Capital market development in CEE

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CEE capital markets in the post-crisis environment

The earlier global financial crisis of 2007 hit the economies of Central and Eastern Europe (CEE) hard, exacerbated by over-reliance on foreign currency lending, a highly Eurorised economy and low levels of domestic savings. The actions agreed at the Vienna Initiative stemmed the immediate financial stability risks and established that a move away from an over-reliance on traditional banking services was an absolute priority.

A lot of constructive policy reform has occurred since then- including the launch of the EBRD's "Local Currency and Capital Markets Development Initiative" in Zagreb in May 2010- but the latest crisis, precipitated by the COVID-19 pandemic, and the capital outflows from the region, show that there is some way to go.

We recognise the CEE as a dynamic region, which has the potential to grow at a faster rate than the EU as a whole. Integrated capital markets must remain an essential part of this formula, and a constructive and innovative approach is required to shift these economies in the right direction.

The CEE countries face specific challenges in developing their financial sectors due to the limited size of their individual markets. Any policy interventions, including post-crisis response, should consider these when arriving at solutions:

- Recent events suggest that an on-going priority is to develop secondary market liquidity in order to build investor confidence – volatility in markets was exacerbated by the inability to execute trades and hedge currency and interest rate risks. Facilitating access to local markets for all investors is key, as well as developing connectivity, and reducing transaction costs.
- Linked to this, single country solutions for developing capital market infrastructure tend to be uneconomic and do not pique investor interest. Regional solutions that highlight the CEE as a "region within a region" are preferred.
- Local capital markets in CEE countries do not attract investors nor support larger issuers because of their limited scale. Under-developed money markets, domestic government and corporate bond markets undermine strong, market-oriented economic development.
- Banks still finance 90% of the economy in CEE (the EU average is 75%) and focus on traditional business, resulting in a relatively limited range of financial products available. The rise of innovative products, such as covered bonds, is recent and limited.
- EU funds have been valuable in targeting public sector and infrastructure development, but there are huge gaps in access to finance for the private sector, particularly SMEs. SMEs will also be hardest hit by the adverse effects of the current crisis.

The EU Capital Markets Union is a hugely beneficial initiative, which will remain integral in post-crisis actions to reopen financing channels. It needs to remain an agile framework that takes into account the distinctive challenges of the CEE countries.

So, where do we go from here? Regardless of whether we are undertaking crisis response or post-crisis rebuilding, 'regional initiatives', something that the EBRD has championed for many years, must remain a priority. Short-term Central Bank securities purchase programs and IFI support facilities to boost liquidity are valuable but we also need to address the core issues of instrument supply, secondary market liquidity and regulation on an on-going and multi-asset basis.

> *Going alone is not an option: through collaboration, CEE countries can tackle the unique challenges they face.*

In the Baltic States, expansion of products through uniform Covered Bond and Real Estate Investment Trust (REIT) regimes, championing a regional index, and promoting their green credentials, are tangible steps in supporting our broader effort to obtain a single Frontier market classification for these combined markets.

Equally, the SEE link project currently connecting the stock exchanges of seven countries in a virtual trading hub – should boost secondary market liquidity when the clearing and settlement infrastructure is connected in Stage II. Harmonisation of regulation both facilitates investments and enhances private sector competitiveness.

Capital markets in the CEE region will only flourish if we continue promoting collaborative innovative solutions and strategic priorities.

Going alone is not an option: through collaboration, CEE countries can tackle the unique challenges they face. Should they grab it, they will show that unity makes strength.

Tomislav Ridzak

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Croatian Financial Services Supervisory Agency (HANFA-CFSSA)

Capital markets promote best practices for corporate governance in the CEE

Capital market development is important for any country and its effects go beyond financing. Specifically, in the CEE region capital markets are important promotor of best practices for corporate governance. Companies that are listed on the market adhere to higher standards of corporate governance and serve as a role model for other companies. If the listing is successful and other companies follow suit, positive economic and social effects of good governance spread throughout the economy.

