Chapter 8
Supporting Resilience and Good Governance

Introduction

As part of management’s rethinking on the path of transition, following the global financial crisis, stress was laid on the role of institutions in supporting economic and social development.

The Bank stepped up efforts to bolster those institutions, taking greater steps to create an environment within which the private sector economy could flourish.

At the same time, it worked more intensely on the development of domestic markets that could fuel the sustainable growth of those economies.

Effective markets would build up resilience in the face of future exogenous shocks, while the greater emphasis on institutions helped promote a quality of governance in both the private and public sectors that would galvanise, not stifle, economic enterprise.

Indeed, financial resilience and good governance were characteristics that would become increasingly important in all countries as the decade advanced. The EBRD’s role would be to promote these qualities in fostering the transition of its countries of operations towards a more sustainable future.

Twenty years on from the Bank’s inauguration, it was evident that markets could function without the need for multiparty democracy, as the extraordinary rise of China showed. However, that did not lessen the importance of good governance for their effective operation.

It was also clear that markets could not carry out their function without certain institutional features being present, such as arrangements to ensure effective competition, well-designed macroeconomic and regulatory rules,
the sound application of the rule of law to business activities and central banks’ careful management of access to finance.

The experiences of the EBRD’s countries of operations diverged sharply in some of these respects. Countries that had joined the EU, and many of those aspiring to do so within a foreseeable timeframe—that is, most countries in the Western Balkans—had made good progress in developing better institutional underpinnings to market functioning and market behaviours.¹

Further south and east the post-crisis picture was less promising. Here, economic factions continued to dominate, corruption was endemic and society polarised between political elites and their largely powerless populations. The core institutions that in advanced economies balanced the rights of people across different interests were decidedly weak in most less advanced transition counties, and in some were missing entirely.

The EBRD was unusual in having a political as well as an economic mandate. No other IFI had a similar remit. To become a recipient member of the EBRD, the Treaty establishing the Bank required countries to be “committed to and applying” principles of multiparty democracy, pluralism and market economics.

The exercise of the political mandate in practice manifested itself primarily in a political assessment of whether a country complied with Article 1 of the AEB as part of the country strategy process. In addition, EBRD Presidents regularly conducted important, and sometimes intensive, discussions which touched on political and other governance questions with leaders of countries of operations behind closed doors. But these high-level debates did not of themselves normally resolve the more practical problems deriving from poor governance and weak institutions seen at the operational level.

The development of the private sector in the EBRD regions was often blocked by widespread state-led corruption, mundane bureaucratic hurdles and deficient legal practices that mattered to business, such as insolvency rules or fair opportunities to win public procurement contracts.

A Business Environment and Enterprise Performance Survey (BEEPS) study of MENA, for example, showed how “corruption may be deterring many firms from strategies that require engagement with public authorities, limiting their

¹ See Figure 8.2 below p. 302 and Transition Report 2019–20, Chart 1.1, p. 14.
opportunities. More generally, there was often a lack of basic understanding of how markets work among decision-makers and officials.

It was in this context that an EBRD legal transition team was able to provide valuable assistance. It had been created in the mid-1990s. But now, with a post-crisis focus on the need to improve institutional quality high on the agenda, its work accelerated.

The legal work covered a multitude of issues, but chief among them was an effort to raise legal and regulatory standards and improve the business environment.

As Bank operations picked up pace, and as economies developed, increased attention was paid to strengthening corporate governance, which was poor in many countries of operations. It was only after the first phase of economic development, as small family-run businesses grew larger, that many company owners began to realise the importance of good governance to the future success of their businesses.

Bad corporate practices and corruption not only hampered the smooth evolution of markets but also prevented the banking side of the EBRD from following up potentially valuable deals. Programmes for improvement could strengthen investors’ appetite to provide growth capital and other finance. In the worst cases, often concerning state-owned enterprises, the EBRD was able to offer finance conditional on wider improvements to governance as a way of furthering the transition.

The focus on institutions also received input from a different direction. The original team of political counsellors based in OCE was expanded to include governance experts. The larger group, later spun off from OCE to become the Governance and Political Affairs (GPA) team, developed initiatives aimed at governance at the national policy level and sought more general improvements to the investment climate.

Efforts on better governance by the legal transition and governance teams, who worked closely together, contributed to unlocking institutional impediments to transition progress. They were supported by Chakrabarti as an EBRD President who set particular store by governance matters and related policy discussions with the authorities. The debate leading up to the Transition Concept Review (see Chapter 6) helped further by making

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clear, including to bankers pursuing investments, that ‘well-governed’ was an important quality which needed to be in place for a successful transition to a sustainable market economy.

A second stream of work that also received significantly greater attention after the financial crisis, again as a result of the ‘learning from the past’ process, concerned local currency and capital market development. Like the pursuit of better governance, it was not a new subject for the EBRD. The goal of improving capital markets in the EBRD region, and lending in local currency for operations, had been there from the beginning.

However, clients’ desire for foreign currency had proved to be addictive in the boom times of the early 2000s—a dependency picked out later at one memorable Operations Committee meeting by a senior Committee member confronting an astonished team, who were proposing a foreign currency loan to a client ahead of an all-too-likely devaluation: “Don’t sell them more of these FX drugs. Yes, I mean it, D-R-U-G-S!”

When the crisis came the result for those holding Japanese yen or Swiss franc mortgages was indeed very painful. If an excessive dependency on foreign currency lending was not to happen again—and with the rapid cooling on new transactions on the part of foreign financiers—local capital markets needed to be able to facilitate better the intermediation of domestic savings and make local finance more easily available for investment. The EBRD too needed to be able to offer a wider range of competitive local currency financial products.

This prompted a move, led by the Chief Economist and Treasury departments in 2010, to create a small cross-departmental team and the preparation of what became the first comprehensive initiative, and later strategy, by the EBRD on Local Currency and Capital Markets.

The work tied in with the analysis being done under the Vienna Initiative where regulators, the European Commission and several IFIs were similarly concerned with the failures of capital markets that had been seen in the global and European financial crises.

The internal mix of economists and financial markets’ specialists grew to become a self-standing team, interacting with the Banking and Treasury departments to facilitate projects and technical assistance in several areas.

The core of the work was designed to build up the resilience of countries of operations against financial shocks, one of the transition qualities that acquired greater prominence after the crisis.
Much of the work was directed at weaker transition countries, where it concentrated on improving market infrastructure and the proper sequencing of reforms, starting with better functioning money markets and developing interest rate benchmarks, as well as on the provision of local currency through Bank operations to help smaller businesses less able to access finance from banks.

But there was also work in the advanced transition countries to introduce more sophisticated capital market instruments and mechanisms seen in more developed markets, such as covered bonds, electronic trading platforms and robust company listing arrangements.

This chapter looks at how the EBRD supported resilience and good governance in its countries of operations, two qualities captured by the Transition Concept Review, and the way this played out in practice through the efforts of the Bank, notably during the decade or so after the global financial crisis.

1. STRENGTHENING ECONOMIC RESILIENCE

1. The Role of Financial Markets

“Capital markets are the engine rooms of modern economies,” Chakrabarti said at the 2018 launch of the EBRD’s Strategy for Local Currency and Capital Markets Development. “They help to mobilise and price capital, as well as mitigate risks”, he added.3

Capital market development was one of the key elements in the EBRD’s efforts to deliver resilience, especially in the face of external shocks. The focus on resilience had increased since the financial crises at the turn of the decade.

The Bank had launched a Local Currency and Local Capital Market Development (LC2) initiative in 2010 as a direct result of vulnerabilities that had been unmasked by the 2008-2009 global financial crisis, particularly an overdependence on foreign exchange (FX) borrowing in its countries of operations.

The 2010 initiative provided substance and a systematic approach to a priority that the EBRD’s founders had established from the Bank’s earliest days. The Agreement Establishing the Bank expressly provided that it was a

function of the EBRD “to stimulate and encourage the development of capital markets”.4

As western equity and debt capital markets became increasingly sophisticated, the Bank worked to share these developments with its countries of operations and help them create or deepen their own markets and to diversify risks.

For many countries of operations, it was the money market that needed attention first. Without efficient interbank and treasury bill markets longer term local debt capital markets would not be able to emerge. Economic instabilities in these countries, together with weaknesses in their financial markets, also led to reliance on foreign currency over domestic currency. These factors hampered local financial market development and posed additional risks to financial stability. The EBRD paid particular attention to the underlying causes of these problems and ways to alleviate them.

Over the decades there was solid progress in building up financial markets in most countries of operations, helped by the gearing up of activities after the global and EU financial crises. The Bank was instrumental in bringing forward changes that helped financial intermediation work more effectively, allowing countries to step up to the next level and add to the supply of finance through capital markets. The EBRD was an important and influential force, taking a pioneering role in many market milestones.

Thirty years after the signing of the AEB, as demand for finance by private enterprises rose rapidly as a consequence of the Covid-19 pandemic, an even more intense focus was thrown on the vital need for well-functioning, efficient and transparent financial markets. Demand for capital was rising sharply as finance from all available sources—including from capital markets—was needed to fund cash shortfalls and a post-crisis recovery.

There was still more to be done to address vulnerabilities and deepen financial markets to support a more resilient economic future, even in the capital markets of the EBRD’s most advanced economies.

Foreign or local currency?

However axiomatic the promotion of effective financial markets may have seemed to the early supporters of the EBRD—and perhaps especially so from

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4 Article 2 (v) of the AEB.
the EBRD Headquarters in the heart of the City of London—the goal had not always been so eagerly embraced by the EBRD’s countries of operations.

As became apparent during the global financial crisis, some of the blame for an earlier reluctance to build local capital markets fell on the EBRD itself for so actively—and so successfully—promoting a development model that relied on a dominant banking system and inflows of foreign investment in hard currency.

In its early lending to banks and domestic corporates—such as in Russia where clients preferred to operate in US dollars—the Bank’s business activities were almost entirely conducted in the US dollar and the euro and its precursor, the ECU.

At the same time, there were many apparently financially rational arguments for clients borrowing money at low interest rates in currencies managed by institutionally robust foreign central banks.

What was the balance of risks between local and foreign currency lending and borrowing?

The EBRD perspective

From the EBRD’s point of view, there were good arguments in principle from the beginning for lending and borrowing in local currency to support its operations.

Lending in local currency would reduce unhedged currency mismatches on the balance sheets of corporate and household sectors and extend the maturity of local currency loans available in the market—reinforcing market indices (or creating new ones). Short-term liquidity would return to the domestic economy and the Bank could reduce its exposure to FX risks in projects that generated local currency income and thereby improve their creditworthiness.

By borrowing in local currency, the EBRD could offer a triple-A benchmark as an alternative to the government yield curve, which would increase the transparency of corporate pricing in the domestic market and strengthen market indices, and EBRD debt instruments created an opportunity for credit diversification in domestic investors’ portfolios (and a conduit for international investors).

In practice, however, the Bank experienced difficulties in funding local currency: its offer was limited, demand was weak relative to FX and it was
expensive to arrange and manage. There was strong and growing demand for lending in FX, and with the EBRD’s predominantly hard currency balance sheet requiring matched currency and interest rate risks, local currency matters did not command significant management attention at that time.

Early days of local currency and capital market development

The EBRD’s first tangible example of support for market development was a local currency bond the Bank issued in Hungary in 1994. The funds were used to finance a local currency investment in a Hungarian motorway.

Other issues followed that five-year, inflation-linked forint bond, and in the next eight years EBRD bonds also appeared denominated in the Czech, Estonian, Polish, Russian, and Slovak currencies. The first steps had been taken. More widely, outstanding local corporate bond issues in emerging markets increased nearly tenfold between the late 1990s and 2003.

By 2006, the Bank had also made loans in eight domestic currencies: the Polish zloty, the Russian rouble, the Hungarian forint, the Romanian leu, the Czech koruna, the Bulgarian lev, the Slovak koruna, and the Kazakh tenge.

Extending the Bank’s ability to lend in local currency had some particular transition advantages: it allowed banks to on-lend to riskier sub-borrowers, such as SMEs without foreign currency earnings; it mitigated currency mismatches for corporate borrowers, reducing balance sheet risks and funding costs, allowing room for more investment; and with public sector utilities in several countries legally barred from borrowing in foreign currency, it widened the scope for the Bank’s engagement in the municipal infrastructure sector.

A report by the EBRD’s Treasury and Economics departments published in 2006 underlined the challenges and pitfalls involved in carrying out this complex mission.

The findings reminded readers that previous crises had underlined the importance of diversifying the funding of the private sector away from foreign currency sources, and from short-term domestic bank finance that was also prone to disruptions.

The EBRD’s interventions were meant to help advance local bond markets so they would ultimately become sustainable without IFI involvement,

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in line with the EBRD’s overall transition mandate—only being there when it is needed.

However, the report warned: “The experience has been that developing liquid local bond markets in transition countries is a process that requires lengthy and costly reform of financial regulations and institutions.”

It was, moreover, by no means clear that such markets would ever become viable in those countries that lacked a liquid banking system or where financial transactions were largely conducted in a foreign currency.

Given the havoc that overdependence on foreign currency borrowing would wreak on EBRD countries of operations during the crisis two years later, the report was perceptive.

It noted that currency mismatches on the balance sheets of corporates and households in transition countries had grown following a period of relative exchange rate stability. Banks in these countries had rapidly expanded the stock of their loans denominated in foreign currency, typically but not exclusively in euro or US dollars.

