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THE JOURNAL FOR GOVERNMENTS, INTERNATIONAL ORGANISATIONS, LEGAL PRACTITIONERS AND OTHERS ACTIVE IN PROMOTING COMMERCIAL AND FINANCIAL LAW REFORM IN TRANSITION COUNTRIES

LAW IN TRANSITION JOURNAL

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Miroljub Labus	p31
Mrak_hr/iStockphoto	p33
Silverjohn/iStockphoto	p36
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Stockbyte/Getty Images	p38
EBRD/Bryan Whitford	p45, p63
Vladans/iStockphoto	p46
Zgr_pro/iStockphoto	p48
Stewart K. Pirnie	p49
Franny-anne/iStockphoto	p51
LHKPhotography/iStockphoto	p54
Vladimir Nikulin/iStockphoto	p56, p58
Stefan Antonić	p57
Darko Jovanović	p57
EBRD/John McConnico	p60
EBRD/Susan Braun	p62
Monia33/iStockphoto	p65
LDProd/iStockphoto	p68
Aiaze Mitha	p69
Bartâomiej Szewczyk/iStockphoto	p72, p76
Bernd Volk	p73
Bbourdages/iStockphoto	p75
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CONTENTS

Marie-Anne Birken

BOOSTING SMALL BUSINESSES: A LEGAL AFFAIR?

The importance of small and medium-sized enterprises (SMEs) as the bloodline of economies has always been well known – together with the challenge that most SMEs tend to face to access finance. However, the financial crisis has made the issue more acute than ever, as the liquidity squeeze experienced by financial institutions across the world and the regulatory response to the causes of the crisis have resulted in a sharp slow-down in SME lending. The prolonged economic downturn and subsequent increase in late payments have put further pressures on already thinly capitalised SMEs. This is forcing us to re-examine the support that can be given to the SME sector to foster its growth, and the role that legal and regulatory frameworks can play to promote SME development.

Since its inception, the EBRD has been committed to SME development through its investment activities and by supporting governments in building more

FOREWORD

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robust financial systems that are conducive to SME finance. Through its Legal Transition Programme, the Bank's Office of the General Counsel supports the development and implementation of law reform programmes in the countries where it invests. Our work so far has included: promoting and supporting reforms in collateral systems, with a view to increasing the types of assets that enterprises can offer as collateral and reducing the costs of creating and enforcing such collateral; strengthening credit-information registration systems; creating specific financial instruments that aim to serve primarily SMEs (such as factoring services, leasing products, pre- and post-harvest financing tools); and encouraging expedited out-of-court debt restructuring procedures which can help SMEs navigate their way through – and survive – financially difficult times (if the business itself is sound).

The EBRD's Legal Transition Programme puts a strong emphasis on national ownership of reforms. This is achieved through intense policy dialogue, followed by technical assistance aimed at providing bespoke advice and expertise to the relevant authorities, or building the capacity of institutions, including the judiciary, in the countries where we invest. These activities have increased in the last couple of years as the demand for legal reform assistance, including from the southern and eastern Mediterranean region, grows.

The EBRD is of course not alone in this work – strong ties have been forged with various international organisations. This cooperation is crucial for making the best use of limited resources to support reforms and ensures that the Bank is at the cutting edge of policy advice in the SME sector.

This issue of *Law in transition* is a testimony to this work. I hope that it will become a leading source of inspiration for those who make and influence legal reform policy in transition countries.

Michel Nussbaumer

INTO A THIRD DECADE OF LAW REFORMS

The EBRD Legal Transition Team was established as a distinct unit within the Bank's Office of the General Counsel in 1995.[1] Its 20th anniversary is a good time to reflect on the changes that have occurred in the way the EBRD undertakes legal reform, from the perspective of those in charge of running such activities. The Bank's Legal Transition Programme has grown and evolved over the last 20 years, both substantively and geographically. This has taken place in response to the changing circumstances in countries in which the EBRD invests, the ever more complex world economy and the Bank's expanded mandate. While the core reform methodology remains largely the same, there have been operational changes in both funding mechanisms and legal matters covered by the programme. There is also now an increased emphasis on measuring results, which will only become more important in a tight budgetary environment.



Over the past two decades, the Legal Transition Team (LTT) has carried out the Bank's Legal Transition Programme (LTP), an EBRD initiative which contributes to improving the investment climate in countries in which the Bank works by helping to create an investor-friendly, transparent and predictable legal environment. LTP activities focus on developing legal rules and establishing the legal institutions and culture on which a vibrant market-oriented economy depends. These past 20 years have seen extensive growth in country law expertise at the Bank and the development of more than 200 technical cooperation projects in over 30 countries, touching on many aspects of commercial law and institution-building. The LTP has also encouraged reflection on commercial law reform through numerous outreach events and by publishing 34 issues of *Law in transition*.[2]

An external evaluation conducted in 2012 concluded that the LTP had been successful overall, with some sectors and activities being deemed highly successful.[3] This backs up the LTT's own perception that through its programme the Bank has had an impact on the investment climate and economic development of transition countries by improving their legal framework for businesses. However, the environment in which the LTP operates is constantly changing and past achievements are no guarantee of future success.

"The Bank's Legal Transition Programme has grown and evolved over the last 20 years, both substantively and geographically."

"The regional and global financial crises have shown that even modern legal frameworks have their limits and can fail."

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COMMERCIAL LAW IN TRANSITION COUNTRIES – CHALLENGES OLD AND NEW

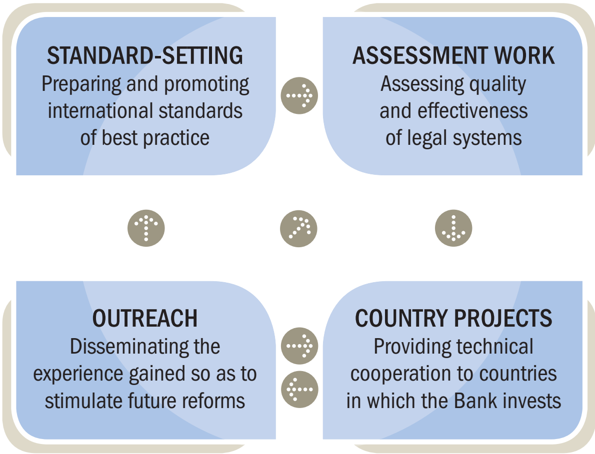
Considering the big picture of commercial law reform in the EBRD region, which is the background against which the LTP operates, it is evident that the environment has changed dramatically. In the 1990s the new market economies of central and eastern Europe were boldly seeking to establish legislation and institutions to support the growth of business activities. In these countries, the need for technical assistance was immense and so was the appetite to learn from "western" experience. Twenty years later, many transition countries have made significant progress towards fully functioning market economies with relatively well-developed laws. Yet the need for technical assistance across the region keeps growing. Why is that?

First, despite unquestionable progress in establishing legal frameworks for modern business activities, the development of sound institutions in these countries has been uneven. The EBRD's legal assessments continue to show that, despite legislation of decent quality in many countries, there remains a substantial deficit in the implementation of commercial law. There are many contributing factors to this problem, which differ from country to country, including: a general lack of resources to train officials and judges (or even to remunerate them as appropriate); low levels of transparency, which masks improper dealings and creates inefficiencies; and weak institutional organisation and management, all of which translates into under-performing systems. International organisations and donors are often called upon to assist governments in addressing such concerns. There is a general agreement in development circles that building strong institutions is much more difficult than passing laws.

Second, the regional and global financial crises (the last one being in 2007-09) have shown that even modern legal frameworks have their limits and can fail. Policy-makers in transition countries are now considering the best way to continue reforms. Governments are seeking fresh approaches in their efforts to transition fully to the market economy, while taking stock of the lessons learned from the crises. This is a difficult balancing act, which can be facilitated by external assistance and comparative analysis of the kind conducted by the LTP.

Lastly, the international legal framework for businesses has continued to develop globally and transition countries often need to catch up with new approaches. A typical example is public procurement, where e-Procurement has transformed the operational landscape and is expected to be introduced everywhere in the near future. Many countries in which the EBRD invests lack the financial resources and technical expertise to introduce such reforms and must therefore turn to institutions like the EBRD for assistance. Further, commercial law is becoming ever more complex in response to developments in the markets and the use of technology in society. This is particularly the case with financial products, which pose significant policy challenges for governments.

CHART 1 THE EBRD VIRTUOUS CIRCLE OF LEGAL FORM



Source: EBRD

EVERGREEN VALUES

While much has changed in the LTP, its core features remain intact even 20 years after its inception. The fundamental approach to project management is the same – the Bank continues to retain full in-house intellectual ownership and control of the technical assistance it provides. The LTT remains structured as a group of experts on specific topics, who call on external consultancy services as needed, but who ultimately deliver the EBRD message and take responsibility for the contents of advisory services. This model is restrictive in terms of leverage opportunities (that is, the internal lawyers in charge cannot carry out more projects than they can personally manage at any given time). However, the approach has distinct advantages with regard to quality control and consistency. The Bank can be confident that the substance of its legal technical assistance is in line with its philosophy and policies, rather than being left to the judgement of external consultants.

Another feature that remains current is the adherence to the "EBRD virtuous circle of legal reform" (see Chart 1). From the beginning, the LTP has been engaged in a series of activities that are mutually reinforcing, such as: (i) contributing to the establishment of international standards and best practices; (ii) conducting diagnostic activities; (iii) following up with advisory services in countries in which the Bank invests; and lastly (iv) disseminating lessons learned to external audiences. At the EBRD, all four activities are within the remit of the LTT, whereas other organisations have divided these functions.[4] Each approach has its pros and cons. Even though the LTT operates with limited resources, the view at the EBRD is that combining these four activities in the same operational unit is beneficial and leads to cross-fertilisation. For example, lawyers having conducted a comparative assessment of insolvency laws in countries in which the EBRD invests are well placed to engage in policy dialogue with officials in those countries. They are able to indicate how that particular country fares compared with neighbouring countries, identify the current shortcomings in the system, determine which reforms have worked abroad, and so on. Similarly, experience in the preparation of standards for transition countries is of great help to LTP lawyers when designing a diagnostic tool for the same legal area.

In addition, the Bank took the view early on that some of its lawyers should work full-time on legal reform activities (as opposed to doing this part-time in addition to their investment-related duties). This approach remains in place today. It is seen as a good way for in-house lawyers to handle the potential conflict that could arise between the daily pressures of investment operations and the longer-term time frames and objectives that are typical of legal reform work. It also helps to create a strong pool of expertise in policy dialogue and law reform.

FROM SECURED TRANSACTIONS TO RESOURCE EFFICIENCY

Having started with a relatively narrow focus on secured transactions, which was identified as the most pressing need in developing credit markets in the region in the 1990s, the programme rapidly grew to include new focus areas. These additions were guided by the feedback of EBRD bankers working on investment operations and the desire to create a better business environment throughout the region. By the new millennium, the programme was already working on corporate governance, telecommunications regulation and concessions/ public-private partnerships. Then came insolvency

CHART 2 LEGAL AREAS WHERE THE EBRD CURRENTLY FOCUSES ITS TECHNICAL COOPERATION

Source: EBRD

(2004), judicial capacity-building (2006), public procurement (2008), and energy law and regulation (2011). At the same time, expansion has occurred within some of the focus areas. For example, secured transactions have evolved from covering security over movable and immovable property to including credit-information reporting systems, and have further extended to cover the full access-to-finance range, including factoring and leasing. Telecommunications regulation has grown to encompass all infrastructure regulation. The energy focus has broadened into a resource efficiency approach. And judicial capacity now covers alternative dispute resolution and the work of bailiffs.

The future will most likely see more developments in the programme. Knowledge management and innovation are important thematic issues within the Bank. Subject to resource constraints, the LTP's remit may expand into topics such as intellectual property, venture capital and private equity.

FROM MOSCOW TO CASABLANCA

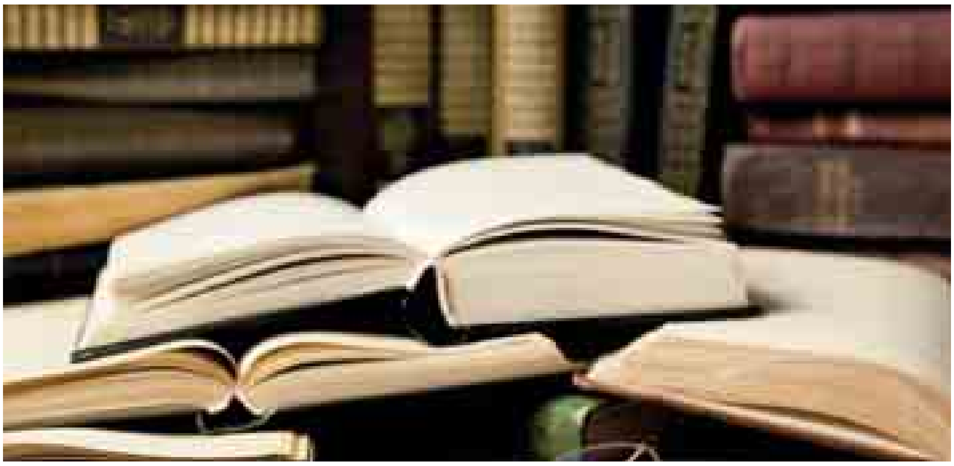
Changes have also occurred on the geographical side. Three years ago, the Bank implemented the most exciting change since it was established. Having worked for two decades on promoting transition to market economies in central and eastern Europe, it turned its attention to the countries of the "Arab spring". This move was approved by the Bank's shareholders, eager to support the political reforms that were developing in parts of the Arab world. Although the Bank was established to help countries transition from centrally planned economies to market economies, its skill-set and experience were seen as relevant for other economies with significant state control or those with a need to boost small enterprises. The LTT embraced this new direction with enthusiasm and its lawyers approached the new jurisdictions with interest but caution, mindful that new thinking might be necessary. This proved to be the case. Whereas in eastern Europe the EBRD is recognised as an authority on the market economy and is welcomed as an adviser by transition countries, the Bank is more of an unknown in the southern and eastern Mediterranean (SEMED) region.[5] As such, more effort is required in these countries to establish credible policy dialogue and build rapport with officials in charge of reforms. A meeting in SEMED typically starts with an explanation of what the EBRD is, which is unnecessary in the "traditional" region where people are very much aware of the Bank's existence and mission from the beginning. Additional care and attention is needed to convey LTP messages to policy-makers in Arab countries. It is also more important than ever to build coalitions with other aid providers, to undertake

more frequent visits to interact with stakeholders on the ground, and to become acquainted with local culture and traditions. Though it has taken some time to strike up policy dialogue in the new region, there is now a certain momentum. At the time of writing, the Bank had been able to initiate several legal technical cooperation projects in the SEMED region, such as legislation for secured transactions and derivatives in Morocco, a regulatory environment for small and medium-sized enterprises in Egypt and judicial capacity-building in Jordan.

"There is no question that legal technical assistance will be a priority for the EBRD's involvement in transition countries in the future."

MONEY MAKES REFORM GO ROUND

The majority of LTP activities are funded by donors. Their monies are used to hire consultants where necessary, to organise events and trainings, and publish analytical materials. At present, this represents an annual spending of approximately €6-8 million, compared with approximately €1 million in the early 2000s. The Bank runs a donor programme, which collects contributions from its shareholders and makes them available for technical cooperation activities. The trend over the past 10 years has been to move away from tied bilateral donor funding[6] and to increasingly use multi-donor funds comprising untied money. This is a result both of the growing awareness of donors that their money could be used more efficiently in collective schemes combining various resources, and of the Bank's position that donors should "untie" their donations to facilitate the best use of funds. This has been a very positive development for the LTP and has created more flexibility in hiring consultants. Think, for example, of having to



source experts to promote public procurement law reforms in the Kyrgyz Republic and being forced to hire most of the experts from only one jurisdiction, to which funding is tied. This is a serious limitation which could cause problems. Typically, such a project would require local expertise in the recipient country and some international expertise in the public procurement sphere, preferably consultants with Russian language skills. The mismatch between tied funding and law reform requirements is obvious.

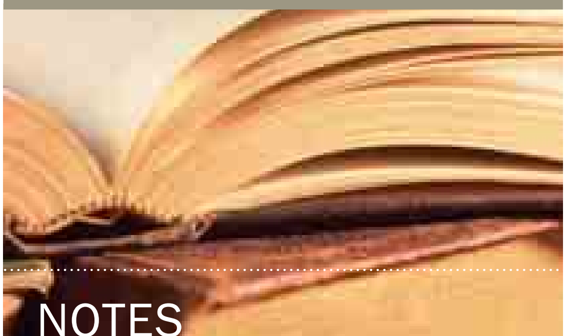
There has been abundant funding for technical cooperation in the last 10 years or so, such that the Bank has rarely had to walk away from a law reform project due to lack of funding. The Bank has almost always been able to match some donor funds with the proposed activities, or to obtain support from the EBRD Shareholder Special Fund, which can be used to fund legal reform projects, among other things. Back in the 1990s, the situation was very different and new projects would routinely face a nervous wait for donor funding. More recently, donor funding has once again become somewhat scarce and one cannot assume that the LTP will always be able to find support for the funding needs of its many projects.

STRONGER INTEGRATION OF EBRD ACTIVITIES

Another important change in the LTP has been the greater integration of its activities into the Bank's strategic initiatives. Legal policy dialogue has moved a long way from the 1990s, when it was very much a niche activity developed by specialists; it is now much more a part of the Bank's mainstream activities. In the last decade, the LTP has been operating under three-year action plans prepared in consultation with all other units in the Bank. As a result, recent initiatives launched or prepared by the Bank (for example, the Small Business Initiative, Knowledge Economy Initiative and Sustainable Resource Initiative) include a significant policy dialogue component where the LTP is expected to contribute. This integration has helped boost the programme's activities. However, it also makes it necessary to manage internal and external expectations about what can be achieved with a relatively small team of lawyers.[7]

MANAGING FOR RESULTS

In the 1990s the understanding that "good laws make good economies" increasingly became accepted as one of the cornerstones of international development assistance. The EBRD itself made this point very early on[8] and highlighted the positive correlation it had observed between legal reforms and economic transition. Later on, this doctrine was promoted by the World Bank's *Doing Business* reports[9] and associated research, which all underlined the importance of efficient and properly implemented laws and regulations to support economic development. Encouraged by these findings, international financial institutions



NOTES

1 Note that the EBRD did engage in law reform activities from as early as the year of its foundation (1991), but until 1995 these were carried out on an ad hoc basis by various members of the Office of the General Counsel.

2 For more information on the EBRD's Legal Transition Programme, see www.ebrd.com/law (last accessed 12 December 2014).

3 See http://www.ebrd.com/downloads/about/evaluation/121109legal.pdf (last accessed 12 December 2014).

4 For example, at the World Bank standards-setting is done by the Legal Vice Presidency, whereas diagnostics and advisory services are provided by other departments.

5 SEMED is the acronym used by the EBRD to refer to Arab countries where it works. This currently includes Egypt, Jordan, Morocco and Tunisia.

6 Tied funding refers to donor money to which specific conditions are attached, typically the mandatory use of some of the funding to hire consultants from the donor's country.

amplified their efforts to improve legal frameworks for businesses in developing and transition countries. However, uneven attention was paid to measuring the actual impact of such development assistance. At the EBRD in particular, some measuring was done, but on an ad hoc basis rather than on a comprehensive and systematic basis. More recently, governments, in particular those of donor countries, have been asking for more detailed results of their assistance. The *2005 Paris Declaration on Aid Effectiveness* establishes as one of its main principles the need to manage for results.[10] This attempt to better capture the effect of development assistance has translated into specific measures at the EBRD. Since 2013 all new technical cooperation projects must include a "results matrix" detailing the expected outcome and outputs of EBRD assistance, and specific indicators that allow the Bank to measure success or lack thereof. This new approach will be monitored closely and is expected to give donors more detailed information on what has been achieved with their money.

These developments are welcome and should give more legitimacy to the work of international financial institutions. One might say there is a certain cost entailed, as staff may end up spending more time preparing sophisticated instruments to measure success, and therefore have less time to spend on actual assistance to transition countries. However, such systems promote proof of success in legal reform, which is important to improve the investment climate – the LTP's ultimate objective. Obviously the right balance must be struck between these conflicting parameters. The Bank has also been experimenting with other tools to measure the results of judicial training programmes, such as the use of randomised impact studies to monitor the effectiveness of training activities. Although the high cost of such studies has been questioned by some stakeholders and detailed analyses can only be conducted in a few selected cases, their value cannot be underestimated. They offer hard proof that legal reform projects have achieved legal and economic success.

