SYSTEMS APPROACH POLICY VALUE CHAIN ANALYSES

INVESTMENT FUNDS LAW

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ACRONYMS

AmCham	American Chamber of Commerce
ADB	Asian Development Bank
BNFC	Benefica, Investment Bank
BOG	Bank of Georgia
CCG	Caucasus Capital Group, Investment Bank
CEO	Chief Executive Officer
CF	Cerberus Frontier, Investment Fund
CFO	Chief Financial Officer
CSO	Civil Society Organization
CMWG	Capital Market Working Group
EBRD	European Bank for Reconstruction and Development
GCIF	Georgian Co-Investment Fund
GFMTA	Georgia's Financial Markets Treasuries Association
G&T	Galt and Taggart, Investment Bank
GOG	Government of Georgia
G4G	Government for Growth
GSCD	Georgian Securities Central Depository
GSE	Georgian Stock Exchange
GSPF	Georgian State Pension Fund
IARP	Inter-Agency Reform Platform
INVC	Investors Council
LGIF	Law of Georgia on Investment Funds
MOESD	Ministry of Economy and Sustainable Development
MOF	Ministry of Finance
NBG	National Bank of Georgia

PEA	Political Economy Analysis
PLR	Policies, laws and regulations
PMO	Prime Minister's Office
SOE	State Owned Enterprise
TBC	TBC Bank
TBCC	TBC Capital, Investment Bank
USAID	United States Agency for International Development
WB	The World Bank

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1 EXECUTIVE SUMMARY

A country's economic growth is strongly correlated to the health and robustness of the financial sector and its ability to mobilize domestic savings and to channel those resources into the economy. Collective investment undertakings, or investment (mutual) funds, are the backbone of the capital market, and they create market liquidity and capitalization growth potential. Investment funds attract international portfolio and direct investments to the country, boosting economic growth. The Government of Georgia (GOG) has recently initiated a new, more sophisticated, and flexible investment funds law, which was developed with the critical assistance from USAID and submitted to Parliament in March 2020. However, the implementation of the new law will face many obstacles and some decisive measures will be required to create the investment fund infrastructure that is needed in Georgia.

Using a Systems Approach Policy Value Chain Analysis methodology that draws from Political Economy Analysis (PEA) and root cause analysis, this report explores conditions for the successful implementation of the Law of Georgia on Investment Funds (LGIF), such as effective enforcement infrastructure, and transferable equity and debt securities as regulated asset classes for authorized investment funds. It also analyzes key stakeholders and scores them according to their influence, interest, motivation and importance.

The paper conducts root cause analyses to break down the conditions and identifies key constraints. It also proposes and explains specific opportunities for action on several issues, including market and regulatory capacity building; the development of asset securitization regulation, which will enable income-generating assets to transform into transferable securities; and the strengthening of private sector advocacy.

SUMMARY OF KEY FINDINGS

- Main challenges for the successful implementation of the Law:
  - the lack of capital market infrastructure;
  - the absence of a clear "owner" within the public sector to drive the development of the capital market; and
  - the regulator needs to become more industry friendly and be oriented towards capital market development.
- Secondary legislation to the Law and the regulatory structure should be flexible and investment-friendly to generate trust in local and foreign investors.
- It is essential that the market reaches the necessary critical mass to be successful.
- The private and public sectors have a steep learning curve to be able to effectively set up and establish a well-functioning capital market.
- National Bank of Georgia, as the designated capital market regulator, needs to be assigned a responsibility for capital market development.
- The private sector needs substantial capacity strengthening to balance the disproportionately strong regulator.

PRIORITIZED ACTIVITIES

The goal of the reform is to create an efficient investment funds ecosystem to attract international investors and facilitate the influx of capital into Georgia. To assist this process, the Program could apply "green beret" strategy and tactics and act as a force multiplier to mobilize and train "friendly forces" who then take the matter in their own hands to ensure the consistence and sustainability of the reform. That implies the strengthening of the private sector as a major advocacy group, and the establishment of a government-supported inter-agency reform platform for facilitating public-private dialogue and partnership for better coordination of the reform to keep the momentum going. The Ministry of Economy and Sustainable Development (MOESD), the National Bank of Georgia (NBG), and the private sector would have permanent representation on the platform, which would also engage other GOG agencies and Parliament in the reform process.

It is also critical to support the GOG in drafting and implementing a securitization law and regulations, which are vital for creating secured, transferable assets for an investment fund portfolio.

2 BACKGROUND OF THE REFORM

The reform has strong support from the Prime Minister, MOESD, Ministry of Finance (MOF), and capital market operators.

1. According to Dr. Richard Ho, and Clement Wong—*The Role of Fund Management in Promoting Capital Markets Development in Asian Economies*—investment funds are the most important segment of capital markets, as they "attract foreign capital inflow, mobilize domestic savings and support rapid economic expansion." While the Georgian economy is relatively stable, potential growth is limited by a lack of investment and capital raising opportunities for both domestic and foreign investors.
2. In 2015, the Asian Development Bank (ADB) and USAID Government for Growth (G4G) project sponsored a comprehensive capital market study that identified gaps and opportunities and gave recommendations for how the capital market could be developed in Georgia. All follow-up activities supported by USAID were aligned with that study. The USAID G4G led the development of the draft Law of Georgia on Investment Funds (LGIF). The law is aimed at introducing liquid and regulated transferable investment vehicles (investment fund units) for the state pension fund and other low-risk collective investment undertakings. The law introduces global best practice-based functional and regulatory mechanisms to create a favorable investment climate that attracts large institutional investors with sizable foreign participation. This initiative is well aligned with the pension reform, which requires diverse and liquid transferable securities as pension fund portfolio assets.
3. The Capital Market Working Group (CMWG) was established in 2019 to bring together a wide range of actors from the financial industry and the key government agencies responsible for the financial sector in Georgia to foster a broad public-private discussion of the LGIF. The group includes representatives from commercial and investment banks, the NBG, MOESD, the Investors Council (INVC), the American Chamber of Commerce (AmCham), the Georgian Stock Exchange (GSE), the Georgian Securities Central Depository (GSCD), the Georgian Co-Investment Fund, and leading consulting and law firms.
4. In March 2020, the final draft Investment Funds Law was approved by the GOG and was submitted to Parliament. On July 15, 2020, the LGIF has been adopted by Parliament.
5. This assessment uses the systems approach on the gaps in the inputs to the implementation of the Investment Fund Law along the policy value chain as well as the network of relationships and behaviors of the stakeholders engaged in the reform.

3 CURRENT STATE OF THE REFORM ECOSYSTEM

The Georgian Stock Exchange (GSE) trading statistics indicate that currently Georgia has virtually no equity market and very few large institutional investors. Investments are illiquid with no clear and transparent exit strategy or equity appreciation potential. The absence of diversified investment sources and the risk of being illiquid make companies unmotivated to go public. Access to finance in general is the second most-cited problem for businesses in Georgia, according to the 2017-2018 World Economic Forum's Global Competitiveness Index. In 2019, IFC estimated the total finance gap for businesses in Georgia at $2.1 billion which is almost 12 percent of the GDP. Accordingly, local companies suffer from under-capitalization and most of them are over-leveraged because of the absence of organized equity channels. Based on data from the National Statistics Office of Georgia, FDI has decreased since 2014 when it stood at just over $1.8 billion: it totaled $1.2 billion in 2018, falling even further in 2019 ($1.08 billion or 41 percent of the 2014 total). While the drop was mostly due to the completion of the Baku-Ceyhan pipeline, the fact that a single project caused FDI to fall by almost half indicates that the capital market is not diversified enough (or at all). Portfolio investments are critical in creating market liquidity, which is a key factor while considering overseas investments. Additionally, there are very limited opportunities for the public to invest in collective undertakings, or alternative savings plans. While some attention was given to the topic in 2009, it stopped short of the major adjustments that were needed to change the existing legal structures to allow for fund creation and the development of a solid capital market.

The GOG, with the support of USAID, first seriously explored developing a capital market in 2015. The ADB and USAID G4G project funded a preliminary study, and the USAID-sponsored draft Investment Funds Law was developed in 2019 as a follow-up. As part of the legislative package, the team also analyzed other related laws that would need to be amended for the full implementation of the proposed reform.

To gain wide feedback and foster public-private dialogue and buy-in for the reform, the G4G project established the CMWG, which included key stakeholders from both the private and public sectors. The CMWG conducted weekly working sessions to discuss and amend the draft law. In March 2020, the final draft Investment Fund Law was approved by the GOG and submitted to Parliament. Parliament adopted the LGIF on July 15.