The authors pointed to the lessons of experience elsewhere:

Recent financial crises, most notably in Uruguay in 2002, have underlined that currency mismatches can be an important vulnerability of the financial system ... Balance sheet risks—in terms of currency or maturity mismatches—have proven to be one of the most debilitating features of rapid financial development, with the potential to set growth and poverty reduction back by many years.6

In these early days, local currency bonds were mostly issued in order to raise funding for local currency lending, including by the EBRD, and targeted international investors. These debt instruments were settled off-shore and often listed on the London Stock Exchange, which had the advantage of keeping costs and bureaucracy low.

While valuable in their own right, these operations did not generally support the wider development of domestic capital markets and a more comprehensive solution was needed.

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MosPrime: a benchmark index that supported capital market development

The Bank issued three domestic rouble bonds in 2005 and 2006 that played an important role in the development of the Russian capital market. The five-year floating rate notes worth a total of 17.5 billion roubles provided the benchmark in the market, as the country’s first international triple-A issue.

Much more significant, however, had been the extensive legal and regulatory dialogue between the EBRD and the Russian authorities, involving amendments to 13 laws, to arrive at this stage. The Bank had been working with Moscow since 1999 providing the technical and legal expertise needed to develop a framework for long-term local currency bond issues.

This had led to a new Securities Market Law in 2003, the registration of disclosure regulations for IFIs in Russia, the creation of listing regulations for bonds from foreign issuers and there was now provision for EBRD issues to be eligible for repurchase deals with the Russian central bank.

Finally, and perhaps most visibly, extensive negotiation between the EBRD and Russia’s National Currency Association led to the creation of a new money-market index, the Moscow Prime Offered Rate, MosPrime.

Launched in 2005, MosPrime, was based on the yield for money-market time deposits offered by first-tier banks in the Russian market to financial institutions of comparable credit standing. It quickly became a credible benchmark index and provided a high level of transparency and consistency in pricing. It allowed the interbank money-market to develop greater liquidity, making it more efficient, and eventually led to longer maturities of interbank money market transactions.

To add to its credibility, the EBRD priced all of its domestic Russian bonds off MosPrime and promoted MosPrime pricing as a credible benchmark for commercial loans and local currency bond issues by entities other than IFIs.

In 2006, the EBRD used MosPrime as a benchmark when it syndicated rouble loans to Mosenergo, the Russian power generation company, and Hydro-OGK, the hydropower company. The loans extended the tenors on corporate debt to up to 10 years and helped encourage commercial banks to enter the market.

In 2009, at the height of the global financial crisis, high rates for the MosPrime index as well as unwelcome volatility caused concerns for borrowers. The response from the Russian authorities was to provide the index
with more institutional support and the EBRD pledged to help further deepen and strengthen it.

Following the successful introduction of MosPrime, similar benchmarks developed with the EBRD’s help soon appeared in Ukraine with KievPrime,7 and in Kazakhstan with KazPrime.8

The dangers of excessive FX exposure

Even as the EBRD worked to gain access to finance in local currencies and to pass on the funds in domestic loans, the appetite for low interest rate foreign credit continued unabated.

Potential clients for local currency funding often found the terms uncompetitive9 or they fixated on the interest rate differential and disregarded possible currency risks of foreign borrowing.

There was a logic to the reluctances, especially in less advanced transition countries. Potential borrowers were concerned about volatile domestic interest rates that reflected macroeconomic, and sometimes political, instability. There was little or no opportunity to hedge risks and the domestic pricing mechanism was less transparent than in the larger, more liquid markets. Weak market infrastructure posed settlement risks on top of the pricing and rollover risks.

The shift toward the heavy reliance on foreign currency debt further accelerated after eight of the EBRD’s countries of operations joined the EU in 2004.

As mortgage markets developed in the Baltic States and elsewhere, they were denominated almost entirely in foreign currencies.

In Hungary, hundreds of thousands of FX mortgages were taken out, and by 2008 they accounted for 75 per cent of the total portfolio, compared with just 16 per cent in 2004. Many of the mortgages were in euros, but the overwhelming majority were in Swiss francs.

During the heady days of growth around the middle of the decade, and buoyed by optimism linked to EU access, there seemed to be little risk.

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9 Limited choice and weak regulation in many countries meant banks were able to obtain local deposits at well below base rates while weak competition and high inflation allowed them to charge borrowers high interest rates.
And the prospect of cheap funding to finance aspirational lifestyles was appealing.

As the EBRD’s *Transition Report 2010* explained, Hungary stood out with a particularly large gap between domestic and foreign borrowing rates. A Hungarian household taking out a one-year consumer loan in forints in early 2006 would have been charged interest of about 22 per cent. With inflation running at an annual rate of eight per cent at the start of 2007, the real interest rate paid on the local loan would have been around 14 per cent. The borrower would have paid about seven per cent interest on the same credit in euros which, based on the Hungarian inflation rate and a roughly unchanged euro-forint exchange rate over the year, implied a real interest rate of close to zero.

There was of course an economic reason for high domestic interest rates. In the case of Hungary, they reflected the real possibility of a currency crash and a spike in inflation. An IMF mission to Hungary in 2006 had warned “the state of public finances—epitomised by endemic deficit overshooting—is undermining economic stability and growth prospects” and pointed to “the risk of a fiscally-induced crisis”. The *Transition Report* noted that “consumers borrowing in forints would have been protected from the consequences of such a crash, while consumers borrowing in euros would have seen the local currency value of their debts rise sharply.”

After a long period when the risks had been ignored, the dangers did emerge dramatically as soon as the global and euro area crises struck and currencies in central and eastern Europe came under pressure.

The Hungarian forint lost 66 per cent of its value against the Swiss franc between September 2008 and November 2011, driving the cost of those mortgages and other loans sharply higher and leaving thousands of homeowners in arrears and many in financial distress.

The consequences were long-lasting. As part of a populist move against the banks (most of which were foreign-owned), the government of Viktor Orbán launched a debt relief scheme for FX borrowers in 2011 that allowed mortgage holders to repay their loans at a discount to market rates.

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“I do not want to live in a country ... where one million people must live in debt slavery ... I will change this,” Orbán told a radio programme, adding that the banks had to bear two-thirds of the cost of the programme. The Hungarian measures provoked an angry response, especially from neighbouring Austria, home to many of the mortgage lenders.

A reassessment of the financial development model

The EBRD’s 2009 Transition Report, issued in November of that year, took a long, hard look at the development model for the transition region. This model, as Chief Economist Erik Berglof said in his foreword, had “cut both ways”. The very close economic ties with more advanced countries and a financial dependence on them had made many transition countries highly susceptible to the crisis in the West.

It was, however, precisely those links that had managed to mitigate the impact of capital outflows, help develop more mature institutions and also galvanise international support just when it was most needed. “For all these reasons, this crisis has not spiralled out of control,” Berglof said.

Nevertheless, that double-edged development sword had been particularly apparent in the financial sectors of the EBRD’s countries of operations. Financial integration had led to excessive private sector credit growth and excessive private sector debt levels. Berglof continued:

It is also likely to have encouraged indebtedness in foreign currency, which has complicated the crisis in many countries. The lesson from this experience is not to attempt to reverse financial integration—that would be both unfeasible and unwise—but to mitigate its risks, particularly through policy frameworks and institutional development that address the problem of foreign currency lending and that lead to a better management of future booms.

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12 Reuters, 28 October 2011. ‘Hungary PM will save Hungarians from FX debt “slavery”’.
13 Further measures were taken against the banks in the following years, including a Borrowers’ Refund Scheme in 2014.
14 EBRD Transition Report 2009, Foreword.
The need for a more robust framework

While the *Transition Report* concluded it would be wrong to reverse or fundamentally change the development model there were a number of key policy conclusions that had to be drawn. One of these was that: “The transition region must deal with the bias toward FX lending, which could continue to pose a threat to stability.”

The available evidence suggested the need for a three-pronged strategy. First, it was important to build credible macroeconomic frameworks and institutions that focused on stable inflation and allowed exchange rate flexibility, where that was possible.

Second, local currency money and bond markets had to be developed in a systematic fashion, with limited subsidy, in order to extend the sources of domestic funding and make it easier to price domestic currency loans at longer maturities.

And third, there had to be regulation that limited foreign currency exposure in the banking, corporate and household sectors.

The report made clear that the first condition was a *sine qua non* of the process. A credible macroeconomic framework and low inflation volatility were preconditions for local currency market development. Without them, local issuance with longer maturities would be prohibitively expensive. Furthermore, any form of regulation that put a limit on foreign currency exposure would make no sense if that foreign borrowing were a response to an environment of volatile domestic inflation.

Regulation had plenty of useful roles to play, especially in the more advanced countries with stronger institutions. But in less advanced economies, there could be no substitute for tackling the most basic economic problems:

Less advanced transition countries in which macroeconomic institutions are relatively weak need to focus above all on strengthening their fiscal frameworks and enhancing the credibility of their monetary policy institutions.

2. The Local Currency and Local Capital Markets Development Initiative

The 2009 *Transition Report* was a prelude to the launch in 2010 at the EBRD’s Annual Meeting in Zagreb of the Local Currency and Local Capital Market
Development (LC2) Initiative that was a collective enterprise on the part of Banking, Legal Transition, OCE and Treasury.

The LC2 Initiative was an important part of the EBRD’s response to the global financial crisis and the weaknesses in the system that it had unmasked.

Vulnerabilities due to FX lending combined with poor standards of information and credit assessment were now clearly visible. Unsustainable external imbalances were widely recognised.

Significantly, the new initiative made the point that local capital markets development had to be a priority even for those countries on their way to becoming members of the eurozone.

The EBRD countries of operations that had joined the EU in 2004 and 2007 had also signed up to adopt the euro, whenever the conditions were right. Some market commentators at the time said this had led to capital markets lethargy, as euro membership was seen as some sort of panacea for problems linked to raising capital safely.

But the EBRD initiative made clear that this capital markets development work “even for eventual eurozone members [is] not a detour” 15.

What was clear as the initiative got underway was that the response to the lack of appetite for local currency borrowing was a much bigger exercise than just making local currency available.

The Bank and its partners needed to focus on all the factors that explained the lack of local currency and capital markets development, including the histories of inflation volatility and lack of macroeconomic credibility and the inadequate market infrastructure. It had to address a poorly regulated and undercapitalised banking system, as well as institutional and legal weaknesses.

It was also important to take into account vast differences that prevailed across all of the EBRD regions at this time. There was no one-solution-fits-all for economies which had attained very different levels of market sophistication—or no market sophistication at all.

The main contribution the EBRD could make lay in its unique combination of a role in promoting sound policies in the region and the operational demands of providing investment capital.

Under the initiative, it would establish a diagnostic framework that would identify obstacles to capital markets development and local currency funding and lending.

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It would work together with governments, partner IFIs and the private sector to provide technical and policy advice, especially in the legal and regulatory area and on market infrastructure. It would be predicated on evidence of government commitments to macroeconomic stability.

It would continue to strengthen risk management and the capitalisation of the banking sector.

It would undertake its own local currency funding to support the development of the markets as well as EBRD projects.

It would develop demand for local currency assets from domestic institutions by actively supporting pension funds and insurance sector development and, in coordination with other investing IFIs, it would work to “make markets” in the domestic currencies.

The initiative broadened the EBRD’s approach. Whereas previously the Bank had primarily focused on reforms that would allow EBRD funding and lending in local currency, the focus now was on actions that benefitted the development of local capital markets and local currency funding.

Specifically, in the less advanced transition countries the focus—with guidance from the IMF—would be on trying to change inflation expectations, adopting a consistent approach to the use of local currency and helping to shift sovereign debt management towards domestic funding sources.

One priority was to ensure that any foreign exchange regulation aimed at discouraging the use of foreign currency borrowing made economic sense and did not just end up cutting the economy off from all sources of credit.

Launching the initiative at the EBRD Annual Meeting in Zagreb, Berglof, said:

The crisis laid bare the region’s twin vulnerabilities of excessive reliance on foreign capital and excessive use of foreign exchange borrowing. As the recovery takes hold in the region, it is important to urgently address these vulnerabilities, with a fresh eye and approach that fuses the knowledge and expertise of key stakeholders: governments, IFIs, the banks and other private sector stakeholders.\(^\text{16}\)

\(^{16}\) EBRD Press release. 15 May 2010. ‘EBRD launches local currency and local capital markets initiative’. 
The Vienna Initiative’s role

The new initiative put a significant emphasis on a collective response that involved all of the major international financial institutions. Already ahead of the launch, in a drive led by the EBRD, officials involved in the Vienna Initiative, the private-public platform that had been established to coordinate the response of market participants to the immediate impact of the global financial crisis, were working on a plan.

In March 2010, Piroska Nagy-Mohácsi, EBRD Director of Country Economics and Policy and a driving force of the first iteration of the Vienna Initiative, delivered a call for action to a meeting of the Vienna Initiative in Athens as it contemplated a new phase, Vienna Plus.

She laid out the problems that had arisen from currency and capital markets weaknesses in a positive way, stressing that strong and sustained growth in emerging Europe was in the interest of every stakeholder present. The “time is right”, she said, to address the region’s twin vulnerabilities: excessive reliance on foreign capital and FX lending to unhedged borrowers. Efforts had to be directed towards “reforming the growth model”.

This was a problem to which the Vienna Plus community could respond. It needed to be fixed and there was a road map. “Let’s do it!” was Nagy-Mohácsi’s appeal to the group.

The EBRD led what was to become the Vienna Initiative Working Group on Local Currency and Capital Markets Development, whose report was formally approved by a Full Forum Meeting in March 2011 in Brussels.

The Working Group came up with a division of labour between the key stakeholders in the local currency debate: the authorities in the regions, the banks and the IFIs.

