Law in transition 2009

European Bank
for Reconstruction and Development

Corporate governance in banking | Turkey

The EBRD is an international financial institution that supports projects from central Europe to central Asia. Investing primarily in private sector clients whose needs cannot be fully met by the market, the bank fosters transition towards open and democratic market economies. In all its operations the EBRD follows the highest standards of corporate governance and sustainable development.

About this report

Legal reform is a core dimension of the EBRD's work. Legal reform activities focus on the development of the legal rules, institutions and culture on which a vibrant market-oriented economy depends. Published twice a year by the Office of the General Counsel, *Law in transition* provides coverage of legal developments in the region and, through sharing lessons learned, aims to stimulate debate on legal reform in the transition economies.

Foreword

Restoring market confidence through the Rule of Law

The global financial crisis that started in 2008 has generated a review of the financial sector's policy-making practices and may lead to significant changes in financial regulations throughout the world. Policy-makers have, once again, been given an opportunity to reflect on the role of the law in providing stability to financial markets. Over the last year, we have been witnessing the consequences of poor implementation of prudential and supervision rules. Looking ahead, decision-makers need to prevent any recurrence of the crisis, among other things by strengthening legal and regulatory frameworks. The temptation will be for governments to address the shortcomings that contributed to the crisis by introducing new detailed regulation and the pendulum may well swing too far in that direction. Legislators will be well advised to exercise caution and keep business interests in mind.

The EBRD's countries of operations have now become particularly vulnerable, as the crisis has reached them through financial and trade channels.

The crisis has highlighted some fundamental components of financial sector policy-making, such as the need for a robust market infrastructure, which includes sound accounting and auditing standards, effective collateral registration and enforcement mechanisms, and appropriate corporate governance frameworks. The EBRD is keen to promote each of these components of the financial legal infrastructure. This issue of *Law in transition* focuses more specifically on corporate governance in the banking sector. Because of the critical financial intermediation role of banks in the economy and the need to protect depositors' funds, corporate governance of banks is of particular importance to the international financial system and merits specific attention and guidance. In many transition countries, the banking sector is one of the most advanced and better organised of the commercial sectors. Further, banks often occupy a position in which they can influence the corporate governance of their borrowers. In other words, banks are expected to become role models for other companies in implementing better corporate governance.

Effective corporate governance practices are those which protect the interests of all stakeholders of the banking system, including minority shareholders and depositors, while at the same time allowing business to flourish without undue restrictions. They are essential to achieving and maintaining public trust

and confidence in the banking sector, which in turn are critical to the proper functioning of the banking system and economy as a whole. In this context, the main issues to be considered relate to the role of boards and specialised committees, the existence of clear lines of responsibilities and accountability, internal and external control functions, compensation, and disclosure of information.

This issue of *Law in transition* aims to offer guidance on the above issues. It draws on the recommendations of the Task Force on Corporate Governance of Banks in Eurasia, an initiative sponsored by the EBRD and the Organisation for Economic Co-operation and Development (OECD), which released a corresponding Policy Brief[1] in 2008. The EBRD has been using this Policy Brief as guidance for its technical cooperation projects (a recent example being the preparation of a corporate governance code applicable to listed companies and banks in Armenia, a project developed in cooperation with the International Finance Corporation).

This issue of the journal also contains a section on Turkey, which became a country of operations of the Bank in November 2008. The section aims to reflect on how Turkish law compares with international standards applicable to commercial law. The Bank will welcome opportunities to collaborate with the Turkish authorities on enhancing its legislative framework and the corresponding institutions, using the lessons it has learned from 15 years of legal reform in transition countries.

It is my hope that this issue of *Law in transition* will be a leading source of ideas for strengthening legal frameworks in the transition countries of eastern Europe, the Caucasus and Central Asia.

Thomas Mirow
President, European Bank for Reconstruction and Development

[1] The document can be downloaded at www.ebrd.com/country/sector/law/corpgov/eurasia/policyen.pdf

01

TELECOMMUNICATIONS IN TRANSITION

PAUL MOFFATT, JAN GUETTLER AND PETER LUNDY

In the European Bank for Reconstruction and Development's countries of operations, the legal and regulatory environment for telecommunications networks and services is an important determinant of overall investment and market effectiveness. The EU countries have demonstrated the success that the presence of sector-specific regulatory bodies in each country can bring.

The key legal and regulatory developments in telecommunications

During the final two decades of the 20th century, technological advances allowed alternative ways of offering telecommunications services, thereby providing the initial impetus for challenging the sector's traditional monopoly structure. The United Kingdom introduced the first enabling legislation, the Telecommunications Act in 1984 which privatised British Telecom, removed its monopoly over telecommunications services and established a sector regulator to introduce network competition.

In 1990, the First European Directive on Open Network Provision[1] created a single market in value-added telecommunications services in the European Union (EU). More liberalising directives followed in the 1990s.

In order to promote a competitive approach for all telecommunications markets and to accelerate liberalisation, the World Trade Organization (WTO) in 1997 reached a binding agreement on members' commitments,[2] an important element of which was a reference paper defining a set of regulatory principles for the establishment of fair market conditions.[3] In 1998, the EU made full liberalisation a legal obligation for all member states and since then its policy and regulatory framework has become increasingly recognised as the global benchmark.[4]

The EU legal and regulatory framework for telecommunications

Since the 1998 legal obligation to member states came into effect, EU authorities have been implementing liberalisation of the electronic communications sector.[5] The EU laws for the sector comprise the 2002 regulatory framework (supplemented by enhancements due to be implemented in 2009)[6] which itself rests on the foundation of the competition provisions in the EU Treaty. The framework requires national authorities to regulate the sector in accordance with common rules. Compliance with these rules is closely monitored by the European Commission and, where necessary, is enforced on national authorities by the European Court of Justice.

The EBRD commenced a project in May 2008 to assess the communications sector in each of the countries in which it operates.

Countries that are preparing for EU membership are particularly encouraged to abide by the framework whereas compliance is mandatory for member states.

The 2008 EBRD Communications Sector Assessment [7]

The EBRD (European Bank for Reconstruction and Development) commenced a project in May 2008 to assess the communications sector in each of the countries in which it operates. The communications sector in this context refers to the market for the supply of telecommunications services, principally fixed-line, mobile and broadband services.

The specific objectives of the communications sector assessment were:

- First, to provide a credible assessment of the communications sector in the Bank's transition countries in order to encourage, influence and provide guidance for ongoing and future legal reform efforts in those countries
- Second, to provide credible information by which the EBRD can measure the legal and regulatory risks in relation to specific investment activities in the telecommunications sector.

In order to appraise the EBRD's transition countries, Cullen International, in conjunction with Development Dynamics, worked with the EBRD to create an assessment model which applied WTO principles for the telecommunications sector together with the EU experience in implementing effective market regulation.

The EBRD assessment model

The assessment model is based on the WTO reference paper, although many of the specific indicators are drawn from the examples provided by the EU regulatory framework. The model for each country comprises the following elements:

- operational environment, covering competitive safeguards and interconnection access
- institutional framework, covering regulatory independence and dispute resolution and appeal
- market access conditions.

Although there is a rough equivalence between the three categories, slightly more weight has been attributed to the operational environment because this defines the ability of operators to compete in a fair market that is protected against the abuse of a dominant position. The institutional framework which oversees compliance with laws and regulations has second priority as it is essential that this function is carried out in an impartial manner. Slightly less weight has been given to market access conditions because of barriers to entry or complex authorisation procedures, which may prevent operators from participating in the market or prevent them from making investments.

A further element of the model assesses whether a country distorts the market when it promotes a more universal telecommunications service.

The results of the assessment

The individual country assessments are presented in the form of diagrams (see Chart 1 on page 8), which include six main group indicators (defined below). For each indicator, the diagram presents the scores as percentages of the maximum achievable rating. The scores begin at *zero* at the centre of the chart and reach *1.00* at the outside so that, in the overall chart, the fuller the coloured "web" the better the scores in the assessment. The model assigns 32 points to the institutional framework, 30 points to market access and 38 points to the operational environment.

> **A country's legal framework should include a regulatory authority that is independent from the operators, reasonably free from political pressure and with sufficient powers to regulate the market.**

The six group indicators (and point-scoring potential) in the diagrams are detailed below:

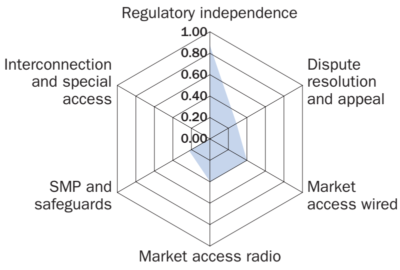
1. **Regulatory independence (maximum 22 points)** A country's legal framework should include a regulatory authority that is independent from the operators, reasonably free from political pressure and with sufficient powers to regulate the market.
2. **Dispute resolution and appeal (maximum 10 points)** A national regulatory authority (NRA) should have the power to resolve commercial disputes between operators and there should be a reasonably efficient appeal mechanism. A country's scoring is reduced if the appeal procedure takes too long or if the appeal mechanism is not being used.
3. **Market access (wired) (maximum 20 points)** In telecommunications, services can be provided over physical connections (wired) or by using the radio spectrum (for example, mobile phones). Since radio frequencies can be a scarce resource, different regulations need to apply in order to ensure fair access for a fully competitive market. This indicator rates the authorisation framework for networks and services that do not depend on scarce resources. A country's scoring is reduced if services are not open to competition, if there are high licensing fees and if authorisation procedures are not plain and transparent.
4. **Market access (radio) (maximum 10 points)** The regulatory framework should ensure non-discriminatory access to the radio spectrum. This indicator also considers whether other scarce resources (such as blocks of telephone numbers) are available to all operators.
5. **Significant market power and safeguards (maximum 20 points)** Competitive safeguards should protect new entrants against the anti-competitive practices of an incumbent operator(s) with significant market power (SMP), including an objective procedure for identifying the existence of SMP. This indicator assigns a higher value if this procedure is based on a formal market analysis according to competition law principles, and a lesser value if a more simple procedure based on market share is used. It looks for specific implementation (in legal provisions and in practice) of facilities that improve a consumer's competitive choice, such as the ability to keep their existing phone number when they change operator, or the ability to choose the cheapest operator for making different types of calls.
6. **Interconnection and special access (maximum 18 points)** This indicator gives points for the existence of a reference interconnection offer (RIO – an inter-operator agreement enabling customers of one operator to be able to make calls to customers of another operator) that is approved by the NRA and published. A country's scoring is reduced, however, if the legal framework does not set out a requirement for non-discrimination for RIO usage or if there is little evidence that the RIO is being used. Similarly, the indicator looks for the existence of a reference unbundling offer (RUO – a special type of inter-operator agreement that allows a new operator to rent subscriber access facilities from the incumbent operator in order to provide competitive services) and assigns value where an RUO has been approved and additional points if it is actually used to provide services by alternative operators.

Another measure, universal service, is not shown on the diagrams and takes into account the effectiveness of universal service regulation. The WTO and EU frameworks leave individual countries to define their universal service policy. Where one exists, the assessment model looks at whether it is being implemented in a technologically and competitively neutral manner.

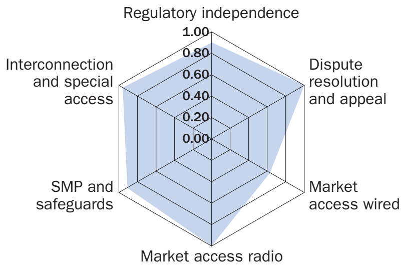
Chart 1
Quality of telecommunications regulatory frameworks in transition countries

Central eastern Europe and the Baltic states   South-eastern Europe and Turkey   Commonwealth of Independent States and Mongolia

Serbia

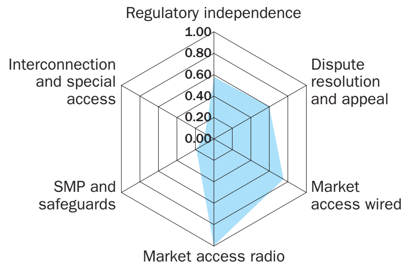


Turkey[11]

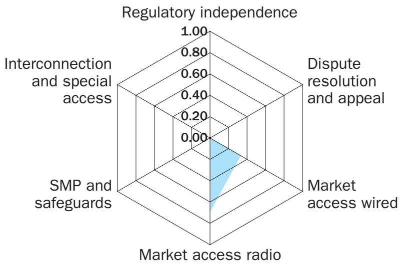


CIS+M

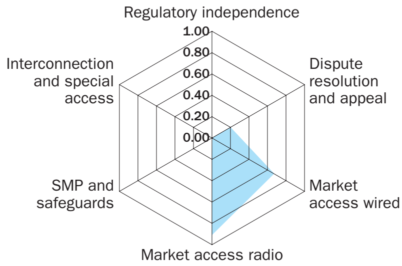
Armenia



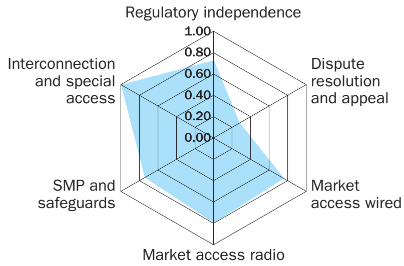
Azerbaijan



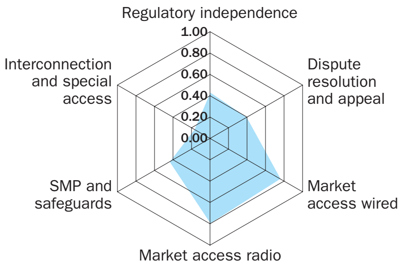
Belarus



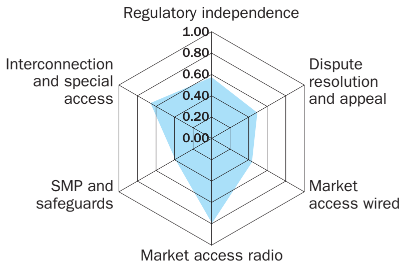
Georgia



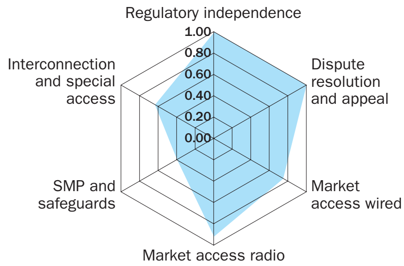
Kazakhstan



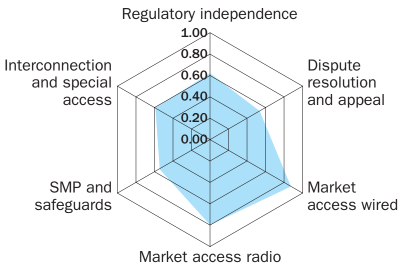
Kyrgyz Republic



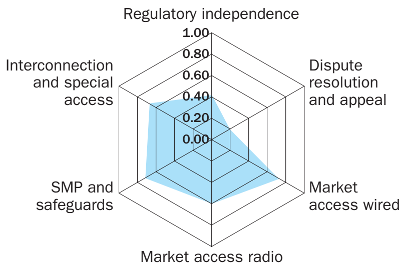
Moldova



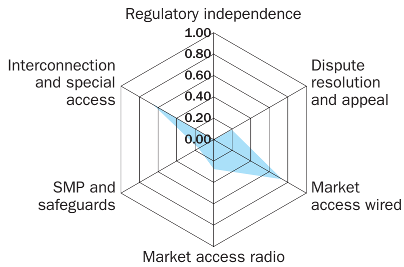
Mongolia



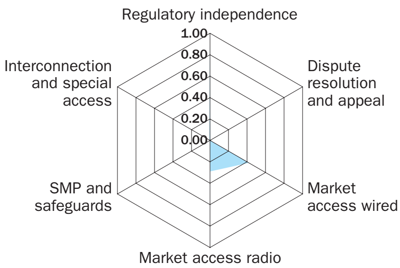
Russia



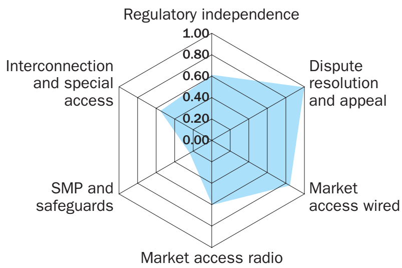
Tajikistan



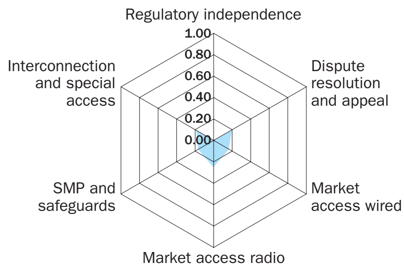
Turkmenistan



Ukraine



Uzbekistan



Note: The diagrams show the combined quality of institutional framework, market access and operational environment when benchmarked against international standards issued by the WTO and the European Union. The extremity of each axis represents an ideal score of 1.00, that is, full compliance with international standards. The fuller the “web”, the closer the overall telecommunications regulatory framework of the country approximates these standards. SMP – Significant market power.

Source: EBRD, Telecommunications Regulatory Assessment, 2008.

Case study

Albania

The new Law on Electronic Communications that came into force in June 2008 is the main legal instrument that regulates the telecommunications sector in Albania. It defines the institutional framework, including the responsibilities of government, the relevant ministry and the national regulatory authority. The Law replaces the previous Law on Telecommunications 2000 and is intended to bring the Albanian law into compliance with the principles of the EU 2003 regulatory framework for electronic communications.

In seeking to implement the EU regulatory framework well before accession to the European Union, Albania is pursuing an aim that is based primarily on its own, direct economic interest and not simply to satisfy the European Union's conditions of entry. A modern, independent regulatory regime is needed at all times. The EU framework is not static and to keep abreast of regulatory practice and policy development in the European Union, Albania will follow closely the day-to-day agenda and activities of the committees and groups which exist to maintain consistency among all European countries that are EU members or working towards it.

A key strand of policy in Albania is therefore to achieve full compliance with the EU framework and to maintain this position continuously until accession is achieved.

Regional results

Country scores in the assessment reflect the level of compliance with the defined regulatory benchmarks for implementation of a liberalised telecommunications market. "Full" compliance in Table 1 means an assessment score of 90-100, "high" compliance scores 75-89, "medium" compliance 50-74 and "low" compliance under 50. (It is possible to have full compliance even if a country's scoring is reduced on some of the indicators.)

All countries in CEB are members of the European Union and have harmonised their legislation with the *acquis communautaire*, the body of law that countries must adopt to become EU members. Latvia, Lithuania and Slovenia received maximum 100 per cent ratings (see Chart 2). Although the others achieved between 90 per cent and 99 per cent because of some remaining issues with implementation, they were still judged to have achieved full compliance under this assessment.

In SEE, Croatia, FYR Macedonia and Romania achieved full compliance, having aligned their frameworks with the EU's *acquis communautaire*. Bulgaria achieved less than full compliance due to remaining concerns about regulatory independence and weaknesses in its market review implementation. Albania (see case study) and Bosnia and Herzegovina achieved high compliance. In the medium compliance category, Montenegro had weaknesses in its identification of, and remedies for, market dominance. Serbia was in low compliance because its licensing regime is not yet developed and it has insufficient competitive safeguards (see Chart 3).

In the CIS+M, only Georgia achieved a high compliance rating in the assessment, scoring highly in the market access conditions and regulatory independence categories. There were, however, some weaknesses regarding competitive safeguards. In Moldova the regulatory framework is undergoing a radical overhaul and past performance may not be a relevant indicator of the future. In addition to Moldova, six countries achieved medium compliance: Armenia, the Kyrgyz Republic, Mongolia (see case study on page 12), Montenegro, Russia and Ukraine. Market access in these countries was generally good, but most had weaknesses in their institutional framework or operational environment. Russia has implemented relevant competitive safeguards in a strong market and Ukraine scored highly on dispute resolution and appeal mechanisms. The seven other countries of the region, including Kazakhstan (see case study on page 11) were grouped in the low compliance category, mainly because regulatory provisions remain insufficiently independent of government (see Chart 4).

Conclusion

Advances in telecommunications technology have produced significant consumer and economic benefits over the last 10 years. For example, mobile networks have overtaken fixed-line penetration and the growth in broadband services is having a significant impact on every aspect of domestic and business life. Regulatory progress across the EBRD's countries of operations remains variable. The countries of the EU have already achieved regulatory effectiveness and their markets are operating competitively.

Table 1
Quality of telecommunications regulatory frameworks in transition countries/compliance with WTO and EU standards

Full compliance	High compliance	Medium compliance	Low compliance
Croatia	Albania	Armenia	Azerbaijan
Czech Republic	Bosnia and Herzegovina	Kyrgyz Republic	Belarus
Estonia	Bulgaria	Moldova	Serbia
FYR Macedonia	Georgia	Mongolia	Kazakhstan
Hungary		Montenegro	Tajikistan
Latvia		Russia	Turkmenistan
Lithuania		Ukraine	Uzbekistan
Poland			
Romania			
Slovak Republic			
Slovenia			

Note: The results for Serbia do not include Kosovo. Assessed separately, Kosovo achieves medium compliance, its main shortcomings being in the area of interconnection, special access and competitive safeguards (see full assessment report at www.ebrd.com/country/sector/law/telecoms/index.htm for more detail).

Source: EBRD, Telecommunications Regulatory Assessment, 2008.

Case study

Kazakhstan

Until 2007, the telecommunications sector was regulated by three separate entities:

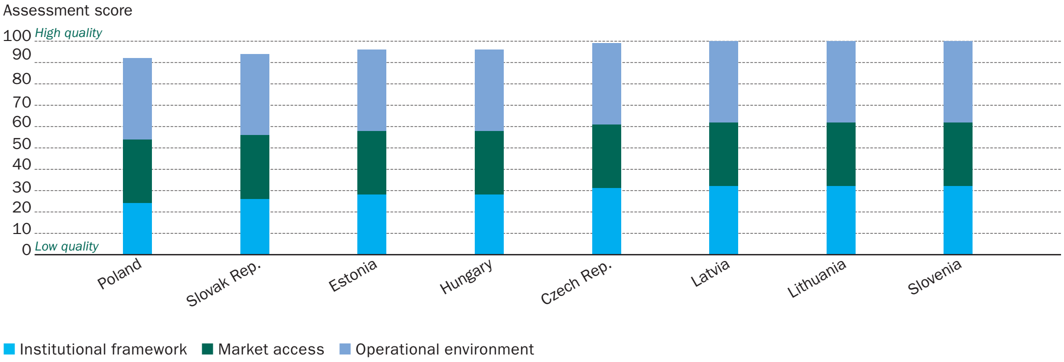
- the Agency for Informatics and Communications (AIC)
- the Agency for Natural Monopolies (AREM)
- the Committee for Protection of Competition (CPC) which was replaced by the Agency for Protection of Competition (APK) in 2007.

Before 2007 the three regulatory agencies appear to have acted largely separately from each other. Although regulatory actions have been attempted since the opening of the market to competition in 2004, using existing laws on telecommunications and competition, very few have been implemented and the sector continues to be dominated by the incumbent operator KazakhTelekom, which is 51 per cent owned by the government.

In 2007, all relevant powers to regulate the sector were transferred to the AIC. New regulatory methods and procedures are being prepared and progressive regulatory proposals for retail tariff rebalancing, market access and interconnection charging have been drafted, but the necessary steps have not been implemented by KazakhTelekom.

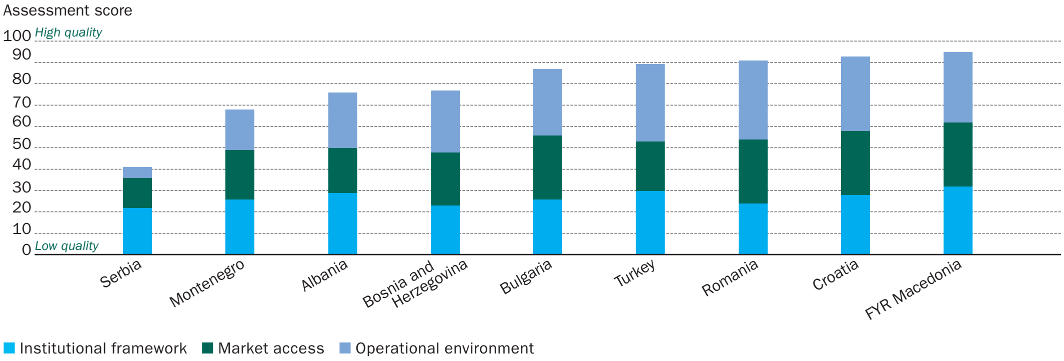
The absence of meaningful control over KazakhTelekom's market dominance has made market entry or survival for competitive operators difficult. Therefore, the market continues to make slow progress on consumer choice, competitive investment and new services.

Chart 2
CEB/Quality of telecommunications regulatory frameworks, by indicator



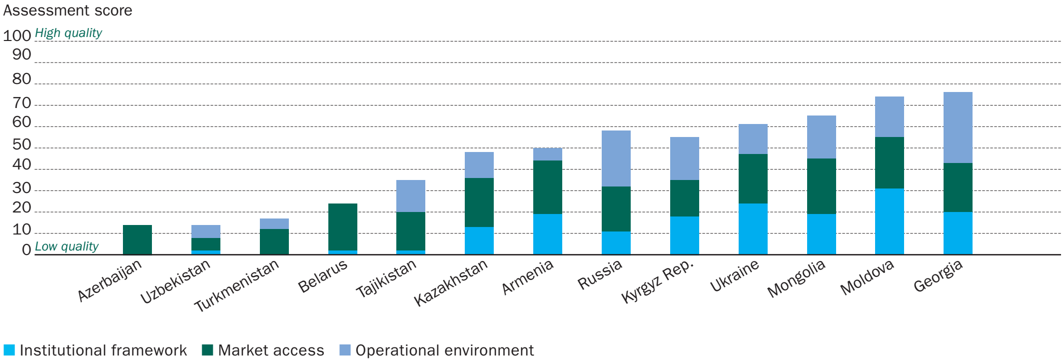
Note: The chart also shows the score for each country in the region for quality of institutional framework, market access and operational environment when benchmarked against international standards issued by the WTO and the European Union. Combined scores are calculated on a scale of 0 to 100, with a score of 90 or more indicating full compliance with international standards.
Source: EBRD, Telecommunications Regulatory Assessment, 2008.

Chart 3
SEE and Turkey/Quality of telecommunications regulatory frameworks, by indicator



Note: The chart also shows the score for each country in the region for quality of institutional framework, market access and operational environment when benchmarked against international standards issued by the WTO and the European Union. Combined scores are calculated on a scale of 0 to 100, with a score of 90 or more indicating full compliance with international standards.
Source: EBRD, Telecommunications Regulatory Assessment, 2008.

Chart 4
CIS+M/Quality of telecommunications regulatory frameworks, by indicator



Note: The chart also shows the score for each country in the region for quality of institutional framework, market access and operational environment when benchmarked against international standards issued by the WTO and the European Union. Combined scores are calculated on a scale of 0 to 100, with a score of 90 or more indicating full compliance with international standards.
Source: EBRD, Telecommunications Regulatory Assessment, 2008.