THE FUTURE

The EBRD Legal Transition Programme is ready to enter its third decade with confidence. The challenges highlighted in this article call for continuous adaptation. However, there is no question that legal technical assistance will be a priority for the EBRD's involvement in transition countries in the future. That said, the Bank may struggle between the desire to expand LTP activities, clearly expressed by all stakeholders, and the tight budgetary environment which points to limited resources in future years. Indeed, consistent funding levels must not be taken for granted. These can fluctuate due to donor budget limitations or to possible reductions in the portion of EBRD profits that can be allocated to technical cooperation. Efforts will need to continue to rationalise assistance, improve coordination with other institutions and make the best use of past experiences. In addition, particular attention must be paid to measuring and publicising results (or lack thereof) of technical cooperation projects. If these conditions are met, the LTP can be expected to contribute to the realisation of the UN's Post-2015 Development Agenda in its regions, from central and eastern Europe to Central Asia and the southern and eastern Mediterranean.

7 At present, the LTT has 13 permanent lawyer positions and a few ad hoc research assistants.

8 EBRD (1995), "The contribution of law to fostering investment", *Transition Report 1995: Business in transition*, Chapter 6, pp. 101-108.

9 See http://www.doingbusiness.org/ (last accessed 12 December 2014).

10 See http://www.oecd.org/dac/effectiveness/34428351.pdf (last accessed 12 December 2014).

Lorenzo Ciari and Alan Colman

BUILDING STRONGER COMPETITION FRAMEWORKS

A fundamental requirement for the transition from planned to market economies is the development of an effective competition framework. Without it, monopolies and restrictive practices can inhibit private sector development. In other words, the commanding role of the state in the planned economy becomes replaced by dominant firms and enterprises controlling segments of a distorted market economy. Competition policy creates a level playing field and facilitates the entry of new market players and products.

There is an important role for the EBRD to play in working with transition countries to improve their competition frameworks and to strengthen the enforcement of competition law. In carrying out this work, the Bank is able to draw on two of its internal resources: (i) the Legal Transition Team (LTT) in the Office of the General Counsel, which conducts legal analyses and designs technical assistance projects to help improve laws and strengthen key institutions, with the objective of improving the investment climate in the region; and (ii) the Bank's Office of the Chief Economist (OCE), which has an intimate knowledge of the development of competition policy in the region and considerable expertise on economic concepts underpinning competition law. Over the past two years, LTT and OCE have worked together on a number of technical assistance projects aimed at enhancing the effectiveness of the institutions which are responsible for upholding competition, namely competition authorities and the courts. This work was prompted by the EBRD's own research – and in particular the Bank's transition indicator for competition – on the progress of transition countries in developing competition policy.

COMPETITION POLICY: THE COMPETITION INDICATOR

The EBRD's annual transition indicators have been mapping economic transition in the region since the Bank was first established. One of the indicators looks at the quality of competition policy and its enforcement. The indicator is based on surveys and in-depth research undertaken by the Office of the Chief Economist collecting information on both the institutional environment in which competition authorities operate and the actual enforcement of competition law. The scoring system used for the competition indicator consists of a scale ranging from 1 (denoting a complete absence of competition legislation) to 4+ (denoting the kind of competition framework that is typical of an advanced industrialised economy) (see Box 1).

The most recent competition scores for countries where the EBRD invests are set out in Chart 1. The average score for all countries is 2.4. The best performing region, as one would expect, is the European Union (EU), with an average competition

"The EBRD's annual transition indicators have been mapping economic transition in the region since the Bank was first established."

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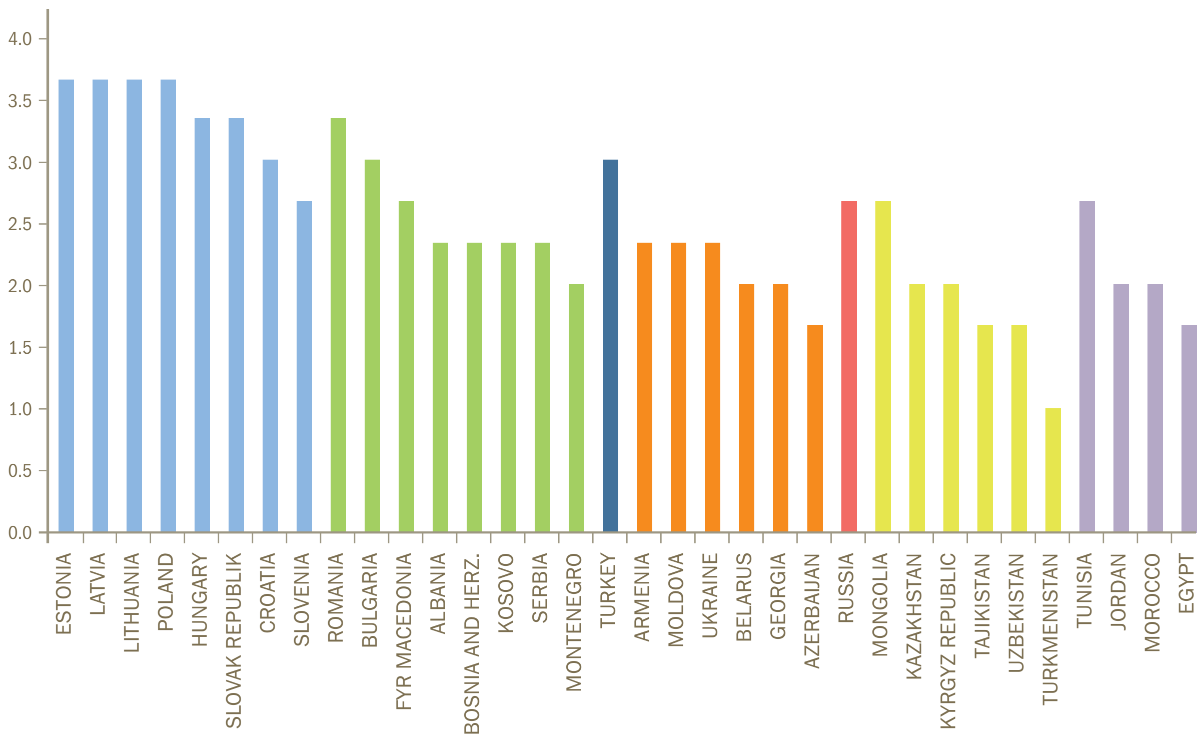
score of 3.3. The Commonwealth of Independent States has the lowest average regional score (2.0), reflecting strong state involvement in the economies of several countries, notably Belarus, Turkmenistan and Uzbekistan. The countries of south-eastern Europe all sit between 2.0 and 3.0 on the scoring spectrum. The mode average score (value that appears most often in a set of data) is a tie between 2.0 and 2.3, the very point on the scale at which improved institutional effectiveness is required before progressing to the next step. It is clear that these countries need to focus on improving the implementation of competition law, in part by strengthening the institutional capacity of regulators and the courts that review their decisions. Yet when one examines the historical transition indicator scores, it is striking to see that a number of countries have been stalled at 2.0 or 2.3 (2+) for many years. Indeed, in recent years relatively little progress has been made across the transition region in improving competition frameworks and their enforcement. Of the 34 countries in which the survey was conducted, 13 have made no progress in their competition

CHART 1 TRANSITION INDICATOR SCORES FOR COMPETITION (2013) IN COUNTRIES WHERE THE EBRD INVESTS (BY REGION)



Source: EBRD

BOX 1 SCORING SYSTEM FOR THE EBRD TRANSITION INDICATOR FOR COMPETITION

1	No competition legislation and institutions.
2	Competition legislation and institutions set up; some reduction of entry restrictions; some enforcement actions on dominant firms.
3	Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including dominant conglomerate break-ups; substantial reduction of entry restrictions.
4	Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
4+	Standards and performance typical of advanced industrial economies; effective competition policy; unrestricted entry to most markets.

BOX 2 EBRD TECHNICAL ASSISTANCE WORK ON COMPETITION POLICY

Judicial training in competition law	Capacity-building of competition authorities
Bosnia and Herzegovina (2012)	Jordan (2015)
Jordan (2015)	Moldova (2015)
Kyrgyz Republic (2010)	Montenegro (2014)
Moldova (2013)	Serbia (2014-15)
Mongolia (2013)	
Montenegro (2014)	
Serbia (2013)	

Note: Includes completed projects and projects under development.

indicator scores for five years or more, and a further eight have made no progress for at least three years. Of the remaining countries, data for five have only been available since last year – that is, new countries where the EBRD works in the southern and eastern Mediterranean (SEMED) and Kosovo. This leaves only eight countries which have made some improvement in competition policy over the last three years, and of these, two were downgraded in 2013 (Hungary and the Slovak Republic).

TECHNICAL ASSISTANCE

In examining opportunities for technical assistance projects, the Bank has paid particular attention to south-eastern Europe, where basic competition legislation is in place and institutional shortcomings now represent the main obstacles to progress. This is where the real challenge lies. Adopting competition legislation and regulations and setting up new organisations is relatively easy. However, making those organisations run effectively is much more difficult. There is a keen awareness in government circles of the importance of strengthening the effectiveness of organisations involved in the implementation and enforcement of competition policy. The Bank's technical assistance efforts in relation to competition have focused mainly on judicial training in competition law and policy, and capacity-building work with competition authorities. An overview of this work is set out in Box 2. Some of these projects are discussed further below.

JUDICIAL TRAINING

In 2012 the EBRD launched a project with the judicial training authorities in Bosnia and Herzegovina aimed at strengthening the skills of the judiciary in the area of competition law. EU reports had noted that, although the country's Competition Act of 2005 was largely in compliance with the *acquis communautaire*, implementation remained uneven. This was in line with the country's transition indicator score of 2.3. The objective was to prepare judicial training and a specialist handbook for judges of the Court of Bosnia and Herzegovina, which hears appeals against the regulator, the Competition Council. Judges had not previously received any training in the field of competition and few had significant experience in this area. One notable statistic was the fact that the court had never ruled against the competition authority in a claim brought by a private entity seeking to challenge one of its decisions. The project design paid special attention to discretion and legal remedies available to the court when resolving claims in these areas, as well as relevant market, economic and financial aspects of competition matters.

In 2013 a similar judicial training programme was implemented by the EBRD, this time for the benefit of judges of the Serbian Administrative Court, which hears appeals against decisions of the Commission for the Protection of Competition (CPC). Serbia's current transition indicator score for competition is 2.3 – again pointing to problems with the implementation of its competition framework. The focus of this project was not competition law, but rather the economic concepts that underpin competition law. The first question that arises in many competition cases is the definition of the relevant market. This involves applying economic techniques that require an understanding not only of how markets work, but also of general economic theory. The Bank worked with the Judicial Academy in Serbia towards developing a training programme that covered areas such as: economic analysis of market definition; the economics of monopoly power and price discrimination; and dominant market positions and their abuse, such as predatory pricing. The programme involved a series of seminars by leading Serbian academics, as well as guest lectures by judges from Croatia, the Czech Republic, Hungary and

Romania. As part of the project, a website was created which includes all of the training materials for the programme, as well as recordings of the various seminars and a self-test facility allowing participants to test their knowledge of the course content.

Judges in administrative courts are often required to deal with non-legal disciplines pertaining to the jurisdictions of the administrative bodies whose decisions they are reviewing. The economics of competition cases is just one example; accounting skills for taxation and insolvency matters are another. It is important that judicial training initiatives be sensitive not only to training needs in relation to substantive law, but also in relation to associated non-legal areas. Judges do not necessarily need to have high levels of expertise in these areas, but they must have a sufficient grasp of the relevant concepts to be able to understand disputes, ask probing questions of counsel and expert witnesses, and come to well-reasoned conclusions, applying all of the academic disciplines relevant to the case in a coordinated fashion.

CAPACITY-BUILDING OF COMPETITION AUTHORITIES

The Bank's technical assistance work on competition has also been directed at competition authorities. In late 2013 the team launched a small project with Serbia's Commission for the Protection of Competition, similar to that conducted at the Serbian Administrative Court. The training course on economic concepts that had been offered to the Serbian judges was revised and reworked for the CPC, where a high level of specialisation and economic knowledge is expected of its members. The training programme was coordinated with other organisations working with the CPC, and covered the various microeconomic concepts underpinning competition policy and regulation, looking at their relevance for members and staff of the CPC. One new element was a component explaining the relevance of econometric techniques in detecting violations of competition rules.

Following a review of the project in 2014, and after further discussions with the CPC and other international organisations supporting the development of the competition framework in Serbia, the Bank launched a second project comprised of four main components. Under this project, CPC members will receive training on how to conduct independent econometric studies. On-the-job training is considered to be the most effective way of doing this, building on the basic training given to members in 2013. The CPC will also acquire software to facilitate the implementation of econometric studies and will provide training on the use of these tools. The second component will seek to develop the CPC's competence in using its statutory powers to conduct dawn raids. Various observers, including the European Union, have encouraged the Serbian authorities to exercise these powers in appropriate cases. That said, entering premises and seizing evidence is an intrusive measure and needs to be carried out judiciously. Furthermore, proper use of forensic software is required to analyse data seized in dawn raids. The third component will enhance members' capacity to perform the CPC's role as a public advocate for competition policy in Serbia. This is an important function, which has the potential to raise public awareness of competition policy in a country where competition rules are still not well understood and in some cases remain counter-intuitive for the general public. The final component will facilitate closer cooperation between the CPC and sector-specific regulators, primarily the telecommunications

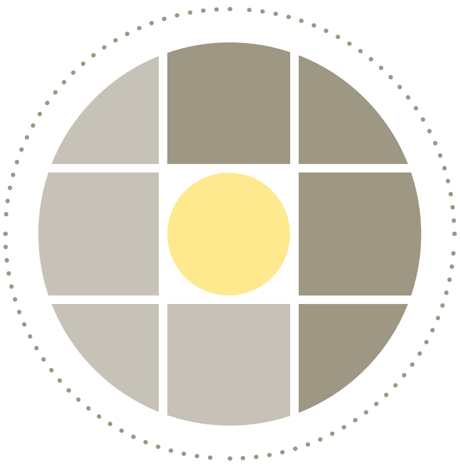
and broadcasting regulator and the energy regulator. The CPC and the sector-specific regulators require a better understanding of the division of responsibilities between them, as well as the importance of approaching relevant issues in a harmonised manner.

Another competition authority with which the EBRD has been working is Montenegro's Agency for Protection of Competition (APC). Montenegro's transition indicator for competition has been stalled at 2.0 since 2009. However, the recent prospect of EU accession has been encouraging reforms. Chapter 8 of Montenegro's EU accession negotiations, concerning competition law and policy, opened in October 2012. A range of legislative amendments were passed in 2012, including provisions establishing the APC as a functionally independent authority. Since then, the APC has sought to strengthen its case-handling capacity and it has been assisted in these endeavours by the EU. However, APC members still lack a greater understanding of underpinning economic concepts, such as merger assessments and evaluation criteria. Merger control has been one of the APC's principal activities since its establishment; however, substantive instruction still has not been provided to APC members on this subject. It remains a particularly important component of competition policy in the Montenegrin market, which is still undergoing a privatisation process. In 2014 the EBRD launched a project to respond to these needs. Merger-related aspects of the project include understanding merger notification procedures, as well as assessment and decision-making in accordance with EU regulations and practices. The project design emphasises the importance of determining the purpose and effect of available remedies in merger control, with practical examples from EU member states, as well as specific merger assessment guidelines for various sectors, such as banking, insurance and retail.

CONCLUSION

Certain conclusions can be drawn from the Bank's technical assistance work in the area of competition frameworks. First, the Bank believes the projects conducted to date have been useful. Participants that have benefited from training attest to improvements in knowledge, and government counterparts are eager to build on this work and make further progress in the enforcement of competition standards. Second, the Bank has been fortunate to have worked with enthusiastic counterparts and to have identified competent local consultants to help carry out the project. Each country's needs are unique and projects must therefore always be carefully tailored. Lastly, the perspectives of local stakeholders on the state of development of competition policy appear to corroborate the overall assessment of the EBRD transition indicator scores in the countries where projects have been conducted. The basic story they tell is consistent – while the "law on the books" is generally in good order, its implementation needs to be improved. This phenomenon of an implementation gap is well known to the Bank, and has been a feature of the evolution of legal frameworks in the region throughout its transition period.

An important part of the EBRD's future work will also involve looking back to assess the impact of its past projects over time. We must study how greater knowledge and capacity translates into practice. Will we see more confident, capable actions on the part of regulators and better, more consistent judgments from the courts? If so, we can expect to see progress in the transition indicator scores of the countries concerned. The results will prove that improving a country's competition framework enhances its investment climate.



Josefina Stubbs

FOCUS SECTION
SMALL BUSINESS FINANCE

It is my great pleasure to introduce you to this focus section of *Law in transition*, on behalf of the International Fund for Agricultural Development (IFAD).

Rural areas in many developing countries are undergoing rapid transformation, driven by both global and country-specific developments. Reducing rural poverty by fostering inclusive agricultural value chains creates employment, generates income and contributes to national growth. As an institution that is deeply involved in shaping agricultural and rural development policies and programmes in many low or middle-income countries around the world, we understand farming, at whatever scale, as a business. We know that smallholder family farmers need more and better access to finance, financial products, markets and insurance to enhance their productivity, increase their income and contribute to local and national economies.

The substantial tightening of capital adequacy, which came as a regulatory response to the recent financial crisis, and the resulting contraction in bank lending to small businesses has made the subject of access to finance for small businesses, and ultimately small and medium-sized enterprise (SME) growth, a very prominent issue. Governments across the world have recognised the significance of this problem and we have seen numerous initiatives taking place with the aim of facilitating finance and enhancing the operational environment for small businesses. It has also long been recognised that one of the pieces of this puzzle is the establishment of a legislative framework, which could either promote or impede innovative financing solutions.

Small businesses are faced with various problems when trying to access finance. They may, for example, struggle to provide potential lenders with acceptable collateral. This may be due to limitations in existing collateral systems, which do not provide lenders with a reasonable level of risk mitigation (owing to inefficient laws or enforcement procedures), or due to the fact that existing legal rules do not enable certain types of assets to be used as collateral at all. As portrayed in Ivor Istuk and Ahmed Meziou’s article on the status of collateral regulations in the region, the vast majority of the countries where the EBRD invests have introduced modern collateral laws and registries (both for movable and immovable assets). However, the article also shows that the success of these reforms has not been even and that there is more work to be done on fine-tuning the developed systems or reforming the under-performing ones.

The ways in which innovative legislative concepts can help to break this deadlock by creating new types of collateral are illustrated in Stefan Antonić and Darko Jovanović’s case study on crop receipts. The authors introduce us to the almost alchemic world of creating collateral value from thin air (future outputs of agricultural production) and show us that this is possible when adequate contractual frameworks, inspections and pledge enhancement mechanisms are put in place.

Small businesses may also struggle to provide evidence of a track record, which lenders generally seek. As such, many small business owners are turning to alternative asset-based lending methods, such as sale and leaseback arrangements or other types of operating and financial leases. The importance of a supportive regulatory and legislative framework, as well as proper risk assessment techniques for leasing operations, are portrayed in Stewart K. Pirnie's article on leasing in Mongolia, where the government has committed to revising the current leasing law and further developing the leasing market.

In addition to the problem of securing long-term finance, SMEs suffer from inadequate cash flow caused by late payments, and the sale of accounts receivable (factoring services) may sometimes be the only way to give small businesses quick access to working capital. As Ivor Istuk and Miroljub Labus show in their article on improving supply chain finance in the EBRD region, factoring is experiencing a marked revival in the current economic context, boosted by the development of more sophisticated legal and technical solutions. However, a suboptimal legal and regulatory environment can limit this development.

Modern times offer the excitement of new technologies, especially when such technologies enable millions of micro businesses and individuals in the world's unbanked regions to access various financial services and hence stimulate the development of local economies. Such is the motivation behind the EBRD's support for the development of mobile money services in Tajikistan, brought to us by Sibel Beadle and Aiaze Mitha. These reforms enable individuals and small businesses to manage their bank accounts, transfer money domestically or internationally from phone to phone or to make payments using their mobile phone, thus integrating them into the modern financial world. On the other hand it remains a fact that three-quarters of the world's poorest people live in the rural areas of developing countries. Most of them depend on agriculture for their livelihoods. In a very interesting article, IFAD staff explain how innovative contract farming structures facilitate vertical integration among producers, wholesalers and retailers and help increase agricultural production and productivity, as well as strengthen the food security of rural producers and the rural poor at large.

