

IMPLEMENTATION OF FINANCIAL DERIVATIVES ON THE CAPITAL MARKET OF REPUBLIC OF MOLDOVA: CHALLENGES AND OPPORTUNITIES

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Abstract

The creation of derivatives market in Republic of Moldova is an actual necessity dictated by the improvement of market relations on international financial market and the development of national capital market. However, the implementation in practice of this desideratum can be realized in certain circumstances. The Moldovan capital market is very young and is trying hard to conform to international standards. Its evolution hasn't still reached the level of investors' expectations and is facing serious problems. This research includes the analysis of capital market of Republic of Moldova and possibilities of implementing derivative instruments by market participants.

Keywords capital market, derivatives market, derivative financial instruments, futures, options, forward contract, stock exchange, commodity exchange, OTC market

Jel classification: G23, G28, Q14.

Introduction

During the past decades the derivatives market has known a continuous evolution on international scale once with the development of a variety of new financial instruments. This phenomenon is produced due to a high level of financial market volatility and instability of interest or exchange rates that determined investors search new opportunities for risk management.

Successful economies should evolve towards direct capital market model where savings are intermediated through financial market instruments and risk is, thus, effectively managed by derivatives market. A secure liquid capital market and a strong base of institutional investors are key ingredients for economic development. Markets are deemed to be incomplete if they are operating only on spot basis or without the futures price discovery element of the derivatives markets.

Derivatives require some conditions that demonstrate market maturity, but they also enhance the liquidity and price discovery in those underlying markets.

Capital market development in Republic of Moldova

Capital market from Republic of Moldova is still on its incipient phase of development and does not offer population and real sector sufficient instruments for financial intermediation.

First characteristic of the Moldovan capital market evolution is represented by *a low volume of transactions with securities*.

Analyzing the segments of the Moldovan securities market during the last years, there is an obvious prevalence of OTC market according to number of transactions performed, and an insignificant record of stock exchange transactions in terms of transactions' volumes. Data provided in Table 1 attest uneven developments of volumes and number of transactions performed on stock exchange, thus in 2014 registering a low decrease in transactions' volumes on the secondary market in ratio with the previous period. This fact allows us to determine *a poor investment activity on the capital market as the rhythm of transactions performed by participants is practically the same during the last years*.

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Table 1

Transaction volumes on the securities market during 2009-2014

Indicator	2009	2010	2011	2012	2013	2014
SE market						
Nr. trans. (units)	1570	2601	2046	1877	1258	1471
Vol. trans. (th. lei)	141.22	267.89	241.97	623.29	822.01	708.6
OTS market						
Nr. trans. (units)	218267	3082	3267	2521	2846	2941
Vol. trans. (th. lei)	480.7	291.3	1698	628.2	889.6	599.2
Total sec. market						
Nr. trans. (units)	219837	5683	5313	4398	3744	4412
Vol. trans. (th. lei)	621.89	559.14	1940.0	1251.5	1711.6	1307.8

Source: data provided by National Commission of Financial Market, www.cnpf.md

A good indicator of capital market activity consists in the number of new created joint-stock-companies, as it shows the level of investors' interest for capital market as destination for resources' placement, creation of new investment projects. Unfortunately, *at present, Republic of Moldova doesn't represent an attractive investment destination for investors*. Thus, by 2014, the volume of issues done for creation of joint-stock companies reached 0.12 million Lei, being registered only 2 new companies, with a dramatic decrease in comparison to 2012, when this indicator reached 356.2 million Lei (CNPFF, 2014, p. 60).

Additional issues of securities represent efficient tools in the process of attraction of investments in the real sector of economy on a long-term, which are necessary for joint-stock companies for the realization of investment programs. During 2014 additional issues of securities were done by means of closed issues, being preferable common stocks' issues. According to Figure 1 the volume of additional issues in 2014 registered 1249.5 million Lei, with 299.8 million Lei higher in comparison with previous year (CNPFF, 2014, p. 61). Still, *this indicator is too low for an efficient development of capital market, and allows us to conclude that investors find other sources to cover investment necessities, and are avoiding the capital market*. The highest level of additional issues was reached in 2004 (1636.5 million Lei), when there were registered additional issues by JSCs in electrical networks (675.8 million Lei), Apa-canal Chisinau (413.3 million Lei) and by banks (290.17 million Lei).

