CEE Finance and Capital Markets 2022–2023

The Impact of Geopolitics and Macroeconomics on Banking, Finance and Capital Markets in Central and Eastern Europe

Freshfields Bruckhaus Deringer

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Introduction

Introduction

Freshfields Bruckhaus Deringer in collaboration with some of the leading local law firms in central and eastern Europe (CEE) forming part of our Stronger Together network is pleased to present an update on the emerging market and legal trends in the CEE banking, finance and capital markets sectors.

In light of numerous global developments, we are focusing on how geopolitics and macroeconomics are impacting banking, finance and capital markets in the CEE region.

Emerging from the once-in-a-century pandemic that exacted an enormous human and financial toll on the region and beyond, CEE is now the scene of a conflict with significant global consequences. The confluence of the pandemic and the war in Ukraine have brought supply chain bottlenecks and increasing energy as well as food prices that have contributed to challenging economic recovery and rapidly rising inflation.

As governments and central banks unveil new policies designed to weather these crises, the banking, finance and capital markets sectors will have to continue to show their ability to adapt to these extraordinary economic and legal challenges. With the EU's green and digital "twin" transition in mind — but also as a matter of necessity — there are tentative signs that the war in Ukraine has accelerated the European drive towards greener energy and a more sustainable economy. Across the CEE region, there is significant momentum in channelling private and public funds into green infrastructure projects. Coupled with this, many in CEE are intensifying efforts to digitise the banking sector, delivering FinTech innovation and new capabilities. These developments demonstrate the sector's ability to look beyond the seemingly ever-present uncertainty and volatility and seek out the opportunities for a better future.

Crisis upon crisis

Despite a turbulent two years caused by the pandemic, many banks in the region have emerged relatively stable. Robust support from national governments and central banks helped to counter the unprecedented drop in output as a result of lockdown. Generally modest capitalisation rates ensured that banks were well-equipped to respond to the pandemic and return to profitability once economies began to ease open.

Across the CEE region, the banking, finance and capital markets sectors have begun to show cautious signs of post-pandemic recovery. For example, Romania's capital markets were very active during 2021, while liberalisation and simplification of the market in Bulgaria has seen smaller companies able to make public offerings with fewer requirements.

Pandemic-related disruptions remain, however, and are exacerbated, of course, by war in Ukraine, bringing new challenges and threats. Increased energy and food prices intensified by the war, coupled with supply chain bottlenecks — particularly as China persists with its zero-Covid policy — and an elevated level of demand have contributed to rampant inflation rises across the region and beyond. With an already slow economic recovery limiting the menu of policy options for tackling inflation, stagflation is a major risk — also to the financial services sector.

The sanctions packages adopted by the EU in response to Russia's invasion of Ukraine have had a significant effect on the operations of many Russian entities across the CEE region. In Hungary, the broad language adopted in the package of sanctions has led to uncertainty in the sector as banks and other institutions struggle with the burden of compliance and, in some cases, overcompliance, with similar experiences in all other countries in the region.

Meanwhile, in Poland, the war in Ukraine is being felt in a much different way, as Polish banks are tasked with providing services to hundreds of thousands of Ukrainian refugees. It is also thought that, at the conflict's eventual conclusion, the Polish banking and financing sector is likely to also contribute — through funding or cooperation — to Ukrainian reconstruction efforts.

Going green and digital

There is a growing consensus that, across the CEE region, the war in Ukraine — along with dependence on Russia for energy supplies — has helped to accelerate the transformation towards sustainability. It is anticipated that financial actors, in collaboration with national governments, will be central to the expected increase in energy investments and green finance initiatives.

In an effort to become a climate-neutral economy, Lithuania has seen a huge push on the environment element of ESG, with private funding playing a significant role in major energy and climate action plans. To this end, Lithuania has developed a Strategy and Action Plan on Sustainable Finance providing guidance how the private financial market could be utilized to create a sustainable finance ecosystem, with similar plans underway across the entire Baltics.

Serbia recently launched its first €1bn green bond to (re)finance projects for renewable energy, green buildings, and energy efficiency among others, while a recent state budget put aside significant sums for solar, wind and hydropower projects.

Digitalisation of the banking sector has further enabled adaptation to unprecedented and dynamic events. Polish digitisation of the sector has helped to ensure broad access to electronic banking services. In Bulgaria, further digitalisation and FinTech innovation, along with green finance, is seen as a major driver of the sector. However, digital banking also brings cybersecurity threats and challenges. Tackling these threats will require sector-wide cooperation, along with national and even regional support.

Outlook

Given the enormity of the crises that the region and indeed the world faces, it is no surprise that the CEE banking, finance and capital markets sectors will continue to face significant ongoing challenges ahead. Conflict in bordering nations presents unique problems, yet despite the aggravation of geopolitics by challenging macroeconomics, the sectors continue to demonstrate resilience in adapting and contributing to projects that will define the future.

Across the region, public and private actors have mobilised to accelerate a green transformation. Through infrastructure and energy transition projects, green finance initiatives and wider efforts on ESG activity, there is potential for the financial services sector to play a leading role in building a more sustainable economy.

Staying up to date with evolving geopolitical moves and macroeconomic trends can be challenging. Understanding the effect of such complex and evolving circumstances on financial markets is key for all participants.

With this in mind, we have compiled the following articles from firms within our Stronger Together network who are attending the CEE Finance and Capital Markets Workshops 2022. We extend our sincere thanks to all Stronger Together colleagues for their contributions and wish you an interesting read.

Baltics

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Baltics

Looking ahead to the future of the Baltic region

Reflecting on the past couple of years, the Baltic states have endured the same macroeconomic turmoil as many other European nations have. Covid-19 brought challenges including economic slowdown and a serious hit to several economic sectors including hotels, restaurants and commercial real estate development. Whilst the GDP growth amongst the Baltic states in 2021 was higher than the European Union (EU) on average, the effects of the rising cost of living and inflation have been felt by many. Compared with other EU nations, the Baltics have been heavily affected by global supply chain disruptions, especially in the construction sector.

These challenges have been met by resilience and adaptability, hence with a highly digitised economy, large proportions of the services sector were able to adapt to the new working style after the Covid-19 lockdowns. The banking sector and other industries were quick to take up FinTech solutions to meet their banking and financing requirements.

The Russian invasion of Ukraine brings new challenges to the region including national security risks, energy dependency, and supply and trade disruptions.

1. Strategy and Action Plan

There are many driving factors towards a sustainable economy, including EU legislation, public opinion, and commercial opportunities. According to European Climate Law, Member States will be required to take action to achieve the European Union's objective of net zero emissions by 2050 and to take steps to strengthen their resilience to climate change. However, the shift towards a sustainable future has certainly been accelerated by the current geopolitical situation — namely the Russian war against Ukraine.

Lithuania is the only EU Member State enjoying complete independence from Russian energy supplies (gas, oil, electricity) after having secured alternative sources. At the same time, there is work to be done to align this with the efforts of achieving a climate-neutral economy. Lithuania's Baltic neighbours have taken similar steps to achieve energy independence from Russia - Estonia is reviving its frozen LNG terminal project (together with Finland), Latvia has passed legislation prohibiting Russian gas imports, and both countries are moving fast to harness wind and solar power.

Many EU countries, including the Baltic states, have started working on their plans to achieve this objective. With the assistance of the European Bank for Reconstruction and Development (EBRD), Lithuania has developed a Strategy and Action Plan on Sustainable Finance. The Strategy, available on the website of the Lithuanian Ministry of Finance, provides guidance on how the private financial market could be utilised to achieve these goals. Similar projects are now underway in Estonia and Latvia, so some key recommendations from the Lithuanian study may be helpful.

The Strategy now mainly focuses on the E (environmental) criterion, which is part of ESG (environmental, social, and governance) criteria. The S and G criteria are expected to be added gradually in the future.

2. Public plus private financing

When considering the rising cost of living, inflation, and the expected decline in GDP due to the macroeconomic factors mentioned above, the state must balance the need to provide consistent public services, new infrastructure projects and control the public debt, whilst factoring in the requirement to achieve the European Union's objective of net zero emissions by 2050.

One solution is to also rely on private funding to help alleviate the pressures of fulfilling new infrastructure projects solely on public funds.

The strategy adopted in Lithuania, and under consideration in Estonia and Latvia, states that in addition to the EUR 10 billion needed by 2030 (one of the benchmark years according to the Lithuanian Energy and Climate Action Plan), some EUR 4 billion should come from private funding — mainly banks and capital markets.

Banks operating in Lithuania already offer green mortgage and green leasing products, and pension funds have integrated sustainability criteria in their investment strategies. Corporates have started issuing green bonds (energy companies Ignitis and EPSO-G, agricultural company Auga Group, the contemplated green bond issuance by national railway company LTG). This requires no specific incentives, just labelling and more data to assess how green the project to be financed is (see section "Sustainable finance infrastructure" below). According to the Strategy, the greatest potential lies in combining public funds with private funds in the following areas:

(a) Channelling public funds allocated for sustainability targets together with private funds in the form of lending, and not subsidies which are not economically efficient. The State could be the first risk-taker, providing private sector incentives to co-finance sustainable projects; and

(b) Sustainable infrastructure (especially PPP/PFI projects). In Lithuania, political influence has, for the most part, led PFI projects to be demonised as lacking economic efficiency hence resulting in a standstill in the development of such projects. The Strategy recommends revising the approach, identifying a list of sustainable infrastructure projects, and bringing them to the PFI table.

The latter, where the local market has limited potential, may also be of interest to foreign investors once they become attractive in size. Notably, due to the Russian invasion of Ukraine, foreign banks have started to look at the region more carefully, but in June and July there was a resurgence in financing, increasing hope that green infrastructure developments will continue.

3. Size does matter

In addition to large infrastructure projects, there are other areas where foreign institutional investors could contribute as well, such as sustainable sovereign borrowing (Lithuania was one of the first EU Member States to issue green bonds back in 2018, with the proceeds going to housing renovation projects) and sustainable bonds by large state-owned enterprises (SOEs). The Strategy recommends gradually increasing the share of sustainable sovereign borrowing and establishing a pipeline of green bond programmes for SOEs.

Smaller sustainable projects (anything less than EUR 50 million) are of limited interest to international players. The solution for attracting foreign capital is pooling the smaller projects under one umbrella and issuing sizeable sustainable bonds secured by the proceeds from such smaller projects.

The Strategy recommends establishing a Baltic Sustainable Investment Fund. This recommendation is based on experience with the State Aid Fund for Businesses set up by the Government in response to the economic impact of Covid-19. In addition to public funds, the Fund, under their EUR 400 million EMTN programme, has used SPVs that issued bonds, and the proceeds have been used to finance Covid-19 affected companies.

The Baltic Sustainable Investment Fund should be a vehicle of a National Development Agency to be established through the merger of four national promotional institutions into one strong national development bank. The German KfW model here serves as an example. It is also contemplated that the fund (taking larger risk share) would invest together with private investors, so that bonds would not be the only instrument to attract capital.

4. Sustainable finance infrastructure

Sustainable finance infrastructure is to be developed by establishing the Green Finance Institute, creating a centralised sustainability database, and implementing green labelling solutions.

In other countries, the Green Finance Institute (e.g. UK) is an independent body coordinating public and private sector efforts in achieving the sustainability goals. Economic efficiency was the reason behind Lithuania's decision not to establish a separate body and to assign these functions to a department of the National Development Agency. To achieve independence and representation from the public sector (banks, academic institutions, consumer bodies), an Advisory Committee is to be set up to oversee the activities of the Green Finance Institute.

The main obstacle indicated by private financial market players is a lack of reliable sustainability data. The Strategy recommends that data from various public registers be merged into a centralised sustainability database and that companies provide further information as an additional national measure in relation to the Corporate Sustainability Reporting Directive. The reason for this is that only a few companies in Lithuania meet the "large company" criterion and the number of publicly listed companies is not that high. Therefore, the disclosure requirements should also apply to Lithuania's medium or small-sized enterprises, which dominate the Lithuanian economy.

Labelling (or assessing how green a particular project submitted for financing is) is another challenge. There is no universally accepted methodology, and it could be arguable whether to involve companies operating internationally (like Sustainalytics) in smaller Lithuanian projects. The Strategy discusses the idea of the Green Finance Institute initiating the development of a methodology and then licencing the methodology to local agencies which will work under the labelling guidelines issued by the Institute.

