Law in transition 2013

European Bank
for Reconstruction and Development

Financial law reform: from Moscow to Casablanca

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About this report

Legal reform is a unique 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 Legal Transition Programme, *Law in transition* covers legal developments in the region, and by sharing lessons learned aims to stimulate debate on legal reform in transition economies.

Foreword

Same aspirations, different journey

The European Bank for Reconstruction and Development (EBRD) was set up in 1991, as part of the international community's response to the collapse of the Soviet Union, to assist the countries of central and eastern Europe on their journey to open markets. Since then the EBRD's key focus has been to develop the private sector as the driver of economic growth and ultimately prosperity. From the outset, the Bank has advocated the principle that a well-functioning legal and institutional system is the cornerstone of transition. It is part of its mandate to help create an investor-friendly, transparent and predictable legal environment in its countries of operations. For the last two decades, the Bank has pursued this goal through its Legal Transition Programme, which assists governments to develop the rules and institutions on which a vibrant market economy depends.

In 2011 aspirations for economic opportunities, social justice and transparency were voiced across the southern and eastern shores of the Mediterranean. High unemployment, especially among the young, social injustice, political repression and in some cases government mismanagement have been the main catalysts behind the "Arab spring". Once again, the EBRD was given the privilege to be associated with the international community's response. Egypt, Jordan, Morocco and Tunisia have become new potential recipient countries (together referred to as the southern and eastern Mediterranean region - SEMED). The EBRD has begun contributing to the development of a vibrant private sector via investment, policy dialogue and capacity building in these countries. I believe that the EBRD's experience of assisting countries moving from state-controlled to market economies, opening up to global markets and promoting opportunities for development at all levels (from small enterprises and farmers to large corporations), is very relevant to this effort.

This new issue of *Law in transition* represents a case in point. It focuses on financial law reform – a key area for SEMED region – and explores issues which are widely seen as

priorities by drawing a parallel but also contrasting with the work and trends of central and eastern Europe. A number of interesting points emerge:

- Unlike the former communist countries in the 1990s, the SEMED region does not start with a "clean slate". Enabling reform will entail not only developing new laws and regulations but, perhaps more importantly, repealing and streamlining a vast array of regulations that have become obsolete or impede business development. The Egyptian call for better regulation developed in this issue is particularly telling.

- The financial sector in the SEMED region is already quite sophisticated yet presents, in some aspects, gaps or shortcomings. The articles reviewing capital market development in the four SEMED countries and the one on the development of covered bonds in Morocco show this clearly. Reform efforts will thus have to be highly targeted and tailored to local conditions in order for tangible economic benefits to be reaped.

- SEMED can learn important lessons from the experience in eastern Europe, and vice-versa. Improving corporate governance of companies and banks, for example, is an area where much remains to be done in both regions and cross-fertilisation of ideas and experience is highly desirable. The same goes for the area of insolvency and debt resolution, which are crucial to resolving the global financial crisis.

It is hoped that this issue of *Law in transition* will contribute to the debate about the reform process. The demand for legal technical assistance is immense in these countries, as are the challenges resulting from the complex legal culture and socio-political environment. However, the task is both critical and urgent.

Suma Chakrabarti
EBRD President

01

Financial assistance prohibition in Turkey

A familiar concept in an unfamiliar jurisdiction

YEŞIM BEZEN, NADIA CANSUN, CAN ÖZILHAN AND ALAZ EKER ÜNDAR

This article discusses the financial assistance prohibition introduced by the recently enacted Turkish Commercial Code, and its implication on existing and future financial transactions. It also suggests untested yet potentially viable alternatives in which the market can engage.

General section

The Turkish Commercial Code No 6102 (TCC) entered into effect on 1 July 2012. It is fair to say that the new Code incorporates many paradigm shifts which have shaken the Turkish corporate world, including an important reform on capital maintenance.

Now that the practical discussions on the overall reform have taken place and an established approach is starting to take form, the Turkish market is now looking at the nuts and bolts of joint stock companies – which historically have been an investor's favourite – in a new light. What is slowly unfolding is a debate on one of the most controversial topics of the TCC – the financial assistance prohibition.

This article intends to give a high level summary of the new provisions and suggests untested but theoretically viable alternatives that the market may use to adapt to this new environment.

What is financial assistance prohibition?

EU-based investors will not be strangers to this concept, closely associated with the trend of leveraged buyout (LBO), which the world has witnessed in the last decade or so. In essence, financial assistance prohibition consists of restricting or prohibiting the acquisition of a controlling share of a target company with the target company's "credit card".

An LBO is an acquisition (usually of a company but it can also be a single asset such as real estate) where the purchase price is financed through a combination of equity and debt and in which the cash flows or assets of the target are used to secure and repay the debt. As the debt usually has a lower cost of capital than the equity, the returns on the equity increase with increasing debt. The debt thus

> **The financial assistance prohibition is categorised as an "evasive transaction" – by reference to the restriction on share buy-backs by joint stock companies**

effectively serves as a lever to increase returns, which explains the origin of the term LBO.

Notwithstanding the general definition above, the implications of this restriction are more far-reaching than leveraged acquisitions and the financial assistance prohibition is likely to come up in virtually any transaction.

In the context of Article 380(1) of the TCC, financial assistance is a "*transaction*" for the provision or grant of an "*advance, loan or security*" entered into by a "*company*" with a "*person*" "*for the purpose of acquiring shares*" in that "*company*".[1]

Unlike in the United Kingdom, there are no exceptions such as the now abolished "whitewash" procedures. The only exceptions are (i) where the transaction is an ordinary course of business credit line granted by financial institutions (the "financial institution exception") and (ii) the transaction is entered into for the purchase of shares for employee stock options (the "specific purpose exception").

On the basis of the above, we can make the generalisation that financial assistance will be prohibited in all cases unless it falls within one of the two limited exceptions.

Analysis of each component

Let us now take a closer look at each of the components of this prohibition, with the view of analysing in detail the application of the prohibition.

The company

The financial assistance prohibition applies with respect to joint stock companies both public and private without distinction. Although the Civil Code contains provision for capital maintenance applicable to limited liability companies, the financial assistance prohibition would not, in our opinion, be applicable to limited liability companies.

Furthermore, there is no express reference in the restriction on financial assistance granted by subsidiaries of a target company. This would mean that the company's subsidiaries should not be caught by the restriction. The current inclination of the Turkish market is to adopt this interpretation.

A person

As per the definition of the TCC, the person entering into the transactions with the target company can be a real person, a company or a partnership and does not need to be the (proposed) purchaser of the shares.

A transaction "for the purpose of acquiring shares"

The TCC gives the examples of *advance, loan or security* with an express note in the annotations that these are intended as non-exhaustive examples and that the reference to "transaction" should be interpreted broadly – this is consistent with the *ratio legis* interpretation of law, and we are expecting the Turkish courts to adopt this view.

It is noteworthy that the definition does not distinguish between transactions funded out of distributable reserves – although the application of the exceptions is dependent on the reserve requirement, as discussed below.

In terms of the "purpose" of the transaction, it is unclear at this stage what interpretation the Turkish courts will make, although the general expectation is that Turkish courts will undertake a "commercial purpose" review, that is to say, analyse the transactions taking into account the circumstances surrounding it as well as its commercial effects.

In any event, until there are some relevant court precedents, the TCC, unfortunately, offers little certainty on the type of analysis this will prompt in the event of a dispute and, in particular, how much weight will be placed on the purpose stated in a contract and how, in the case of a series of connected transactions, purpose will be assessed.

Consequences of unlawful financial assistance

The consequence of unlawful financial assistance, at first glance, is clearly stated in the TCC – namely the relevant transaction for the provision of unlawful financial assistance is "null and void". A closer look demonstrates that this is not so straightforward.

The financial assistance prohibition is categorised as an "evasive transaction" – by reference to the restriction on share buy-backs by joint stock companies. The annotations in the TCC question whether a purchase, if funded

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What sparked controversy was not the introduction of the rule (to which the Turkish market had some indirect exposure from EU-based borrowers’ credit lines with a CAPEX tranche) but that it was being introduced in the form that preceded the relaxation to the Second Council Directive made in 2006

by unlawful financial assistance, would also be declared invalid.[3] The very small amount of published work on this question suggests that the likely interpretation to emerge will be to view the two transactions – the financial assistance and the purchase – independently and that the purchase will not be an evasion to the restriction on share buy-backs. We should note that we agree with this view and do not consider a purchase to be automatically invalid if funded by unlawful financial assistance.

Exceptions

We can now review the two exceptions to the financial assistance prohibition mentioned above.

(a) Financial Services Exception

Some would say that this exception was designed to reassure the Turkish market and prevent it from opposing the new prohibition provisions by entertaining the belief that financial assistance would still be permitted if a traditional lender was to sit on the receiving end of the transaction that constitutes financial assistance. Some even argue that this exception would apply to all banking transactions in general. However, we do not agree with this interpretation. As read carefully, it becomes clear that the exception has a very narrow scope of application, encompassing only credit lines and advances granted by banks and other financial institutions in the ordinary course of business (and security granted for those credit lines and advances) which subsequently are used to purchase shares in that bank or that other financial institution – not any joint stock company as some have argued. In other words, in this context, the bank or the other financial institution would become the “*company*” that is providing the financial assistance.

(b) Specific Purpose Exception

The second and final exception is for financial assistance granted to an employee of the target or a subsidiary of the target.

(c) Restrictions

We should note here that the exceptions are not absolute but subject to the quantitative reserves test: if the financial assistance (i) reduces the restricted reserves or (ii) breaches the rules of utilisation of restricted reserves, and (iii) the company does not have sufficient distributable reserves in an amount equal to the financial assistance granted, the exception does not apply and the financial assistance is thus declared null and void.

The choice of an absolute prohibiton

We mentioned at the beginning of this article that the introduction of financial assistance prohibition had been a very controversial topic. What readers may find interesting is the fact that what sparked controversy was not the introduction of the rule (to which the Turkish market had some indirect exposure from EU-based borrowers’ credit lines with a CAPEX tranche) but that it was being introduced in the form that preceded the relaxation to the Second Council Directive made in 2006.[4]

No explanation has been made by the drafting committee on what we presume to be a conscious choice to disregard the inclination towards allowing more flexibility as is the case in the European Union. However, the TCC displays a deliberate trend (even sometimes going beyond the original intention) to introduce a strict capital maintenance regime applicable to public and private joint stock companies without nuances – another reflection of the general tone of the TCC which (relative to the previous Commercial Code) views joint stock companies as a model for a public company and not a model for a closed project/special purpose company.

Another point to note is that, despite the reference in the annotations to the model for the restriction being the Second Council Directive, a closer parallel would be with the restriction existing in the German Stock Corporations Act. Germany will therefore definitely be a place where practitioners will be able to look to find creative structures.

Skeletons in the closet

The implementation law of the TCC makes no exception to the principle of “no retroactive application” – thus the financial assistance prohibition should only apply to new transactions. However, this does not mean that “skeletons” of the past will not haunt lenders and borrowers in the era of the TCC. In particular, the taking of security over future assets pursuant to any anti-dilution measure, or

While the restriction is absolute, this should not necessarily mark the end of leveraged buyouts in the Turkish market

security value covenants that are activated after the date of entry into force of the new TCC will likely be caught by the restriction. It will thus be essential for lawyers to be extremely vigilant.

Also, target assistance for the refinancing of the acquisition debt may also be considered unlawful financial assistance. This is a somewhat grey area but the conservative view generally adopted is that the route to refinancing of acquisition debt incurred before the entry into force of the TCC is now closed if the access to target assets is a must for that refinancing.

Re-thinking common structures

The effect of the prohibition on financial assistance on leveraged acquisitions is quite obvious – debt pushdowns are now questionable and credit lines secured by target assets are now structures to avoid. However, as expressed earlier in this article, the restriction goes much beyond leveraged acquisitions. Options in corporate transactions where the valuation tab is picked up by the company, general credit lines with CAPEX tranches should also be reconsidered in light of this new restriction.

The explicit/direct effect of this financial assistance prohibition on acquisition finance transactions is quite obvious. Yet, using the assets of the to-be-acquired entity, rather than the already owned ones, is an extremely popular option for investors as it removes the risk of making larger assets subject to security enforcements for an acquisition which is not significant in value compared with their portfolios of investment. It is also standard market practice for lenders to require the establishment of security over the assets of the target entity, as the borrower will, in all likelihood, be a special purpose vehicle with no significant assets, or, as the case may be, no assets other than the potential loan in question. This raises two separate issues.

On the one hand, it remains to be seen whether lenders will now feel comfortable with being granted a limited range of security (for example, share pledges backed up by personal guarantees, sureties, and so on) or will now require that the deal is restructured in a way to enable them to have access to the assets of the target entity.

On the other hand, shareholder option rights granting the unilateral right to call/purchase the shares in a joint stock company where certain assistance (share price valuation, provision of indemnities, and so on) is given by the company as a result of the exercise thereof, will also be affected. In this context, it is evident that the prohibition under Article 380 will also have an effect on corporate transactions as well as on any acquisition finance scenarios.

Alternatives

While the prohibition is absolute, this should not necessarily mark the end of leveraged buyouts in the Turkish market – let us set out to explore a couple of options which have been somewhat consistently practised in other EU jurisdictions prior to the 2006 amendments.

Limited Liability Company Conversion

As briefly touched on above, this prohibition should only be applicable to joint stock companies and therefore should not affect any granting of security by target companies established as or converted to limited liability companies.[5]

We are of the view that the scope of the mandatory provision is specific to joint stock companies and should not be extended to render transactions entered into by other types of companies, in particular limited liability companies, null and void. However, conversion is often a time-consuming exercise and there will be concerns of increased tax liability and administrative burden on transfers of shares in limited liability companies, which also reduces security value from the practical perspective.

The timing concerns should therefore be kept in mind when discussing accession mechanics in relation to the target, and the increased tax liability and administrative burden on transfers should also be kept in mind by both lenders and purchasers in line with their investment horizons.

Merger LBOs

A post-acquisition upstream merger (a so-called "merger LBO") with the acquisition vehicle as the surviving entity could also be appealing to the lenders.

However, there is still a risk that the transaction would constitute a breach of the financial assistance prohibition on the basis that this transaction is in fact an "evasive transaction" itself. In other words, the question as to whether a judge would, in the case of a dispute, deem the transactions entered into by the post-merger entity also null and void, although unlikely, cannot be totally excluded.

Conclusion

The numerous novelties in the new TCC will certainly keep the legal market and commercial parties on their toes! However, with the market looking to adapt and draw on the experience of other EU member states, we do not believe that the situation is as bleak as portrayed.

Leveraged acquisitions will certainly need to be given more thought and require Turkish legal advisers to be part of the early structuring phases of the transaction. In any case, a wider range of alternative structures are expected to emerge once the market has more visibility on court practices.

Notes

[1] Article 380(1) of the TCC reads as follows: *Evasive Transactions Article 380 – (1) Any transaction providing for the grant of an advance or loan or the provision of security by the company to another person for the purpose of acquiring shares in the company shall be null and void. The foregoing shall not apply to transactions in the ordinary course of business of credit institutions or financial services institutions nor to the grant of an advance or loan or the provision of security for the purpose of the purchase of shares by employees of the company or its subsidiaries. However, such exceptional transactions shall also be null and void if they reduce the reserves which the company is required to create pursuant to law and its articles of association or violate the rules of utilisation of reserves set out in Article 519 and they do not permit the company to create the reserve set out in Article 520. […]"*

[2] We note that the term limited liability company is used in this Article to refer to a "*limited şirket*" and not reference to companies with limited liability.

[3] Annotations to Article 380 of the TCC read as follows: *"[…] The provision states that the transaction for the provision of assistance is null and void but does not state the fate of the transaction for the purchase of shares which is the result of evasion. The answer to this question is left to the doctrine and jurisprudence. Foreign doctrine suggests that invalidity affects the core transaction [contract for the purchase of shares] but does not affect the performance of that core transaction [transfer of the shares] and that where the core transaction has not been performed, performance cannot be requested and that following performance, rules of unjust enrichment will apply. […]"*

[4] The amendments introduced by the Council Directive 2006/68/EC replace the requirement for member states to legislate an absolute prohibition with the option to carve a route for companies to provide financial assistance to the extent of their distributable reserves and subject to compliance with a whitewash-like corporate approval process. If it interests the reader, the full text of the amendment may be accessed at: (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:264:0032:01:EN:HTML)

[5] On the assumption that the target company is not active in a regulated field requiring it to be incorporated as a joint stock company.

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02

Evaluating the EBRD's Legal Transition Programme

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The EBRD Legal Transition Programme has aimed – since its inception in 1991 – to enhance the rule of law, develop the legal structures necessary for growth, and more generally improve the investment climate in the Bank's countries of operations. This article presents the evaluation of the Programme from the period 2001–10 conducted by a team of independent evaluators working with the EBRD Evaluation Department, and provides key recommendations for taking the Programme to the next level.

Introduction and background

Empirical studies have shown that legal and regulatory reform has a significant impact on economic development and growth, particularly in emerging and transitioning economies. This insight has come to form the cornerstone of the EBRD's Legal Transition Programme (LTP). The LTP has pursued – since its inception in 1991 – a programme aimed at enhancing the rule of law, developing the legal structures necessary for growth, and more generally improving the investment climate in the EBRD's countries of operations.

As the largest developmental lender within its region of operations, the EBRD continuously evaluates the performance of it's completed projects and programmes through systematic analysis of the results both of individual projects and wider themes defined by the Bank's policies. It is with this philosophy in mind that in 2011, the authors (the Evaluation Team) – in conjunction with the EBRD's Evaluation Department – undertook an independent review of the LTP's activities from 2001–10.[1]

The LTP and the scope of the evaluation

In advancing the transition towards a market-based economy in its countries of operations, the LTP has identified several key activities as being critical in the promotion of legal transition.

- **Legal assessments:** The objective of the LTP's legal assessment work is knowledge building on the existing legal frameworks in the Bank's countries of operations, primarily to provide a basis for policy choices by a particular country. Dissemination of legal assessment information encourages local debate about the need for reform

The Legal Transition Programme has identified several key activities as being critical in the promotion of legal transition: legal assessments, standard setting, outreach activities and legal reform

within particular countries and also allows governments themselves to tap directly into this wealth of information.

- **Standard setting:** Standard setting focuses on developing appropriate guidance for legal and institutional reform, as well as criteria for assessment. This is in line with the Bank's core objective under its transition mandate – to assist the countries in which it operates in establishing practice standards that are in harmony with international norms and practices.

- **Outreach activities:** This component focuses on disseminating the Bank's work to maximise its impact. Of particular note are two major resources: Law in transition and the LTP website, both of which are valuable and easily accessible sources of information. Together they form a comprehensive source of information on legal and institutional transition in the Bank's countries of operations.

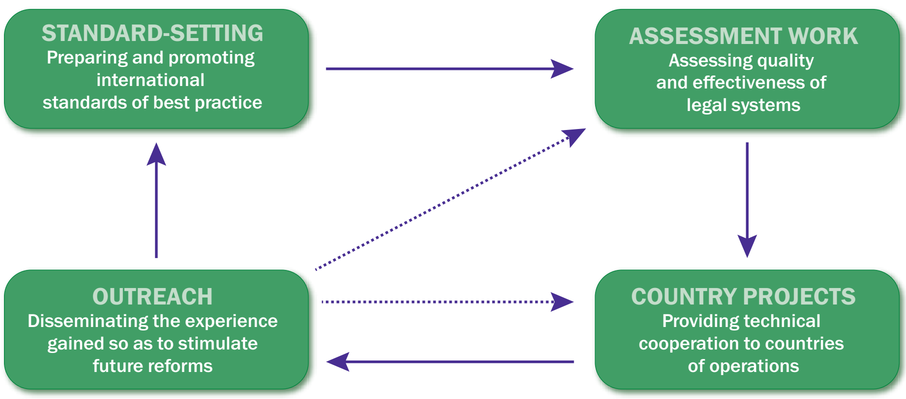
- **Legal reform:** Legal reform projects are undertaken based largely on the political will and commitment of a country's government and stakeholders to conduct reforms in pursuit of advancing their domestic economy. For transition economies, both the adoption of legislation supporting legal and institutional reform and its implementation are critically important. Legal and institutional reform needs to transcend the promulgation of "black-letter law" and, by necessity, should involve a development process that involves societal commitment and ownership of a rule of law doctrine that then advances to actual application, rather than merely creates a façade to satisfy the international community.

These general activity fields, together referred to as the "EBRD Virtuous Circle of Legal Reform" (see Chart 1), largely represent the overreaching focus of the Bank's resources and commitments and comprise the foundational activities of what the Bank does in the legal reform sector.

Within these activity fields, the Bank, through the LTP, focuses on eight core legal areas: concessions/public-private partnerships (PPPs), corporate governance, infrastructure regulatory reform and competition, judicial capacity building, secured transactions, insolvency, public procurement and securities markets (the "core legal areas").

During the evaluation period, the LTP was very active, having initiated 87 legal reform projects funded under the Bank's Technical Cooperation Funds Programme for a total value of €26 million, benefiting 25 countries in its region of operations. Most of these projects have now been completed or are at an advanced stage of implementation. In addition, the LTP has completed a number of internally funded legal transition-related projects (assessment, standard setting, or outreach) totalling €1.35 million. To carry out the evaluation of such a large programme and to be able to gauge its overall coherence and effectiveness, it was necessary to organise a sampling of these activities that could be used as a proxy, while also undertaking a broad overview of the LTP. The evaluation therefore involved field visits to five sample

Chart 1
LTP Toolkit – The "EBRD Virtuous Circle of Legal Reform"



> The evaluation concluded that the Legal Transition Programme made an important contribution to legal reforms in the Bank's countries of operations, as well as enhanced the Bank's operational objectives

countries from different regions and at different stages of transition: Armenia, Hungary, Mongolia, Russia and Serbia. Extensive information was gathered on site with the LTP's project beneficiaries and stakeholders in the sample countries, as well as from EBRD staff in London.

Overall assessment

The evaluation concluded that the LTP made an important contribution to legal reforms in the Bank's countries of operations, as well as enhanced the Bank's operational objectives. Overall, the LTP's performance was evaluated as ***"Successful"***. Through promoting legal reforms, the LTP directly supports the Bank's objectives of assisting countries in the transition to open market economies and the establishment of entrepreneurial opportunities within a multiparty democratic system. The Bank deliberately keeps the LTP's efforts within a narrow focus to make a targeted contribution to legal transition.

The *relevance* of the LTP's work was rated ***"High"***. The LTP's core areas represent key legal transition areas in which both the LTP and the EBRD have accumulated extensive experience. These core areas reflect the Bank's priorities in terms of required improvements needed by the legal environment to better enable its operations.

The LTP's *overall effectiveness* was rated ***"Good"***, mainly on account of strong evidence that the LTP's advice has largely been followed. Many laws and regulations the LTP helped to draft were approved and are utilised, while a substantial number of legal practitioners in the Bank's countries of operations benefited from the LTP's training, although it has not always been able to verify the effectiveness of such training. However, some institution building projects were of lower effectiveness and this is an area on which the LTP may need to focus more in the future.

The LTP's *overall efficiency* was rated ***"Good"***. It varied across the eight core legal areas and depended largely on the LTP's success in attracting and keeping high-calibre specialists in the given core areas.[2]

It was also noted that the LTP has successfully consolidated and mainstreamed its activities within the EBRD and substantially enlarged its reputation among its partners in the countries of operations and with international organisations.

Main findings

The evaluation shed light not only on the LTP's activities and the strengths of its model, but also on its weaknesses.

- The need for "law on the books" reform assistance varies widely across the Bank's countries of operations. However, the functioning of legal systems and institutions in practice continues to require attention in all of the Bank's countries of operations. Institution building has been an important part of almost all of the LTP's projects to date. To further strengthen the impact of its interventions, the LTP should now put even more emphasis on training legal practitioners and establishing institutions and administrative competency.

- Most of the LTP's projects have defined operational and funding life spans, whereas the process of legal reform is usually long and highly susceptible to changes in the priorities, personnel and political configuration of the recipient country. In addition, there is often a lack of clarity and measurability in project-level benchmarks.

- The LTP's core legal areas are also key operational areas for the EBRD. In turn, LTP activity fields respond to the technical needs of the Bank and its countries of operations. In dividing the needs of transition countries across several focus areas, the LTP has identified gaps within the larger legal structures. Such gap analysis has enabled the LTP to address systemic issues within legal frameworks.

- While there has been increased compatibility and cohesiveness between the Bank's operational departments and the LTP, a recurring internal view is that the LTP should proactively promote its work more to the Bank's banking unit, while liaising more closely with staff from other support units, keeping them informed about its operational priorities. The improvement of an "internal outreach" should be directed particularly towards EBRD staff based in the regional offices.