Low volumes of issues demonstrate *a weak development of material basis on the domestic capital market. The existent investments are not sufficient for the creation of the market material basis and its subsystems of insurance*.

Another characteristic of investment activity on the domestic capital market is *lack of financial instruments*, as only two types of securities are traded - stocks and bonds, while public issue of securities through public auctions have an episodic nature. Thus, state securities are not used to finance investment projects of national importance and are missing on the secondary market. Collective investment institutions are also missing.

In great part, transactions that are performed on the stock exchange, are transactions of consolidating stocks' packages. This process started once with distribution of ownership bonds and the privatization process from '90s, but, the problem is that once with receiving these bonds, population was not instructed how to use them and some "smart investors" started a process of barter, by changing some goods and money means through stocks, and population received a value less than the value of stocks held (Hîncu R., Iordachi V., 2012, p. 124). Legislative juncture at that moment allowed the new shareholders not to register these stocks and after legislation reformation on the capital market, this process finally ended. The biggest tragedy consisted in bankruptcy of investment funds in one single night, leaving population without shares and money.

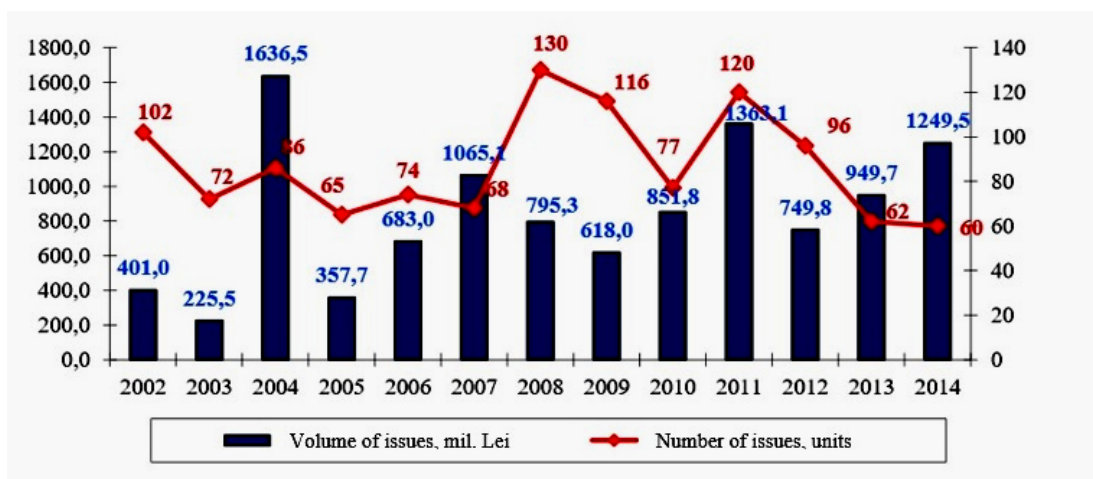


Fig.1. Additional issues of securities on the capital market of Moldova during 2000-2014

Source: National Commission of Financial Market, 2014, p. 61

Practically all issues of shares on the Moldovan capital market are closed and limited to a restrained circle of persons, being performed outside the stock exchange, thus, limiting the participation of other potential investors. Thus, analyzing transactions with securities of joint-stock companies included in the listing at the Moldova Stock Exchange, bank sector owns the prevalence, registering the total volume of transactions 460 million Lei. The same situation is stated in performing transactions within out crying unique packages of stocks - 51 million Lei. The real sector is represented only by JSC "Efes Vitanta Moldova Brewery", which traded on the secondary market 8 shares in volume of 785 Lei (CNPF, 2014, p. 62).

In Republic of Moldova there are few profitable securities that could bring profits to investors in form of dividends or from speculative transactions. The most profitable shares are issued by commercial banks and insurance companies. For example, if the nominal price of one share issued by a bank in Moldova is 200 lei, the earning from dividends is 75%, while from bank deposits - 12%.

The major shareholders in companies from the real sector are primarily directed towards consolidating their controlling stake. There is practically no possibility to invest in profitable shares of banks, as most issues are done by means of closed procedure among already existent shareholders. The refuse of companies to perform an open issuance procedure is explained by control over minor shareholders by the controlling ones, who are afraid to reduce their participation stake.

