EVALUATION DEPARTMENT SPECIAL STUDY

EBRD SUPPORT FOR THE DEVELOPMENT OF LOCAL CAPITAL MARKETS

ANNEXES

July 2017

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European Bank
for Reconstruction and Development

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Abbreviations

COO	country of operations (of the EBRD)
CSD	central securities depository
ETC	early transition country
EU	European Union
EvD	Evaluation Department (EBRD)
FCY	foreign currency
GDP	gross domestic product
IFI	international financial institution
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	initial public offering
ISDA	International Swaps and Derivatives Association
LC2	Local Currency and Local Capital Markets Initiative
LCM	local capital market
LCY	local currency
MiFID	Markets in Financial Instruments Directive
MoU	memorandum of understanding
NSSMC	National Securities and Stock Market Commission
OTC	over the counter
PLN	Polish zloty
RON	Romanian leu
SEE	south-eastern Europe
SEE Link	South-Eastern Europe Trading Platform
SEMED	southern and eastern Mediterranean
SME	small to medium-sized enterprise
SSF	Shareholders Special Fund
TC	technical cooperation project (EBRD)
USAID	United States Agency for International Development
UX	Ukrainian Exchange

Annex 1: Local capital markets portfolio analysis

A1.1. Introduction

This annex provides an overview and analysis of the Bank's portfolio of projects classified as "supporting LCM development" (see the definition in Box 1, section 1.2 of the main report), signed and implemented during the four-year evaluation period of 2012-15. All of the portfolio data were provided by the Local Currency and Local Capital Markets Initiative (LC2) team.

It should be noted that the Evaluation Department (EvD) identified 11 projects (accounting for €0.66 billion in aggregate) in the Bank's local capital market (LCM)-supportive portfolio, the impact of which on LCMs is doubtful because they were foreign currency (FCY) denominated and issued on international, rather than local markets (or privately placed) (see Table 4, section 6.1 of the report). However, the LC2 team argued that they had some impact on LCM by supporting the definition of yield curves for local bonds and by attracting international investors. These projects are, therefore, included in this portfolio analysis.

The overview below analyses the Bank's investment and technical cooperation operations portfolios separately, focusing on statistical data and identification of trends.

A1.2. Investment operations

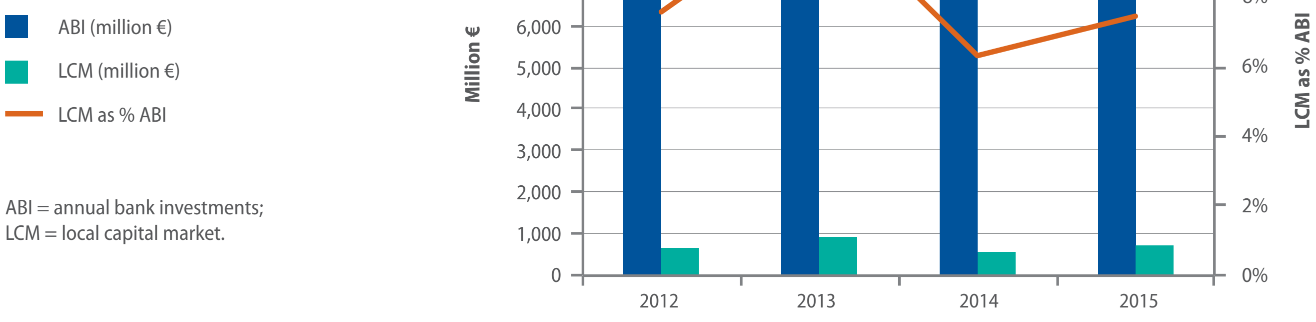
A1.2.1. Overall number and volume analysis

The total number and volume of investments signed during the evaluation period, classified as LCM-supportive, were 92 and €2.8 billion respectively (see Annex 3 for the list of the Bank's LCM investments). LCMs accounted for about 8 per cent on average of annual bank investments during this four-year period, with a high of 10.7 per cent in 2013 and a low of 6 per cent in 2014, while the average annual volume was €700 million (see Figure 1). The reason for the drop of LCM-supportive transactions in 2014 was that the EBRD is currently not financing any new projects in Russia, which accounted for an important part of LCM-supportive projects, and an absence of large transactions, which boosted volumes in 2012 and 2013 (investment in listed equity of the Moscow Stock Exchange and R1 Motorway bond in Slovak Republic, both at around €200 million). Once an adjustment is made for these two large (and atypical) transactions, the financing flows in the four-year period fluctuate between €460 million and €740 million per annum.

The number of Bank LCM-supportive investments experienced rapid growth (50 per cent) between 2012 (18) and 2013 (27); however, it remained relatively stable thereafter (23-24 projects during the two subsequent years). LCM-supportive projects accounted for 6 per cent of the Bank's total number of projects on average during the evaluation period.

In terms of the 'LC2 portfolio' (which includes all of the Bank's local currency (LCY) transactions and LCM-supportive projects in both local and foreign currencies), LCM-development projects represented 38 per cent of this portfolio in 2015 (a share similar to that in the earlier years).

FIGURE 1: VOLUME OF LCM OPERATIONS IN RELATION TO ANNUAL BANK INVESTMENTS, 2012-15



ABI = annual bank investments;
LCM = local capital market.

A1.2.2. Regional and country analysis

The regional distribution of the LCM financing by value and number is presented in Figures 2 and 3. Central Europe and the Baltic states and South-Eastern Europe (SEE) were the primary beneficiary regions, each accounting for about one-third of the Bank's LCM-supportive investments.

FIGURE 2: LCM-SUPPORTIVE FINANCING BY REGION BY VALUE (%)

CAS = Central Asian states; CEB = Central Europe and the Baltic states; EEC = Eastern Europe and the Caucasus; REG = regional; RUF = Russia; SEE = South-Eastern Europe; SEM = Southern and Eastern Mediterranean; TRK = Turkey.

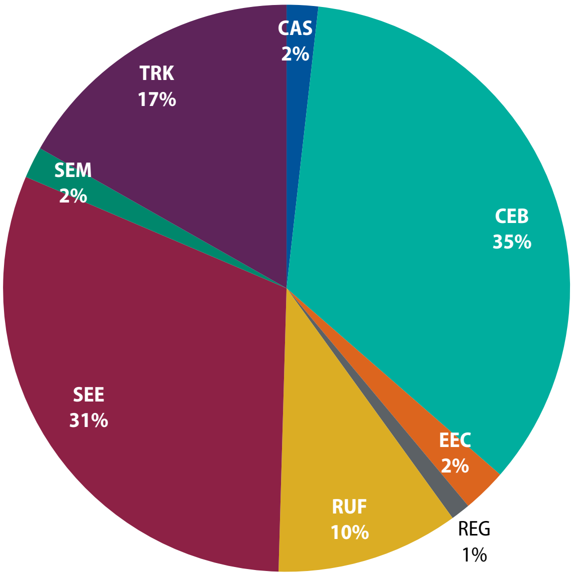


FIGURE 3: LCM-SUPPORTIVE FINANCING BY REGION BY NUMBER OF PROJECTS

CAS = Central Asian states; CEB = Central Europe and the Baltic states; EEC = Eastern Europe and the Caucasus; REG = regional; RUF = Russia; SEE = South-Eastern Europe; SEM = Southern and Eastern Mediterranean; TRK = Turkey.

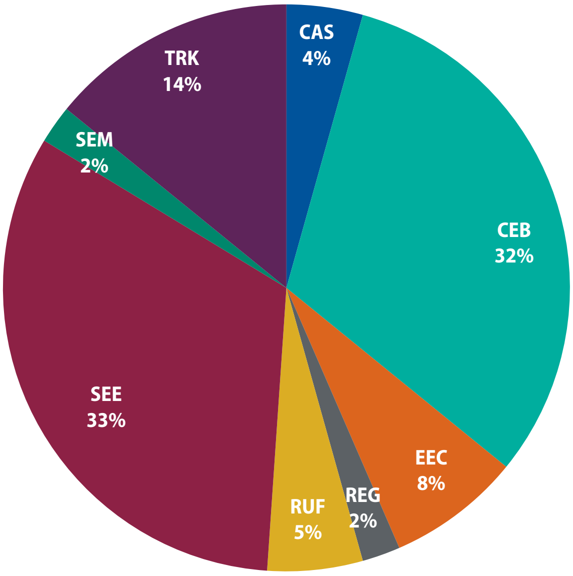
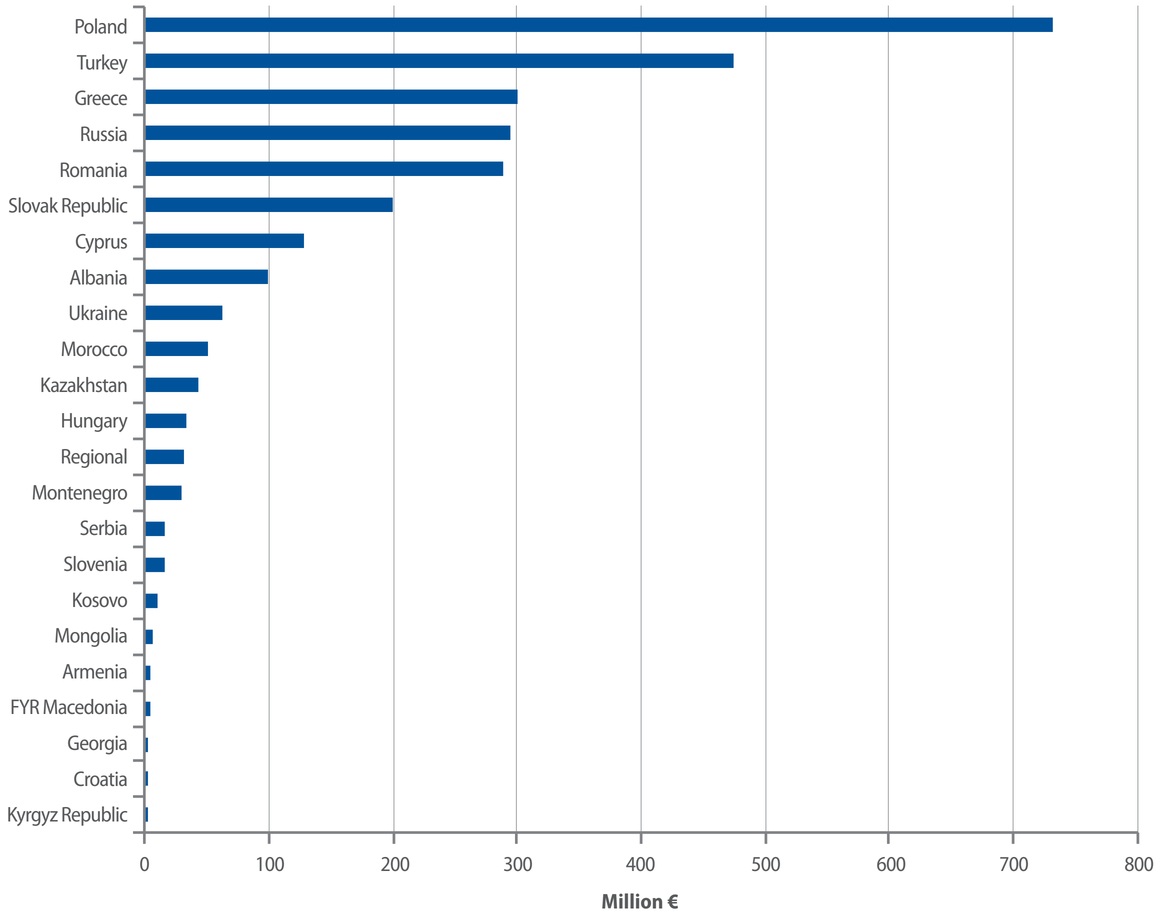


Figure 4 provides a breakdown of LCM-supportive investments by country showing that Poland and Turkey were by far the most significant recipients of such financing, followed by Greece, Russia and Romania; however, each of these latter three countries received less than half of the investment received by Poland.

A €200 million investment in a motorway bond in Slovak Republic was a one-off transaction, while the remaining countries benefited very little from LCM-supportive projects, with the volumes invested in each (except for Cyprus) below €100 million. Therefore, excluding a one-off, unusually large investment in Slovak Republic, it can be concluded that the Bank's LCM-supportive investments were concentrated in five countries (and with no new operations in Russia being approved since early 2014, and in only four countries in the most recent two years).

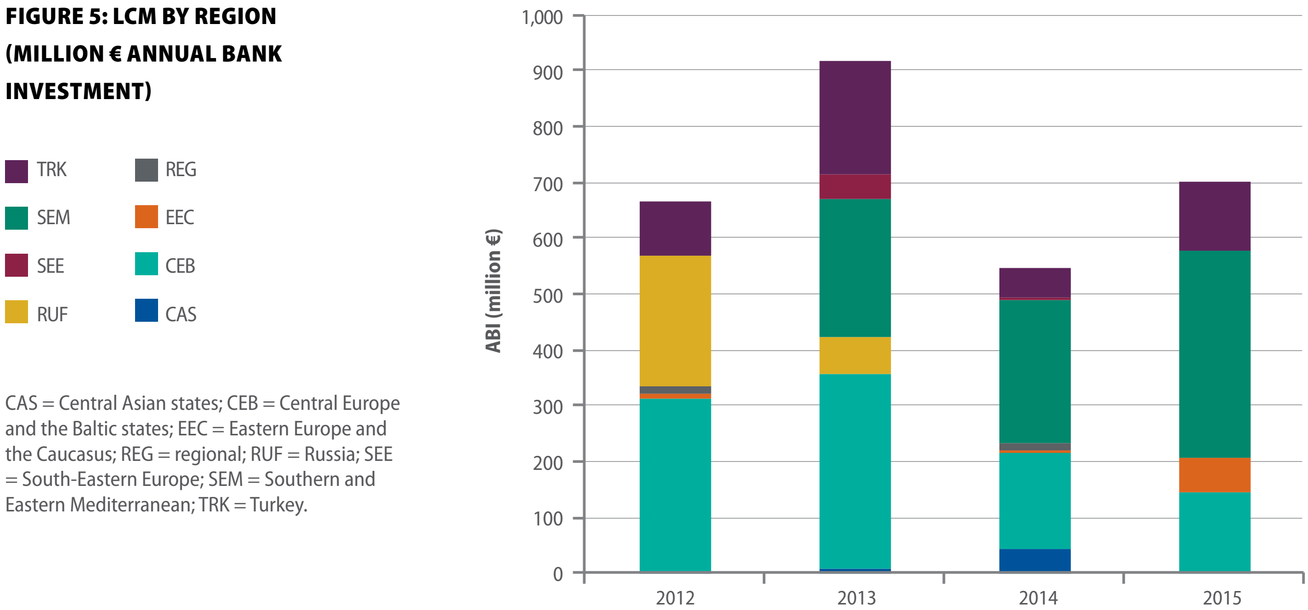
FIGURE 4: LCM-SUPPORTIVE FINANCING BY COUNTRY BY VALUE (MILLION €)



FYR = Former Yugoslav Republic.

Regional allocation of the Bank's LCM-supportive investments over the four-year period was quite volatile, with a gradual shift out of Central Europe and the Baltic states and into SEE, coupled with a dip in overall volume in 2014 and moderate growth in 2015 (see Figure 5). The increase in SEE volumes in 2015 was helped by €250 million of direct equity investments in four Greek banks and into a €50 million corporate bond issued by Hellenic Telecom. These five transactions (€50-70 million each) represented 40 per cent of LCM financing in 2015.

FIGURE 5: LCM BY REGION (MILLION € ANNUAL BANK INVESTMENT)



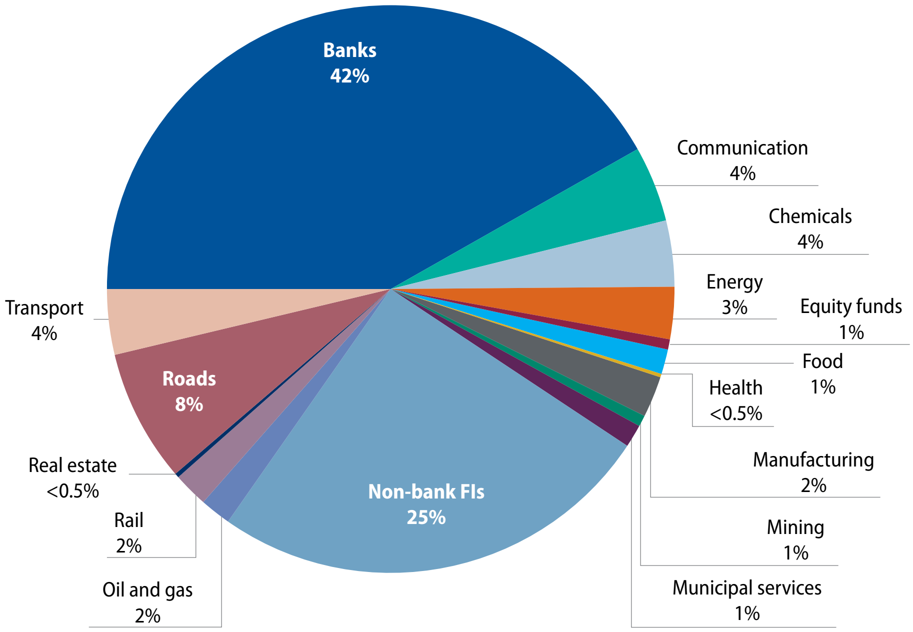
CAS = Central Asian states; CEB = Central Europe and the Baltic states; EEC = Eastern Europe and the Caucasus; REG = regional; RUF = Russia; SEE = South-Eastern Europe; SEM = Southern and Eastern Mediterranean; TRK = Turkey.

A1.2.3. Industry sector analysis

Figure 6 shows the dominance of the financial institutions sector in the Bank's LCMs portfolio. It accounted for two-thirds of all investments, with 42 per cent of the portfolio invested into banks and 25 per cent into non-bank financial institutions. This was not surprising as many of the financial institution projects were classified as LCM-supportive by definition (for example, investments into stock exchanges, insurance companies and pension funds). Financing outside the financial institution sector was relatively small and diverse. Roads (thanks to one large investment into a Slovak motorway bond) accounted for 8 per cent, while other transport, chemicals and information and communications technology (ICT) sectors accounted for 4 per cent of the portfolio.

FIGURE 6: LCM-SUPPORTIVE PROJECTS BY SECTOR (% ANNUAL BANK INVESTMENT)

FI = financial institution.



Annual sector investment analysis (see Figure 7) shows that over time the significance of non-bank financial institutions has been declining, while banks have become increasingly important. There is no apparent trend in LCM-supportive financing in other sectors over the analysis period, and there were two large outliers in the form of unusually large €200 million financing for Moscow Stock Exchange in 2012 and Slovak Republic roads in 2013.

FIGURE 7: LCM-SUPPORTIVE FINANCING BY SECTOR AND BY YEAR (MILLION € ANNUAL BANK INVESTMENT)

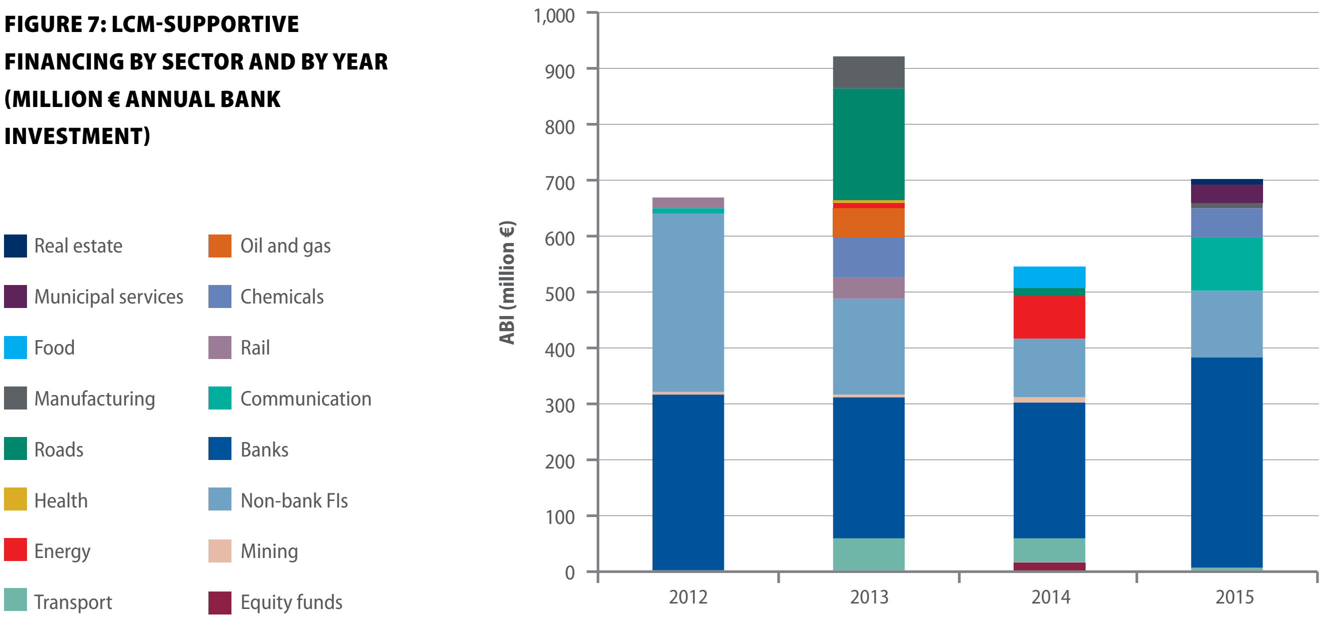
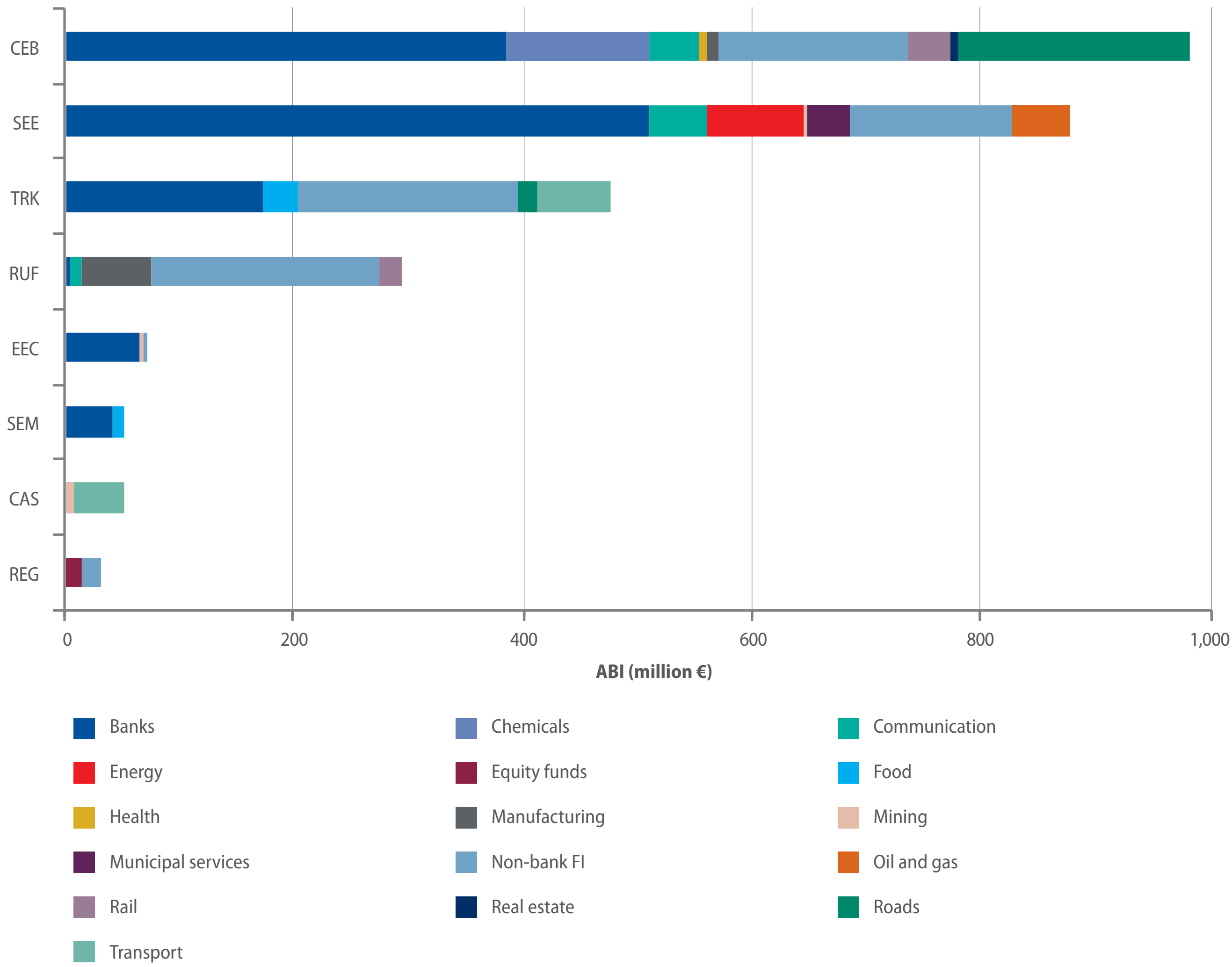


Figure 8 provides a breakdown of LCM-supportive financing by region and sector that shows how banks have been dominant in all regions except for Russia and Turkey, where the non-bank financial institution sector was the primary beneficiary thanks to the Bank's large investments into Moscow (€200 million) and Istanbul (US$112 illion [€94 million]) stock exchanges, as well as Central Asia, where there were only four LCM-supportive projects during the four-year period – three very small and one bigger (€42 million) into a bond financing a Kazakh transport company.

FIGURE 8: LCM-SUPPORTIVE PROJECTS BY REGION AND SECTOR (MILLION € ANNUAL BANK INVESTMENT).

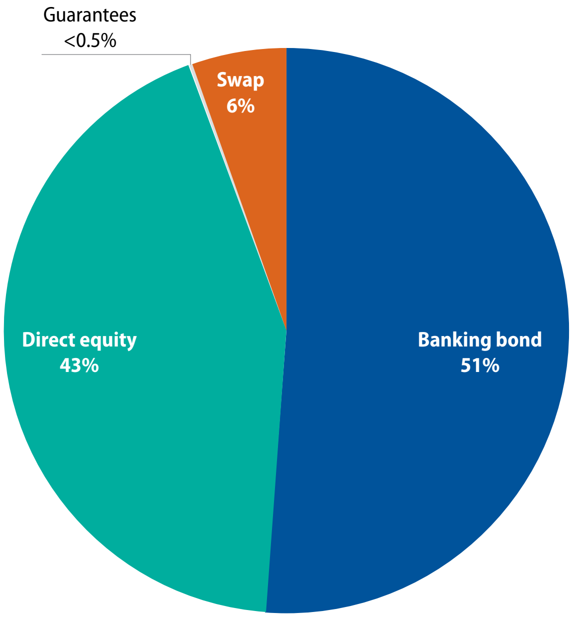


CAS = Central Asian states; CEB = Central Europe and the Baltic states; EEC = Eastern Europe and the Caucasus; FI = financial institution; REG = regional; RUF = Russia; SEE = South-Eastern Europe; SEM = Southern and Eastern Mediterranean; TRK = Turkey

A1.2.4. Analysis of financing instruments

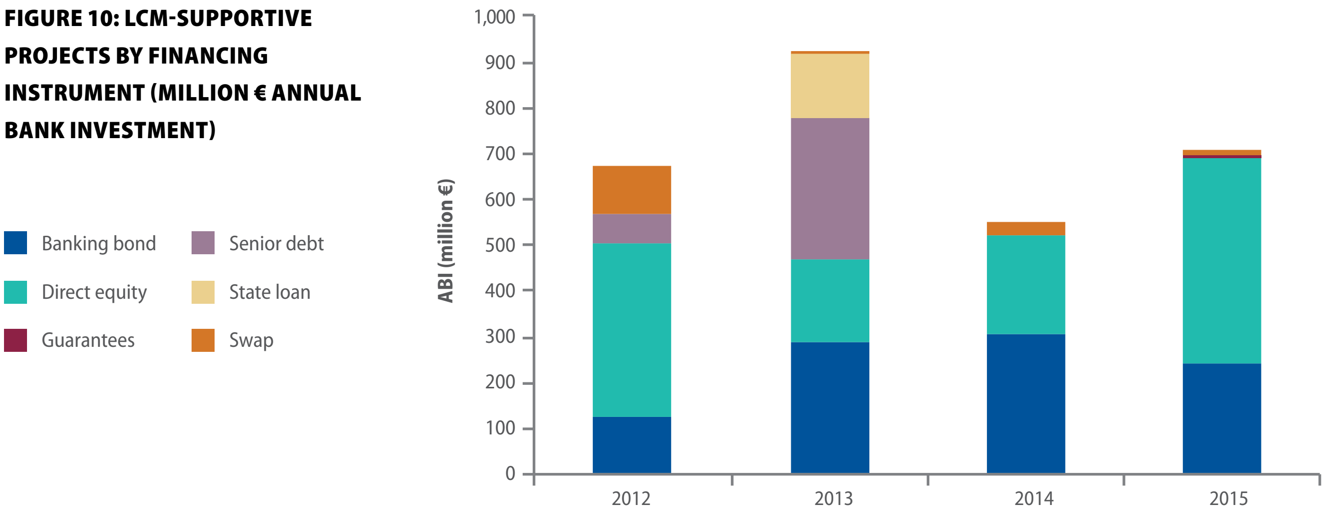
Corporate bonds have been the most important financing instrument, accounting for 51 per cent of the LCM-supportive portfolio, followed by direct equity (43 per cent) and swap transactions (6 per cent) – see Figure 9.

