with

Finanšu ministrija

FINAL REPORT

Structural Reform Support Service (SRSS)

Local Currency and Capital Markets Initiative Technical Cooperation Framework

Latvia: Consultancy services to reach Frontier and, if feasible at a later stage, Emerging Market Status

March 2019

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Content

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Acronyms:

ATVR	Annual Traded Value Ratio
AIF	Alternative Investment Fund
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CSD	Central Securities Depository
CREPMF	Conseil Régional de l'Epargne Publique et des Marches Financiers
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EMEA	Europe Middle East & Africa
GNI	Gross National Income
HFT	High Frequency Trading
IPO	Initial Public Offer
IT	Information Technology
MoF	Ministry of Finance
MoU	Memorandum of Understanding
ROE	Return On Equity
SOE	State-Owned Enterprise
SRSS	Structural Reform Support Service
T2S	Target 2 Securities
USD	US Dollar
VC	Venture Capitalist
WAEMU	West African Economic and Monetary Union
WFE	World Federation of Exchanges

INTRODUCTION

During the 1st phase of the project, a diagnostic work was carried out dealing with the following aspects:

- Benchmarking of the Latvian capital market against Index Providers criteria and detailed analysis of MSCI methodology,
- Analysis of the existing situation in Latvia,
- Initial international assessment and dialogue with MSCI.

The main finding of this evaluation was that the key issue is the size of the market. According to the results of the analysis of MSCI methodology, the only missing criterion for Latvia to be eligible for Frontier Market status is the size of the market, and more precisely the number of companies with a minimum market cap (full market cap > USD 741 mm and float market cap > USD 69 mm). At the same time, the current size of the equity market does not correspond to the size and the status of the Latvian economy.

This problem of market size is usually a vicious circle on stock markets. Local investors need diversification: if the local market is too small, they have to invest a significant share of their asset portfolios abroad. Symmetrically, international investors will turn away from the market concerned because it is too small: what is the motivation to invest in a market and undertake the corresponding market access arrangements (study of regulations and tax regime, set-up of brokerage and custody accounts, etc.), if the number of tradeable stocks is very limited? There are problems also from issuers' point of view: a large-scale fundraising operation is not risk-free, there are only a handful of local investors and associated issues with the take-over rate. However, diversification is difficult because of the absence of international investors. Therefore, only small-size transactions are conceivable, operations that can only develop the market up to a limited extent in the short term and may even tend to discourage large issuers which may consider this reserved for small companies.

The same situation is found in equivalent proportions in the other Baltic countries (Estonia and Lithuania), even though they have already attained MSCI Frontier Market status. This is why a regional approach should also be considered, in line with the implementation of Nasdaq Baltic.

The final report consolidates the results of the initial phase by complementing them with:

- The findings of the consultation with international investors;
- A set of recommendations; and
- An Orientation Plan setting out a road map towards achieving identified objectives.

1. Benchmarking against Index Providers and detailed analysis with MSCI criteria

1.1 Benchmarking against index providers

Several index providers are mentioned in the project Terms of Reference as possible benchmarks for the market classification of Latvia, including MSCI and FTSE Russell.

According to the MSCI market classification, Latvia has no status, unlike Estonia and Lithuania which are classified as Frontier Markets (see more detailed explanation in section 1.3. below).

On the other hand, Latvia is already recognised as a Frontier Market by FTSE Russell (Figure 1), like Estonia and Lithuania, but an upgrade to the FTSE Emerging Market status will necessitate a significant step change in terms of development of equity and derivatives markets. To be upgraded to FTSE Emerging Market status, liquidity should be significantly increased on the cash market, while there are currently no derivatives products traded on Nasdaq Baltic.

Figure 1: Frontier Markets – FTSE Russell (September 2018)

FTSE QUALITY OF MARKETS CRITERIA (EUROPE Frontier) as at September 2018

CRITERIA	DEV	ADV EMG	SEC EMG	SEC EMG WATCH	Romania	FRONT	COUNTRY NAMES: Bulgaria	Croatia	Cyprus	Estonia	Iceland*	Kazakhstan	Latvia	Lithuania	Macedonia	Malta	Serbia	Slovak Republic	Slovenia
World Bank GNI Per Capita Rating, 2017					Upper Middle		Upper Middle	High	High	High	Upper Middle	Upper Middle	High	High	Upper Middle	High	Upper Middle	High	High
Credit Worthiness					Investment		Investment	Speculative	Speculative	Investment	Investment	Investment	Investment	Investment	Speculative	Investment	Speculative	Investment	Investment
Market and Regulatory Environment																			
Formal stock market regulatory authorities actively monitor market (e.g., SEC, FSA, SFC)	X	X	X	X	Pass	X	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Fair and non-prejudicial treatment of minority shareholders	X	X			Pass		Pass	Pass	Pass	Pass	Pass	Restricted	Pass	Pass	Pass	Pass	Pass	Pass	Pass
No or selective incidence of foreign ownership restrictions	X	X			Pass		Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income	X	X	X	X	Pass	X	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Developed equity market	X	X			Not Met		Not Met	Not Met	Pass	Not Met	Restricted	Not Met	Not Met	Not Met	Not Met	Restricted	Not Met	Not Met	Pass
Developed foreign exchange market	X	X			Restricted		Not Met	Not Met	Pass	Not Met	Restricted	Not Met	Pass	Not Met	Not Met	Restricted	Not Met	Not Met	Restricted
No or simple registration process for foreign investors	X	X			Restricted		Restricted	Restricted	Pass	Restricted	Pass	Restricted	Pass	Restricted	Restricted	Restricted	Restricted	Restricted	Pass
Custody and Settlement																			
Settlement - Rare incidence of failed trades	X	X	X	X	Pass	X	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Custody-Sufficient competition to ensure high quality custodian services	X	X	X		Pass		Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Clearing & Settlement - T+2 / T+ 3	X	X	X	X	T+2	X	T+2	T+2	T+2	T+2	T+2	T+2	T+2	T+2	T+3	T+2	T+2	T+2	T+2
Settlement - Free delivery available	X				Restricted		Pass	Pass	Not Met	Pass	Pass	Pass	Pass	Pass	Restricted	Restricted	Restricted	Pass	Pass
Custody - Omnibus and segregated account facilities available to international investors	X	X			Not Met		Restricted	Pass	Not Met	Not Met	Restricted	Restricted	Pass	Not Met	Not Met	Pass	Not Met	Not Met	Not Met
Dealing Landscape																			
Brokerage - Sufficient competition to ensure high quality broker services	X	X	X		Pass		Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Liquidity - Sufficient broad market liquidity to support sizeable global investment	X	X	X		Restricted		Not Met	Not Met	Not Met	Not Met	Pass	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met
Transaction costs - implicit and explicit costs to be reasonable and competitive	X	X	X		Pass		Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Stock Lending is permitted	X				Restricted		Restricted	Not Met	Not Met	Not Met	Restricted	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met
Short sales permitted	X				Restricted		Restricted	Not Met	Pass	Restricted	Restricted	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met
Off-exchange transactions permitted	X				Restricted		Pass	Pass	Pass	Pass	Pass	Not Met	Pass	Pass	Not Met	Restricted	Pass	Pass	Pass
Efficient trading mechanism	X				Pass		Pass	Pass	Pass	Pass	Pass	Not Met	Pass	Pass	Restricted	Pass	Pass	Pass	Pass
Transparency - market depth information / visibility and timely trade reporting process	X	X	X	X	Pass	X	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Derivatives																			
Developed Derivatives Market	X				Restricted		Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met	Not Met

Shading indicates a rating change from March 2018

*Iceland to be reclassified as Frontier from September 2019

Source: FTSE / September 2018

Overall, the classification of Latvia by FTSE is consistent with that of its Baltic country peers. This is why the benchmarking will be made against MSCI criteria, considering the gap in terms of classification in comparison with the other Baltic countries. In addition, MSCI is the established international reference benchmark, especially for international investors, who are the ultimate targets in the project of country classification upgrade.

1.2 Countries covered by MSCI in the last review (June 2018)

Every year, MSCI is conducting a Market Accessibility Review that provides an assessment of each individual market covered by MSCI, as well as a summary of changes in market accessibility across markets. The last review was conducted in June 2018[1] and was published on the MSCI website. This review allows analysis of the evolution of Developed, Emerging, Frontier and Standalone Markets in terms of market accessibility.

There was no mention of Latvia in the last review document. The countries that are currently covered by MSCI universe are set out in Figure 2 below.

Figure 2: Market Classification by MSCI (June 2018)

MSCI ACWI & FRONTIER MARKETS INDEX										
MSCI ACWI INDEX						MSCI EMERGING & FRONTIER MARKETS INDEX				
MSCI WORLD INDEX			MSCI EMERGING MARKETS INDEX			MSCI FRONTIER MARKETS INDEX				
DEVELOPED MARKETS			EMERGING MARKETS			FRONTIER MARKETS				
Americas	Europe & Middle East	Pacific	Americas	Europe, Middle East & Africa	Asia	Americas	Europe & CIS	Africa	Middle East	Asia
Canada United States	Austria Belgium Denmark Finland France Germany Ireland Israel Italy Netherlands Norway Portugal Spain Sweden Switzerland United Kingdom	Australia Hong Kong Japan New Zealand Singapore	Brazil Chile Colombia Mexico Peru	Czech Republic Egypt Greece Hungary Poland Qatar Russia South Africa Turkey United Arab Emirates	China India Indonesia Korea Malaysia Pakistan Philippines Taiwan Thailand	Argentina	Croatia Estonia Lithuania Kazakhstan Romania Serbia Slovenia	Kenya Mauritius Morocco Nigeria Tunisia WAEMU[2]	Bahrain Jordan Kuwait Lebanon Oman	Bangladesh Sri Lanka Vietnam
			MSCI STANDALONE MARKET INDEXES[1]							
				Saudi Arabia		Jamaica Panama[3] Trinidad & Tobago	Bosnia Herzegovina Bulgaria Ukraine	Botswana Ghana Zimbabwe	Palestine	

[1] The MSCI Standalone Market Indexes are not included in the MSCI Emerging Markets Index or MSCI Frontier Markets Index. However, these indexes use either the Emerging Markets or the Frontier Markets methodological criteria concerning size and liquidity.
[2] The West African Economic and Monetary Union (WAEMU) consists of the following countries: Benin, Burkina Faso, Ivory Coast, Guinea-Bissau, Mali, Niger, Senegal and Togo. Currently the MSCI WAEMU Indexes include securities classified in Senegal, Ivory Coast and Burkina Faso.
[3] MSCI Panama Index has been launched as a Standalone Market Index.

Source: MSCI / June 2018

When a new market is included in the Frontier Markets universe, MSCI announces it to the concerned market at least six months before the upcoming May Semi-Annual Index Review.

[1] MSCI GLOBAL MARKET ACCESSIBILITY REVIEW – June 2018 https://www.msci.com/documents/1296102/1330218/MSCI_Global_Market_Accessibility_Review_June_2018_%28FINAL%29.pdf/04dd3b70-487a-8395-912c-89a202b5b4fa

1.3 MSCI Criteria for Frontier Markets

As explained in the MSCI Global Investable Market Indexes Methodology[2] and further detailed in Figure 3 below, there are two main categories of criteria considered for the inclusion of a country into MSCI Frontier Markets universe: i) Size and Liquidity Requirements, and ii) Market Accessibility Criteria.

Figure 3: Three criteria of the MSCI market classification framework (November 2018)

Criteria	Frontier	Emerging	Developed
A Economic Development			
A.1 Sustainability of economic development	No requirement	No requirement	Country GNI per capita 25% above the World Bank high income threshold* for 3 consecutive years
B Size and Liquidity Requirements			
B.1 Number of companies meeting the following Standard Index criteria	2	3	5
Company size (full market cap) **	USD 741 mm	USD 1,482 mm	USD 2,964 mm
Security size (float market cap) **	USD 69 mm	USD 741 mm	USD 1,482 mm
Security liquidity	2.5% ATVR	15% ATVR	20% ATVR
C Market Accessibility Criteria			
C.1 Openness to foreign ownership	At least some	Significant	Very high
C.2 Ease of capital inflows / outflows	At least partial	Significant	Very high
C.3 Efficiency of the operational framework	Modest	Good and tested	Very high
C.4 Competitive landscape	High	High	Unrestricted
C.5 Stability of the institutional framework	Modest	Modest	Very high

* High income threshold for 2017: GNI per capita of USD 12,235 (World Bank, Atlas method)
** Minimum in use for the November 2018 Semi-Annual Index Review, updated on a semi-annual basis

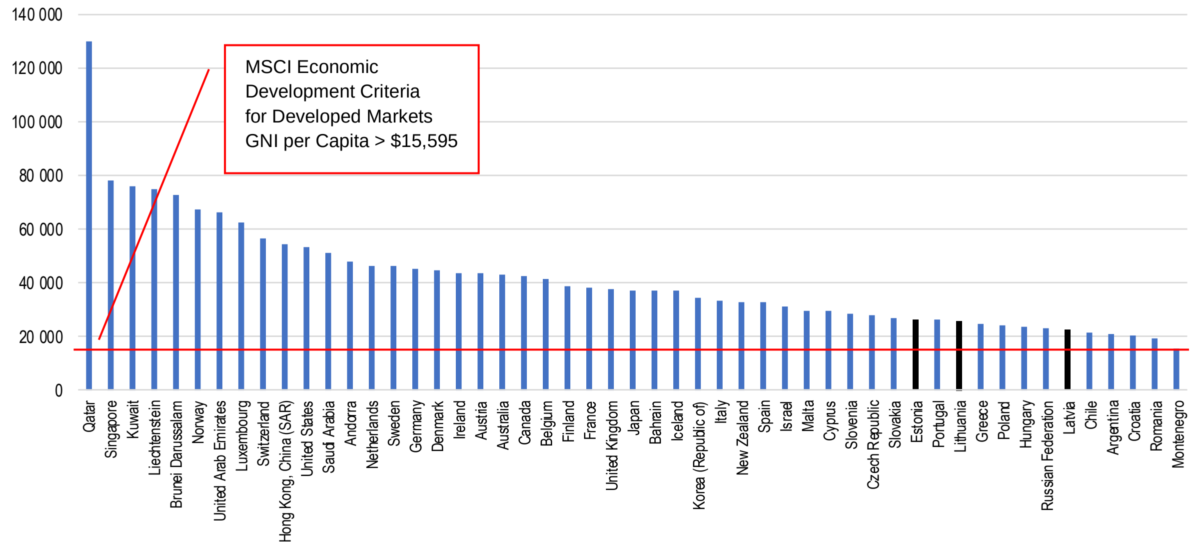
Source: MSCI / November 2018

The third criterion, i.e. Economic Development, is only used in determining the classification of Developed Markets. As explained in MSCI's methodology, the distinction in terms of economic development is not relevant for classifications between Emerging and Frontier Markets, given the very wide variety of development levels within each of these two universes.

