In its *Sector Competitiveness Strategy for Ukraine* (2009), the OECD identified agriculture as a sector with important strategic advantages for Ukraine. World consumption and trade of agricultural products is expected to expand rapidly over the coming decade (OECD/FAO, 2011), and Ukraine is well-positioned to take advantage of this growing demand. The country is located close to large and growing markets in the Eurasia and Middle East/North Africa (MENA) regions, has favourable agro-climatic conditions, and holds 41.6 million ha of agricultural land[1], with one-third of the world's most fertile soil. The sector has been underperforming, however, with high variability of production suggesting that important productivity gains can still be achieved.[2] Accelerating soil degradation and a concomitant increase in droughts over the past 15 years makes the need for enhanced investment and productivity gains more pressing.

Boosting the productivity of the agricultural sector is expected to have a significant impact on the Ukrainian economy as a whole. Berlin Economics (2012) has forecast that sectoral productivity increases of 30% – that is, to roughly catch up with Poland – could increase Ukraine's GDP by 4.4% over the medium term (5 years) and 12.5% over the long term (10 years). It also notes that this GDP growth would particularly benefit the poor, via wage increases for unskilled workers and income increases for rural households.

The competitiveness of the Ukrainian agricultural sector is lagging despite its strong potential. This is partly the result of incomplete markets and of policy and regulatory distortions that impede fair competition and choke off smaller players.

Agricultural SMEs in Ukraine face limited access to finance, low access to technology, and deteriorating fixed assets. There is still no legislative framework to mark them as fully fledged participants in markets for inputs, financial resources, and agricultural produce. They lack access to labour protection and social-security systems, and they have virtually no access to support programmes (MoAPF 2015). This situation contrasts with Ukraine's large, vertically integrated "agriholdings", which tend to be the 30,000-200,000 ha of land range and can reach up to 500,000 ha (UCAB, 2013). Through vertical integration, these holdings are able to minimise supply-side risks such as price volatility, and use modern managerial techniques and production technologies to gain a competitive edge over other enterprises operating in the country (World Bank, 2013). This is also facilitated by their preferential access to factors of production, particularly finance – since they are able to access international capital markets – as well as their preferential access to policy makers (traditionally) (World Bank, 2013).

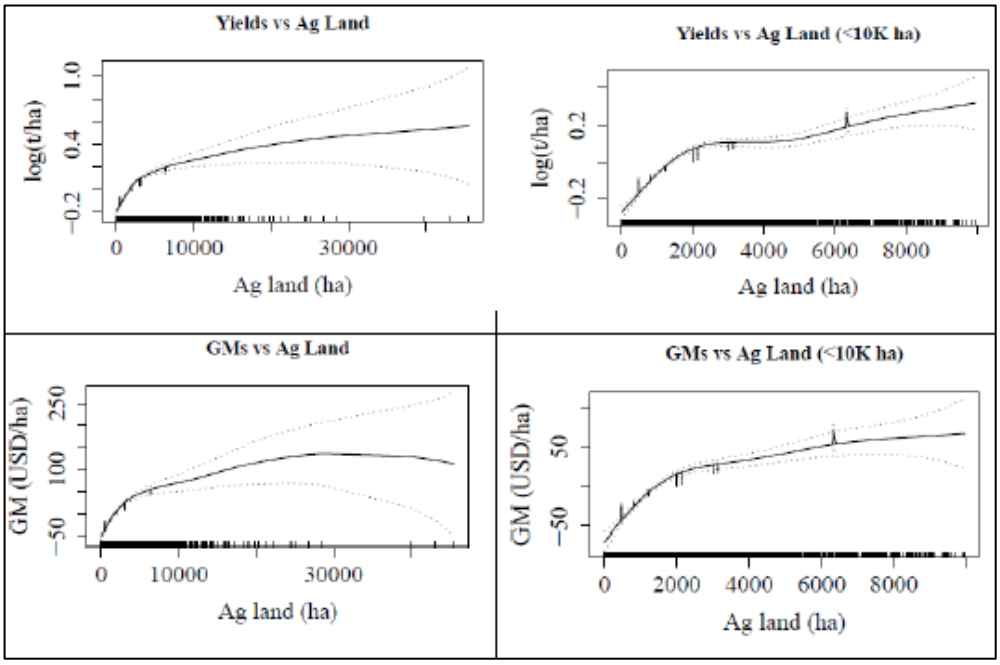
This is not necessarily an optimal development. An analysis of winter wheat yields in Ukraine suggests that the productivity effects of land consolidation in Ukraine plateau at 3,000 hectares, and gross margins even begin to decline after 30,000 hectares (see Figure 1). In addition, the recent financial turmoil significantly affected the performance of several agriholdings in Ukraine, suggesting

[1] By comparison, France, which holds the greatest share of agricultural land in the European Union, holds 29 million ha of agricultural land.

[2] For instance, the World Bank (2013) shows average wheat yields in Ukraine to be 2.2 tonnes/hectare (t/ha), whilst the top 30% of performing farms record wheat yields of 5-7 t/ha.

that these agriholdings may not be increasing their market share because they are the most efficient type of enterprises in Ukraine, but rather because they are favoured in the Ukrainian environment. Since this event, commercial banks and others have become increasingly interested in initiating relationships with smaller agricultural players.

Figure 1. The relationship between land productivity and farm size in Ukraine (2009)



Source: World Bank (2013)

In addition, small locally owned farms can generate significant economic multipliers for rural economies, by boosting rural employment and diversifying economic outputs. The farming practices of smaller farms also tend to be more environmentally friendly than large, industrial farms. The use of monoculture (favoured in industrial farming) can negatively affect yield per hectare, and the use of heavy machinery and pesticides can increase the incidence of early soil erosion. Improving the business environment for smaller agricultural players in Ukraine could therefore increase biodiversity, open up new market opportunities for organic farming (which could attract new investors), increase environmentally friendly production more generally, and create economic spillovers for rural economies as a whole.

One of the most prominent market failures for agricultural SMEs in Ukraine is access to land. There are more than four million micro-farms in Ukraine, which produce food mainly for subsistence purposes yet accounted for 38% of Ukraine's total agricultural land and almost 45% of its gross agricultural output (GAO) in 2014.[3] An important step in increasing general productivity is land consolidation, and under normal conditions it is likely that the micro-farms would be bought by larger players. However, the fragmentation of land in Ukraine is largely attributable to the country's land-allocation process after the collapse of the Soviet Union[4] and its subsequent moratorium on land sales, which has been in place since 2001. The OECD (2015c) suggests that whereas the moratorium on the

[3] Data from the Ministry of Agrarian Policy and Food, in its Agricultural Strategy for 2015-20.

[4] At this time, the country's collective farms were broken up and their workers were each awarded with a land parcel of around 2 ha.

sale of agricultural land aimed to protect small landowners, it mostly benefitted large producers and state-owned players. The moratorium reduces land value, makes land valuation difficult, increases transaction costs to access land, and limits access to finance as land cannot be used as collateral. The moratorium does not affect all agricultural players equally, and may benefit larger players whilst creating significant transaction costs and fixed costs for smaller players, who cannot absorb such costs and do not have the bargaining power to achieve favourable outcomes from the public authorities currently responsible for land allocation.

To date, the moratorium on the sales of agricultural land has been extended six times, resulting in an informal market of "land leasing". Around 84.5% of agricultural land in Ukraine is leased. Most of it is owned by pensioners whose children have moved away and this contributes to leasing rights' being significantly undervalued – in 2012 they typically ranged from hryvnia (UAH) 200/ha to UAH 600/ha, but are often paid in kind. The absence of a formal land market in Ukraine is the principal growth constraint[5] for agricultural SMEs[6], as they cannot expand their land holdings with legal certainty and are hindered in their ability to access finance since they cannot use their land as collateral. This is one of the principal barriers affecting SMEs competitiveness, because it incentivises short-term business planning, informality and a lack of transparency, low investment, and inadequate training of staff. It also impedes investment in infrastructure, especially for irrigation, and reduces incentives for maintaining soil fertility.

Resolving these market failures for SMEs should have spillovers for the sector as a whole. It would create a more liquid market, allowing small, high-performing enterprises to increase their scope of activity and/or turnover, and for micro- or poorly performing/languishing farms to fall out of the market and be absorbed by these high-performing smaller players whose activities and industrial structure would be more similar to their own. As a consequence, the consolidation of the market would result in healthier competition for Ukraine's agriholdings and in a more appealing sector for investors.

Over the past years, the OECD's work has focussed on identifying the barriers to competitiveness that agricultural SMEs face in Ukraine, and providing policy recommendations to address them – for instance, the development of co-operatives and increased financial literacy, the design of internships programmes with private firms, and a review of investment policies in the sector[7]. The barriers are numerous, however, and addressing some of them will require reforms to other institutions, such as the strengthening of land-tenure rights and making the land administration more accessible, reliable, and transparent. Also, the responsibilities of the central government versus local authorities should be clearly defined to promote efficiency, reduce corruption, and enhance law implementation and enforcement. Institutional arrangements for land management may also need to be reformed to reduce the monopolistic position of the State Agency on Land Resources (SALR), which is perceived as a corrupt organisation whose discretionary power facilitates the imposition of extra-judicial levies (OECD, 2015c).