FIGURE 9: LCM SUPPORTIVE FINANCING BY FINANCING INSTRUMENT (% BY VOLUME)



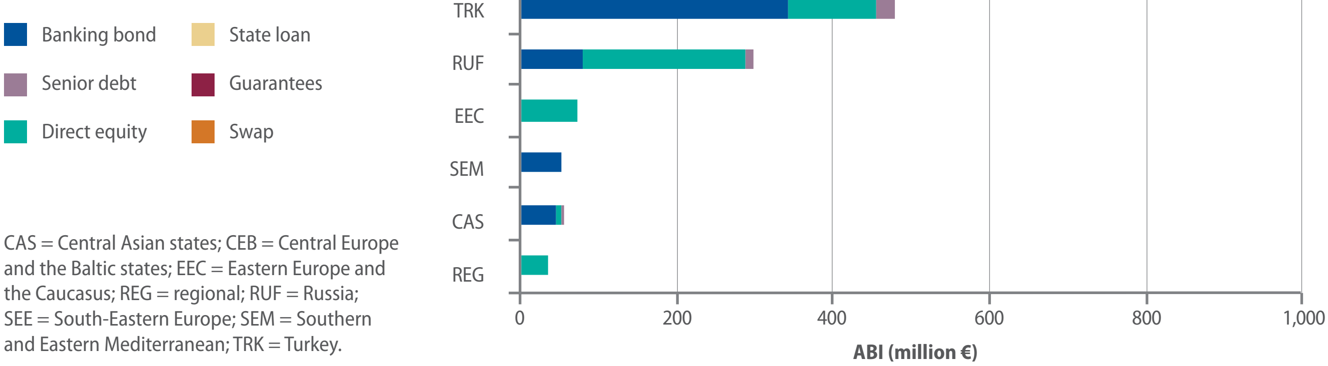
The level of equity investments has been volatile, ranging from approximately 20 per cent of the LCM portfolio in 2013 to 65 per cent in 2015, as shown in Figure 10.

FIGURE 10: LCM-SUPPORTIVE PROJECTS BY FINANCING INSTRUMENT (MILLION € ANNUAL BANK INVESTMENT)



The SEE region has received the largest amount of equity, followed by Central Europe and the Baltic states and Russia (Figure 11).

FIGURE 11: LCM-SUPPORTIVE FINANCING BY REGION AND FINANCING INSTRUMENT (MILLION € ANNUAL BANK INVESTMENT)



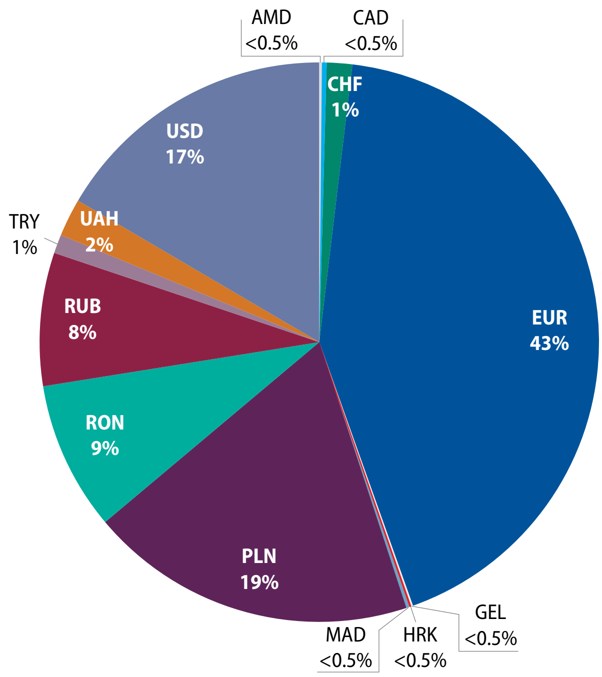
CAS = Central Asian states; CEB = Central Europe and the Baltic states; EEC = Eastern Europe and the Caucasus; REG = regional; RUF = Russia; SEE = South-Eastern Europe; SEM = Southern and Eastern Mediterranean; TRK = Turkey.

A1.2.5. Currency of financing

The Bank financed LCM-supportive investments mostly in euros (43 per cent), followed by Polish zloty (19 per cent) and US$ (17 per cent). In all, foreign (non-euro) currencies accounted for over 60 per cent of the total financing (Figure 12).

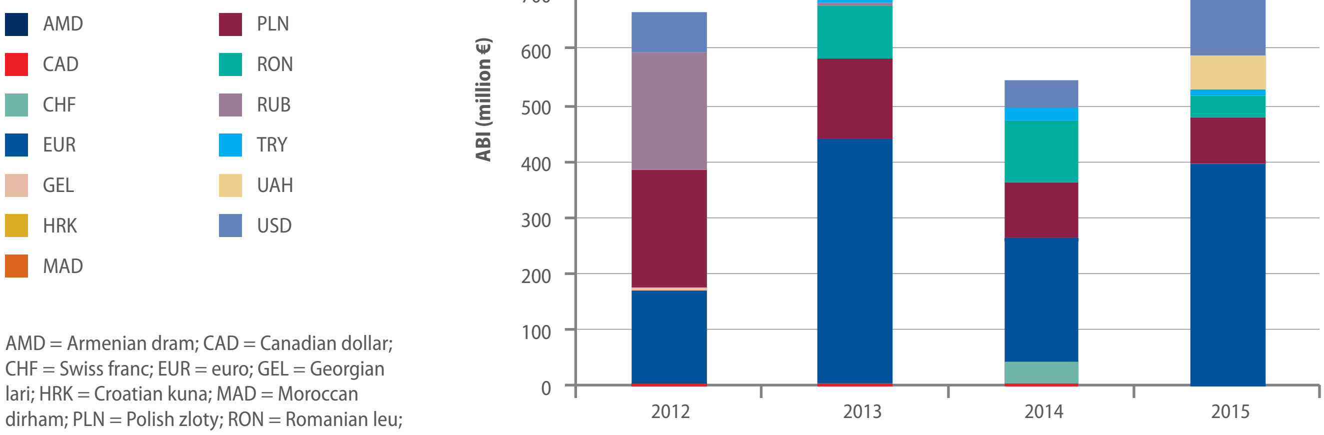
FIGURE 12: LCM-SUPPORTIVE PROJECTS BY CURRENCY (% € EQUIVALENT ANNUAL BANK INVESTMENT)

AMD = Armenian dram; CAD = Canadian dollar; CHF = Swiss franc; EUR = euro; GEL = Georgian lari; HRK = Croatian kuna; MAD = Moroccan dirham; PLN = Polish zloty; RON = Romanian leu; RUB = Russian rouble; TRY = Turkish lira; UAH = Ukraine hryvnia; USD = United States dollar.



With the exception of 2012, when Russian roubles were an important source of finance, the mix of euro, zloty and US$ was relatively constant across years, as shown in Figure 13.

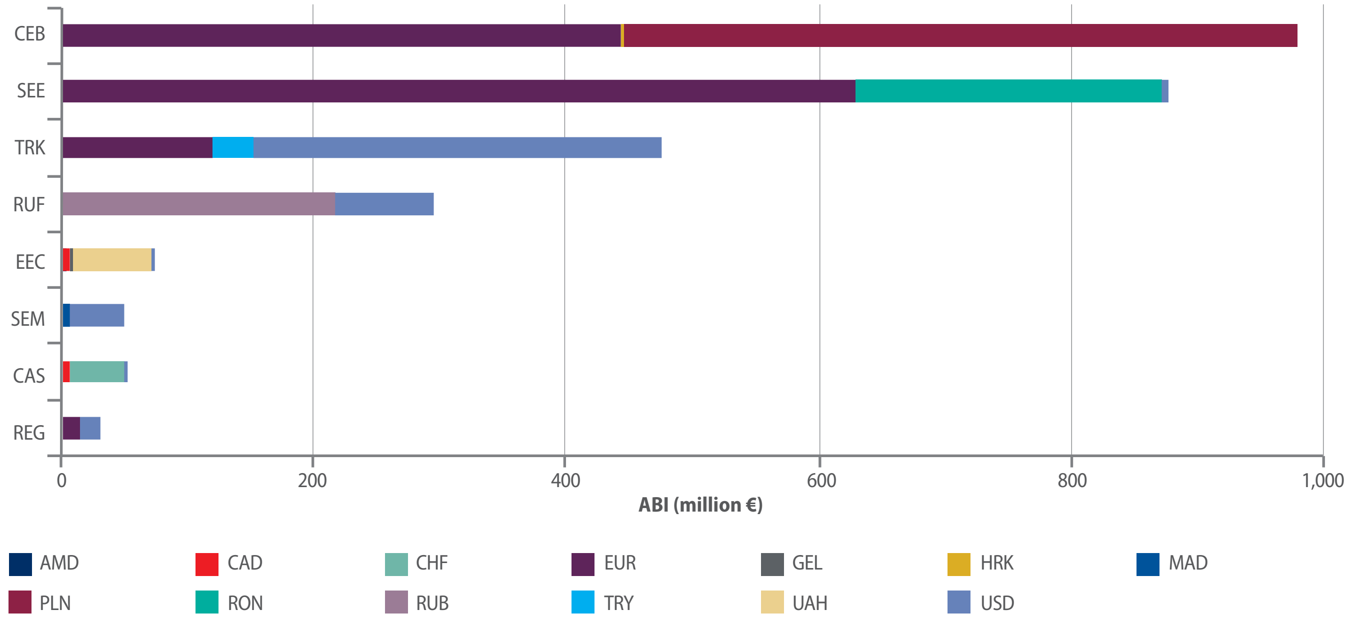
FIGURE 13: LCM-SUPPORTIVE PROJECTS BY CURRENCY OVER YEARS (MILLION € EQUIVALENT ANNUAL BANK INVESTMENT)



AMD = Armenian dram; CAD = Canadian dollar; CHF = Swiss franc; EUR = euro; GEL = Georgian lari; HRK = Croatian kuna; MAD = Moroccan dirham; PLN = Polish zloty; RON = Romanian leu; RUB = Russian rouble; TRY = Turkish lira; UAH = Ukraine hryvnia; USD = United States dollar.

Euro financing was important in all countries, even when LCY financing was significant (for example, Poland, although financing in Polish zloty was slightly more prevalent there) – see Figure 14.

FIGURE 14: LCM-SUPPORTIVE FINANCING BY REGION AND CURRENCY (€ EQUIVALENT ANNUAL BANK INVESTMENT)



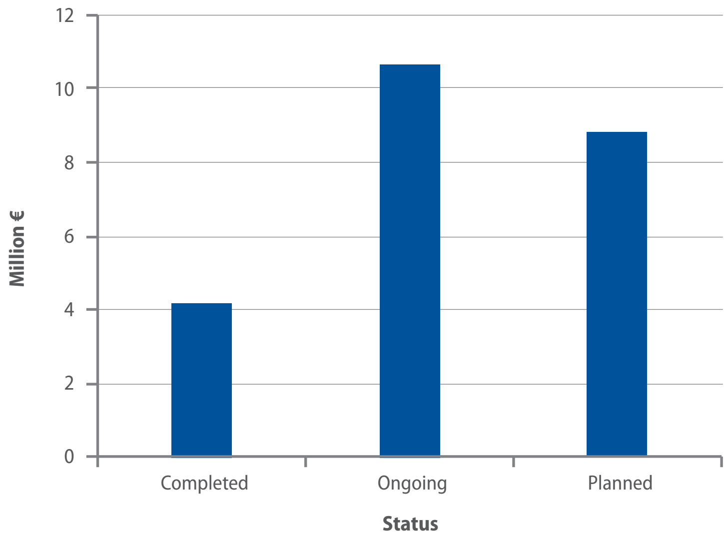
AMD = Armenian dram; CAD = Canadian dollar; CHF = Swiss franc; € = euro; GEL = Georgian lari; HRK = Croatian kuna; MAD = Moroccan dirham; PLN = Polish zloty; RON = Romanian leu; RUB = Russian rouble; TRY = Turkish lira; UAH = Ukraine hryvnia; US$ = United States dollar.

A1.3. Technical cooperation

During the evaluation period the LC2 team implemented 40 technical cooperation projects (TCs). Nearly all of them supported LCM development (rather than LCY financing) and ranged from diagnostic and capacity-building to supporting integration of stock exchanges or preparation of new laws and regulatory regimes (for example, for derivatives or covered bonds).

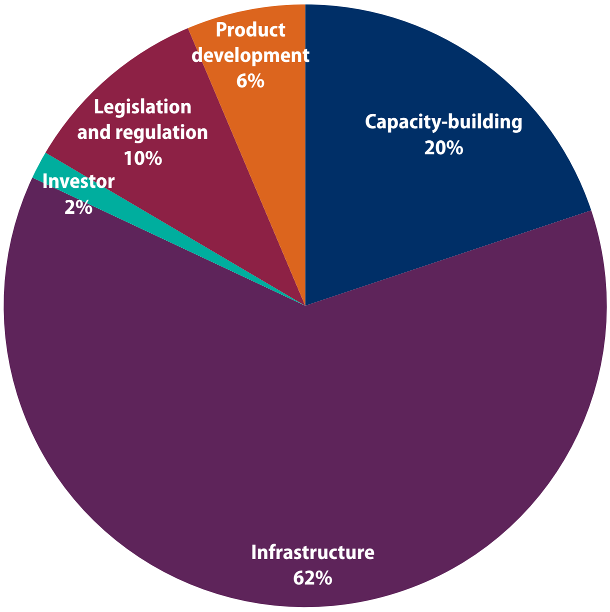
In 2016, 18 of these TCs were completed and 22 were ongoing. In addition, the LC2 team had 24 TCs in the planning stage (classified as "in the pipeline"). The LC2's TCs had a total value of €23.6 million (including those in the pipeline). However, within this total about 60 per cent (€14 million) financed completed or ongoing projects, while the balance was allocated to the projects still in the planning phase (see Annex 3 for the list of LCM TCs). See Figure 15.

FIGURE 15: VOLUME OF LC2 TC FUNDS BY STAGE OF IMPLEMENTATION



Most of the TC funds (62 per cent) were allocated to development of LCM-supportive infrastructure, followed by capacity-building (20 per cent) and legal and regulatory reforms (10 per cent) as shown in Figure 16.

FIGURE 16: VOLUME OF LC2 TC FUNDS BY PURPOSE

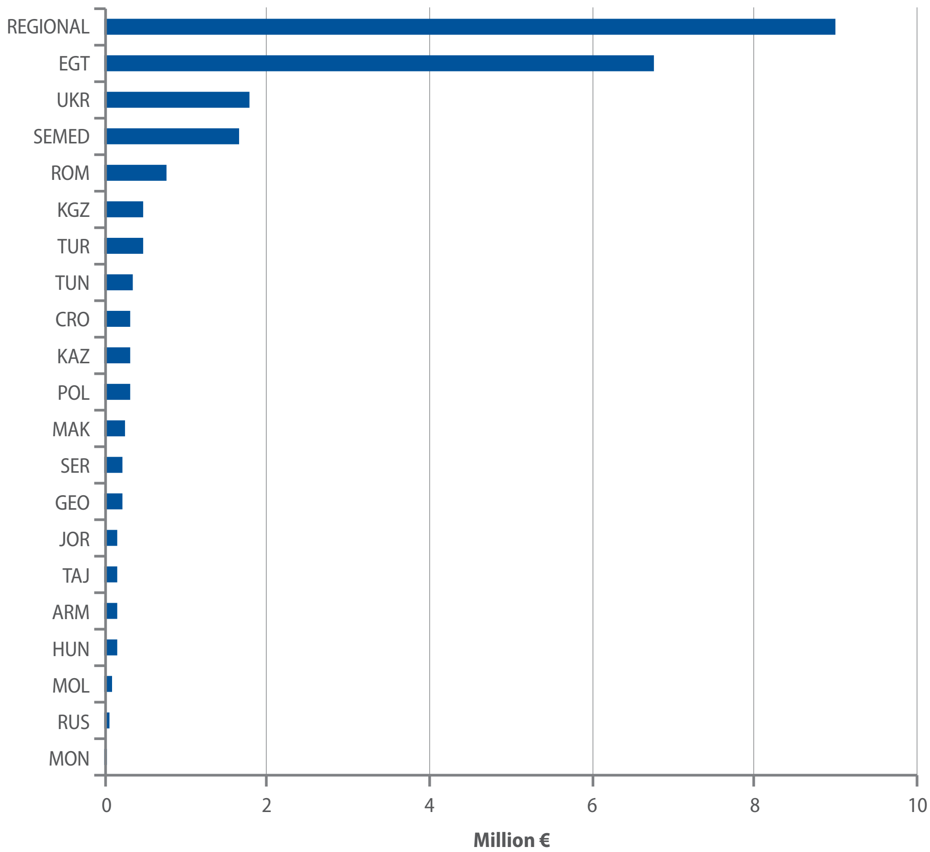


This was due to two large LCM infrastructure TCs – Central Securities Depository for the National Bank of Egypt and South-Eastern Europe Trading Platform (SEE Link) (see more in section 6.2 of the report).

The LCM TC portfolio has been dominated by regional TCs (38 per cent), followed by a large technical assistance project of €6.7 million (accounting for 27 per cent of the LCM TC portfolio) to support the Central Bank of Egypt to develop capital-market-related infrastructure. However, most of the regional projects covered early transition (ETCs) or Southern and Eastern Mediterranean (SEMED) countries. The first TC supported the preparation of the first corporate bond issue in the Kyrgyz Republic and TC projects in other ETCs followed. The EBRD signed Memoranda of Understanding (MoUs) with six ETCs on cooperation in LCM development that provided frameworks to initiate several TCs. Overall about 20 TCs (half of the total) benefited at least one ETC or SEMED country. Figure 17 presents the composition of the LC2 TCs by volume and country.

FIGURE 17: VOLUME OF LC2 TC FUNDS BY COUNTRY

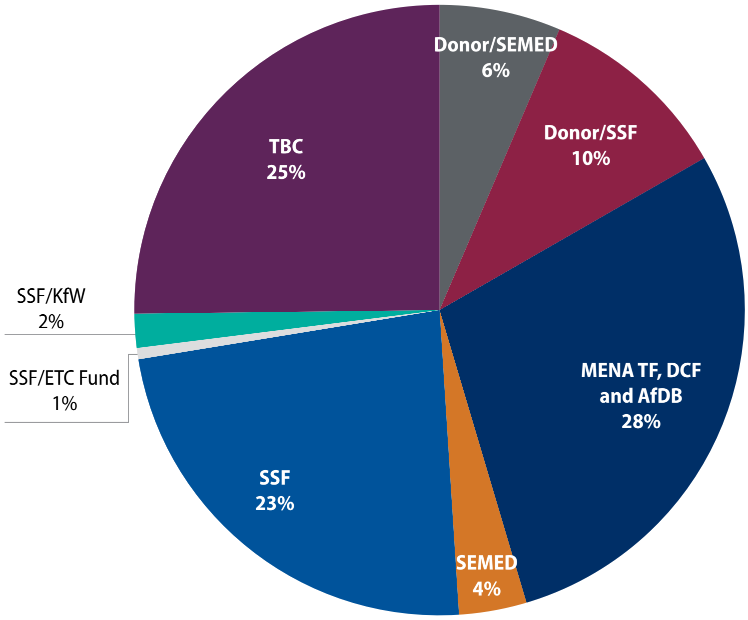
ARM = Armenia; CRO = Croatia; EGT = Egypt; GEO = Georgia; HUN = Hungary; JOR = Jordan; KAZ = Kazakhstan; KGZ = Kyrgyz Republic; MAK = Macedonia; MOL = Moldovia; MON = Mongolia; POL = Poland; REGIONAL = regional; ROM = Romania; RUS = Russia; SEMED = Southern and Eastern Mediterranean; SER = Serbia; TAJ = Tajikistan; TUN = Tunisia, TUR = Turkey; UKR = Ukraine.



About a quarter of TC funds were sourced from the Shareholders Special Fund (SSF), and the balance that has been funded to date was obtained from donors or regional special funds (Figure 18). No source of funding has yet been confirmed for 25 per cent of the TC projects (in the pipline).

FIGURE 18: SOURCES OF FUNDING FOR LC2 TCS

AfDB = African Development Bank; DCF = Donor Coordination Fund; ETC = Early Transition Country; MENA TF = Middle East and North Africa Transition Fund; SEMED = Southern and Eastern Mediterranean; SSF = Stakeholders Special Fund; TBC = to be confirmed.



A1.4. Conclusions

The following conclusions can be drawn from the analysis of LCM-supportive operations over the period 2012-15.

- LCM-supportive financing has been relatively small, accounting on average for about 8 per cent of the Bank's annual bank investment and 6 per cent of the Bank's projects. Both volume and number of LCM-supportive operations have been largely stable over recent years, with an average volume of approximately €700 million per annum, financing on average 23 projects.
- Poland, Turkey and Romania were the primary recipients of the Bank's LCM-supportive financing during the whole of the evaluation period, with Russia also an important recipient in the two earlier years, while Greece became the dominant recipient in 2015 (40 per cent of the portfolio). There was little LCM-supportive investment in other countries and regions (for example, only four, generally small, investments in Central Asia).
- The LCM-supportive portfolio was dominated by financial institutions, which accounted for two-thirds of the total portfolio, comprising primarily banks (42 per cent) and non-bank financial institutions (25 per cent), while investments outside these sectors were small and diverse.
- Over time investments into banks have been growing, whereas there has been a slight decline in non-bank financial institution financing.
- Foreign currencies, consisting of euros, and to a lesser extent US$, accounted for 60 per cent of LCM financing, followed by Polish zlotys (19 per cent), indicating that LCY has not been a popular choice for financing LCM-supportive investments in most countries.
- The volume of the LC2 TCs at €23 million was much higher than the €1.3 million presented in the LC2 strategy, with about a quarter being sourced from the SSF and the balance from donors or co-financed by other institutions. However, only 60 per cent of these funds have been utilised so far (that is, for completed or ongoing projects), with the balance allocated to projects in the planning stage.
- Two-thirds of the LC2 TC budget has been allocated to support LCM infrastructure, with the single largest project dedicated to the development of LCM infrastructure at the Central Bank of Egypt.
- Regional projects dominated the LC2 TC portfolio. However, most of the regional TCs were firmly focused on ETCs and more recently SEMED countries, with half of all TCs benefiting at least one country from these two categories.

Annex 2: Evolution of the Bank's approach to LCM

A2.1. The Bank's support for LCM development until 2009

Between 1991 and 2010 the Bank concentrated on promoting LCY lending and borrowing, promoting borrowing also through the issue of the EBRD's own bonds on domestic and international markets, complemented by policy dialogue aimed at legislative and regulatory changes to enable such issues. The Bank issued the first LCY bond in 1994 on the domestic market in Hungary and made a first forint loan the same year. Another Hungarian forint issue took place in 1996. However, there were no further domestic issues until the 2005 Russian rouble bond. The Bank faced serious challenges to increasing its LCY borrowing and lending volumes (see Box 1); as a result, LCY Eurobonds and short-term promissory notes dominated its LCY borrowing.

The 1997 Asian and 1998 Russian financial crises highlighted both the risks from FCY mismatches and the weaknesses of LCMs. In 1999 the EBRD launched the Local Currency Lending and Borrowing Programme, managed by the Treasury department, designed to invigorate and expand LCY borrowing and lending. Internal EBRD documents state that the second objective of LCY funding is the participation of the Bank in the development of LCMs in accordance with Article 2.1(v) of the Agreement Establishing the Bank.

However, the programme produced limited results given the numerous market features detrimental to LCY borrowing and lending that persisted (see Box 1). In October 2006 the EBRD treasury team prepared an internal paper on local currency operations and considerations on country and client selection which argued for more extensive LCY lending. It did note that providing more LCY loans alone did not address dollarisation issues or help develop LCMs. LCM development could be deepened through the EBRD issuance of LCY bonds with an objective to help establish a yield curve of long-term traded financial instruments that could be used for bond pricing and valuation. The paper presented excellent analyses of LCMs and highlighted the need for Bank technical assistance for legal and regulatory changes, and to develop institutions and infrastructure to create an enabling environment for LCMs. Willingness of the authorities to accept and implement these changes was flagged as a key consideration. However, the paper did not elaborate much on how to operationalise these observations.

In practice, the issuance of bonds on LCMs under the Local Currency Lending and Borrowing Programme (2000-10) was limited to two countries and it achieved a critical mass only in Russia, where the Bank issued 16 rouble bonds for a total of €1.1 billion equivalent, with an average five years maturity. The Bank also issued one 10-year RON130 million (€28.7 million equivalent), dual-listed London Stock Exchange–Bucharest Stock Exchange bond in

Box 1. Obstacles to the Bank's LCY borrowing

- The Bank's triple-A rating gave it a funding advantage when borrowing in FCY but not in LCY. It had a hard currency balance sheet based on the € and US$ that had encouraged a policy of avoiding foreign exchange rate and interest rate risks.
- Further problems arose due to concerns about the negative cost of carry to the EBRD on the issuance of local bonds. These costs were compounded by slow-disbursing projects, regulatory obstacles to domestic bond issuance and a lack of currency swaps with sufficient scale and tenor to support LCY lending volumes. At that time the use of the Bank's TC funds was restricted to its investment projects, therefore Treasury used its own staff to address these deficiencies in selected countries, with a focus on Russia.
- On the demand side, the size of LCY markets in the countries of operations (COOs) was relatively small due to lack of developed financial institutions, high interest-rate differentials and a high level of dollarisation that created demand for FCY rather than LCY.[1]
- The demand for the Bank's LCY was further constrained by the Bank's limited offer. Local banks could access LCY deposits, often at rates well below the base rate, and offer LCY multi-year fixed-term interest rate loans, while the Bank offered floating rates and short tenors. The Bank could offer longer tenors, but still the demand for LCY loans was weak.

1 Difference between (usually high) interest rate for borrowing in local currency and lower interest rate in foreign currency.

Romania. These two domestic issues demonstrated that the Bank could make an important contribution to LCM development when it undertook such issues: the rouble issues were preceded by several years of work on improving the Russian legal and regulatory environment, which resulted in the amendment of 13 different laws (see Box 2 for the list of the laws and their impact). Simultaneously, the Bank contributed to the development of the first credible and transparent money market benchmark – the MosPrime index. It made possible the subsequent issue of floating rate bonds by other issuers, as well as providing a benchmark for the domestic market for bank loans (that is, money market yield curve). The Bank also participated in the development of the Rouble Overnight Index Average (RUONIA).