Though not directly relevant to Latvia's classification as either a Frontier or Emerging Market, it is nonetheless important to highlight its performance against the Economic Development criterion. The main indicator used by MSCI for this criterion is the level of Country GNI per Capita, which should be 25% above the World Bank high income threshold[3] for 3 consecutive years. As highlighted in Figure 4 below, Latvia, as well as the two other Baltic countries, are above this threshold, and could therefore be qualified as Developed Markets based on this criterion alone.

[2] MSCI Global Investable Market Indexes Methodology - Index Construction Objectives, Guiding Principles and Methodology for the MSCI Global Investable Market Indexes – November 2018
https://www.msci.com/eqb/methodology/meth_docs/MSCI_GIMIMethodology_Nov2018.pdf
[3] High income threshold for 2016: GNI per capita of USD 12,476 (World Bank, Atlas method)

Figure 4: GNI per capita for Very High Human Development Countries in 2015



Source: World Bank

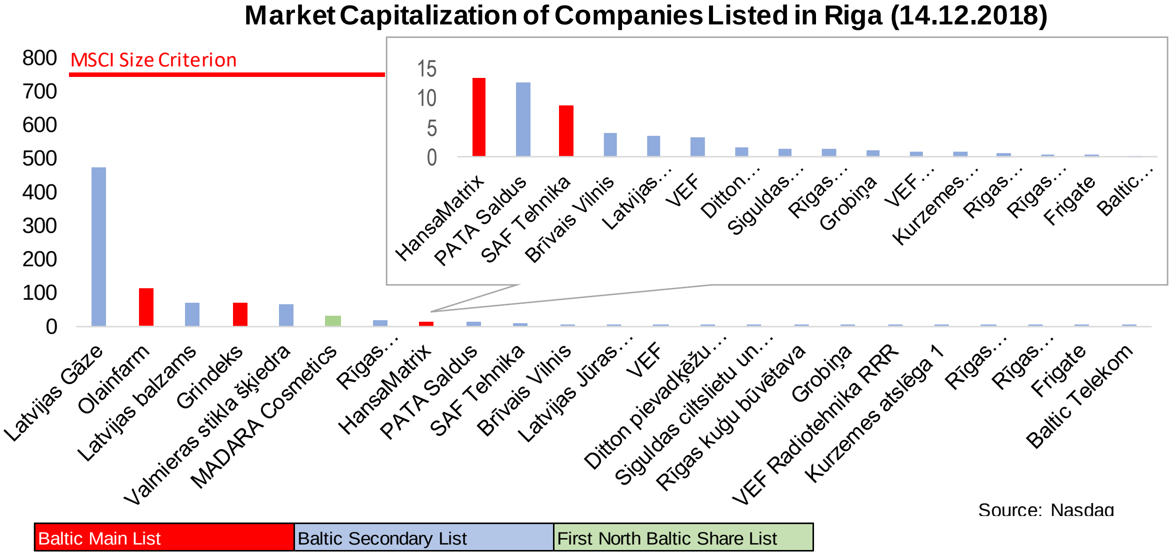
While market accessibility criteria are relevant too (see section 1.3.2.), the main challenges for Latvia to enter into the MSCI global investable universe are the size of its capital market and secondary market liquidity.

1.3.1 Size and liquidity

The size criterion for Frontier Market status is the following: there needs to be at least two listed companies with a full market capitalisation superior to USD 741 million and a free float market capitalisation superior to USD 69 million. It is presently not the case neither for Latvia, nor for the two other Baltic markets (Estonia and Lithuania) taken separately.

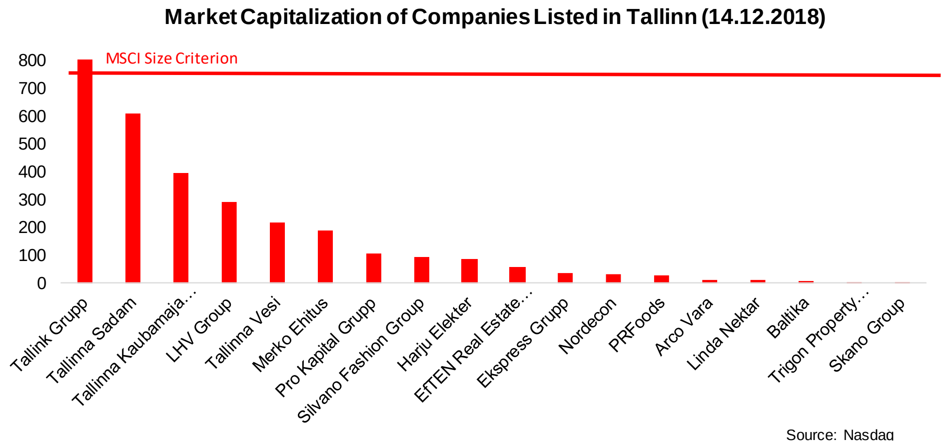
The largest company listed on Latvia's Main List at the end of 2017, Latvijas kuģniecība, was delisted on 13 February 2018. Latvijas kuģniecība is a Latvian shipping company founded on 29 October 1940. The company owns 20 ships and employs more than 700 seamen from Latvia. The market capitalisation of Latvijas kuģniecība at the end of 2017, when it was listed, was equal to USD 510 million i.e. more than 30% below the MSCI threshold for inclusion in the MSCI Frontier Market universe. The delisting decision followed the increase of stake from the main shareholder, Vitol Netherlands B.V., from 91.3% to 97.05% in December 2017. Vitol Netherlands B.V. had made a mandatory takeover bid in the summer of 2017. Latvijas kuģniecība shares have been traded on NASDAQ since June 26, 2002.

Figure 5: Market Capitalisation of Companies listed in Riga



At the end of 2018, the largest company listed in Lavia was Latvijas Gāze, a natural gas distribution operator and natural gas trader. The market capitalisation of Latvijas Gāze (USD 473 million) is far below the MSCI threshold of USD 741 million used as a criterion to qualify for Frontier Market status (Figure 5) and the company is not listed on Baltic Main List.

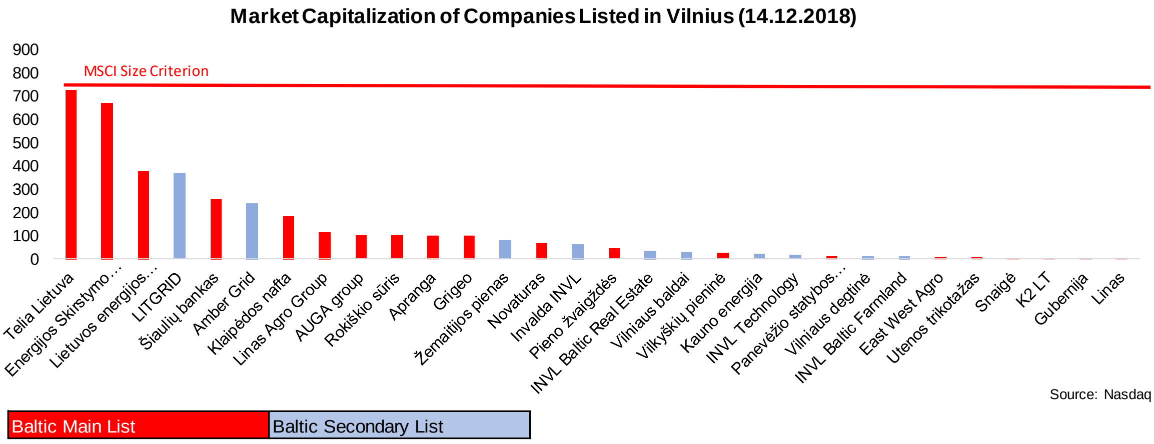
Figure 6: Market Capitalisation of Companies listed in Tallinn



As far as the two other Baltic countries are concerned, despite the fact that they are already included in the MSCI Frontier Market universe, they no longer meet the size requirement. Indeed, as highlighted in Figure 6, at the end of 2018, there is only one company in Estonia that is above the MSCI Market Capitalisation threshold for Frontier Market status and it is very close to that threshold.

In Lithuania, the two largest listed companies that have a Market Capitalization close to the MSCI threshold, namely Telia Lietuva and Energijos Skirstymo Operatorius, are slightly below that threshold as at December 2018 (Figure 7).

Figure 7: Market Capitalisation of Companies listed in Vilnius

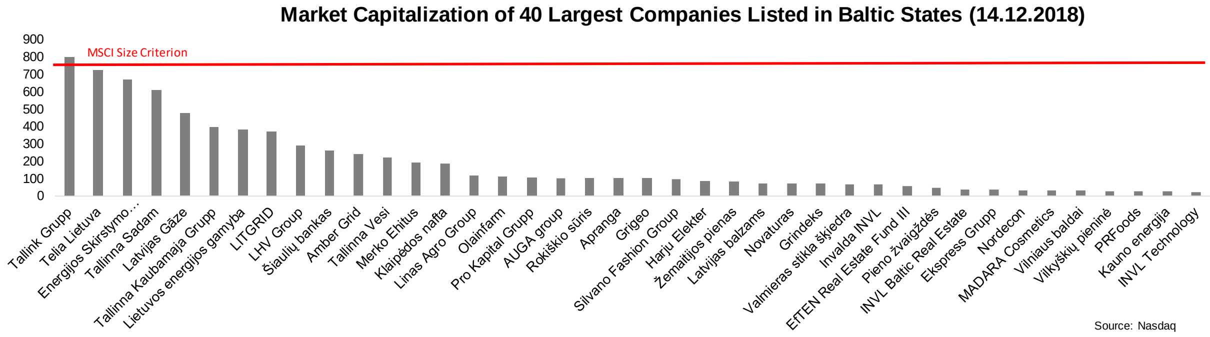


It should be noted that, in June 2018, at the time of the last MSCI Market Accessibility Review, there were not two listed companies with a market capitalisation above the MSCI threshold, neither in Estonia nor in Lithuania. Nevertheless, the two countries were not reclassified by MSCI. Though the risk of reclassification from Frontier Market status to Standalone status for those two countries cannot be ignored, there are no specified provisions in the Market Accessibility Review on the basis of which to assess this risk. Specifically, it is not possible to determine for how long a country can stay in a particular MSCI category/universe, while no longer meeting the classification size criteria. On the one hand, as mentioned in the Market Accessibility Review document, there is a willingness from the MSCI's perspective to preserve the stability of the Index and therefore it can be expected that MSCI would wish to avoid too many reclassifications. On the other hand, the document also specifies that MSCI will only consider markets for upgrade, if a change in classification status can be viewed as irreversible; therefore, we can assume that MSCI should be convinced that the applicant country or region should be able to continue to meet the size criterion in a sustainable manner.

Only the consolidation of the 3 Baltic markets, would allow to maximise the chances to have at least two listed companies with a Market Capitalisation superior to USD 741 million and therefore to meet the MSCI criterion for Frontier Market status. Though even with a consolidation of the region, with current levels of Market Capitalisation, the Frontier Market criteria are not met (Figure 8)[4].

[4] It is not clear at present whether a formal re-application would need to be made to MSCI jointly on behalf of the three Baltic countries, should they wish to be considered for classification on a regional basis. In the absence of new listings of large

Figure 8: Market Capitalisation of the Largest Companies listed in the Baltics



It should be noted that the recent Initial Public Offering (IPO) of Port Tallinn (Tallinna Sadam), on 13 June 2018 on NASDAQ Tallinn's Main List, should consolidate the position of the Baltic market as Frontier Market in terms of size as per MSCI criteria. Tallinna Sadam is one of the largest cargo- and passenger port complexes in the Baltic Sea region with the throughput of 10.6 million passengers and 19.2 million tons of cargo in 2017. Its Market Capitalisation (EUR 540 million i.e. USD 610 million) is still 18% below the MSCI threshold used for Frontier Market classification, but it is a positive and encouraging sign of a large company in the Baltic region incentivised to go public. The IPO attracted a broad range of institutional and retail investors.

In addition to the size criterion, MSCI also assesses the liquidity of listed securities when considering the inclusion of markets in its Frontier Market universe. The ratio used by MSCI is the Annual Traded Value Ratio[5] (ATVR) and the requirement is to have at least two companies with an ATVR superior to 2.5%. Though we do not have access to all the data needed for the calculation of ATVR for each security listed on the NASDAQ Baltic exchange, there is evidence to conclude that the level of liquidity in Baltic countries' equity markets would be sufficient for inclusion in the MSCI Frontier Market universe. Indeed, when we measure the global liquidity on all exchanges in the EMEA region against the Turnover Velocity Ratio indicator (Annual Value of Share Trading / Market Capitalisation), we can see that the level of liquidity in Riga, Tallinn and Vilnius is superior or equivalent to that observed in some other Frontier Markets such as Kazakhstan, Croatia, Bahrain or Mauritius (Figure 9). Nevertheless, to qualify for Emerging Markets status, the MSCI liquidity requirement is significantly higher: three

companies ahead of this, a risk therefore exists that a consolidated application may result in the Baltics region failing to achieve Frontier Market status.