<u>Impact on the Economic Governance and Challenges for Implementation of the Law</u>

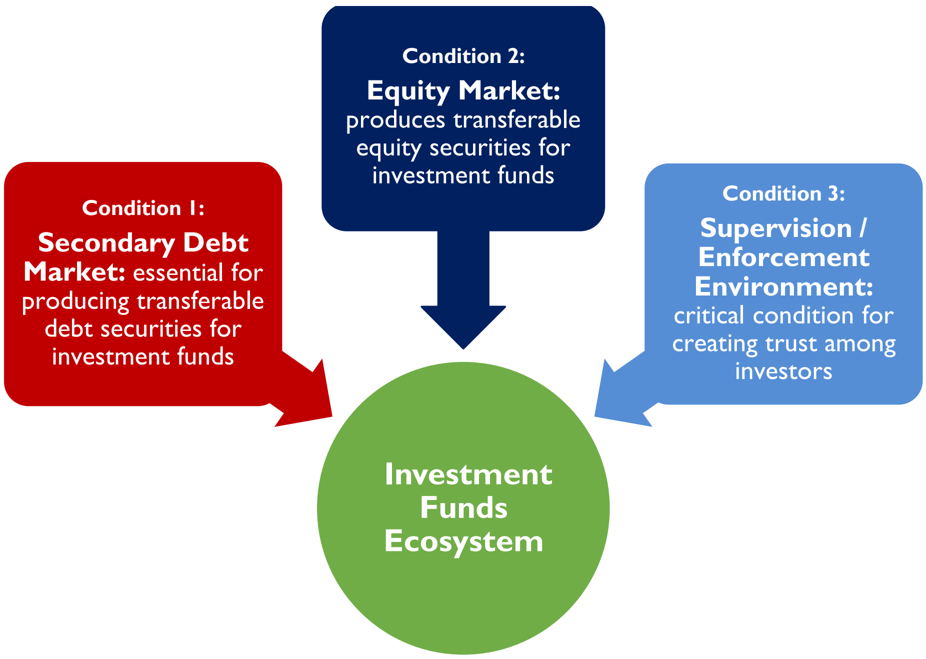
Through the analysis, the USAID Economic Governance Program ("the Program") team identified the following three main constraints that hinder achieving the main objective of the reform:

1. No Secondary Debt Market – bonds and other securitized debt are a primary asset class for domestic and international investment funds in developing countries. According to *U.S. News Money* "emerging market mutual funds invest more than 65 percent of their assets in bonds from developing countries."[1] Also, debt securitization is the easiest mechanism to produce transferable investment vehicles, which allow mutual funds to start functioning in a country like Georgia.

[1] https://money.usnews.com/funds/mutual-funds/rankings/emerging-markets-bond

2. No Equity Market – equity securities are essential for achieving the goal of providing the economy with much needed long money. However, the development of the equity market ecosystem will require a more sophisticated approach. It strongly depends on how successful Georgia will be in the implementation of LGIF and the development of investment fund mechanisms. According to the World Bank's *The Global Growth of Mutual Funds*, as a country develops from a low- to middle- to high-income economy, institutional investors like mutual funds gradually shift their interest from debt assets to equity securities which, in turn, encourages corporate IPOs and a secondary equity market.
3. Supervision/Enforcement Environment – US Ambassador to Georgia Kelly Degnan stressed the importance of the judiciary in attracting investors during a press conference on May 20, 2020: "Businesses need to know that they are investing in a country that has a reliable judiciary, that their disputes will be resolved fairly and in a timely manner, otherwise they invest in another country."

Figure 1 shows the main objective of the reform and three main conditions to achieve it.



The main challenges for the successful implementation of the law are:

1. The lack of a capital market infrastructure, which includes funds to invest in and professionals with the requisite knowledge.
2. The absence of a clear "owner" within the public sector to drive the development of the capital market.
3. The lack of an independent regulator that is oriented toward capital market development.

Both the private and public sectors support the law that was presented to Parliament. The challenge is implementing the regulations and developing a foundational structure that promotes trust and confidence for domestic and foreign investors. While the law enables the creation of investment funds, the end goal is to create an attractive investment market for both domestic and foreign investors. It is also essential that the market reaches the necessary critical mass to be successful.

The funds initially need to reach more mainstream investors, who have "cheaper" money and who are willing to invest. The legislation needs to be attractive to draw mainstream investors, as the market matures and prepares for foreign investment.

The implementation of the law will become a "chicken and egg" problem of demand vs. supply in the market. There is more supply than demand, as most Georgians and Georgian business owners do not know about capital markets, how they work, or why different investment and liquidity options would be worthwhile. At the same time, the private and public sectors have a steep learning curve to effectively set up and establish a well-functioning capital market.

Another challenge for the law of Georgia on Investment Funds, as well as the accompanying regulations and implementation, is that Georgia is the only country in the region that is adhering to US and EU standard laws and regulations. The belief is that this practice will create more transparency and trust for foreign investors, however the transition process should allow for the gradual implementation of regulations to create a functioning system first, as the requirements are too stringent for a nascent fund and investment banking industry.

The NBG is a key factor in the implementation of the LGIF and in the regulation and oversight of the capital market. According to all sources interviewed, there are several issues with the NBG's role in developing and regulating investment funds and the capital market. At present, there is little incentive for the NBG to take on a more active role in growing the capital market, and there are conflicts of interest in its role as both an agent and regulator of investment opportunities. In addition, the NBG needs to build up capacity for developing guiding regulations and procedures to authorize funds, register funds, or conduct investigations—all of which are critical steps in implementing the LGIF.

4 STAKEHOLDER ANALYSIS

The LGIF impacts all layers of the capital market ecosystem by creating the opportunity for general corporations to attract investment and participate in collective investment schemes. It mobilizes and channels public savings into the economy. The law will enable the creation of jobs by diversifying the financial services industry through the introduction of asset management and expanding the demand for investment banking and investment bankers. LGIF also gives commercial banks the opportunity to diversify their services by using their retail outlets as points of sale for investment fund units.

Key stakeholders that have been involved in the development and discussion of the draft law include investment banks (Galt & Taggart (G&T) and TBC Capital), GSE, GSCD, commercial banks, asset management companies, large and medium businesses, business associations, and the general public as investors. There has been active participation from the private sector in the CMWG, as well.

The incentives for the private sector are numerous, as the reform will benefit from clear, unambiguous, and investment-friendly business and regulatory mechanisms to raise capital and have broader investment options. Business associations can play a vital role in the process of developing the investment funds ecosystem. However, local corporations have little knowledge and expertise with the capital market and regulatory mechanisms. A comprehensive awareness raising campaign is needed among large and medium companies. The campaign should include a series of professional workshops for Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs). Awareness raising assumes full-time activities on data-collection, development of training materials, communication campaign, *etc*. The private sector, represented by a few investment services firms, is still undeveloped and has limited resources to undertake such a complex task alone. The Program's assistance will be essential in the process.

Members of the GSE, including the major commercial banks and large businesses, have provided strong support for the draft law and the development of the capital market. GSE board members work together as a coalition. The board members represent senior bank executives and bank CEOs and have considerable influence over the development of any new financial services. There are lingering concerns, however, that regardless of how strongly the private sector supports and advocates for the reform, the NBG's resistance to take active steps could hinder its success.

Potential conflicts of interest between commercial and investment banks (joint ownership) and the need for flexible regulations to allow joint affiliation will need to be resolved. The current draft law does mandate a firewall between investment and retail businesses, but this issue will need to be addressed fully to create the infrastructure and range of businesses and entities needed for a robust capital market and investment platform.

4.1 STAKEHOLDER MAP

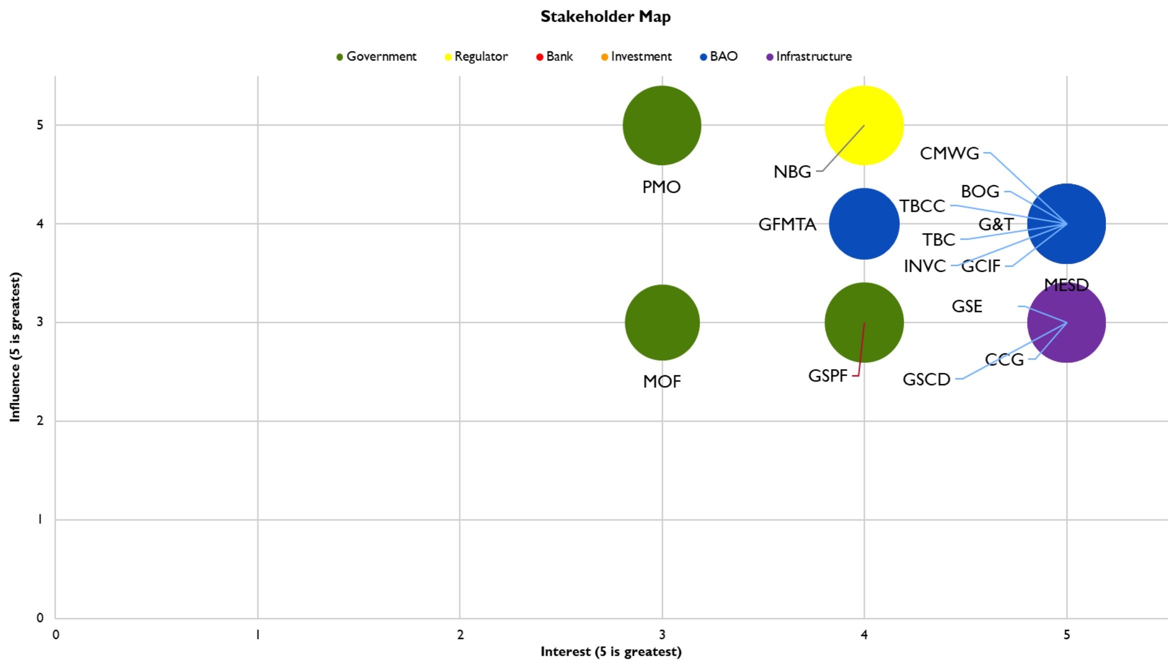


Figure 2. Reform Stakeholder Map

The stakeholder map identifies the reform stakeholders and scores them according to their interest/involvement in the reform as well as their influence, motivation and importance. The map was created based on the Program team's experience working with the industry stakeholders that participated in the CMWG, which consists of all major public and private players. It also reflects the results of multiple interviews with a range of stakeholders.