Although most of these amendments concerned the Bank (or IFIs), some of them had universal impact – for example, the law on joint stock companies, the law on currency regulations and currency control, and new regulations on disclosure, which were applicable to all issuers and had a lasting, positive impact on the Russian LCM. The Bank worked closely with the Russian authorities, such as the Central Bank, the regulator, the National Currency Association, the State Pension Fund and the stock exchange MICEX, the latter to produce listing regulations for supranational borrowers and to finalise the prospectus and other disclosure requirements. The work positively impacted the capacity of local officials and helped to forge good relations with the Moscow Stock Exchange, which later resulted in the Bank's taking an equity stake in it.

The 2009 bond issued in Romania introduced a new floating rate benchmark, extended the yield curve (from 7 to 10 years), enabled the adoption of the European Commission Prospectus Directive (which facilitated 'passporting' of documentation from the London Stock Exchange, reducing transaction costs), stimulated a direct interference between the RoClear and Euroclear/Clearstream, and introduced bond eligibility for repos with the National Bank of Romania.

Both domestic issues were prepared mainly by Treasury and legal finance staff, with little reliance on external consultants. Capacity constraints, long lead times to prepare such issues and the high cost of domestic issues forced the Bank to seek LCY through credit lines (from local banks) or issue of LCY Eurobonds denominated in LCYs (Czeck koruna, Estonian kroon, Hungarian forint, Kazakhstan tenge, Latvian lats, Polish zloty and Slovak koruna). These Eurobonds were issued on offshore markets and were settled through the international clearing system (Euroclear, Clearstream or DTC). They allowed the Bank to access LCY at funding levels commensurate with the Bank's triple-A rating in currencies that were acceptable for full settlement. LCY denominated, these Eurobonds paid coupons in € or US$ at the prevailing spot rate (that is, the investors took foreign exchange risks in return for a higher coupon rate). Such issues were possible only in the currencies that were fully convertible. No changes in legislation were needed for such issues; however, their impact on LCMs was generally limited to forging linkages between local and international depository systems, which subsequently helped attract international investors to the LCMs (as securities were then cleared under English law). The EvD notes that portfolio foreign direct investments into the central European markets (for example, Czech, Hungarian, Polish) indeed grew substantially during 2003-08. Although any causal link with the Bank's LCY Eurobond issues is difficult to establish, it is likely that they contributed to this increase; however, the main reason for this increase was these countries' accession to the European Union (EU) and adoption of the EU market regulations.

In addition to Russia and Romania, the Bank worked in other countries, although it did not succeed in issuing domestic bonds in any other country at that time. In preparation for future bond issues, the Bank provided Armenia, Serbia and Ukraine advice regarding amendments to their securities markets laws and to Serbia and Ukraine on their repo and foreign exchange laws. Moreover, the derivatives laws were amended with the Bank's assistance in the Czech Republic, Hungary, Kazakhstan, Poland, Russia and Slovak Republic, as was the debt market law in Albania.

The Bank also supported the development of local clearing and depository systems in Croatia, Romania and Russia, as well as links between local central security depositories and the International Central Security Depositories. At the end of this period work started on inflation targeting in Armenia, Georgia and Kyrgyz Republic.

Following up on the successful launch of the MosPrime and RUONIA indices, the Bank contributed to the development of KievPrime in Ukraine and KazPrime in Kazakhstan, which improved monitoring and analysis, and stimulated trading on these markets.

Box 2: Russian laws and regulations amended during the preparation of the first rouble bond domestic issue where the EBRD provided advice

- Federal Law on the Protection of Rights and Legal Interests of Investors in the Securities Market No. 46-FZ of 5 March 1999 – the amendment limited the information to be disclosed on the circulation of securities to whatever the new Federal Commission on Securities Markets regulations say; and allowed details of bond issues to be circulated by email, Reuters, Telerate and Bloomberg without triggering the advertising rules.
- Federal Law on Advertising No. 108-FZ of 18 July 1995 – the amendment allowed details of bond issues to be circulated by email, Reuters, Telerate and Bloomberg without triggering the advertising rules.
- Civil Code of Russia, part I, 1993 – the amendment redefined securities in line with the Securities Market Law to encompass those which do not attest property rights and those for which there is no documentary form.
- Instruction of the Central Bank of Russia of 17 September 1996 No. 8 On procedure of securities issue and registration by lending agencies on the territory of Russia – the amendment allowed the registration of securities by foreign issuers to be governed by other legal acts (including the Securities Market Law).
- Resolution of the Federal Securities Market Commission of 28 May 1997 No. 268-p – the amendment identified the body authorised to effect registration of securities by foreign issuers including international financial institutions (IFIs).
- The Federal Law "On joint stock companies" No. 208 of 26 December 1995 – the amendment added the definitions for "public subscription" and "closed subscription".
- The Law "On currency regulation and currency control" No. 3615-1 of 9 October 1992 – the amendment determined procedures for payments relating to allotment circulation and interest and principal repayment on bonds issued by foreign entities.
- The Federal Law "On specific features of issue and circulation of state and municipal securities" No. 136-ФЗ of 29 July 1998 – the amendment brought the definition of bond in line with that in the amended Securities Market Law, allowing both discount bonds and credit profile number-bearing.
- General terms of issue and circulation of state federal bonds (approved by the Resolution of the Russian Government of 12 May 1998 No. 439) – the amendment brought the definition of bond in line with that in the amended Securities Market Law, allowing both discount bonds and credit profile number-bearing.
- Provision on procedure of disclosure of the information about important facts (events and actions), pertaining to financial and economic activities of issuer of issuable securities (approved by the Resolution of FSMC of 12 August 2001 No. 32) – the amendment simplified the disclosure of material facts and events (that is, material adverse change), eliminating need for a stamp and a state code.
- The Law "On currency regulation and currency control" of 9 October 1992 33615-1 – the amendment ensured the use of funds raised in the bond markets for loans, and the repayment of bond issues by any requisite means.
- Instruction of the Central Bank of Russia "On procedure of opening of banking accounts in Russian currency by authorised banks and effecting operations with these accounts" of 12 October 2000. No. 93 – the amendment extended to IFIs the provisions governing "international organisations", and added to "N account" (and "K account") provisions the ability to pay in rouble-bond proceeds.
- The Russian Tax Code, Part I, 1999 – the amendment added IFIs to provisions governing the bonds of international organisations and municipal securities.

Independently, the Legal Transition team started working on the model investor protection law and corporate governance laws improvements in a number of countries, which also had a facilitating impact on the development of LCMs.

At the strategic level, annual meeting statements by the EBRD Presidents present high-profile opportunities to set out institutional strategic priorities for shareholders. Review of these speeches between 1992 and 2009 indicates that the issue of LCM development was flagged infrequently and for the most part in very general terms (see Box 3).

The 2006 *Transition Report* (EBRD, 2006) highlighted the dominance of the banking sector in the countries of operations, stressed the risks related to FCY loans, and reiterated the need for better developed LCMs as an alternative to bank financing. However, it was the onset of the global financial crisis in 2008 that highlighted once again the risks associated with FCY financing. In response the EU, European Investment Bank, International Monetary Fund (IMF), the EBRD and the World Bank Group launched the Vienna Initiative in January 2009 primarily to limit the escalation of the crisis in central and eastern Europe by preventing a large-scale and uncoordinated withdrawal of cross-border bank groups. As systemic risks abated from early 2010, the Vienna Initiative's focus gradually shifted to critical region-wide policy issues to making financial sectors in emerging Europe more resilient in the longer term (Vienna Plus Initiative). The Bank played an important role in both Vienna Initiatives, leading the Public–Private Sector Working Group on Local Currency and Capital Markets Development which was set up in March 2010. Its task was to identify the main impediments to the increase of LCY lending and LCM development, as well as to provide recommendations for governments, private banks and IFIs on how to address them.

The Bank's interventions during this period had positive outcomes (legislative changes had lasting effect, bond issues were pioneering, while new indices helped in market monitoring and analysis). However, larger impacts were limited to three markets where LCY bonds were issued (Russia, Romania and to some extent Hungary). The Bank reported to the Board on these activities through semi-annual reports on Treasury activities, as well as through the annual borrowing programme reports; however, it lacked a coherent strategy for LCM development.

A2.2. The Bank's LC2 launch and its operations during 2010-12

LC2 was launched at the annual general meeting in Zagreb in May 2010. It built on the Vienna Plus Initiative. The Bank saw it as the next logical step, stemming from its leadership of the Public–Private Sector Working Group on Local Currency and Capital Markets Development, which would create an institutional framework within which the EBRD would implement actions identified while working under the Vienna Plus Initiative. In his opening statement at Zagreb AGM the President said: "Looking ahead, we are now planning further steps based on maintaining this successful inter-institutional approach and focusing especially on foreign-exchange vulnerabilities and the development of local capital markets", and then "In the financial sector we will work towards strengthening balance sheets and risk practices, and we will launch a concerted effort, together with other IFIs, to accelerate the development of local capital markets". The latter quote was largely repeated in the President's inaugural speeches at annual general meetings in 2011 and 2012.

In April 2010, before the meeting in Zagreb, Treasury, Banking and Office of the Chief Economist presented a memo to the executive committee – *LCM development: Work plan and potential resource implication* – followed by a presentation of LC2 to the Board, which provided the first outline of the LC2 objectives, scope and proposed organisation. This highlighted the existence of enabling conditions in the countries of operations to launch the initiative and explained the need for a holistic and coordinated approach to address all the factors that hindered the use of LCY and the LCM. They stressed that in the past the Bank had focused predominantly on the reforms that would allow EBRD funding and lending in LCY; however, now it was to adopt a new approach, shifting its focus to actions that benefited both LCY funding and LCM development (not necessarily connected to the Bank's funding plans). They also reiterated the need for close cooperation among the IFIs active in this field.

At the beginning, the initiative planned to focus on market diagnostics, undertaking joint country assessments with other IFIs to identify reform priorities, and those Banking investments and Treasury activities that would promote the LCM development process. The country assessments were to provide clear guidance for the country-specific LCM development strategies, which would be spelled out in the agreements with target

Box 3. References to LCM development in the EBRD Presidents' AGM inaugural speeches 1997-2009

1997	(first mention) "In the strengthening of banks and capital markets, the restructuring of enterprises, the development of commercial infrastructure and the promotion of energy efficiency and environmental sustainability, the EBRD is still additional to the market and able to impact transition"
1998	"We can facilitate domestic capital market development and local currency project financing …"
2000	LCM development was identified as one of the four main challenges facing COOs, but no details on how the Bank planned to address it were given
2001-04	importance of lending in LCY indicated but LCM development not mentioned
2005	"we will develop capital markets in the region by financing of projects in local currency, as we have done recently in Russia"
2006	"the EBRD has contributed to the development of capital markets, for example by helping to introduce instruments for securitisation, developing mortgage lending and launching bonds in local currency. The launch of rouble bonds in Russia provided the Bank with roubles to finance projects – especially for municipalities and to modernise the power sector – in local currency rather than coping with the volatility of loans in US$. But just as importantly, with its first launch of a rouble bond in 2005, the EBRD helped establish a credible new currency index for Russia, the MosPrime rate"
2007	speech remarked only that "the EBRD has taken a prominent role in helping to deepen and strengthen LCMs"
2009	"In the financial sector we shall focus on strengthening balance sheets and bolstering intermediation capacity, with special emphasis on the further development of domestic capital markets and local currency lending"

countries, and then implemented by the governments with the assistance of the Bank and other IFIs.

LC2 identified five interrelated sequential themes (LC2 focus themes), which it intended to pursue through programmes tailored to each country of operations:

- building stable and sustainable macroeconomic policy frameworks
- improving the legal and regulatory framework to support capital market activity
- developing financial market infrastructure including clearance and settlement
- developing the institutional investor base
- promoting a more efficient transaction environment and expanding the product range.

LC2 was to be implemented by an interdepartmental working group consisting of the Treasury, Banking, Economist and Legal departments. The working group, jointly with other IFIs, set the initial priority list of countries that would be targeted, selected on the basis of the relevant authorities' interest, geographical diversity and the likelihood of success. The list initially included Georgia, Hungary, Kazakhstan, Poland, Romania, Russia, Serbia, Turkey and Ukraine. Subsequently, Armenia, Azerbaijan, Kyrgyz Republic, Moldova, Mongolia and Tajikistan were added to the list because, as ETCs, these countries were eligible for financing from the ETC Local Currency Loan Programme and Establishment of the ETC Local Currency Risk-Sharing Special Fund.[2] The rationale for this fund is presented in an action plan to improve local currency loan markets in ETCs, which further formulated the framework for the initiative's strategy, although limited to ETCs. The action plan highlighted LCM development as the primary objective of the new fund, alongside the creation of LCY reference benchmarks for interest rates and reforms to increase

2 BDS10-323 – currently known as SME Local Currency Special Fund, December 2010

the role of pension and insurance companies. Importantly, the LCY Risk-Sharing Fund was designed to provide a mechanism to share risk between the EBRD's ordinary capital resources and donor funds, making the Bank's loans cheaper, which would help catalyse the LCY loan market. Access to this fund required a signed MoU between the host country and the EBRD that stipulated the country's commitment to LCM development.

Another strategic underpinning for the initiative, particularly in respect of its cooperation with other IFIs, stemmed from the Vienna Plus Initiative's *Report by the Public–Private Sector Working Group on Local Currency and Capital Market Development*, published in March 2011 and authored largely by the Bank, the working group's leader (EBCI, 2011). It listed the working group's main findings and provided 13 recommendations for COO governments, private banks and IFIs. The four actions recommended for the latter are presented in Box 4.

Box 4. Recommendations for IFIs from the Vienna Plus Initiative's Report by the Public–Private Sector Working Group on Local Currency and Capital Market Development

IFIs can, in close coordination with each other, support:

- governments to pursue macroeconomic and regulatory policies that are conducive to the use of LCY (low and stable inflation, sound macroeconomic policies)
- the development of local capital markets according to their remit and expertise; this includes, for investing IFIs, helping develop LCY longer-term funding instruments and markets, the investor base (pension and insurance funds) and lending in LCY as established above; lending by asset class could be closely coordinated so as not to undermine ongoing efforts for LCY use
- provision of long-term funding in local currency, including at fixed rates to the extent possible
- global regulatory reform with a view to developing and implementing macro-prudential best practices.

The report clearly identified LCM development as a priority area of work for IFIs, with a long-term view to reduce dollarisation, increase use of LCY and create a stable and efficient platform for the sustainable economic development of the country of operations.

This report was followed in December 2011 by the Bank's internal paper to the Board on LC2, which provided an update on the initiative's activities to date and presented its work plan for 2012. This document was quite detailed and could be viewed as a forerunner of the LC2 strategy. It reported on the completion of the needs assessment missions (together with the IMF and the World Bank) to 10 countries and presented the priorities for five countries, divided into five categories, one of which was LCM development. The memo noted that the recommendations were jointly put forward by the EBRD, the IMF and the World Bank. The IMF was tasked with following up on recommendations for the improvement of the macroeconomic environment, while the World Bank was to focus on those concerning regulatory frameworks and public debt management issues. In turn, the EBRD was to concentrate on strengthening institutions that play a key role in the market development process, and improving the functioning of money and capital markets.

The recommendations for IFIs stemming from the report and the Bank's internal paper mobilised the Bank to adopt a more concerted effort to address deficiencies in LCM development.

During the next few years the Bank started investing more in corporate bonds, acting as anchor investor (including into pension funds). However, the cooperation among the IFIs, with carefully allocated responsibilities, has not worked out exactly as planned. The IMF indeed continued working on macroeconomic stability in selected countries but its coordination and sharing of information with other IFIs has been infrequent. This led the EBRD to launch its own inflation forecasting and yield curve development projects in several ETCs (Armenia, Georgia, Kyrgyz Republic).

In 2010 the World Bank established the Global Emerging Markets Local Currency Bond Program. There were some synergies with the Bank's operations, for example in Morocco where the World Bank's work during 2010-13 contributed to improved liquidity of the benchmark yield curve. However, there have been no joint projects involving several IFIs, except for diagnostic studies (for more on EBRD cooperation with other IFIs see section 6.4 of the report).

Annex 3: List of technical cooperation projects managed by the LC2 team, 2012-15

TC	TC description	Status	Countries covered	TC approval reference date	Funding source
Legal and regulatory assessment (COO)	This project aimed at assessing capital market development, laws and regulation in the old EBRD COOs. The assessment provides short- and long-term recommendations. Follow-up actions, such as the one in Ukraine, are taking place.	Completed	Hungary, Kazakhstan, Mongolia, Poland, Romania, Russia, Serbia, Turkey, Ukraine	Pre-2014	SSF
Legal and regulatory assessment in SEMED	The project aimed at assessing capital market development, laws and regulations in the SEMED region. The assessments were not only to provide an overview of the legal framework but also to identify legal impediments to the development of local capital markets and short- and long-term recommendations to address such impediments. The jurisdictions to be assessed were: Egypt, Jordan, Morocco and Tunisia.	Completed	Egypt, Jordan, Morocco, Tunisia	Pre-2014	SEMED
Legal seminar on Financial Markets Law and Regulation	A series of seminars conducted with the London School of Economics on the key issues of particular sensitivity for transition economies in areas related to the regulation of financial markets.	Completed	All COOs	Pre-2014	–
Feasibility of establishment of CCP	This study, conducted in selected EBRD countries, aimed at evaluating a feasibility of establishing the CCP, including benefits in creating CCP in relevant jurisdictions.	Completed	Kazakhstan, Poland, Romania, Russia, Turkey, Ukraine	Pre-2014	SSF
Integration of SEE stock exchanges	This project aimed at providing TC to eight Balkan stock exchanges that were working on the regional integration based on the T-Rex model.	Completed	Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia, Slovak Republic	Pre-2014	Donor/SSF
Inflation targeting	This project, conducted mostly in ETCs, aims at strengthening inflation forecasting ability and, when necessary, shifting policy focus from nominal exchange rate to low and stable inflation.	Completed (first phase); second phases in Georgia, Moldova	Armenia, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan	Pre-2014	SSF
Borrower Risk Management	Basic practical workshops to reinforce the risks involved in FCY borrowing, including theoretical breakevens, covered interest arbitrage and creation of theoretical FX rates derived from borrowing and lending rates in domestic and foreign currency. Targets microfinance institutions (MFIs), small banks and regulators.	Completed	Armenia, Georgia, Kyrgyz Republic, Moldova, Tajikistan	Pre-2014	ETC Fund

TC	TC description	Status	Countries covered	TC approval reference date	Funding source
Development of Forecasting and Policy Analysis Systems (FPAS) Models	Development and maintenance (for 2 years) of FPAS to improve the capacity to deliver LCY funding and to improve information dissemination through development of a portal. Supporting Treasury and ETC role.	Completing in 2016	Armenia, Georgia, Kyrgyz Republic, Moldova	Pre-2014	SSF
Judicial training courses on financial instruments, with focus on derivatives	The EBRD, together with P.R.I.M.E. Finance, provided a one-day course on financial products with a strong focus on financial derivatives to Russian judges. One took place on 26 November 2012 in Moscow and another training course will be scheduled in 2013 in Yekaterinburg.	Completed	Russia	Pre-2014	SSF
CCP presentations in Turkey	Presentation of results of the CCP study to Capital Markets Board and market participants.	Completed	Turkey	Pre-2014	SSF
Transaction Cost Study	This project aimed at assessing the cost of issuance and listing of securities in selected the EBRD COOs to provide a comparative study base on which follow-up actions can be initiated. Was extended to cover Morocco and Jordan.	Completed	Georgia, Jordan, Kazakhstan, Morocco, Poland, Romania, Russia, Serbia, Turkey	Pre-2014	SSF
Infrastructue finance conference	Co-hosted conference in Istanbul on the subject of infrastructure financing and the role that capital markets can play.	Completed	Turkey	Pre-2014	SSF
Pilot Bond Kyrgyz Republic	Develop a strategy paper-cum-issuance blueprint. Assist with successful issuance of pilot LCY bank bond. Advise on issuance procedure. Detail optimum types of instruments and maturity dates as well as generic terms and conditions. Recommend level of EBRD involvement including potential anchor investment.	Completed	Kyrgyz Republic	Pre-2014	SSF
SEMED Flagship Report	Production of SEMED Flagship Report on Capital Market Development.	Completed	SEMED	2014	SEMED
Ukraine Phase 1: Gap analysis and identification of optimal capital-market infrastructure set-up, including an implementation road map	Based on a request received from the Ukrainian Securities Market Regulator, the LC2 team conducted a capital market infrastructure workshop for high-level decision-makers and was asked to support its consolidation and development through policy dialogue and TCs. The TC was to indentify the optimal capital market infrastructure set-up and will provide a detailed and timed implementation road map.	Completed	Ukraine	2015	Donor / SSF
CCP – Regional	Feasibility study on the establishment of a regional CCP.	Completed	Hungary	2015	SSF

TC	TC description	Status	Countries covered	TC approval reference date	Funding source
Pension Reform – Romania	Review of the Romanian pension fund sector.	Completed	Romania	2015	SSF
Covered Bonds – Romania	Technical assistance on the implementation of the legal and regulatory framework for covered bonds in Romania. Similar projects expected in Croatia and Poland.	Completed	Romania	2014	SSF
Inflation targeting (extension)	This project, conducted mostly in ETCs, aims at strengthening inflation forecasting ability and, when necessary, shifting policy focus from nominal exchange rate to low and stable inflation.	Ongoing	Kyrgyz Republic, Mongolia, Tajikistan	2015	SSF
Money Market	TC aimed at looking at the potential to develop money markets in selected countries.	Ongoing	Armenia, Azerbaijan, Georgia, Montenegro, Serbia	2015	SSF
Small and medium-sized enterprises (SMEs) study in SEMED	Background study on SMEs' readiness to access capital markets.	Ongoing	SEMED	2015	SEMED
Derivatives Feasibility Study	Study on the feasibility of developing exchange-traded derivative markets in selected countries.	Ongoing	Montenegro, Romania, Ukraine	2015	Donor (Republic of Korea)
FPAS	Maintenance of Forecasting and Policy Analysis Systems (FPAS) model.	Ongoing	Kazakhstan, Kyrgyz Republic, Montenegro, Tajikistan	2016	SSF
Derivatives – Ukraine	Drafting legislation providing for enforceability, validity and legality of derivatives transactions.	Ongoing	Ukraine	2014	SSF
Private equity – Egypt	Study to identify barriers to the further development of a private equity sector in Egypt.	Ongoing	Egypt	2015	SSF
CSD – Central Bank of Egypt	Large technical assistance project to establish a central securities depository in the Central Bank of Egypt. Also contains a component that looks at the development of a yield curve pricing model.	Ongoing	Egypt	2014	Mutiple
REIT – Morocco/ Egyp /Turkey	Technical assistance on creating the necessary environment for a REIT transaction. Linked to a specific EBRD investment.	Ongoing	Morocco	2015	–
Derivatives – Morocco	Working with the LTT on derivatives legislation in Morocco.	Ongoing	Morocco	2015	SEMED
Jordan Capital Market Action Plan	Technical assistance for the implementation of the capital market development plan developed for Jordan.	Ongoing	Jordan	2015	SEMED

TC	TC description	Status	Countries covered	TC approval reference date	Funding source
Capital-market development – Kyrgyz Republic	Planned capital market development consultant to provide technical assistance.	Ongoing	Kyrgyz Republic	2015	SSF & KfW
Macedonia CSD	Upgrade of the Macedonian CSD's services for investors and issuers to increase the transparency of the market by introducing automatised/ web-based account and information services. The Macedonian CSD will cover 20% of the costs.	Ongoing	FYR Macedonia	2015	Donor/SSF
Poland – WSE Benchmarking Exercise	Benchmarking exercise with the Warsaw Stock Exchange to identify the impediments to further development of the market.	Ongoing	Poland	2015	SSF
Romania – Capacity-building at the CSD/stock exchange	Capacity-building exercise to ensure CSD/exchange development plans are suitable.	Ongoing	Romania	2015	–
Croatia – Covered Bond	Technical assistance on the implementation of the legal and regulatory framework for covered bonds in Croatia.	Ongoing	Croatia	2015	–
Romania – Judicial Training	Provide two-day training course to various authorities and regulatory bodies to develop staff capabilities and improve enforcement on capital market instruments – debt, equity, derivatives.	Ongoing	Romania	2016	–
Georgia – Derivatives	TC project aiming at assisting the National Bank of Georgia with the creation of the derivatives legal framework, while also providing a market infrastructure assessment and capacity-building activities.	Ongoing	Georgia	2015	SSF
Armenia – Derivatives	TC project on the development of derivatives law in Armenia.	Ongoing	Armenia	2015	SSF/ ETC Fund
Moldova – Stock Exchange	TC to audit IT system, trading rules of the Moldovan Stock Exchange.	Ongoing	Moldova	2015	SSF
Tunisia Clearing	Technical assistance linked to upgrade central security depository software and hardware. TC to be specifically related to scoping, implementation and maintenance.	Ongoing	Tunisia	2016	–
Ukraine	TC review of the draft law on bondholder meetings and rights in Ukraine.	Ongoing	Ukraine	2015	49,000 MDA, 25,000 LTT Quick response budget

Notes:
– = not available; AfDB = African Development Bank; CCP = central counterparty clearing house; COO = country of operations; CSD = central securities depository; DCF = Donor Coordination Fund; ETC = early transition country; FCY = foreign currency; FX = foreign exchange; FYR = former Yugoslav Republic; IT = information technology; LTT = Legal Transition Team; MENA TF = Middle East and North Africa Transition Fund; REIT = real-estate investment trust; SEE = south-eastern Europe; SSF = Shareholders Special Fund; SEMED = southern and eastern Mediterranean; TC = technical cooperation project; WSE = Warsaw Stock Exchange.

Annex 4: Case studies

A4.1. Case study 1: Ukraine derivatives law development – technical cooperation

A4.1.1. Introduction

As part of this case study, the EvD team assessed the progress and impact of the Bank's TC project, the objective of which was to deliver a new derivatives law for Ukraine. Discussions were held in July 2016 in Kiev with:

- Ukrainian Exchange (UX) – the largest stock exchange, already trading derivatives
- National Reforms Council (ex-USAID) representative
- Sayenko & Kharenko – solicitors (consultants), commissioned by the EBRD to deliver the new law
- Citibank – market participant
- Ministry of Finance – policy-maker
- National Securities and Stock Market Commission (NSSMC) – the national regulator for capital markets.

The team focused its review predominantly on the derivatives law development project, but it also discussed a wider range of issues relevant to the development of the Ukrainian capital market.

A4.1.2. Project relevance

Derivatives are seen by market participants as a valuable addition to Ukraine's capital market, filling a legislative gap that needs to be addressed to mitigate risks related to currencies (for example, by enabling hedging) and commodity trading (by enabling trading of futures contracts for commodities). This is important because Ukraine is a major agricultural commodities exporter and a major oil and other fuel energy commodities importer in the region. Certainty of the price at which grains or soya beans are to be delivered is of the utmost importance for major investors operating in Ukraine such as Cargill, DuPont, Louis Dreyfus and Monsanto, as well as for hundreds of smaller agribusiness companies. Moreover, due to the rapid devaluation of the Ukrainian hryvnia against all major currencies (70 per cent in aggregate during 2013-15), the ability to mitigate currency risk became the top priority for trading companies and therefore a very important issue to address in the Ukrainian capital market development framework (currently hedging is not possible).

There is no adequate law regulating derivatives trading at present – only pieces of the securities law and the civil code cobbled together with other laws (for example, the law governing options). There is no finality of settlement, which creates uncertainty in respect of the validity of transactions. However, international investors, as well as domestic institutional investors, need legal certainty. There have been a number of attempts to draft new derivatives laws. For example, the United States Agency for International Development (USAID) Ukraine Capital Markets project implemented in 2005-10 (see section A4.1.7) included among its many outputs a review of the derivatives law proposed at that time. It also provided comments and recommendations related to the new law. However, that law was deemed to have too many deficiencies and was not pursued further. Another draft was produced in 2011 under an IMF project, which was also seen as too generic and inadequate for the Ukrainian situation.

The Bank's approach was different. The project initiated at the end of 2013 involved contracting local legal counsel and setting up a working group of key local stakeholders, as well as extensive work with governmental agencies and private market participants to produce the current draft for the NSSMC to take into legislation. The new draft law has significant support in Ukraine, not only from the Ministry of Finance but also from the Ministry of Energy and the Ministry of Agriculture, as well as private market participants.