It was the responsibility of the authorities primarily to ensure macroeconomic stability and a low inflation environment. However, there was also a need for them to address the risks of foreign currency exposure to borrowers without foreign currency income.

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17 See Chapter 2.
Banks had to strengthen risk management procedures to take into account the higher credit risk of unhedged borrowers in foreign currency. Other steps included proposals that they discontinue the riskiest forms of foreign currency lending to unhedged borrowers and that they themselves proactively participate in local currency funding.

It was up to IFIs, including the EBRD, to coordinate their support for governments in their pursuit of policies conducive to the use of local currency and in the development of local capital markets, “according to their remit and expertise”.

For investing IFIs like the EBRD, this included helping develop local currency longer-term funding instruments and markets, the investor base (pension and insurance funds) and lending in local currency.

The Vienna Plus effort had wide applicability but was focused very directly on the EU and its immediate neighbourhood. Further afield were EBRD countries of operations which had largely escaped the worst of the calamities that beset the main European arena but were no less vulnerable. Here, macroeconomic instabilities and weak financial market infrastructure and regulation were particularly significant and a cause of poor economic resilience. But the Bank continued to face difficulties in the provision of local currency in those markets and a further effort was needed.

Help for Early Transition Countries (ETCs)

One specific offshoot of the EBRD’s 2010 LC2 initiative had been a local currency loan programme aimed at the least advanced EBRD economies, the Early Transition Countries (ETCs) in Central Asia and the Caucasus.

Their exposure to the dangers of almost exclusive borrowing in US dollars had followed local currency devaluations of up to 30 per cent that coincided with a growing risk aversion on the part of international investors towards these markets.

Most of these economies were highly dollarised and local currency interest rates were high, which reflected the significant levels of risk and limited development of their financial markets.

The particular problem facing the EBRD in lending local currency to banks and corporates in the ETCs was the high cost of funding. Sourcing these little-traded currencies was difficult and expensive, and high margins were needed on top for risk and sound banking reasons. As a result, the
EBRD local currency offer was not competitive even against local banks’ lending at double digit rates.

To make headway, the Bank needed both to pursue policy dialogue with the authorities to upgrade the financial infrastructure and to be able to increase local currency lending to clients in these economies.

In February 2011, the Board approved a new programme, the ETC Local Currency Loan Programme, whereby the EBRD and each participating country would agree an MoU under which the Bank and the local authorities pledged to work together to create an environment that was conducive to local currency and capital market development. The EBRD would then follow up with lending in the local currency to financial institutions, corporates and SMEs.

The programme aimed for a better match between lending currencies and revenues to reduce insolvency risk at the micro level and to reduce the increasing systemic risk from dollarisation in the financial sector at the macro level.

The Bank was able to use a grant-funded risk facility to deliver its local currency lending to the ETC countries under the programme, with a significant reduction in its margin which allowed it to price its loans closer to market rates.

Financial support for that facility came from an ETC Local Currency Risk Sharing Special Fund that combined EBRD capital and donor grants.

Early loans under this programme included credits to micro-lending organisations in Tajikistan and the Kyrgyz Republic, boosting the availability of Tajik somoni and Kyrgyz som loans to local entrepreneurs.

By the following year, the Bank had reached agreements on local currency lending with five of the ETC countries: Armenia, Georgia, Kyrgyz Republic, Moldova and Tajikistan and management was quickly able to report real progress.

An update to the Board in April 2012 said:

The Programme has begun to lead to a shift in the Bank’s lending in the MoU Countries away from the US Dollar into local currency. Since the start of the Programme, 48 per cent of the EBRD loans signed in 2H2011 that were eligible for the Programme were signed in local currency—a significant increase over 18 per cent in 2010 and 10 per cent in 2009.20

The EBRD was able to support its local currency lending to ETCs via its connection with the Currency Exchange Fund (TCX), an organisation in which the EBRD was an investor and which helped hedge currency risks. The EBRD funded itself in the local currency of the relevant ETC on the back of currency swaps with TCX, a specialist in “exotic” currency hedges.

**A focus on local currency lending to SMEs**

By late 2015, the ETC programme had expanded to include Mongolia and was showing signs of success.

In January 2016, the Board approved a new, similar programme—the SME Local Currency Programme—that broadened the original initiative and extended it beyond the ETCs.

The new programme had three components, the first of which was EBRD-led policy dialogue and technical cooperation to improve domestic financial intermediation in local currency, supporting capacity building for central banks in areas like policy formulation.

Second, it would broaden the range of instruments that the EBRD’s Treasury team was able to use to fund and hedge its local currency exposures, so as to step up further availability of local currency funding for SMEs.

The third component was a US$ 500 million Local Currency Lending Facility that would lower the premium on interest rates on EBRD SME local currency loans over domestic market rates, by reducing the Bank’s margin on its loans with the help of funding from donors to provide a first-loss guarantee to the EBRD.21

The earlier programme had just been open to ETCs. The new facility was available to all EBRD countries of operations that did not use the euro as their local currency (de jure or de facto), and which still had transition gaps as far as MSME financing was concerned.

The number of countries signing up for the programme continued to increase and, by 2020, 15 countries were involved: Albania, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Kyrgyz Republic, Moldova, Mongolia, Morocco, Serbia, Tajikistan, Tunisia, Ukraine, and Uzbekistan.

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21 Funding came from donors to the ETC Multi-Donor Fund (active donors: Canada, Finland, Germany, Ireland, Japan, Korea, and Luxembourg), the US Treasury, Switzerland’s State Secretariat for Economic Affairs (SECO) and Japan, as well as from the Shareholder Special Fund (SSF).
In December 2020, the facility was increased to US$ 600 million, in response to rising demand during the Covid-19 pandemic.

3. Raising Regulatory Standards and Capital Market Innovations

Another key element in the 2010 LC2 Initiative was the development by the EBRD’s Legal Transition team of new tools to assess the relevant legal and regulatory framework in individual countries of operations.

Although the analysis revealed country-specific trends, there were common themes where the EBRD could take an advisory role, including in issuance and listing procedures, a legal framework for derivatives and repurchase agreement (repos), the insolvency treatment of bondholders and credit rating requirements.

In more advanced countries like Romania and Hungary, the development of secured products, in particular covered bonds and simple transparent securitisations, was identified as an important step.

Covered bonds

In subsequent years, the EBRD was to assume a leading role in the development of the market for covered bonds, which it saw as an important and efficient source of long-term funding for credit institutions.

In the covered bond market, banks issue mortgages to customers and these mortgages are then ring-fenced and used as collateral for bonds sold to investors.

According to Jacek Kubas, who leads the innovation group of the EBRD’s Capital Markets Development (CMD) team, this long-term funding tool has huge benefits for issuers, investors, market participants and the general public.

“Especially in central and eastern Europe, this has grown into an important source of stable funding,” says Kubas who has been a major proponent of the instrument within the Bank. He added:

A well-functioning covered bond market made an important contribution to more affordable housing. With this stable, fixed-term funding source, credit institutions are in a much better position to provide affordable mortgages for consumers and businesses.
The EBRD teams led the way in providing support for legal and regulatory reforms to help the development of the covered bond market in the region.

In Poland, the EBRD played an active role. In response to a request from the Polish Ministry of Finance, the Bank worked on drafting legal provisions for the new law which was approved by the Polish Parliament and entered into force on 1 January 2016.

The EBRD followed up this legal work with a 50 million zloty (approximately €12 million) investment in 2017 in the first zloty-denominated covered bond issue by PKO Bank Hipoteczny, providing PKO with access to long-term funding for its mortgage loan portfolio.

Two years later, PKO Bank became the first Polish institution to issue “green” covered bonds, where the funds were used to finance residential buildings that reduce greenhouse gas emissions and to provide a new capital market instrument for PKO to finance green mortgages.

The EBRD took part in the issue, taking up 20 per cent of the total 250 million zloty bond, in what was the first project under a new EBRD Green and Sustainability Bond investment framework targeted at financial institutions.22

In Romania in 2015, there had been no covered bond issuance since the adoption of a covered bond law in 2006. The EBRD played a significant advisory role in developing an updated covered bond law that was passed by the Romanian Parliament in September 2015.

As with PKO Bank in Poland, the EBRD followed its advisory support with an investment in Romania’s first covered bond, taking a €40 million portion of a €200 million offering from Romania’s Alpha Bank.

Similar legal support took place in the Slovak Republic, the Baltic States and Croatia.

In addition to the covered bond investments in Poland and Romania, the EBRD also supported issues in Greece, Hungary, Turkey, and the Slovak Republic.

By the end of 2020, the EBRD had invested a total of €788 million in covered bonds across its regions.

22 Green bonds are also discussed in Chapter 9.
Sequencing financial market development

The launch of the LC2 Initiative in 2010 took place alongside the EBRD’s 2011–2015 strategy, Capital Resources Review 4, which placed capital market development at the very top of its list of strategic initiatives for the period. Under the rubric of Building Stable Financial Sectors, it said:

The Bank will draw on its comparative advantage in promoting sound balance sheets and risk practices in financial institutions. More broadly, it will make a concerted effort, with other IFIs, to accelerate the development of local capital markets in order to reduce systemic vulnerabilities.23

In 2013, the EBRD took its engagement in this area to a new level with the elaboration of a more wide-reaching strategy. On 10 December, the Board formally endorsed the new LC2 Development Strategic Initiative.

A year earlier a designated team of experts had been created to spearhead the strategy. The role of this team (originally called LC2 and later CMD), headed initially by Estonian banker André Küüsvek, was to coordinate, support and complement the LC2 related activities of Banking, Treasury, OCE and the Office of the General Counsel, through a combination of policy dialogue, transaction design and support, and capacity building.

The strategy brought together the strands of thinking that had been developed during the first years of the original initiative. This was encapsulated in a pyramid model demonstrating the sequencing needed to support successful financial market development based on an IMF paper.24

Jim Turnbull, a financial markets veteran and Deputy Director in the CMD team, said the pyramid underscored the importance of proper sequencing and ongoing diagnostics in the development of capital markets. This could not be underestimated, he said: “The message is crystal clear. For it to be sustainable, only do the next level of capital market development work that is appropriate and builds on the existing level of development.”25

23 Capital Resources Review (CRR 4), President’s Recommendation, p.2.
25 Interview, February 2021.
The team had clear objectives that were approached on a Bank-wide level, including upgrading capital markets policy frameworks, enhancing legal and regulatory environments, improving capital market infrastructure and expanding the product range and investor base across the EBRD’s countries of operations.

There were in the coming years strong examples of areas where the EBRD led the way in pioneering market developments that were creating real change to strengthen financial resilience.

A pan-Baltic capital market

One specific focus was on the Baltic countries, Estonia, Latvia, and Lithuania, three EU states with relatively sophisticated markets, but whose small size was holding them back from making more progress.

The EBRD worked closely with the European Commission and the relevant local authorities to launch a pan-Baltic capital market, forging an agreement that in the first instance harmonised capital market regulation and broke down investment barriers.

An MoU to this effect was signed in November 2017, with the EBRD providing both policy support and investments in specific projects that underpinned the market development.
The support for a covered bond market in the region was just one example where the Bank helped deepen market links across the Baltics.

The Bank was also involved in dialogue with index providers, such as MSCI and FTSE-Russell, to have the Baltics States classified as an emerging market under a single rating. This would attract a larger share of passive investor capital since the markets were unclassified or classified as frontier markets due to their small size.

In 2020, the EBRD was also supporting the creation of a pan-Baltic commercial paper market that aimed to address the short-term needs of corporate borrowers who were urgently seeking alternative sources of working capital financing, because of the contraction of the banking sector following the outbreak of the coronavirus pandemic.

Capital market support for eastern Europe and the Caucasus

In the same way that the EBRD had supported the development of the covered bond market in its regions, it also worked closely with the authorities in a number of countries in successfully delivering laws and regulations governing the use of derivatives that aimed to deepen the markets and allow more effective hedging of market risks.

Already in 2016, the Armenian parliament passed a package of laws on the financial markets, described by the then head of the EBRD’s Yerevan operations, Mark Davis, as a “milestone”. The EBRD had provided technical cooperation to support the drafting of the legislation, complex work involving amendments to 17 laws and the introduction of 15 new ones. The new rules provided for the enforceability of derivatives transactions, including “netting and close-out netting”—mechanisms for reducing risks associated with derivatives deals.

The EBRD worked for nine years with the Ukrainian authorities on a law passed in June 2020 that created the legal and regulatory framework for derivatives, helping Ukrainian entities such as banks, farmers and manufacturers, to hedge their foreign exchange exposures.

The Georgian parliament passed new financial market laws in early 2020, with the EBRD again helping with drafting and capacity building exercises, in coordination with the International Swaps and Derivatives Association (ISDA).

Before this, the EBRD had notched up a series of firsts on the Georgian capital markets. In March 2014, the EBRD launched the first ever bond
Transforming Markets

issued by an IFI in Georgian lari, a key step in securing the local currency for local transactions. Then, in April 2017, the EBRD issued its first Eurobond denominated and settled in lari; and in July of the same year, the EBRD took part in the first secured corporate bond denominated in lari, a first both for Georgia and the wider Caucasus region.

Capital markets innovations and linkages with transition goals

There were many other examples of the EBRD’s pioneering role in individual projects.

In 2020, the EBRD invested in the first green bond issue in Greece, a €500 million offering from National Bank of Greece (NBG).

The bond was aligned with the International Capital Market Association’s (ICMA) Green Bond Principles, which recommend transparency and disclosure, and promoted integrity in the development of the green bond market.

Another transaction that combined the EBRD’s commitments to capital market development and low carbon transition was an investment in Poland in November 2020 in the first ‘energy transition’ linked bond from one of the country’s largest energy companies. The Bank signed up to 24 per cent of a 1 billion zloty bond issued by the Tauron group to support its decarbonisation strategy.