The Legal Transition Programme has built an adequate repository of information and experience that can contribute and add value to the Bank's future projects in the southern and eastern Mediterranean region

- A well-functioning, investor-friendly and free market-oriented legal structure is at the core of transition initiative. The LTP's projects usually have a high degree of transition potential, but their actual impact varies depending on the determination of the LTP's local partners. The strongest impact was achieved in those core legal areas where the LTP had well-developed in-house expertise and in those countries where its staff were able to focus their efforts for an extended period. However, there are clear limitations to the impact of the LTP's work as exogenous conditions may and sometimes do hinder LTP reform efforts. For instance, although an LTP mortgage training manual was heavily utilised by the local banks in Moldova, the growth of mortgage lending has been hindered by the global financial crisis and low salaries.

In considering the Bank's expanding operations remit, the LTP has built an adequate repository of information and experience that can contribute and add value to the Bank's future projects in the southern and eastern Mediterranean (SEMED) region. The current core legal areas and activity fields serve as a useful starting point, although country-specific assessments will largely dictate the practice and policy areas of concentration. However, the difficulties inherent in assessing local conditions in a new and totally different region cannot be overstated.

Key recommendations for taking the LTP to the next level

Despite the LTP's many achievements, the Evaluation Team made a number of recommendations aimed at further improving the impact of the programme, especially in the light of an ever challenging economic environment and the expansion of the Bank's activities to a new region in the SEMED.

- Over the last 10 years, the LTP has dedicated substantial resources to conducting legal assessments and developing legal standards. These were highly successful undertakings and a prerequisite to further actions. The LTP should continue updating its assessments and fine-tuning the set standards.

- The Bank, via the Office of the General Counsel (OGC), should undertake a strategic review of the LTP's priorities, core areas, resource allocations and the modes of engagement with the rest of the Bank as well as external players (for example, other international financial institutions), with a view to re-orienting its focus in some areas (for example, securities markets to take account of the Bank's major Local Currency Capital Markets Initiative [LC2], telecommunications regulations to take account of development and convergence in the information and communication technology [ICT] market), while increasing activities in others (for example, energy law and regulation, public-private partnerships). Historically the LTP has achieved the greatest success in areas to which considerable resources (funds and staff) have been dedicated over the longer term. To strengthen and expand the impact of its projects the LTP will require a gradual increase in its resources. For example, adding a concessions/PPP expert could result in the LTP making a stronger impact beyond Russia. Similarly, a dedicated energy regulation and/or transport regulation specialist(s) would be required to build the LTP's reputation in these fields.

- The LTP should sharpen its focus on projects that directly support legal reform processes, particularly with institutional capacity building and well-designed training programmes for judges, registrars, PPP and procurement officials. Such training should incorporate specific targets for expected outcomes/accomplishments and specific measures to verify impact. The LTP has recognised the importance of such measures with its more recent projects.

- More focus on company law is needed as this area greatly facilitates the Bank's engagement and is at the core of transition. Increased efforts are needed in developing local capital markets. In this respect, the LTP could usefully intensify its work on capital market development, possibly within the framework of the Bank's LC2 Initiative.

- The LTP should better structure its collaboration with other organisations (by organising it in a more systematic way, for example) and by setting specific objectives and plans for such a collaboration in its three-year action plans.

Notes

Conclusion

The socio-political and legal landscape within the Bank's region of operations has undergone and continues to undergo, significant change. In the evaluation upon which this short article is based, the Evaluation Team concluded that the Bank and the LTP are properly positioned not only to continue as a relevant force within the EBRD's current countries of operations, but also to enter new markets, relying on both its experience and analytical tools.

[1] *Special Study: Legal Transition Programme Review,* Special Study No: PE11-537 (London: European Bank for Reconstruction and Development – Evaluation Department, Nov. 2012) (available at: http://www.ebrd.com/downloads/about/evaluation/121109legal.pdf).

[2] For full details and ratings, see *id*.

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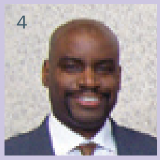
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Financial law reform:
from Moscow to Casablanca




From Moscow to Casablanca sounds like an arduous journey, nothing short of an odyssey requiring a traveller to face very extreme geographical conditions and necessitating a great sense of adaptation. Yet, this is the journey – admittedly more of a mental than a physical one – that the EBRD committed to embark on when it accepted the invitation to finance operations in the southern and eastern Mediterranean (SEMED) region.

This edition of *Law in transition* builds on this expansion to take the reader on a journey all the way from Russia, which made a significant departure in 1991 by embracing the market economy and capitalism, to Casablanca where a well-established monarchy has led the country through decades of economic transformation following the declaration of independence. This issue concentrates on financial law reform, and more specifically four major legal areas needed for an efficient financial and corporate sector: secured lending, corporate governance, capital markets and insolvency. The intention was to challenge the EBRD's Legal Transition Programme to approach seemingly familiar issues in a different way. In the panel interview that opens the special focus section, a group of eminent experts reflect on the changes that are currently taking place in the SEMED countries; the lessons that ought to be drawn from past experience and, more generally, how they foresee the changes, including legal changes shaping up in the next few years. One clear theme emerges: transition is indeed under way in the "Arab spring" countries and the EBRD has a great deal to contribute in supporting such transition.

However, when drawing comparisons, it is important to remember that the historical perspective is crucial in understanding what drives change. Modern legal systems and best international practices do not materialise overnight. Numerous legal reforms have been introduced repeatedly across many countries and over centuries. Insolvency is perhaps the best case in point. In her article "Insolvency – a second chance?" Catherine Bridge provides an historical context in which the insolvency system of many countries has evolved to include corporate insolvency and restructuring focused on corporate recovery. She also discusses the stigma of insolvency which still discourages many potential entrepreneurs, especially in the SEMED region.

Reform is a long-term, often open-ended process. Some reforms have led to overly complex legal and regulatory systems while others have produced clear coherent ones. This point is illustrated in the access to finance article by Ivor Istuk and Dina Anastas. In discussing the role of modern access to finance systems

Focus section




in enabling small and medium-sized enterprises (SMEs) to expand and grow, the authors reflect on the advantages and disadvantages of two different approaches to reform (piecemeal or complete overhaul), adopted by two of the EBRD's countries of operations (Serbia and Croatia) in modernising their access to finance system – a choice the SEMED countries should be mindful of, if and when, they embark on the reform journey.

The specificities of each country, and its needs, must also be acknowledged. This is revealed clearly in the article written by Sherif Fawzi Abdel Gawad on the Egyptian experience of regulatory reform, as the accumulation of regulations can sometimes lead to overly complex and confusing systems that require rigorous simplification and review to achieve coherence and efficiency. On a different subject, we learn that the Moroccan housing finance system has now reached the point where debt products supported by housing loans can find the perfect ground in which to grow. Nouaman Al Aissami and Hicham Talby also discuss the introduction of covered bonds into the Moroccan capital markets. These pan-European instruments have proved to be sound and resilient following the 2008 global financial crisis.

But the journey does not have to be one way only – from Casablanca, one may wish to travel back to Moscow to further reflect on how global issues can be addressed all over the world. Indeed, so it is in the case of corporate governance. Both eastern Europe and central Asia (EECA) and the SEMED region have implemented considerable reforms in this area, yet challenges remain which are uncannily similar in both regions. Nick Nadal elaborates on the introduction of the "corporate governance" concept in the Middle East and North Africa and its development which culminated in countries adopting codes of corporate governance targeted at different types of companies and/or banks. Gian Piero Cigna provides an update on similar developments in the EECA region. Both authors conclude that implementation and further fine-tuning of the instruments to target specific types of companies (banks, state-owned enterprises and so on) are required.

What will the future hold for the local capital markets in the SEMED region? Will new, more sophisticated financial products be introduced? These questions are the focus of the final article written by local law firms with the collaboration of Clifford Chance and the EBRD, which provides a snapshot of the state of local capital markets and the ongoing reform efforts, where much remains to be achieved. But then, every journey must start with the first step…

03

Panel interview: Reform in the southern and eastern Mediterranean region

Frédérique Dahan put questions to a panel of experts about key issues that are at the core of the transition process the region is undertaking and how the EBRD is preparing itself as it begins operating in these countries.

MONCEF CHEIKH-ROUHOU, Professor of International Finance, HEC Paris and Deputy Chairman of the Finance Committee, National Constitutional Assembly, Tunisia
MOHAMED GHANNAM, Partner, Baker & McKenzie, Egypt
RABII LEOUIFOUDI, Member of the Permanent Secretariat, Comité National de l'Environnement des Affaires (CNEA) which centralises and coordinates investment climate reforms, Morocco
EMMANUEL MAURICE, General Counsel, EBRD
ROBERTO ROCHA, Senior Advisor, The World Bank, and main editor of "Financial Access and Stability: A Roadmap for the Middle East and North Africa", published in 2011
KHALED SAQQAF, Partner, Al Tamimi & Company, Jordan

Focus section

What would you consider to be the major areas in need of development in your respective countries?

Rabii Leouifoudi: The Comité National de l'Environnement des Affaires (CNEA)'s core area of intervention is the legal environment for Moroccan enterprises. A major area in need of development in Morocco, which is thus the focus of the CNEA, is the legal environment of Moroccan enterprises. This covers all aspects of the legal environment from their creation to their dissolution. This includes not only the legal system that governs the enterprises, but also the process of creating a better match between the demands from employers in the workplace and from human resources.

There also has to be better coordination and harmonisation between the policies and strategies of various sectors. At the moment, there is a tendency for policies to be formulated vertically within each ministry or sector, in silos. Instead, we want to see that these policies and strategies are adopted in a coordinated fashion among the different sectors. Moroccan economic policies should generally have better governance and be more integrated into the overall investment climate reform. This is the very purpose of the CNEA which was established in 2009.

Moncef Cheikh-Rouhou: In Tunisia there is a great demand for infrastructure development, which will require a good deal of investment in the form of public-private partnerships (PPPs). The emphasis should be placed on the partnering efforts between public and private sectors. I see the role of the private sector as key because it will bring much-needed qualified local competencies, which could contribute to the success of these projects, and this will also drive down costs. However, this will additionally require cooperation from labour unions. They will need to communicate better with management

Mohamed Ghannam

> “There is a great need for government reform. Egypt has a very large government with over six million public servants who are low paid and at times not really qualified to meet the demands that are put to them

in order for businesses to flourish. This is a key issue in Tunisia. Finally, I also see a need to train government staff and to equip them with the knowledge and experience to meet the demands of both today and tomorrow's market economy.

Mohamed Ghannam: First, there is a great need for government reform. Egypt has a very large government with over six million public servants who are low paid and at times not really qualified to meet the demands that are put to them. Egypt would be better run with a smaller government, where many tasks would in effect be automated.

Second, a key issue is balancing the public budget, and I believe this will have to be done via a reduction of subsidies in the energy sector. Subsidies need to be rationalised so that they primarily reach the low income sector of the population.

Third, there is a need for legislative reform. The Egyptian economy is highly regulated, and this body of regulations and laws needs to be reformed: it is too restrictive and incoherent at times; it contains contradictions and often very vague concepts which lead to high levels of uncertainty. A good example is the licencing system for setting up businesses: in some cases, one needs to secure 25 approvals and permits from different agencies to obtain a license to operate a business and the requirements are not coordinated. Another example is the state land regime. Land in Egypt is by default owned by the state and the transfer of ownership is governed by confusing and inconsistent rules. Procedural mistakes are often made.

Fourth, law enforcement tends to be very weak in Egypt for a number of reasons: when laws are confusing and contradictory, and unskilled public servants are not paid well, there is room for corruption in administrative bodies.

Finally, I believe that the education system has to be reformed so that new graduates have the necessary skills that are required by the market. This is particularly prevalent in the legal profession. Legal education is weak, which is a shame considering that Egypt used to be a beacon for legal education only 50 years ago.

What has the “Arab spring” changed to the reform agenda?

Roberto Rocha: The “Arab spring” has generated the prospects of a promising reform agenda in certain countries, but the situation differs markedly from country to country. In Egypt, reforms were initiated in the first half of the last decade but lost momentum in recent years. While the reform agenda has become even more relevant, it is evolving in a highly uncertain environment. It is very difficult to predict the shape the political environment is taking. Compared to my experience in central and eastern Europe, advising on reform is made difficult because of the lack of reliable and accurate information in Egypt and other countries of the Middle East and North Africa (MENA). Sometimes, I feel that organisations like the World Bank have to provide advice without having full clarity on the initial conditions. We are hoping that the “Arab spring” will lead to more commitment on behalf of the domestic parties and to information sharing. Furthermore, the issue of corruption and nepotism within the ministries and the former government are both a concern many have voiced.

Tunisia, on the other hand, has been most positively affected by the “Arab spring”. The transition looks more promising in that country. Morocco and Jordan currently also have interesting reform agendas which seem to have been maintained through the “Arab spring”.

Going beyond the SEMED region, I think that the “Arab spring” has had a very strong influence. For example, the World Bank has experienced a significant increase for technical assistance from the Gulf countries, in particular for improving access to finance – clearly the message underlying the “Arab spring” has been well heard.

Rabii Leouifoudi: I agree with Roberto's analysis. The “Arab spring” has affected Morocco economically and politically, but in a specific way. One such manifestation is the constitutional reform that has been carried out by the government and all active constituencies in Morocco since March 2011, with free elections and a new government in place since early 2012. The pace of the reforms led by the CNEA has thus slowed down in 2011 but the work was resumed in 2012 and accelerated, and we expect a very good performance in 2013. At the moment, I would say that the key event which is affecting Morocco is the economic crisis within the European Union, and also the global economic downturn.

Are the 20 past years of transition in eastern Europe and central Asia known in the southern and eastern Mediterranean countries? What seems relevant to you?

Emmanuel Maurice: As the EBRD's General Counsel, I find that the Treaty which founded the EBRD and gave the Bank a mandate to operate in transition economies is very relevant for the SEMED region. The EBRD Treaty is based on the concept of "transition". In 1991, this applied to the countries which had committed to move from communism to open, market economies. The main question now is whether the SEMED countries, namely Egypt, Jordan, Morocco and Tunisia are also countries in transition. A similar question was asked in 2008 when Turkey requested to become a country where the EBRD would be able to operate. The Turkish economy was then in major need of de-monopolisation, decentralisation and privatisation. As a result, Turkey was declared to qualify as a country in transition. The four SEMED countries have similar needs, and therefore it was concluded that these should also be considered countries in transition and that the EBRD has a role to play there.

Rabii Leouifoudi

> "Since its independence, Morocco has opted for an open economy. In fact, one could say that it has been in transition, economically, politically, socially and democratically ever since

Rabii Leouifoudi: Indeed, the concept of transition, as well as the experience of the EBRD in the countries of eastern Europe and central Asia, is relevant to Morocco. Of course, there is a contextual difference, historically and politically. Since its independence, Morocco has opted for an open economy. In fact, one could say that it has been in transition, economically, politically, socially and democratically ever since! I also note that central and eastern Europe have achieved considerable economic growth and inclusion in the world economy in 20 years. Morocco aspires to be on a similar path. We think we have a lot to learn from such experience.

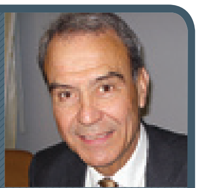
Khaled Saqqaf: The experience in the eastern Europe and central Asia (EECA) region is very relevant in Jordan. What strikes me most is the level of dialogue that economic players can have with the regulator, and the transparency of this dialogue. This is also happening in Jordan. Now, an increasing number of instructions, meetings' minutes, and decisions can all now be found online. There has also been more focus on increasing the participation of the private sector in the economy. The transition process that took place in the EECA region is very well perceived in Jordan.

Moncef Cheikh-Rouhou: The EBRD is the first multilateral financial institution in the region that not only focuses on financial development and economic growth but also on facilitating transition. This is exactly what we are seeing in the "Arab spring" countries, there is a democratic as well as an economic transition, and this is where the EBRD comes in. The EBRD was called by the Deauville Partnership to complement the work of the other international financial institutions (IFIs) in the region. Primarily, Tunisia needs expertise and assistance in transitioning from a state running the economy to a state cooperating with the private sector. The EBRD is certainly uniquely well-placed to assist us with this mission.

Mohamed Ghannam: There is not sufficient awareness in Egypt in relation to the transition in the EECA region. In fact, we have little information on eastern Europe and certainly much less on Central Asia. However, listening to the other panellists, I can understand how it can be relevant in a country like Egypt.

Do you consider that "state involvement in the economy" is a feature common to all southern and eastern Mediterranean countries?

Moncef Cheikh-Rouhou: Yes, I believe that the state is unduly involved in Tunisia. When we look at the former Soviet Union countries, particularly where the state was heavily involved, we see the drawbacks of this type of system and we can learn from their experience and how they transitioned from pure state involvement into an open economy. We all agree that the real engine of the economy is the private sector: it is the largest employer and the creator of wealth, as well as a large contributor to the budget. It is imperative to make the Tunisian economy more business friendly, in order to promote and further develop the private sector. However the role of government should not be dwarfed: it is the main long-term resource planner, the main inceptor of both structural policy and stabilisation and growth policies. Of course, it will be monitored and controlled by parliament from now on but its contribution (and good and efficient governance) will be decisive.



Moncef Cheikh-Rouhou

> "It is imperative to make the Tunisian economy more business friendly, in order to promote and further develop the private sector. However, the role of government should not be dwarfed

Roberto Rocha: I think that one needs to distinguish between different economies. There is a very strong state presence in countries such as Algeria, Iraq, Libya, Syria and even Egypt, despite the reforms in recent years in some of these countries. Large enterprises and banks still belong to the state and in some of these countries only small firms are in effect operated by the private sector. Some of these countries resemble the "pre-1991 central European situation in the Mediterranean"!

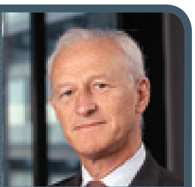
The situation in Tunisia is actually more balanced; the state has more of an intermediary role with the private sector enjoying a big slice of the economy and the financial system. The private sector's share is bigger in Morocco and more so in Jordan. However, one must not forget that the lines can sometimes be blurred: for example, some private banks are still subject to strong state influence. This does not mean that all state interventions are necessarily negative: for instance, I do not see government's credit guarantees in the financial sector as a large concern – they can lead to fiscal problems, of course, but they can in some cases be very well designed and these credit guarantee schemes are not particularly large in SEMED, compared to other regions in the world.

The key to transition has been the constructive dialogue between the private sector and government as key partners. Is this also taking place in the southern and eastern Mediterranean region and do you think that it can be replicated there?

Rabii Leouifoudi: The dialogue between private and public sectors is the genesis of the CNEA as the framework for the institutionalisation of the dialogue between the private and the public sectors. The CNEA is headed by the government and comprises all representatives of the private sector. The committee meets twice a year to agree on an agenda of reforms, which will be carried out in close consultation between the private and public sectors. What is different about the CNEA is that the reform agenda and the implementing responsibilities are shared between the two sectors. The impact of the CNEA can be seen, for instance, in the improvement in ranking that Morocco has achieved in the World Bank's 2011 *Doing Business* Report. We think that these rankings are important to improve investors confidence in the country. With the arrival of the EBRD, we hope that such dialogue can be accelerated.

Khaled Saqqaf: As I mentioned before, we have seen significant improvements in the dialogue between both sectors in Jordan. Public-private partnership projects are underway. The privatisation law adopted in 2000 has also facilitated the restructuring of projects and institutions. I believe that there will be many opportunities for the EBRD to further facilitate such dialogue in Jordan and we look forward to the outcomes.

Moncef Cheikh-Rouhou: The dialogue between the private and public sectors has been taking place over the last 30 years in Tunisia. However, it has not yielded great results because this cooperation has been limited to a very small part of the private sector. Family ties were getting in the way. Therefore, Tunisia now needs a real dialogue between the **real** private sector, representatives of the entire economy, and the government. The role of the state should be limited to that of a referee.



Emmanuel Maurice

It is our ability to work with both the private and public sectors and to have a dialogue with both that distinguishes us from other international financial institutions already present in the southern and eastern Mediterranean region

Emmanuel Maurice: It is for this very reason that the EBRD has been called in. It is our ability to work with both the private and public sectors and to have a dialogue with both that distinguishes us from other IFIs already present in the SEMED region. The EBRD is in the best position to have a dialogue with the two sectors and to facilitate a dialogue between them. The policy dialogue we undertake with the governments is primarily focused on what is needed for the private sector to develop, and we intend to apply the same approach in the SEMED region.

I see the work that is carried out by the EBRD Legal Transition Team as being particularly important for the development of the private sector. The Legal Transition Programme focuses on, *inter alia*, secured transactions, concessions and insolvency, which are all related to the business and regulatory environment that the financial and private sectors need in order to be able to develop.

Mohamed Ghannam: In this respect, I can say that things in Egypt started changing in 2004-05. Before that time, the dialogue did not exist at all – it was unthinkable to imagine meetings taking place between the private sector and the relevant government departments to discuss reform. However, this started changing – the government started to be more receptive to the comments and feedback expressed by those concerned by the reform and this led to dramatic results. I can think of the tax reform for example. However, with the 2011 revolution, dialogue has become once more dormant. This should hopefully resume.

Roberto Rocha: Before the "Arab spring", the dialogue between governments and the private sector hardly existed, and when it did, it was restricted to a very small number of connected parties with preferential access to finance and credit and was conducted to further their privileges. The "Arab spring" was, and still is, a reflection of a segment of the private sector that lacks these privileges and is still struggling for a level playing field. Note that two recent World Bank reports have dealt extensively with this issue, one focused on finance and the other focused on private sector development.

Whether the "Arab spring" has changed the nature of the dialogue is hard to tell at this point in time, particularly in Egypt. We do however see dialogue starting to take place in Tunisia. Jordan and Morocco again, are among the countries that have embraced constructive dialogue in the region but whether this will lead to concrete changes is still hard to predict.

How do you think the EBRD can best utilise the experience it gained during two decades of transition and development in eastern Europe and central Asia and how useful will it be for the southern and eastern Mediterranean region?

Emmanuel Maurice: The EBRD is a project finance institution and there are certainly a number of bankable projects which will provide us with the opportunity to apply our experience. However, I can see some significant differences between the two experiences. Culturally, the two regions are of course, very different, which means that the process of development and transition may require a different approach in the SEMED region. Having said this, EECA started a process with no private sector at all, whereas the SEMED region has a private sector that is already quite developed but needs to be further assisted. There are also questions of integrity which need to be addressed in both regions. Finally, the question of political uncertainty in the new region is something we have to address to an extent similar to what we have already experienced in the EECA at the very beginning in 1991.

What are, in your opinion, the three factors that would make the contribution of the EBRD significant in the region?

Rabii Leouifoudi: We have already discussed them to a great extent: to facilitate the dialogue between the government and the private sector, to rebuild the confidence in the market, and to harmonise the collaboration between all relevant parties.

Roberto Rocha

> For the World Bank, the challenge was to decide on whether it was appropriate to engage with governments that lacked democratic credentials and transparency

What are the key lessons that have emerged from the experience of other international financial institutions in this region? What does the EBRD need to be aware of?

Roberto Rocha: For the World Bank, the challenge was to decide on whether it was appropriate to engage with governments that lacked democratic credentials and transparency, in order to push for reforms and also to decide on how to react when reforms were only partial. This requires being equipped to undertake a political analysis of what is often a very complicated situation, to weigh the pros and cons. This requires a lot of judgement.

What social issues/cultural awareness should the EBRD be aware of when operating in the SEMED region?

Khaled Saqqaf: At this point in time, I would turn the EBRD's attention to the problem of corruption, which has been a concern for Jordan in the past couple of years. In response to this concern, the Jordanian government introduced a number of measures in 2011, in particular greater regulation and supervision of public spending. On the question of social awareness, the Jordanian economy remains based primarily on family structures; though we have begun to see other types of investments entering into the country. Despite this, it remains the case that such structure can impact an external, strategic investor's willingness to invest or expand in Jordan.

Emmanuel Maurice: May I come back to the question of corruption? It is very good to hear that new laws have been passed to fight corruption, but very often the question is whether these laws will be enforced. Do you see a strong enforcement drive in order to fight corruption in Jordan?

Khaled Saqqaf: Yes I believe there is, and some actions have already been taken in this respect. The general prosecutor is investigating all charges that come to the anti-corruption commission.