In conclusion, for the domestic capital market the following peculiarities demonstrate poor achievements in its development (Iordachi V., 2014, p.113):

- Lack of active institutional investors;
- A poor capital market infrastructure that does not correspond to standards of European capital market model;
- Insufficient resources for the creation of market material basis and its subsystems of insurance;
- Lack of financial instruments;
- Few profitable securities that could bring dividends or profits from speculative transactions;
- Transactions are primarily directed towards consolidating the shareholders' controlling stake.
- Investments in state securities are limited only to banks.
- Restrained circle of investors;
- Few companies from real sector are listed on the stock exchange, while the major part is represented by shares of commercial banks.

Another barrier for the development of capital market is lack of culture in investments on behalf of investors, thus a great part of population seems not to have any idea about capital market transactions.

Legal premises for the development of derivatives market in Republic of Moldova

In the content of integration process of Republic of Moldova into European Union, regulation bodies of capital market launched a whole set of activities in adjusting the national legal framework towards the EU directives, which promises a radical reformation of market infrastructure and a strong openness for foreign investors. Thus, the Parliament of Republic of Moldova adopted *Law nr. 171 from 11.07.2012 „On capital market”* and in this context market actors in leading role banks hope to change many things, in conditions in which the old rules limited the development of the market and there existed many barriers that hindered market intermediaries, as well as issuers of securities.

According to The Law on capital market, which was developed according to the requirements of EU directives, namely MiFID, financial instruments are treated as a whole set of⁶⁴ (CNPF, Law on Capital Market, 2012):

- a) securities;
- b) units (securities) issued by undertakings for collective investment in transferable securities, also called investment funds;
- c) money market instruments;
- d) options contracts, futures, swaps, interest rates forwards and other financial derivatives relating to securities, currencies, interest rates, rates of return, financial indices or assets;
- e) financial derivative instruments for transferring credit risk;
- f) financial contracts for differences;
- g) other financial instruments admitted to trading on a regulated market and / or in a multilateral trading system.

Thus, national legislation gives premises for the implementation on the Moldovan capital market of some innovational products like derivative instruments - futures and options contracts on commodities or currency as underlying assets.

Derivative financial securities are also reflected in The Moldova Stock Exchange Regulation, where art. 24 (c) states that *options and other forward contracts are admitted for trading on stock exchange. At the same time, forward contracts include futures, options and other derivatives, which represent a type of standardized contracts in terms of quantity and price, and which involve making / accepting delivery of securities at a fixed date in future (CNPF, Regulile Pieței Reglementate, BVM, 2015).*

A successful implementation of derivative instruments on the domestic capital market cannot be possible within actual legislative framework. It is necessary to highlight and formulate correct notions of financial derivatives in the Law on capital market, as well as to define separately the terms of futures and options contracts.

At the same time, the existing legal system cannot create necessary conditions for the successful regulation of futures' trading system as all procedures should be regulated in complex, starting with registration, securities trading and ending with the liquidation of instruments.

Implementing derivatives in national economy: opportunities and main barriers

Considering the peculiarities of national economy development, in Republic of Moldova, at present, *derivative instruments could be implemented by agricultural producers to protect against price fluctuations, or by real sector to secure imports and exports against currency rates changes.*

For the whole periods of national economy development, prices on agricultural products suffered price changes (Figures 2 and 3) caused in major part by unfavorable climate conditions, but also by external factors, like: fluctuation on external markets of prices on feed crops that subsequently influence the prices of other fodder crops; entry of international companies on the domestic market,

⁶⁴ Art. 4 (1) of the Law on capital market

which have the capacity to occupy a greater part of the market; losing World Bank credit resources in form of subventions in 2009, as a result of Government resignation, etc.

