# INTRODUCING HEDGING INSTRUMENTS IN THE EBRD REGION

Over the past 30 years, the use of derivatives as hedging instruments has become more significant as the role of derivatives in global financial markets has grown. Derivatives are an efficient tool for capital market development, whether they are being used to hedge risk, for speculation or to improve market efficiency. Their use and availability can encourage investment activity, supply and demand, and protect more vulnerable assets from volatile market conditions. As a result of the increase in activity that derivatives encourage, capital markets are able to provide economies with more alternatives to bank financing, thus fostering increased economic growth and a more sustainable financial sector.

In this article we will explore how derivatives can have a positive impact on EBRD countries of operations and how the Local Currency and Capital Markets (LC2) Development Initiative at the Bank works to introduce them to emerging capital markets.

## HISTORY OF DERIVATIVES

The use of derivatives can be traced back to ancient civilisations. Around 1750 BC, King Hammurabi of Mesopotamia created one of the first legal codes that enabled the use of derivatives. Hammurabi's code stipulated that witnessed written contracts could facilitate sales of goods and assets to be delivered at a future date and at an agreed price. While no longer written on clay tablets, many derivatives still reflect this formula. Their use has evolved over the centuries, focusing on various commodities ranging from crops to newspaper print and even fine art.

The Chicago Mercantile Exchange, the first official derivatives exchange, was founded in 1894 by farmers who could not find buyers for their commodities. This was the first instance of standardised contracts that could be bought and sold by anyone.

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## FINANCIAL CRISIS

Flash forward to the 2008-09 global financial crisis, a situation that focused the attention of regulators on derivatives, which many observers associated with speculation and risk-taking. At the 2009 G-20 summit in Pittsburgh, leaders of the world's most advanced economies issued a statement pledging "to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter derivatives market and to create more powerful tools to hold large global firms to account for the risks they take."[1]

In particular, they stipulated that "all standardised OTC (over-the-counter) derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

This led European and American law makers to pass legislation that demanded a more structured approach, enforced strict reporting standards and strengthened client protection by introducing margin requirements.

## EXPLAINED USES

Derivatives are a tool to manage exposures and hedge risk – and this is exactly the use that the EBRD is promoting across its countries of operations. Derivative instruments enable the taking up, selling and management of risk, but in certain cases can also support speculation on the market or improve the market efficiency of the underlying assets.

Swaps constitute one of the most commonly used types of derivative instrument and are important because of their ability to mitigate and hedge risk. If the local interest rate is expected to go up, owners of local assets may purchase an interest rate swap to help maintain the asset's value. In the more volatile emerging markets, being able to mitigate potentially harmful interest rate movements will allow for better and faster market development.

As well as mitigating risk, swaps can also lower the cost of transactions for local and foreign investors, who may invest in a foreign exchange (FX) swap to protect their investments against volatile exchange rates. EBRD clients often hedge either their interest rate exposure or FX risk.

Options, another type of derivative, are more versatile than swaps because, while they can provide an effective hedge, they also facilitate speculation. If an investor is worried about market movements, options can guarantee that their asset will be sold at a certain price. If they are proven wrong, however, they will have to shoulder the extra cost.

Aside from hedging, servicing and speculating, derivatives also provide transparency and price discovery insights into capital markets. The nature of the futures market provides a continuous flow of information from around the world. As commodity prices and demand are impacted by a range of market climate conditions, geopolitical events and defaults, it is easy to track movements in commodity prices.

Most importantly, however, derivatives can only ever be useful if there is a market underlying them. If there is not, their use can be mainly destructive and can undermine the positive development of capital markets and of local economies.

## THE EBRD'S DERIVATIVES REFORM WORK

The strategic objective of the LC2 Initiative is to achieve more efficient and self-sustaining financial intermediation in the EBRD's countries of operations through the broader use of local currencies and the development of local capital markets, thereby contributing to economic growth and a more stable financial environment. The development of the derivatives market is important for establishing stronger capital markets.

To assist countries in the EBRD region to effectively use derivatives, the Bank provides support via technical cooperation (TC) projects for reform of the legal and regulatory framework for these capital market instruments. In many developing capital markets, this framework does not provide for the enforceability of derivative transactions or for concepts such as close-out netting or financial collateral. In some countries of operations, derivative transactions are even classified as gambling and are thus considered unenforceable.