[5] The ATVR of each security is calculated in a 3-step process:

1. Median traded values = median daily traded value X number of days in the month the security is traded Daily traded value = number of shares traded during the day X closing price
2. The monthly median traded value of a security is divided by its free float-adjusted security market capitalization at the end of the month for each month, giving the monthly median traded value ratio
3. 12-month ATVR is obtained by annualizing (X 12) the average of the monthly median traded value ratios of the previous 12 months. The 3-month ATVR is obtained by annualizing (X 12) the average of the monthly median traded value ratios of the previous 3 months

securities with an ATVR superior to 15%. Therefore, there is a sizeable liquidity gap between the Baltic countries and MSCI Emerging Markets.

Figure 9: Turnover Velocity on EMEA Exchanges in 2017

Exchange	Domestic Market Capitalisation (USD millions)	Number of Listed Companies	Turnover Velocity	MSCI Classification
Borsa Istanbul	227 512	375	172%	Emerging
Iran Fara Bourse Securities Exchange	17 851	103	121%	-
BME Spanish Exchanges	888 838	3136	79%	Developed
Deutsche Boerse AG	2 262 223	499	65%	Developed
SIX Swiss Exchange	1 686 497	263	56%	Developed
LSE Group	4 455 408	2498	52%	Developed
NASDAQ Nordic Exchanges	1 533 497	984	52%	Developed
Saudi Stock Exchange (Tadawul)	451 379	188	48%	Standalone
Euronext	4 392 995	1255	44%	Developed
Oslo Bors	287 192	225	41%	Developed
Namibian Stock Exchange	2 915	44	35%	-
Warsaw Stock Exchange	201 393	890	31%	Emerging
Budapest Stock Exchange	31 554	41	31%	Emerging
Johannesburg Stock Exchange	1 230 977	366	31%	Emerging
The Egyptian Exchange	46 546	255	31%	Emerging
Tel-Aviv Stock Exchange	231 049	457	29%	Developed
Dubai Financial Market	107 575	61	29%	Emerging
Athens Stock Exchange (ATHEX)	50 605	200	29%	Emerging
Wiener Borse	150 646	536	25%	Developed
Moscow Exchange	623 425	234	23%	Emerging
Irish Stock Exchange	146 554	52	19%	Developed
Qatar Stock Exchange	130 610	45	14%	Emerging
Palestine Exchange	3 891	48	12%	Standalone
Tehran Stock Exchange	106 329	326	12%	-
Bucharest Stock Exchange	23 621	87	11%	Frontier
Muscat Securities Market	21 299	112	11%	Frontier
Tunis Stock Exchange	8 923	81	11%	Frontier
Abu Dhabi Securities Exchange	124 529	69	10%	Emerging
Amman Stock Exchange	23 969	194	10%	Frontier
Nigerian Stock Exchange	37 218	167	6%	Frontier
Bourse de Casablanca	67 048	74	6%	Frontier
NASDAQ Nordics & Baltics - Tallinn	3 111	17	6%	Frontier
Beirut Stock Exchange	11 492	10	5%	Frontier
Stock Exchange of Mauritius	9 743	76	5%	Frontier
NASDAQ Nordics & Baltics - Riga	1 521	24	4%	-
BRVM	12 486	45	3%	Frontier
Bahrain Bourse	21 706	43	3%	Frontier
NASDAQ Nordics & Baltics - Vilnius	4 533	27	3%	Frontier
Cyprus Stock Exchange	2 822	74	2%	-
Malta Stock Exchange	5 171	23	2%	-
Zagreb Stock Exchange	22 765	155	2%	Frontier
Kazakhstan Stock Exchange	45 558	103	2%	Frontier
Ukrainian Exchange	5 198	96	0%	Standalone
Luxembourg Stock Exchange	68 639	168	0%	-

Source: World Federation of Exchanges, National Exchanges – Calculations IEM-Finance

1.3.2 Market accessibility

The other set of criteria used by MSCI for markets classification are market accessibility indicators. As Latvia was not covered by MSCI in its last Market Accessibility Review of June 2018, there is no public information available about the evaluation by MSCI of the five market accessibility criteria, which are:

- Openness to foreign ownership,
- Ease of capital inflows / outflows,
- Efficiency of the operational framework,
- Competitive landscape, and
- Stability of the institutional framework.

The evaluation of the accessibility measures is mainly based on investor experience. MSCI seeks feedback from multiple participants in all markets including active and passive asset managers, asset owners, brokers, custodians, stock exchanges and regulators.

The assessment of market accessibility in Estonia and Lithuania by MSCI is positive (Figure 10).

There are only three criteria on which MSCI reported that there were improvements needed or possible. Those three points are stock lending, short selling and stability of the institutional framework. For all the Frontier Markets and most Emerging Markets, MSCI mentioned that stock lending, short selling and stability of the institutional framework needed to be or could be improved. It is not a blocking point for Latvia, Estonia or Lithuania to achieve MSCI Frontier or Emerging Market Status. Moreover, securities lending activities are available among market participants in Latvia and there are no impediments to the development and functioning of securities lending. As in other Baltic countries, short selling is also permitted in Latvia.

It should be noted that the assessments of Estonia and Lithuania are exactly the same i.e. same three criteria reported with improvements needed or necessary and that, among the MSCI Frontier Markets, they are the only two markets with only three criteria reported with no issues. On all other Frontier Markets, MSCI mentioned at least four, on average ten and maximum thirteen, criteria that needed to be or could be improved.

Figure 10: MSCI Market Accessibility Assessment Results for Estonia and Lithuania

	Estonia	Lithuania
Openness to foreign ownership		
Investor qualification requirement	No issues	No issues
Foreign ownership limit (FOL) level	No issues	No issues
Foreign room level	No issues	No issues
Equal rights to foreign investors	No issues	No issues
Ease of capital inflows / outflows		
Capital flow restriction level	No issues	No issues
Foreign exchange market liberalization level	No issues	No issues
Efficiency of the operational framework		
Market entry		
Investor registration & account set up	No issues	No issues
Market organization		
Market regulations	No issues	No issues
Information flow	No issues	No issues
Market infrastructure		
Clearing and Settlement	No issues	No issues
Custody	No issues	No issues
Registry / Depository	No issues	No issues
Trading	No issues	No issues
Transferability	No issues	No issues
Stock lending	Improvements needed	Improvements needed
Short selling	Improvements needed	Improvements needed
Competitive landscape	No issues	No issues
Stability of institutional framework	Improvements possible	Improvements possible

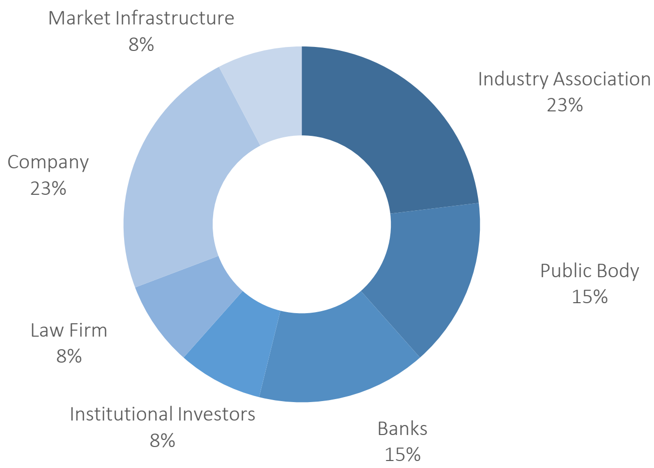
Source: MSCI Global Market Accessibility Review - June 2018

We can therefore be reasonably comfortable that MSCI would have a similar assessment of market accessibility in Latvia to that in other Baltic countries, namely that market accessibility is in fact superior as compared to that in any other Frontier Markets. This is reiterated by the FTSE Russell assessment where all Baltic States have the Frontier Market status confirmed. Therefore, as far as these criteria are concerned, Latvia and the other Baltic countries could easily be classified as Frontier or Emerging Markets by MSCI.

2. ANALYSIS OF THE EXISTING SITUATION (MARKET PLACE CONSULTATION)

In order to obtain a precise understanding of the Latvian capital market eco-system, during the week of the 23rd of April 2018, we conducted a number of meetings with representatives of local industry associations and market participants (Figure 11).

Figure 11: Breakdown of Meetings in Riga by Type of Market Participant



The meetings organized in Riga and its surroundings provided a fair sample of the overall Latvian capital market participants and included the following institutions:

- Association:
  - Financial Services and Capital Market Commission
  - Association of Latvian Commercial Banks
  - Latvian VC Association
- Public Body:
  - Ministry of Finance
  - Cross-Sectoral Coordination Centre
- Market Infrastructure
  - NASDAQ
- Banks:
  - LHV
  - SEB
  - Swedbank

- Institutional Investors
    - INVL
- Law Firm:
    - Eversheds
- Various companies among which:
    - Latvernergo
    - HansaMatrix

Through the course of this round of interviews with key market players, a number of issues have arisen that will need to be tackled in order to foster greater activity and participation in the Latvian public equity markets.

2.1 Main findings: Issuers

The issuing parties that we have met during our round of meetings in Riga operate in very distinct industries and are of very different size. For instance, HansaMatrix is a small company providing integrated manufacturing services that has raised funds through equity issuance. Latvernergo is the state-owned electric utility company and has rather relied on bond issuance. However, they have in common a strong focus on corporate governance and a successful history with fund raising on capital markets. Representatives from these companies (e.g., CEOs and/or CFOs) also share similar views on some of the issues that should be addressed to revamp the Latvian capital markets:

- **Market capitalization is below industry standard**. In more advanced markets, certain companies that are currently part of the NASDAQ Riga Main List would have sourced funding via stock issuance on an alternative/secondary market or via the private equity market, rather than through public IPO on the main list due to the limited level of their market capitalization. The limited depth of a number of issues are a clear impediment for the participation of traditional foreign institutional investors as it may not be sufficient to absorb their average transaction size without creating too much market impact;
- **Access to foreign investors is limited**. There is a clear difficulty for issuers to reach institutional investors. While NASDAQ may provide some support, it nevertheless appears that institutional investor engagement and road-shows are done on a case by case basis. It might be relevant to promote the Latvian market as a whole and organize road-shows in foreign financial centres (e.g., Stockholm) with a selected number of Latvian companies;
- **Improving corporate governance and investor relations activity**. While the firms that we have met are meeting global standards when it comes to corporate governance and investor relations, they have all mentioned that some of their peers are doing the bare minimum on that front and that there is clearly room for improvement. As the representative from Latvernego stated: *"efficient corporate governance was not only beneficial to investors but also to the company as whole"*. This type of "win/win" outcome

could certainly be promoted and be an incentive for firms that are lagging behind to improve their corporate governance standards. Nevertheless, efforts have been made by the Exchange (Nasdaq Baltic) to attract issuers and investors. To help issuers to improve the communication with existing and potential investors, mass media and other members of the stock exchange, Nasdaq is organizing dedicated Webinars with them. The videos of webinars are then displayed on Nasdaq Baltic YouTube channel. The Exchange is also helping listed companies to build the investor's relation section of their website. This is an important element to maintain a good corporate-investor relationship. The information and data provided by the Exchange on its website about listed companies is very comprehensive and easy to access. Strengthening corporate governance and listings standards is an important attraction factor for investors. In November 2018, Nasdaq Baltic exchanges and Nasdaq CSD launched the bi-annual Nasdaq Baltic Awards to celebrate outstanding achievements by Nasdaq Baltic-listed companies in the areas of transparency, sound corporate governance and investor relations ;

- **Reputational perception can be enhanced**. The Latvian government has taken significant steps in the recent past to create a more conducive environment for investors (e.g., decision to improve minority shareholders' rights protection, etc.), however, more needs to be done to communicate the improvements to the local and global investment community;
- **Good quality issuance will drive investor interest** ;
- **State owned companies' capital markets activity should be boosted**. The Cross-Sectoral Coordination Centre in its Information Report has provided a list of several public companies to analyse their economic interest in being partially privatized and/or issuing corporate bonds to raise funding for their development. While this is not a list of selected companies that could be quoted, the CSCC report provide nevertheless a good assessment of potential quotation for this companies. A good example of such initiative is the IPO of the Port of Tallinn in Estonia which was oversubscribed threefold and has driven a significant increase in market liquidity (turnover was over €1 million after just seven minutes of trading). All the representatives that we interviewed were clearly in favour of such projects in Latvia as it would attract additional international attention to the market and foster increased trading activity.

The issues raised by corporate issuers are not insurmountable, but they are not trivial either; they will require precise planning and coherent and decisive strategy to be tackled effectively.

2.2 Main findings: Institutional Investors

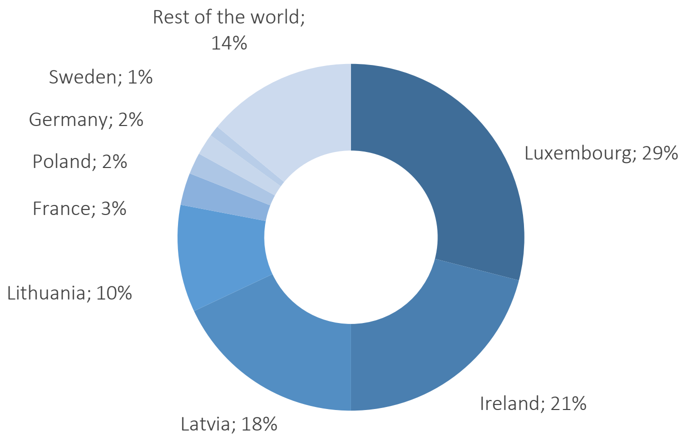
The Latvian financial market is predominantly a bank driven market, where local banks and foreign bank branches still account for a vast majority of financial assets (above 80% in 2016). Even if the situation is evolving with banks reducing their loan portfolio and credit exposure, the banking industry is unlikely to lose its dominant position in the short term. The investment plans from State funded pension schemes are ranked second when it comes to Latvian asset holding value with around 10% market share, followed by the insurance industry with around 3%.