4.2 STAKEHOLDER INFORMATION

The law received a high level of support from the government and the private sector. There are two main GOG stakeholders, the MOESD and the NBG. Secondary stakeholders include the MOF, in its role overseeing taxation and tax regulation, and the courts. There are several private sector stakeholders, which are discussed in the following section.

Ministry of Economy and Sustainable Development (MOESD) - MOESD is responsible for developing and drafting economic policies and legislation that are directly linked to the management and functioning of the Georgian economy, including the LGIF.

National Bank of Georgia (NBG) - The NBG is Georgia's Central Bank, and it is the designated regulator of the capital market.

Ministry of Finance (MOF) - The MOF leads the design of the taxation regime for collective investment undertakings.

Capital Market Working Group (CMWG) - an unofficial platform of public-private stakeholders created with USAID assistance for drafting the LGIF.

Georgian Stock Exchange (GSE) - the only organized securities trading platform in Georgia.

Securities Central Depositary (GSCD) - The GSCD is a GSE subsidiary, it runs clearing and settlement for securities transactions and maintains broker/dealer and broker/client accounts.

Galt and Taggart (G&T) - A major investment bank, affiliated with the Bank of Georgia (BOG) Group.

TBC Capital - A major investment bank, affiliated with TBC Bank.

Private funds - The companies that manage funds have expressed keen interest in the capital market reforms.

Investors Council (INVC) - A GOG advisory body founded by the European Bank for Reconstruction and Development (EBRD).

Caucasus Capital Group (CCG) - An independent investment bank.

Commercial banks - Some local retail banks have investment banking arms; others see the opportunity for the diversification of products and services offered to clients.

Business associations, large and medium businesses - These businesses have a direct interest in the reform, as it creates alternative capital raising opportunities.

Georgia State Pension Fund (GSPF) - The GSPF is governed by the State Pension Agency, which was created in 2019. The mandatory pension accrual system was worth GEL 503 million as of December 31, 2019.

Georgia Financial Markets and Treasuries Association (GFMTA) **-** The association represents entities with a primary focus on foreign exchange and fixed income markets.

General public - Lacks knowledge about savings opportunities provided by the capital market. Awareness raising is needed to create positive perception and educate the general public on the reform, including the alternative savings opportunities and retail investor protection mechanisms. Once the Law is implemented, investment funds can provide feasible and competitive savings vehicles.

Courts - The success of the reform strongly depends on the efficiency of the judiciary/enforcement system in Georgia. The courts are currently poorly informed and educated about capital market concepts. The reform should also address awareness raising and training in the court system, to make disputes and law-enforcement less time-consuming and less expensive for investors.

Development Agencies - ADB, World Bank (WB), and EBRD have shown high interest in the reform. ADB has been the major sponsor for the State Pension Fund since its incorporation.

KEY STAKEHOLDER CHARACTERISTICS BASED ON THE PEA ANALYSIS, VISUALIZED IN FIGURE 3

Figure 3 Stakeholder connections (formal)

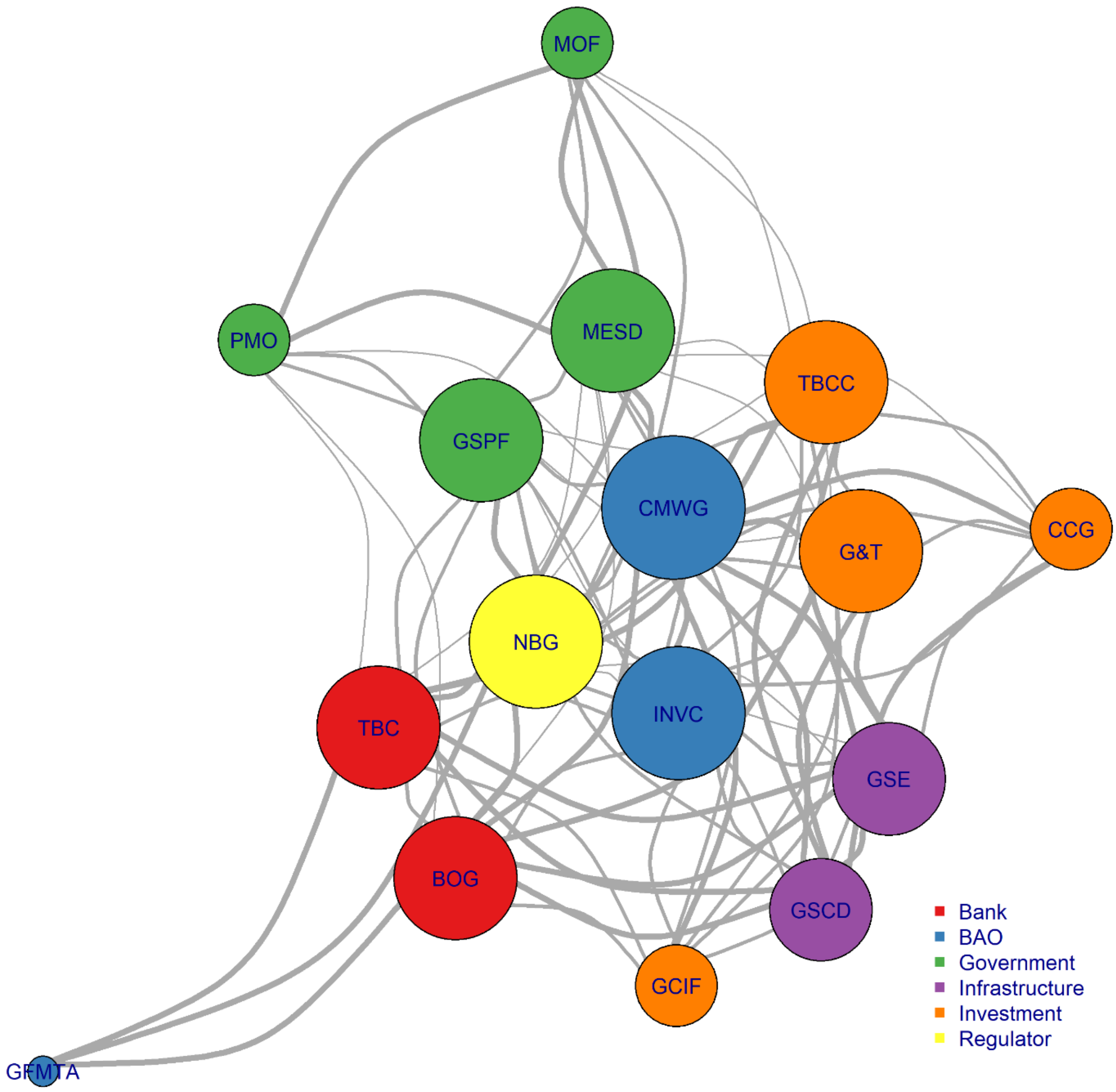


Figure 3 shows the formal connections between the stakeholders. The importance of a stakeholder is determined based on the number of connections with other stakeholders, and the strength of those connections. The size of the circle next to the stakeholder names illustrates that connection.

5 ROOT CAUSE ANALYSIS OF KEY CONSTRAINTS

The Program team conducted interviews with public and private sector stakeholders to collect data on the key constraints and conditions that must be in place or addressed for the reform to be successfully implemented. To arrive at root causes, the analysis posed a series of questions to move past symptoms and understand the underlying factors that drive the perceived constraints.

The key constraints or core problems identified through the stakeholder interviews and working sessions were prioritized by the Program team and a root cause analysis was conducted on the key problem/constraint and a map (figure 8) was developed. The analysis generated a root cause tree and detailed explanation of the findings. This section also includes proposed activities that the Program could support in response to the issues identified during the analysis.

