POLICY BRIEFING 07| 2021

Developing medium and long-term finance in Ukraine: The role of the export credit agency

– Summary of results –

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Executive summary

- Access to medium/long-term (MLT) export finance is of importance for the international competitiveness of Ukrainian exporters but Ukraine's Export Credit Agency (ECA) has not yet become fully operative.
- The corporation's low capitalisation and the absence of any additional state guarantee for ECA's operations is a major problem
- If the buyer's credit guarantee would be accepted by NBU as credit collateral, banks would benefit from lower capital costs
- For the guaranteed portion of the export credit a so-called "nil-risk-weighting" could become applicable if the credit is denominated and funded in UAH.
- For credits in FX, the sovereign risk rating of Ukraine would apply for the bank's weighting of the credit risk exposure.
- In most cases this will be less expensive, export finance thus becomes more attractive for banks involved.
- To achieve this, Cabinet of Ministers, ECA, NBU, commercial banks must develop a sustainable solution for the acceptance of ECA buyer's credit guarantees as valid collaterals allowing the lowest possible risk-weighting for the financing bank.

➢ **Clear and transparent regulation and external financial control strengthen confidence in the reliability of ECA's operations.**

Structure

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3. Commercial banks’ risk valuation
4. Regulation of ECA’s operations
5. Recommendations

1. Introduction

Background:

- This policy briefing summarises the results displayed in PP/02/2021
- Medium/long-term export finance is still underdeveloped in Ukraine
- Export opportunities, in particular for manufactured goods, cannot be fully used
- Ukraine's ECA ("EKA") is (yet) unable to serve as risk-transfer counterparty for banks

Purpose of this Policy Briefing:

- Analysing the obstacles for medium/long-term export finance
- Strengthening ECA's role in MLT export promotion and export finance
- Reducing capital costs in export finance for Ukrainian banks

➢ **Increasing global competitiveness of Ukrainian exporters of manufactured goods**

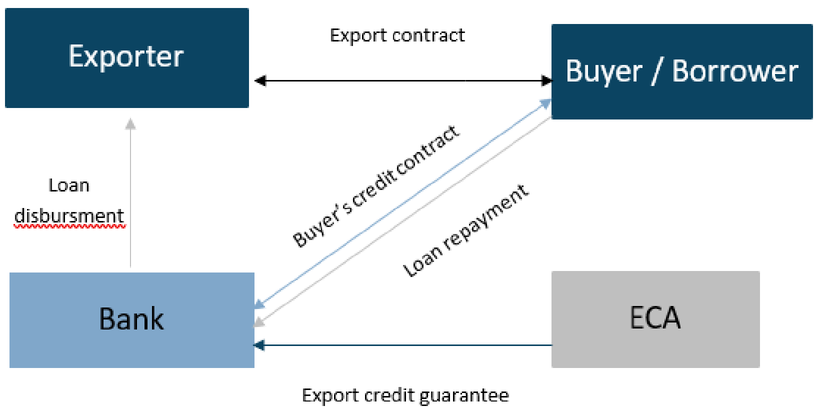
2. Medium and long-term export finance

Ukraine's ECA's insufficient role as risk off-taker for banks

- Currently Ukraine's ECA cannot serve as risk transfer counterparty for banks due to various reasons:
  - The low capitalisation of the ECA is insufficient for MLT export guarantees
  - The ECA is state-owned but registered as a joint stock company and thus has by law a limited liability only
  - There is no additional sovereign guarantee for its operations in place
  - Banks would not trust in the value of an ECA MLT guarantee product, if any
  - The NBU does not recognise ECA export guarantees as a fully valuable loan collateral

