POLICY BRIEFING 6| 2020

German Economic Team
UKRAINE

Interest support for Ukrainian exports

Hans Janus / Garry Poluschkin

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1. Introduction

Background:

- Long term fixed interest financing in one of the world's leading currencies is of utmost importance for financing of exports of capital goods
- Most exporters/lenders cannot absorb with their balance sheets the risk of changing costs for short term refinancing of medium/long term fixed interest export loans, particularly in times of rising interest rates
- The OECD's CIRR mechanism is a tool for government support for fixed income financing, shifting the risk of rising refinancing costs to the state

Purposes of this Policy Briefing

- Explanation of international regulatory framework for state support for export finance
- Demonstrating the CIRR methodology and basic features of its application
- Giving practical recommendations for a CIRR system for Ukraine, highlighting the chances and limitations of such a system

2. Why interest support ?

- International medium/long term deals are in most cases no longer initiated by exporters but by foreign investors/sponsors
- Deal origination requires the foreign buyer’s conviction of the attractiveness of the exporter’s products and of his financial offer
- No international competitiveness without comparable financial conditions
  - Length of repayment period
  - Interest rate
  - Contractual currency
- Winning of international orders usually only through public/private procurement tender procedures

3. International framework for official financial support

1. World Trade Organisation (WTO), Agreement on Subsidies and Countervailing Measures (ASCM)

   - Prohibited are: “subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex 1” (Art 3 par. 1 lit. a) ASCM)
   - Annex 1 to the ASCM Agreement: **Illustrative list of prohibited Export Subsidies** offers **two permitted exceptions** from the general prohibition of export subsidies:

   a) For **Export Credit Agency (ECA) support** in the form of **“pure cover”:**

      - “lit. j): The provision by governments (or special institutions controlled by governments) of **export credit guarantee or insurance programmes**, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, **at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.”**

International framework for official financial support

b) For official finance support through **direct lending** and/or **interest support**:

- "lit. k): The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of **export credits at rates below those which they actually have to pay for the funds so employed** (or would have to pay if they borrowed on international capital markets in order to obtain funds of the same maturity and other credit terms and denominated in the same currency as the export credit), or the **payment** by them **of all or part of the costs incurred by exporters or financial institutions in obtaining credits**, in so far as they are used to secure a material advantage in the field of export credit terms."

International framework for official financial support

- For official finance support through **direct lending** and/or **interest support**:

  - “lit. k) (continuation):

Provided, however, that if a Member is a party to an international undertaking on official export credits to which at least twelve original Members to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original Members)*, or if in practice a Member **applies the interest rates provisions of the relevant undertaking, an export credit practice which is in conformity with those provisions shall not be considered an export subsidy prohibited by this Agreement.”**

* OECD Arrangement on officially supported Export Credits (“Consensus”)

International framework for official financial support

2. OECD Arrangement on officially supported export credits ("Consensus")

- First issued 1963, current version: January 2020
- Participants: Australia, Canada, EU, Japan, Korea, New Zealand, Norway, Switzerland, Turkey, and USA
- Many non-Participant countries follow the OECD export credit discipline de facto or de jure
- OECD Consensus rules are **international best practice** for officially supported export credits

4. OECD rules for CIRR based interest support

1. Definition of CIRR (Commercial Interest Reference Rate)

The CIRR rate is a fixed interest rate that the OECD sets for its member states on a monthly basis for a limited number of currencies as a minimum reference rate for officially supported financing of capital goods exports and related services. CIRR financing is not classified as a prohibited export subsidy and thus not in conflict with WTO/OECD rules.

2. Basic features

- Risk based interest rates (plus fees) – Art. 19 b), 21
- Referenced to funding cost of fixed interest rate finance in the domestic market of the currency concerned for first class foreign borrowers – Art. 19 a)
- Switching variable funding rates into long term stable fixed lending rates
- Shifting risk of interest rate fluctuations to the government
- CIRR rates shall not distort domestic competition conditions

OECD rules for CIRR based interest support

3. CIRR methodology (Consensus Art. 19 and Annex XVI)

- CIRR rates are fixed once per month and valid until the next fixing
- The CIRR rate (“base rate”) is increased by 100 basis points (“contract CIRR”)
- During contract negotiation the interest rate can be “reserved” for a period of no longer than 120 days; If the CIRR rate shall be reserved already at the time of the offer for the commercial contract, an additional margin of 20 basis points shall be added to the relevant CIRR (“offer CIRR”)
- It is not permitted to offer either CIRR or floating interest rate whatever is lower
- In a case of a voluntary early repayment the borrower has to compensate the breakage costs