While the present report focusses on one approach for improving access to finance for agricultural SMEs, the success of a Credit Guarantee Scheme will depend on measures to address these other barriers, some of which are discussed below. The impact in isolation is likely to be far more limited than its effect as part of a broader package of reforms affecting both the agricultural sector and the wider business environment.

[5] As was confirmed in an OECD/IPC survey that was conducted in key agricultural regions of Ukraine in early 2015 (p. 21).

[6] In this report, agricultural SMEs refer to enterprises farming between 100 and 2,000 ha.

[7] See *Sector Competitiveness Strategy for Ukraine* project (www.oecd.org/globalrelations/ukrainesectorcompetitivenessstrategy.htm)

1.1.2 Limited access to finance for agricultural SMEs

The OECD (2015c) confirms that access to finance remains limited, especially for SMEs. In the 2013-14 Global Competitiveness Report, 16.7% of respondents identified access to finance as the main obstacle to doing business (in a single-choice survey), ahead of corruption and inefficient public administration. The events of 2014 that reduced liquidity and increased external risks have hindered access to financial resources even further.

Although the sector offers a high return on capital compared with other sectors in Ukraine,[8] very few bank loans go to agriculture.[9] Creditors are reluctant to provide capital to the sector on account of macroeconomic and financial sector risks, as well as agriculture-specific risks. The latter include high variability of production, low financial literacy and poor-quality bookkeeping, in addition to the general unpredictability of the sector attributable to distortive policy interventions. The former are factors that discourage lending in Ukraine more generally and make banks more risk-averse. These factors include limited bank funding and high exposure to exchange-rate risk, a high level of non-performing loans (NPLs) (particularly following external shocks, often linked to exchange-rate movements), and low return on assets (OeNB, 2015). This context makes credit allocation decisions highly conservative, with high interest rates and short maturities[10] – more so for risky sectors. All this must be seen against a backdrop of macroeconomic and political volatility, as well as institutional weaknesses that make for a very risky contracting environment.

Access to finance is a particularly critical issue for agricultural SMEs in Ukraine because, besides having little access to bank credit, they have little or no access to capital markets and often have limited capability to self-finance their investments or working-capital needs. In OECD countries, the most common source of external finance for SMEs is debt-based finance provided by banks. Lending in Ukraine is highly collaterised, however, and agricultural SMEs usually have limited collateral to guarantee their debt.

When loans *are* extended, it is usually on terms that are difficult for SMEs to absorb, such as very high and volatile interest rates. Between 2012 and 2013, interest rates on agricultural loans fluctuated from 15% to 23% for loans in local currency and from 7% to 12% for loans in foreign currency, whilst rates for some SMEs reached 40% (OECD, 2015; UCAB, 2014). During the recent financial turmoil the National Bank of Ukraine raised the country's key interest rate to 30%,[11] leading to an almost complete shutdown of agricultural lending at any rate. Even if SMEs are willing to undertake the liability of buying credit at such rates over a longer term, the fact that banks tend to offer loans only with short maturities means that very few SMEs can use such loans for investment, prolonging long-term underinvestment – for instance in agricultural machinery, equipment and storage. These two features of the credit market for SMEs in Ukraine – high interest rates and short maturities – mean that SMEs can rarely access credit for investment purposes, which in turn means that they cannot invest in fixed assets that could serve as collateral until the moratorium on land sales is lifted for agribusiness SMEs, resulting in a vicious circle.

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[8] The World Bank (2013) found that returns on capital in agriculture were 2.5 and 6.4 times that in the industry and service sectors respectively, averaging 25% between 2002 and 2007. In addition, these returns have continued to grow throughout the period.

[9] The World Bank (2013) found Ukraine's share of agricultural loans relative to agriculture's contribution to GDP to be significantly lower than in the European Union.

[10] For instance in 2014, half of all local-currency corporate loans had maturities of less than one year and only 12% had maturities of five years or more (OECD 2015b). By way of comparison, 21.5% of Romanian local currency corporate loans were for five years or more (National Bank of Romania, 2014).

[11] This was a measure to stem decline of the hryvnia and stabilise money markets.

1.1.3 Mixed policy measures and results

The Ukrainian government has implemented some policy measures to address these constraints, mainly through the Ministry of Agrarian Policy and Food. It has generally not been very effective, however, at addressing the underlying structural market and non-market barriers that impede agricultural SMEs' access to finance. According to the OECD (2013), the majority of Ukraine's producer support is in the form of input subsidies, of which the vast majority – 86% in 2010-2012 – is provided in the form of the "value added tax (VAT) accumulation mechanism"[12]. The remainder is provided in investment grants and commodity input subsidies, predominantly for seeds. The component of support targeted at encouraging agribusinesses to access traditional bank finance constitutes a very small share: about 5% of all input subsidies in 2010-2012. This component supports SMEs seeking to acquire loans at the high market rates, but it does not incentivise banks to decrease their rates. Furthermore, the programme does not target SMEs, its process is opaque, and it receives minimal or no monitoring and evaluation.

Ukraine has a mechanism for providing credit guarantees to enterprises, a public guarantee scheme that is completely funded from the state budget. It is legislated under the "Law on the State Budget of Ukraine" and is administered by a small team within the Ministry of Finance. However, OECD consultations with officials and experts in Ukraine indicate that the guarantees are granted by decisions of the Cabinet of Ministers and in practice have been allocated to large agro-holdings and state-owned enterprises. The existing scheme does not necessarily target SMEs, and the evidence suggests that such schemes are usually highly exposed to moral hazard[13] and political influence.

The country does have some experience of donor-funded credit guarantee schemes. One is that of the United States Agency for International Aid (USAID), which provides guarantees on loans that credit unions extend to agricultural SMEs. The scheme has not been very active, however, due to the insufficient liquidity of credit unions in Ukraine, and the fact that credit unions can legally lend only to individuals. The European Investment Bank and the European Investment Fund (EIB/EIF) are working on the design of a guarantee facility that will be operational in Ukraine in mid-2016. This scheme is expected to guarantee a fixed share of defaults on the partner banks' portfolio of loans provided to an agreed-upon set of eligible firms. The firms will be SMEs under the European Union (EU) classification.

1.1.4 Tailored policy recommendation

In this context, a CGS could be established as an instrument to share risk with and reduce the costs of lending for commercial banks in Ukraine, in order to encourage them to start lending to the underserved segment of agricultural SMEs and thereby increase the volume of formal finance available to these SMEs. Preliminary demand and market assessments conducted in 2012 under the project *Sector Competitiveness Strategy for Ukraine Phase II* recommended the design of a CGS targeting agricultural SMEs of 100-2,000 ha operating in four regions: Cherkassy, Vinnytsia, Poltava, and Kharkiv.

[12] This is a form of producer support whereby agricultural producers can accumulate the VAT due on their primary and processed products in special accounts. Accumulated funds should be directed to cover the VAT on purchased inputs, while the residual sum can be used for other production purposes (OECD, 2015).

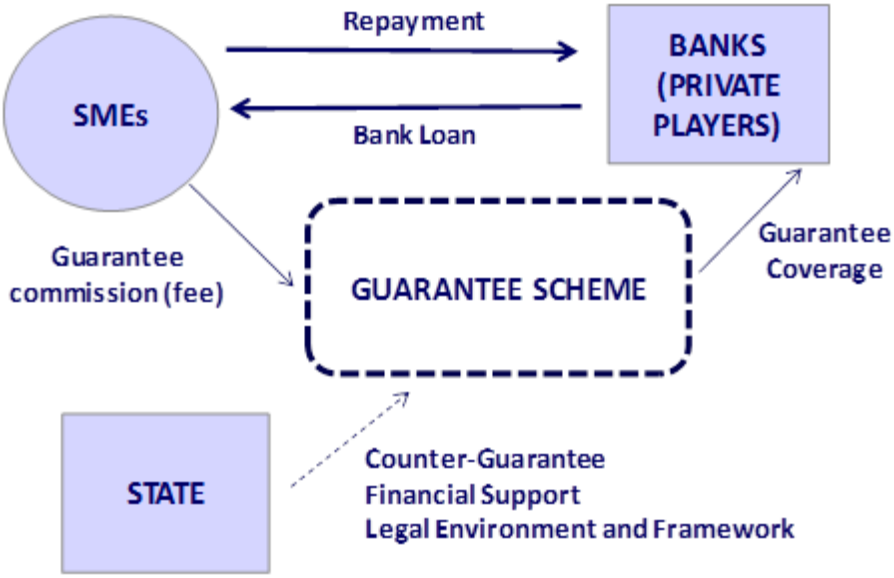
[13] Moral hazard describes behaviour when agents do not bear the full cost of their actions and are thus more likely to take such actions.

1.2 CGS mechanisms and types

1.2.1 How a Credit Guarantee Scheme works

Credit guarantee schemes can help bridge the financing gap that SMEs face by providing a security to banks in order to assist SMEs that are otherwise creditworthy but do not have adequate collateral to meet the banks' requirements and to obtain a loan. The CGS provides this collateral coverage by guaranteeing a portion of the loan made to an SME that could eventually reduce the amount of collateral required. A successful scheme is able to help riskier SMEs obtain financing by mitigating part of the risk of a loan extended to them, limiting transaction costs and guaranteeing repayment in case of default. Thus, a CGS is the institutional arrangement created by the partnership of three main actors: the guarantor, the lender, and the borrower (Figure 2).