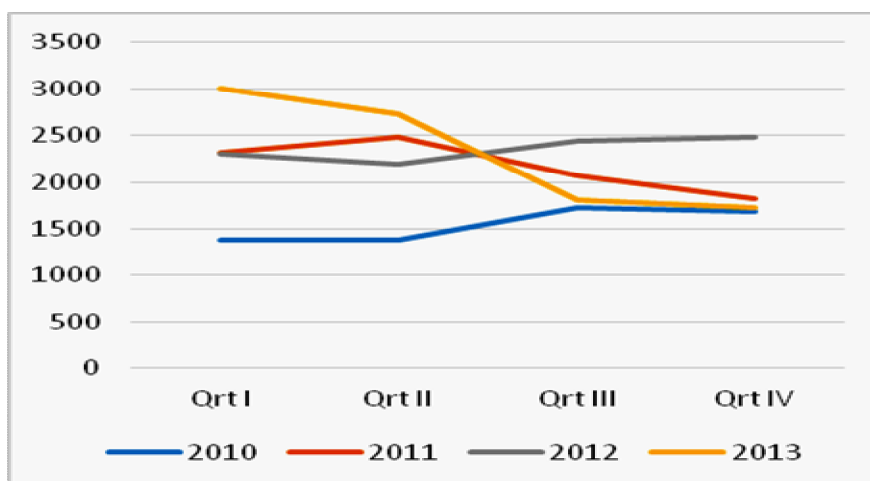


Fig.2. Quarter evolution of wheat price in Rep. Moldova for 2010-2013, Lei/t
 Source: elaborated by authors in base of data from National Bureau of Statistics of RM

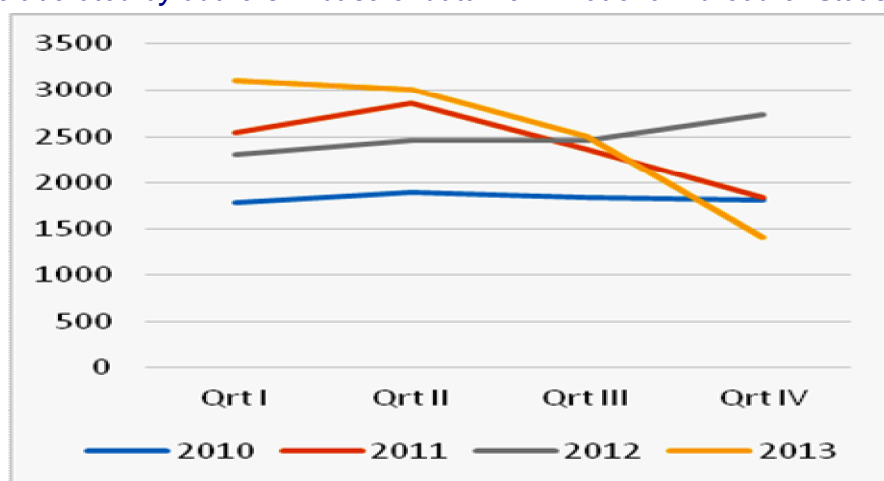


Fig.3. Quarter evolution of corn price in Rep. Moldova for 2010-2013, Lei/t

Source: elaborated by authors in base of data from National Bureau of Statistics of RM

Another factor was the continuous increase of VAT quota applied to agricultures from 8% to 20% beginning with 2013, causing price increase by 25%. All this suggest an extremely vulnerable and manipulable character of agricultural market on different external factors, which determine farmers search opportunities for risk management.

In Moldova, first location, where producers of agricultural production and especially of cereals could apply for forward transactions, is The Commodities Exchange. Thus, according to the amendments to the Rules of exchange trade, companies have obtained registration of forward contracts with advance payment opportunity. These contracts allow producers obtain advance payments for future production of the product, setting initial prices for their production. Having the guarantee that their production will be purchased, the sellers are able to set a price that will ensure optimal profit. Also, within The Commodities Exchange trading rules, forward contracts can also be used to obtain a bank loan on the account of future production (Universal Commodity Exchange of Moldova, 2014).

Although The Commodities Exchange of Moldova offers possibilities to local farmers to trade on a forward basis, still, businessmen are reserved to apply for these innovative trading techniques and the statistics on these transactions lacks.

The creation of a functioning market where the derivatives would be traded is an important problem for national authorities in the attempt of implementing derivatives on the Moldovan capital market. These instruments are more complex in comparison to the primary financial securities and their implementation should conform to some strictly determined terms. International

experience relates that a successful implementation of a futures contract depends on the market liquidity of the underlying asset. This is the main premises that determined the reorganization of Commodities Exchanges from other countries into futures market.

Businessmen could also use OTC market in Moldova to minimize risks related to price changes.