FOREWORD

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Next to building supportive legal environments, SMEs also need know-how to improve their performance and growth. Charlotte Ruhe's article on the Small Business Support team's advisory services for small enterprises illustrates how the EBRD has been able to build expertise and experience by providing businesses with the advice they need when they need it, which could ultimately translate into growth and employment. Likewise, Lorenzo Ciari and Alan Colman's piece on the Legal Transition Team's assistance with judicial training in competition policy and its capacity-building work with competition authorities is a good reminder that SMEs also need an even playing field, which only strong regulatory institutions can guarantee.

Last but not least, the search for innovative finance mechanisms and reform support should not only focus on the end users of finance. Improving access to finance for financial intermediaries can yield even better results. For example, helping financial institutions find different solutions for refinancing their exposures to the small business sector could make them more confident and willing to invest further in the small business financing market. The viability and market appeal of one such new and innovative financial instrument is analysed by Bernd Volk in his very informative article on SME covered bonds.

Ivor Istuk and Ahmed Meziou

COLLATERAL
WHERE DOES REFORM STAND TODAY?

Laws affecting secured transactions and their implementation directly influence the availability and cost of credit and the efficiency of the market for secured credit. Whether it is a farmer who needs to borrow money to buy a tractor, an enterprise that needs credit from its supplier, or developers of a power plant who need to finance a major new project, the inability to obtain valuable and viable security over a debtor's assets is likely to discourage potential credit providers.

The primary objective of improving secured transaction laws is economic. A lender or creditor will accept a mortgage or a pledge in order to reduce the risk of losing the money that he is owed. If the law, or the way in which it is applied, does not give creditors confidence that they can recover real value from mortgaged or pledged assets, collateralising will have little economic benefit. On the other hand, a lender with legal rights to turn to his debtor's assets in case of non-payment will assess credit risk quite differently, which may influence his decision on whether to give credit or not. It may also change the terms under which the creditor is prepared to lend, either by increasing the amount of the loan, extending the period for which the loan is granted or lowering the interest rate.

The EBRD Secured Transactions Project was established in 1992 to encourage countries to update their collateral laws and also offer assistance at all stages of the reform process. In 1992 most countries in which the EBRD invested either did not have any rules on secured transactions or had outdated or inadequate rules, which did not give creditors the economic benefits that one would expect from security. In 2014, as part of its regular assessment of transition challenges, the EBRD Financial Law Unit conducted an extensive legal framework assessment to examine the practices and effectiveness of taking collateral in countries where the EBRD works (the Secured Transaction Assessment).

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"The primary objective of improving secured transaction laws is economic."

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The assessment examines the options available for securing different types of assets. In addition to security interests, which grant ancillary property rights over the asset (pledges and mortgages), the assessment also includes quasi security such as sale and leaseback transactions (finance leasing), assignment of accounts receivable and financial collateral. The assessment also looks at the processes for creating, perfecting and enforcing a security interest. The approach was based on legal efficiency methodology developed by the EBRD, which outlines the key objectives of secured transaction reforms. According to these objectives, the law should not only fulfil its basic legal function, but should also maximise economic benefits for the parties.

In other words, the assessment aims to gauge the extent to which existing legal regimes allow creditors to take security on different assets, with the view of giving secured creditors legally enforceable rights to the collateral in priority over other creditors in case of default. It also examines whether the adopted solutions fit well with the economic, social and legal context of the examined jurisdiction.

The overall results show that considerable progress has been made in collateral reform by the region as a whole in the course of the last 25 years or so. All transition countries have laws in place, which generally provide for the creation of security interests (or quasi security interests) over movable and immovable assets, and such interests tend to be publicised through a registration system. This is an interesting finding given that the region's political landscape has been very diverse, to say the least, and that reforms have proceeded at different times, under different agendas.

However, in spite of this great progress, it is also evident that the countries' legal frameworks for collateral are not equally "legally efficient", and that even the best performing systems would benefit from further improvements in certain areas. Enforcement procedures and more sophisticated instruments, in particular, would enable modern types of financing, such as security over bank accounts, syndication and grain warehouse receipts.

With regard to developing and implementing collateral law, it seems that the countries in which the EBRD invests can be divided into three main groups. The first group comprises countries that have achieved a fairly sophisticated level of development. They have modern secured transaction systems (both mortgage and pledge) that are being used in practice. This group includes countries from central Europe and the Baltic states, eastern Europe and the Caucasus, south-eastern Europe and Russia. For the purposes of this article we will use the acronym CESECBR for these countries.

The second group consists of countries that have implemented reforms but their systems, especially for security over movable assets, have not lived up to expectations due to either a lack of proper implementation capacity, poorly drafted or incomplete legal provisions, or a lack of economic activities, which has limited the development of established practices. This group includes countries from Central Asia.

The third group represents countries that joined the Bank later in the process of transition. In these countries, movable property pledges are based on variations of the French *fonds de commerce* (pledge over business assets). This group includes Turkey and countries from the southern and eastern Mediterranean (SEMED) region.

Grouping countries is always a difficult task but analyses of the status of development of legal frameworks, and the efficiency of taking collateral in general, showed more or less consistent results within the groups. There were deviations within each group (countries that are still catching up with the average or are ahead of the rest of the group) but in general it is safe to say that within groups one can find similar results across. The differences between the groups are easily identifiable when features such as scope, creation, registration and enforcement of security rights are cross-compared (see Charts 1-2).

EFFICIENCY OF COLLATERAL-TAKING AND ENFORCEMENT IN THREE REGIONS WHERE THE EBRD INVESTS

CHART 1

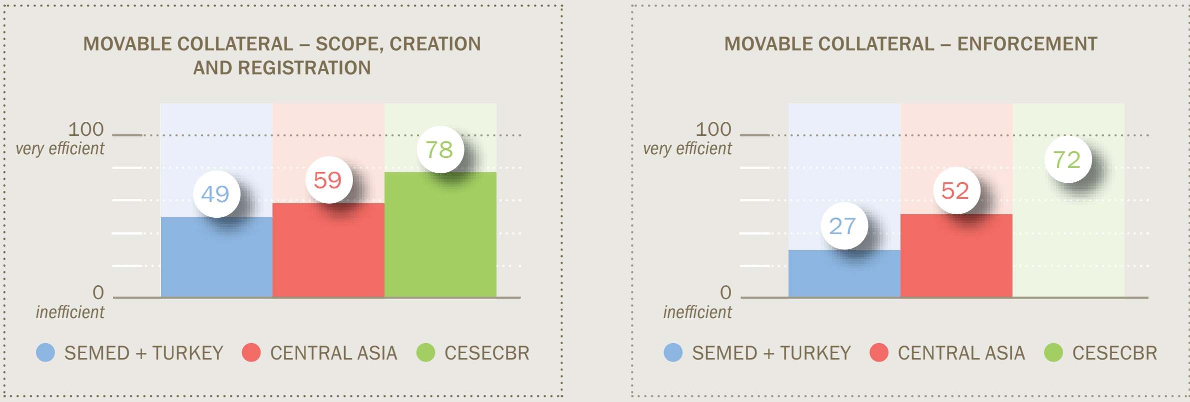
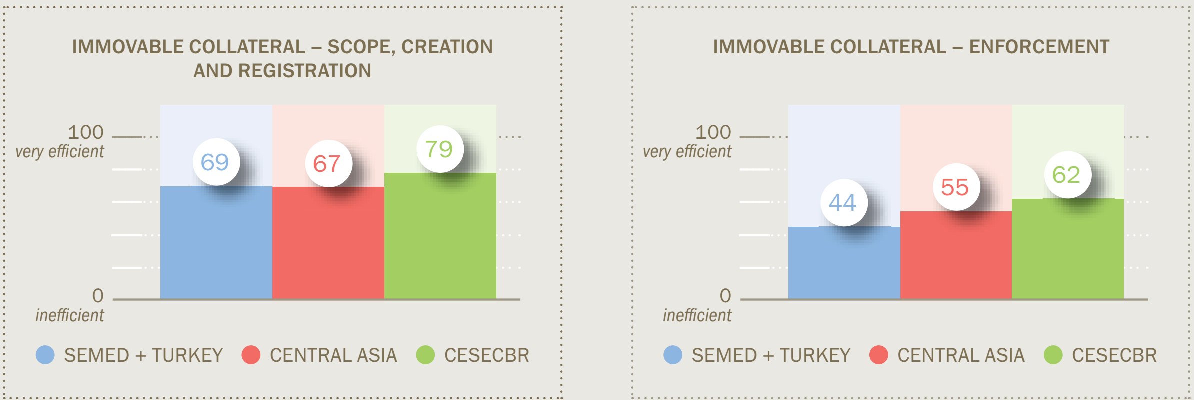


CHART 2



Note: SEMED includes Egypt, Jordan, Morocco and Tunisia. CESECBR includes central Europe and the Baltic states, eastern Europe and the Caucasus, south-eastern Europe and Russia.

Source: Secured Transaction Assessment 2014

Another interesting fact brought out by the assessment is that enforcement is the weakest area in all systems across the board. However, efficiency is correlated with the overall success of the system. Efficient legal systems in central Europe, for example, score better on enforcement overall than systems in the SEMED countries where, as mentioned, full-blown reforms have not taken place. In addition to intrinsic weaknesses in the systems, enforcement procedures have also been subject to a number of regulations that have been motivated by social concerns triggered by the financial crisis in 2008. For example, pre-pack procedures for insolvent corporates preventing or postponing enforcement of collateral in Croatia, or protection for residential property owners in Hungary by mandating grace periods before starting enforcement procedures over such properties. Work on achieving efficient, and at the same time socially sensitive enforcement regimes, will probably be the focus of any future reforms in this field.

The following section examines each group of countries in turn and analyses the findings of the assessment in further detail.

EUROPE – A SUCCESS STORY IN NEED OF FINE-TUNING

When the EBRD started working in the region in 1992 none of its countries of operations had any practical laws that allowed non-possessory security over movable assets, except for a few countries with laws that pre-dated the Soviet era, but these could not be described as efficient.[1] In addition, taking collateral over immovable property was burdened either by inefficient rules or inadequate (or, in some places, inexistent) land registers (cadastres).

These countries, supported by international financial institutions, launched ambitious and exciting reforms, involving local and international businesses and legal communities. This resulted in reformed laws and developed and/or developing institutions. Effective tools, such as centralised collateral registries, improved the accuracy of land registries. In addition, clearer, more predictable contractual rules were put in place to increase the legal certainty of financial activities.

Today most of the countries belonging to the CESECBR group have centralised land and pledge registries operating at a satisfactory level, and in some cases well above, from a user perspective. This means that financial institutions and investors can depend on a reliable source of public data when making business decisions. For example, 16 out of 23 countries in this group provide direct or indirect online access to land registries and 15 countries offer the same services for pledge registries (with 18 having introduced modern all-encompassing pledge registries).

TABLE 1 REGISTRATION SYSTEMS IN EUROPEAN COUNTRIES IN WHICH THE EBRD INVESTS

	Land Registry		Pledge Registry	
Countries	**Existence of a land registry**	**Online access to land registry**	**Existence of a pledge registry**	**Online access to pledge registry**
Albania	✓		✓	
Armenia	✓			
Azerbaijan	✓			
Belarus	✓	✓		
Bosnia and Herzegovina	✓		✓	✓
Bulgaria	✓	✓	✓	
Croatia	✓	✓	✓	✓
Estonia	✓	✓		
FYR Macedonia	✓	✓	✓	✓
Georgia	✓	✓	✓	✓
Hungary	✓	✓	✓	✓
Kosovo	✓		✓	✓
Latvia	✓	✓	✓*	✓
Lithuania	✓	✓	✓	✓
Moldova	✓	✓	✓	
Montenegro	✓	✓	✓	✓
Poland	✓	✓	✓	✓
Romania	✓		✓	✓
Russia	✓	✓	✓	✓
Serbia	✓	✓	✓	✓
Slovak Republic	✓	✓	✓	✓
Slovenia	✓	✓	✓	✓
Ukraine	✓		✓	✓

* Pursuant to Latvian law, registration requirements for collateral over movable property only apply to commercial pledges (extended by legal persons involved in business activities), which are registered in the Commercial Pledge Register.

However, the efficiency of these registries, or their reliability when checked remotely (online), differs from country to country. They range from a very successful system in Romania, to a less reliable one in Montenegro, to a system in FYR Macedonia that is still in the process of redevelopment.

Exceptions are Armenia, Azerbaijan, Belarus, Estonia and Latvia, which still have not introduced a modern all-encompassing system of taking non-possessory collateral over movable property and property rights. The development of pledge laws in these countries ranges from a very well-developed and flexible system, such as the Commercial Pledge Law in Latvia (which covers all movable assets and is almost an all-encompassing, modern legal pledge system, except that the pledge can be extended only by a legal person engaged in business), to limited non-possessory pledges over businesses (mortgages) and non-possessory pledges over registered movable property only (for example, intellectual property or ships) in Belarus and Estonia. This is not to say that these countries are standing still. Indeed, reforms are ongoing in Armenia, Azerbaijan and Belarus.

Another significant change that has happened in the region since the start of its transition relates to restitution claims for real estate and land registration. It seems that restitution claims in most of the countries have been resolved or are no longer seen as a major risk to the reliability of land registration systems (which is key for the creation of mortgages). Only in Romania and Serbia has it been reported that the process of registering land and buildings in cadastres is still seen as a potential impediment to lending.

In addition, the legal framework in countries belonging to this group does not impose any restrictions on who can extend or take collateral (except agricultural land, where the rules differ, and publicly owned residential properties). The debt can in most cases be described with enough flexibility to encompass future and fluctuating obligations (for example, revolving loans). Furthermore, we can generally conclude that the majority of the countries have achieved a very good level of satisfaction with regard to the basic legal functions of collateral laws.

Where the countries differ most and where major efforts should be invested in the future, are in areas related to specific, sophisticated products or transactions, including: the ability to use collateral managers (agents, trustees) in syndicated lending; the pledging of bank accounts; security over accounts receivable (for example, the requirement that all accounts receivable should be specifically identified when the security is created, is impractical); the extension of mortgage rights over land used to erect buildings in construction projects, and so on.

Most of the countries do not have rules that support security manager structures. This is all the more surprising given that syndicated lending is well developed in central Europe and the Baltic states, and that the alternative of parallel debt structures presents considerable legal uncertainties. Positive developments can be seen in recent legislative changes in Hungary, Romania and Russia where new civil codes introduce the concept of security managers. Meanwhile, in Serbia, laws in relation to security over movable assets have been in place for some time, and the country is currently trying to introduce similar regulations to the Mortgage Law.

As financial markets further develop and evolve, taking into account the lessons learned from the financial crisis, it is logical to expect some fine-tuning of the reforms. The challenge for market players will likely be to bring the legislators' attention to what may appear to be small gaps and seemingly insignificant problems (as the "modern" systems have already been introduced) and to secure legislative and academic approval of these changes.

SEMED AND TURKEY – TRANSFORMING THE LEGAL SYSTEM FOR SECURED TRANSACTIONS

In SEMED countries as well as in Turkey, legal frameworks for collateral have existed since the very beginning of the 20th century and are largely influenced by a combination of the French Civil Code, the Ottoman Civil Code and Islamic law.

Land and buildings are often not registered, or the property rights over them are unclear or subject to a complex and overlapping set of rules, which ultimately impedes the efficiency of mortgage lending. The strict requirement of debt specification is also an impediment, making it near impossible to secure future debts and fluctuating debt such as revolving loans.

Neither the SEMED countries nor Turkey have a modern all-encompassing law for taking non-possessory security over movable property. These countries have outdated and fragmented provisions governed by different laws and regulations, which have in most cases (except Jordan) not been reformed for many years. This makes taking security a complex and costly process as each legislation and regulation provides its own set of rules for creating, registering and enforcing security. Furthermore, the types of assets that can be used as collateral are quite limited (see Chart 3).

One of the most commonly used security instruments is security over a *fonds de commerce*. This is a legal concept originally developed under French law, which primarily targets the intangible assets that make up a business – the enterprise's commercial name, goodwill, leasing contracts, but also in some cases equipment and inventory. These elements can collectively be pledged to creditors on a non-possessory basis subject to registration.

CHART 3 TYPES OF ASSETS THAT CAN SERVE AS COLLATERAL IN SEMED AND TURKEY

	Egypt	Jordan	Morocco	Tunisia	Turkey
Fonds de Commerce	✓ [a]	✓ [b]	✓ [c]	✓ [d]	✓ [e]
Equipment and machinery			✓	✓	
Pledge of agricultural commodities			✓	✓	
Pledge of mining products			✓	✓	

a. Can include only trade name, leasing contract of the premises, goodwill, trademarks, licences and permits, furniture, machines and equipment related to the activities of the enterprise.

b. In accordance with the law concerning mortgages of movable property (Jordanian Law No. 1/2012), this type of pledge includes all the movable assets of a company/trader. There is no "cherry picking" of assets that are pledged, as this pledge is only taken when it covers all the business assets owned by the charger. This charge can include movable assets owned by the company/trader such as vehicles, airplanes, vessels, intellectual property, securities, inventory or machinery; and are subject to registration. However, according to local practitioners, the mentioned law has not yet come into force.

c. Can include only trademarks, leasing contract of the premises, goodwill, commercial furniture, machinery and equipment related to the activities of the enterprise, intellectual property and inventory.

d. Can include only trademarks, intellectual property rights, leasing contract of the premises, goodwill, commercial furniture, machinery and equipment related to the activities of the enterprise. Cannot include inventory.

e. Can include machinery, equipment, tools and motor vehicles that are used for the operation of the enterprise at the date the charge is created.

Evidence of the need for law reform is usually found when market practices develop to "circumvent" these very legal provisions. These practices can achieve the intended result, but such results tend to be legally risky and come at a high cost. For example, it seems that banks in Egypt engaged in financing small and medium-sized enterprises find that the *fonds de commerce* mortgage is too cumbersome as many of the assets that would be included into the mortgage are not sought after by the bank, 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. In addition, as the mortgage requires the agreement to be notarised and registered at a competent commercial registry, the transaction costs are disproportionately high. Therefore, banks have in some instances reverted to taking a possessory pledge over the assets they are willing to accept as collateral, and including in the pledge agreement the provision that the transfer of possession will be made to the manager of the debtor company acting as a third party for the interest of the bank (custodian).

A similar example is found in Jordan for equipment and machinery pledges, where possession is entrusted to an independent third party known as the *Adel*, which then "on-lends" the relevant assets to the pledger for its use. This may be a well-accepted practice; however, it would make much more sense to legally recognise the concept of non-possessory security 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.

Enforcement is another issue that would benefit from reform. Out-of-court enforcement is non-existent as none of the countries generally allow enforcement outside of judicial proceedings (with some exceptions, such as the pledge of bank accounts in Tunisia, or the share pledge given to Egyptian banks). When it comes to enforcement over collateral, creditors do not play any role in the process, which takes the form of a public auction, resulting in delays and devaluation of the assets below fair market prices. This is, to some extent, avoided in Turkey by fiduciary security assignments where the creditor owns the assets for the duration of the loan. The transaction has been recognised by various Supreme Court judgments, although it does not have legislative underpinning.

Due to the fact that collateral systems already exist in these countries, if and when embarking on legal reform, decision-makers may be faced with a choice between undertaking a general overhaul of the system by repealing all existing legal provisions and adopting a new single law, or amending and fine-tuning the existing legal framework. While the latter approach may seem more appealing to law-makers (since it appears to be a simpler exercise and does not require a drastic departure from existing tradition and practices) sometimes introducing amendments does not bring the same clarity that an overall reform might offer; that is, the final framework could end up being very complex and may include contradictions and loopholes.

The motive when tackling reforms should be the end result and not the complexity of the process. In this context, it is worth mentioning that Morocco is currently pursuing a general overhaul reform of its secured transaction system, supported by the EBRD, the World Bank Group and the Arab Monetary Fund.

CENTRAL ASIA – THE LONG JOURNEY OF REFORM

In contrast to the previous group, where a system of secured transactions has been in place for decades (albeit in need of reform), Central Asian countries (Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan) had to start building their systems from scratch at the beginning of their transition.