However, the importance of promoting and adhering to higher standards of corporate governance does not mean that financing part of the equation is not important. Especially in times of crisis, one can clearly see that the companies with strong balance sheet, that are adequately capitalized, fare better. Such companies have less need to shrink their business, and weather the storm much better than companies that use a high leverage based on debt. As a result, social costs of adjustment for those companies are much smaller. Croatian experience from previous financial crisis that started in 2008 had shown exactly that. Croatian companies that were highly leveraged experienced significant problems and had to adapt to new reality where financing was scarce with significant costs. This change also affected lenders, with non-performing loan ratio for medium sized enterprises surpassing 30 per cent and for the large corporations 19 per cent. On the other hand, companies that were solidly capitalised fared much better through recession.

Although the CEE region is not big, there are significant differences in terms of capital market development and levels of cross border investments. Several decades after their (re)opening, there is relatively big variation between regional stock markets in terms of trading volume and listed shares. Originally, at the beginning of transition, stock exchanges and public listings were a venue where recently privatized state owned companies listed their shares in order to facilitate trading for new owners. Nowadays, we see relatively livelier trading on some of the exchanges (i.e. Warsaw stock exchange, Bucharest stock exchange). On the other hand, many other CEE exchanges have firms with significant market capitalization listed while trading is less dynamic. Some exchanges seem to settle in an equilibrium with low turnover and only few listed companies. Finally, international integration of the regional stock exchanges also varies, where exchanges with more turnover attract more international investments.

Capital markets union is an important part of the single market that should be further promoted in the future. At the same time, regional markets are still very important in the CEE countries. Plans to further develop capital markets union should take this in to account. Many companies that are listed on regional exchanges will not list on the big EU exchanges due to various reasons (i.e. listing requirements, costs, dual reporting, etc.). On the other hand, some companies that surpass the ability of the local market to service them, will graduate towards dual listings on bigger EU exchanges. However, in order to save the ability of such companies to fund on capital market and preserve ecosystem of financial intermediaries, we must implement sensible policies. Decreasing regulatory requirements for financial intermediaries that operate on a small scale while increasing capital market integration should provide relief and incite the development of regional capital markets not only in CEE but throughout European Union. By doing so, we are increasing options for consumers with supply of more readily available products from intermediaries throughout EU, while at the same time giving chance to regional markets and intermediaries to operate with the regulation level that is suitable to their size and risk profile. ●

Leonardo Badea

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Continuing the development of capital markets in Romania

Unquestionably, modern capital markets have come a long way in Romania since their reopening during 1990s, their evolution being in close sync with the development of the market economy and the consolidation of the democratic society after the communist era. However, as it is often the case almost in all areas, this progress has not been linear and has not always been consistent. In financial markets, our most valuable asset is trust, that's why all the past major crises took their toll and caused important setbacks, as will certainly be the case with the one that we are fighting now.

Today, Romanian capital markets are mostly aligned with developed western European capital markets in terms of institutions, systems, technical capabilities and interconnections, regulation and best practices, thus are better ▶

equipped to go through bad times and to recover afterwards, although it will most probably not be an easy or fast recovery given the complexity of the crisis.

Romanian capital markets are now better equipped to withstand bad times and to recover afterwards.

Of the two main sectors of the capital markets, the collective investment undertakings enjoyed a significant increase in assets during the last years, especially for the open-end fixed income funds, while the alternative investment funds remains an important segment (mainly former privatization funds - a particularity of the Romanian market). The structure of funds by risk categories is well diversified and the situation should further improve once the new law regarding the alternative investment funds is implemented.

The other main sector, the stock market, experienced a significant decline during the global financial crisis (both as a traded value and as a level of the stock indices) and was not able to recover in a consistent manner since than. Moreover, the term market for derivative financial contracts has gradually decreased until total termination of transactions in 2017. Although there are projects to restart it, they are largely dependent on the success of the current actions for the establishment of a local central counterparty. As a result, the market is currently mostly focused on stock transactions, and traded values are only slowly improving, being still below 2007-2008 levels, despite listings of major companies over the past two years.

Also, the market capitalization related to GDP is rather low when comparing at regional level. In order to recover the gap compared to the European average, we need to continue the efforts for listing new companies, to stimulate the local corporate bond issuances and to restart the financial derivatives market.