5.1 CONSTRAINTS

CONSTRAINT 1: NO SECONDARY DEBT MARKET

ROOT CAUSE TREE

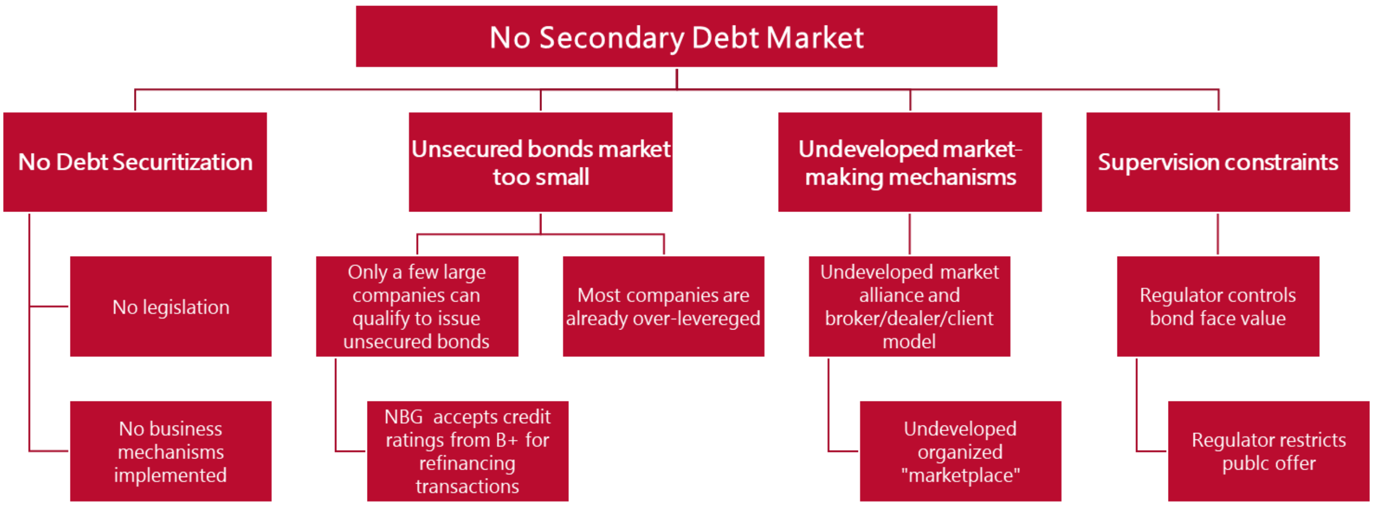


Figure 4. Constraint 1 Root Cause Tree

Securitized debt is the most popular asset class used by investment funds to build their portfolio in frontier and emerging markets. It is less risky for the investor and, at the same time, it is a more conventional instrument for businesses to attract funding. In addition, there is a sizable volume of corporate and personal debt outstanding in Georgia that can be securitized. This mechanism will be mostly attractive for small and medium banks to write off loans, improve their ratios and seek more leverage, and keep their operation going to support their clients.

Currently Georgia has no secondary debt market. Loans-extended and other corporate obligations are not transformed into securities and sold. This issue is caused by several factors:

1. **No Debt Securitization**. There are no securitization regulations in place that would allow the transformation of income-producing assets into marketable securities.
2. **Unsecured Bonds Market is Too Small**. To encourage the corporate bond market, NBG started accepting B+ and higher rated bonds as collateral for refinancing transactions.

However, only a few large companies can achieve this rating. As of June 18, 2020, there are GEL 263 million and $102 million corporate bonds at face value outstanding in Georgia, (according to GSE, this excludes IFI and retail bank issued bonds). The volume of secondary trading is zero. Additionally, if the necessary regulations and mechanisms were in place, a substantial number of medium-sized companies could issue and successfully place secured bonds.

3. **Underdeveloped Market-Making Mechanisms.** Bond markets need large dealers/market-makers to sustain liquidity and security in the market. Market alliances and an organized marketplace are also essential for the functioning of the industry. The marketplace could be within the GSE or a separate entity, as long as it reflects specific features inherent to fixed-income instruments and their trading mechanisms.
4. **Supervision Constraints**. Interviewed investment services firms outlined that the regulator informally restricts bond offering and trading to institutional and sophisticated investors by allowing only high face value transactions. This restriction makes the bonds illiquid and less affordable for retail investors.

CONSTRAINT 2: NO EQUITY MARKET

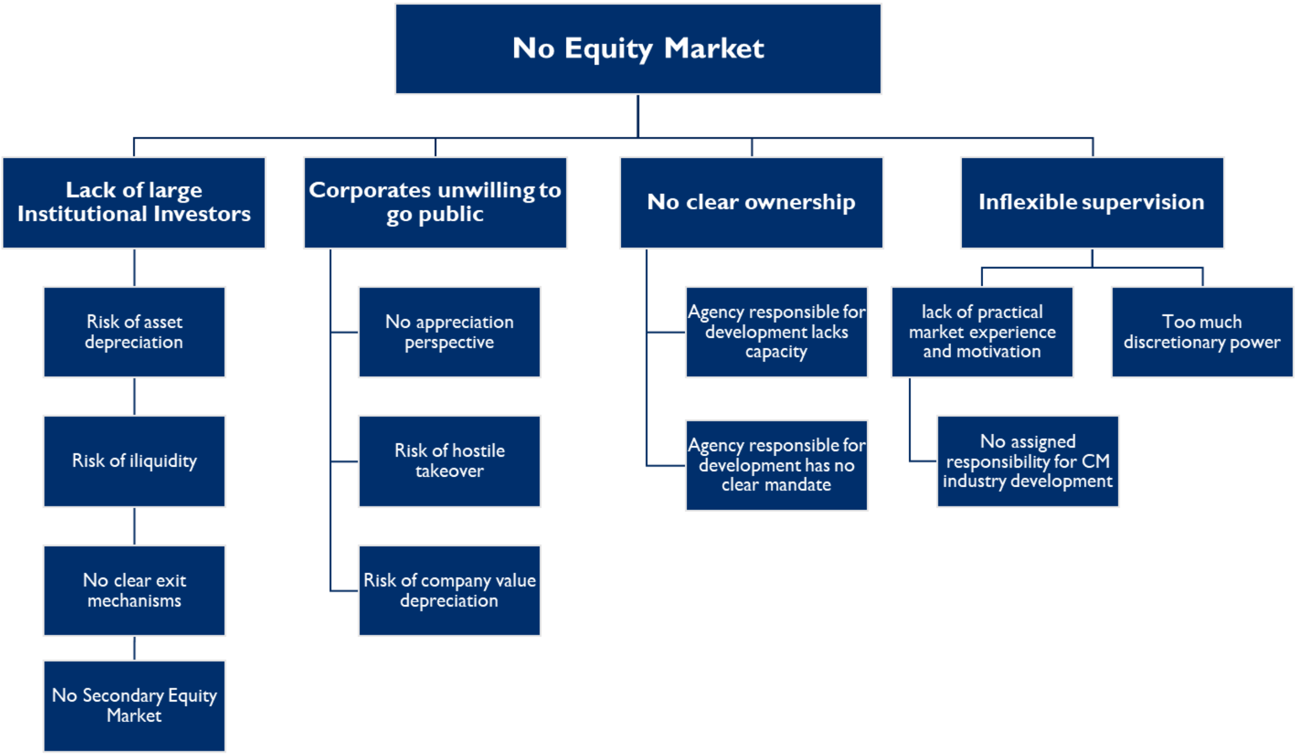


Figure 5. Constraint I Root-Cause Tree

Dr. Sridhar Ryakala noted in *Indian Stock Market and Institutional Investments* that the growing importance of institutional investors is one of the most significant financial developments in the world, as individual investors increasingly delegate the management of their investment portfolios to professional fund managers. In recent years, the continuing liberalization of cross-border capital flows in developing economies has led to the international diversification of institutional portfolios from developed economies, and the growth of the fund management industry in developing economies.

Georgia has not been able to capitalize on this global trend due to the absence of a liquid equity market and the fact that few large institutional investors operate in the country. The result is a dearth of investment liquidity and no clear and transparent exit strategy or equity appreciation potential. Companies lack motivation to go public due to the absence of diversified investment sources and the risk of being illiquid and depreciated. FDI is still scarce because there are no vehicles for portfolio investments in the Georgian market, which is one of the key indicators for sustaining pro-investment decisions.

On the government side, there is a lack of efficient coordination among state agencies, and functions and responsibilities are not clearly defined. MOESD's Capital Market and Pension Reform Department, which has nominal ownership of the reform, shows keenness and expertise. However, it is underfunded and inadequately staffed. The regulator (NBG) has no legislatively assigned function to promote the development of the market. For the time being NBG's main concern is to protect retail investors from risks inherent to the capital market industry. This makes the NBG unenthusiastic about the reform and reluctant to promote and assist new legislative initiatives. As a result, the NBG, which is supposed to be driving market development, is not investment friendly.

