

# EBRD SUPPORT FOR THE DEVELOPMENT OF LOCAL CAPITAL MARKETS

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## Background

Development of local capital markets (LCMs) was a core strategic objective of the European Bank for Reconstruction and Development (EBRD) at its inception in 1991. However, it was not until the Local Currency and Local Capital Markets Initiative (LC2) was launched in 2010 that it became an important operational objective in its own right. In 2012 the Bank established a dedicated LC2 team to improve implementation of the initiative. In 2013 LC2 was designated as one of the Bank's three strategic initiatives and an LC2 strategy was approved.

Under this strategy the LC2's strategic priorities include legal and regulatory improvements, developing financial market infrastructure, supporting institutional investors, promoting improved transaction efficiency and expanding the Bank's range of products. The initiative has an ambitious operational plan for effective LCM engagement.

In 2016 the Bank's independent evaluation department launched an evaluation of LC2 activities from 2012 to 2015, reviewing them against the LC2 strategy, the Bank's needs and legal assessments, and country strategies for its countries of operation. This report focuses on the Bank's LCM development work; it does not assess work focused on local currency activities (except where those impinge directly upon LCM). Despite the clear strong link between: (a) Bank operations supporting local currency and local banking systems; and (b) LCM development, the many loans to corporates have not shaped LCM development and so are excluded from this report.

## Evaluation approach

The evaluation relied on internal and external interviews, extensive document review and review of a portfolio of 92 LCM investments and 40 technical cooperation

## LCM-supportive transactions (LC2 team, 2015)

Local capital market investments (as opposed to local currency financing) may be denominated in local or foreign currency but must fall into one of the following three categories (LCM-supportive transactions):

- investments in bonds, securitisations, repos or derivative frameworks
- equity investments in listed companies (including initial public offerings and pre-initial public offerings investments), capital market infrastructure (stock exchanges, depositories, etc.) or domestic institutional investors focusing long term (life insurance companies and pension funds, but not banks or non-life insurance companies)
- investments in deposit insurance guarantee schemes.

projects. Eight country strategies and four sector strategies were reviewed through the prism of the LC2 strategic objectives.

For each of the three LC2 focus themes the evaluation team selected one case study and two sample projects. Case studies were primarily based on a document review, and internal and external stakeholder interviews.

Case studies and sample projects were rated for relevance, effectiveness and efficiency, and for their delivery of outputs and achievement of their targets in terms of LCM development. No other aspects of project performance were assessed. For recently completed or ongoing projects only the potential for achieving results and overall impact was assessed.

## EBRD LCM focus themes (LC2 strategy, 2013)

- Improving the legal and regulatory environment to support capital markets\*
- Developing financial market infrastructure\*
- Promoting a more efficient transaction environment and expanding the product range\*
- Developing the institutional-investor base
- Building stable and sustainable macroeconomic policy frameworks.

\* Primary focus of EBRD LC2 LCM work and this evaluation.

Broader LCM transition impact indicators and changes to them (2012-14/15) were analysed for all countries of operation.

### Evaluation findings

Overall, there appears to be a disconnect between the Bank's high (but undefined) ambitions for transforming LCMs and its limited capacity (resources, priorities, organisation, collaboration with other organisations) to do so. If this is not addressed, the evaluators foresee few accomplishments in LCM development beyond those already achieved (reported below in summary). Current Bank-wide initiatives offer real opportunities to reassess the way forward, but this requires appropriate strategic decisions. This evaluation presents a clear case for fundamental reassessment of the Bank's LCM development work.

#### Content and implementation of the LC2 strategy

- The LC2 strategy identifies appropriate areas of focus as broad activities and products. Quantitative and qualitative outcomes and intended results for the main target countries are poorly defined and not sufficiently specific. Sequenced operations based on country

circumstances are central to the strategy, but there is little evidence that they drove interventions.

- Useful early diagnostic work was done on country LCM needs and legal issues, but this was not initially widely incorporated into country strategies; LCM action plans were agreed with only two non-early transition countries. Action plans are to be developed for priority markets as country strategies are updated, but greater alignment is needed across the range of Bank country documents and the LC2 strategy.
- Cooperation with other multilateral financial institutions has been limited, mainly to joint assessments and local currency matters related to specific transactions. While the EBRD supports several policy forums led by international financial institutions, different priorities and processes have hampered effective collaboration in both transactions and policy dialogue. There have been no joint LCM-focused projects.
- In the transition from a centrally planned economy to a market economy, the LCMs of five countries have been upgraded, while seven have regressed. This highlights the limited overall impact of Bank interventions in the