Case study

Mongolia

Mongolia has the lowest population density in the world. Its 2.7 million people occupy a vast territory. Rural inhabitants, numbering just over 1 million, are spread very thinly. Fixed penetration is only 6 per cent and mobile penetration is around 46 per cent. Broadband penetration has not yet reached 1 per cent. Although technically liberalised, little or no competition has emerged in the fixed-line market and growth (and competition) has been through wireless services.

The Communications Regulatory Commission (CRC) is responsible for a range of regulatory functions including licensing, numbering, SMP designation and operating conditions, interconnection and tariffs, spectrum management, radio frequency allocation, dispute resolution, investigations, compliance, technical standards and the management of the universal service fund.

The Law on Communications 2001 liberalised the telecommunications market, although there is evidence that certain sectors (such as mobile telephony) were liberalised, to an extent, before 2001.

More recently the CRC has encouraged fair competition in defined markets, partly through increased transparency in its decision-making process.

A significant success story is the innovative use of competitive universal service funding processes to increase investment in rural areas. Although it is a sparsely populated country with challenging geography, the Mongolian experience can teach many of its CIS neighbours lessons in how to implement a successful universal service policy by energising and motivating a nation's existing licensed operators.

SEE is fast catching up, as are some countries of the CIS+M. Other countries have been slower to adopt regulatory reform. Although the approaches to sector policy and regulation still vary regionally, the overall impetus is towards greater liberalisation. Competition has generally become the accepted tenet in all telecommunications markets.

The EU's implementation of a common telecommunications regulatory framework has demonstrated how successfully such an approach to market regulation can be applied across different countries with variable initial market characteristics.

In SEE countries the adoption of the EU framework has been viewed as a defining step towards better-functioning markets, as well as being an essential part of the EU accession process. The progress that some countries in this region have made in recent years has been remarkable, given earlier records of relatively low investment and poor economic management.

However, policy-makers and market regulators in the CIS+M have yet to embrace fully the necessary independent regulation and competitive safeguards to complete the liberalisation of the sector. Nevertheless, continuing growth of mobile services and strong demand for broadband services provide significant investment prospects in the region.

The CIS+M countries do not have a common legislative and regulatory framework in each country, and they still retain past methods, leading to a slower transition. The key success factor in the EU (and in the transition countries that demonstrated high compliance in the assessment) is the existence of an independent regulator in each country with powers of secondary legislation to enforce low barriers to entry, effective market access and proper competitive safeguards.

Notes and authors

1 See "Council Directive on the establishment of the internal market for telecommunications services through the implementation of open network provision" ec.europa.eu/archives/ISPO/infosoc/legreg/docs/90387eec.html accessed on 18 December 2008.

2 Scheduled commitments on basic telecommunications services annexed to the fourth protocol of the General Agreement on Trade in Services, 15 February 1997.

3 See www.wto.org/english/news_e/pres97_e/refpap-e.htm. "Negotiating Group on Basic Telecommunications", accessed on 8 December 2008.

4 "Progress report on the single European electronic communications market 2007" (13th report) (COM [2008] 153).

5 The term "electronic communications" covers all forms of communications via electronic means, via telephone (fixed-line or mobile), facsimile, internet, cable, satellite and so on. The open definition of this term reflects the principle of technology neutrality which is one of the fundamental features of the EU Telecom Rules.

6 See "Proposal for a Directive of the European Parliament and of The Council of … 2007 amending Directives 2002/21/EC, …2002/19/EC… and 2002/20/EC" ec.europa.eu/information_society/policy/ecomm/doc/library/proposals/dir_better_regulation_en.pdf accessed 18 December 2008.

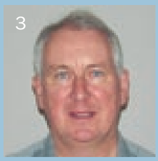
7 The full assessment report, country-by-country analyses and regional comparative assessments can be found at www.ebrd.com/country/sector/law/telecoms/index.htm.

8 Although the Czech Republic is included (for comparison purposes) in this region, it has "graduated" from the EBRD, meaning that the Bank no longer makes any investments there.

9 Although Bulgaria is an EU member state, it is included in SEE in this report for the purpose of regional comparison.

10 Although Romania is an EU member state, it is included in SEE for the purpose of regional comparisons.

11 The diagram on Turkey has been added to reflect its new status as a country of operations within the EBRD, effective November 2008.



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02

THE LEGAL ASPECTS OF INTERNET ACCESS IN CENTRAL ASIA

PAUL BYFIELD

The countries of Central Asia that formed part of the former Soviet Union – Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan – are at different stages of economic and political development. They now face the serious challenges of addressing the constitutional and political imbalances that exist in their societies. It is widely acknowledged that the internet is essential for the dissemination of political, cultural and business knowledge and ideas. If the ability to access these ideas and knowledge is in any way restricted or censored, there is a corresponding detrimental effect on the flow of knowledge and ideas and therefore on the country's development in terms of transition.

The first 10 years of independence for the Central Asian republics coincided with the internet revolution, which was a time of unprecedented technological development. In 1999 Reporters Without Borders,[1] an international organisation that campaigns for a free media, issued a press release entitled “The twenty enemies of the internet”. In it, they identified a group of countries, including the five Central Asian Republics that “control access totally or partially, have censored web sites or taken action against users”.

In the years since that press release these countries have experienced major political changes. The Kyrgyz Republic underwent great political change in 2005 and Turkmenistan recently experienced a change in government when a new president took office. In 2007 the Turkmen Academy of Sciences was reopened, which is seen as a positive move to promote further education and learning in the country.

These changes may well prove to make these countries more attractive to foreign investment. However, in 2007 Reporters Without Borders published a report entitled “Internet Black Holes”. It focused on 15 countries that, in their opinion, limit freedom of expression on the internet. Two of the countries in this article (Turkmenistan and Uzbekistan) are still listed and Central Asia continues to be cited as an example of how freedom of information is censored. This article will analyse the limits on internet access (whether due to economic, political or legal factors) as well as make comparisons with other countries.

The countries of Central Asia illustrate the large gulf that exists from region to region.

The international picture

In 2007 the Global Information Technology Report,[2] a joint project by the World Economic Forum and INSEAD (an International Graduate Business School), aimed to capture the state of technology readiness worldwide (the capacity of economies to use and implement current technology and adapt to new technologies). One particularly indicative statistic is the number of internet users per 100 inhabitants (see Table 1).

The EBRD countries of operations that have recently joined the European Union (ranked 12th-35th) feature relatively high on this list. These encouraging figures indicate that a significant number of people in these six countries use the internet and data indicate that these users are accessing the internet for various reasons (leisure, social, educational and business). However, further down the list the countries of Central Asia illustrate the large gulf that exists from region to region. The very low levels of access (that is, below 10 per cent) indicate that major economic, political and social changes are needed to put the technology in place. Turkmenistan and Uzbekistan were not listed due to an absence of reliable data.

The UK experience

Most people (at least in Europe and North America) have what they regard as unfettered access to the internet. In addition to this, countries in these regions have mature telecommunications infrastructure in place that ensures geographical difficulties do not restrict access to the internet.

For example, in 2008, 16 million households in Great Britain (65 per cent) had internet access (see Chart 1). This is an increase of just over 1 million households (7 per cent) over the last year and 5 million households (46 per cent) since 2002.

This “unregulated” approach has, however, seen changes over the last few years. For example, BT (formerly known as British Telecom), in consultation with the UK government, already passes internet traffic through a service called “Cleanfeed”, which uses data provided by the Internet Watch Foundation[3] to identify pages believed to contain child pornography. When such pages are found, the system creates a “URL not found page” error message rather than delivering the actual page or a warning page. Other internet service providers (ISPs) use different systems, such as “WebMinder”.

Table 1
Number of internet users in selected countries

Rank	Country	Score
1	Netherlands	88.87
2	New Zealand	78.77
3	Sweden	76.97
4	Australia	75.12
5	Luxembourg	72.01
6	Korea	71.11
7	United States	69.10
8	Japan	68.27
9	Canada	67.89
10	Iceland	65.30
12	Slovenia	63.62
17	Estonia	57.36
25	Latvia	46.65
31	Slovak Republic	41.76
34	Hungary	34.75
35	Czech Republic	34.69
85	Kazakhstan	8.42
95	Kyrgyz Republic	5.60
127	Tajikistan	0.30

Note: Figures indicate the percentage of countries’ inhabitants who are internet users. The table shows the top 10 countries and selected transition countries.

Source: Global Information Technology Report, 2007.

Despite challenges, internet use is increasing rapidly in the region, albeit from a very low base.

Currently, the only sites that ISPs are expected to block are those identified as containing child pornography. However, technology is capable of blocking any web site, making it simple to change this policy in future. The UK government has also considered requiring ISPs to block access to articles deemed to be "glorifying terrorism", within the meaning of the Terrorism Act 2006, which states that "our legislation as drafted provides the flexibility to accommodate a change in Government policy should the need ever arise". These particular measures were put in place to censor two extreme forms of expression and would in most cases receive large popular support.

Regional overview

The constitutions of all five countries in Central Asia enshrine principles of freedom of expression and prohibit censorship. Nevertheless, these provisions are often interpreted flexibly when it comes to implementation.

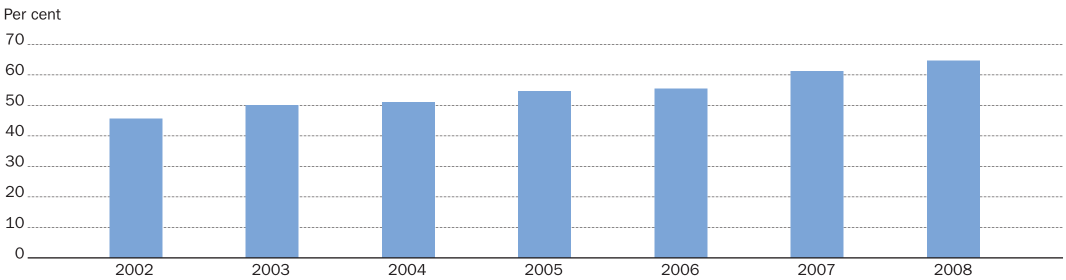
There are also social obstacles to overcome. Since independence in 1991, all the governments have taken a more authoritarian approach to dealing with the perceived threat of religious extremism and the effect that it may have on the region.

Cost is another challenge to widespread internet use. The average monthly wage in Central Asia is under US$ 100, which prohibits regular use of the internet. Where access is publicly available, for example in internet cafes, the decision to limit content is often controlled by the cafe owners, however one can assume that their filtering results from a fear of sanction.

For its size, Central Asia has a relatively underdeveloped telecommunications system and is largely dependent on Russian telecommunications suppliers. To overcome this hurdle, the countries obtain connectivity from their neighbours (in some cases from China, as Uzbekistan does, is discussed on page 19). Despite these challenges, internet use is increasing rapidly in the region, albeit from a very low base. Some of this is due to the actions of international organisations and development agencies, for example USAID runs an Internet Access and Training Program (IATP),[4] which offers the public free computer training and internet access. The training figures are impressive: each month approximately 8,000 people use the internet for the first time.

In terms of regulation, Russia remains the leader in the countries of the former Soviet Union and has been increasingly proactive in influencing and assisting other states from the former Soviet Union. Since late 2000 Russia's approach to information security (that is, national security being at the centre of government policy) has been adapted in various forms by other countries.

Chart 1
British households with internet access, 2002-08



Source: National Statistics Omnibus Survey; Northern Ireland Omnibus Survey, National Statistics web site: www.statistics.gov.uk.

The Kyrgyz Republic has one of the highest internet penetration rates in Central Asia.

Kazakhstan
The biggest obstacle to widespread internet use in Kazakhstan is still the high cost of connection. The largest national ISP is the state-owned monopoly Kazakhtelecom, and OSCE (the Organization for Security and Co-operation in Europe) research indicates that for unlimited access Kazakhs would need to pay more than €3,700 a month, which is about 100 times more than the price a customer in western Europe would pay, but on an average monthly salary that is 10 times lower. Higher speed cable connection costs just under €30,000 a month – about 1,000 times higher than in western Europe.

In 2006 Kazakhstan adopted an Information Security Concept. This Concept "provides a basis for developing and implementing a single state policy for the Republic of Kazakhstan to provide for information security; its provisions will be taken into account in creating and developing a single information space for Kazakhstan and further improving the Government's policy of information technology development". In practice the guidelines provide for increased governmental control over internet use by offering vague and broad definitions of potential threats.

Kyrgyz Republic
The Kyrgyz Republic has one of the highest internet penetration rates in Central Asia.

In 2002 the government declared information and communication technology (ICT) development a priority and implemented a strategy to manage this development. However, this approach initially focused on harnessing internet capabilities to stimulate economic growth, and as such concentrated on providing internet access to government ministries and their employees. A joint programme between the government and international organisations has enabled 95 per cent of central government bodies and 50 per cent of local government bodies to have internet access and provide online information about their services. By contrast the OpenNet Initiative (ONI)[5] detected only three Kyrgyz web sites belonging to opposition political parties.

The administration has made further efforts to introduce restrictive measures to control internet content. In the spring of 2005 members of the government proposed amendments to the Law on Mass Media that would have led to all ".ru" domain sites that contained offensive information on the Kyrgyz Republic being blocked. In turn, this would have limited Kyrgyz access to sources solely on the ".kg" domain, which is regulated by local authorities. Although this proposal was rejected, it revealed a shift in official attitudes toward internet development in the country.

Event-based filtering
The ONI documented the presence of "event-based" filtering. This type of filtering occurs for specific events and is therefore harder to track. For example, during the Kyrgyz Republic's 2005 parliamentary elections, two ISPs who were publishing material favourable to the opposition were disrupted and threats were posted on the affected ISPs' visitor logs, stating that unless the sites stayed offline the attacks would continue. The opposition accused the government of ordering the attacks as a means of undermining the opposition. The government responded by ordering the affected ISPs to keep their resources online, but this was impossible because the disruption had stopped their ability to provide any services.

Tajikistan
The level of internet access in Tajikistan is very low, even when compared with the rest of Central Asia. It also remains largely unaffordable, as the average monthly salary is approximately US$ 40. In comparison the price for one hour of internet access in cybercafes is US$ 0.41; unlimited access per month for dial up costs US$ 29 and broadband costs US$ 25.

The Ministry of Communications requires all ISPs to obtain licences in order to operate. Currently 11 first-tier ISPs, (that is, those ISPs with a direct connection to the internet) are actively providing internet services.
The main regulatory bodies are the Security Council, the ICT Council and the Ministry of Communications. The government restricts the distribution of information that contains state secrets and other privileged data that intend to "discredit dignity and honor of the state and the President", or that contain "violence and cruelty, racial, national and religious hostility… pornography… and any other information prohibited by law".[6] The provisions of this

> In Turkmenistan less than 1 per cent of the population has regular access to the internet and restrictions are still in place.

regulation are broad, allowing state agencies wide discretion in their application. The control over information security is assigned to the main Department of State Secrets and the Ministry of Security.

Tajikistan does not have an official policy on internet filtering. However, state authorities have been reported as restricting access to some web sites at politically sensitive times by communicating their "recommendations" to all top-level ISPs – another case of event-based filtering. For example, before the 2006 presidential elections, the Communications Regulation Agency issued a "Recommendation on Filtering" advising all ISPs that "for the purpose of information security" they should "engage in filtering and close access to those internet sites that are undermining the state policy on information sphere".[7]

As a result, several opposition news web sites hosted in Russia or Tajikistan were inaccessible to Tajik users for several crucial days, thus undermining the flow of information about the election. This type of influence or persuasion is less direct than what happened in Kazakhstan, or even the attempts to impose restrictions in the Kyrgyz Republic. However, it remains an effective and unchecked method.

Turkmenistan

In Turkmenistan less than 1 per cent of the population has regular access to the internet and restrictions are still in place. (Turkmentelecom, the main ISP in the country, is controlled by a special department of the national security committee, the NSC). The cost of access is also prohibitively high; the average salary is approximately US$ 70 per month but it costs US$ 4 an hour to access the internet via one of the few internet cafes that have recently opened. Getting authorisation for household internet connection is deemed almost impossible for most, with thorough checks carried out by the National Security Ministry. Universal internet access had been promised, but when two internet cafes opened in Ashgabat in February 2007 they were prohibitively expensive. These restrictions are severe, as the internet represents an essential source of information in such an isolated country.

Uzbekistan

Most ISPs are under government control and news web sites such as centrasia.ru, fergana.ru, RFE/RL and the BBC have their content filtered. In Uzbekistan the law on mass media holds journalists and editors responsible for the content of published material and this has encouraged independent media and bloggers to practice self-censorship.

In Uzbekistan the principal intelligence agency, the National Security Service, monitors the Uzbek area of the internet and works with the main regulatory body to impose censorship. Uzbekistan imposed restrictions in 2005-06 by temporarily or permanently closing many foreign-funded organisations in Uzbekistan.[8]

Buying connectivity from China

Uzbekistan purchases its internet connectivity through China Telecom. This reselling of internet connectivity has resulted in another phenomenon known as "upstream" filtering, indicating that the filtering is initiated in another jurisdiction. This practice was first observed during ONI testing in Uzbekistan in 2004. ONI testing in 2006 indicated similar patterns where connectivity had been resold in other countries in the region, particularly where countries had purchased connectivity via a Russian provider.

According to the ONI, the number of ISPs has grown from 25 in 1999 to 539 in 2005.[9] This is staggering growth, albeit from a low base. The number of internet users in Uzbekistan in May 2007 was 1,745,000, or 6.6 per cent of the population. This is in comparison to 2000 when 7,500 users or 0.1 per cent had access (data provided by the International Telecommunications Unions). Increasingly internet cafes are offering inexpensive connection at a rate equivalent to about US$ 0.50 an hour, which is affordable for many Uzbeks. This development is particularly welcoming as the high cost of internet access will always discourage ordinary citizens from accessing the internet, notwithstanding any fear of censure or criminal convictions.

The countries of Central Asia have experienced a general trend towards greater internet regulation and control particularly over the past decade, despite the growth in internet penetration.

Conclusion

The countries of Central Asia have experienced a general trend towards greater internet regulation and control particularly over the past decade, despite the growth in internet penetration. Although Kazakhstan, the Kyrgyz Republic and Tajikistan do not practice substantive or pervasive filtering, control of internet content through regulation, self-regulation or intimidation appears to be increasing throughout the region.

In most cases, the legal and judicial framework for filtering (or other restrictions) is ambiguous and open to interpretation. Also, the laws are often applied in an ad-hoc fashion, with more subtle measures designed to promote self-restraint, or self-censorship, of both ISP providers and content producers. Information control is clearly seen as an important issue for the governments in Central Asia. “National security” is often cited as the reason to control internet access and this allows overt measures, such as event-based filtering, as recently seen in the Kyrgyz Republic.

The combination of these legislative and political actions plus the economic limitations in place, continue to discourage internet usage. It is hoped that further political reform and the action of international organisations will encourage more open access.

Notes and author

1 Reporters Without Borders, www.rsf.org/rubrique.php3?id_rubrique=20 accessed on 12 January 2009.

2 Insead Global Information Technology Report 2007-08, www.insead.edu/v1/gitr/wef/main/home.cfm accessed on 12 January 2009.

3 Internet Watch Foundation, www.iwf.org.uk/ accessed on 12 January 2009.

4 Internet Access and Training Program, www.irex.org/programs/iatp/ accessed on 12 January 2009.

5 See www.iwf.org.uk/

6 OpenNet Initiative – Tajikistan, opennet.net/research/profiles/tajikistan accessed on 12 January 2009.

7 OpenNet Initiative – Tajikistan, opennet.net/sites/opennet.net/files/tajikistan.pdf accessed on 12 January 2009.

8 Amnesty International Report 2007 – Europe and Central Asia, report2007.amnesty.org/eng/Regions/Europe-and-Central-Asia/Uzbekistan accessed on 12 January 2009.

9 OpenNet Initiative – Uzbekistan, opennet/research/profiles/uzbekistan assessed on 12 January 2009.

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03

NEW REGULATION ON MORTGAGES IN MOLDOVA

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Moldova's Mortgage Law[1] was passed by parliament in June 2008 and came into force on 2 September of the same year. The main goal of the reform was to consolidate into a single law all provisions concerning mortgages and tackle the serious shortcomings that were limiting market developments. The new regulation is therefore more streamlined, adopts international best practices and is in line with the EBRD's Core Principles for a Mortgage Law.[2]

The drafting of an adequate legal framework for mortgages[3] has been a high priority for the Moldovan government, encouraged by policy and strategy objectives. The need for a specific law regulating mortgages was also mentioned in the "Assessment of the current mortgage lending market in Moldova" prepared with the assistance of the European Bank for Reconstruction and Development (EBRD) in 2005 at the Moldovan government's request.[4] As a result of the report's recommendations the government, through the Ministry of Economy and Commerce and with technical assistance from the EBRD, embarked on developing a new legal framework for mortgages.

Experts from various jurisdictions were involved in the drafting process and contributed to the creation of the new mortgage law, which follows the best practices and the experience of mortgage reforms in neighbouring countries, such as Romania, Russia, Serbia and Ukraine. Public and private institutions which are directly or indirectly involved in the mortgage market also contributed towards the law's conceptual approach.

Before the adoption of the new mortgage legislation, the mortgage market in Moldova was based on the provisions of the Civil Code[5] and the Law on Pledge.[6] Certain aspects of the mortgage system were also governed by the provisions of the Civil Procedure Code,[7] the Law on Cadastre of Immovable Property,[8] the Law on Notary Activity[9] and others. However, the framework was often incomplete and fragmented and this contributed to the lack of clear and uniform practices in mortgage lending.

The Law now makes possible the creation of a mortgage over buildings and apartments that are still under construction, or even only at the planning stage.

The reform of the legal framework for mortgages aims to achieve the following objectives:

- the improvement and clarification of the existing principles and regulations governing the primary mortgage market, the development of which should contribute to the establishment of a secondary mortgage market
- the consolidation of the most relevant provisions governing mortgages in one Act that is dedicated to mortgages
- the establishment of a clear, flexible and easy-to-understand legal framework for mortgages
- the "relegation" of the existing Law on Pledge as a general law governing security interests for movable and immovable[10] property and the Mortgage Law as a specific law focusing on security interests in real property.

To the extent that it was reasonable and appropriate, those drafting the new Law used terminology and legal instruments from the existing legislation. Some legislative acts were amended in order to accommodate the new law. The aim was to minimise any disruption of existing practices, as well as to substantiate the law with the level of detail necessary for proper functioning of mortgage lending.

The Mortgage Law provides for a number of innovative rules and provisions aimed at clarification of existing concepts. The sections below describe these key innovative features.

I. Obligations secured with a mortgage

The Law states that mortgages can be secured on *any obligation* regardless of the loan's purpose (business investment, home construction or renovation, holidays and other personal expenses). The intention was to eliminate the perception that mortgages were limited to securing loans for the purchase of real estate, which is a very restrictive approach to mortgage lending. The new Law emphasises the regulation of *future and generally described obligations*, which should facilitate the creation of "all sums" mortgages. Mostly used to secure business credit, an "all sums" mortgage is used to secure any liability that a borrower may have vis-à-vis a lender at any point in time. It is predicted that Moldovan lenders may shortly take advantage of this new instrument, hitherto unavailable to them.

II. Parties to a mortgage agreement

Financial institutions (banking or non-banking) as well as all legal or physical persons are allowed to act as mortgage creditor (mortgagee).[11] The Law does not set any limitation in this respect – in contrast with other jurisdictions where mortgages are sometimes limited to banks or credit institutions. However, in order to ensure creation of a transparent market and uniform practices, the Mortgage Law requires that mortgage-lending activity is supervised by the appropriate state authority. At present, banking institutions are supervised by the National Bank of Moldova and non-banking institutions are supervised by the National Commission for Financial Markets. This provision is important and was one of the recommendations of the 2005 Assessment, to avoid unregulated organisations offering mortgage loans to individuals without adhering to the proper code of conduct and lending policies.

The mortgage debtor[12] or mortgagor[13] can be any legal or physical person who uses an immovable property which it owns as collateral to secure performance of its obligations.

III. Mortgaged property

The new Law endorses the general principle that mortgages can be established on any kind of immovable property. The Law now makes possible the creation of a mortgage over buildings and apartments that are still under construction, or even only at the planning stage. This innovation extends the range of available collateral which the developer can offer to the financier (although of course it does not remove the construction risk that the financier would have to take on the project). Such unfinished or future constructions are referred to in law as "future property" and require registration in the Register of Immovable Property[14] (Register) and are assigned with a separate cadastral number in order to then be mortgaged. This technique can only be used on the other end of the project – for individuals willing to borrow to purchase an apartment still under construction. These new features are believed to create a good transition mechanism enabling a more developed financing of construction business.

An important breakthrough has been made as far as mortgaged property valuation is concerned. Valuation by an independent certified valuer is now mandatory, which

> **Enforcement is the most sensitive aspect of mortgage lending: it was the intention of the legislator that the Mortgage Law should provide mechanisms which would be perceived as fair, simple and efficient.**

differs from the previous practice where the bank relied on the valuation report of its in-house real estate specialist. Independent valuation contributes to the protection of both the lender and the borrower's interests and sets the value as a fair and reasonable starting point for determination of the size of the loan a borrower may receive. The new requirement is in line with international best practice (also established in the EBRD List of Minimum Standards for Mortgage Lending).[15] The valuation report must indicate the market value and the replacement value (when appropriate) and both must be stated in the mortgage agreement.

IV. Mortgage agreement

The mortgage agreement must be made in writing, include a number of essential clauses, and be authenticated by a notary. The notary verifies the legality of the contract and checks the title over the immovable, the availability of the necessary consents and other documents. The Mortgage Law has also resolved a specific technical issue. As a general rule, when a purchaser applies for a mortgage loan to acquire a property, they accept that on transfer of the property title from the seller to them, the mortgage in favour of the lender will be seamlessly recorded on the property. Unfortunately, this was not possible in Moldova until now since the mortgage agreement could not be signed before the mortgagor (borrower) had title over the property. Now, the Law provides that the notaries are legally obliged to authenticate the mortgage contract based on a non-registered contract of sale and purchase, where the mortgage is established in connection with the acquisition of the object of the contract of sale and purchase. The Registrar can then register consequently the transfer of title and mortgage over the property.

V. Subsequent mortgagees

The new Law allows for subsequent mortgages, provided the first mortgagee has not prohibited their creation. Prohibition on creating subsequent mortgages should be noted in the Register in order to ensure that any third party is aware of an existing prohibition.

The subsequent mortgagee could enforce their mortgage rights only when the preceding mortgagee(s), duly informed of the intention of starting the foreclosure procedure, has not availed themselves of this right. In any case, the distribution of the proceeds obtained from foreclosure of the property is done in the ranking order (that is, based on the registration date).