A number of issues have been raised by local institutional investors and their association regarding the Latvian equity market, but the main one is liquidity. The market is not deep and liquid enough to receive a larger share of fund allocation:

- **Latvia is an exporter of funds**. There are not enough instruments to trade on the local market and liquidity on NASDAQ Riga is insufficient to absorb the investment capacity of local institutional investors. Hence, less than 40% of Pension Funds' assets are invested locally. INVL fund allocation as at 2018 was as follows:
    - 15% in Latvia
        - <3% in equity
        - 10% in bonds (govies and corporates)
        - 2% in AIFs
    - 85% Abroad;

In fact, Latvian pension funds' asset allocation outside of Latvia seems to be geared towards two main locations, Luxembourg and Ireland where the bulk of the European fund industry is domiciled. This implies that a significant share of Latvian pension funds' assets under management is invested in units of Global or European investment funds; only 18% of Latvian pension plans' investments remain in Latvia (Figure 12).

Figure 12: Geographical breakdown of Latvia pension plans investment
(2018 AuM = €460 million)



- **An unbalanced market where public market offerings are limited**. Local investors could absorb more issuances, if available and of good quality;
- **Latvia is the smallest fund market in the Baltics**. Estonia and Lithuania have a bigger fund industry, even if it is small compared to Western European standards. According to the IMF, non-bank financial institutions only finance 4% of GDP in Latvia, compared to 10% in Lithuania and 17% in Estonia;
- **ROE level in Latvia is insufficient**. The ROE of Latvian equities is often not sufficient from investor perspective, considering the liquidity risk and country risk associated with it. This is an issue that can hardly be addressed by an evolution of the capital market structure, as it reflects the economic development and potential growth of the Latvian economy. The challenge for Latvian listed companies is that they are competing for asset allocation within foreign investors' portfolio with companies operating in countries (e.g., Vietnam, Tunisia, etc.) that have less stringent regulatory framework (e.g., corporate governance, environmental , etc.), and often lower labour cost. In addition, numerous of these competing markets will have a stronger demographic growth compared to Latvia, which might drive eventually a significant increase of the addressable market of these local companies.

2.3 Main findings: Others

Through the course of the interviews with stakeholders, a number of issues have been raised that cannot be attributed to a particular type of market participant, but are shared by a heterogeneous set of interviewees:

- **Limited locally-owned banking industry.** The Latvian banking industry is dominated by subsidiaries of foreign entities. . As financial institutions and especially banks are typical candidates for large-value IPOs, this situation limits the opportunity to rely on issuances from the banking sector to boost the Nasdaq Riga overall market capitalization;
- **Relative preference for debt over equity capital markets of Latvian corporates**. With the support of financial institutions, local issuers are quite comfortable sourcing funding through the debt market; some levers (e.g., a fiscal incentive that would foster investment in equity market by limiting the taxes on profit made through this type of investment) could be deployed to encourage a switch from bond issuance towards the equity market;
- **Inconsistent cost of regulation in Baltic markets**. Numerous participants, and notably investors, have mentioned the issue of inconsistent regulatory costs across the Baltic markets, where it seems that the Latvian Financial Services Authority is more expensive compared to its Baltic counterparts. The situation might partially explain why the fund industry is more developed in Estonia than in Latvia.

2.4 Recommendation from local market participants

During the interviews, a number of recommendations were provided by local market participants which can contribute to reviving the Latvian Capital Market:

- **Creation of an integrated Baltic market with a single regulator**. While the market infrastructure is already fully integrated with a single trading platform and a single CSD, thanks to NASDAQ initiatives, the emergence of a single regulator for the three Baltic markets would be a decisive step towards integration;
- **State-owned companies should be listed**. As we have mentioned earlier, NASDAQ Riga market depth is still quite limited to attract significant investment flows. Partially opening up ownership of state assets – in particular through the partial privatisation of some SOEs – to private investors (retail and institutional) would broaden the spectrum of investment possibility and boost market depth;
- **Education of both retail investors and issuers**: Educating retail investors on the basic principles of equity trading, and issuers on the benefits of sourcing funding through equity issuance, could revamp local market participants' activity and foster greater participation in local equity trading;
- **Targeted fiscal measures:** currently there is a 20% taxation of dividend income in Latvia, irrespective of investment horizon; targeted measures, similar to the "Plan d'Epargne en Actions" in France, which is a tax-free mechanism for individuals in compensation for long-term investment in equity, could incentivise greater participation in local equity markets;
- **Reorganizing listing on Latvia's "Main List".** There are a number of listed companies that attract almost no interest from investors and on whose shares trading activity is limited. It should be considered if it still makes sense to have these companies included on the "Main List";
- **Improve corporate governance**. As mentioned above, there are many benefits for corporate issuers of implementing state-of-the-art corporate governance practices. Appropriate measures should be considered to provide the right incentives and educational framework to tackle this issue for the benefits of all market participants;
- **An average free-float of companies of around 30% is considered appropriate by market participants to boost market activity.** There should be sufficient free-float share in total company equity to attract investor interest and ensure that minority shareholders can weigh-in during proxy voting season, such that they can adequately participate in company decision-making processes;
- **Creation of a public fund** to support and foster activity on Latvian listed equities. A public fund could be a tool for the Latvian government to support directly the funding of the

economy via the equity market[6]. The fund would not only invest in local securities and hold inventories of local issues but it could also foster greater liquidity on Nasdaq Riga by acting as an active member of the exchange. Finally, this could become a Latvian government arm to direct funding into companies that are considered strategically important;

- **Encouraging additional retail participation in equity markets**. If the state decides to partially open up ownership of public companies to private investors, it should consider providing a discount to attract retail investors and stimulate trading activity and liquidity.

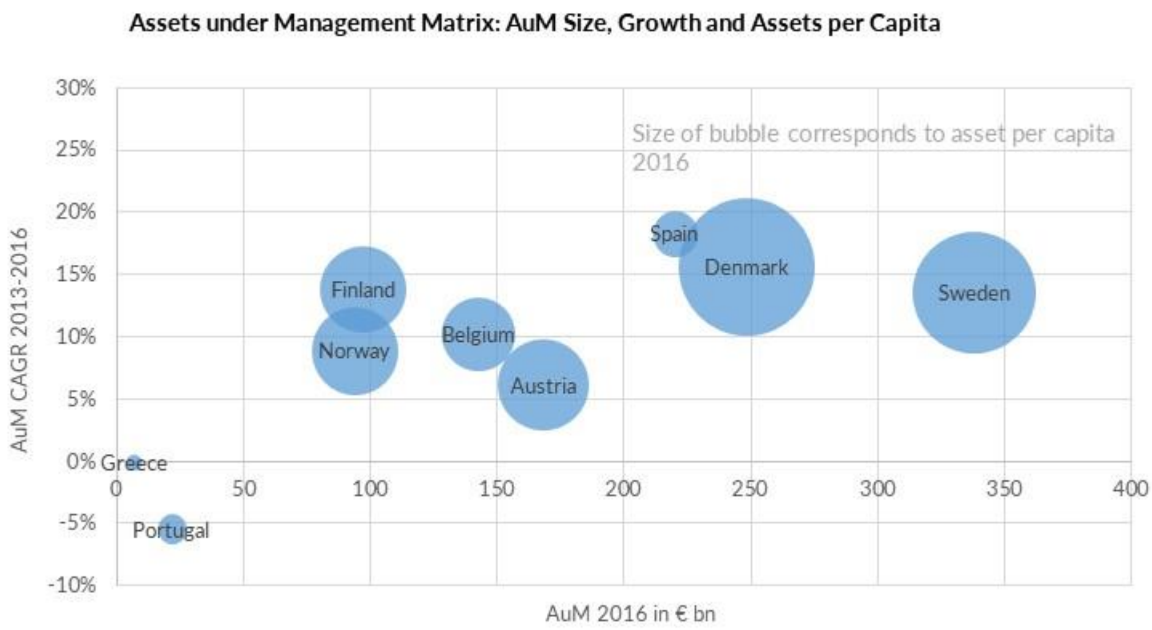
[6] Such operation, if pursued, should be fiscally neutral (e.g. using a portion of existing excess budgetary reserves that may be currently placed on central bank deposit for targeted investments on local equity markets) and result in only minority shareholdings in companies it invests in.

3. INTERNATIONAL ASSESSMENT

3.1 Accessibility of Riga market by Nordic investors

The Nordic asset management industry represents tremendous opportunities with a combined €777.7bn of asset under management. Apart from Tier I European markets (e.g., France, Germany, Italy, Luxembourg, UK etc.), the Nordic countries are the next largest source of funding in Europe. In addition, they have enjoyed a very significant growth (above the 10% mark) in total asset under management in the past few years (Figure 13).

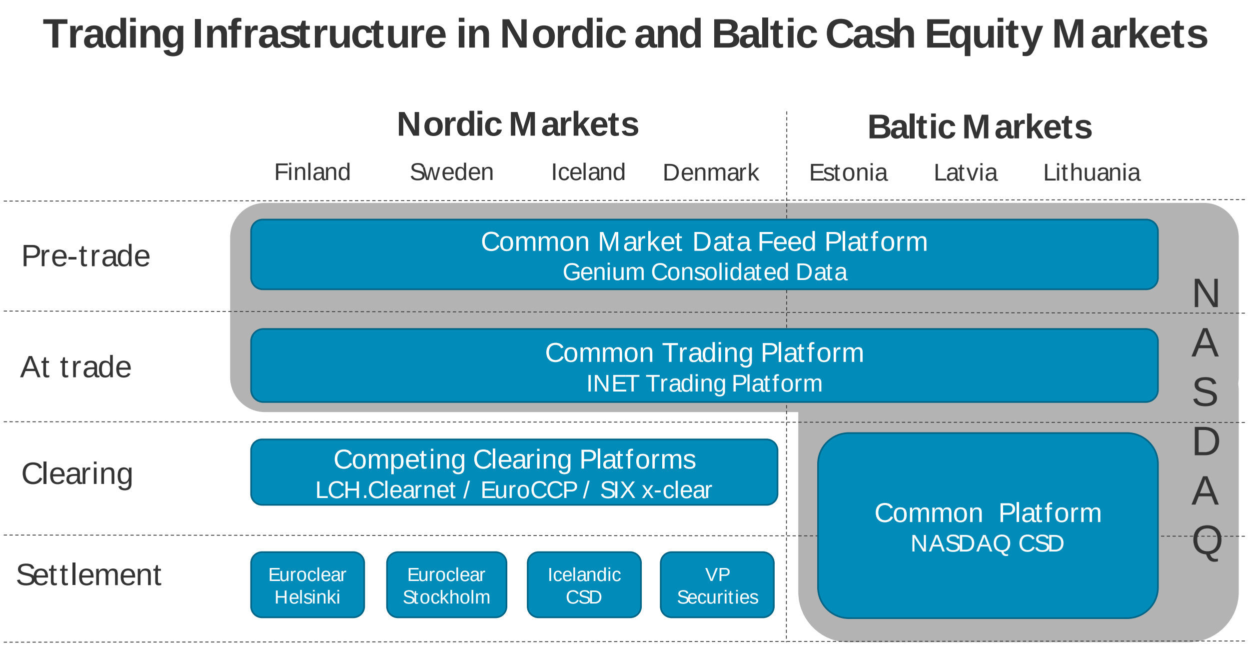
Figure 13: Assets under Management Matrix in select European countries



Acknowledging the geographical proximity and common market infrastructure operators (NASDAQ) between Latvia and the Nordic markets, Nordic institutional investors should be an obvious source of funding for the Riga equity market. Therefore, we estimated that it was important to evaluate the complexity and cost associated with trading Latvian equities for Nordic investors. It appears that only the post-trade side of the value chain could generate additional cost to these players, while the pre-trade and at trade processes would run smoothly since they are already integrated in NASDAQ OMX infrastructure and therefore available to Nordic investors that already have the relevant connectivity and framework in place to trade on these markets (Figure 14). In details:

- **Data feed**. A single source of data feed for both Nordic and Baltic markets. However, if an investor wishes to access only data feed for the Latvian market, they could purchase it via NASDAQ Riga;
- **Trading**. Since Q4 2007, Swedish investors could access and trade stocks listed on the Helsinki, Riga, and Tallinn stock exchanges via the SAXESS cash trading system. Currently, the situation is even better as NASDAQ markets share one single platform (INET) and one common data centre (the exchange's data centre in Väsby, north of Stockholm, Sweden). Therefore, even co-location services for HFT would be similar for both Nordic and Baltic markets. Hence, Nordic institutional investors, if interested, could trade Baltic equities in a similar fashion and at similar transaction costs as Nordic ones;
- **Post-trade**. For a Norwegian or Swedish investor trading in the Baltic region could generate higher post-trade cost, as it would require the use of a sub-custodian since the Nordic CSDs are not part of T2S and the clearing infrastructures are quite different. However, while in theory it could be an impediment to increased cross-border trading volume, in practice this is not the case, as traditional investors tend to be less sensitive to post-trade costs.

Figure 14: Trading Infrastructure and Baltic Cash Equity Markets



The opportunity represented by the size of the Nordic asset management industry combined with the shared trading IT infrastructure of NASDAQ Nordic and Baltic markets should turn Nordic asset managers into an obvious source of funding for the Latvian equity market. Hence, they will be a clear focus of our analysis in the next phase of our project.

3.2 Dialogue with MSCI

Following the initial analysis of gaps between the current Latvian situation and the criteria used by MSCI to assess markets in the 1st phase of the project, the consultants' team and EBRD inititated a dialogue with MSCI. The aim was to better assess the likelihood for Latvia, or the Baltic region as a whole, to integrate for inclusion into the MSCI classification and better understand the necessary steps for this integration.

With the aim of receiving a formal feedback from MSCI, it was decided in November 2018 to send an official letter to the MSCI from the Ministries of Finance of the three Baltic countries, EBRD, the European Commission and Nasdaq Baltic. The letter expressed the joint willingness of all these parties to achieve a single MSCI classification for the Baltic countries similar to the well-established MSCI WAEMU Index.