Rabii Leouifoudi: I think the EBRD should be mindful of the reform endeavours, both political and economic, that were carried out by the Moroccan government in the last few years. There is also a historical and political context to the reform, part of which is marked with a relative success in an effort to stabilise the political and economic system and to safeguard the macroeconomic indicators, which had been up to then somewhat elastic. All this must be taken into consideration.

In terms of cultural awareness, Morocco is an African-Muslim county, with Arabic and Amazigh as the two official languages since the Constitution of 1 July 2011, with a sociocultural composition that is considered rich and diverse for the entire country across the different regions.

Mohamed Ghannam: I am afraid the IFIs in Egypt are not viewed very positively by the general public. There is a strong suspicion of interference in the national agenda. This will need to be worked on, especially in the media. So the EBRD has a role to play in building public trust for the benefit of the IFIs' operations in Egypt.

In terms of developing capital markets or more generally the non-banking financial sector, the region is quite behind. Why is this and what changes do you think will be necessary to overturn the current situation?

Khaled Saqqaf: Jordan, in comparison with the neighbouring countries in the region, enjoys a good basis, both legal and structural, for capital markets. The Jordanian Investment Law allows foreign participation in public shareholding companies without any limitation. However, the Jordanian capital market is not fully developed. The size of the market is relatively small in comparison to the region, and the priority is thus to develop more international structures that cannot be currently accommodated in the Jordanian markets, such as P-Notes, global depository receipts, and so on. Other products, such as repos, cannot be implemented in Jordan due to the current capital markets regulation, and this will need reforming.

Do people in your respective countries believe that legal reform can make a tangible improvement to the business environment? If not, why not?

Mohamed Ghannam: There is the belief in Egypt that law reform is key, but the term has been abused in the past. There has been a good deal of talk about reform, yet people have not seen any tangible benefits. So any new efforts in law reform will need to be accompanied by visibility on the ground.

Can you give us some examples of successful commercial law reforms that have made a real difference in the last 5-7 years?

Khaled Saqqaf: Yes, I can think of the Companies Law, which has introduced the private shareholding company into Jordan. This new structure is very flexible, including on voting rights and I believe only a few countries in the region have such a system. The Investment Law is also a good example: it provides for foreign investors to have the same rights and treatment as local investors, and allows in some cases as much as 100 per cent of the investment to be foreign-owned. Finally, the Sukuk Law was passed last October: it sets forth the framework to encourage the issue of Sukuks.

Mohamed Ghannam: Like Khaled, I can think of a number of examples. The Tax Law, reformed in 2005, introduced the flat tax rate of 20 per cent, and simplified the tax system. This resulted in a marked increase in the amount of taxes the state collected, which was seven times more than in previous years. I also think the reform that took place in Egypt in the banking sector and in the Central Bank of Egypt has been key to ensuring the stronger Egyptian banks that one can see now.

Which jurisdictions usually serve as a source of inspiration when drafting legislation in your countries?

Rabii Leouifoudi: Morocco has always drawn inspiration from the French legal system, particularly in the economic and administrative spheres. However, this does not prevent Morocco from being open to other models.

Khaled Saqqaf: The Jordanian legal system is broadly French based, but some laws have also been drawn from the US system, the UK, sometimes even from the Malaysian or the Singaporean systems. We also take into account international treaties and best practices when drafting legislation.

Moncef Cheikh-Rouhou: While Tunisia has an old French based judicial system which works very well, it is now heading towards an Anglo-Saxon one. In fact, we can also see other influences, such as that of Malaysia.

Khaled Saqqaf

"I am also optimistic, and I hope to see Jordan further down the path of development

How do you see the SEMED region in ten years' time?

Rabii Leouifoudi: As an optimist, I see Morocco as a better place in ten years' time. I would like to think that the legal and institutional reforms will be accelerated in the next 10 years.

Khaled Saqqaf: I am also optimistic, and I hope to see Jordan further down the path of development. I hope that the upcoming elections in Jordan will provide more stability to the country and relieve it from the unrest that it is currently experiencing as a result of what is happening in the neighbouring countries.

Moncef Cheikh-Rouhou: I would like to see Tunisia as an emerging economy with a growing economy and employed young Tunisians.

Roberto Rocha: I have the feeling that the situation may get worse before it gets better. There is a large uncertainty as to how things will transpire in the coming few years. The four countries will be facing a lot of challenges; chief among them is the pressing unemployment challenge. It will be very hard to keep the new generation excluded and in the dark, especially with the advent of technology.

As to how the SEMED region will look in 10 years' time, one must look at the entire region and not only at those four countries. What is happening in the West Bank and Gaza, Algeria, Libya, Syria and Lebanon will also influence the outcome for the entire region, not to mention the Gulf Cooperation Council countries. However, despite the complex political economy of each SEMED country, opportunities are immense to advance towards sustained development and growth.

Mohamed Ghannam: Presently, Egypt is at a crossroad. We have had a setback with the parliamentary election, and now we are experiencing another setback with the drafting of the Constitution. If this political struggle is resolved quickly and amicably, and the constitution is properly drafted, we will be on the right track. The next few months will be very decisive for our future.

Emmanuel Maurice: I hope that with the EBRD's assistance, the SEMED region will be in a better position, economically and politically. However, the EBRD will not be the principal cause of change in these countries; the movers and shakers will be the countries themselves. It is entirely up to them to take the right approach and to carry out whatever is needed for their own improvement.

What we have seen in the EECA is that transition is not linear. There was progress but also regression at times. There was, and still is, vulnerability to external events. It is for this very reason that despite the great progress that the countries in central Europe have made, including becoming members of the European Union, the EBRD is still present and operating there. Transition takes a long time and certainly much longer than what was initially envisaged.

Panellists

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04

Insolvency – a second chance?

Why modern insolvency laws seek to promote business rescue

CATHERINE BRIDGE

This article considers some of the broad socio-historical, political and economic factors that have shaped modern insolvency laws leading to the development of the "rescue" culture. It also examines some of the unique features of insolvency law reform in the former socialist bloc and seeks to anticipate some of the issues that may be encountered in the southern and eastern Mediterranean region.

Insolvency laws are under greater scrutiny than ever before as governments and legislators seek to mitigate the effects of the global financial crisis on both businesses and consumers. While some insolvency laws have been comprehensively overhauled, others have introduced new procedures or have been subjected to important amendments, especially with a view to encouraging business rescue. Legislative change has not been confined to the sphere of business insolvency. The expansion of consumer credit in recent years has resulted in reforms to consumer insolvency laws. Some countries, such as Lithuania, have introduced for the first time a consumer insolvency regime to address the problems of personal over-indebtedness. The pace of insolvency law reform has been fast and even, at times, relentless.[1]

International financial institutions have been involved in reform efforts and, in certain cases, have made financial assistance conditional upon insolvency law reform. Ireland and Portugal are countries where the reform of insolvency laws is part of an International Monetary Fund programme of assistance. At the EBRD, insolvency is a focal area of technical assistance and insolvency best practice is encouraged as part of measures to improve the investment climate in the Bank's region of operations. The EBRD region includes a number of European Union (EU) countries. These have benefited from efforts by EU legislators to ensure better coordination of insolvency proceedings among EU Member States through the 2000 European Union Insolvency Regulation (EUIR).[2] The EUIR, which regulates insolvency proceedings of natural or legal persons involving an EU cross-border element, was the product of many years of labour that commenced with the establishment of the Insolvency Working Party in the late 1960s. The EU has sought to

Insolvency is an area of law where there is little uniformity of approach even among countries that share a similar common or civil law framework

promote insolvency best practice at Member State level, supporting projects advocating a "fresh start" after insolvency for consumers in the 1990s and from 2000 onwards following the European Councils of Lisbon and Feira, for entrepreneurs and small and medium-sized enterprises. The United Nations Commission on International Trade Law (UNCITRAL) has also sought to encourage greater cooperation and coordination of insolvency proceedings among international states through its 1997 Model Law on Cross-Border Insolvency, which has been adopted by some 20 jurisdictions across the world to date.[3]

Notwithstanding such initiatives, insolvency is an area of law where there is little uniformity of approach even among countries that share a similar common or civil law framework. This reflects the numerous areas of law and human experience that insolvency touches on, from employment and pension matters to property and secured rights. Despite such diversity, one can see across most insolvency jurisdictions in the Western world, a historical shift in policy terms from viewing insolvency as a terminal proceeding for businesses ending in liquidation, to recognising insolvency proceedings as a gateway to potential business rescue. This has been accompanied in many quarters by a reduction in the stigma attached to insolvency, which historically led to debtors being treated as criminals and social outcasts. Effective insolvency laws have come to be recognised as an essential part of an economy that encourages businesses and persons to be entrepreneurial and to take economic risks.

The launch of EBRD's investment activities in the south and eastern Mediterranean (SEMED) region of Egypt, Jordan, Morocco and Tunisia presents new and exciting challenges for the EBRD as an institution, including in the field of insolvency law reform. This article considers some of the broad socio-historical, political and economic factors that have helped shape modern insolvency laws, with particular emphasis on business insolvency. At the same time, it examines some of the unique features of insolvency law reform in transition economies following the dismantlement of the communist system and seeks to anticipate some of the issues that may be encountered in SEMED. The terms "insolvency" and "bankruptcy" are used interchangeably throughout the article.[4]

The development of business insolvency law

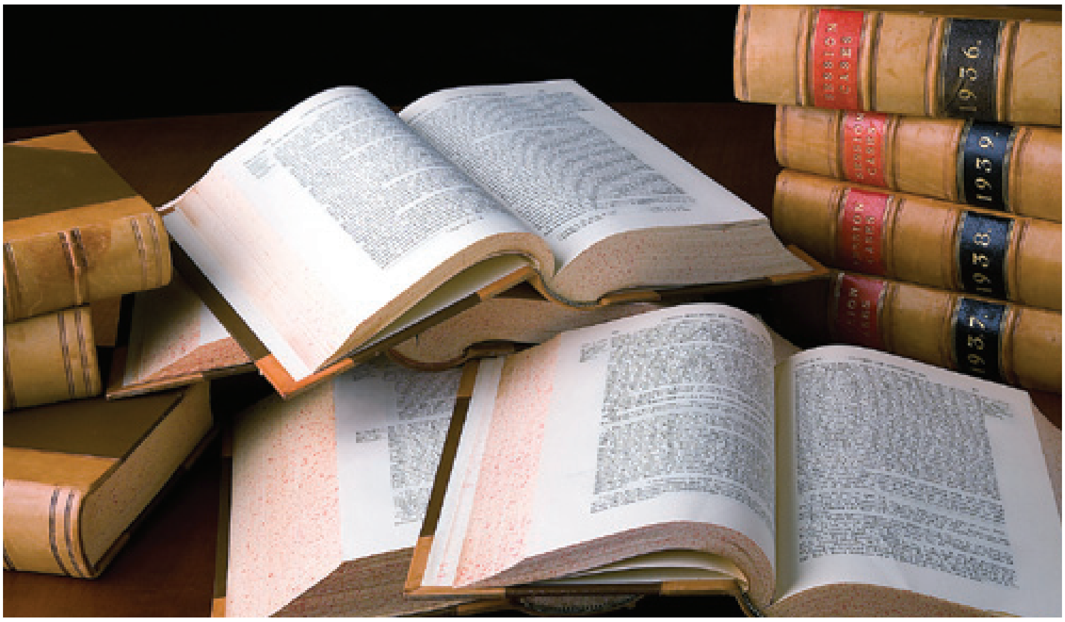
Insolvency would not be possible without the existence of credit since insolvency is, by definition, the inability to pay one's debts. The extension of loans and founding of a credit based economy brought with it the risk of default, leading to the introduction of laws and procedures to regulate non-payment.

The Romans formulated insolvency concepts that are familiar today, from assignment of the debtor's property to his creditors *(cessio bonorum)* to liquidation of the debtor's assets *(distratio bonorum)* and compositions with creditors *(dilation)*. Later, the bankruptcy of merchants came to be regulated by medieval European law merchant *(lex mercatoria)*, a substantial part of which was absorbed into English common law. Law merchant emerged from the body of commercial law developed in the merchant cities of northern Italy, where the practice of modern banking was first established.

In Russia, a law of 1497 (the *Sudebnik*) enacted by Ivan III sought to regulate, among other matters, the repayment of commercial loans in instalments for merchants whose goods were lost, through no fault of their own, for instance by being sunk at sea, or burned, or seized by troops.[5] In England, the first modern bankruptcy law was the 1542 Statute of Bankrupts of Henry VIII, which was primarily a debt-collection device for creditors. It directed the sale and distribution of the debtor's assets and codified for the first time in English statute law the *"pari passu"* principle of equal treatment of creditors. The principle of discharge of debts for natural persons was first introduced into English bankruptcy legislation by the 1705 Statute of Anne, which required the debtor to prove his honesty before benefiting from any debt discharge, hence its title *"An Act to Prevent Frauds Frequently Committed by Bankrupts"*.

Bankruptcy legislation became more extensive with time, the influence of some bankruptcy law models extending geographically with colonisation and empire. The first federal US Bankruptcy Act of 1800 was based on English bankruptcy legislation before a century of reforms, many of which were short-lived, saw the US taking a very different approach towards bankruptcy than England (discussed below). The bankruptcy provisions

The notion of "corporate insolvency law", by which a corporate entity goes through insolvency without recourse to its owners or shareholders, is relatively recent



of the French Commercial Codes of 1807 and 1838, first codified in the 1673 Ordonnance de Commerce, formed the basis of many Napoleonic bankruptcy laws around the world, including Morocco, Egypt and Tunisia. In the 19th century, bankruptcy laws were introduced by newly formed European states. The first federal German Bankruptcy Code came into force in 1877, following unification in 1871. Similarly, the Italian Commercial Code of 1869, which contained bankruptcy procedures, came into force soon after the founding of the Italian state in 1861.

Nonetheless, before the birth of the modern company in the mid-19th century onwards, bankruptcy laws were reserved for individuals. Typically, a distinction was drawn between individuals acting in a commercial capacity (merchants) and those acting in a personal capacity (non-merchants). In England, bankruptcy laws were only for merchants, until the enactment of the 1861 Bankruptcy Act extended the availability of bankruptcy laws and bankruptcy debt relief to non-merchants. This development was followed by the 1869 Debtors Act, which abolished imprisonment for debt and the punishment of certain fraudulent debtors.[6] Imprisonment for debt, principally affecting small debtors, had been common in the earlier 19th century. References to "debtors" prisons' pervade the literature of the period, including the work of Thackeray and Dickens; the latter's father was imprisoned in the Marshalsea debtors' prison. Debtors' prisons existed throughout Europe. Cervantes and Molière were among earlier well-known European writers in the 16th and 17th centuries to have been imprisoned for failure to pay their debts.

The notion of "corporate insolvency law", by which a corporate entity goes through insolvency without recourse to its owners or shareholders, is relatively recent. It is founded on the principle of corporate limited liability, a development in company law that limited the liability of shareholders for a company's actions and at the same time marked acceptance of the fact that not all corporate debt would necessarily be repaid. Corporate limited liability for joint stock companies was first introduced in the UK by the 1855 Limited Liability Act,[7] however there were attempts to pierce the corporate veil and restrict the application of limited liability in insolvent liquidation. These were defeated in the landmark case of *Salomon v Salomon*,[8] in which the House of Lords (the then highest court in England) upheld the distinct legal personality of the company from its shareholders, overturning the judgment of the Court of Appeal, which had found the majority shareholder of the company liable for the company's debts in liquidation, on the grounds that the company was a "fiction" and had been created to screen its owner from liability. Developments in English company law in the second half of the 19th century also saw the birth of the "scheme of arrangement", a

> The history of bankruptcy has been variously described as a move from *"debtor repression to debtor protection"* and a *"redefinition of insolvency from sin to risk, from moral failure to economic failure"*

court-sanctioned compromise or arrangement between a company and its creditors, introduced by the Companies Act 1862 and the Joint Stock Companies Arrangement Act 1870.[9] Although infrequently used because of their complexity, schemes of arrangement provide a useful means of dealing with the run-off of the insurance business and are increasingly being used as a debt restructuring tool for both English and, more recently, foreign-incorporated companies with English law-governed debt facilities.[10]

In some jurisdictions, corporate insolvency law has developed out of laws for individual bankruptcy and has evolved to form a distinct body of law. In England bankruptcy laws were initially applied by analogy to the insolvency of corporate entities, prior to the development of a distinct body of corporate insolvency law.[11] Today English insolvency law contains two separate regimes of "bankruptcy" for natural persons and "insolvency" for legal persons or corporate entities.[12] In France and in other Napoleonic jurisdictions, insolvency laws are divided along "merchant" and "non-merchant" lines. Merchants, including corporate entities and individual entrepreneurs, fall under one "business law" insolvency regime, while non-merchants, such as consumers, fall under a separate regime. In any event, the focus on "corporate" insolvency law varies according to the relevant economy. In some countries, a significant number of businesses are operated by individuals or families and may be unincorporated. Even where incorporated, banks may seek personal guarantees from the company's shareholders in respect of corporate loans to mitigate the risk of non-payment. The practice of obtaining personal guarantees appears to be quite common in the SEMED region. Corporate insolvency can thus become entangled with individual or personal insolvency.

The move towards business rescue and the US model

The history of bankruptcy has been variously described as a move from *"debtor repression to debtor protection"*[13] and a *"redefinition of insolvency from sin to risk, from moral failure to economic failure"*. [14] The treatment of debtors in early bankruptcy laws was severe[15] and bankruptcy was a creditor-driven process. The concept of voluntary bankruptcy initiated by the debtor is a modern invention. Grounds for the change in the treatment of bankruptcy started in the US, which became the leading exponent of a new business rescue culture. Some commentators have traced the roots of this culture back to the US's early history

> **The US approach of the "fresh start" in bankruptcy has proved extremely influential in the subsequent development of business rescue legislation in Europe**

as a country of immigrants, eager to start over and with a general optimism about the future and the potential of the US economy.

The main turning point in US attitudes towards business bankruptcy originated in the second half of the 19th century, which witnessed the failure of a high number of US railway companies. Given the strategic importance of the railway industry in the development of the US economy, ways had to be found to mitigate the effects of failure. The solution came first from the judiciary, which developed the common law "equity receivership" as a tool for reorganisation, to safeguard the company's assets and enable an agreement to be reached with its creditors. When Munroe Railroad and Banking Co defaulted on its loans in 1894, the US court ordered the sale of the business as a going concern, since a piecemeal sale of the company's assets would have resulted in financial loss for all parties. In 1898, the US legislator introduced a new and lasting Bankruptcy Act, containing a limited compromise procedure for debts.[16] The 1898 Bankruptcy Act is widely recognised as enshrining the principle of the "fresh start" for businesses in US bankruptcy legislation.[17] Although modified many times, significantly by the 1938 Chandler Act, the Act remained in place until replaced by the 1978 Bankruptcy Code. The Chandler Act strengthened composition procedures under US federal bankruptcy law. It introduced Chapter 11 for small debtors and Chapter 10 for public companies, both of which allowed for bankruptcy "reorganisation" as an alternative to straight liquidation. The Chandler Act thus marked an important milestone in the development of the "fresh start" model for US businesses.

The US had come to see bankruptcy as a necessary part of a society that valued entrepreneurial risk and became known for its liberal acceptance of financial failure. Today it is widely considered one of the leading jurisdictions in terms of debtor protection. The debtor-in-possession model, introduced by the 1978 Bankruptcy Code, in which the existing management of the debtor remains in place during corporate reorganisation proceedings, absent their displacement by a court-appointed trustee for cause (such as fraud), embodies the very essence of the "fresh start", since it expresses faith in the ability of the debtor to continue to manage its financial affairs. The US approach of the "fresh start" in bankruptcy has proved extremely influential in the subsequent development of business rescue legislation in Europe, where the concept has formed parts of efforts to strengthen and revitalise Europe's economy.

European legislative developments in business rescue

In France, the first substantial reform of the 1889 law relating to insolvency appeared in 1955 and this promoted business rescue. It introduced a new system of recovery proceedings known as *règlement judiciaire,* which provided for the re-establishment of the debtor in business, as an alternative to liquidation. Further legislation in France in 1967 enacted a moratorium for businesses that were not yet in a state of cessation of payments and set the framework for present day French insolvency legislation. Following the enactment in 2006 of the *procédure de sauvegarde*,[18] a debtor-focused rescue procedure inspired by Chapter 11 of the US Bankruptcy Code, French insolvency legislation is generally considered among the most rescue-focused in the world.

In England and Wales, a new Insolvency Act was enacted in 1985, bringing into force two new corporate rescue procedures, the "company voluntary arrangement" and "administration"[19]. This followed the recommendations of the 1982 Cork Report, which held that one of the aims of a good modern insolvency law was *"to provide means for the preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country"*.[20] Nevertheless, the take-up of the new corporate rescue procedures under the new Insolvency Act was perceived by many to be disappointingly low.[21] The appointment of an out-of-court "receiver" to realise any security over the debtor and the debtor's property (including its business) continued to be used by secured creditors, as an alternative to liquidation. Although receivership was recognised as having facilitated the rescue of many businesses, the focus of the new regime had shifted to the broader platform of rescue of the company as a whole.

In 2001 the UK government produced a report called *"Insolvency – A Second Chance".* This argued that companies in financial difficulties should not be allowed to close down

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The second half of the 20th century saw the introduction of more “rescue focused” legislation in western Europe

unnecessarily and honest individuals should be granted a “fresh start”, given that *“in a dynamic market economy some risk taking will inevitably end in failure”.* The series of reform proposals contained in the 2001 report formed the basis for the 2002 Enterprise Act, which sought to encourage productivity and entrepreneurship through changes to UK insolvency and competition law. Significantly, the Enterprise Act expanded the “administration” procedure, with the objective of making it the main collective corporate insolvency rescue procedure.[22]

Further efforts to promote corporate recovery took place at the EU level as part of a drive to make the EU market economy more competitive. The 2000 European Council in Lisbon had set the goal for Europe to become by 2010 *“the most competitive and dynamic knowledge-based economy in the world”.* This was followed in June 2000 by the endorsement of the European Charter for Small Enterprises at the Feira European Council, which called for an assessment of national bankruptcy laws in light of good practice. In 2002, the project “Restructuring, Bankruptcy and a Fresh Start” was launched under the Enterprise Directorate-General (DG). This resulted in the publication of a final report of the same name in 2003. The report recognised that legal systems could be a real deterrent to a fresh start in business and cited the US, France, Germany and (since the introduction of the Enterprise Act 2002) the UK as jurisdictions that encouraged reorganisation rather than liquidation of companies. Those setting up a business were mindful of the consequences of bankruptcy proceedings and the disqualification and restrictions imposed on those subject to proceedings. The authors argued that failed entrepreneurs generally learned from their mistakes and were more successful in the future. This meant that they should be provided with the opportunity of a fresh start, particularly given the importance of entrepreneur contributions to GDP and economic development. Like the 2001 UK government report, the 2003 EU Report emphasised the need for a distinction to be drawn in insolvency legislation between circumstances where an individual debtor or directors had committed fraud and where they had acted *bona fide.*

The second half of the 20th century thus saw the introduction of more “rescue focused” legislation in western Europe. This reflected widespread recognition of the economic benefits of corporate rescue, as compared with piecemeal liquidation. Nevertheless the philosophy behind the reforms differed quite markedly across jurisdictions. In continental jurisdictions such as France, the motivation for corporate rescue was not so much

> **In some cases, the introduction of business rescue legislation has been driven by economic protectionism and the government's desire to protect a specific industry or strategically important company**

the encouragement of entrepreneurial risk, as in the US, but the preservation of business and continuity of employment. Preservation of employment is one of the stated goals of French insolvency law. The UK was more mindful of the interests of creditors in insolvency proceedings, the subsidiary (second) purpose of the administration procedure, after rescue of the company, being the achievement of *"a better result for the company's creditors as a whole than would be likely if the company were wound up"*.[23] Other factors continue to reveal a different philosophical insolvency mindset, such as the presence in certain jurisdictions of liabilities for creditors that recklessly extend credit or the imposition of criminal rather than civil sanctions on directors who continue to trade while the company is insolvent.