This was not a ‘green bond’ but an issue that helped Tauron implement an ambitious strategy to reduce its carbon footprint. The company was planning a fundamental shift away from coal-based electricity generation, by closing down coal capacity, expanding its renewable portfolio of wind and solar over the coming years and investing in its distribution network so it could absorb more intermittent renewable energy generation.

With the ‘transition bond’, Tauron was making a clear signal of a change in direction to investors and stakeholders by including in the bond terms formal commitments to cut its CO₂ emission intensity and increase renewables capacity. It was the first time a Polish utility had issued a bond with such commitments, explicitly targeting decarbonisation investments.

Another element in this particular issue was that it was an important step in the EBRD’s Just Transition Initiative, which aims to provide social protection to economies as they move away from high-carbon energy generation.²⁶

Tauron’s operations are primarily located in Silesia, the largest producer of hard coal in Europe, where mining employs 80,000 workers, or about five per cent of the regional workforce. One of the covenants in the bond issue committed Tauron to a programme to address the social impacts of closing coal generation operations.

Similarly, in Turkey, the EBRD tied a capital market innovation to an investment in the largest local energy company, Enerjisa Enerji. In August 2017, the Bank invested 100 million Turkish lira (€24 million) in an inflation-linked bond from Enerjisa Enerji. This was the EBRD’s first investment in an issue linked to a consumer price index. At five years, the issue had the longest tenor for a local currency instrument from a Turkish company.

Local currency borrowing is particularly important for utilities where revenues are usually overwhelmingly denominated in that currency. However, the CPI link was an added benefit for distribution companies like Enerjisa Enerji, whose revenues are also often tied to the inflation rate.

In the municipal bond sector, the EBRD supported a ground-breaking issuance by the City of Bucharest in 2015. A single maturing Eurobond which increased both currency and refinancing risk to the City, was replaced by four local currency benchmark issues with maturities of three, five, seven and 10 years—immediately resulting in a local currency yield curve benchmark for pricing municipal debt in the country. The EBRD participated in the seven and 10-year tranches to build investor confidence in longer dated issuance.

A further local currency transaction followed in Croatia where Zagreb Holding issued a local currency municipal bond which was largely purchased by local pension funds.

Stock exchanges

During this period, the EBRD also looked to increase its influence on stock market developments by directly investing in some exchanges, where the status of shareholder allowed the Bank to nominate candidates for election to the boards of directors and seek improvements in corporate governance.

It had already in 2012 bought a 6.29 per cent stake in Russia’s MICEX-RTS stock exchange, a holding it continued to maintain, despite the lack of new investment by the EBRD in Russia since 2014.
In 2015, the EBRD took a 10 per cent stake in Borsa Istanbul, only to sell it four years later following a disagreement over the appointment of a new CEO.

The EBRD still has holdings in the Bucharest stock exchange, the largest bourse in south-eastern Europe, which it bought in 2014, and in the Zagreb stock exchange, which it acquired in 2016.

In a separate development in south-eastern Europe, the EBRD played an important role in the development of SEE Link, an innovative platform that, initially, united the Bulgarian, Croatian and Macedonian stock exchanges. The three exchanges set up the SEE Link company, based in Skopje, in May 2014 and the platform became fully operational with the launch in March 2016 of an order routing system that the EBRD helped establish with a €540,000 grant.

SEE Link also created its own indices, which aimed to give the markets more visibility and greater transparency. The initial three members were subsequently joined by bourses from Belgrade and Ljubljana in December 2016, and Banja Luka and Sarajevo in August 2017.

In 2020, the EBRD teamed up with the investment bank Wood and Company to launch a dedicated research programme for SMEs listed on the exchanges of six south-eastern European economies, in Bulgaria, Croatia, North Macedonia, Romania, Serbia, and Slovenia.

At the launch of the research programme, Ivana Gažić, President of the Management Board, Zagreb Stock Exchange (ZSE), said the programme was a logical next step for the development of the SEE Link area of operations. “The lack of information about companies is often the main obstacle to making investment decisions and discovering the region’s potential,” she said. 27

Kubas noted that even though an important step had been taken to give these markets scale by bringing them together on a single platform, more work was needed to increase trading volumes, with further development in the individual jurisdictions and an integrated post-trading structure. 28

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28 Interview, February 2021.
4. EBRD Treasury and Markets Development

Local currency

Axel van Nederveen, a Dutch capital markets expert and EBRD Treasurer since 2004, has overall responsibility for the Bank’s Treasury and funding operations and liquidity management. Treasury plays a key role in financial markets development, especially through funding local currencies and on the money market side.

Van Nederveen argues that the international development community could do more to develop local currency finance, even though there has been an increased awareness of its importance, and the challenges, since the 2009 crisis.

In a 2019 paper,29 Aude Pacatte, Head of Portfolio Management, and van Nederveen said that issuance of local currency bonds per se by international institutions was not the panacea to unlock local currency lending and local financial markets development that they were supposed to be.

Quite often, the proceeds of such bonds had been used as relatively cheap arbitrage opportunities via swaps back into hard currency, rather than for on-lending to companies that needed access to sources of local currency. They argued that the focus should be on the development of local financial markets “in a more holistic manner” and concentrate, as in the EBRD’s case, “first and foremost on creating a local currency loan offering that is in the best interests of our clients”.

This could be accomplished by overcoming capacity constraints and offering wider advice than just securities market law reform. They wrote of the EBRD’s approach:

To overcome the issues of lack of capacity to borrow local currency and timing mismatches between investor demands and borrowers, we borrow from [the] domestic investor pool, by and large banks, on a floating rate basis … This … accommodate[s] clients’ needs in terms of interest rate and maturity.

The fundamental advantage to this method, said the authors, which distinguishes it from the more restrictive, traditional back-to-back approach, is that “we are ready to manage risks on our balance sheet to borrow and

29 A. van Nederveen and A. Pacatte, ‘Local currency finance: Development must or nice to have?’, July 2019.
on-lend at different times in different forms”. This means: “We have the willingness and capacity to bridge market gaps or imperfections by absorbing the associated risks within our balance sheet.”

Turning to advice and other capacity improvements, van Nederveen and Pacatte suggested many factors were needed to increase local currency financing, including better macro frameworks, legal changes that supported new products and improved market infrastructure. They insisted that operating as a market participant in local markets, as the EBRD does routinely, made a significant difference.

The Treasury paper listed the obstacles in the way of capital market development, including high domestic interest rates, incomplete legal frameworks and the failure of banks to provide a diverse range of products.

It also highlighted the lack of an analytical toolbox, referring to the fact that the international community had not agreed clear understandings on the specific state of development of any particular market or what the next logical development steps might be, leaving governments “inundated with conflicting advice”.

In response to this challenge, the EBRD developed a money market diagnostic framework in cooperation with the financial markets’ development company, Frontclear, which it used in a number of countries, contracting the consulting firm OGResearch to run the diagnostics.

The framework measured money market development across a series of different criteria, providing a much clearer assessment of gaps compared with the “best of class” markets and facilitating the choice of optimum responses. By 2021, OGResearch was running diagnostic assessments in Armenia, Azerbaijan, Belarus, Egypt, Jordan, Mongolia, Morocco, Russia, and Uzbekistan.

The EBRD combined the diagnostic with Money Market Working Groups (MMWGs) which bring together the major banks and the central bank and the EBRD as an advisor. It is up to the working groups to use the results of the diagnostic framework to formulate the next logical financial market development steps.

Money markets

The original purpose of the MMWGs had been to help in the reform of money market benchmarks or the creation of such mechanisms where they did not already exist.
In just the same way that the EBRD Treasury department had helped with the creation of the MosPrime benchmark in Russia in 2005, it was also instrumental in establishing new money market benchmarks in a number of countries of operations.

The Bank had supported the calculation of the Rouble Overnight Index Average (RUONIA) that Russia introduced in 2010 and then worked with the Russian monetary authorities in subsequent years on further developments. In line with its policy of making transactions in the markets that it helps create or promote—having “skin in the game”—the EBRD traded the first rouble Overnight Interest Rate Swap after the RUONIA launch.

It subsequently also issued Eurobonds linked to ROISfix, an index of fixed interest rates for which RUONIA was the underlying instrument and inaugurated a rouble interest rate swap derivative also based on ROISfix.

More recently, the EBRD worked in cooperation with the authorities in its countries of operations on money market benchmarks in line with reforms for major currencies in other jurisdictions, in preparation for the switch to “risk-free rates” (RFRs) from the London Interbank Offered Rate (LIBOR), such as SONIA in the United Kingdom, or EONIA in the eurozone.

The EBRD assisted with the methodology for Georgia’s Tbilisi Inter Bank Rate (TIBR) that was launched in August 2018, in what the National Bank of Georgia said was “of great importance for the development of the GEL money and capital markets” and which could be used for both cash and derivatives contracts.30

With similar support from the EBRD, Turkey introduced the Turkish Lira Overnight Reference Rate (TLREF) in June 2019, and Egypt launched the Cairo Overnight Interbank Average (CONIA) benchmark two months later.

Morocco and Ukraine introduced, respectively, the MONIA and UONIA benchmarks in 2020 and a reformed TONIA benchmark for the Kazakh tenge has been in place since the end of 2020.

In all markets where viable money market benchmarks have been created, the EBRD supports their usage by using the benchmarks in its own transactions, be they loans, derivatives or bonds.

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30 The National Bank of Georgia website: www nbg gov ge
In June 2020, Ukrainian economist Alexander Pivovarsky took over the LC2 team from Küüsvek and, after a review of responsibilities relating to its activities across the wider Bank, the group was renamed Capital Markets Development (CMD).

Pivovarsky stressed that the EBRD’s capital market objectives remained unchanged and that the team’s support for policy reform and product development would continue. It was, he said, important to ensure that progress in capital markets development be appropriately recognised in the operational assessments of transition and that activities were further mainstreamed across the Bank.

Looking to the future, Pivovarsky pointed to the very strong emphasis on data gathering and analysis and the ability to assess market development. Similar to the money market diagnostic frameworks established in a number of countries, the Treasury, CMD and other groups were working on a financial markets development index. Although still embryonic, the envisaged index would provide a systematic assessment of capital market development across a series of pillars—including macroeconomic policies and stability, the legal and regulatory environment, and market structure and access.

Pivovarsky said the index would help determine what was really a priority for any country, with dialogue based around facts rather than hopes. With the backing of the index, it would be easier to articulate what the operational teams were doing and why.

At the start of 2021, it was becoming increasingly clear that the mobilisation of alternative sources of financing through capital markets would be needed to support post-Covid 19 recovery in the EBRD’s countries of operations. Funding needs were expected to be above the capacity of the banking system to deliver, making the ability to attract private capital key. Stronger capital markets help to increase the “shock absorption” capacity of the wider economy.

Against this backdrop, Pivovarsky considered continued EBRD support for capital market reforms was essential. The EBRD could also play a role of “honest broker” in light of a growing role of the state in the economy and increased demands on national authorities in response to the crisis.

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31 Interview, 2021.
The EBRD’s further support to create well-functioning, efficient and sustainable capital markets was expected to help financial sectors across its regions meet their post-Covid economic goals and contribute to the economic resilience of countries of operations.

II. GOOD GOVERNANCE

6. Good Governance and Economic Performance

In her foreword to the 2019 Transition Report, called “Better Governance, Better Economies”, the EBRD’s newly appointed Chief Economist, Beata Javorcik, wrote: “Good governance matters. ... There is a significant economic and social dividend to be reaped from improvements in governance at country, region and firm level.”

The Report emphasised the importance of strong governance as one of the six key qualities of a well-functioning economy.

Jarvorcik gave three reasons why poor governance was detrimental to performance. It creates uncertainty which is bad for business investment and causes stress to people which “discourages them from investing in their futures”. Second, it damages competitiveness. Corruption imposes costs on businesses, education and access to health services from the need to pay bribes and the delays involved. The third reason was that it leads to an unlevel playing-field by conferring advantage on certain groups, to the detriment of others. Inequality of opportunity leads to an inefficient allocation of resources and disillusionment with political institutions.

The EBRD’s analysis showed that while there had been clear improvements since the 1990s in the “governance gap” of transition countries relative to advanced economies (see Figure 8.2), this had now mostly come to a halt, and in some cases showed signs of reversal.

Yet, it was estimated that:

Closing half the gap between the quality of economic institutions in the EBRD regions and the G7 average would boost income growth per capita by an average of 0.9 percentage points a year across the EBRD regions as a whole.

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There were two countries in the region, Georgia and Serbia, which showed how economies that achieve particularly remarkable improvements in governance (relative to the global average) outperform their peers. Over the period 1996-2017, the report said, Georgia’s improvements in governance allowed it to grow 3.5 percentage points a year faster than might have been expected, compared with economies with similar per capita incomes; in Serbia, the figure was 1.2 percentage points a year on the same basis.

There were other important findings, for example that emigration was greater and regional disparities worse when governance was poor.

In the case of Albania, the report suggested that if a “newly established confidence” could be created “that the government is fighting corruption” it would have the same impact on an individual’s intention to emigrate “as a wage increase of around US$ 400 per month—roughly three-quarters of the average pay rise that can be expected after moving to the intended country of destination.”

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Or, in the case of regional disparities, raising the level of governance in Romania’s worst performing region (Sud-Est) to that of its best performing region (Sud-Muntenia) “would boost regional growth by an average of 1.7 percentage points a year.”