Figure 2. Schematic diagram of relationships in a basic credit guarantee scheme[14]



Source: OECD (2012) based on Financial Services Authority (2005), "A Framework for Guarantee Schemes in the EU: A Discussion Paper."

The main features of a CGS must be carefully defined, as a weak design may lead to adverse selection and moral hazard, which would reduce the welfare-enhancing potential of CGS (EIB 2014). CGS are vulnerable to high risk of moral hazard, which may decrease incentives for a borrower to repay a loan, and for banks to conduct sufficient screening and monitoring of guaranteed loans or sufficiently pursue payment recovery in the event of default. This was apparent in some of the earliest attempts to establish such schemes in post-communist economies in Central Europe (OECD, 1999). Thus, the CGS must be scrupulously designed, to ensure that all actors perform their role to achieve the objectives of the scheme.

[14] Here is shown the fee paid by the borrower to the scheme. However, it can also be paid to the bank, which will then transfer it to the CGS.

1.2.2 Key indicators of a successful CGS

The main indicator of a successful CGS is the degree of additionality it can achieve whilst retaining its sustainability. The following section discusses the key features that can help countries to perform better on these indicators through good design, based on international good practices.

Additionality

The additionality of a CGS is defined in two parts, one being the scheme's financial additionality and the other its economic additionality[15]. Financial additionality refers to the increase in the volume of credit flowing towards viable SMEs as a result of the scheme. Specifically, it refers to guaranteed credit that would not have been provided without the guarantee, or more favourable credit conditions that emerge as a result of the guarantee; for instance, longer maturities or lower interest rates. Economic additionality describes the effect of increased access to finance on overall economic welfare. This is generally measured in terms of increased sales, employment, investment or innovation by of the supported SME or, at the macro level, by increased competitiveness and growth. Most schemes target and measure financial additionality, but few target and measure economic additionality. Two features should be considered to maximise the additionality of a CGS:

- **A competitive bank selection process.** Creating an environment of competition around guarantees, particularly in the scheme's early days, will encourage banks to strive harder to meet the additionality aims of the CGS. For instance, in Chile, FOGAPE auctions its guarantees to banks operating in the country. Banks must bid for guarantees, and successful bidders are the banks prepared to offer the highest leverage and the lowest interest rates.

- **Advisory services.** Having the CGS also provide advisory services to credit officers can ensure that banks also have the capacity to make more and better loans to clients they were unable to reach previously. This is particularly relevant in countries with low financial-sector development or limited experience of lending to a particular segment, and can increase the additionality effects of the scheme. In Afghanistan, for example, DEG also provides hands-on technical assistance to local credit officers of banks that participate in its CGF (co-funded with USAID).

Sustainability

Sustainability refers to the CGS's ability to cover its own costs whilst increasing leverage towards its target group. A sustainable scheme will also encourage more reliable partner banks to trust the value of the scheme's guarantees, thus increasing the volume of credit extended to target firms. A scheme's sustainability will depend on its ability to encourage lender participation, so as to achieve a sufficient volume of credit. Key features that need to be taken into account when designing a CGS and maximise its sustainability are:

- **Risk-adjusted fees.** Risk-adjusted fees enable the scheme to theoretically offset higher credit risk (and the greater likelihood of default) through higher pricing. For instance, the annual fees that Japanese Credit Guarantee Corporations charge depend on the credit risk of the borrower, which is determined by the CGS's credit-risk database and varies between 0.5% and 2.2% (OECD, 2013).

[15] OECD (2013a), Second Meeting of the OECD Working Group on Access to Finance for Agribusiness SMEs (Kyiv, 9 July 2013).

- **A diversified portfolio.** Portfolio diversification reduces a scheme's exposure to co-variant risks, enabling it to stay more sustainable and additional. Forms of diversification include holding a portfolio with firms from a range of sectors or regions, or guaranteeing loans with a range of maturities or business purposes. For instance in Lithuania, the ACGF has structured its portfolio to diversify as much as possible given its sectoral focus. Consequently, 36% (the largest share) of its portfolio covers loans in activities ancillary to agriculture, followed by a 35% in crop production (where business cycles are generally short-term) and 27% in stockbreeding (where business cycles are generally long-term) (all data from 2012).

- **Partial coverage rate.** In almost all OECD countries, guarantees cover only a portion of the loan (usually just its principal). This is designed to offset risk by ensuring that the lender maintains part of the loan's credit risk and thus conducts credit appraisal in a thorough manner. Beck *et al.* (2010) report a median coverage ratio of 80% across 76 schemes worldwide, but this is usually lower for schemes that are more risk-averse (such as those that cannot count on public subsidies) or are exposed to higher risk (such as those that target only one sector, as would be the case here).

2. DESIGNING A CGS FOR UKRAINE

This section discusses the primary features for designing and setting up a CGS institution in Ukraine based on international good practices and desk analysis carried out by the OECD and Internationale Projekt Consult GmbH (IPC)[16].

2.1 Recommended primary features of the CGS in Ukraine

The careful design of CGS features is a crucial element in securing the perception of reliability, responsibility, and trustworthiness for CGS partners. The design of CGS features begins with the identification of its primary features, which constitute the basic concept of the CGS. For the purposes of this project, the mission, targeting, and CGS type are considered primary features of a CGS. The description of these features is presented in Box 1.

Box 1. Primary features to design a CGS

- **Mission:** The mission refers to the defined mandate of the CGS, on which its stakeholders have agreed. In order to avoid potential conflicting objectives, CGS stakeholders should agree on the mission statement, which will present the policy objectives of the CGS.
- **Targeting:** Targeting means the identification of the specific group of credit-constrained firms that would benefit from the CGS. This will define the eligibility criteria, which will in turn define more precise metrics for the firms that can request a guarantee – in terms of firm size, creditworthiness, and other criteria.
- **Types**: The type of CGS refers to its ownership structure. Broadly four types of CGS are identified in the literature, as noted in section 2.1.3 of this report.

Source: OECD (2012) and OECD analysis (2015).

This section will sketch the primary features of this CGS for Ukraine, presenting the theory behind each feature and international experience, followed by recommendations for Ukraine.

2.1.1 Primary feature 1: Mission

Recommendation: increase credit access for target group

The main goal of a CGS is to increase loan access by providing banks with a security against lending for a targeted group of eligible borrowers. Some CGS also target other objectives, such as increasing exports, increasing female entrepreneurship, boosting regional development or, more broadly, also improving the terms of credit (such as lower interest rates or longer maturities).

The primary objective of the proposed CGS for Ukraine is simply to increase credit access to land-based agricultural SMEs, in order to facilitate improved production techniques and higher farm productivity. Over time, it is intended that complimentary policy reforms will work with guarantees also to improve credit terms, thus increasing capital investment in fixed assets and facilitating engagement in higher-value-added activities that may require longer business cycles (such as livestock

[16] For further information, please refer to Task Force presentations and IPC reports.

production). The project's Task Force discussed and adopted the mission statement presented below at its meeting in October 2014. It represents the guiding principle of the CGS in Ukraine and underpins all of the design mechanisms and operating criteria:

> ***Mission statement:*** *"The Ukrainian Agribusiness Guarantee Scheme is an independent credit guarantee instrument that aims to support agricultural SMEs in rural areas and is working under the regulation of the National Bank of Ukraine or Natskomfinposlug*[17]*. Its long term aim is to create a liquid credit market for bankable agribusiness SME projects that promote productivity growth in the sector."*[18]

The mission statement is the basis on which operational objectives will be set, and outlines the purpose and objectives of the scheme for all future communication with the scheme's clients (namely, partner banks and potential investors).

2.1.2 Primary feature 2: Targeting

Recommendation: agricultural SMEs only; initially just from Cherkassy, Poltava, Vinnytsia and Kharkiv Oblasts

Targeting is closely tied to the scheme's mission, and identifies the scope of borrowers that will receive guarantees. This includes considering whether the scheme will target specific sectors and regions, and how firm size might be measured. Almost all CGS in OECD countries target SMEs, and schemes (particularly public and donor schemes) that specifically target agricultural SMEs are relatively common – Beck *et al.* (2008) noted that, in a survey of 76 partial guarantee schemes around the world, 41% of monosectoral ones targeted agriculture or rural enterprises.

As noted by the International Finance Corporation (IFC) (2011) and others, however, the segmentation of enterprises engaged in primary agricultural production is complicated because they do not easily conform to standard SME definitions. Variations across countries and regions, as well as differences in production structure at the farm level, mean there are no international standards for segmentation of agricultural enterprises by size. Moreover, classifications that do exist in certain country case studies tend to integrate other non-income-based measures such as the size of land holdings.

The project analysis recommends that the identification of the scheme's target group also take this land-size criterion. Specifically, it has been proposed that the scheme be open only to land-based agricultural SMEs farming 100-2,000 hectares. The rationale is that farms of less than 100 ha are deemed too small to be the focus of a CGS and the cost of using the CGS would be too high for small loans. Evidence from consultations with industry representatives also suggest that farms of less than 100 ha look at other sources of financing such as credit unions, which are outside the scope of this project. For their part, farms of more than 2,000 ha are assessed to have more access to finance and to have high funding requirements that would deplete the resources of a CGS (see Figure 3). In addition, the recommendations would provide schemes of sufficiently modest market size to scale up to other regions, and perhaps other agribusiness and rural activities beyond primary agricultural production (in order to diversify the scheme's portfolio). In subsequent reports further eligibility criteria will be defined, such as additional requirements on annual turnover, loan size, and experience.