The main components of leading to the lack of an equity market:

1. **Lack of Large Institutional Investors**: Large institutional investors, such as investment funds, are a critical component of capital markets. They make the market and create liquidity. In their research paper *Determinants of FPI (Foreign Portfolio Investments) in Developed and Developing Countries,* Monica Singhania and Neha Saini provide a detailed analysis of the major issues that are critical when considering investing in a developing country. According to the study, investment decisions are influenced by several key factors that hinder the participation of institutional investors, including:
   - Appreciation potential of the market—when the market is active and demand and trade volumes are high (relative to the market size); or, on the negative side, the risk of depreciation—when the market is slow or inactive.
   - Liquidity—a product of an active market. An inactive market, on the other hand, creates the risk of illiquidity and, as a result, the investment assets become less marketable.
   - Exit mechanism—when the investment assets lack marketability, there is no clear exit mechanism that would sustain pro-investment decision.
2. **Corporates Unwilling to Go Public**. A corporation's decision to go public is first and foremost motivated by the potential for the value of the company to appreciate. If businesses do not see high potential for appreciation or there is high risk associated with the attempts to grow, they will not take the risk. Illiquidity in the market will most likely cause the value of the company to depreciate, and when a company's value depreciates, the risk of hostile takeover is high.
3. **Lack of Proper Management and Reporting Mechanisms.** Corporates lack the proper management and reporting mechanisms to comply with the high standards of capital

market culture. However, there has been a significant improvement in this field since the GOG created a designated agency to oversee the implementation of international accounting and auditing standards.

4. **No Clear Ownership**. According to the *Capital Market Diagnostic Study* sponsored by USAID and ADB, there is no government entity clearly responsible for and driving the development of a robust and well-regulated market. In turn, the private sector is too weak to push for the reform.
5. **Inflexible and Unfriendly Supervision**. The NBG, as the capital market regulator, has been rather heavy-handed in its supervision, often imposing disproportionate and unnecessarily strict requirements on issuers and operators. It associates major social risks with capital market development and adheres strictly to EU regulations, which are for developed and sophisticated markets. A market such as Georgia's needs more flexible and investment-friendly regulation to stimulate the creation of investment funds and other investment vehicles that would be attractive to both domestic and foreign investors.

CONSTRAINT 3: SUPERVISION/ENFORCEMENT ENVIRONMENT

ROOT CAUSE TREE

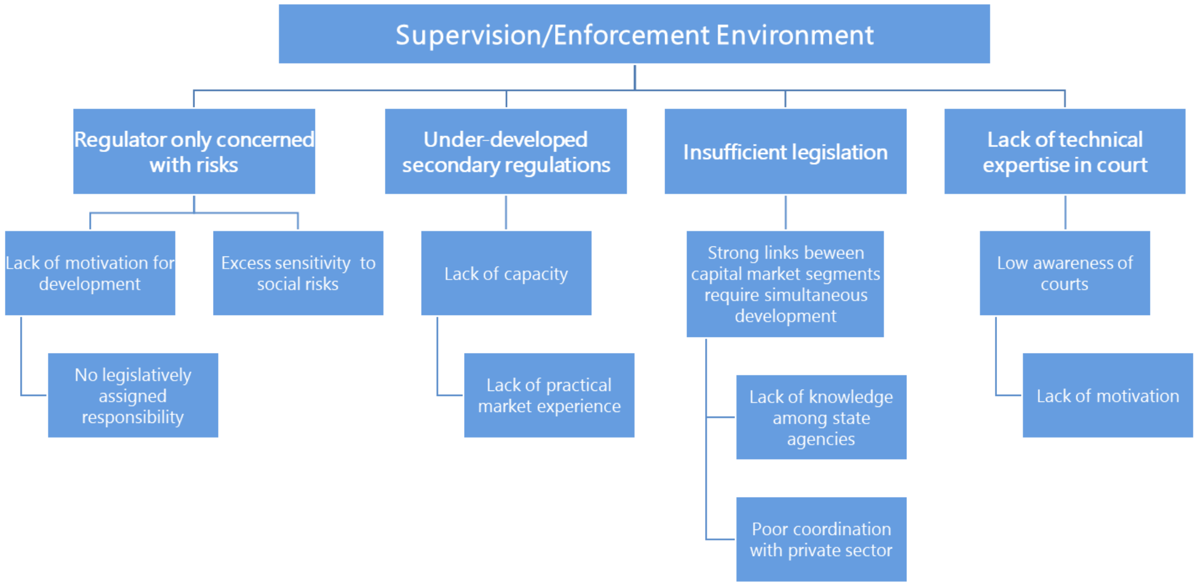


Figure 6. Constraint 3 Root Cause Tree

Nobel Laureate Douglass North argues that "how effectively legal contracts are enforced is the single most important determinant of economic performance" (North, Cato 1991). The nature of capital market financing relies heavily on a supportive legal environment that ensures the efficient and fair enforcement of financial transactions and contracts. Strong and effective creditor rights and efficient and predictable insolvency regimes provide greater assurance that debts will be paid in full and on time. They also minimize investor losses in the event of borrower difficulties that jeopardize repayment.

Researchers have identified several ways effective legal systems can support capital markets. Specifically, quite a few studies have shown that the general strength and impartiality of the legal system and observance of the rule of law correlate well with capital market development. Effective legal systems also typically exhibit greater judicial protection of private property rights, more efficient litigation processes, and, most importantly, greater respect and support for enforcing private contracts. Today, the private sector's perception of how efficiently the judicial system settles legal disputes continues to be positively and strongly correlated with corporate securities markets.

The main conditions impacting the supervision and enforcement environment include:

1. **Regulator only concerned with risks**. The NBG associates capital market development with major social risks and tends to adhere to EU regulations, which are for developed and sophisticated markets. Georgia's developing market requires more flexible regulation to stimulate the creation of investment funds and other investment vehicles that would be attractive to both domestic and foreign investors.
2. **Undeveloped secondary regulations**. It is the NBG's mandate to design secondary legislation aligned with the LGIF that will set clear rules and procedures for the constitution, authorization, and oversight of the operation of investment funds. So far, the NBG has not introduced any concept or mechanisms for an efficient system of regulatory policies and instructions. The lack of these policies and guidance will hinder the implementation of the LGIF.
3. **Insufficient Legislation**. A capital market is a complex and sophisticated system with strongly interlinked components. All segments of the system should be developed simultaneously to allow the efficient functioning of the industry. For instance, to enable the issuance and transferability of secured bonds it would require substantial amendments of various pieces of legislation. If there are no such regulations and mechanisms in place, investment funds will struggle to function. The same applies to insolvency and general entrepreneurship regulations. At this point the legislative system in Georgia lacks this systemic logic.
4. **Lack of Technical Expertise in Courts.** Courts lack the knowledge and expertise to ensure the functioning of an efficient dispute resolution and enforcement mechanism.

Figure 7 indicates that the government and supervisory/judicial system contribute to the most constraints, as identified in the root cause analysis. While the GOG strongly endorses the reform, it still lacks proper coordination among involved public agencies, as well as a holistic vision for the development of the capital market. USAID – G4G was successful in bringing together public and private sectors to draft the LGIF. This success story inspired the Government to propose the creation of the IARP, which will coordinate the effort to develop the capital market, including setting up a proper supervisory structure and the reformation and education of the judiciary.

On the map, insufficient legislation appears as the biggest issue and affects virtually all factors of capital market development. A capital market is a complex and multifaceted mechanism and its development requires legislation to align with the spirit of the reform. In 2019, USAID sponsored the development of the Package of Legislative Changes Related to the Investment Funds Law, which was adopted by Parliament along with the LGIF. However, the legislation still lacks pieces on critical segments such as securitization-special purpose vehicles, covered bonds, *etc*., and respective amendments in related laws and legal acts that are vital for the development of the industry. In many cases regulations are inadequately burdensome, creating obstacles for the development of the industry. For example, secondary legislation to the Securities Law discourages corporations from going public. This issue requires special attention from the GOG.

The other regulatory issues, including under-developed secondary legislation, are mostly related to the NBG, which needs to adopt a more reform-oriented role and take responsibility for capital market development rather than merely directing all its effort to complete risk aversion.

The IARP will address these issues by bringing together the GOG, NBG, and the private sector; designing a holistic regulatory concept; and sponsoring the drafting of specific pieces of legislation and amendments as well as regulatory policies and instructions.

On the business side, the map clearly indicates that the lack of large institutional investors, such as investment funds, is the biggest issue. This is directly interlinked to the legislative/regulatory drawbacks and market deficiencies, including the lack of investment instruments and undeveloped market-making mechanisms. The map also visualizes the importance of the parallel development of market supply-demand mechanisms.