The countries underwent major reforms by adopting new civil codes, often influenced by the German tradition. These codes provided a general framework for taking security over immovable and, in some instances, movable assets. However, the codes contained some rather obsolete concepts, such as dating the opposability of a security from the moment of signing the agreement rather than on registration in a public register, as is the case in Mongolia for security over movable assets. These laws have since been amended in most cases or supplemented with specific laws on mortgages and pledges, and legal underpinning has been much improved. However, what still seems to be a major impediment is the implementation of infrastructure and/or active use of the developed systems in some jurisdictions.

For example, while Kazakhstan and the Kyrgyz Republic have introduced modern pledge registries, registration in the Kyrgyz Republic is mandatory only if debt exceeds a certain minimum threshold, and in Kazakhstan only a limited type of assets can be registered (such as rolling stock, tractors, promissory notes and securities). Mongolia and Turkmenistan do not have these registries in place and Mongolia even lacks a specific pledge law that would effectively resolve uncertainties arising from the Civil Code and provide legal underpinnings for registration. Uzbekistan has only recently introduced a registry of pledges (1 July 2014) hence no relevant practice exists yet. Tajikistan lacks a land registry, therefore information on eventual encumbrances over real estate has to be sought from the Minister of Justice, which runs a registration

system based on delivered agreements. All of this, coupled with the lack of market-based financing in some of the countries, impedes the development of these systems.

These countries are no exception to the overall finding that enforcement is lacking across the region, and almost all practitioners interviewed describe the enforcement process as cumbersome, lengthy and costly.

In addition to strengthening the building blocks of a sound legal framework for secured transactions, countries in Central Asia need to develop specific financial instruments or sectors, such as grain warehouse receipts or factoring and leasing, to improve access to finance in the region.

CONCLUSION

The 2014 Secured Transaction Assessment demonstrates that the countries where the EBRD works have achieved remarkable results in building secured transaction infrastructure over the past 25 years. Despite the fact that transition is a very slow process, sometimes even reversing, the assessment shows that the policy work of local and international stakeholders does make a tangible difference. However, it also shows that progress has not been uniform across the board and that there remains a need for tailor-made efforts in many jurisdictions.

In that sense the assessment results are encouraging, by showing what has been achieved, and at the same time can be used as a tool for working through reform agendas in the future.

> "The assessment was based on legal efficiency methodology developed by the EBRD, which outlines the key objectives of secured transaction reforms."

> "The assessment shows that progress has not been uniform across the board and that there remains a need for tailor-made efforts in many jurisdictions."

NOTE

1 EBRD Legal Transition Programme (2000), "Ten years of secured transaction reform", *Law in transition*, p. 1.

Ivor Istuk and Miroljub Labus

FACTORING AND REVERSE FACTORING REFORMS IN THE EBRD REGION

Cash is vital for businesses – to pay staff wages, purchase stock and raw materials, and meet tax obligations and other operating costs. Securing the amount of working capital needed to finance regular business cycles is one of the most critical issues facing businesses today across the world. Statistics on payment delays and bankruptcies, compiled in the Organisation for Economic Co-operation and Development (OECD) Scoreboard,[1] show that companies have difficulties maintaining cash flows because of the stalled recovery and tightening of credit markets, which is reflected in the decline in small and medium-sized enterprise (SME) loans and the increase in interest rates and collateral requirements.

"On the demand side, SMEs are the main target group for factoring and reverse factoring."

The European Union's review on SME performance[2] concluded that banks now require substantial guarantees as they must comply with a number of new regulations, such as Basel III. SMEs find it difficult to provide required guarantees as they rarely have assets available for collateralisation (long-term assets have often been leased or are already encumbered by a previous bank loan).

In addition, SME suppliers are usually required to offer trade credit to their large buyers and to hold accounts receivable on their balance sheets, which increases their working capital funding problems as they typically lack available cash. Factoring, as a financial service based on the sale of accounts receivable, is a useful financing tool because it allows for quick access to working capital for SMEs, off the balance sheet (in certain cases), and usually at a better rate than a short-term unsecured loan because it is priced against the often better credit standing of SME customers than that of the SME.

Despite having been used for decades, factoring is experiencing a marked revival in the current economic context, boosted by the development of more sophisticated legal and technical solutions.

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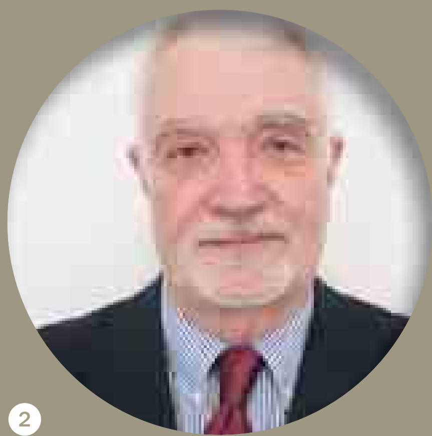

2

"The EBRD has been involved in the promotion of factoring services for businesses through its Trade Facilitation Programme for some time and the Bank's Financial Institutions Team has been investing in the development of factoring businesses."

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The EBRD has been involved in the promotion of factoring services for businesses through its Trade Facilitation Programme for some time and the Financial Institutions Team has also been investing in the development of factoring businesses. With the development of factoring operations in the EBRD region, it has become increasingly clear that the suboptimal legal and regulatory environment limits the development of factoring, which in turn undermines the Bank's efforts in promoting factoring.

While the assignment of accounts receivable – the core of factoring from a legal perspective – is legally possible in countries where the EBRD works, the legal provisions of general laws (civil codes, obligations acts, and so on) are not always tailored to the needs of factoring services. This can increase factoring transaction risks (for example, courts redefining recourse factoring transactions as secured lending, which limits the rights of the factor if the client goes bankrupt) or limit the scope of factoring transactions (for example, no validity of assignment of future claims).

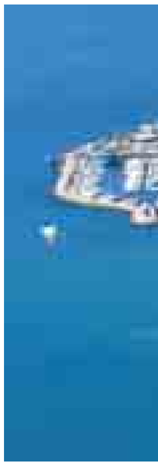
As a result, the EBRD Legal Transition Team set up the Factoring Legal Development Programme, which supports legislative reforms in order to create a more enabling legal framework for factoring activities. Work on the legal framework consists of introducing concise rules to encourage the development of factoring services by raising the legal certainty of factoring transactions. In broad terms, the legal framework should: (i) define the factoring (framework) agreement as a contract of its own kind; (ii) provide clear definitions of the different types of factoring; (iii) allow for simple and clear assignments of present and future accounts receivable; and (iv) ensure the legality of factoring by electronic means. The tax treatment of factoring activities should also be conducive to the business.

The Factoring Legal Development Programme targets countries where the Bank has already invested, where expansion of activities is planned in the near future or where the EBRD's comparative advantage in leading the work would be best leveraged by future investments in the sector. In this article we will demonstrate how the Bank's efforts through technical assistance resulted in the enactment of a factoring law in Croatia and we will present the results of a feasibility study in establishing a reverse factoring programme in Serbia.

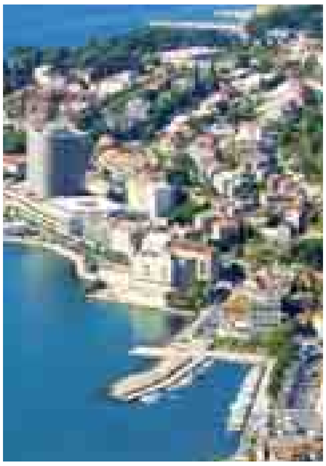
LEGISLATION REFORM ON FACTORING IN CROATIA

With the development of factoring companies in Croatia, certain legal issues have become more prominent and have required special legislative attention in order to increase efficiency and decrease the legal uncertainty of factoring. The purpose of introducing the new law was to facilitate the further development of factoring services by creating a sound, clear and predictable legal framework tackling the abovementioned issues and introducing meaningful oversight that guarantees the stability and legitimacy of the industry (that is, ensuring that the market players are well-established commercial entities capable of meeting certain regulatory requirements).

Some of the essential features of the law include: (i) the definition of a factoring (framework) agreement as a contract of its own kind; (ii) clear definitions of the different types of factoring services, including recourse and non-recourse factoring, as well as a definition of the supply (reverse) factoring agreement; (iii) facilitation of simple and clear assignments of future and/or multiple accounts receivable; (iv) recognition of the nature of factoring as a sale transaction; (v) legality of factoring by electronic means; (vi) licensing and minimum initial capital requirement of not less than 1 million kuna (€150,000 equivalent) paid in cash in full prior to formation; (vii) no capital adequacy requirements (respecting the systemic low-risk nature of factoring); and (viii) clear rules and procedures for supervision (authority, reporting measures, and so on).



"The Factoring Legal Development Programme targets countries where the Bank has already invested, where expansion of activities is planned in the near future or where the EBRD's comparative advantage in leading the work would be best leveraged by future investments in the sector."



In "ordinary (classic) factoring", the SME sells individual accounts or its complete portfolio of receivables from multiple buyers to a single factor. Many factors will only purchase complete portfolios of receivables in order to diversify their risk to any one seller. However, this diversified portfolio approach requires factors to collect credit information and calculate the credit risk for many buyers, which is labour-intensive and costly. One solution to this is a specific type of factoring often referred to as reverse factoring (now regulated in the new law).

In reverse factoring, the factor purchases without recourse (basically pays out) accounts payable only from well-known, high-quality buyers. The factor's credit risk is thus based on the default risk of the high-quality customer, not on the more risky SME. Under pre-agreed conditions, the buyer accepts the supplier's invoice by confirming the delivery of the supplier's goods and then transfers the invoice to the financier, who will assume the debt under the invoice and pay the supplier, discounting the invoice for an early payment rate based on the buyer's credit standing. On the due date the buyer pays the financier. Hence, reverse factoring serves as a mechanism to mitigate the adverse effects of information asymmetry on the supplier's (SMEs) cost of finance, thus lowering the costs of working capital financing for SMEs.

Reverse factoring schemes are made even more efficient owing to the establishment of online platforms where the buyer can register its approval of the supplier's invoice on an information system that is accessible to all three parties (supplier, buyer and interested financiers) and thanks to the automatically generated financing conditions, the

SME supplier is just one click away from the money being transferred to its account. Following the successful example of a reverse factoring platform in a developing country (Nacional Financiera, a development bank in Mexico), the international financial community is currently looking into the possibility of replicating it.

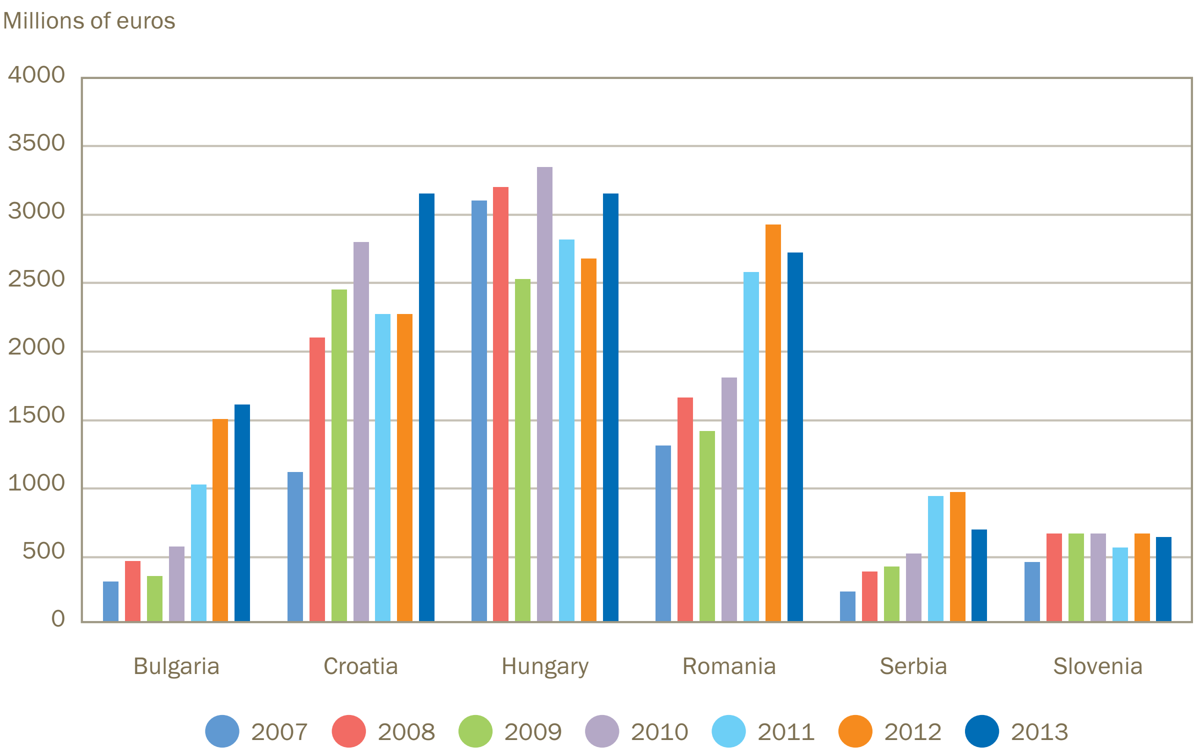
The Croatian Factoring Act was enacted in July 2014 and it will be interesting to see whether, and in which form, factoring will develop in the Croatian market in the future. However, what is certain is that providing a comprehensive legal framework underpinning factoring services was a positive step towards further developing the Croatian financial sector.

POTENTIAL FOR DEVELOPING A REVERSE FACTORING PLATFORM IN SERBIA

Serbia enacted its Law on Factoring in 2013, providing for the first time definitions of various factoring products, establishing rules for factoring of receivables and introducing regulations for factoring providers. The law also defined reverse factoring as a special type of factoring. The notion of reverse factoring is new to the Serbian financial system, while traditional factoring has a much longer history. Under the right conditions the reverse factoring market has great potential in Serbia.

Traditional factoring developed rather spontaneously over the last decade despite many uncertainties and a lack of legislation, which created a mixture of financial instruments based on elements of factoring, reverse factoring and discounted promissory notes. There were particular doubts whether state-owned enterprises (SOEs) and public entities (Serbian budget beneficiaries) struggling with liquidity constraints were eligible to conduct

CHART 1 FACTORING VOLUME IN SELECTED COUNTRIES



Source: Factors Chain International, Annual Review, 2014.

factoring and reverse factoring operations. They could potentially constitute a significant market, since the public sector in Serbia still comprises 40 per cent of the country's GDP. In addition, at the time, many markets for goods and services had oligopoly structures, where large buyers exercised strong market power and set favourable terms for purchase contracts, including informal extensions on the payment period beyond the due date. Unsurprisingly, many small and medium-sized suppliers experienced cash flow constraints and the government responded by introducing the Late Payment Law to cut late payments (without much success) and the Law on Factoring to facilitate the development of factoring services.

The factoring law came into force in 2013 and it seems that this helped to shape the early development of the reverse factoring market. However, reverse factoring still comprised only 3 per cent of the total factoring volume in 2013 and it is logical to conclude that there are other obstacles that prevent this market from developing faster in Serbia. In order to identify these obstacles, we need to study the factoring market in Serbia in more detail.

The data show that Serbia is lagging behind regional peers in factoring transactions. Chart 1 provides information on the volume of factoring turnover over the past seven years in Serbia and its neighbouring countries. Serbia and Slovenia have on average a factoring volume below €1 billion annually. Bulgaria has a slightly higher volume, while Croatia, Hungary and Romania approach €3 billion. All countries, except Slovenia, reveal an upward trend in factoring turnover, with some downward pressure in Hungary over the last three years, and Serbia this past year. Compared with its neighbours, Serbia still has a lot of room for improvement, and widening the factoring base through reverse factoring structures (by actively involving big buyers) may be an important opportunity for the country.

For example, mainly large companies are involved in factoring transactions in Croatia. This explains the remarkable level of factoring turnover in this country. Quite the opposite in Serbia, where only SMEs participate (that is, start the process) in factoring. The law in Serbia precludes public entities from engaging in reverse factoring, but SOEs – a significant part of the Serbian economy – are free to engage in both factoring and reverse factoring transactions.

As mentioned, factoring practices in Serbia are still built on the mostly individual initiative of SME suppliers, as depicted in Chart 2. Standard reverse factoring schemes, on the other hand, require the active involvement of the buyers with factors, as presented in Chart 3. A switch from one chart to the next shows the path Serbia needs to take in order to boost reverse factoring operations.

CHART 2 FACTORING IN SERBIA

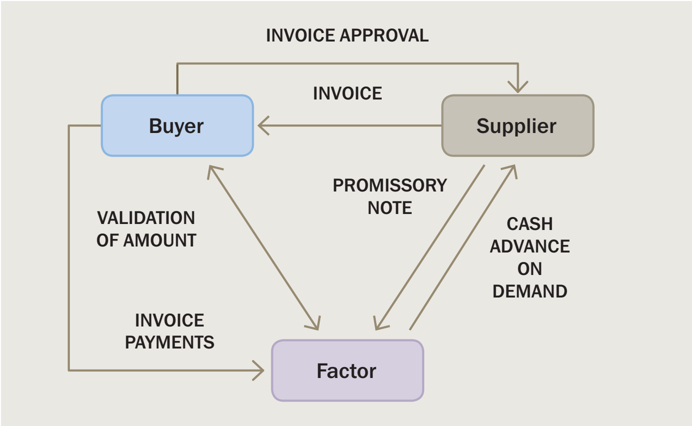
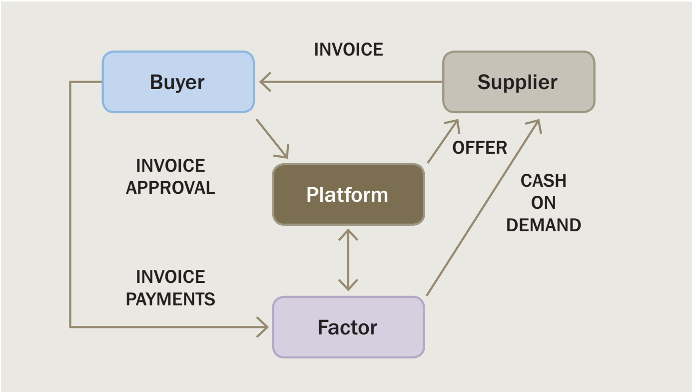


CHART 3 REVERSE FACTORING SCHEME



Serbian SMEs have lower credit ratings than large buyers and have difficulty accessing the market to finance working capital, and therefore pay higher interest rates than their trading counterparts. In addition, under the currently prevailing factoring scheme, they take the complete risk in factoring receivables under unfavourable terms because the majority of factoring is done with recourse (guarantee for payment). This harms the business. As such, it makes sense to switch from factoring to reverse factoring if one wants to improve supply chain finance in Serbia.

A typical reverse factoring process is started by the buyer. In this way the buyer shows that it cares about the supply chain and that it is ready to help suppliers access liquidity at favourable terms (based on its credit rating) before the invoice due date. In order to start the process, the buyer must make the first move and agree to an open credit line with the factor on behalf of its suppliers. Since the large buyer guarantees invoice payments, the factor may be ready to pay on demand the full amount of receivables. Under Serbian law this implies that the supplier must agree to assign the debt to the factor in a reverse factoring transaction. It is deemed that such consent is given if the supplier demands cash payments from the factor.

The benefits for large buyers participating in reverse factoring schemes are manifold. By keeping their suppliers liquid, large buyers can ensure regular delivery of goods and services. In addition, not only can the company ask suppliers for longer invoice payment terms and discounts for early payment (*cassa sconto*), but it also does not have to deal with collecting and managing receivables and getting frequent requests from suppliers for early payment, which all reduce operational costs.

Reverse factoring also has benefits for factoring companies, such as a stable income and a large volume of transactions. Factors have an excellent source of income over a long period of time. Compared with doing business directly with SMEs, reverse factoring generates higher transaction volumes, which would not be possible in case-by-case transactions with small companies.

The development of an online reverse factoring platform requires certain favourable legal and market conditions. All interested buyers, suppliers and factors must sign an agreement, which defines legal and operational terms under which the platform operates. If an agreement is signed, the buyer can then post the approved invoice on the platform after it receives goods and services from the supplier. By doing so, the buyer fully commits to paying the invoice amount on the due date to any one factor which may, in the meantime, purchase the invoice from the supplier. This means that suppliers can access the platform to select which invoices they want to have paid to them earlier than dictated by the standard payment terms. However, they will only receive the money if and when factors accept the discount terms. Factors not only assess the credit rating of the large buyer, the payment period and other conditions of the contract, but also propose invoice discount terms to the supplier. Competition between factors will set the proper discount rate. General legal conditions for this exist; nevertheless, a specific by-law regulating detailed aspects of the trade should be enacted.

