UKRAINE – EBRD REFORM ANCHORING & CRISIS RESPONSE PACKAGE

EXECUTIVE SUMMARY
In Ukraine’s current context, the Bank is seeking to maintain the pace of its investments, capacity building and policy dialogue to provide support for economic stabilisation and growth, while targeting continued impact on the country’s transition to a sustainable market economy.

Three priority areas have been identified: a deep restructuring of the financial sector, fundamental reform of the energy sector, and support to inherently viable corporates deemed likely to endure and shape the structure and profile of their industry beyond the crisis years.

The success of the proposed package depends on three tightly interrelated conditions. First is the political will, which is the responsibility of the Ukrainian leadership, and which the international community can support. Second is the expertise necessary to design a reform vision, operationalise and implement it. Third is the funding. The IFIs’ role is concentrated in providing most of the second and part of the third pillars. If the first is lacking, it will not be possible to implement this strategy and achieve the desired deep transition impact. Thus the willingness of the Bank to take risks in Ukraine, within the recently calibrated general prudential limits, is a function of the scale and depth of the reforms. The proposed package will need to be implemented in the context of Ukraine’s difficult financial and economic environment, requiring high flexibility of implementation, as well as efficiency and speed of delivery.

BACKGROUND
Since early 2014, EBRD has been able to step up its engagement in Ukraine in view of the new political forces’ willingness to implement broad-ranging reforms, while remaining acutely aware of the heightened risks in the operational environment. In effect, the Bank has been operating so far in a ‘crisis response mode’ while remaining within the usual parameters for its operations. The elections in October 2014 have consolidated the reformist forces, opening the way to decisive steps, but also highlighted the urgency of implementation of reforms and the scale of funding needs. Beyond being fully coordinated with other IFIs, the European Union and donor partners, in areas like banking sector and energy security/reforms, EBRD and its partners must continue to work on close collaboration and joint action/projects with key Ukrainian stakeholders to ensure complementarity of macro and micro level conditionality for consistent reforms;

- The Bank will prioritise its support, as well as policy support and capacity-building assistance, against urgent crisis needs of the economy as a whole and its clients in particular, ensuring maximum impact of the Bank’s limited resources in where the ground;
- Crisis response requires a flexible and expedient approach to the operational process for investments and should include interventions to preserve the financial viability of players that would be key and amenable to foster reforms in the medium term.
- When assessing projects, the Bank will take into account exceptional circumstances, at the country or local level, to decide how to tailor best its support and what (if any) level of concessionality is required taking into account affordability factors, as may be relevant.

1. PRIORITIES AND PRINCIPLES
The crisis response framework as outlined below was envisaged for two years, until the end of 2016; at the end of 2015 it was reviewed in light of the political and economic situation on the ground as well as of the results of its existing operations in terms of delivery efficiency and outcomes.

The Bank will continue to closely monitor the developments in Ukraine and the performance of its portfolio in the country. It will consider new/continued investments consistent with sound banking principles.

Within the context of the underlying principles stated below, there continue to be three core priorities for EBRD interventions, each combining investment and policy dialogue:

1. Banking sector stabilisation and restructuring
2. Energy security and energy sector reforms
3. Financial support for key private corporate sector players

It is envisaged that some 70-75% of EBRD activities will target these priority areas

Support for the commercialisation and corporatisation of public utilities, including within the context of decentralisation of powers to municipalities will also be maintained.

UNDERLYING PRINCIPLES
- The EBRD package, to be impactful, requires the continuation of strong reform orientation and ensuing actions. The political leadership for reform and the ownership of crisis management are with the Ukrainian authorities. It is anticipated that civil society will continue playing a vital role in promoting such reforms and monitoring their implementation.

- EBRD activities form part of and rely on overall international efforts to support Ukraine. The Bank works in close cooperation with other IFIs and the EU, as befits the urgency of implementation of reforms and the scale of funding needs. Beyond being fully coordinated with other IFIs, the European Union and donor partners, in areas like banking sector and energy security/reforms, EBRD and its partners must continue to work on close collaboration and joint action/projects with key Ukrainian stakeholders to ensure complementarity of macro and micro level conditionality for consistent reforms;

- The Bank will prioritise its support, as well as policy support and capacity-building assistance, against urgent crisis needs of the economy as a whole and its clients in particular, ensuring maximum impact of the Bank’s limited resources vis-à-vis the needs on the ground;

- Crisis response requires a flexible and expedient approach to the operational process for investments and should include interventions to preserve the financial viability of players that would be key and amenable to foster reforms in the medium term.

- When assessing projects, the Bank will take into account exceptional circumstances, at the country or local level, to decide how to tailor best its support and what (if any) level of concessionality is required taking into account affordability factors, as may be relevant.

CORE PRIORITY 1: BANKING SECTOR STABILISATION AND RESTRUCTURING
To anchor economic recovery, Ukraine’s banking sector needs to resume fulfilling its financial intermediation function, i.e. restart lending to real economy for supporting growth. For this to happen, the NBU needs to continue with consolidation and restructuring, ensuring adequate capitalisation of the banking system. In a similar fashion, tight supervision must be exercised to ensure compliance with restrictions concerning related party lending and rules regarding transparency of ownership and good governance.

The Bank’s approach to the sector will include:

- Participation in recapitalisation of selected banks that are deemed viable (equity investments with participation in the board of the bank and associated capacity building/TC).
• Effectively, the Bank would take the lead in providing advice and resources for good governance, board participation and oversight;

• Support for the Deposit Guarantee Fund (technical advice, capacity building/TC).

Bank restructuring in many cases would need to go hand in hand with corporate (debtor) restructuring thus contributing to the success in the third priority area, i.e. support for key private corporate clients.