Figure 7 Connections between causes/root-cases that made up constraints

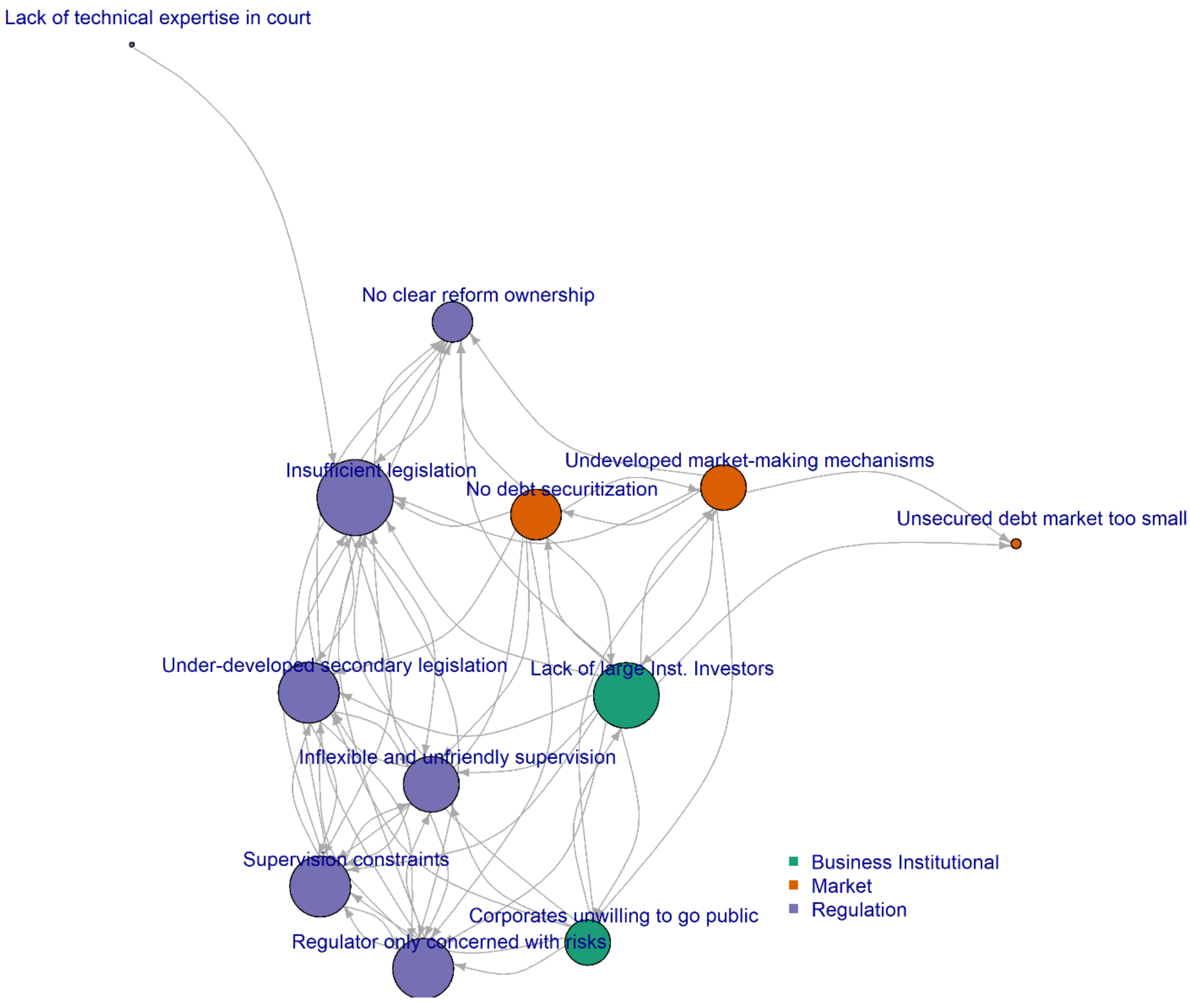


Figure 7 shows the connections between causes/root-causes of the constraints. The more interconnected the causes (mainly issues), the bigger the problem(s)/issue(s) they create for the Investment Funds Ecosystem. The size of the circle next to the name of the causes/root-cases also illustrates that connection.

5.2 REFORM MAP

A comprehensive map of all the reform conditions and behaviors is outlined in Figure 6. The reform map depicts the overall objective of the reform and its three high-level conditions. Each condition has its own sub-conditions along with the responsible stakeholders and actions.

Figure 8. Reform Map - Behaviors, Relationships, and Conditions (or BRC) Map

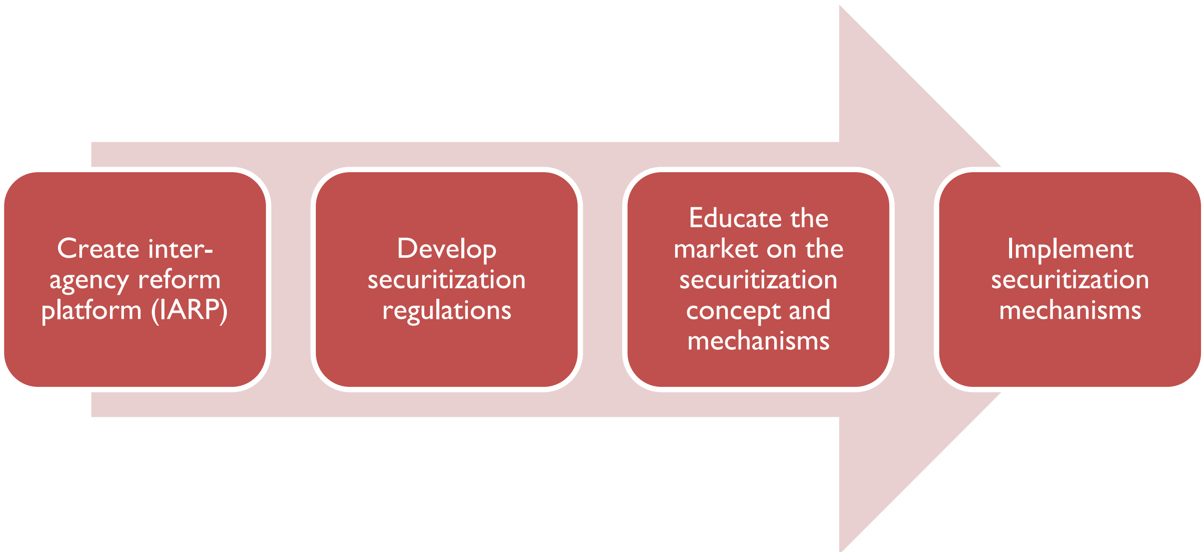
6 ACTIONS NEEDED FOR SUCCESSFUL IMPLEMENTION OF THE REFORM AND PRIORITY ACTIVITIES FOR THE PROGRAM AND USAID

The Program team determined that a range of actions need to be taken for the reform to be a success. This conclusion is based on an analysis of the findings from the PEA interviews with a cross-section of stakeholders, as well as the views of sources identified in the report, and our expert panel. Given that the investment fund ecosystem needs to be built from scratch, the implementation of the LGIF will require a series of actions from all stakeholders, including:

6.1 CONDITIONS AND OPPORTUNITIES FOR ACTION: CONSTRAINT 1

The Capital Market Diagnostic Study emphasizes the importance of efficient coordination between the GOG agencies working on the reform. The PEA interviews revealed that the private sector expects the GOG to have coordinated short to mid-term plans on capital market development. The idea to create an inter-agency reform platform (IARP), which would coordinate the industry reformation effort, came from discussions with CMWG and the MOESD. The GOG has already given the MOESD the necessary mandate to create the IARP and the Ministry strongly endorses the initiative.

Figure 9 Key conditions for constraint 1



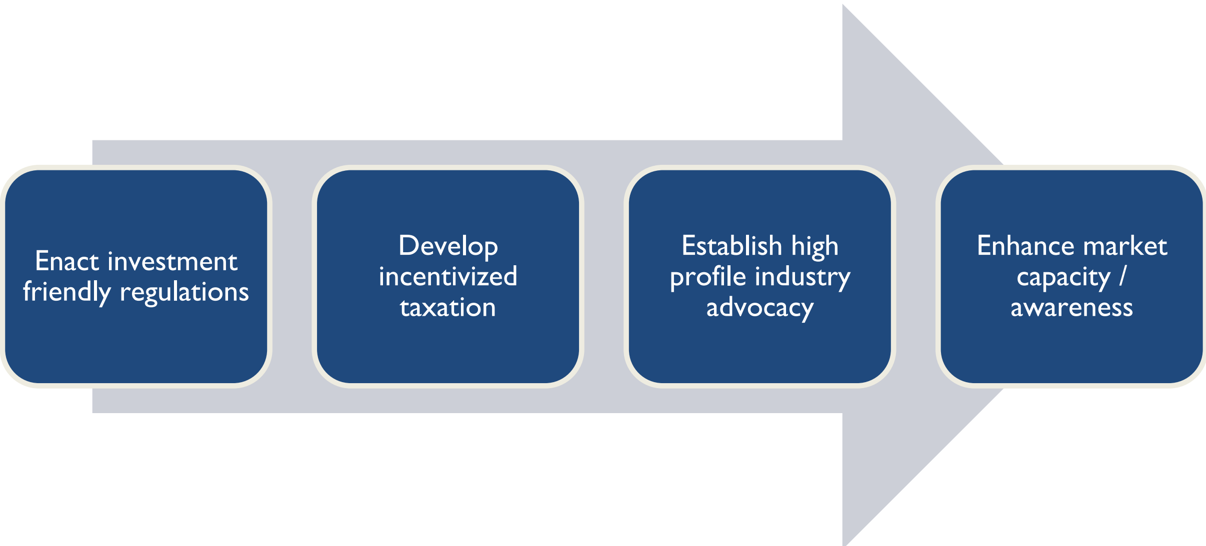
- The creation of the IARP, supported by both the public and private sectors, will facilitate the systemic development of various regulations concerning the investment funds ecosystem.
- The current regulatory set-up makes the issuance and transferability of secured bonds virtually impossible. The MOESD and the private sector consider the development and adoption of securitization regulations to be critically important for the investment funds industry to function.
- Securitization mechanisms are quite complex and sophisticated and require a solid knowledge base for both the supply and demand sides of the market. The MOESD and CMWG plan to set up a training platform that will educate financial professionals, as well lawyers and the courts, on the concept of collective investment undertakings and structured finance.