VI. Insuring the mortgaged property

The Mortgage Law has also significantly changed the market because the legal regime now requires the mortgaged property to be insured. Prior to the enactment of the Law, insurance was not required although the EBRD List of Minimum Standards for Mortgage Lending has always provided for it. This rule is aimed at protecting the interests of the mortgagor and mortgagee alike, and further reduces the risk of giving credit.

VII. Assignment of the mortgage-secured claims[16]

The Law also provides for the assignment of mortgage loans – a technique which is the key to future securitisation of these claims. Such assignment does not require the mortgagor's consent, provided that they were notified in writing about the possibility of the assignment when the mortgage contract was signed, and does not require that the assignment be registered in the Register (although of course parties may choose to do so). Mortgage loans can also be pledged, and such a technique could become the basis for the development of mortgage bonds as well as securitisation.

VIII. Enforcement[17]

Enforcement is of course the most sensitive aspect of mortgage lending: it was the intention of the legislator that the Mortgage Law should provide mechanisms which would be perceived as fair, simple and efficient.

Before the start of the enforcement procedure, the mortgagee should notify the mortgagor (both the debtor and mortgage guarantor, if different) of their intention to enforce the mortgage. This information is made public and the debtor is given a period of time in order to remedy their default under the secured obligation.

Moldova's Mortgage Law provides a more consistent, consolidated and flexible regulation, which adopts a number of best international practices and follows the EBRD Core Principles for a Mortgage Law.

If default is not remedied, the enforcement can proceed and be *voluntary* (that is, both mortgagor and mortgagee agree and collaborate on the process) or *forced*.

- The mortgagor and the mortgagee may enter into an agreement on voluntary execution of the mortgage rights at any point during the mortgage rights' enforcement. This agreement will typically provide for the method and timeline for sale of the mortgaged property or acquisition thereof by the mortgagee themselves.
- During the enforcement of the mortgage rights, the mortgagee is granted the right to acquire the mortgaged asset, which differs from the previous legislation. This innovation should facilitate mortgage rights enforcement by mortgagees.[18]
- The mortgagee can enforce their mortgage rights through a "court ordinance procedure", which is a quick and simplified enforcement procedure by which the mortgagee requests the court to issue in a few days an order allowing them to proceed with realisation of the property. The mortgagor could object to the ordinance issued by a judge, however, the new Law now provides an exhaustive list of motivated objections on the grounds of which the judge may repeal the court ordinance and thus discourage the debtor from deliberately obstructing enforcement.

The mortgagee may choose between the following methods of realisation of the property:

- sale of the mortgaged property
- acquisition of the mortgaged property by the mortgagee
- administration of the mortgaged property and appropriation of the income generated.

The Law requires that the mortgagor and other persons residing in the mortgaged immovable will vacate the mortgaged property as soon as the agreement on voluntary execution takes effect or when the court ordinance remains final.

IX. Information requirements and debtor protection

Consumers enjoy specific protection according to the new Law. The previous mortgage legislation did not protect consumers and there were reports of many abusive situations. The new Law establishes rules regarding:

- certain aspects of the content of the advertising of mortgages
- the mortgagee's duty to inform the debtor of all clauses and terms of the mortgage contract and related costs
- prepayment conditions of the loan
- duty to inform in case of a change in the interest rate and confidentiality of data regarding the debtor.

These provisions closely reflect the European Union Voluntary Code of Conduct for Pre-contractual Information on Home Loans adopted in 2001.

Conclusion

Based on the above, it is believed that Moldova's Mortgage Law provides a more consistent, consolidated and flexible regulation, which adopts a number of best international practices and follows the EBRD Core Principles for a Mortgage Law. The Law strengthens the position of lenders but also creates a legal framework which is the first of its kind for the protection of debtor rights. It paves the way for dealing with construction financing but does not impose rigid schemes and is considered to be a progressive piece of legislation. It also provides the basis for development of the secondary mortgage market as and when the Moldovan market is ready for it.

Notes and authors

[1] Law on Mortgage, No. 142-XVI, adopted on 26 June 2008, Official Gazette of the Republic of Moldova Nr. 165-166/603 dated 2 September 2008.

[2] See www.ebrd.com/country/sector/law/st/core/mortgage/core.htm

[3] Mortgage – a security right that guarantees the fulfilment of an obligation (for example, the payment of a debt) through the value of an immovable asset. A mortgage is an "accessory right". This means that its existence depends on an obligation between the creditor and the debtor. If the secured debt is invalid or has been extinguished, the mortgage ceases to exist.

[4] See www.ebrd.com/country/sector/law/st/new/develop/moldova.pdf

[5] Civil Code of the Republic of Moldova, Law No. 1107-XV, adopted on 06.06.2002, Official Gazette of the Republic of Moldova No. 82-86/661, dated 22.06.2002.

[6] Law on Pledge, No. 449-XV, adopted on 30.07.2001, Official Gazette of the Republic of Moldova, No. 120/863 dated 02.10.2001.

[7] Civil Procedure Code of the Republic of Moldova, Law No. 225-XV, adopted on 30.05.2003, Official Gazette of the Republic of Moldova No. 111-115/451, dated 12.06.2003.

[8] Law on Cadastre of Immovable Property, No.1543-XIII adopted on 25.02.98, Official Gazette of the Republic of Moldova, No. 44-46/318 dated 21.05.1998.

[9] Law on Notary Activity No 1453-XV, adopted on 08.11.2002, Official Gazette of the Republic of Moldova No. 154-157/1209, dated 21.11.2002.

[10] Immovable asset (immovable) – for example, land plots, buildings, constructions, apartments, other isolated units and so on, including future or unfinished buildings.

[11] Mortgagee – creditor whose claim is secured by a mortgage (also lender, creditor).

[12] Debtor – the mortgagor or any other person having the obligation to the mortgagee, where the performance of the obligation is secured by a mortgage (also borrower).

[13] Mortgagor – the person who mortgages an immovable asset with the purpose of securing fulfilment of an obligation (also borrower).

[14] Register of Immovable Property (Register) – a state register of immovable property and rights over such property, including where the mortgage is registered.

[15] See www.ebrd.com/country/sector/fi/debt/mortlist.pdf

[16] Secured claim/debt – a claim or debt secured by a mortgage.

[17] Enforcement – the process by which the rights of a mortgagee are exercised.

[18] At the same time, the rule regarding the prohibition of the inclusion in a mortgage contract of a clause regarding the transfer of the right of ownership on the mortgaged property to the mortgagee in the case of non-performance of obligations by the debtor has been maintained. It must be noted that this rule and the provision regarding the possibility to acquire the mortgaged property are not in conflict, as the first is aimed at the prevention of abuse of the mortgagee's negotiating position, which is stronger at the moment of the contract's conclusion, while the second offers the mortgagor the possibility of selling its assets in voluntary enforcement, directly to the mortgagee, where the latter offers a more advantageous price than the price that could be obtained as a result of sale by auction, for example. The mortgagor's interests during enforcement are protected by the fact that the mortgagee may acquire the asset only by sale under the supervision of the court of justice.

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Part II
Corporate governance in banking

Sound corporate governance practices in the banking sector are essential for achieving and maintaining confidence in banking organisations. Poor corporate governance contributes to bank failures which represent significant public costs and may lead markets to lose confidence in the ability of a bank to properly manage its assets, liabilities and deposits. This could, in turn, trigger a bank run or liquidity crisis, as has been witnessed at the end of 2008 and the beginning of 2009.

Corporate governance of banks is especially important in the EBRD's countries of operations for a number of reasons. First, banks have an overwhelmingly dominant position in transition economy financial systems and are extremely important engines of economic growth. Second, as financial markets in the majority of countries where the EBRD operates are still underdeveloped, banks are typically the most important source of finance for companies and are simultaneously the main depositories for the nation's savings. Lastly, the majority of the EBRD's countries of operations have recently liberalised their banking systems through privatisation. Consequently, notwithstanding the heavy regulation in the sector, bank managers have obtained greater freedom in how they run their banks.

The EBRD is concerned with the corporate governance of banks and attaches great importance to the modernisation of the financial institutions in its region, as a larger proportion of the Bank's investments are directed towards the financial sector than any other sector.

These concerns led the EBRD to take a proactive approach to the development of sound principles of corporate governance for banks

in its countries of operations. In April 2008 before the recent financial crises raised the profile of bank liquidity among international investors and lenders, the EBRD, in collaboration with the Organisation for Economic Co-operation and Development, published a set of recommendations on how to improve corporate governance of banks in Eurasia.[1] The “Policy Brief on Corporate Governance of Banks in Eurasia” identifies key corporate governance challenges affecting Eurasian banks and the banking sector and proposes recommendations to address them.

The first article “Improving corporate governance of financial institutions in Central Asia”, written by Gian Piero Cigna of the EBRD and a member of the taskforce which developed the recommendations, provides an overview of the Policy Brief on Corporate Governance of Banks and an insight into the banking legislation on corporate governance in Central Asia. The purpose of the Brief is to support policy-makers, banking supervisors, capital market regulators, banks and banking associations in their work to strengthen corporate governance practices.

In the second article, the EBRD’s Sibel Beadle examines the impact of the financial crisis on the banking sector in transition countries, regions which had originally bypassed the fallout from the sub-prime crisis.

Lastly, Bistra Boeva, member of the European Corporate Governance Forum and Professor at the University for National and World Economic Studies in Sofia, discusses the corporate governance and banking framework in Bulgaria and the importance of the reliability of that system.

[1] The subject transition countries for the purposes of this research are Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, Ukraine and Uzbekistan.

04

IMPROVING CORPORATE GOVERNANCE OF FINANCIAL INSTITUTIONS IN CENTRAL ASIA

GIAN PIERO CIGNA

Working with the Organisation for Economic Co-operation and Development (OECD), the European Bank for Reconstruction and Development has led the push for the development of a set of standards devoted to improve corporate governance of banks in Eurasia.[1]

A policy brief on improving corporate governance of financial institutions in Central Asia was presented on 30 April 2008 at the EBRD Headquarters in London. The policy brief[2] is the result of a 12-month study undertaken by a taskforce comprising representatives from banks, banking associations and regulators from the aforementioned region, supported by the technical assistance and expertise of the EBRD and the OECD.[3]

The document identifies key corporate governance challenges affecting banks in the 10 transition countries and suggests ways to address them. Its purpose is to support policy-makers, banking supervisors, capital market regulators and banks and banking associations in their work to strengthen corporate governance practices.

Corporate governance in the banking sector

Corporate governance in banks differs from the "ordinary" corporate governance of companies. This is due to the nature of the banking business, the need for protection of the "weakest link in the chain" (that is, the depositor, although in corporate governance of companies, much attention is paid to minority shareholders) and the systemic risks that a bank failure might cause. As was evident during the second half of 2008, bank failure also undermines a core element of the market economy: people's confidence in banks. Banks play a significant role in ensuring capital flow within an economy and providing liquidity for business. The success or failure of banks has more significant repercussions on the economy compared with the success or failure of other companies; therefore a stable and accountable banking system is critical to a country's long-term growth. In the majority of countries in the region, the banking sector is the only advanced financial industry, while stock exchanges are inactive or characterised by

National authorities should actively review the legislation in place and understand how the rules are applied in practice.

low liquidity – with the notable exception of Kazakhstan (see Chart 1). Because of their key role in financing enterprises, banks are in a good position to influence the corporate governance of their corporate borrowers and can become role models for other companies in implementing high standards of corporate governance.

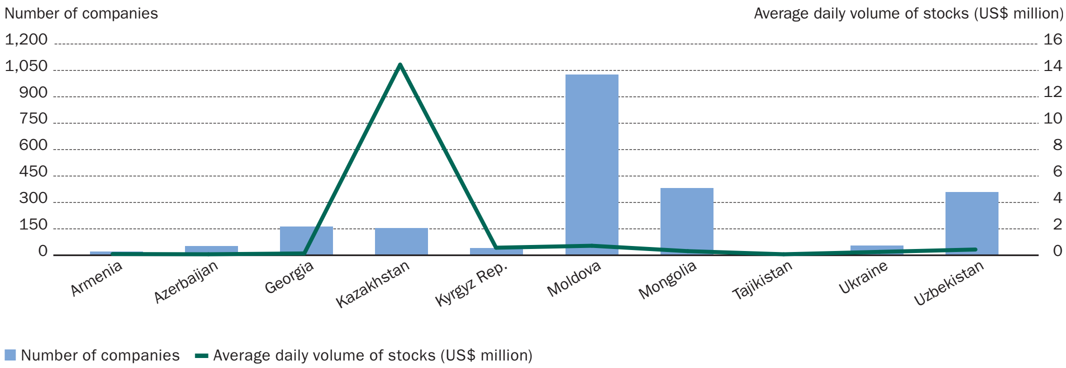
The taskforce identified several weaknesses in the corporate governance framework in the region. Weak implementation of the legislation is a major issue. National authorities should actively review the legislation in place and understand how the rules are applied in practice. While statutory laws and regulations are essential for ordinary banking supervision, corporate governance objectives are often formulated in the form of "soft law": namely, voluntary corporate governance codes that are not directly binding. The taskforce recommended that the subject countries seek an appropriate combination of hard and soft law. Codes are often implemented on what is called a "comply or explain" basis[4] whereby firms that do not comply with requirements must clearly explain their reasons to shareholders. This approach provides flexibility for banks in adopting the best practices, it allows the market to know how the corporate governance structure of the financial institutions is organised and provides banking supervisors with information on how the best practices are implemented and what the difficulties are in their implementation (the "explain" part).

The adoption of a code and the enhanced standards and practices that would result could contribute to making banks safer and more attractive to investors and depositors. The introduction of independent directors and specialised committees within the board (such as auditing, remuneration, nomination and risk management) could easily be facilitated by a code. The taskforce recommended that banking supervisors and banking industry associations in the subject countries, in conjunction with securities regulators and stock exchanges, develop national codes of corporate governance for banks. Codes should be shaped on statutory legislation, should propose higher standards of corporate governance to enhance the practices already in place and banks should be required to report on their implementation.

The policy brief

The taskforce has identified a series of areas where reform is needed. Recommendations address issues such as qualification of board members, disclosure of beneficial ownership, a definition of clear boundaries of responsibility and accountability, internal and external audit, transparency and disclosure. The policy brief also identifies concrete actions – one for all, including the abolition of the Revision Commission – an old Soviet-style corporate body often without clear responsibilities and reporting duties; and the introduction of the Audit Committee, an independent body responsible for overseeing the bank's internal and external auditors; approving the appointment, compensation and dismissal of external auditors; and ensuring that management is taking appropriate corrective action to address lack of internal control and non-compliance.

Chart 1
Stock exchanges in the 10 selected transition countries



Source: (2008 data from the Federation of Euro-Asian Stock Exchanges website (www.feas.org, December 2008).

The policy brief is a non-binding document that seeks to identify objectives and suggest various means of achieving them.

With the aim of improving banks' corporate governance in the subject countries, and based on well-known international standards such as the OECD Principles of Corporate Governance[5] and the Basel Committee on Banking Supervision's Guidance on Enhancing Corporate Governance for Banking Organisations,[6] the discussion by the taskforce was developed, taking into consideration the specific features of the subject countries. The policy brief is a non-binding document and does not aim to provide detailed prescriptions for national legislation. Rather, it seeks to identify objectives and suggest various means of achieving them. Its purpose is to serve as a reference point together with other international guidance mentioned above.

Key recommendations

The policy brief sets out 10 key recommendations, which are detailed below.

Boards, board members and specialised committees

In addition to guiding corporate strategy and monitoring managerial performance, boards of banks[7] should also be aware of their responsibilities to depositors, the ordinary citizens who entrust their savings to the banks. In order to exercise objective and independent judgement, banks' boards should be required to have a sufficient number of independent directors. These independent directors are not just non-executive directors. They cannot be affiliated with senior management and controlling shareholders. The taskforce understands that due to the size, structure and complexity of the market in many of the region's countries, the role of "independent director" has not been developed. The policy brief proposes a "negative" set of criteria defining when an individual is not regarded as an independent director. However, banks' boards in all countries should have an audit committee that is composed in such a way that independent directors can exert their influence in order to help ensure objective judgments. The taskforce believes that all audit committee members should be financially literate and at least one member should possess recent and relevant specialist knowledge in financial reporting, accounting or auditing.

Moreover, the establishment of nomination, remuneration and risk management committees is recommended. That said, it does not matter how many committees a bank has, more that the board is effective and able to exercise objective and independent judgement in delicate matters. If the size of the bank is small or the number of board members including independent directors is limited, the responsibilities of some board committees can be combined in order to ensure effective, lively discussions and independent judgement.

Banks' strategic objectives, corporate values and high standards of professional conduct

Bank boards should be responsible for reviewing and guiding the development of bank strategies and major action plans. Banks are encouraged to develop codes of conduct, setting professional standards and business ethics. Boards should be responsible for ensuring that a compliance-oriented culture prevails throughout the banks. Banks should also be required to report regularly to the market and to the regulator and disclose their compliance structure and activities, and implementation actions in their annual reports.

Particular attention needs to be focused on related-party transactions. This is one of the most serious risks in the region, especially in countries where beneficial shareholders can easily hide behind complex and opaque structures. These transactions should be concluded at an arm's length basis and made on market terms and conditions. Transactions that are materially important should be subject to prior approval by the boards, disclosed to banking supervisors and reported in the financial statements according to international financial standards.

Clear lines of responsibility and accountability

Unspecified, confusing and multiple lines of accountability and responsibility can create a vacuum where no one is in charge. In order to avoid this risk, boards should exercise effective supervisory powers over the management. In some of the subject countries with a two-tier board structure, the management and supervisory boards are directly appointed by the general shareholder meetings. This mechanism may impede a clear line of accountability within the institution. Even if the law provides shareholders with the power of appointments and removals of management, the supervisory board in charge of management board supervision should have the authority to propose such appointments and removals at the general shareholders' meeting.

Qualified and independent external auditors are expected to play an important role in helping to ensure sound corporate governance.

Oversight by senior management and internal control functions

Internal control is a process designed to provide reasonable assurance regarding the achievement of objectives (for example, performance, information, compliance and risk management). Internal control is usually represented by the "four eyes principle"[8] (for example: segregation of duties, cross-checking, dual control of assets and double signatures). Banks need to monitor and assess the effectiveness of their internal control mechanisms continuously, in addition to the evaluations made by internal and external auditors. Senior management should improve banks' internal control systems based on these evaluations and boards should guide senior management accordingly.

Internal and external audits

Internal audit is part of the ongoing monitoring of the banks' systems of internal controls (for example, financial, compliance and operational audits). The internal audit function should have a direct reporting line to the audit committee. Internal auditors should be suitably trained and have the relevant experience to understand and evaluate the business they are auditing.

In some of the subject countries, the internal audit function involves the participation of Revision Commissions that are either given direct responsibility for the internal audit function or instruct the internal audit units. They are separate bodies from the boards or senior management and members are appointed at the general shareholders' meetings. In many instances, Revision Commissions do not seem to be functioning effectively. Given that the roles and responsibilities of boards are increasingly being highlighted and enhanced globally, the abolition of the Revision Commissions via a shift of their functions to the audit committees, should be considered.

Armenia: Development and implementation of a Corporate Governance Code

Taking the Policy Brief as a benchmark, the EBRD is assisting the Ministry of Trade and Economic Development of Armenia in developing a Corporate Governance Code applicable to state-owned companies, listed companies and banks.

A Working Group comprised of representatives of stakeholders in the country has been created. The Group is in charge of discussing the proposed solutions to be included in the Code.

The Code is being developed based on the current legislation. Following a preliminary assessment the Code is expected to concentrate on the protection of minority shareholders, disclosure and transparency practices, board members' duties and responsibilities, related-party transactions, accountability and independence rules. The Code would be a formal collection of rules grouped in Articles. These would take the form of recommendations to companies in cases where the law indicates that corporate governance procedures should be at the company's discretion or where the law does not outline any procedures. The body of the Code will contain general recommendations whereas detailed instructions and explanations as to how to implement these in practice and how to control the implementation of these will form a Commentary. The Commentary would also include a set of templates to be used by companies in implementing the Code. The Code will be complemented by three Annexes with specific provisions applicable to state-owned enterprises, listed companies and banks.

The EBRD and the IFC's Global Corporate Governance Forum are providing the Working Group with all necessary tools and assistance for the development of the Code. The Code aims to be an important reference tool for state-owned enterprises, listed companies and banks wishing to improve their corporate governance practices and for investors in defining best standards at the national level. It is expected that the Code will propose higher standards than the current legislation, in order to be a reference standard for 22 banks, 712 joint-stock companies owned by the state, 371 joint-stock companies owned by local authorities, 272 state-owned enterprises (that are not joint-stock companies) and 32 listed companies. Further, the Code might also potentially be applicable to 956 open joint-stock companies wishing to improve their corporate governance practices.

The project is sponsored by the Early Transition Countries Multi-Donor Fund (contributors to the multi-donor fund are Canada, Finland, Ireland, Japan, Luxembourg, the Netherlands, Norway, Spain, Sweden, Switzerland, Taipei China and the United Kingdom).

> **It is in the best interests of the banks themselves to assess and monitor the corporate governance structures and practices of their corporate borrowers.**

Qualified and independent external auditors are expected to play an important role in helping to ensure sound corporate governance. Banking laws should provide the legal basis on which banking supervisors receive information from external auditors. External auditors should be required to report to the banking supervisors when they detect crimes or other significant breaches of law. It is further recommended that banking supervisors have the statutory power to reject and rescind the appointment of a bank's external auditor if the auditor is deemed to have inadequate expertise or independence or does not follow established professional standards. Lastly, rotation of auditors is recommended.

Compensation

Banks need non-executive and supervisory board members that can effectively perform their functions, backed by experience and professionalism. These professionals should be sufficiently remunerated in accordance with the responsibilities that they are expected to fulfil. The remuneration policy should be aligned with the long-term interest of the individual bank.

Transparency and disclosure of information in terms of corporate governance

National rules should require banks to comply with high-quality accounting and disclosure practices consistent with internationally accepted standards. The banks should have their financial statements audited by an external auditor in accordance with high quality internationally accepted auditing practices and standards. One of the most important information disclosures for the subject countries' banks concerns ownership structure. An opaque ownership structure poses a significant risk for the depositors, other stakeholders and minority shareholders.

Corporate governance of state-owned/controlled commercial banks

When the state is a bank's shareholder, it should not be a passive, indifferent owner that simply acts as a "rubber stamp". It should develop and make public an ownership policy that defines the overall objectives of state ownership, the state's role and how it will implement its ownership policy. The objectives stipulated in this policy may include the pursuit of profitability in the form of specific targets (for example, the rate of return or dividend policy) but may also include trade-offs, for example, between shareholder value and public service. The state should therefore indicate its priorities in its ownership objectives. At the same time, the state should refrain from unduly intervening in the management of banks.

Banks' monitoring of the corporate governance practices of their corporate borrowers

What roles are the subject countries' banks expected to play with reference to the corporate governance of their corporate borrowers? It is in the best interests of the banks themselves to assess and monitor – with forecast and actual figures – the corporate governance structures and practices of their corporate borrowers to the extent that those structures or practices affect the borrowers' creditworthiness. Banking supervisors in the subject countries should therefore encourage banks to assess and monitor the quality of corporate governance of their debtor companies as a critical part of their ongoing credit risk management. To avoid conflicts of interest and to contribute effectively to the enhancement of borrowers' corporate governance, banks should play a transparent role and thus the governance-related requirements they may impose on their borrowers should be clearly stated in advance (that is, included in covenants) where appropriate.

A brief overview of the corporate governance framework for banks in each of the 10 transition countries

Armenia

The basis of the legislation in Armenia on corporate governance for banks is entrusted in the Law on Joint-Stock Companies and the Law on Banks and Banking. In 2005 the Central Bank of Armenia, in consultation with the Union of Armenian Banks, prepared a concept of corporate governance of banks, proposing a set of amendments to the Law on Banks and Banking. The amendments, which came into force on 1 January 2006, were aimed at strengthening minority shareholders' rights, clarifying the functions and responsibilities of the management and board and introducing additional disclosure requirements. However, there are no requirements for banks to have mandatory committees. Although the law states the main aspects of board composition, in practice there are still problems (for example, board members do not fully understand their roles and responsibilities in terms of corporate governance, owing to lack of expertise). In some cases it is hard to achieve the optimal independent board structure due to the banks' ownership structure. Financial statements must be prepared under the Accounting Standards of the Republic of Armenia, adopted by Government Resolution Number 2159 on 9 December 2005. These standards have been drafted in line with international financial benchmarks, however they have not been updated to incorporate recent developments.

The implementation gap (the spread between the quality of legislation and its effective implementation) in Armenia is still very high and the Central Bank is facing a challenging task to enforce corporate governance effectively and translate the values of good laws "on the books" into real economic benefits. As shown in the chart on page 32, the Armenian Stock Exchange has been characterised by a low number of listed companies and little liquidity. There is no voluntary corporate governance code in the country, but the EBRD is working with the Ministry of Economy, the Central Bank and the Stock Exchange to develop a code applicable to banks, listed companies and state-owned enterprises.

Azerbaijan

Azerbaijan's banking sector is still in a relatively early stage of development, with a number of small banks and two major banks dominating the market. In November 2004 the National Bank of Azerbaijan developed a set of Rules on Applying Corporative Governance Standards in Banks. The rules are largely drawn from the Basel Committee's recommendations. The National Bank also prepared a set of voluntary standards on risk management, strategic planning, internal auditing and reporting standards. The framework is complemented by the Law on Banks which establishes the mandatory requirements on the composition of the banks' boards. Banks are required to have an audit committee at the supervisory board level. A Risk Management Committee should be established if a bank's assets exceed Manat 6 million. The creation of other committees is left to the bank's discretion. Accounting regulations require compliance with the International Financial Reporting Standards. The Law on Banks requires that banks be audited by an external auditor. Like the majority of markets in the region, the Baku Stock Exchange is characterised by a low number of listed companies and low liquidity. Lastly, there is no voluntary corporate governance code applicable to listed companies, but a new code is currently being developed.

Georgia

In Georgia there are no specific regulations on corporate governance for banks. The Law on Banking Activity, enacted in 1996 and amended in March 2007 regulates the banking sector. Supervision of banks is performed by the National Bank of Georgia.

One of the major shortcomings of corporate governance of banks in Georgia is the opaque beneficial ownership structure. The Law on Banking Activity previously limited a single shareholder or a group of shareholders acting in concert to a maximum of 25 per cent of the bank's share capital. To overcome this restriction major shareholders began to divide their shareholdings, registering them to different names also using offshore companies. As a result the law was amended in April 2006 and the limitation lifted. At present, it may still be difficult to identify the beneficial owner of shares, regardless of the authority of the National Bank to require information about significant shareholders of banks. The Law requires banks to establish an audit committee. This requirement adds to the provisions enacted by the National Bank requesting banks to establish a credit committee and an asset liability committee. The Tbilisi Stock Exchange is characterised by a relatively high number of listed companies, but trading volumes are very low. The Association of Banks of Georgia is currently working on the development of a voluntary code applicable to banks.