This important step is expected to have a significant impact on the percetion of investment opportuunities in the region by MSCI and more broadly by international investors.

3.3 Interest from international institutional investors

The issue for international investors is well identified: stock picking requires research and analytical coverage solutions, local trading and custody facilities. At the end, it is a matter of cost, compared to the depth and return potential of the market concerned. The less deep the market is, the higher the corresponding cost. That is why accessibility is a necessary, but not sufficient condition.

We organized a series of interviews in order to:

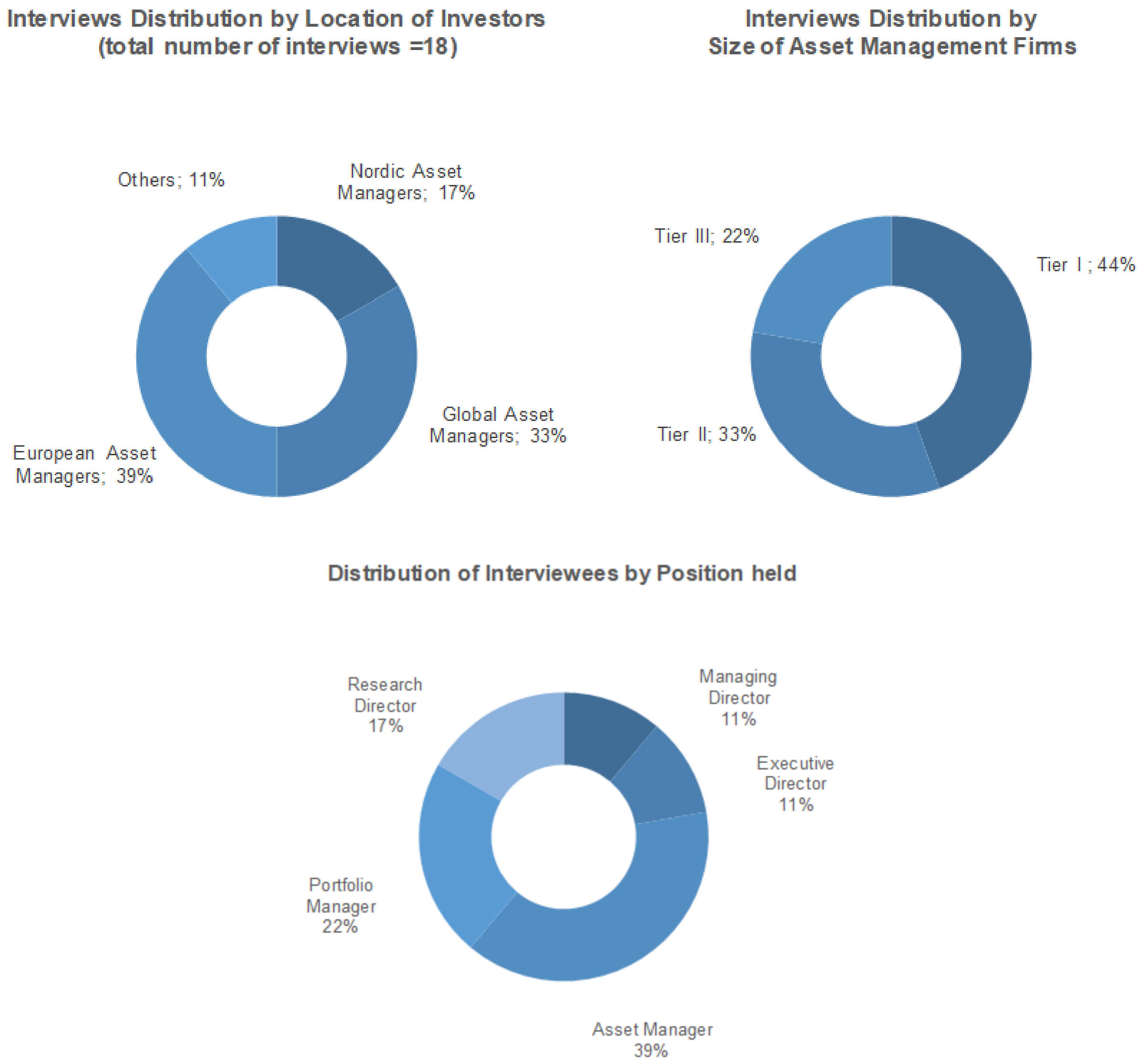
- Evaluate perceptions of the Latvian market by international institutional investors,
- Analyze the impact of a potential MSCI Frontier status classification on institutional investors' portfolio allocation into Latvia,
- Gather recommendations on a strategy to improve institutional investor flow into Latvian capital markets.

In terms of methodology, we focused on contacts with existing exposure to Eastern European markets, Frontier markets, Emerging markets and Nordic markets. Around a hundred contacts in the industry were approached, with approximately twenty interviews conducted.[7]

[7] The objective of this round of interviews was to determine the perception of the Latvian capital market by institutional foreign investors and to gather insights on potential area of improvement. To ensure that respondents had sufficient understanding of the issues at stake, they were sourced from a list of contacts at asset management companies that had activities/exposure with either Eastern European markets, Frontier markets, emerging markets and Nordic markets. Around a hundred contacts in the industry were solicited and twenty interviews conducted. In order to facilitate an open and frank discussion, anonymity of interviewees was guaranteed. In addition, to provide a representative sample of the institutional investor's base, participants were selected among Tier 1, Tier 2 and Tier 3 asset managers.

Participants in the interview process provided a fair representation of the international investors' landscape with higher investment potential into Latvia, in particular as they hold senior position at asset management firms (Figure 15):

Figure 15: Characteristics of Interview Participants (International Investors)



The first issue raised by asset managers interviewed is the **lack of a sufficiently active local investor base**:

- "In order for us to participate in any foreign markets, we need a strong local investor base" (Head of Eastern European Markets Investment Strategy at global asset manager),

- "The development of a local investor base is key; without locals you won't have foreign investors. It might be worth considering a similar strategy as Poland to foster greater adoption of pension fund scheme[8]" (Asset Manager, tier II Nordic asset management firm),
- "Latvia has all the resources at home, they should make information work locally" (Asset Managers, European asset management firm),
- "The yields are very low, there are probably too much savings on bank accounts that should be invested. Creating an incentive to drive these savings towards the equity market should be the first step in developing a resilient local investor base" (Portfolio manager, Frontier Markets, European asset management firm),
- "Liquidity is key and you need local investors to ensure that it is resilient, as foreign ones are too sensitive to market sentiment" (Managing director, European asset management firm).

The second issue raised by asset managers interviewed is the **limited investment opportunities**:

- "The Latvian equity market has two main issues: its size and its depth" (Asset managers, Nordic fund focused on Baltic markets),
- "There are a limited number of issues that would drive our interest. For example, the majority of local banks are owned by foreign entity. Hence, our approach to investment in Latvia would be opportunistic rather than strategic" (Asset manager, European asset management firm),
- "The equity market reflects an economy, Latvia is just too small for us." (Executive director, portfolio manager for European equity),
- "Our fund was focused on Baltic markets, eventually we had to pivot our strategy from equity to property as we could not find sufficient investable companies" (Asset manager, Nordic firm focused on Baltic markets),
- "To address the issue of the market size, the Latvian government could privatize part of the infrastructure" (Portfolio manager for Eastern European countries at European asset management firm).

Finally, some participants remained **sceptical regarding the benefit of reaching Frontier status**:

- "Even if Latvia reaches the Frontier Market status of MSCI, the share Latvia will have in global indices will remain too small to drive any surge in liquidity" (Head of investment research, global asset management firm),
- "Liquidity and investment opportunities are more important than a Frontier status, meeting the criteria would not change our approach to this market. However, it might

[8] In August 2018, the Polish government adopted the Employees Capital Pension Scheme, which will allow Poles to increase voluntarily their contribution to their pensions, while the employer will pay up to 4 percent of the worker's salary into the pension scheme.

generate some curiosity from less informed investors" (Portfolio manager, Nordic asset management firm),
- "There is a mismatch between the ROE of Latvian equities and a Frontier status" (Head of emerging Europe, global asset management firm).

In conclusion, there were three common issues brought forward by the majority of interviewees regarding the Latvian capital market that need to be addressed:

- The lack of liquidity,
- The limited number and size of local market issuance, and
- The insufficient local investor base.

On the other hand, a big majority considered that reaching Frontier market status should be a benefit for the Latvian capital market, but will not be sufficient to increase international investor flow towards the market.

4. SET OF RECOMMENDATIONS

Beyond the MSCI classification, what is highlighted is that the size of the stock market does not match the size of the economy of a Eurozone country. The same can be said for Estonia and Lithuania. Moreover, while there are structural explanations for this situation, the limited size of the economy further reinforces the problem, as investors in the stock market need diversity to invest.

In order to settle this market size issue, two possible solutions must be simultaneously considered:

- To increase the market size by listing new companies of significant size on the Riga Stock Exchange, and
- To approach the development of the market from a regional perspective (pan-Baltic), on the basis of a principle of a stock market union.

4.1 Increasing market size

4.1.1 Increasing market size by floating state-owned companies

The most consistent method of analysing the size of the Latvian stock market is to assess it in relation to domestic GDP and then compare this ratio with the same ratios of other countries, in order to determine a theoretical market capitalization. Based on the MSCI Universe, the results are as follows:

Figure 16: GDP of countries included in MSCI universe (2017 - bn USD)

Frontier Markets		Emerging Markets		Developed Market	
Mauritius	13	Hungary	139	New Zealand	206
Estonia	26	Qatar	168	Portugal	218
Latvia	30	Greece	200	Finland	252
Bahrain	35	Peru	211	Singapore	324
Jordan	40	Czech Republic	216	Denmark	325
Tunisia	40	Egypt, Arab Rep.	235	Ireland	334
Serbia	41	Chile	277	Hong Kong SAR, China	341
Lithuania	47	Pakistan	305	Israel	351
Slovenia	49	Colombia	309	Norway	399
Lebanon	52	Philippines	314	Austria	417
Croatia	55	Malaysia	315	Belgium	493
Oman	73	South Africa	349	Sweden	538
Kenya	75	United Arab Emirates	383	Switzerland	679
Sri Lanka	87	Thailand	455	Netherlands	826
Baltic countries	103	Poland	525	Spain	1 311
Morocco	109	Turkey	851	Australia	1 323
Kuwait	120	Indonesia	1 016	Canada	1 653
Kazakhstan	159	Mexico	1 150	Italy	1 935
Romania	212	Korea, Rep.	1 531	France	2 583
Vietnam	224	Russian Federation	1 578	United Kingdom	2 622
Bangladesh	250	Brazil	2 056	Germany	3 677
Nigeria	376	India	2 597	Japan	4 872
Argentina	638	China	12 238	United States	19 391
Average	**130**	**Average**	**1 192**	**Average**	**1 960**

Source: World Bank

It is evident that the three Baltic countries have relatively similar economy sizes, which are small in relation to the considered universe. According to the market capitalization to GDP indicator, the results are explicit (Figure 17):

- With a ratio of 5%, Latvia has the joint lowest ratio in the MSCI universe with Vietnam,
- This ratio is 2 times lower than that of the other two Baltic countries, and
- 6 times smaller than the average ratio of the MSCI Frontier Markets universe.

Figure 17: Ratio Market capitalization/GDP in countries included in MSCI universe (2017 – %)

Frontier Markets		Emerging Markets		Developed Market	
Latvia	5	Egypt, Arab Rep.	20	Portugal	35
Vietnam	5	Hungary	23	Austria	36
Baltic countries	9	Greece	25	Ireland	44
Lithuania	10	Turkey	27	New Zealand	46
Nigeria	10	Mexico	36	Germany	62
Estonia	12	Poland	38	Israel	66
Slovenia	13	Colombia	39	Spain	68
Argentina	17	Russian Federation	40	Norway	72
Sri Lanka	22	Brazil	46	Belgium	89
Tunisia	22	Peru	47	France	106
Lebanon	22	Indonesia	51	Australia	114
Kazakhstan	29	United Arab Emirates	63	Japan	128
Oman	29	China	71	Netherlands	133
Bangladesh	35	Qatar	78	Canada	143
Croatia	42	India	90	United States	166
Jordan	60	Philippines	93	Singapore	243
Morocco	61	Chile	106	Switzerland	248
Bahrain	61	Korea, Rep.	116	Hong Kong SAR, China	1 274
Mauritius	73	Thailand	121	**Average**	**171**
Average	**31**	Malaysia	145		
		South Africa	352		
		Average	**77**		

Source: World Bank, World Federation of Exchanges

In other words and in theory, the size of the Latvian stock market should be 4 to 6 times bigger than it is today, with the Market Capitalisation to GDP ratio reaching 20% to 30% over the medium to long term. Such a ratio would correspond to a market capitalisation of 6 to 9 Bn USD, which would allow Latvia to be not only eligible for the Frontier Markets universe, but also for Emerging Market classification.

Such significant increase in size cannot be envisaged in the long term as part of a normal process of IPOs, especially since the small size of the market is in itself a brake on its development. This is because:

- Large private companies will tend to consider a listing abroad,
- And the change of scale in market capitalization for SMEs entering the stock market is a long and uncertain process.

Therefore, the only possibility to see the market significantly change in size in a relatively short period of time reflects the partial privatisation of state-owned companies, as Estonia did with Tallinna Sadam[9]

[9] « The sole owner of the company before the offering was the Republic of Estonia. After the offering, the Republic of Estonia will remain the major shareholder in the company by owning 67% of the shares.” https://nasdaqbaltic.com/en/news/nasdaq-welcomes-port-of-tallinn-to-nasdaq-baltic-main-list

and Lithuania with energy sector companies Litgrid AB and Energijos Skirstymo Operatorius AB[10]. To make sense, such a process must meet a broader need (corporate financing, state budget, etc.), target companies with appropriate profiles to be floated and attract investors, and be conducted on a certain scale. Indeed, it must form part of a program, including several state-owned companies, as the gap to fill is considerable.