Obviously, the methodology remains an open question in other jurisdictions, so there are high hopes that a unified international standard will be developed some time in the future.

5. Pan-Baltic dimension

The economy of each Baltic State, if taken separately, is not large, but all three countries together make up a 6 million people economy with a GDP of more than EUR 100 billion. Moreover, most investors see the Baltics as one region and tend to invest simultaneously in all Baltic States.

Hence, solutions for combining local efforts make economic sense. The Strategy provides that the Baltic Sustainable Investment Fund could also involve Latvian and Estonian projects, and the labelling methodology could be another area for Baltic cooperation.

Projects similar to the one involving the Lithuanian Strategy have also been launched by EBRD in Latvia and Estonia, which gives hope that some joint solutions will be proposed and implemented in the future. Over the last couple of years, the Baltic markets have seen a diversification in financing sources and the share of non-banking finance (bonds, crowdfunding) is constantly growing, nevertheless, market players say that bank financing will remain cautious. One tendency is clear — a sustainability element will prevail in any type of private financing, and state policies will incentivise this.

6. Conclusion

Russian aggression against Ukraine has forced EU countries to look for alternative energy resources. The Baltic States have cut their energy reliance significantly, and Lithuania in particular is completely energy independent from Russia. In addition, it is a good time to speed up the implementation of climate goals to use less energy and make the energy used stem from greener sources. The Lithuanian Strategy and Action Plan on Sustainable Finance is a good example of Baltic efforts towards that target, which cannot be achieved without the involvement of private financial market players which should be incentivised in creating the supply of sustainable finance products. The State plays a major role here, but public funding should be used wisely alongside the required private funds.

Bulgaria

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Bulgaria

Uncertainty is the only certainty

1. The status of the Bulgarian economy and the financial sector at a glance

The Bulgarian economy is gradually recovering from the slowdown caused by Covid-19. At the same time, it remains exposed to high volatility and uncertainty due to the continuing war in Ukraine and its direct and indirect effects on the economy. The current forecasts of the Bulgarian central bank for GDP growth are 1.9 per cent in 2022, 1.7 per cent in 2023 and 3.7 per cent in 2024.

The main risk for the Bulgarian economy remains its strong export orientation, which makes it vulnerable to outside turbulences. Potential future travel restrictions, new Covid-19 pandemic restrictions and the high price volatility of energy and commodities due to the war in Ukraine might slow down the economic recovery and growth.

Inflation in 2022 continues to rise and is expected to be around 15 per cent by the end of 2022. Salaries in the country, which are amongst the lowest in the EU, also continue to rise to catch up with the rate of inflation.

Fiscal stability and the Currency Board (which has pegged the Bulgarian domestic currency to the euro for 25 years now, since 1997) remains solid, although the public spending related to measures against the Covid-19 pandemic, the war in Ukraine and compensations for the sharp increase in prices of energy, have surged in 2021 and in the first half of 2022.

Bulgaria aspires to join the eurozone in the beginning of 2024, however, there may be some delay.

Banks in Bulgaria remain very well capitalised and profitable, despite the economic slow-down caused by the Covid-19 pandemic and the war in Ukraine. They have invested heavily in digitalising their services in response to the rising demand of their customers for online banking services. In addition, the banks are increasingly more interested in financing “green” projects such as investment in renewable energy generation.

The capital market in Bulgaria, which is traditionally not very strong, has seen some positive development since the introduction of an SME growth market in the Bulgarian stock exchange allowing smaller companies to make public offerings of shares on less stringent conditions and with fewer requirements.

The FinTech industry in Bulgaria is also growing, and 2022 saw the birth of the first Bulgarian unicorn — Payhawk, a FinTech company.

The war in Ukraine along with various EU, US and other sanctions related to it, has made the KYC and sanctions processes of banks in Bulgaria much more stringent. Most banks have suspended any new business involving Russian clients regardless of whether they are formally on the sanctions lists or not and apply very strict rules for dealings with existing clients with Russian ownership.

The indirect effect of the war in Ukraine on the economy in general, such as increased prices of energy, food and transport and high volatility of commodity prices have affected most of the banks’ clients, especially those from the high energy consumption industries and transportation. Clients from those sectors have increased their demand for working capital loans.

Due to the peg of the Bulgarian domestic currency to the euro, the recent increase of interest rates by the ECB will increase the interest costs of loans and might reduce the appetite for long-term financings and investments. Companies with higher indebtedness will be more affected by the increase in interest rates, and some might default on their loans.

On the other hand, high energy costs have increased the demand for optimisation and have thus resulted in increased investment into renewable energy manufacturing for Bulgaria’s own needs, and in turn, less energy consuming production technologies which will require long-term financing.

2. The political situation in Bulgaria and its indirect effect on the finance market

Among the main problems of the business and investment climate in Bulgaria remains the corruption in the public administration and the unreformed judicial system.

The desire to fight against corruption and reform the judicial system were the main reasons why the new political party (*We Continue the Change*) was formed in 2021 (just prior to the general elections in November 2021). The new party was formed by two newcomers in politics who appeared on the political scene after they had been appointed the care-taker ministers of economy and finance. Their party became the first political party in Parliament after the general elections in November 2021 and managed to form part of the new coalition reformist government.

However, after just 191 days in power, the government of Bulgaria, led by Prime Minister Kiril Petkov (from *We Continue the Change*) fell following a successful non-confidence vote supported by its former coalition partner which is led by a populist TV showman.

Early general elections seem quite possible, although a final attempt to form a coalition government within the existing Parliament is currently underway.

If this final attempt to form a government fails, it will be hard to predict the outcome of the early general elections. Nevertheless, statistic polls indicate that the new Parliament will be equally fragmented, albeit some players in it might change.

3. Conclusion

Needless to say, the political stability of a country, as well as its geopolitical course, have a major impact on its economy in general, including its financial sector. This is especially true in this moment of general geopolitical instability in Europe which is caused by the war in Ukraine that has resulted in high prices of energy, distorted supply chains and an influx of refugees into Bulgaria and other countries in Europe.

Since Bulgaria aspires to join the eurozone by 2024 and expects billions of euros in EU funds to support its economy under the Recovery and Resilience Plan, a change of the geopolitical position in Bulgaria will have a dramatic effect on its economy.

In general, apart from one political party which is clearly pro-Russian and anti-EU and NATO, there seems to be political consensus for the EU and NATO geopolitical direction in Bulgaria. However, a change is not to be excluded *per se*.

If Bulgaria remains on its current geopolitical course, the main drivers of the banking and financial markets will be further digitalisation, innovation, FinTech and financing renewable energy and other green projects.

Croatia

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Croatia

Countdown to eurozone

Following two challenging years affected by the Covid-19 pandemic, Croatia is currently undergoing a significant transition in its monetary policy. After more than twenty-five years of using Croatian Kuna, as of 1 January 2023 Croatia is expected to introduce the euro as its official currency. Considering the circumstances of rapidly growing inflation and an expected increase in interest rates, Croatia is undergoing a significant number of regulatory changes which are necessary to join the eurozone. It remains questionable how all these circumstances and changes will affect the financial sector and capital markets in the upcoming period.

1. Stability of the financial sector

The pandemic-related uncertainties, as well as the recent geopolitical tensions, have so far not threatened the stability of Croatia's financial sector. Good liquidity and capitalization of the banking sector have thus far played an important role.

Following the Russian invasion of Ukraine, the EU adopted a sanctions package that had a significant effect on the operations of one of the largest Russian banks in Croatia, Sberbank. Due to a rapid deterioration of liquidity, in February 2022, the European Central Bank announced that Sberbank is failing or likely to fail and adopted the moratorium on the operations of Sberbank based on which the Croatian National Bank initiated the resolution proceedings.

The resolution has been successfully carried out by means of a sale to Hrvatska poštanska banka and the bank's regular operations resumed in March 2022. Hrvatska poštanska banka, accounting for 5.56 per cent of the assets of the banking system, is the sixth largest bank in the country and is under the majority ownership of the Republic of Croatia. The successful resolution of Sberbank in Croatia has ensured the financial stability of the local banking sector and protected the public interest as well as clients' deposits.

Sanctions towards Russia and Belarus have not affected the stability of the non-banking financial sector (insurance undertakings, investment funds and pension funds). Pension funds as large players in Croatia's capital market do not hold direct investments in Russian, Belarusian and Ukrainian securities and money market instruments. Pension funds as primarily long-term investors are usually not significantly affected by short term disruptions on the global financial markets and are expected to maintain stable returns.

As most Croatian banks are not largely exposed towards debtors affected by the sanctions regime, the stability of the banking sector is not expected to be significantly disrupted. However, the impact of sanctions on the costs of raw materials and energy supply will probably lead to a worsening of the general economy in the long term and result in an increased number of borrowers who are unable to pay their debts in a timely manner. Therefore, in the long run we might anticipate a rising demand for refinancing and debt restructuring.

2. Corporate borrowings and interest rates

During the last quarter of 2021 there has been an increase in corporate borrowings caused by increased demand for working capital, restructuring and increased M&A activity. Such increases were facilitated by the strong liquidity of the domestic banking sector (averaging EUR 10.6 billion) and low interest rates. Since March 2020, the average interest rates for corporate borrowings have been between 1.8 and 2.2 per cent, with a record low interest rate of 1.75 per cent at the end of 2021.

The interest rate on new corporate loans rose in January by 50 basis points to 1.80 per cent, almost equalling the decrease seen in the previous month. The rise in financing costs was mainly the result of a fall in the share of large enterprises' financing, whose strong borrowing in December 2021 led to a noticeable fall in the total interest rate on pure new corporate loans.

However, consumer price inflation continued to accelerate as a result of the high prices of energy products and other raw materials, disturbances in supply chains and high freight rates. The record high inflation at a yearly rate of 10.8 per cent and the recent announcement on rising interest rates by the European Central Bank, have given rise to concerns that the positive trends from 2021 are unlikely to continue.

The cost of new borrowing and the cost of repayment of active facilities with variable interest rates are expected to grow in the long term. Therefore, is it expected that such uncertainty will result in a decrease of corporate loans for investment and growth, while the banking sector might face an increasing demand of liquidity loans necessary to cover the growing costs of businesses. On the other hand, it is expected that the implementation of the euro will act as a shock absorber and will mitigate the growth of future long-term interest rates to come. However, the income of the banking sector might be affected by increased costs arising from the euro implementation and a reduction of conversion rate income.

3. Currency risk and monetary policy

The Croatian government and Croatian National Bank are currently undertaking the necessary actions to enable a smooth implementation of the euro as the official currency of Croatia starting from 1 January 2023. It is expected that the obligatory display of dual prices in euro and Kuna will begin on 5 September 2022 and will last until 31 December 2023.

The public perception towards the introduction of the euro remains generally positive. However, in circumstances of growing inflation, there is a concern that the conversion of prices to euros will result in the additional price growth of both goods and services. Therefore, the Croatian government aims to ensure strict monitoring of the conversion process and the enforceability of consumer protection tools in case of an unjustified increase in prices by businesses.

Even though the abolishment of the Croatian Kuna is perceived as a significant restriction, due to losing autonomy over Croatia's independent monetary policy, the scope of such policy has been rather limited due to high currency risk exposure and a substantial share of foreign ownership over the banking system.

As Croatian foreign currency debt amounts to approximately 127 per cent of GDP, the Croatian economy is highly vulnerable to currency risks. Therefore, eliminating such currency risk is likely to reduce the risk premiums and ultimately benefit the borrowers in Croatia.

In terms of the banking sector, the introduction of the euro will result in reduced regulatory costs by decreasing the minimum reserve requirement from 9 per cent to 1 per cent and terminating the obligation to ensure the coverage of liabilities denominated in foreign currency. These changes are expected to significantly reduce operating costs and consequently reduce interest rates and thus boost the financing of the local banks.

Although the introduction of the euro will result in one-off implementation costs which will specifically affect the banking sector, ultimately it will eliminate conversion fees and reduce transaction costs. This will contribute to ensuring the competitiveness of the Croatian market by allowing for easier price comparability, thus making the Croatian market even more attractive for foreign investors.