[17] Officially known as the Commission for Regulation of Financial Services Markets of Ukraine.

[18] OECD (2014), Second Meeting of the Task Force on a Credit Guarantee Scheme (Kyiv, 15 October 2014).

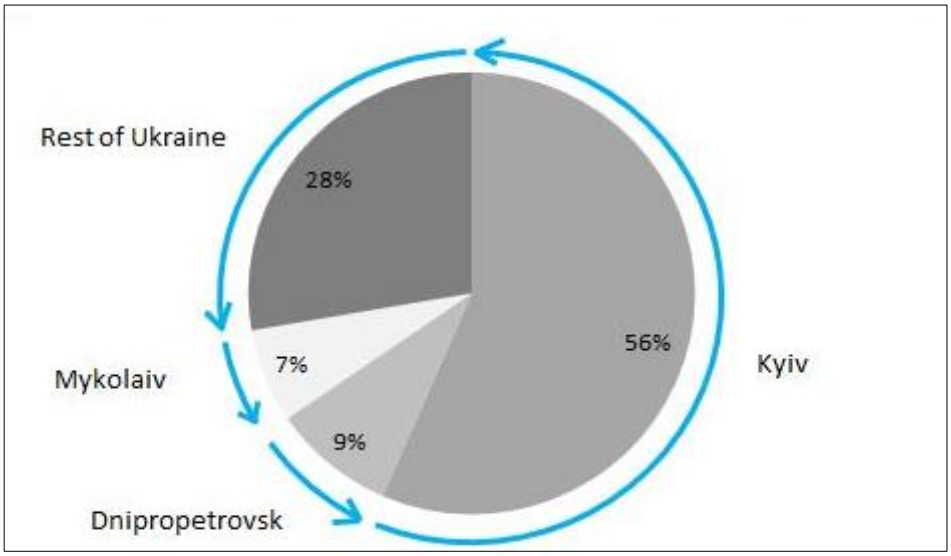
Figure 3. Average financial requirements per year by agricultural SMEs in Ukraine

	MICRO	SMALL		MEDIUM
	BELOW 100 ha	*100- 1 000 ha*	*1 000 – 2 000 ha*	*2 000 – 10 000 ha*
NUMBER OF FIRMS	33 500	10 000	2 800	2 900
AVERAGE FINANCIAL REQUIREMENT PER YEAR IN UAH	18 k	300-700 k	800k – 1 m	2 m
% CREDIT-CONSTRAINED FIRMS	99	90	80	70
PERCENTAGE OF LOANS COVERED BY BANKS	Not applicable	Not applicable	Not applicable	30%
FOCUS OF CGS PROJECT	✗	✓	✓	✗

Source: OECD (2012)[19].

Given that unmet credit demand for this target group would be too high to tackle for the entire country, it is also recommended that the CGS initially focus on selected regions and then possibly scale up to other regions. The regions identified as suitable for this initial pilot phase of the scheme are Cherkassy, Kharkiv, Poltava and Vinnytsia. The rationale is that they make an important contribution to gross agricultural output, whilst receiving low access to loans and low state support. The latter two issues are not uncommon: agricultural loans and agricultural state support are overwhelmingly directed to a handful of regions, whilst the rest receive a fairly even share of the remainder.

Figure 4. Distribution of agricultural loans in Ukraine by region (2014)



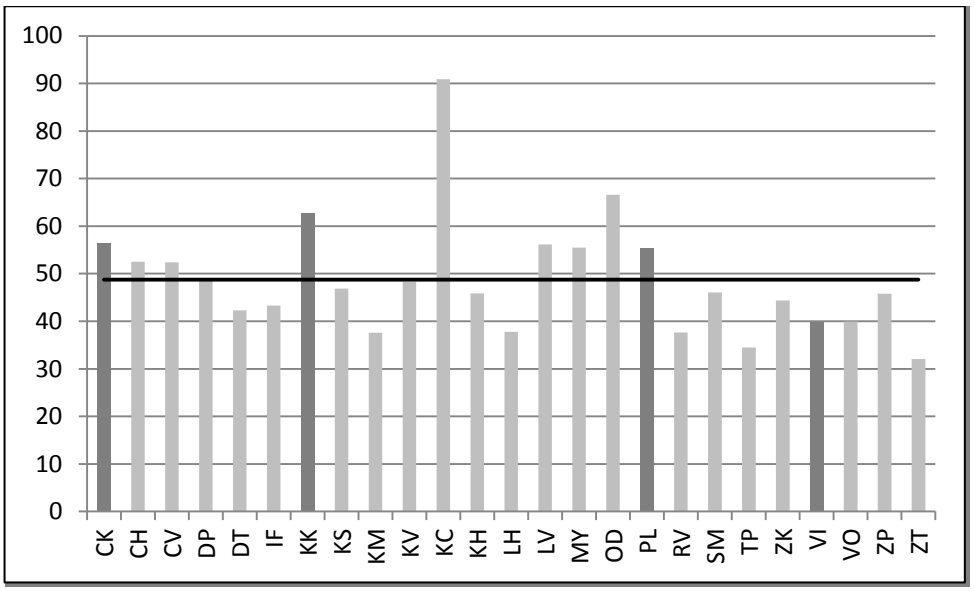
Source: National Bank of Ukraine

[19] Data extracted from State Statistics Committee of Ukraine (SSCU) (2010), except for estimates of the average financial requirements per year, which derive from USAID data (2012a).

As shown in Figure 4, the majority of agricultural loans are directed towards firms based in Kyiv, Dnipropetrovsk, and Mykolaiv. The high share of loans directed towards Kyiv is explained by the fact that that most agro-industrial complexes have their headquarters in the city and its region. Likewise, Dnipropetrovsk's high share could be because it is an industrial district where banks are already active and several large agricultural enterprises are headquartered there.

The proposed pilot regions generally have a higher-than-average share of bank branches per 100,000 people, suggesting that the infrastructure for increased lending is present (Figure 5). Moreover, they have a good critical mass of agricultural SMEs within the target size.

Figure 5. Bank branches per 100,000 people (2014)



Source: National Bank of Ukraine and State Statistics Service

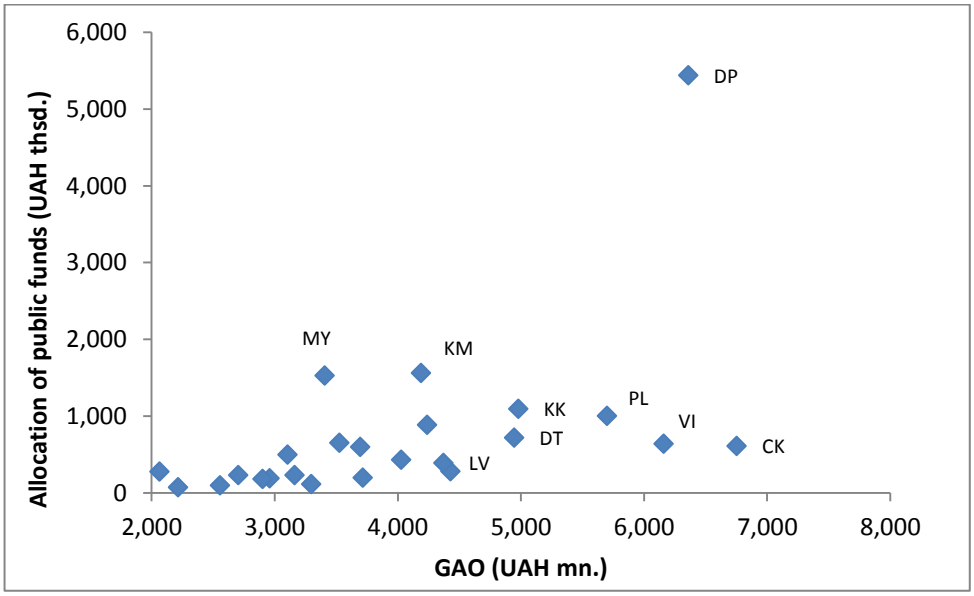
Table 1. Number of Agricultural SMEs with 100-2000 ha (2014)

	Cherkassy	Kharkiv	Poltava	Vinnytsia	Total Pilot Regions	Total (UA)	Av. in UA per region
Number	603	621	680	716	2,620	10,371	494

Source: Ministry of Agrarian Policy and Food.

Not only do these regions have very little access to bank credit, they also receive very little state support to overcome the market failures. Allocations of state support have been skewed towards only a few regions (Figure 6), and a subsequent evaluation by USAID (2012) found that subsidies from the government's interest-rate compensation programme in 2011 were given only to around 60 agribusiness firms – specifically, agroholdings and big players. Thus it is proposed that the scheme be initially piloted in these four regions, which produce a significant share of Ukraine's agricultural output but have limited access to bank credit and receive scant state support.

Figure 6. Allocation of public funds vs. gross agricultural output (GAO) by region (2011)[20]



Source: OECD with data from State Statistics Service and Ministry of Agrarian Policy and Food.

2.1.3 Primary feature 3: Type of CGS

Recommendation: internationally funded public/private model

The type of CGS is defined by its ownership structure (*i.e.* the types of entity that "own" the scheme), and this influences the nature of its funding and governance. Four main types of guarantee scheme can be identified as relevant to the Ukrainian context.[21] Table 2 provides some examples illustrating each structure.