Kazakhstan

In Kazakhstan, corporate governance of banks is not subject to special regulations. The Law on Banks and Banking Activities, issued in 1995, regulates the activities of commercial banks. The National Bank of Kazakhstan and the Agency on Regulation and Supervision of Financial Markets and Financial Organizations are in charge of monetary policy and banking supervision. According to the Law on Banks and Banking Activities, banks are required to set up a credit committee, while there is no legal requirement for the creation of other committees. As shown in Chart 1 on page 32, the Almaty Stock Exchange is the only exchange in the region characterised by some liquidity. A voluntary corporate governance code was developed in 2005 and revised in 2007. It applies to all listed companies including banks.

Kyrgyz Republic

Corporate governance of banks in the Kyrgyz Republic is the subject of a regulation that was enacted by the National Bank of the Kyrgyz Republic (NBKR) in March 2008. The regulation outlines a set of principles dealing with the management of banks, the general shareholders' meeting, the board of directors, professional ethics, conflicts of interest and transparency and disclosure. The regulation complements the Law on Banks and Banking Activities, last amended in May 2008, which regulates the banking business in the country. The NBKR is in charge of banking regulation and supervision. Banks are required to establish an audit committee, consisting of three independent members and a credit committee. The bank's board of directors may decide to create other committees, in particular: a risk management committee and a committee for the management of assets and liabilities. There are three stock exchanges in the Kyrgyz Republic but the number of companies listed and the volume of trade are low. A new corporate governance code is currently being developed.

Moldova

In Moldova the general provisions on corporate governance – also related to banks – are included in the Law on Joint-Stock Companies. Specific provisions applicable to banks are also included in the Law on Financial Institutions. A voluntary Corporate Governance Code, applicable to listed companies (including banks) was developed in 2007. Banks are required to have an audit committee, created from a majority of independent members; a credit committee; an asset and liability management committee; and a risk management committee.

As shown in the chart on page 32 the Stock Exchange is characterised by a high number of companies listed (mainly due to the privatisation process) but a very low trading volume.

Mongolia

The Bank of Mongolia has adopted a "Methodology for implementation of corporate governance in banking organisations", which includes a set of recommendations on how to improve corporate governance of banks. In particular, the methodology concentrates on defining the bank's strategic objectives and management's ethical standards, setting up a clear accountability structure within the bank, conflicts of interest, board supervision and internal and external audits. Further, it recommends that banks establish a risk management committee, audit committee, a remuneration committee and a nomination committee. The issue of the independence of members of the specialised board committee remains problematic.

Tajikistan

The legal framework governing Tajikistan's financial sector has recently undergone significant reform. The banking sector in Tajikistan is essentially regulated by the Banking Law, issued on 23 May 1998 and amended on 2 December 2002. The framework is accompanied by a series of Instructions issued by the National Bank of Tajikistan (NBT).[9] Banks are generally liquid but the expansion of their loan portfolio demands enhanced governance and supervision practices. In particular, higher standards of disclosure should be introduced in order to avoid potential conflicts of interest. Corporate governance of banks is essentially entrusted in the Resolution of the National Bank of Tajikistan Number 69 dated 25 February 2005, "Principles of Corporate Governance in the Commercial Banks and Other Financial and Credit Institutions Licensed by the National Bank of Tajikistan". The principles include a set of seven recommendations aimed at establishing a basic framework for corporate governance of financial institutions. The principles tackle corporate values, strategic objectives, levels of responsibility and accountability, skills and expertise of board members, bank supervision, internal and external auditing, compensation and transparency. The principles recommend that banks establish: a risk management committee; an audit committee, composed of experts of recognised reputation and experience in economic, financial, monetary and legal issues not related to the bank's shareholders; and a Remuneration Committee. In Tajikistan the stock exchange is inactive and there is no voluntary code of corporate governance.

Ukraine

The corporate governance framework in Ukraine is regulated by the Law on Banks and Banking Activities, with its most recent amendments of 27 April 2007 and the Law on the National Bank of Ukraine of 1999 as amended on 1 December 2005. The National Bank of Ukraine (NBU) is responsible for supervision and regulation of the banking sector.

Banks are organised using a two-tier system but in many there is no clear division between the functions of the various governing bodies and often there is a lack of supervision committees. Many weaknesses in the Ukrainian banking system are caused by inconsistent and unclear banking legislation. Related-party lending and insider transactions are two of the major problems. In this context, the NBU has initiated efforts to improve disclosure of bank ownership and structure, which is essential for better evaluating risk management and improving corporate governance practices. There are two major stock exchanges in Ukraine but their liquidity is limited (see Chart 1 on page 32). In 2003, the Ukrainian Securities Commission developed a set of corporate governance principles applicable to listed companies[10] but there is little evidence of these principles being applied by listed companies and banks.

Uzbekistan

The corporate governance framework in Uzbekistan is essentially regulated by the Law on Joint-Stock Companies and Protection of Shareholders' Rights, amended in September 2008. Banking activities are regulated by the Law on Banks and Banking Activity enacted in 1995. Corporate governance of banks is entrusted in the Regulation on Corporate Governance in Commercial Banks enacted by the Central Bank in June 2000. The Regulation oversees the rights and duties of bank shareholders and the management board, and details board committee provisions and board supervision. The law requires banks to establish a revision committee, while the Regulations recommend that the board should establish an audit committee, a credit committee, an investment committee and an asset-liabilities management committee. In June 2005 the Bank Association of Uzbekistan adopted a Banking Ethical Standards Code. Even though the Code is voluntary, most of the banks follow these professional standards as members of the Association. As in many of the other countries in the region, the Tashkent Stock Exchange is characterised by low liquidity.

> **Banks play a key role in guaranteeing the necessary liquidity to companies and may play a key role in improving corporate governance practices.**

The role of supervisors and next steps

The final recommendation is dedicated to the banking sector's watchdogs. The taskforce believes that banking supervisors in the subject countries should place more emphasis on promoting good corporate governance of banks in the region. Banking supervisors should determine whether the bank has adopted and effectively implemented sound corporate governance policies and should have an active role in assessing the quality of banks' internal control functions, internal and external audit.

Conclusion

The policy brief merely sets out the beginning of the process of improving corporate governance in financial institutions. In many of the countries in the region, corporate governance of banks has been the subject of specific secondary legislation but the framework is still insufficient to provide comprehensive regulation. While on the one hand the regulatory process needs to continue, on the other, attention needs to be focused on the effective implementation of the framework.

As the majority of stock exchanges in the region lack sufficient liquidity and are unable to provide financing to companies, banks play a key role in guaranteeing the necessary liquidity to companies and may play a significant role in improving corporate governance practices.
In order to begin this process, it is essential that authorities place corporate governance of banks at the top of their agendas and actively monitor the level of regulation and the practices in place.

A useful monitoring tool is the adoption of voluntary corporate governance codes based on the "comply or explain" mechanism. Voluntary corporate governance codes need to be developed by banking authorities and commercial banks should be required to report on compliance with the proposed recommendations. Any disclosed information should then be assessed by banking regulators and discussed with legislators in order to fine-tune the framework and propose appropriate amendments where necessary.

Notes and author

[1] The subject transition countries for the purposes of this research are Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, Ukraine and Uzbekistan.

[2] The document can be downloaded at www.ebrd.com/country/sector/law/corpgov/eurasia/policyen.pdf

[3] The EBRD's co-financing of the initiative is sponsored by the Early Transition Countries' (ETC) Multi-Donor Fund. Contributors to the multi-donor fund are Canada, Finland, Ireland, Japan, Luxembourg, Netherlands, Norway, Spain, Sweden, Switzerland, Taipei China and the United Kingdom.

[4] For an overview of corporate governance codes in the EBRD region, see www.ebrd.com/country/sector/law/corpgov/codes/index.htm

[5] See www.oecd.org./dataoecd/32/18/31557724.pdf accessed on 22 December 2008.

[6] See www.bis.org/publ/bcbs122.pdf accessed on 22 December 2008.

[7] The term "board" is meant to indicate the board of directors in one-tier jurisdictions, and the supervisory board in two-tier systems.

[8] The requirement that internal control is to be effectively conducted by at least two individuals is called the "four eyes" principle.

[9] NBT Instruction Number 132 (2004), "On order of regulating banks activity" and Government Decision Number 206 (2003) "On fixing of volume (quotas) of participation of foreign capital in the banking system of Republic of Tajikistan".

[10] The English translation of the "Ukrainian Corporate Governance Principles" is available at www.ebrd.com/country/sector/law/corpgov/codes/ukraine.pdf

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05

THE IMPACT OF THE FINANCIAL CRISIS ON THE BANKING SECTOR IN TRANSITION COUNTRIES IN 2008

SIBEL BEADLE

In the second half of 2008, the global financial system experienced a period of exceptional instability. The previous era of strong worldwide economic growth underpinned by low interest rates, ample capital resources, the search for the highest return and rising asset prices came to a halt and was replaced with a "flight to quality",[1] severe funding shortages, illiquid markets, a dramatic drop in the stock markets and a downturn in real estate.

Problems emerged in early 2007, with issues in the US housing market and the subsequent US sub-prime crisis. Financial sector pressures continued to increase throughout 2007 and the first half of 2008. What originally began as the sub-prime crisis and was an asset-based problem for banks with high exposure to derivative instruments[2] and underlying exposure to US sub-prime mortgages, soon became a liquidity and funding crisis for banks worldwide.

Following the bankruptcy of Lehman Brothers in September 2008, the international financial system experienced a marked increase in market stress as counterparties dramatically limited their financial institutions' exposures. Global stock markets, particularly bank equities, dropped dramatically. Risk aversion increased, especially in inter-bank lending, as evidenced by drastically reduced inter-bank liquidity and access to wholesale funding.

The crisis spread beyond the advanced economies where it had originated, with the emerging markets also suffering. Initially, banking sectors in the EBRD's countries of operations[3] were unaffected by the turmoil outside the region as banks in the transition countries had little or no exposure to US sub-prime mortgages. However, the high dependence on external funding in these countries and the extended duration of the crisis led to severe distress. The countries that are currently worst affected by the

> **Strains in the global inter-bank funding network placed financial institutions under intense pressure and a number failed, including some in the transition countries.**

financial crisis are those which had the fastest-growing banking systems before the crisis (see Charts 1a and 1b) and were funding such growth via external sources.

Following the system-wide loss of confidence triggered by the bankruptcy of Lehman Brothers, several transition countries experienced dramatic drops in their stock markets and a rapid increase in credit default swap (CDS)[4] spreads. Many banks no longer had access to external funding or only at exorbitant prices.

Strains in the global inter-bank funding network placed financial institutions under intense pressure and a number failed, including some in the transition countries. These developments prompted national authorities to take unprecedented action to underpin the banking system. Central banks employed measures to ease the intense funding pressure, including lending to a wider range of financial institutions for longer periods and against a broader range of collateral. Regulators in a number of countries restricted the short selling of shares in financial institutions in an attempt to stop share prices falling.

Several countries experienced significant bank failures, such as Ukraine's sixth-largest bank, Prominvest, and 4 out of the top 50 Russian banks. In Latvia the government took over the second-largest bank, Parex Banka. In Serbia, two smaller banks, Metals Banka (1.3 per cent of market share) and Agrobanka (2.3 per cent of market share) became illiquid.

Financial intermediation

Chart 1a
Credit/GDP 2004 and 2007

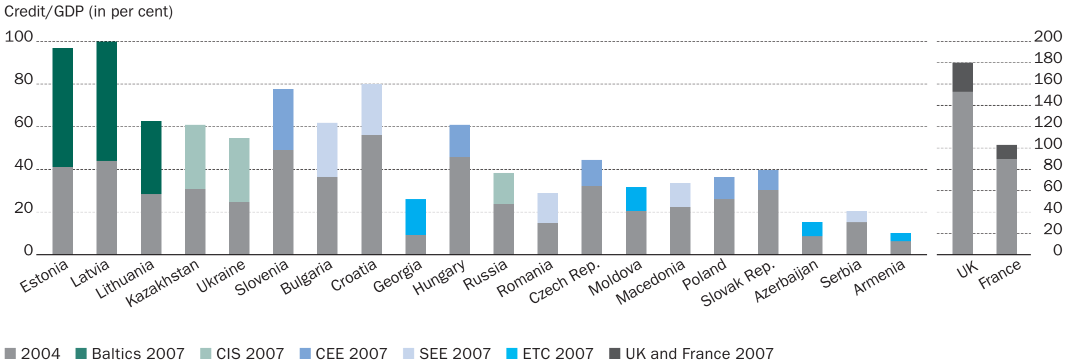
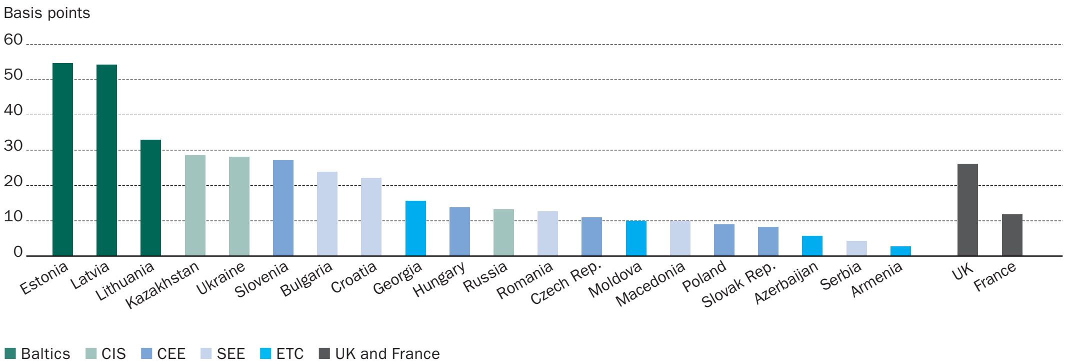


Chart 1b
Change in credit/GDP 2004-07



Source: Fitch Ratings and EBRD estimates.

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According to the International Monetary Fund's *World Economic Outlook*, forecast world growth will slow to 0.5 per cent in 2009.

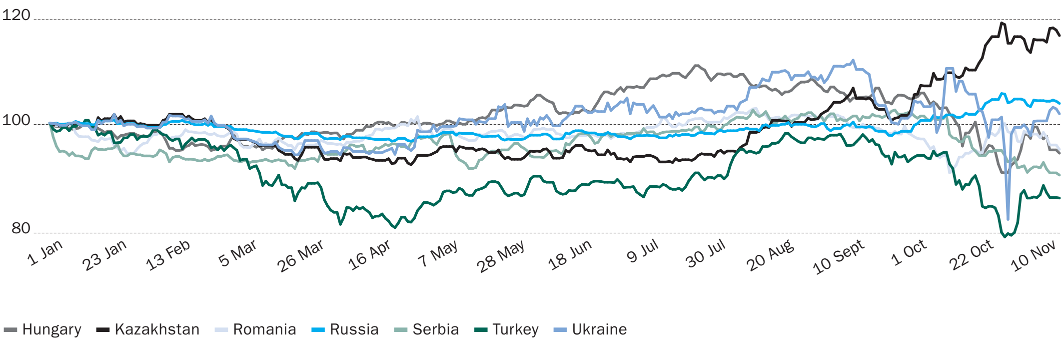
Expectation of moderate growth prospects

According to the International Monetary Fund's (IMF) *World Economic Outlook*, forecast world growth will slow to 0.50 per cent in 2009 (the 2008 forecast was 3.75 per cent); in many advanced economies growth is not expected until mid-2009. The forecast GDP growth in the countries of operations has also dropped to –2.2 per cent and 5.6 per cent, falling from between 7-10 per cent. However, the heavy reliance on international wholesale funding in the banking sector and the turbulent market situation may drag growth down further in some of the more exposed economies. Further, open economies such as the Czech Republic and Hungary, cannot expect to decouple from the global slowdown, particularly given the likelihood of a recession in the eurozone. Elsewhere, Ukraine, in addition to being hit by the liquidity crisis, experienced a terms-of-trade (ToT)[5] shock, with falling steel prices affecting exports, and rising gas import prices. Several other countries of operations that were harder hit by the liquidity crisis are likely to experience a marked drop in growth.

The turmoil in currency markets takes its toll

Due to the high levels of foreign exchange borrowing and lending in the countries of operations, banks are vulnerable to a rapid devaluation of currency. In mid- to late-2008, driven by high volatility in exchange rates, several of the central banks spent significant resources in an effort to support their currencies. In the second half of 2008 Bulgaria, Czech Republic, Hungary, Russia and Ukraine experienced either periods of rapid depreciation or used significant amounts of reserves to prevent a rapid depreciation (see Chart 2).

Chart 2
High volatility in the exchange rates against the euro (indexed to 100 as of 1 January 2008)



Source: EBRD.

According to Fitch Ratings, the banking systems in most EBRD countries of operations are designated as either weak or very weak.

In the process of defending its currency Ukraine's foreign exchange reserve dropped US$ 1 billion over nine days in October 2008. Russia also spent more than US$ 100 billion in foreign exchange reserves to defend the rouble between September and October 2008, which included US$ 30 billion in the last week of October. In contrast to many transition countries, Russia had a strong government balance sheet to start with (mainly due to oil exports) and as of late 2008 still had robust foreign exchange reserves. The central bank's foreign exchange reserves stood at US$ 531 billion (US$ 341 billion excluding the Sovereign Wealth Funds) in October 2008. Nonetheless, pressure has been increasing markedly.

Banks experienced intense pressure to refinance existing loans

The banking sector in several countries faced high refinancing needs; problematic in the wake of the financial crisis. The lack of available credit resulted in slower growth in the banking sector (leading to a contraction in some cases) and is likely to cause problems in banks where the rapid deceleration in lending will lead to a swift accumulation of non-performing loans.

In the second quarter of 2008, Russian banks had short-term debt of US$ 61 billion and corporates US$ 37 billion. In Ukraine, the tight liquidity situation may make the refinancing of US$ 19 billion in 2009 harder than had been anticipated before the crisis.

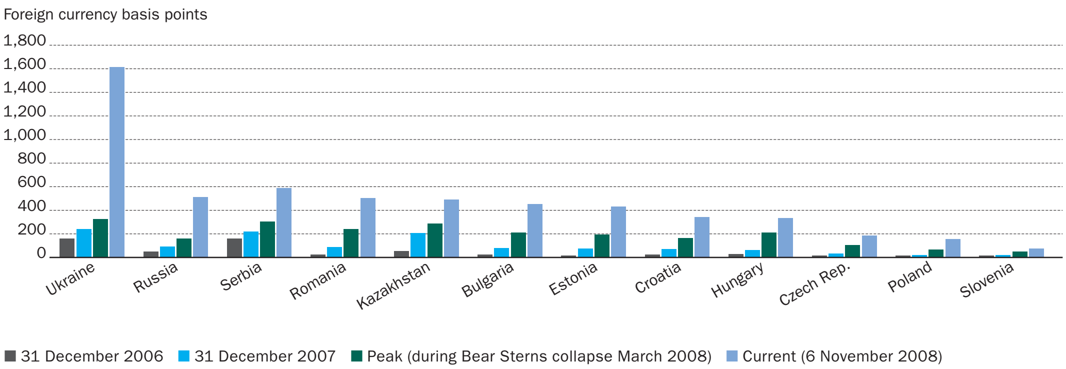
Dramatic repricing of risk

While banks were under intense pressure to refinance existing loans, the market was effectively closed for most, and for those few banks which were able to tap markets, the funding costs were exceptionally high (see Chart 3).

Downgrade of ratings

According to Fitch Ratings, the banking systems in most EBRD countries of operations are designated as either weak or very weak. Several countries were either put on ratings watch or downgraded towards the end of 2008, including Bulgaria, Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Russia, Serbia and Ukraine.

Chart 3
Increase in the cost of risk at the country level (CDS spread, 5-year default)



Source: Markit.

Up to November 2008 the stock indices of Bulgaria, Romania and Serbia dropped more than 70 per cent, Hungary fell 46 per cent and Russia also plummeted by 70 per cent.

Average credit growth in the region will still be faster than anywhere else globally, but has ground to a halt in Kazakhstan and slowed sharply in other countries – notably Azerbaijan; the Baltic states of Estonia, Latvia and Lithuania; Georgia and Ukraine.

In addition, Armenia, Azerbaijan, Kazakhstan, Romania, Russia and Slovak Republic are categorised as countries with vulnerable macroeconomic environments and high banking system stress.

Moody's altered the outlook of Ukraine's key ratings from "positive" to "stable" and lowered the country's local currency deposit rating following the National Bank of Ukraine's six-month suspension on early withdrawal of household term deposits. Fitch also downgraded Ukraine, which reflected concerns that Ukraine faced a material risk of a currency crisis involving a large depreciation of the hryvnia and further financial instability.

Dramatic drop in stock markets

Stock markets have plunged since January 2008. Up to November 2008 the stock indices of Bulgaria, Romania and Serbia dropped more than 70 per cent, Hungary fell 46 per cent and Russia also plummeted by 70 per cent. The shrinking equity values have the potential to trigger a further negative impact on the already-poor economic outlook (see Chart 4).

Liquidity squeeze puts customer deposits under the spotlight

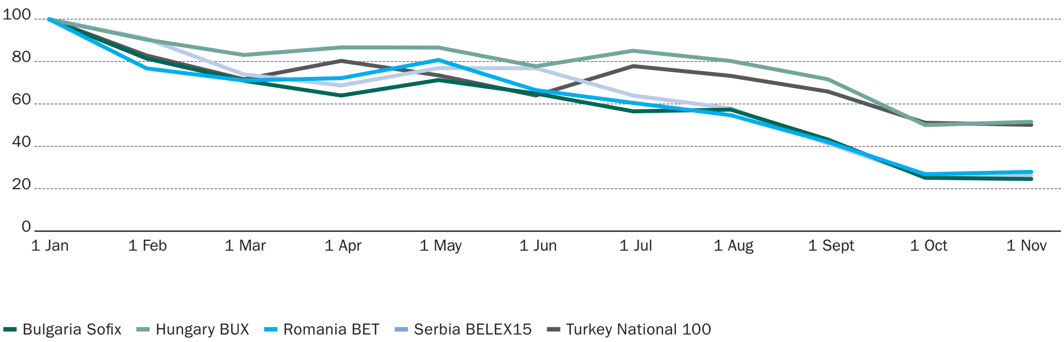
Almost all transition countries experienced some loss of deposits ranging anywhere from 5-20 per cent. In many countries there was also a flight to quality, for some this meant a relocation of deposits to neighbouring countries or moving of deposits between banks.

Ukraine's banking system experienced deposit withdrawals in the second half of 2008, particularly following the failure of Prominvest. Russia experienced a loss of deposits of 5-10 per cent on average since September 2008. Kazakhstan, a country which was hit by the credit crunch as early as September 2007, experienced the most significant deposit losses.

South-eastern Europe (SEE) experienced some deposit withdrawals. Serbia suffered 15 per cent deposit withdrawals (€700 million) in October 2008. In addition, particularly in SEE, there was also relocation of deposits from one country to another as deposit insurance provisions varied widely across the region.

While customer deposits by nature are prone to bank runs and are a relatively expensive source of funding, they are nonetheless the cornerstone of a healthy financial system and an important funding source. In the current environment banks that have expanded their branch networks and customer base have a notable advantage.

Chart 4
Relative performance of stock market indices (indexed to 100 at beginning of period 1 January 2008)



Source: Local stock exchanges.

> **The strong reliance on wholesale funding of the banking sector for financing the credit expansion proved problematic as the global liquidity situation deteriorated.**

Overall the customer deposit base in the transition countries varies from country to country; however, customer deposits as a source of funding (measured as the percentage of total assets funded by customer deposits) are weaker in countries such as Kazakhstan, Russia and Serbia (see Chart 5). Strengthening the customer deposit base in these countries would mean assisting banks to expand their branch network, but also improving the confidence in the banking system by strengthening the financial infrastructure.

The strong reliance on wholesale funding of the banking sector for financing the credit expansion proved problematic as the global liquidity situation deteriorated. Even in those countries where the loan-to-deposit ratio is more balanced, the funding of persistent demand for loan growth has become one of the key challenges. The ongoing pressures on funding and capital resulting from global deleveraging and deteriorating asset prices drove parent banks to reduce external financing to the region. As is common in any slow-down, banks tightened lending criteria due to the prospect of a hard landing and changing funding strategies. Increasingly, subsidiaries operating in the transition countries have been asked to fund a greater portion of credit growth from their domestic markets. In addition, competition to attract customer deposits increased, driving prices up. In order to stabilise the banking system through protecting retail deposits, some countries, including Bosnia and Herzegovina, Croatia, Czech Republic, Lithuania, Romania, Serbia and Ukraine, have raised their levels of deposit insurance.

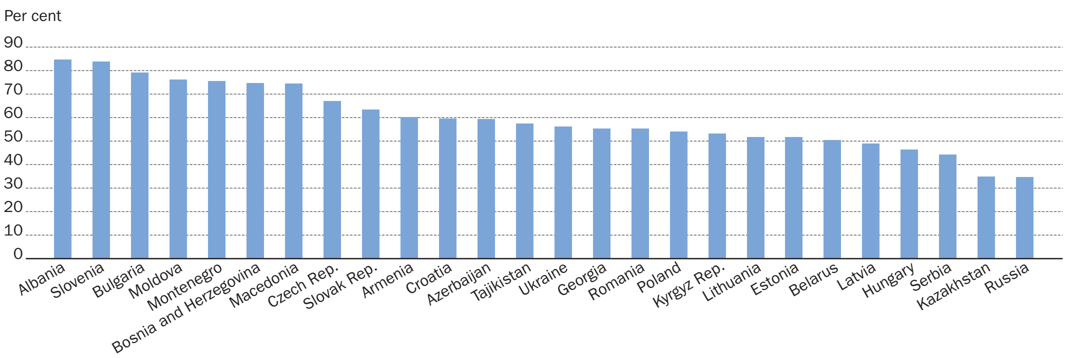
Over the medium term, banks need to adjust the structure of their balance sheets and decrease the funding gap, thus reducing vulnerability to rollover risk by financing a greater proportion of loans through deposits.

Rescue packages

The transition countries actively fought the liquidity crisis by reducing reserve requirements (to release liquidity), fighting devaluation or increasing deposit insurance levels. International rescue packages specifically geared to the transition countries were also implemented.

The IMF announced a short-term liquidity facility designed to help emerging markets with a track record of sound policies to address the fallout from the crisis. The facility, approved by the IMF's executive board on 29 October 2008, is (unlike other IMF packages) unconditional once a loan has been approved and offers extensive upfront financing to help countries restore confidence and combat financial contagion. The European Union revived medium-term financial assistance mechanisms that could make up to €12 billion per country available to EU members that were not already in the Economic and Monetary Union (EMU). The first loan of this type issued since 1993 was offered to Hungary at the end of October 2008.

Chart 5
Customer deposits as a funding source/total bank assets, 2007



Source: CEE Banking Sector Report; EBRD; Fitch Ratings, * or latest available.

