Ex post evaluation – Ukraine

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Sector: Financial sector (CRS 24030)
Programme/Project: Support programme for Ukrainian banks, 2009 66 549
Implementing agency: Three Ukrainian private commercial banks

Ex post evaluation report: 2015

		Project (Planned)	Project (Actual)
Investment costs (total)	EUR million	30.00	30.00
Counterpart contribution	EUR million	0.00	0.00
Funding	EUR million	30.00	30.00
of which BMZ funds	EUR million	30.00	30.00

*) Projects in the 2014 random sample

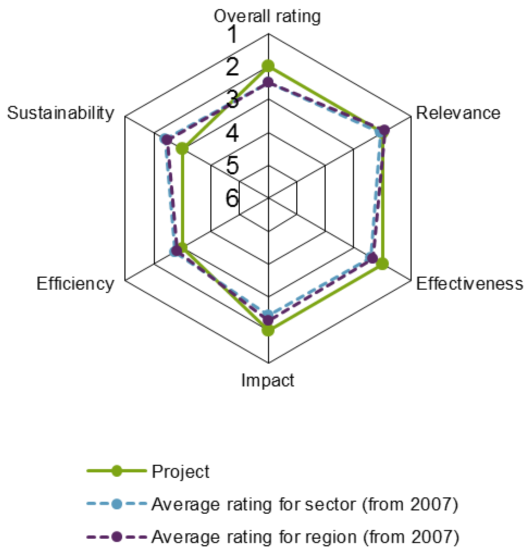
Summary: As part of the project, three private Ukrainian banks focusing on small and medium-sized enterprises (SMEs) were given capital in 2009 amounting to the equivalent of 30 million EUR in the form of share capital and subordinated debt).

The project aimed to stabilise the Ukrainian financial system, which came under huge pressure from 2008 onwards following the global economic and financial crisis. The strengthening of equity capital was meant to enable the financial institutions to maintain or expand their volume of lending to the (M)SME sector, and thereby cushion the negative impacts of the crisis on the real economy.

Objectives: Overall development objective: help to stabilise the Ukrainian financial system during the crisis as well as to expand and deepen the sector after the crisis, thereby contributing to the promotion of the private economy as well as an increase in employment and income. **Programme's objectives:** contribute to overcome the credit crunch in Ukraine by stabilising the equity capital of Ukrainian banks focused particularly on SMEs, and mobilise additional financing.

Target group: Direct: financial institutions focusing on SMEs; indirect: Ukrainian SMEs.

Overall rating: 2



Rationale: The goals of the project could not be met on a continuous basis owing to the longer than anticipated financial crisis, the political upheavals and the resultant regulatory intervention in the banking sector. Thanks to their strong shareholders but also their viable business models, close customer ties and comparatively comfortable liquidity positions, the banks survived the crisis situation in 2008/2009 relatively well. We expect them to emerge as winners from the current political crisis too. This is why the project still has been rated as good.

Highlights: Two of the three partner banks deliberately expanded their lending in the first half of 2014, in contrast to their competitors and under the toughest conditions (ongoing political instability, currency depreciation, withdrawal of deposits, forced closure of branches in the Crimea/in eastern regions), thereby providing the SME sector with the urgently needed liquidity. As a result they crucially contributed to the stabilization of the economy, income and employment.

Rating according to DAC criteria

Overall rating: 2

General conditions and classification of the project

As part of the programme, three private Ukrainian banks were given capital in 2009 amounting to the equivalent of 30 million EUR in the form of share capital and subordinated debt).

The programme aimed to stabilise the Ukrainian financial system, which came under huge pressure from 2008 onwards following the global economic and financial crisis. The strengthening of capital was meant to enable the financial institutions to maintain or expand their volume of lending to micro, small and medium-sized enterprises (MSMEs), and thereby cushion the negative impacts of the crisis on the real economy.

Relevance

The results chain assumed at programme appraisal, according to which increasing the equity of banks would boost lending in the MSME sector and therefore contribute to overcoming the financial crisis as well as subsequently to expanding and deepening of the financial sector, is still plausible from today's perspective. At the same time, maintaining access to financial services for the private sector positively contributes to the development of income and employment in Ukraine.

When it comes to evaluating the programme it has to be taken into account that more than 75 % of micro and small companies in Ukraine are registered as self-employed contractors for tax-related purposes, but in reality these are employees of larger companies (fake self-employment). To be able to measure the programme's success properly, the focus of the evaluation has to be placed on small and medium-sized enterprises (SME)[1] .

