Issues and Challenges in the Development of the Local Capital Market

Some Preliminary Thoughts

Trinidad and Tobago has posted eight years of consecutive growth. Inflation is currently estimated at 3-4% per annum and the official reserves are in excess of $2.5billion. From all indications, economic activity is poised to increase over the coming years, particularly so when we consider the itinerary of projects schedule to break ground in the critical energy sector.

Critical to the success of these initiatives and the continuation of economic growth is the efficient mobilisation of capital. Indeed a well functioning capital market is a sine-qua-non to economic development.

Against this background the need for the development of the local Capital Market takes on urgent proportions. The urgency of this problem is further highlighted when one considers that the Financial Institution Act prohibits Banks from lending more than 25% of its capital base to any one entity and in the case of groups no more than 32% of its capital base. In the case of RBTT Bank, the largest of the indigenous Banks, this cap would restrict lending to approximately $245MM and $312MM respectively. Given the dimension and scale of some of the projects envisaged in the foreseeable future serious consideration need to be brought to bear on the issue of capital mobilisation.

This preliminary analysis at treating with a most complex issue will proceed sequentially in three (3) phases. In the first instance we will briefly outline the benefits of an efficient capital market. Having demonstrated its merits we will then proceed to discuss what are the major issues and challenges facing the development of the local capital market (with particular emphasis on the Bond Market). This aspect of the discussion will proceed under two (2) distinct headings: Supply-Side Issues and Demand Side Issues. Finally we conclude with some recommendations.

Benefits of the Capital Market

- An improved allocation of scare economic and financial resources
- More efficient savings and interest
- Reduced transaction cost
- Improved liquidity management
- Lower Cost of Capital to Firms
- Signaling Value
- Deeper Financial Markets

➢ SUPPLY SIDE ISSUES

1. Cultural Aversion to listing and disclosure

In Trinidad and Tobago as well as most developing capital markets there tends to be both a cultural aversion as well as a lack of incentives to attract private closely held family owned enterprises from issuing Public Security in general and Bonds in particular. These stems largely from the fact that the degree of disclosure that are required for Bond issues sometimes runs counter to the financial objectives of these firms which sometimes keep multiple financial records.

2. Bank centric Vis a Vis Stock Market centric Money and Capital Markets in Trinidad and Tobago: The Distinction Made

The evolution and development of financial markets typically follow one of two major developmental paths: Stock Market Centric versus Bank Centric developmental models. In the stock market centric system, while a large number of banks exist, they do not play a significant role in the development of the capital market. In the bank centric model, banks dominate the financial landscape and are the primary mobilisers of capital. The two basic forms of capital market development differ substantially in terms of availability of institutional infrastructure, in their basic role, objective, risk propensity, regulatory institution and level of involvement. More importantly for the present analysis, the developmental model (bank-centric versus stock market-centric) has direct implications <u>for the level and depth of the Bond market</u>.

The money and capital market in Trinidad and Tobago has followed the Bank Centric Model and this has contributed directly to the rudimentary state of the local Bond Market. The commercial banking sector is by far the most dominant component of the local financial sector which comprises of Insurance Companies, Mutual Funds, Trust Companies and Merchant Banks. They dominate the local landscape both in terms of their size (assets) as well as their pervasiveness via the branch network system.

Banks by their very nature mobilise short -term deposits and then utilise them for on lending to businesses. In the process of so doing banks mobilise funds and allocate to the most productive sectors of the economy. More importantly, however, in mobilising these funds Banks earn intermediation income. Consequently, Banks have a vested interest in building assets as the more assets they acquire the greater their intermediation income.

In an efficient Capital Market and especially one in which the Bond Market plays a significant role, the stronger projects, which would normally access bank financing, by-pass the commercial banking sector and deal directly with those individuals or institutions which are net savers. Typically, these are pension funds and insurance companies. The net effect of this is a cannibalisation of the Balance Sheet of the Bank.

It is obvious, therefore, that in a Bank centric capital market, Banks would not be eager to encourage the development of the Bond Market and would view such as anathema to their own development and survival.

Another factor, which contributes directly to the limited number of new Bond issues and the rudimentary state of the Bond market in Trinidad and Tobago, relates to the fact that Commercial Banks do not price their loans properly. In this regard, in the quest to retain assets and to grow their balance sheets in a highly competitive environment, bank spreads are constantly being compressed. In this regard, the disparity between the pricing of investment grade securities and credits of an inferior nature sometimes does not adequately address the risk profile of these securities. Because of the relatively cheap financing available from the banks, prospective borrowers are less likely to seek financing from the Bond market that normally requires a higher degree of financial disclosure.

3. Nationality of Borrowers and cost of Local Capital

The nationality of borrowers, especially in the crucial energy sector, is another contributory factor to the under-developed nature of the local capital market. Apart from the issuance of a Bond by BPTT and Phoenix Park Gas Processors little else by way of financing in the local capital market has been done by foreign multinationals operating in the energy sector.

A cursory analysis of this issue suggest that the major explanatory variable is the simple fact that it is only natural for International Banks to follow their top tier clients overseas.