4. Glimpse into the future

For almost a decade, Croatia has been the smallest EU Member State still using its own currency. As of 1 January 2023, Croatia is expected to introduce the euro as its official currency. While the general public sentiment towards the euro is generally affirmative, concerns related to the loss of independent monetary policy and the surging of consumer prices are still present. In light of growing inflation and the expected increase of interest rates, it is reasonable to question whether the timing for such a significant change is right and whether the burden of the regulatory process and conversion costs will slow down the increased activity in the finance sector. Although the overall market trends largely depend on geopolitical factors and the situation on global markets, the introduction of the euro in Croatia is expected to reduce the currency risk, mitigate the growth of long-term interest rates and thus boost corporate finance and investments into Croatia in the foreseeable future.

Czech Republic

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Czech Republic

Amidst Record High Inflation and an Energy Crisis, Czech Banks Remain Focused on ESG Financing

Record-high prices driven by the war in Ukraine and the Green Deal combined with the structural problems within the Czech economy are threatening the viability of many Czech businesses, in particular industrial companies, and are causing social unrest. To bring prices down, the Czech National Bank has engaged in an aggressive policy of interest rate hikes, which has resulted in an increase of the interest rates on borrowing as well. In addition, banks are tightening their credit policies, resulting in stricter collateral requirements. However, banks remain eager to finance ESG friendly activities, such as renewables energy projects, and appetite for this type of financing is growing.

1. Czech inflation hit a 30-year high at the end of June

Inflation in the Czech Republic surged to a new 17,2 per cent year-on-year high at the end of June. This is the highest level since 1993 and inflation may not have yet peaked, given the broader volatility within the global economy and potential energy supply disruptions. In particular, the Czech Republic, which sources roughly 80 per cent of its natural gas from Russia, would be heavily affected if gas flow fails to resume following the announced shutdown of Russian gas supplies while maintenance work begins on the Nord Stream 1 pipeline which brings gas to Germany via the Baltic Sea.

As a result, the Czech Republic is one of the EU countries hardest hit by inflation, second only to Estonia, Latvia and Lithuania. Furthermore, the current surge in consumer prices has been driven by record energy, food, and fuel prices as well as housing expenditures. In addition to the war in Ukraine and the Green Deal, inflation is blamed on the Czech governments' policies. The country has distributed some of the highest pandemic-related subsidies and continues to do so in an effort to stem social unrest, including the recently announced subsidies to reduce consumer energy bills. In parallel, the Government (counter-intuitively) reduced taxes on several occasions (personal income taxes were lowered during the pandemic and excise duties on fuel were recently reduced) and is now only starting to timidly acknowledge the need for tax hikes.

2. Difficulties faced by Czech businesses

Consumer confidence is waning, and businesses are struggling with record high energy prices, increased pressure on wages, disruptions in supply chains and the effects of the Russian aggression in Ukraine. Businesses have seen energy prices rise to levels which are much higher than in neighbouring countries and make them uncompetitive. Some industries are heavily dependent on natural gas (e.g. glass manufacturers or bakeries) or particularly sensitive to supply chain bottlenecks (e.g. Czech automotive production, which is key to the Czech economy, has been slowing down due to missing supplies, such as computer chips).

As the Czech economy is more of an "assembly shop" type with the share of domestic value added being one of the lowest globally, many manufacturing businesses will struggle (and are already struggling) to pass on key input price hikes to their customers.

The outlook for the Czech economy is rather gloomy with stagnation/stagflation (if not recession) predictions and a wave of insolvencies and restructurings is expected to hit the economy by the end of 2022.

3. Interest rate hikes and other attempts to stabilize the situation

The Czech National Bank is attempting to prevent a weakening of the Czech Crown from driving up inflationary pressures by intervening on the market. In addition, it has launched an aggressive series of interest rate hikes to cool off the economy and bring down prices, raising its benchmark interest rate to 7 per cent at the end of June 2022 (up against 0.25 per cent only in May 2021). While freshly appointed Czech National Bank Governor Aleš Michl does not support interest rate hikes, one should not exclude the possibility that this trend will continue.

The effectiveness of the aforementioned interest rate hikes has been recently called into question by various experts, forcing the Czech National Bank to defend its policy publicly. The fact that the ever-increasing growth of housing prices (the press recently referred to the Czech and New Zealand real estate "bubbles") seems to have now come to a halt is interpreted as a positive sign by some.

In addition, the Government is now considering introducing a "windfall tax" on energy companies and possibly banks. This tax, which is primarily targeting Czech energy giant ČEZ, is presented as a temporary tax to be imposed on the extraordinary and unexpected profits currently being achieved by energy companies, thanks to the energy crisis. It could bring an extra CZK 10-20 billion of income for the treasury and its proceeds could be used to reduce energy costs for consumers and businesses.

Another long-term project that is being discussed to bring energy prices under state control (and which was rejected by previous governments) is to split up ČEZ, which is 70 per cent owned by the state and 30 per cent owned by minority shareholders, into two separate parts. Under this scheme, while coal and nuclear power plants would become 100 per cent state-controlled (which would facilitate the construction of new nuclear facilities in line with Czech energy policy), renewables, energy services and distribution would be "privatized". This would however involve paying significant compensation to minority shareholders and would take months, if not years, to implement.

4. Impact on financing of renewables projects

(a) General impact on financing

Record-high inflation is driving up interest rates. As a result, appetite for foreign exchange (in particular EUR) loans is growing, and the share of foreign-exchange loans in corporate borrowing recently reached an all-time high. However, foreign-exchange loans can result in balance sheet mismatches and require a good understanding of foreign exchange risks and are therefore not a good solution for everyone. In any event, the demand for foreign-exchange loans may start faltering when EUR and CZK-related interest rates start to converge, which is expected to happen on a mid to long-term basis.

In parallel, banks are tightening credit policies, which has resulted in stricter collateral requirements.

As a result of this, corporate borrowers are expected to start considering alternative forms of financing such as debt securities or FinTech solutions, for example, crowdfunding or P2P factoring platforms.

(b) Financing of renewable energy projects is growing

The energy crisis and geopolitical situation have created a favourable environment for new renewable energy projects, and the demand for loans to finance these projects is therefore growing. The investors are generally stronger and more sophisticated players than those who rode the 2009-2010 solar energy investment wave.

The borrowers are less worried about high loan interest rates which they expect to be thoroughly accounted for by the record- high electricity prices.

The demand for financing in EUR has also increased in this area, which banks view favourably provided that there is an economic justification such as sufficient project income in EUR.

Most of those investments are in photovoltaic projects as the approval process for new wind farms is fairly lengthy and cumbersome, the technology is more expensive and local municipalities are generally not welcoming, deterring new investments into this area.

As banks are taking sustainability and ESG issues seriously and aspire to be green, they have become eager to finance such projects, which generally translates into favourable loan pricing (lower interest rate margins).

(c) A sound business model is a prerequisite

The difficulty in predicting the amount of income generated from new projects over the term of the project/loan (roughly 20 years) in the context of volatile energy prices complicates the risk analysis for banks. The following tools (or a combination thereof) may be used to address the issue:

- banks require cross-collateral to secure the project, as a result of which the assets from an older project with a guaranteed purchase price may be used to secure the loan for the new project. This favours larger players which are in a position to offer such cross-collateral; and
- ideally, the borrower should have a power purchase agreement in place with a customer for the supply of the energy (or part thereof) to be generated by the project with a price determination mechanism that reduces uncertainty about project income (this may for example, include a fixed-price arrangement or a mechanism to determine the price within a certain pre-determined band).

Various financial (hedging) instruments are being considered and might be used in the future to fix minimum purchase prices.

5. Conclusion

It is becoming increasingly difficult for Czech corporates, in particular SMEs, to secure loans for their new projects or for working capital requirements. In addition to record-high interest rates and increased scrutiny from banks, which are now also checking sustainability and ESG risk issues, they are struggling with the rising prices of supplies (if at all available), in particular energy, and with the volatility within the global economy.

In this environment, the share of alternative forms of financing, including debt securities issues and FinTech solutions, can be expected to grow.

However, as the Czech Republic will be striving to increase the share of renewables in its energy mix and to de-carbonize its economy and as banks are providing stronger support for green projects, the environment will be particularly favourable for banks financing green technology, including renewable energy projects.

This being said, even in this area, borrowers will likely be subjected to stricter bank credit policies and collateral requirements, as a result of which more sophisticated borrowers and larger groups will be best placed to obtain financing for their projects.

Hungary

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Hungary

Status quo effect of sanctions

For decades, legal counsel on different sides of transactions have argued over the various ways of interpreting certain substantive provisions of law. Depending on the approach and on the clients' interests, some have made use of a conservative reading, whereas others were more flexible. In 2022, stakeholders have found an area where common ground seems to have been unequivocally achieved among counsel and clients. There only seems to be a limited number of questions or issues about how sanctions are to be interpreted. However, this consensus can take its toll in small jurisdictions such as Hungary.

1. Speed versus clarity

The occurrence of unusual, out-of-the-ordinary events often results in swift reactions. This has been the case with attempts to mitigate the effects of Covid-19; and is also the case regarding the war in Ukraine. Whilst ambiguities arising from Covid-19 legislation primarily concerned lawyers and market participants in each jurisdiction separately, various international sanctions (such as those issued by the UN, US, UK and EU) and national sanctions which are improved against regimes can cause wide-ranging cross-border problems. The rapid introduction of sanctions imposed against Russia might have satisfied the imperatives of diplomacy, intergovernmental institutions and supranational organisations and hence also delivered a message of unity. However, on a practical level, their application can cause wide-ranging frustration — all rooted in the ambiguity of rapidly drafted texts, interpretation issues and the lack of a framework for applying the sanctions in accordance with their purpose. Hungary, being a small and open market economy where foreign direct investment (FDI) levels are high, which is also critical of some of the sanctions, is experiencing such frustration.

(a) Overcompliance

When dealing with financial institutions, we have experienced overzealous compliance by some clients or counterparties with sanctions against Russia. An example that we have observed is where an asset or person is sanctioned by country X, the Hungarian institution would nevertheless approach the matter as if that asset or person were also sanctioned in Hungary. This approach develops for a variety of reasons, among which is certainly the expression of a valid moral standpoint for those countries imposing the sanctions (with adjusted internal policies), but also the fear of secondary sanctions, the expectation that sanctions will ultimately be the same or very similar in each jurisdiction sharing similar political views; and also that it is simply easier to take a conservative view to avoid addressing challenges that have already been regarded as unfavourable elsewhere. Whatever the reasoning for overcompliance might be, what it does in many cases is to prevent market participants, be they corporate or financial, from quickly adjusting themselves to conform lawfully with the new environment created by the sanctions. In the case of a transaction that has been made unlawful by sanctions, many operational, re-financing and other difficulties might arise.

(b) Broad language

Broad language leads to a multitude of possible interpretations of the same text and invites disagreement on interpretation, which largely depends on the various interests of the jurisdictions/stakeholders. Financial institutions, investments funds, investment firms and investors in Hungary have different views and differing approaches towards the sanctions against Russia, all depending largely on the approach of their various parents in their respective jurisdictions and the nature and territory of their businesses. Terms, such as "control", "affiliate", "asset", "wind-down" and others have different meanings in many jurisdictions so that, for example, a US owned bank might have an almost completely different understanding of such terms compared to that of a Hungarian bank having an Austrian parent. Similarly, for example, an investor with Russian interests and links might aim to apply a more flexible or liberal interpretation (such interpretation might also be based on publicly formed criticisms of some Hungarian officials regarding the sanctions against Russia) whilst a German or South Korean company might interpret and apply the same sanctions in a completely different way; all these differences on interpreting the sanctions are being cumulated on a mass scale within a small country such as Hungary. This fuels uncertainty in the interpretation and application of the sanctions and drives each stakeholder (save for Russian stakeholders) to take the most conservative interpretation, or to start a multijurisdictional due diligence and analysis, the result of which might not be straightforward. Cautious financiers demand having their own due diligence, and thus pre-transactional preparations made by a seller and a buyer might be worth much less in today's environment: financing banks will still spend a lot of time and money to conduct their own due diligence relating to the sanctions and this might involve a dozen or more jurisdictions. By the end of a long due diligence process, changes in a fast-moving market with fluctuating prices might render the original term sheet into a redundant document, even if the due diligence might conclude that the transaction could be a bankable transaction.