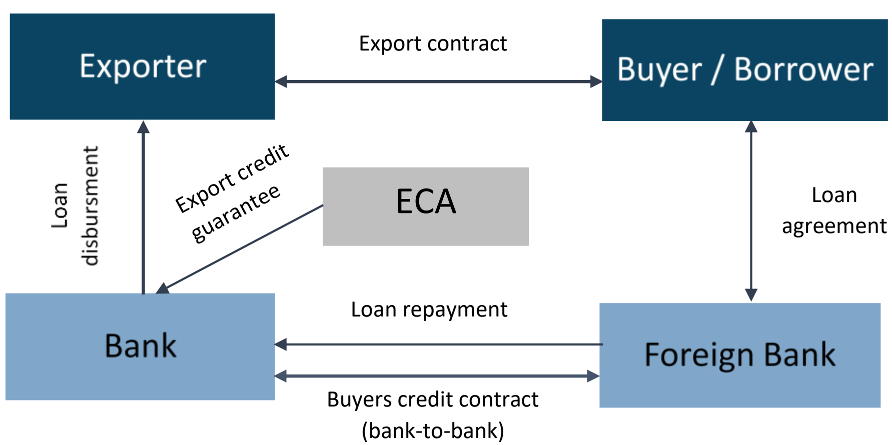
2. Medium and long-term export finance

Buyer‘s credit guarantee with 3 parties (plus ECA)



Source: Own illustration

Buyer‘s credit guarantee with 4 parties (plus ECA)



Source: Own illustration

Basic features of MLT export finance

- Medium-/long-term export credits hardly possible without bank financing
- Bank financing usually requires a risk transfer to an export credit agency (ECA); otherwise capital costs are too high
- Only a strong and mature ECA can off-take the credit risks from banks through export credit guarantees
- The standard product of the ECAs is the „buyer‘s credit guarantee“
- Risk transfer to the ECA reduces the capital costs for financing banks significantly

2. Medium and long-term export finance

Minimum standards for an ECA buyer's credit guarantee

- Prudent and sound underwriting policy
- Cautious and selective risk-taking to comply with WTO requirements
- Risk assessment process must include potential risks of own customer, foreign buyer etc. (Know-your-customer risk check)
- Product features of buyer's credit guarantee need to be attractive and risk reducing for financing banks by:
  - Proximity to a first demand bank guarantee
  - High percentage of cover
  - Short claims waiting period
  - Short period for processing of claims and claims payments

3. Commercial banks' risk valuation

Insufficient experience of exporters and cautious attitude of banks

- Exporters have little experience, if any, with MLT export contracts. Most negatively affected are exporters of manufactured goods.
- Export finance is not yet a well-developed area of business for most Ukrainian banks
- The reasons for this development are:
  - Exporter's general lack of working capital
  - Lack of export experience in many companies
  - Non-performing loans remain on a high level
  - Very cautious lending policy by banks
  - Difficulty to arrange affordable refinancing with matching maturities
  - Missing recognition of ECA cover by NBU as valid credit collateral
  - No "nil risk-weight exposure"

3. Commercial banks' risk valuation

Basel III and high costs of capital for banks

- Capital Requirements Regulations for banks („Basel III") require a **tier-1 own capital of usually 6 % of the total risk exposure**
- **Each single risk exposure must be prudently valuated** and has a respective risk weighting
- **Export credits in risky markets or with borrowers not excellently well rated, have a high-risk weighting of up to 150 %**
- This makes a bank's funds for **export loans relatively expensive** and consequently export finance relatively **unattractive**.

Risk weighting for banks' exposures to central governments or central banks

MEIP*	0	1	2	3	4	5	6	7
Risk weight	0 %	0 %	20 %	50 %	100 %	100 %	100 %	150 %

Source: Own illustration based on Art. 137 CRR, * Minimum Export Insurance Premium

3. Commercial banks' risk valuation

Risk (and cost of own funds) reduction through ECA guarantees

- ECA buyer's credit guarantees are risk mitigation tools with a very high level of security for financing banks (if they are compliant with CRR requirements)
- ECA buyer's credit guarantees are legally very similar to unconditional, first demand bank guarantees; there are hardly any reasons for the ECA to deny or delay the indemnification payment
- **When Ukrainian ECA develops a buyer's credit guarantee product, this product must be designed as close to CRR requirements as possible**

Why has NBU currently problems to regard ECA guarantees as fully valuable collaterals?