> **While some of the problems in the market are temporary, the liquidity crisis has altered financial markets in such a way that some of the changes are permanent.**

Several transition countries are either in talks, or are already receiving IMF support, including Bulgaria, Hungary, Serbia, Turkey and Ukraine.

In Hungary, a joint IMF, European Union and World Bank financing package of US$ 25 billion was approved in October 2008. To prevent mass deposit withdrawals the government also extended a guarantee on all retail deposits. There was European Central Bank (ECB) support in the form of a new overnight standing foreign exchange swap facility supported by a €5 billion repurchase agreement (repo) facility from the ECB. The EBRD has moved to expand its business volume in 2009 by 20 per cent to €7 billion and establish an action plan to support sound banks and other institutions in the region affected by the crisis. To this end projects have already been signed in Georgia, Romania, Ukraine and Russia.

The Russian government committed the equivalent of 15 per cent of GDP to stem the negative impact of the liquidity crisis, including:

- a partial guarantee for inter-bank loans from state-owned to smaller, less well-capitalised institutions
- subordinated lending and central bank repo injections
- fresh capital worth US$ 5 billion for VEB[6] to assist with failures of several second- and third-tier banks
- a central bank credit facility of US$ 74 billion to VEB to provide an external refinancing source for Russian corporations and banks.

The Kazakh government announced at the end of October 2008 that the newly established state-holding company, Samruk-Kazyna, will acquire blocking minority stakes (25 per cent plus one share) in the four largest banks. Initial capital injections are planned as follows:

- BTA (US$ 2.3 billion)
- Alliance Bank (US$ 500 million)
- Halyk Bank (US$ 500 million)
- KKB (US$ 300 million).

This equity participation would be temporary (three to five years), until international liquidity conditions improve. The government is likely to be represented on the supervisory and management boards of the banks. In addition to the capital injections, Samruk-Kazyna plans to issue bonds for up to US$ 5 billion (to be acquired by the National Oil Fund), which will be deposited within the banks and designed for financing small and medium-sized enterprises (SMEs) and other sectors considered to be important for the economy. Existing shareholders and potential foreign investors will be offered an opportunity to inject capital as well as liquidity before the newly established public fund intervenes.

Conclusion

The transition countries continue to enjoy outstanding prospects for growth and prosperity. The financial sector in these regions was, early on, able to defy the impact of the US sub-prime crisis on the availability and pricing of external funding. However, the spread of the contagion to other parts of the financial market and the global economy, as well as the extended duration of the crisis, have left a mark on the banking sector development.

While some of the problems in the market are temporary, the liquidity crisis has altered financial markets in such a way that some of the changes are permanent. As a consequence, the current market situation will have significant implications for the region, the state of financial institutions, as well as the responsibility of the EBRD.

Whether the measures adopted so far will be sufficient to limit the negative effects of the liquidity and funding crisis remains to be seen. It is important for the development of the banking sector to proactively safeguard the reform progress made to date, including overseeing the legal reform in the region.

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One of the main criticisms of the Basel II framework has been its pro-cyclical nature.

The implementation of Basel II in EU countries and its impact on transition economies

While the transition countries have not yet adopted the Basel II framework, its implementation in several developed countries and in the European Union region had a negative impact on the transition region in the current environment. This was due to the:

- pro-cyclical nature of Basel II
- turmoil in CDS markets that made the hedging of emerging market exposure difficult or expensive
- dramatic increase in risk aversion.

One of the main criticisms of the Basel II framework has been its pro-cyclical nature. In the framework, banks are required to hold higher capital against higher risks. However, since capital requirements are directly linked to the ratings of institutions, in today’s volatile environment with banks, corporates and countries having been downgraded, the structure also requires banks to put aside additional capital in a downturn. For example, in 2008 the main rating agencies Standard & Poor’s, Moody’s and Fitch Ratings downgraded 70-80 per cent of all their ratings on structured instruments by several notches. Many international banks, which before the crisis would have never been questioned, were downgraded. The sovereign ratings of several transition countries were also downgraded. During such turbulent times, the Basel II framework requires that banks continuously increase their equity in order to be able to maintain their capital adequacy.

The turmoil in the CDS markets also had a negative effect on the transition region. The direct impact of this was that CDS spreads rocketed and made lending very expensive. However, there was also a more subtle but nonetheless significant impact with the implementation of Basel II in most developed countries. Before the crisis, CDS spreads were low and it was easy for an international bank operating under Basel II to have exposure to emerging markets and hedge this exposure by buying protection in CDS markets. Protection was cheap and often provided by a triple-A rated institution, therefore avoiding hefty capital charges. According to Basel II, the capital that a bank would need to put aside for a €100 loan to a B-rated corporate client (or loan to another bank) would be €12. However, if this bank were to hedge this position by buying protection from a triple-A rated institution, the capital requirements are as low as €1.60.

Following the bankruptcy of Lehman Brothers, CDS markets went into turmoil and it became very expensive to hedge exposure to emerging markets. This limits the willingness of banks to lend to other banks and corporates in emerging markets. Such increased risk aversion is probably having the largest negative impact on institutions’ willingness to lend to emerging markets. However, the Basel II implementation certainly did not help.

Notes and author

[1] The flow of funds from "riskier" to "safer" investments in times of financial crisis or market uncertainty.

[2] Derivatives are financial contracts, whose values are derived from the value of something else (the "underlying"). Examples are: forwards (or "futures"), options and swaps.

[3] Countries where the EBRD invests.

[4] Credit default swaps are derivative contracts (swaps) designed to transfer the credit exposure of fixed income products between parties. CDS spreads are often used as a crude indicator for risk and in pricing. A sharp increase in spreads indicates a marked increase in the risk associated with that country or that institution, and a steep increase in prices. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the product's creditworthiness. Therefore the risk of default is transferred from the holder of the fixed income security to the seller of the swap. For example should the bond default on its coupon payments, the buyer of a credit swap will be entitled to the par value of the bond from the seller of the swap.

[5] ToT is the price a country receives for its exports relative to the price it pays for its imports. Improved ToT is beneficial for an economy as it "costs" fewer units of exports to pay for a unit of imports. Sudden and unexpected changes in this relationship are known as ToT "shocks" and have serious implications for the economy in question, such as sudden changes in the profitability of industry, reduced real income and deteriorating economic growth.

[6] Vnesheconombank (VEB) is a Russian bank commonly known as the Russian Development Bank. It is used by the Russian government to support and develop the economy and to manage Russian state debt and pension funds.

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06

CORPORATE GOVERNANCE AND THE BANKING SYSTEM IN BULGARIA

BISTRA BOEVA

This article describes corporate governance practices in Bulgaria's banking system, a country that moved from being a centrally planned to a market economy in a short space of time, joining the European Union in 2007. This article discusses not only the basic features of corporate governance in Bulgaria but also the importance of the reliability of that system.

Corporate governance developments in Bulgaria

Corporate governance is one of the features of the modern Bulgarian economy. The dramatic changes in corporate ownership, the transformation from a centrally planned economy towards a market-driven one and the creation of a new legal framework and system of regulation, have created a favourable environment for the development of corporate governance in the real economy[1] and the financial sectors.[2]

It is worth shedding some light on the components of this legal framework. The main pieces of relevant legislation are the Commerce Act, the Law on Public Offering of Securities (LPOS), the Accountancy Act and the Law on Financial Independent Audit.[3]

Within the Commerce Act, with which all joint-stock companies must comply, there are provisions for the protection of shareholders and minority shareholders, disclosure and fiduciary duties for board members. The governance structure of Bulgaria's joint-stock companies is defined by that law. Bulgarian companies, including public companies and banks, have a unique choice: it is at their discretion to decide on the implementation of a one-tier board structure (board of directors only) or a two-tier (supervisory board and management board) board structure. Companies floating on the Bulgarian Stock Exchange (BSE) must comply with the additional requirements provided by the amended LPOS, that is, that one-third of board members (supervisory board or board of directors) must be independent directors.

Companies are also required to disseminate information about their corporate governance practice and conflicts of interest. The latest amendments to the Law on Financial Independent Audit, which occurred in 2008, require that enterprises acting in the public interest should establish an audit committee.[4] The ongoing implementation of this provision indicates another step towards a modern corporate governance infrastructure.

In the last two decades the Bulgarian banking system has undergone several crucial stages, accompanied by turmoil and change.

Like most former socialist countries, it is the "top-down approach" that characterises the way corporate governance began in Bulgaria: the state provides standards and guidance while businesses develop adequate practices. At present, the National Code on Corporate Governance[5] offers detailed guidance to the business community on how to implement the corporate governance best practices. Bulgaria's membership of the European Union (EU) encouraged local business and investment circles to build on the Code, with an aim to serve the public interest and foster the development of efficient financial and capital markets.[6] Aligned with the globally accepted OECD (Organisation for Economic Co-operation and Development) Principles of Corporate Governance,[7] the Code marks the transition from a top-down approach to a mixture of top-down and bottom-up approaches.

The Bulgarian banking system

In the last two decades the Bulgarian banking system has undergone several crucial stages, accompanied by turmoil and change. The emblematic financial crisis of 1996-97 brought about significant transformations in the national financial landscape and led to the establishment of the Currency Board.[8] This was followed by the privatisation and acquisition of Bulgarian banks by international banks and membership of the European Union in 2007. The current banking system started from a very low level of transactions intermediated by the financial system and has gradually grown to reach the levels of other EU banking systems. The Bulgarian banking system exhibits the following characteristics:

- The privatisation of the banking sector is complete. At present 98 per cent of the banking assets are owned by the private sector.
- There is a high concentration of ownership or a block-holder (majority shareholder) governance structure.
- Most bank assets are in the hands of foreign financial institutions. At present the biggest Bulgarian Banks are Unicredit Bulbank, DSK, United Bulgarian Bank, Raiffeisen Bank, EuroBank and EFG Bulgaria (the "big five") which are subsidiaries of international financial groups from Italy, Hungary, Greece and Austria. These same countries characterise the share ownership in the majority of banks and foreign branches in Bulgaria.
- As in many other transition countries, banking reform was supported by the equity participation of international financial institutions such as the IFC (the International Finance Corporation) and the EBRD.
- The market share of the five largest credit institutions had reached 57.6 per cent by mid-2008.[9]
- Based on commercial banks,[10] rather than investment banks, the system is supervised by the bank regulator, the Bulgarian National Bank. Regulation of the banking system is consistent with the European Union's *acquis communautaire*: that is, EU directives on banking are incorporated into the Bulgarian legal system. The National Bank has succeeded, through prudent and systematic regulation measures, in establishing a sound banking sector in Bulgaria.
- The Currency Board was established in 1997. The Board has a positive impact on the economy, both from the perspective of the results achieved, that is, the increasing confidence of the international investment community and rising inflows of foreign direct investment (FDI), as well as from the perspective of the global financial crisis. The strict regulation that followed the establishment of the Currency Board, as well as the linkage of the national currency to the euro[11] have contributed to the macroeconomic stability in the country. This can be attributed to the stable level of the national currency that is in stark contrast to the devalued national currencies in other emerging economies as a result of the current global financial crisis.
- Lastly, we point out the measures that the government has initiated to cushion the impacts of the crisis, such as prudent and conservative regulation of the banking sector.[12]

The present foundations of the Bulgarian banking sector demand fair and sound rules for bank activities.

The present foundations of the Bulgarian banking sector, that is, the concentrated ownership structure, high level of competition and a significant degree of involvement in the EU financial system on the one hand, and prudent and conservative regulation on the other, demand fair and sound rules for bank activities.

Bulgaria's system of corporate governance

The corporate governance system in Bulgaria corresponds to the principles that the OECD recommends to public companies.

How do the specifics of the banking sector accommodate these principles?

Various academics have examined the phenomenon[13] without offering sufficient arguments. They have focused on the banks' position in the economy and the special attention the banks pay to depositors, customers and shareholders. Some academics have concentrated on the role of banks for national and international financial stability.[14] International practices have introduced some important measures. In 1999 the Basel Committee on Bank Supervision developed a modified version of the OECD Principles adapted to the banking sector. In 2006 a new format[15] of corporate governance rules for banks was presented. Its focus was on the responsibility and accountability of the boards, transparency and internal control and audit. Bulgaria's legislation, regulation and practice are benchmarked to these principles.

Legal framework and Basel principles for corporate governance

A thorough examination of the Law on Credit Institutions[16] reveals not only the standards for banks and their various functions but also provides owners and managers with the basics of corporate governance. According to the law, the submission of a bank license must include information about the internal control rules of the future bank, including: *"[a] clear organisational structure with well defined transparent and adequate levels of responsibilities and efficient procedures for identifying management, monitoring and reporting the risks to which the bank might be exposed."*[17]

The law requires management to adopt and regularly review the bank's organisational structure as well as the procedure for defining and delegating the power and responsibility to the administrators[18] with reference to risk management and control system efficiency.[19]

Another provision of the law foresees the establishment of an internal audit office and appropriate management staff;[20] a pillar of the modern corporate governance structure. The law explicitly provides a norm for the external audit, with which the banks must comply.[21] There is a strict provision that an external auditor cannot audit a bank's financial reports for more than five consecutive years.

In addition, the Law on Credit Institutions details the basic requirements with which the banks' owners, directors and managers must comply. Articles 51 and 52 of the Law require board members to disclose conflicts of interest in writing and the bank's administration[22] to elaborate on procedures for such disclosure. The same Law also establishes detailed rules for disclosure of key corporate governance documentation[23] such as financial results and information on shareholders' meetings.

The Law on Credit Institutions makes essential the "fit and proper" criteria for banking directors and managers. Management board members and the board of directors must be university educated (other documents further specify a masters-level university degree in economics or law) and hold a sufficient qualification and have professional experience in banking.[24]

Our study of corporate governance in the Bulgarian banking sector revealed that disclosure is one of the priorities of the banks' boards.

The law also promotes the concept of "fiduciary duty". In the section on disclosure of conflicts of interest and fiduciary obligations, the legislator foresees that *"in performing their functions administrators and other employees of a bank shall be obliged to place the interest of the bank and its customers before their own interest"*.[25] The concept of fiduciary duties is not new for the Bulgarian business community. It was the LPOS in 2002 that introduced the standards for duty of care and duty of loyalty (Article 116 b)[26] for the board members of public companies.

The above summary of the Law on Credit Institutions leads us to conclude that Bulgaria's legislation, in synthesis with EU Directives, contains a number of corporate governance principles that the Basel Committee recommends. From this perspective, the Bulgarian banking system could be considered to be aligned with the modern format of corporate governance.[27]

Banking practice and Basel principles on corporate governance

From a practical point of view, it is interesting to observe how banks cope with these legal requirements.

Our research[28] reveals that banks comply extensively with the legal requirements. This was confirmed by the representatives of the Bulgarian National Bank and the corporate board members. The legal framework translates into rules and procedures that the banks implement. What is important is the fact that commercial bank managers and directors view the above standards not only as legal requirements. As previously mentioned, in the course of the interviews that were conducted, it was explicitly confirmed by the bank administrators that their understanding of the above standards tallies with their appreciation of specific corporate governance principles drawn up by the Basel Committee. In other words, in the course of compliance with the Law on Credit Institutions the managers and directors of Bulgarian banks have gradually accepted the good practice of corporate governance.

Banks also pay special attention to the protection of depositors' and shareholders' rights. Among the priorities of corporate governance in the banking sector the following should be highlighted:

- the internal organisation structures that serve the requirements for effective implementation of the fiduciary obligations
- internal control and clear responsibilities of the management and the board members.

Our study of corporate governance in the Bulgarian banking sector revealed that disclosure is one of the priorities of the banks' boards. It is not typical for a bank to disclose information that it legally does not have to. This is another feature that differs between corporate governance in the banking sector and the practice in the real sector.

Each bank's position as intermediary on the financial market helps it to promote the implementation of corporate governance principles in the real sector.

How is this highly important role to be decoded? Banks maintain a number of rules in their credit activities. Whereas formal criteria once existed for evaluating a prospective credit applicant, corporate governance is no longer among the basic criteria to be taken into consideration at this stage. Banks' board members share the view that the corporate governance practices of their clients are more important in the course of management of credit transactions, that is, after the credit application has been approved. The banks are increasingly playing a stakeholder role, demanding more transparency and disclosure.[29]

Lastly, Bulgarian banks adhere to the internal Ethical Code, with a view towards prudent and efficient banking.[30] From the perspective of corporate governance, the standards that the Code sets for the banks are very important, such as those regarding relationships with clients and bank-stakeholder relationships.[31] The Code foresees that the relationship between the bank and its clients will function on the principles of mutual trust and the bank's disclosure of reliable information.

> **Corporate governance adds value to the efforts of law-makers and regulators to maintain a stable financial system and help it to function properly.**

Plain language is recommended for every document addressed to clients by the banks.[32] The voluntary nature (that is, the fact that the codes are not prescribed by the law or by the regulator) of the document could be considered another pillar of corporate governance in Bulgaria's banking sector.

The field research into banking practice in Bulgaria, as well as observance of the legal framework, give us grounds to conclude that the Basel principles on corporate governance are shared by the corporate board members of Bulgarian Banks irrespective of whether they are publicly floated companies or not. In presenting the status of corporate governance in the sector it is worth noting that the few banks with free float that are traded on the BSE (official market-segment B)[33] comply with the additional requirements for corporate governance imposed by the LPOS (for example, requirements for independent directors, appointment of investor relations officers,[34] and so on). According to that Law, all public companies including the Corporate Commercial Bank, First Investment Bank and Central Cooperative banks[35] are required to disclose not only a financial statement certified by a registered auditor as provided by the Accountancy Act, but also an annual activity report and a programme for the application of internationally recognised best standards of corporate governance.[36] In conclusion we should also mention that the above banks have officially declared their acceptance of and compliance with the National Code of Corporate Governance.

Other drivers affecting corporate governance practice in the Bulgarian banking system

The above information reveals the basic drivers for the implementation of corporate governance: the legal and regulatory framework and the code.

Looking at the governance structure of the majority of Bulgarian banks it is not difficult to deduce their multi-faceted relations with large regional and international financial groups. As part of these groups, local banks are linked not only through ownership ties with their parent companies, but also through an internal system of rules and procedures.

The results of interviews with the managers and directors of Bulgarian banks[37] reveal that parent companies of the "big five" Bulgarian banks,[38] as well as the parent companies of the majority of the remaining banks, comply with the laws and national codes of corporate governance in the country of their registration in the European Union, the United States and Japan. Apparently Bulgarian subsidiary companies are positively affected by the good standards of the corporate banking in these countries. The direct foreign involvement in Bulgarian banks also enhances corporate governance practices.[39]

In this regard we can also conclude that in the Bulgarian banking sector two systems co-exist: a formal system for the implementation of corporate governance (that is, laws regulating the banking activities, laws regulating banks traded on the BSE: the National Code for Corporate Governance) and an informal system of implementation of corporate governance practices (that is, internal rules that banks follow as part of international banking groups).

Both systems embed the basic standards and checks and balances of corporate governance, as well as the Basel principles for the banking sector.

Although reflecting the specifics of the national banking system, the corporate governance implemented by Bulgarian banks corresponds to modern trends and practice.

This review discusses not only its basic features but also the importance of the reliability of that system. Corporate governance adds value to the efforts of law-makers and regulators to maintain a stable financial system and help it to function properly.

Notes and author

[1] The real economy refers here to the manufacturing and other sectors of the economy, but excludes the financial sector.

[2] During the period of voucher privatisation, the legislator prepared some standards of corporate governance to protect the rights of share owners and enhance their confidence during the transition process. Although these standards were coming into effect, a new law was introduced that enforced the transformation of more than 1,400 privatised companies from closed to public. That way any siphoning of these companies was blocked and the securities trade began on the Bulgarian Stock Exchange. The progress in building the foundations of a more favourable environment of transparency, accountability and protection of minority shareholders' rights was marked by the adoption of the Law on Public Offering of Securities (LPOS) in 2000.

[3] The Law for the Amendment of the Law on Independent Financial Audit, State Gazette issue 67, 29.07.08, article 40e. According to the definition, enterprises that act in the public interest are public companies, issues of securities that are traded on regulated capital markets, banks and insurance companies.

[4] Ibid.

[5] The document on corporate governance codes in the EBRD region is available at: www.ebrd.com/country/sector/law/corpgov/codes/index.htm.

[6] To unify the efforts of the Bulgarian business community, the BSE, regulators, NGOs and the academic community, a voluntary taskforce launched the Bulgarian National Code for Corporate Governance on 9 October 2007. The launch demonstrated the willingness of the business community to work according to the Code's basic principles. The BSE published the Code on its web site (www.download.bse-sofia.bg/pdf/CodeksEN.pdf accessed on 17 December 2008).

[7] See "White Paper on Corporate Governance in South East Europe", OECD, June 2003 (www.oecd.org/dataoecd/9/21/20490351.pdf accessed on 17 December 2008).

[8] The Currency Board, established in 1997, is an entity charged with maintaining the value of local currency with respect to another specified currency. The board combines a traditional rule-based exchange arrangement with legal and structural measures. It combines a fixed exchange rate between the Bulgarian lev and a benchmark currency (for example, the euro), automatic convertibility and a long-term commitment to the board's system.

[9] Banks in Bulgaria, April-June 2008, Bulgarian National Bank, S. 2008.

[10] At present there are 24 commercial banks and six branches of foreign banks in Bulgaria.

[11] W. Kouts, "Bulgaria and the global financial crisis", third annual meeting of the Bulgarian government and Bulgarian business, Dnevnik, 29.10.08

[12] Ibid.

[13] See for example, G. Ferri, "Corporate governance in banking sector and economic performance", ADB Institute Discussion Paper N 3, August 2003, p 13.

[14] J. Charkam (2003), "Guidance for the Directors of Banks", Focus 2, Global Corporate Governance Forum, Washington DC, www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/Focus_2_Guidance_for_Directors/$FILE/Focus_2_Guidance_for_Directors_of_Banks.pdf Accessed 5 January 2009.

[15] "Enhancing corporate governance for banking organisations", Basel Committee on Banking Supervision Basel (September 1999 version: www.bis.org/publ/bcbs56.pdf?noframes=1; February 2006 version: www.bis.org/publ/bcbs122.pdf). The principles that the Basel Committee recommends are: the role of the corporate boards for overseeing the strategic objectives; corporate boards should set and enforce clear lines of responsibility and accountability throughout the organisation; the board should ensure that there is appropriate oversight by senior management consistent with board policy; the board and senior management should effectively use the work conducted by the internal audit function, external auditors and internal control functions; the bank should be governed in a transparent manner; and lastly, supervision should provide guidance to banks on sound corporate governance and a proactive policy should be in place.

[16] Law on Credit Institutions, Durzaven vestnik, issue 59, 21.07.06. It is worth mentioning that the law transposed EU Directive 2006/48 which embedded Basel principles on corporate governance.

[17] Law on Credit Institutions, Article 15 Durzaven vestnik issue 59, 21.07 06.

[18] According to the additional provisions (1) of the Law on Credit Institutions, the administrator must be a member of the supervisory and management board (board of directors); a procurator or someone who manages specialised internal control.

[19] Ibid, Article 73.

[20] Details on the implementation of norms for internal control are embedded in a separate Ordinance (N 10).

[21] Law on Credit Institutions, Article 76, paragraph 1.

[22] See note 16.

[23] According to article 70, Law on Credit Institutions: "…[a] bank shall publish its balance sheet and profit and loss account every six months in at least one central daily newspaper."

[24] Law on Credit Institutions, Article 11.

[25] Law on Credit Institutions, Article 51, paragraph 5.

[26] In the course of implementation of ROSC I on corporate governance in Bulgaria, the concept for fiduciary duties was embedded in LPOS in 2002. Later the Commerce Act (Article 237) enlarged the implementation field of the concept for all joint-stock companies.

[27] "Enhancing corporate governance for banking organisations", Basel Committee on Banking Supervision, Basel, February 2006.

[28] In the course of October 2008 the author interviewed managers and directors of Bulgarian banks. The goal of the field research was to reveal the status of corporate governance practice in the national banking sector.

[29] This function was foreseen in the White Paper on corporate governance in south-eastern Europe, OECD, June 2003, p 67.

[30] In 2004 the members of the Association of Commercial Banks in Bulgaria (known as the Association of the Banks in Bulgaria since 2007) introduced the Ethical Code for the overseeing of its activities. It regulates the banks' relationships with their clients, stakeholders and so on.

[31] See www.abanksb.bg/, Ethical Code, accessed on 17 December 2008.

[32] Ibid.

[33] See www.bse-sofia.bg/ accessed as before.

[34] LPOS, 2000.

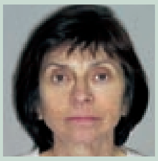
[35] These three banks are classified as public companies, according to LPOS standards. Nine Bulgarian banks are bond issuers.

[36] LPOS, article 100.

[37] The field research and interviews were conducted by the author in October 2008.

[38] The banks' names are detailed on page 52.

[39] Some academics such as B. Kogut consider foreign direct investment to be promoting corporate governance. G. Ferri shares the view concerning the positive impact of foreign banks on the efficiency of the domestic sector ("Corporate governance in the banking sector and economic performance", ADB Institute Discussion Paper Number 3, August 2003).



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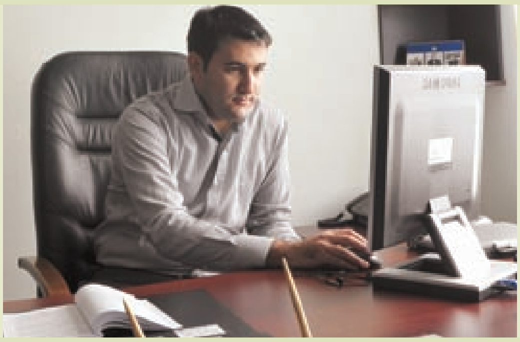
Part III
Legal transition in Turkey



Turkey was a founding shareholder of the European Bank for Reconstruction and Development in 1991. However, it was only in November 2008 that it became a country of operations of the Bank. This means that the EBRD can now invest in Turkey and the prospects for such investments are numerous: infrastructure, agribusiness, small and medium enterprises, to name a few. Besides the investment support that the EBRD can bring to Turkey, an important policy dialogue is anticipated with its authorities, including those in the legal sector. The country shares many of the features of transition economies and many of the reform challenges. The EBRD's well-established expertise in fostering transition to market economies will doubtless be an asset in helping Turkey develop its potential.

Turkey had, until the 1980s, what was virtually a planned economy. Thereafter, a liberalisation movement led to significant improvements in commercial legislation in accordance with the needs of an open market economy. A large number of new laws have been enacted and amendments to existing laws have been made. Despite the fact that reform progress has slowed periodically due to a number of economic crises, the pace of reform has recently quickened as a result of the economic progress during 2005-08 and the prospect of European Union (EU) membership.

Using a methodology developed by the EBRD's Legal Transition Programme (LTP), the first article in this section, written by Michel Nussbaumer and Özlem Barut of the EBRD's Office of the General Counsel, assesses selected

components of Turkey's commercial law. It presents the main findings related to corporate governance, insolvency and secured transactions – areas fundamental in attracting foreign investment to Turkey. Based on the EBRD's experience in other transition countries, it is suggested that significant economic potential could be unleashed by reforming Turkey's secured transactions regime.