CORE PRIORITY 2: ENERGY SECURITY AND ENERGY SECTOR REFORMS

With the renewed reform momentum and the pressing need for investments, EBRD crisis response in the energy sector, co-ordinated with other IFIs and the EU, both regarding investments and reform support, will focus on the following:

REFORMING THE GAS SECTOR

Reforming the gas sector and ensuring financing for critical investments to rehabilitate the UTG transmission network and to increase energy supply reliability through, for instance, gas purchase financing support for NAK, are priorities for the Ukrainian government and the Bank.

The Bank together with the EU, the World Bank, the IMF and the EIB has been actively engaged in joint policy dialogue with the Ukrainian Government for a number of years with the aim to provide technical and financial assistance to reform and restructure the gas sector and modernize the gas infrastructure based on market-based principles and liberalisation. The key transition objectives of the joint IFIs action plan in the energy sector can be grouped into three themes:

1. Restructuring of Naftogaz according to EC Directive 2003/55/EC, including through the Corporate Governance Action Plan which envisions putting in place a board of directors with majority independent directors, unbundling of the gas sector/NAK by implementing effective separation of transmission activities from the operations not related to transmission and ensuring the independence of the gas transmission network operator. The unbundling of the company when coupled with effective regulation will improve the overall operation of the sector though improved transparency and decreased corruption;

2. Adoption of EU-based liberalisation legislation as per Energy Community Treaty requirements, through the amendment of current regulatory legal acts and the drafting and approval of new legislative acts and by-laws necessary to complete the regulatory framework;

3. Establishment of a credible independent regulator focussed on the long term development of the network and integration with larger, more liquid gas markets. The regulator will drive the country’s commitments on the liberalisation of the gas market through the introduction of cost-reflective end user prices, the implementation of effective, non-discriminatory third party access and the introduction of efficient access and use of system tariffs.

EBRD’s crisis response will focus on:

• Financing together with the EIB critical capex investments to rehabilitate and upgrade the gas transit network to ensure safe and reliable transit to the EU and reversal flow of gas to Ukraine.

• Development of financing structures to facilitate imports of gas from the Western route, which is important to the diversification of Ukrainian supply.

ENERGY SECURITY AND EFFICIENCY

While the gas reform clearly is the key to unlock the transformation of the sector, in addition, the rest of the energy sector requires deep-reaching reforms, as well as investment, through a comprehensive strategy of diversification of sources and energy efficiency.

EBRD’s crisis response projects will focus on:

• Financing the upgrade, refurbishment and expansion of the high and low voltage transmission grid;

• Financing hydropower projects;

• Financing on a project finance/corporate finance basis development of renewable energy projects;

• Implementing residential energy efficiency credit line facilities to finance residential buildings energy retrofits;

• Increasing the scope and number of district heating energy efficiency investments;

• Implementing the technology transfer initiative to ensure prompt deployment of resource efficient technologies to local corporates while facilitating creation of suitable environment for technology transfer via the comprehensive technical assistance and policy dialogue support;

• Rolling out an ESCO financing programme and technical assistance for public buildings,

In addition, the EBRD is currently focusing on the following reform assistance in the power sector:

• Assistance with the transition phase of the Wholesale Electricity Market Reform;

• Corporatisation of Ukrenergo and Energoatom;

• Sector legislation adaptation for Energy Community Treaty/ENTSO-E integration purposes, and implementation of a Grid Code with third party access;

CORE PRIORITY 3: FINANCING KEY PRIVATE CORPORATE PLAYERS

The crisis in Ukraine has had a profound impact on the availability of finance for the corporate sector. The Bank is well placed to be additional in providing financing to many corporates facing immediate difficulties in meeting working capital, refinancing and capex needs. The Bank has already responded through the Ukrainian Corporate Support Facility to assist existing private clients in the corporate sector via provision of short to medium term financing.

The crisis has created a situation where Ukrainian corporates previously not interested in EBRD financing (e.g. owing to established relationships with house banks with ready access to existing lines of credit or to international credit and capital markets) are seeking the Bank’s assistance. The Bank will respond by seeking to support private sector clients possessing:

• Sound business plans and good prospects for medium term viability;

• Demonstrable need for finance unobtainable otherwise;

• Good governance or else some demonstrable improvement in corporate governance (e.g. IFRS, external audit).
Among the clients who meet the above conditions, priority will be given to those who are:

• Standard-bearers in the Ukrainian economy who will provide visibility to turnarounds or improved confidence in the sector/economy more generally

• Lend support to Ukraine’s current account (foreign exchange earnings), exhibit strong forward or backward linkages to the rest of the economy, and deemed able to relieve pressures on local suppliers (finance, longer payment periods); or that are

• Willing to improve energy efficiency, which remains a major deficiency across all sectors in Ukraine.

Clients should be free from integrity concerns and committed to making tangible progress or preserving earlier achievements. The primary focus of policy dialogue and capacity building assistance in the corporate sector, will be on improving the business climate, including through the operations of the Business Ombudsman Institution.

TRANSITION IMPACT ASSESSMENT
In implementing these strategic objectives, the Bank will apply its existing transition impact methodology and maintain high standards with regard to transition impact. In relation to the consideration of investment projects under the Reform Anchoring & Crisis Response Package, the following approach is proposed:

• transition objectives should be appropriate for the crisis situation and aligned with overall reform objectives supported by IFIs/EU for each of the three key priority areas outlined;

• when assessing the transition impact potential of investment projects, taking into account the reform conditionalities required and policy support provided by IFI partners working in a joined up effort with EBRD; and

• when assessing the transition impact potential of investment projects, taking into account the spillover effects from broader capacity building assistance and policy support EBRD itself is providing in the context of its crisis response, but not necessarily conditioned by/directly linked to a specific investment project.