- Currently, there is a sizable volume of income producing assets and liabilities on the market that could be transformed into secured bonds. The implementation of securitization mechanisms will facilitate the process of the issuance and circulation of secured bonds that newly authorized investment funds will buy.

6.2 CONDITIONS AND OPPORTUNITIES FOR ACTION: CONSTRAINT 2

Numerous case studies of developed and successfully developing capital markets indicate that there is a very strong correlation between the investment influx into a country, the friendliness of its respective regulations, and the degree of incentivization of the taxation regime. In Luxembourg, for example, fund authorization and asset manager licensing procedures are simple and transparent; Undertakings of Collective Investments in Transferable Securities (UCITS) are not subject to income and capital gain taxation. To become a popular international investment destination, Georgia will have to compete with such jurisdictions.

Figure 10 Key conditions for constraint 2

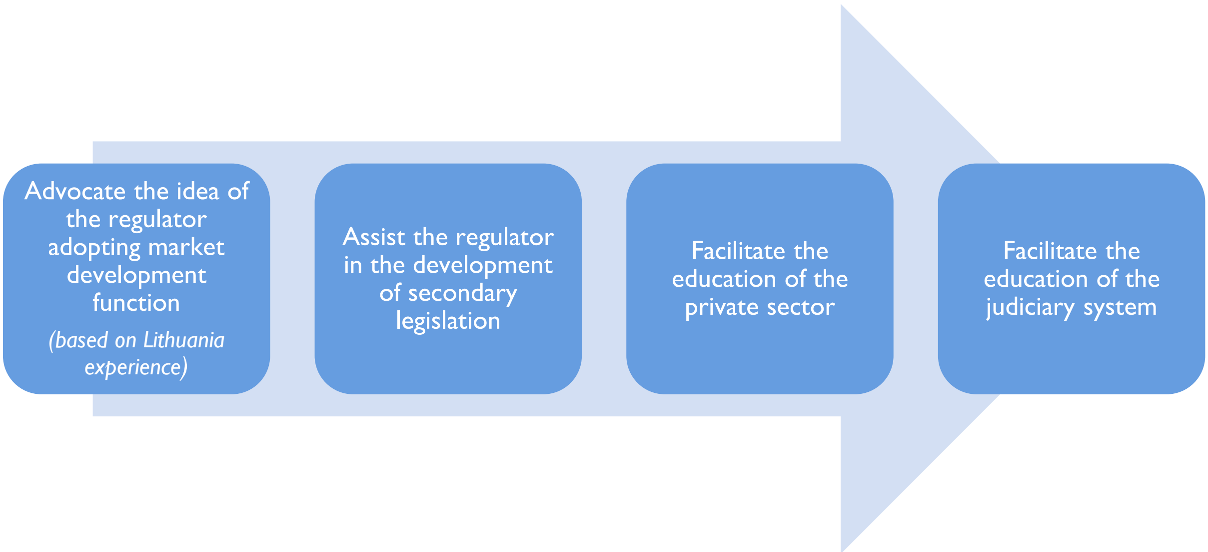


- The CMWG and IARP should work proactively with the GOG to achieve the development of effective and unambiguous capital market and parallel legislations that will synchronize the overall legal framework with the goal of becoming an international investment hub.
- The CMWG, in close cooperation with the IARP, should help the MOF to develop a taxation regime that will sustain pro-investment decisions.
- The investment funds industry should form alliances with other business associations in order to gain a high reputation. It should also be proactive in the CMWG and IARP.
- Investment funds industry operators should educate the business community on collective investment undertakings mechanisms through workshops and trainings for corporate finance professionals.

6.3 CONDITIONS AND OPPORTUNITIES FOR ACTION: CONSTRAINT 3

In the article "*The Effects of Judicial Strength and Rule of Law on Portfolio Investment in the Developing World,"* Joseph L. Staats and Glen Biglaiser demonstrate that "countries with a higher level of judicial strength and rule of law are more able to attract portfolio investment because they provide greater protection of property rights and better risk environments for investors." Currently, Georgia's regulatory and judiciary set-up does not constitute an integrated system of statutes, policies, and establishments that would provide investors with such unambiguous protection. The IARP should take on the task of the development of a solid and transparent judicial/regulatory structure that will become a welcoming banner for international investors.

Figure 11 Key conditions for constraint 3



- Lithuania, which has a similar regulatory set-up (the Central Bank) started aggressively developing its investment funds industry in 2016. The country has since adopted a set of policies and reforms modeled after successful markets. As a result, investment funds total asset volume stands at $1.5 billion as of the end of 2019. The IARP should explore the case and help the NBG to transform into the major reformer of the industry.
- The IARP and CMWG should work with the NBG proactively to make sure that the latter's policies and authorization/overseeing procedures are not too burdensome for investment funds, asset managers, and other regulated entities.
- Businesses should be educated on their rights and obligations through their inhouse legal teams as well as law firms that specialize in capital market.
- The MOESD has proposed setting up a designated training facility for judiciary personnel to educate them on capital market concepts. This can be done with the School of Justice.

6.4 PRIORITIZED ACTIVITIES FOR THE ECONOMIC GOVERNANCE PROGRAM AND USAID SUPPORT

The Program team has identified main directions where it could contribute its knowledge and expertise and achieve the most productive outcome to address constraints 1, 2 and 3. These directions are sequenced according to their importance and stakeholder readiness and encompass the following actions:

Table 1 Opportunities for Action and the Program Activities

The Program's Prioritized Activities	Counterparts	Other Potential Donors	The Impact on the Overall Reform
Support the MOESD to create an interagency reform platform that will coordinate the effort to develop the whole investment fund ecosystem including various asset classes and a flexible and investment-friendly regulatory structure. The idea, endorsed by the GOG and MOESD, stems from experience with public-private cooperation within the CMWG platform. It sets a perfect example for a productive partnership between the GOG and the private sector.	MOESD CMWG NBG MOF PMO IC	ADB EBRD	The platform, which will have permanent representatives from the MOESD, NBG, and private sector, will tackle all three constraints. Constraint 1. – Absence of the Secondary Debt Market. The IARP will have a legal team that will review the legislation to detect shortfalls and/or gaps that may hinder the successful implementation of a debt securitization system in Georgia. The team will also provide recommendations on legislative changes to enable the proper establishment and operation of the system. The IARP will work with international experts to implement best-practice general debt securitization mechanisms and technologies in the local market. Constraint 2. – Absence of the Equity Market. The IARP will structure short and mid-term plans for the development of the equity market in Georgia. These plans will contain studies of successful cases in emerging markets and will provide specifically sequenced recommendations for the GOG and private sector on how to make the Georgian equity market work. Constraint 3 – Inadequacy of the Supervision/Enforcement Environment. The IARP will work closely with the private sector, Parliament, NBG, MOJ, and the PMO to identify shortfalls and bottlenecks in the regulatory and judiciary systems and provide a public-private

			dialogue platform for broad discussions and finding solutions to problems.
Support the MOESD to develop and implement securitization regulations. This is a high priority and should be the next step in implementing the LGIF and developing the capital market. To ensure rapid drafting, discussion, and submission to Parliament, the Program could support the MOESD and work with the CMWG to draft a law that has buy-in and support from the NBG, ensuring the proper level of supervision and regulation, *i.e.* not too risk averse. The Program could test different scenarios for advocating the reform, including the Prime Minister's Office or other high-level champions, to move toward the rapid adoption of a securitization package. This will be key to maintaining private sector confidence in the development of the sector.	● ■ MOESD ● ■ CMWG	N/A	This activity will address Constraint 1—No Secondary Debt Market—by creating securitized debt instruments for investment funds.
Support the Capital Market Working Group (CMWG) to strengthen its capacity as an advocacy group and promote better coordination between the private and public sectors. Facilitate the transformation of the CMWG into a capital market association (CMA).	● ■ CMWG	TBD	This activity will address all three constraints by advocating a holistic approach to the development of the investment funds ecosystem. Constraint 1. The CMA will provide expertise in the development of securitization regulations and business mechanisms. Constraint 2. The CMA will form alliances with other business associations and coordinate the effort to develop the equity market in Georgia by advocating new laws and regulations. It will also improve financial literacy and public awareness about sources of equity financing.