In some cases, the introduction of business rescue legislation has been driven by economic protectionism and the government's desire to protect a specific industry or strategically important company. In Ireland, for example, the examinership rescue procedure (described above) was introduced in 1990 at a time when the Goodman Group of companies, of strategic importance to the Irish beef industry, seemed to be in a state of imminent collapse.[24] Similarly, in Italy, the collapse of dairy producer Parmalat in late 2003 prompted the Italian government to introduce the "Marzano Law", a special insolvency law to deal with the insolvencies of large companies having 500 or more employees.[25] It was later amended and used to deal with the insolvency of another important company and employer, Alitalia.[26]

Nevertheless, only a small number of jurisdictions in Europe have to date adopted the US debtor-in-possession model for corporate recovery proceedings. Depending on the jurisdiction, the court or the insolvency office holder will, to a greater or lesser extent, dominate the proceedings. In France, existing management are allowed to stay in place during the *procédure de sauvegarde* and *règlement judiciaire* proceedings, although the proceedings are closely overseen by the court and generally require the appointment of an office holder *(administrateur judiciaire)* to assist the company's management with the preparation of a reorganisation plan. In the Irish rescue procedure of "examinership", existing management stays in place but an examiner (usually an accountant) is appointed to guide the company through a restructuring for a limited period of 70 days, extendable to 100 days. In most jurisdictions, for example, in England and Wales and in Germany, the appointment of an insolvency office holder on the commencement of insolvency proceedings has the effect of displacing existing management powers in favour of the insolvency office holder.

Insolvency reform trends in central and eastern Europe

In the region where the EBRD has operated since 1991, the political and economic landscape in the 1990s was completely different. Communism as an ideology had dictated social and economic policy until 1989. In many of the state-planned economies of central and eastern Europe (CEE), profits from successful companies could be redistributed to meet the losses of unsuccessful companies. As the government controlled the banking sector, loan default by a failing enterprise could be forgiven and a new loan extended. Nevertheless, there were differences among the countries' economies: some remained agrarian, while other countries, such as Poland, had moved towards a centralised, industrial economy. The absence (albeit in different degrees throughout the region) of a market economy and competition during communism meant that insolvency laws, to the extent these existed, had remained for the most part dormant, such as Poland's 1934 bankruptcy law. There were of course exceptions to the rule. In Hungary, two decrees were introduced in 1978, regulating the liquidation of cooperatives and economic associations and state-owned enterprises. A further 1986 Act set out details regarding liquidation proceedings and provided for the restoration of solvency, as well as the winding-up, of enterprises. Of the more limited variety of exceptions, in Russia during the new economic policy, insolvency provisions were included in the 1922 Civil Code to regulate an insufficiency of assets.

In the aftermath of communism, Western economists saw a new role for insolvency laws in assisting the restructuring of the economy and the allocation of assets from the state to the private sector, in addition to their traditional role as a safety net for financial failure in a new market economy. Many state-owned enterprises were technically insolvent. The adoption of insolvency laws depended on the privatisation strategy adopted by the relevant country. By

> Unsurprisingly, the transition to a market economy led to a high volume of insolvency law reforms across central and eastern Europe countries from the 1990s onwards, the focus of which has been on business insolvency

1992, most CEE countries had embarked on a strategy of privatisation. Some countries, such as the Czech Republic, gave priority to privatisation and delayed the introduction of insolvency laws. Others, such as Hungary, brought in insolvency legislation to assist with the implementation of economic restructuring. In 1992 Hungary implemented a new bankruptcy law. This contained a narrow liquidity test for insolvency and included penal sanctions for managers who failed to file within 90 days of illiquidity, prompting widespread bankruptcy filings. In Poland, liquidation procedures were widely used as part of the privatisation process.

Some countries, such as the Czech Republic, were able to revive earlier bankruptcy laws. The Czech Republic's 1991 Bankruptcy Law was based on the 1915 Austro-Hungarian Bankruptcy Act, which contained limited composition (debt compromise) procedures. Poland relied on its 1934 Law on Bankruptcy, only replacing it with its existing Law on Bankruptcy and Rehabilitation in 2003. Russia, by contrast, drafted its 1992 Federal Bankruptcy Law without reference to any specific precedent. The transition to a free market economy with the phenomenon of bankruptcy was a cultural and economic shock. There were fears of widespread, uncontrolled bankruptcies and the large scale unemployment this could trigger. In countries such as Romania, governments sought to protect larger businesses from bankruptcy by making them exempt from bankruptcy legislation. The lack of proper infrastructure was a further major issue. There were no insolvency specialists among judges and other professionals. Debtors and creditors were themselves unfamiliar with insolvency procedures. Many people associated bankruptcy with criminality and did not believe that bankruptcy proceedings could lead to anything beneficial.

Unsurprisingly, the transition to a market economy led to a high volume of insolvency law reforms across CEE countries from the 1990s onwards, the focus of which has been on business insolvency. Russia replaced its 1992 law with a new law in 1998 and then again in 2002 with its present law. Hungary, by comparison, retains its Act XLIX of 1991 on Bankruptcy Proceedings, Liquidation Proceedings and Voluntary Dissolution, but has amended this over 30 times. The Czech Republic introduced a new Act on insolvency in 2006. A fresh impetus for insolvency law reform in the CEE came with the advent of the global financial crisis, which reached the region in 2008. Easy, foreign-financed credit suddenly became unavailable and export markets collapsed, causing the region's economy to enter into a deep recession. This resulted in legislators in a number of countries, including Latvia, Romania, Serbia, Moldova, Russia and Hungary, taking decisive action to improve their insolvency law regime.[27]

Social and religious attitudes to insolvency and debt

Despite the recent high volume of insolvency law reforms in the CEE and throughout the world, in most countries the stigma of financial failure persists in some form today. Individuals in particular face the risk of social stigma. The inability to meet one's financial obligations has been interpreted at various times by many groups in society as a breach of trust and lack of financial self-restraint. Stigma is relevant since it can impede the proper functioning of rescue mechanisms within insolvency laws and reduce the opportunities for a "fresh start". Although much reduced, residual traces of social stigma related to bankruptcy can be seen in the UK and even in the US, despite its generous debt forgiveness regimes for businesses and consumers.[28] Nonetheless, attitudes are likely to vary according to the community and the sector within that community.

The 2002 UK Government Report on Insolvency observed that the financial and business communities generally did not attach as much stigma towards business failure as consumers and the general community. Acceptance of the separate identity of corporate entities, independent from their owners, has likely helped to reduce the stigma of insolvency for companies. Nevertheless in the business community, the failed entrepreneurs of an insolvent business may have difficulty obtaining loans for new ventures and directors connected with an insolvent company may not easily find further management positions. This is particularly the case where there has been misconduct. In the UK, directors that are found guilty of misconduct in office, by, for example, continuing to trade to the detriment of creditors at a time when the company was insolvent, may face disqualification under the Company Directors Disqualification Act 1986. In some societies, the stigma of financial failure is particularly severe. A recent study on

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The stigma of financial failure has been around throughout history and was particularly severe in ancient times, when it was accompanied by severe punishments for the unfortunate debtor

Japan concluded that the stigma attached to suicide was lower than for bankruptcy.[29] There are inevitably exceptions to the rule. It is reported that in India in the past and to a lesser extent today, some families have perceived it desirable to marry into another family that has experienced bankruptcy or insolvency, since this is evidence of the vibrant, entrepreneurial nature of the family.

The stigma of financial failure has been around throughout history and was particularly severe in ancient times, when it was accompanied by severe punishments for the unfortunate debtor. The Greeks allowed the amputation of the debtor’s limbs and his sale into slavery. Under early Roman law, the debtor’s body could be cut up and distributed amongst his creditors, before the *Lex Poetelia* in 326 BC prohibited death and slavery and the Romans developed procedures that were directed at the debtor’s assets, rather than his person. Religion has often been a key component of social attitudes and beliefs. Major religions have viewed default on debt payment as seriously wrong but have enjoined creditors to treat the debtor with mercy. Psalm 37:21 of the Old Testament reads, *“The wicked borroweth, and payeth not again: but the righteous showeth mercy, and giveth”*. In Chapter 5 of the Qur’an, debtors are enjoined to respect their promises in the verse *“Oh, ye who believe! Fulfil obligations”,* and creditors are asked to be patient and generous with creditors: *“if the debtor is in difficulty, grant him time ‘til it is easy for him to repay. But if ye remit in by way of charity, that is best for you if ye only knew”* (Verse 2.280). Common to both Christianity and Judaism is the Jubilee year, a special year of remission of sins and pardons, where every 50th year *“ye shall return every man unto his possession, and ye shall return every man unto his family”* (Leviticus 25:10). This concept inspired the “Jubilee debt campaign”, an initiative launched in 2000 between local and regional groups and national organisations to cancel the unserviceable sovereign debts of poorer countries.

In the medieval church, the stigma attached to non-payment of debt was accompanied by a corresponding stigma directed at creditors lending with interest (usury). The Catholic Church banned the charging of interest by clerics from AD 314 and laymen in 1179, leaving socially marginalised groups to carry out the role of lending with interest. As part of the English Reformation and the break with the Catholic Church, King Henry VIII repealed the usury laws in 1546. While lending with interest is no longer prohibited by the Catholic Church, lending at prohibitively high rates of interest continues to be forbidden under Canon Law. Vestiges of the

A study of Insolvency Systems in the Middle East and North Africa suggested that the region's laws were the "least developed in the world" with regard to reorganisation of companies in financial distress

restriction on usury remain in the legislation of certain countries today, such as the caps on charging higher rates of interest or the prohibition on charging interest on rolled-up interest (such as seen in payment in kind instruments).

In countries that follow Islamic (*Shari'a*) law, the prohibition on earning interest (*riba*) on loans continues to be enforced. This is to be distinguished from the principle of allowing an increase in price to reflect usage of a particular asset over time, which is permitted under *Shari'a* law. A number of *Shari'a* law principles interact with insolvency law and may affect insolvencies, particularly in the context of a reorganisation or restructuring of Islamic financing structures, where financiers wish for these to remain *Shari'a* law compliant. The prohibition on riba will, for example, prevent the deferral of a payment obligation additional fees or interest.[30] Interestingly, although bankruptcy may result legally in a forgiveness of debts and only partial payment of creditors, the debtor will remain under a religious obligation to repay any difference to his creditors later in his life if he should come into money.

Shari'a law is part of the legal framework of Islamic countries, although its application and interpretation varies from country to country. In Jordan, the Constitution specifically grants the *Shari'a* courts exclusive jurisdiction over matters affecting the personal status or family code of Muslims. In Morocco, *Shari'a* law is at the origin of the family code. Recently, the extent to which *Shari'a* law will be recognised as the principal source of law by the new constitutions of Egypt and Tunisia has been a matter of dispute between different national groups. Egypt's former Mubarak-era constitution had recognised *Shari'a* law as the main source of legislation, unlike Tunisia, which was a predominantly secular regime. The prevalence of *Shari'a* law in the future may affect the financing structures adopted in SEMED and, by extension, the insolvency and restructuring framework.

Southern and eastern Mediterranean

Given the variety of approaches to insolvency law found in national legal systems, it is perhaps to be expected that differences also exist within the EBRD's new region of operations. One common theme that can be identified among all of the SEMED countries, however, is the influence of French law upon insolvency legislation. In Morocco and Tunisia, such influence has continued into modern times, hence the inclusion in the Moroccan and Tunisian commercial codes of the French law business rescue procedures of amicable settlement *(règlement amiable)*[31], aimed at promoting a settlement between a debtor and its creditors prior to insolvency and judicial reorganisation *(redressement judiciare),* which involves the preparation of a reorganisation plan during the course of insolvency proceedings.

By contrast, Egypt and Jordan, while influenced by the French (Napoleonic) model, have not (yet) incorporated business rescue procedures into their insolvency legislation. Instead their insolvency legislation contains more limited debt composition procedures. A study of Insolvency Systems in the Middle East and North Africa (MENA) presented by Hawkamah/World Bank/OECD/INSOL International in 2009, which included Egypt and Jordan but not Morocco and Tunisia, suggested that the region's laws were the *"least developed in the world"* with regard to reorganisation of companies in financial distress. In the insolvency laws of certain SEMED countries, including Egypt and Tunisia, there remains an overt emphasis on penal sanctions in connection with insolvency, which may encourage the social stigma of insolvency. The Tunisian Commercial Code provides that failure of a merchant to file for insolvency, within one month of a state of insolvency or suspension of payments, will result in criminal liability.[32] In Egypt, a debtor who in bad faith fails to list all of his creditors in his filing for bankruptcy may be subject to a prison sentence for a minimum period of six months,[33] whereas under the Tunisian Commercial Code it is a criminal offence for a creditor to have agreed, with the debtor or a third party, certain rewards for voting in the bankruptcy proceedings.[34] The insolvency legislation of Egypt and Jordan, as well as Tunisia, is under review at present. It is hoped that reforms will result in the introduction of more business-friendly rescue procedures aimed at promoting the survival of viable businesses, while lessening in certain cases the punitive emphasis of the insolvency laws.

The existence of laws that provide for business rescue is only the starting point. There may be deficiencies in how the laws are administered or within the actual detail of the legislation. The EBRD's analysis to date suggests that obstacles to a proper functioning of insolvency law may also exist within the SEMED region, particularly

Insolvency laws have been in a state of flux and there are indications that greater change lies ahead

as regards business rescue. One of LTT's key findings from meetings with stakeholders in Tunis in June 2012 was that adoption of the French law *règlement judiciaire* procedure in the 1995 Reorganisation Law[35] appears to have resulted in overly long insolvency proceedings in Tunisia. The strict time periods (up to a maximum of six months) prescribed by the 1995 Reorganisation Law for the preparation of a reorganisation plan of the debtor's business are not respected in practice. Parties cited reorganisation cases as taking on average three to seven years to complete. Within the 1995 Reorganisation Law itself, there are issues with the lack of effective compromise procedures to force a reduction in the overall principal amount of the debt on a dissenting minority of creditors, which have resulted in reliance on a lengthy, and possibly ineffective, deferral or rescheduling of debts. Tunisia is in the process of considering reforms to its insolvency laws, which may seek to address such issues.

Further reforms are likely to be needed in Tunisia and other SEMED countries to improve the overall system of qualification and regulation of insolvency office holders, which play a central role in the management of the estate of the debtor and, often in business rescue proceedings, in the preparation of a reorganisation plan. The EBRD has focused many of its past insolvency-related technical assistance projects on strengthening the profession of insolvency office holders in countries, such as Serbia and Russia and was behind the development of a set of insolvency office holder principles which provide recommendations of some of the issues that should be addressed by legislators in relation to the profession within an insolvency law regime.[36] Such work was run in parallel with commenting on proposals to reform Serbian and Russian insolvency laws. As the EBRD expands its operations into SEMED, the EBRD will work to apply its insolvency-related expertise gained in the CEE to new technical assistance projects for insolvency law reform and capacity building in the SEMED region.

Conclusion

There have been significant advances in recent times to facilitate access to business rescue across a number of jurisdictions in the EBRD's region of operations. These developments have taken place against a wider backdrop of evolution in the nature of insolvency laws since their inception. Many jurisdictions have moved towards a de-criminalisation of many aspects of insolvency and have sought, as part of this process, to differentiate between dishonest or irresponsible debtors and honest debtors, reserving the majority of penalties and sanctions for the former. Efforts have been made by national legislators to reduce the stigma historically attached to business failure through a re-labelling exercise, following the lead of the US, which replaced references to "bankrupts" by the more neutral term "debtors" in its 1978 Bankruptcy Code. The existence of business rescue proceedings has helped facilitate a change in public perception. In the UK, the Association of Recovery Professionals, R3, has sought to demonstrate the positive contribution of its members (insolvency office holders and other professionals) and the insolvency sector to the wider economy.[37]

Insolvency laws have been in a state of flux and there are indications that greater change lies ahead. In December 2012, the European Commission published a proposal for a Regulation of the European Parliament and Council to amend the European Union Insolvency Regulation to address a range of practical problems in the Regulation.[38] Of particular concern was the lack of existing coverage and coordination of national practices in promoting the rescue of enterprises in difficulty. In a statement about the proposed amendment, the EU Justice Commissioner, Viviane Reding, commented, *"Our current insolvency rules need updating to make it easier for viable businesses in financial difficulties to keep afloat rather than liquidating. 1.7 million jobs are lost to insolvencies every year – we want to give honest companies and the people they employ a second chance."*

An effective insolvency regime has come to be valued by many as a key component of a free market economy that values entrepreneurship and competition. At the same time, it has been recognised as providing an important toolkit for dealing with the present global financial crisis, which has affected so many businesses and sectors of the economy. Nevertheless, even where insolvency laws legislate for business rescue, a careful balancing exercise will still need to take place between the interests of all of the various parties, the debtor, its creditors, its members or shareholders, with a view to the broader interests of society and the economy as a whole.

Views

Insolvency – a second chance?

A development perspective

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As a provider of technical assistance on issues relating to insolvency and non-performing loans (NPL)/debt resolution to countries around the world, the World Bank Group has had an opportunity, together with other donors such as the EBRD and the IMF, to witness an increased awareness among policy-makers of the importance of sound insolvency systems. As Catherine's paper notes, the financial crisis precipitated an urgent response, in some countries, to a rise in NPLs. A more common phenomenon, however, has been a contraction of credit and an overall retrenchment by financial institutions, even in countries where NPLs did not rise significantly during the height of the crisis. This reluctance to lend is the result, in part, of an overall debt enforcement and insolvency environment that creates an environment of uncertainty and unpredictability for lenders.

As countries have experienced the crisis in vastly different ways, so too have they differed in their approach to insolvency reforms. At the same time however, trends, particularly within regions, can be observed in the approaches being taken. In the eastern Europe and central Asia (EECA) region, for example, Catherine's paper notes the pervasiveness of reform during the immediate "transition" period following the fall of the Berlin Wall. Many countries in this region can be said to have enacted their "first wave" of insolvency reforms, although with differing levels of success. In these countries we see a move to address some of the more difficult and intractable implementation challenges related to insolvency reform, such as the regulation of insolvency practitioners and the establishment of frameworks to resolve insolvency cases outside of formal court proceedings. Many of the weaknesses in the application of the law that give rise to these reforms were highlighted in the EBRD's 2004 Legal Indicator Study of EECA insolvency systems (http://www.ebrd.com/pages/sector/legal/insolvency/legal_indicator.shtml).

In the Middle East and North Africa (MENA), by contrast, the "Arab spring" has prompted a renewed focus on, among other things, creating an enabling environment that supports the growth of the private sector – with a hope that the private sector will contribute significantly to job creation in the region. To that end, countries are embarking on a range of "first wave" reforms, including in the field of insolvency. These typically involve either the introduction or the significant refinement of forms of business rescue. Drawing on international experience consistent with their domestic legal traditions, many countries in MENA are opting to develop local versions of the French insolvency process, including through the use of the *mandataire ad hoc* to provide third-party assistance to debtors and creditors trying to seek negotiated solutions, albeit under the umbrella of a formal court proceeding.

A practitioner's view

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European insolvency law has gone through a remarkable transformation over the past decade. Until recently, in contra-distinction to the US market, restructuring of finance obligations took place through the negotiation of restructuring agreements between the debtors and the various financial creditors (predominantly financial institutions). The alternative to reaching a consensual solution was bankruptcy and a severe loss of enterprise value for everyone. The principles against which the restructuring would take place are known as the INSOL Principles, which still form the basis of international best practice (see http://www.ifecom.cjf.gob.mx/PDF%5Carticulo%5C4.pdf). These principles evolved in turn from the London Rules or the London Approach, based on best practice promoted by the Bank of England in the London market in which English law debt was originated for the world of international finance.

These principles have nevertheless come under strain with the growing complexity of debt obligations (including circumstances where a debtor has a mix of obligations in relation to widely held capital market instruments as well as bank debt) and the development of the secondary debt market where purchasers of the debt may be prepared to act contrary to the principles. In response to this, European jurisdictions, to some extent led by the London market with its use of schemes of arrangement, have been developing moratorium and composition procedures to facilitate restructurings where creditors who hold out must be bound in or crammed down. Additionally, the London market has developed the use of "pre-pack" administrations to break the deadlock between shareholders, company and creditors by means of a quick sale of operating companies or the debtor's business to an entity controlled or financed by those creditors "in the money".

The restructuring of Eurotunnel through the *procédure de sauvegarde* in France probably marked the first serious restructuring in Western continental Europe to be facilitated by the European Union Insolvency Regulation. We are seeing an increasing use of English schemes of arrangement for non-English companies, pre-packs and local composition procedures as the market becomes ever more sophisticated. These ideas have started to be exported to countries in the Gulf as well. All of this is a far cry from where we were not too long ago.

Notes

[1] Insolvency law reforms have been introduced over the past few years in countries such as Albania (2008, 2009), Bulgaria (2006, 2010), France (2008, 2010), Germany (2012), Hungary (2009), Italy (2010, 2012), Kazakhstan (2012), Latvia (2008, 2010), Lithuania (2010, 2012), Moldova (2012), Portugal (2012), Romania (2010), Russia (2008, 2009), Serbia (2009, 2011), Spain (2009, 2011) and Ukraine (2012).

[2] Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings. Note that it does not apply to Denmark. On 12 December 2012, the European Commission published a proposal for reform of the EUIR.

[3] Australia 2008, Canada 2005, Colombia 2006, Eritrea 1998, Greece 2010, Japan 2000, Mauritius 2009, Mexico 2000, Montenegro 2002, New Zealand 2006, Poland 2003, Republic of Korea 2006, Romania 2002, Serbia 2004, Slovenia 2007, South Africa 2000, Uganda 2011, British Virgin Islands 2003, Great Britain 2006, and the United States of America 2005.

[4] "Insolvency" derives from the words "in" (not) and the Latin "solventem" (paying). "Bankruptcy" is thought to have its origins in the Italian "*banca rotta*" or Latin "*banca rupta*" (literally: broken bench) and the symbolic practice in medieval Italy of breaking the bench of a bankrupt merchant or money lender.

[5] See Article 55 *(Concerning Loans)* of the Sudebnik 1497, translated by H. W. Dewey at: http://www.departments.bucknell.edu/russian/const/sudebnik.html

[6] The practice of debtors' prisons in the US ended earlier in 1833.

[7] The 1844 Joint Stock Companies Act was the first general Act of Parliament to allow for the incorporation of a company as a distinct legal entity, although it provided for unlimited liability for the company's members.

[8] *Salomon v Salomon* [1897] AC 22.

[9] Schemes of arrangement between a company and its members were introduced at a later date by section 120 of the UK Companies (Consolidation) Act 1908.

[10] Foreign companies to have used English law scheme of arrangements include Seat Pagine Gialle (Italian), Rodenstock and Primacom (German), La Seda and Metrovacesa (Spanish), British Vita and Wind Hellas (Luxembourg) and Vivacom (Bulgarian).

[11] In England and Wales the 1844 Winding Up Act was the first Act of Parliament to make corporate entities subject to bankruptcy legislation.

[12] Personal bankruptcy and corporate insolvency were unified for the first time in one legislative Act in 1986.

[13] Principles of International Insolvency, Philip Wood, 2nd Edition, 2007, Sweet & Maxwell.

[14] Bankruptcy in the Age of American Independence, Bruce H Mann, 2009, Harvard University Press.

[15] In England and Wales, the death penalty for so-called "fraudulent bankruptcy", where the debtor failed to turn over all assets and books, submit to examination and otherwise cooperate fully with the bankruptcy commissioners, was abolished and converted to imprisonment or hard labour in 1820.

[16] The practice of equity receiverships continued to operate up until the 1930s. An amendment to the Bankruptcy Law in 1933 provided a similar level of protection for consumers who had been affected by the Great Depression.

[17] In fact, the move towards a more rescue-orientated culture in the US had begun earlier with the introduction of the 1841 Bankruptcy Act, which was repealed within 18 months as it proved too debtor-friendly. Prior to the inauguration of the 1898 Bankruptcy Act, there had not been a federal bankruptcy law in place for 20 years.

[18] Law No. 2005-845 of 26 July 2005, which came into force on 1 January 2006.

[19] Unlike the US, which witnessed rapid bankruptcy reform in the 20th century, the legislative picture in England and Wales remained relatively stable. The 1914 Bankruptcy Act remained in force, with minor amendments, until 1985. On the date it entered into force, the 1985 Insolvency Act was replaced by the 1986 Insolvency Act, which consolidated the Insolvency Act 1985 with the principal insolvency provisions of the Companies Act 1985.

[20] See paragraph 198(j) of the 1982 Report of the Review Committee chaired by Sir Kenneth Cork. According to the Cork Report, fresh impetus for insolvency law reform in England and Wales came with membership of the European Economic Community in 1973.

[21] See the 2001 UK government report "Insolvency – A Second Chance" at paragraph 2.1.

[22] One of the ways this was achieved was by prohibiting the use of"administrative receivership" by secured creditors, involving the appointment of a receiver to the whole or substantially the whole of the debtor's business. This prohibition was subject to certain limited exceptions contained at sections 2B to 72GA of the Insolvency Act 1986. Secured creditors who might otherwise have been able to appoint an "administrative receiver" were given the option of appointing their choice of administrator out-of-court.