In the second article, Elisabetta Falcetti and Elçin Akçura, from the EBRD's Office of the Chief Economist, look at the main transition challenges faced by Turkey. They include the financial sector and access to finance; general industry and trade; and energy and infrastructure. The main focus of the EBRD's efforts will be on sectors and product areas where there are significant transition gaps.

Following this, Halil İbrahim Çanakcı, Undersecretary of the Treasury of Turkey describes recent structural reforms in the country and examines legal aspects associated with them.

Lastly, Güniz Gökçe and Tulu Harsa, Partner and Associate, respectively at Gide Loyrette Nouel in Istanbul, discuss issues surrounding minority shareholder protection in mandatory tender offers of public companies amid the context of Turkey's commitment to adopt the European Union's *acquis communautaire*.

07

ASSESSING TURKEY’S COMMERCIAL LAWS: AN EBRD PERSPECTIVE

MICHEL NUSSBAUMER AND ÖZLEM BARUT

Using the methodology developed by the Legal Transition Programme, in late 2008 the EBRD assessed selected components of Turkey’s commercial law.[1] This article presents the main findings related to corporate governance, insolvency and secured transactions – areas fundamental in attracting foreign investment to any country.

Following the end of the Ottoman Empire and the formal abolition of the Sultanate, the Republic of Turkey was established in 1923 under the leadership of Ataturk, who swiftly instituted a series of legal reforms. A new constitution was adopted in 1924 and the country formally became a secular state in 1928. The Islamic codes were then replaced by Western-style legislation reflecting the influence of various European countries.

The Civil Code and Code of Obligations were adopted from Switzerland in 1926, virtually word for word.[2] Similarly, the Execution and Bankruptcy Code was based substantially on its Swiss equivalent. At the time, Swiss law was considered to be modern and simply formulated, which made it very attractive to the new state.[3] Around that time, a Commercial Code based on the German and Italian systems was enacted. This Commercial Code was abolished in 1956 by a new code prepared by a German academic.[4] Lastly, codes of administrative law were mainly adopted from France as a result of the long tradition of French influence on the administrative system of Turkey.

Until the 1980s, the Turkish economy was virtually a planned economy – with a small, financially weak and uncompetitive market sector. The ball was set rolling for Turkey's liberalisation movement in 1980 under the influence of Western liberalisation trends. This led to improvements in commercial legislation in accordance with the needs of an open market economy. Since then, a large number of new laws have been enacted and amendments to existing laws have been made. Despite the fact that reform progress has slowed periodically due to a number of economic crises, the pace of reform has recently quickened as a result of the economic progress during 2005-08 and the prospect of European Union (EU) membership.

Turkey, which was a founding member of the EBRD, became a country of operations of the Bank in November 2008, which means that the EBRD can now invest in that country.

Turkey began early on in 1959 to seek close cooperation with the European Economic Community (EEC). This cooperation was established with the Ankara Agreement executed in 1963 and further strengthened by the European Union-Turkey Customs Union which took effect in 1996. One of the key dates on Turkey's path towards potential EU membership was in October 2005, when accession negotiations began.[5]

Turkey, which was a founding member of the EBRD, became a country of operations of the Bank in November 2008, which means that the EBRD can now invest in that country. Within this context, one of the EBRD's objectives is to encourage and contribute to ongoing and future legal reform efforts in Turkey. Turkey is now seeking to develop an entrepreneurial economy and attract foreign investment, while facing the challenges of sustaining and consolidating its internal markets. The country shares the characteristics and reform challenges of transition economies.[6]

Assessing the quality of commercial legislation

In terms of its analysis[7] of corporate governance and insolvency legislation, the EBRD assessment usually involves a two-step process. First, the Bank evaluates the level of compliance of local legislation (the "law on the books") against the relevant international standards of best practice. This first criterion is referred to as the "extensiveness" of the legal framework. Analysis is conducted on the basis of a checklist of questions, which reflect the relevant international standards. The second step of the analysis relates to the law's "effectiveness", that is, the actual practice developed in the countries. This type of assessment is based on case studies which serve as proxies for the functioning of the relevant area of law.[8]

In the field of secured transactions, the Bank has undertaken a review of the relevant legislative provisions and their application against the EBRD Core Principles for a Secured Transactions Law.[9] The principles are drawn on the assumption that the role of a secured transactions law is economic. It is not needed as part of the essential legal infrastructure of a country: its only use is to provide a legal framework enabling the operation of a market for secured credit. The principles do not seek to impose any particular solution on a country – there may be many ways of arriving at a particular result – but they do indicate the result that should be achieved.

Insolvency

Insolvency in Turkey is primarily governed by the Enforcement and Bankruptcy Act (EBA), enacted in 1932 and amended in 2003 and 2004 in the wake of the economic crisis in 2001. In addition, the Turkish Commercial Code, Code of Obligations, Code of Civil Procedure and the Banking Act also govern various aspects of the insolvency system. The EBRD assessment indicates that the EBA and related legislation work together to form a relatively sound insolvency regime, although specific improvements are needed.

As Chart 1 indicates, the Turkish insolvency laws "on the books" are at medium-to-high compliance with recognised international standards of best practice.[10] Provisions for the treatment of estate assets and creditors are fully compliant with international standards but there is significant room for improvement of legislation governing case commencement, liquidation and reorganisation processes.

The EBA adequately defines assets forming the debtor's estate and requires that they be delivered to a functionary for protection. The EBA also contains provisions for avoidance of pre-bankruptcy transactions that are below market value, preferential or intended to defeat the interests of creditors.

Creditors receive adequate notice of the requirement to file claims which may be lodged at any time during the proceedings. Creditors also have adequate rights of participation in the insolvency proceedings, including the right of appeal, and creditors of the same class are treated equally. The rights of secured creditors to recover completely from the proceeds of asset foreclosure are fully protected.

Although most of Turkey's insolvency provisions are sound, the EBRD's insolvency assessment has identified several areas of the insolvency legislation that would benefit from improvement.

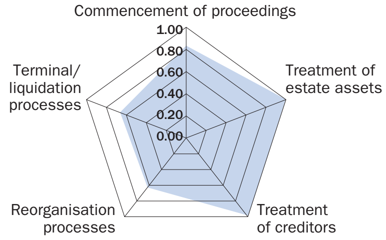
The Insolvency law adequately provides for the preparation and approval of a reorganisation plan, but fails to ensure that all creditors receive sufficient information about the plan before voting.

In the area of commencement of proceedings, provisions for appointment of a functionary to oversee the debtor's estate are particularly lacking. The EBA provides for court appointment of a three-person body called the Bankruptcy Administration (BA) to serve in the role of functionary, but there is no requirement that any of the BA members be independent or lack conflicts of interest. Members of the BA are also not required to have specialised training or knowledge. Instead, the EBA requires only that the functionary have "sufficient knowledge and experience in the business line of the debtor". Other commencement provisions that would similarly benefit from revision include procedures for notifying individual creditors that proceedings have begun and strengthening the automatic stay of actions that attaches when the court declares the debtor bankrupt.

Improvements in the areas of reorganisation and liquidation/terminal proceedings are also needed. For example, the law adequately provides for the preparation and approval of a reorganisation plan, but fails to ensure that all creditors receive sufficient information about the plan before voting. A related regulation regarding the reorganisation of corporations requires plans to certify that creditors have been given all material information necessary to vote, but there is nothing in the insolvency law itself that would guarantee this protection. The EBA would also benefit from stronger provisions for the management of a debtor's business during the reorganisation process and provisions directed at reorganisation financing. Liquidation/terminal provisions could also be improved by providing for a complete discharge of the debtor on completion of proceedings and enabling the Turkish courts to assist in respect of foreign proceedings.

In addition to the EBRD insolvency assessment described above, the EBRD conducted a case study to understand how the EBA is applied in practice. This study used two hypothetical scenarios which focused on the ease of obtaining a bankruptcy order, in proceedings initiated by a debtor and a creditor, respectively. In the opinion of the insolvency professionals who responded to the study, parties tend to have confidence in the system, but cost, inefficiencies and delays make the regime less effective (see Charts 2a and 2b).

Chart 1
Quality of insolvency legislation in Turkey



Note: the extremity of each axis represents an ideal score in line with international standards, such as the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, the United Nations Commission on International Trade Law (UNCITRAL) Working Group on Legislative Guidelines for Insolvency Law and others. The fuller the "web", the more closely the country's insolvency laws approximate these standards.

Source: EBRD Insolvency Sector Assessment 2008.

How Turkish insolvency legislation works in practice

Chart 2a
Creditor-initiated insolvency

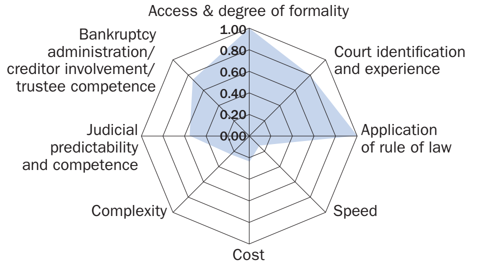
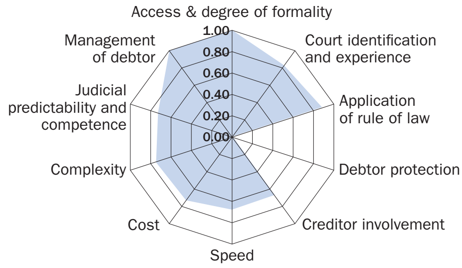


Chart 2b
Debtor-initiated insolvency



Note: The results have been derived from legal practitioners' responses to questions about the practical functioning of the insolvency regime. The extremity of each axis represents an ideal score: the fuller the "web", the more effective the insolvency regime.

Source: EBRD 2008 Legal Indicator Survey on Insolvency.

The bankruptcy process is seen as relatively slow and it appears both common and easy for debtors to delay the process even further.

Based on the responses of insolvency professionals who participated in the study, debtors and creditors tend to see the proceedings as clear and reliable. Practitioners report that there is confidence in the BA and the court system as a whole, and that participants tend to view the process as being well established. Further, the responses indicate that corruption is not seen to be a major problem in the Turkish courts.

Nevertheless, practitioners report that there are shortcomings in the system that tend to act as barriers to effectiveness. For example, the bankruptcy process is reported to be relatively slow and it appears both common and easy for debtors to delay the process even further. Courts are overloaded, resulting in breaks of between two and four months between hearings. Since the judges appoint bankruptcy experts and make final decisions by considering their opinions, it can take several hearings for the courts to finalise the cases. Reorganisation proceedings, however, are seen to be quicker, and are expected to be resolved within four months.

In addition, the cost of proceedings appears to be somewhat prohibitive for creditors and debtors alike. Practitioners note that they would often advise a creditor not to initiate proceedings due to the risk that the court will require a relatively high deposit, and to instead join proceedings initiated by another party. Debtors also tend to view the process as expensive because they must bear all costs. These can include costs for announcements/notices, preparation of proposals, expert witness fees, attorney fees, front-end application fees and also a percentage fee based on the amount of money distributed.

Corporate governance

The main law regulating companies and corporate governance in Turkey is the Commercial Code, which has been amended several times since its enactment in 1956. A draft commercial code has been prepared recently by the Turkish authorities and at the time of writing this article the draft was pending before the Turkish Grand National Assembly. Its adoption may help address a number of issues discussed in this section.

The corporate governance landscape of Turkey is also determined by the Capital Markets Law (CML) of 1981, which introduced a market regulator, the Capital Markets Board (CMB). For nearly 25 years, the CMB has been issuing binding *communiqués* related to public companies,[11] investors, financial institutions and external auditors. Apart from the statutory requirements, listed companies are also required to report their compliance with a voluntary code, the Corporate Governance Principles (CGP) launched in 2003 and updated in 2005 by the CMB. The CGP, modelled on the Principles of Corporate Governance issued by the Organisation for Economic Co-operation and Development (the OECD Principles), are to be implemented by public companies on a “comply or explain” basis.

In 2008 the EBRD benchmarked Turkey’s relevant corporate governance legislation against the OECD Principles. Results showed that the national legislation is at a high level of compliance with the relevant standards (see Chart 3).

Although the quality of legislation on the books is generally good, improvements are needed, especially with reference to the rights of shareholders and the role of stakeholders in corporate governance. For example, the Turkish system should enable shareholders to participate more effectively in shareholder meetings. The current first-call ordinary shareholders’ meeting quorum (that is, the presence of shareholders who hold at least one-quarter of total shares) should be increased in order to avoid important decisions being made without the participation of a shareholder majority. Moreover, key decisions such as amendments to the company’s charter as well as a merger, reorganisation or winding-up of the company, should be made subject to a qualified-majority vote.

Stakeholders (for example, employees, suppliers, creditors) should be offered access to corporate information and specific independent committees for dealing with such matters as audit, corporate governance or financial reporting, if required. In addition to these issues, practitioners have expressed concerns that the current mandatory tender offer rules are not sufficiently clear and detailed.[12]

> The majority of Turkish holding companies are controlled by large families and there is a high degree of cross-ownership within the company groups.

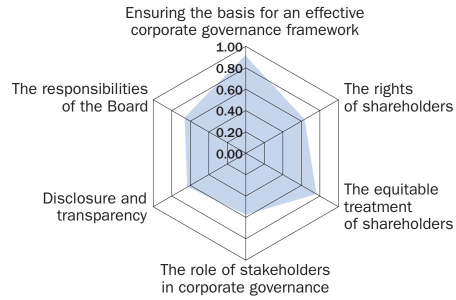
OECD research[13] has highlighted that the corporate governance environment in Turkey is characterised by concentrated ownership. The majority of Turkish holding companies are controlled by large families and there is a high degree of cross-ownership within the company groups. Despite this, Turkey's framework fails to regulate cross-ownership. Shareholders are not required to disclose beneficial ownership of shares and the law is silent on the disclosure of shareholder agreements.

In 2008 the EBRD conducted a case study to test how the Turkish corporate governance legislation works in practice. A case study dealing with related-party transactions was designed. The study investigated the position of a minority shareholder seeking to access corporate information in order to understand if a related-party transaction was indeed entered into by the company and how it was possible to obtain compensation should the company suffer a financial loss. The effectiveness of legislation was then measured according to four principal variables: institutional environment, enforceability, complexity and speed (see Charts 4 and 5).

The case study revealed that minority shareholders have limited options in order to obtain disclosure. A court request for the appointment of an independent auditor appears to provide effective results. The framework for obtaining redress offers several avenues but the procedure can be lengthy. Action is generally clearly provided for by the legislation and the enforceability of judgments is improving but is still problematic. Lastly, the effectiveness of the enforcement relies on the capacity and experience of court executors which can vary considerably across courts and jurisdictions.

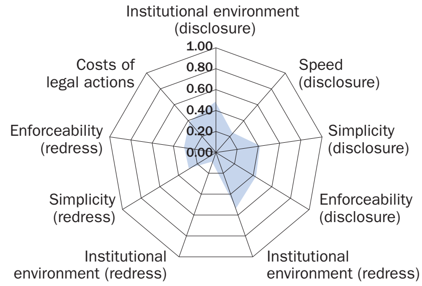
When shifting the analysis to the institutional framework, the survey revealed that the competence and experience of courts, prosecutors and the market regulator need to be improved. Judicial proceedings are slow, providing the defendant with numerous possibilities for obstruction.

Chart 3
Quality of corporate governance legislation in Turkey



Note: The extremity of each axis represents an ideal score in line with international standards, such as the OECD Principles on Corporate Governance. The fuller the "web", the more closely corporate governance laws of the country approximate these standards.
Source: EBRD Corporate Governance Sector Assessment, 2008.

Chart 4
How Turkey's corporate governance legislation works in practice



Note: The chart shows the disclosure, redress and the institutional environment in Turkey. The average results from the case study scenarios are shown. "Disclosure" refers to a minority shareholder's ability to obtain information about their company. "Redress" refers to the remedies available to a minority shareholder whose rights have been breached. "Institutional environment" refers to the capacity of a country's legal framework to effectively implement and enforce corporate governance legislation. "Costs" refer to the expenses a minority shareholder must pay to take legal action. The extremity of each axis represents an ideal score: the fuller the "web", the better the corporate governance framework.
Source: EBRD Legal Indicator Survey 2008.

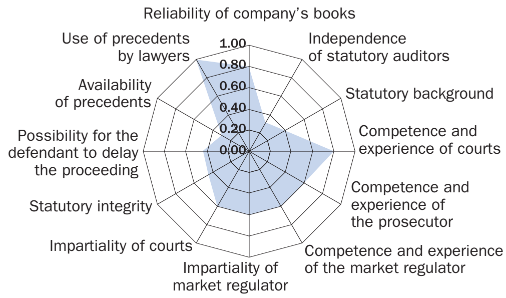
Judicial proceedings are slow, providing the defendant with numerous possibilities for obstruction.

Other enforcement mechanisms are no more efficient: arbitration is only available when a shareholder agreement with a specific clause has been concluded, while an action before the CMB will not help as inadequate fines are not discouraging illicit behaviour.

Secured transactions

The Civil Code is the main source of law governing secured transactions – both pledges (that is, security rights over movable property) and mortgages (security rights over immovable property). Typically for a civil law regime, the Civil Code comprises a chapter with provisions on property rights, including mortgages (articles 850-938) and pledges (articles 939-972). The Code of Obligations (articles 162-172), Execution and Bankruptcy Act (articles 145-153) and the 1971 Commercial Enterprise Pledge Act also contain relevant provisions.

Chart 5
Institutional environment for corporate governance in Turkey



Note: "Institutional environment" refers to the capacity of a country's legal framework to effectively implement and enforce corporate governance legislation. "Statutory background" relates to how comprehensive, clear and well structured a country's definition of related-party, self-interest, self-dealing, or conflict-of-interest transactions is. In particular, the definition covers transactions where the director or the dominant shareholder has an indirect interest (for example, the party to the transaction is a dominant shareholder's subsidiary). Statutory integrity refers to the level of corruption within a country, as determined by Transparency International's Corruption Perception Index. This index is measured on a scale from 0 to 1, with 0 being the most and 1 the least corrupt environment. The extremity of each axis on the graph represents an ideal score: the fuller the "web", the better the institutional environment.

Source: EBRD Legal Indicator Survey 2008.

The fundamental approach to pledges is to require the possession of the collateral to be transferred to the creditor (or a person appointed by the creditor) for the entire duration of the pledge. Ways to circumvent this requirement have been designed by practitioners and the legislator, but these alternatives are necessarily complex and restricted. For comparative data and suggested reform, see page 68.

Specific types of pledges have been created by statute to serve a particular segment of the economy, such as, for example, the commercial enterprise pledge. With this instrument, the pledgor can continue to use the pledged assets. The downside of this instrument is that the assets included in the pledge are listed by law on a limited basis (trade and enterprise names, machinery, equipment and vehicles used by the enterprise, and if the parties choose to do so, intellectual property rights) and do not include assets that were not allocated to the activity of the enterprise at the time of the agreement (future equipment), stock in trade or accounts receivable. Moreover, the pledgee's consent will be required for any operation with the collateral (including replacement).

> **Taking security over intangible assets such as accounts receivable or bank accounts is a well-established practice.**

Pledges over shares are treated as any other pledges – they require the physical delivery of the certificates representing the shares or the annotation into the Central Depository system (for publicly listed companies). The biggest drawback concerns the voting or dividend rights which are not included in the pledge. In practice, the technique used is either to require proxies or to obtain a right of usufruct[14] over the shares from the shareholders. Taking security over intangible assets such as accounts receivable or bank accounts is a well-established practice. Accounts receivable are usually assigned, as opposed to pledged, and this requires a precise description of the assigned claims. Although the third-party obligor's consent is not needed for the validity of the assignment, the common understanding is that notice should be formally given to the obligor – in fact, many market participants require that this be done by a public notary to guarantee evidence of the notification's date and contents. An assignment of all future and present claims would not be possible according to the general principles of the Civil Code. Future rights and receivables could be pledged as long as they can be defined in monetary terms at the time of the pledge. Pledges over bank accounts are widely used in practice. Notification to the bank where the account is held is recommended (but not required for the validity of pledge) and the pledged accounts should be specifically identified in the pledge agreement. It seems that there is a consensus among users that the pledgor would not be allowed to close and to draw money from the pledged account without the pledgee's consent.

Mortgages are the preferred type of security rights and the system is well established. The system is fairly similar to that found in other European countries. The Law Amending the Laws Related to Housing Finance, widely known as the Mortgage Law, was enacted in 2007. Specific features include the fact that the mortgaged assets can include "accessories to the immovable property" that are "allocated" to the operation and benefit of the property. In other words, these are movable assets that are attached to a building or land to be mortgaged (for example, furniture, equipment). The regime presents a sophisticated system of ranking, which does not entirely depend on the chronological order of registration but also on the parties' contractual arrangement. Escalation rights may be granted, thereby giving a creditor the right to move up a level when the ranking held by another creditor has been released. There are two types of mortgages that can be entered into.

"Definite amount mortgages" secure:

- the principal amount as provided in the mortgage agreement
- up to three years' worth of contractual interest
- default interest
- certain enforcement-related costs and expenses.

If parties confirm a "maximum amount mortgage", they can define the secured debt as they wish, in particular as a credit line or overdraft. It should be noted that the enforcement procedure is considerably easier when the mortgage is a definite amount mortgage as opposed to a maximum amount mortgage. Also, it is not possible to define in foreign currency a debt secured by an enterprise pledge or by mortgages (in the latter case that is unless the beneficiary is a credit institution).

Reforming secured transactions law in Turkey?

It is invariably controversial to claim that a legal system is in need of reform, especially when that opinion is expressed by an outsider. Legal frameworks have often developed over many years or even decades. Their users have grown accustomed to the rules and are often quite comfortable with the status quo. Recommendations from abroad are usually regarded with suspicion. Moreover, and more rationally, the costs associated with change may seem too high for the anticipated benefits.

We believe that the call for change is best when it comes from within, based on an objective, dispassionate analysis of the current system; its strengths but also its limitations; and informed evidence of what alternatives may be possible. Only when a consensus has emerged can solutions be put forward. An understanding of how other jurisdictions in a similar position have tackled such problems may prove invaluable for Turkey's commercial, financial and legal community. At this stage, we can only make a few preliminary remarks about the status of the current law and what the reform process may entail, based on our secured transactions reform experience over the last 15 years providing technical assistance to transition countries. For the sake of simplicity, our comments will be limited to the law of pledge but a similar analysis could also be prepared for mortgages.[15]

Turkey has had long experience of taking security over property (whether movable or immovable) and has developed a number of procedures and practices to serve economic needs. However, it looks as if this has happened *despite* the legal framework. In other words, the legal rules and institutions have not particularly contributed to or encouraged secured credit, especially when a security right is to be created over movable property.[16] The active and relatively sophisticated commercial and financial sector relies on complex, and in some ways limiting, laws and institutions. Further analysis would probably reveal that this limits the availability of credit to the private sector, both in terms of breadth (who benefits from credit and who is excluded) and depth (how much credit and on what terms it is made available).

From a comparative point of view, Turkey's secured transactions regime exhibits many of the features found in European civil law countries, and particularly those of central and eastern Europe *before* the reforms over the last 15 years.

We detail the features below.

- The system of taking security over movable property is based on the concept of **transfer of possession**. This is for two main reasons: (i) transferring the possession of the collateral to the creditor or a person appointed by them, provides the creditor with certainty that the property will immediately be available for realisation in case of default on the secured debt; and (ii) possession operates as a means of publicising the existence of the pledge: once the property has been taken away from the pledgor, third parties will not be misled by the apparent "false wealth" of the debtor and the property will not appear to be available for payment of other debts. Possessory pledge was also the main mode of security over movable property in Bosnia and Herzegovina, Croatia, the Czech Republic and the Slovak Republic in 2000 when the EBRD published its first *Secured Transactions Survey*.[17] At present, each of the EBRD's countries of operations, including the four noted above, has reformed its secured transactions law to provide for non-possessory pledges which are publicised by way of registration (with the notable exception of Russia). The provision of registration of security rights over movable property needs to be implemented via an effective registration system. The procedures and institutional setting can have a fundamental effect on any benefits derived by the parties. Poland has unfortunately not managed to establish a system allowing a fast registration of pledges. Ideally, registration of a pledge should be easy, quick and cheap and the recorded information should be fed electronically into a central database that the parties to the pledge and the general public should be able to consult remotely and instantly.

- The Turkish secured transactions law adheres in many ways to the strong civil law principle of **specificity** with regard to rights *in rem* (real rights). This principle often dictates that the secured debt is strictly defined, including its detailed amount. Specificity also implies strict identification of the assets which will serve as collateral: at the extreme, the asset must exist at the time of the security agreement; be described in specific, not generic terms; and could not be used or replaced by the pledgor. Russian secured transactions law, for example has not moved much from these principles (as shown in the table opposite) and this limits many modern transactions. Ukrainian law, on the other hand, undertook a major reform in 2004 which resulted in a significant improvement in making credit accessible.

- *Lex commissaria* and court-led enforcement with realisation of the property via public auctions (unless both parties can agree on a different mode) are common features in civil law countries. The *lex commissaria* principle prevents parties from agreeing at the time of the security agreement that in case of default the creditor will be entitled to keep the collateral in payment for the debt. Instead, the collateral must be sold. Enforcement is very often led by the courts: a court will need to issue a judgment of default, followed by an order of enforcement over the collateral. The sale will then be led by a court-appointed executor through public auctions. While central European jurisdictions have confirmed their attachment to the *lex commissaria* principle, many have recognised that courts are not well placed to deliver the simple, fast and inexpensive enforcement that would benefit creditors and debtors alike. The results are usually spectacular: a comparison of Poland and Russia (which do not allow pledge enforcement outside the court, either by virtue of law or in practice) with for example, Slovak Republic and Ukraine (see table opposite) reveals that improving the enforcement of secured transactions is not an impossible task, even when the institutional environment is challenging. Indeed, the enforcement process appears to be more smooth and efficient in the Slovak Republic and Ukraine.

What are the ramifications of the above for Turkish law? That will be for stakeholders and policy-makers to decide but it seems that the trend that has swept central and eastern Europe from the mid 1990s – which it is important to remember, was not motivated by the EU accession process as secured transactions are not part of the European Union's *acquis communautaire* – may well have some relevance for the Turkish economy. Access to credit has become a global issue that is crucial for sustained development and demands modern and efficient rules for secured transactions.

Note: The following table relates to non-possessory security rights (pledges) over movable and intangible assets. The survey is best understood if read in conjunction with the **EBRD Core Principles for a Secured Transactions Law** (www.ebrd.com/country/sector/law/st/core/model/core.htm), which specify the basic criteria for a modern secured transactions law. **Explanatory Notes for the Regional Survey Tables** (www.ebrd.com/country/sector/law/st/facts/notes.pdf) describe the methodological approach to the survey.

