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Capital market development in CEE: on-going initiatives and potential new solutions

On-going changes in the growth model of the CEE region

Before the Covid-19 outbreak, CEE economies were enjoying relative economic stability, after having recovered from the 2008 crisis, but potential growth forecasts in the region were deteriorating and the timeline for the completion of the economic convergence process was spreading out. In addition, there was a persistent investment gap in the region in terms of quantity (approximately 4% of GDP) and composition. This gap is more pronounced for NFCs (Non-Financial Companies) because EU funds tend to target mainly the public sector and infrastructure investments at present.

These trends mean that the growth and financing model of the region will need to evolve in the coming years. The economic impacts of the current sanitary crisis will however also need to be evaluated. The pre-2008 crisis model involved a great deal of foreign investment going into labour-intensive industries and infrastructures, as well as portfolio capital coming into foreign-owned banks, both of which are expected to diminish in the future. Financing infrastructure and manufacturing plants will remain a priority, but there will be a need to place a greater emphasis on domestically driven productivity growth (requiring further investment of NFCs, particularly in the service sector, into new equipment and ICT i.e. information and communications technology) and the financing of more innovative, technology-intensive and high-growth industries. This will require developing workforce skills and a higher capacity to invest in intangible assets.

A rebalancing in the CEE region in favour of more capital market financing is necessary, but challenging

Several supply and demand-related issues need to be addressed. Currently, banks finance 90% of the economy in CEE, which is higher than the EU average of 75%, and they focus mainly on traditional business such as loans and savings products. A result of this is the relatively limited range of financial products available to investors and savers. That said, a growing number of CEE banks are increasingly accessing domestic and international capital market financing and are issuing more innovative products such as covered bonds, which has helped local capital market development and expanded the product range available. Despite these positives, local capital markets currently lack the scale and capabilities that are needed to attract foreign investors and support larger issuers.

In this context, banks will continue to be the main source of financing in CEE in the short term. Potential underlying factors such as bank deleveraging, NPL issues, compliance with prudential requirements and local tax measures, etc. could restrict lending to the real sector and need to be closely monitored in these countries. Additional measures to facilitate bank lending for innovative companies and infrastructure investment may also need to be encouraged

However, there is a growing realization amongst policy makers that the financing model needs to be progressively diversified in the CEE region as a consequence of the economic evolutions mentioned above, with a greater role for capital markets, supported by a stronger local investor base with a longer term investment horizon (pension funds, life insurance). Capital market instruments and particularly private and public equity are indeed more suitable than bank credit for financing innovative projects and intangible assets, because they have a longer term perspective and do not require the same guarantees, collateral, credit history or regularity of cash flows. In addition, compliance with applicable prudential requirements might restrict the availability of bank financing over time to the broader economy and particularly the SME sector. .

Companies in the region are mostly small and prefer debt financing. Their managers have limited experience of capital markets and perceive them as complex and costly to use. They are also reluctant to make the changes required in terms of governance and transparency. Retail investors based in the CEE region also generally do not participate in financial markets and mostly use cash holdings and bank deposits for their savings, leading to an erosion of wealth over time. The expansion of local institutional investors such as capital-funded Pillar 2 retirement systems may also be hindered by decisions made by several CEE countries to revert to the traditional system of paying pensions from the central budget.

The actions that are underway at the EU and regional levels to develop capital markets and local financing resources need pursuing and expanding

The actions initiated at the EU level to foster the development of capital markets need to be beneficial for the CEE region. The efforts made to implement the EU capital market rulebook throughout the EU should provide the CEE countries with a consistent set of rules. This should facilitate the development of appropriate investment offerings across the multiple and relatively small CEE markets and also facilitate investment into the CEE region from other parts of the EU and third-countries. Actions proposed in the context of the Capital Markets Union (CMU) should further support the development of capital markets in the region. Whilst the progress made so far with this initiative is promising, it is still limited. Actions are being conducted under the aegis of the EU Commission in the context of the Structural Reform Support Programme (SRSP) to support the development and integration of local capital markets. Projects in CEE countries range from capital markets diagnostics and strategies, through SME equity listing support instruments and pre-listing support programs, to reforming the legal and regulatory framework for covered bonds and securitization, and improving the investment environment for institutional investors.

Multiple initiatives are also underway at the regional level, with the support of IFIs (international financial institutions such as the EIB and the EBRD), to develop and interconnect local capital markets. Work is under way to establish a Pan-Baltic framework for covered bonds, with an additional project aiming to obtain a single Frontier market classification jointly for the three Baltic countries to enhance the attractiveness of these combined equity markets to institutional investors. The SEE link project, also supported by the EBRD, aims to create a regional capital markets infrastructure by connecting the stock exchanges of 7 countries including Bulgaria, Croatia, Slovenia and N. Macedonia. A follow-up project is being implemented to connect securities clearing, settlement and depositary infrastructures at the regional level for the SEE Link markets. Local initiatives have been put in place in Romania or Bulgaria to activate dormant retail share accounts, a legacy of the

1990s Privatization processes. Actions are also being conducted by the EIB through the EIF Investment Facility and the EBRD to support the development of venture capital and private equity in CEE, investing in funds that operate in the region and also providing investment expertise. The EBRD has also provided capacity building to venture capital and private equity funds and public implementation agencies, and supported the development of a new fund law in Estonia.

Moreover, the IFIs provide local banks with support, aiming to increase their lending capacity in the region. The EIB is supporting new securitisations and providing local banks with new risk-sharing mechanisms (through the SME initiative) that enable them to lend to innovative SMEs in an uncollateralized way. This includes providing banks with a first-loss guarantee on portfolios of loans to growing SMEs and innovative firms, which should help them to take more risks notably regarding intangible investments. The EBRD has helped implement covered bond reforms in several CEE jurisdictions, including Romania, Poland and Slovakia, with work ongoing in the Baltics and Croatia, bringing national regulatory frameworks in line with EU and international standards and providing these markets with renewed momentum in CEE.