2. Freezing the status quo

Let us look at an example of a group operating in Hungary with financing in place provided by a syndicate of UK and Russian lenders. Take a security trustee having a US parent. Imagine that none of the Russian lenders are directly sanctioned in the EU, but some of them are sanctioned in the US or in the UK. Both a refinancing or a change in obligor would be nearly impossible although the ultimate goal would be to re-structure the transaction to comply with the imposed sanctions against the Russian lenders.

Exemptions and options to obtain licences from sanction authorities (e.g. a wind-down licence) have deadlines. These deadlines are usually quite tight and might give the stakeholders no option but to rush into a deal which they have had limited time to think through properly.

Once this rapid structuring is complete, and a deal is in place, applications would be submitted in various jurisdictions. And from that point onwards, the future of the transaction would be in largely uncharted territory. There would rarely be any communication, let alone indication as to when the authorities would be able to process the application. Operating companies might not be able to plan, they might run into defaults (if, due to the sanctions they would not be able to pay interest or instalments to one or more lenders), non-sanctioned finance parties might be in limbo and shareholders might be stuck with no means to convene proper shareholders' meetings. These are but a few of the examples of challenges many companies might face.

EU sanction rules apply across the EU, including Hungary, but interpreting the same rules is within the competence of each member state. The EU Commission issues guidance, detailing one possible way of suggested interpretation, but the guidance is far from specific. For instance, if a question arises around the meaning of “wind-down” in a particular transaction envisaged to be implemented for the purposes of re-structuring a group or a financing to be in compliance with the imposed sanctions, the stakeholders would need to file queries in each jurisdiction where the transaction has relevance (a lender, an obligor, any collateral and so on) and not only in Hungary. The authority responsible for interpreting EU sanction laws is different in each jurisdiction. Some create a special authority for this purpose, others (such as Hungary) use a designated department of the tax authority, many have allocated such tasks to the ministry of justice or to the ministry of foreign affairs. Each application must be made in the local language.

Consequently, *applying* sanction rules properly is not only difficult due to their nature per se, but also very challenging if one considers the possible uncertain outcome, the timing the due diligence and re-structuring requires, and last but not least, the cost it involves complying with the sanctions. However, it may now be time to work on harmonising the various interpretation of the applicability of these sanctions. This may be done by implementing clear and simple procedural rules, deadlines with accountability and similar measures that will protect the interests of those who wish to re-structure their operation and finance structures to comply with the primary goal in the sanctions without unduly reducing the impact of the sanctions on the sanctioned.

Poland

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Poland

The Banking Sector in a Border Country

As a result of Russia's aggression against Ukraine, Poland's geopolitical environment has changed significantly. This situation has influenced many spheres of social and economic life, including the banking sector.

With the outbreak of the war in Ukraine, the Polish banking sector has been faced with new tasks such as providing services to hundreds of thousands of refugees from Ukraine. At the same time, the banks themselves have had to face new challenges, including cybersecurity threats.

Despite such challenges, the Polish banking sector has coped with the new situation quite well thanks to its many strengths. Generally speaking, the sector is remarkably stable, and the largest Polish banks regularly occupy leading positions in the European Banking Authority's EU-wide stress tests. The domestic banking sector is also highly digitalised, ensuring broad access to banking services via electronic channels. Moreover, Polish banks are involved in social services, ensuring that citizens can log in to administration websites and even submit applications for social benefits online. In addition, the sector also proved that it was able to quickly adapt to new, extraordinary conditions at the height of the Covid-19 pandemic (for example by increasing access to banking services via electronic channels, distributing state aid, handling an increased demand for cash, etc.).

1. Banking products for refugees

As of 15 July 2022, roughly 4.78 million refugees had crossed the Polish-Ukrainian border since the beginning of the war, of which more than 1.5 million have remained in Poland. This has made it necessary to provide hundreds of thousands of Ukrainian clients with access to banking services in Poland. Fortunately, Polish banks were able to benefit from their prior experience in servicing a significant number of Ukrainian clients who were already present in Poland before the war began.

In order to standardise the sector's approach to offering products and services to the refugees from Ukraine, the Office of the Polish Financial Supervision Authority (the PFSA) issued a public statement on 4 March 2022. The PFSA stated that such products and services should primarily include a basic payment account and a connected payment card and that no fees should be charged for these services. The PFSA also emphasised that banks should provide contractual documents in Polish, Ukrainian, English and Russian language versions to ensure that convenient services were being provided for the various groups of refugees.

Banks have also significantly simplified their procedures to open an account for Ukrainian citizens. People with identification documents may usually gain access to banking services without much difficulty but establishing bank account agreements with individuals who have come to Poland without any documents presents a bigger challenge. As such, it has been necessary to cooperate with the relevant national and occasionally foreign institutions in order to confirm an applicant's identity.

Another important issue is the simplification of the process for refugees to use payment cards in Poland. The Regulation (EU) 2021/1230 applies to cross-border payments within the European Economic Area and requires that fees charged by the payment service provider for such payments in euros, and in the other currencies of the Member States, be in alignment with fees for domestic payments. However, this protection does not apply to the users of payment cards issued by Ukrainian entities. In order to standardise the relevant procedures implemented by payment service providers operating in Poland, the PFSA issued a statement on 22 April 2022, in which it expressed its expectation that such providers refrain from charging persons using Ukrainian payment instruments (such as cards) any additional costs related to the conversion of funds for transactions at a payment terminal or an ATM.

The number of Ukrainian citizens serviced by Polish banks currently exceeds one million, which includes Ukrainians that already resided in Poland before the war. It is expected that the number of Ukrainian customers using banking services will continue to increase. In particular, some of those who extend their stay in Poland indefinitely will certainly use not only current accounts and payment instruments but also lending services in the future.

2. Threats related to cybersecurity

As indicated above, the domestic banking sector is highly digitalised, thus ensuring broad access to banking services via electronic channels. On the one hand, this represents one of the sector's advantages, while on the other, it poses a significant challenge as it is open to constant cybersecurity threats.

The sector has cooperated in taking action to counteract such threats along with the participation of the PFSA. As of today, there have been no significant IT failures or interruptions in the availability of banking services, but there is no doubt that the banking sector's IT security expenses will increase in future. As a result, it can be expected that the sector will attempt to optimise such expenses by cooperating more closely. There are also opinions being expressed within the sector that more of the entities in the banking infrastructure (such as credit history offices or clearing houses) need to develop security systems for the entire sector in order to reduce the costs that banks currently bear.

3. Impact on credit activity

Before the war broke out, the Polish banking sector had no significant exposure to either Ukraine or Russia. As a result, there was a lower risk of the conflict causing direct losses. However, indirect impacts which result from the influence of the war on Polish borrowers that either cooperated with contractors from Ukraine or Russia or that carried out business activities related to these countries, are possible.

Regardless of these risks, the war in Ukraine may change the needs of entrepreneurs on various levels in terms of obtaining financing. First, irrespective of the ongoing energy transformation, full independence from mineral resources from Russia may mean undertaking certain energy investments that require credit facilities from banks. Secondly, due to the war's intensification of the supply chain disruptions which began to occur during the Covid-19 pandemic, financing may be required to construct local manufacturing plants that will produce otherwise unavailable products. Changes in the banking sector in terms of financing defence expenditures cannot be ruled out in the current situation either.

A very important role for Polish banks may arise at the eventual end of the conflict in Ukraine. It is highly probable that they will directly or indirectly play a significant role in the reconstruction of Ukraine, not only by providing financial resources, but also by cooperating with their Ukrainian counterparts.

4. Impact on mergers and acquisitions

In the context of assessing the proposed acquirers of banks, insurance companies, brokerage houses and other regulated entities in the financial sector, as well as members of their management boards, the PFSA adopted a resolution on 14 April 2022, in which it states that ties or relations with the Russian Federation and the Republic of Belarus raise significant doubts in terms of ensuring that such acquirers or managers are able to provide the relevant warranty required by law. Without such a warranty, it is not possible to obtain the regulatory approval to acquire shares or to take certain roles on the management boards of regulated entities. For all practical purposes, this means that the Russian aggression in Ukraine has blocked the path to any natural and/or legal person from the Russian Federation and the Republic of Belarus operating in the Polish financial sector.

5. Conclusion

The Polish banking sector has been faced with new tasks and threats due to the outbreak of the war in Ukraine. Firstly, Polish banks have had to quickly provide several hundred thousand new Ukrainian customers with access to basic banking services. This task was successfully accomplished. It should also be expected that the number of Ukrainian citizens using banking services in Poland will increase. Secondly, cybersecurity threats in Poland were largely counteracted within a framework of sectoral cooperation. In order to optimise the costs that banks have incurred, such cooperation will be intensified to some extent, while the possibility remains that, in the future, some tasks will be transferred to other entities in the banking infrastructure. Thirdly, the war in Ukraine affects the credit needs of certain industries, and thus also the lending activity of banks. In particular, it is highly probable that the Polish banking sector will participate in the reconstruction of Ukraine after the end of the conflict. Lastly, the Russian aggression in Ukraine has practically blocked the path for natural and legal persons from the Russian Federation and the Republic of Belarus to operate in the Polish financial sector.

Romania

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Romania

Between two very different futures

Romania is facing radical uncertainty. There are arguments for both a very favourable outcome for the economy and business in general, as well as for a major disruption that will affect this country for the next decade, the latter resulting from a toxic cocktail of inflation, war at the borders and supply chain disruptions from the lockdowns in China. The veil of uncertainty may be lifted in the first half of 2023 and, until then, one can only wait and watch carefully, planning for resilience in the event of a storm.

In this article, we will try to give some background for each of the potential outcomes and address both the strengths and weaknesses of Romania, economically as well as geopolitically, and how these will likely impact the Romanian banking and capital markets sector.

1. The government backed “boom” of the pandemic era

Like most countries in Europe, since March 2020 Romania has seen unprecedented support provided by its central bank, its government, as well as its banking sector, with the objective of countering the massive drop in output experienced during the initial lockdowns resulting from the Covid-19 pandemic.

Measures to support the business sector as well as the population have been abundant and have included most notably:

(a) the (quantitative) easing program implemented by the National Bank of Romania;

(b) government backed support schemes for businesses, through guarantee schemes implemented by EximBank, on behalf of the Romanian State; and

(c) measures to suspend loan payments for the population (for up to 9 months).

Moreover, Romania has tapped into the debt markets quite aggressively during this period, sharply raising its debt to GDP rate to more than 50 per cent.

The National Bank of Romania is a bastion of conservatism and, unlike some other central banks (such as the US Federal Reserve, for example, which observes a dual mandate, maximum employment and price stability), it has a mandate that strictly focuses on price stability.

Romania has had a history of hyperinflation during the 1990s, and until the 2000s, it has struggled tremendously to confine inflation and inflation expectations within a manageable corridor.

It is therefore quite a surprise when the National Bank of Romania started to reduce its policy rate quite significantly and implemented what can be regarded as a form of quantitative easing (QE), beginning in March 2022. Of course, the magnitude of the easing bears no comparison with the US, or other European countries, but given the history, it did come as a surprise to the markets.

As part of the program, the central bank initiated an incremental reduction of the central bank policy rate from 2.5 points ultimately to 1.25 points in 2021, along with a program to purchase government securities.

The government intervened as well by ramping up infrastructure spending, increasing access to EU funding, as well as supporting the population and businesses.

The increased spending was backed in part by a jaw-dropping (by Romanian standards) increase of government debt by more than 15 per cent, compared to 2019, reaching a level of around 50 per cent of the country’s GDP in 2021. Such a per centage would have been unimaginable in 2019 for an economy the size of Romania’s, with experts considering that a comfortable level for government debt should peak at a maximum per centage of 40—45 per cent of the GDP.

Romanian capital markets have seen the largest activity in history in 2021, with some Romanian stocks being included in the FTSE Russell Emerging Markets index, and more than 27 obtaining financing through bond issuance and some other 23 companies going public on the Bucharest stock exchange.

Liquidity and support have poured in from all sources. As a result, after a sharp fall in Q1 2022, Romania’s GDP increased steadily in the next quarters, and even after the start of the war in Ukraine and the supply chain disruptions in China at the beginning of 2022, it has still risen a further 5.2 per cent in Q1 2022, against all expectations.

2. The party is over

In 2022, inflation has erupted to double digit figures. This is likely to be a result of a combination of factors: monetary policy (monetary inflation), the war in Ukraine (affecting prices for energy and food) and supply chain disruptions from China (generating push inflation on a number of fronts), as well as a generally elevated level of demand that has resulted from the of easing of Covid-19 related restrictions.

