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THE CASE OF ARMENIA:
Setting incentive based benchmarks are better way forward

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I would like to first of all thank the organizers for this important gathering, which going forward will deepen our understanding of global rules and the importance of the regional perspective of the corporate governance issues and capital markets. I would also like to thank the OECD and the authors of this well-represented and candid report. We could certainly use it as a reference guide in our day-to-day work.

Why the Central bank? Very recently we have completed the transfer of functions of the Securities Commission to the Central Bank (CBA), which became the unified regulatory and supervisory body for the entire financial sector. Therefore, the CBA is now responsible for both securities markets and business conduct regulation and supervision. Moreover, at the end of last year the banking legislation was amended to incorporate the best international practice of corporate governance in banks. An important feature of this endeavour is the clear political will to implement this best practice in the banking system: legal amendments followed two years extensive and hot discussions of the CBA concept paper with all the stakeholders, and there is a clear action plan for the implementation.

After this brief background, let me again return to the report before us in order to make my contribution for this discussion. I fully share the trust of the report, which suggests clear measurement criteria, provides sufficient background to understand strengths and weaknesses of corporate governance in our region, and clearly indicates the enforcement as a priority for the future. It is also clear from the report that while the situation with the legislation is sufficient to move forward, at least judging by the number of "Yes"s in the assessment table, the implementation of these laws and rules remain a challenge.

What is missing though are incentives, clear checks and balances and a stronger case for regional integration of capital markets that would trigger the private/corporate sector initiative to play the game. These three issues would be the main topics of my presentation. To my sincere believe these are important precondition that would make access to capital tangible, and corporate governance relevant for the private sector.

Therefore, in this context I better skip the progress and greatest difficulties part by subscribing myself to the views of the authors in the report, and concentrate on priorities for advancing corporate governance reform.

Incentives

Some important incentive features in the corporate sector that makes corporate governance relevant are: (i) divers ownership structure, where owners do not focus on a piece of assets but see clear benefit from company's economic performance; (ii) there is a clear principle-agent issue, when a single majority shareholder or shareholders appoint a manager, but are not interested in running the company by him/herself; (iii) large domestic institutional savings and autonomous foreign direct investment is available; and (iv) there are reputable infrastructures that could present well managed companies to domestic saving institutions and international capital markets.

We have already initiated several incentive enhancing measures, which I will present in the order of priority to us. These are:

- Partnering with an reputable European Stock exchange;
- Promoting 7 local companies for international rating by Moody's or Fitch together with the State that applies for sovereign rating;
- Rating local companies by the CBA on a voluntary basis, which provides access for these companies' debt instruments to money markets and facilitates access to loans via supervisory incentives. Currently we negotiate with international reputable rating companies to outsource this function to them.

These measures are mostly consistent with our vision that internationalization of capital markets is the best way out towards developing domestic capital markets and thus creating incentives for the corporate governance best practice.

Nevertheless, for smaller and remote markets like ours, targeting at benchmark companies with ambitious long term strategies, and cooperating with already reputable international stock exchanges that provide global trading platform and access to international capital markets for these benchmark companies is the key incentive structure that I would like to present you. In other words we need to create success stories that would have spillover effects on the rest of the corporate sector. In the Armenian context, if this dream comes true the following sequencing of events may happen:

1. Armenians will start investing in international capital markets through domestic or foreign brokers and investment companies, and thus introduce them to international players. Domestic private savings have spiked in 2000 from almost 0 to 20-25 percent of GDP. If I accrue these flows for the last 5 years it provides about 4-5 billion USD, of which only 100mln USD appeared in the Banking system. The rest is in private hands, and I believe could be collected if a good investment strategy abroad is offered.

2. International investment companies will start purchasing firstly bonds then shares of domestic Armenian companies. Meanwhile, we could train the brokers and dealers, and potential issuers that those could prepare and present financially sound borrowing and capitalization strategies.

3. Foreign reputable investment companies underwrite and invest private Pillar II pension funds both in foreign and Armenian securities and stocks. We have actuarial analysis, which shows that the new pension system we are proposing would build up pension fund assets to GDP ratio to about 15-17 percent of GDP in the next ten years. This is about a couple of billion USD in 10 years.