Looking at firm-level corporate governance, there was significant variation among countries of operations in the quality of legislation and corporate practices, with weak non-financial disclosure and unclear responsibilities between boards and independent directors cited as particular concerns. When it came to management, foreign-owned firms tended to be better managed than domestic firms, with the gap in managerial quality particularly large in SEMED, Turkey and Central Asia.

There was other evidence of corporate governance weaknesses in the EBRD regions. Most private companies were family-owned or owned by individuals, rather than under the dispersed ownership seen in more advanced countries. This was difficult to change because of weak legal protection for outside and minority investors in companies, and reluctance of firm owners to relinquish control or comply with enhanced transparency and disclosure requirements.

Studies also show that performance is enhanced by the presence of professional managers in firms. But low levels of trust and weaknesses in the rule of law and its application, for example limiting recourse against unscrupulous managers and fraudulent activities, meant only 17 per cent of family-owned firms in the EBRD regions were run by professional managers.

In most countries of operations state-owned enterprises played an important role in the economy. The quality of governance in these companies was frequently very poor. Poor governance in major utility companies, such as electricity companies, had a direct impact on the quality of infrastructure used by businesses and households and increased their costs.

There was plenty of economic evidence to suggest that independent boards and professional managers could improve state-owned companies’ efficiency, and returns on equity and assets. However, in several countries political interference was common owing to the absence of company

35 Econometric analysis showed that only a small part of the difference could be explained by particular firm-level characteristics, such as the industry the firm operated in, size and age of firm and whether it was listed on a stock exchange. See Table 3.2, EBRD Transition Report 2019–20, p. 66.
ownership policies and the practice of making political appointments to boards and management. Board members often lacked appropriate qualifications and political goals were promoted over financial performance. State-owned enterprises often benefitted from subsidies and faced less pressures over poor service than their counterparts elsewhere and regulators were rarely truly independent.

If the transition to a well-functioning economy was to succeed, it was clear that attention had to be paid to improving governance and institutional quality in many countries of operations.

For Milica Delević, a former Serbian Assistant Foreign Minister and today Head of the EBRD’s Governance and Political Affairs team:

The quality of governance influences the level of economic development and whether it’s attainable. The EBRD has developed specific expertise and a comparative advantage in really knowing the private sector and understanding what it needs in terms of effective economic governance. We know how to engage with both companies and governments, and how to support dialogue between them, and this can help effect business-supportive policy changes and improvements in governance.37

A wide acceptance by both government and businesses of the need for better institutions and good governance to support economic growth and transition gave prominence to EBRD efforts in this field. Some areas of EBRD activity supported improvements in the business environment through tackling governance issues at a national or regional level, for example by developing platforms for public-private dialogue to identify and address constraints to the business environment, supporting business recourse mechanisms such as business ombudsmen to give confidence to investors and supplying advice on better regulation and legislative amendments to strengthen the investment climate. Other contributions operated at the enterprise level to raise standards and quality of corporate governance.

37 Interview, 2021
7. Governance at the National Level

For many years, the EBRD as a transaction-led bank had looked into the integrity of prospective clients as it decided whether to provide companies with investment finance. As this work evolved a separate department, the Office of the Chief Compliance Officer (OCCO), was created to support the due diligence process and was staffed with specialist investigators.

Separate work on legal transition and corporate governance matters also helped to address the wider impact of corruption and other impediments to a permissive business environment. But there was less focus and engagement at a national policy level.

According to Delević, a more targeted approach towards national policy efforts to tackle anti-corruption and strengthen investment climates took off after the Transition Report 2013: ‘Stuck in Transition’ and was helped by the development of the ‘well-governed’ transition quality:

The introduction of the well-governed transition quality allowed the Bank to engage more and have a more analytic and systematic framework for looking at standalone policy interventions at the national level. As a project-lender we hadn’t focused very much on what needed to be done at national policy level. With ‘Stuck in Transition’ it became obvious that talk of 20 years of successful operations missed the fact that some patients had died! It’s not enough to populate a bad policy landscape with good projects alone.

So, to be sure that EBRD projects were not just islands of positive deviation but promoted change to the fullest we wanted to make sure they did so in the best possible environment. Sometimes you need to make interventions at the national level to make the business environment more enabling.38

In the aftermath of the global financial crisis there had been a noticeable loss of momentum in progress to strengthen the application of the rule of law, control of corruption and wider reforms to improve government effectiveness. After a period of post-crisis reflection (see Chapter 2), Management and Board Directors were more conscious than ever of the importance of

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38 Interview, 2021.
good governance and institutional improvements. Officials were concerned that further weaknesses in these areas would adversely affect investor perceptions and damage long-run growth.

Anti-corruption and good governance were also matters that the EBRD President cared about strongly. Chakrabarti was keen for the Bank, with its unique mandate, to make a difference here as far as it could and he made a point of raising corruption and governance issues with presidents and prime ministers as he toured the EBRD regions after taking office in 2012.

The Investment Climate and Governance Initiative (ICGI)

As a response to the analysis in the Transition Report 2013: ‘Stuck in Transition’ and to questions from the Board on how the Bank intended to respond to its findings, the economists and political counsellors, then still in OCE, along with their legal and compliance counterparts began to develop some overarching ideas to address the governance issue. They were encouraged to do so by the President’s Office.

What was needed was an umbrella approach that brought together the existing useful but limited governance projects in one place and a mechanism to drive them forward in a more coherent fashion. The goal was to improve governance in the round—economic, political, legal and corporate—through policy reform engagement, but to do so as a complement to the investment purposes of the Bank, that is from the perspective of facilitating private sector development and market efficiency.

These ideas were brought together in an Investment Climate and Governance Initiative (ICGI). This was not launched with the same fanfare as other Bank initiatives, but first appeared at an Information Session for the Board in January 2014.

Early preparations on how the ICGI might be implemented had been underway, in Albania for example. But with the Revolution of Dignity happening on the streets of Kyiv as the depths of the 2013-14 winter approached, a sense of urgency was given to the task.

The bloodshed that ensued in Ukraine just weeks after the Information Session gave even more prominence to the need for a coherent EBRD response to national and regional governance issues.

The ICGI was built around four themes: strengthening public-private dialogue, mainly through focused Investment Councils; providing recourse
mechanisms for businesses with legitimate complaints over the infringement of their rights by state entities; building capacity in state institutions responsible for economic governance; and enhancing transparency in business reporting and streamlining business regulation.

To make the Initiative more credible it was important to show that there was a serious commitment by each Government involved in it to discussing and implementing better practices across a number of areas. This was to be managed by negotiating in each country a Memorandum of Understanding (MoU) between the government, independent business representatives and international institutions.

A first MoU, the Albanian “Cooperation in support of the Investment Climate and Good Governance”, was signed by Chakrabarti and Prime Minister Rama on 4 February 2014. Its main focus was on establishing a high-level Investment Council to facilitate dialogue between the government and private sector.

A second agreement, with Ukraine, followed soon afterwards. “The Memorandum of Understanding for the Ukrainian Anti-Corruption Initiative” was established between the Ukrainian government, five business associations, the OECD and the EBRD on 12 May 2014. This aimed to deal with corruption and unfair treatment of business and proposed the creation of an independent “Business Ombudsman Institution”.

The development of the Ukrainian MoU was made easier by the fact that the EBRD had already been working with officials to address governance issues, especially Ukraine’s endemic corruption, before Yanukovych and his regime were ousted in February that year. As described in Chapter 5, progress to that point had been mired in procrastination and delay, including Yanukovych’s refusal to sign any anti-corruption agreement. It was the Revolution of Dignity, and civil society’s demand for improvements, that opened the door to change.

The earlier preparations meant that the EBRD, and others involved like the OECD, were familiar enough with the problems and legislative requirements to be able to translate ideas into actions swiftly. A new and willing Ukrainian government ensured rapid agreement.

Later in the year the MoUs were also signed with Moldova and Serbia.

39 As an example of this, see the section on the Ukraine Reform Architecture in Chapter 5.
Investment Councils

The idea of bringing together the business community and government leaders in countries of operations through Investment Councils (ICs) had been pursued by the EBRD from 2007 as a feature of the ETC Initiative. They were mostly devices designed for relationship management purposes, with their main starting point the facilitation of dialogue between the government and private sector where previously there was none.

In Tajikistan, for example, the Investment Council aimed to create opportunities for constructive engagement between the authorities and business, particularly for small and medium-sized businesses where access to decision-makers was very limited. Chaired by the Tajik President, it is still providing access to the highest levels.

The early ICs had some success in bringing a higher profile to the difficulties experienced by many smaller businesses from harassment by government entities and officials. The EBRD’s involvement provided a level of trust that was frequently absent between government and business in these countries.

When the ICGI took off in 2014, however, efforts were made to make ICs more structured and their number expanded to include Albania, Georgia and Moldova, and later Belarus and Uzbekistan. As one pillar of the ICGI they were reflected in the MoUs agreed between the EBRD and host Governments.

The ICs provided a means for the private sector to have a greater input in decisions that affected them and to be able to share their experiences with policymakers, who generally understood less well the market implications of policy changes, and to help design and prioritise reforms. Operating as open, transparent institutions they could improve the effectiveness of governance and the momentum and monitoring of reforms.

Chakrabarti outlined his vision of the ICs’ work:

Public-private dialogue can take various forms. However, in order to have systemic impact, such dialogue needs an established, trusted platform. That platform should be a forum for regular meetings between the
authorities and the business community, one at which businesses can air their concerns and the government can respond in a credible way.42

The platforms for dialogue between the public and private sectors that the ICs offered were normally attended by high-level representatives of government, and in almost all cases were chaired by the prime minister or president of a country. Trust and credibility were enhanced by the presence of representatives from the international community, including the EBRD.

The Bank funded IC secretariats with the help of the SSF and donor funds, notably from Italy’s Central European Initiative and the UK’s Good Governance Fund.43 The secretariat would organise structured agendas based on what businesses and investors were finding troublesome for their ability to operate effectively.

It was important that the secretariat, especially its head, was seen as competent and independent by both main parties. They needed to show a sound understanding of their role to ensure a good dialogue and regular, well-attended meetings. A charter, setting out the objectives of the IC, how it would operate and clear and transparent rules of membership, was also important to success.

Hester Coutanche, a senior governance adviser, believes ICs were useful since they provided “a means for discussing potential opportunities to help address the constraints facing businesses”. Especially for less well-connected companies, “it was an important platform to have an open and transparent dialogue around the key issues that needed to be dealt with as part of the overall reform approach in the country.”

It was when governments showed an appetite for reform, and a willingness to change policies, that these public-private platforms had their greatest value, Coutanche argued: “Support from the Government is absolutely key to having an Investment Council that works. The success of an IC is down to the will of the Government to make it happen and have a genuine desire to listen and respond to the private sector.”44

43 In 2015, the UK Government and the EBRD established an EBRD-UK IC and Governance Fund with a budget of £2.6 million. Funds from the SSF were also used.
44 Interview, 2020.
Some ICs focused on domestic issues, as in Armenia where the problems of SMEs were the main concern, while in others, Uzbekistan for example, the agenda looked at ways to build the confidence of foreign investors to come into the market. In Georgia, both dimensions featured.

Coutanche explains that for many of these less advanced transition countries: “The fact that the ICs are recognised and valued by both governments and private sectors means they are having an impact by building trust.”

Delević points to Albania and Georgia as particularly successful cases. Albania was a country that emerged only slowly from a long period of isolation and confidence in public institutions was especially low. Family and close connections were the main source of trust in its largely informal economy, where illegal activities were significant. The business environment was far from propitious. In 2005, for example, Albania ranked 117th out of 155 countries in the World Bank’s Ease of Doing Business index.45

A detailed analysis of the obstacles facing Albanian businesses from the fifth round of the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS V), carried out in 2012–14, found that access to electricity, competitors’ practices in the informal sector and corruption were seen as the biggest obstacles to business by companies facing the most severe problems.46.47 These difficulties were rooted in a weak investment environment and governance failures.

A new government was formed in September 2013, led by Edi Rama after eight years in opposition, which aimed to tackle these deficiencies. Following discussions between the Albanian Prime Minister and the EBRD President, a pilot MoU was signed five months later.

The Government, keen to pursue reforms that would assist Albania’s EU accession process, committed under the ICGI to establish an Investment Council as a key mechanism for reform.48 The MoU said:

47 An econometric analysis in the same paper which assessed the biggest costs revealed by firms from obstacles to doing business came from taxes (tax rates and administration), access to electricity and competition from the informal sector, ibid. p.17
48 Three other commitments under the MoU were to strengthen the functioning of the judiciary, improve the business registry and help design an effective consumer credit bureau. www.ebrd.com/documents/corporate-strategy/icg-mou-albania.pdf
The Government ... intends to ... promote the work of a dedicated Investment Council to support the National Economic Council ... implement ... measures suggested by the business community ... and lead efforts to strengthen the rule of law, prevent corruption, reinforce mechanisms of dispute resolution, enhance transparency and address the issue of informality in the economy.

Meeting four to five times a year with the participation of the business community and IFIs, the Investment Council has since endorsed more than 250 reform recommendations, half of which have been implemented by relevant government institutions. Improvements have been made in areas such as dispute resolution mechanisms, measures to address the informal sector, especially in tourism and agribusiness, VAT refunds and simplification of tax and customs administration and in regulatory inspections for businesses.

An assessment by the EBRD Evaluation Department noted that:

[The ICGI] has improved governance standards by increasing transparency and accountability ... Government support was a prerequisite for the Council’s success in Albania. ... Initially, the level of trust in the IC was very low but it is increasing as the private sector sees that the Council’s priorities and actions are led by technical experts, and not by government officials.49

Business Ombudsman Institution

A second major feature of the ICGI was to provide redress mechanisms for businesses facing corruption and other impediments to the smooth working of their commercial activities. A prominent and innovative example, the independent Business Ombudsman Institution (BOI), was established in Ukraine in 2015.