[23] Insolvency Act 1986, Schedule B1, paragraph 3(1).

[24] The Companies (Amendment) Act of 1990, which introduced Irish examinership, was substantially amended by the Companies (Amendment) (No. 2) Act 1999.

[25] Law Decree No. 347 of 23 December 2003.

[26] The amendment of the Marzano Law was enacted by Law Decree No. 134 of 28 August 2008, converted into Law No. 166 of 27 October 2008.

[27] Report by the European Banking Coordination Initiative Working Group on NPLs in central, eastern and south eastern Europe, March 2012.

[28] Note that access to the debt forgiveness regime for consumers under the US Bankruptcy Code has been restricted by a series of amendments introduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

[29] Mark West, *"Dying to Get out of Debt: Consumer Insolvency Law and Suicide in Japan",* University of Michigan Law School (2003).

[30] Religion may even have an impact on the willingness of debtors to respect their financial obligations. See, for example, the study by Baele et al., "*Of Religion and Redemption: Evidence from Default on Islamic Loans*"(2012).

[31] *Règlement amiable* in France was replaced by the new procedure of conciliation in 2005.

[32] Article 448 of Book IV on Composition Procedures and Insolvency of the 1959 Commercial Code.

[33] Article 769 of Chapter V of the Code of Commerce number 17 of 1999.

[34] Article 577 of Book IV on Composition Procedures and Insolvency of the 1959 Commercial Code.

[35] Tunisian Law no. 95-34 of 17 April 1995 (as amended).

[36] http://www.ebrd.com/downloads/legal/insolvency/ioh_principles.pdf

[37] See for example, *"The Value of the Insolvency Industry: A study into the economic significance of the insolvency, recovery and turnaround profession",* July 2008 on R3's web site: http://www.r3.org.uk/media/documents/publications/professional

[38] http://ec.europa.eu/justice/civil/files/insolvency-regulation_en.pdf

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05

Access to finance in the southern and eastern Mediterranean region – translating legal transition to post revolution

IVOR ISTUK AND DINA ANASTAS

This article emphasises the economic significance of modern access to finance legal systems. It also aims to understand how the Bank’s experience in supporting access to finance reforms in eastern Europe and central Asia can be of relevance in the southern and eastern Mediterranean region.

Over 20 years ago, none of the EBRD's countries of operations had developed the infrastructure enabling market-based access to finance to companies or individuals. As the introduction of the concept of "market economy" was under way, financial products such as secured lending, financial leasing, factoring and housing finance were almost non-existent. The legal regimes that would have allowed such products lacked most of the rules that would enable market participants to engage in financial transactions with a minimum required level of legal certainty and market efficiency.

The EBRD's Secured Transactions Project was thus established in 1992 to assist with the legal reform related to secured transactions. Over the years, the Bank's Legal Transition Programme (LTP)[1] expanded to other areas such as collateral registries, credit bureaus, financial leasing and agricultural financing, in addition to separate areas of the law, such as corporate governance, insolvency, infrastructure regulation and energy efficiency.

It is striking that a fairly recent publication by the World Bank on Financial Access in the Middle East and North Africa region[2] pointed to the financial infrastructure in general, and creditors' rights more specifically, as a major stumbling block to the region's broadening and deepening of access to finance. With economic reforms as a cornerstone of the demands expressed during the so-called "Arab spring", it is believed that the time has come to tackle those issues.

The purpose of this article is to understand how the EBRD's experience in supporting access to finance reforms in its traditional countries of operations, eastern Europe and central Asia (EECA) can be of relevance in the EBRD's new region – the southern and eastern Mediterranean (SEMED).

The complexity of legal rules can perhaps create in the mind of the economic players a false impression of sophistication

A totally different starting point

While the legal provisions allowing access to finance in the EECA countries were almost non-existent at the beginning of their transition process, the situation in SEMED is very different. A cursory overview shows that all SEMED countries' legal regimes provide for techniques such as leasing, housing finance and mortgage law, non-possessory security rights over movable assets, and credit information reporting systems. This does not, however, mean that there is no need for reform in SEMED but that the approach to reform cannot be inspired by the early EECA transition experience. Both the openness of countries to engage in legal reforms (very high in the early EECA transition) and the existing legal systems (rudimentary in EECA) provide a very different starting point.

While the approach to reform itself may not be inspired by the early EECA transition experience, it seems very apposite to take inspiration from lessons drawn from the different experiences of EECA countries in relation to reform, bearing in mind that reform in itself did not always yield the results that might have been foreseen. As will be presented below, some legal frameworks that have undergone reform, actually display overly complex legal provisions, often based on obsolete concepts and even contradictory principles. The complexity of legal rules can perhaps create in the minds of the economic players a false impression of sophistication. This can compound the difficulty of recognising the need for improvements. Also, a developed and complex system, albeit inefficient, would necessitate a very tailor-made analysis of how best to proceed with reform since changes would in all likelihood disturb the existing equilibrium (however deficient to the overall economy) among the economic stakeholders.

EBRD assessment – focusing on economic objectives

In the course of its work on secured transactions, the Bank has formulated ten core principles for a secured transactions law, which provide broad directions for reform. These principles are set out in the table below.

EBRD 10 core principles for a secured transactions law

1. **Reduce risk of credit**
   Security should reduce the risk of giving credit, leading to an increased availability of credit on improved terms.
2. **Non-possessory security, easy and cheap to create**
   The law should enable the quick, cheap and simple creation of a proprietary security right, without depriving the person giving the security of the use of his assets.
3. **Satisfaction through realisation in case of default**
   If the secured debt is not paid, the holder of security should be able to have the charged assets realised and to have the proceeds applied towards satisfaction of his claim, prior to other creditors.
4. **Effective enforcement**
   Enforcement procedures should enable prompt realisation at market value of the assets given as security.
5. **Effective in insolvency**
   The security right should continue to be effective and enforceable after the bankruptcy or insolvency of the person who has given it.
6. **Low cost**
   The cost of taking, maintaining and enforcing security should be low.
7. **All types of assets/debts/persons**
   Security should be available
   - over all types of assets,
   - to secure all types of debts and
   - between all types of persons.
8. **Publicity**
   There should be an effective means of publicising the existence of security rights.
9. **Priority**
   The law should establish rules governing competing rights of persons holding security and other persons claiming rights in the assets given as security.
10. **Commercial flexibility**
   As far as possible the parties should be able to adapt security to the needs of their particular transaction.

If the legal framework for secured transactions is to operate in a way which *maximises economic benefit*, the system for creation and enforcement of pledges should be simple, fast and inexpensive

These core principles do not seek to impose any particular solution on a country as there may be many ways of arriving at a particular result. The core principles do however seek to indicate the result that should be achieved from an economic standpoint. In order to assess whether the particular route chosen by a given country has achieved its objectives, the EBRD focuses on the concept of legal efficiency, that is to say, the extent to which a law and the way it is used provides the benefits that it was intended to achieve.

While recognising that it may also have important social functions and consequences, the prime purpose of a secured transactions law is economic, since the secured credit market has essentially an economic function. A secured transactions law should thus be essentially facilitative since a secured credit market is not a necessity, it being theoretically possible for any jurisdiction to function without it. We work on the premise that the basic legal framework should be *conducive* to a flexible market for secured credit. There are also social issues, for example relating to consumer credit and economic issues, such as risk management, but the driving force behind the introduction of a law on secured transactions is the benefits that such a law is expected to bring to the economy.

A relatively simple indicator of the success of a secured transactions law reform (or primary motive for undertaking the secured transactions law reform) would be the subsequent increase in the *volume* of secured lending. This is a crude and narrow indicator, inadequate by itself. The intended function of the secured credit market may be more than just to boost the amount of credit granted against security. It may also include, for example, opening up credit to new sectors of society, encouraging new housing construction, or allowing privately funded infrastructure projects.

The intended function of a law has to be looked at in the context within which it is to operate. Its ramifications have to be considered not just in economic terms but in social and cultural terms as well. Thus an appropriate balance has to be struck between fulfilling the law's economic purpose and ensuring that the effects of the law are acceptable in context.

The EBRD has thus designed a set of criteria evidencing the legal efficiency of a secured transactions legal regime by looking at the degree to which the legal framework enables secured transactions first, to achieve their basic legal function (further discussed below) and secondly, to operate in a way which maximises economic benefit – which is itself broken into five separate headings: simplicity, cost, speed, certainty and fit-to-context.

The basic legal function of a secured transactions law is to allow the creation of a security right over assets which, in the case of non-payment of a debt, entitles the creditor to have the assets realised and the proceeds applied towards satisfaction of his/her claim prior to claims of unsecured creditors, based on a predictable priority order among secured creditors. If a secured transactions law only gives the creditor a personal right against the debtor but no right in the assets, or if there is no right to enforcement or priority regarding other creditors, the law fails to achieve its basic legal function. An absolute priority for taxes and other state claims ranking above the secured creditor, or the right in insolvency of ordinary creditors to share in a portion of the proceeds of secured assets are more than mere inefficiencies in the secured transactions law; they are defects which prevent it from fully achieving its basic function. They may be intentionally created (a super-priority of the state usually is) but they reflect a compromise between two laws with conflicting purposes.

If the legal framework for secured transactions is to operate in a way which ***maximises economic benefit***, the system for creation and enforcement of pledges should be simple, fast and inexpensive. There should also be certainty as to what the law is and how it is applied, and it should function in a manner which fits the local context.

The advantage of such an assessment approach is that it enables the EBRD and others to undertake a review of a legal framework dispassionately, with the view of identifying objectively areas of strength and areas of weakness, as opposed to applying a rigid approach where a system would *a priori* qualify as weak because it does not fit formal expectations of what the law should look like; or conversely as strong because in theory it ticks all the boxes but fails to work properly in practice.

Evidence for the need for reform is usually found when market practices develop, which circumvent certain rules. These practices can achieve the intended result but such a result tends to come with a high dose of legal risk and/or high transactions costs

When the market calls for reform

Turning back now to the SEMED region, preliminary enquiries show that lenders (mostly banks) favour greatly, if not exclusively, land and buildings as assets, which can serve as collateral. Land and buildings have of course always been seen as the most valuable and reliable form of collateral – primarily because they are immovable and thus less subject to dissipation as well as tending to have a more stable market value. However, secured lending that would rely exclusively on land and buildings would be extremely limited since many businesses and individuals do not necessarily own or have sufficient land or buildings available to provide as security. Moreover, modern finance has permitted the turning of intangible assets such as accounts receivable, stock and shares, bank accounts, and other assets, into collateral. Therefore a modern, economically sound legal system must allow the use of other types of assets, such as inventory, stock or bank accounts, as valuable collateral, including future property.

The legal system that would be tailored on the modern approach of legislating non-possessory security rights over any type of movable property does not currently exist in any of the SEMED countries. Besides the principle of possessory pledges, limited exceptions have been created by statutes with regard to specific assets. One of the most commonly used is the pledge/mortgage over a *fonds de commerce*.[3]

Fonds de commerce is a legal concept originally developed under French Law, which primarily targets the intangible assets that constitute a business – the commercial name, goodwill, leasing contracts, but also in some cases equipment and stock of goods. These elements can collectively be pledged to creditors on a non-possessory basis subject to registration.

For instance, the Egyptian *fonds de commerce* mortgage has a defined scope over the assets it can include.[4] Moreover, the assets need to be specifically designated into the pledge agreement. This means that future assets, such as equipment that the business may acquire in the future, would not automatically be included in the *fonds de commerce* mortgage. Furthermore, the type of mortgage creditors that can take a *fonds de commerce* mortgage is limited by law to banks and other financial institutions. This excludes trade creditors (for example, wholesalers) and other non-financial institutions from using this type of security when extending trade credit which can have a negative effect on the availability or price of such finance.

Evidence for the need for reform is usually found when market practices develop, which circumvent certain rules. These practices can achieve the intended result but such a result tends to come with a high dose of legal risk and/or high transactions costs. For example, it seems that banks in Egypt engaged in SME finance find that the most relevant security instrument (*Fonds de Commerce* morgage) is too cumbersome (many of the assets that would be included in the mortgage are not sought after by the bank and/or the borrower may not be prepared to grant the bank a security over them as the value would be disproportionate to the secured debt) and/or too costly (the mortgage requires notarisation of the agreement and registration at the competent Commercial Register).[5] Therefore, banks have in some instances reverted to the taking of a possessory pledge as governed by the Civil Code over the assets they are willing to accept as collateral but would include in the pledge agreement the provision that the transfer of possession would be made to the manager of the debtor company acting as a third party for the interest of the bank (custodian). This may be a well-accepted practice; however, one could say that it would be legally much more coherent to instead recognise the concept of non-possessory pledge over assets which would be defined as the parties deem fit, and to review the conditions of validity of the security agreement in order to keep transaction costs low.

A well-functioning modern secured transactions legal framework should reflect some basic principles which have proven to facilitate successfully access to finance. It should (i) enable a wide range of entities and individuals to use a broad scope of permissible collateral which includes a future and fluctuating pool of assets, (ii) allow a high degree of flexibility in describing the secured debt (securing overdraft facilities), and (iii) embrace clear priority rules and efficient solutions of enforcement of secured creditors' rights. Legal rules should be clear and precise leaving no room for contradictory interpretations while allowing

> If and when the local stakeholders in any of the southern and eastern Mediterranean countries decide to embark on the journey of legal reform, they will first be faced with a hard choice: a general overhaul of the system or amending and fine tuning the existing legal framework

the parties the freedom to tailor the security package to their needs. As already presented, legal systems that underpin lending against movable assets in the SEMED region do not reflect well these principles and there is therefore a real market need for reform.

Starting all over or piecemeal reform?

If and when the local stakeholders in any of the SEMED countries decide to embark on the exciting but demanding journey of legal reform, they will first be faced with a hard choice.

On the one hand, they could decide to undertake a general overhaul of the system. This would consist of repealing all legal provisions on security over movable property and potentially other transactions serving as security (such as financial leasing) and adopting a new single law. The advantage of this approach is that it creates coherence in the system and users would have all relevant provisions under one law. However, this approach is a time consuming major undertaking, especially since the market players (as mentioned above) have already developed an extensive practice of the system and may therefore not welcome the costs associated with radical changes. A good example of a developed jurisdiction caught up in a similar debate for the last decade is England and Wales where the law allows for a multiplicity of different security interests. While most legal practitioners agree that some aspects of the system do not function well or would benefit from simplification,[6] there has also been resistance to the costs that such a wide-ranging reform would entail.

On the other hand, local stakeholders in the SEMED countries might prefer amending and fine tuning the existing legal framework. This is usually more appealing as it appears to be a simpler exercise and does not require a drastic departure from existing tradition and practices. However this comes at a price that may be less obvious initially. Amendments would not necessarily bring about the same level of clarity that an overall reform would and the final framework could end up being very complex and include contradictions and loopholes. Further, amendments may also entail the market failing to grasp the opportunities brought about by change, which would result in *de facto* no results at all, all parties remaining in their initial positions.

The EECA region provides a good example of both approaches – an almost perfect

The main reason for taking a complicated route of legal development in this area was probably due to the perception that it is impossible to touch the "sacred cow" that the Property Act represents

comparative experiment in two countries that shared a similar legal heritage: Croatia and Serbia, both former republics of the Socialist Federal Republic of Yugoslavia.

After initial reform of the Yugoslav 1980 Basic Proprietary Relations Act,[7] which was carried out after Croatia's independence, Croatia opted for a gradual fine tuning approach of its secured transactions system. Faced with the lack of flexibility of the provisions of the newly introduced Property Act,[8] lawyers, in a rather ingenious interpretation of the provisions, started using the enforcement law to create security.

One procedure provided in the Enforcement Act[9] allows to freeze debtor's assets in favour of a creditor. The advantage of such legal fiction is that the creditor is in a very strong position to enforce its security over the assets, should the debtor default. The downside, on the other hand, is that such an approach can only apply to existing assets and also it would not be possible for another creditor to take security over the same assets (ranking second, as a "classic" secured transactions law permits). In addition, the Enforcement Act introduced the concept of a fiduciary transfer of ownership for security purpose over immovable and movable property and rights and allowed the parties to execute such contracts in the form of a contractual enforcement writ, thereby avoiding the need to obtain a court decision before proceeding with a judicial sale of the collateral.

It has to be noted that although the Enforcement Act was amended more than a dozen times since its introduction in 1996, the practice of using some of its provisions as a basis for creating security rights has survived and was even confirmed by the legislators in 2005 when the Act on Registry of Pledge over Movable Property was introduced to establish a register of non-possessory security and fiduciary transfer of ownership created according to the Enforcement Act. In addition to establishing the register, and probably as a result of the legal gap the previous developments have failed to fill, the Act also introduced, in its final and transitory provisions, a new type of collateral, a floating charge over movable property which applies to a fluctuating pool of any movable assets (described generically in the pledge agreement) which are linked to the specifically designated space, thus adding to the already terribly fragmented regulation of security rights.

> **The financing of farmers, agricultural companies or importers of agricultural products is often challenging for banks and other financial institutions because of their limited ability to provide valuable collateral**

The main reason for taking such a complicated route of legal development in this area was probably due to the perception that it is impossible to touch the "sacred cow" that the Property Act represents. Instead, the lawmaker took the seemingly easier path and built on the practice of taking security using the procedures provided in the Enforcement Act. *De facto* regulating secured transactions as part of the Enforcement law, apart from being conceptually wrong, has naturally created legal uncertainty and made transaction costs much higher than necessary. For example, since the security agreement is in essence part of a voluntary enforcement process, it has to be notarised, thereby increasing costs. Up until the recent changes to the Act, it used to cause a voluntary freezing of the underlying assets in favour of the creditor (raising questions on the practicability and legality of taking security over revolving intangible assets such as accounts receivable).

Serbia, on the other hand, took a totally different approach by opting for a unified and coherent approach to reform. With the support of the EBRD, Serbia repealed provisions on pledge which existed in the Yugoslav 1980 Basic Proprietary Relations Act[10] and enacted in 2003, the Law on Registered Charges on Movable Assets which introduced a simple, clear and efficient means of pledging and registering movable property and rights. The adoption of the Law was followed by the creation of the Register of Pledges on Movable Property and Rights kept by the Business Registers Agency. The consequence of such a comprehensive and coherent approach was an increased legal certainty and wider accessibility to asset-based finance due to simple creation, registration and enforcement procedures provided in the Law.

Of course, all countries are unique and each reform follows its own economic and political path. However, we believe that some important lessons can be learned from examining the choice made by other countries, and the related outcomes.

Creating new instruments

Reforming the fundamentals of secured credit is often only one step towards unleashing the potential of diverse financing instruments serving all segments of the economy. Specific market products have to be tailor-made for a specific sector, and the agricultural sector is a good case in point where the EBRD has been called to play a key role in the EECA region, and is hoping to share such experience in the SEMED region. In September 2012 the Food and Agriculture Organization of the United Nations (FAO) and the EBRD organised a large regional Conference on "Private Sector for Food Security" in Istanbul. This forum enabled agricultural private and public stakeholders in the EECA and SEMED region is to meet and discuss their concerns and ongoing projects. The positive experience of the East-Agri[11] platform in promoting different models of financing and the development and maximizing of the efficiency of food chains were discussed. As a co-founder of the East-Agri platform the EBRD has been providing technical assistance in setting up and investing in modern warehouse receipts systems facilitating commodity finance and access to finance by farmers.

The financing of farmers, agricultural companies or importers of agricultural products is often challenging for banks and other financial institutions because of their limited ability to provide valuable collateral. Inspired by the US experience of the 19th century, a modern grain warehouse receipt system can help these borrowers to access finance. Broadly speaking, the system is based on storage of commodities into a warehouse where the warehouse operator issues a receipt on delivery of the commodity. The receipt can then be used as collateral – typically, the receipt would be issued in two parts, one part evidencing the commodity ownership, the other part, the right of pledge created against the commodity for the benefit of the holder of that part.

The EBRD investment experience and the FAO/World Bank study "The use of warehouse receipt finance in agriculture in transition countries"[12] clearly show that an appropriate legal framework is a prerequisite for a well-functioning warehouse receipt system. The system hinges on four pillars which increase reliability of the warehouse receipts and thus its acceptability by financiers:

1. The modern grain warehouse receipt should be a document evidencing that defined commodities were deposited at a licensed warehouse which undertakes to keep safely the commodities and hand them over on demand to a person in possession of the receipt.

Providing for warehouse receipts in legislation is not sufficient to build a reliable system that can flourish

2. The protection of depositors or receipt-holders against fraud is provided by an indemnity fund.

3. The system used for receipt issuance must provide an optimal level of protection against fraud by preventing the forging of warehouse receipts. Electronic register of issued warehouse receipts can be a good approach.

4. The enforcement of secured creditors' rights is facilitated by an efficient out-of-court enforcement which would provide the secured creditors with the opportunity to directly sell or take the warehoused goods from the warehouse operator without further involvement of courts.

Providing for warehouse receipts in legislation is not sufficient to build a reliable system that can flourish. As mentioned, it is an entire infrastructure that must be put in place. A number of EECA countries have done so: grain warehouse receipts systems have been built in Bulgaria, the Czech Republic, Hungary, Kazakhstan, Lithuania, Poland and the Slovak Republic, with reform still ongoing in Serbia, Ukraine and Russia. The EBRD has often been instrumental in the process, as have the FAO and United States Agency for International Development (USAID). The importance of having all pillars as part of the reform package was highlighted in the Croatian case. Croatia introduced the grainhouse receipt law in 2009 but the Croatian banks refused to lend against it since both pledging and out-of-court enforcement of the instrument were seen as inefficient. Only when the indemnity fund was set up in 2010 and the law modified in 2011, did the lending against the receipts follow.

It is believed that the SEMED countries also need to build such an infrastructure as there is no modern warehouse legislative framework in place.

Conclusion

The Bank's 20 years of experience in EECA has demonstrated that legal reform is a lengthy process and remains a permanent work in progress. The operational implications of reform aiming at access to finance differ from one country to another, depending on the approach taken and the various economic and political factors at play.

Initial assessment of the SEMED countries has revealed that the existing legal framework limits access to finance by relying on rather obsolete legal solutions, in particular in the case of secured transactions. However these limitations, coupled with the raised ambitions in the post revolution area, may in fact be an opportunity to engage in legal reform. The choice of approach to reform rests on the local government and stakeholders and ultimately, it is the end result that matters. A reformed legal system should bring clear and simple solutions, increase legal certainty and improve availability of finance for generations to come.

Notes

[1] For more information on the work of the LTP, please visit http://intranet.ebrd.com/ebrdnet/depts/ogc/about/lttteam.shtml

[2] Financial Access and Stability: A Road Map for the Middle East and North Africa. World Bank: 2011. Roberto R. Rocha with Zsofia Arvai and Subika Farazi. Available at <<http://siteresources.worldbank.org/INTMENA/Resources/Financial_Flagship_Report_Middle_East_North_Africa_2011_Full_Report.pdf>>

[3] Egyptian Law No. 11/1940, , Moroccan Commercial Code Law No. 15-95, , Tunisian Commercial Code, similar concept found as well in Jordanian Law No. 1/2012.

[4] The assets subject to a "*Fonds de Commerce*" mortgage are limited to the title, the trade name, leasing or similar rights relating to real property, goodwill including the right to acquire and contact clients, trademarks, licenses and permits related to the "*Fonds de Commerce*", movables, for example,. furniture, furnishings and equipment related to activities of the "*Fonds de Commerce*". Article 9 of Law No. 11 of 1940 regulating the Sale and Mortgage of "*Fonds de Commerce*" in Egypt.

[5] Under Articles 11 and 12 of the Egyptian "Fonds de commerce" Law, a "fond de commerce" mortgage must be notarised and registered within a period of 15 days from the date of the mortgage agreement. Otherwise, the mortgage becomes null and void. Such registration should take place in the Commercial Register with jurisdiction over the branch of the business or the place where its assets are located.

[6] The City of London Law Society, "Discussion Paper: Secured Transactions Reform", www.citysolicitors.org.uk/FileServer.aspx?oID=1290&lID=0. , Secured Transactions Law Reform Project web site: http://securedtransactionsproject.wordpress.com/about/

[7] Basic Proprietary Relations Act, Official gazette of the SFRY 6/80, 36/90 and Official gazette of the Republic of Croatia 53/91, 91/96

[8] Property Act, Official Gazette of the Republic of Croatia, 91/96, 73/00, 129/00, 114/01, 79/06, 141/06, 146/08, 38/09.