The supply side of the financial market is vulnerable to insolvency in the real sector, which constrains banks' exposure to factoring companies and SMEs. The share of non-performing loans (NPLs) to gross loans in Serbia reached 21.4 per cent in 2013 and further increased to 23 per cent in the second quarter of 2014. The corresponding figures for short-term loans are 34 per cent in the corporate sector and 25 per cent in the sole proprietor sector (all of which are SMEs). However, despite the banking sector facing significant levels of NPLs, it nonetheless has the required level of loan loss reserves and is well capitalised. Provisions to potential losses were 116 per cent in the second half of 2014, while the capital adequacy ratio stood at 20.4 per cent. The structure of financial assets and liabilities is dominated by short-term deposits and short-term loans. New investments primarily depend on inflows of foreign capital, which are expected to be below the historical average this year. Financial assets are highly euroised with more than 70 per cent of loans and deposits being either in euros or indexed in foreign currency. A moderate financial depth and higher risks in the financial system as a result of this situation call for additional funding of supply chains.

In 2014 the government provided interest rate subsidies for working capital loans scheduled to affect €2 billion worth of placements. However, these opportunities are far from being fully realised owing to the reluctance of SMEs to apply for subsidised loans as they do not have guarantees that large buyers will fulfil their payment obligations on schedule. Large buyers are struggling to find customers due to low consumer demand and are therefore trying to transfer the burden of adjustment to their suppliers. The pressure is not only on price discounts, but also on the extension of payment periods. The payment period is regulated by the law to a maximum of 60 days, but this obligation is rarely obeyed in practice. The consequences are silent breaches of contracts that could jeopardise long-term trade relationships between buyers and suppliers. For these reasons it may be wise to consider channelling a portion of the subsidies towards the development of a reverse factoring market.

On the demand side, SMEs are the main target group for factoring and reverse factoring. SMEs are unable to raise sufficient financing for their working capital and are forced to pay high interest rates. According to our study, the average interest rate in factoring agreements in terms of hard currency (without exchange rate risk) was 9 per cent annually in 2013 and 7 per cent in 2014. In terms of Serbia's local currency (the dinar), large buyers offer premature contract payments at 3 per cent monthly, while factoring companies charge on average 2 per cent monthly. This has not changed much in 2014, even with the annual inflation rate dropping to 2 per cent.

Based on interviews conducted with a wide range of stakeholders in Serbia, a SWOT matrix for reverse factoring was carried out in 2013, the results of which are presented in Table 1. According to the

NOTES

1
Financing SMEs and Entrepreneurs 2013, an OECD Scoreboard, available at: www.oecd.org/cfe/smes/Scoreboard_2013_extract_chapter2.pdf (last accessed 3 December 2014).

2
Progress on the implementation of SBA in Europe 2012-2013, European Commission, August 2013, available at: www.ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2013/summary-paper_en.pdf (last accessed 3 December 2014).

TABLE 1 SWOT MATRIX FOR REVERSE FACTORING

	Strengths 4.17		Weaknesses 2.51
4.31	Improving liquidity	2.50	Inefficient legal system
3.91	Delivery on time	2.43	Weak internet access
	Opportunities 4.04		Threats 2.80
4.28	Boosting activity	2.80	False warranty
3.59	Providing employment	2.67	Increasing risks and fraud

Note: A SWOT analysis (alternatively SWOT matrix) is a structured planning method used to evaluate the strengths, weaknesses, opportunities and threats of a project or business venture.

Source: Reverse Factoring Study in Serbia, commissioned by the EBRD and conducted by Belox Advisory Services, Belgrade, 2014.

expressed views, strengths are higher than weaknesses (average score 4.17 against 2.51) and opportunities are greater than threats (average score 4.04 against 2.80). Stakeholders see inefficient legal systems as the main weakness of the proposed reverse factoring project and identified false warranties as the main threat for it. On the other hand, they unanimously agree that the strengths and opportunities of reverse factoring lie in improving liquidity and boosting activity, respectively.

From all analysed data it can be concluded that if an online platform were created and the government initially supported reverse factoring transactions by introducing SOEs to the platform and/or offering subsidies, the market could further develop on its own.

CONCLUSION

Despite having been used for decades, factoring is experiencing a marked revival in the current economic context, boosted by the development of more sophisticated legal and technical solutions. However, a suboptimal legal and regulatory environment can limit the development of the service, which in turn undermines the Bank's efforts in promoting factoring. As such, the EBRD Legal Transition Team set up the Factoring Legal Development Programme, which supports legislative reforms to create a more enabling legal framework for factoring activities. The Bank has supported factoring reforms in Croatia, Montenegro and Serbia, with plans to expand activities in Armenia, Turkey and other countries in which the EBRD invests in the near future.

Charlotte Ruhe

PREPARING SMES FOR ACCESS TO FINANCE: CHALLENGES **IN SEMED COUNTRIES**

Access to finance for small businesses continues to be a top priority for economic policy-makers across European countries and emerging markets. The financing gap between the resources available to small businesses and the funds they need to expand is large and growing. At the EBRD, we have a powerful toolkit to help fill this gap, including a wide array of financial instruments, such as factoring, which is discussed in this journal. Providing small and medium-sized enterprises (SMEs) with the know-how they need to improve their performance and boost growth is another important instrument in the EBRD's toolkit.

Finance alone often cannot meet the challenges faced by SMEs. Companies encounter a variety of problems that need to be addressed before they can even consider seeking external financing. These include a lack of reliable information on their operations, the need for a state-of-the-art, customised management information system and trained staff to use it to full effect. With this information available to SMEs, management can see where they can most profitably allocate resources and where they may need to cut back. Typically, a firm that installs a basic management information system soon sees the benefit of further advice in areas such as enterprise resource planning, human resources management, accounting, and so on.

SMEs also face other problems which are more complex. For example, family-owned firms may need modern corporate structures with formalised roles and responsibilities, or they may need to ensure their manufacturing facilities meet good manufacturing practices in order to sell their products in the European Union or other international markets. To assist them with this, we offer many complex services and types of advice. Without such support, many firms stand little chance of qualifying for financing. However, with good advice from local consultants or international experts, SMEs can become more competitive and have a better chance of qualifying for financing, whether from local commercial banks, a private equity fund or the EBRD itself.

“The EBRD has been helping small and medium-sized enterprises access advice since 1993 through its Small Business Support (SBS) team and has assisted some 15,000 enterprises in over 30 countries.”

“With good advice from local consultants or international experts, SMEs can become more competitive and have a better chance of qualifying for financing, whether from local commercial banks, a private equity fund or the EBRD itself.”

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The EBRD has been helping small and medium-sized enterprises access advice since 1993 through its Small Business Support (SBS) team and has assisted some 15,000 enterprises in over 30 countries. Currently operating in 25 countries in which the EBRD works, the SBS programme is funded by a wide range of donors and delivered on a cost-sharing basis to SMEs. Our advice is tailored to the specific problems faced by the enterprises with which we work. Advice is provided either through local consultants, which are trained and screened by the SBS team to ensure they are capable of delivering the advice needed, or through international experts with many years of experience in the same industry as the client company. In order to ensure that the quality of local advice is comparable, whether delivered in the Kyrgyz Republic or Romania, we have developed a suite of training courses for local consultants to build a sustainable network of support for SMEs on the ground in each country.

One year after completing each project, we return to measure changes in the client's business performance. Results show that within a year of a project ending:

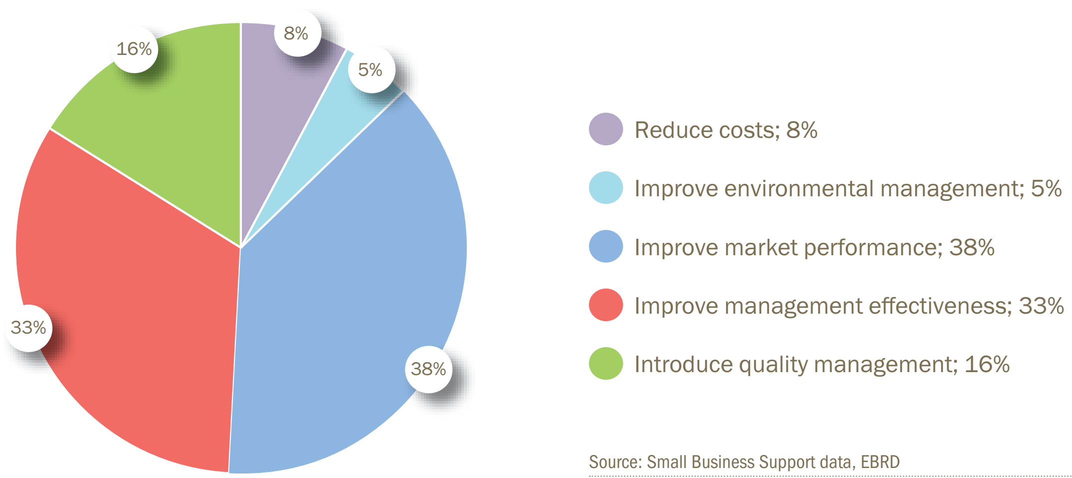
- 77 per cent of our clients increase their turnover by an average of 23 per cent and improve their productivity by an average of 8 per cent
- 57 per cent create new jobs, increasing their employee numbers by an average of 14 per cent (in 2013 alone, our clients created nearly 10,000 jobs)
- 17 per cent secure external financing.

Clearly, advice has a positive impact on enterprise performance. In order to achieve these results, the Bank starts by performing integrity checks and due diligence on the clients before each project is undertaken. We have well-tested monitoring and evaluation procedures. From the outset, we are clear about the results expected from each project, which is carried out with carefully prepared terms of reference and monitored closely to ensure that we are on track to deliver the anticipated results. We then benchmark our projects against industry trends and market developments to ensure that our advice is getting results consistent with global best practices, and adapt them if they are not.

As shown in Chart 1, over one-third of the EBRD's advisory project portfolio has been aimed at improving market performance. This is explained by the fact that smaller businesses operating in a competitive environment have to invest a lot of effort towards improving their marketing strategy, finding new business partners and searching for viable investment opportunities before they can apply for finance.

About 33 per cent of projects aim to improve management effectiveness. Many growing businesses acknowledge that they need advice on how to improve their organisation to be able to deal with the challenges of further growth. Greater employee numbers and increased output levels complicate resource management and supervision, which creates the need to introduce automated

CHART 1 ADVISORY PROJECTS BY OBJECTIVE



Source: Small Business Support data, EBRD financial and management information systems that will also provide accurate financial information to potential financiers.

Local companies show a high interest in quality management systems and certification, which is mainly motivated by the pressure they face to seek new markets in countries where product certification is expected and to comply with the requirements of clients, partners and suppliers. At the same time, businesses that implement quality systems are driven by the need to improve their organisational structures and to reassure clients of their ability to consistently provide high-quality products or services. Any bank will appreciate seeing this trait in a borrower.

Cost-reduction studies make up the fourth largest group of SBS advisory projects. Obsolete and deteriorating SME production facilities are low in efficiency and hence do not generate a high return on assets. Capital expenditure funding (following advisory projects focused on manufacturing automation, business process optimisation and engineering solutions) generally leads to increased operational efficiency and turnover.

The smallest share of SBS advisory projects (5 per cent) focuses on improvements in environmental management. Such projects range from performing environmental audits and impact assessments to implementing sophisticated environmental management or engineering solutions, and they demonstrate the increasing importance that these considerations have in the business environment.

As illustrated below in the Healthy Mushrooms case study, external advice positively affects sales, productivity and ultimately profitability in a number of ways. Market research and branding open up new markets and help to increase sales. Feasibility studies and business plans prepared by industry experts ensure that the goals are realistic and achievable, so that associated investments are successful. Energy and other resource efficiency projects save money, while environmental projects reduce waste disposal costs. A successful strategy provides a clear roadmap for day-to-day operations to avoid wasting resources on business areas that have not been vetted and agreed upon.

A case in point is Aroghj Sunk (translated as "Healthy Mushrooms"), an Armenian mushroom production company founded in 2004. The business has three mushroom farms producing around 200 tonnes of fresh mushrooms monthly, which are delivered to stores, supermarkets and restaurants across Armenia. The EBRD's first engagement with the company was through a marketing project with a local consultant in 2008. The project aimed to develop a corporate identity and brand to help the company compete in a market dominated by imports. A year after the project ended, turnover had increased by about 64 per cent and the company began exporting to Georgia.

As the company continued to grow, they realised they needed to upgrade their internal management systems. An international adviser and agribusiness specialist from Ireland designed and helped the company install a management information system, and also developed a marketing and sales promotion plan to increase exports and foster foreign match-making. After this engagement, Aroghj Sunk applied for a loan from the EBRD's Medium-Sized Co-Financing Facility, through a credit line with HSBC. The company already produced its own compost for growing mushrooms and wanted to expand this production by building a new production site. To access the loan, they needed to bring their financial statements in line with international financial reporting standards. The SBS team helped them work with a local audit firm to accomplish this task. The company received a loan for €8.6 million and is currently working on a second project with an international adviser from Italy to upgrade its new production facility to international standards, thereby raising the quality of their product and increasing their output capacity. In total, since the first project in 2008, turnover and gross profits have risen by approximately 438 per cent and 171 per cent, respectively. Their exports have also increased by €1.72 million, and through import substitution the company has gained an impressive market share.

For firms, successfully engaging external advice also shows important qualities to future financial investors – that this is a firm managed by people who are serious about its future, who invest time and money to improve operations and who are willing to make important changes to their business.

External advice takes many forms. While contemplating granting a loan to Borges, a major olive oil producer in Tunisia, the EBRD helped the company to work with an international expert that trained Borges' suppliers in agricultural best practices, enabling the company to better ensure high-quality olives and higher-quality oil. By improving machine maintenance and quality controls for temperature and product integrity, the company was able to guarantee the colour and texture of its olive oil, thereby increasing its competitiveness.

While the operational results from advisory projects are very strong, statistics show that the impact of Small Business Support advisory assignments on access to finance is less dramatic. This is, in part, the result of the short period (one year) between the completion of the advisory project and its evaluation. Anecdotal evidence among the firms financed directly by the EBRD shows that getting external financing takes time. Many of the firms that have been financed by the EBRD in Central Asia, eastern Europe and the Western Balkans had their first advisory assignment 3-5 years prior to receiving financing.

This may also relate to the difficulties SMEs face in accessing finance in the traditional EBRD region.[1] Since 2008 finance in commercial banks has been tight and economic growth has been subdued in much of the region compared with the previous period (2003-08). Many small firms have delayed investment due to economic uncertainties. Of those that are investing, many rely on their own internally generated resources to grow their businesses.

In the southern and eastern Mediterranean (SEMED) countries, the situation for SMEs wishing to access finance is even more challenging. The EBRD started working in Egypt, Jordan, Morocco and Tunisia in 2012. Advisory programmes were also introduced in the four countries that same year. While the SEMED region already had a rich tapestry of assistance programmes for SMEs, there was clearly a need for an efficiently delivered and tailor-made approach. The Bank also put a special emphasis on Advice for Agribusiness, a programme that aims to provide advisory services to help local agribusiness companies prepare to access finance directly from the Bank. Overall, the EBRD's advice for small and medium-sized businesses has been met with substantial demand from the start.

There are a few significant differences in the SEMED markets compared with those in the EBRD's traditional region. According to the 2012 Business Environment and Enterprise Performance Survey (BEEPS V),[2] 36 per cent of small businesses in Jordan perceive access to finance as a major or very severe obstacle to their operations. In Egypt this figure is slightly lower at 30 per cent; however, only 11 per cent of small businesses have a line of credit or a loan from a financial institution, whereas in Jordan this figure is 22 per cent. Across all the countries in the traditional EBRD region, the percentage of businesses with credit or loans from financial institutions is significantly higher, at 35 per cent on average.

Informality in the SEMED region is an even bigger concern compared with the countries in which the Bank has been working for more than 20 years. Until firms register formally, pay their taxes and account for all of their employees, it will be very challenging for them to gain access to finance. Of those firms operating in the formal sector, it is a very common practice for firm owners to diversify their risks and opportunities by establishing new companies for different (but often related) lines of business. This makes it difficult for any financial partners to be sure that money provided to one company will not be transferred to another firm with the same owner. Transfer pricing and overall lack of transparency reduces the chance that such firms will qualify for bank loans or gain the interest of a private equity firm.

Financial institutions are generally more risk-averse than in south-eastern and eastern Europe, where collateral requirements for SMEs are often in the range of 300 per cent. In addition, long-term investment loans are difficult to obtain. Sometimes the terms and conditions of working capital loans are not sufficiently attractive, leading firms to approach the EBRD for a range of financial products.

A key issue on the supply side is that the banking sector remains highly concentrated and banks have few incentives to tailor financial and lending products to SME needs. The reason that nearly 20 per cent of small businesses in Jordan have not applied for new financing is due to complex application procedures or unfavourable interest rates. In Egypt 16 per cent of SMEs reported similar issues.[3] Indeed, according to the Organisation for Economic Co-operation and Development,[4] credit guarantee schemes and other sources of financing, which can play important roles in easing access to bank lending, remain insufficient and have been constrained by political instability across the region.

For the company Pharaoh-Tech, an Egyptian electrical engineering systems producer (air conditioning, security and fire-safety systems), accessing finance presented a great challenge. The company, which has around 40 employees, was looking to expand by producing their own parts rather than sourcing them externally. An advisory project to develop a feasibility study was a great step forward as it reaffirmed the market demand and confirmed the viability of the project, but that alone was not enough to attract financing in a difficult banking environment.

In Morocco we helped Citruma, a leading juice producer known for its widely recognised brand name, Marrakech, to obtain a €3.6 million mezzanine loan from the EBRD in November 2013. The mezzanine structure provided long-term resources and the flexibility needed to support the firm's objectives. However, before the investment took place, an advisory project was carried out to help Citruma's management improve their product development process, engage with new foreign customers and suppliers, and improve management effectiveness. This helped the company become a more credible banking client.

Citruma is a medium-sized company with annual sales expected to reach €11 million in 2014. However, at the other end of the spectrum are the micro and small firms that are wary of approaching financial institutions. Since it starting investing in SEMED, the EBRD has made a number of loans to financial intermediaries in the region. Among these are the National Bank of Egypt (NBE) and the Microfund for Women (MFW) in Jordan.

The MFW was established as a non-governmental organisation and is now the largest microfinance institution in the country as measured by number of clients (30 per cent of market share) and the second largest by gross loan portfolio (13 per cent of market share), with total assets worth US$ 47.3 million. The MFW reached 100,000 clients in 2013 and has received a US$ 4 million loan from the EBRD to enable it to better finance its client base, which has grown beyond the micro segment. Enterprises seeking loans above €10,000 but below €70,000 face difficulties in accessing finance from banks that impose excessive collateral and burdensome lending procedures. The Jordanian Department of Statistics estimated that, in 2010, 83 per cent of SMEs in Jordan were in the trade and services sectors, and only 14 per cent were in the industry sector. Service sector enterprises often lack real estate and other tangible collateral that banks seek when extending loans. This is even truer for women entrepreneurs and means that access to physical assets, which serve as a basis for loan assessment, is limited. In contrast, the Microfund for Women relies on client knowledge, lending methods based on cash flow and a fast response time, which SMEs need.

The EBRD disbursed a €50 million loan to the National Bank of Egypt, a state-owned commercial bank, for on-lending to SMEs. The NBE has also taken out a further loan for on-lending to women-led businesses, which the EBRD is providing as part of a Women-in-Business package combining finance and advice for women. This product has been developed over the course of 2014 and involves donor funds to compensate for the lack of collateral that is often a barrier to women-led businesses gaining access to finance. Together with a loan from the EBRD and advice for women entrepreneurs, the programmes will provide a suite of training courses (covering financial literacy, leadership skills, online marketing, and so on), as well as access to mentoring, networking, and for those identified as high-potentials, coaching opportunities. In addition, advisory services through local consultants and international experts will be made available. The National Bank of Egypt is an important first mover among commercially operated financial institutions in this field.

At present, the Bank is already offering similar assistance to women-led enterprises in cooperation with the Social Fund for Development in Egypt. Under this programme, the Bank is working with the Egyptian Business Women's Association and the Arab Women Investors Union on networking. In the past 14 months, some 133 women entrepreneurs in Cairo, the Nile Delta and Upper Egypt have attended awareness-raising events, where they have benefited from business diagnostics and have been given advice on areas where their businesses need improvement. Over the same period, the Bank completed projects to help about 35 of those entrepreneurs advance their businesses. One of these firms, Dallah Misr, is a table oil manufacturing company owned and managed by a woman. The Bank assisted the firm in implementing a computerised financial control system, making the flow of information easier and more accurate, thereby enabling management to take a strategic decision on the expansion of the company's operations.