The implementation of such a program should allow Latvia to be quickly eligible for MSCI Frontier Markets status. This would allow attracting a significant number of new investors whose investment rules reflect MSCI market classification. They allocate the vast majority of their AUM to the most developed and liquid markets, but obtaining a Frontier Market status would as at least include Latvian equities in the permissible investment universe for these market participants. This classification should also allow the development of passive investment products (e.g. market/index-tracking ETFs, etc.) and should therefore improve the liquidity of the market.

It is difficult to quantify the precise impact of obtaining Frontier Market status, but we can observe what happened in the past in countries that first entered the MSCI universe or evolved from one classification to another. Figure 18 presents past MSCI market reclassifications[11]. Reclassifications from Standalone to Frontier Markets are highlighted in orange and reclassifications from Frontier Markets to Emerging Markets are highlighted in blue. In the Latvian case, we often assumed that the possible inclusion in the MSCI universe, would first go through an access to Frontier Markets status. Nevertheless, as explained in sections 1.3 and 4.1 above, the state of development of the Latvian economy is closer to that of other Emerging Markets than countries in the Frontier Market category. Moreover, there are precedents of other countries obtaining Emerging Market status directly, without first being classified as Frontier. As an example, during the last Annual Market Classification Review in June 2018[12], it was announced that the MSCI Saudi Arabia Index would be included directly in the MSCI Emerging Markets Index without having been included in the MSCI Frontier Markets Index First. Once reviewed by MSCI, especially if considered together with other Baltic countries as a whole, Latvia could in theory obtain Emerging Market status directly, as was the case for Saudia Arabia.

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[10] Energijos Skirstymo Operatorius is the electricity and gas distribution operator, whose total market capitalisation amounts to 672 million USD. It is a subsidiary of Lietuvos Energija (which still owns 94.98% of the capital), the state-controlled Lithuanian energy company group. On the other hand, Lietuvos energija issued green bonds for 300 million euros. The bonds are dual-listed on the Nasdaq Vilnius and Luxembourg exchanges. It's a good step in trying to attract investors state-controlled companies and promoting sustainable investment.

[11] https://www.msci.com/market-classification

[12] https://www.msci.com/documents/10199/238444/RESULTS_OF_MSCI_2018_MARKET_CLASSIFICATION_REVIEW_%28FINAL%29.pdf/95fa3628-ff2e-e9cd-53b9-8912329ec40c

Figure 18: Past MSCI reclassifications[13]

COUNTRY INDEXES	MARKET RECLASSIFICATION	DATE*
MSCI China Index	China-A Shares included in the Emerging Markets	May 2018
MSCI Pakistan Index	From Frontier Markets to Emerging Markets	May 2017
MSCI WAEMU Index	From Standalone to Frontier Markets	Nov. 2016
MSCI Bulgaria Index	From Frontier Markets to Standalone	Aug. 2016
MSCI Ukraine Index	From Frontier Markets to Standalone	Aug. 2015
MSCI Qatar Index	From Frontier to Emerging Markets	May 2014
MSCI UAE Index	From Frontier to Emerging Markets	May 2014
MSCI Greece Index	From Developed to Emerging Markets	Nov. 2013
MSCI Morocco Index	From Emerging to Frontier Markets	Nov. 2013
MSCI Trinidad & Tobago Index**	From Frontier Markets to Standalone	May 2011
MSCI Israel Index	From Emerging to Developed Markets	May 2010
MSCI Bangladesh Index	From Standalone to Frontier Markets	May 2010
MSCI Argentina Index	From Emerging to Frontier Markets	May 2009
MSCI Pakistan Index***	From Standalone to Frontier Markets	May 2009
MSCI Jordan Index	From Emerging to Frontier Markets	Nov. 2008
MSCI Lithuania Index	From Standalone to Frontier Markets	Nov. 2008
MSCI Serbia Index	From Standalone to Frontier Markets	Nov. 2008
MSCI Sri Lanka****	From Standalone to Frontier Markets	Nov. 2007
MSCI Venezuela Index*****	From Emerging to Standalone	May 2006
MSCI Greece Index	From Emerging to Developed Markets	May 2001
MSCI Portugal Index	From Emerging to Developed Markets	Nov. 1997

In Figure 19 below we look at the net annual equity inflows over the past years for countries that have been reclassified by MSCI from Standalone to Frontier Market status i.e. Sri Lanka, Serbia, Lithuania, Pakistan and Bangladesh.

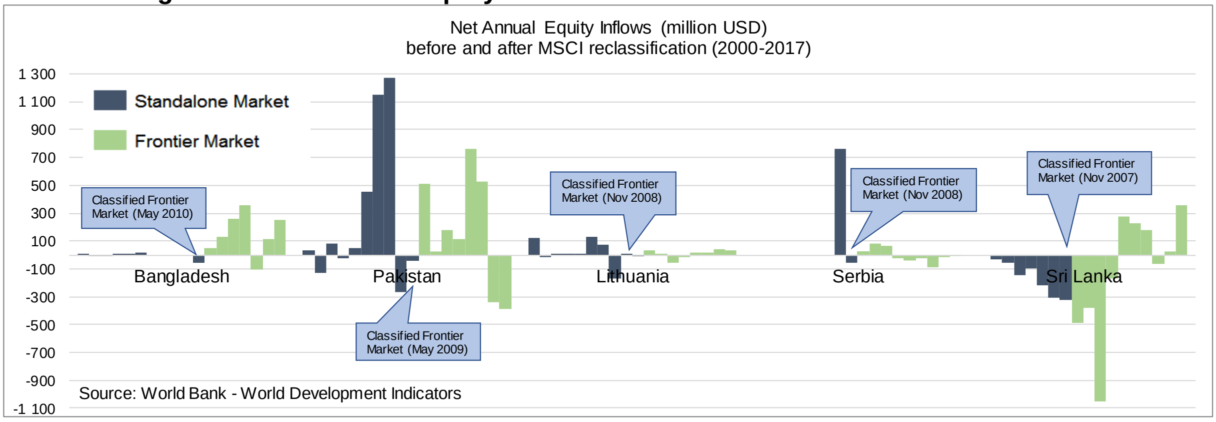
It is too early to assess the impact in the WAEMU region, with data that is currently available. As per the World Bank definition, portfolio equity includes net inflows from equity securities other than those recorded as direct investment and including shares, stocks, depository receipts (American or global), and direct purchases of shares in local stock markets by foreign investors.

Pakistan and Bangladesh were reclassified from Standalone to Frontier Markets respectively in 2009 and 2010. The graph above indicates that both countries experienced positive equity inflows in the years that followed immediately this reclassification, but this trend was only with limited amplitude

[13] *As of the close of the last business day of the month.
**Trinidad and Tobago was added to the MSCI Frontier Markets Index in May 2009
***Pakistan was removed from the MSCI Emerging Market Index in December 2008 and maintained as a standalone country index
****Sri Lanka was removed from the MSCI Emerging Market Index in June 2001 and maintained as a standalone country index
*****Index was discontinued on January 2, 2008

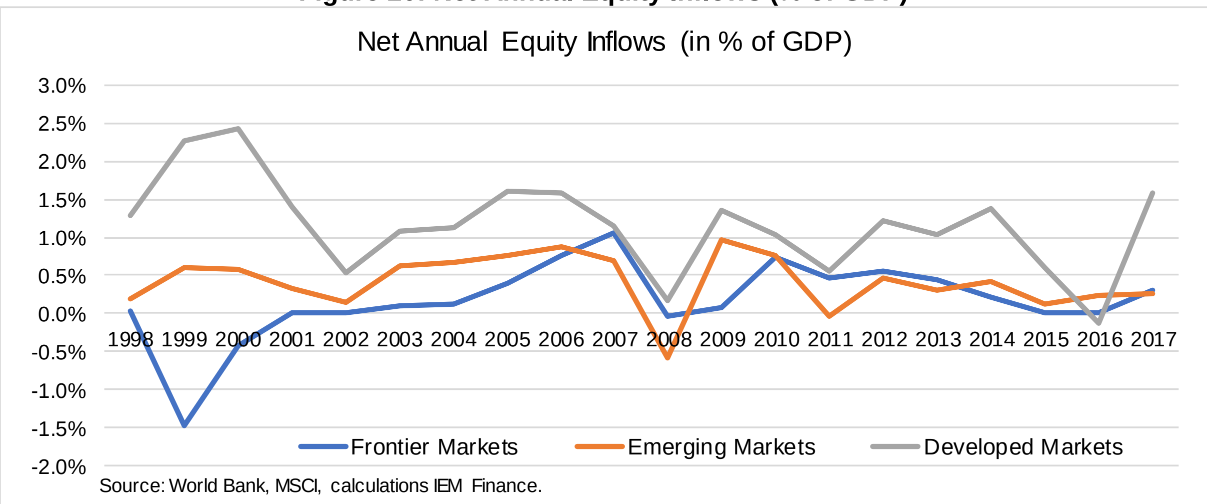
and temporary. Looking at Lithuania and Serbia, which were both reclassified in 2008, it is difficult to observe significant inflows following their reclassification. Lastly, negative inflows were observed in Sri Lanka in 2008, 2009 and 2010 after the reclassification of November 2007, but this might be at least partly explained by the effects of the financial crisis. All in all, it is difficult to quantify the effect reclassification from Standalone to Frontier Markets had on Net Equity inflows. The trends differed from one country to another and were also influenced by the global economic context. Unfortunately, we do not have sufficient data to assess the impact of reclassification from Frontier Markets to Emerging Markets on equity inflows in the countries concerned (Pakistan, Qatar and UAE).

Figure 19: Net Annual Equity Inflows before and after MSCI reclassification



If we now consider the evolution of net annual equity inflows over the past 20 years (Figure 20), on an aggregated level, for Frontier Markets as compared to Emerging Markets and Developed Markets, we can see that the gap between Frontier Markets and Emerging Markets in terms of equity inflows is not significant.

Figure 20: Net Annual Equity Inflows (% of GDP)



A recent study published by the World Federation of Exchanges[14] shows that a country's inclusion in the MSCI Emerging Markets Index has a positive correlation with equity inflows. But this impact is less significant, from a statistical point of view, than equity returns (both at the level of individual market returns as well as at the emerging market level overall) or corporate governance standards. The same study also presents some interesting feedbacks from countries that were reclassified by MSCI.

For example, in Colombia there were several developments that have helped to attract foreign investors:

- The regulator relaxed the requirement that foreign asset managers investing in Colombia had to set up a deposit with the central bank,
- The ratings agency Fitch changed the rating by one notch from BB+ (non-IG) to BBB- (IG), and as a consequence "the investment-grade rating's outlook was revised down to stable from positive following the upgrade",
- Tax reductions were offered to foreign investors.

Colombia was included in the MSCI Emerging Markets Index in 2012.

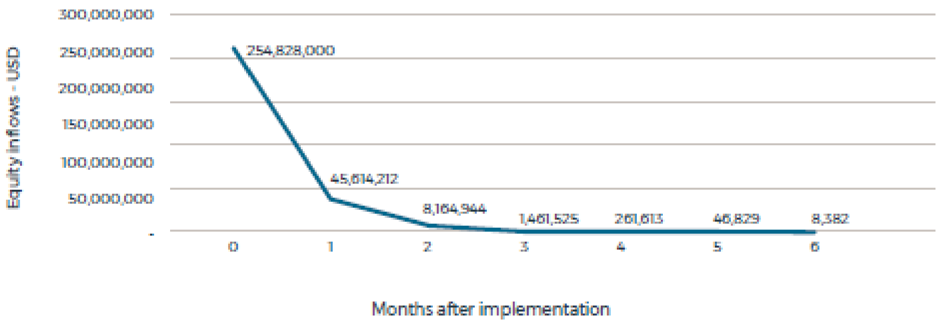
The Greek case, highlighted in the same study, where the country was downgraded to the Emerging Market status in 2013 is also instructive. The study shows that the reclassification exposed Greece to a different class of investors, with a higher risk appetite and a shorter investment horizon. The Exchange believes it may have benefitted from the downgrade. While the total pool of funds invested in emerging markets is lower than that invested in developed markets, Greece accounts for a larger proportion of the EM Index than it did in respective Developed Market indices. As a European Union member, Greece is also considered a relatively safer and more stable market than other emerging economies. In addition, as Greece is part of the Eurozone, investors face much lower exchange rate risk than they do in other emerging markets. Thus, despite the significant drop-off in foreign participation, the Exchange (ATHEX) has managed to increase the level of foreign market participation by more than 10% above the pre-crisis period.

For the moment, Greece is the only Eurozone country to be included in the MSCI Emerging Market Index and we can see that it benefited from this position. Though the size of the whole Baltic region in terms of GDP is about half the size of Greece, Baltic countries would certainly benefit similarly from being the second set of countries from the Eurozone in the MSCI Emerging Markets universe, when considered against and competing with less safe and stable countries.

[14] World Federation of Exchanges - What attracts international investors to emerging markets? – December 2018 https://www.world-exchanges.org/storage/app/media/research/report_covers/EM/WFE%20attracting%20international%20investors%20to%20EM%20Report%20FINAL%20VERSION%2003.12.18.pdf

Lastly, the WFE study also examines how long after implementation, inclusion in MSCI indices produces tangible effect. It shows that the impact on equity inflows decreases quite rapidly in the period immediately following reclassification.

Figure 5: Influence of being included in the MSCI EM Index



Note: elaboration based on the estimation of a DPD model (specification of Table 3, column (4)).

4.1.2 Implementing additional actions to support the market development

Two complementary actions to support the market development should be considered:

- To list real estate investment trusts (REITs) on Nasdaq Baltic,
- To create a public fund designed according to the model of Fondul Proprietatea (FP) from Romania.