The derivatives law development TC is the LC2 team's only activity in this country, although Ukraine has been part of two multi-country feasibility studies (one on the establishment of central counterparty clearing house and another on depository registry issues). LC2 also has a couple of TCs for Ukraine in the pipeline (on post-trade infrastructure and regulations, and mobile auctions for government bonds).

An EBRD internal assessment report of May 2011 identified four priorities for LCM development in Ukraine.

- Improve the insolvency legal framework – improving insolvency law by introducing mechanisms for restructuring an issuer's obligations upon potential or actual default and clarifying the rules for set-off of claims between holders of securities and the issuer.

- Clarifying the rules and regulations regarding repo transactions – unifying rules for repo transactions, including mandatory rules for repo settlements at stock exchanges and standardising repo contracts.
- Permit the issuance and facilitate circulation of securities by foreign entities.
- Clarify rules relating to derivative transactions.

In addition, three long-term areas of priority work for LCM development were recommended.

- Strengthen disclosure and reporting requirements for issuers – requiring the issuer to promptly disclose all material information in a timely manner and strengthen the NSSMC to effectively investigate any failure to disclose such material information.
- Improve regulations governing bank reserves and regulatory capital – amend the regulations to recognise lower risk of mortgage bonds and to encourage investments in securities.
- Improve regulation of local credit agencies – prepare guidelines for producing ratings and disclosing their methodology.

Out of this menu of LCM development issues, the Ukrainian authorities chose the amendment of the derivatives law for its first TC in Ukraine. There were a number of reasons for this decision. For instance, USAID included the development of a global purchase agreement for repos as part of its Capital Markets project, so this issue was considered to be in the process of being addressed. The improvement of the insolvency legal framework was seen as an area better suited for the Bank's Legal Transition team to address.[3] Another reason was that derivatives law development had a local champion (the Head of the Parliamentary Commission on Financial Reform and then the Minister of Trade and Economy), who was committed to driving the new law's approval process, which was seen as an important advantage and influenced the Bank's decision to select this project.

However, the EvD team notes that numerous interviewees pointed out that a deficient capital market infrastructure, particularly inadequate central counterparty clearing house and central securities depository, poses a larger (or at least equally important) challenge to LCM development than the lack of a comprehensive and adequate derivatives law.

Nevertheless, based on the opinion expressed by all interviewees that the development of a derivatives law has been of critical importance to Ukrainian capital markets development, and on the good fit between this project and the priorities identified under the needs assessment for the Ukrainian capital market, the relevance of this TC is rated fully successful.

A4.1.3. Efficiency of project implementation

All interviewees stressed their high regard for the EBRD's inclusive approach to the project. At the start, the team of consultants set up a working group of market participants. This approach ensured that the resulting draft reflected the specific needs of the Ukrainian market rather than being a generalised, generic product. The NSSMC had requested a systemic approach, which covered all types of derivatives and the resulting act met this need. The NSSMC was encouraged to consult with participants and did so. Participants reported that they had been fully consulted and felt they had been involved in the process with their views and issues being considered and incorporated.

However, the whole project took considerably more time and resources than envisaged under the initial TC; it had been scheduled to run for two years (from August 2013 to August 2015), with €250,000 budget. Of the four main tasks set in the consultants' terms of reference for this TC, two were completed within the set budget and time frame (drafting of new legislation and its presentation to the working group). However, the two remaining tasks (supporting the draft during submission to the Parliament and guiding the working group in preparing the implemention framework) were transferred to Phase 2 TC. One more task was added to Phase 2: organisation of awareness activities to publicise the new law among market participants. Phase 2 was designed to take one year and had an additional budget of €150,000. It expired in August 2016, but was extended by another year (with additional budget). However, most of the delays have been caused by the longer time required by the Ukrainian counterparts to review and comment on

3 In mid-2016 the Legal Transition team started a project to facilitate the resolution of non-performing loans in Ukrainian bank balance sheets, which should contribute to making the insolvency environment more efficient. The Legal Transition team is also considering a more general insolvency law reform project.

the subsequent versions of the law (which was also a result of political upheavals and subsequent changes in the Parliament's priorities). The consultants performed well and provided drafts to the required deadlines. All of the interviewees spoke very highly about the professionalism of the Bank staff and the consultants involved in this project. The inclusive approach, based on wide consultation, was particularly praised as it contrasted with that of some other IFIs which had attempted to address derivatives law issues. For instance, the former deputy minister at the Ministry of Finance commented that the delivered bill was the most comprehensive draft he had ever seen. He also noted that "EBRD projects are properly structured" and contrasted them with other projects, which produced "lots of irrelevant reports".

Despite project delays and budget overruns, the efficiency of project implementation is rated fully successful.

A4.1.4. Project results

The desired output of this project, that is a draft of the new law, has been achieved. The new derivatives law has been submitted to the Parliament (Rada) and passed its first reading on 31 March 2016. The achievement of the outcome, that is adoption of the law, following the second reading in the Parliament, was expected in September 2016. However, before the second reading, the NSSMC added a number of clauses to the bill. These clauses, as described by the NSSMC, which are not directly related to derivatives, would:

- remove the requirement to gain Ministry of Justice approval for rule changes (this has been the most controversial provision) – currently the Ministry reviews rule changes and this can take up to one month
- change the status of NSSMC staff so that they have legal immunity when acting in the course of their job, as normal international practice
- permit the NSSMC to protect data from disclosure requests under the freedom of information law, which can be used to force disclosure of confidential data
- permit the NSSMC to cooperate with foreign regulators – this would allow the NSSMC to sign the International Organization of Securities Commissions (IOSCO) Multilateral MoU, which is a basic qualification for regulators providing international credibility.

Crucially, the new provisions would enable the NSSMC to charge a small fee to market participants (as international practice) and thus obtain much better funding of its budget. This in turn should enable the NSSMC to offer better terms of employment (including higher salaries), which would help it attract and retain competent staff (low salaries are one of the main reasons for the agency's limited effectiveness, as indicated by both NSSMC and market participants).

These additional clauses are, in themselves, highly desirable developments and would allow the NSSMC to sign the IOSCO Multilateral MoU – which it cannot do at the moment. The clauses were proposed under an IMF project and have become conditions for a substantial World Bank loan. This is subject to a near-term deadline. The derivatives law itself is not seen as controversial but these clauses are more so since they significantly enhance the capacity and powers of the NSSMC and so improve its effectiveness as a regulator. Opposition is said to come from certain market participants who are opposed to stronger regulation and who also have significant political influence. As a consequence, the passage of the bill in its revised form is uncertain.

The additional clauses are highly beneficial in themselves. They will raise the regulatory regime in Ukraine to IOSCO standards. Currently the NSSMC is a member of IOSCO but is unable to sign the IOSCO Multilateral MoU, which is seen as the crucial international standard for regulators.

The EBRD and the consultants involved would prefer that the derivatives law is presented for its second reading in its original form without the new clauses, with the new provisions related to NSSMC powers being presented as a separate law. However, the NSSMC seems determined to stick with the revised bill for two reasons: the conditions attached to the World Bank loan and, probably more importantly, it needs the additional clauses and the derivatives law, with its widespread support, to act as a vehicle to drive thorough the more controversial changes. The EBRD has voiced its view but the NSSMC seems determined not to withdraw the additional clauses. This introduces a significant risk to the passage of the derivatives law.

All major Ukrainian stock exchanges signed a letter to the members of Rada in support of the provisions related to derivatives in the new law, but asking the deputies to reject the law as currently proposed due to the additional provisions incorporated by the NSSMC.

Although the TC delivered the required output (the new law, which the client, the NSSMC, has accepted) its approval has been delayed several times and it is now at risk of being indefinitely delayed. Therefore, as there is no prospect of its approval, the results of the project are rated partially unsuccessful. However, according to the LC2 team, there is still some chance of the law being approved in the future, therefore this rating could be upgraded.

A4.1.5. Context for the new derivatives law

Exchange-traded derivatives

The UX is one of several exchanges operating in the country, of which three can claim to be significant. The UX claims to be the largest exchange for equity trading in Ukraine. The UX has been offering derivatives trading since May 2010. It currently offers trading in futures on:

- US$/€ exchange rate
- Ukraine hryvnia/€ exchange rate
- US$/Ukraine hryvnia exchange rate
- gold
- UX Index – market value weighted price index of the 10 "most liquid and highly capitalised local shares" (though not all appear to trade every day).
- options (puts and calls) on the UX Index.

The exchange would welcome a revised law to improve the foundations of its derivatives market. The current legal structure is weak on settlement and the central counterparty clearing house it uses for derivatives trading is legally constituted as a broker rather than as a market infrastructure provider. The central counterparty clearing house is not compliant with international standards as it does not truly guarantee settlement. However, even with a better law, it would be difficult for the exchange to acquire a better clearing house as these are expensive and the exchange's business volumes are inadequate to fund such a purchase. In addition, there are three guarantee funds but the amounts involved are inadequate even for the current market size. In practice this means that only the least risk-averse are willing to trade and so trading, which is restricted to qualified investors though it is unclear how this is enforced, is entirely speculative.[4]

In the opinion of UX officials, one reason why international investors do not invest in Ukrainian derivatives is indeed the deficiencies of the legal framework regulating such transactions. At the same time, they stressed that those who did trade derivatives did not experience any legal problems, for example related to the validity, finality or settlement of their transactions. However, there is a consensus that a more robust and clear legal structure would attract foreign investors and local institutions, though the central counterparty clearing house weaknesses would remain.

The derivative trading volumes are small: there were 20 trades on 5 August 2016, a not untypical day, of which 12 were in the €/US$ future and eight in the gold future. Trading in the UX Index future is rare but trading in the underlying stocks is also light.

Development of the over-the-counter (OTC) currency market, as discussed below, would stimulate the exchange-traded market. The market for equity-based derivatives will depend upon general development of the market for corporate securities in Ukraine. The UX lists nearly 300 companies with a market value of around US$9 billion. However, many of these are the result of compulsory listing of mass privatisations and trade very little.[5]

Over the counter derivatives

Future development prospects are limited by the following.

- Currency restrictions: local banks would like to offer contracts for currency risk but current exchange controls prevent them from engaging in significant amounts of forex trading and only in support of import/export transactions.
- There is no money market benchmark for writing derivatives: there was CF Prime, but this no longer exists. The repo market is not developed.

4 The qualified investors concept is used in a wide range of markets (from the US 144a market to the Chinese SME bond market) to exclude retail investors from inappropriate investments. However, in those markets it has a clear and legally robust definition which is not the case in Ukraine.

5 To illustrate: the market value of the UX Index stocks is only 8 per cent of the total market value – the main index of a market is usually well over 50 per cent of the market.

- There is no generally accepted framework for OTC derivative transactions such as the International Swaps and Derivatives Association (ISDA) standard swap agreement. There is an official National Bank of Ukraine framework agreement but this is inadequate and needs to be replaced by a local version of the ISDA agreement. This could be developed with external assistance perhaps based on the Russian model, which is ISDA compliant. It is said that 10 banks are still working towards this.

But even if no OTC derivatives are launched there will be gains from a derivatives law which will create infrastructure – for example, for escrow accounts.

Commodity derivatives

Ukraine is a major producer and exporter of wheat, but the commodities market is highly fragmented with some 500 separate exchanges. There is no centralised price discovery, though it could be presumed that informal arrangements allow some form of arbitrage between markets. The NSSMC, which is the regulator of commodities markets as well as financial markets, plans a two-pronged approach to improve the efficiency of the market and provide risk management for users:

- The individual commodity markets will be obliged to become regulated markets on the Markets in Financial Instruments Directive (MiFID) model and, as such, will be required to collect and publish reports of transactions. This, in itself, will substantially improve pricing efficiency and lead to a benchmark price for wheat.

- The existence of a benchmark price will attract exchanges, regulated by the NSSMC, to set up derivative exchanges.[6] Economic factors will probably lead to consolidation into a national derivatives exchange for Ukrainian wheat. The NSSMC expects the contract to be cash-settled (since a deliverable contract would require a level of product quality standardisation which does not yet exist in Ukraine) but does not prescribe any particular contract type.

6 CME Group operates a Black Sea Wheat derivative. However, this is a deliverable contract and daily margins are payable in Chicago in US$ which, for Ukrainian traders, would be subject to exchange controls. The CME contract is very lightly traded.

A4.1.6. Project impact on LCM

There has been wide consensus on the need for a comprehensive and clear derivatives law. Various entities face significant currency and commodity price risks, which derivatives would allow to be transferred to those more willing to bear or more able to manage those risks.

Feedback from counterparts suggests that the project was appropriate, well structured and practical, and involved a high level of consultation with government agencies and market participants. The early establishment of a working group was seen as a particularly sound basis for the project.

There is now a risk of the draft not being successfully passed into law. This in no way reflects on the project which, in technical terms, successfully produced a deliverable that the counterpart is very comfortable with. However, while the new clauses added to the bill are desirable, it is unfortunate that they have been incorporated into the draft bill. While this is, in the end, a decision for the NSSMC, it is unfortunate that the loan conditions imposed by another IFI's project were part of the decision-making process and perhaps suggest a need for greater inter-IFI consultation and coordination.

Further work will be required before OTC financial derivatives make a significant contribution to the Ukrainian capital market. The strict exchange controls on commercial currency transactions remain a considerable barrier to forex and forex-derivative operations by banks. The relaxation of these will be a matter for the National Bank of Ukraine and will depend on the macroeconomic outlook. Other, more technical issues that could be addressed are the absence of an interest rate benchmark in the interbank market and the lack of a standard agreement format for use in OTC derivative contracts.

The UX already trades derivatives on currencies, gold and the stock market index, though on shaky legal and infrastructure foundations. A new law would help but would not address the infrastructure (central counterparty clearing house) weakness. The development of currency derivatives will depend upon the OTC market and the National Bank of Ukraine policy on exchange control, and the development of corporate securities derivatives will depend on the growth of the underlying market. This, in turn, depends upon a growing willingness of Ukrainian companies to raise equity capital – consensus is that the first initial public offering (IPO) will be in 2018; a growth of domestic investors, particularly institutional investors, which has barely begun; and a renewed confidence among foreign investors, which will be difficult in the current political situation.

The NSSMC has a development strategy for commodity derivatives which seems sound since it relies on creating a regulatory environment which encourages the private sector, including the stock exchanges, to respond to commercial imperatives and the gradual improvement of market quality resulting from increased transparency.

The National Bank of Ukraine has opposed trading of forex and, in turn, of forex derivatives on the stock exchanges. This is understandable in the current exchange control climate, but if that climate changes it would be desirable, and in line with international practice, if the decisions about products, exchanges and trade are made by the exchanges licensing authority – the NSSMC.

The new derivatives law has had no wider impact on Ukrainian capital markets so far as it has not yet been enacted. However, there are some hopes for the law's approval in the future and there is a strong potential for the law to have a positive impact on such markets when it is enacted. In the words of the interviewees, it is expected to bring order, stability and clarity to derivatives trading legislation and ensure validity of derivatives transactions. The introduction of new concepts, such as escrow accounts, goes beyond derivatives trading and has the potential to support overall business practices in the country. Also, provisions such as permission for derivatives contracts in English are expected to increase interest in Ukraine among international investors. Finally (and unintentionally), the Bank project facilitated the adoption of important legal provisions, which should increase the effectiveness of capital market regulation in Ukraine (also ensuring the release of an important IMF loan). Based on such potential the current impact of this project is rated acceptable, with potential of being upgraded if and when the law is finally enacted.

A4.1.7. Activities of other IFIs

Other IFIs have implemented two main projects related to capital markets development and relevant to the Bank's TC.

Between 2005 and 2010 USAID worked on the Ukraine Capital Markets Project, with a budget of US$14.2 million, which had three broad objectives:

- strengthen the capacity of the financial market regulators
- broaden the range of financial instruments available for portfolio investments and market infrastructure development
- strengthen the capacity of pension fund providers.

The EBRD noted considerable progress, particularly with a derivatives law, a framework for pillar 2 pensions, installation of a disclosure system, ESCREEN (akin to the US Securities and Exchange Commission Electronic Data Gathering, Analysis, and Retrieval system known as EDGAR) and a single depository. But feedback from Ukrainian agencies and participants raises questions as to how much of this progress has been sustained. It was reported that ESCREEN did not function as intended and was abandoned in 2014; the depository is still split between government and other stocks; no pillar 2 schemes have been introduced; and the derivatives law remains inadequate. However, counterpart feedback implies that the project was not successful and that the follow-on projects have been more helpful. The follow-ons, Finrep 1 (implemented in 2013-14) and Finrep 2 (2013-15), have involved practical support, such as using US SEC regulators to train NSSMC staff and the provision of a road map for agricultural commodities market development, and so are regarded as very useful. Finrep 3, which focuses mainly on non-bank financial institutions, is being set up. The projects have also provided valuable finance for new equipment for the NSSMC.

The IMF has also been involved in LCM development in Ukraine and continues to be. An IMF expert drafted a derivatives law after 2011 but it was not adapted to Ukrainian circumstances and so was not enacted. There is a current IMF project involving a US$500 million loan. The loan conditions include those added to the draft derivatives law after its first reading.

However, it has been stressed that since 2012 USAID and the IMF have decided "to leave derivatives law" to the EBRD, which was perceived as being more competent in this field. Since then cooperation among IFIs has been very close.

A4.1.8. Other issues related to LCM development in Ukraine

Besides the derivatives law TC, the EvD mission discussed a number of more general capital market development issues noted below.

Stock markets

The domestic share market in Ukraine is very small. The market value of listed equity is equivalent to 11.7 per cent of gross domestic product (GDP) (end 2014), illiquid and the trading velocity is extremely low at 2.7 per cent. The trading levels were better in 2012 prior to the political upheavals of 2013-14. There are nearly 300 companies listed, including a lot of mass privatisation stocks, which were compulsorily listed, and many tax shells. These have low levels of compliance and little investor interest. There have never been any IPOs and there are no prospects of there being any until at least 2018. Until then the market will be focused on government securities. In preference to the local market, 13 Ukrainian companies are listed on the Warsaw Stock Exchange.

The NSSMC has delisted many low-compliance, low-interest companies, but there are many more that require delisting if the market is to have a healthy list of investable companies. The NSSMC is reported as wanting to reduce the number of listed companies to about 15, which it sees as the "proper" public companies. Indeed, in conversation, the NSSMC suggested that no more than three of the currently listed companies were really sustainable (meaning they could comply with rules and attract investment interest). There are reputed to be some good potential state-owned enterprise privatisation prospects but these have not yet been progressed.

There are no attractive corporate bonds, only government bonds. The government market is a telephone market between primary dealers with no proper quotes or trade reporting. The NSSMC is aiming to improve market quality and publish a daily yield curve to assist development of the corporate bond market. The UX also trades repos – essentially a way of allowing participants to leverage capital (similar to margin trading).

Mutual funds exist but are mainly tax shelters or real estate investment companies. Pension funds do not really exist though the USAID project claims to have set up a legal infrastructure for company schemes. The only widely used scheme is the national pay-as-you-go scheme. There are some limited pillar 3 pension schemes. Some foreign mutual funds entered the market in 2011-12. They have since withdrawn but may return if the market and general situation improve. Foreign investors have been scared off by current uncertainty and, in the longer term, the risky settlement infrastructure will remain a deterrent.

The market lacks credibility because of poor disclosure, low transparency and prevalence of abuse. Transparency and disclosure are acknowledged as poor by the NSSMC but they intend to implement the relevant EU directives in the near future. They intend to implement EU capital adequacy directives by 2020. There are no specific market abuse regulations, just some general provisions combining criminal and administrative procedures. The NSSMC takes action under these with some claimed success but the problem remains. Most equity trading is OTC. Trade reporting only relates to exchange trading – NSSMC wants to extend to OTC to meet MFID standards.

The market is very fragmented. There are currently 10 stock exchanges although only two, perhaps three, do any significant amount of trading. The UX focuses on equities and derivatives but the other exchanges are focused mainly on government bonds. Two of the three major exchanges (including UX) were entirely or partially owned by the Moscow exchange (MICEX) and their licences were withdrawn in 2014. The two exchanges are now majority locally owned and the licences have been restored. The exchanges also have a large number of member firms: the UX website lists around 100 member firms. This would suggest that a lot of the firms are not active and are likely to be poorly compliant.

The NSSMC intends to follow the MFID model, designating exchanges as MFID regulated markets listing the few companies that are of adequate quality and will allow other companies to be traded on Multilateral Trading Facilities. The NSMC anticipates consolidation of exchanges, possibly into a single exchange ultimately.

Regulation and enforcement

The NSSMC's capacity is constrained and they are heavily reliant on government finance and donor contributions. They are subject to civil service pay scales and so recruitment of adequately qualified staff is difficult. The NSSMC wishes to move towards a user-pays model and believes that, in time, it will be able to cover all its running costs.

Auditors are not yet subject to regulation. The NSSMC has responsibility, but has not implemented regulations yet. The legal system is not robust and judges lack the capacity to handle financial cases. There is a lack of transparency in many legal decisions.

Market infrastructure

The Settlement Centre, which is the clearing agency for securities trading, is set up as a bank and is not bankruptcy-exempt (in contrast to Euroclear and Clearstream). The stock exchange trading system requiring prepayment for buyers (and pre-allocation of stock for sellers) means that client money and stock is held in the Centre (in the named account of the settlement bank) and could be caught up in any bankruptcy (which clears for the regulated exchange markets and the unregulated OTC market). Banks keep as little as possible in Settlement Centre accounts to minimise risk.

The infrastructure is generally weak. The central counterparty clearing house is not European Market Infrastructure Regulation compliant, the depository is not compliant with international norms and settlement is not in central bank money. The requirement to pre-block (stock and money) imposes problems (for example, on day trading). There are too many exchanges trading too little which means they are unlikely to be able to fund infrastructure improvements.

A4.1.9. Key findings and recommendations

Findings

- When engaging in the development of a new law, the Bank is exposed to the risk that its client may want to combine the new law with unrelated, politically charged provisions, which it hopes have a better chance of being adopted on the back of the law developed by the Bank. This can stall the approval process and jeopardise the project's chances of achieving the desired results.

- An inclusive approach to new law development (involving local lawyers and a working group of local stakeholders) is much more successful than one relying on external consultants only.

- TCs related to the development of new legal provisions often require extensions and additional budgets.

- As found by other IFIs working with the Ukrainian capital-market regulator, "capacity building TCs have their limitations when salaries offered by such regulator to its staff are extremely low". More fundamental reforms of the funding system for LCM regulators are needed to attract and retain quality staff, ensuring the regulator's effectiveness.

- Top priorities for LCM development in Ukraine, raised most frequently by the interviewees were the following:

    - improvement to capital markets infrastructure, particularly central counterparty clearing house (described by one interviewee as a "monster") and central securities depository (CSD), which would enable the stock exchanges (preferably consolidated into one, maximum two) to undertake proper clearing and settlement of transactions

    - improvement of the regulatory enforcement and judiciary system – as stressed by one interviewee "even best laws will fail if their enforcement (including effectiveness of courts) fails"; currently the NSSMC cannot do much as penalties for market manipulation or other offences are extremely low and do not serve as an effective deterrent; serious deficiencies in the operation of Ukrainian courts (cases take years and their cost are high) deter international investors, who do not accept the risk of having to deal with Ukrainian courts

    - reform of currency regulations, which are very restrictive, for example they prevent repatriation of dividends abroad

    - pension system reform – currently there is no pillar 2 in the pension system and very few people opt for pillar 3; in consequence there are no institutional investors in Ukraine which could support the LCM.

Operational considerations

- Sign pre-project agreements/MoUs with TC clients for the development of new laws, preventing them from combining Bank project outputs (new laws) with unrelated (or loosely related) legal provisions, which could then be presented to the law-makers as a package.

- When engaging in the development of new laws, coordinate closely with other IFIs involved in the same field.

- In the short term, consider a follow-up TC to develop a standard framework agreement for derivative transactions on the OTC market and for repo transactions.

- In the longer term, consider a central counterparty clearing house and CSD development project with the NSSMC.

- Building on the achievements of USAID FinRep 2 project, consider a TC (possibly together with the Agribusiness team) aiming to consolidate and strengthen agricultural commodities exchanges in Ukraine, with a long-term goal of creating a leader in the Black Sea region.

- In relation to the ongoing derivatives law development TC, consider liaising with the IMF to agree with the NSSCM to split the law into two – one purely on derivatives and one on increasing the NSSMC's independence.

- For the Legal Transition team – consider insolvency law reform, as well as a project for commercial training for judges in Ukraine; the latter could include a twinning programme with judges from other COOs, for example Poland or Romania.

A4.2. Case study 2: South-Eastern Europe Stock Exchange Linkage (SEE Link) development

A4.2.1. Introduction

As part of this case study the EvD team reviewed the Bank's TC project that was designed to deliver a linkage between the south-eastern European stock exchanges in the form of a regional trading platform known as SEE link. Its overall objective was to support integration of highly fragmented stock markets, mainly in the Western Balkans, without formal mergers or corporate integrations (which were politically sensitive and for which earlier attempts had failed), using only technology that would enable participating stock exchanges to remain independent yet complementary and allow investors easier and more efficient access to these markets through a local broker.

It was envisaged that the SEE Link project would be implemented in two stages, with four exchanges establishing the Link in Stage 1, and a further three exchanges expanding the Link in Stage 2. Stage 1 was completed in March 2016 and it is now operational, covering Croatia, Bulgaria and Macedonia. Bosnia and Herzegovina, Serbia and Slovenia joined subsequently, bringing the total number of exchanges involved to six as of November 2017. The involvement of Slovenia in Stage 1 adds an additional dimension in that the Ljubljana Stock Exchange has the Xetra system (originated by Deutsche Borse), which allows brokers in other European Union countries to be remote members and access the Ljubljana exchange and, through SEE Link, potentially other SEE markets.[7] At the time of TC approval it was expected that the ownership of the platform would be equally divided between the stock exchanges in Croatia, Macedonia, Serbia and Slovenia, and that the company providing the platform would be established in the form of a limited liability company and located in Macedonia (mainly because of lower costs of business establishment).

The TC was financed by a grant of €540,000 from the EBRD's SSF approved in mid-2013. There was no EBRD loan or investment follow-up on this TC (although one was considered). To assess the results of the project, the EvD held discussions in September 2016 in Zagreb, Croatia with the Zagreb Stock Exchange – which is the largest stock exchange and leading participant in SEE Link – and InterCapital Securities, a Zagreb-based investment bank with a brokerage arm and regional interests.

The evaluation team focused its review predominantly on the SEE Link project but it also discussed a wider range of issues relevant to the development of the Croatian and Western Balkan capital market.

A4.2.2. Project relevance

The stock markets of south-eastern Europe (SEE) suffer from low levels of market capitalisation and trading volumes. The commercial viability of all the stock exchanges in the region is doubtful at current business levels and there is a significant risk that some or all of them will not survive. Regional integration was identified under an earlier USAID-financed project (Partners for Financial Stability) as the most viable option to ensure the continued survival of the exchanges in the region (though this does not and

7 This is only possible for brokers and exchanges based in EU countries and which have common passports.

should not preclude mergers and similar collaborative activities to improve business viability). However, regional integration of capital markets has generally been difficult where it has been tried (the sole example of a successful integration being the EU market under MiFID 2). The EU model was driven forward by centrally agreed directives providing harmonised rules defining mutual recognition of participants and instruments. Some SEE countries are already EU members and the others are aspiring to membership, so a process of harmonising capital-market regulation to MiFID 2 standards is in progress.

Other IFIs and development agencies have not been active in the region's capital markets. An exception was USAID, which finished a capital market development project in the Western Balkans in June 2013. This project identified regional integration as a way forward to address the lack of commercial viability of the exchanges in the region. The project appears to have had a wider aspiration for a closer regional integration but encountered difficulties reaching agreements among all stakeholders that led to a narrower focus on an order system. In its final stage, the USAID project assisted the exchanges to develop a solution based around an order-routing platform. It engaged with the regional exchanges, post-trade operators, regulators and relevant political representatives in SEE and released a study that confirmed the feasibility of an order-routing link between the SEE exchanges.