A base case scenario of the central bank sees the inflation rate peaking in Q2 2022 at more than 14 per cent and probably staying in the double-digit territory until Q2 2023. A more adverse scenario is also stipulated, in which the inflation rate continues to increase throughout 2022 and maintains over double digits for a longer period.

The National Bank of Romania has started unsurprisingly to increase the central bank policy rate aggressively. On 6 July 2022, the bank announced yet another increase of the policy rate (the 4th rate hike) by another 100 bps to 4.75 points, therefore almost quadrupling the rate from the lowest level seen in 2021. Many even argue that 200 bps would have been even more appropriate.

The Romanian Interbank Offer Rate (ROBOR) at 3M, the inter-bank lending rate, has peaked at 6.76 per cent at the time of writing, increasing steadily from the rate of 1.49 per cent which was published only a year ago. Financial conditions have therefore tightened significantly for businesses, while the same effect will be occurring rapidly for the population as well. The Consumer Credit Reference Index (CCRI), the reference rate to which all retail loans with a variable rate are related, has a lagging effect, but it will follow the increase of ROBOR in three to six months, thus exerting tremendous pressure on the purchasing power of households.

Whether this will be enough to stem off inflation is very uncertain, as neither of these measures address the push the inflation caused by extraneous factors (the war in Ukraine and lockdowns in China). What is certain is that they will have a recessionary effect, given the concurrent weakening of major European economies that are major partners of Romania.

There are now talks of fiscal consolidation and increasing fiscal discipline, but it will be fair to say that these have never been Romania's strongest points, and it is unlikely that they will become so, especially as the Romanian Government is now led by an unlikely coalition of right-wing and left-wing parties, each seeking support from their base. Stagflation therefore is a major risk, if the weakening of the economy is sufficiently intense to cause an actual decrease in GDP. All eyes are on the GDP numbers to be unveiled in the following quarters.

In this context, a "deceleration" of lending is generally acknowledged within the banking sector. The term "deceleration" has been used by banks to reflect the current situation characterised by caution coupled with a more thorough assessment of businesses based on their supply chains, reliance on gas and electricity and typology of their clients.

On the retail lending side, banks are tightening the standards while the interest rates increase, leading to a reduction in consumer loans. This could further intensify the downtrading behaviour already visible throughout Europe.

On the corporate side, there is an increase in demand from both large companies and medium and small enterprises for working capital financing and a strong preference for euro denominated loans (rather than loans denominated in lei). The impact of inflation, as well as that of the geopolitical risk and of supply chain disruptions, on the Bucharest stock exchange is yet to be assessed. Investors are waiting for the half year financial results of listed companies to become available and look for companies in those sectors which have growth potential.

3. The (relatively) good part of Romania's position

While Romania is obviously struggling with high inflation, a lack of fiscal discipline, a pervasive, low level of financial intermediation rates, low capitalization of local firms and a lack of political unity on major issues (such as education and infrastructure), there are some important aspects to consider positively:

(a) Romania is the EU's second largest country in CEE (after Poland) and Romania's economy is not nearly as fragile as it was 10 to 20 years ago - it has surpassed the Czech Republic in nominal GDP, and Hungary and Greece in GDP per capita (although Romania exhibits major regional disparities with some regions remaining some of the poorest in the EU);

(b) dependence on Russia, be it on Russian oil and gas or FDI, is very low, one of the lowest in Europe (although, again, the indirect impact from Germany, the Netherlands, and other important business partners, may be far greater than any direct one);

(c) while increased government debt stands at a "digestible" 50—60 per cent of the GDP, it is no way near the levels of its European counterparts, and therefore, generally, country default risk should be reasonably low (again, this is not fully reflected in yields, which show a very notable spread that is unfavourable towards Romania, which tends to borrow at much higher rates than other EU countries);

(d) The Romanian banking system is, from a liquidity and credit risk perspective, a very robust one and the top banks (most of them part of strong EU financial groups) have acted and continue to act as strong partners to companies and small and medium enterprises with viable businesses. At the same time, Romanian subsidiaries of international companies continue to be financed at group level, having access to facilities made available by EU or international banks and financial institutions. and

(e) Romania is a well-regarded ally of NATO, and a good-standing member of the EU. Its geopolitical position is also strongly aligned with the US, which regards it as an important partner in the region. It is therefore possible that Romania will arise stronger from this crisis, should the economy hold on to positive levels of growth.

4. Impact on finance and capital markets

With the rapid deterioration of financial conditions, capital markets and financing activity have already decreased significantly, and the outlook is negative for the relative near term. It is reasonably expected that the market will move from an exuberant origination to restructuring, and preventive measures to decrease the risk of a rapid increase in non-performing positions will most likely be put into place.

This of course leads to a different type of investors coming into the scene, with a focus on:

(a) restructuring and special situations.

- Romania has already implemented the Preventive Restructuring Directive, and there is now a legal framework for restructuring debtors in difficulty, in advance of any intervening insolvency.
- In this context, it is plausible that banks will favour turnaround and restructuring processes which will lead to more resilient businesses, and it is likely that opportunities will arise from this process of corporate renewal, especial in agribusiness, IT, and the energy sector.

(b) equity investment in strategic positions which will become more reasonably priced.

- There is an increasing level of interest in this area, especially regarding entrepreneurial businesses which in the past have been "for sale" but at a very high price and previously did not match the expectations of potential buyers. Both take-overs and acquisitions of minority stakes are on the rise and, depending on the outlook for 2023 and beyond in Europe (particularly in the context of the war in Ukraine), there is room for very lucrative opportunistic transactions.

(c) distressed acquisitions and non-distressed M&A by larger players focusing on acquiring less resilient regional businesses.

- There is no doubt that this period will be heavily testing the resilience of various businesses across different industry sectors. There is already a very large gap between well-funded, well-run companies and others which have not used the time since the inception of the pandemic to build their defences. In this context, current and quick ratios are deteriorating, and revenues incur unprecedented volatility, thus creating major opportunities for distressed M&A, as well as strategic acquisitions of businesses which will be underperforming for the next 1-3 years but are very valuable strategically.

5. The future of legal work in radical uncertainty

Times such as these test the legal creativity and results driven behaviour of most lawyers. While 2021 has been a particularly good year for structuring and originating some of the most interesting transactions on the Romanian markets (NNDKP has held major roles in some of the largest club and syndicated deals for large Romanian players), 2022 and possibly 2023 will be marked by more work on restructuring, as well as turn-around work, which was already needed even then, but was "hiding" under the largest level of monetary and fiscal support provided in recent history.

In this context, it will be interesting to watch how the implementation of the Preventive Restructuring Directive in Romania will play out, and to what extent businesses put under pressure will manage to produce better results than in the financial crisis (when only a minority of distressed cases were successfully restructured, while the vast majority filled up bankruptcy courts).

In this context, volume work, which is constantly becoming more of a commodity, is likely to be replaced by a focus on real added value, as structures of transactions will increasingly move from being a "cookie cutting" exercise to "bespoke tailoring". In uncertain waters, a truly good legal advice is likely to become more important than ever.

Serbia

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Serbia

Old and new challenges persist in spite of growth

The Republic of Serbia has been facing a series of challenges lately on its quest to join the ranks of the developed countries. Intermittent geopolitical tension, a pandemic, supply-chain issues, rising interest rates, and inflation have together taken a toll on the economy. On an optimistic note, some of these issues have been navigated quite well, e.g., in post-Covid, 2021, real GDP growth of Serbia rebounded strongly by 7.4 per cent, supporting a narrower fiscal deficit and a decline in the public debt ratio. However, most recent tests will require some delicate political acts and persistence with regards to implementation of earlier projects and plans.

1. Standing at the crossroads

(a) Old/new government

For more than a decade, political leaders of Serbia have endorsed a neutral foreign policy, pursuing simultaneously good relations with the EU, the US, China, and Russia. Even in a happier, less-conflicted world, the strategy has on occasions appeared to be tricky and unsustainable, although it produced some significant economic outcomes. To illustrate, a French company runs the Belgrade airport, an American company is building one of the most important motorways, a Russian company owns the former state oil company, and Chinese companies have bought some of Serbia's largest industrial facilities, including a steel factory in Smederevo, and a copper mine in Bor. Conversely, a change in foreign policy could also have significant economic consequences, including redefining or severing and replacing the existing ties.

The parliamentary elections in Serbia took place on 3 April but the new government has not yet been formed. The official reasons for the delay were repeating irregularities occurring in one municipality causing multiple reruns of the voting. Until the process is over, the results of the elections are not final and the parliament cannot be constituted. Incidentally, the ruling party, which again commands most of the vote, could certainly use the extra time to prepare for some tough political decisions. One of the toughest decisions being its response to the mounting pressure to align with EU foreign policy: in particular, to join the EU sanctions against Russia.

(b) Banking and payment systems

Even without taking this step, the indirect effects from the Russia-Ukraine crisis and the EU's measures are already present. For one, the Serbian financial sector is deeply integrated in the European framework since the parents of most of the country's biggest banks are based in the EU member states. Their groups' policies and home country rules are already affecting how local subsidiaries are dealing with Russian clients. Also, on a more general note, the processing of payments to and from Russia takes much more time than before the conflict because of additional checks and new demands arising under correspondent bank relationships.

The mitigating factor is that Russian banks hold a minor part of the market especially now after the resolution of the local subsidiary of Sberbank. The National Bank of Serbia had applied the sale of business tool for the first time and transferred the ownership of this bank to another market participant. From the regulator's point of view, the measure was a success: the bank continued its business, the deposits were protected, and adverse effects on financial stability were avoided. On the other hand, so far at least, there have been no public announcements that the Sberbank group intends to challenge the move.

(c) Energy dependency

In contrast to the relatively loose ties between the financial markets, the Serbian energy system is highly dependent on Russia. Serbia imports around 90 per cent of its consumption of natural gas and virtually all of it comes from Russia. A joint venture owned by Serbian gas monopoly Srbijagas and Gazprom manages a major underground gas storage. Naftna Industrija Srbija (NIS), the former state-owned oil monopoly in which Gazprom Neft and Gazprom currently hold a controlling stake, operates a major oil refinery and is extracting crude oil and natural gas in Serbia.

The monopoly control of the gas market is particularly difficult to break. The Energy Community has already determined that Serbia is not complying with the ownership unbundling and third-party access requirements of the EU Third Energy Package. According to their findings, the Serbian government has not implemented the unbundling plans for Srbijagas and Yugorosgaz, another affiliate of Gazprom in which Srbijagas has a 25 per cent stake. Srbijagas has also reportedly failed to enable other suppliers access to their infrastructure. In public, the Government keeps broadcasting the message of their commitment to implement the restructuring in these companies and other large public utilities companies over the medium term.

NIS has come under intensifying pressure of the sanctions, which according to the company, could limit its ability to move funds across the group, obtain financing from external sources, and purchase supplies, equipment, and services from foreign sellers. Despite reassurances of the company that the continuity of its business is not in doubt, there are speculations about a potential temporary or permanent transfer of the ownership to state or a third-party buyer.

2. Green push

The current developments will likely accelerate the clean energy transition. The investments into the renewable energy sources are underpinned by significant initiatives, such as the National Energy and Climate Plan, which will soon be presented to the public, and Serbia's commitment to the

EU-backed Declaration on the Green Agenda for the Western Balkans. Serbia has recently launched its first-ever EUR 1 billion green bond which will (re)finance projects for renewable energy, green buildings, energy efficiency, pollution prevention and control, wastewater management and eco-friendly transportation. The state budget for 2022 paves the way for new investments including EUR 1.3 billion in loans to be taken by the government for a construction of solar plants and wind farms and up to EUR 1,5 billion in loans for a construction of a pumped storage hydropower plant.

In parallel, the government has introduced a new set of incentives for renewable energy production based on so-called feed-in premiums i.e., a mechanism consisting of a payment of premiums for renewable energy production on top of the electricity market price. Major stakeholders have raised an issue around the bankability of new windfarm projects because the maximum purchase price for electricity produced from wind is apparently set too low so this will have to be re-addressed in future.