To list real estate assets is an interesting option to develop the stock market. First, equity REITs (as opposed to mortgage REITs) offer investors diversifiedand cost-effective direct exposure to property assets, while reducing idiosyncratic risk. They provide access to large-scale income-generating assets, in particular commercial real estate, for example, office and apartment buildings, warehouses, hospitals, shopping centers and hotels. For developers, they offer a different financing mechanism, whereby capital can be raised for several large projects simultaneously. Mortgage REITs can also be used to provide access to performing residential and commercial real estate portfolios, and have also been used to help clean up banks' balance sheets from non-performing loans (e.g. for example, NBG Pangaea and Grivalia in Greece). Real estate investment companies could become an option for some Latvian banks to clean-up their balance sheets and restore their lending capacity, while also providing interested investors access to performing property assets in an easily-investible format. For local authorities, they can be used as a way to fund the refurbishment of their property portfolio or to divest part of their assets. Evidence from other markets (e.g. Bulgaria, Greece, etc.) indicates that REITs can generate considerable secondary-market activity, with average turnover in these entities often exceeding total regulated market turnover.

In addition, the creation of a listed fund to support the equity market could be another solution to support liquidity, which is a key issue to attract both investors and issuers. Such a fund was suggested by Latvian market participants during interviews and could be developed based on the experience from the Romanian fund Fondul Proprietatea (FP)[15]. Actually Fondul Proprietatea is invested mainly in Romanian equities and equity-linked securities and is itself listed on the stock exchange (Bucharest and London). Besides, the fund has a great influence in the governance of the companies in which it is invested. The transposition of such an investment mechanism would make sense in Latvia:

- An institutional investment player would "secure" the IPOs,
- It could play the role of a liquidity provider on the market to some extent,
- As an institutional holder, the fund should be involved in the governance of the companies in which it would invest and support the upgrade of corporate governance practises,
- It would be listed and by itself upgrade the size of the Exchange list,
- It could invest as well as be a seeder in private equity or in other equity funds.

The funding of such a fund still has to be defined. Most probably, a public/private scheme could be considered:

- A significant public seed funding seems to be necessary,
- In order to attract private institutional investors,
- Followed by a stock market floatation after the first phase of investment, which would allow a new phase of investment or initialise a redemption process for initial investors.

4.2 Approaching the development of the market from a regional perspective

Already united under the banner of Nasdaq Baltic and integrated into the European Union, the three Baltic countries face the same problem regarding the development of their stock markets. This is why a joint approach of the three finance ministers, with the support of the EBRD, was undertaken vis-à-vis MSCI in order to benefit from a regional (and no longer national) consideration, as was done for the MSCI WAEMU Index.

Indeed, even if each of the markets reached its optimal theoretical market capitalization, i.e. one which is consistent with the size of its economy, the size of each market would remain below the requirements of the Baltic institutional and other international investors. Moreover, in several respects, this regional dimension already exists:

- Baltic investors often have a regional investment approach, and

[15] "Fondul Proprietatea was established in 2005 to assure the financial resources necessary to compensate the persons abusively expropriated. Following the fulfillment of specific phases strictly determined by law, holders of compensation titles have become shareholders of the Fund. The compensation has been made in shares, representing the actual value of the real estates which are not given back in kind." It is managed by Franklin Templeton Investments.

- Baltic market professionals generally tend to have a pan-Baltic dimension.

That is why an even stronger integration of the three markets makes sense and can constitute an objectively favourable opportunity. However, the reinforcement of the capitalization must be seen from the points of view of both national (each of the countries) and regional angles (coordinated approach). Indeed, the symmetry between each country is essential to maintain a balance between the three markets within a stock exchange union. With the principle laid down and accepted by parties concerned, the process of implementing such a union has to be effected on several levels:

- Political,
- Regulatory,
- Professional,
- And institutional.

Even if the processes and time periods concerned are different, in many ways, this is the type of approach adopted for Euronext at the time of its creation with the merger of the stock exchanges of Brussels, Paris and Amsterdam. However, this stock market union has not witnessed full integration, since the three underlying remain separate for investors.

The political level reflects the necessary coordination between Latvia, Estonia and Lithuania. This coordination has already resulted in the creation of Nasdaq Baltic.

The Ministries of Finance of Estonia, Latvia and Lithuania, in cooperation with the European Commission and the EBRD, have signed the Memorandum of Understanding in respect of their co-operation for regional capital market development in the Baltics, on 6th of November, 2017. The Annex 1 of the MoU provides the indicative and non-exclusive list of possible cooperation areas:

- Promoting the Pan-Baltic asset class,
- Developing a regional legal and regulatory framework for covered bonds and other structured products, such as securitisation,
- Supporting the development of new capital market instruments - as an alternative to the banking sector - including equity, derivatives and other listed vehicles,
- Supporting and promoting access to capital market financing for small and medium sized enterprises, including listing support and research coverage,
- Mobilising local investment and encouraging local capital market investment by pension funds and other Baltic institutional investors,
- Supporting the development of capital market innovations and new technologies with a consideration for regional Fin Tech solutions, such as distributed ledger technology,
- Creating a strategy to better address index labelling for the Baltic Region.

The three Ministries of Finance met in Riga on 21st of March, 2018 in order to follow up on the MoU and discussed the development of the action plan. One year after the signature of the MoU, a high-level "Pan-Baltic Capital Market" conference took place at the EBRD in London on 18th of October 2018, and reaffirmed the three countries' commitment to the development of a pan-Baltic capital market by:

- Joint cooperation projects,
- The harmonisation of national capital market regulation,
- And the dismantlement of investment barriers.

Among the first projects of cooperation is the pan-Baltic covered bond project, which aims at establishing a joint framework for covered bonds, in order to enable larger issuance sizes. This cooperation has also recently led to the joint approach vis-à-vis MSCI.

Individual country regulators are subject to the same European directives, so the regulations and legislative frameworks applicable within each of the three countries broadly follow the same principles. Nevertheless, regulatory integration could be further strengthened to reduce regulatory differences and a common regulator[16] might be considered, as in the case of WAEMU. Of course, setting up a single regulator is not just a technical issue, it also has a political dimension, that warrants further discussion. As a first step, a permanent coordination group could be established between the three national regulators and should begin a project of deep harmonisation of the rules. In the same way, the discrepancies in terms of regulatory costs within the Baltic markets should be addressed by this coordination group in order to harmonize the fees between the 3 regulators.

Successful integration also requires a regional association of professionals from the three stock markets. It would gather the professionals who would use the integrated market place and - in practice - implement integration. This association should bring together investment service providers, investors, issuers, advisers, as well as representatives of the Ministries of Finance, regulators and Nasdaq Baltic. This association will be in charge of making proposals to the authorities, launching initiatives to develop the market, lobbying for example with associations such as EFAMA, engaging with policy makers at national, regional and supranational level, etc..

These different dimensions - political, regulatory and professional - must be found in an institutional dimension, in order to give substance to this regional market. This dimension will undeniably be embodied by the market place association and its leaders, but it will also materialize through

[16] The establishment of a common financial market was provided for by the Treaty of 14 November 1973 establishing the West African Economic and Monetary Union (WAEMU), which brings together 8 countries, namely Benin, Burkina-Faso, Ivory Coast, Guinea-Bissau, Mali, Niger, Senegal, Togo. The official creation of this market took place on 3 July 1996 with the signature of a Convention establishing the Conseil Régional de l'Epargne Publique et des Marchés Financiers (CREPMF). Its regulations were adopted by the WAEMU council of Ministers the following year. The regional stock exchange (Bourse régionale des Valeurs Mobilières - BRVM) and the central depository were created at the end of 1996 and licensed by the CREPMF in 1997. (http://www.crepmf.org/wwwcrepmf/);

institutional communication actions, both within the three Baltic countries and beyond (including road shows, communication campaigns, etc.).

If successfully implemented, the impact of the consolidation of the three Baltic countries is expected to be significant. Such a consolidation should facilitate the integration of Baltic markets into the MSCI universe. In the following section, we highlight the projected impact of the consolidation of the three countries on main economic indicators. This should also help to identify the countries from whose experience Baltic countries can learn.

Figure 21: GDP of countries included in MSCI universe (2017 – Bn USD)

Frontier Markets		Emerging Markets		Developed Market	
Mauritius	13	Hungary	139	New Zealand	206
Estonia	26	Qatar	168	Portugal	218
Latvia	30	Greece	200	Finland	252
Bahrain	35	Peru	211	Singapore	324
Jordan	40	Czech Republic	216	Denmark	325
Tunisia	40	Egypt, Arab Rep.	235	Ireland	334
Serbia	41	Chile	277	Hong Kong SAR, China	341
Lithuania	47	Pakistan	305	Israel	351
Slovenia	49	Colombia	309	Norway	399
Lebanon	52	Philippines	314	Austria	417
Croatia	55	Malaysia	315	Belgium	493
Oman	73	South Africa	349	Sweden	538
Kenya	75	United Arab Emirates	383	Switzerland	679
Sri Lanka	87	Thailand	455	Netherlands	826
Baltic countries	103	Poland	525	Spain	1 311
Morocco	109	Turkey	851	Australia	1 323
Kuwait	120	Indonesia	1 016	Canada	1 653
Kazakhstan	159	Mexico	1 150	Italy	1 935
Romania	212	Korea, Rep.	1 531	France	2 583
Vietnam	224	Russian Federation	1 578	United Kingdom	2 622
Bangladesh	250	Brazil	2 056	Germany	3 677
Nigeria	376	India	2 597	Japan	4 872
Argentina	638	China	12 238	United States	19 391
Average	**130**	**Average**	**1 192**	**Average**	**1 960**

Source: World Bank

The consolidation of the three Baltic countries, would allow the region to reach a significant size in terms of GDP, as compared to other Frontier Markets. Indeed, the consolidated GDP (103 Bn USD) is close to the average GDP of countries classified as Frontier Markets by MSCI (Figure 21).

It would still be about half the size of Greece, which is the only Eurozone country to be included in the MSCI Emerging Market universe, but twice the size of Slovenia, which is the only other Eurozone country, along with Estonia and Lithuania, to be included in the MSCI Frontier Market universe.

Looking at GDP per capita, the consolidated Baltic countries are reaching a level of economic development (17,317 USD per capita) that is above the average of both Frontier and Emerging Markets according to MSCI classification criteria. It should be noted that Frontier and Emerging Markets have relatively similar levels of economic development, as measured by their GDP per capita. The average GDP per capita in Emerging Markets is only 26% higher than in Frontier Markets, while the average GDP per capita in Developed Markets is 253% higher than in Emerging Markets.

As explained above, the level of economic development is measured by MSCI using GNI per capita, but Figure 22 below focuses on GDP per capita, as more consistent data across jurisdictions was available for this indicator. The two indicators are relatively close and they both measure the level of economic development.

Figure 22: GDP per capita in countries included in MSCI universe (2017 – Current USD)

Frontier Markets		Emerging Markets		Developed Market	
Kenya	1 508	Pakistan	1 548	Portugal	21 136
Bangladesh	1 517	India	1 940	Spain	28 157
Nigeria	1 969	Egypt, Arab Rep.	2 413	Italy	31 953
Vietnam	2 343	Philippines	2 989	Japan	38 428
Morocco	3 007	Indonesia	3 847	France	38 477
Tunisia	3 491	South Africa	6 161	United Kingdom	39 720
Sri Lanka	4 065	Colombia	6 302	Israel	40 270
Jordan	4 130	Peru	6 572	New Zealand	42 941
Serbia	5 900	Thailand	6 594	Belgium	43 324
Lebanon	8 524	China	8 827	Germany	44 470
Kazakhstan	8 837	Mexico	8 903	Canada	45 032
Mauritius	10 547	Brazil	9 821	Finland	45 703
Romania	10 814	Malaysia	9 945	Hong Kong SAR, China	46 194
Croatia	13 295	Turkey	10 541	Austria	47 291
Argentina	14 402	Russian Federation	10 743	Netherlands	48 223
Latvia	15 594	Poland	13 812	Sweden	53 442
Oman	15 668	Hungary	14 225	Australia	53 800
Lithuania	16 681	Chile	15 346	Denmark	56 308
Av. Baltic countries	17 327	Greece	18 613	Singapore	57 714
Estonia	19 705	Czech Republic	20 368	United States	59 532
Slovenia	23 597	Korea, Rep.	29 743	Ireland	69 331
Bahrain	23 655	United Arab Emirates	40 699	Norway	75 505
Kuwait	29 040	Qatar	63 506	Switzerland	80 190
Average	**10 604**	**Average**	**13 629**	**Average**	**48 136**

Source: World Bank

5. Orientation plan

Establishing an action plan in the context of this assignment, with concrete deliverables and time-bound actions involving actors at multiple stakeholders and several different jurisdictions, reflects multiple technical and strategic challenges, as well as possible political sensitivities, that go far beyond operational considerations. Nonetheless, the need for Latvia to strengthen its stock market is widely recognised, at the risk of no longer having a financing tool for Latvian enterprises and a saving tool for local investors.

The Orientation plan set out below focuses on the two key recommendations:

- (1) Development of the Latvian market through the partial privatisation of state-owned companies, and
- (2) Enhanced stock market integration between the 3 Baltic countries.

5.1 Development of the Latvian market through the partial privatisation of state-owned companies

Action 1: Consultation with the LPA and the CSCC to use the stock exchange channel as part of broadening the ownership of state-owned enterprises

As already mentioned, the gap to be filled in order to reach a market size consistent with the size of the Latvian economy is such that only strong state involvement and unequivocal public support for the measure can effectively address the problem in the near- to medium-term. However, this Action must form part of a broader time-bound implementation agenda, reflecting adequately the multiple intertwined considerations involved with taking a company public.

These include its underlying financial performance, funding mix and medium-to long-term financing strategy, fiscal and budgetary considerations, optimum market conditions for launch, sectoral economic strategy, etc. It is well understood that the capital of state-owned enterprises cannot be opened with the sole objective of strengthening the List of the Riga Stock Exchange, or more precisely solely with the aim of developing the local capital market, so that it plays its full role in financing the economy and investment solutions for Latvian private and institutional investors.