			Constraint 3. The CMA will advocate for improvements to the regulatory environment and, through identifying challenges, engage in dialogue with the GOG and regulator.
Support the GFMTA and CMA in developing a training platform for professions engaged in the investment funds business, FX and money markets, as well as for corporate financial managers and other decision-makers. Support business associations through a series of seminars/conferences on the investment fund and money market mechanisms and the regulations. Investment services firms and money market operators will contribute to this activity	● ■ MOESD ● ■ CMWG	TBD	This will address all three constraints by raising awareness and educating capital market professionals, corporate financial managers, legal advisors, and the courts about the investment funds business and legal mechanisms.
Key: ● High awareness ● Medium awareness ● Low or no awareness ■ High motivation ■ Medium or unknown motivation ■ Low or no motivation			

ANNEX: SYSTEMS MAPS

Figure 12 Stakeholders: Betweenness centrality

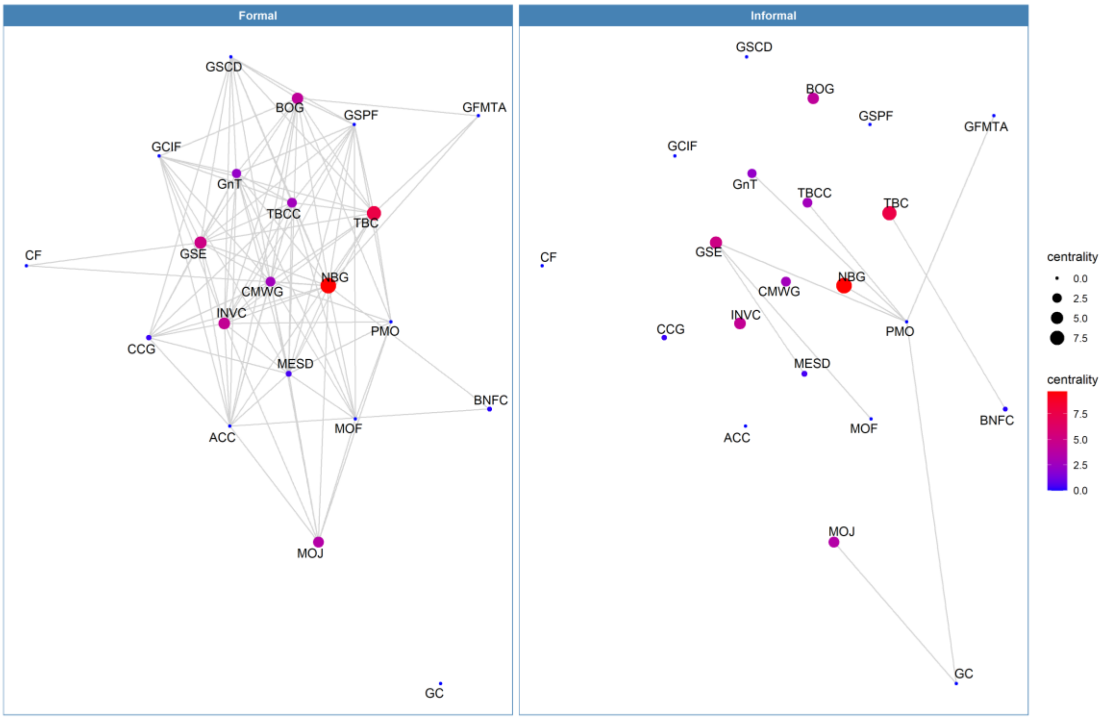


Figure 13 Stakeholder: Degree centrality

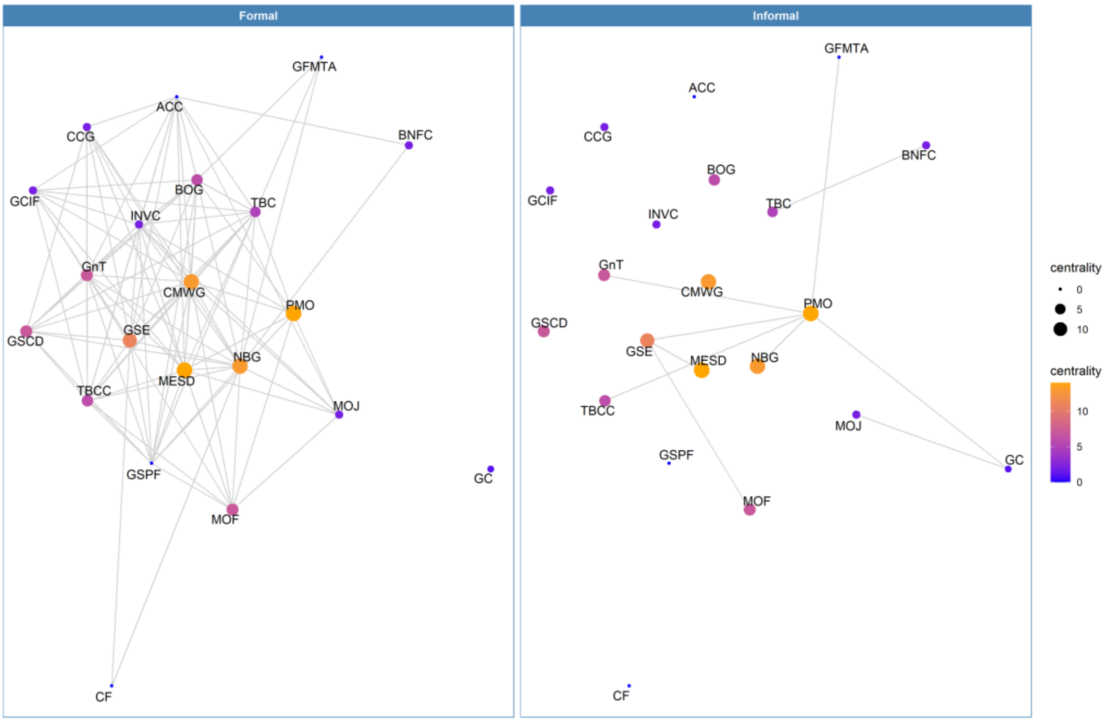


Figure 14 Stakeholders: Eigen centrality

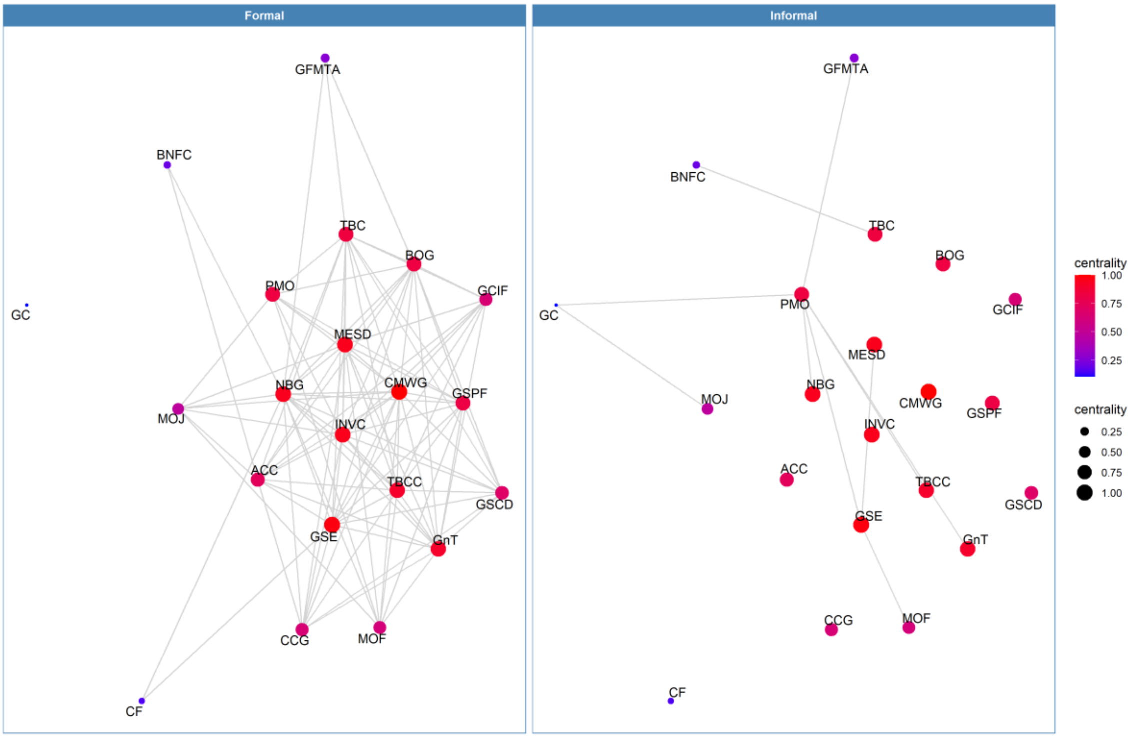


Figure 15 Stakeholders: Hub centrality