3. Raising capital

In the period prior to the crisis in Ukraine and the local parliamentary elections, the state has been very active in promoting new infrastructure projects and raising capital for their funding. Among other credit transactions, Serbia has recently completed the financing of EUR 830 million in aggregate loans for the construction of 110-km motorway from Pojate to Preljina (Morava Corridor) arranged by J.P. Morgan and other participants. Around the same time, the state has taken a loan of around EUR 200 million from BNP Paribas and UniCredit Bank, which is secured by Sinosure and will be used for construction of the wastewater treatment facility in Belgrade. We participated in negotiations over some other loan transactions with the state, but the implementation of the projects has been postponed until the new government takes office. It is still unclear to what extent the inflation, interest rates rising globally, and the geopolitics will affect the ability of the state to directly borrow from international lenders and the terms of such borrowing.

As for capital markets, in the beginning of 2022, the Ministry of Finance has announced that it will not issue Eurobonds but only local securities. A lot has happened since then and there are indications that the decision may have to change. Among other things, Serbia is preparing to introduce a primary dealer system for the first time which should decrease the risk of debt issuances being unsuccessful (a risk that materialised recently with a couple of issuances in the local market).

With new pressures on public finances, we expect increased use of public-private partnerships, concessions, and other models which do not require employment of budget funds from the outset of the transactions.

4. Conclusion

After a relatively quiet start, the stage is now set for the new government to get on with the job and unlock the legislative processes and other activities that were outside the technical competencies of the current government. The way in which the government will continue to handle foreign relations in light of the Ukrainian crisis will be a major driver for economic performance and investor confidence. There are many energy and infrastructure projects in the pipeline, but the questions as to how these will be financed and on what terms are a bit more complicated now than they were last year.

Slovakia

Eva Hromadkova

PRK Partners

Slovakia

Postpandemic Slovakia looks towards an ESG-focused Future

Slovakia had not yet fully recovered from the Covid-19 pandemic when it was hit by the impact of the war in Ukraine. The impact has been especially hard since Slovakia is in close geographical proximity to Ukraine and heavily relies on Russian energy (in 2020, 85 per cent of Slovakia's gas supply came from Russia). Next to a high level of inflation, Slovakia has also experienced, much like other EU countries, an increase in commodity and other input prices in general. In addition to this, it is attempting to cope with the humanitarian task of integrating the Ukrainian refugees who have crossed the Slovak - Ukrainian border.

1. Banking Sector and Green Financing

(a) Banking sector

The banking sector weathered the pandemic fairly well. The Slovak banks are healthy and continue to generate profit, mainly due to increasing interest rates, the growth of loan financing, and the abolishment of a special bank levy (applied since 1 January 2021). The capital adequacy of the Slovak banks is higher than it was before the pandemic and the share of non-performing loans remains low. That said, the regulator remains vigilant and continues to closely monitor the financial sector and to assess spill overs of the war. No Slovak bank is Russian-owned, and Slovak banks are thus not directly affected by the sanctions. However, even though the banks' exposure to Ukraine, Russia or Belarus is very low (most likely no more than 0.1 per cent of the overall assets), they may be hit secondarily through the impact on the economy, firms and financial markets. After the Russian attack on Ukraine, Slovakia together with Poland, Czech Republic, Bulgaria, and Romania, terminated its membership in two international Soviet-era and Russian-dominated banks —International Investment Bank based in Budapest and International Bank for Economic Cooperation based in Moscow.

The main topics that resonate in daily life are an expansion of the finance sector caused by a steep growth in the lending and real property markets. Similarly, household debt continues to rise at a high rate (mainly loans for housing which increase by about 10 per cent annually) together with an increase in real property prices. Interest rates on new mortgage loans are rising as well. However, with Slovakia being in the eurozone, the rates are still comparatively low (about the third lowest in the eurozone) and continue to be widely accessible.

(b) Sustainable finance

Public funds will not be sufficient to ensure achieving the goal of a carbon-neutral economy by 2030 / 2050; in order to achieve these goals, private capital must be involved (especially since the Slovak banks provide a significant part of financing in the local market). The Slovak banks joined the initiative on sustainability and sustainable development by acceding to a joint memorandum of the Slovak Banking Association and signing the Paris Agreement and the European Green Deal. All banks are expected to focus on sustainable finance by integrating environmental, social or governance (ESG) factors in the investment process, being in line with the EU Taxonomy and by making non-financial reporting and expected disclosure in line with the EU Corporate Sustainability Reporting Directive.

One of the first examples of green investments in Slovakia was a EUR 300 million unsecured revolving loan to U.S. Steel, a steel producer and one of the biggest Slovak industry players which produces about a quarter of all CO2 emissions in Slovakia. The deal was arranged by ING Bank which also leads the Steel Climate-Aligned Finance Working Group, a working group established to take action on the effects on the climate by the steel sector. The deal is one of the first financing deals imposing environmental and social obligations within ESG well as including an annual reduction of CO2 emissions. Debt servicing costs of U.S. Steel will depend on achieving sustainability goals, global carbon intensity, global efficiency in safety at work and obtaining the Responsible Steel certificate.

2. Capital Market – Corporate Bonds

Over the years, we have seen a trend of increasing investment into local corporate bonds, which is most likely due to the low interest rates on bank deposits (near zero) and active distribution networks (banks, investment firms and their financial intermediaries). In four years, from 2016 to 2021, the volume of such investments has more than doubled, from EUR 2 billion to EUR 5.5 billion with retail investments amounting to about half of such volume. Nevertheless, corporate bonds represent merely 3.5 per cent of the financial liabilities of Slovak non-finance businesses (with banking and intra-group financing still leading the way).

The rise of the bond investments was slowed down by the pandemic, followed by the downfall of two investment groups - namely, Arca Capital with almost EUR 1 billion owed mainly to Czech and Slovak investors; and Helske with EUR 60 million raised from Slovak, Czech and Slovenian investors (both currently undergoing insolvency or restructuring proceedings).

The regulator reacted by warning investors about specific aspects of corporate bonds, mainly illiquidity, high concentration of issuers (about 20 issuers covering 60 per cent of bonds issued by non-financial issuers and about 40 issuers covering almost 80 per cent of the market), and non-existence of credit ratings of such bonds. The regulator also issued a supervision benchmark on distribution of corporate bonds aiming to unify distribution of corporate bonds and educate and protect retail investors. Although for the past two years we have not seen the continuance of dynamic growth in retail bond investments but rather stagnation on the same level, this is most likely due to the pandemic rather than heeding the regulator's warnings.

3. New Preventive Restructuring

With effect of 17 July 2022, Slovakia implemented the EU Restructuring Directive to introduce preventive restructuring as a tool to deal with threats of insolvency (in particular, cases caused by potential illiquidity and inability to pay debts when due). If the preventive restructuring is not successful (e.g. instances in which the court does not approve a restructuring plan), the potential debtor does not automatically enter insolvency, as it is the case in a "standard" restructuring. The preventive restructuring could be a potentially useful tool for firms in distress in the wake of the energy and supply crisis.

One of the drawbacks of the new scheme that has arisen is the tax treatment of debts discharged in preventive restructuring schemes which is unfavourable compared to those discharged in insolvency restructurings. The legislator failed to implement (i) the tax deductibility of receivables so that creditors may waive or write these off within the approved restructuring plan; and (ii) an income tax exemption for a debtor in relation to its liabilities that have been written off or waived within the approved plan. Creditors are thus not incentivised to participate in preventive restructuring but would rather wait for actual bankruptcy. An amendment to the aforementioned tax law aimed at rectifying this drawback has been proposed and is expected to be adopted and become effective as of 2023.

4. Conclusion

The main priority of the Slovak government and the EU is to ensure energy security and to reduce dependence on Russian fossil fuels, introduced as the RePowerEU Plan. The plan also tackles a climate crisis and furthers green transition by promoting renewable energy sources, energy savings and energy efficiency. We all remain hopeful that both the energy and climate crises will not deteriorate, and once stability returns to the region, there will be more optimistic news to share.

Slovenia

Lidija Zupančič, Senior Associate

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Slovenia

How is Slovenia coping with the turbulent economic situation?

Just as the negative impacts of the pandemic were coming to an end and the market was slowly picking up, the adverse effect of the Russia/Ukraine crisis began to impact the Slovenian market. In order to mitigate the situation, Slovenia has adopted several measures alongside implementing those of the EU. However, the current economic situation in Slovenia remains uncertain and unstable, which makes it hard realistically to predict how it might unfold in the coming months.

1. Current situation on the Slovenian market

Less restrictive measures for preventing the spread of the coronavirus and the effective adaptation to the “new normal” of business activities were the key elements for successfully mitigating the negative impact of the pandemic. As a result, the Slovenian GDP growth recorded in 2021 was 8.1 per cent.

According to the Bank of Slovenia, Slovenian GDP growth is projected at 5.8 per cent in 2022. However, the relatively high growth projections for this year can be largely attributed to the high economic activity in the second half of last year. The Bank of Slovenia also made forecasts in case the war in Ukraine should continue into 2023 and sanctions were to escalate, i.e., if a complete ban on imports of Russian energy products was to be implemented into the EU. In this scenario, Slovenian economic growth would be projected at only 4.3 per cent in 2022.

(a) Disruptions in supply chains

The situation on the global markets, in particular the delays in supply chains, impacted both the Slovenian automotive and construction industries. Most notably, they have caused delays in the supply of cars and car parts, accompanied by a rise in prices.

It is possible that supply chains will move closer to European markets, and thus Slovenian companies will have access to new opportunities. In such a case, they are likely to need additional resources to expand their capacity, which could increase financing in this area.

(b) Inflation

Like most European countries, Slovenia is struggling with high inflation. The inflation forecast for 2022 is expected to be 9.0 per cent on average. According to the Statistical Office of the Republic of Slovenia, by the end of June 2022, consumer prices already rose by 10.4 per cent over the year, prices of goods by 13.1 per cent on average, and prices of services by 5.3 per cent.

Until the end of June 2022, higher prices of electricity, gas and other fuels were the main contributors to the overall annual price increase, followed by higher prices of petroleum products and an increase in food prices.

High inflation will lead to tighter financing conditions. Indeed, in response to the high inflation rates, the European Central Bank (ECB) has announced measures that will tighten the monetary policy, which includes raising interest rates.

Slovenia has also seen an almost unprecedented rise in real estate prices. The growth in real estate prices continued to sharply rise in 2021, surpassing the previous record highs set in 2008. Nevertheless, banks report an above-average increase in housing loans over the last few months.

(c) Banking sector

The Russia/Ukraine crisis is also impacting the banking sector. At the end of February, the Slovenian subsidiary of Sberbank was estimated to be failing or likely to fail due to an extraordinary decline of its liquidity. To avoid disrupting the Slovenian economy, Sberbank’s Slovenian subsidiary was - as a measure imposed by the authorities - taken over by the largest banking group in Slovenia, NLB. Thus, as of 2 March 2022, all customers of Sberbank’s Slovenian subsidiary were able to use banking services normally; and the nervousness concerning the potential failure of Sberbank’s subsidiary subsided almost instantly. The deposit guarantee scheme was not triggered and, considering the complexity of the matter, the transaction was carried out extremely rapidly, which is in most part attributable to the exceptional collaboration between the EU and national banking regulators.

Another development is, as elsewhere in the world, the growth of interest rates, both fixed and floating. There are certain indications that the banks are considering ceasing offering fixed interest rate loans (although currently they are still available), and generally further growth of interest rates is expected. As the financing conditions are tightening, the number of loan applications could decrease in the future.

There are, however, also certain Slovenian specifics requiring significant resources from Slovenian banks.

First, Slovenian banks are making every effort to ensure that the recently adopted CHF loans law does not enter into force in its current state. This law retroactively shifts the majority of CHF loan related risks onto the banks and imposes extremely strict sanctions in case of failure fully to comply with the relatively onerous obligations imposed on banks (including an easily triggered loss of banking licence). In March, the entering into force of the respective law was on the initiative of the banks, having been suspended by the Slovenian Constitutional Court until the final ruling on its constitutionality has been made.

The other pressing topic for Slovenian banks is the defence to several collective legal actions in relation to the use of

Slovenia

zero-floor EURIBOR (either in absence of contractual clauses or based on contractual clauses which are claimed to be unfair). The respective dispute proceedings commenced in May 2022.

(d) Sanctions

In response to Russia's actions destabilising the situation in Ukraine, the EU has adopted various restrictive measures (sanctions), such as prohibiting or limiting trade with Russia, as well as targeting certain Russian citizens and legal entities in Russia. Slovenia has largely followed the EU sanctions and, where necessary, implemented them into Slovenian legislation.