- Ukrainian ECA's extremely low capital of UAH 200 m
- No additional (very high/unlimited) sovereign guarantee
- No protection against Ukrainian ECA's potential insolvency
- No first-class reinsurance panel established yet

3. Commercial banks' risk valuation

Reasons for NBU to possibly change their position

- The sole shareholder of ECA is the Ukrainian Cabinet of Ministers. The state's share of capital may not fall below 50 % plus one share (Art. 2 ECA law).
- Additional state guarantees to secure the ECA's honoring of its debt obligations are foreseen in the law (Art. 3, 7, 11 ECA law)
- The share capital of ECA shall be increased from UAH 200 m (Art. 2 ECA law) to UAH 2 bn already in 2021
- The key objectives of ECA are defined by the law and make ECA a state (policy) corporation for export promotion (Art. 3, 4 ECA law)
- A strong and first-class reinsurance panel could drastically reduce the portfolio and single transaction risks of ECA and increase its capacity for the issue of new export credit guarantees
- A supervisory board with renowned experts including independent directors has been established

3. Commercial banks’ risk valuation

Consequences of a possible recognition of Ukraine‘s ECA buyer‘s credit guarantees by NBU:

For the covered portion of the loan (usually 95 %):

- Locally regulated banks would benefit for loans in UAH and funded in UAH from nil-risk weight (0 %) because, in the case of the foreign borrower‘s default, the insured bank has a direct claim against Ukraine‘s ECA, representing the central government of Ukraine
- Loans in other currencies would, in principle, be weighted as exposures with a risk weight of 100 % based on Ukraine‘s „B“-rating unless the risk weighting for the foreign borrower and his country leads to a lower risk weight

For the uncovered portion (usually 5 %):

- Regardless of the currency concerned the CRR-risk-weighting for the foreign borrower and his country is applicable as floor

In the case of the foreign borrower‘s default:

- No deduction of loan exposure from tier-1 capital during years 0 to 7 for covered portions of nil-weighted exposures

4. Regulation of ECA' s operations

<u>Supervision</u>

- The Ukrainian ECA is neither regulated by banking nor by insurance supervision
- Cabinet of Ministers specifies „procedure and forms of control" over the ECA's activities (Art. 9 par. 5 no. 5 ECA law)

➢ This is not totally unusual for ECAs, but clarity and transparency are needed

<u>External financial control</u>

- External financial control (going beyond financial statements) should not be neglected
- Accounting Chambers or comparable state institutions for independent external public financial control function as controlling bodies in many countries

➢ Regulation and external financial control shall go hand in hand

5. Recommendations

1. The share capital of Ukraine’s ECA must be significantly increased
2. It is recommended that the Ukrainian state should maintain full ownership, at least for the period until ECA’s operations are fully developed
3. The ECA law should make sure that ECA represents the full faith and strength of the sovereign, i.e. ECA’s liabilities should be recognised as liabilities of the Ukrainian government
4. Clear and transparent regulation and external financial control strengthen confidence in reliability of Ukrainian ECA’s operations
5. ECA should develop a MLT buyer’s credit product with features allowing the lowest possible capital allocation for banks
6. The credit risk assessment process should be done by both, the financing bank and ECA individually. Sound underwriting and cautious risk taking must be applied
7. ECA should try to set-up a first-class panel of reinsurers
8. ECA, NBU, state-owned and commercial banks must develop a sustainable solution for the acceptance of ECA export credit guarantees as valid collaterals allowing the lowest possible risk-weighting for the financing bank

About the German Economic Team

Financed by the Federal Ministry for Economic Affairs and Energy, the German Economic Team (GET) advises the governments of Moldova, Georgia, Ukraine, Belarus and Uzbekistan on economic policy matters. Furthermore, GET covers specific topics in other countries, such as Armenia. Berlin Economics has been commissioned with the implementation of the consultancy.

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