1. **Public guarantee schemes.** These are established by public policy and almost always involve state subsidies, especially in the initial stages. Usually they are managed by a public organisation or an administrative unit of a government body.

2. **Private guarantee schemes.** These are generally funded and operated by the private sector, *e.g.* guarantee companies, banks, and chambers of commerce (they are sometimes referred to as corporate or mutual guarantee schemes). They often benefit from the direct involvement of experienced lending professionals and are usually managed by entities from similar professional backgrounds (*e.g.* manufacturers, co-operatives, retailers).

3. **Public-private guarantee schemes.** These are a combination of the two models above and exist most often as independent organisations formed with public or donor money but managed by private-sector representatives, selected either through a public tender or owing to their sectoral expertise and background.

[20] The graph excludes Kyiv to allow for better visibility of state support to other regions of Ukraine. It shows that support is spread more or less (with the exception of Dnipropetrovsk) at a very low base.

[21] OECD (2013b), Working Group on Access to Finance for Agribusiness SMEs.

4. **International guarantee schemes.** International schemes are government, non-governmental organisation (NGO), or IFI/international organisation initiatives. These schemes often combine a guarantee fund with loans and/or technical assistance to lenders, borrowers, or both to ensure the effectiveness and additionality of the scheme.

Table 2. Selected examples of CGS types

Type of CGS	Selected examples
Public guarantee schemes	Garfondas (Lithuania)
Private guarantee schemes	AgroInvest (Serbia)
Public-private guarantee schemes	AVHGA (Hungary)
International guarantee schemes	Development Credit Agency (USAID) COSME programme (European Investment Fund, EIF)

The most common model in OECD countries is public guarantee schemes, which are generally funded from the state budget and earn only partial coverage of expenses from fees and charges from the partner bank or the borrower[22]. The second-most common scheme is mutual and combines elements of public and private management and ownership. In the vast majority of OECD countries, the CGS model is completely state-funded (public) and is designed to support a designated group that policy makers perceive to be unserved or underserved by the banking sector.[23]

Consultations with public and private stakeholders, as well as desk research, suggest that public seed funding will not be available in the short to medium term owing to a small budget and competing policy priorities for the Ukrainian government, in addition to a general lack of resources and capacity. Considering the economic and political situation in Ukraine, a non-public model will be the most probable option for a CGS formation. A purely private scheme is unlikely, however, given the strong additionality aims of the scheme and the credit risk of the target group (making a corporate scheme unlikely), as well as the lack of strong mutualist structures in Ukraine (making a mutual scheme unlikely).

Analysis was conducted to identify the most suitable type of scheme to deliver guarantees to agricultural SMEs in Ukraine. A list of pros and cons was developed for each type, listed in Table 3. In this context, and drawing upon OECD analysis, it is proposed that the scheme be formed as a public/private entity, seeded by international donor funds. The formation of a Ukrainian institution is proposed to enhance the scheme's demonstration effects, and will allow for the possibility of eventually selling out to private investors once the scheme has demonstrated good performance and no longer requires any element of subsidy.[24] Since the scheme will be seeded with donor funds, the nature of funding will be a particularly relevant issue.

[22] KPMG (2011), p.14. Most CGS are state-run and publicly held, mainly through public capital. Given the importance of such a tool, however, KPMG expects the private sector to increase its participation in CGS.

[23] *Ibid.* (2011), p.8.

[24] For some schemes, this happens once the scheme begins no longer to need a subsidy element. Most often it is bought out by commercial banks that also participate in it.

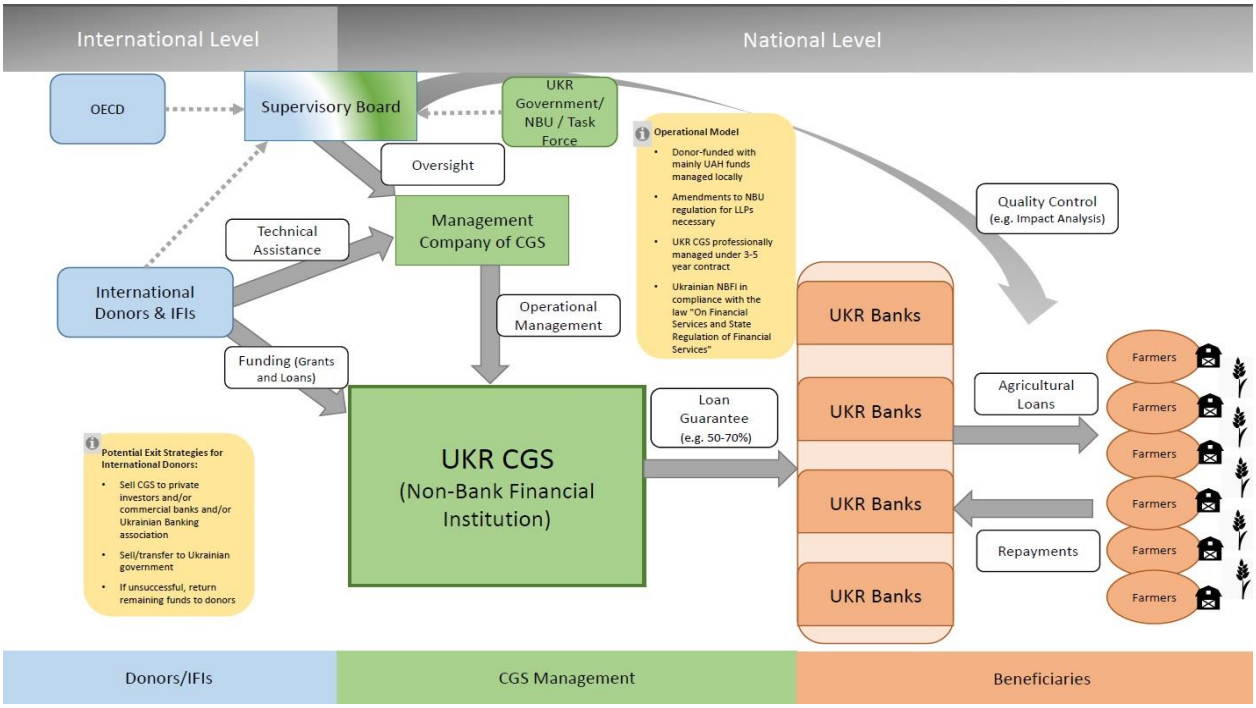
Table 3. Comparative assessment of CGS types for Ukraine

Model	Pros	Cons
Public	Ongoing Ukrainian state support after establishment	No exit strategy possible
	Regulation exists for legal form	Annual budgetary commitment required
	Full accountability with NBU	Limited replicability
Private	Strong demonstration effect	Needs enough capital/credibility
	Possible under existing regulatory environment	High price of capital
	High operational efficiency	Commercial pressure (re: return on investment [ROI], *etc.*) will shift CGS focus away from development goals
	Can be easily sold/expanded	
Public/private	Positive aspects from both public and private models, if sufficient support from both	Risk of failure due to limited public-private partnership (PPP) experience and little experience with CGS
	Highest likelihood of long-term sustainability	Private operator needs to be selected. Needs to develop a strong selection method
International	Allows for mixed CGS funding with technical assistance and international know-how	Chance of reduced ownership, if no private partner
	Offers range of opportunities for future development	Largely driven by policy goals, which may reduce commercial viability

Source: OECD and IPC analysis.

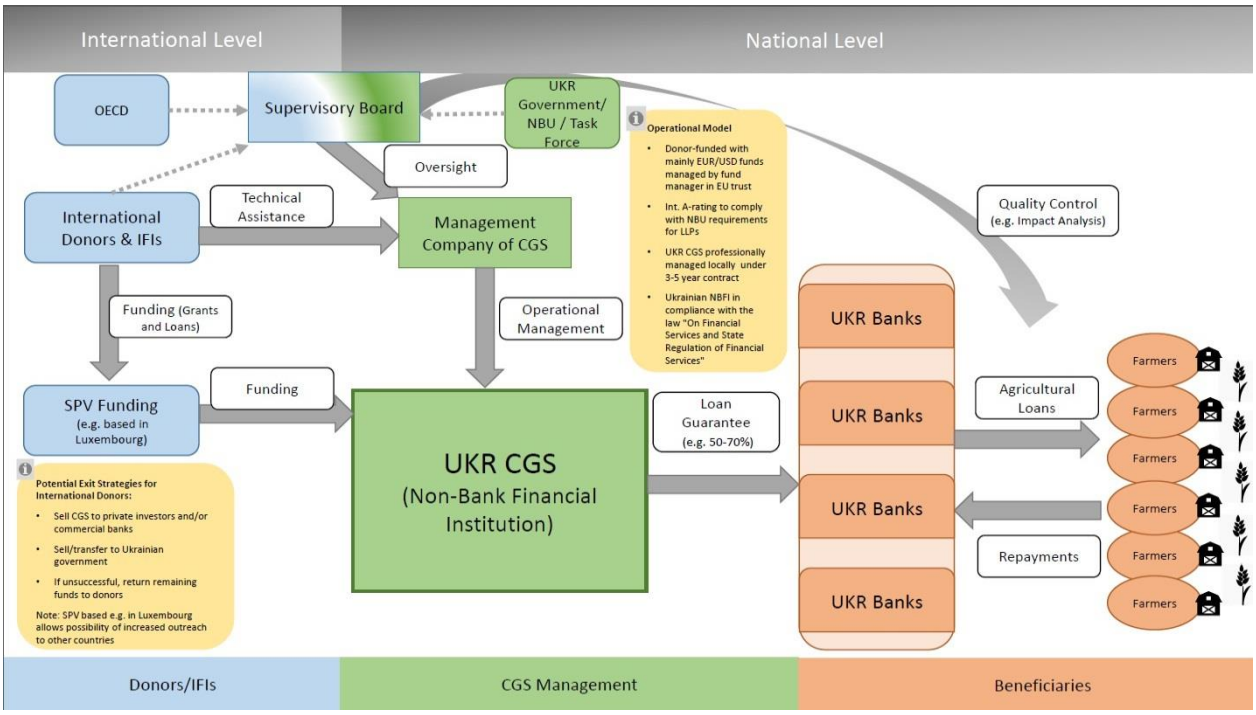
In addition to the type of CGS, one of the most important decisions will be whether the scheme's funds will be registered in Ukraine or in a foreign jurisdiction. Both options have different pros and cons, and these shall be explored more thoroughly during the technical phase of the project. A preliminary diagram of the two models for Ukraine is presented in Figures 7 and 8.