With the Ukraine ICGI MoU in place in 2014, which provided explicitly for the adoption of a BOI, the EBRD sent a senior governance specialist to Kyiv to lead the work that resulted in the establishment of a Business

49 ‘Special Study: The EBRD’s Investment Climate Support Activities Albania Case Study’, p. 20, EBRD Evaluation Department, February 2018.
Ombudsman Council. The Bank was instrumental in putting in place the necessary institutional, legal and organisational arrangements for it to function.

Unlike a traditional business ombudsman, who is appointed and dismissed by government authorities, the BOI could only be appointed unanimously by the BOI supervisory board—comprising the government, business associations and international organisations—and could not be dismissed without a two-thirds majority vote by the same board.

The BOI was a novel independent recourse mechanism that sought to protect the basic rights of businesses and entrepreneurs and investigate claims that state authorities have abused their powers. It drew broadly on some elements of the High Level Reporting Mechanism (HLRM) principles developed jointly by the OECD, the Basel Institute of Governance and Transparency International in 2013, which in turn had been prompted by rising G20 concerns over global corruption.

The EBRD and other international bodies had consistently argued that Ukraine’s anti-corruption institutions needed independence and operational capacity to be effective. So, it was clear for the Business Ombudsman Council to work well it needed fairly extensive investigative powers, as well as strong legal protections against possible actions by government authorities designed to prevent it from conducting objective and rigorous investigations.

Once these governance protections were in place the BOI opened for business in May 2015. It was only the second case globally (along with Colombia), where the core principles and standards of HLRM had been applied and followed through comprehensive governance instruments.

While the BOC was able to draw attention to various systemic failings and thereby improve the investment climate its recommendations were not binding. There was no intention for the Ombudsman to interfere with normal legal proceedings or court decisions. Instead, it could contribute to

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50 The terms Business Ombudsman Council and Business Ombudsman Institution are used interchangeably in this context.


52 ‘Investment Climate Support Activities, Case Study: Business Ombudsman Institution in Ukraine’, p.4, EBRD Evaluation Department, July 2018.
improving the business environment by making recommendations to the Ukrainian authorities in individual cases and via reports, for example on reform of law enforcement institutions such as the Prosecutor’s Office and the State Security Service, as well as by issuing regular reports on its investigations and more detailed analyses on wider systemic issues.

The EBRD shaped the structure of the BOI and provided support through the EBRD-Ukraine Stabilisation and Sustainable Growth Multi-Donor Account, which is funded by a large number of donors with more than half of the funds provided by the EU.53

The first Business Ombudsman in Ukraine was selected through a competitive process, with the representatives of the three main parties—government, business associations and international organisations (represented by the EBRD and OECD)—each having one vote. Algirdas Šemeta, a former Lithuanian Minister of Finance and European Commissioner, was officially appointed in December 2014.

The appointment of two deputies and a staff of investigators, by competitive selection, followed. The BOI staff reached a total of 14 full-time employees by mid-2015 and, as demand for its services grew, expanded to around 30 a few years later. In October 2019, Marcin Święcicki, a former Polish member of parliament and a mayor of Warsaw, became the second Business Ombudsman in Ukraine.

The results have been impressive. In his latest published report to the end of 2020, Święcicki notes that there have been 8,265 complaints from businesses since May 2015, with more than two-thirds “investigated in detail”. “Out of all closed cases more than a half were solved successfully,” he says. By the end of 2019, he claims: “We assisted in recovering almost UAH 18 billion [US$ 745 million] imposed on business unlawfully.”54

In 2020, 74 per cent of complaints were lodged by SMEs and 87 per cent originated from Ukrainian local enterprises. The biggest number of complaints concerned tax inspections, closely followed by appeals over actions by law enforcement bodies. There were also complaints concerning failures of state bodies to carry out court decisions and over property rights protection.

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53 The EU, UK, Sweden, USA, the Netherlands, Norway, Finland, Denmark, Switzerland, France, Germany, Italy, Japan and Poland.

The institution has been an evident success. An EBRD Evaluation Department review concluded:

Initiating and supporting the activities of the Ukrainian BOI is one of the most successful examples of the Bank’s non-investment operations in the country. ... The BOI is effectively a substitute for dysfunctional dispute resolution between private businesses and state agencies. ... The BOI has become a trustworthy institution in the eyes of the public. This is a great achievement since trust is something that Ukrainian state institutions have persistently lacked.55

Success in Ukraine gave encouragement to others to consider a similar route. A recent example has been in the Kyrgyz Republic.

In the past, persuading Kyrgyz business associations to engage in more open and collective dialogue with the authorities had been challenging for fear of clashes over their powers to defend businesses. However, when they met the Ukrainian Ombudsman, its clients and heard about the tangible results the institution was able to deliver without compromising the business associations they realised how the arrangement could help them.

Anastasia Rodina, a senior governance adviser based in the region, describes the sea-change in attitude:

After learning about the Ukrainian Ombudsman at an OECD/EBRD event, the Kyrgyz stakeholders were invited to Ukraine to see how the BOI worked in practice. The business delegates became so convinced of the value of an Ombudsman office they decided to be the driving force behind one in Kyrgyz and formed a working group to draft decrees and establish it! It was based on the Ukrainian (EBRD) model and ensured the key principle of independence.56

The Kyrgyz Institute of Business Ombudsman opened for business in February 2020 with Robin Ord-Smith, a former UK Ambassador to the Kyrgyz Republic, selected by open competition as its first Ombudsman. Although 2020 was a challenging year, the Kyrgyz BOI established itself as

56 Interview, 2020.
a trusted partner of businesses, saving them over US$ 1 million, and helping to voice their concerns over the pandemic challenges.

8. Legal Reforms and Better Regulation

Public rules, practices and regulations which affect the conduct of business in market democracies are underpinned by well-established legal arrangements and legislative procedures. In emerging markets, the underpinnings derived from the rule of law are often less securely based than in advanced economies. This was especially true of EBRD countries of operations as they first emerged from the world of command economies.

Despite significant improvements from those early days, weak governance surrounding public institutions and regulatory regimes has remained a problem in many countries in the EBRD regions since then.

A Legal Transition Team

From the moment the EBRD started operations in 1991 the legal department became heavily engaged in work on the Bank’s investment transactions. As business volume grew so did the number of lawyers dealing with the documentation and negotiation of the Bank’s loans, equity investments and other financial operations. They were also instrumental in ensuring clients’ adherence to the Bank’s rules and procedures, compliance with financial agreements and other legal requirements relating to Bank operations. Today more than half of the Office of the General Counsel (OGC) is made up of transaction lawyers.

Early in the Bank’s life it was recognised that legal work was needed beyond the immediate transaction level in view of the rudimentary state of legal and regulatory arrangements in countries of operations at the time. Shortly after the successful publication in 1994 of a model law on secured transactions, which set standards for the design of laws on the taking of security over movables in several countries of operations, a small team was set up in 1995 by John Taylor, then General Counsel, which became the Legal Transition Team (LTT). It was developed further by his successor, Emmanuel Maurice.57

57 See Kilpatrick, After the Berlin Wall, Chapter 3, p. 74.
The effective application of the rule of law required not only sound legislation and regulations to be in place but also an understanding of how the relevant laws and ordinances should be implemented in particular sectors and country circumstances. Legal impediments to business sapped efficiency and innovation so improvements to the legal landscape were vital to the generation of investment opportunities and markets development more generally.

The task of LTT was to find ways to raise standards of the laws and regulations in the countries across the EBRD region necessary for their transition to fully functioning market economies, thereby facilitating the work of EBRD’s bankers and transaction lawyers on investments.

The main idea behind the approach, which continues to this day according to Michel Nussbaumer, the current Director of LTT, was to create a “virtuous circle of legal reform”. This took the form of introducing relevant international legal standards as a first step, creating reference norms that countries could use to build their legal regimes.

Assessments of the quality of countries’ commercial legislation and practices would then be measured against these standards. As a next step, support would be given through technical assistance projects to help prepare and make amendments to legislation and regulations, along with related work to strengthen implementation and enforcement capabilities. Finally, the dissemination of information on legal practices and advances would be conducted through outreach programmes in countries of operations.

One early example of the approach which derived from the model law work was legislation on secured transactions in the Slovak Republic in 2000. Another success story was the contribution to the preparation of the Russian Corporate Governance Code in 2002.

A decade or so later, after a request from the Central Bank of Russia (CBR), the team made a significant contribution to a review and strengthening of the Code and its implementation. The new Code that followed in 2014 required listed companies to disclose their compliance with the Code and to explain the reasons for any lack of compliance. Annual monitoring reports on the implementation of the Code were published by the CBR as part of the new arrangements, helping companies realise disclosure was being monitored and become more aware of the importance of what they published in their annual reports.

A further example from the mid-2000s involved the team branching out to increase judicial capacity in the commercial law sector in the Kyrgyz
Republic. This was done in collaboration with the International Development Law Organisation (IDLO), an intergovernmental organisation promoting the rule of law and related training.

As experience grew, the Bank aimed for standards first suited to local capacity, usually by working with local counsel alongside relevant officials, to introduce progressive steps towards international best practices. New laws and regulations were thereby introduced which were better suited to existing systems and easier to implement and enforce. As a result, the process of reform suffered from fewer setbacks and was better appreciated by local stakeholders than efforts to apply international standards in one fell swoop. The results were also more long-lasting.

The approach was effective in opening up investment opportunities. Legal advice was given in a wide range of areas designed to support the development of a predictable investment climate where it was most relevant to the Bank’s investment activities. Among these areas was work on PPPs and concessions to facilitate infrastructure investments, changes in laws that related to access to finance, insolvency and debt restructuring, efforts to improve dispute resolution through improvements in the judicial sector and through mediation activities, more transparent public procurement and legislation to promote resource efficiency.

There were a host of more specific areas where the legal transition team’s expertise could be applied, including improving credit information reporting systems, assisting with commercial law to judicial training in competition law and capacity building of competition authorities. Efforts were also made to strengthen regulation in competitive sectors such as telecommunications and banking.

Georgia’s PPP legal and policy framework

Growing demand for public infrastructure created demand for private sector participation, especially in countries facing fiscal constraints. Weak state capacity in managing large infrastructure projects and in meeting demanding technical standards strengthened the case for private sector involvement.

However, the legal and economic framework had to be adequate to attract high-quality private sector infrastructure companies. LTT was able to help prepare clearer rules governing concessions and more transparent laws on
PPPs in several countries which matched investors’ needs and attracted private sector support.

In Georgia, for example, work with the legal authorities began in 2015 on developing a PPP law that could support private sector investment and modernise the economy. By May 2018, the Parliament had adopted the PPP law and corresponding amendments to other primary laws enabling its practical application. PPP secondary legislation prepared by the Asian Development Bank (ADB) with the EBRD’s help was issued in summer 2018.

The new PPP law provided clear guidance on definitions, project identification, initiation and preparation, as well as detailed procedures for the selection of private partners. It also marked out the stages of project implementation and post-implementation relationships. The work ensured all the elements for a comprehensive and effective legal framework were in place to promote investment in Georgia’s infrastructure and improve public services.

Expanding the legal transition programme

Two factors helped LTT’s work—the Bank’s Legal Transition Programme (LTP)—expand more quickly in the 2010s.

The first related to the Shareholder Special Fund (SSF), derived from allocations of the Bank’s net income, which had been created towards the end of the previous decade. This provided greater access to the technical assistance funds that were essential to the programme. Bilateral donor funds, such as those made available by Japan, Switzerland, Taipei China and the UK, and later Luxembourg and South Korea, also helped.

As compared with bilateral funds, the SSF had the advantage of speed, since no lengthy negotiations with donors were needed. It also helped LTT maintain more consistent relationships with recipient governments, since there were fewer gaps in funding availability, such as when donor funding had to be renewed with existing donors or past donors had to be replaced by new donors. The conditionality attaching to the use of SSF funds was also more consistent and less burdensome than with bilateral donor funds. Since 2016, the majority of LTP funding has been from the SSF.

The second factor was the greater prominence to the work of the team that came in the wake of the global financial crisis. The recognition of the importance of strong institutions in fostering the transition strengthened
the demand for the team’s services. It became more visible across the Bank as a useful source of expertise which could help improve the environment for business in countries of operations. Chakrabarti’s message on the importance of policy engagement and structural reform was a further spur to these law reform activities. And the clearer strategic focus of country strategies, including with the introduction of Priority Policy Objectives (PPOs) in strategies, also supported this work.

As a result, both the number and value of projects managed by the team rose threefold in the 2010s, compared with the previous decade, and the team grew to around 20 people dealing with around 80–90 projects per year. The advent of the transition qualities showed projects were most commonly designed to improve governance (under “well-governed”), but not exclusively, with several projects strengthening the resilience quality, as for example through work on non-performing loan (NPL) regimes, and competitive performance. The LTP was also a strong contributor to the PPOs, where the team led, individually or jointly, up to 20 PPOs a year, or around 15–20 per cent of the Bank’s total.

The legal reform needs of early transition countries were the biggest drivers of the work though some technical assistance was also given to EU member states (via EU funds). Recent examples show how digital transition and related innovations in policy may reverse the typical direction of policy impact, whereby Poland and Greece have expressed interest in open digitalisation of public procurement after seeing its successful implementation with the EBRD’s help in Moldova and Ukraine.

The Ukraine case on public procurement demonstrates how the work of the legal transition programme improved governance at the national level and led to better practices that enabled businesses to gain access to contracts in a fairer and more competitive manner.