5. Structure of a CIRR system

1. CIRR System as a financing support offered by the government

   - CIRR financings are often called “government supported interest rate”. This demonstrates that CIRR Systems always need an organisational and financial backing by the government of the exporter’s/lender’s State
   - CIRR financings are usually only offered for Exports of goods/services with substantial national content (national added value) or exports of high national interest
   - CIRR financings can be offered either by state owned banks or by private banks mandated by the state
   - CIRR financings are in most cases covered by the ECA against political/commercial non-payment risks

Structure of a CIRR system

2. Experience with existing CIRR-Systems

- The state must create a financial compensation mechanism for possible future losses under CIRR financings
- Special funds in the budget and in the medium term financial planning must be allocated for CIRR financing
- In most countries the state has mandated one institution to manage the CIRR-System, e.g. KfW in Germany, SEK in Sweden, UKEF in UK, Simest in Italy
- Since CIRR financing is a banking product, most governments have mandated a financial institution to manage CIRR
- The CIRR-financing can either be a Buyers Credit or a Bank-to-Bank loan

6. Chances and limitations of a CIRR system

1. CIRR financing can strengthen the export performance of selected Ukrainian exporters

- Long term fixed interest financing is a strong element for export success in international markets
- Availability of CIRR financing generates equal conditions across boundaries for financial offers for export transactions
- Availability of CIRR financing creates international competitiveness of Ukrainian exporters
- CIRR financings develop and modernise the know-how of all institutions involved in long term export finance

Chances and limitations of a CIRR system

2. CIRR financing is not a remedy for poor export performance on international markets

- CIRR is a suitable instrument for a (very) limited group of exporters only
- Public or private banks must be educated in using CIRR methodology
- CIRR is categorised as a subsidy and permitted only under clear and tight international rules
- CIRR can never be an instrument for an interest rate subsidisation in a wider scale and for a larger group of exporters/banks

Chances and limitations of a CIRR system

3. CIRR financings are impossible without strong official financial and administrative support
   - Financial costs of public CIRR System will be (very) high, if
     - Floating refinancing costs are higher than “outside” interest rate of CIRR based export loan, and in particular, if
     - Interest rates rise during lifetime of the export loan
   - Institutional framework needs to be established
     - State Fund with financial means dedicated for CIRR financings’ interest compensation
     - Organisational body for CIRR management
     - ECA with sufficient amount of share capital and/or state guarantee needed
     - ECA cover for long term CIRR based loans must be provided
   - Corruption Risk must effectively be condemned

7. Practical recommendations for a CIRR system

- The CIRR system needs an administrator. This can be e.g. a state organisation, a public or private bank or an ECA
- A clear set or rules based on OECD CIRR methodology must be defined and strictly obeyed
- Financial model needed for calculation of budget risks and amount to be allocated within budget
- Operations may only start after allocation of a dedicated budget

7. Practical recommendations for a CIRR system

- The system should be open for (all) commercial banks wishing to offer medium/long term CIRR based export financing
- Any distortion of competition must be avoided
- CIRR financing should be only offered if the payment risk is covered by the ECA. This guarantees:
  - Sound underwriting principles
  - Risk based pricing of export credit guarantee cover
- Effectiveness, financial results, orderly administration and fulfilment of objectives must be regularly audited

About the German Economic Team

The German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Georgia and Uzbekistan regarding the design of economic policy reform processes and a sustainable development of the economic framework. As part of the project we also work in other countries on selected topics.

In a continuous dialogue with high-level decision makers of the project countries, we identify current problems in economic policy and then provide concrete policy recommendations based on independent analysis.

In addition, GET supports German institutions in the political, administrative and business sectors with its know-how and detailed knowledge of the region's economies.

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CONTACT

Garry Poluschkin, Project Manager Ukraine
poluschkin@berlin-economics.com

German Economic Team
c/o BE Berlin Economics GmbH
Schillerstraße 59
10627 Berlin

Tel: +49 30 / 20 61 34 64 0
info@german-economic-team.com
www.german-economic-team.com
Twitter: @BerlinEconomics
Facebook: @BE.Berlin.Economics

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