[9] Enforcement Act 1996, Official Gazette of the Republic of Croatia 57/96, 29/99, 42/00, 173/03, 194/03, 151/04, 88/05, 121/05, 67/08, which was later replaced by Enforcement Act 2010, Official Gazette of the Republic of Croatia 139/10, 125/11, 150/11, 154/11, 70/12, which was most recently replaced by Enforcement Act 2012, Official Gazette of the Republic of Croatia 112/12.

[10] Basic Proprietary Relations Act, Official Gazette of the SFRY 6/80, 36/90 and Official Gazette of the Federal Republic of Yugoslavia 29/96 and Official Gazette of the Republic of Serbia 115/2005

[11] East Agri is an informal platform for sharing information, best practices and lessons learned on agricultural and agribusiness financing and rural development among key practitioners working in eastern Europe, Central Asia and the Caucasus. Created in 2002, East Agri has 24 institutional members and 200 individual users. Its founding members are: the Food and Agriculture Organization of the United Nations (FAO), the European Bank for Reconstruction and Development (EBRD), the World Bank and the Central European Initiative (CEI)., http://www.eastagri.org/about.asp

[12] http://www.ruralfinance.org/fileadmin/templates/rflc/documents/The__use__of__warehouse_pdf.pdf

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06

Corporate governance post "Arab spring" in the Middle East and North Africa

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This article provides a regional perspective on corporate governance in the Middle East and North Africa and how the rising demands for transparency and accountability are likely to impact on the way companies are run.

Introduction

The Middle East and North Africa (MENA) region has been one of the emerging markets in which corporate governance is seen as a relatively new concept; indeed it is only in the last 10 years that an Arabic word, *"hawkamah ash sharikat"* for "corporate governance" has emerged. However, despite its infancy in the region, corporate governance has been making significant headway in the past few years. Although it is difficult to predict the outcome of the current turmoil, or the "Arab spring", it has highlighted some pressing demographic, political and socio-economic challenges, which, if properly addressed, should lead to further corporate governance reform.

Initially fuelled by calls for *kefaya* ("enough" in Arabic), the "Arab spring" became a long-standing call for *karama* ("dignity" in Arabic) punctuated by calls for accountability that reverberated in the streets of Tunisia, Egypt, Syria, Bahrain, Yemen, Libya, Morocco, Algeria and others. It has been two years since the self-immolation of the Tunisian street vendor Mouamed Bouazizi which sparked protests in Tunisia that spread around the Arab world. Citizens from many Arab countries have had to revisit their social contracts with their governments and each country is going through their own governance journey. However what is clear so far is that the work of rebuilding citizens' trust in their institutions will be a long and arduous one.

It is striking that many countries in the MENA region undergoing transformational scenarios were ranked as top reformers (for the past six years) in the World Bank's *Doing Business* report. This suggests that introducing *Doing Business* related policy reforms may be ineffective if there is no "trickle down" effect and inclusive socio-economic policies, and if

> **The popular uprisings have pointed the finger of blame at weak and poor governance**

public engagement and support for the proposed measures is absent. Chart 1 shows the scoring of MENA countries and the distribution of cumulative changes, comparing each economy's distance to the highest performance observed (distance to frontier) across the broad set of nine indicators during a six-year period between *Doing Business 2008* and *Doing Business 2013.*

Systematically, the popular uprisings have pointed the finger of blame at weak and poor governance, to the absence of accountability and to the implementation of policies serving special interest groups and not serving the public at large. The persistence of widespread and deep rooted malgovernance has been destructive and can potentially lead to a situation where corruption becomes rife and the state and its agencies are subject to capture.

In a region where state- and family-owned companies dominate the corporate scene and small- and medium-sized enterprises (SMEs) proliferate in the private sector, discussions of corporate governance play a key role in articulating the nature of business-society interaction, where the values of corporate governance – transparency, accountability, fairness and responsibility—are important starting points towards better business practices. Corporate governance, in its basic form, is a "set of relationships between a company's management, its board, its shareholders and other stakeholders"[1]. These relationships are also influenced by the legal, regulatory and institutional environment from which companies thrive including business ethics and corporate awareness of the environmental and social interests of the communities in which it operates.

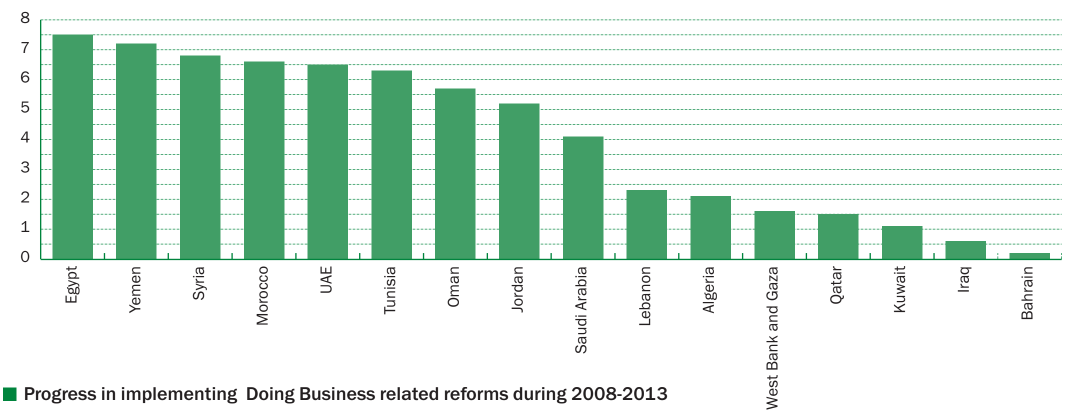
Overview of recent corporate governance developments

The Hawkamah Institute for Corporate Governance was set up in 2006 to help bridge the corporate governance gap in the region. The Institute was founded by international organisations including the Organisation for Economic Co-operation and Development (OECD), the International Finance Corporation (IFC), the World Bank and Center for International Private Enterprise (CIPE), and regional organisations such as the Union of Arab Banks and the Dubai International Financial Centre (DIFC) Authority. The Institute grew out of the recognition of a growing need for a regional organisation working on the ground, in order for corporate governance to achieve the buy-in of stakeholders. Since then Hawkamah has been at the forefront of the corporate governance debate in the region.

Hawkamah's primary goal is to establish corporate governance as a topic on the agendas of MENA policymakers by providing the region's

Chart 1

The countries undergoing political changes have been strong economic reformers in the past 5 years



■ **Progress in implementing Doing Business related reforms during 2008-2013**

The 0-8 axis shows the extent to which a country has closed the gap to the Doing Business frontier[2] during 2008-2013, with 8 representing a significant progress and 0 a lack of progress.

Source: World Bank Doing Business

> In the initial years, Hawkamah's calls for corporate governance reform were very much like lone voices in the desert

Table 1. Corporate governance codes existing in the Middle East and North Africa region

Country	Code type	Year	Compliance
Algeria	Code for FOEs & SMEs	2009	V
Bahrain	Code for Joint Stock Companies	2010	C
Egypt	Code for Listed Companies	2005/2011	C
Egypt	Code for the Public Enterprise Sector	2006	V
Egypt	Guidelines for FOEs	2008	V
Jordan	Code for Banks	2007	M
Jordan	Code for Listed Shareholding Companies	2007	C
Jordan	Code for Private Shareholding Companies, Limited Liability Companies, Non Listed Public shareholding Companies	2012	C
Jordan	Code for Insurance Companies	2006	M
Lebanon	Code for Joint Stock Companies	2006	V
Lebanon	Guidelines for Listed Companies	2010	V
Lebanon	Guidelines for FOEs	2010	V
Morocco	Code of Corporate Governance	2008	V
Morocco	Code for FOEs and SMEs	2008	V
Morocco	Code for Listed Companies	2011	V
Oman	Code for Listed Companies	2002	M
West Bank and Gaza	Code for Listed Companies	2009	M
Qatar	Code for Public and Listed	2009	C
Qatar	Guidelines for Banks and Financial Institutions	2008	C
Saudi Arabia	Regulations for Listed Companies	2006/2010	M
Syria	Code for Financial Intermediaries	2008	M
Syria	Code for Joint Stock Companies	2009	M
Tunisia	Code of Best Practice of Corporate Governance	2008	V
UAE	Code For Banks	2008	M
UAE	Code for Joint Stock Companies	2010	M
UAE	Federal Decree on Board Membership of SOEs	2011	M
UAE	Code for Real Estate Developers	2012	C
UAE	Code for SMEs (9 Pillars)	2011	V
Yemen	Guidelines on Corporate Governance for FOEs	2010	V

V=Voluntary, C=Comply or Explain, M=Mandatory
Source: IFC and internet research

companies and regulators with practical tools on how to improve corporate governance in the region. The Institute's work involves engaging governments and industry, conducting surveys and studies, and creating regional benchmarks which act as catalysts for reform.

In the initial years, Hawkamah's calls for corporate governance reform were very much like lone voices in the desert. Although the need for better corporate governance was recognised, the prevailing opinion was that the region was not ready for reform. Illustrative of the state of corporate governance is the finding of the 2007 Hawkamah-IFC[3] study that only three per cent of listed companies and banks in the MENA region followed good corporate governance practices, with none complying with international best practices.

> **Hawkamah is witnessing an increasing number of Middle Eastern and North African companies starting to invest in better governance and addressing their corporate governance shortcomings**

Much has changed since then. Subsequent Hawkamah studies have indicated that there have been significant improvements in corporate governance in the MENA region in just a few short years. Although implementation is still patchy, the concept and principles of corporate governance are now well accepted. Regulators and companies have taken substantial steps, albeit from a low base, to improve their practices. Most MENA countries have now issued corporate governance codes or are in the process of doing so, as evident in Chart 1. Some of the key questions explored in these codes are ones of implementation, with an equal number of countries pursuing voluntary compliance and others have opted for the mandatory and/or "comply or explain" approach. These codes send a strong signal to the markets and companies on the need (and not a choice) to introduce corporate governance reforms. As such and coupled with public cases of regulatory actions against companies and boards related to corporate governance,[4] Hawkamah is witnessing an increasing number of MENA companies starting to invest in better governance and addressing their corporate governance shortcomings.

Drivers of corporate governance in MENA

To date, corporate governance reform in MENA has not been investor driven. Much of this stems from a combination of facts such as the ownership structures of MENA companies (mainly family or state-owned), the ready availability of liquidity and financing from regional banks, and the relatively underdeveloped capital markets. The region is also generally overlooked by global long-term investors largely because of the region's poor track record in transparency, disclosure and reporting. Also regional asset managers such as the sovereign wealth funds have not exhibited governance vigour in their investment processes. Consequently, the benefits of good corporate governance have typically been seen by companies in terms of better strategic decision-making and regulatory compliance rather than being associated with better and cheaper access to credit and capital.

S&P/Hawkamah ESG Pan-Arab Index

To address this gap Hawkamah, in partnership with Standard & Poor's and the IFC, have created the first-ever Environmental, Social and Governance (ESG) Index for the MENA region. It ranks and tracks the transparency and disclosure of regional listed companies on

> In a region which is dominated by nonlisted, family-owned enterprises and/ or small and medium-sized companies that typically look to banks to finance their expansion through loans, it is the banks that are in the prime seat to drive governance reform

ESG issues. The constituents of this Index are derived from 11 Arab countries. The purpose of this Index is to identify the MENA companies that go the extra mile in ESG reporting and it is a tool for international and regional investors who may not have the expertise in the MENA companies or with incorporating corporate governance in their investment processes.

The Index is not only a tool for investors, but also for companies. Inclusion in the Index provides public recognition for a local company of its ESG practices, but the Index is more than just a badge of honour. As the Socially Responsible Investment movement spreads to the region, capital will start flowing towards companies with better ESG reporting, thereby improving their access to external capital.

Regional investors and banks

Regional investors, as noted above, typically have not formally incorporated corporate governance criteria in their investment decision making process. The Index is being used to raise awareness among the region's sovereign wealth funds on the impact that good corporate governance can have on the bottom line and the Index has outperformed the market benchmark by a significant margin. One of the region's sovereign wealth funds has invested in the Index and hopefully others will follow.

Encouraging the sovereign wealth funds to adopt a more active role in promoting good corporate governance would not only be a welcome step for the development of MENA capital markets, but also across the world in the markets and companies in which they invest.

However, in a region which is dominated by non-listed, family-owned enterprises and/or small and medium-sized companies that typically look to banks to finance their expansion through loans, it is the banks that are in the prime seat to drive governance reform. Hawkamah, in partnership with the OECD, has issued a Policy Brief on corporate governance for the banking sector.[5] Although the Brief is primarily focused on addressing the governance challenges faced by the sector and the central banks, one of its recommendations is for banks to incorporate corporate governance into their lending criteria.

The regulators

As mentioned above, corporate governance codes are now largely in place in the MENA region. The issue now is that of implementation. Given the market dynamics, in which there is an absence of institutional investors scrutinising the governance arrangements of companies, the burden of ensuring implementation falls on the regulators. Some countries have started taking significant steps in this regard - in 2010 both the Saudi and Omani Capital Market Authorities set up corporate governance units to ensure proper implementation and compliance with their governance codes. But the focus of implementation should not be solely on enforcement, but also on facilitation of better corporate governance practices by capacity building initiatives as one of the barriers to better governance, often cited by companies, is the lack of know-how and experts.

In other words, there have been significant improvements in MENA within the realm of listed companies, but the next challenges are even greater: the governance of state-owned enterprises and instilling a culture of governance to family-owned enterprises as well as to the small and medium-sized enterprises (SMEs).

The "Arab spring" and corporate governance

The "Arab spring" movement has uncovered a number of vulnerabilities, chief of which is the demographic picture. Some 60 per cent of the Arab population is now younger than 29 years of age, and youth unemployment averages 25 per cent, with the young female rate reportedly at 30 per cent. These young and unemployed are restless and despairing, not least because sclerotic educational systems have made so many of them unemployable. Young women feel particularly dejected because their often high educational attainment rates are schizophrenically linked to low labour force participation and their exclusion from economic and political life.

This sense of vulnerability is political because it reflects not only young peoples' lack of participation and representation but also frustration with widespread corruption, the state's lack of accountability and inadequate public services. Mounting dissatisfaction with the governance of many Arab states is fuelled by

> The challenge for many countries is to develop clear state-ownership guidelines, set clear mandates for the state-owned enterprises, and employ profit and market-oriented managements that are autonomous and insulated against political and bureaucratic predation

a sense that often natural resources have been captured by special interests, and that state control of the media has stifled the "voices" of society. Political repression of this sort has not surprisingly led to widespread calls for the restoration of "*Karama*", human dignity.

The two themes that are coming out of the "Arab spring" are employment and accountability, which directly relate to the need for private sector growth and reform of the state-owned enterprises.

Private sector growth and corporate governance

Private companies and family-owned enterprises constitute the backbone of the corporate sector and account for a large fraction of employment. It is this sector that needs to grow if the region is to tackle the unemployment crisis.

For the private sector to grow, a mechanism must be set up to facilitate the process through which companies could tap into the equity markets. The regional capital markets are tailored for large companies, whereas a stock exchange should be created to meet the needs and ambitions of the private companies. A second tier market—like those developed in Tunisia and Egypt—might become a key driver in the development of a liquid capital market, the diversification of economic activities and provide long-term capital for the growth of the dynamic entrepreneurial segment of the economies of the region. However, the development of these markets will hinge on the readiness and sophistication of the entrepreneurs to participate in the market, the ability of the market to attract a critical number of investors, and the platform and infrastructure on which the market is built. Nonetheless, such second tier markets would also facilitate the introduction of corporate governance into this important segment of the economy in order to respond to investors' transparency and disclosure requirements.

Private equity (PE) has also emerged as a potential source of corporate governance reform within the SME realm. To facilitate this process, Hawkamah will be issuing best practice guidelines for the PE industry in the MENA region in the first quarter of 2012. The guidelines address multiple levels – portfolio companies, PE firms and limited partners.

Similarly, the banks have a role to play to facilitate and support entrepreneurship. However, recent World Bank data shows that SME lending of regional banks account for about eight per cent in total lending in the region. Bankers cite the need to address some of the financial infrastructure challenges to support SME lending, which includes modernising insolvency and restructuring frameworks, as well as creating centralised credit registries and improving data collection on companies by developing something similar to the UK's Companies House.

Governance of state-owned enterprises

The public sector of many Arab countries has been at the heart of the unrest. The finger of blame has been pointed at government, to weak and poor governance and the implementation of inadequate policies serving special interest groups, the personal interests of leaders, political clientelism and not servicing the public at large. It is not uncommon for underperforming state-owned enterprises (SOEs) to have undermined competition and thus weighed down on growth. The results are destructive and can lead to "failed States" – corruption becomes rife and the state and its agencies are subject to "capture" and while natural resources may be plentiful, growth and development are dismal. The core issue is clearly that of governance and accountability.

The challenge for many MENA countries is to develop clear state-ownership guidelines, to set clear mandates for the SOEs, and employ profit- and market-oriented management that is autonomous and insulated against political and bureaucratic predation. There should be a clear separation of ownership from regulation, policy-making and other state-related functions of SOEs, including industrial policy. The separation of the ownership function ensures a level-playing field with the private sector and provides for a healthy environment for competition. To facilitate this process, Hawkamah is currently working with the OECD to publish a Policy Brief which sets out key recommendations on corporate governance practices within SOEs.

> The next challenges for the region involve addressing the shortcomings of state-owned enterprises and to facilitate private sector growth

Conclusion

The MENA region has been striving to improve governance standards and much has been achieved in a relatively short period of time. Codes for listed companies have been issued by most MENA countries and the issues now relate to implementation of those codes, particularly in the areas of transparency and disclosure, risk management and board practices. Currently much of the burden of ensuring proper implementation falls on the regional regulators, but investors, particularly the sovereign wealth funds must play a more active role.

The MENA region needs to move its focus of corporate governance beyond the realm of listed companies. The next challenges for the region involve addressing the shortcomings of SOEs and to facilitate private sector growth, both of which require sound corporate governance practices. While these are sizeable challenges, as the political response to the “Arab spring” unfolds and leads to greater accountability and transparency in governance, the opportunity is greater.

Table 2. Corporate governance codes existing in the eastern Europe and central Asia region

Country	Code	Year	Compliance
Albania	Code for Unlisted Joint-Stock Companies in Albania	2011	V
Armenia	Code for Listed Companies, State-owned Enterprises, Banks and Insurance Companies	2010	C
Azerbaijan	Standards for Joint Stock Companies	2011	V
Belarus	Corporate Governance Code	2007	V
Bosnia and Herzegovina (Federation of BiH)	Rules on the Governance of Joint Stock Companies	2007	C
Bosnia and Herzegovina (Republic of Srpska)	Standards for Joint-Stock Companies	2006	C
Bulgaria	Code for Public Companies	2007	C
Croatia	Code for Joint Stock Companies	2010	C
Estonia	Recommendations for Listed Companies	2005	C
FYR Macedonia	Code for Listed Companies	2006	C
Georgia	Code for Commercial Banks	2009	C
Hungary	Recommendations for Listed Companies	2008	C
Kazakhstan	Code for Joint Stock Companies	2007	M
Latvia	Principles and Recommendations for Listed Companies	2005	C
Lithuania	Code for Listed Companies	2004	C
Moldova	Code for Companies	2007	C
Mongolia	Code for Publicly Traded Listed Companies	2007	C
Montenegro	Code for Listed Joint Stock Companies	2009	C
Poland	Code for Listed Companies	2007	C
Romania	Code for Listed Companies	2009	C
Russia	Code for Joint Stock Companies	2008	C
Serbia	Code for Stock Joint Companies	2008	C
Slovak Republic	Code for Listed Companies	2008	C
Slovenia	Code for Listed Companies	2009	C
Turkey	Code for Public Joint Stock Companies	2005	C (some provisions are M)
Ukraine	Code for Stock Joint Companies	2003	V

V=Voluntary, C=Comply or Explain, M=Mandatory
Source: EBRD (see http://www.ebrd.com/pages/sector/legal/corporate/codes.shtml)

Corporate governance in the eastern Europe and central Asia region

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Notwithstanding the many historical, economic and cultural differences between the two regions, the corporate governance challenges highlighted by Nick Nadal in the MENA region are very similar to those that central and eastern Europe and central Asia (EECA) has been facing since 1991. When the Iron Curtain collapsed, corporate governance was mainly seen as a new concept. The new independent, former Soviet Union countries had little or no rules in place to govern corporate entrepreneurship. In this context, it was immediately clear to the EBRD that a key priority was to help these countries in establishing and strengthening an appropriate legal, regulatory and institutional environment for sound corporate governance practices.

Twenty years have now passed and the situation is very different. Similar to the progress that is taking place in the MENA region, the large majority of EECA countries have now enacted comprehensive company laws regulating the establishment and functioning of their corporate entities. In many cases, they have also adopted sophisticated corporate governance codes, drafted in line with international best practices (see Table 2). This is undoubtedly a positive development. Codes are excellent tools to complement the national corporate governance legal framework as they serve as guidance for companies to improve their practices, but should not be seen as an end in themselves. Only if properly understood and implemented can codes contribute to enhancing corporate governance practices. Unlike laws – which are mandatory - codes are usually voluntary taking the form of non-binding recommendations to be implemented under the so-called "comply or explain" principle. This principle requires companies to (mandatorily) report on how they have applied corporate governance guidance and, where they have not applied the guidance as envisaged, provide an explanation as to why they have not done so.

"Comply or explain" is based on the assumption that, when it comes to effective governance, there is no *"one size fits all"*. While it may be possible to single out mechanisms and structures that could be best practice for the majority of companies, there will always be cases where it is in the best interest of a company (and its shareholders) to adopt different practices.

Codes therefore introduce significant flexibility into the governance system and allow companies to take into account their individual situations. They serve as an incentive for companies to grow towards better governance practices, without having to revolutionise their internal structures and procedures in a manner not suitable for their organisation. This flexibility is, at the same time, the codes' strength and weakness. Due to the "voluntary" nature of their recommendations, companies often feel under little or no pressure to understand and attempt to comply with the code's recommendations. When looking at how codes are implemented in both regions, the extent of the problem is evident.

Notwithstanding the diffusion of comply or explain codes, it is rare to see companies providing reference as to whether their governance structure and practices meet the codes' recommendations and to find meaningful explanations as to the reasons why certain code's recommendations are not met. Codes complement rules by setting out higher and more aspirational standards. For instance, all codes place great emphasis on the role of *"independent directors"* in ensuring objective judgement at the board. The principle of *"independent directors"* is one of the pillars on which the oversight of companies is based upon and is especially important in regions where ownership is highly concentrated – a phenomenon that exist in both the MENA and EECA regions. Furthermore, this principle is fundamental for banks, where lack of objective judgement at the board can expose the whole banking sector to systemic risks. However, in practice independent directors are the exception rather than the rule. Non-financial disclosure remains poor in the majority of EECA countries and it is often impossible to understand who does what within a company. This poses a problem especially for listed companies, as investors need access to regular, reliable and comparable information in sufficient detail to assess the stewardship of management and make informed decisions about the shares' valuation, ownership and voting. Insufficient or unclear information hinders the functioning of the markets, increases the cost of capital and results in a poor allocation of resources.

In order to enhance the effectiveness of codes, authorities should review the practical application of codes and assess whether the proposed implementation mechanism is effective. It is clear that, if the code is purely voluntary, there are few expectations about its impact. In contrast, when the code is based on a "comply or explain" mechanism, there are expectations about the value of disclosure and the reaction that such disclosure can trigger in investors (especially institutional investors). Authorities should assess whether companies provide meaningful compliance statements in which they report on how they comply with the code and the reasons for their non-compliance. In this respect, authorities should gauge how institutional investors and shareholders' associations look at non-financial disclosure and the leverage they have to exert influence on their companies for enhancing their corporate practices. Without leverage, it is unlikely that a "comply or explain" code would provide substantial improvements, even if it is drafted in line with best international standards.

Implementation is thus key for effective reform. The EBRD is looking at the long-term effects that the proposed reforms are expected to bring. It is clear that projects should aim not only at establishing sound regulations, but also at making sure that such regulation is well implemented. Training and institution-building is an essential part of every reform project. Authorities and companies should be trained to understand the added value that sound corporate governance is bringing about, beyond the life of the project.

There is still much work to do to promote sound corporate governance standards. The EBRD has opened up to the new region with a number of lessons learned. Clear focus on sustainability, implementation and training is key for the success of legal reform projects and the experience gained by the EBRD can be extremely valuable for meeting the challenges the SEMED region presents.