TABLE 1. THE EVALUATION CASE STUDIES AND SAMPLE PROJECTS

| LC2 focus theme  | Case studies   | Sample projects  |
|--|--|--|
| Improving legal and regulatory environment   | Derivatives Law and Regulations Development TC – Ukraine   | Covered Bonds Law and Regulations Review TC – Poland<br>Derivatives Law and Regulations Development TC – Morocco           |
| Developing financial market infrastructure   | South-Eastern Europe Trading Platform (SEE Link) TC – trading platform, integrating smaller stock exchanges in the Balkans (managed by Zagreb Stock Exchange, Croatia) | Bucharest Stock Exchange – Romania (investment)<br>Moscow Stock Exchange – Russia (investment)                             |
| Promoting a more efficient transaction environment and expanding the product range | Bucharest Municipal Bond – Romania (investment)  | OTE corporate bond (first mid-term post-crisis bond) – Greece<br>KICB corporate bond (TC and investment) – Kyrgyz Republic |

KICB = Kyrgyz Investment and Credit Bank; OTE = Hellenic Telecommunications Organisation S.A.; TC = technical cooperation project.



context of negative macro-policy changes. Transition gaps narrowed in three countries but widened in six; however, this was due in part to a change in the methodology of calculating transition gaps in 2013.

### **Operations**

- LCM support increased and diversified somewhat after the creation of the LC2 team, which added a much-needed policy dimension. The Bank invested more in corporate bonds and listed equities, and there are cases of legislative and regulatory improvements. However, volumes were relatively small and any observable larger market effects beyond documentation and issuance process will not emerge for some time.
- Standard LC2 products (derivatives law reforms, covered bond law) have been efficiently implemented in several cases, but their range in terms of EBRD banking transactions is limited and they do not always directly target country priorities (as identified in needs assessments and country strategies). However, their availability does promote hedging and creates a platform for financial market intermediaries, including the EBRD, to offer a greater range of local currency products.
- The impact of portfolio-type investments on LCMs has been largely limited to corporate bond markets in Poland and Romania where the Bank was an anchor investor; but there is limited evidence that this has lengthened their average maturities. Bond investments in Turkey were accompanied by policy dialogue to create a new bond index. Investments into stock exchanges have had positive effects on corporate governance, settlement connectivity and transparency, but improvements in secondary market liquidity have

been patchy. There were only three investments into institutional investors (all life insurance companies).

### **Technical assistance and policy dialogue**

- Many technical cooperation projects achieved their targeted outputs, but they often lacked any focus on the larger strategic priorities identified in needs assessments; relatively little technical cooperation went to larger countries seen as most ripe for LCM investments. Rapid response interventions focused on ad hoc needs.
- Technical cooperation needs for the initiative were projected to be significant. The initial small technical cooperation budget was supplemented ad hoc (mainly from the EBRD Shareholder Special Fund), but this has been insufficient. Supplementary donor funding, particularly for European Union and Turkish markets, has been difficult to obtain, although recent allocations have helped.

### **Organisation and resources**

- While the dedicated LC2 team was created to improve organisational focus and processes to implement the strategy, pre-existing sector and regional reporting lines remained unchanged. Consequently, it is unclear how strategic and operational choices are made. A steering committee created to guide the initiative provided limited strategic guidance or coordination and was subsequently replaced by quarterly liaison meetings with stakeholders.
- The LC2 does not have a strategic resourcing plan, and resources appear insufficient to meet its challenges and aspirations. The team relies heavily on external and often short-term staffing resources; consequently member turnover has been high.

## Recommendations

- The Bank should prepare a new LC2 strategy with much greater focus on LCM development. The strategy should clearly articulate the Bank's strategic objectives and its envisaged role and operations. It should also incorporate:
  - alignment with the new 'transition' concept
  - inclusion of a results framework based on clear performance benchmarks for key target countries
  - clear definitions of LCM objectives, effects and instruments
  - a template for treatment of LCMs in new country strategies
  - an objective consideration of the Bank's experience with operations, organisation and resources.
- The Bank also requires a full resource and organisation plan to execute the new strategy, including an organisational structure for decision-making, staff resources in headquarters and resident offices, and specifying the funding needed (and its sources) to support technical cooperation and policy dialogue, including rapid response interventions.
- New country strategies should identify whether LCMs will be a priority for operational work and, if so, should specifically include treatment of LCM development needs and gaps.
- The EBRD should actively consider leading an initiative in the Bank's areas of operation to encourage greater cooperation with other international financial institutions – on diagnostic work, policy dialogue, tackling procedural obstacles to collaboration and targeting joint operations.



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