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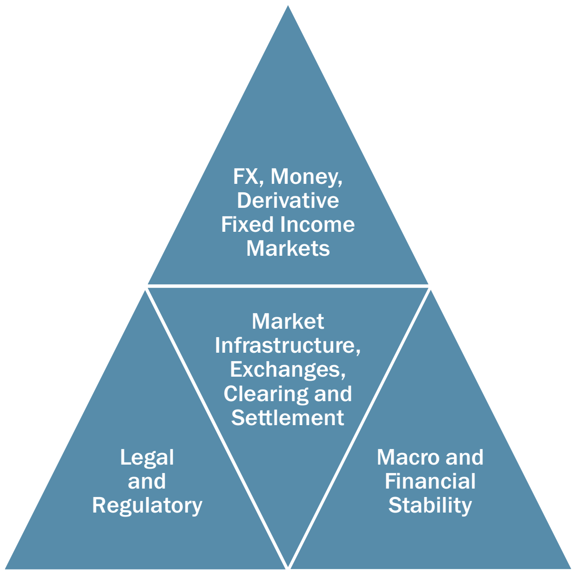
**Figure 1** Targeting and sequencing of capital market development




Source: Based on Figure 1 on page 8 of Karacadag, C, Sundararajan, V and Elliott, J.A. (2003), IMF Working Paper "Managing Risks in Financial Market Development: The Role of Sequencing".

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## HOW DOES LC2 TACKLE THESE ISSUES?

It all starts with an assessment[2] in which the LC2 Initiative team identifies gaps in a country's legal framework, infrastructure or skill-set and provides recommendations. The LC2 team coordinates with other units within the EBRD to gain funding approvals and begin their efforts. Subsequently, the team agrees on an action plan with that country's government or other stakeholders and this forms the basis of a donor-funded TC project.

TC projects in this area mostly focus on legal and regulatory reform to introduce the enforceability of derivative transactions and, among other instruments, close-out netting and financial collateral (see boxes). These changes help to bring the existing legislation up to international standards.

In 2016 the LC2 and OGC Finance Team completed a derivatives legal and regulatory TC project in Armenia and work in Georgia, Morocco and Ukraine was ongoing at the end of the year. A TC project is soon to begin in Kazakhstan.

As well as helping countries adopt good derivatives legislation, the EBRD works to improve the implementation of these laws by enhancing the knowledge of market participants, regulators and the judiciary. It also undertakes efforts to develop derivatives market infrastructure.

In such reform efforts, the EBRD closely cooperates with local and international market participants, the International Swaps and Derivatives Association (ISDA) and the International Capital Markets Association (ICMA).The LC2 team collaborates with departments across the Bank throughout the TC project implementation phase working together with OGC Finance and Treasury.

**Close-out netting** is the primary means of mitigating credit risk associated with over-the-counter derivatives transactions. It refers to a process involving the termination of obligations under a contract with a defaulting party and the subsequent combination of positive and negative replacement values into a single net payable or receivable.

**Financial collateral:** Posting collateral is also highly convenient as a means of hedging credit risk, using cash and investment securities as collateral or margin in financial obligations. Parties will post collateral to each other to provide security in the event that one of them defaults on payment.

## AN EXAMPLE OF REFORM IN ARMENIA

In Armenia, the LC2 team, Treasury and OGC Finance identified a need to introduce hedging instruments and partnered with the Central Bank of Armenia (CBA) to develop a TC project to create the relevant legal framework. Because of its ability to generate efficient and affordable hedging, the CBA saw derivatives as an essential part of its wider capital market development programme, especially with respect to foreign exchange and interest rates. The project constituted an element of the action plan set out by the Memorandum of Understanding on local currency and capital markets development that the EBRD and the Armenian government signed in March 2016.

Armenian legislation at that point lacked any specific derivatives regulations, only defining them as a form of security and excluding the use of OTC derivatives. The EBRD and CBA reform programme sought to introduce legal concepts that would facilitate the use of all types of derivative instrument and remove obstacles to their development. It also aimed to create legal certainty as to the enforceability of derivative contracts. This was an important step for the formation of robust capital markets in Armenia as it would enhance the ability of market participants to raise funds in cross-border capital markets transactions.

Financial support from the EBRD Shareholder Special Fund facilitated the hiring of local and international consultants who helped the EBRD and the CBA draft the new law.

### *Risk of recharacterisation*

This is a common issue in countries of operations where derivatives are frequently characterised as bets or games, are rarely awarded judicial protection and are often poorly treated under insolvency proceedings. Before the reform, Armenian anti-wagering rules impeded the utility of derivatives. Thanks to the EBRD TC project, Article 1039 of Armenia's Civil Code was amended to stipulate that claims arising out of derivative financial instruments do not qualify as games or gambling, even if they have features inherent to such provisions.