According to estimates by the SME Banking Club, an interest group founded in 2010 in the Ukrainian SME sector, the inadequate access to loan capital still poses a substantial hurdle for SMEs, alongside insufficient tax legislation, high regulatory requirements and corruption. Only around 20 out of 180 registered banks (as of 1 January 2014) offer SME financing, and fewer than 10 of these banks are actually active in this sector. This bottleneck has tightened further since early 2014 because of the high political and therefore economic instability in the country. Some 50 of the 180 banks are currently in the process of being wound up, and the remaining banks had mostly abandoned their lending activities at the time of the evaluation for lack of funding opportunities. The few banks which are still active have sharply increased their lending requirements, forcing SMEs short on cash into the non-regulated and over-priced informal financial market (Sayapin, Alexey 2014).

The programme's objective corresponded with the BMZ's developmental goals and guidelines focusing on "sustainable economic growth", and supported the Ukrainian government's strategic promotion of SMEs. In 2012 the government passed a law on the "promotion and state support of SMEs in Ukraine", which targeted improved framework conditions for SMEs, among other things by alleviating taxes and through deregulation. This objective has only been partly fulfilled so far. Ukrainian SMEs still see themselves confronted with high bureaucratic and tax-related obstacles. The programme complemented the measures taken by other donors, such as the European Bank for Reconstruction and Development and the International Monetary Fund (IMF), which provided substantial funds for recapitalising Ukrainian banks in response to the banking crisis in 2008/2009.

Overall, the relevance of the programme is assessed as good.

Relevance rating: 2

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[1] Based on the EU definition, companies in Ukraine belong to the SME category if they employ up to 250 people and have annual sales of no more than 50 million EUR. While Pivdennyi Bank bases its activities in the SME sector on this definition, Megabank and ProCredit Bank have lower requirements.

Effectiveness

Considering the dramatic events from the unresolved political conflict between Russia, the European Union and Ukraine since early 2014, the effectiveness of the programme is evaluated for the period prior to 30 December 2013, i.e. before the current crisis, as well as on the basis of half-year figures by 30 June 2014.

The credit portfolio volume as of 31 December 2013 of two of the three banks was equal to or higher than before the crisis (programme's objective indicator 1). It should be emphasised that these two banks also significantly increased their credit volumes in the sub-segment of SMEs, which is attributable to the expansion of business activities in 2013. Only one bank clearly missed its target volume by the end of 2013 due to an ongoing reorganisation. All three banks display an increase in credit volumes as of 30 June 2014, measured in local currency.[2] This is particularly remarkable because the banking sector was confronted with a massive withdrawal of deposits in the first half of the year[3], while access to other funding sources in the local currency hryvnia as well as in foreign currency mostly dried up. The banking business is additionally burdened by new supervisory regulations, which aim to prevent a further risk concentration of foreign currency loans in balance sheets. Since 2009, for example, lending in foreign currencies is limited to borrowers with regular income in foreign currency. Additionally, it was recently decided to oblige banks to convert foreign currency accounts into hryvnia mandatory, as well as to limit cash withdrawals.

When analysing the credit portfolios of the supported banks, it transpires that they have expanded their local currency lending to SMEs significantly since 2009. The portion of SME loans compared to the entire credit portfolio currently stands at 50 % (bank 1), 70 % (bank 2) and 95 % (bank 3). The mentioned banks are still active in the SME sector in 2014 despite considerable difficulties (abandoning business activities in Crimea, in the oblasts of Donetsk and Luhansk, extreme depreciation of the local currency, significant decrease of deposits). As a result of good customer relationships as well as SME appropriate products and processes, banks were able to increase their credit volumes again in the first half of the year.

The target to increase annual lending to SMEs (programme's objective indicator 2) has only been reached continuously by one bank since 2011. This is due to the large number of customers having income in foreign currency (US dollars) which enabled the bank to expand its portfolio of US dollar loans despite various constraints placed by the Ukrainian central bank. The other two banks were able to significantly increase their annual lending to SMEs in local currency as well, however this growth was offset by a sharp decline in foreign currency credit volumes. As a result, both banks were able to fulfil the agreed yearly growth rate only from 2013 on. Given the reported expansion of the local currency portfolio, the regulatory interventions and the volatile economic environment, this indicator can be considered largely fulfilled byr both banks. This is particularly backed by the assumption that, in light of the economic situation in Ukraine and the banks' different strategic priorities, a standardized target portfolio growth rate of 15 % p.a. for all three banks is not considered appropriate.

Given the extent of the economic and financial crisis, it seems that the time-frames to increase lending volumes (programme's objective indicators 1 and 2) have been calculated too ambitiously at appraisal..