The EBRD recognised the importance but also limitations of capital markets integration in the Western Balkans. It adopted a 'small steps' approach, building on the USAID project and its conclusions. It worked towards creating a relatively simple electronic linkage between the markets with the aim of increasing trading volumes and improving liquidity, which in turn would support LCM development in the Western Balkans and also lead to an increase in economic value of the exchanges. The project's relevance is rated fully satisfactory. This rating recognises the relatively limited scope and functionality of the SEE Link system. However, it emphasises the importance of a start-up project, aiming at closer integration of capital markets in the SEE region.

A4.2.3. Project results

To date the linkage has provided a facility allowing brokers in one SEE country (the originator broker) to route orders to a broker (the receiving broker) in another SEE country. Under this system the receiving broker establishes a relationship with the originator broker, agreeing to accept orders routed by their counterpart broker through SEE Link. The linkage does not allow for direct access of the originator broker to the exchange in the other SEE country as that would require mutual recognition of the originator broker by the regulator in the receiving country. Nor does the facility offer links to settlement. As such, it was conceived as a transitional development, which would be enhanced as the scope of the system expanded and it became a more integral part of the regional market, involving more countries.

SEE Link is a routing mechanism and it is not a market. In the first instance responsibility for regulatory compliance rests with the receiving broker. The regulators from the countries whose stock exchanges participate in SEE Link have signed an MoU allowing the regulators in the two countries for any transaction in the system to share information.

The project's planned outputs for Stage 1 were:

- establishment of common legal and organisational framework for the system (among other things, establishing a company that would run the system, its by-laws and standardised brokerage agreements)
- ensuring that country-specific legal, IT and operational procedures can facilitate access to the system (may be phased in depending on individual countries' readiness)
- development of a core IT system for SEE Link
- creation of common interfaces
- engagement of brokers and institutional investors.

The long-term outcomes of the project were to be:

- increase of regional cross-border investments and trading
- improving options for raising capital through the capital market (IPOs)
- standardising and improving financial services in the region
- presenting the region as one investment proposal to international investors.

The project's main impact was to be a closer integration, as well as increased attractiveness and liquidity, of capital markets in the Western Balkans.

The project's outputs have been largely achieved as the project is operational across three exchanges. Specifically, a SEE Link operating company was set up and the IT system is operational for the participating exchanges. Stage 2 will extend the system to a wider group of exchanges.

The system commenced operation in March 2016 and, so far, 27 brokers have joined it by signing inter-brokerage agreements. A marketing programme is being operated by Zagreb Stock Exchange. This is modestly staffed and has limited resources: so far it has found the marketing required to get brokers to sign up to be a substantial and quite demanding task, although the Bank has been also publicising the system during various conferences and through articles.

As the system had been operational for only half a year at the time of evaluation there is not yet sufficient evidence of its desired outcomes being met. However, three issues emerged as critical for the future achievement of the project's outcomes – membership of regional exchanges in the system, its business attractiveness and the expansion of its functionality.

Membership

The membership of stock exchanges in SEE Link has evolved, undergoing a number of changes during the implementation phase. At the early stage it was envisaged that the ownership of the platform would be equally divided between the stock exchanges in Croatia, Macedonia, Serbia and Slovenia, and that the company providing the platform would be established in the form of a limited liability company and located in Macedonia (mainly because of lower costs of business establishment). These exchanges were seen as the participants for Stage 1 of the project, during which the link would be made operational.

There are now six exchanges using SEE Link: Bulgaria, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Slovenia.

The total market capitalisation of the stock exchanges currently participating in the SEE Link (with Sofia) amounts to US$30 billion equivalent. If all other interested exchanges joined, capitalisation of markets connected by SEE Link and trading volumes would multiply rapidly. So, an expanded SEE Link could offer international investors easy access to a market of a size and volume worth consideration.

However, there are still some limitations to what even an expanded electronic platform such as SEE Link can do for the region's capital markets, in particular: (a) increased local usage will require a change in investment strategy among regional investors, who currently tend to invest outside the region if they invest internationally; and (b) usage by international investors will require substantial development of the local market in terms of more investable assets and enhancements in regulation and especially corporate governance.

Business attractiveness

In many markets brokers have arrangements with their counterparts in other markets to transact business on their behalf. So electronic linkage schemes in other regions, which bypass those arrangements, have often not been seen as attractive. Such existing arrangements might be between subsidiaries of brokers within a cross-border grouping or just contractual (so-called correspondent relationships) between independent firms. If such arrangements were common in SEE, then SEE Link would merely be offering a replacement and it would not be obvious that brokers would prefer to use SEE Link in preference to existing arrangements. It is also possible that brokers will prefer to use their own arrangements as they have more confidence in their own infrastructure than in a centrally provided one. It is understood that such relationships (both types) did exist in the region perhaps 10 years ago but, to some extent, have been allowed to lapse as business was affected by the financial crisis – though, naturally, links which generate business have remained open, though the overall contraction of business has pushed brokers away from maintaining expensive subsidiaries in other centres. It is an open question whether brokers will choose to reopen such links or use SEE Link. For now, SEE Link does not charge user fees and has no intention to do so in the foreseeable future. However, its operators do not exclude the possibility of introducing such fees in the longer term. This would of course decrease the system's attractiveness.

Functionality

SEE Link was designed to have limited functionality and it is seen as a transitional step. It is limited to providing a cross-border messaging service between brokers, rather than direct market access by remote brokers (in other countries) or back-office settlement functionality (for example, links to clearing systems, central counterparty clearing houses or depositories).[8] It was decided to limit the project scope as more extensive functionality would have made the project much more complex and could have led to increased political resistance.[9] It was thought that as contacts through SEE Link developed, there would be increased willingness to accept, develop and use additional functionality. Given that other efforts at capital markets integration elsewhere in the region have become bogged down in politics and complexity, the decision to implement a simple system was justified (it also helped the project to be implemented in a relatively short time and at a low cost). However, expanding SEE Link's functionality will be difficult. For instance, each participating country has a different depository agency, some state-owned, some private. All of them are profitable, so they are likely to be wary of closer integration, which could decrease their profits. The Zagreb Stock Exchange stressed that, as a neutral player, the Bank's participation in explaining the benefits of the system to the depository agencies will be critical if their support is to be won.

The project has only been operational for about six months, so it is too early to fully assess its outcomes; however, based on performance so far there is a good potential for the results to be fully satisfactory. To date, volumes have been small but increasing steadily – it is estimated that about 20 transactions (on average less than four per month) have been routed through SEE Link, nearly all of them involving the Zagreb Stock Exchange. The markets in the region are very small and relatively underdeveloped, so it would be unlikely that there would be a sudden increase in activity just because a linkage has improved the cross-border trading infrastructure. Improving markets in SEE is very much a project for the long haul – in fact the infrastructure is relatively well developed (or developing; for example Croatia will soon introduce a central counterparty clearing house). The Zagreb Stock Exchange reported no decrease of trading cost due to SEE Link. It is also doubtful whether the system will stimulate standardisation or a substantial improvement of quality of financial services in the region, although it will certainly facilitate certain types of cross-border regional trade. In the opinion of some interviewees, regulatory harmonisation is better done by the EU rather than IFIs. One clear benefit that can be confirmed at this stage is that the linkage has, for the first time, given Macedonian investors access to regional stocks since the law requires them to invest through the Macedonian Stock Exchange, which only lists Macedonian stocks.

A4.2.4. Project efficiency

The LC2 team hired the former consultant working on the USAID project, who further developed the concept of SEE Link. The project was structured to be implemented by an external project manager (an individual consultant), whose task was to coordinate the work of two groups of consultants – legal and ICT. Having an external project manager coordinating all the project stakeholders turned out to be good way of implementing the project as the role required frequent consultations with multiple stakeholders and an LC2 manager would not be able to do it among their other tasks.

The terms of reference for all consultants indicated that the project was planned to be completed "within 8-12 months". After the project's approval (July 2013) it took another year to select and contract all three consultants. The project started in July 2014 and was completed in March 2016, indicating an 8-month delay. This was due to longer than planned preparation of legal documentation and IT solutions in the context of ever-changing membership of the platform, as well as longer consultation and approval process involving exchanges and brokerage companies from several countries. However, the project has been completed on budget. All consultants have been sourced locally, which ensured good value of services employed.

Two participants interviewed confirmed that the level of consultation and involvement in the project had been good. The implementation team actively involved all the participating exchanges. Brokers had been significantly involved in technical discussions but less in business consultations.

SEE Link's marketing programme has been operated by the Zagreb Stock Exchange. However, the Zagreb Stock Exchange has been modestly staffed and has found the marketing required to get brokers to sign up to

8 Direct market access describes a system whereby entities that are not members of the exchange can send orders directly to the exchange. Usually, but not always, a local broker has responsibility for settlement and regulatory compliance.

9 In most countries, including in SEE, stock exchanges are seen as important national institutions and there is political resistance to foreign ownership or any developments which might be seen as weakening or bypassing the local stock exchange. In practice the EU example shows that opening up the market for trading venues to competition while it may take business from the local stock exchanges (though no EU stock exchange has closed) has reduced costs and improved the efficiency of the capital market – to the benefit of investors and issuers.

be a substantial and quite demanding task, indicating that this task has not been adequately resourced/ budgeted. However, the Bank helped in SEE Link's marketing by organising a number of conferences (one gathering five prime ministers from the SEE region) which, in the opinion of the Zagreb Stock Exchange, played an important role in many regional exchanges expressing interest in joining the system in Stage 2 (the Bank's Communication department was specifically mentioned as doing a good job in spreading information about SEE Link).

Reporting by the project manager has been to a high standard. The reports of January 2015 and January 2016 were detailed and informative.

Based on the comments of the Zagreb Stock Exchange, it has been clear that the Bank established excellent relations with it and there is high degree of trust and understanding between the two parties (one reason being that the Bank has been also a 5.2 per cent shareholder in the Zagreb Stock Exchange under a separate project signed at the end of 2015 [opID 47604]).

The Bank has also considered investing in the SEE Link and having a representative on its board, as planned at approval. However, the project turned out to be too small for such an investment, while corporate governance of the SEE Link company has been set up to high, international standards, so added value of having a Bank board representative was deemed limited. Overall, despite some shortcomings (including a delay), efficiency of project implementation is rated fully successful.

A4.2.5. Overall performance

As for longer-term impacts, the project aimed to encourage greater regional integration among SEE capital markets by offering improvements to infrastructure while avoiding the complexity and political issues of other more complex projects tried in other regions. The project was recognised to be transitional in terms of functionality and that not all participants would join on day one. Therefore, for now, it is only the project's potential which is rated good, as there are clear prospects that the project will make a meaningful impact on the region's LCMs integration.

A clear achievement of the project is that it delivered a workable linkage system with potential to expand and there was a high level of involvement and interaction among its participants, as well as that it generated a growing interest of other stock exchanges in the region in joining the system in Stage 2.

Regional integration is a long process and it has to start with exchanges and other participants becoming familiar with each other and developing interpersonal linkages. Then, as the business possibilities become more apparent, a willingness to accept integration will develop. On that basis the development of a successful common project and its potential extension to a wider range of participants is a critical first step on the road to regional integration – but not its end. In conclusion, it is too early to fully assess the outcomes and impacts of the project. For now, it is clear that its outputs were delivered within the scope defined at approval and that it has a strong potential to further integration (although still in a small way) of capital markets in the Western Balkans region.

A4.2.6. Other issues related to LCM development in SEE

The regional markets in SEE are all very small. The exchanges currently participating in the project (including Sofia) have capitalisation of US$30 billion. The Zagreb Stock Exchange, one of the larger markets in the region, made an average of 500 trades per day in August 2016 with an average daily value of US$1 million.[10] There is also reported to be OTC trading which has about six times larger volumes. IPOs are rare as there are relatively few significant companies that could seek a listing. The Zagreb Stock Eexchange has just started a market for small to medium-sized enterprises (SMEs) but otherwise there is little movement to attract new companies. IPO rules are said to be complex. There are only four pension funds in Croatia, which hold about €10 billion under a mandatory pillar 2 scheme; however, they are not very adventurous in investing, tending to avoid all but the safest investments. Standards of corporate governance for many ex-state-owned enterprises are reported to be low. Infrastructure is improving – the Zagreb Stock Exchange uses a NASDAQ trading platform and the Ljubljana exchange uses Xetra.

The region's settlement system was viewed by many interviewees as a 'Pandora's box' with a multiplicity of ownership structures. This will be a challenge if it is decided to expand SEE Link by offering settlement functionality.

10 Source: World Federation of Exchanges (http://www.world-exchanges.org).

A4.2.7. Key findings and recommendations

Findings

- Improving LCM infrastructure in the Bank's countries of operations is important; however, on its own it will not make significant positive impact on the development of LCMs. In parallel, support for macroeconomic stability, changes of investors' attitudes and habits, as well as a more investor-friendly legal framework are needed (largely in line with the Bank's five-prong approach to LCM development).
- Regional integration of smaller stock exchanges in the Bank's COOs has been politically sensitive and usually failed. A gradual approach, involving small-steps measures, has a higher chance of success than regional mergers or acquisitions by larger players.
- Trading platforms such as SEE Link support mainly smaller brokers as larger firms usually have subsidiaries, partners or correspondent companies in the main regional markets.
- There has been no evidence of cross-border trading platforms decreasing costs of trades.
- The Bank effectively contributed to the expansion of SEE Link's membership through conferences and articles, which publicised its benefits.
- In EU member or candidate countries, capital market regulatory improvement or harmonisation is better done by the EU than by the IFIs.
- Governments tend to support IPOs of state-owned enterprises mainly when their budgets are threatened by excessive deficits. Growing economies and stable budgets actually discourage such IPOs.

Operational considerations

- Lack of post-trade integration has been the main weakness of SEE Link. However, before proceeding with expansion, prepare a business case that rigorously analyses the likely usage of the additional functionality and its economic benefit in relation to its cost.
- If expansion of SEE Link is decided, consider supporting it by policy dialogue with governments to encourage participation of relevant depository agencies in the system.
- Commercial viability of stock exchanges can also be achieved by mergers, acquisitions or outsourcing of back-office functions. There is political resistance to such moves; however, the takeover of the Ljubljana Stock Exchange suggests these may not always be insurmountable. While supporting SEE Link, the Bank should ensure that it does not discourage any natural, market-based developments.
- The stock exchanges in SEE need more investable assets. LC2 should launch a Bank-wide initiative, requiring all bankers to encourage suitable clients to consider the benefits of listing on a stock exchange.
- Moreover, consider policy dialogue with suitable governments towards a strategic approach to LCM development, including such solutions as an introduction of tax incentives for companies which decide to go public, and new rules for pension funds which would require them to invest a certain percentage of their portfolios in the local markets.

A4.3. Case study 3: Bucharest municipal bond investment

A4.3.1. Introduction

The City of Bucharest issued a euro-denominated Eurobond for €500 million in 2005, which was due for redemption in 2015. The original bond proceeds were used to build a major road overpass and to develop the tram system. At the EBRD's suggestion and in agreement with the municipality it was decided to refinance the debt with LCY bonds issued for the same value. The excess of LCY liquidity encouraged the municipality to opt for a bond denominated in lei – the lei to euro premium is not large. The bonds were issued in 3-, 5-, 7- and 10-year tenors, in roughly equal tranches, based on eventual market demand. The issuance was arranged and underwritten by a local operation of Raiffeisen Bank (the arranger), selected by a tender process. The bonds were offered as a private placement through a book-building process and listed on the Bursa De Valori Bucaresti (Bucharest Stock Exchange). The bonds are structured as a series of bullet repayments, one for each maturity. There is no sinking fund or similar provision and the repayments will be made from the general revenue of the municipality. The EBRD evaluation took place in 2015-16.

A4.3.2. Project relevance

The project was highly relevant to the needs of the Romanian capital market since the non-government bond market, and specifically the municipal bond market is undeveloped. There are a number of instruments that are described as municipal bonds in issue and listed on the Bucharest Stock Exchange. However, these are, in fact, small issues (the largest is RON100 million [€22 million] and no municipality has more than RON200 million outstanding) to a very small group of investors (possibly just one), usually banks – essentially they are syndicated loans constructed as bonds. This issuance ceased in 2011 and had not resumed. The corporate bond market is also small.

In the wider national context Bucharest and other municipalities have financing needs that are currently met by bank borrowing. In the longer term this is likely to be inadequate to meet their infrastructure needs and a diversification of funding sources would enable faster development of infrastructure. Financing capex (capital expenditure) investments from central government sources is not an option as, following decentralisation, Romanian municipalities can only finance such investments from their own revenues (share in taxes or local taxes) or borrowed funds. The development of the municipal bond market would enable municipalities to expand their infrastructure investments. The current system, where the Ministry of Public Finance controls borrowing, reduces overall spending by municipalities because the central government imposes annual limits (RON100 million per municipality) on annual borrowing, irrespective of the size of the municipality, which limits local indebtedness. Relevance of this project is rated excellent.

A4.3.3. Project results

The EBRD's involvement in the project was solely as an investor. However, that involvement was seen as trail-blazing and it established the feasibility of municipal bond issues. Without the EBRD's involvement as an anchor investor it is likely that engagement of other investors would have been weaker. The EBRD's approach was sufficiently flexible and could accommodate the features of the local market to enable the investment to be successfully completed. The project proposal described a number of transitional impacts which are presented along with results in Table 1.

In summary, it is still early to fully assess the impact of this project on Romania's capital market. The bond certainly contributed to this market's increased volume and product diversity. However, as the bond is traded infrequently, its impact on the market's liquidity has been very limited so far. Importantly, the issue has failed to prompt any follow-up by other municipalities so far. However, this lack of activity reflects the current state of the market (cheap and easy bank credit), as well as legal and institutional capacity barriers (see below) rather than any limitations of the project. The future potential of the project is rated fully successful; however, more positive results need to be demonstrated in the future to sustain this rating.

A4.3.4. Project efficiency

The project was led by Raifaissen Bank as an arranger, and the EBRD mainly played the anchor-investor role. However, the challenge was to obtain all internal Bank approvals before the tight deadline for the issue of the bond. This has been achieved and therefore the efficiency of this project is rated as fully successful.

A4.3.5. Overall project impact on LCM

The current impact of the project on Romania's LCM has been very limited and its demonstration effect has yet to be proved by follow-up issues of municipal bonds. As the EvD recognises that it is still too soon to fully rate its project's actual impact, it rates only its future potential as good, mainly in recognition of the project's pioneering nature, which was well received and certainly noticed by the market.

A4.3.6. Other capital market issues

One of the aims of this investment was to develop the yield curve for municipal bonds. The most liquid bond market in Romania is the government bond market, which is reported to be highly liquid (the market is almost entirely OTC and there are no data collected on its size). Typically, yield curves are calculated using data from primary auctions and secondary market trading. Since there are no reporting requirements on OTC secondary market trading in Romania, these data are not available. The National Bank of Romania has launched an initiative whereby it publishes a daily yield curve for benchmark issues using end-of-day price data collected through Bloomberg. This is a valuable development but it would be better if the yield curve were based on actual trades. Bloomberg's

TABLE 1: ACHIEVEMENT OF OBJECTIVES

Overall objectives of project	Monitoring benchmarks	Implementation timing	Outcomes
To successfully refinance the city's existing Eurobond issue via domestic bond issues	The Bond Programme is successfully launched, with full placement of all issues	June 2015	Achieved. The bonds were successfully issued in April 2015. The issue was oversubscribed and the EBRB investment was correspondingly reduced. The EBRD investment was considered by the market to be an important sign to other investors and encouraged their participation.
Transition impact objectives of project	**Monitoring benchmarks**	**Implementation timing**	
Market expansion through the development of domestic capital markets	Creation and maintenance of a yield curve for the City of Bucharest (based on at least 3-, 5-, 7- and 10-year bond tenors) Ability to clear euros	End 2016	Outcome still unclear. While trading is limited, as is common with municipal bonds (indeed all bonds other than government benchmark issues), a yield curve does now exist for Bucharest Muni Bond. Issuing the bonds at four separate maturities makes a yield curve more feasible.
	Improved market liquidity through evidence of significant monthly secondary market activity for all of the issues	End 2016	Outcome still unclear. There have been 29 trades in 10-year bonds (the highest number of all trades). This is insignificant by international standards but in the view of the Bucharest Stock Exchange and the City, it is satisfactory.
	Obtaining repo-eligibility and ability to clear euros for the bond issue	June 2015	Achieved. The Central Bank (BNR) issued a circular in August 2016 which defines new eligibility criteria for repo-eligibility. While these would include the Bucharest bond, the list of eligible bonds on the BNR website has yet to be updated. Previously, Romanian law required all Romanian bonds to be held in the Depozitarul Central (central depository). At the instigation of the arranger, the law has been amended to permit Euroclear to have an account in the depository and so the bond can now be settled through Euroclear. This will also apply to any future bond issues.
Overall objectives of project	**Monitoring benchmarks**	**Implementation timing**	**Outcomes**
Demonstration of new ways of financing	Replication of similar bond issues by two other municipalities in the region that are publicly placed with multiple investors, with tenors of at least 5 years	End 2017	Not yet due/not achieved. There have been no follow-up municipal bond issues in Romania or in the region since the Bucharest bond was issued. The issue and the EBRD's involvement were seen as landmark events. However, there remain significant barriers to extending bond issuance to other municipalities. In particular the requirement for individual multi-project facility approval for each issue, the small size and poorer credit quality of other municipalities, the lack of guidance procedures and awareness in other municipalities and, but certainly not least, the current easy availability of bank credit for municipal borrowers in Romania (it is noted that in July 2016 Zagreb Holding Company issued a bond guaranteed by the city of Zagreb – however, this had a different structure to the Bucharest bond).
	Replication of one RON-based, publicly placed and traded municipal-bond issue in Romania	End 2017	
Skill transfer	Completion of the TC targeting debt and cash-flow management capacity-building within the city administration	June 2016	Achieved. The TC was completed successfully and was considered useful by the administration. There is a need to extend to other municipalities where cash-flow management is much less well developed than in Bucharest.
	Adequate level of amortisation verified at the maturity of the 3-year bonds (that is, only economically justified rollover)	June 2018	Not yet due. By agreement between the involved parties all the bonds are to be repaid from normal revenues and there are no amortisation provisions. Spreading over several tenors has reduced the repayment/ refinancing risk.

trading system supports trade reporting and it would be relatively straightforward to require and enforce such reporting. The implementation of MiFD 2 in January 2018 will require reporting of all transactions, so a solution will need to be developed and this will improve the quality of the yield curve for government issues.[11]

There are legal barriers restricting further issues of municipal bonds in Romania, contained in Law 273/2006 on Local Public Finance administered by the Ministry of Public Finance. There is a marked lack of clarity in the understanding of these laws but the main provisions are as follows.

- Municipalities require Ministry of Public Finance authorisation to borrow, which is assessed on a case-by-case basis. The Ministry of Public Finance assesses the creditworthiness of the municipality and approves or refuses the application accordingly.

- The total annual borrowing per municipality is limited to RON100 million regardless of the municipality's size, needs or revenues. Bond issues and co-financing with EU grants are exempt from this ceiling.

- Municipalities are not permitted to borrow amounts that would result in future debt support (interest and capital) exceeding 30 per cent of their total projected revenue. The Ministry of Public Finance can, through Emergency Ordinances, issue a special derogation to allow the ceiling to be exceeded as it did for the original Eurobond (which required a single bullet payment). It is understood that the same derogation could be claimed for the new bond because it was a refinancing of the old bond which had been approved by the Ministry of Public Finance.

It is not clear how long this process takes but the time required for a government agency to prepare a detailed assessment will be considerable. Other municipalities are considerably smaller than Bucharest and are unlikely to be able to make significant bond issues within the 30 per cent ceiling.

11 MiFID 2 – The Markets in Financial Instruments Directive is the EU legislation that regulates firms that provide services to clients linked to financial instruments (shares, bonds, units in collective investment schemes and derivatives).

A4.3.7. Other IFI involvement

The World Bank had earlier been involved in municipal finance in Romania and produced a *Policy Note* in June 2008 (Mukherjee et al., 2008). This paper made recommendations designed to remove the requirement for Ministry of Public Finance pre-approval, move to a more market-based system and clarify the extent of possible bailouts.

A4.3.8. Key findings and recommendations

Findings

- The Bank can play an important role as an anchor investor in relatively new products, such as municipal bonds, particularly for longer-term tranches. The arranger confirmed that initially there was very limited interest in longer-term bond maturities. The EBRD's commitment provided confidence to other investors. It was also seen as flexible and committed to the process, willing to accept a lower yield and absorb the swap risk to ensure the issue was a success.

- Legal and institutional barriers restrict further municipal bond issues. There are legal and administrative barriers which greatly limit the attractiveness of bonds for municipalities. Unlike the city of Bucharest, smaller cities lack know-how on how to approach the issue of municipal bonds.

- Lack of clarity about bankruptcy: The process of credit assessment by the Ministry of Public Finance implicitly makes it responsible for any lending it approves. The Law on Public Finance provides for bankruptcy and sets out procedures for resolution. However, there is provision for central funds to be lent or contributed in the event of insolvency which could be seen as a bailout. In practice, the market sees the Bucharest bond as equivalent to a sovereign bond, meaning there is an implicit government guarantee. This perception would be less strong for other municipalities, which are much smaller. Therefore, the Ministry of Public Finance is likely to be very cautious in approving borrowing by these smaller agencies.

- For Romanian municipalities a bond issue carries additional risks and effort, while bank borrowing is easier and cheaper. There is currently an abundance of bank liquidity in Romania. Municipalities, in the current situation, have relatively easy access to bank credit. In contrast, the process of gaining approval for a bond issue (which might not be granted) is likely to be considerably longer. Currently bank debt is also cheaper than other sources of debt. So there should be no expectation of a move away from bank debt in the near term. In addition, municipalities do relatively little longer-term financial planning and are willing to depend on flexible bank financing even if it became more expensive, rather than go to the trouble of developing a capital market profile, which would enable them to make regular bond issues. Nor do they have any guidance procedures on how to issue a bond.

- High listing costs: While the listing procedure was described as simple and short, the fees levied by the Bucharest Stock Exchange were relatively high. The annual maintenance charge for the Bucharest Stock Exchange listing of the current bond is €10,000 per tranche (a total of €40,000 per year). The business of listing bonds in Europe is highly competitive with the London and the Luxembourg stock exchanges taking most of the business for international bonds (the previous Eurobond was listed in Luxembourg). The annual maintenance fee for listing in Luxembourg would be a maximum of €2,800 for all four tranches (Luxemburg Stock Exchange, 2017) and on the London Stock Exchange the annual cost would be zero (London Stock Exchange, undated).

- More generally, pension funds are heavy investors in government stock with some 67 per cent (June 2014) of their assets in government bonds. Romania has a relatively well-developed and growing pillar 2 pension system but diversification of its investments into equities and a wider range of bonds would be beneficial.

- No facility for structured bonds: Outside the USA, few markets have good provisions for municipal default and most rely on approvals or control ratios to avoid irresponsible borrowing. An alternative is to encourage the use of revenue bonds or similar structures such as project bonds where borrowing is linked to specific infrastructure projects and serviced from pledged cash flows. Sometimes these instruments are linked to a public–private partnership arrangement but they do not have to be. There seems to be no facility for this type of structure in Romania and, even if there were, the tax treatment would be very uncertain. This capacity might allow municipal borrowing to develop with the required protection against irresponsible borrowing but without the need for Ministry of Public Finance credit assessment.

- The LCM development priorities communicated by the Romanian interviewees to the evaluation team included:

  - development of a regional central counterparty clearing house
  - conversion of mass privatisation vouchers deposited on 8 million dormant accounts into stocks listed on the Bucharest Stock Exchange
  - development of the derivatives law
  - development of a 'notional interest rate' law to enable deduction of fundraising costs on LCM (in line with deduction for bank interest payments) – such a law would be in line with EU legislation.

Operational considerations

- Consider policy dialogue with the Ministry of Public Finance leading to less restrictive approval requirements for municipal bonds. The requirement for pre-approval by the Ministry of Public Finance is one of the barriers to development of the municipal bond market. Ideally, Romania should move towards a market-based solution or a system of ratios to prevent excessive borrowing, as is common in other countries.