NOTES

1 These countries include all of the Western Balkans, central and eastern Europe, and Central Asia.

2 BEEPS are implemented in all Mediterranean and North African (MENA) countries. Currently, data are only available for Egypt and Jordan.

3 EBRD-World Bank (2012), Business Environment and Enterprise Performance Survey (BEEPS V), EBRD-World Bank-EIB, Middle East and North Africa Enterprise Surveys (MENA ES).

4 OECD (2014), *Financing SMEs and Entrepreneurs 2014: An OECD Scoreboard,* Paris.

5 International Finance Corporation (2012), *Why Banks in Emerging Markets are Increasingly Providing Non-Financial Services to Small and Medium Enterprises*, Washington, D.C.

The Bank has had to overcome some critical challenges to bring this work to fruition. SME owners in general, and specifically women-led enterprises in remote regions, are not often aware of the importance of business advisory services to grow their companies. As such, the Bank has held a number of small, carefully targeted visibility events and meetings to raise awareness on the benefits of accessing the know-how companies need in order to grow. As a result, half of the projects in Egypt are with enterprises based outside of Cairo.

According to a 2012 study conducted by the International Finance Corporation,[5] "such [advisory] services have the potential to help SMEs become more bankable, increase their ability to repay loans and improve their business practices to grow their enterprises".

A common issue for the EBRD – not in any way unique to Egypt or SEMED – is the lack of qualified local consultants in some countries and in many provincial regions. To address this, the EBRD has developed the Grow Your Consulting Business training series, a set of six courses which offer local consultants the opportunity to develop their skills. The courses cover a range of critical skills for consultants and offer those with better established practices the opportunity to develop their project management, diagnostic or marketing skills. The courses are offered in all of the countries where the EBRD gives advice to small businesses. Consultants participate on a cost-sharing basis and the courses are presented in the local language wherever possible. In addition, we have developed courses to help consultants learn specialised skills, such as offering export promotion advice and conducting energy audits (which requires engineering skills to participate).

By transferring this important knowledge, the EBRD is building the skills base required for SMEs to access quality local advice. In addition, we are working with local organisations to improve their capacity to manage programmes similar to those offered by the Bank's Small Business Support team. In Croatia the Bank has been working alongside HAMAG Invest to share information about best practices for advising small businesses. After a year of collaborating with the Bank, HAMAG Invest will continue to offer advice to small businesses while the Bank will concentrate on offering advice for women in business. Naturally, an exit strategy like this requires strong local administrative capacity and well-developed local skills. Over time, the Bank anticipates providing similar capacity-building support to ensure that this advice is sustainable in other markets, while also focusing its attention on the countries in which skills need further improvement.

Based on our activity in the SEMED region over the past couple of years, it is clear that the gap in access to finance for SMEs is significant and that the need for advice is equally substantial. Hence, the Small Business Support team intends to be active in the region for quite some time to come.

Stewart K. Pirnie

DEVELOPING LEASING AS A FINANCING TOOL IN MONGOLIA

With a population of less than three million people (35 per cent of which live in the capital Ulaan Baatar) and a land mass three times the size of Spain, developing the leasing sector in Mongolia is not an easy task. It is, however, possible with the correct products and an aggressive approach to the market. The fundamental problem, at the moment, is the general lack of awareness and understanding of finance leasing as a method of financing assets. Mongolians have been leasing cars for several years now, but the penetration percentage for leasing as a means of financing in the equipment sector is still low.

Mongolia is rich in natural resources and this has created tremendous wealth for a limited number of individuals and companies in the mining sector. Unfortunately, much of the equipment required by vast mining companies cannot be leased by the Mongolian leasing sector as the individual cost of the equipment is so high (a Caterpillar dump truck can cost up to US$ 6 million) and there is simply insufficient funding available in the domestic finance sector. Leasing companies everywhere prudently limit their exposure to individual customers (usually to a maximum of 10 per cent of their receivables).

The farmers in Mongolia, with its vast land resources, have traditionally been herdsmen grazing their livestock on relatively poor land, although this is changing slowly with new farming enterprises attempting to grow cash crops.

It may appear that the future for finance leasing in Mongolia is unfavourable, but this is not the case. For example, those farmers mentioned above now present the leasing sector with opportunities to offer finance leasing for equipment, such as tractors and combine harvesters, manufactured by global companies such as John Deere and Challenger, which have authorised distributors operating in Mongolia.

"There are many sectors using many types of equipment that are suitable for finance lease products."

"The EBRD's SME Leasing Policy Initiative will not only inform potential future lessees about the availability of finance leasing, but will also promote its features and benefits."

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There are many sectors using many types of equipment that are suitable for finance lease products and the movement from the use of collateralised bank loans to finance leasing will gather momentum when potential lessees become aware of the attractiveness of the finance lease product.

Most first-time lessees are surprised at the similarities between a bank loan and a finance lease (see Table 1). Organisations such as the European Bank for Reconstruction and Development and the International Finance Corporation promote the "level playing field" approach between the two products on most aspects, including fiscal treatment.

There are, of course, many differences between the two products, many of which make finance leasing appear more attractive than taking a bank loan for customers considering an asset purchase (see Table 2).

It can be seen, from the tables, that although bank loans and finance leases are similar they also differ significantly. The task, therefore, for the Mongolian leasing companies is to explain clearly what a finance lease is (that is, "spread the word") and mainly to the small and medium-sized enterprise (SME) sector of the Mongolian business economy.

Within its remit, the EBRD's SME Leasing Policy Initiative will not only inform potential future lessees about the availability of finance leasing, but will also promote its features and benefits. This initiative will be widely publicised through various Mongolian media platforms, including social media, and by direct contact with SMEs across Mongolia, not only in Ulaan Baatar. The types of SMEs that will be attracted to leasing may not always be the types of SMEs that will be attractive to leasing companies, however, as not all business sectors in Mongolia may have the credit risk profile required by the leasing sector.

TABLE 1 SIMILARITIES BETWEEN BANK LOANS AND FINANCE LEASES

Bank loan	Finance lease
Customer chooses asset	Customer chooses asset
Customer repays asset cost plus interest	Customer repays asset cost plus interest
Loan may be repaid early	Lease may be repaid early
Collateral recovered in event of default	Asset repossessed in event of default

TABLE 2 DIFFERENCES BETWEEN BANK LOANS AND FINANCE LEASES

Bank loan	Finance lease
Collateral (200 - 300%)	Asset is collateral
Complicated process	Simple process
Complicated contract	Simple contract
Slow risk decision	Fast risk decision
Customer visits bank	Lessor visits customer
Customer has ownership rights	Customer has usage rights

All finance leasing contracts that have ever been written, and ever will be, have two elements, namely the customer and the asset, and both must be creditworthy.

As can be seen on the opposite page, the sole collateral for a lease is almost invariably the asset to be financed. The leasing company mitigates its risk by asking the lessee to make a down payment (for example, 20 per cent of the invoice value). This, therefore, means that the leasing company has the legal ownership of an asset for which it has paid only 80 per cent of its value. This may appear, on face value, to create a very secure transaction but some assets have different future values than others (that is, they depreciate at different rates).

For example, an agricultural tractor manufactured by a global company such as John Deere may be worth around 60 per cent of its original cost after four years of use by a Mongolian farmer, but a laptop that a farmer requires for his business may be worth only 10 per cent of its original value after two years. So while the leasing company may consider the farmer to be creditworthy it would not be very positive about offering a five-year lease on a laptop with, say, a 10 per cent down payment.

The SME Leasing Policy Initiative must, therefore, be careful about the message it sends out to Mongolian SMEs, as it may create demand for a product for which there is no supply. Basic errors were made by the nascent leasing sector when the "wrong types" of assets were leased partly due to the sector's lack of knowledge and partly to its sales approach that was effectively an open-door approach; that is, the leasing companies opened their office doors in the morning and waited for customers. The problem with doing this is that every potential customer was a surprise; the leasing company neither knew the potential lessee nor did it understand most of the assets that the lessee wished to lease. Also, the potential customer was very often, too often actually, not a good credit risk and had already been rejected for a bank loan by all of the banks in town.

"It should be noted that leasing companies do not accept higher risks than banks, only that their credit risk policy is different."

Mongolian leasing companies can control the potential customers that walk through their office doors. In the same way that hospital staff perform triage on patients, the receptionist at the leasing company can assess the type of potential customer arriving at its premises just by asking two questions:

- Which type of asset would you like to lease?
- Who is supplying the asset?

If the type of asset is not on the leasing company's list of approved assets then the receptionist can politely inform the potential customer that the asset cannot be leased (by that leasing company).

If the supplier is not on the approved list of suppliers then the answer to the customer will be the same.

This approach may appear brusque but it is, above all else, prudent. Leasing companies, not just in Mongolia, but all leasing companies should only offer leasing for assets that they understand and that comply with the following criteria:

- movable
- identifiable (for example, serial number, chassis number)
- supplied by a known vendor (although this vendor may be located outside of Mongolia there should be a local supplier of service and spare parts)
- have known future value (the leasing company should be able to calculate the depreciation of the asset over (at least) the duration of the lease)
- be resalable (in the event of repossession, the leasing company should be able to sell the asset to a third party or back to the original supplier)

The last two points are worth expanding on.

THE LEASED ASSET'S FUTURE VALUE

As the asset is (usually) the only security/collateral for the lease, the leasing company should understand how its value will change in relation to the outstanding capital on the lease (that is, the amounts still to be repaid at any moment in time). Although these future values are seldom 100 per cent accurate they should be calculated using real data, much of which is available on the internet. Most leasing companies use "gap analysis" as a visual aid for making risk decisions. This procedure simply plots two sets of values on the same graph: outstanding capital over the duration of a lease and the future value of the asset.

EXAMPLES OF GAP ANALYSIS CHARTS IN A LEASING CONTRACT

1 BASELINE SCENARIO: INADEQUATE COVERAGE

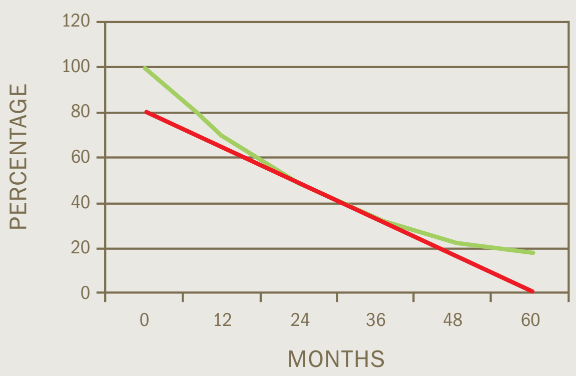
In this example it can clearly be seen that the future value of the leased asset is less than the outstanding capital from the start of the lease to around month 43. If the leasing company finds this to be an unacceptable amount of risk (as most leasing companies undoubtedly will) then the leasing company has two options. In practice most leasing companies will use a combination of the two.

"The best risk mitigant for all leasing companies is the down payment. This is, effectively, the lessee's own 'investment' in the asset."

THE LEASED ASSET MUST BE RESALABLE

The second point (the leased asset must be resalable) accepts that not all leases will be repaid by the lessee and that some assets will have to be repossessed. It is important that the leasing company be able to quickly resell the repossession for a fair price; that is, at a fair market value. The speed of this sale will depend on there being willing buyers for this asset. The more specialised the asset, the fewer the buyers. As Mongolia has a very small population (in other words, few potential buyers of repossessions) it is very important for the leasing company to know, at the commencement of the lease, how difficult it could be to dispose of a repossession.

2 FIRST OPTION: TAKING A DOWN PAYMENT



MARKET VALUE OF LEASED ASSET
DEBT AMOUNT

It can take a down payment from the customer (in this example, 20 per cent)

3 SECOND OPTION: SHORTENING LEASE PERIOD

MARKET VALUE OF LEASED ASSET
DEBT AMOUNT

Or it may reduce the tenor of the lease from 60 to 36 months.

Unfortunately, the current law on leasing is very detrimental to a leasing company being able to repossess and quickly dispose of the asset, as a lessee must be three months overdue on its leasing repayment before temporary repossession may take place and then the leasing company must store the repossession while allowing time for the lessee to repay the overdue leasing repayments. If the overdue repayments are paid then the leasing company must return the asset to the lessee.

Leasing laws should be fair to both lessors and lessees and it is hoped that the above problem will be solved by the amendments that will be proposed by the EBRD team, which will take on the task of drafting changes and improvements to the current law in 2015.

The three most important issues when it comes to leasing laws are: (i) definition of a lessor, the lessor's rights in a leasing contract and its obligations to a lessee; (ii) definition of a lessee, the lessee's rights in a leasing contract and its obligations to a lessor; and (iii) the repossession process. These definitions should be clear, simple and unambiguous, so much so that they could be used in the marketing of finance leasing. The most important right within a law should be that, in consideration of a lessee making his lease rental repayments in a timely manner, he will be allowed continuous and uninterrupted use of the asset. This right can then be explained within the terms and conditions of the lease contract.

Leasing companies want lessees to repay the lease rentals on time. They do not want to repossess assets. This is very much a last resort scenario and usually only happens after many attempts have been made by the lessor to persuade the lessee to pay overdue lease rentals. The period of time between a lease rental becoming overdue and the leasing company being able to repossess the asset should not be governed by a law, but should be agreed within the terms and conditions of a lease contract. If the lessee does not believe the term or condition related to this time period to be fair then he should not sign the lease contract.

If the asset must be repossessed, then the preferred method of repossession for a leasing company is commonly known as "self-help". This operates on the fact that the leasing company owns the asset and that the lessee is in default, so the leasing company can locate the asset and remove it from that location to a place of storage of its own choosing. No courts are involved in this process.

THE EBRD'S SMALL BUSINESS INITIATIVE

The SME Leasing Policy Initiative is inspired by the EBRD's Small Business Initiative (SBI). This is an organisation-wide initiative to provide comprehensive support to small businesses through access to finance, business advice and policy dialogue.

The SBI has five pillars:

- **Indirect financing** – Financing of financial intermediaries for on-lending to micro, small and medium-sized enterprises; investments in equity funds with a focus on SMEs.
- **Co-financing/risk-sharing** – Co-financing SMEs or risk-sharing with local partners, whether they be banks or equity funds (for corporations).
- **Direct financing** – Direct, tailor-made debt and equity financing of SMEs with strong potential for good return on investment.
- **Business advisory** – Various business advisory activities in support of SMEs.
- **Policy dialogue** – Policy dialogue initiatives aimed at improving SMEs' business environment and access to finance.

If this method is considered too aggressive for Mongolia then the leasing companies will accept the need for a court official, granting permission for repossession, on the condition that this process is consistently simple, free and quick (a few days). The leasing company should present the court official with proof of ownership and proof of default, and there should be no requirement for the lessee to be present at this time.

"If changes to the legislation can be made then the leasing sector in Mongolia can safely grow in the future and this will mainly benefit the SME sector."

The disposal of the asset at a fair market price may be open to abuse by an unscrupulous leasing company (for example, repossessions may be sold to "friends" for a price much less than the asset's real value). This problem can be covered in several ways, such as the leasing company being obliged to advertise the asset for sale on a public site; being required to find a minimum of, say, three offers and also informing the lessee of the proposed sale price; and allowing the lessee a period of time (for example, 14 days) to find an alternative buyer prepared to pay a higher price.

If these changes to the legislation can be made then the leasing sector in Mongolia can safely grow in the future and this will mainly benefit the SME sector by bringing access to finance to this important part of the Mongolian economy.

Stefan Antonić and Darko Jovanović

SETTING UP A PRE-HARVEST FINANCING FRAMEWORK **IN SERBIA**

Over the last 10 years, considerable legislative efforts have been made towards creating a favourable framework for financing agribusiness and agricultural production in Serbia. The latest piece of legislation in that sector is a law on secured pre-harvest financing.

Looking back, in 2005 Serbia introduced the national strategy on agricultural development (the Strategy), which outlined obstacles and set goals with regard to financing agribusiness and agricultural production. At that time, the main problems were a lack of: (i) short-term financing which would bridge the gap between selling newly harvested agricultural products and collecting the purchase price; (ii) mid-term financing for investing in working capital (as such investments cannot be financed by the yield of a single production cycle); and (iii) long-term financing for purchasing agricultural land. In other words, the main issue was a lack of easily accessible financing for inputs, production and the accompanying support operations required for agricultural production. The Strategy aimed to expand the market in which financing was accessible to include all participants in the agricultural production cycle.

However, rather than following the approach outlined in the Strategy, the Serbian state adopted a different approach to solving the problem of financing agribusiness and agricultural production. Specifically, the state was directly involved in financing agricultural production (for example, by granting subsidised loans and interest rate subsidies), while at the same time creating optimal conditions for the financing of agricultural production by developing the existing legal framework.

"A big step in creating a favourable legal framework for financing agribusiness and agricultural production in Serbia was the law on secured pre-harvest financing."

"The law aims to finance pre-harvest production, specifically financing the inputs required for agricultural products."

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In 2009 Serbia enacted the law on public warehouses for agricultural products, which was a milestone from a legal framework development perspective. This piece of legislation introduced a rather safe and simple system for pledging existing agricultural products, allowing them to be used as collateral when obtaining financing for agribusiness and agricultural production. In that way, a new avenue for financing agricultural production was created.

The next big step in creating a favourable legal framework for financing agribusiness and agricultural production in Serbia was the law on secured pre-harvest financing (the Law). During the drafting of the Law, all major agrarian business stakeholders in Serbia (that is, banks, insurance companies and agribusiness companies) were involved in providing input, which was used as the starting point for drafting certain solutions introduced by the Law.

The Law aims to finance pre-harvest production, specifically financing the inputs required for agricultural products, with a loan tenor that corresponds to the term of the entire crop cycle. In summary, the main focus of the Law is to help farmers access pre-harvest financing in order to bridge the funding gap between investing in agricultural production and collecting the price upon sale of the newly harvested agricultural products.

The Law not only governs contracts on agricultural pre-harvest financing, but also the registration of such agreements, the settlement of creditors' claims under the agreement (by using future agricultural products as a form of loan security without taking them into possession) and special rights and obligations of the contracting parties in agricultural financing. Specifically, the Law introduces distinct financing/enforcement mechanisms, custom-made for the Serbian market model.

The financing mechanism set in the Law allows the contracting parties to regulate their mutual rights and obligations relating to the financing of agricultural production by concluding an agricultural financing agreement. Since these agreements are subject to specific provisions (for example, exclusion of *force majeure*) prescribed by the Law, financing is provided in a more favourable and secured legal framework. These agreements contain mandatory elements and are entered into a registry of financing contracts run by the Serbian Business Registers Agency.

Besides this mechanism, the Law also introduces a simple, quick and reliable system of enforcement, incorporating new solutions for overcoming impediments encountered in practice when pledging future agricultural products. Under the general legal regime (that is, Serbia's civil law rules), future agricultural products can be pledged but also mortgaged at the same time. However, the way in which these two liens affect each other is unregulated. As such, the Law contains a set of rules to regulate these transactions.

In addition, while enforcement mechanisms introduced by the Law are based on the standard pledge model under Serbia's civil law rules, certain parts of the registration and enforcement procedures have been altered and specifically tailored to meet the particular needs of participants in the agricultural production financing process.

At the moment there are number of financing options offered to the agricultural sector, namely by banks (and affiliated leasing companies), state funds and major agribusiness companies. However, the availability of financing options offered by banks (and affiliated leasing companies) is significantly constrained due to a combination of legal, economic, institutional and behavioural factors, which usually perceive the creditworthiness of borrowers from the agricultural sector as weaker than those in other sectors. In that regard, the Serbian market still lacks banking facilities for agricultural production. Instead, big agribusiness companies are the key figures in financing agricultural production.

In conclusion, the impact of the Law should be twofold. Specifically, financing/enforcement mechanisms provided by the Law should help to provide financing both to small agricultural producers and big agribusiness companies. Therefore, as financing becomes accessible to all participants in the agricultural production cycle, the Law will not only provide cheaper and more accessible financing for agricultural production (primarily for small agricultural producers), but will also support market development.

The Law was adopted in November 2014 and it should come into effect from 1 June 2015. Although the practical and market effects of the Law are yet to be seen, it is reasonable to expect further development of the financial market in Serbia and especially the market segment dealing with the financing of agricultural production.