As certain sanctions are rather ambiguous, the legal analyses of practical issues can be very interesting. By way of example, one of the earliest sanctions included a prohibition of the sale of luxury goods to natural persons in Russia or for use in Russia. In one of our cases, the question was raised whether this sanction also applies to natural persons who have Russian citizenship (or in some cases even double citizenship - Russian and from an EU country) but reside in the EU and have not ordered luxury goods to be delivered to Russia. At the time of the matter, the restrictive measures had been recently adopted and considering the lack of practice and guidance on interpretation thereof, we advised that the competent authorities may interpret the applicable rules broadly and hence, there is a risk of sanctions also in such cases.

(e) M&A financing projects and forecasts

The current situation on the market as described above, does not however seem to have any material negative impact on M&A financing projects. We have recently worked on certain M&A transactions of a larger scale, and there are also many acquisitions of SMEs. The banks are supportive.

Moreover, the whole impact of the pandemic, as well as the Russia/Ukraine crisis - contrary to general expectations — did not cause many bankruptcy cases.

Many are predicting that a recession will start at the end of the year, however M&A activity does not yet support such predictions.

2. Challenges for the new government

Parliamentary elections were held this spring and a new left-to-centre government was formed in June 2022. Although instilled with a different political focus, we expect that the new government will also be occupied predominantly with the mitigation of the effects of the Russia/Ukraine war and the predicted recession, as well as the desperately needed reform of the health sector, a prospective tax reform (envisaged to enter into force in 2024) and the digitalisation of the society.

The measures used or announced to be used soon include, among others, certain regulations concerning petroleum product prices, certain aids to Slovenian farmers (including subsidies for fuel and fertilisers) and the purchase of all the wheat grown in Slovenia.

In an effort to tackle high inflation rates, a new measure is being discussed. This measure would include introducing a tax on the ownership of real property as well as create a basket of fifteen products the prices of which will be monitored and may (to an extent) be controlled. For the time being, the aim of this measure is to make prices of comparable products more transparent and thereby inform the consumers where they can purchase such products at the lowest price.

Albeit with autumn approaching, the most pressing concern for the Slovenian economy appears to be ensuring the receipt of the needed quantities of natural gas. According to the recent statements of the Slovenian Chamber of Commerce and Industry, Slovenia does not have its own gas storage capacities, and there is a 90 per cent dependency of the industry on Russian gas.

Moreover, in the following months, adopting fiscal measures to help the most vulnerable populations and exposed parts of the economy will most likely be one of the highest priorities of the new government.

As the uncertainty encompassing the whole situation is extremely high, it makes future developments very difficult to predict. It seems that many of the measures were adopted in haste and consequently not all (financial) impacts were closely considered. For instance, the petroleum companies have filed claims against Slovenia to be compensated for the loss of profit due to the regulation of petroleum prices, however until now it is not clear if they will be compensated. If the petroleum companies will have to bear these losses, this will most likely be reflected in the (non)fulfilment of obligations towards their financial creditors. At the same time, the price of their stock could also be negatively affected.

3. Conclusion

As in other European countries, the situation in Slovenia depends largely on the developments in the geopolitical situation at the European level.

It is possible that the financing of local companies will increase due to supply chains moving closer to the European markets. However, on the other hand, due to high inflation, the financing conditions are tightening, which could result in banks granting fewer loans.

It is inevitable that the newly adopted measures of the Slovenian government will affect the financial market, however as the current situation is so unstable, some time will need to pass before they crystallise and later also materialize.

Looking ahead, like most other countries, Slovenia's macroeconomic forecast is affected by the consequences of the Russian military aggression in Ukraine, and growth continues to be threatened by continued disruptions in supply chains as well as possible new outbreaks of coronavirus infections. It is expected that, to a certain extent, the Slovenian economy will remain unstable, although the legal services market may not necessarily feel this.

Türkiye

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Türkiye

Recent Major Changes Implemented in Türkiye to Mitigate the Effects of Geopolitical and Macroeconomic Developments

This article is intended to provide an overview of major legal reforms that have taken place in Türkiye in the course of 2021 and 2022 in relation to finance and capital markets as a result of different geopolitical and macroeconomic factors. Türkiye is considered to be amongst the countries that initially achieved robust recovery from the global outbreak of the Covid-19 pandemic in 2021. Strong consumer spending, a considerable increase in investments with the help of easily accessible TRY loans and trade figures surpassing pre-pandemic levels have all been drivers of the economy. However, the momentum slowed considerably by the end of 2021 as the effects of monetary and fiscal stimuli began to recede and major supply-chain disruptions emerged throughout the world. At the same time, the economic implications of the Russia-Ukraine conflict contributed to a significant slowdown in growth in the first half of 2022 and further fuelled inflation numbers which are now considered the principal hurdles of the country. In addition to domestic complications, global inflation, fuel and food prices have also increased, giving rise to an additional adverse stimulant. As a result of these developments, Türkiye has adopted, both at the administrative and legal levels, much needed action plans which aim to encourage and entice the investment of foreign capital into the country, and to protect the capital adequacy of banks and the value of TRY by enhancing the effectiveness of the monetary policies.

1. Establishment of the Istanbul Financial Centre

The Istanbul Financial Centre ("**IFC**") was established pursuant to the Istanbul Financial Centre Law numbered 7412 (the "**IFC Law**") on 28 June 2022. The IFC Law regulates the management and operation of the IFC, financial activities that are to be provided by the IFC and the incentives, deductions, exemptions and exceptions applicable to such activities.

Pursuant to the IFC Law, 75 per cent of the profits generated by participants will be deductible from the corporate income tax base, and this deduction rate will be 100 per cent for the fiscal years between 2022 and 2031. Further exemptions, such as those relating to banking and insurance transaction tax, stamp duty, administrative fees; and income tax exemptions for foreign employees to be employed at the IFC, have also been introduced.

Participants may keep their books and records in foreign currency, as well as have their transactions, agreements and communication in a foreign language for activities between themselves and those carried out within the IFC. Participants may freely choose the governing law in private law transactions and agreements for the activities between themselves, provided that such designation is not a breach of any potential legislation which may be exclusively applicable to a given participant.

In line with its geographically strategic location and logistics network capacity, Istanbul intends to act as a global hub and to function as an international financial centre. The establishment of the IFC will hence boost the country's global competitive capacity with regards to the financial sector and further promote the development of financial products and services.

2. Regulations in Foreign Exchange and Banking

(a) Turkish bank regulator limits commercial TRY loans for firms having foreign currency positions

On 24 June 2022, the Turkish bank regulator, the Banking Regulation and Supervision Agency (the "**BRSA**"), adopted its decision to prohibit banks from extending new commercial loans in TRY to companies having foreign currency holdings over a certain threshold.

The measure will be applicable to companies: (i) subject to independent auditing; and (ii) holding foreign currency on their financials exceeding TRY 15,000,000 provided that such amount exceeds 10 per cent of their total assets or annual revenues. Accordingly, such companies are required to analyse their respective financial position, investment plans, existing debts and liabilities since such limitation will adversely affect their chances of taking on new commercial loans.

The intention of BRSA, by virtue of such decision, is to motivate companies meeting the foregoing criteria to liquidate their foreign currency positions in an attempt to slow down the depreciation of TRY against USD and EUR, and to counter rising inflation.

(b) FX payments regarding the sale of moveable goods are prohibited

On 19 April 2022, with an amendment to the Communique No. 2008-32/34 on the Decree No. 32 on the Protection of the Value of the Turkish Currency, it is no longer possible to pay the purchase price in foreign currency in respect of the sale of goods between parties that are resident in Türkiye. The Ministry of Treasury and Finance however published a clarification announcement on 21 April 2022, stating that certain transactions are excluded from the coverage of this prohibition. The following are amongst the most notable exceptions:

- payment obligations regarding negotiable instruments indexed to a foreign currency (e.g. cheques) issued in relation to contracts executed prior to 19 April 2022 may remain in a foreign currency;
- payment obligations regarding invoices issued before 19 April 2022 may continue to be carried out in a foreign currency;
- purchase and sale transactions regarding precious metals and precious stones carried out in a foreign currency and

Türkiye

payment obligations within the scope of the settlement of such transactions in the Precious Metals and Precious Stones Market of Borsa İstanbul A.Ş. may continue to be carried out in a foreign currency; and

- the issuance, sale and purchase of capital market instruments.

The intention of the policy maker is again to increase the number of instances where companies and individuals are motivated to liquidate their USD and EUR positions. Taking into consideration that transactions concerning movable assets are rather common and correspond to a substantial transactional volume, such requirement could potentially enhance the value of TRY against foreign currencies and perhaps slow down the inflation hike.

(c) Amendment of the Regulation on the Principles and Procedures regarding the Central Bank of Türkiye's Monitoring of Transactions Affecting Foreign Exchange Positions

Pursuant to the recent amendments to the Regulation on the Principles and Procedures regarding the Central Bank of Türkiye's (the "**CBRT**") Monitoring of Transactions Affecting Foreign Exchange Positions, companies, whose foreign exchange denominated loans or foreign exchange indexed loans borrowed from lenders residing in Türkiye or overseas correspond to at least USD 15,000,000 as of the last business day of their respective monthly accounting period, are now required to notify the CBRT in relation to their financial positions on a monthly basis. This amendment enables the CBRT to more efficiently use the Systemic Risk Data Tracking System which was established to monitor transactions of companies that affect the foreign exchange position. This further enhances the ability of the policy makers to keep track of non-TRY positions of corporate entities and gives access to further information and statistics for the purposes of analysing fluctuations in the value of TRY.

(d) Amendments to the Capital Movements Circular

Banks were required to review only SWIFT messages relating to foreign exchange transfers to Turkish residents' accounts from overseas to determine if a relevant foreign exchange amount is (or will be) used as a loan. Pursuant to the recent amendments, the scope of this requirement has been extended to include SWIFT messages regarding TRY transfers to Turkish residents' accounts from overseas.

Banks were required to obtain a written declaration and supporting documentation from Turkish residents for any unidentified foreign exchange transfer from overseas which exceeds USD 50,000. For TRY transfers, this requirement has now been set as TRY 250,000.

Further, two new exceptions have been introduced that will allow Turkish residents to use loans from abroad without bringing the proceeds thereof to Türkiye. They are as follows:

- if such loans are used by the same borrower for refinancing purposes. However, any amount of such loan which is not used for the payment of an existing loan should still be brought to Türkiye; and
- pertaining to the proceeds of a foreign loan if the Ministry of Treasury and Finance is a party (in the capacity as a borrower or guarantor) on behalf of Türkiye.

(e) Presidential Decision on Financial Restructuring

Pursuant to the Presidential Decision on Financial Restructuring, the validity period of the temporary Article 32 of the Banking Law, which regulates (i) financial restructuring transactions carried out within the scope of framework agreements and (ii) incentives and tax exemptions granted for these transactions, has been extended for an additional two years. The purpose of the temporary article is to enable obligors to perform their repayment obligations and to continue contributing to employment figures.

3. Regulations in Capital Markets

(a) Regulation of Project-Backed Securities

Pursuant to the Communiqué on Project-Backed Securities ("**PBS**") No. III-61/B.1 (the "**Communiqué on PBS**"), which was published and entered into force on 17 July 2021, long-term projects that carry out public services and require large amounts of capital can now be financed with capital market instruments. Accordingly, a project finance fund (the "**Fund**") has been established. The Communiqué on PBS regulates the establishment, operation and management of the Fund which carries out its operations through an independent asset regime to operate a portfolio for PBS. The Fund will be established by a bank which is authorised to carry out investment services and activities or an authorised intermediary institution, managed by a team designated by such institution, and a service provider will also be assigned to carry out the daily operations of the Fund. The Fund's portfolio may consist of assets including, without limitation, loan receivables from projects and any other income and rights of projects which are financed by way of project financing.

The Communiqué on PBS will enable long-term public projects to be financed with the effective use of alternative financing methods. This will increase the possibility of obtaining financing for such projects.

(b) Capital Markets Board of Türkiye accepted the Sustainability Guidelines

The Guidelines on Green Debt Instruments, Green Lease Certificates and Sustainable Lease Certificates (the "**Guidelines on Green Debt Instruments**") issued by the Capital Markets Board of Turkiye (the "**CMB**") sets out the assessment criteria for issued debt instruments to qualify as green debt instruments and regulates matters such as (i) green projects; (ii) green debt instruments and green lease certificates; (iii) green debt instruments framework documents and green lease certificate framework documents; and (iv) external assessment institutions.