- Engage with the Bucharest Stock Exchange to rationalise its listing charges for municipal bonds. The high costs levied by the Bucharest Stock Exchange for listing are a reflection of its generally high charges. The Bucharest Stock Exchange has made strong and successful efforts to reduce transaction costs but some other costs remain too high. As the Romanian market becomes more integrated with the wider EU market the Bucharest Stock Exchange will be at an increasing competitive disadvantage if its charges remain higher than those in other markets. The scale of the Bucharest Stock Exchange makes it difficult to reduce charges and remain viable but it is not alone in facing this challenge.

- Consider providing assistance in developing procedures for municipal bond issuance, in the form of user-friendly guidelines. Bond issuance is outside the experience of municipality staff and there is, quite rightly, considerable reluctance to risk non-compliance with the law. Much of the work for an issue will be done by the arranger, but the municipal staff would benefit from: (a) having guidance as to how to proceed towards an issue, and (b) what information is likely to be required as part of the issuance process.

- Support selected Romanian municipalities to develop long-term investment plans and their financing projections (in conjunction with municipal and environmental infrastructure projects). The lack of longer-term capital investment and cash-flow planning at municipalities is a barrier to more bond issuance. Bucharest is now working on a financing strategy involving future issues and the EBRD might consider a TC aimed at supporting second-tier municipalities to build these capacities (especially as such TCs have been municipal and environmental infrastructure project standard product in other countries).

- Assess pension fund investment barriers: The concentration of pension fund investments in government bonds and their low interest in the Bucharest bonds may be symptomatic of a barrier to diversification and development of the capital market. It would be beneficial to investigate if the concentration of pillar 2 pension funds is a consequence of legal/regulatory restraints, lack of assets or lack of capacity to manage funds. Building on an earlier TC completed by the Bank in this area, consider developing a follow-up project to address this issue and allow the transformative capital-market potential of pension funds to be fully realised.

- Investigate innovative financing techniques: The problem of reducing the risk of irresponsible borrowing without stifling necessary infrastructure spending has been addressed in other markets by using a wider range of financing or regulatory options. These involve the use of pledging revenue streams to service borrowing and transferring some of the risk from the municipality onto the bondholders. These have been combined with public–private partnerships, but do not need to be. It might be beneficial to investigate whether the legal/regulatory structure would be adequate to support the use of alternative financing techniques.

Annex 5: Sample project reviews

A5.1. Covered Bonds Law improvement TC – Poland

A5.1.1. Background

At the request of the Polish Ministry of Finance (MoF), the Bank commissioned an expert to provide comments on the proposed amendments to the Law on Covered Bonds and Mortgage Banks (prepared by MoF and market participants) and suggest revisions (if required) to reflect international best practice.

Covered bonds enhance a bank's long-term funding base. They enable the matching of maturities between bank funding instruments (covered bonds are issued by banks) and mortgage loans financed by these banks. Without covered bonds, banks have to finance long-term mortgages with short-term bank deposits – a practice which is inadequate and carries serious risks. Moreover, covered bonds are secured with assets financed by mortgages organised in 'cover pools', which substantially reduces their risk (no cover bond has ever defaulted) and therefore are attractive to long-term investors. The new legislation made it easier for specialised (mortgage) banks to issue covered bonds to obtain long-term funding to finance mortgages. This TC was implemented in 2014-15, with a €45,000 budget.

A5.1.2. Relevance

The existing law on covered bonds (enacted in 1997) was restrictive, making the operation of mortgage banks (uniquely allowed to issue covered bonds) unattractive (for example, mortgage banks were able to finance up to 60 per cent of loan-to-value (LTV)/ property purchase price, while universal banks offered 120 per cent). Consequently, Polish covered bonds outstanding at the end of 2015 accounted for only 0.2 per cent of GDP, while in Germany, France and Czech Republic they accounted for 14, 15 and 6 per cent, respectively. All interviewees (the regulator, MoF, Warsaw Stock Exchange, private banks) stressed the importance of the new covered bond legislation to Polish capital market development as it was expected to attract foreign investors (especially institutional), as well as helping the banks to obtain long-term funding.

As covered bonds constitute a very efficient vehicle for the financing of long-term loans (mortgages in particular), many of the Bank's countries of operations that do not have a legal framework to enable them have recently been preparing such laws (for example, Croatia and Romania) – some with the support from the EBRD.

The MoF prepared draft amendments to the covered bonds law following the recommendations of the Polish Financial Supervisory Authority (KNF) which, in 2013, established a working group to develop the Polish market for long-term debt instruments. Independently, in 2011, the EBRD commissioned a needs assessment of the Polish capital market which produced five recommendations, the first calling for maturity mismatches in the banking sector to be addressed, with covered bonds being the main instrument recommended for an enhancement.

The need to find efficient ways of long-term financing for Polish commercial banks became even more pressing as the government issued a draft of a new law (expected to be approved soon) which allows Swiss franc-denominated mortgage holders (about 50 per cent of all mortgages in Poland) to convert them into PLN-denominated mortgages at attractive terms, with the cost being met by the banks. This programme is expected to create huge pressure on the banks to find new ways of long-term financing.

The new regulations have already been tested with several large covered bond issue programmes launched by the largest Polish banks (the EBRD participated in some of them as an anchor investor, see below). On this basis, the relevance of this TC is rated excellent.

A5.1.3. Results

The amendments to the law were approved by the Parliament in July 2015 and have been in force since the beginning of 2016. The law aligned the framework with international standards – unifying the LTV limits for financing from both mortgage and universal banks (90 per cent). It also excluded foreign investors from a withholding tax. This is expected to greatly increase the attractiveness of covered bonds to foreign investors (including institutional). In addition, new regulations regarding insolvency procedures were adopted.

The Bank consultant made 14 recommendations for the enhancement of the law in her report. Of these, six have been incorporated into the law, most importantly:

- clear segregation of cover pools from a mortgage bank's general assets (for insolvency proceedings)
- ability to issue multiple covered bonds according to original prospectus
- recognition of the loss incurred on the transfer of loan receivables as a tax-deductible cost.

Moreover, two other recommendations have been effectively accepted (or are not needed) due to further revisions of the law. Finally, there is a good chance that three additional recommendations will be accepted in the future.

In addition, the interviewees stressed that the Bank played a very important role earlier in the process, when the key changes to the law were mapped out, for example the increase of LTV for mortgage banks and the exemption of foreign investors from withholding tax. These proposals, critically important for increasing the attractiveness of covered bonds, were more easily accepted by the government because of the EBRD's support.

The interviewees praised the Bank for organising a London workshop for the Warsaw Stock Exchange/MoF and London-based major investment banks, which greatly publicised the new investment opportunities in covered bonds in Poland and provided a forum to exchange valuable comments between the Polish side and foreign investors. This enabled the MoF to fine-tune the law (for example, ensuring transparency of the bond issuance process and Independent Commission on Banking eligibility).

The main limitation of the law is that it still applies only to mortgage banks. The cost, time and effort related to the establishment of a new bank can deter smaller banks from doing so. However, this has not been a problem for the large Polish banks, three of which (PKO BP, Pekao, mBank) have established mortgage bank subsidiaries (three more mortgage banks are reportedly in the process of being established). Moreover, one of them has been testing a system where their universal bank can originate residential mortgages and book them on their mortgage bank's balance sheet (this is in line with the Bank consultant's recommendations on "shared infrastructure" between universal and mortgage banks). Importantly, in April 2016 the Bank purchased €5 million equivalent of covered bonds issued by PKO Bank Hipoteczny (the mortgage arm of the largest Polish Bank) and in June followed up with a larger (€18.4 million equivalent) investment in the subsequent issue of the PKO mortgage bank's covered bonds. Moreover, the Bank intends to invest €500 million more in this bank's covered bonds when they are issued later in 2016. The Bank also obtained an approval for a further €600 million investment in Poland under a framework that includes covered bonds (among other financial vehicles). On this basis, despite the relatively limited impact, the results of this TC are rated fully satisfactory.

A5.1.4. Efficiency

This was a relatively small TC (one consultant, with a €45,000 budget) which helped the efficient and focused execution of the assignment. The consultant made several visits to Poland and consulted widely with market participants and policy-makers, including KNF (the regulator), MoF, the Association of Polish Banks, the Mortgage Financing Development Foundation, and several large banks and brokerage houses. However, some interviewees commented that the consultant's report lacked the description of mortgage finance models existing in other countries (including comparative analysis). One example (of Denmark) was seen as insufficient. Despite this shortcoming, the consultant's and the Bank's input to discussions on the shaping of the Polish covered bond and mortgage bank law was seen as very valuable. This category is rated fully satisfactory.

A5.1.5. Overall rating

Although this was a relatively small and low-profile TC, it played an important role in fine-tuning the new law on covered bonds and mortgage banks in Poland. Even before the TC, the Bank contributed to shaping the new law by supporting or suggesting investor-friendly provisions. The law has been in force since the beginning of 2016, therefore it is difficult at this stage to fully assess its impact on the Polish capital market. However, in 2015 outstanding covered bonds amounted to €1.3 billion (€414 million equivalent covered bonds were issued in 2015 by three mortgage banks). Following the introduction of the new law, PKO's mortgage bank embarked on a covered bond issue programme equivalent to €120 million. Moreover mBank's mortgage arm issued €85 million equivalent in covered bonds in the first six months of 2016. Assuming PKO's issue goes ahead in late 2016, this would constitute a 70 per cent increase in the covered bonds issued in Poland as compared with (pre-new law) 2015. The 2016 issues would also account for over a half of all Polish covered bonds outstanding at the end of 2015. This clearly indicates that the new law provided a strong incentive for the issuance of covered bonds and therefore enriched and expanded the Polish capital market in general. Therefore, overall this operation's impact on Polish capital markets is rated good.

A5.1.6. Key findings and recommendations

Findings

- The development of covered-bond financing is very important for Polish capital markets as it is expected to attract foreign investors (mainly institutional), which have been missing from the market in recent years.
- An adequate pension policy is critically important for capital market development; however, pension reforms have been highly politicised and the Bank has not yet been able to contribute substantially to this process (in any country).
- Contribution to the amendment of the covered bond law in Poland enabled the Bank to develop expertise in this particular area and create a product (covered bond law) which it could then offer in other countries (Croatia, Lithuania and Romania).
- In the opinion of interviewees, to aid the development of the Polish capital markets the Bank should consider projects supporting pensions reform (to re-establish pillars 2 and 3 and ensure that they remain an attractive option for savers) and development of real-estate investment trusts (REITs).

Operational considerations

- Consider helping Poland to create a comprehensive capital market development strategy.
- Continue working on Polish pension reform.
- Consider cooperating with the Property & Tourism team to develop/invest in REITs in Poland.

A5.2. Bucharest Stock Exchange – Romania

A5.2.1. Background

In 2014 the EBRD invested €2.75 million into a 4.99 per cent stake in the Bucharest Stock Exchange (BVB). The BVB, which is itself listed on the exchange, had an unusually large number of shareholders (some 1,700) and it was felt that vested interests (brokers) were dominating and slowing progress. The legal requirements for a quorum also meant that, given the diverse shareholder structure, quorums could rarely be achieved so decision-making was restricted and important reforms stalled. The BVB is a majority owner of the Central Depository (CD) though it had no direct management oversight.

A5.2.2. Relevance

The governance and decision-making processes at the BVB were weak and important reforms – for example, reducing the unusually high charges or developing the settlement infrastructure – could not be approved by the board. The BVB is a significant stock exchange in the region – the largest apart from Athens in SEE. These factors make the BVB an important regional player and its development is particularly important for the EBRD's regional capital markets strategy. Moreover, the Bank's investment into the BSE was closely aligned with the LC2 2013 strategy, as one of its five pillars calls for Bank support to capital market infrastructure. Because of the project's regional and country-specific importance, as well as its close alignment with the LC2 objectives, the project's relevance is rated excellent.

A5.2.3. Results

The legal amendment to permit shareholdings to exceed 5 per cent was passed as part of a new Capital Market Law in December 2015 and the EBRD increased its shareholding to over 5 per cent. The new law changing the quorum requirement by reducing the thresholds and eliminating the problem of decision-making at the BVB was enacted before the Bank's investment (end of 2013). Also the review and reduction of BVB's charges was championed by its new CEO, with little Bank contribution to the process. Nevertheless, the management of the BVB believes that the Bank's investment served its purpose reasonably well. Most importantly it sent a strong signal to international investors that the BVB is open to the outside world and welcomes international investors. The Bank's participation also helped improve the BVB's corporate governance – for example, in December 2015 the EBRD proposed a board nominee who was duly elected (moreover, the EBRD proposed a candidate to serve on the board of a depository company 67 per cent owned by the BVB). The Bank promoted the adoption by the BVB of a new system of compliance, more rigorous disclosure process and more stringent rules applicable to companies, which are part of the indices. Importantly, the Bank contributed to the drafting of the code of compliance for the BVB. In the words of the BVB's management, the EBRD's involvement provided the BVB with the moral mandate to push for higher corporate governance standards.

Finally, the BVB has high hopes related to its planned participation in SEE Link (a Bank-sponsored project – see case study 2, Annex 4), expecting higher flow of orders from neighbouring countries' pension funds as well as, in the longer term, closer consolidation of the stock exchanges in the SEE region.

One expectation of the BVB related to the Bank's investment which has not yet been fulfilled has been the Bank's assistance to the Romanian government to initiate more state-owned enterprise privatisations through listings on the BSE, as well as help to resolve the issue of dormant mass privatisation vouchers. These vouchers have been kept on 8 million accounts and are unlisted (with most of their owners not even being aware that they exist). Consolidating and converting them into shares and listing them (that is, putting to work untapped capital market resources existing in Romania) would substantially increase capitalisation and the number of listings at the BVB.

The project proposal included 16 detailed transition impact benchmarks. Four of them are not yet due, while 10 are considered achieved (they mostly covered corporate governance issues described above). Table 2 describes and assesses the current status of the achievement of additional benchmarks included in the proposal to increase the Bank's shareholding in the BSE.

The EBRD involvement has achieved its main aims of improving decision-making and governance of the BVB and its subsidiaries. The improved governance is starting to have an effect on the exchange's business by, for example, improving its attractiveness by lowering

TABLE 2: ACHIEVEMENT OF OBJECTIVES

Transition Impact area	Benchmark	Current status
Setting standards of corporate governance (CG)	Contributing to improving the CG of BVB and its key subsidiaries by: improving board effectiveness and reducing control of vested interests	Achieved. The EBRD now has its nominee on the board of the BVB and on the board of the depository. Opinion at the BVB, the CD and the ASF (securities regulator) is that governance has been improved. The BVB has worked to significantly reduce its trading charges which were regarded as excessive. However, fees for listing remain high, so more work is required.
	improving relationships with the depository and clearing providers	Achieved. The depository and clearing providers confirmed that their cooperation with the BVB has been good.
Develop local capital market	Determine feasibility of a central counterparty clearing house	Not achieved. The central counterparty clearing house discussion has been ongoing but without agreement as yet. In summary, the BVB sees little to gain from a cash market and its CEO is leaning towards a regional clearning house solution (which the EBRD is working on), while the ASF/MoF favours developing a local solution.
	Reduce transaction costs	Achieved. Trading costs have been reduced, though not the listing fees. There may have been some confusion as the EBRD board document talks about reducing transaction costs, which to a stock exchange would mean the costs of trading rather than the cost of listing.
	Support improvements to IPO process	Achieved. A number of the EBRD TCs have been conducted covering regulating corporate governance, strengthening disclosure enforcement and improving IPO processes. The timescale for IPO processes has been streamlined by the BVB and the ASF to significantly speed up processing of documents.
Participation in LCY fixed-income and equity issuances	Invest in LCY bonds	Achieved. The EBRD has previously invested in bonds and most recently in the Bucharest Municipal Bond.
	Invest in equity IPOs	Not achieved. There have not been any IPOs on the BVB since the investment. However, there is some prospect of part-privatisation of several state-owned enterprises through IPOs over the next year, which should provide investment opportunities if CG is adequate.

charges and introducing a market for SMEs (which enabled it to replace the defunct and discredited RASDAQ market). Generally, the background conditions for quick development of the BVB have not yet been fully present – for example, the absence of IPOs for the last few years and the unresolved central counterparty clearing house issue – but the infrastructure has been strengthened to support growth when conditions improve. The assessment of results achieved so far is therefore rated fully satisfactory.

A5.2.4. Efficiency

Expanding the EBRD stake has proved more difficult than expected given the low liquidity of secondary shares. Based on advice from Treasury it was decided to employ a broker to gradually build up the holding as stock became available rather than, for example, having a tender offer. With hindsight, this may have slowed the process. However, as the EBRD is already seen as an influential shareholder and has the desired board representation, the impact of any delay in building up the stake has been mitigated. The BVB stock has been volatile in line with other emerging markets stocks. Therefore this category is rated fully satisfactory.

A5.2.5. Overall rating

This was a small investment, yet in an important project in a high-profile country, as Romania is a relatively large capital market in the region and has been a major country for EBRD activities. Benefits in terms of improved governance are already clearly visible. Therefore, the project's overall impact on the Romanian capital market is rated as good. However, the longer-term impact, while looking promising, must await an improvement in the capital market situation in Romania.

A5.2.6. Key findings and recommendations

Findings

- The central counterparty clearing house proposal is in limbo. The proposal to introduce a clearing house appears to be stuck in an impasse between the advantages of a regional solution and the political preference (supported by brokers) for a local solution. In the meantime, this basic infrastructure requirement is not being developed – a clearing house is essential for a derivatives market (although this is some way off in Romania) and increasingly the norm for cash markets. Central counterparty clearing houses are expensive and there is a good case in a region of small markets to have a regional solution either through outsourcing or a cooperative approach (combining central counterparty clearing houses is different to a regional depository, which is more difficult). Romania's SIBEX market has set a precedent by using the Greek central counterparty clearing house.

- Derivatives not likely to be introduced: The SIBEX market, which started as an alternative stock exchange but came to be a derivatives market, is practically defunct. The BVB seems anxious to arrange a merger with it; however, it is hard to see where the value lies. SIBEX has not succeeded in building a derivatives market and there seems little appetite for derivatives at the BVB.

- Lack of investable assets especially through IPOs: As with other exchanges in the region, the BVB needs to attract more IPOs for investors to buy. Romania has a fairly well-developed pillar 2 pension system but the funds mainly invest in government bonds because of the shortage of alternative investments. In part, this will be addressed if privatisation is resumed. The BVB needs to develop marketing capability to attract new private companies. It now has a reasonable infrastructure of market tiers and appropriate regulations, but experience elsewhere suggests that the benefits of listing need to be sold to companies. This is especially true where, as in Romania, bank finance is readily available. So marketing needs to focus on a wider range of benefits that can accrue from a listing.

- The BVB's charges remain high but are becoming more competitive. Market costs are high as pointed out in the report on the Bucharest Municipal Bond, though BVB trading costs have been reduced. Other costs related to trading (depository costs and FSA levy) are also quite high. For example, the Financial Supervisory Authority trading charge is 6 basis points compared with the BVB charge of 4bp (this has not been reduced though other FSA charges have been). In fact the FSA's revenue from trading fees was only RON10 million (€2 million) in 2014 (its total revenue from the financial markets activities was RON78 million) – the problem is that the market volumes are low. One feature of the Romanian market is the large number of regulated entities such as broking firms, listed companies, SMEs and foreign companies. These companies need supervision and regulation, which represents a substantial cost for the FSA.

- Legacy of dormant mass privatisation voucher holdings: Like other countries which had voucher privatisations Romania has a large number of dormant accounts – perhaps as many as 9 million. The holdings are not large but are seen as a depressing legacy, which should be tidied up before Romanians will be interested in capital market investment. In addition, financial literacy is seen as very low despite some efforts by the BVB.

Operational considerations

- To ensure effective implementation of the central counterparty clearing house, there is a need for a focused national policy debate to decide on a way forward. The EBRD, in its role as shareholder and board representative and by using its regional experience, could play a more prominent role in the discussion on clearing house infrastructure development.

- Reinvigorating privatisations would have a transformational effect on the BVB and on pension funds. The EBRD engagement should be used to prompt a more coherent and focused privatisation strategy.

- The dormant mass privatisation voucher accounts are a legacy issue which may not be too much of a problem in reality. However, their continued existence does leave a feeling of a depressing hangover from the past. Under the current set-up the vouchers do not contribute to LCM development. It would require a change in the law to resolve this issue but it could help increase listings on the BVB. Moreover, the problem exists in a number of countries and the EBRD could develop a package – as it has done, for example, with covered bonds – to be rolled out across several markets to deal with this issue.

- Despite improvements, the charges of the BVB (and also arguably the CD and the FSA) remain too high. This was apparent in the annual listing costs levied on the Bucharest Municipal Bond, which are several times higher than the costs would be in London or Luxembourg. This is a challenge in a small market, which cannot exploit economies of scale, but the EBRD could continue to encourage the BVB to control costs and all participants to look for regional solutions for infrastructure.

A5.3. Advice on Derivatives Law TC – Morocco

A5.3.1. Background

At the request of the Moroccan Ministry of Economy and Finance (MoEF), the Bank commissioned a local legal firm to act as consultants in preparing amendments to the Derivatives Law for Morocco. A law had recently (2014) been enacted but it was found to have gaps in certain key areas and was not covering the OTC derivatives.

Derivatives are a key element of financial market development as they allow participants to hedge risk on a range of financial and other assets including currencies, stocks, interest rates and commodities. Derivatives, which include a range of products such as futures, options and swaps, may be created as OTC products – essentially bilateral contracts – that are usually used for wholesale transactions. They may also be traded on organised exchanges, where they offer hedging and trading opportunities to smaller-scale participants, and provide a mechanism for wholesale participants to lay off some of the risks in their OTC contracts. As a result, in developed markets the OTC and exchange-traded segments are mutually supportive. Exchange-traded derivatives are attractive, revenue-generating products for organised exchanges and they have shown very rapid growth in stocks and bonds trading. In February 2014 the Bank provided €283,660 of TC to MoEF to develop this market by addressing the market gaps that had been identified.

A5.3.2. Relevance

Morocco is an LC2 priority country and has successfully developed its financial services sector to become one of the most developed markets in Africa and the Middle East. Its stock market capitalisation at US$51 billion (€43 million) (end August 2016) is the third largest in Africa, being slightly smaller than Egypt (although the largest African exchange in Johannesburg is 20 times larger). However, there is practically no derivatives market, with both the OTC and exchange markets being very small.

There has been demand for derivatives to hedge certain commodity risks as Morocco is a large importer of wheat and oil, and an exporter of citrus fruit. The absence of an adequate legal framework prevented risks associated with trading contracts in these commodities from being adequately mitigated. Derivatives were identified by the MoEF as a major part of Morocco's reform agenda and a new law was drafted and enacted in 2014.

The MoEF saw the 2014 law as part of a broader reform agenda for the financial markets, which had three main objectives:

- ensuring stability of the banking sector – through new monitoring and forecasting mechanisms
- broadening financial inclusion – by introducing new instruments and encouraging more companies to participate in the capital markets (the government also plans to develop a detailed national strategy for financial inclusion)
- increasing the depth of the financial markets – by creating a private debt market, covered bonds, REITs and new institutions.

However, the 2014 Derivatives Law was considered by the MoEF to be deficient in three main areas and amendments were needed to address these issues:

- extending the scope to include OTC derivatives
- removing the risk that derivatives could be seen as gambling or speculative transactions (and therefore allowing derivative transactions to be declared as void at any time)
- introducing enforceability of netting in insolvency proceedings for all participants including foreign participants.

The MoEF received assistance in implementing the above-mentioned reform programme from various IFIs and development agencies, such as the World Bank (on microfinance instruments and financial education), USAID (crowdfunding development) and Deutsche Gesellschaft für Internationale Zusammenarbeit (on global SME finance). To address deficiencies in the derivatives law, the MoEF requested the EBRD's support. In addition to having practical advantages for Morocco's trade companies, the improvement of this law was (and is) considered very important because it is expected to improve capital market liquidity (by enabling short-selling).

As part of the reforms the law governing the Casablanca Stock Exchange (CSE) was also changed, so that it could develop infrastructure such as a central counterparty clearing house which would provide an essential part of an exchange-traded derivatives market, and possibly an OTC market operating in line with EU rules on OTC derivatives. The law governing the regulator, the Autoritie Morocaine du Marche des Capitaux (AMMC), was also changed to give its board more independence from government to enable it to regulate the market. These three strands provided a sound legal, regulatory and infrastructure framework for the development of the derivatives market.

The importance of the country's reform agenda made the EBRD's TC highly relevant and timely, therefore its relevance is rated excellent.

A5.3.3. Results

The Bank contracted local legal consultants, who drafted amendments to the Derivatives Law and submitted them to the MoEF, which accepted them without major comments. The amendments were then sent to the AMMC and the central bank for review. The process has been slower than initially envisaged. The MoEF explained that this was not due to any controversy over the amendments, but the governmental institutions and the Parliament have been overwhelmed with new legislation in the last year, due to the government's large-scale reform agenda. As a result, the derivatives law was expected to be ready for submission to the Parliament by the end of 2016. There is an expectation that the amendments will be enacted during the first half of 2017, together with two other laws (on taxation and foreign-exchange regulations). Enactment of the amendments to the Derivatives Law will give Morocco a complete legal framework for trading derivatives, both OTC and exchange traded. This legal framework will provide the basis for trading derivatives, although weaknesses in the commercial environment for derivatives (see section 5.3.6.) make it uncertain when trading will begin. Most interviewees suggested it would be several years before a functioning derivatives market would emerge. As the amendments to the Derivatives Law have not yet been adopted, the results of this project are not rated; however, based on discussion with the MoEF, the prospect is that they will be fully satisfactory.

A5.3.4. Efficiency

Officials of the MoEF interviewed by the EvD confirmed their satisfaction with the efficiency of and working relations with the Bank and the consultants. At an early stage the EBRD organised a conference in Rabat, where the issues related to derivatives law were discussed in detail and the need for the inclusion of OTC market in the law and other provisions were confirmed. The TC was carried out by a local legal firm which performed very well. The fieldwork interviews showed that there had been good consultation throughout the project. Specifically, the AMMC, the Casablanca Stock Exchange and the brokers' association were consistently involved in the design and implementation of the reforms. Due to delays in obtaining the MoEF's final comments and the approval of the Parliament, the project has not been completed yet and five months have passed since the original completion date. Nevertheless, the consultant is still involved and continues to work towards the final approval (the original budget has not been exceeded). This category is rated fully satisfactory.

A5.3.5. Overall rating

The TC was relatively high profile as the improvement of the derivatives law is of major interest to the MoEF and is part of the national reform agenda. The project had a well-defined and focused scope as the Moroccan participants were all aware of the deficiencies of the previous 2014 law. The other legal changes made to the AMMC and the CSE gave added impetus, so the new amendments were (and are) unlikely to run into controversy. The project was well conducted according to the client and others involved. There was extensive and adequate consultation. However, the commercial barriers to developing derivatives in Morocco remain considerable and the development of this market is not expected to be rapid, although the legal underpinnings will be very much strengthened (see below). Therefore, this TC's overall impact on the Moroccan capital market is (preliminarily) rated as good. The final assessment will be only possible after the law has been adopted and tested by market participants.

A5.3.6. Key findings and recommendations

Findings

- A deficient derivatives law enables transactions to take place but there are risks related to legal loopholes that are priced into the costs of such transactions. In effect such transactions are expensive and are rarely conducted.

- Large-scale reforms result in many new laws requiring approval. This may delay the adoption of Bank-sponsored legislation.

- A TC to improve the derivatives law is a good example of an LC2 team standard product, which the team has developed and efficiently implemented in several (in this case seven) countries. Another example could be the covered-law development – a TC implemented by the LC2 in five countries.

- While the legal, regulatory and infrastructure framework for derivatives is nearing completion, the commercial environment to support derivatives is less advanced. In particular:

  - The currency is managed in a tight band (±0.6 per cent) against a US$/€ basket. There is a possibility that the band will be widened eventually leading to a free float; until that happens currency derivatives will not be commercially attractive. The relaxation, when it comes, is expected to result in a depreciation of the Moroccan currency. Derivatives will not be attractive until that adjustment is completed.

  - The government bond market is developing well, but the lack of transparency in the market because of incomplete trade reporting will restrict the accuracy of benchmark pricing for derivatives.