From the International Fund for Agricultural Development (IFAD)

CONTRACT FARMING AND SMALLHOLDER PARTICIPATION: **LESSONS LEARNED**

Three-quarters of the world's poorest people live in the rural areas of developing countries. Meanwhile, some 500 million family farms support the lives and livelihoods of 2 to 2.5 billion people around the world, and produce about four-fifths of the food supply in developing countries. Due to the constantly rising demand for agricultural products, there is a greater emphasis on vertical integration among producers, wholesalers and retailers. At the same time, strong links to markets are essential to increase agricultural production and productivity, and improve food security for rural producers and the rural poor at large.

Contract farming (CF) is an important approach, which can help link market needs with production capacities, diversify and increase the availability of products on local and global markets, and improve overall value chain efficiency. The United Nations International Fund for Agricultural Development (IFAD) promotes CF arrangements between smallholders and the private sector in its policies, strategies and operations on the ground. As an international financial institution, IFAD aims to reduce rural poverty and invests in smallholder agriculture by providing concessional loans and grants to developing countries in order to finance innovative agricultural and rural development programmes and projects. By the end of 2013, IFAD had supported 241 such projects with a total investment of US$ 5.4 billion, reaching out to an estimated 430 million rural people globally.[1]

More than half of IFAD's current programmes include a value chain development component. By seeking to integrate IFAD's target groups of small rural producers involved in farming, livestock or fisheries into such value chains, IFAD-funded projects and programmes are able to improve smallholder access to secure markets, thereby raising their incomes.

Agricultural and food value chains are essentially led by the private sector whether said private sector is small, medium or large; local, regional or international. IFAD considers public-private-producer partnerships (4Ps) alongside agricultural value chains as a powerful tool to attract private sector investment in the smallholder sector and in market segments that may otherwise not be profitable to private companies without public support and/or concessional donor financing. IFAD is committed to stepping up its efforts in promoting contractual arrangements to help small agricultural producers seize opportunities in agricultural value chains at lower levels of risk.[2] This article presents ways to create CF arrangements that are advantageous for both producers and contractors. Building on IFAD's work in agricultural and rural development programmes in the Near East, North Africa and Europe region, this article highlights agricultural value chain development projects in Egypt and Moldova. Both projects have unique CF components and serve as case studies that provide critical lessons for policy-makers, investors and agricultural and rural development intervention planners.

SETTING THE STAGE: CONTRACT FARMING AND SMALLHOLDERS

Smallholder farmers in developing countries have limited options when it comes to increasing their productivity and moving from subsistence farming towards market-oriented production methods. Limited access to productivity-enhancing inputs, technologies, information and credit are major obstacles for many smallholders, as are uncertainties over land tenure, which restrict their ability to invest in the land they farm. These obstacles, in turn,

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make it difficult for smallholders to produce the quantity and quality of agricultural goods required by the market. This is where contract farming models can make a difference.[3]

As a means of enhancing market competitiveness and profitability as well as addressing the effects of market failures, contract farming integrates smallholder producers into modern agricultural value chains by providing credit, insurance and information for contracted farmers. Contract farming is an agreement between sellers (producers/farmers) and buyers (processors/traders) of agricultural commodities. The contract covers the obligations of both parties: the producer is required to supply specified volumes and high-quality products, and the buyer must purchase the goods. In addition, buyers provide other services, such as inputs (seeds, plantlets, fertilisers, and so on) and credit or other non-financial services (training and logistics). Contracts vary to a great extent in terms of their form and content, as well as the ways in which they are negotiated and concluded. They can, for example, be formal or informal (concluded in writing or orally), and arranged with individual farmers or groups of farmers (that is, farmer associations). The obligations set forth in contracts can either be left rather ambiguous or specified in detail, and may be long term or cover one season only.[4]

If well managed, CF arrangements can benefit smallholder producers and agribusinesses alike. For producers, CF models offer better and more stable incomes through higher yields and improved access to inputs (in kind or through buyer credits). In addition, where banks accept forward contracts as collateral, access to credit for further investment is improved and credit risks reduced.

Proper CF arrangements can also help ensure reliable and stable market access. Longer-term farm planning, greater access to inputs, advisory services and new technologies help to minimise market and production risks, and increased diversification improves food security.[5]

As for contractors, they profit from guaranteed volume and product quality, which minimises the supply risks associated with non-organised or traditional markets, reduces reputational risks and improves marketing.[6] Contractors also have the opportunity to expand their business activities without large-scale investments, as operational and staff costs are cut through subcontracting. Transaction costs are, therefore, reduced owing to a regular and stable supply of produce, and investment risks are minimised due to a more efficient use of capacities.

However, CF arrangements can also bear risks, both for producers and contractors. First, contractual arrangements may be costly to set up, implement and enforce. Smallholders, for example, may face the risk that buyers fail to deliver on the terms of the contracts (such as agreed prices or embedded services). Second, contractors could encounter problems (such as side-selling and side-buying) when working with smallholder farmers. Third, smallholders sometimes fail to meet quality standards required by the market, even when inputs are provided. For example, climatic conditions (extreme temperatures) often lead to significant crop losses, which impede production. Lastly, weak law enforcement and the lack of a formal code of conduct among buyers and producers impose additional constraints.[7]

CASE STUDIES: IFAD IN EGYPT AND MOLDOVA

The following case studies are two classic examples of IFAD-supported agriculture and rural development projects. The rationale for selecting these cases is as follows: (i) they were designed and supervised by IFAD's Near East, North Africa and Europe Division (NEN), which mirrors a similar region covered by the EBRD; and (ii) the two projects/programmes have at least one specific component addressing CF development that is already showing results. The two case studies build on project design, evaluation and completion reports.

EGYPT WEST NOUBARIA RURAL DEVELOPMENT PROJECT

From 2003 to 2014, the West Noubaria Rural Development Project (WNRDP)[8] supported smallholder farmers and young graduates working on small holdings (1-2 ha). The WNRDP focused on increasing agricultural and livestock productivity and profitability, strengthening community development, and providing support to small and medium-sized enterprises to help them gain access to credit, establish market links and increase employment opportunities. Some 36,180 households (or 228,000 individuals) benefited from the project. The project is valued at an estimated US$ 55 million, of which approximately US$ 19 million was financed by an IFAD loan, US$ 30 million by the Italian-Egypt Debt Swap programme and US$ 6 million from Egyptian government contributions.

Under its marketing component, the WNRDP helped link small farmers to big businesses. With the WNRDP's support, a total of 30,571 smallholder farmers were able to organise themselves into six marketing associations (MAs). The MA members were not only trained in pre- and post-harvest marketing of fruit, vegetables, groundnuts and dairy products, but also in the cultivation of medicinal, aromatic and organic crops (including harvest and post-harvest techniques, as well as food technology and processing methods). In addition, farmers learned how to build enterprises and meet quality control standards, such as those required for Good Agricultural Practices certification. The formation of marketing associations helped farmers benefit from economies of scale and enhanced their ability to better bargain with traders. By helping farmers improve their brokering skills in business relationships, MAs also succeeded in developing contracts with larger processors, exporters and suppliers in domestic and international markets. In particular, the WNRDP helped to increase exports of non-traditional and organic agricultural products to Europe, mainly as a result of enabling the MAs to sign contracts with private companies in the area.[9] This proved to be the best option for a farming environment characterised by low farm-gate prices, a predominance of traditional crops and a lack of efficient marketing.

As a result of the project's support, 63 contracts were established with 56 private companies. The largest of these was with Heinz. Under the contract, which was signed in 2012 and is ongoing, Heinz buys 6,000 tonnes of tomatoes each year from some 300 farmers to process into tomato juice, ketchup and salsa. As part of the contract, Heinz provides farmers with adapted cultivars and high-quality seedlings. Initially, contracts covered only two types of crops with a total cultivated area of 12 ha and 20 greenhouses, but by September 2013 contracts covered eight types of crops with

a total cultivated area of 5,520 ha and 52 greenhouses. Thanks to successful contract farming arrangements, the existing cropping systems were diversified into more than 26 field crops, fruits and vegetables. Furthermore, the adoption of more advanced production and irrigation technologies, artificial insemination, improved management practices and greater marketing opportunities, resulted in a significant increase in crop yields and livestock production (milk and meat).

In collaboration with the USAID-funded Premium Project, the WNRDP also trained agricultural cooperatives and MAs to meet certification requirements and helped them register with GlobalGAP and Fairtrade's FLO-Cert. Through this cooperation, 1,192 farms across five cooperatives obtained GlobalGAP certification for the production of seven crops and Fairtrade certification for three crops. In 2013-14, four contracts were signed with four cooperatives under GlobalGAP and one contract with one cooperative under Fairtrade.

The six marketing associations are becoming financially self-sufficient by buying inputs at wholesale prices and selling them to their members at a reasonable profit margin, and by collecting a 1 per cent service charge from the companies with whom they sign marketing contracts. The region has been transformed into a recognised and specialised area for the production of high-value fruits and vegetables. Over 1.4 million tonnes of the region's fruits and vegetables are being supplied to national fresh produce markets, the food processing industry and export markets. In addition, over 1 million tonnes of field crops are destined for the market.

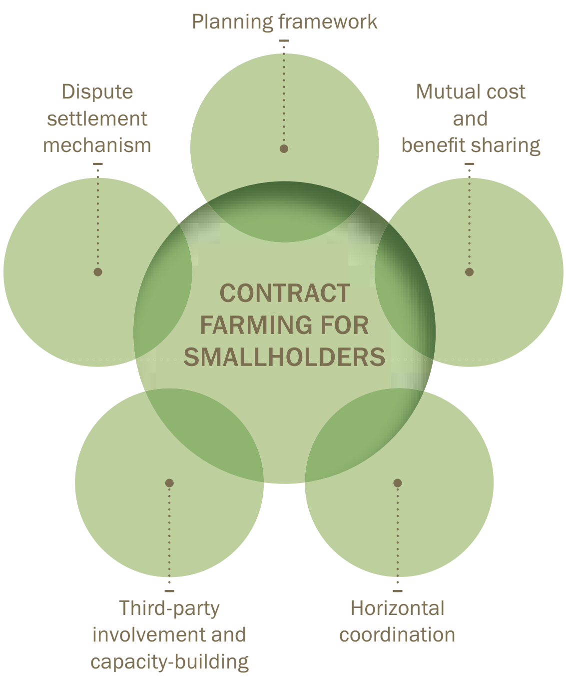
More recently, the government of Egypt requested assistance from IFAD to design another project, Sustainable Agriculture Investments and Livelihoods, in some of the newly settled lands. The government identified nearly 100,000 feddan (42,000 ha) spread over 30 new settlements encompassing around 40,000 rural households (or 280,000 people). The proposed project has been designed on the back of the WNRDP's success in establishing and strengthening rural institutions – especially community development associations and agricultural cooperatives – and aims to support water management arrangements and establish MAs with links to a variety of value chains (fruit, vegetables, aromatic and medicinal products).

LESSONS LEARNED: SUCCESS FACTORS FOR SMALLHOLDER PARTICIPATION IN CONTRACT FARMING MODELS

Markets for smallholder agriculture in developing countries are often characterised by imperfections. These can range from low levels of trust and power imbalances between suppliers and buyers to inadequate road and market infrastructure, highly volatile prices, inconsistent produce quality and a lack of reliable harvest forecasts or market information systems. Against this difficult background, CF arrangements have emerged as a powerful tool to build and strengthen self-sustaining situations that are mutually beneficial for smallholders and other market participants.

The IFAD-supported projects in Egypt and Moldova show that successful CF arrangements have great potential for generating economic growth and enhancing food security for smallholder farmers and the rural poor, as long as critical design factors are duly considered (see Chart 1) and common implementation pitfalls avoided.

CHART 1 SUCCESS FACTORS FOR CONTRACT FARMING AND SMALLHOLDER PARTICIPATION



Source: IFAD

MOLDOVA RURAL FINANCIAL SERVICES AND AGRIBUSINESS DEVELOPMENT PROJECT

In Moldova IFAD is engaged in two projects with specific contract farming subcomponents, under which it seeks to develop producers' business skills and increase input supply, marketing, technology transfers, and ultimately, income.

The Rural Financial Services and Agribusiness Development Project (RFSADP) is an ongoing project (2011-16), with a total investment of approximately US$ 40 million.[10] The project aims to help smallholders establish competitive commodity value chains by creating links with local and regional markets and promoting access to financial services. It also provides support for market research and development, business development services and the setting-up of producer associations. By linking producers (or SME entrepreneurs) to agricultural commodity chains, these types of CF-related activities seek to address the need for sustainable enterprise development, market efficiency, the adoption of new technologies and employment in rural areas.

The main findings of a CF analysis under the RFSADP recommended: (i) greater involvement of banks in tripartite agreements with producers and contractors; (ii) the formation of producer groups similar to the MAs in Egypt; and (iii) a general step-by-step approach to improving the performance of producers. In 2012 processing companies were selected as value chain drivers and technical innovation studies were conducted. According to the studies, potential partners for contract farming along the value chain (producers, processors, financial institutions, input suppliers, and so on) indicated a high degree of risk aversion towards the existing market environment and thus considered themselves rather conservative when making decisions to enter into any agreement.

In 2013 the RFSADP started working with three groups of cucumber producers (22 members with a cultivation area of 72 ha) and contracts were signed with specific production targets. From a market perspective, the potential for cucumber production and processing is high. Therefore, the project is seeking to build greater capacity among farmers to access finance and improve their production technologies in order to reach economies of scale and enter into contractual agreements with processors.

While fruit, vegetables and dairy were set as the main priorities for contract farming, the RFSADP also supported sugar beet producers in the north of Moldova. Sugar beet production is primarily based on contractual arrangements, and production must take place in the vicinity of the processing plant. A total of 11 farmers, with a production area of 3,250 ha, received support to develop their production technologies, which improved productivity, increased yields and raised product quality.

Farmers and agribusinesses in Moldova do not have a long history of operating in an internationally competitive environment. The main participants in agricultural value chains are farmers and agribusinesses that have surplus production and high-quality goods, which is attractive for buyers. However, small producers may also enter into the market if they pool their small quantities of produce and improve the quality of their goods through marketing groups, cooperatives or companies.

While Moldova has a number of producer organisations, they are not engaged in joint marketing. Instead, they provide advocacy, general market promotion and information on regulations, prices, markets and technologies. In Moldova IFAD's value chain development support – including contract farming – is through a phased approach, which is initially aimed at developing capacities, thus creating a foundation for future value chain development.[11]

The first factor for successful CF schemes is an adequate planning framework. A careful analysis of conditions such as policies, legislation, administration and infrastructure are crucial for setting up CF arrangements that are competitive in national, regional and international markets. Furthermore, CF schemes need to be adapted to local circumstances, and the relationships between different actors along the value chain must be balanced adequately. CF arrangements must also take into account existing services, specific agricultural commodities and production processes, market opportunities, and the capacities of farmers and buyers. It is also important to set up monitoring and evaluation systems at the beginning, to accommodate for lessons learned through the actual contract phase and to be able to modify CF arrangements where necessary. As evidenced by the Moldovan case study, a comprehensive situational analysis on contract farming opportunities and constraints is a necessary first step before any CF subcomponent can be carried out. The situational analysis in Moldova identified the causes and drivers of low competitiveness among Moldovan farmers. The results were fed into the development of the project's plan, which led to the creation of producer groups and tripartite agreements with banks, producers and contractors.

Mutual cost and benefit sharing can be considered a second key element for success. Whether or not smallholders can engage profitably and with low risk in modern agricultural markets depends on the willingness of private actors to engage with them, and vice versa. Contract farming is a distinct business model in which the parties aim to make profits through improved access to supplies and markets, and where the partnership is mutually beneficial for both farmers and contractors. The arrangement that lays the ground for future business relationships needs to provide all parties with sufficient incentives to comply with their respective contractual obligations.

The WNRDP connected small farmers with the entire value chain, from input supply and capacity-building (seeds, fertilisers, pesticides, drip irrigation systems, food safety certification, and so on) to packaging and merchandising. As a result of obtaining GlobalGAP and Fairtrade certifications, farmers were able to gain access to larger markets and export certified produce to foreign markets in the European Union, Turkey and the United States, in addition to selling their produce to domestic markets. This led to a nearly fourfold increase in the average yearly income to US$ 8,857 per household compared with the yearly minimum wage of US$ 2,200. Owing to the success of the project, the farmers were also able to move up the value chain, thereby gaining additional margins for many crops. For example, growing and marketing organic potatoes led to a 66 per cent increase in the farm-gate price from US$ 110 per tonne to US$ 183 per tonne. An important consideration when introducing the contract farming system is to improve producers' access to loan financing for working capital – lack of such access is identified

NOTES

1. IFAD (2014), *Reforming IFAD, Transforming Lives*, Rome.
2. IFAD (2011), *IFAD Strategic Framework 2011-2015*, Rome.
3. IFAD and Technoserve (2011), *Outgrower Schemes – Enhancing Profitability*, *Technical Brief*, available at http://www.ifad.org/ruralfinance/pub/technoserve.pdf (last accessed 9 December 2014).
4. C. Eaton and A. Shepherd (2001), "Contract farming: Partnerships for growth", *FAO Agricultural Services Bulletin No. 145*, Rome.
5. M. Will (2013), *Contract farming handbook: A practical guide for linking small-scale producers and buyers through business model innovation*, GIZ, Germany.
6. IFAD (2010), *Rural Poverty Report*, Chapter 4, Rome.
7. IFAD (2010), *Rural Poverty Report*, Chapter 4, Rome.

as a major constraint to improved production. Establishing closer links between projects and private sector partners may require considerable time and a change in mindset. With a growing market demand, the existing capacity and the use of processing plants are expected to increase. This, in turn, may create more favourable conditions for future cooperation between producers and processors.

This is why a horizontal coordination of smallholder farmers through farmer associations and cooperatives is considered another important factor for success. Such groups can negotiate more favourable agreements and they have more opportunities to realise economies of scale and share the burden of market risks. Group contracting arrangements can also support the internal handling of grievances and compliance issues. For contractors, dealing with well-established and functional smallholder groups also minimises risks, as smallholder groups are more likely to fulfil their contractual obligations than individual farmers. As evidenced by the case study in Egypt, organising groups of small farmers into MAs allowed them to compete with larger farmers and agribusinesses. Meanwhile, in Moldova the competitiveness of smallholder farmers is a major constraint because producer organisations are not engaged in joint marketing activities.

Involving third parties can further facilitate brokering links between contracting parties. Neutral actors such as IFAD can provide assistance when it comes to negotiating and monitoring the observance of CF schemes, particularly where market failures constitute a major obstacle to CF development. Neutral actors not only facilitate and advocate for the involvement of suitable agribusiness firms, but also build the capacity of local producer groups. Of particular relevance is the transfer of knowledge and technologies through capacity-building that comes with the involvement of development partners such as IFAD.

Lastly, CF schemes should also include a dispute settlement mechanism to further minimise risks, taking into account the different capabilities of the contracting parties. Based on clear contractual obligations and pricing structures, the mechanism should be equally accessible and mutually recognised by the involved business partners.

For the five factors to be mutually reinforcing and effective, they need to be underpinned by complementary and supportive institutions and partners – be it contractors and farmers, policy-makers, civil society organisations or donors – who trust each other. IFAD, as an organisation working in partnership with, and investing in, rural people, strives to facilitate and foster these CF arrangements, and is committed to scaling up those projects that have proved to be successful, as in the case of Egypt.

“If well managed, contract farming arrangements can benefit smallholder producers and agribusinesses alike.”

8 See http://operations.ifad.org/web/ifad/operations/country/project/tags/egypt/1204/project_overview (last accessed 9 December 2014).

9 See http://operations.ifad.org/documents/654016/f24b8e29-24fc-4862-b84d-caa15c326be3 (last accessed 9 December 2014).

10 See http://operations.ifad.org/web/ifad/operations/country/project/tags/moldova/1562/project_overview (last accessed 9 December 2014).

11 See http://www.ifad.org/evaluation/public_html/eksyst/doc/country/pn/moldova/moldova_full.pdf (last accessed 9 December 2014).

Sibel Beadle and Aiaze Mitha

MOBILE MONEY IN THE EBRD REGION TAJIKISTAN CASE STUDY

"Mobile money" is revolutionising the way millions of people around the world manage their finances and is increasingly replacing traditional over-the-counter banking and cash payment systems in a number of emerging markets. A mobile phone is now more than just a handy way of conducting business and staying in touch with loved ones. It is an essential tool for accessing financial services, sending and receiving money, paying bills, making purchases in retail stores, managing savings and even accessing credit.