Perhaps the most important recent progress was registered in September last year when the FTSE - Russell rating agency published the decision to promote the Bucharest Stock Exchange to the emerging secondary market status. Also, significant steps were made towards the setting up the local central counterparty and for resolving the situation of latent accounts of financial instruments (with the Central Depository), with the support of the EBRD. An optimal and rapid conclusion of these projects will certainly have benefits for the entire local financial markets. We are also currently working at a national strategy for developing the capital markets, with the help of World Bank, following similar examples in our region. ●

Lukasz Januszewski

Member of the Board,
Raiffeisen Bank International AG

Capital markets development requires long-term players

What are the main areas of improvement and future development objectives of capital markets in the CEE region?

When it comes to local bond markets, we have seen a shift to local currency issuance by the major sovereigns in the CEE region in recent years. Such a move boosts the depth of local capital markets and strengthens sovereign credit profiles. Moreover, we have seen increasingly long maturity local currency debt issuance, lengthening the duration of government's liabilities.

All in all, the above-mentioned trends contribute to the development of a dedicated local and international investor base, a key aspect for developing capital markets and an important business area for leading banks in the region such as RBI.

How are banks such as Raiffeisen contributing to the development of capital markets in the CEE region and are there significant challenges or obstacles?

Capital markets development requires long-term players, such as RBI, who understand the region's economies and spreads best-in-class know-how across markets.

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RBI continues to grow as a primary market dealer and now provides direct LCY government bond auction access in 11 government bond markets in the region. Alongside this RBI continues to invest heavily in trading technology to facilitate secondary market making in interest rates, equities and FX.

The group also supports corporates and governments in the region hedge risk through a broad cross currency and interest rate derivatives offering. RBI also continues to leverage its capital markets franchise to arrange bond financing for the region's sovereigns and corporates and within this is increasingly active in green bonds too. It goes without saying that RBI is actively working on bringing Western investors in the CEE region.

Do current EU and regional policies support appropriately the development of capital markets in the region? ▶

▶ The EU's Capital Markets Union project is also positive for CEE capital markets development, especially given the CMU also covers ECM, corporate bond issuance and venture capital. For CEE, this means that larger corporates may get easier access to international/offshore financing. In terms of green financing and the European Green Deal (EGD) we also see a lot of potential. However, estimated investment sums for "greening" in CEE far exceed public funds announced to date. In this respect, considerable private sector co-financing will be necessary. Therefore, the EGD could contribute to the development of local capital markets in the area of long-term and structured financing in CEE. Participation in such a process would certainly be of interest to players like RBI.

What new or additional actions may be needed?

Three areas are important: (a) a clear classification system for sustainable economic activities for green finance. (b) faster progress in CMU. (c) an inclusive framework for non-euro area EU capital markets. The fact that the euro area is largely limited to Western EU members suggests that the ECB monetary policymaking shall not be instrumentalised for the EGD implementation. Such a move would possibly fuel further scepticism among EU members in CEE towards the EGD. It goes without saying that having strong private pensions systems would support local Capital Markets development and ensure a steady stream of new equity and debt finance for domestic economies. ●

Ivana Gažić

President of the Management Board,
Zagreb Stock Exchange

Croatia: leading the capital markets development in the region for 30 years

Croatian capital market has been leading the development of the capital markets in the region for almost 30 years and represents a bridge between the European Union and the rest of the region.

Croatia joined the EU in 2013, and it can be said that long before that, the financial sector was completely ready for this step and harmonized with the EU regulation. And for a long time before that, we followed all EU and global trends and working on developing the capital market in line with the best European and global practices. From this standpoint, it proved to be quite beneficial for Croatian capital market, and many Zagreb Stock Exchange's (ZSE) project were supported by the EBRD.

ZSE's strategy is to ensure the highest level of transparency and open up some new investment opportunities as well as create the conditions to provide growth capital to companies in all stages of their development, fostering a positive environment for entrepreneurs that also will be conducive to economic growth and employment.