As regards green debt instruments, 4 essential components as set out below have been set forth and the obligations of issuers of green debt instruments with respect to such essential components have been designated:

- Use of Funds Obtained from the Issuance;
- Project Evaluation and Selection Process;
- Management of Funds Obtained from the Issuance; and
- Reporting.

In this context, the Guidelines on Green Debt Instruments aim to increase the issuance of green debt instruments and green lease certificates, reinforce investor trust by way of transparency and external assessment criteria and diversify the investment opportunities for projects which contribute to sustainable development. The CMB's intention is to further align Turkish issuances with global best practices, standards, the International Capital Market Association's principles and the United Nations Sustainable Development Goals and the Paris Climate Agreement. Such amendments could perhaps attract foreign investments at a time where foreign liquidity is desperately needed to stimulate the economy.

4. Conclusion

In 2021 and the first half of 2022, Türkiye was not an exception and was adversely affected by the global inflation trend in the world. Similar to other jurisdictions, the Covid-19 pandemic and the Russia-Ukraine conflict have also taken their toll on the country. However, despite high inflation and rising borrowing costs, Türkiye has taken crucial steps in the fields of finance and capital markets. With the legal reforms enacted and measures taken, the CBRT and the BRSA encourage the use of TRY to boost the use of the domestic currency in the banking sector. The CMB brings further clarity and predictability to the capital markets and investors by introducing specific secondary legislation. However, whether such measures will in fact act as an antidote for the country's multitude of macro-economic obstacles remains to be seen.

Ukraine

Yulia Kyrpa, Executive Partner

AEQUO

Ukraine

Finance and Capital Markets Transactions for Ukrainian Borrowers: The Impact of the War

1. Environment in the Country at War

The unprovoked Russian invasion of Ukraine, unprecedented in Europe since the end of World War II, has been a huge tragedy for the Ukrainian population as well as leading to a myriad of global financial and economic implications. The ongoing war has a direct impact on trade and investment channels and encompasses disruptions to (i) commodity markets (especially food and energy), (ii) logistic networks, (iii) supply chains, (iv) foreign direct investment, and (v) specific sectors. According to the World Bank, world trade will drop by 1 per cent, lowering global GDP by 0.7 per cent and the GDP of low-income countries by 1 per cent in 2022. Beyond these direct effects, the war's long-term implications for global trade and investment will largely depend on how governments respond to the changing geopolitical environment.[1]

The war commenced by Russia against Ukraine created an enormous economic, humanitarian and refugee crisis in Ukraine. Towns and cities across Ukraine are bombarded by Russian armed forces and substantial Ukrainian territories are under de facto temporary occupation by Russian armed forces.

To manage the crisis, to the extent possible, martial law has been introduced in the whole country as of February 2022 and the Government of Ukraine and the Ukrainian Parliament continue to fulfil their duties despite the ongoing war. The Ukrainian economy faces extraordinary challenges which result from fiscal cash flow disruptions and huge expenses needed to cover critical defence, social and humanitarian costs. For example, the Government's monthly expenses to finance the war amount to approximately USD 5-6 billion. Under these circumstances, economic and financial challenges are among the biggest challenges for the country. To combat this, proper engagement and cooperation with IFIs and other creditors to raise new financing and restructure existing debts becomes vital. A revived economy will massively increase the chances of Ukraine to maintain its core operations and rebuild its destroyed infrastructure.

2. Access to Financing

Ukrainian international partners, including EU, G7 and USA have committed to provide financial, military and humanitarian aid to Ukraine. However, even essential financial aid provided by foreign partners of Ukraine is not sufficient to tackle the challenges resulting from rapid GDP reduction. It is expected that Ukraine's GDP will shrink by 30—45 per cent by the end of 2022.[2]

Given that Ukraine's sovereign Issuer Default Rating was downgraded by Fitch Ratings to single C in July 2022, international capital markets for Ukraine remain closed this year. Hence, the Government found themselves in financial difficulties with proper liquidity management seeming to be the only available option.

International capital markets and international financing opportunities remain closed for Ukrainian blue chips as well — most of the Ukrainian businesses have been significantly affected by the war, have lost some of their assets in the temporarily occupied territories, face cash flow reductions or continue operations whilst constantly needing to adjust their business models and adapt to the new environment. As most of the Ukrainian cities remain under bombardment by Russian missiles and artillery, and considering the low rating of the Ukrainian state, private investors and banks are not prepared to accept the risks of Ukrainian borrowers.

In this extremely challenging environment, leading IFIs, such as the EBRD and EIB have taken the lead in financing some Ukrainian companies which operate in strategic industry sectors.

In particular, the EBRD has been swift to condemn the Russian invasion of Ukraine on 24 February and has pledged to stand with Ukraine. In early April, the EBRD's Board of Governors voted to suspend the access of Russia and Belarus to EBRD finance and expertise, and the Bank closed its offices in Russia and Belarus. The EBRD also adopted its EUR 2 billion Resilience and Livelihoods Framework by supporting countries affected by the war on Ukraine. Within Ukraine, the Resilience and Livelihoods Framework will focus on four main elements: (i) payment deferrals, debt forbearance and restructuring, (ii) trade finance, including for fuel imports, (iii) emergency liquidity finance in coordination with partners, and (iv) emergency reform, to support the

1 "World Bank. 2022. The Impact of the War in Ukraine on Global Trade and Investment. Washington, DC. World Bank. https://openknowledge.worldbank.org/handle/10986/37359 License: CC BY 3.0 IGO."

2 Based on the data of the Ministry of Finance of Ukraine and interview of the Minister of Finance Serhii Marchenko (in Ukrainian): https://mof.gov.ua/uk/news/interviu_ministra_finansiv_sergiia_marchenka_vidanniu_mind_01062022-3464

Ukraine

Ukrainian authorities with immediate legislative and regulatory interventions.[3]

The EBRD has been financing Ukrainian companies whose operations are vital for Ukraine's survival during war time. For example, the EBRD granted EUR 20 million to a leading Ukrainian pharmaceuticals manufacturer, JSC Farmak to cover its working capital needs, support production and improve access to essential medicines for people living in Ukraine. Supporting the pharmaceutical sector during the war in Ukraine is a key element of EBRD's five-pronged support plan for the economy of Ukraine and the surrounding region. The EBRD is also supporting trade, energy security, vital infrastructure and food security.

Moreover, in June 2022, the EBRD signed a loan facility agreement with Naftogaz, the biggest gas producer and supplier in Ukraine, envisaging that the EBRD intends to lend up to EUR 300 million, out of which EUR 50 million will be available for emergency gas purchases. The loan should be used to purchase natural gas to fully meet the demand of Ukrainian energy consumers. The loan agreement is secured by the sovereign guarantee of Ukraine.

The EBRD will be sharing the risks under the Resilience and Livelihoods Framework with their partners — the European Union and the European Fund for Sustainable Development.

The European Investment Bank (EIB), in its turn, announced a EUR 4 billion program for 2022 and 2023 to help cities and regions in EU Member States by addressing urgent investment needs to meet the challenges of welcoming and integrating war refugees from Ukraine. The new EIB program aims to finance the development of key social infrastructure for the provision of public services to refugees, including housing, schools, hospitals and kindergartens. The financial support will be complemented by advisory support, helping local authorities in EU Member States with free technical assistance to assess local needs rapidly, and plan, prioritise and prepare the related investments.

Moreover, in March 2022 the EIB Board approved the 1st EIB Solidarity Package for Ukraine. As part of that package, in the period from 8 to 25 March 2022, the EU Bank disbursed EUR 668 million of urgent liquidity support to the Government of Ukraine — to enable the Ukrainian Government to continue providing critical public services for citizens which remain in Ukraine. These funds are foreseen to support transport, energy, urban development and digital projects.

In July 2022, the EIB provided financing to Ukraine on favourable terms as part of the 2nd EIB Solidarity Package in the amount of EUR 1.59 billion to help Ukraine repair the most essential damaged infrastructure and resume critically important projects, hence, addressing the urgent needs of the Ukrainian people. The second package of support for Ukraine under the EIB Ukraine solidarity urgent response was developed in close cooperation with the European Commission.

The second relief package under the EIB Ukraine solidarity response is supposed to help essential services to resume and get the most critical infrastructure up and running again, strengthen the country's resilience and maintain economic stability. It consists of two blocks of intervention:

(a) Immediate financial assistance totalling EUR 1.05 billion. This will consist of upfront disbursements under eight existing finance contracts. It will help the Ukrainian government to cover priority short-term financing needs, provide support to strategic state-owned companies, ensure urgent repairs of damaged infrastructure, resume the provision of disrupted municipal services, and support urgent energy and energy efficiency measures in preparation for the cold season.

(b) Resuming implementation of EIB-financed projects in Ukraine totalling EUR 540 million, where possible, excluding areas of active hostilities and territories not controlled by the Ukrainian government. The selected projects will cover energy, energy efficiency, roads, transport, education and infrastructure, as well as reconstruction and recovery programmes. The exact timing of these disbursements will depend on the state of advancement of underlying projects.

3. Capital Markets Transactions during War Time

The extreme challenges for Ukraine and significant war-related risks are not acceptable for foreign lenders and investors, thus, Ukraine and its companies have not been able to raise new funding in the international capital markets since the beginning of the war in February 2022. To manage liquidity of the state-owned enterprises, several consent solicitation procedures were launched in summer 2022.

In particular, consent solicitation procedures launched by the State, by Naftogaz, the biggest gas producer and gas supplier in the country, by Ukrenergo, an electricity transmission system operator in Ukraine and the sole operator of the country's high-voltage transmission lines, and by Ukrautodor, the state road agency of Ukraine, matched the proposal of the State. All three state-owned enterprises launched their consent solicitation procedures on the identical terms with the State, requesting a two-year deferral of maturities and interest payments across each series of outstanding notes. No consent solicitation fee was offered, and the waiver of covenants was limited to the bare minimum.

3 https://www.ebrd.com/news/2022/ebrd-unveils-2-billion-resilience-package-in-response-to-the-war-on-ukraine-.html

The State proposal has been endorsed by global creditors, including the Paris Club. As of the date of this publication, the consent solicitation proposal of the State was supported by the creditors who have demonstrated a phenomenal level of understanding, unity and desire to assist Ukraine in the war. Hopefully all three major state-owned enterprises will receive the same level of unwavering support from the creditors. To implement successful consent solicitation procedures and avoid a default, it was necessary to engage with many financial and commercial creditors on a bilateral basis to obtain various waivers, forbearance or amendment agreements in respect of the relevant obligations under facility agreements and material commercial contracts.

Ukraine and its state-owned enterprises declared their intention to continue working with their international partners and creditors to ensure strong global support and growing financial assistance, which is vital to end the war and to rebuild Ukraine afterwards.

Major private Ukrainian companies have also been able to demonstrate successful engagement with their creditors. For example, Ukrainian poultry producer MHP launched a consent solicitation proposal in March 2022 — to defer repayment of principal and interest under Eurobonds, after the company missed the deadline for the coupon repayment. MHP had to preserve cash, having faced a number of huge disruptions to its business resulting from Russia's invasion in Ukraine. The holders of the notes voted in favour of the proposal.

4. Post War Rebuild of Ukraine

The rapid response of the Ukrainian Government to the extreme challenges of the war, the governments cooperation with IFIs, other creditors and Eurobond holders, as well as the coordinated efforts of state-owned enterprises and the cooperation between creditors and Ukrainian "blue chips" has already led to some positive results. In particular, the EBRD has pledged to help finance Ukraine's reconstruction once conditions permit. EIB, the lending arm of the European Union, proposed to create a funding structure, involving an EU-Ukraine Gateway Trust Fund, which should help allocate up to EUR 100 billion to finance rebuilding bridges, renovating water and wastewater services, particularly in the cities most affected by the war, facilitate Ukraine's exports, support Ukraine's energy and digital infrastructure sectors, as well as small and medium enterprises.

Hopefully international creditors which consented to the deferral of payments by Ukrainian borrowers in these challenging times, will be able to benefit from future investments into dozens of important and profitable projects and will play a key part in rebuilding Ukraine in the near future.

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