Figure 7. Public/private scheme, funds registered in Ukraine



Source: IPC analysis.

Figure 8. Public/private scheme, funds registered abroad



Source: IPC analysis.

In terms of the legal form of the CGS institution itself, a preliminary legal assessment and consultations with representatives of the NBU and the Commission for Regulation of Financial Services Markets (Natskomfinposlug) suggest that the CGS could be established as a joint stock company or a limited liability company. The "Law of Ukraine on Financial Services and State Regulation of Financial Services" provides the relevant legal framework for the formation of such a CGS. According to this law, the provision of guarantees is regarded as a financial service, and an organisation must have the status of a registered financial institution. In addition to this law, the "Regulation on the State Register of Financial Institutions" is the main legal framework governing the activities of financial institutions. Currently, the regulation of such institutions is performed by Natskomfinposlug[25], but the regulatory body for the CGS will need to be determined when the CGS is established.

In addition, a decision must be made on whether the scheme provides individual or portfolio guarantees.[26] The advantages of each approach are presented in Table 4.

Table 4. Advantages of portfolio vs. individual guarantee delivery

	Delivery channel	
	Portfolio	**Individual**
Advantages	Lower operational costs	Greater control over guaranteed portfolio
	Rapid	Better information for monitoring

Source: Deelen and Molenaar (2004).

It is proposed that the CGS in Ukraine provide individual guarantees to banks. This is on account of the high additionality aims of the scheme, the risky nature of the operational environment and target group, and the intention initially to pilot the scheme in four regions. Providing individual guarantees will enable the scheme to maintain control over the development of its portfolio and allow it to better reach the most credit-constrained clients.

2.2 Development of secondary features for the scheme

After the Project Task Force has developed and approved the primary features, a set of secondary features will be designed. For the purposes of this project, secondary features include eligibility criteria, coverage rate, guarantee fee, and application and claim procedures. The secondary features will be discussed in a separate report, the feasibility study.

[25] A draft law (no. 2414) is being discussed in Parliament, however, which proposes the dissolution of Natskomfinposlug and a division of its responsibilities between the National Securities and Stock Market Commission (NCSSM) and the National Bank of Ukraine, to take effect in 2016.

[26] "Individual" is known as "retail", and "portfolio" as "wholesale."

3. PROFILE OF THE CGS TARGETS

From January to April 2015, the project team undertook a series of visits to the four proposed pilot Oblasts – Cherkassy, Vinnytsia, Poltava, and Kharkiv – to interview farmers holding 100-2,000 hectares about their funding and investment needs, business constraints, business activity, and loan access. In addition, focus groups were organised in each region to discuss the scheme and farmers' funding needs with a group of relevant stakeholders.[27] The findings are outlined below.

3.1 Profile of the target group

Analysis of the target group conducted during this field survey revealed that agricultural SMEs below and above 500 ha generally display different characteristics – in terms of their business expertise and management, the quality of their reporting, and the protection of their interests – that affect their ability to access finance from commercial banks. Table 5 highlights some particularities of the target group, including their financing needs.

Table 5. Features of agricultural SMEs below and above 500 hectares

Features	100-500 ha	500-2000 ha
Quality of management	Farmer usually performs functions of the agronomist and animal technician. All work done either by farmer personally or with the help of family members. Workers are employed only during fieldwork seasons. Farmer's spouse usually serves as accountant.	Such enterprises usually have hired agronomists, animal technicians, and accountants. The business owner usually acts as manager. The company employs permanent workers, and, if need be, hires seasonal workers.
Quality of reporting	Low, for the following reasons: low qualification of accountants; fear of regulatory authorities; need for cash to repay private loans; habit of degrading performance reporting, supported by the lack of an effective monitoring mechanism and penalties for unreliable information.	High: strong qualification of accountants and high business formalisation lead to largely objective reflection of business information in financial statements. However, there are cases of overstating some indicators in financial statements in order to increase chances of obtaining a bank loan.
Protection of interests	These farmers feel vulnerable to regulatory authorities, contractors, and competitors. This is due to the low level of economic and legal education, a lack of funds and confidence, and corruption in the judicial system.	These farmers hire lawyers to protect their interests in court.
Working-capital needs	These farmers usually experience seasonal working-capital shortages due to weak business activity planning.	As a rule, these farmers are secure for working capital, though they may need better materials to improve performance.

[27] Namely, farmers, representatives of farmer associations, local bank managers, and representatives of local government.

Features	100-500 ha	500-2000 ha
Investment needs	They have sufficient machinery and equipment to conduct agricultural activities, but need upgrades or complete replacements. They also face problems with storage capacity.	Farmers have basic agricultural machinery and regularly upgrade. For them, investment projects are more relevant, *e.g.* grain elevator construction.
Business development	Developing small farms understand that technologically sophisticated equipment improves the effectiveness of their activities. The largest part of their earnings is used for personal expenses. Barriers to a significant increase in acreage include: - lack of desire to expand - limitations of fixed assets - lack of managerial skills	Farmers are willing to develop their business, but their main constraint is the lack of available land. Farmers are willing to start new activities to diversify their business.

Source: IPC analysis.

3.2 Sources of funding for the target group

Access to finance remains relatively limited for agricultural SMEs. Nevertheless, agricultural SMEs with 500-2,000 ha can access a broader range than those with less than 500 ha of funding sources, such as banks loans, input suppliers, leasing, and private loans. The latter feel the shortage of working capital more acutely than larger SMEs. Thus agricultural SMEs cultivating less than 500 ha resort more extensively to alternative sources of financing, particularly private loans, which tend to be highly expensive and are often tied to the US dollar even if provided in UAH, creating additional exchange-rate risk for the borrower.

Table 6. Sources of funding of the target group

Source	100-500 ha	500-2000 ha
Banks	These farmers do not represent a priority segment for banks due to the poor quality of their financial reporting and a general lack of collateral. They generally resort to consumer loans subscribed for business purposes, taken as an individual rather than as a legal entity.	Although funding for these enterprises remains scarce, banks assess land holdings above 500 ha to be less risky, provided they can furnish satisfactory financial reports and eligible collateral.
Credit unions	Credit unions are currently able to lend only to individuals and not to legal entities. Discussions have been ongoing since 2015, however, to allow them also to provide credit to legal entities. Credit unions generally work with farmers cultivating under 100 ha.	These farmers generally cannot obtain credit from credit unions due to the relatively large scale of their farming activities and existing restrictions on the legal form of eligible businesses.
Suppliers of agricultural materials	Usually only available for farmers with land holdings over 400 ha.	Farmers with over 400 ha can generally receive commodities loans for bulk purchases, usually of fertilizers and seeds, in the event that they face liquidity problems.

Source	100-500 ha	500-2000 ha
Leasing operations	These farmers generally cannot access leasing services due to low financial performance indicators and a limited range of agricultural machinery provided by the lessor.	These farmers can usually access leasing services.
Private loans	A lack of alternative options make private loans the most common form of financing for these farmers, but it is usually the most expensive source of funding.	These farmers do not generally count on such loans due to their high cost. If a private loan is taken, it tends to be for a very short period.

4. BANK SELECTION

Credit guarantee schemes typically partner with banks due to banks' greater share of financial assets relative to those of other institutions, and the fact that guarantees are designed to address specific information asymmetries that banks face. Levitsky (1997) suggests that a large number of participating banks and a greater volume of guarantees would enhance the economic and financial impact of the scheme, as well as its sustainability. As an alternative, some CGS choose to partner with credit unions or leasing companies, but this is rare.

Commercial banks are the only real contender for partnership with a CGS in Ukraine, particularly given the legal and funding constraints of the country's credit unions that were mentioned previously. However, it is important to note that the environment for partnering with commercial banks is very challenging, particularly in the current context. Banks are facing the effects of low liquidity, low profitability, and poor credit quality. Specifically, banks in Ukraine have been strongly affected since the beginning of 2015 by a large depreciation of the hryvnia, particularly against the US dollar and the euro, substantial deposit outflows, and a sharp increase of non-performing loans or otherwise impaired assets. The International Monetary Fund (IMF) has provided financial and technical assistance, which has helped the National Bank of Ukraine introduce effective monetary and administrative measures. Whilst international support has averted the collapse of the Ukrainian banking sector, additional funding is needed to recapitalise and restructure the banking system. It is expected that more Ukrainian banks will fail and exit the market.