ProZorro, Ukraine

Many private companies in western economies look to public procurement of goods and services as an important source of business, and private sector expertise properly applied improves the efficiency of public services. In some areas, state procurement can help the private sector develop innovative technologies. However, in emerging markets the odds are often stacked against the majority of private firms from fulfilling these roles when the politicians
in charge of public procurement use contracts as a means to win or repay favours among a close circle of business supporters.

In Ukraine, with an annual public procurement budget of some US$ 20 billion, misuse of public procurement was no exception. Decades of concealment and corruption allowed the country’s ruling elite to exploit the state procurement system in their interests.

The huge gaps in the Ukrainian public procurement system were more readily addressed in the new, more receptive environment after the Revolution of Dignity. The Bank’s legal transition team was able to promote modern regulatory policy and contribute to the approval of a new procurement law in 2015.

This law complied with the World Trade Organization’s (WTO) Agreement on Government Procurement (GPA) standards and requirements. The EBRD worked with the Ukrainian government to complete the GPA negotiation process in September that year.

The adoption of WTO public procurement policy standards held several advantages for Ukraine. The GPA introduced good governance standards and stimulated competition and growth by allowing businesses from other GPA countries to bid for Ukrainian public contracts. Under GPA market access, international suppliers from more than 48 countries would participate in public tenders in Ukraine. At the same time, becoming a GPA member increased the size of the public procurement market available to Ukrainian businesses globally.

As the negotiations on Ukraine’s WTO GPA accession progressed, the focus of EBRD support shifted towards meeting GPA transparency standards in practice. This involved developing an independent complaints mechanism and a national-level electronic procurement system for state purchasing of goods, works and services.

Building on the innovative ideas of the civic activists who had sought increased transparency and reduced corruption after the 2014 Maidan protests, the Bank supported a coalition of Ukrainian civil society organisations (led by Transparency International Ukraine), businesses and government officials in developing a pilot concept in early 2015 called “ProZorro”, a new model of e-procurement based on the Open Contracting Data Standard (OCDS).°

° Transparency International was initially guardian of the “electronic” keys to the ProZorro platform (so that
Prozorro means transparent in Ukrainian, reflecting the aim of full transparency of public procurement decisions by making procurement information open to all online. This was achieved by making the ProZorro system connect a new open source central database to existing platforms, and made full proactive disclosure of procurement data available in real-time.

By making procurement information open to anyone, corruption risks were reduced while real-time access improved economic efficiency. Procurement officers across Ukraine could access information on suppliers and contracts for example, or publish new online tenders in a few minutes, something which would take days in many richer countries.

The ProZorro pilot was very successful, attracting almost 1,000 contracting entities within first three months of its operation. Local suppliers began to trust the public procurement market for the first time, helping to strengthen competition and deliver better value for money for Ukrainian taxpayers.

The ProZorro system became mandatory from 1 April 2016 for all public institutions, local governments, state-owned enterprises in small or large-scale purchases and has developed into one of the most advanced e-procurement platforms in the world.

ProZorro won several international awards for transparency safeguards and digital innovation and publishes annually about four million electronic tenders from about 41,000 public buyers in Ukraine.

Ukraine’s Ministry of Economic Development estimates that between 2015 and 2020 ProZorro saved as much as US$ 4.1 billion of public funds.

Other results are also impressive. In 2020, the number of registered domestic and international suppliers reached 260,000 while the share of procured value through competitive procedures increased from 25 per cent before the launch of ProZorro to 76 per cent. New bidders reached a total of 71,000 in 2020 and the number of online platforms participating in ProZorro went from zero to 38. Ukraine’s ranking in the UN e-participation index moved up considerably, to 46th out of 193 countries by 2020 from 83rd

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59 The 2016 World Procurement Award, the 2016 and 2017 Davos Awards, and the 2016 Open Government Award.
An econometric analysis of the effects of ProZorro, published in 2019 by the Center for Global Development, found:

There is evidence of a greater number of bids, higher savings, and greater participation in provision of contracted goods and services (more unique winners per tender in each entity), as well as strong evidence of reduced time to procure goods and services.\(^6^1\)

Civil society organisations and others across Ukraine became familiar with the public procurement system and could report tender violations and other risks, supporting independent monitoring and an improved culture in public procurement. A survey of companies by Transparency International Ukraine in 2019 showed 80 per cent of respondents were satisfied with work on the platform, and 41 per cent of users said they had never encountered corruption in ProZorro.

The Open Government principles have been applied elsewhere. A similar online platform, ProZorro.Sale, was launched in 2017 for selling Ukrainian state and communal property and assets, including NPLs, mineral extraction rights, rail car leases and more. According to estimates,\(^6^2\) between 2017 and 2019 ProZorro.Sale delivered income of UAH 21 billion (US$ 840 million) through 2,411,000 auctions on 50 market places, including substantial sales of assets of bankrupt banks and some revenue from small scale privatisations.\(^6^3\)

Following the success in Ukraine, the EBRD deployed the ProZorro Open Government concept as an e-procurement standard in a number of other countries, including Moldova, the Kyrgyz Republic, Tunisia, and Uzbekistan.

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\(^{60}\) The index looks at the use of online services to facilitate provision of information by governments to citizens (“e-information sharing”), interaction with stakeholders (“e-consultation”) and engagement in decision-making processes (“e-decision-making”). https://publicadministration.un.org/egovkb/en-us/Data/Country-Information/id/180-Ukraine/dataYear/.


Insolvency and debt restructuring

An important part of the financial process in a well-functioning economy is its ability to wind up poorly performing businesses and redistribute remaining assets of value. This forms part of the reallocation of resources that efficient markets facilitate. In turn, this process depends on an effective insolvency and debt restructuring regime.

The EBRD played an important role in raising standards of insolvency and debt restructuring and their application in many countries of operations. From 2005 the legal transition team began to apply 10 core principles, later increased to 15, to insolvency law regimes when making their assessments.64

The principles complemented two international standards: the United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law65 and the World Bank’s Principles for Effective Insolvency and Creditor/Debtor Regimes.66 The two sets of rules were brought together to create the Insolvency and Creditor Rights (ICR) Standard in 2011, recognised by the Financial Stability Board (FSB) as one of the key standards for sound financial systems.67 The EBRD approach was consistent with this standard but extended insolvency law and practice, especially to support early restructuring.68

In many countries facing insolvency challenges, the EBRD was able to act quickly with its expert team, making use of well-qualified consultants and suitable local counterparts. It applied the core principles to deliver projects and conduct policy discussions with the key decision makers. In its efforts to improve insolvency and debt restructuring frameworks, the Bank operated alongside other key international stakeholders, especially the IMF, World Bank and European Commission, which helped to keep the pressure up for reform.

64 For the latest edition, see ‘EBRD Core Principles of an Effective Insolvency System’, September 2020.
67 https://www.fsb.org/2011/01/cos_0512101/. The FSB is an international body that promotes international financial stability by coordinating national financial authorities and international standard-setting bodies to develop sound financial regulatory and supervisory policies.
68 The ICR standard, for example, also covers effective credit access and protection mechanisms, commercial enforcement and credit risk management frameworks.
The EBRD’s presence on the ground helped with the frequent delays that came with enacting new laws and implementing higher standards. Its corporate recovery team was also able to assist based on its experience in dealing with impaired loans on the Bank’s books which helped to reveal weaknesses in insolvency and debt restructuring regimes for future improvement.

Non-performing loans on the books of financial institutions became a very significant problem in many countries of operations after the global financial crises of the early 2010s.

It was important that resolution of bank NPLs was managed in a way that preserved overall financial stability. The legal transition team worked with national authorities to develop strategies for the resolution of NPLs and removal of impediments in legal and regulatory frameworks. Among the actions that followed were the transfer of impaired loans to “bad” (resolution) banks and the use of specialised asset management companies for enforcement and partial recovery. These efforts were conducted under the auspices of the Vienna Initiative, and assisted debt resolution efforts especially in the EU neighbourhhood.

Commenting on the results of 19 legal transition projects from 2011 to 2018 on insolvency and debt restructuring, the Bank’s Evaluation Department said:

The quality and speed of insolvency resolution has improved, which enhances trust in the system among market operators and prompts behavioural changes in the rule of law (Bulgaria, Croatia, Cyprus, Greece, Serbia, Kosovo, North Macedonia, Tunisia).

New institutional capabilities for voluntary, mediation-based, out-of-court, financial restructuring procedures are used more widely for NPL resolution, reducing the burden on courts. This contributes to higher standards of corporate governance in banks and companies ...

Interventions in 14 countries over a substantial period of time have resulted in the adoption of important legislation and regulations, as well as institutional changes that enable quicker and higher quality procedures. The high quality of expertise, flexibility, and mostly timely interventions are praised by local stakeholders … Gradually enhancing the skills and knowledge of judges and legal professionals in the areas of insolvency, restructuring

69 See Chapter 2.
and accounting, as well as strengthening the legal framework and implementation practices ... improves understanding and prevents ... default bankruptcy procedures [and] reduces pressure on the court system.70

A distinctive asset of the EBRD

For Nussbaumer, a distinct legal team focused on improvements to the underlying investment climate of countries of operations distinguishes the EBRD from most other MDBs. The build-up of its expertise since 1995 and strong engagement with the policy work of the Bank has helped with its credibility internally and externally. “Creating a distinct unit was certainly part of the success story”, says Nussbaumer.

The Evaluation Department concurs. In 2021, it praised the legal transition programme highly, saying that it is “the Bank’s single largest, highest profile, and probably most important advisory operation.” Active in every country of operations and in most sectors it “is highly appreciated by external clients”. It concluded:

The LTP has become a distinctive institutional asset for EBRD in its efforts to improve investment climate in the countries of operation. It is a key part of EBRD’s unique institutional “offer” and a key differentiator versus other IFIs and private sector financiers.71

9. Corporate Governance

The “well-governed” transition quality encompasses corporate-level governance, the system of rules and practices by which companies are directed and controlled. Part of LTT focused on this aspect of good governance. Like the rest of the team its work began to flourish from the mid-2000s onwards, accelerating after the global financial crisis with a stronger realisation of the importance good governance at the company level to wider institutional development and economic performance.

Corporate governance and investment projects: SUAL and Rusal, Russia

One of the early episodes that involved the legal corporate governance team in a prominent way was an aluminium project in Russia.

In 2004, a proposed bauxite mining project, 250 kilometres south of the Arctic Circle in the Komi region of Russia, raised eyebrows among Board Directors. Bauxite is the essential ingredient in the production of alumina, the raw material used in aluminium smelting. Aluminium production was a sensitive issue when it came to Russian business.

The mining company involved was majority owned by SUAL, one of the world’s largest aluminium producers which in turn was owned through the investment vehicles of two Russian oligarchs, Viktor Vekselberg and Leonard Blavatnik.

The aluminium industry in Russia had a poor governance record. In making the case for the investment, which was to be financed in parallel with the IFC, the EBRD banking team with the help of LTT lawyers presented a series of actions to be implemented by SUAL as part of the deal that would improve the transparency and corporate governance of the company. This would potentially also assist with a future public listing that its owners were considering.

Despite some misgivings the Board agreed to go forward with the operation. A year later, SUAL formed a 50/50 joint venture with Rusal, a competitor and the largest aluminium company in Russia. Directors’ eyebrows rose further since Rusal was owned by Oleg Deripaska, an oligarch who had emerged a winner from the Russian ‘aluminium wars’ in 1990s, which had raised significant integrity issues.

In the ensuing renegotiation of the financing, the EBRD and IFC lawyers worked hard to force greater disclosure as a condition of providing the earlier promised finance. After an extensive review of Rusal’s record and ownership structure, and after much debate internally, the EBRD and IFC said in January 2006 that they now planned to disburse the US$ 150 million financing (US$ 75 million each) for the Komi aluminium project.

A joint statement explained the basis for the decision was that agreement had been obtained to the full disclosure of Rusal’s and Basic Element’s ownership by Deripaska (Basic Element was Deripaska’s investment vehicle) and commitments to transparency and good corporate governance, which would now also cover Rusal and Basic Element. Compliance with these
commitments was covenanted in the legal agreements. The statement made clear the commitments to be undertaken:

IFC and the EBRD welcome the adoption by RUSAL of an action plan over an 18-month timetable covering significant corporate ownership disclosure, the publication of financial information and specific steps aimed at improving corporate governance—notably the election of three independent directors.

These independent directors, to be appointed in agreement with IFC and the EBRD, will chair and constitute the majority of the sub-committees that will oversee audit and corporate governance as well as other corporate matters. 72

The transaction marked the start of a greater integration of legal advice on corporate governance issues and Banking operations. Up until that point, the expertise of the small legal corporate governance team had been somewhat tangential to the core business activities of the Bank.

Gian Piero Cigna, Head of Corporate Governance in OGC, observes:

Until that moment, the corporate governance work of LTT had little direct exposure to our investments. No-one on the Banking side was asking us for help. I was thinking “How can we develop effective legal reform without knowing the challenges that companies face in countries?” By engaging with Banking, we learnt more about the corporate governance challenges our investee companies faced and, in turn, we could translate this knowledge into better legal reform and targeted actions for these companies.

The Rusal transaction was a good example of how we could make a difference. After a few months, the whole corporate structure of Rusal and Basic Element was put on the internet as a result of our work. It was the first time ever that such a level of transparency was reached in Russia.73

72 ‘IFC and EBRD welcome commitment to high governance and business standards by RUSAL Chairman Oleg Deripaska: Banks confirm financial support for Komi Aluminium project after change in ownership’, IFC/EBRD, Washington/Moscow, 17 January 2006. See also ‘Oleg Deripaska Brings His Core Assets into the Open’, Vedomosti, Moscow, 4 April 2006.