Notes

[1] OECD Principles of Corporate Governance

[2] http://www.doingbusiness.org/~/media/GIAWB/DoingBusiness/Documents/Annual-Reports/English/DB13-Chapters/Ease-of-doing-business-and-distance-to-frontier.pdf

[3] http://www.mudara.org/services/research/reports/files/MENA+Corporate+Governance+Survey.pdf

[4] Particularly Saudi Arabia, Kuwait and the UAE

[5] http://www.hawkamah.org/events/conferences/conference_2009/files/mena-policy-brief-banks.pdf

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07

Morocco covered bonds project

NOUAMAN AL AISSAMI AND HICHAM TALBY

Morocco began planning for the introduction of covered bonds, in 2010. This article presents the rationale for introducing covered bonds into the Moroccan market, describes how the project was managed and gives an overview of the main characteristics of the draft covered bonds law.

Rationale for introducing covered bonds in Morocco

The Moroccan financial sector has grown strongly over the last decade with financial assets exceeding 200 per cent of gross domestic product (GDP) in 2008 and is steadily increasing. This has been allowed by the supportive economic environment in a sound macroeconomic framework combined with comprehensive financial sector reforms.

On the one hand, economic growth increased steadily from a medium GDP growth of 3.2 per cent in 1998–2000, to reach 4.4 per cent in 2002–05 and 5 per cent in 2006–11 despite the negative impact of the international financial and economic crisis. This growth was achieved in the context of long term sustainable inflation with, on average, a low inflation rate of 1.8 per cent over the last 16 years (0.9 per cent in 2011) compared with a medium inflation rate of 6.2 per cent during 1990-95.

On the other hand, the government has carried out a comprehensive set of financial sector reforms over the last two decades. These reforms encompassed consolidating the banking sector, improving financial regulation and supervision, which included banking, capital markets and insurance, and deepening capital markets. As a result, the financial sector is strongly regulated and endowed with the main actors and instruments.

The continuous reform efforts are currently primarily dedicated to consolidating financial regulation and supervision, improving access to finance mainly for low income households and micro, small and medium-sized enterprises (MSMEs), and completing capital market instruments by introducing a new generation of financial instruments. The latter includes setting up a legal and regulatory framework for the issuance of covered bonds.

> The growth of mortgage loans was especially strong in 2005–08 with an average annual progress of more than 35 per cent followed by a healthy decrease in 2009–11 to an average annual progress of almost 11 per cent

The banking sector has experienced a rapid and strong growth over the last few years, with total bank assets reaching 129.4 per cent of GDP in 2011 compared with 102.4 per cent in 2006. Bank lending to households and corporations has increased by 50 per cent in five years reaching 84.8 per cent of GDP in 2011 against 56.4 per cent in 2006. Mortgage lending has been one of the main drivers of this increase with total mortgage loans doubling to 25.4 per cent of GDP in 2011 from 12.6 per cent in 2006. Housing loans represent two-thirds of mortgage lending, that is, 17 per cent of GDP.

The growth of mortgage loans was especially strong in 2005-08 with an average annual progress of more than 35 per cent followed by a healthy decrease in the period 2009-11 to an average annual progress of almost 11 per cent. This was driven by a strong demand for housing combined with an improved offer notably in social housing, thanks to supportive government policies and the emergence of large real estate developers.

This strong increase in mortgage lending has exacerbated interest rate and liquidity risks due to the fact that a large proportion of mortgage loans are fixed-rate (almost 70 per cent) and due to maturity mismatches between increasingly long-term loans, with mortgage loans average maturity being more than 18 years and their funding coming mainly from short term deposits. The need for long term resources is also driven by a more general gap between the increase in customer deposits and that of credit, with a ratio of customer loans to deposits that had lately reached and exceeded 100 per cent.

Given this situation, the Moroccan banks have successfully issued private medium to long-term debt, mainly certificates of deposits and subordinated debts, which have found a demand from a large base of local institutional investors. On the other hand, the Central Bank has progressively adjusted reserve requirements from a high rate of 16.5 per cent up to January 2008 to 4 per cent in September 2012. Nevertheless, it was felt that more needed to be done to tackle the risks created by this ever-growing mortgage loans portfolio in the Moroccan banks.

Overview of the objectives and main characteristics of the draft covered bond law

Based on the European covered bond industry success story, in the second half of 2010 the Moroccan Ministry of Economy and Finance launched a project for establishing a legal and regulatory framework for covered bonds with the main objective of addressing these issues and specifically:

- allowing banks to further offer mortgage loans at affordable rates
- reducing banks' maturity mismatch and interest rate risks
- providing institutional investors, notably insurance companies and pension funds, with a new class of long-term, high-quality private debt to reduce their term gaps

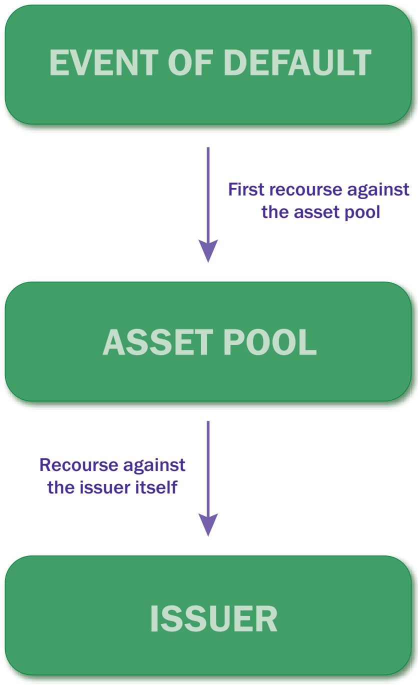
Covered bonds also have a positive collateral impact in promoting sound loan origination given that the loans eligible as cover assets have to meet high quality eligibility criteria on an ongoing basis.

The most significant characteristics of the Moroccan covered bonds draft law may be summarised as follows:

- **Issuance structure.** There are typically three types of CB issuance structures, all associated with the cover pool of assets: it can be transferred to a special purpose vehicle (SPV), a specialised bank (as mainly used in the French system) or the assets can be kept within the bank balance sheet. There is no perfect choice, each of these structures having its own advantages and disadvantages. In Morocco, the choice went to the direct issuance by the bank, which is the most common structure internationally, as it seemed the simplest and most appropriate to the nature of the bonds as senior bonds and the ongoing flows between the cover pool assets and the other bank assets.
- **Issuer and supervisory system.** Based on international benchmarks, the issuers will be banks that will have received a specific licence granted by the Central Bank on the basis of their capacities and the specific

> Two constraints have to be resolved: the first is that the quality level of eligible assets must be high enough to ensure the international standards of covered bond quality, and the second, the existence of a significant pool of eligible assets

Chart 1
Recourse the bondholder has against the assets and the issuer



covered bond management system put in place. These conditions have to be maintained on an ongoing basis. Regarding supervision and prudential regulations, the Moroccan system is to treat the cover pool almost like a small bank. Hence, the draft law provides for specific supervision of the covered bonds activity by the Central Bank, monitoring of the cover pool by an independent comptroller and implementation of specific prudential regulations on the cover pool (internal audit, risk management, liquidity obligations, and so on).

- **Eligible assets.** Two constraints have to be resolved: the first is that the quality level of eligible assets must be high enough to ensure the international standards of CB quality, and the second, the existence of a significant pool of eligible assets. If it is not possible to optimise the two constraints, this means that the market is not yet ready for covered bonds. In Morocco, the draft law has established two kinds of bonds, Mortgage CB (MCB) and Public CB (PCB).

Eligible assets for MCB are primary mortgage loans with a loan to value (LTV) ratio of less than 80 per cent for residential loans and 60 per cent for commercial loans. Mortgage loans had reached MAD 218.6 billion in September 2012, from which MAD 147.5 billion corresponds to housing loans. It is estimated that around 40 per cent of the housing loans may presently fulfil sufficient quality criteria to be eligible as a cover asset. Currently this corresponds to total assets of MAD 60 billion (around US$ 7 billion), increasing annually by more than 10 per cent, to which a proportion of other mortgage loans could be added.

Eligible assets to PCB are loans to local government that meet certain financial conditions, and loans to public corporations guaranteed by the government. Loans to local government currently exceed MAD 11 billion. It should be noted that local government debts are strongly regulated in Morocco and mainly granted by a specialised bank *("Fonds d'Equipement Communal")*. The

> The covered bond project was part of a broader financial sector reform accompanied by the World Bank. It has benefited during its different stages from specific technical assistance funded by the "First Initiative" trust fund

local government delinquency rate is less than one per cent and largely corresponds to delays in repayment due to expenditure processes that are generally regulated. The inclusion of PCB is aimed at allowing a new class of assets for investors and is expected to gain importance in the medium to long term, thanks notably to the regionalisation process currently ongoing in Morocco.

- **Cover pool.** It is important to emphasise that there is a unique cover pool for all issued MCB and a unique one for PCB. The law provides that the bank has the ongoing obligation to maintain sufficient eligible assets in the cover pool that allow coverage of issued covered bonds both in stocks and flows. To this end, the Central Bank enacts specific and prudent valuation techniques of the cover pool assets. Any asset that loses quality criteria or is prepaid has to be replaced by other eligible assets. There is also a minimum legal over-collateralisation of at least five per cent that can be set to a higher level in the regulatory framework, by using substitution high quality assets listed in the law, notably government bonds. Specifically for MCB, mortgage commercial loans cannot exceed a small percentage of the cover pool (10 per cent).

- **Customer deposits protection.** The recurrent question arising from the introduction of covered bonds, and answered differently from one country to another, is that too high a level of protection for CB holders may be to the detriment of customer deposits in the case of the issuer's bankruptcy. Covered bond supporters would respond that by allowing banks to issue CB, the system is promoting their financial soundness. In Morocco, the risk of depositors was not deemed to be a major issue in an emerging market. Yet, it was judged prudent to include in the law the provision that the issuance is limited to a share of the issuer's total assets to be set in the regulatory framework (at present, 20 per cent) and more stringent limits can be set by the Central Bank, notably in the case of banks with a specific risk profile.

- **Bankruptcy remoteness.** The law must provide effective protection for covered bond holders. This includes ensuring the effectiveness of the priority ranking of CB holders to the cover pool and the bankruptcy remoteness of the cover pool combined with its capacity to survive the bank. The law states that a specific cover pool manager will be designated in case of bankruptcy and given sufficient power and tools to continue the management of the cover pool or to transfer it to another bank. It is also important to underline that the law explicitly enacts the principle of asset continuation in case of bankruptcy.

Covered bonds objectives and project management

The CB project was part of a broader financial sector reform accompanied by the World Bank. It has benefited during its different stages from specific technical assistance funded by the "First Initiative" trust fund. This technical assistance allowed the mobilising of high level experts to assess the prerequisites and rationales for introducing covered bonds in Morocco and to comment on the draft law.

First of all, it is important to note that prerequisites for implementing CB are the existence of a comprehensive financial infrastructure and of a strong financial supervisory framework, especially in the banking sector (the central bank). The steps already taken in Morocco to implement covered bonds are as follows:

1. The first step was to clearly identify the need for covered bonds on the issuer side and the appetite of investors for such instruments. These needs, which were described in the above section, are mainly that there is a large pool of potential eligible assets comprising notably of housing mortgage loans and a large base of institutional investors comprised mainly of insurance companies, pension funds and mutual investment funds (banks may also be one of the main CB investors) A covered bond workshop was organised in November 2010 for all market players and supported by senior international experts who could share their experience in developing such a reform and implementing it. Meetings were also organised between the main financial market actors, supervisory agencies and potential issuers and investors.

2. As a second step, a very first draft law was prepared internally by the Ministry of Economy and Finance (Directorate of Treasury and External Financing) based on benchmarks drawn mainly from the German *Pfandbrief* legislation, one of the most developed covered bond legal frameworks.

3. As a third step, the draft law was submitted in April 2011 to a technical committee comprising all the main market players, including the Central Bank, the Moroccan capital markets authority, major banks, a securitisation company, a law firm, and an accountancy firm. The technical committee refined and finalised the draft law that was submitted in September 2011 to all market players for comments.

4. The fourth step was, once all the comments had been received which took more than two months, to prepare a final draft law taking into account market comments. The draft law was submitted in late June 2012 to the formal approval process, which includes adoption by the government and the parliament with the objective of implementing the law in late 2013. The draft law is currently under legal review.

The preparation of technical and operational regulations, including prudential regulations, has already begun with comprehensive technical assistance from KfW Bankengruppe in the context of bilateral cooperation. This technical assistance has allowed in its first stages a review of the draft law. The target is to have all the operational regulations ready before the draft law is finally adopted.

Conclusion

Establishing the covered bonds legal framework is a long and complex process that has to be managed efficiently. It is important to this end to follow a structured process involving all market participants and to benefit from international experience and expertise.

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08

The Egyptian experience in "better regulation" reform

SHERIF FAWZI ABDEL GAWAD

"Better regulation" is the broad strategy that developed economies use to manage their regulatory environment to consolidate, codify and simplify existing legislation and regulation, and make it accessible to the public. This article describes the role and the accomplishments of the Egyptian Regulatory Reform and Development Activity in addressing the regulatory challenges of the business climate in Egypt.

Introduction

Laws and regulations are necessary to ensure a fair and competitive marketplace as well as for the effective protection of public health, the environment and the welfare of citizens.

Regulation can appear to be a solution with relatively low costs for the government itself. It can seem to be the most familiar and lowest risk option available to policy-makers to address a problem. But the reality is that a regulation is never cost-free, either for the government or for those whose behaviour is being regulated. It can be ineffective in achieving its planned outcomes if its effects on the system as a whole have not been properly considered. If the details of its proposed implementation have not been thought through, including the costs on the economy and the potential impact of enforcement on different groups in society, the burden of regulation can be much higher than necessary.

Recent years have seen important developments aimed at improving the quality of regulation. Governments across the world have developed a variety of approaches to help simplify regulatory systems, bring greater discipline and more rigorous analysis to the design of regulation, and to reduce the burden on those affected by regulation.

"Better regulation" is the broad strategy that developed economies use to manage their regulatory environment to consolidate, codify and simplify existing legislation and regulation, and make it accessible to the public. It further entails improving the quality of new legislation and regulation by evaluating its likely economic, social and environmental impacts. "Better regulation" also involves the engagement of stakeholders in preparation of regulations that impact their lives through consultation. There is also evidence that "better regulation" can boost productivity and employment significantly, thus contributing to growth and job creation.

> Poorly conceived and ill-considered regulations often prove to go beyond what is strictly necessary and can at times be a hindrance

Recent revolutions in the Middle East and North Africa have also highlighted the importance of the need to modernise public service delivery and enhance the efficiency and effectiveness of regulations.

Most countries in the Arab world have experienced more public engagement over the past two years. This was mainly initiated by political unrest and changes in some regimes, amid calls for reform to overcome entrenched challenges such as unemployment, poverty, corruption and the uneven distribution of income. The public demanded more participation in the political process, accountability and transparency and better services. Meeting public demands will involve, among other things, substantial regulatory reforms. For example, freeing businesses and civil society groups in the Arab world from unnecessarily burdensome regulation, and simplifying the complex regulatory system, can free up the capacity they have to innovate, diversify and hence promote growth and create jobs.

In Egypt we regulate at all levels – at local, national and regional levels. But poorly conceived and ill-considered regulations often prove to go beyond what is strictly necessary and can at times be a hindrance. Some regulations are overly prescriptive, unjustifiably expensive or counterproductive. Layers of overlapping regulation develop over time, affecting businesses, the voluntary sector, public authorities and the general public.

Attempts to reform the regulatory framework in Egypt

In Egypt, there is no comprehensive single approach for regulatory reform. Over the past 10 years, the government has made some efforts to enhance the regulatory framework, mainly for businesses. These efforts were motivated by the desire to promote investment and create job opportunities through a series of reforms undertaken by the Ministry of Finance and the Ministry of Investment. Reforms have included tax reform, banking reform and business start-up. The Ministry of State for Administrative Development (MSAD) also made remarkable progress in administrative simplification in public service delivery – through “one-stop” shops, where new businesses could obtain start-up licenses without having to go around the offices of different government authorities – and e-government services where citizens could obtain certain services online, such as applications for different types of documents (ID, power of attorney, permits and so on).

Notwithstanding the achievements of these programmes, most of their development has been characterised by a lack of coordination among different government bodies and the absence of a clear and consistent methodology in review of regulations based on structured consultation with all stakeholders. Although consultation took place on some significant issues, most of the time it was informal and on a limited scale.

One of the initiatives in this respect was the National Committee for Review of Economic Legislation, which was established by Prime Minister Decree 1816/2004 to update economic legislation to enhance Egypt’s competitiveness and promote foreign and local investment. According to the instituting decree, the Committee was mandated to review laws such as: the law regulating the accounting and auditing professions; anti-trust law; tax law; customs law; amendments to trade law; central bank, banking and financial system law; economic courts law and consumer protection law. However, the committee was unable to achieve its objectives owing to the absence of a clear framework for its work. Eventually, it stopped functioning although no decree was issued by the Prime Minister to end its work.

Another initiative was launched by the Ministry of Justice, based on Minister of Justice Decree No. 4186/1994, amended by Decree No. 1071/2005. The initiative entailed setting up a consultative committee comprising members from the Information and Decision Support Center (affiliated with the Cabinet) and the Ministry of Justice to propose a general framework for a regulatory support programme, as well as objectives, criteria and methods to be adopted by the government to support regulatory reform. The committee issued a detailed report, in 2007, about its work and recommendations which involved laying down controls to implement the general framework of regulatory reform.

Furthermore, the Ministry of Justice and MSAD set up a committee aimed at improving government work to promote transparency by organising the stages of legislation preparation in an easier way to contribute to regulatory quality. This committee issues an annual report about its work on

> **ERRADA was established to help create an economic system based on competitiveness that attracts investment and generates more job opportunities**

fighting corruption and advancing transparency through promoting this in different regulations. However, the committee did not conduct an inventory or review existing regulations in a detailed way. It only laid down general guidelines to be followed in drafting new regulations.

Notwithstanding these efforts, one could conclude that review of the stock of legislation in Egypt is generally done on an ad hoc basis, that is, on specific issues based on the priorities of the competent ministry at a certain time. These priorities are usually associated with a certain problem or pressing issue. Review is conducted by legal or technical committees that comprise senior experts or advisers. There is no single entity mandated to review the stock of legislation periodically nor is there a comprehensive regulatory reform policy. This was the reason for the creation of ERRADA.

The rise of ERRADA

The Egyptian Regulatory Reform and Development Activity (ERRADA) was established under the umbrella of the Sub-cabinet Committee for Productive Sector in 2008, by Minister of Trade and Industry Decree No. 1089/2008 (which was endorsed by the Cabinet). ERRADA continued to operate under this Committee until Prime Minister Decree No. 436/2011 was issued on 26 March 2011, which assigned oversight of ERRADA to the Sub-cabinet Committee for Monitoring Economic Performance, chaired by the Minister of Finance.

ERRADA was established to help create an economic system based on competitiveness that attracts investment and generates more job opportunities. This is accomplished through a regulatory management system that reviews and rationalises business related regulations, based on a dialogue between public and private institutions and civil society that promotes transparency and justice. ERRADA seeks to achieve this goal through addressing regulatory challenges of the business climate, notably: multiplicity and overlap of regulations; lack of publication of regulations due to high cost and ambiguity of the entity that bears the cost (issuing or beneficiary); overlap of regulating authorities, and absence of a specific mechanism to assess the socio-economic impact of new regulations.

A total of 11 ministries and three governorates participated in ERRADA, which comprised a team of 44 staff. The institutional setup was established in accordance with international best practice: through units in participating ministries and governorates and a central unit which acted as an oversight body to ensure regulatory quality and provide technical advice to units. Work methodologies (for inventory, review and impact assessment) were developed in-house, to accommodate the local context, after consulting other countries' experience in this area. For example, Regulatory Impact Assessment guidelines were developed using the guidelines of other countries, such as theUK, Poland and Czech Republic, as a reference but tailored to the local context in terms of available information, institutional and legal frameworks. Staff capacity was built through continuous training.

To be able to achieve its mission, ERRADA sought to generate political support through regular meetings between the ERRADA board of trustees and the executive team, and the representative of the participating ministries (usually the minister themselves) whenever possible, to obtain support for the review and ERRADA's work in general.

Contribution

Over the four years of its operations, ERRADA managed to achieve many successes which can be summarised as follows:

1. ***Inventory of more than 30 business related regulations (35 per cent of which is not published) including laws, presidential decrees, prime ministerial decrees, ministerial decrees, subordinate authorities' decisions and so on.*** More than 500,000 regulations were examined (90 per cent of which were administrative decisions related to public administration and did not regulate businesses) from different sources as no existing source was complete or comprehensive. Inventoried regulations were then classified into 200 economic and service topics regulating the work of ministries and governorates participating in ERRADA and the details and scanned copies were entered into the e-Registry (see below).

2. ***e-Registry[1] was made available to the public.*** The e-Registry is an electronic database designed by ERRADA. It has been estimated (using very conservative estimates) that allowing for the accessibility of regulations realises annual savings in excess of LE 24 million to the society (individuals

> This review resulted in the streamlining of more than 2,000 regulations based on ERRADA recommendations through 31 ministerial decrees issued between August 2008 and February 2012

and businesses) that do not have to pay for access to commercially run databases. This also enhances compliance of citizens and businesses as they can then become familiar with their rights and obligations. Today, accessibility of regulations has become an essential right in accordance with the declaration of the World Summit on Information Society, convened in Geneva in December 2003. This Summit emphasised that this freedom is a fundamental right to societies and people and by making them accessible ERRADA's work has been part of making this commitment a reality in Egypt.

3. ***Streamline of inventoried regulations.*** Inconsistencies and overlap in regulations were eliminated through systematic review, in consultation with the private sector and civil society. This review resulted in the streamlining of more than 2,000 regulations based on ERRADA recommendations through 31 ministerial decrees issued between August 2008 and February 2012. Furthermore, around 1,000 implicitly repealed regulations (which might still be in use despite their repeal) have been identified. Some of these were explicitly repealed but there was general resistance from legal advisers to explicitly repeal regulations that are implicitly repealed. They argued that you cannot repeal something which was already repealed. Being used to this practice, they could not see the problems it created. They were also concerned that someone might claim that the regulation was valid between the time it was implicitly repealed and the time it was explicitly repealed.

4. ***Elimination of unnecessary administrative burden for citizens in general and investors in particular without impacting state treasury.*** After measuring the burden they impose on investors, ERRADA simplified some procedures using the standard cost model, which is used by OECD countries. This resulted in annual savings for business in the tourism and agriculture sectors of around LE 9 million in the following areas: diving and marine activities, hotel management companies and building on agricultural land. ERRADA also issued recommendations concerning a number of industry and trade sectors that could result in potential annual savings (if implemented) amounting to LE 68 million. Areas of savings concerned construction permits for industrial enterprises, industrial registry and operating licences, customs release for hazardous chemicals, licensing for steam boilers and thermal machines and trademarks.

5. ***Contribution to increasing state revenues through revision of outdated fees in business related regulations.*** Some of these regulations go back to the mid-twentieth century and needed to be updated to reflect today's real costs. For example, as a result of this update, state revenues increased by around LE 86 million annually in some activities such as tourist restaurants, entertainment, hotel and tourist establishments (tourism) and seeds and register of types for propagation of fruit (agriculture). In addition, ERRADA proposed several recommendations to amend fees in other topics in transport, industry, agricultural and tourism, such as licences for tourist cruises, transport services offered by local administration units and fisheries. These recommendations, if implemented, would result in an annual increase in state revenues of nearly LE 445 million.

6. ***Introduction of Regulatory Impact Assessment (RIA).*** RIA is an evidence-based decision making tool that explores different options to government policies and programmes. It helps policymakers reach decisions based on sound analysis of costs and benefits of different options to promote good governance. ERRADA conducted RIA regarding the allocation of arable land (based on an assignment by the Minister of Agriculture); shipping agencies (based on an assignment by the Minister of Transport); and increasing heights of buildings (based on assignment by the Head of the Authority for Technical Inspection on Construction Works, affiliated with the Ministry of Housing).

7. ***Recommendation of general principles to regulate important aspects of economic legislation.*** Examples of these principles include setting pricing criteria rather than fixing prices; promoting the establishment of a mechanism of appeal to relieve courts by reducing legal disputes.

8. ***Participation in Global Database on Market Surveillance Legislation.*** Based on the invitation of the United Nations Economic Commission for Europe (UNECE), ERRADA participated in a project to develop a global electronic

database that includes legislation related to market surveillance. More than 30 countries participated in this project which aims to promote transparency and provision of a better business climate in participating countries.