For full details on the secured transactions project, including notes, please refer to www.ebrd.com/st.

Turkish Secured Transactions Law – a comparison with selected EBRD countries of operations

		Turkey	Slovak Republic	Poland	Russia	Ukraine
1	**Key elements of a charge**					
1.1	Does the charge create a proprietary security right?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓
1.2	Can the charge be granted by any person?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓
1.3	Can the charge be granted to any person?	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓
1.4	Can the charge secure any debt?	✓✓	✓✓✓	✓✓✓	✓✓	✓✓
1.5	Can the charge cover all types of asset?	✗✗	✓✓✓	✓✓	✓✓	✓✓
1.6	Does the charge give priority over all other creditors?	✓✓✓	✓✓	✓✓	✗✗	✓✓✓
2	**Creation of the charge**					
2.1	Is the manner of creation of the charge clearly defined?	✗✗	✓✓✓	✓✓✓	✓✓✓	✓✓✓
2.2	Is it simple?	✗✗	✓✓✓	✓✓	✓✓✓	✓✓✓
2.3	Is it quick?	✓✓	✓✓✓	✗✗✗	✓✓✓	✓✓✓
2.4	Are charges publicised through registration?	✗✗	✓✓✓	✓✓✓	✗✗	✓✓✓
2.5	Are costs of creation low enough not to dissuade the parties involved?	✗✗	✓✓	✓✓✓	✓✓✓	✓✓✓
3	**Commercial effectiveness**					
3.1	Can the chargor use the charged property?	✗✗✗	✓✓✓	✓✓✓	✓✓✓	✓✓✓
3.2	Can property be described generally?	✗✗✗	✓✓✓	✓✓	✗✗	✓✓
3.3	Can a charge be given over post-acquired property?	✗✗	✓✓✓	✓✓✓	✓✓	✓✓✓
3.4	Can a charge cover a fluctuating pool of assets?	✗✗✗	✓✓✓	✓✓	✗✗	✓✓
3.5	Can the secured debt be defined generally?	✓✓✓	✓✓✓	✓✓✓	✗✗	✓✓
3.6	Can a future debt be secured?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓
3.7	Can the debt be in a foreign currency?	✗✗	✓✓✓	✓✓✓	✓✓✓	✓✓✓
3.8	Can a fluctuating pool of debt be secured?	✓✓✓	✓✓✓	✓✓✓	✗✗	✓✓
3.9	Do parties have wide flexibility to agree commercial terms?	✗✗✗	✓✓✓	✓✓✓	✓✓	✓✓✓
3.10	Are subsequent charges permitted over the same property?	✗✗	✓✓✓	✓✓✓	✓✓✓	✓✓✓
4	**Effect of the security right on third parties**					
4.1	Does a charge give priority in a charged property?	✓✓✓	✓✓✓	✓✓	✗✗	✓✓✓
4.2	Does the secured creditor have priority in bankruptcy?	✓✓✓	✓✓	✓✓✓	✗✗	✓✓✓
4.3	Can a third party determine whether property is charged?	✓✓	✓✓✓	✓✓✓	✗✗✗	✓✓✓
4.4	Does a third party acquire property free from charges in the ordinary course of business?	✗✗✗	✓✓✓	✓✓✓	✓✓✓	✓✓✓
4.5	Is person acquiring in good faith and without a notice of charge, protected?	✗✗✗	✓✓✓	✓✓✓	✗✗✗	✓✓✓
5	**Enforcement of the charge**					
5.1	Is the manner of enforcement of charge clearly defined?	✓✓✓	✓✓✓	✓✓	✓✓	✓✓✓
5.2	Is there tried practice?	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
5.3	Can the chargeholder protect assets?	✓✓✓	✓✓	✗✗	✗✗	✓✓
5.4	Can the chargeholder obtain rapid realisation?	✗✗✗	✓✓✓	✗✗✗	✗✗	✓✓✓
5.5	Can the chargeholder exercise control on the way realisation takes place?	✗✗✗	✓✓✓	✗✗	✗✗	✓✓✓
5.6	Does the enforcement procedure allow expectation of reasonable realisation proceeds after costs?	✗✗	✓✓✓	✗✗	✓✓	✓✓✓
5.7	Does commencement of enforcement have to be publicised?	✗✗✗	✓✓✓	✗✗✗	✗✗✗	✓✓✓
5.8	Is purchaser in enforcement procedure protected?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓

✓✓✓ Yes ✓✓ Yes, but with reservations ✗✗✗ Categorical no ✗✗ Indicates that response is negative, but there are some mitigating factors in law or practice.

Source: EBRD Regional Survey on Secured Transactions 2005-08.

Enforcement appears to be slow and inefficient, despite the fact that the law provides that it should happen within one month.

Modes of enforcement of security rights are in line with the civil law tradition. The *lex commissaria* rule applies, which means it would be invalid in the security agreement to provide that in case of default, the creditor is entitled to receive the collateral's ownership in lieu of payment. The creditor could, however, purchase the collateral during realisation. In theory, out-of-court enforcement and direct sale is legally possible but this requires the consent of all related parties (including that of the pledgor) at the time of default. In practice, such cooperation is unlikely. Enforcement is therefore mostly conducted by the courts' enforcement offices and the property is sold by public auction. The exception to the public auction applies to assets that have a readily established market value (for example stocks, commodities). Enforcement of a commercial enterprise pledge is always led by an executor, who is to decide which assets will be realised. Enforcement appears to be slow and inefficient, despite the fact that the law provides that it should happen within one month. Enforcement is also relatively expensive – the creditor must deposit a substantial amount of monies in order to be able to proceed (just over 5 per cent of the claim if it is a maximum amount mortgage that is being enforced). Appraisal (collateral evaluation) is reported to be problematic. This is significant because on enforcement, the collateral may be sold at auction at 60 per cent of the appraised value (first auction) and 40 per cent at the second auction. Creditors generally do not expect that the property will be sold at market value.

Notes and authors

[1] Special thanks to Melissa Burgess, Gian Piero Cigna and Frédérique Dahan of the EBRD Legal Transition and Knowledge Management team, who provided critical analysis of the Turkish regime for insolvency, corporate governance and secured transactions, respectively.

[2] The adoption of the Swiss Code excluded the provisions relating to Cantons and the Federal government system, since Turkey has a centralised government system.

[3] In addition, the then Minister of Justice, Mahmut Esat Bozkurt, had studied in Switzerland, which may also be one of the reasons behind the Swiss influence.

[4] Dr E. Hirsch, who prepared the Code, sought asylum in Turkey in the late 1930s and worked in various Turkish law schools.

[5] Negotiations were opened on the chapters of enterprise and industry (March 2007); financial control and statistics (June 2007); trans-European networks and consumer and health protection (December 2007); and intellectual property and company law (June 2008).

[6] See Article by Elisabetta Falcetti and Elçin Akçura on page 72.

[7] This article reflects the situation as at end of December 2008 and does not take into account any subsequent reforms.

[8] The checklists and case studies for corporate governance and insolvency were prepared with the assistance of Somay Law Firm (Istanbul). Additional advice was provided by Güniz Gökçe of Gide Loyrette Nouel (Istanbul) and Serkan Pamukkale of Birsel Law Offices (Istanbul).

[9] The EBRD Core Principles for a Secured Transactions Law can be found at: www.ebrd.com/country/sector/law/st/core/model/core.htm

[10] The main standards used for the assessment are the United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law and the World Bank Principles for Effective Insolvency and Creditor Rights Systems.

[11] Under Turkish law a public company refers either to a company listed on the Istanbul Stock Exchange or to an unlisted company with more than 250 shareholders.

[12] See article by Güniz Gökçe and Tulu Harsa on page 86.

[13] OECD (2006), "Corporate Governance in Turkey: A Pilot Study", available at www.oecd.org/document/6/0,3343,en_2649_34813_37490374_1_1_1_37439,00.html, accessed on 23 December 2008.

[14] Usufruct is the legal right to use and derive profit or benefit from property that belongs to another person, provided that the property is not damaged.

[15] On mortgages, see in particular the publication "Mortgages in transition economies" (2007), EBRD, at www.ebrd.com/pubs/legal/mit.htm.

[16] The terms "pledge", "charge", "secured transaction" and "security right over movable property" are used here interchangeably.

[17] See results in "*Law in transition* – Autumn 2000: Secured transactions" at www.ebrd.com/pubs/legal/lit002b.pdf, Part 2, page 32.

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08

SECTORAL REFORM CHALLENGES IN TURKEY

ELISABETTA FALCETTI AND ELÇIN AKÇURA

Since the 1980s Turkey has liberalised its economy and begun to implement structural and institutional reforms. However, such reform strategies have been interrupted by economic crises and high regional inequalities. This article outlines the main sector reforms and the implications for the EBRD's activities in Turkey in the next few years.[1]

Turkey shares many of the features of transition economies and most of the reform challenges: in particular the second- and third-stage reforms of deepening and sustaining markets[2] and adapting institutions to the requirements of an open market economy. Although never ruled by a communist government, the country has a history of strong state control and intervention which has left significant gaps compared with the standards of an open and competitive market economy.

In particular, during the period 1960-80, Turkey undertook an import-substitution industrialisation programme where infant industries were subsidised and protected from international competition by tariff and non-tariff barriers to imports.[3] This resulted in the creation of monopolies and sheltered producers that were focused on the domestic market and relatively uncompetitive in the world markets. In addition there were significant barriers to foreign direct investment and domestic entrepreneurship. As a result, foreign firms limited their production operations in the country and micro, small and medium-sized enterprises (MSMEs) contributed relatively little to economic activity.

Since the 1980s Turkey has liberalised its economy and begun to implement structural and institutional reforms across a range of sectors. Recently the pace of these reforms has increased, following the 2001 economic crisis and anticipation of EU accession negotiations. However, the reform agenda has been interrupted periodically by economic crises. Turkey continues to face significant challenges in developing a more open and entrepreneurial economy. Such challenges are more prevalent in certain sectors of the economy. Moreover, as regional inequalities are high, sectoral gaps may vary between rural and urban areas.

The process of decentralisation, de-monopolisation and privatisation is far from complete and there is considerable scope for strengthening private entrepreneurship.

The financial sector remains highly concentrated, with the largest 10 banks holding 85 per cent of total banking assets, 82 per cent of total deposits and almost 90 per cent of loans.

What follows is a short overview of the main sector transition challenges which will influence the Bank's operational priorities in Turkey in the next two years.

Key sector transition challenges

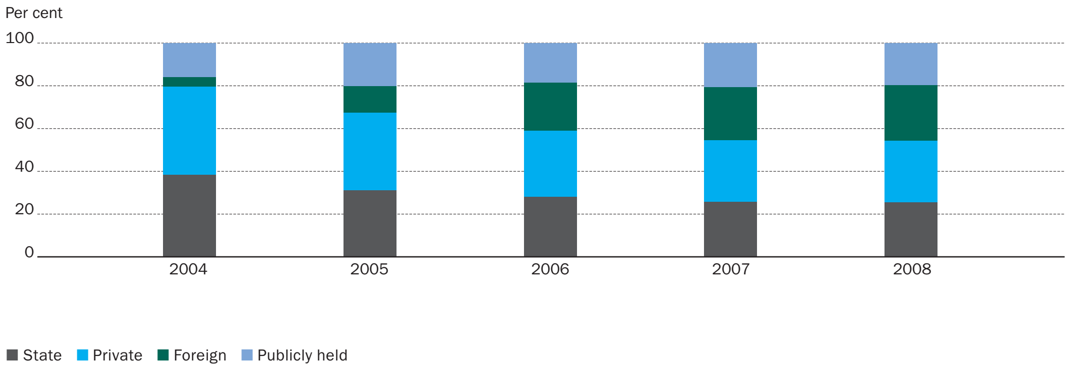
Financial sector and access to finance

One sector that faces significant reform challenges is the banking sector, which is relatively small in size. The sector has strengthened considerably since the crisis of 2000-01, with marked improvements in banking regulation and supervision. However, the sector remains highly concentrated, with the largest 10 banks holding 85 per cent of total banking assets, 82 per cent of total deposits and almost 90 per cent of loans.

Bank privatisation remains a major challenge. State-owned banks still account for close to 25 per cent of total banking sector assets (see Chart 1). Banks are heavily involved in the financing of public sector borrowing, holding 45 per cent of the banking system's government debt portfolio. The first steps towards the privatisation of the three state banks have been taken, but much remains to be done.

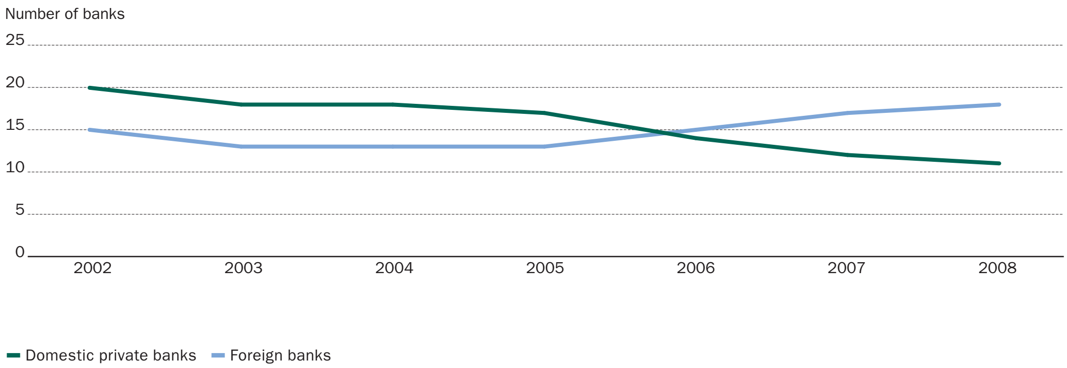
The share of foreign banks in the market remains small although it is increasing. Foreign ownership increased from less than 5 per cent in 2004 to almost 25 per cent of total banking assets in 2008 (see Chart 1). Since 2006 the number of foreign-owned banks has surpassed the number of privately owned banks (see Chart 2).

Chart 1
Banking sector assets in Turkey according to equity ownership



Note: For publicly held shares no distinction is made between domestic and foreign investors.
Source: Central Bank of Turkey (2008), *Financial Stability Report*.

Chart 2
Total number of domestic and foreign private banks in Turkey, 2002-08



Source: Central Bank of Turkey (2008), *Financial Stability Report*.

Financial sector supervision has been strengthened since the 2000-01 crisis.

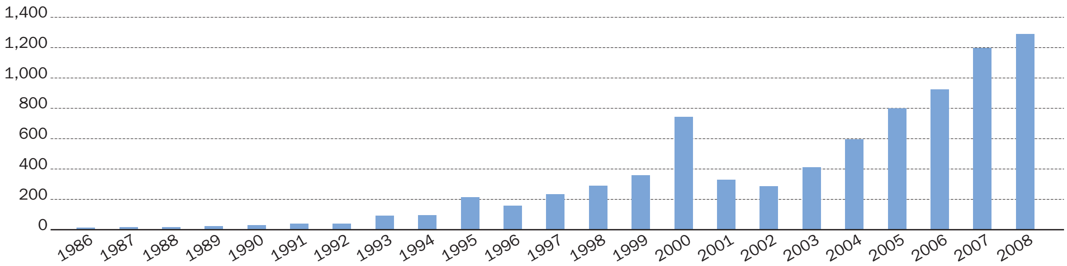
Overall, the financial sector has expanded rapidly but the level of transactions intermediated by the financial system still remains well below EU levels and even those of advanced transition countries. Bank lending to the private sector increased from just over 18 per cent of GDP in 2003 to about 30 per cent of GDP in 2007. This compares with more than 102 per cent of GDP in the eurozone and 36 per cent of GDP on average in central and eastern Europe and the Baltic states countries (CEB). Consumer lending is growing fast although from a very low base. The Mortgage Law, passed by the Turkish parliament in February 2007, is expected to boost mortgage lending which, although growing rapidly, is still in its infancy. The mortgage-loan-to-GDP ratio stood at 3.6 per cent at the end of 2007 (up from 1.0 per cent in 2004). This is less than the EU-8[4] countries but more than in Romania (1.4 per cent of GDP in 2007) and comparable with Serbia (3.7 per cent of GDP in 2007).

Financial sector supervision has been strengthened since the 2000-01 crisis. Indeed, the Bankruptcy Law was improved as part of the resolution of the financial crisis. In addition, a Banking Law was adopted by the Turkish parliament in mid-2005. It gave the Banking Regulation and Supervisory Agency (BRSA) regulatory and supervisory power over financial holding companies, leasing and factoring companies and consumer finance companies. Minimum capital requirements for banks were increased by 50 per cent. Corporate governance of banks has also improved: "fit and proper" criteria have been established for bank owners and risk management requirements strengthened.

The banking sector faces very limited competition from the non-banking financial sector in Turkey. A number of challenges lie ahead for this sector. The financial institutions such as pension funds and leasing services are underdeveloped, as are capital markets and the institutional investor base. The insurance sector remains small, with relatively low insurance expenditures per capita and low penetration.

Equity remains in relatively short supply in the Turkish economy. Corporate debt securities are practically non-existent, and much of the external financing in the business sector is secured through trade credits. The Istanbul Stock Exchange (ISE), Turkey's sole securities market, has developed rapidly since 2001, with significant increases in trading volume as well as value (see Chart 3). The ISE's market capitalisation rose from 26.5 per cent of GDP in 2003 to 40.0 per cent of GDP in 2006.

Chart 3
Stock market average daily trading value in Turkey, 1986-2008



Source: Istanbul Stock Exchange (2008).

The agricultural sector employs about one-quarter of the labour force in Turkey, but remains inefficient and in need of modernisation.

However, this ratio still remains well below that of many of the Western and the emerging economies (see Chart 4).

MSMEs are a major part of the Turkish economy, accounting for a large proportion of the country's businesses and total employment. However, Turkish MSMEs face state interference in the form of cumbersome business creation, registration and bankruptcy procedures. According to the World Bank *Doing Business Survey 2009*, covering the period April 2007 to June 2008, entrepreneurs can expect to follow six steps to launch a business over an average of six days, at a cost equal to 14.9 per cent of gross national income per capita. For existing businesses, obtaining a licence for a new line of business involves 25 steps, 188 days and represents 249.3 per cent of income per capita. The time and cost required to resolve bankruptcies is also high by Organisation for Economic Co-operation and Development (OECD) standards. In Turkey the process of closing a business takes 3.3 years and costs 15.0 per cent of the value of the estate, compared with 1.7 years and a cost of 8.4 per cent of the estate's value in OECD countries.

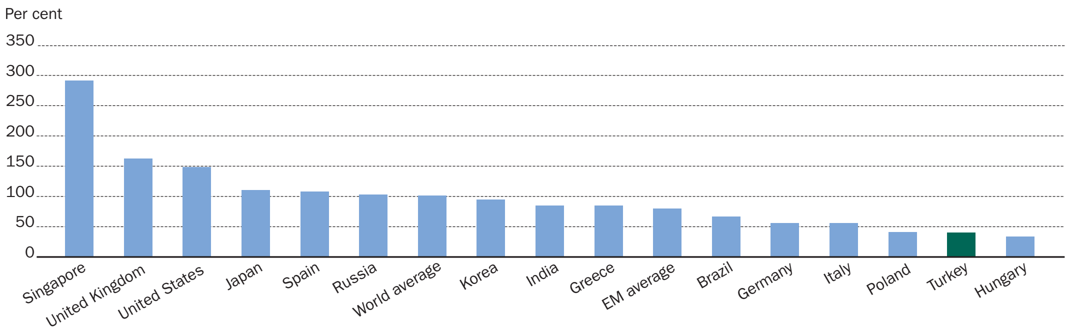
Although statistical information on Turkey's MSME sector is fragmented, some estimates suggest that the MSME sector accounts for 98 per cent of the total number of enterprises (approximately 400,000) and 77 per cent of employment, but only 38 per cent of capital investment, 27 per cent of value added and 5 per cent of bank credit. Therefore, while MSMEs account for a large share of total enterprises and employment, they operate with very limited capital and have access to a very small proportion of the funds mobilised in the banking sector.

General industry and trade

The agricultural sector employs about one-quarter of the labour force in Turkey, but remains inefficient and in need of modernisation. Although over 30 per cent of Turkey's land is arable, the lack of proper irrigation, the relatively small and uneconomic size of individual family-owned farms and the under-supply of capital for the use of modern production inputs, techniques and machinery prevent the country from realising its full agricultural potential. There is still heavy state intervention in price-setting, subsidies and state purchases of crops which keep the sector in a vicious cycle of under-investment, inefficiency and under-performance relative to advanced transition countries.

In the food processing sector, the landscape is scattered with small family-owned enterprises that do not meet Western hygiene or efficiency standards. Nevertheless, in recent years major industrial conglomerates have started investing in and consolidating the food processing sector, attracted by the high revenue margins in the sector. Food retailing is still dominated by small, family-owned shops, particularly those which are located outside the main metropolitan centres. The progress of large-scale retail is impeded by difficulties in acquiring business permits and restricting supermarket development in high-density inner-city locations.

Chart 4
Market capitalisation/GDP, 2006



Note: EM – emerging markets.
Sources: EBRD, World Federation of Exchanges and the World Bank.

Until very recently, Turkey's energy policy had been heavily focused on supply, with emphasis on ensuring additional energy to meet growing demand.

In the corporate sector dominant state-owned enterprises remain in some sectors, particularly in infrastructure[5] where monopoly concessions and anti-competitive practices are common. Insufficient progress has been made in reforming these areas to date. The strengthening of the legislative and regulatory framework for starting and operating a private business remains a significant challenge, particularly as regards the implementation of existing laws and enforcement of contracts. Restructuring of enterprises and improvements in corporate governance and business conduct are also vital in improving the productivity and competitiveness of Turkish firms.

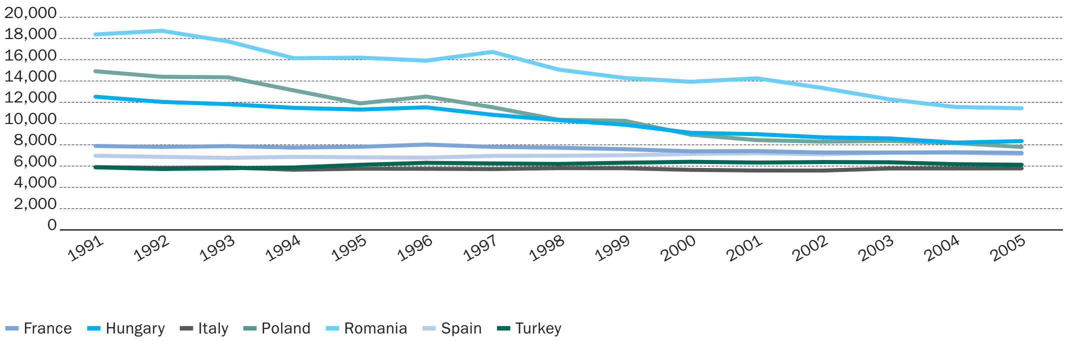
Despite repeated delays, privatisation has progressed in recent years in some sectors. The Turkish Privatisation Agency (OIB) is currently proceeding with plans to privatise Petkim Petrokimya Holding Co., a state-owned petrochemicals company, while the state-owned tobacco company, Tekel, was sold at auction for €1.7 billion to British American Tobacco in February 2008. In May 2008 the OIB sold a 15 per cent stake in Turk Telekom via an IPO on the ISE and the London Stock Exchange. The government raised around US$ 1.9 billion from the IPO. Of the shares on offer, 60 per cent were sold to international investors. The Privatisation Agency still owns 30 per cent of Turk Telekom.

Energy and infrastructure

Until very recently, Turkey's energy policy had been heavily focused on supply, with emphasis on ensuring additional energy to meet growing demand. Energy efficiency has been a lower priority. Energy intensity[6] has been relatively stable for the last two decades and compares favourably with the levels achieved in Romania, Hungary and Poland (see Chart 5).

A law on energy efficiency was implemented in 2007, detailing energy efficiency measures in industry, power generation, transmission and distribution systems, buildings and transport. Among other measures, the law extended existing regulations that mandate the introduction of managers with specific responsibility for energy efficiency issues in larger plants to cover non-industrial establishments, including public and commercial buildings exceeding a certain size. There is, however, still room for further improvements to enhance incentives for energy efficiency investments and for bringing the relevant legislation into full compliance with the EU's *acquis communautaire*.

Chart 5
Energy intensity trend – total primary energy consumption per dollar of GDP in PPP terms



Note: Btu – British thermal unit.
Source: US Energy Information Administration.

The municipal debt market is underdeveloped while long-term capital is only available through government sources. The ability of municipalities to raise long-term finance needs to be enhanced.

The electricity sector is continuing its structural and operational transition to a competitive market system. Notable milestones achieved so far include:

- the unbundling of the sector into a generation company, a transmission company, a trading/contracting company holding independent power producer[7] contracts and liabilities, and a distribution company
- the establishment of a regulatory authority, which is licensing participants and approving market rules
- the launch of the balancing market with trial operations of a transitional balancing and settlement system. However, the move to a market-based regime is being made more complicated by past long-term contracts with private investors and the sector still suffers from frequent shortages. As far as renewable energy is concerned, Turkey has a large wind, geothermal and solar power potential, and would benefit from private investment in renewable energy.

Although municipalities are responsible for delivering municipal and environmental infrastructure services, there remains a high degree of fiscal centralisation and corporate governance of municipal companies – especially in smaller municipalities – that falls far short of international best practice. For water, wastewater, and solid waste services, medium-sized and large municipalities are able to cover the costs of water services but poorer municipalities struggle to cover ongoing asset maintenance and investment projects.

The municipal debt market is underdeveloped while long-term capital is only available through government sources. The ability of municipalities to raise long-term finance needs to be enhanced. At present, municipal indebtedness is controlled by the government through debt limits and approval requirements. The situation is not uniform across the country, with the metropolitan municipalities better placed in financial terms.

In urban transport, it is necessary to enhance the efficiency of private sector operators and ensure an appropriate level of municipal planning and regulation to improve the quality of service. Reform is most needed in the railways. The railway network in Turkey is owned and operated by the loss-making state railways company, Turkish State Railways (TCDD). To become a commercial enterprise, the railway needs to radically reduce its size, improve its services and increase tariffs. To this end, an action plan has been adopted which aims to restructure the railway sector by 2008 and sets out a road plan to align Turkish law with that of the European Union. The various activities of TCDD (railways, ports management and so on) have not yet been unbundled.

Conclusion

There remain significant differences in the way markets, firms and institutions function in Turkey. The EBRD will focus its efforts on sectors and product areas where there are significant transition gaps. Private sector development and energy efficiency will be at the centre of EBRD's activities in Turkey. The Bank will reach out to areas beyond the large metropolitan centres and step up the commercially based provision of core services such as water and wastewater, urban transport, gas, electricity and other municipal services.

Notes and authors

[1] This article draws extensively on extracts from Annex 1 of the Strategic Review paper (CS/FO/08-18) approved by the EBRD Board on 10 September 2008.