Mobile money is usually divided into three types of services: mobile banking, mobile money transfers and mobile payments. Mobile banking is a convenient channel offered by banks, which allows users to manage their bank accounts through their mobile phones. Mobile money transfer services are usually provided by remittance companies and telecommunications operators. These services allow users to transfer money domestically or internationally to, or from, a mobile phone. Mobile payments enable users to make payments using their mobile phone by drawing on funds kept in an electronic wallet.

The EBRD hosted a mobile money conference in 2013, funded by its Shareholder Special Fund and funds for the southern and eastern Mediterranean region. The event was designed to take stock of current developments in the industry and raise awareness on hurdles that need to be overcome to enable mobile financial services in the EBRD region. It was the first conference of its kind for the EBRD region and brought together experts from banks, mobile phone companies and mobile financial service consultants, who shared their experiences from different parts of the world.

"About 50 per cent of the current adult population in central and eastern Europe is unbanked, but most people own a mobile phone."

"For businesses, using mobile money is an opportunity to access capital and improve relationships with buyers, suppliers and customers."

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On paper, there is great potential for mobile money in the EBRD region. About 50 per cent of the current adult population in central and eastern Europe is unbanked, but most people own a mobile phone. In the Kyrgyz Republic, for example, 99 per cent of the adult population is unbanked, but 99 per cent have access to mobile phones.

For some economic actors, such as financial institutions and telecommunications operators, mobile banking is a major business opportunity because it allows them to not only lower costs, but also to increase and diversify revenue streams. For businesses, using mobile money is an opportunity to access capital and improve relationships with buyers, suppliers and customers.

"In 2014 the EBRD carried out a year-long technical cooperation project in Tajikistan. The project, funded by the French Finance Ministry, aimed to establish a regulatory framework for mobile financial services."

"Now that the legal structure is in place, it remains to be seen whether initiatives in Tajikistan can reach the scale and pace needed to make mobile money successful in this country."

Although there are some examples of mobile technologies in the EBRD region, the development of mobile money services, such as M-Pesa, has been slow. The EBRD, keen to support this development, commissioned BearingPoint, a management and technology consultancy, to conduct an in-depth study of mobile financial services in the countries in which the Bank works. The study, which was supported by donor funds from the government of Luxembourg, was completed in December 2012, and its results were shared at the conference.

ADOPTING MOBILE MONEY IN THE EBRD REGION

According to Andreas Rindler, Partner and Head of Mobile Money Services at BearingPoint, although most of the prerequisites for mobile money are met across the region, not every country is operating at the same speed and with the same focus. Given that the majority of countries in which the Bank invests are on average smaller and less densely populated than some of the bigger countries in Africa and Asia, the EBRD region will most likely show a different growth pattern.

The study found that in order to fully exploit the market for mobile money, approaches need to be tailored to roughly three groups of countries: (i) the emerging countries (such as the Kyrgyz Republic, Moldova and Tajikistan), where the market is showing potential and where the challenge is to reach large unbanked populations; (ii) the migrators (such as Azerbaijan, Georgia and Mongolia) where the infrastructure is in place and where mobile money could be the hook that facilitates further retail growth; and (iii) the adopters (Kazakhstan, Russia and Turkey), which have more complex markets and are drivers of large-scale innovation. In Turkey, for example, all major banks and telecommunications companies have entered the mobile money race, with each bank trying to offer distinct mobile money services.

CASE STUDY – TAJIKISTAN

In 2014 the EBRD carried out a year-long technical cooperation project in Tajikistan. The project, funded by the French Finance Ministry, aimed to establish a regulatory framework for mobile financial services. As part of the project, the country's financial sector and telecommunications industry were reviewed, and the desire and ability of both financial institutions and mobile operators to provide mobile financial services was assessed.

The first set of regulatory guidelines was drawn up to address the lack of access to core financial products in Tajikistan. In a country where nearly 50 per cent of the territory is above 3,000 m and where winter divides the country into three isolated parts, enabling credit institutions and other commercial players to offer financial services outside of traditional bank branches using alternative delivery channels, such as retail agents and mobile phones, was a crucial step towards promoting financial inclusion. As a result, the regulatory framework was developed around a bank-centric approach that supported creative partnerships with other stakeholders (such as mobile operators) by providing space for these operators to participate in the distribution of financial services, with the only limitation being that non-financial institutions couldn't offer banking services without prudentially regulated financial institutions being involved, as they are the designated banking service providers. The main objective of the regulation was to allow credit institutions to transfer essential functions, such as opening accounts and taking deposits, beyond branches into service centres, remittance points, exchange offices and mobile operator agents to increase outreach and better serve the unbanked.

The second set of regulatory guidelines addressed payment gaps in Tajikistan. Establishing a nationwide payment infrastructure called for heavier involvement on the part of non-financial players, such as mobile operators and payment kiosk providers. These private organisations, which already had a strong economic incentive to establish a nationwide presence to support their core business, could now be leveraged further to promote mobile payments. The regulatory framework defined eligibility criteria and specific financial/operational requirements for such organisations to become mobile money service providers, and determined the authorised range of services.

Both regulations, when combined, provide an array of options to be pursued by financial and non-financial institutions to advance the distribution of financial services in Tajikistan. Now that the legal structure is in place, it remains to be seen whether initiatives in Tajikistan can reach the scale and pace needed to make mobile money successful in this country.

Bernd Volk

SME COVERED BONDS: AN INTERESTING NEW FORMAT

Covered bonds backed by unsecured loans to small and medium-sized enterprises (SMEs) could be a new funding tool for European banks. However, with the European Central Bank (ECB) providing unconditional cheap funding under its targeted longer-term refinancing operations (TLTROs), at least for the first two years, interest by eurozone banks to actively use SME covered bonds will likely be limited for the time being.

Nevertheless, banks, regulators and market participants are showing a general interest in SME covered bonds owing to the need of European SMEs to find alternative funding sources, especially given the relatively low level of investor demand for SME asset-backed securities (ABS) and the generally favourable regulatory treatment of covered bonds in the European Union (EU).

The greater structural complexity of SME covered bonds typically distinguishes them from traditional mortgage and public sector covered bonds, and makes them less attractive for traditional investors interested mainly in "plain vanilla" legal-framework-based covered bonds. Still, investor interest in SME covered bonds could increase due to the ultra-low yield environment, forcing real money investors in particular to watch out for any yield pickup.

SME COVERED BONDS ARE NOT CRR AND ECBC COMPLIANT

Article 129 of the EU Capital Requirements Regulation (CRR) defines assets that are eligible collateral for covered bonds and which receive preferential treatment under EU regulations (for example, preferential risk weighting). As unsecured SME loans are not mentioned in the CRR, SME covered bonds do not benefit from risk weight preferential treatment in the EU. According to the

"The issuing bank has an incentive to make sure that the cover pool quality remains strong, otherwise future public issuance of SME covered bonds could be challenging."

"Investor interest in SME covered bonds could increase due to the ultra-low yield environment, forcing real money investors in particular to watch out for any yield pickup."

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European Covered Bond Council (ECBC), the use of covered bond structuring techniques to finance the portfolios of unsecured loans to SMEs increased significantly during the global financial crisis, and covered bonds have generally proven to be a highly effective financing tool. However, over the past few years the covered bond community has identified and agreed upon the key macro-prudential features required for an asset to qualify for the ECBC Covered Bond Label (CBL). The CBL, which establishes a qualitative parameter for covered bonds and defines minimum quality standards, does not envisage unsecured SME loans as qualifying assets.

LEGAL-FRAMEWORK-BASED SME COVERED BONDS COULD QUALIFY FOR CBPP3

On 4 September 2014, the ECB announced its third covered bond purchase programme, CBPP3, which requires covered bonds to "fulfil the conditions for their acceptance as own-use collateral" but also mentions "underlying assets that include exposure to private and/or public entities". While unsecured SME loans are not CRR compliant, in our understanding, legal-framework-based and UCITS-compliant[1] SME covered bonds offering comparable protection to the criteria set out by the ECB[2] do qualify for CBPP3. At this stage, the practical relevance is negligible.

Unsecured SME loans are eligible collateral for legal-framework-based covered bonds in Italy and Spain. However, so far, there are no outstanding SME covered bonds in those countries. Moreover, numerous Italian banks have publicly said that they are not interested in using the opportunity provided by the new legal framework to issue SME covered bonds.

LIKE ALL COVERED BONDS, SME COVERED BONDS ARE BANK BONDS

In line with covered bonds in general, SME covered bonds are characterised by a dual recourse nature. That is, they have recourse to the issuing bank and recourse to the pool of assets if the issuer defaults. However, there are major differences between SME covered bonds and traditional mortgage and public sector covered bonds with regard to cover pool credit quality, refinancing risk and interest rate risk.

Banks that issue SME covered bonds retain the SME loans on the balance sheet and have a strict legal obligation to pay the principal and interest on the covered bond regardless of the performance of the SME loans in the cover pool. Generally, covered bond cover pools are dynamic. That is, the issuing bank can, and based on contractual or legal obligations often must, replace non-performing loans with performing loans. Strict eligibility criteria stipulated in specific covered bond framework, and/or the SME covered bond documentation, typically reduce the replacement risk of the dynamic cover pool. The issuing bank has an incentive to make sure that the cover pool quality remains strong, otherwise future public issuance of SME covered bonds could be challenging. Moody's and DBRS highlighted that the new type of covered bond may lack systemic support, arguing that it should be subject to specific regulations and supervision, which is the case for mortgage and public sector covered bonds.

"SME covered bonds could be a valid investment alternative when the risk of bail-in increases, as SME covered bond investors would benefit from additional security provided by the SME loans."

A specific legal framework for covered bonds could govern the eligibility of SME loan receivables as cover assets and ensure the segregation of the cover pool from the issuer's insolvency estate, among other protection measures in place for covered bond investors. In the case of contractual law-based SME covered bonds, the structure is solely based on contractual bond documentation (that is, unsecured SME loans are not specifically mentioned as eligible collateral by a covered bond law). In both cases – SME covered bonds based on a specific legal framework for covered bonds and structured SME covered bonds based on contractual law only – asset encumbrance increases. Hence, banks that heavily use traditional covered bonds or other sources of secured funding (for example, repurchase transactions) need to keep an eye on asset encumbrance, a topic of increasing focus for regulators (even though a strict regulatory asset encumbrance limit regarding covered bonds is unlikely to be imposed in the EU in the near future).

INITIATIVES TO KICK-START SME COVERED BOND ISSUANCE IN VARIOUS COUNTRIES

There have already been various efforts to kick-start SME covered bond issuance. Among others, HSH Nordbank in Germany has included unsecured SME loans guaranteed by KfW in its existing covered bond pools. Due to the KfW guarantee, the loans meet the eligibility criteria of the German Pfandbrief Act regarding public sector collateral. Consequently, the respective covered bonds are not SME covered bonds but public sector covered bonds based on a specific legal framework, the Pfandbrief Act.

Meanwhile, with the Decree Law 145 (Destinazione Italia) passed on 19 February 2014, Italy created a new type of covered bond backed by assets other than mortgage and public sector loans. According to Fitch Ratings, the new "collateralised bank bonds" will be dual recourse bonds similar to Italian mortgage and public sector covered bonds, but secured by assets (for example, SME loans) that were not, up until now, eligible collateral for Italian covered bonds.

SME COVERED BONDS TYPICALLY USE A PASS-THROUGH STRUCTURE

According to Fitch Ratings, in the case of Italian SME covered bonds, the liquidity gaps and creditworthiness of the underlying cover pools could limit the potential uplift of the bonds above the issuer rating. Should the issuer default, any maturity mismatches between the cover assets and bonds would be difficult to bridge given that SME loans are typically less tradeable than assets eligible for mortgage and public sector covered bonds. However, this is not specific to Italian SME covered bonds. Due to lower liquidity and higher discounts in the case of fire sales of SME loan portfolios, compared with mortgage or public sector loan portfolios, the argument applies to SME covered bonds in general.

Consequently, the typical hard or soft bullet structure of traditional covered bonds does not result in the same notching differential between the bank's unsecured rating and the rating of the covered bonds. In the case of SME covered bonds, using a hard or soft bullet structure (with maturity extensions up to 24 months) would typically either lead to very high over-collateralisation requirements by rating agencies to achieve a certain rating, or even generally limit the potential rating uplift of SME covered bonds above the bank's unsecured rating.

In line with this, according to DBRS, banks are more likely to contractually include more flexible asset-liability matching terms – such as a conditional pass-through structure – in SME covered bond contracts. Pass-through covered bonds reduce the risk of asset fire sales if the issuer defaults. As a result of the long maturity extensions associated with pass-through covered bonds, post-bank-insolvency cover pool administrators are able to collect sufficient cash flow from the assets before repaying the bonds.

In contrast to public sector and mortgage covered bonds, Italian banks issuing SME covered bonds are not subject to the minimum capital ratio requirement. As a result, smaller Italian banks, which cannot issue Italian mortgage and public sector covered bonds because they do not meet respective capital requirements for issuing banks, could issue SME covered bonds.

SME LOANS ARE ELIGIBLE AS COVERED BOND COLLATERAL IN TURKEY

Turkish banks started to issue SME covered bonds in 2011 following the Turkish asset-backed covered bond legislation, under which unsecured SME loans became eligible as cover pool collateral, as is the case for asset-covered bonds. Asset-covered bond is the term for Turkish covered bonds backed by eligible assets other than mortgage loans. Prior to this, Turkish SME covered bonds were typically privately placed (for example, with the European Investment Bank).

Besides the Turkish covered bond regulation, Turkish SME covered bonds also include various contractual enhancements in the bond documentation, further increasing investor protection. The law provides assurance that the asset pool and transaction accounts will not form part of the issuer's insolvency estate, if the issuer becomes insolvent. A security supervisor – an independent audit institution authorised by the Capital Markets Board of Turkey – is responsible for monitoring the assets in the cover pool and ensuring that the issuer operates in accordance with the provisions of the Turkish covered bond legislation.

The Turkish covered bond law stipulates strict asset coverage, as well as matching and over-collateralisation requirements, which the security supervisor must check. The assets in the cover pool cannot be pledged or be subject to an attachment, or be included with the issuer's other assets in the case of insolvency.

COMMERZBANK SME COVERED BONDS: AN EXAMPLE OF CONTRACTUAL-BASED SME COVERED BONDS

In Germany, under the Pfandbriefe Act, unsecured SME loans are not eligible as collateral for legal-framework-based covered bonds. Besides a limited number of substitute assets, German asset-covered bonds (Pfandbriefe) can be backed by several types of loans. Indeed, there are four different categories of German asset-covered bonds: mortgage Pfandbriefe (backed by residential and commercial mortgage loans), public sector Pfandbriefe, ship Pfandbriefe and aircraft Pfandbriefe.

In 2013 Commerzbank (CBK) introduced a covered bond programme for SME loan collateral, which is not governed by the German Pfandbriefe regulations, but is based on contractual law and the use of a refinancing register. Commerzbank SME covered bonds are ECB eligible (as covered bonds) but not CRR compliant. As such, they are not eligible for own-use ECB repo transactions.

Contractual-based SME covered bonds are directly issued by Commerzbank but benefit from dual recourse via an unconditional and irrevocable guarantee by SME Commerz GmbH, a special-purpose vehicle (SPV) holding the unsecured SME loans. The cash flow from a cover pool of SME loan receivables is transferred to the SPV, which backs the guarantee given to covered bond investors. The SPV is consolidated on Commerzbank's balance sheet and buys SME loans from covered bonds funded by a subordinated loan. If Commerzbank issues new bonds, the SPV will buy further loans to fulfil the over-collateralisation requirements stipulated in the covered bond documentation. The SME loans in the SPV are registered in a refinancing register, and once registered, are deemed insolvency remote.

While Commerzbank SME covered bonds are not based on a specific legal framework for covered bonds, the use of the refinancing register, which enables cover pool asset segregation in case of bank insolvency, provides safety measures and ensures insolvency remoteness (that is, Commerzbank SME covered bonds are at least partly based on specific legislation instead of contractual law only). According to Fitch Ratings, the refinancing register provides sufficient comfort that the register effectively allows segregation of the registered loans from the insolvency estate of Commerzbank. Prior to this, the refinancing register had only been used by German banks in structured finance transactions.

COMMERZBANK SME COVERED BONDS USE A PASS-THROUGH STRUCTURE

As long as Commerzbank pays all its dues with regard to the SME covered bonds which it directly issued, and fulfils the over-collateralisation requirements stipulated by the covered bond documentation, cash flows generated by the SME loans are released to the bank. Should Commerzbank stop paying SME covered bond dues, the guarantee provided by the SPV for the covered bonds will be triggered and the cash flows generated by the SME loans in the cover pool (the SPV) will be used to pay interest and principal on the SME covered bonds.

Hence, in a situation where Commerzbank is not making the necessary payments, the guarantee will step in. The guarantee will be irrevocably triggered if the bank defaults on an interest or principal payment on any bond for more than 30 days, or if the bank ceases to make any other payment for 60 days. Following a guarantee event, cash flows from the asset pool will no longer be released to the issuer, but will be accumulated in eligible investments or used for principal payments. All existing bonds

NOTES

1 UCITS stands for Undertakings for Collective Investment in Transferable Securities.

2 See Annex VI, Part 1, point 68 to 70 of Directive 2006/48/EC, available at www.ecb.europa.eu/ecb/legal/pdf/oj-jol_2014_ 335_r_0010-en-txt.pdf (last accessed 10 January 2015).

maintain their original (bullet) maturity date. As soon as a bond reaches its maturity date, principal is paid to the extent available under the new priority of payments. If principal remains outstanding after the maturity date, the remainder is paid as soon as available (that is, the bond switches to pass-through). All available amounts (for example, interest and principal from the asset pool, amounts transferred from reserves, swap payments received, liquidity facility drawings and eligible investments) will be distributed on each monthly payment date, according to a priority ranking stipulated in the Commerzbank SME covered bond documentation.

"Overall, SME covered bonds are an innovative covered bond format that differs greatly from SME asset-backed securities and traditional covered bonds."

SME COVERED BONDS LIKELY TO REMAIN A NICHE PRODUCT

Overall, SME covered bonds are an innovative covered bond format that differs greatly from SME asset-backed securities and traditional covered bonds. Despite significant differences and typically higher complexity compared with traditional mortgage and public sector covered bonds, most strikingly via the use of pass-through structures to achieve a relatively high rating above the issuer, investor protection is strong. Consequently, SME covered bonds could be a valid investment alternative when the risk of bail-in increases, as is the case with unsecured bank bonds, because SME covered bond investors would benefit from additional security provided by the SME loans (a security layer that unsecured bank bond investors do not have). In addition, a potential yield pickup compared with traditional covered bonds could provide a strong incentive for investors in the ongoing ultra-low yield environment. While the European Central Bank's TLTROs reduce the likelihood of public issuance taking off in the near future, SME covered bonds are likely to remain on bank radars as alternative funding tools, or at the very least are likely to remain on the radar of regulators and politicians willing to support the real economy by supporting unsecured SME lending. The fact that numerous countries – for example Italy, Spain and Turkey – already allow unsecured SME loans as eligible collateral for legal-framework-based covered bonds confirms this view.

ABS	Asset-backed securities
APC	Agency for Protection of Competition
BEEPS	Business Environment and Enterprise Performance Survey
CBK	Commerzbank
CBL	Covered Bond Label
CBPP3	Covered bond purchase programme
CF	Contract farming
CPC	Commission for the Protection of Competition
CRR	Capital Requirements Regulation
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECBC	European Covered Bond Council
EU	European Union
IFAD	International Fund for Agricultural Development
LTP	Legal Transition Programme
LTT	Legal Transition Team
MAs	Marketing associations
MENA	Middle East and North Africa
MENA ES	Middle East and North Africa Enterprise Surveys
MFW	Microfund for Women
NBE	National Bank of Egypt
NPLs	Non-performing loans
OCE	Office of the Chief Economist
OECD	Organisation for Economic Co-operation and Development
PPPs	Public-private partnerships
PPPPs	Public-private-producer partnerships (4Ps)
RFSADP	Rural Financial Services and Agribusiness Development Project
SBI	Small Business Initiative
SBS	Small Business Support
SEMED	Southern and eastern Mediterranean
SMEs	Small and medium-sized enterprises
SOEs	State-owned enterprises
SPV	Special-purpose vehicle
TLTROs	Targeted longer-term refinancing operations
WNRDP	West Noubaria Rural Development Project

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