The credit portfolio quality (programme objective indicator 3) met the requirements at all three banks by the end of 2013. As of 30 June 2014, however, the indicators deteriorated significantly. The portfolio quality of one bank was already reported slightly above the target value. This can be traced back to defaulting borrowers in Crimea as well as in the eastern regions of Donetsk and Luhansk, which are still unsettled by fights between the Ukrainian army and Separatists. If the simmering crisis cannot be resolved quickly and sustainably, credit portfolio quality will likely continue to decrease, also in view of the looming spill-over effects (negative impact on economic performance even in areas not directly affected). It has to be noted that according to the central bank definition for calculating the portfolio at risk indicator "PAR > 30 days", no differentiation is made between restructured and non-restructured loans. This means that the significant number of restructured loans following the financial crisis in 2008/2009 is only partly covered by the

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[2] This also applies for banks whose credit portfolios measured in local currency have risen sharply, even after the recent significant devaluation of the hryvnia against the US dollar.

[3] According to the central bank, approximately 30 % of all deposits nationwide were withdrawn between January and August. This deposit collapse particularly affects the crisis-ridden areas of the Crimea, Donetsk and Luhansk.

PAR > 30 days, as they are only taken into account if the borrower is still in default more than 30 days after the restructuring. This impedes a comparison of the credit portfolio quality with other countries.

With respect to capital adequacy (programme's objective indicator 4) the prospects are much better.). The capital adequacy was strengthened by the share capital /subordinated debt provided by KfW within this programme, and therefore continuously stayed above the stipulated 12 % since 2009 in all three partner banks. However, caused by the most recent crisis and the deterioration of the portfolio quality, all three partner banks are proactively thinking about further strengthening their share capital in order to be able to maintain current lending volumes to SMEs.[4]

No indicator was chosen for the targeted mobilisation of additional financing in the form of equity or debt. This is justifiable because this objective is desirable from a programme perspective, but can only be influenced by the programme to a limited extent.

The overall effectiveness of the programme is rated good.

Effectiveness rating: 2

Efficiency

Providing share capital or subordinated debt not only enables banks to expand their credit business, but also reinforces their solvency. This is therefore the most promising and efficient approach to promoting efficient lending to the economy, without taking away the flexibility that banks need for their business activities. This applies all the more so in a strongly changing economic and political environment.

The profitability of the partner banks was affected very badly by the financial crisis in 2008/2009, but all three partner banks generated steady, albeit sometimes very small, annual profits. In comparison to the market as a whole they have been above their competitors' averages with respect to the profitability ratios "return on average assets" and "return on average equity" since 2011, almost without exception. Tapping new resources of income (mainly commission earnings), but also the banks' clear focus on the target group of SMEs contributed to this.

Apart from Crimea (forced branch closures after the annexation by Russia), the supported banks are represented with branches in all SME-relevant regions of the country. This enabled the partner banks to expand their lending further to SMEs. Based on the EU definition, companies in Ukraine are counted as SME if they employ up to 250 people and have an annual turnover of no more than 50 million EUR. According to this definition, one bank, which is one of the 20 largest banks in Ukraine, increased its lending to SMEs from 60 % in 2009 to more than 70 % in 2014. The second bank expanded its share of SME loans from 11 % in 2009 to 50 % as of today. For this bank, companies with no more than 250 employees and an annual turnover of up to 10 million USD belong to the target group of SMEs. The third – significantly smaller bank – recently disbursed 95 % of its loans to SMEs. This bank considers enterprises with an annual turnover of no more than 3 million EUR and an outstanding credit volume of less than 250,000 EUR.

According to the partner banks, the expansion of SME lending activities is the result of a good customer relationship, which has been nourished even during the crisis. Even though it cannot be ruled out that some customers might be overburdened with the repayment of their loans, given the high number of restructured loans in the banks' portfolio, the overall allocation efficiency of the programme can be rated good.

The banks do not publish any information about staff productivity, so that an evaluation of the production efficiency has to rely on available data, such as the amount of employees and the volume of the credit portfolio. Employee turnover averages 14 % for two of the banks, standing below the European average of 18.3 % (Hay Group, 2013). As all banks have stabilised or even increased their credit portfolios with comparable or even significantly smaller workforces between 2009 and 2013, it can be assumed that the optimisation measures triggered by the banks, which aimed to standardise products and streamline processes, were implemented successfully. As a result, the banks were able to shorten the processing time

[4] At the evaluation KfW had a request from one bank for a capital increase, while the other two banks expressed similar thoughts in bilateral discussions.

between loan applications and loan approvals for small and medium-sized enterprises to about ten banking days, while competitors still need up to two months. The cost income ratio in all banks still hovers between acceptable 60 % to 70 %, not taking risk provisions into account. The production efficiency of the programme is therefore assessed as satisfactory.