  - The stock market, although larger than others in the region, is still small and highly illiquid. Equity turnover velocity (turnover divided by market value) on the CSE in 2016 (Jan–Aug) averaged around 5 per cent – compare Egypt where the velocity averaged around 34 per cent – and it is not seen as a liquid market.

  - The main commodity traded by Morocco, which could benefit from improved derivatives legislation, is oil. There are already global derivatives exchanges for oil – though current exchange control rules would prevent Moroccan entities from accessing them.

  - Other market features which are seen as essential for a successful derivatives market are still missing, most notably stock borrowing/lending and third-party repos.

  - It is not clear whether well-thought-out plans for the commercial development of derivatives exist.

- The barriers to capital movement mean that the Moroccan market is relatively small and confined to a few large players rather than being part of the global market. The large players are reluctant to take on too much counterparty exposure to other Moroccan entities because of the risk. There is an 'offshore' market in Tangiers where offshore Moroccan dirham can be traded.

- The current planned approach to derivatives regulation would exclude all but qualified investors from the market.

- In most successful derivatives markets retail investors have been a major driver of market growth (for example, Republic of Korea and Thailand). Naturally, there is a desire to avoid retail investors getting drawn into a market which exposes them to excessive risk, but straightforward purchase of options is relatively safe since traders can lose no more than the premium they pay to buy the option. This is in contrast to futures and to writing options, which expose traders to potentially unlimited losses. Normal practice is to restrict retail investors to trading options and possibly writing covered options but to prohibit them from writing naked options.[12]

- The tax treatment of dividends in Morocco is unsatisfactory and unclear. There is a working group led by the MoEF and a new framework was planned for the next Finance Bill (Jan 2017).

- Some Moroccan private companies are reluctant to list on the CSE due to high transparency requirements, which are seen as a disadvantage in terms of tax efficiency. The AMMC believes that improving tax-collection efficiency could encourage many to list.

Operational considerations

- Consider further assistance to increase the size of investable assets in Morocco – including changes to listing rules to permit self-registration of bond programmes and to support partial privatisation of state-owned enterprise assets.

12 Buying put or call option is relatively low risk since the buyer's maximum loss is limited to the premium paid. Writing options where the writer (seller) owns the asset (covered writing) is also relatively low risk since the writer can use the asset to settle the liability if the option is exercised. Normal practice is to allow retail investors to buy options and in many markets to write covered options. Writing naked options, where the writer does not own the underlying asset, is much more risky since the writer faces a potentially unlimited liability if the option is exercised, so retail investors are usually prevented from engaging in naked writing.

- Consider assisting the development of a framework to support stock borrowing and lending and third-party repos (coordinate with other IFIs to ensure complementarity).

- As noted the potential regulations for derivatives may exclude retail investors, a group which, elsewhere, comprises significant participants. Consider assisting the AMMC/CSE by demonstrating to them how other markets address the protection of retail investors in derivatives markets (for example, by supporting twinning arrangements for this purpose and to build further capacity at the AMMC).

- Consider assisting the MoEF to develop the capital markets strategy (including, for example, a national strategy for financial inclusion, commercial development of derivatives and attracting SMEs to capital markets).

- In the longer term consider supporting the development of a regional trading platform for North Africa (similar to SEE Link).

A5.4. Equity investment in the Moscow Stock Exchange – Russia

A5.4.1. Background

In 2012 the EBRD made an investment of €199 million in the merged entity Moscow Stock Exchange (MOEX). This was the Bank's first investment in a stock exchange. The merger had taken place in December 2011 between the Moscow Interbank Currency Exchange (MICEX) and the Russian Trading System (RTS) exchanges. At the time of the Bank's investment the merger was still very much work in progress as the exchanges were operating separate trading systems and settlement systems. A crucial part of the transition impact rested upon the appointment of the EBRD nominee as a board director with substantial involvement in the running of the exchange. It was hoped that this involvement would lead to substantial governance improvements at MOEX, as well as significant gains in strategic planning and elsewhere. Recent political tensions involving Russia did not affected this project but may hinder approval of future investments.

A5.4.2. Relevance

The governance and decision-making processes at the two Moscow exchanges were weak and important reforms relating to governance/disclosure were not being implemented. The fragmentation of business between the two exchanges, MICEX and RTS, led to lower business viability and weaker infrastructure development. Moscow is a national financial hub and has aspirations to become a regional hub. As such it is important that high standards and systemic resilience are present in the Russian financial markets. From this viewpoint the EBRD's operation in Russia was highly relevant. Therefore the relevance of this project is rated excellent.

A5.4.3. Results

A number of transition impacts were expected from the project relating to governance and organisation of the stock exchange, governance of listed companies and market development. The impacts and current status are summarised in Table 3.

The EBRD investment has achieved its objective to facilitate development of the Russian stock exchange, prompting it to improve the structure of the industry by combining the two previous exchanges, greatly improving the governance of the merged exchange, improving the governance of listed companies and imrpoving the quality of the market infrastructure. This has been accompanied by a reduction in state and quasi-state involvement in the ownership of the exchange and a general broadening of the exchange's ownership. The transition impact, expected at approval, has been delivered. MOEX is making good progress

TABLE 3: ACHIEVEMENT OF OBJECTIVES

Impact detail	Comments	Result
Objective 1: Setting standards for internal corporate governance at the exchange		
Appointment of an EBRD board member by MOEX	A board member was appointed shortly after the Bank's investment and has been in place ever since. The impact of the Bank's board member has been pivotal for the development of MOEX as her main focus has been on improving the corporate governance of the stock exchange. The board member has been pivotal in driving that forward and MOEX has standards of corporate governance and disclosure that are among the best, if not the best, in Russia.	Achieved
Maintain the board seat post-IPO	The IPO took place in February 2013 and the board representation has been continued. The senior staff at MOEX are very happy with the arrangement and have no intention of terminating or changing the arrangement.	Achieved
Nomination of the EBRD board member to one of the board committees	The Bank's board member chairs the Audit Committee and is a member of the Strategy and Planning committees of MOEX's Supervisory Board.	Achieved
Listing of MOEX on an international exchange	The senior management of the exchange sees little to be gained from a foreign listing – and indeed sees it as negative and counter to its overall aim of getting Russian companies listed on MOEX rather than on foreign exchanges.	Not achieved and unlikely to be achieved in the near future
Advanced discussions with international exchanges and/or technology partners	MOEX sets great store by its technological sophistication. It is, we understand, in discussions with three major exchanges. More specifically, it is in discussions with potential Chinese partners on RUB/RMB trading. MOEX is very conscious of the need for compliance with international standards and is seeking European Markets Infrastructure Regulation recognition, membership of foreign clearing entities and recognition from the US Commodity Futures Trading Commission recognition. However, external political events are acting as a brake on progress.	Achieved and ongoing but at some risk from external political events
Completion of combined exchanges IPO	The two Moscow exchanges (RTS and MICEX) have successfully merged as MOEX and the merged entity had an IPO in February 2013 and is listed on the exchange.	Achieved
Decrease in sovereign and quasi-sovereign entities' shareholding from current >50% to around 30%	At the time of the IPO the combined shareholding of Russian government-related entities was 53% but has since been reduced to 32%. In particular, the holding of the central bank (which is now, under the new framework, the regulator for MOEX) has reduced from 21.4% to 11.7%.[i] More generally MOEX now has a free-float of 62%, the highest of any Russian listed company.	Achieved

TABLE 3 continued

Impact detail	Comments	Result
Objective 2: Setting standards for corporate governance and business conduct: improve listing requirements and laws relevant to capital markets		
New listing segment for the trading of shares by companies that commit to adopting corporate governance practices in addition to those required by law	MOEX has restructured its listing segments, reducing the number from six to three. It has recently introduced a new corporate governance code for listed companies. The new code was worked on with the Organisation for Economic Co-operation and Development (OECD) and complies with OECD standards. In particular the code imposes stricter requirements for the independence of directors and board committees. The code was subjected to industry consultations. The central bank (as the regulator of securities markets) was heavily involved in drafting the detailed provisions of the code.	Achieved
Expansion of eligible securities list for Russian institutional investors to allow pension funds/mutual funds to invest in stocks other than those on the A1 list	The restructuring of listing segments has been accompanied by some liberalisation of the rules relating to pension and insurance investments. Funds are permitted to invest up to 40% of their assets in securities of companies in the 1st List and this has been extended to allow that investment to be through purchasing at the IPO (which was earlier forbidden). Funds are also permitted to invest up to 10% of assets in the 2nd List. MOEX is continuing its dialogue with the regulator with a view to further relaxation.	Partly achieved and ongoing
Objective 3: Market expansion: improve liquidity, introduce new derivative products, create a central securities depository (CSD) and enhance regional expansion		
Create a single CSD	The National Securities Depository (a MOEX subsidiary) was granted status as the national CSD in 2012.	Achieved
Introduce timely settlement	Settlement within 2 working days (T+2) fully implemented on equity market in 2013.	Achieved
Migration of government bonds to MICEX platform from central bank platform	In 2012 this migration was achieved, so government bonds are now traded on the same platform as corporate and banking bonds. Government bonds can also now be traded on the OTC platform and reported to MOEX for settlement (and surveillance) purposes. There has been an increase in liquidity, though whether this is because of the MOEX trading platform or the liberalisation of OTC trading is unclear.[ii]	Achieved
Establish a segment for second- and third-tier corporates	MOEX has established a 3rd List for SMEs. This is described as "more than just admission to trading" since the companies are subject to the full rigours of disclosure requirements (though lower governance requirements).	Achieved
Introduction of interest rate derivatives	These have been introduced, though the focus on forex risk rather than interest rate risk has meant that the derivatives have experienced very little trading.	Achieved
Develop new products in the Ukraine	MOEX recently sold its stakes in the Ukrainian stock exchange (Sayenko Kharenko, 2016).	Not achieved and unlikely to be achieved in the near future

i The central bank did not, in fact, exercise its full rights as a shareholder as, for example, it would let one or more of the board seats to which it was entitled be taken by a public-interest member.

ii It is common in other markets for bond trades to be negotiated OTC and reported to a central entity for settlement and supervision. MOEX does not distinguish such trades from those traded though its own platform. But, however the trading is negotiated, it seems to be reported to, supervised by and settled by MOEX.

on a few remaining benchmarks, with the exception of those which the current political environment rules out. The impact of the EBRD board nominee has been exceptionally effective and this has been acknowledged by MOEX senior management. The rating of this project's results is therefore excellent.

A5.4.4. Efficiency

The Bank's nominee to serve as a board member of MOEX has been well selected. She is a highly experienced professional, with excellent knowledge of the capital markets and the intricacies of the operations of stock exchanges, therefore she was able to champion important corporate governance reforms at MOEX. Recently the Bank appointed a new board member to MOEX. He worked closely with the previous member and, so far, he has been able to successfully continue initiatives started by the previous member. The Bank continues to be invested in MOEX. The stock price remains volatile, driven by the external impact. The Bank has no exit plans in the near future. The project's efficiency is rated partly unsatisfactory, primarily due to the current losses in € terms (which, however, may yet be recouped by the time of exit).

A5.4.5. Overall rating

This was a high-profile investment in a high-profile country – Russia has a large and relatively well-developed capital market (the EBRD's Transition Indicator ranks it on par with Poland and only slightly less developed than Turkey). The major impact of the project has been through the EBRD-appointed board member, who has been very successful, leading to significant improvements in corporate governance and has gained the full and grateful acceptance of the senior management of the exchange. The project achieved most of the transition impacts expected at approval which led to real improvements, mainly in the operation of the exchange but also to some extent in corporate governance of the companies listed on the exchange. Given it is a listed company, the Bank's investment value can change by the time of the Bank's exit. Based on the strong transition impact achieved, the project is rated outstanding.

A5.4.6. Key findings and recommendations

Findings

- MOEX now presents a well-organised operation with a sound business model, diverse ownership, solid infrastructure and a sound, realistic forward plan. The current three-year plan is focused on further adoption of international standards and alignment of technology with international practice to allow greater interconnectivity.

- MOEX has, in its view, succeeded in encouraging domestic companies to list on MOEX, rather than seek listings on foreign exchanges. There have been no sole listings of Russian companies on foreign exchanges since 2013. Some have apparently delisted from the London Stock Exchange. However, the total number of new listings on MOEX since 2013 has been running at about half the previous levels. So, it remains to be seen whether this marks a step change or whether it is merely a reflection of current circumstances, which will be reversed when global conditions change.

- MOEX has an unusually diversified business model for a stock exchange, since it also provides the main trading/settlement facilities for the bond, forex and money markets – most stock exchanges confine themselves to equities and derivatives with the other markets being mainly over the counter. MOEX says that its strength is in being the first mover in these markets and in the provision of a solid technical platform so the over the counter markets never really developed as they have elsewhere. This diversity, which also means it has a wider customer base, gives it greater business resilience especially when, for example, high currency uncertainty depresses stock-exchange business but increases forex-related business.

- Related to the diverse business model is the high dependence of MOEX on interest received as a revenue source. For example in the second quarter of 2016 "interest and other finance income" represented 55 per cent of total revenues (it was actually higher in each of the previous six quarters). The revenue derives interest earned on client funds held on behalf of foreign exchange traders. Traders could deposit bonds or other assets but currently chose not to do so. It seems unlikely that, over the longer term, traders will be willing to forgo a sum of approximately RUB4 billion per year in interest income by leaving funds in non-interest-bearing accounts at MOEX.

- The Moscow international financial centre is an aspiration that has considerable political backing. The model is different to that pursued in several other countries as it does not rely on carving out an 'offshore' segment where different laws and taxes prevail. Such offshore structures are facing increasing challenges from regulators and international bodies acting against tax havens and money laundering. The Moscow International Financial Centre model seems to rely on improving the environment and infrastructure so that companies and investors will be attracted to Moscow. On that basis it seems a more sustainable and desirable model than is being pursued or considered elsewhere.

Operational considerations

- The EBRD's board member's involvement with MOEX has been highly beneficial as acknowledged by all involved.

- If the EBRD Board resumes approving operations in Russia, the policy dialogue with the central bank to permit pension funds and insurance companies to invest more freely in listed companies' securities should be continued. The current rules, while slightly relaxed, require pension funds to maintain a minimum of 50 per cent of their assets in deposits and government securities, which has not proved a good strategy for pension provision in other countries. In addition, pension funds and insurance companies are excluded from investment in the third market segment (mainly SMEs), which excludes them from a potentially high-growth investment segment – though prudence would suggest that capacity-building in managing SME portfolios should precede any liberalisation in SME investment.

A5.5. OTE Corporate Bond – Greece

A5.5.1. Background

In November 2015 the Bank approved a two-part financing operation for Hellenic Telecommunications Organisation S.A. (OTE), the main Greek telecom operator (which also has operations in Romania and Albania). The OTE is 40 per cent owned by Deutsche Telekom and 10 per cent by the Greek government (though privatisation is likely under Greece's agreement with the EU). The operation consisted of two parts: (a) a corporate bond with a six-year maturity and a total value of €300-350 million of which the Bank would take the lower of 20 per cent or €50 million, and (b) a syndicated loan for €200-250 million of which the Bank would hold on its own account €150 million. The finance was to be used for capex to develop OTE's fixed-line telephone and broadband network, primarily in Greece's underserved rural areas. This assessment, which relates to capital market development, focuses on the bond.

A5.5.2. Relevance

At the time of the issue the Greek borrowers were effectively shut out from the international market in consequence of the country's macroeconomic difficulties and because capital controls were in force. This issue was the first after the imposition of capital controls. The LCY market, at the time, was also not functioning and longer-term borrowing, even from banks, was unavailable. This issue and the EBRD's support was intended to provide much-needed capex finance and act as a positive signal to other lenders/ investors and issuers. Given the situation at the time in Greece the relevance of this project is rated excellent.

A5.5.3. Results

The issue was intended to have two transition impacts: (a) to support the improvement of Greece's telecom infrastructure; and (b) to encourage a revival of the Greek capital market. The focus here is on the latter. The bond was issued successfully and was significantly oversubscribed. The issue had been difficult because of uncertainties about the Greek situation, the fact that many international banks had no appetite for further exposure to Greece and the wide spread of ratings from the different rating agencies. The successful sale of the bond was helped by the very recent recapitalisation of Greek banks which provided a window of opportunity. The EBRD invested €50 million. Other investors included hedge funds, international investors and domestic banks. The targets set for capital market transition impact were: (a) at least five new bond issues by 2017; and (b) at least two syndicated and/or capex financing transactions with Greek non-investment grade corporates by 2017.

The issue was followed by five further corporate bond issues in the ensuing 12 months. Table 4 shows recent bond issues (including the OTE issue). According to the Athens Resident Office, a pipeline of further issues exists.

In addition, in March 2016, a syndicated loan of €75 million was arranged for Energean Oil and Gas, Greece's sole oil producer with an EBRD contribution of €50 million syndicated with another domestic oil company. A further loan of €20 million followed in July 2016. The targets have therefore been fully achieved substantially ahead of the deadline set for these benchmarks. Therefore the results of this project are rated excellent.

A5.5.4. Efficiency

The bond was arranged by Deutsche Bank. Due to a firm deadline for the bond issue, the project required

TABLE 4: BOND ISSUANCE IN GREECE IN LATE 2016

Company	Type of bond	Rating	Issue date	Tenor (years)	Issue amount (€ million)	Currency	Coupon	EBRD partic. (€ million)
OTE	Eurobond	B+	25 Nov 15	3.25	350	Euro	4.375%	50
Titan Cement	Eurobond	BB	10 Jun 16	5	300	Euro	3.50%	15
Intralot	Eurobond	B1	16 Sep 16	5	250	Euro	6.75%	
Hellenic Petroleum	Eurobond	–	24 Oct 16	5	375	Euro	4.875%	
Wind Hellas	Eurobond	B–	31 Oct 16	5	250	Euro	10.00%	
Housemarket (Fourlis)	Domestic		4 Oct 16	5	40	Euro	5.00%	6

very fast due diligence, preparation of approval documentation and an efficient approval process. All these stages were managed very well and the project is an example of efficient cooperation between the Bank's headquarters and (relatively new) resident office. The project's efficiency is rated excellent.

A5.5.5. Overall rating

The importance of the issue in opening up the moribund Greek capital market was very significant. This, combined with the successful completion of the issue and the success in signalling the reopening of the Greek market as evidenced by the number of bonds and loans subsequently issued, means that this project is rated as outstanding.

A5.5.6. Key findings and recommendations

Findings

The project was aimed at reviving the Greek bond market, but the Greek equity market was also stagnated and arguably for much longer. While the trend in the normal metrics (market capitalisation and turnover) is concealed by the overall volatility of the market, one key metric, the number of companies listed, fell from 313 in 2001 to 236 in 2015. To some extent this could represent a weeding out of inactive companies but other figures give a similar picture of decline. Two important comparators are the market capitalisation to GDP and the turnover to GDP. The market capitalisation to GDP averaged 53.9 per cent in the five years 2001-05 but for the five years 2011-15 it averaged 24.5 per cent. The turnover to GDP averaged 18.8 per cent for 2001-05 and 9.8 per cent for 2011-15. Between 2006 and 2016 the exchange only had 10 IPOs and from 2011 to 2016 only two. All this points to a fairly significant decline and the detailed annual figures suggest this has been going on since well before the current crisis. Athex Group has made significant improvements in market structure, regulation and developing new products, but this has not been sufficient to offset the overall weakness in attracting new business to the core activities of the exchange – raising capital and providing liquidity.[13]

Operational considerations

Considering projects supporting the Greek equity market, the Bank involvement has led to some revival in the bond market but this may be fragile and may need further support following up on the other bond investments the Bank has made in Greece. However, the equity market is also showing signs of sustained weakness and no sign of recovery and so could benefit from assistance. The Athens exchange is relatively well developed and it does not appear that weaknesses in infrastructure or regulation are the issues, although this would need to be verified. Its main weakness seems to be its inability to attract new companies (it is not alone in this problem but it does appear to be more persistent in Athens). Inevitably the weak macroeconomic conditions are not currently supportive of IPOs, but capacity-building in marketing and supporting companies through the IPO process would make the exchange and market better prepared to respond when conditions improve.

13 Source: World Bank (except new companies); Athex Group Fact Books (new companies; http://www.athexgroup.gr/info-markets-activity-publications-fact-book/-/asset_publisher/6RHtX9YlV3JD/document/id/4808329).

A5.6. Kyrgyz Investment Commercial Bank Corporate Bond – Kyrgyz Republic

A5.6.1. Background

In 2000 the Bank bought a stake in the start-up bank Kyrgyz Investment Commercial Bank (KICB) and provided it with a loan. The Kyrgyz government invested alongside the EBRD and other IFIs took the balance. In 2012 the EBRD approved an investment of up to US$500,000 in KICB's first corporate bond issue totalling US$2 million in LCY equivalent. The Bank also provided TC to support the issue, which was approved by the securities regulator and listed on the stock exchange.

A5.6.2. Relevance

The EBRD internal initial assessments from 2012 showed the Kyrgyz Republic was an ETC with an underdeveloped capital market. This assessment identified six priorities for LCM development in the Kyrgyz Republic, one being: "advise on corporate bond issuance with a view to establish a pilot bank bond programme aimed at deepening the market". The EBRD (along with other IFIs) was already involved via its stake in the KICB, so it was logical to use this bank as the conduit to issue a pilot bond. It enabled the Bank to leverage its existing involvement in the KICB to promote the development of the LCM. It was Bank's first such bond issue in support of LCM in an ETC. The relevance of this project is rated excellent.

A5.6.3. Results

The project goals were to: (a) improve long-term LCY funding in the Kyrgyz Republic by demonstrating the feasibility of a bank-bond issue; (b) specifically develop the Kyrgyz market for corporate bonds by assisting a bank to make an issue; and (c) address developmental barriers through policy dialogue. The market was very under-developed with crucial features, such as adequate disclosure documentation, missing and a lack of structure which introduced unnecessary risks for participants.

TABLE 5: ACHIEVEMENT OF OBJECTIVES

Impact detail	Comments	Result
Objective 1: Improve long-term LCY funding in the Kyrgyz Republic by demonstrating the feasibility of a bank bond issue		
Gain regulatory approval and market acceptance leading to a successful issue	The bond was successfully issued including gaining regulatory approval, pricing and market acceptance resulting in oversubscription. The KICB's strong commitment to the marketing process is seen as a major contributory factor	Achieved
Objective 2: Develop the Kyrgyz Republic market for corporate bonds by assisting a bank to make an issue		
Improve business standards	• Placement period reduced from 12 months to 3 months • Coupon/accrual conventions defined to international standards • Proper payment agreements using escrow accounts to remove settlement/counterparty risks • Removed payment grace (delay period for coupon payments) • Introduced a 'market-making' arrangement whereby the issuer would buy back bonds (at a price below par) during the life of the bond – a form of liquidity guarantee	Achieved
Improve disclosure documentation	This resulted in the regulator adopting a template for a viable prospectus by specifically: • clarifying wording and presentation to include disclaimers and remove misleading wording • adding or amending definitions • putting terms and conditions in a single sheet and clarifying coupon/accrual conventions • adding risk disclosures and default procedures	Achieved
Objective 3: Improve regulatory and investment policy constraints		
National bank	Obtained informal approval for loss-reserve provisioning, risk-weighted assets and liquid-asset treatment of bank bonds	Achieved
Capital market regulator	Gained acceptance of improvements to disclosure requirements and template prospectus	Achieved

The successful issuance of the pilot bond was accompanied by significant enhancements to disclosures and issuance procedures. These may benefit future issuance by other Kyrgyz corporates, though none appears to be under consideration at the moment. The policy dialogue with the securities regulator and the central bank on provisioning and other topics was informally agreed. This bond issue was followed up by two more issues by KICB in subsequent years; however, there has been no evidence of the project's broader impact, as no other Kyrgyz corporates followed with their own issues. Despite limited impact and the inability to achieve some of the higher-level objectives, the bond issue was successful and many of the improvements to the issue process, documents and coupon payments were adopted. Therefore, the results of this project are rated fully successful.

A5.6.4. Efficiency

The project involved a Moscow law firm, a local arranger (Sentis) and a market consultant hired by the EBRD. The legal firm was asked to apply their experience of the Russian capital market – on which Kyrgyz regulations are based – and to apply Russian disclosure standards, rather than the more stringent international standards. This proved to be a realistic approach and was completed successfully. The legal consultant was judged to have performed well. The local arranger lacked experience in corporate bond issues but performed adequately. The market consultant completed the tasks and deliverables leading to a successful issue and substantial improvements to bond issuance processes (although his final report delivered to the Bank was of very poor quality). The policy dialogue was conducted by the LC2 team, Banking department and the consultants. It was well structured (although only partially successful, as mentioned in section 5.6.3. above). The project's efficiency is rated fully successful.

A5.6.5. Overall rating

The project brought about significant improvements in the environment for corporate bond issues especially in documentation, where the project legacy includes a much-improved prospectus template and the beginnings of standardised terms for bond issues and procedures to reduce risk. The bond was successfully issued and was oversubscribed despite the limited investor base. However, the special status of KICB (co-owned by the IFIs and the government) made it easier to attract investors and it is uncertain whether it will be followed by other Kyrgyz corporates, especially given the low capacity of market participants (which was not addressed in this project). It is noted that the approval documentation for this project alluded to the Bank's intention to replicate it in other ETCs, but that has not happened. Therefore, with some hesitation and mainly because of the project's pioneering nature in an ETC, the project is rated overall as good.

A5.6.6. Key findings and recommendations

Findings

- The Kyrgyz capital market was at an early stage of development and the recommendation to adopt the Russian regulatory model in this market was justified. However, while the basic structure is sound the capacity to implement and enforce regulations is weak due to the lack of capacity and practical experience at the regulator and elsewhere. The project was a successful start at addressing this regulatory deficit but much more needs to be done.

- The lack of experience meant that the terms and conditions of the bond issue, which normally would have been clearly described in the prospectus, were not clear – for example, the convention for coupon calculation and the treatment of default. An important result of this project was to make a clear distinction between the primary and secondary markets. Previously the distinction was blurred and the subscription period was unspecified. This bond provided a demonstration with a clear subscription period.

- The regulations currently exclude pension funds from investing in corporate bonds (funds can only invest in private bonds if there is a 100 per cent provisioning by the issuers). In other markets pension funds are keen buyers of any longer-term paper. This demonstrates the difficulty of policy dialogue related to pension rule reforms aiming to invigorate LCM.

- The issuer of the bond, KICB, has made two further issues. However, it is an unusual entity, being co-owned by the government and IFIs. Investors could reasonably expect that such an entity would not be likely to fail or default but this would not be true of issues by other Kyrgyz entities and it is not clear that default processes are fully in place or fully understood in the Kyrgyz Republic. So the demonstration effect of this project may be limited.

- The government bond market exists in the Kyrgyz Republic but it is not well developed. There is no real yield curve for pricing corporate debt. The Bank's LC2 team has been working (under another TC) on the development of the yield curve in the Kyrgyz Republic; however, this project is still a work in progress.

Operational considerations

- The project provided significant benefits in developing the primary market, but the capacity of the regulator remains weak. Consider a follow-up project aimed at developing regulatory capacity.
- The obstacle to pension fund investment in corporate bonds (and indeed any non-government securities) is a significant barrier to developing pensions and the capital market.
- As there are no detailed default procedures in the universal Kyrgyz law, they need to be specified in each prospectus, which is inefficient. Therefore, it is recommended (for the Bank's Legal Transition team) to consider a project in Kyrgyz Republic to introduce such provisions in the country's law.
- The Bank should follow up on its undertaking at project approval and develop corporate bonds in other ETCs.

Annex 6: Links between selected countries' LCM development priorities and the LC2 strategy

The Bank's actions related to specific priorities are briefly indicated in brackets **(in bold)**.