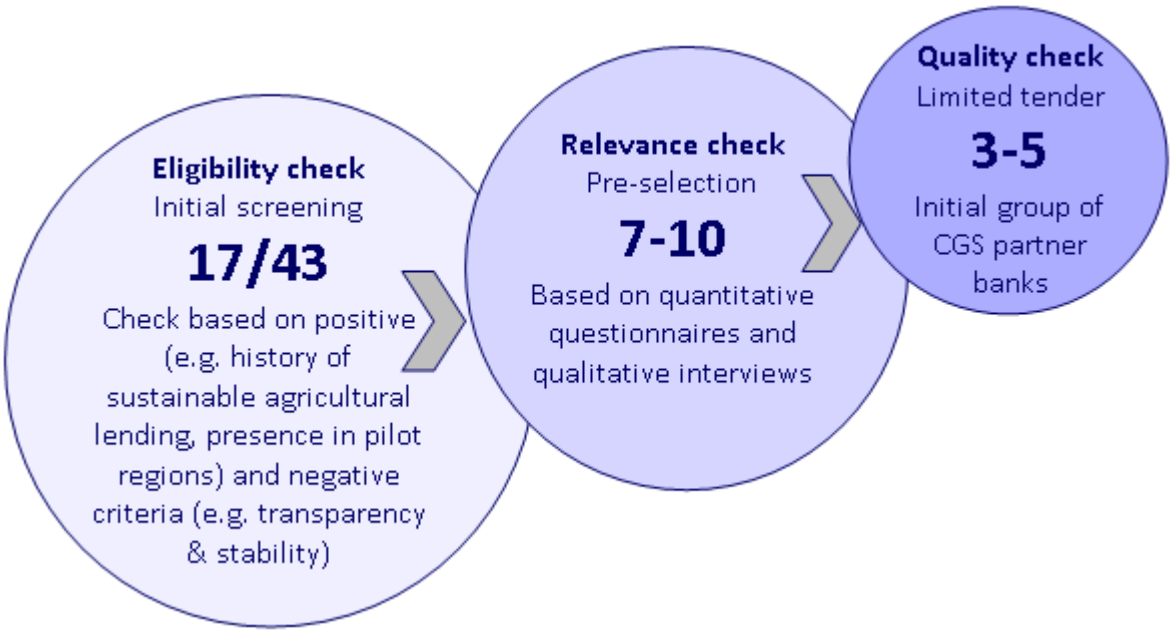
Given this context, one of the key challenges of the scheme will be to ensure that banks and borrowers in Ukraine develop a high level of confidence in the newly founded CGS. Field and desk research have suggested that the role of partner banks should be to implement most of the credit procedures, whilst the CGS focusses on risk management. To this end, the selection of competitive and reliable partner banks will be essential to the success of the scheme. Its initial partners must be financially stable and reliable banks known for their competence, integrity, and interest in providing financing to agricultural SMEs. Thus, a rigorous partner-selection process is needed to pave the way for a successful and sustainable CGS.

In terms of bank interest in the scheme itself, interviews conducted with representatives of key banks in Ukraine have revealed that interest in the agricultural SME sector has increased in recent years. Reforms to the tax code have led agricultural SMEs to report their accounts in a more accurate way, resulting in the increased formalisation of such firms. In addition, the rate of NPLs for this segment is relatively low, probably owing to a highly conservative approach towards such firms. Banks are therefore generally enthusiastic about a CGS instrument, which allows them to explore the sector whilst mitigating their credit risk.

4.1 Proposed approach to partner bank selection

The suggested approach is multi-stage, starting from (i) an initial bank screening (eligibility check), followed by (ii) the pre-selection of eligible banks that are relevant to the CGS (relevance check), then (iii) a due-diligence process of applicant banks conducted in the framework of a limited tender-quality check. Figure 8 provides an overview of the proposed approach.

Figure 10. Methodological approach for the selection of CGS partner banks



Source: OECD, IPC and NBU analysis (2015).

The steps build upon each other, with each subsequent step using increasingly detailed analytical methods. The process will not only provide a robust and comprehensive assessment of potential partner banks, but will also generate some "buy-in" from banks to ensure that they also actively participate in the scheme. The process will also show "in action" whether the targeted banks are truly interested and capable of employing the loan guarantees, and under what conditions.

4.2 Application of method to the Ukrainian banking sector

In the case of Ukraine, the results of the selection approach are summarised below.

Step 1: Initial screening (eligibility check)

A total 43 of the 166 banks operating in Ukraine in early 2015 are deemed eligible for an agricultural SME portfolio. This list includes all 15 of the large banks (classified by the NBU as "Group 1" banks) as well as 15 small banks ("Group 4" banks)[28].

An assessment was conducted to check the eligibility of the 43 identified banks to participate in the scheme, according to eight criteria:

- Strategy: strong business focus on SMEs
- Activities: the volume and number of agricultural loans disbursed

[28] The NBU classifies banks by their asset size. As of 2014, the following indicators were adopted to group banks into four ranked categories: (i) Group 1, which includes banks with assets of more than UAH 21 bn; (ii) Group 2, which includes banks with assets of more than UAH 6 bn; (iii) Group 3I, which includes banks with assets of more than UAH 3 bn; and Group 4, with banks with assets under UAH 3 bn. More information is available at NBU Decision No. 975, 20 December 2013: www.nabu.com.ua/Analitics/Rozpodil%20bankiv%20na%20grupy%202014%20rik.docx

- Products: the availability of specific agricultural finance products
- Presence: the number of branches within CGS pilot regions
- Relevance: the total value of assets; agri-loans' share in total portfolio; average agri-loan size
- Quality: the NPL rate for agricultural loans
- Standing with National Bank of Ukraine: the bank's credit rating
- Recent portfolio developments

Banks were also assessed based on additional criteria: integrity, transparency, stability, and ownership. For example, a number of banks were deemed ineligible based on foreign-state ownership or the strong risk of high related-party lending risk. Step 1 resulted in the compilation of a short-list consisting of 17 banks[29] likely to be eligible for the CGS. In this respect, it is again important to note the lack of solidity in the Ukrainian banking sector and the macroeconomic instability of the country. The eligibility check should be carried out again once the CGS is established in order to obtain a more accurate and current result.

Step 2: Pre-selection (relevance check)

The pre-selection stage intends to further reduce the group of potential CGS partner banks by conducting a relevance check through qualitative interviews and a quantitative survey. The objective is to retain eligible banks based on their interest, capacity, and expertise in increasing lending to agricultural SMEs with the help of credit guarantees. The implementation of step 2 limited CGS-eligible banks to a group of 10 banks.[30] As with step 1, this process should be revisited as and when a CGS is created, in view of the instability of the financial system.

Step 3: Due diligence (quality check)

The third step consists of opening a limited tendering process to the remaining group of 10 banks, along with a detailed quality check. The objective is to select three to five banks, which will be the final CGS bank partners. The due-diligence process must aim primarily at the assessment of bank policies, procedures, processes, concrete lending results, and future targets in the field of agricultural SME lending. This will allow for a better evaluation of the quality of lending activities to the target group, and can also provide the basis for a risk-based pricing model within the CGS. Whilst it is recommended that the scheme be launched with three to five of the most qualified banks, the current turmoil of the Ukrainian banking sector advocates for an even smaller group of two or three banks. This step has not yet been implemented but should be once the scheme is operational.

Additional partner banks can be selected at a later stage through new tenders, provided the CGS develops well and new potential bank partners can be identified as generally eligible and relevant in accordance with the same criteria applied for selecting the initial group of partner banks. The selected CGS partner banks should be reassessed annually.

[29] The OECD carried out this step of the initial screening according to the suggested methodology. The outcomes will be discussed with the project's donors and eventually the CGS shareholders in due course.

[30] *Ibid.*

5. REVIEW OF POTENTIAL RISKS TO THE PROJECT

A number of internal and external risks to the scheme that could challenge its short-term viability have been identified. They are summarised below. Proposed mitigation measures are presented at the end of this section.

5.1 Internal project risks

Limited funding availability

The operationalisation of the scheme may be hindered by a lack of funding, especially seed capital for its establishment or financial resources for its guarantee coverage fund. Public financial support to the CGS would probably not be granted in the short to medium term, given other priorities of the government and a general lack of resources. In addition, whilst interviewed banks were interested in participating in the scheme as lenders, they were not willing to fund it especially over the short term mainly due to the turmoil of Ukrainian banking system.

Lack of buy-in

Poor design of the CGS could lead to a lack of buy-in from banks. Commercial banks are wary of credit-support measures provided through public policy. They also emphasise that a CGS should not be subject to any political influence whatsoever when it comes to individual lending decisions.

Limited managerial capacity

The risk of a management team's running the CGS with little or no credit experience is very significant for the viability of the scheme. Commercial banks unanimously agree on the need for professional management, notably to ensure transparency, proper risk-assessment techniques, and a low level of bureaucracy.

Limited lending technical capacity

Bank lending to the target group could be hindered by a lack of understanding of the agricultural-SME business cycle or the absence of regional branches in the pilot regions.

Limited financial literacy and formality of target

Bank lending to the target group could be hindered by low formality of the target group and low financial literacy. If SMEs lack the requisite financial literacy, they may not be able to maintain financial records to the standard that partner banks require.