The overall efficiency of the programme is assessed as satisfactory.

Efficiency rating: 3

Impact

The programme aimed to stabilise the Ukrainian financial system, which came under huge pressure from 2008 onwards following the global economic and financial crisis. The strengthening of capital was meant to enable the financial institutions to maintain or expand the lending volume to the SME sector, and thereby cushion the negative impacts of the crisis on the real economy, and especially SMEs. In addition, the programme was set up to expand and deepen the financial sector (overall development goal 1) and to contribute to the promotion of the private sector as well as an increase in employment and income (overall development goal 2).

As part of the evaluation it was assessed to what extent an informative and practical ultimate objective can be included to assess the stability of the banking sector. Generally speaking, the capital adequacy ratio that follows standard guideline calculations is seen as an ideal parameter. The ratio is calculated monthly by the central bank and published as an average for all banks. Nevertheless, the Tier 1 + Tier 2 capital adequacy ratios in Ukraine are losing relevance in the current, instable environment. After averaging at 18 % in late 2013 showing a comfortable buffer to the minimum requirements of 10, a recently conducted stress test in the fifteen largest banks in the country discovered that nine of them will need additional equity capital in order to meet the minimum requirements in future as well. Another possible indicator is the level of savings and term deposits. As the Ukrainian financial sector is still mostly cut off from external financing sources and currently struggling with further extreme devaluations of the national currency, term saving and deposit products stabilise the funding side of banks and therefore the entire sector. However, this indicator is in this case not appropriate either because saving and term deposits are not subject to minimum holding periods by law in Ukraine, and can be drawn at any time by the private customers. Therefore no additional indicator is included to evaluate the banking sector's stability. Irrespective of the adequacy of the listed indicators, it is difficult to assess the contribution of the supported banks to the stability of the Ukrainian financial sector with its large number and variety of institutions. Though it can be assumed that the partner banks as key regional players have significantly stabilised the funding supply for the target group of SMEs.

To assess indicator 1 for the overall development goal (increasing lending in local currency) official statistics from the central bank are used. The indicator can be considered fulfilled. Outstanding loans to private companies increased by 61 % to 380 million UAH from 2009 to June 2014, while the volume of US dollar loans only increased by 5 % (NBU). The supported banks contributed to this, albeit to different extents. It can also be assumed that the banks contributed to the expansion of the product range and therefore to (further) structural development in the sector by developing products and processes tailored to SMEs, such as agricultural loans.

No data is available for indicator 2 of the overall development goal (increasing SMEs' share in GDP (gross domestic product)), which means the indicator cannot be evaluated. It has to be considered though, that SMEs accounted for almost 95 % (2009: 99 %) of all companies in Ukraine and employed almost 68 % (2009: 61 %) of the working population at the end of 2013, despite considerable bureaucratic and tax-related obstacles. SMEs still play an important role for the construction sector, trade and the agricultural economy, and contribute between 70 % and 90 % to turnover in these sectors (BFC 2013). Therefore it can be assumed the Ukrainian SME sector significantly supports employment and income (BFC 2013), despite the fact that it accounts for a rather small part of the GDP of Ukraine summing up to approximately 15 % (Prodan, Oksana 2012).

Even though two of the supported banks are rather small institutions in comparison to their competitors, it can be assumed that the programme had positive structural impacts both on the financial sector as well as income and employment trends in Ukraine. In the first half of 2014, in contrast to their competitors and under the most difficult conditions mentioned, two of the three banks expanded their lending to SMEs, thereby ensuring livelihood and jobs for many SME customers.

Indicator	Initial value 09/2009	Reference value 12/2013	EPE 06/2014
(1) Lending in local currency to the private economy stabilises and increases again after the financial crisis (NBU, 2013)	236 million UAH	418 million UAH	380 million UAH

To sum up, we rate the overall developmental impacts of the programme as good.