In order to achieve these goals, ZSE has developed several solutions as a part of its integrative strategy. Young innovative companies will be the main driver in the years to come, and therefore it is extremely important to keep them operating in an environment in which they were established and enable them to access the capital for growth and development. ZSE has a 20% interest in the Funderbeam South-East Europe Company, a part of the Estonian Funderbeam Group, which operates a start-up financing facility and runs an innovative trading platform for start-ups based on blockchain technology. To date, Funderbeam SEE has enabled Croatian start-ups and SMEs to raise more than EUR 5 million in capital via 10 campaigns.

Progress Market was registered as one of the first and very few SME growth markets in Europe. It is a multilateral trading facility which may be used by small and medium-sized enterprises as a vehicle for the implementation of their investment plans.

Cooperation between markets is a necessity. As owners of the Ljubljana Stock Exchange, ZSE sees many positive effects for both exchanges and both capital markets. At the very close of the year 2019, the ZSE acquired a 5.3% share in the Macedonian Stock Exchange (MSE) as a step towards active participation in its development.

Together with Bulgarian and Macedonian stock exchanges, the SEE LINK Company was established in 2104 with the objective of creating a regional infrastructure for trading securities listed on those three markets. SEE Link order-routing system now supports trading for a total of seven markets, with over 1500 securities eligible for trading. A total of 26 investment companies are licensed to trade via SEE Link. There are still many challenges ahead of obtaining full potentials of this project, primarily regarding the solution for settling cross-border trades.

> *Leading the development of the capital markets in the region for almost 30 years.*

ZSE's goal is to continue to lead the development of the capital market in the region while providing transparent, secure, cost-effective and efficient marketplace as well as obtaining the highest quality of capital market services in order to meet the needs of investors, issuers and all stakeholders. ●

Miroslav Singer

CEE Institutional Affairs & Chief Economist, EXCO Member, Generali CEE Holding B.V.

Insurance as the driver of the development of Balkan Capital Markets

The potential contribution of the Insurance industry to the development of Balkan and the „new Europe" states capital markets cannot be overstated. This is clear from comparisons with the developed European economies. The investment portfolios exceed 60% of GDP of an average European economy, such as Belgium or Germany. In some cases, Spain, Sweden, UK not to focus on somehow specific Luxembourg case, they are comparable with the GDP. Thus, investment portfolios of insurance companies -in line with one of the major social benefit of insurance companies, i.e. investments into the valuable but lower liquidity long-term projects-, support the development of capital markets and the economy as a whole. The situation contrasts sharply with the Balkans and „new Europe." Here investment portfolios of insurance companies are much smaller. They range between few percent of GDP – Bulgaria, Romania – and a quite meagre 15% (circa) of GDP in the case of Slovenia. The unfulfilled potential is clearly enormous.

As for the state of financial markets in the region let me stress that since the Generali group insurance companies are present in most CEE and Balkan countries, we can dare to assess the situation with a local perspective. Currently, only the „big new 4" countries – Czech Republic, Hungary, Poland and Romania –possess reasonable liquid forex and governmental bond markets. Once we begin to asses less elementary instruments, we find only three CEE economies that can enjoy sufficiently liquid IRS markets. And moving further up the ladder of sophistication of products, the situation gets worse. Smaller Balkan economies do not have a depth of markets thanks to both lack of issuers and investors for domestic currency debt, in terms of euros the situation is a bit better but keep in mind international buyers are open to consider issues over 300 million euros from rated issuers... As to equity markets, their development is related to pension or health reforms. The largest equity market in Poland reflects the size of the Polish pension industry and also the regulation limiting hedging of the portfolios. The relatively larger assets of the insurance industry in Slovenia is a consequence of a health system mainly based on private insurance.

As to the role of global players like Generali, I believe that apart from an obvious role of investor, we are contributing to the development of the market by setting the example to other market players as well as setting standards that in some markets are stricter than those set and enforced by local authorities. We are observing in compliance with group ESG standards preventing us from investments of some issuers, we are flag bearers of implementation of new pan-EU regulation in countries and being an anchor investor, we are simply with our presence making some issues reality.

Of course, EU regulation plays a positive role as local authorities strive for convergence. At the same time its implementation is rather expensive, and the costs associated might hinder the arrival of new investors in many smaller Balkan markets. Consequently, a simplification corresponding with the market size might become a significant impulse for the development of those. ●