Moreover, ERRADA initiated legislative drafting standards in line with international best practice, to use it as a guide when preparing draft decrees during review. The legislative drafting standards address the way for preparing regulations in terms of format and structure. It also established the following seven criteria for ensuring the quality of the regulation, namely:

- **Clarity:** text should be clear without any ambiguity; it should not include any phrases that could lead to confusion of issues or concepts.
- **Accuracy:** text should be accurate, specific and focused – not so general or broad as to raise questions, and there should always be clear identification of the person targeted by the text.
- **Conciseness:** the phrase should be simple, that is, not too long; only basic verbs should be used.
- **Coherence:** phrases should be coherent with other articles in the same regulation, that is, complementing each other and should not involve any contradiction.
- **Consistency:** drafting of the regulation should be consistent with other existing legislation.
- **Completeness:** drafting should cover all aspects it is supposed to cover.
- **Comprehensibility:** drafting should be easily understood by the average person and should not convey more than one meaning.

ERRADA managed to achieve these accomplishments despite the challenges it faced, which included some initial scepticism as to the added value of ERRADA; limited participation of government entities (only 11 ministries and three governorates) which constrained its ability to enhance the business climate in an integrated way; scepticism of business (and society in general) in government reform effort in light of previous negative experiences.

The legacy of ERRADA

With the disruption in government after the political developments in Egypt, it was decided to close down ERRADA in July 2012. Notwithstanding the achievements of ERRADA, it should be noted that its real contribution does not actually lie in its direct output as presented above, but in the systems and methodologies it has laid down and the awareness it raised in Egyptian public administration about the importance of systematic regulatory reform effort and the institutional experience acquired in this respect. One could even claim that to some extent ERRADA in fact paved the way for building a sustainable regulatory management system to meet public demands and aspirations in the new era.

Notes

[1] http://eregistry.errada.gov.eg

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09

Developing local capital markets in the southern and eastern Mediterranean region

ALI SHARIF ZU'BI, CLIFFORD CHANCE CASABLANCA, JURISMED, SHARKAWY & SARHAN, WITH THE COLLABORATION OF CLIFFORD CHANCE US LLP AND THE EBRD

This article presents an overview of the current stage of development of the capital markets (debt and money markets) in each southern and eastern Mediterranean jurisdiction (Egypt, Jordan, Morocco and Tunisia), the ongoing reforms and also the areas where changes would be beneficial to encourage the deepening of the market.

Introduction

Capital market development has always been high on the transition agenda for the majority of the EBRD's countries of operations. In 2010, following the global financial crisis, the EBRD launched the Local Currency and Local Capital Markets Initiative (Initiative), whose aim is to encourage local currency lending as well as the development of local capital markets where local sources of domestic funding can be mobilised, thereby reducing the reliance on foreign currency lending and the related foreign exchange risks, and encouraging local savings. As part of the Initiative, the EBRD conducted an assessment reviewing the legal and regulatory framework necessary to support a vibrant local capital market, against the stage of development of the jurisdiction in question. The assessment was conducted in 10 jurisdictions in the eastern Europe and central Asia (EECA) region: Georgia, Hungary, Kazakhstan, Mongolia, Poland, Romania, Russia, Serbia, Turkey and Ukraine.

Following the Bank's expansion into the southern and eastern Mediterranean (SEMED) region, the EBRD and its Legal Transition Team, in cooperation with international law firm Clifford Chance US LLP, teamed up with expert local counsel from the region to provide an assessment of the legal and regulatory regime for capital markets activity in SEMED. The ECA assessment's tested methodology was used. This article presents a summary overview of the current stage of development of the capital markets in each SEMED jurisdiction, the ongoing reforms and also the areas where reforms would be beneficial to encourage the deepening of the market. The main focus of the assessment and, therefore, this article, is on the debt and money markets.

The Companies Law provisions on corporate bonds are neither sufficiently clear nor detailed to create the confidence on the part of companies to issue corporate bonds

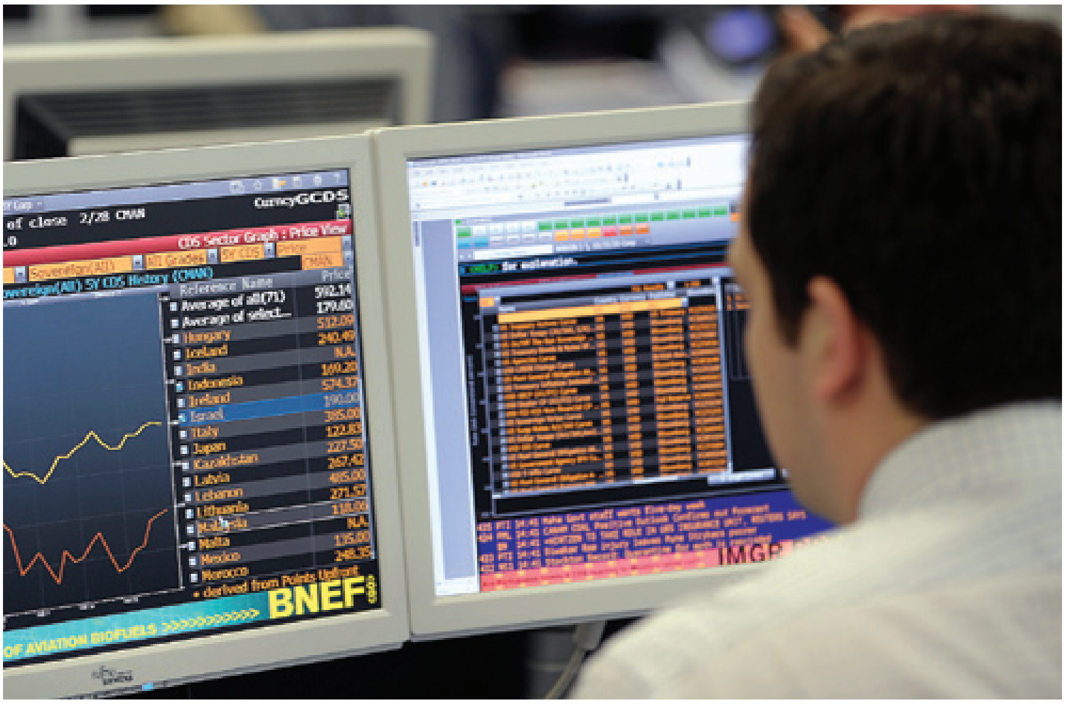
One needs to note that although SEMED countries share to some extent the same culture and language and are partially based on the French civil law system (Morocco and Tunisia, Egypt to a lesser extent), their respective legal frameworks are rather distinct and each jurisdiction is at a different stage of capital markets development and faces different issues hampering such development.

Jordan

In Jordan, the primary bodies and institutions which regulate and monitor local capital market activity are the Council of Ministers, the Higher Ministerial Committee for the Management of the Public Debt, the Jordan Securities Commission (JSC) and the Central Bank of Jordan (CBJ).

The laws, regulations and instructions governing securities in Jordan tend to be couched in general terms. This lack of specificity, combined with a general dearth of practical experience by both market participants and regulators, sometimes leads to poor guidance concerning the issuance and regulation by the JSC of debt securities and this uncertainty may contribute to the general low volume of instruments issued.

For example, the provisions in the Securities Law[1] surrounding private placements of securities are unclear as to whether a private placement is defined as one where securities are *placed* with up to 30 investors or *offered* to up to 30 investors. Furthermore, neither the Law nor the applicable instructions offer guidance as to the length of the offering period. Another example of somewhat imprecise provisions can be found in the exemption, provided in the Securities Law, from issuing a prospectus if the securities are sold to an investor who is capable of assessing and bearing the investment risks. However, there is no definition as to who qualifies as such investors and thus, the concept of "qualified investor" is not appropriately defined. Also the Instructions for Registration, Deposit and Settlement of Securities of 2004 do not consistently distinguish between the types of securities and it is difficult to determine which specific provisions are to apply to different instruments, such as equities or bonds. Moreover, the Companies Law[2] provisions on corporate bonds are neither sufficiently clear nor detailed to create the confidence on the part of companies to issue corporate bonds, therefore explaining the low activity in this market. For example, under the Companies Law, on the issuance of corporate bonds,



> The Jordanian money market, including derivatives, is rather nascent, partially because of the lack of legal certainty on derivatives

an Assembly must be formed and entrusted with the duty of protecting the rights of all bondholders. The Assembly must meet at the outset based on an invitation by the issuing company's board of directors. The Assembly has the right to appoint an Issuance Trustee, which must be licensed by the JSC. However, the Companies Law provides no further guidance on the Assembly's scope of authority or responsibility, particularly with respect to the duty of protection of the bondholders' rights.

Interestingly, the Jordanian parliament has recently adopted an Islamic Finance Sukuk Law No. (30) of 2012 (Sukuk Law), which will expand the variety of debt instruments in Jordan and will enhance the attractiveness of the Jordanian debt capital markets for Islamic market participants. The Sukuk Law allows these bonds to be issued in local currency (Jordanian dinar) or foreign currency; to be issued by government, public institutions, Islamic banks and companies; and to be traded on the Amman Stock Exchange or over-the-counter (OTC). However, the success of this Law will largely depend on implementing regulations, which still need to be developed by the JSC.

The Jordanian money market, including derivatives, is rather nascent, partially because of the lack of legal certainty on derivatives. For example, the definition of "securities" under the Securities Law specifically identifies certain derivatives contracts, namely "spot" contracts and "forward" contracts. Even though the definition also seems to include a catch-all provision which technically allows other types of derivatives to be considered "securities" under the Securities Law, the JSC has deemed the lack of implementing regulations, which allow for the regulation and issuance of derivatives as effectively prohibiting the use of such instruments. In addition, the CBJ has further restricted bank investment in derivatives by issuing instructions to restrict derivative investments by members of these industries. Another difficulty is that engaging in speculative derivatives transactions may qualify as engaging in gambling activities, which would, as in most countries, be illegal and void under the Jordanian Civil Code and under general Jordanian public policy. Because it is unclear to market participants which derivatives transactions would be considered "speculative" under Jordanian law, the use of derivative transactions in commercial transactions is strongly discouraged.

Tunisia

Tunisian capital markets are regulated and monitored by the Ministry of Finance (MOF), the Financial Market Council and the Central Bank of Tunisia. While many aspects of the framework that governs local debt markets in Tunisia are still rudimentary, legislative and regulatory reforms are ongoing. Specifically, the Tunisian authorities are currently considering a number of legislative changes, including expanding the types of debt securities instruments allowed as well as the adoption of laws to encourage Islamic finance, including sukuk issuances. The creation of a foreign exchange component in the Tunis Stock Exchange is also under consideration.

The current Law on the Reorganisation of Financial Markets[3] (Financial Markets Law), which was adopted in 1994, has not kept pace with more sophisticated instruments like derivatives transactions. In addition, there is considerable overlap between the Financial Markets Law and other, capital market-related laws, which may cause occasional conflicts and does not provide the clarity and guidance necessary for market participants and for the development of the local capital market. Moreover, the Financial Markets Law defines a "public offering" as an offering to 100 persons or more or an offering of securities which are listed or are to be listed on the Tunis Stock Exchange. This definition with respect to the reference to 100 persons is outdated and could be revised, focusing instead on whether the offering is made only to "sophisticated investors". This definition will also need to be modified to encompass all entities and natural persons that have the expertise, knowledge and skills necessary to undertake investment decisions and evaluate risks relating thereto. The new definition of "sophisticated investor" could, for example, be similar to the one provided by the recently adapted decree No 2012-2945 dated 27 November 2012 implementing Article 23 of Law No. 88-92 of 2 August 1988 relating to investment companies and Article 22d of the Code on collective investment schemes. This definition of "sophisticated investor" encompasses companies that meet a number of defined criteria[4].

> There are currently several legislative initiatives which are expected to expedite the development of the local capital markets in Tunisia

There are currently several legislative initiatives which are expected to expedite the development of the local capital markets in Tunisia. First, the Law 2003-49 dated 25 June 2003 is under modification to allow for use of sale and purchase transactions (known as "repo" transactions) by entities other than banks. In addition, a Sukuk Law is under preparation, which would thus expand the variety of debt instruments in Tunisia and would enhance the attractiveness of the Tunisian debt capital markets for Islamic market participants.

The Tunisian derivatives market is very limited and its development has been hindered by the risk that certain derivatives transactions could potentially be unenforceable under the Tunisian Civil Code if qualified as gambling or speculative transactions. Moreover, Tunisian law provides for enforceability of set-off if the conditions of set-off are met, that is, in the case of due and liquidated claims. However, there are no specific provisions on the enforceability of close-out netting contractual terms in insolvency proceedings. Currently, it is not clear under Tunisian law whether the opening of a reorganisation proceeding under the Law No 95-34 dated 17 April 1995 on the reorganisation of companies under financial difficulties would prevent the operation of a set-off or close-out netting provisions. Thus, specific provisions to confirm that a contractual set-off is valid notwithstanding an insolvency proceeding should be introduced.

There exist a number of regulatory limitations to foreign currency transactions in Tunisia: for instance, participation in Tunisian government bonds or Tunisian equity or debt securities by non-residents is limited. In addition, the Financial Markets Law requires that all debt instruments issuers fulfil certain specific conditions which are generally appropriate for local issuers but are not pertinent to foreign issuers, such as that financial statements of issuers in the local debt market be prepared in accordance with local legislation and that issuers provide additional documents required by the code on commercial companies.

Egypt

In Egypt, the primary institutions which regulate and monitor capital markets activity are the Egyptian Financial Supervisory Authority (EFSA) and the Egyptian Stock Exchange (EGX) in relation to corporate bonds and shares, the Ministry of Finance (MOF) and, the Central Bank of Egypt (CBE) in relation to

Egypt does not yet have a legal or regulatory framework for the issuance of Islamic securities, and, as a consequence, an Islamic securities market has not developed

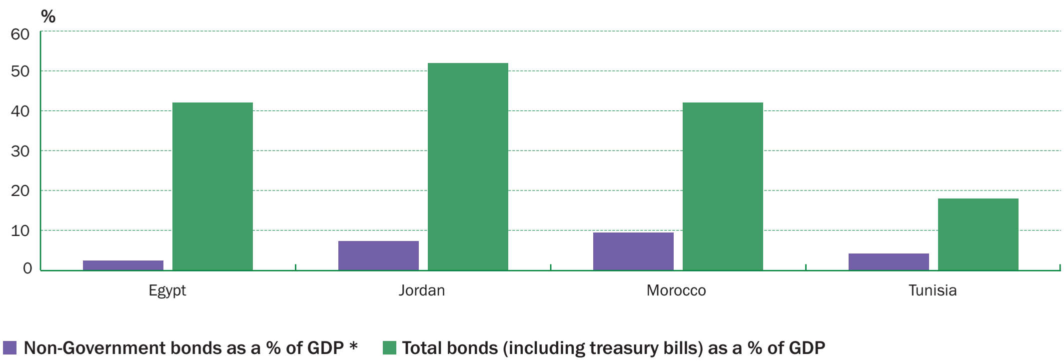
government bonds and treasury bills. One of the key areas of the existing legal framework that could benefit from improvement is the current review process carried out by the EFSA of issuing documentation for local debt securities. Market participants view it as very time-consuming and often inconsistent, which is a factor that discourages issuances. To improve the efficiency of this offering process and increase consistency it may be desirable to re-evaluate the documentation which is currently required as well as coordinate the various divisions within the EFSA involved in the review. Moreover, some of the applicable EFSA regulations, such as the one on convertible bonds issuances, may need to be revised as market participants view some of them as not aligned with regulatory practices outside of Egypt and unnecessarily discouraging valid market activity. Similarly, the regulation of repo transactions would benefit from clarification as repo transactions which have not been expressly authorised either by the EFSA or CBE could be unenforceable.

Egypt does not yet have a legal or regulatory framework for the issuance of Islamic securities, and, as a consequence, an Islamic securities market has not developed. While the Capital Market Law[5] provides for the possibility of issuing shares, bonds and sukuk, there are no detailed rules governing the issuance of sukuk and there is no description for the possible underlying structures. A draft regulation on issuance of sukuk is being developed by the EFSA and adoption of this regulation should improve matters significantly.

The corporate bond market is generally underdeveloped, as is the case in the other SEMED countries (see Chart 1), due to lack of timely availability of price information on OTC trades of government bonds. Due to this price opacity, it is difficult for market participants not involved in a given trade to establish accurate benchmark yield-curves, which corporate bond issuers could use to price their issuances. Real-time price information on trades of treasury bills would be a step forward to facilitate the development of benchmark yield curves.

A recent and positive development in Egyptian capital markets is the discussion on the drafting of a complete new chapter of the Executive Regulations to the Capital Market Law in connection with mutual funds. One of the main advantages of this proposed revised regulation is that, *inter alia,* it would override the currently existing two separate regimes regulating mutual funds depending on when those funds were formed (post- or pre- 2002) and, is therefore, expected to simplify mutual fund management. The most prominent reform proposed in the new draft intends to address previous weaknesses in the regulation, particularly in relation to the corporate structure and legal personality of funds and the lengthy procedures in relation to fund incorporation and offering of fund certificates. In addition, the draft regulations would provide more detail on the activities

Chart 1
Total volume of the outstanding non-government bonds compared to total volume of the outstanding bonds, in relation to GDP as of January 2013



* Non-governmnet bonds includes corporates, municipalities and public companies bonds.
Source: Bloomberg; National Exchanges of Egypt, Jordan, Morocco and Tunisia; and the Gulf Bond and Sukuk Association.

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The city of Casablanca has the ambition to become a major financial centre for north and west Africa, through the creation of a new regional financial hub, Casablanca Finance City

of specific purpose funds and fill in some of the gaps present in the current regulation. However, the unstable socio-political situation in the country at the time of writing means that progress has so far been very limited.

Morocco

The primary institutions which regulate and monitor capital market activity are the *Conseil Déontologique des Valeurs Mobilières* (CDVM), the Moroccan stock exchange (Stock Exchange), the Ministry of Finance (MOF), Bank Al-Maghrib (Central Bank) and the *Commission de coordination des organes de supervision du secteur financier* (Joint Supervision Commission). A significant number of important legislative and regulatory reforms of the regulation of capital market activity in Morocco have been undertaken recently. Specifically, some of the primary institutions regulating the capital markets are being reformed to increase their independence and supervisory powers; efforts to introduce Islamic finance products are underway; a draft law on covered bonds is being prepared (more details are provided in “Morocco Covered Bonds Project” by Nouaman Al Aissami and Hicham Talby, at page 62 of this journal); and a draft law establishing a regulated market (under the supervision of the CDVM and the Central Bank) for the trading of derivatives instruments is being prepared. The Moroccan legal and regulatory framework governing capital markets is currently being reformed and harmonised with the EU *acquis communautaire*, primarily to reflect the best practices that EU law is seen to incorporate. The city of Casablanca has the ambition to become a major financial centre for north and west Africa, through the creation of a new regional financial hub, Casablanca Finance City (CFC)[6]. For the CFC to be successful, the Stock Exchange should be modernised, and in this respect, the Stock Exchange is currently working on a draft law that would expand and update its trading platform to allow for listing of a wider variety of instruments. Also under discussion is the Stock Exchange’s ownership structure, and expediting of the listing process.

Draft laws are under way to amend the Banking Law and the Securitization Law to enable the establishment of participative finance investment vehicles, which would facilitate transactions consistent with the principles of Islamic finance.

The main factor discouraging the access of foreign issuers to the Moroccan debt capital markets is the number of limitations to foreign

> **SEMED countries share some similar problems hampering the development of capital markets, such as the uncertainty surrounding validity of derivatives transactions and also enforceability in case of one party's insolvency**

financial transactions. For example, foreign companies must seek prior consent of the MOF for any kind of public offering (either a primary listing of securities on the Stock Exchange or the issuance or sale of securities to the public by way of canvassing or marketing). Furthermore, there are no detailed published rules for this approval process and such applications are considered by the MOF on a case-by-case basis.

Currently, Morocco has no specific legislation authorising or governing the purchase and sale of derivatives instruments, whether on the Stock Exchange or OTC. In the absence of appropriate framework, there is a risk that some transactions might be classified as "gambling" and therefore void. Moreover, automatic set-off allowed by law does not benefit non-resident parties, which have to obtain the prior approval of the Foreign Exchange Office; furthermore, both set-off and close-out contractual terms may be unenforceable in insolvency proceedings. The Draft Derivatives Trading Law being developed by the CDVM to set up a regulated market is expected to provide solutions to these issues. However, at this stage, this draft law does not address the OTC market where most of the transactions take place.

Conclusion

This brief overview shows that SEMED countries share some similar problems hampering the development of capital markets, such as the uncertainty surrounding validity of derivatives transactions and also enforceability in case of one party's insolvency. It will thus be important across the four jurisdictions to introduce concepts of set-off and close out netting, where these concepts either do not exist or are not fully developed. The EBRD has advised and followed the development in this area in a number of countries (most recently in Ukraine, for example), and therefore could assist in this respect.

It is also worth noting that all four SEMED countries are currently exploring the opportunity for, or actively working on, the introduction of Islamic financial products. However, marked differences in development stage and pace of reform are found: in Morocco, for instance, capital market reform is high on the agenda and no less than 12 laws are being developed. In Egypt, the reform process has slowed, despite various issues that need to be addressed. Less developed capital markets jurisdictions, like Jordan or Tunisia, should ensure appropriate sequencing of reforms by addressing basic impediments first, before introducing more advanced instruments.

Lastly, the assessment has also revealed the need to strengthen the various regulatory bodies responsible for the capital markets in the various countries in the SEMED region and to ensure enhanced cooperation among them. This would be of importance in building a more coherent and consistent application of a legal and regulatory framework to market participants and would thus impact positively on investors' confidence in the markets.

Notes

[1] The Securities Law No. (76) of 2002 which came into effect on 31 December 2002.

[2] The Companies Law No. (22) of 1997 which came into effect on 15 June 1997.

[3] Financial Law: Law No. 94-117 dated 14 November 1994 on the reorganisation of the financial market.

[4] The decree requires at least two of the following conditions to be met for a person to qualify as a sophisticated investor:
- annual average over 200 people
- balance sheet total of more than 20 million dinars
- consolidated turnover or net income in excess of 40 million dinars

Any individual investor who conducted an initial subscription of at least one hundred thousand dinars and filling at least one of the two following conditions:
- having occupied for a period of at least two years, a position in the financial sector, and has evidence that he has acquired knowledge of managing portfolios securities
- holding a portfolio of securities or for deposits worth equal to or greater than one million dinars

[5] Capital Market Law number 95 of 1992.

[6] http://www.casablancafinancecity.com/?Id=89&lang=en

[7] Input from the Casablanca office of Clifford Chance International LLP was received on the Moroccan part of this article.

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Abbreviations

CAPEX	Capital expenditure
CB	Covered bonds
CBE	Central Bank of Egypt
CBJ	Central Bank of Jordan
CBT	Central Bank of Tunisia
CDVM	Conseil Déontologique des Valeurs Mobilières
CEE	Central and eastern Europe
CFC	Casablanca Finance City
CIPE	Centre for International Private Enterprise
CNEA	Comité National de l'Environnement des Affaires
DIFC	Dubai International Finance Centre
EBRD	The European Bank for Reconstruction and Development
EECA	Eastern Europe and Central Asia
EFSA	The Egyptian Financial Supervisory Authority
EGX	Egyptian Stock Exchange
ESG	Environmental, social and governance
ERRADA	The Egyptian Regulatory Reform and Development
EU	European Union
EUIR	European Union Insolvency Regulation
FAO	Food and Agriculture Organisation of the United Nations
GDP	Gross domestic product
GDR	Global Depositary Receipt
ICT	Information and Communication Technology
IFC	International Finance Corporation
IFIs	International Financial institutions
JSC	Jordan Securities Commission
LBO	Leveraged buyout
LC2	Local Currency Capital Markets Initiative
LE	livre égyptienne (French for Egyptian pound)
LLC	Limited liability company
LTP	Legal Transition Programme
LTV	Loan to Value
MCB	Mortgage covered bond
PCB	Public covered bond
MAD	Morocco dirhams
MENA	Middle East and North Africa
MSAD	Ministry of State for Administrative Development
MOF	Ministry of Finance
MSMEs	Micro, small and medium-sized enterprises
OECD	Organisation for Economic Co-operation and Development
OGC	Office of the General Counsel
OTC	Over the counter
PE	Private equity
P-Notes	Participatory notes
SEMED	Southern and eastern Mediterranean
SME	Small and medium-sized enterprise
SOEs	State-owned enterprises
SPV	Special purpose vehicle
PPPs	Public-private partnerships
RIA	Regulatory Impact Assessment
TCC	Turkish Commercial Code
UNCITRAL	The United Nations Commission on International Trade Law
UNECE	United Nations Economic Commission for Europe

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