In advanced economies, a functional OTC market adds a very necessary time variable for risk management in agriculture. The vast majority of agricultural producers in Moldova, especially those who hold small and medium-sized farms, at present, is based almost exclusively on physical spot markets to sell their products. Lack of derivatives accessible on local capital market, such as forwards, options and swaps, does not allow them revenue optimization over a period of time. If it were possible to "lock" the price of transactions long before, it might exist the possibility to better plan investments and, thus, extend production.

In such a way, development of a derivatives market is important, but, still, in Moldova Government is actively intervening in fixing prices, which represents a significant barrier.

Also, ***OTC market should base on some prerequisites such as transparent grading and weighting of products, transparent information on spot prices, quality of production, as well as data on how much products were produced, deposited and consumed.***

The organization of trading with financial derivatives at the Moldova Stock Exchange, for the moment, is not possible, irrespective the fact that it is the only financial institution in the country equipped with necessary system and infrastructure that might organize transactions with futures. The Moldova Stock Exchange is a very young institution, having only 12 years of activity, but which is trying hard to correspond to all international norms and standards.

However, realizing the analysis of stock activity in Moldova, we have come to the conclusion that to be successful in trading, it is not enough to create trading platforms and purchase latest technology, it is necessary to invest in specialists who would activate in terms of market forecast and analysis, as well as to eliminate the existing psychological constraints that is created due to superficial knowledge and wrong perception of stock exchange activity by government authorities and investors.

Integration of the Republic of Moldova in world economy and the tendency to cover new market segments will slowly lead to implementing innovational products within stock exchange transactions. It is not difficult to organize trading with these titles, the main problem appears within the process of elaborating and maintaining the trading mechanism with participation of external traders. Thus any agent (resident or nonresident) should have the possibility to access easily trading platforms (without the presence of broker in trading room) and this supposes the existence of a functioning distance trading system, which in Moldova lacks.

In order to improve trading activity on platforms of Moldova Stock Exchange, as well to give premises for derivatives' implementation, the following recommendations would be advisable:

- Improving electronic trading mechanism, creation of an adequate physical location for performing transactions and open auctions;
- Creation of an effective communication network that could provide an instant distribution of information to all beneficiaries on prices and transaction volumes, respecting the principle of equal access;
- Improving the mechanism of transactions' registering;
- Creation of efficient margins, deposits and clearing systems that would allow customers realize their gains from futures positions;
- Creation of viable options and futures contracts that will be permanently adapted to new market juncture.

At present, the Moldova Stock Exchange is regarded as a functional institution equipped with automated trading system, which could offer the necessary technical support for the organization of transactions with derivative financial instruments. Unfortunately, the poor condition of telecommunication networks and the withdrawal of external financial support offered to it impede full and practical realization of this goal. Implementation of derivative financial instruments must be preceded by preparation of trading mechanisms, organizing special courses for professional participants on theoretical and practical approaches in organizing transactions with these products.

It will be also advisable to create a separate department within the Moldova Stock Exchange or Commodity Exchange to perform transactions with derivatives. Thus, it would be less difficult to organize trading with these instruments. Listing procedures, namely registration of futures contracts and their admission for quotation, could be accomplished by the existing Listing and Trading Department, while clearing and settlement functions may be assigned to the Clearing and Settlement Department. At the same time, implementation of these changes requires the modernization of the existing system of electronic negotiation, and the creation of a guarantee fund by introducing a system of margins.

Conclusions

For a successful implementation of financial derivative instruments in Republic of Moldova, the following recommendations would be necessary:

- Increasing production level in national economy, which will foster the liquidity level of financial assets proposed for negotiation (at present, only state securities could be included within underlying assets for futures contracts, as they are most liquid on the domestic capital market).
- Elaboration of a more concise legislation on trading mechanism of derivative instruments;
- Modernization of the activity of the National Securities Depository according to international clearing and settlement principles of trading financial derivative instruments;
- Attraction of free financial resources from national economy and foreign investors on capital market;
- Integration of domestic capital market into international financial circuit and a better collaboration with foreign investors.

It is important to elaborate a complex strategy of capital market development in Moldova, which would in fact be a normative reform that would trace distinct efficient development methods, including – capital market development concept on norms of populations' informing, as well as reestablishing of investors' trust in institutional structures. For a positive development of capital market, population needs to be informed on the possibilities of active and efficient trading on the secondary capital market.

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