5.2 External project risks

Political influence

There is a risk of political influence in a CGS. Guarantees could be directed to loans that politically connected companies request companies instead of being granted on the basis of their alignment with the CGS's overall objectives. Consequences would be weak oversight, a discrepancy between initial CGS targeting and its actual beneficiaries, and increased risks of low repayment rates.

Unstable macroeconomic environment

Ukraine has an unstable macroeconomic environment that is vulnerable to dramatic shocks (for instance in 2009 and 2014). Thus, a CGS could be vulnerable to mass defaults, particularly given its complete exposure to one sector.

Limited banking-sector liquidity

The implementation of a CGS could be hindered by limited liquidity in the banking sector. The Ukrainian banking sector has been under considerable stress since 2014. Banks face challenging conditions due to significant deposit outflows, a strong depreciation of the currency, significant NPL rates, and a high central-bank key interest rate. These factors have pushed several banks out of the market (39 from year-end 2012 to mid-2015) and limit their overall ability to lend to the CGS target group.

Corruption, related-party lending, and the presence of "pocket banks"

The Ukrainian banking sector is highly fragmented, with 137 banks as of mid-2015. The vast majority are small, and many are closely connected to the treasury functions of their corporate owners – usually providing an inexpensive source of liquidity to other firms within their group. These "pocket banks" are the result of lax and uncertain regulation in the early years of transition and the subsequent lack of effective supervision. The fragmentation of the sector makes it more unstable, weakening the efficiency and resilience of the banking system in Ukraine, so the CGS should also take care to avoid partnership with such banks.

Challenging legal and regulatory environment

The overall legislative environment in Ukraine can be difficult to navigate, and regulation for a legally separate Ukrainian entity providing individual guarantees is underdeveloped. Capacity to enforce contracts is weak: Ukraine ranks 98 out of 189 economies for enforcing contracts in the World Bank's Doing Business Index, relative to an average of 68 for OECD high income countries and 29 (Belarus), 5 (Russia), 55 (Poland), and 34 (Romania) for its regional peers. This may be a problematic environment for a novel financial instrument that is based on the enforcement of contracts amongst three counterparties.

5.3 Mitigation measures

A summary of the relevant risks and relevant mitigation measures is presented in Table 7.

Table 7. Summary table of project risks and mitigation measures

	Type	Mitigation measure
Internal	Limited funding resources	Limited funding resources can be overcome by mobilising financial resources from international donors. The elaboration of a donor strategy would allow the targeting of relevant bilateral donors and international financial institutions (IFIs) able to provide financial and technical support for the establishment of a CGS.

	Lack of buy-in	The attractiveness of the scheme can be ensured through a proper risk-sharing design as well as dialogue with banks. To fully ensure take-up of guarantees, the CGS must work closely with local banks to ensure that the scheme's terms and conditions are beneficial to all parties, especially end-users.
	Limited managerial capacity	The project is addressing the risk of limited managerial capacity. A series of capacity-building seminars are being organised, and the training materials will be made available for future reference.
	Limited lending technical capacity	A sound screening of banks eligible to participate in the CGS should be conducted based on the specific multi-stage method developed for this purpose. In addition, technical assistance could be provided to selected banks to strengthen their knowledge of the agri-SME business cycle.
	Low financial literacy of farmers	Banks are likely to extend loans (even with guarantees) only to farmers with adequate financial literacy; however the scheme may also need to be coupled with financial education programmes. The OECD has already conducted work on financial literacy amongst farmers in Ukraine and prepared a set of policy recommendations to address this barrier (OECD, 2015d).
External	Unstable macroeconomic environment	Such a scheme should be established only once the macroeconomic environment is stable. Risk assessment such as a sensitivity analysis should be conducted frequently, and once the pilot is complete the Supervisory Board should consider different avenues for portfolio diversification – such as opening to rural enterprises or food processing companies. This process may involve identifying firms that are less vulnerable to macroeconomic shocks and encouraging their participation.
	Political influence	The selection of a completely independent and skilled management team should be ensured through a public tender, and separating it from the political leadership would mitigate the risk of political influence.
	Corruption, related-party lending, and the presence of "pocket banks"	Banks should be carefully selected. The bank selection tool mentioned previously looks not only at "positive criteria" but also at "negative criteria" – such as the strong risk of high related-party lending risk. Since 2012, all commercial banks are obliged to implement International Financial Reporting Standards (IFRS); this should increase the transparency of commercial banks in Ukraine. The scheme should partner only with banks that have implemented these standards, and the NBU should enforce compliance.
	Limited banking-sector liquidity	The application of a sound bank selection method would ensure that the most suitable partner banks for the CGS are identified and selected. In addition, it is recommended that the tendering process be limited in its pilot phase to two or three banks with the resources to provide loans to the targeted SMEs. IFIs could provide credit lines to participating banks in order to boost their liquidity.

Challenging legal and regulatory environment	While the “Law of Ukraine on Financial Services and State Regulation of Financial Services” might initially seem sufficient for the operation of a CGS, a full in-depth legal assessment should be conducted in order to anticipate any legal barriers and any requisite legal changes.

6. INITIAL RECOMMENDATIONS

Field and desk research conducted for the pre-feasibility study have found that there is a significant appetite for the establishment of a Credit Guarantee Scheme in Ukraine. Interviewed banks saw the benefits of such a scheme and showed interest in participation. Based on these interviews, consultations with Task Force members and desk research, a number of initial recommendations have been made. The feasibility report will further explore and build on these to determine secondary features and later continue with the definition of risk-management procedures. The main recommendations stemming from the present report are summarised in Table 8.

Table 8. Summary of key recommendations

Key recommendations
❖ The impact of a CGS on agricultural SMEs in Ukraine will be far greater where key reforms in the banking and agricultural sector are advancing. These should be considered in tandem with the implementation of a CGS in Ukraine. ❖ The CGS should be established as a public/private institution, seeded with donor funds. It should provide individual guarantees. ❖ The CGS should be regulated as a financial service under the Natskomfinposlug (or relevant institution) once the law on the consolidation of financial services regulation is passed. ❖ The CGS should focus on risk management and delegate the main lending procedures to partner banks. ❖ A conservative approach is recommended at first, with a low coverage rate and borrowers not informed that their loan is guaranteed. ❖ Banks should be carefully selected based on the recommended procedure. ❖ Experienced CGS staff should be selected, with an emphasis on integrity and technical skills.

As stated above, it should be emphasised that whilst such a scheme is an important policy tool for Ukraine, the context in which it should be set up is highly volatile and the policy framework is unstable. Thus, the application of the CGS will require complementary policy reforms to maximise its impact and ensure successful implementation in line with the features discussed in this report. The main policy reforms include:

- The lifting of the moratorium on land sales

The lack of a free land market in Ukraine means that farmers cannot use their agricultural land as collateral, the main resource used in OECD countries. In its *Review of Agricultural Investment*

Policies of Ukraine (OECD, 2015c), the OECD recommended that the moratorium on land sales be repealed but that: "the land moratorium [should] be lifted gradually, [potentially] starting in selected areas having advanced cadastral records and strong political will for reforms."

- Stabilisation of the financial sector and the macroeconomy more broadly

The Ukrainian financial sector is currently characterised by low bank liquidity, poor portfolio performance, and general instability. It is not advised that such a scheme be implemented in the current context – for sustaining the scheme, as well as ensuring take-up of guarantees and ensuring that it achieves its additionality purposes. In addition, IFIs should be considered for providing supplementary credit lines to partner banks, in order to boost their liquidity.

- Strengthening of creditor rights

Creditor rights are extremely low in Ukraine – the country ranks 141 of 189 economies in the World Bank Doing Business index (2015) for resolving insolvency. Whilst the development of a financial model for CGS will take this into account in assumptions of the expected recovery rate, policymakers in Ukraine should look at boosting creditor rights in order to make such schemes sustainable, as well as to decrease the conservatism and high-collateral requirements of commercial banks.

- Increased training for banks on agricultural credit technology

Banks currently have limited knowledge of the sector and a low level of sector-specific credit technology. Whilst capacity-building workshops will be held within the framework of this project, banks in Ukraine should boost training for managerial staff and loan officers.

- Programmes to increase financial literacy

Agricultural SMEs are characterised by a low level of financial literacy and poor financial accounting in Ukraine. The government should step up financial-literacy programmes to address this. In 2015 the OECD conducted a survey of financial literacy amongst agribusiness SMEs in Ukraine and developed some recommendations to strengthen financial literacy among the target group. The main stakeholders in the project – the Ministry of Agrarian Policy and Food and the NBU – should use the findings to develop tailored financial-literacy programmes for this segment (OECD, 2015d).

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ANNEX

List of Oblast Acronyms

CK	Cherkasy
CH	Chernihiv
CV	Chernivtsi
DP	Dnipropetrovsk
DT	Donetsk
IF	Ivano-Frankivsk
KK	Kharkiv
KS	Kherson
KM	Khmelnitsky
KV	Kiev
KC	Kiev City
KH	Kirovohrad
LH	Luhansk
LV	Lviv
MY	Mykolayiv
OD	Odessa
PL	Poltava
RV	Rivne
SM	Sumy
TP	Ternopil
ZK	Transcarpathia
VI	Vinnytsya
VO	Volyn
ZP	Zaporizhzhya
ZT	Zhytomyr

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