The OECD Report "Privatization and the Broadening of Ownership of State-Owned Enterprises" published in 2018 provides the framework and circumstances of privatisations around the world. The first table below summarizes the general framework in Latvia.

	Objectives	Laws, regulations, policies and other rules	Employment conditions post privatisation	Administrative frameworks and procedures
Latvia	As of 2016, SOEs that are not either correcting market imperfections or serving strategic and national security purposes should normally be divested.	Specific privatisation laws, plus laws on SOE governance and public administration. State ownership is assessed every 5 years. Implementation is vested in a privatisation agency. The Privatisation Law prescribes six privatisation methods that can be applied separately or in combination. Various laws establish a sequencing of procedures.	Contractual relationships are not grandfathered after privatisation. The state has the right, but not duty, to impose employment retention guarantees.	The privatisation agency operates independently from the state ownership (coordinating) function.

[17]

The second table extracted from the Report presents the motives of the different countries for privatisations, which are not fully consistent between the 3 Baltic states. Anyway, the support to the stock exchange market does not appear at all as a motive for broadening the ownership of state-owned enterprises.

[17] OECD (2018), Privatization and the Broadening of Ownership of State-Owned Enterprises

Table 2.1. Synthesis of national motives for privatisation since 2008

	Rationale for ownership no longer fulfilled	Improve market structures or economic efficiency	Raise fiscal resources	Improve corporate financial or non-financial performance	Overall policy to reduce the state's role in the economy	Ownership of SOE was intended to be temporary
Czech Rep.		●	●			
Denmark	●			●		
Estonia	●		●			
France	●		●			
Germany	●			●		
Hungary	●	●				
Israel	●					
Italy		●	●	●		
Japan		●	●			
Kazakhstan		●			●	
Latvia	●				●	
Lithuania			●	●	●	
Netherlands	●					●
Norway	●					
Poland	●				●	
Sweden	●		●			
Turkey		●	●		●	
United Kingdom	●			●		●

Source: Table 2.2 and author's assessments.

PRIVATISATION AND THE BROADENING OF OWNERSHIP OF STATE-OWNED ENTERPRISES © OECD 2018

In addition, it should be noted that the stock market is only one of a number of ways to open the capital of SOEs and that the use of this channel versus, for example, a strategic trade sale or via the establishment of a public fund such as FP in Romania (as detailed in section 4.1.2 above), must be duly justified. In other words, the orientations to be considered go far beyond the framework of the stock market, while being essential for the latter.

	The decision to privatise	Partial privatisation or sequencing?	Privatisation methods
Latvia	Based on a privatisation list comprising companies no longer deemed suited for state ownership.	The state has rarely maintained majority or minority stakes post divestment.	Several methods employed. Most common is trade sales, sometimes combined with share issuance to employees or management.

[18]

It is therefore within the framework of the work of the Latvian Privatization Agency (LPA) and the Cross-Sectoral Coordination Center (CSCC) that the stakes of the development of the stock market must be inserted. « In Latvia, the privatisation process is guided largely by applicable law and overseen by the LPA. Few additional administrative procedures and frameworks are involved. In particular, the Cross-Sectoral Coordination Centre (CSCC) – Latvia's state coordination agency – is not involved in the privatisation process, except with regards to coordinating with the LPA as representative of the state as an owner."[19] Furthermore, the Financial Sector Development Plan for 2017-2019, approved by the government on 21st of March, 2017, addresses the issue and is supposed "to develop and explain to the public a clear strategy and plan for capital opening of state-owned enterprises, as well as to identify a list of potential companies". In 2018, CSCC prepared an Information Report on the development of national capital market in Latvia and its contribution to economic growth, which the Government had announced, though later recalled.

Recently the SRSS project request on state ownership policy review (Part II) was approved and will be implemented by CCSC. This request concerns the continuation of improvements in the corporate governance of state-owned enterprises (SOEs), which started with the first project "State ownership policy review" in 2018. The project will consist in the review of the existing SOEs capital structures and financing options, and in the review of the current SOEs portfolio for possible listing on the stock exchange.

Discussions between stakeholders, including Ministry of Economics, Ministry of Finance, the LPA, the CSCC and representatives of the capital market industry, should be continued in order to work on the process of privatisation by the stock market:

- Benefits and drawbacks to systematically considering the stock market in the process of privatisation, (at least for part of the operation);
- Organisation of the distribution between institutional investors and retail investors, between local, regional and international investors;
- Impact on corporate governance for SOEs;

[18] OECD (2018), Privatization and the Broadening of Ownership of State-Owned Enterprises
[19] OECD (2018), Privatization and the Broadening of Ownership of State-Owned Enterprises

- Procedure of flotation.

The discussions between stakeholders should go beyond the privatization process and address the schedule, the eligibility of the different companies to a flotation, the format of the operations, among other aspects. Furthermore, it could also be beneficial to allow for additional flexibility in decision-making regarding the precise timing of flotation, by shortening the horizon for assessment of SOEs' potential for listing from the current at least 5-year review period. Furthermore, there is a list of "non-privatisable" SOEs by law, creating an exception of this general principle. But this law was passed already some time ago and in the meantime the markets have changed. Some of these companies have been even restructured or split (e.g. Latvenergo). That is why it should be recommended that this "non-privatisable" status is revisited allowing for better flexibility in the future.

The roles of relevant stakeholders, the decision-making and rationale for SOEs to become public or seek funding from the stock exchange should be discussed in depth in the light of usual financial scenarios:

- Companies need long term debt financing and bond issues is considered as an alternative to bank loans. The State shareholder should support the operation as a prelude to a further floatation despite a possible financial surcharge;
- Companies need additional equity financing (primary offering). Based on the business plan prepared by the management, the State shareholder may decide to bring additional capital or raise capital on the stock market. The decision will depend on the company activity and situation, as well as on the availability of State funds and the risk/reward analysis. But most of all, the option will be possible only if the capital raising and its design match stock exchange investors' standards and expectations;
- The State shareholder decides to sell its shares (secondary offering) on the market to decrease financial exposure or strategic reasons. In the same way, this option is only possible if the company and the offering correspond to investors' needs.

Then, after the strategic dimension, all practical issues related to the floatation should be addressed:

- Project management entity (e.g. LPA has the relevant experience),
- Advisors and investment banks,
- Operation size and details…

After the appointment of the new Latvian government on 23rd of January, 2019, the position on SOE's ownership issues will be gradually updated.

Action 2: Consultation with the LPA and the CSCC to create investment vehicles to be listed on Nasdaq Baltic

Depending on the assets concerned, some may not be suitable for direct privatization via the stock market, for example real estate. Therefore, it may be useful to consider the creation of investment vehicles in order to float them on the exchange, as for example real estate investment trusts (REITs) in the case of property assets.

Such an approach would have the advantage of providing both a new solution to the LPA and CSCC for privatization, but it would also allow the stock market to diversify its securities offering, for example by allowing individual investors to acquire real estate assets in tradeable securities format.

5.2 Enhanced market integration between the three Baltic countries

Action 1: Establishment of a Coordination Committee at the level of the Ministries of Finance

While it is up to each Baltic state to initiate the process of expanding the size of its market, it has also become clear that there is an even stronger regional and international expectation of further integration, beyond the implementation of Nasdaq Baltic. The joint approach of the Finance Ministers of the three Baltic countries vis-à-vis MSCI is a confirmation of the willingness of Latvia, Estonia and Lithuania to strengthen this integration and a reaffirmation of the three countries' commitment to an equity market union by harmonizing regulations and dismantling investment barriers. Furthermore, according to the MoU signed by the three Baltic ministries of finance, they are committed to establish a steering committee to oversee and foster the progress of implementation of the MoU and projects.

Therefore, the first action proposed would be to set up a permanent operational coordination committee between experts of the 3 Ministries of Finance, under the auspices of the EBRD and the European Commission if appropriate, so that the will displayed by each of the three states to develop their markets is undertaken in concert, for the benefit of each and all of them. The experts group should identify the Baltic market integration-related barriers, support the equity market regulations harmonization in the Baltics, while encouraging the highest international standards and best practices. For example, if each country were to decide to pursue partial privatization of some or several of its state-owned enterprises, ex-ante co-ordination would increase the scope of these decisions and in a practical way, a concerted timetable would further improve the chances of success of the operations with local and international investors. Indeed, the absence of such coordination could result in simultaneous public offerings from two or all three Baltics countries, thus placing the entities concerned in competition for initially limited investor appetite for the region. The recommendations could be submitted to public consultation with market participants and relevant associations.

Finally, from an institutional point of view, this coordination would be likely to send a strong signal to all actors in the region as well as external stakeholders such as MSCI.

Action 2: Enhancement of the cooperation in between pan-Baltic financial sector associations

If the political dimension and the regulatory dimension are essential, the professional dimension is critical too. Indeed, available evidence suggests that many market players have a regional approach already, which allows them to perform their activities across a larger market. Similarly, many investors have adopted a regional approach. This approach is also already materialized in aspects related to key market infrastructures by Nasdaq Baltic. Besides, there is already co-operation in between Finance Latvia Association and the corresponding associations in Estonia and Lithuania.

However, as also confirmed during our local stakeholders' consultations, market players often have an individual and not a collective approach. That is why the creation of a pan-Baltic professional association would be a very powerful lever to support the integration process, forcing professionals to also take their responsibilities in this area.

Drawing from the experience of the model of Paris Europlace or Dubai International Financial Center for example, such a professional association would firstly aim to bring together all professionals related to the financial market of the three countries, under the banner of Nasdaq Baltic:

- Banks and intermediaries,
- Asset managers, private equity investors, institutional investors,
- Issuers,
- Advisers and consultants ...

Its goal would be threefold:

- Work on the development of the regional market,
- Accompany the harmonization process; and
- Promote the market.

Such an association would also be a powerful interlocutor for political authorities and regulators. It could appoint representatives for the working groups, on a regional basis. It would finally provide a formal and organized framework for professionals and enhance the visibility and professionalism of the regional market.

***Action 3*: Enhancement of access to finance for SMEs**

It is necessary to prepare tomorrow's stock market with the access of SMEs to the market, as a solution for their financing. Two complementary actions should be considered:

- The establishment of a pan-Baltic fund,
- The development of SMEs listing support instruments.

Establishment of a pan-Baltic fund to enhance access to finance for SMEs

From a supply of capital perspective, this area can be further improved by establishing a regional fund to enhance access to finance for pre-IPO exchange traded SMEs in line with the Capital Markets Union (CMU) objectives. This would increase issuer and investor awareness through investments in listed SMEs. With the successful launching of such fund, local regional economy could have effective and versatile SME equity financing channels, which would also contribute to the primary and secondary capital market development of the EU member state(s) and to the realisation of the CMU at least in the Baltic region with a wider outreach in the following years. Ultimately, this would demonstrate to local SMEs that it is possible to successfully access equity funding on a regional level via the local capital market infrastructure while enabling:

- An increase of the investor base as an accompanying measure to support company growth starting from early to later stage SMEs;
- To diversify access to capital market financing for SMEs; and
- To make use of private as well as public resources.

Development of SMEs listing support instruments

SMEs listing support instruments in the three Baltic countries should increase the number of companies listed and activate as well the debt market. It has to be noted that similar projects are in preparation on the three markets. We can mention the following SRSS project applications already submitted by Latvia that are relevant to consider for global Baltic equity market development:

- Minority shareholder protection,
- Capital market development strategy.

In the same way, a financial support given to SMEs for the preparation of their IPO process should be considered (auditors and lawyers' fees, due diligence fees…) such as tax reduction, support from the pan-Baltic fund, IPO tariff arrangement.

CONCLUSION

As mentioned by an international investor, the integration of Latvia into the MSCI Frontier Markets universe is not an objective as such but the consequence of a broader objective, that of providing Latvia with a stock market matching its level of economic development.

Indeed, the size of the Latvian stock market should be in the order of 6 to 9 Bn USD, that is to say 4 to 6 times greater than its current size. Even though the gap is larger than it is in Estonia and Lithuania, markets that have entered the MSCI Frontier Markets universe already, the problem is generally the same for the other two Baltic countries. Their stock markets are also small compared to the sizes corresponding to their current levels of economic development.

It is not so much the MSCI classification that is important as what it reflects: the lack of depth of the stock market is a handicap to development because it limits the amount of financing provided to the economy, the investment opportunities and diversification outlets for Latvian investors, and the availability and access to foreign capital. The gap is too large to be absorbed by increasing the size of SMEs entering the stock market. Worse, it may eventually discourage them from entering the market.

Therefore, only the flotation of a number of large companies on the market will provide an adequate response in terms of scale and breadth to the current situation, through a process of opening the capital of state-owned enterprises. They are the only breeding ground to fill the gap and convince large private companies to take the path of the stock market tomorrow.

But this national approach is not enough: investors need an even bigger and more liquid market. And this is why the stock market integration of the three Baltic countries is an appropriate answer. However, this market integration today embodied by Nasdaq Baltic must be pursued steadfastly and further deepened: the capital market development strategies of the three countries must be coordinated, the regulations need to be harmonized, in line with the stated commitments of the three countries. This is backed by the Memorandum of Understanding (MoU) signed in 2017 when Estonia, Latvia and Lithuania agreed to create a pan-Baltic capital market to strengthen their economies and stimulate investment to create jobs with support of the European Commission and EBRD. The goal of the initiative is to attract investment through the creation of a common capital market by combining the strengths of the three Baltic states and overcoming the constraints they often face due to their limited size. The initiative is also in line with the European Union (EU) action plan for creating the CMU.

This integration must also materialize in an increasingly strong integration not only of the regulators, but also of Latvian, Estonian and Lithuanian professionals contributing together to the development and promotion of the regional market.

The joint action of the Latvian, Estonian and Lithuanian Finance Ministers, with the EBRD and the European Commission, vis-à-vis MSCI illustrates this desire for greater market integration. It is also the first tangible result of our mission.