Country	Strategic themes				
	Pillar 1: Stable and sustainable macroeconomic framework	**Pillar 2: Improving legal and regulatory environment**	**Pillar 3: Developing financial market infrastructure**	**Pillar 4: Developing institutional investor base**	**Pillar 5: Promoting a more efficient transaction environment and expanding product range**
Poland	*From Needs assessment*				
	Authorities should closely monitor FCY retail lending.	Simplified process of transferability of collateralised loans would facilitate long-term funding of the mortgage loan portfolio.		Pension funds should support LCM development.	• Covered bond issuance using the substantial mortgage loan portfolio as collateral would help reduce maturity mismatches **(addressed with a TC, successfully completed and Bank recently invested into covered bonds)**. • Support broader use of collateralised transactions to help improve the liquidity.
	From Legal assessment				
		• Expedite the process of transferability of collateralised loans. • Amend the covered bonds regime **(addressed by a TC, successfully completed)**. • Clarify enforcement of monetary claims against the State Treasury and the National Bank of Poland. • Improve the regulators' level of cooperation with market participants (LT) **(legal seminar on financial markets law and regulations)**.	Improve the clearing and settlement system **(feasibility study on central counterparty clearing house)**.		• Raise the statutory limits of liabilities of entities authorised to audit financial reports. • Amend the bonds regime to simplify and expedite issues. • Amend the tax regime to allow direct issuances to foreign investors. • Remove the registration fee for offering of securities which will not be listed.

Country	Strategic themes				
	Pillar 1: Stable and sustainable macroeconomic framework	**Pillar 2: Improving legal and regulatory environment**	**Pillar 3: Developing financial market infrastructure**	**Pillar 4: Developing institutional investor base**	**Pillar 5: Promoting a more efficient transaction environment and expanding product range**
Romania	*From Needs assessment*				
	Strengthen the market's perception of the credibility of the interest rate setting process.				• Help market participants to enhance transparency of market rates starting with the government securities secondary market. • Support development of interbank repo market. • Support development of covered bond markets (TC ongoing).
	From Legal assessment				
		• Revise repo laws and regulations. • Clarify rules and regulations on derivatives transactions **(feasibility study completed)**. • Harmonise legislation and regulation. • Revise the existing mortgage bond legislation and potentially expand such structure to other assets **(addressed with the TC that resulted in the covered-bonds reform)**. • Implement a training programme for judges and regulators (LT) **(successfully completed)**.			• Simplify the offering document approval process and reduce the fees **(transaction cost study and work with the Bucharest Stock Exchange to reduce issue costs)**. • Allow intermediaries to allocate debt securities on a discretionary basis (LT). • Improve on the availability of credit ratings (LT).

Country	Strategic themes				
	Pillar 1: Stable and sustainable macroeconomic framework	**Pillar 2: Improving legal and regulatory environment**	**Pillar 3: Developing financial market infrastructure**	**Pillar 4: Developing institutional investor base**	**Pillar 5: Promoting a more efficient transaction environment and expanding product range**
Turkey	*From Needs assessment*				
			Evaluate possible use of trade repository, central clearing counterparty and other mechanisms for OTC derivatives **(feasibility study on clearing house completed)**.	Evaluate pension investment policies and regulations.	• Strengthen interbank money market and credibility of the reference rates. • Develop interest rate swaps (IRS) market. • Encourage the implementation of a government bond issuance strategy that supports the development of repo and derivatives markets.
	From Legal assessment				
		Clarify the regulations governing repo transactions.			• Encourage local debt-securities issuances **(investment into 13 bonds and IPOs)**. • Improve the rules and regulations governing credit ratings (LT). • Implement legal changes to facilitate Islamic finance (LT).
Ukraine	*From Needs assessment*				
	• Strengthen macroeconomic stability by focusing monetary policy more directly on price stability and allow greater exchange rate flexibility. • Strengthen the liability base of the banking sector. • Promote the reduction of non-performing loans to help lending.			Resolve imbalances in the current pension system and, in parallel, thoroughly analyse the costs and benefits of the sequential transition to a pillar 2 system when fiscal capacity allows.	• Gradually liberalise the foreign exchange market. • Facilitate development of interbank repo markets to improve money-market liquidity.

Country	Strategic themes				
	Pillar 1: Stable and sustainable macroeconomic framework	**Pillar 2: Improving legal and regulatory environment**	**Pillar 3: Developing financial market infrastructure**	**Pillar 4: Developing institutional investor base**	**Pillar 5: Promoting a more efficient transaction environment and expanding product range**
Ukraine (continued)	*From Needs assessment – 2015 update*				
		Upgrade of legal environment to support consolidation of legal/regulatory environment **(TC committee approved)**.	• Gap analysis and reform road map for Ukraine's capital-markets infrastructure **(TC completed August 2015)**. • Consolidation of post-trade infrastructure covering clearing and settlement **(TC started December 2016)**. • Consolidation of trading infrastructure (exchanges).		• Create an environment that encourages local listing of private companies and support listing of medium-sized companies. • Assess the feasibility of SWIFT standard upgrades to support the efficiency of the transaction environment linked to the National Bank of Ukraine real-time gross settlement.
	From Legal assessment				
		• Improve the insolvency legal framework. • Clarify rules and regulations regarding repo transactions. • Permit the issuance and facilitate circulation of securities by foreign entities. • Clarify rules relating to derivatives transactions **(TC implemented, new law drafted, approval pending)**. • Strengthen disclosure and reporting requirements for issuers (LT). • Improve regulations governing bank reserves and regulatory capital (LT).			Improve the regulation of local credit-rating agencies (LT).

Notes: LT = long-term priorities; OTC = over the counter; TC = technical cooperation project.

Annex 7: Links between the LC2 strategy (or five strategic themes) and the Bank's interventions in selected countries

Country	LC2 strategic themes[i]			
	2. Improving legal and regulatory environment	**3. Developing financial market infrastructure**	**4. Developing institutional investor base**	**5. Promoting a more efficient transaction environment and expanding product range**
Poland	• Legal and regulatory assessment (COO) • Covered bonds – framework • Legal seminar on financial markets law and regulation	• Feasibility of establishment of central counterparty clearing house		• Transaction cost study • Poland – WSE benchmarking exercise • 24 bond/equity investments
Romania	• Legal and regulatory assessment (COO) • Covered bonds – framework • Legal seminar on financial markets law and regulation • Judicial training	• Investment into Bucharest Stock Exchange • Feasibility of establishment of central counterparty clearing house • Capacity-building at the central securities depository (CSD)/ stock exchange	• Pension reform review	• Investment into Bucharest Stock Exchange • Transaction cost study • Covered-bonds framework • Derivatives feasibility study • 15 bond/equity investments
Turkey	• Legal and regulatory assessment (COO)	• Investment into Istanbul Stock Exchange • Feasibility of establishment of central counterparty clearing house • Central counterparty clearing house presentations		• Infrastructure finance conference • Transaction cost study • Investment into Istanbul Stock Exchange • 13 bond/equity investments
Ukraine	• Legal and regulatory assessment (COO) • Legal seminar on financial-markets law and regulation • Derivatives-framework preparation TC	• Feasibility of establishment of central counterparty clearing house • Gap analysis and identification of optimal capital market infrastructure set-up and road map (for stock exchange consolidation)		• Derivatives feasibility study and legal framework • 3 bond/equity investments

Note:

i No corresponding interventions in the corresponding countries for strategic theme 1: Stable and sustainable macroeconomic framework.

COO = country of operations; CSD = central secutities depository; TC = technical cooperation project; WSE = Warsaw Stock Exchange.

Annex 8: Status of the LC2 team's work programme 2013-16

Key LC2 theme	Projects	EvD comment
1. Building stable and sustainable macroeconomic policy frameworks	• Enhancing policy frameworks for LCM development in Armenia, Georgia, Kyrgyz Republic, Moldova, Mongolia and Tajikistan • Improving foreign exchange risk management practices in ETCs and other COOs • Assisting financial sector reform in Serbia with Deposit Insurance Agency (DIA) reorganisation • Designing capital market development road map in Mongolia • Developing LC2 foreign exchange capacity-building strategy in all ETCs and Western Balkans states	Completed/ongoing – regional TC for inflation targeting and many markets development Completed/ongoing – as above Completed – credit line for Serbian DIA signed Not pursued – one workshop held Not pursued – some policy dialogue held in selected countries but no strategy documents produced
2. Improving the legal and regulatory environment to support capital market activity	• Establishing international principles on close-out netting (International Institute for the Unification of Private Law [UNIDROIT] project) • Improving legal and regulatory environment for repo transactions in Russia, Poland and possibly other CEE countries with financial institution • Improving legal and regulatory environment for convertible bonds in Russia with Moscow Exchange • Conducting legal-assessment project on capital-markets indicators used in the EBRD's Transition Report • Assessing global regulatory initiatives and the impact on EBRD businesses and COOs	Completed – report published Partly completed – TC in Russia but not in Poland or other COOs Not pursued Completed – indicators used in 2015-16 and 2016-17 *Transition Reports* (EBRD, 2015, 2016) Completed – report published
3. Developing financial market infrastructure including clearing and settlement	• Developing depository and settlement systems in ETCs (Collateral Enhancement Facility project) • Conducting CCP feasibility study and developing follow-up strategies • Supporting a Balkans common execution platform • Supporting equity market consolidation in Ukraine • Supporting custodial reform in Mongolia with Luxembourg aid agency	Completed – Frontclear project completed Completed/ongoing – feasibility study published; work ongoing with Romania, Ukraine and others Completed – SEE Link project Partly completed/ongoing – discussions started in 2016 Not pursued
4. Developing the institutional investor base	• Conducting pension fund surveys in Kazakhstan, Poland and Russia and participating in policy dialogue on identified issues • Supporting Mongolian SME pensions • Identifying asset managers and investment alongside international partners for Armenian pensions • Establishing institutional savings schemes in ETCs	Partly completed – work in Poland started but stopped; survey in Romania done Not pursued Completed Not pursued

Key LC2 theme	Projects	EvD comment
5. Promoting a more efficient transaction environment and expanding product range	• Supporting covered bonds in Poland and mortgage market products in SEMED	Partly completed – done in Poland but not in SEMED
	• Supporting corporate bonds in Kyrgyz Republic, selected ETCs, SEMED and Romania	Partly completed – support to KICB issue in Kyrgyz Republic, as well as in Romania, but not in other ETCs or SEMED
	• Assisting Treasury with new bond issuances in Armenia and Serbia	Completed – bond in both countries issued
	• Developing LCY pricing models supporting long-term fixed interest rate LCY quotes by The Currency Exchange Fund	Completed/ongoing – FPAS model TC
	• Enhancing securitised transactions and establishing market benchmarks in ETCs	Not pursued
	• Assisting money market reform in Turkey	Not pursued
	• Supporting asset liability risk management in a country or regional	Not pursued
	• Supporting cross-currency swap facility risk management in Serbia	Completed
	• Introducing new financial instruments in Tunisia and possibly Morocco with the Venture Capital Association	Not pursued
	• Conducting debt market transaction cost study and global benchmark transaction cost study	Completed – report published
	• Assisting covered bond reform in SEMED with GIZ and German Ministry of Finance	Not pursued
	• Supporting regional equity market development through MoU with Borsa Istanbul (BI) in cooperation with financial institution	Completed/ongoing – MoU signed, BI invested in Montenegro Stock Exchange
	• Derivatives: credit support for cross-border transactions, advisory work for Serbian national bank about derivatives/ISDA (complementary to financial institution swap transaction), derivatives legal and regulatory framework in Ukraine (phases I & II), derivatives legal and regulatory framework Morocco, close-out netting in Romania, derivatives judicial training for judges of Russian Supreme Arbitrazh Court	Partly completed/ongoing – derivatives-framework TCs in Ukraine and Morocco
	• Developing G-20 LCY bond market diagnostic framework	Completed
	• Developing ALM and Treasury products training programme in SEMED	Completed/ongoing – Treasury-led programme
	• Organising technical seminar on transaction reporting in Moscow and London with ISDA	Completed

Notes: In total:

- 18 (51 per cent) tasks completed or largely completed with components still ongoing
- 6 (17 per cent) tasks partly completed or partly undertaken and ongoing
- 11 (32 per cent) tasks not undertaken or failed.

CCP = central counterparty clearing house; CEE = central and eastern Europe; COO = country of operations; ETC = early transition country; EvD = Evaluation Department (EBRD); FPAS = Forecasting and Policy Analysis Systems (model); G-20 = Group of 20 leading industrialised countries; GIZ = Deutsche Gesellschaft für Internationale Zusammenarbeit; ISDA = International Swaps and Derivatives Association; KICB = Kyrgyz Investment Commercial Bank; LCY = local currency; MoU = memorandum of understanding; SEE Link = South-Eastern Europe Trading Platform; SEMED = southern and eastern Mediterranean; SME = small to medium-sized enterprise; TC = technical cooperation project.

Annex 9: Capital market development transition gaps and indicators, 2012-15

	Market structure 2012	Market institutions 2012	Transition indicator 2011	Market structure 2014	Market institutions 2014	Transition indicator 2016
Albania	Large	Large	2–	Large	Large	2–
Armenia	Large	Large	2	Large	Medium ↑	2
Azerbaijan	Large	Large	2–	Large	Large	2–
Belarus	Large	Large	2–	Large	Large	2–
Bosnia and Herz.	Large	Large	2–	Large	Large	2 ↑
Bulgaria	Medium	Small	3	Medium	Small	3– ↓
Croatia	Medium	Small	3	Medium	Small	3+ ↑
Cyprus	N/A	N/A	N/A	Medium	Small	3+
Egypt	Medium	Medium	N/A	Medium	Medium	2+
Estonia	Medium	Small	3	Medium	Small	3
FYR Macedonia	Large	Large	2–	Large	Large	2–
Georgia	Large	Large	2–	Large	Large	2–
Greece	N/A	N/A	N/A	N/A	N/A	3+
Hungary	Small	Small	3+	Medium ↓	Small	3+
Jordan	Medium	Medium	N/A	Large ↓	Large ↓	2
Kazakhstan	Medium	Medium	3	Large ↓	Medium	2 ↓
Kosovo	N/A	N/A	n/a	Large	Large	1
Kyrgyz Republic	Large	Large	2–	Large	Large	2–
Latvia	Medium	Small	3	Medium	Small	3+ ↑
Lithuania	Medium	Small	3	Medium	Small	3
Moldova	Large	Medium	2+	Large	Large ↓	2 ↓
Mongolia	Large	Medium	2+	Large	Medium	2– ↓
Montenegro	Large	Medium	2	Large	Medium	2
Morocco	Medium	Medium	N/A	Medium	Medium	3
Poland	Small	Negligible	4–	Small	Small ↓	4–
Romania	Medium	Small	3	Medium	Small	3– ↓
Russia	Small	Medium	4–	Small	Medium	4–

	Market structure 2012	Market institutions 2012	Transition indicator 2011	Market structure 2014	Market institutions 2014	Transition indicator 2016
Serbia	Large	Medium	3–	Large	Medium	2 ↓
Slovak Republic	Medium	Small	3	Medium	Small	3
Slovenia	Medium	Small	3	Medium	Small	3+ ↑
Tajikistan	Large	Large	1	Large	Large	1
Tunisia	Medium	Large	N/A	Medium	Medium ↑	2+
Turkey	Small	Small	4–	Negligible ↑	Small	4 ↑
Turkmenistan	Large	Large	1	Large	Large	1
Ukraine	Large	Medium	3–	Large	Medium	2 ↓
Uzbekistan	Large	Large	1	Large	Large	1

Notes: FYR = Former Yugoslav Republic; N/A = not available.

Annex 10: World Bank Group support to capital market development, Independent Evaluation Group, 2016 – summary

The evaluation focused on the World Bank Group operational interventions in LCM during 2004-14. The World Bank provided assistance for LCM development in three areas: (a) developing market infrastructure; (b) developing and issuing capital market instruments; and (c) supporting investors in capital market instruments.

Initially, the World Bank and the International Finance Corporation (IFC) sought to issue LCY bonds in offshore capital markets, but impact was limited as it was not linked with operations. Following the Asian Crisis in the late 1990s, LCMs gained in importance. The World Bank sought to strengthen local market infrastructure through regulatory reform, particularly for bonds, and this activity was reasonably successful. It was less successful in the area of payments and securities settlements systems development. The World Bank's efforts to develop instruments such as asset-backed securities and mortgage-backed securities for housing finance were dependent on the stage of development of capital markets within countries. The use of bonds for infrastructure development was rare, while guarantees played an important role in supporting them. On the investor side, most support provided to insurance and pensions firms did not focus on capital market investment.

The IFC was active in the equity markets and supported the development of selected stock exchanges, and then moved towards non-capital market private equity funds (PEF) due to diminished opportunities over time for investments in IPOs and listed equities. The IFC's work with PEFs accelerated in the 2000s, following the setting-up of its dedicated Funds Management Department. The IFC supported local PEFs partly in the expectation they would help develop local stock exchanges though IPOs. In practice these types of exits were rare and financial returns from PEF were mixed.

The World Bank prepared detailed Financial Sector Assessment Programs, which provided substantial data, but they were not sufficiently reflected in the country strategies and financial sector development programmes. Bond market development dominated the actual work programmes and was often financed by special-purpose funds, such as the Financial Sector Reform and Strengthening Initiative (FIRST) Trust Fund and through programmatic lending.

Overall, the World Bank interventions were fragmented and did not accurately reflect the objectives of its overarching capital market development programme. There was little interaction or coordination between operations and Treasury. Examples of sequencing reforms by developing money markets and then moving downstream to government, and then corporate bond market development were rare. There was a reliance on a variety of external sources of trust funds and unusual financing sources such as reimbursable advisory services, and there were weaknesses in knowledge management systems. These factors contributed to the fragmented programme design, both within and across countries.

More recently, there have been adjustments to funding structures to permit a more programmatic approach to strategy design and implementation, and recognition that knowledge management systems need to be strengthened. These new structures are recommended to help the World Bank move beyond the typical country-driven model towards developing and implementing innovative cross-country strategies.

Annex 11: Recommendations from country and legal assessments for three sample countries

A11.1. Romania

A11.1.1. Needs assessment

- Strengthen the market's perception of the credibility of the interest-rate-setting process.
- Enhance transparency of market rates starting with the government securities secondary market.
- Support the development of an interbank repo market.
- Support the development of covered bond markets.

A11.1.2. Legal assessment

- Revise repo laws and regulations.
- Clarify rules and regulations on derivatives transactions.
- Harmonise legislation and regulation.
- Revise the existing mortgage bond legislation and potentially expand such structure to other assets.
- Implement a training programme for judges and regulators (long-term priority).
- Simplify the offering document approval process and reduce the fees.
- Allow intermediaries to allocate debt securities on a discretionary basis (long-term priority).
- Improve the availability of credit ratings (long-term priority).

A11.2. Poland

A11.2.1. Needs assessment

- Simplified process of transferability of collateralised loans would facilitate long-term funding of the mortgage loan portfolio.
- Authorities should closely monitor foreign currency retail lending.
- Pension funds should support LCM development.
- Covered bond issuance using mortgage loan portfolio as collateral would cut maturity mismatches.
- Support broader use of collateralised transactions, such as tripartite repos, to help improve the liquidity.

A11.2.2. Legal assessment

- Expedite the process of transferability of collateralised loans.
- Amend the covered bonds regime.
- Clarify enforcement of monetary claims against the State Treasury and the National Bank of Poland.
- Improve the clearing and settlement system.
- Raise the statutory limits of liabilities of entities authorised to audit financial reports.
- Amend the bonds regime to simplify and expedite issues.
- Amend the tax regime to allow direct issuances to foreign investors.
- Remove the registration fee for offering of securities which will not be listed.
- Improve the regulators' level of cooperation with market participants (long-term priority).

A11.3. Ukraine

A11.3.1. Needs assessment

- Strengthen macroeconomic stability by focusing monetary policy more directly on price stability and allow greater exchange rate flexibility.
- Strengthen the liability base of the banking sector.
- Promote the reduction of non-performing loans to help lending.

- Resolve imbalances in the current pension system and, in parallel, thoroughly analyse the costs and benefits of the sequential transition to a pillar 2 system when fiscal capacity allows.

- Gradually liberalise the foreign exchange market.

- Facilitate development of interbank repo markets to improve money market liquidity.

A11.3.2. Legal assessment

- Improve the insolvency legal framework.

- Clarify rules and regulations regarding repo transactions.

- Permit the issuance and facilitate circulation of securities by foreign entities.

- Clarify rules relating to derivatives.

- Strengthen disclosure and reporting requirements for issuers (long-term priority).

- Improve regulations governing bank reserves and regulatory capital (long-term priority).

- Improve the regulation of local credit rating agencies (long-term priority).

Annex 12: Peer review

This ex-post review was performed by Rolf B. Westling. Mr Westling has been a senior executive, project financier and development banker for more than 47 years. He worked for more than 10 years in the private sector with two internationally active Finnish consulting firms, followed by 36 years with four international financial institutions – the Asian Development Bank, the EBRD, the African Development Bank and the Organization of the Petroleum Exporting Countries (OPEC) Fund for International Development, whose operations collectively cover the entire developing world.

A12.1. Context

1. As rightly noted in the Study Report introduction, "to stimulate and encourage the development of capital markets" was one of seven identified specific functions in the Agreement establishing the EBRD. However, due to the extremely challenging business environment during the 1990s, the Bank, while building its organisation and operational capacity, preferred to focus on the first specified function, "to promote, through private and other interested investors, the establishment, improvement and expansion of productive, competitive private sector activity, in particular SMEs".

2. In doing so, and while building its network of resident offices, the Bank paid attention to the second prioritised function, "to mobilize domestic and foreign capital and experienced management" to foster progress in the first function. This resulted in preparing numerous credit lines to and equity investments in local financial institutions to strengthen their capacity. Since 1994, the Bank started to mobilise domestic resources, for example through issuing LCY bonds. However, the growing exposure to banks, especially in Russia, exposed the Bank to non-performing assets, which prompted enhanced prudential measures constraining financial sector operations for some time. However, it is noteworthy that such LCY operations cumulatively reached €8 billion by end 2013, positively impacting LCM development.

3. Not until 2009, in the aftermath of the 2007-08 Global Financial Crisis, [did] the Bank launch the Vienna Initiative bringing together private and public sector stakeholders, for example, EU-based cross-border banks, regulatory and fiscal authorities, and international institutions (that is, the IMF, the European Investment Bank, the World Bank and the EBRD) towards providing a framework for coordinating the crisis management and market resilience. The mission statement of the Vienna Initiative 2 was further specified to focus on: (i) avoiding disorderly deleveraging; (ii) ensuring cross-border financial stability; and (iii) enhancing policy actions, notably in the supervisory area. The EBRD was leading the working group focusing on LCM.

A12.2. Crisis response and enhanced LCM attention

4. The 2007-08 financial crisis can be seen as a "wake-up" call for the need to build strengthened resilience of countries of operations (COOs) to weather any future potential external shocks. Consequently, during 2010 the Bank prepared a new *Financial Sector Strategy: Dealing with the Legacy of the Crisis and Supporting the Development of Sustainable Financing of the Real Economy in EBRD COOs* (EBRD, 2010). Its strategic objectives and operational priorities bear significant relevance on LCM, in particular one of the four priority components, which specifically focuses on "Local currency and capital market development". In parallel, the idea of creating a specific LCM initiative (LC2) was launched, which eventually received a formal structure with a director in 2012 and a specific LC2 strategy in 2013.

A12.3. Evaluation of Bank support for LCM development

A12.3.1. Evaluation approach

5. As stated, the evaluation focuses on the strategy for Local Currency and Capital Markets Development (LC2). The LC2 strategy covers both LCY and LCM, with a joint score card and results framework. Whereas the EvD evaluation focuses on LCM only. LCY operations also possess capital market benefits, which the study report acknowledges. However, the evaluation objective was specifically designed to emphasise and distinguish LCM development as a growing strategic focus of Bank operations, thus responding to the stated LCM priority function in the Agreement establishing the EBRD (see para 1).

6. The five focus themes of the LC2 may be noted. However, due to limited and/or rudimentary Bank engagement so far in the first and the fourth themes, these were [mostly] excluded from the evaluation. The five LC2 focus themes are:

- (Building stable and sustainable macroeconomic policy frameworks) (excluded)
- Improving the legal and regulatory environment to support capital market activity
- Developing financial market infrastructure including clearing and settlement
- (Developing the institutional investor base) ([mostly] excluded)
- Promoting [a] more efficient transaction environment and expanding product range.

7. The evaluation approach centred on the following four questions.

- Were the LC2 strategy and its objectives relevant to the requirements of the COOs?
- How effectively has the LC2 strategy been implemented?
- What have been the early results of LCM projects and strategy implementation?
- What key issues and lessons may be identified to improve the effectiveness and efficiency of future strategy and operations?

8. Apart from the foregoing, the evaluation includes a review of the LCM portfolio of operations approved during the four-year period 2012-15. It is noteworthy that this portfolio includes an impressive 92 LCM investments for a total volume of about €2.8 billion and 40 technical cooperation (TC) operations for €14.8 million.

9. In addition, the evaluation approach identified three case study projects, one for each [of the] three included focus themes, as well as sample projects, two for each focus theme. These [three] projects, five TCs and four investments were subject to a detailed scrutiny. It is assumed that these were selected on the basis of being representative examples in the portfolio.

A12.3.2. Performance evaluation of LCM operations

10. The Evaluation Report is comprehensive and a fascinating documentation of the evolution of the EBRD's LCM operations. Along with the annexes, the report is highly meticulous and informative and does not seem to leave any "stones unturned". The evaluation is structured around four key areas: (i) LC2 strategy, its objectives, relevance and adequacy to guide Bank operations; (ii) the synergy of LC2 with sector and country strategies, and vice versa, that is the two-way links, and most importantly LC2's responsiveness with the country diagnostics that identify the LCM needs; (iii) effectiveness of organisational arrangements for LCM operations as well as adequacy of staff and budget resources; and (iv) a review of LCM operations during 2012-15 with focus on four key areas:

- the LCM investments and portfolio
- technical cooperation and policy dialogue in support of LCM
- LCM operation support by Bank Treasury operations
- cooperation on LCM operations with other organisations.

11. At the end, the Evaluation Report presents its results in two levels: (i) at project level, that is evaluating the three case study and six sample projects against relevance, effectiveness (results), efficiency (execution) and impact (see para 9); and (ii) at the macro (market and business environment) level. By and large all project performances were found successful. In terms of LCM Transition Indicators over [the] past five years, five countries were upgraded and seven downgraded.

12. The evaluation approach (see paras 5–9) is considered appropriate and the structure and depth of the performance evaluation (see para 10) of LCM operations is considered adequately comprehensive and sufficiently detailed to support the credibility of its findings and recommendations.

13. The Report makes four macro-level recommendations: (i) prepare a new strategy with enhanced focus on LCM; (ii) develop a full resource and organisation plan; (iii) ensure that new country strategies identify/prioritise LCM

needs were appropriate; and (iv) the EBRD should consider leading a cross-IFI team to enhance cooperation, diagnostic work, policy dialogue and joint operations. These sum up the observed areas of concern, that is poor coherence and focus of LC2, inadequacy and structure of allocated resources, inadequate attention in country/sector strategies on LCM, and insufficient IFI collaboration.

A12.3.3. Further observations and takeaways

14. As noted, the LC2 strategy covers both LCY and LCM, while the evaluation focuses on LCM only. Going forward, the feasibility of preparing separate strategies or a comprehensive joint strategy needs to be assessed.

15. The evaluation, conducted in 2016-17, covers LCM operations from 2012 to 2015, and some were not adequately mature to assess final results, which may lower their evaluability and dilute their guiding impact at the project level. However, for the preparation of a new LC2 strategy (macro level) and addressing other concerns the evaluation will be most helpful.

16. The LCM portfolio is grossly concentrated on four to five COOs. This anomaly needs to be addressed by the new LC2 strategy head on. Expanded geographical reach can also be achieved by encouraging enhanced subregional capital market integration, for example by supporting better-performing COOs to act as subregional "anchors". Operational innovation and catalytic impact need attention.

17. In pursuing LCM development in COOs, policy dialogue is important, even critical in less-developed COOs. Needs assessments present the EBRD's opinion, the eventual country strategy represents a negotiated "deal" with the COO. Policy dialogue is effective only when conducted at adequately high levels (by both parties), and by paying attention to the "political economy". Very relevant in topics such as macroeconomic policy formulation.

18. Moving forward, the Bank may also consider launching suitable market tracking vehicles to demonstrate progress. The *Asia Bond Monitor* maintained by the Asian Development Bank serves as a good example.

Annex 13: References for the annexes

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