4. Ordinary Armenians, including Diaspora, also will see the benefit of investing in capital markets.

We will continue negotiating with donors and multilateral investors like EBRD or IFC to become partners in our endeavours. However, after an extensive analysis and communications, we could also find a reputable private partner, which is the OMX (Nordic and Baltic's Stock Exchange). We found out that the OMX has interest towards the region's capital markets and successfully helped the Baltic countries to implement the same policies that I described above. In this context, if we had OMX as a private partner, opportunities for accessing the global capital markets would become tangible and convince the Armenian companies that the latter is not apparel that only EU countries or USA could wear. The mental barrier of domestic companies that they are operating in a bad market will also disappear immediately.

Checks and Balances

Here the most important issue is the right balance between freedom of choice by the market participants, issuers and investors, and regulation. The role of the regulator is to ensure fare contracts and firm commitment that these contracts are enforceable. With a simple glance to the Armenian corporate sector and capital markets one could easily conclude that it is overly regulated and there are too much reporting requirements. We decided to heavily regulate something, which hypothetically might occur. Therefore, more risk based approach and a move from paper inspection to market oversight is critical for the market to take off.

We are currently working on a new policy framework for regulating and supervising capital markets and the corporate sector. Most probably the Stock exchange would be demutualized and offered to market participants and strategic investors like OMX, off site supervision will be improved by ensuring an arm lengthen approach to businesses while supervising, and transparency will be enhanced to ensure that insider and related transactions are appropriately disclosed and prices are not distorted.

Finally, business conduct practices should be revisited to ensure that investors' right are protected, whereas companies are not shy to issue shares because of burdensome watch log by the regulator. It is a novel concept for our region, and because of Soviet legacy we apply the rules in a manner that enhances micromanagement. Our concept would be to follow the full transparency rule and interfere if there is a dispute case between the issuer and the investor. The balance here should be that this is something that is decided between the investor and the issuer and the check is that there is a state business conduct oversight that is authorized to investigate the dispute cases and intervene if necessary.

Regional cooperation and integration of capital markets

I believe that the globalization, large amounts of global liquidity due to structural changes in international capital markets, and speedy consolidation of European financial markets provide an opportunity for our region to integrate into the global markets. All our problems, ambitions and opportunities should bring us together under the force of gravity. This will make us larger and attractive for richer global players, and, therefore, rich capital markets would become a center of gravity for our region.

We need to extend these types of forums and concentrate on success stories in the region. Synchronizing the legislation and rules under the OECD best practices could be another approach forward. However, I do see a stronger case for us to target developed stock exchanges and global market players as developmental partners with us. Most probably we will try to initiate such a forum on the regional case, if we find countries and donors supportive to the idea.

Having said this, I do believe that we can find solutions that we integrate our capital markets without giving up our own infrastructures and national pride.

We could live this idea aside, but as the Baltic case demonstrates it will become unavoidable when one of the countries move forward. The same argument above about success story in the corporate governance case is also relevant in this context. According to my judgment, Estonia made the first move; others were sceptical or did not take the capital markets' developmental issues seriously. Eventually, they joint the effort, but still have much smaller markets than Estonia.

Fortunately, I already see a merit for comparing our vision of corporate governance and capital market development with the one presented in my Kazakh colleague's presentation. I certainly could see common grounds and hope that she also shares my point of view after she heard this presentation.

Conclusions

In conclusion, I think that international standards are important benchmarks and should be vigorously implemented. However, incentives to become globally comparable corporate animals should also be prioritized. This implies that market developmental issues and global integration of our capital markets have a clear priority for the Region in this stage of development. To achieve this objective, we need to create success stories that demonstrate the benefits of being transparent and applying the corporate rules.

Nevertheless, in the Armenian context we have two parallel processes ahead of us: (i) the corporate governance reform in the banking sector, which is mostly targeting on the enforcement of newly adopted laws; (ii) and new incentive based corporate governance reform in the real sector based on capital markets' development, which assumes tangible access to global and domestic institutional savings.

In a couple of years we will see, which approach to take going forward. If we were able to solve capacity constrains by partnering with a "blue chip" stock exchange(s) the second approach has better chance to survive. We already see that the discussion itself triggered a lot of unexpected interest and positive expectations towards the approach.

Because of these ambitions, we are ready to seriously work on the regional case and build up momentum toward the tipping point. We are ready to champion, or join others if they already have such a strategy in mind.

Two specific suggestions:

- OECD could consider a set of standards monitoring the incentives and environment for Corporate Governance in emerging markets;
- The forum should be opened up to the private sector: Building private and public sectors partnership will enhance understanding of relevance of corporate governance and overcome the myths about it. We need to bring together benchmark companies from our region, and blue chip companies and stock exchanges together.