73 Interview, 2021.
Mechanisms to deliver better corporate governance by DFIs

The relationship established with the IFC developed further. Early in 2006, the EBRD and IFC began working with the Dutch development bank, FMO, and a few others\(^\text{74}\) to prepare a common approach to linking corporate governance improvements more directly with investment operations.\(^\text{75}\)

President Jean Lemierre signed the EBRD up to the initiative, called ‘A Corporate Governance Approach Statement by DFIs’, at the Annual Meetings of the IMF and World Bank Group in 2007. It was signed by 31 DFIs.\(^\text{76}\)

A working group, including the EBRD, followed and developed a set of tools (including a questionnaire for clients, instruction sheets, a list of corporate governance terms and sample cases) to provide a common methodology on the assessment of corporate governance in investment operations.

The DFI Toolkit on Corporate Governance was launched in 2010.

The Approach Statement and Toolkit were brought together under a Corporate Governance Development Framework a year later as a common platform for evaluating and improving governance practices in investee companies. It was endorsed by 30 DFIs\(^\text{77}\) in September 2011, once again at the Annual Meetings of the IMF and World Bank Group.

For Cigna, the introduction of the Toolkit as a “win-win”. In particular, he said “it helped us plug our expertise into Banking and bankers could enhance their projects”.

A key aspect of the framework was the commitment by each institution to operationalise the OECD Principles of Corporate Governance, which had been introduced some years earlier, turning principles that resonated with policymakers into a more practical approach that could be applied to individual companies.

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74 The ADB, the Black Sea Trade and Development Bank (BSTDB) and the Development Bank for Latin America (CAF).
77 It has since expanded to 35 DFIs.
It would turn out that use of the Toolkit revealed many less obvious issues that blocked progress on corporate governance than could be seen purely from the perspective of the OECD Principles.

The rationale of the Toolkit is based on the need of a “diagnosis” before jumping to “solutions”. The Toolkit assists in evaluating the practices in place at the companies under a very wide perspective: all pieces of the puzzle are looked at and put together to see what features come out. If a piece is misplaced, it is fixed.

Of course, most corporate practices depend on the legislation in place, and the LTT started mapping the good and bad practices for each jurisdiction. In 2013, the team began working on a comprehensive assessment of the legislation and practices in all countries.78 With this renewed source of expertise, it was much easier and effective to engage with governments for the promotion of reform. The team was able to meet authorities and discuss reform avenues by clearly pointing out the aspects that needed to be tackled.

**EBRD Corporate Governance Reviews**

The Toolkit was adapted for internal use by introducing a Corporate Governance Review process, which was incorporated in the EBRD Operations Manual in 2014. This embedded the idea of conducting assessments of client corporate governance practices against good standards and the development of Corporate Governance Action Plans (CGAPs). The Review combined the diagnostic process of the Toolkit with a series of recommendations based on the analysis.

Because every investee company was different and required its own individual investigation of its core governance features, the team developed different methodologies for different types of companies (family businesses, listed companies, banks), which have different corporate governance challenges. Bankers in turn were able to draw on a more tailored system based on an initial screening tool which catered for six different versions of the client questionnaire. These varied according to the type of company and governance structure involved, differentiating for example between listed, non-listed private companies and state-owned enterprises.

78 The EBRD corporate governance assessment, which is updated regularly, is available at: https://www.ebrd.com/what-we-do/sectors/legal-reform/corporate-governance/sector-assessment.html
A corporate governance matrix, covering practices in five areas—commitment to good corporate governance, the structure and functioning of the Board, the control environment and processes, transparency and disclosure and rights of minority shareholders—measured performance against four levels of achievement, from basic corporate governance practices the EBRD expected from all investee companies to more advanced practices which investee companies should gradually aim to reach.

CGAPs soon became a regular feature of the team’s work, often prompted by economist reviews of bankers’ projects where there appeared to be good potential transition impact from improving the governance of a project company, especially in cases where the legislation revealed room for improvement.

State-owned enterprises

Many of the most important, and most difficult, cases concerned state-owned enterprises (SoEs). Even today, these enterprises comprise about one-half of the team’s annual caseload of 50–60 projects.

SoEs tend to be in heavily regulated enterprises, such as energy utilities and infrastructure companies, or firms in strategic sectors, such as petrochemicals or metallurgy. They generally needed substantial finance, which made them attractive to bankers looking for large-scale deals. But the opportunity to extend larger amounts of finance also had some advantage in providing greater leverage for reform.

SoEs differed from private sector firms in two main ways. First, the key decisions were generally not made by the SoE itself but from outside the company by government ministers and officials. In most cases, the SoE’s management would simply follow orders from that quarter.

The second difference comes from the role of regulation. These firms were mostly in highly regulated sectors so efforts to improve governance through CGAPs at the company level could not gain full traction without parallel reforms at the sector level. This meant actions were also needed to improve regulatory practices and other aspects like tariff setting.

Solutions towards good governance in SoEs thus needed a dual track approach: improvements to corporate governance within the company, but also to government practices and regulations that determined what it was able to do. Achieving clarity on roles and responsibilities in these cases was
paramount. Legal advice was required on both dimensions which the LTT was able to supply.

An important example of what was required came with a major transaction with Naftogaz in 2014 which launched a series of reforms in the company and the Ukrainian gas sector as a whole.

Improving corporate governance at Naftogaz

In October 2014, the first elections since the Revolution of Dignity left the new reformist government confronting the huge range of issues needing to be solved to bring improvements to the people of Ukraine. Among the most difficult was one that had plagued Ukraine for years: delivering energy security and reform of the gas sector.

This could not be done without reform to the oil and gas group Naftogaz. The company employed more than 75,000 people and dominated the gas sector. It was responsible for around 80 per cent of gas production, three-quarters of gas imports and 70 per cent of Ukrainian gas trading.

That year losses at Naftogaz were heading for US$ 3.6 billion, amounting to 5.7 per cent of GDP, a clearly unsustainable state of affairs. Despite many earlier attempts at reform endemic problems remained. George Soros described the company as “a black hole in the budget and a major source of corruption”.80

High stakes were involved in any reform plan. The new government nonetheless had little choice but to press ahead.

With the help of the EBRD and other international organisations that had been involved in policy dialogue with the Ukrainian authorities, a plan soon emerged to reform the gas sector and modernise its infrastructure. In the short-term, help could be provided by rehabilitating the transmission network and improving energy security through gas purchase financing support.

By December, a first EBRD loan was agreed with the Ukrainian government to repair and upgrade the gas transmission system. At the same Board

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meeting where the loan was approved, a paper called ‘Ukraine: Reform Anchoring and Crisis Response Package’ was also discussed. It looked forward to developing “a financing structure to facilitate imports of gas from the Western [EU] route important to the diversification of Ukrainian [sources of gas] supply”. This became a larger financing for gas purchases the following year.

The loans first involved the transmission operator, Ukrtransgaz (UTG), a subsidiary of Naftogaz, and then Naftogaz itself (as described in Chapter 5). However, the key condition of the UTG loan, reinforced in the loan to Naftogaz that followed, was the implementation of a comprehensive reform of their corporate practices under EBRD guidance.

The process began in early 2015 with the EBRD leading a review of Naftogaz’s corporate governance which was completed in June. Problems were legion. According to Cigna, who led the work:

On paper the company was generally aligned with legislative requirements, but the practice was well behind. We ran two parallel reviews: one on the company’s practices and one on the legislation governing these practices.

What we discovered was astonishing. The board was there, but had never met in the last 24 months. There was a lack of clarity on who owned and who decided what. The governing framework was extremely complex with a myriad of norms often conflicting with each other. There was political interference at all levels, no risk management or other internal controls like internal audit and compliance functions, and if the company wanted to buy some paper four or five signatures were needed, yet some substantial operations were conducted with no process at all!

The comprehensive review showed not only a long list of practices within the two companies that needed to be addressed, but also several changes to legislation that impinged on the companies that would allow the proposed reforms to be effective.

Among the priorities identified were the need to reduce state interference with the company’s management, clarify the group’s ownership structure, provide commercial autonomy through separating ownership, regulatory and policy-making functions (which would also reduce conflicts of interest), establish an independent and qualified supervisory board, strengthen internal controls and develop a group strategy. There was a need
too at ministerial level to introduce a ‘state ownership policy’ which could define the rationale behind state ownership.

The scale of the task was huge—necessitating amendments potentially to more than 80 laws, decrees, orders and instructions. It took three months of negotiations before the Cabinet of Ministers approved the Naftogaz Corporate Governance Action Plan on 21 October 2015.

The first stage of the plan, allowing Naftogaz to operate as a commercial company free from political interference, was implemented quickly. The company’s shares were transferred to the Ministry of Economy, clarifying ownership, but without taking on responsibility for operational policy or management which remained with the company. A revised company charter, with terms of reference for the supervisory and management boards, was also approved in December that year.

The changes paved the way for the release of finance from the second EBRD loan and, as agreed under the terms of the loan, purchase by tender in line with best European practices of more than 1 billion cubic metres of gas during the non-heating season for storage in time for the following winter.

Naftogaz’s supervisory board was appointed in April 2016, the first board of a Ukrainian state-owned enterprise to be made up of well-qualified and independent directors.

The road ahead was a rocky one nevertheless.

Naftogaz had yet to fully meet the OECD Principles and Guidelines for Corporate Governance of State-Owned Enterprises, the ultimate goals of the EBRD-inspired action plan. Changes of ministers and a new government in April 2016 interrupted the reform process and a series of departures culminating in the dramatic resignation of the whole of Naftogaz’s supervisory board in September 2017 made it clear that reform remained a complicated process. The outgoing chair of the board laid the blame with politicians in a statement: “Despite assurances from senior politicians, deadlines have passed and commitments have not been delivered, with an environment of government control not envisaged in the corporate governance action plan.”

Key changes made with the EBRD’s help were amendment to the law on joint stock companies to introduce the concept of independent directors in 2015, a law requiring supervisory boards to have at least a majority of independent directors in 2016 and a new law in 2018 which included a provision to prevent a general shareholder meeting from deciding matters reserved for the supervisory board (removing a historic problem seen in Ukraine of bypassing the board).
By November, however, following efforts by the international institutions including the EBRD, and by the Government, a new well-qualified supervisory board was approved by the Cabinet of Ministers. Gradually, further corporate governance improvements were made. Notably, the Government approved the ownership policy of Naftogaz—one of the key documents under the OECD Guidelines—and a new company charter more in line with the Guidelines was introduced in October 2020.

Naftogaz itself acknowledges the CGAP has yet to be fulfilled and that more corporate governance reforms are needed, including to state-owned enterprises more widely. More improvements are being planned.82

Some reflections on corporate governance

For Cigna, looking back in 2021, there were lessons from the Naftogaz experience:

Naftogaz was a page-turner. From this, and 17 years of work on legal reforms and corporate governance, I believe three essential elements are needed for effective reform: pressure, reward and the right culture.

Clients need to feel pressure from covenants, domestic policy discussions and the voice of IFIs, otherwise the risk is that they do nothing.

Reward—in the form of “name and shine”—brings a demonstration effect and encourages wider reform.

Changing the culture is the most challenging of the three. It needs support from the top—from policymakers to company boards and management—and it takes a long time to get there. But all three need to be there for success.

And maybe I can add another element that’s needed: perseverance!

Conclusion

The private sector nature of the EBRD, and its focus on operations, encouraged an effort to improve governance at the corporate level where it was sorely needed.

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In parallel, in its engagement with the authorities of its countries of operations, including in exercising its political mandate, the Bank’s interventions were focused on assessments and policy dialogue.

It was the deeper understanding of the importance of high-quality institutions, and the role they played in making markets work well, that drove the effort by the Bank to tackle governance at a higher level and seek a more business-friendly investment climate.

The EBRD succeeded as a trusted partner and brought public and private players together to engage on market and business issues more effectively. This led to many changes with practical benefits. Pressure from the Bank to introduce independent arbiters—ombudsmen and regulatory bodies—to help tackle market inequities and state-led interference was similarly beneficial. Behind these changes frequently lay the work of specialist lawyers who helped to introduce and amend laws which raised standards and reduced investor nervousness. Markets cannot work in a vacuum but depend on clear rules, well applied. Their legal underpinnings were well-served in many countries of operations through the dedicated work of the EBRD’s lawyers, both in the legal transition team but also on the operations side as companies in the EBRD regions learned to appreciate the value of legal protections offered by sound processes.

On the financial markets side too, the Bank’s legal teams played an important role in improving the regulatory landscape. But it was the pooling of expertise from across the Bank to promote the use of local currency and to strengthen money and capital markets that galvanised changes here. Many novel instruments—from various types of bonds to new interest rate benchmarks—were introduced, alongside specialist advice on financial market structures and regulations. Because the EBRD took risk on its books and made investments as well as giving advice—“putting its money where its mouth was”—it had a market credibility that was unmatched by others in its regions.

The goal of improving countries of operations’ financial infrastructure and range of financing options was to enable them to achieve a greater resilience to unexpected shocks. On the governance side too, the aim of a better investment climate and clearer responsibilities and accountabilities for market institutions was designed to raise economic performance.

The extent of success in these endeavours is not easy to pin down. Improving resilience and governance is a massive task and there is clearly more to
do. Steering through the current Covid-19 crisis, and recovery from it, will be a stern test. The issue of climate change, discussed in the next chapter, is perhaps an even bigger one. But only resilient and well-governed market economies have the best chances of coping with the challenges.