[2] Second-phase, market-deepening reforms include large-scale privatisation and financial sector reforms. Third-phase or market-sustaining reforms focus on governance and enterprise restructuring, strengthening competition and infrastructure.

[3] Non-tariff barriers in Turkey include import licences on certain goods such as agriculture and food products.

[4] EU-8 countries are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.

[5] A number of key industries continue to be dominated by state-owned enterprises, such as the Turkish Petroleum Company (TPAO), Turkish Hardcoal Enterprises (TTK), Turkish Electricity Transmission Company (TEIAS) and Turkish State Railways (TCDD).

[6] Energy intensity is calculated as units of energy per unit of output or GDP. A higher level of energy intensity tends to reflect a less energy-efficient economy.

[7] Independent power producer contracts occur when governments offer guaranteed revenues to private investors to build power plants.

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09

LEGAL ASPECTS OF STRUCTURAL ECONOMIC REFORM IN TURKEY

HALIL İBRAHIM ÇANAKCI

Turkey has undertaken significant structural reforms in the last decade. The main objectives were to achieve macroeconomic stability, improve resilience to external shocks, promote productivity and competition, facilitate privatisation and reduce the public deficits.

Structural economic reforms in Turkey, 2000-08

In the early 1980s, Turkey began to transform itself from an import-substituting closed economy to an outwardly oriented liberal economy. Despite some improvements, up until the 1990s the liberalisation process was slow due to inefficient institutional and legal frameworks. During the 1990s, the development of unsustainable debt dynamics and unhealthy financial sector fundamentals weakened the economy and eventually triggered a crisis in 2001.

That crisis was a turning point for the Turkish economy. In the aftermath, the country has adopted a comprehensive reform programme to address structural and economic weaknesses.

A further catalyst was the opening of European Union (EU) accession negotiations in October 2005. As a result, as a potential EU candidate country Turkey has started to adopt new laws and adjust its legislation in line with the EU's *acquis communautaire*.

The legal amendments for structural reforms and harmonisation with the European Union's standards can be summarised in the following five categories:

- public sector administrative reforms
- financial sector reforms
- structural fiscal reforms
- labour market reforms
- measures to enhance the competitiveness of the economy.

Public sector administrative reforms

Turkey has aligned, to a great extent, its legislation on public procurement and public financial management and control with international standards. Fiscal discipline, transparency and accountability have improved considerably as a result.

> **Significant progress has been achieved in the alignment of the capital markets with European Union requirements.**

Turkey adopted a new Public Procurement Law in 2002 which introduced a transparent and efficient procurement framework. A public procurement agency was established to oversee this process.

A landmark Public Financial Management and Control Law became effective in 2003. The Law extends the scope of financial management and the budget, improves fiscal transparency and accountability and clarifies procedures for the preparation and implementation of the budget. The main features of the Law are as follows:

- The internal control system was redefined and made more comprehensive. The emphasis was on prospective financial control rather than retrospective in order to accelerate the transaction process and increase efficiency in expenditure.
- The scope of the budget has been enlarged. An accrual-based government accounting system was introduced in all public agencies, which covers financial actions and assets and liabilities resulting from public activities.
- In public institutions, strategy development units were established to introduce performance indicators and to determine medium- and long-term policies and objectives in line with the national development strategy.
- The concept of multi-year budgeting was introduced. The state budget is to be evaluated within the scope of the strategic plans. This approach is expected to strengthen the links between planning, programming and budgeting.

In addition to these laws, two additional pieces of legislation had contributed to the improvement in public governance. First, the Law on Rights of Access to Information which gave citizens access to information generated by government agencies was enacted in 2003. Second, in 2004 the Ethics Board for Civil Servants was established to regulate the conduct of civil servants with transparency and accountability.

Financial sector reforms

The financial sector has undergone a complete restructuring and the regulatory environment has been successfully aligned with international standards and best practices.

The legal structure was improved with the new Banking Law enacted in 2005, bringing the regulatory framework more in line with European Union standards. The enactment of this Law enabled the Banking Regulation and Supervision Agency to increase the provisioning requirements, to strengthen capital adequacy and to enhance supervision efforts.

Furthermore, a new Mortgage Law was approved in 2007 to help develop primary mortgage and housing finance markets and to establish a legal basis for a secondary mortgage market. This Law also enables the establishment of alternative funding mechanisms for primary lenders and helps banks manage their portfolios better.

Significant progress has been achieved in the alignment of the capital markets with European Union requirements. To increase investor confidence, a Central Registry Agency – which is in charge of keeping records of capital market instruments – began to operate and an Investor Protection Fund was established.

Structural fiscal reforms

The Social Security Administrative Law adopted in 2006 streamlined the administrative structure and the procedures for social security in Turkey. In addition, a parametric social security reform became effective in 2008. This reform will contribute enormously to the fiscal sustainability of the social security system over the medium and long term. A new universal health system was also introduced to improve the health services provided to citizens.

> **Creating a balance between job security and labour market flexibility has been the main objective of labour market reform.**

Tax reform is another key agenda item. The objectives of the reform are to simplify the tax structure, broaden the tax base and improve tax administration. The strategy is based on three main pillars:

- The personal income tax reform: in March 2007 the Turkish parliament approved a new Income Tax Code to broaden the tax base and make the system more progressive and easier to administer.
- The corporate tax reform: corporate income tax rate was reduced and the system was simplified through eliminating investment allowances.
- The tax administration reform: the aim is to improve the independence and efficiency of the administration and streamline the implementation of tax policies. In this context, three main institutions were established: a semi-independent Revenue Administration (to improve revenue collection practices), the General Directorate of Revenue Policies (to focus on tax policies) and a Large Taxpayers Unit (to better serve the needs of large taxpayers).

Tax reform will continue to be a priority area in the coming years to further simplify the tax structure, broaden the tax base and bring tax policy more in line with European Union practices. The next step in tax administration reform will be to enhance the institutional capacity of the Revenue Administration.

Labour market reforms

Creating a balance between job security and labour market flexibility has been the main objective of labour market reform. Reform strategy for the labour market includes reducing the cost of hiring, developing training programmes and increasing labour market flexibility.

An Unemployment Insurance System was established in 1999 and the first payments from this system were made in 2002. In addition, the Turkish Employment Organisation was established in 2003 to develop national employment policy, to analyse the labour force and to implement active labour market programmes.

The Labour Law came into effect in 2003. It included provisions such as the establishment of a guarantee fund that would remedy the losses suffered by workers should their employer become insolvent. The law also introduces occupational health and safety measures and the establishment of private employment offices. The Labour Market Information Advisory Council was established in 2004 in order to cope with the information constraints of the market. Further, to improve the supply side of the market, the Vocational Adequacy Institution Law was introduced in September 2006. This law aligns technical and vocational training with international standards.

Lastly, the Turkish parliament approved a comprehensive labour market reform package in May 2008. The Law will increase the flexibility of the labour market and at the same time will reduce the financial and non-financial costs for employers. Progress in these areas will support the comprehensive efforts to reduce the size of the unregistered economy.

Measures to enhance the competitiveness of the economy

Significant steps have been taken to improve the overall investment climate, with focus on three main areas: research and development (R&D), the business environment and privatisation.

A Research and Development Law enacted in February 2008 established a new incentive regime for R&D. Its objectives were to improve the competitiveness of the economy and to close the R&D gap with the European Union.

State dominant sectors such as electricity, natural gas, petroleum, telecommunications, tobacco and sugar sectors were opened to competition and independent regulatory and supervisory boards were established for these sectors.

Turkey has significantly improved its investment environment. The international investment indices have confirmed this progress.

In 2005 the Law on the Use of Renewable Energy Resources for Electricity Production Purposes was enacted to increase the share of renewable energy resources in electricity production. Moreover, in April 2007 the Energy Efficiency Law was adopted by the Parliament in order to prevent energy losses; moderate the burden of energy costs on the economy; and increase the energy resources yield and to protect the environment.

The enactment of the Foreign Direct Investment Law in 2003 was a cornerstone providing a "legal guide" to international investors. The law improves the legal framework regarding foreign direct investment (FDI) in line with international standards and streamlines the procedures for employment of foreign labour. In addition, an Investment Support and Promotion Agency was established with the aim of improving the profile of Turkey as an investment centre. Furthermore, the new Land Registry Law of July 2008 enables land ownership by foreigners.

In 2001 the Coordination Council for the Improvement of the Investment Environment (CCIIE) was formed to make recommendations to the Council of Ministers to remove obstacles from the investment environment. The CCIIE was assigned 12 specialised technical committees and each technical committee consists of the representatives of government agencies and the private sector. Productive collaboration between the public and the private sector is the key factor in this process to ensure that policy reforms truly reflect and address investors' concerns.

Besides the CCIIE, another structure with an international perspective, the Investment Advisory Council (IAC) for Turkey, was established in 2004 with a view to raising the competitive position of Turkey in the world economy as an investment location.

The IAC convenes annually and brings together the top executives of leading multi-national companies, international organisations and heads of Turkish private sector associations in Istanbul. Each meeting is chaired by the Prime Minister.

Unsurprisingly, the enhanced investment climate has underpinned the ambitious privatisation programme and privatisation revenue has reached US$ 28 billion since 2003.

For 2009-10, the privatisation of electricity generation, sugar refineries, highways and a large public bank, Halkbank, are on the agenda.

Looking ahead, to improve the investment climate further the government is planning to amend the Competition Law to bring it in line with EU legislation, to establish the Turkish Auditing Standards Board to improve the quality of corporate financial information and to enact a new Commercial Code.

Turkey's main economic indicators reveal the extent of economic transformation. Growth in the Turkish economy has been continuous, averaging 6.6 per cent annually since 2002. GDP per capita has almost tripled in the last six years and reached US$ 9,300 in 2007. The main driver of growth has been the dynamic nature of the private sector as demonstrated by robust investment, export and consumption figures. The inflation rate, which was 71.6 per cent on average annually between 1995 and 2001, dropped to 10.1 per cent in December 2008.

In addition, Turkey's public debt stock under the EU definition fell from 73.7 per cent of GDP in 2002 to 38.9 per cent of GDP in 2007, well below the relevant Maastricht criterion which is 60 per cent of GDP.

As a consequence of the recovery of the main economic indicators and the aforementioned efforts, Turkey has significantly improved its investment environment. The international investment indices have confirmed this progress.

Author

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Turkey’s experience shows the close correlation between legislative reform and economic transition.

According to the United Nations Conference on Trade and Development *World Investment Prospects Survey 2008-10*, Turkey was elevated from the rank of 22nd to the 15th most-attractive economy for the location of FDI.

In the World Bank *Doing Business 2009* rankings, Turkey reached the rank of 59th among 181 countries. This reflects an improvement of 34 places since 2007.

In 2007 net FDI inflows into Turkey reached a historical record, amounting to US$ 22.1 billion.

Conclusion

Turkey’s experience shows the close correlation between legislative reform and economic transition. Policy-makers in Turkey are aware that a strong market-oriented economy depends on the development of sound legal rules and the establishment of legal institutions. As a result the country is now looking to sustain economic growth by placing legal transition high on the agenda.

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TURKEY'S MANDATORY TENDER OFFER RULES: ENOUGH PROTECTION FOR MINORITY SHAREHOLDERS?

GÜNIZ GÖKÇE AND TULU HARSA

The Turkish capital markets legislation includes a number of provisions that aim to protect the interests of minority shareholders in the context of takeover bids and changes of control. The foremost of these measures is arguably the mandatory tender offer requirement. This article offers an analysis of the mandatory tender offer rules, with a focus on the adequacy of the level of protection provided to minority shareholders. This article draws examples from the capital markets legislation, the decisions of the Turkish regulatory authority (the Capital Markets Board) in charge of enforcing the capital markets legislation and case law.

Legal framework

The Capital Markets Law No. 2499 of 1981 (CML)[1] Article 16(A), gives the Capital Markets Board (CMB) the authority to enact secondary legislation governing the acquisition of shares in listed companies by way of tender offers, for the protection of minority shareholder rights and to ensure transparency. Communiqué Serial IV No. 8 on the Principles of Proxy Voting, Proxy Solicitation and Tender Offers (the Communiqué)[2] issued by the CMB sets out these rules.

Conditions

A mandatory tender offer is required to be launched under the Communiqué when a person acting alone or in concert with others, directly or indirectly, in a single transaction or through a series of transactions, or by any other means:

- acquires 25 per cent or more of the share capital and voting rights of a listed company
- acquires shares allowing it to control a listed company, regardless of the number of shares it holds or
- increases its shareholding by 10 per cent or more within any 12-month period in a listed company in which it otherwise already holds 25 to 50 per cent of the share capital and voting rights.

Main steps of a mandatory tender offer

Once the requirement of a mandatory tender offer is triggered, the parties involved must make a public announcement regarding the underlying acquisition through the Istanbul Stock Exchange (ISE), where the shares are listed.

The purchaser of the shares is then required to make an application to the CMB for the approval of the tender offer. Alternatively, the purchaser may seek an exemption from the CMB in respect of the mandatory tender offer requirement, as discussed below.

Although the legislation governing mandatory tender offer rules is straightforward, it does not regulate in detail various issues that rest at the core of a mandatory tender offer, such as the offer price.

Following the approval by the CMB, the tender offer needs to be announced in the newspapers and thereafter launched via an intermediary financial institution. The shareholders of the listed company are entitled to sell their shares in the company to the purchaser during the time period set out in the announcement at the offer price approved by the CMB.

Lastly, the intermediary financial institution acting for the purchaser in the tender offer is required to notify the CMB and the ISE of the tender offer results.

A timeline of a mandatory tender offer process may be reflected as shown in Chart 1.

Exemptions

At the request of the purchaser, the CMB may, at its discretion, grant an exemption from the mandatory tender offer requirement based on the following grounds:

- the acquisition aims at strengthening the financial soundness of the target
- the acquisition is approved by a qualified majority of the shareholders of the target company
- the control of the target company would not change as a result of the acquisition
- the acquisition results from a legal requirement or
- the acquisition is realised through a privatisation process.

The grounds set out in the second and third bullets are the most commonly seen bases for a CMB exemption.

Issues for follow-up

Although the legislation governing mandatory tender offer rules is straightforward, it does not regulate in detail various issues that rest at the core of a mandatory tender offer, such as the offer price.

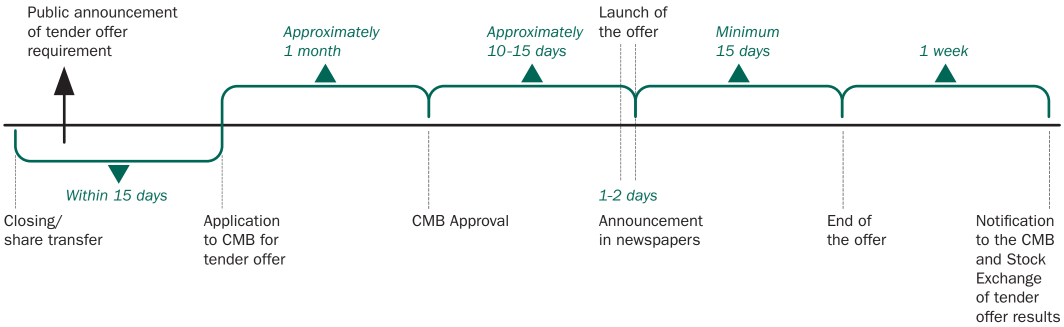
So far, the approach of the CMB has been to exercise discretion on these issues through its decisions on a case-by-case basis.

This gives the CMB greater flexibility in protecting the interests of the parties involved in accordance with the specifics of the transaction at hand. While this approach aims to achieve a result which is tailored to the specific transaction, it may, on the other hand, potentially lessen the level of comfort among investors, shareholders and even practitioners, due to the resulting lack of certainty and relatively limited transparency.

This is mainly because, despite the consistency in the CMB decisions, it is not always possible to have a clear understanding of the guiding principles and reasoning behind them. In most cases, only the operative sections of the CMB decisions are published in the CMB bulletins and there is no, or limited, access to the detailed facts of an application reviewed by the CMB.

In addition, the decisions of the CMB are not frequently challenged and therefore rarely tested before the Turkish courts. This, in turn, means that there is a lack of settled case law reflecting the position of the judiciary on the practice adopted by the CMB in respect of these issues.

Chart 1
The mandatory tender offer process



Source: Article authors.

> There is no explicit regulation on how a foreign currency-denominated purchase price should be converted into Turkish lira in the context of calculating the offer price.

Due to their importance, we have briefly analysed the practice of the CMB on the questions of (i) the calculation of the offer price; (ii) the calculation of the offer price in acquisitions where the purchase price is denominated in a foreign currency; (iii) the calculation of the offer price in indirect acquisitions; and (iv) the accrual of interest on the offer price.

Offer price

The Communiqué states that the offer price must not be less than an amount equal to:

- the highest price per share paid by the purchaser in an acquisition (in a single transaction or a series of transactions) by way of a block sale or a voluntary tender offer
- the highest price paid per share by the purchaser in the three-month period preceding the date the tender offer requirement was triggered, by way of any other type of acquisition.

The offer price is paid in the local currency, in cash.

Offer price in foreign currency-denominated acquisitions

As mentioned above, the offer price in a mandatory tender offer is to be paid in Turkish lira.

There is no explicit regulation on how a foreign currency-denominated purchase price should be converted into Turkish lira in the context of calculating the offer price. Where the purchase price in an acquisition is in a foreign currency, the exchange rate to be used in the calculation of the Turkish lira tender offer price will be determined in consultation with the CMB. The CMB often requests changes in the exchange rate proposed by purchasers to protect the interests of minority shareholders.

The settled practice of the CMB is to require that the conversion be made by taking into account the higher of the Turkish Central Bank's foreign exchange purchase rate at 15.30 (EET):

- on the date of the transaction and
- on the first business day preceding the date on which the tender offer is launched.

Offer price in indirect acquisitions

It is common in acquisitions of listed companies for the target to have listed subsidiaries. In these circumstances the purchaser of the target would be required to launch a tender offer not only in respect of the target, but also for each of the listed subsidiaries.

Indirect acquisitions are not expressly regulated under the Communiqué. However, the CMB has adopted a practice in indirect acquisitions of calculating the offer price based on the weighted-average exchange trading price of the shares of the listed subsidiary for the three-month period before the date of the acquisition triggering the tender offer.

The CMB also takes into consideration factors such as (i) the existence of a valuation on the shares acquired in the listed subsidiary; and (ii) the purchase of shares by the purchaser in the listed subsidiary during the three-month period before the date of the acquisition, in the calculation of the offer price in indirect acquisitions.

The takeover of Yapı Kredi Bank by Koçbank[3] is a recent example of this CMB practice. Koçbank indirectly acquired a number of listed Yapı Kredi subsidiaries including Yapı Kredi Insurance as a result of the acquisition and was required to launch a tender offer in respect of each of these subsidiaries. The CMB in its decision on the tender offer application of Koçbank required the offer price for Yapı Kredi Insurance to be increased to the weighted-average exchange trading price for the three-month period before the date of the acquisition. Accordingly, Koçbank increased its offer price for Yapı Kredi Insurance shares from 1.91 Turkish lira to 2.45 Turkish lira per share, translating approximately to a substantial 28 per cent increase on the proposed offer price.

Significantly, it is worth pointing out that an offer price based on the weighted-average exchange trading price can be lower than the trading price of the listed subsidiary. This issue was the subject of litigation recently in relation to the acquisition of Finansbank by the National Bank of Greece[4] where the shareholders of the listed financial lease company of Finansbank, Finans Finansal Kiralama A.S., challenged the decision of the CMB claiming that the offer price should not be less than the trading price of the shares.

An offer price based on the weighted-average exchange trading price can be lower than the trading price of the listed subsidiary.

The Administrative Court reviewing the matter ruled for the claimant shareholders, cancelling the CMB decision approving the tender offer with immediate effect. The CMB initially appealed the ruling of the Administrative Court and thereafter adopted a second decision requiring the purchaser, National Bank of Greece, to apply to the CMB for a second tender offer and provide with this application the valuation on the shares of the listed subsidiary. The purchaser, National Bank of Greece, provided the valuation for the shares, but challenged the CMB decision requiring a second tender offer to be launched by filing an administrative lawsuit on the grounds, among others, that the tender offer was already completed.

The above clearly shows that until investors start litigation, the settled practice of the CMB can be sufficient in addressing the unregulated issues relating to tender offers. But once the Pandora's box is opened and the CMB practice is challenged, things can get complicated.

It is highly likely that these developments will lead to a change in the CMB practice or prompt new regulation to be enacted by the CMB on the matter of tender offer pricing in indirect acquisitions.[5]

Accrual of interest on the offer price

The duration of a tender offer process can significantly vary depending on the specifics of an acquisition transaction. It is quite common for acquisitions to incorporate an adjustment component in respect of the purchase price in circumstances where the acquisition process is lengthy.

In acquisition transactions, particularly where the purchase price is denominated in Turkish lira, the CMB closely monitors the timing involved in the tender offer process and if, in its view, this term is longer than that of what may be considered a typical tender offer, interest is accrued in the calculation of and applied to the offer price by the CMB.

The applicable rate of interest is determined by the CMB on a case-by-case basis with an aim of "making whole" the minority shareholders for any financial loss that they may suffer due to the delay in the payment of the offer price.

Some recent examples are the acquisition of Finansbank by the National Bank of Greece, where the CMB applied interest on the purchase price for the 95-day adjustment period at a rate of 5.47 per cent yearly, and the acquisition of Migros by Moonlight Capital where the CMB applied interest for a period of 45 days due to the unjustified delay that occurred in the completion of the application file.

Sanctions for a breach of mandatory tender offer requirements

The Communiqué sets out the conditions of a mandatory tender offer process, but what happens when a purchaser does not comply with these requirements?

Neither the CML nor the Communiqué includes provisions imposing specific sanctions on the violation of mandatory tender offer rules. Therefore, the general sanctions applicable to the violation of capital markets legislation as set out in the CML will also apply to the violation of mandatory tender offer rules.

Accordingly, under Article 47(A) of the CML, the CMB may impose a fine for the violation of a mandatory tender offer requirement of an amount of 15,000 Turkish lira to 100,000 Turkish lira (approximately, €7,128 to €47,517).[6] Significantly, the CMB refrains from imposing repeated fines where a purchaser's failure to comply with the mandatory tender offer requirement continues.

It is clear that these sanctions are not severe enough to have a dissuasive effect on the market participants. There are very few examples of violations of mandatory tender offer requirements in the Turkish market, but this fact does not change the potential legal risk as perceived by the investors and minority shareholders in relation to violations of the mandatory tender offer rules.

Remedies available to minority shareholders

In the event of a violation of the mandatory tender offer requirements, any of the minority shareholders may initiate litigation proceedings against the purchaser that failed to comply with such requirements.

Case law, although very limited on the matter, suggests that Turkish courts view tender offer requirements as minority rights that must equally benefit all shareholders.

Case law, although very limited on the matter, suggests that Turkish courts view tender offer requirements as minority rights that must equally benefit all shareholders. In lawsuits where the minority shareholder petitioned the court to rule for the purchaser that violated the tender offer requirements to purchase its shares, it was ruled that the court may not decide in favour of shares of solely the shareholder initiating the lawsuit, but must order the purchaser to launch a mandatory tender offer to all shareholders as per the requirements of the capital markets legislation.

If the purchaser fails to comply with the judgment of the court, that is, fails to launch a mandatory tender offer, the shareholder that initiated the lawsuit would be entitled to compensation. However, a claim for compensation necessarily means additional litigation costs and a further delay in recovery of losses to the detriment of the minority shareholders.

Arguably, the litigation path is a long and burdensome one for the minority shareholders with no guaranteed time frame and outcome.

An additional point of interest worth noting is that case law and scholars' views suggest that courts should take into consideration the actions of minority shareholders following the date of the acquisition. In this context, it is argued that if a minority shareholder continues to trade in the shares of the target, that is, sells and buys-back or buys additional shares in the target after the date of the acquisition, then this can be construed as consent to the change of control by the relevant shareholder, relinquishing its rights to the mandatory tender offer. In the practice of mandatory tender offers, no distinction is made between shareholders that have acquired shares before or after the date of the acquisition.

Towards a more efficient minority protection

With many shortfalls in the legislation and limited dissuasive measures as sanctions, it is important to tighten the regulatory framework governing mandatory tender offer rules under Turkish law in order to better protect the interests of minority shareholders and foster a more investor-friendly legal environment.

In this context, the issues that have been addressed through the CMB practices should be regulated under the Communiqué. We understand that the draft Communiqué that was prepared by the CMB in 2003 aimed at achieving this purpose, but for now it remains pending.

Specific sanctions should be introduced to allow the CMB to impose tougher sanctions on violations of mandatory tender offer requirements. These could include sanctions authorising the CMB to suspend the exercise of all ownership-related rights of the purchaser (other than dividend rights) in respect of acquired shares pending a corrective action on the violation of the mandatory tender offer requirement. Similar sanctions exist in banking legislation and have been important tools in ensuring compliance with the mandatory provisions of this legislation.

It is time for Turkey to revisit and improve the protection of minority shareholders' rights in the context of mandatory tender offer rules. In so doing, Turkey should also align its laws with that of its European counterparts, and particularly the European Directives on Takeover Bids, in line with its commitment to adopt the European Union's *acquis communautaire*.

Notes and authors

[1] Published in the Official Gazette numbered 17416 and dated 30.07.81.

[2] Published in the Official Gazette numbered 21872 and dated 09.03.94.

[3] Under a share purchase agreement dated 8 May 2005 by and between various Çukurova Group companies, Mehmet Emin Karamehmet, Koç Finansal Hizmetler and Koçbank Nederland, Koçbank acquired 57.4 per cent shares in Yapı Kredi Bankası.

[4] Under a share purchase agreement dated 3 April 2004 by and between Fiba Holding, Fina Holding, Fiba Faktoring Hizmetleri, Girişim Factoring and National Bank of Greece, National Bank of Greece acquired 46 per cent of the ordinary shares in Finansbank and 100 per cent of the founders' (privileged) shares.

[5] In fact a draft communiqué was prepared by the CMB in 2003 regulating various issues including pricing for tender offers in indirect acquisitions. However, the draft communiqué is still pending as of the date of this article.

[6] The applicable amounts are subject to revision on an annual basis. The above figures relate to 2008. The currency rates were converted on 30 January 2009 at a rate of one Turkish lira to 0.475496 euros.

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Law in transition is a publication of the Office of the General Counsel of the EBRD. It is available in English and Russian. The editors welcome ideas, contributions and letters, but assume no responsibility regarding them. Submissions should be sent to Michel Nussbaumer, Office of the General Counsel, EBRD, One Exchange Square, London EC2A 2JN, United Kingdom; or nussbaum@ebrd.com

Law in transition is printed on Hannoart Silk, an environmentally responsible paper which is 100% TCF (Totally Chlorine Free).

Printed in England by Moore using environmental waste and paper recycling programmes.

7427 Law in transition 2009 (E/4,000)
ISSN: 1683-9161

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