### *Definitions*

Derivatives were often misdefined or not defined by Armenian legislation. Instead, they were defined as securities, which excluded OTC derivatives from the law's scope and denied them legislative protection. It was decided that defining derivatives as financial instruments would not only facilitate their use, but also would align local legislation with international regulations (for example, the European Union's Markets in Financial Instruments Directive) and global standards of best practice.

### *Capacity and authority limits*

A further central concern of the reform project was to ensure that the legal status of market participants would allow them to freely enter into derivatives transactions. The CBA wished to remove restrictions on the capacity of participants to execute derivative instruments or enter into collateral-posting arrangements.

To achieve this, the TC project recommended that amendments be made to a number of laws dealing with financial institutions, including the Law on Banks and Banking, the Law on Securitisation and Asset Backed Securities, the Law on Funded Pensions, the Law on Investment Funds, the Law on Credit Organisations, the Law on Insurance and Insurance Activity, the Law on Payment Systems and Payment Organisations, to enable them to enter into derivative transactions. These amendments entered into force in November 2016.

### *Financial collateral*

Posting collateral is important for derivatives and repurchase agreement (repo) transactions and provides security in the event that one of the parties to the transaction defaults on payment. The Credit Support Annex of the ISDA master agreement facilitates the transfer of collateral and its subsequent use or hypothecation.

In respect of financial collateral arrangements, the TC project led to the introduction of amendments to Armenia's civil code in line with the European Union (EU) directive on Financial Collateral Arrangements. These changes aimed to enable the counterparties to the Credit Support Annex (CSA) to efficiently enforce their rights under collateral posting agreements.

### *Close-out netting*

Netting arrangements are widely used in the financial markets to manage the credit risk of counterparties. ISDA agreements are based on the enforceability of the netting concept, so it is critical to ensure that netting agreements can be enforced in case of counterparty insolvency. Close-out netting is the primary means of mitigating credit risk associated with OTC derivatives transactions. It refers to a process involving the termination of obligations under a contract with a defaulting party and the subsequent combination of positive and negative replacement values into a single net payable or receivable.

The primary goal of the TC project was to establish a safe harbour exemption that would survive the existing moratorium and insolvency regime. This exemption would also allow for the enforceability of close-out provisions for both commercial companies and financial institutions. The approach adopted by the ISDA Model Netting Act and the principles of the International Institute for the Unification of Private Law (UNIDROIT) on the operation of close-out netting provisions were considered and amendments to the abovementioned laws were enacted to set out an efficient close-out netting regime. An important novelty included under the reform was providing applicability of the new close-out regime to repurchase agreements using Global Master Repurchase Agreement (GMRA) standard documentation.

### *Governing law*

To encourage market participation, the EBRD project supported amendments that allow local counterparties to govern their agreements under foreign law, as seen in the ISDA master agreement and in CSAs which acted as model agreements in the reform. This amendment allowed Armenia to further align itself with international practice, making it a more attractive prospect for international counterparties as the country's capital market continues to develop.

### *Tax*

Before the reform, Armenian tax laws failed to provide for any specific rules on the taxation of derivative instruments. As a consequence, there were significant questions about whether payments made as a result of the netting of obligations under derivative financial instruments were tax deductible. To address such uncertainty, specific provisions were introduced into the Draft Tax Code.

The law was enacted at the end of October 2016 and has already entered into force. Following on from the initial success of the reform project, LC2 are working closely with Armenia to further develop its capital and derivatives markets.

## WORKING WITH THE ISDA

The aim of the ISDA, as set out in its mission statement, is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. The mission statement also provides a framework and standards that the ISDA requires its members to adopt to guarantee the integrity of the market.

The EBRD and the ISDA work closely together to encourage capital market development through the use of derivatives. The framework in the ISDA master agreement facilitates market growth and liquidity by simplifying the comparison of terms between agreements offered by different counterparties.

Furthermore, the ISDA requires any participating market to ensure the quality and integrity of its participants' practices. This contributes to the overall improvement of capital market standards, beyond the trade in derivatives.

"The EBRD's end goal is to improve the investment climate of our countries of operations so their economies can advance in their development," says Jacek Kubas, a member of the LC2 team. "Derivatives and associated reforms help to foster this transition. Our legal reform and capacity building work in this field promotes them as a hedging tool and creates a safe and efficient underlying environment."

1 http://www.g20.utoronto.ca/2009/2009communique0925.html (last accessed 13 January 2017).

2 http://intranet.ebrd.com/ebrdnet/depts/lc2/assessments.shtml (last accessed 13 January 2017).