Impact rating: 2

Sustainability

From a development point of view, the sustainability of the programme is particularly evident in the current crisis. Instable political frameworks and the resulting implications for the Ukrainian economy will pose a huge challenge for the banking sector and partner banks in the foreseeable future, to an extent nobody could have foreseen at programme appraisal. The Ukrainian banking sector is as of today again under enormous pressure due to fact that the local currency temporarily devalued by up to 75 % since December 2013. Several banks are already under liquidation, and foreign banks either stopped SME lending or even left the Ukrainian market due to the persistent risks. Further structural adjustments in the outsized banking sector can be expected, and are generally welcomed, if not only the national deposit insurance fund is being replenished with sufficient capital but also the central bank has the ability, the necessary autonomy and the personal capacity to accompany the structural adjustment of the market. At this very moment, the central bank, which is driven by the interests of the various stakeholders (IMF, government, market pressure), operates on a mainly reactive basis, providing emergency liquidity assistance, limiting free currency conversions or forcing banks and exporters to sell foreign currencies at a defined rate. In parallel the central bank investigates the largest banks in a stress test in collaboration with the IMF. The first results show massive demand for additional capital in most banks.

The supported partner banks overcame the crisis in 2008/2009 comparably well, amongst others thanks to the funds provided by German Financial Cooperation. In addition to the strengthened equity and liquidity base, the reputation of Financial Cooperation in particular played a role, enabling the banks to mobilise additional, urgently needed funds.

The partner banks have a good chance of exiting this crisis as winners thanks to their strong shareholders but also as a result of their viable and well-balanced business model, good customer relationships and a comparably comfortable liquidity position. Even during the global financial crisis in 2008/2009, which negatively influenced the financial sector in Ukraine overall, the banks were able to continue their business activities successfully. The shareholders already signalled to support the portfolio growth of the banks with additional capital.

However, the partner banks will also be affected by the particularly difficult environment in Ukraine. If the situation does not calm down soon, one expects that the loans granted in Crimea as well as to the eastern regions will have to be written off completely. At the time of the evaluation, the banks made provisions for bad debt at a level similar to the previous year; they will not be able to cover the losses resulting in a complete default of the endangered loans. Two of the partner banks therefore already planned a capital increase for 2015. However, additional capital might be required in future. The banks now focus more strongly on funding their business activities by deposits. As a result they are more independent of the inter-bank market. On the other side the increasing competition for the scarce capital resources squeezes margins and a sudden withdrawal of deposits, as experienced during the political crisis in the first quarter of 2014 or the escalation in the eastern regions in the first quarter of 2015, hampers a proper liquidity management. In the near future, the partner banks will remain dependent on foreign donors.

Overall the sustainability of the programme is assessed as satisfactory due to the unstable political outlook.

Sustainability rating: 3

Notes on the methods used to evaluate project success (project rating)

Projects (and programmes) are evaluated on a six-point scale, the criteria being **relevance, effectiveness, efficiency** and **overarching developmental impact**. The ratings are also used to arrive at a **final assessment** of a project's overall developmental efficacy. The scale is as follows:

Level 1	Very good result that clearly exceeds expectations
Level 2	Good result, fully in line with expectations and without any significant shortcomings
Level 3	Satisfactory result – project falls short of expectations but the positive results dominate
Level 4	Unsatisfactory result – significantly below expectations, with negative results dominating despite discernible positive results
Level 5	Clearly inadequate result – despite some positive partial results, the negative results clearly dominate
Level 6	The project has no impact or the situation has actually deteriorated

Rating levels 1-3 denote a positive assessment or successful project while rating levels 4-6 denote a negative assessment.

Sustainability is evaluated according to the following four-point scale:

Sustainability level 1 (very good sustainability): The developmental efficacy of the project (positive to date) is very likely to continue undiminished or even increase.

Sustainability level 2 (good sustainability): The developmental efficacy of the project (positive to date) is very likely to decline only minimally but remain positive overall. (This is what can normally be expected).

Sustainability level 3 (satisfactory sustainability): The developmental efficacy of the project (positive to date) is very likely to decline significantly but remain positive overall. This rating is also assigned if the sustainability of a project is considered inadequate up to the time of the ex post evaluation but is very likely to evolve positively so that the project will ultimately achieve positive developmental efficacy.

Sustainability level 4 (inadequate sustainability): The developmental efficacy of the project is inadequate up to the time of the ex post evaluation and is very unlikely to improve. This rating is also assigned if the sustainability that has been positively evaluated to date is very likely to deteriorate severely and no longer meet the level 3 criteria.

The **overall rating** on the six-point scale is compiled from a weighting of all five individual criteria as appropriate to the project in question. Rating levels 1-3 of the overall rating denote a "successful" project while rating levels 4-6 denote an "unsuccessful" project. It should be noted that a project can generally be considered developmentally "successful" only if the achievement of the project objective ("effectiveness"), the impact on the overall objective ("overarching developmental impact") and the sustainability are rated at least "satisfactory" (level 3).