Many commentators have agreed that the post-war growth of multinational banks can be rationalised in term of the response of these banks to follow their MNC clients' abroad. Such a strategy becomes necessary if one is to maintain business with the domestic partner. More importantly, failure to follow one's client may result in a situation where the client will be forced to turn to local banks or domestic rivals with branches abroad to facilitate their needs.

Additionally, some of these projects, structured as they are, are essentially self-funded. They are usually extremely tightly structured with Tripple A sponsors and long-term off-take contracts which lend the project to attractive LIBOR based funding not available locally.

4. Regulatory Issues as impediments to the development of the Local Bond Market

In emerging markets, regulatory authorities sometimes exercise extensive influence over the market by controlling the number and quality of the issues brought to the market and, in some instances, determine the price at which securities can be offered. In contrast, regulatory authorities in the United States, Canada and the United Kingdom do not control prices, or quality of the issues brought to the market since this is normally left to the market forces.

With the passage of the Securities Industry Act, 1995, before a security can be offered for sale to the public in Trinidad and Tobago it must first be registered and then approved by the Securities and Exchange Commission. This is so whether it is a Private Placement Issue or a Public Offering. As consequence of this requirement for registration and approval, it has become very cumbersome in recent times to issue securities in Trinidad and Tobago. Depending on the complexity of the issue this process can take anywhere between three (3) to six (6) months.

The net effect of all of this is the stifling and stagnation of the Bond market in several ways:

a) Issues delayed because of red tape at the SEC are sometimes postponed indefinitely because of fundamental changes in market conditions.

b) Because of delays, investors lose confidence and underwriters are forced to hold securities on their book for considerably longer periods of time than which they anticipated.

In addition to the foregoing the cost of issuance could also be prohibitive. In addition to paying underwriting, issuance and legal fees, the SEC is now imposing a charge for reviewing a prospectus that could be as high as $35,000.00.

The net effect of all of this is that issuers are sometimes not able to take advantage of a favourable interest rate environment at the time the registration for public offering is prepared.

5. Limited Number of New Issues

Capital Market financing and Bond financing in particular is normally restricted to these firms with well established financial management strong capital base and a low probability of financial stress. Accessibility to bond markets require a strong legal and regulatory base if only to provide protection to bond-holding, transparent market with fully implemented international quality accounting and auditing standards, and a culture of information disclosure.

If 1999 represents a typical year in Bond Market activities it provides concrete evidence of the thinness of the Market. In that year 23 new issues totalling approximately $3.9 Bn came to the market.

6. ***Improper Benchmarking and Floaters***

A key ingredient for a well functioning corporate Bond Market is a well functioning market for government debt. A strong government bond market provides an ideal learning ground to achieve pricing and trading skills without the **distractions of credit risk**. Market based benchmarks rate for medium and long term securities facilitate more accurate pricing and contribute to the development of a deep bond market. It furthermore allows issues such as trading practices registry, transfer and settlement.

A vibrant government securities market often takes the lead and provides for benchmarking across the range of maturities. An efficient government securities market in Trinidad and Tobago is a sine qua non in order to provide a benchmark for private issuers of debt securities. In the Caribbean, the lack of adequate benchmarks has hindered the development of private debt markets with longer maturities.

In the context of Trinidad and Tobago, it is clear that one of the impediments to the developments of an active secondary market is the fact that the Government Bond Market is not properly structured. In the first instance there is the absence of a proper yield curve from which benchmarking can take place. In this regard, while there is a plethora of issues at the shorter-end of the maturity spectrum (90-days, 180-days, 1-year) and the longer end of the maturity spectrum (10-years, 15-years, 20-years), there is a paucity of medium-term securities (2-years, 5-years, 8-years) in order to fill out the yield curve.

Another problem relates to the fact that the majority of Government issues (particularly the more seasoned issues) are floating rate issues with built in call options. This poses another problem in that it becomes difficult to price these issues as interest rates move.

Another factor that militates the development of this critical segment of the market is the practice of Underwriters of Government and other securities of stripping the primary issues and selling derivatives products to the market. Since yields on the primary issues are not made public in a transparent fashion, stripping contributes to the further weakening of the secondary market.

Finally, the Government Bond market lacks predictability in that there is typically not an organised program of borrowing which is adhered to so that institutional investors could plan their cashflows properly and with a fair degree of confidence.

➢ DEMAND SIDE ISSUES

1. Involvement of Individual Investors and Lot Sizes

A comparative analysis of the local stock market with that of the Bond Market will immediately highlight the fact that more individuals hold shares in companies when compared to their participation in the Bond Market. This is a consequence of a number of factors. In the first instance it is a function of marketing, as stock and shares are marketed more aggressively in Trinidad and Tobago through the network of Brokerage Houses. At another level, it could also be said that this phenomenon is also a function of the fact that shares are cheaper to acquire than Bonds. When we compare the cost of acquiring a block of shares with entry into the Bond Market, we immediately recognizes the wide disparity that has historically existed.

Bonds are usually sold in multiplies of $100,000 whilst an investor could probably acquire a block of shares for as little as $1,000.00. The cost of entry for the individual in the Bond Market is therefore, also a factor in the lack of development in the Bond Market.

2. Restriction on the type of securities making up Fund Portfolios

Institutional investors are central to a well functioning money and Capital Market. Sophisticated investors can mobilise savings in a cost effective manner for individuals who otherwise might not participate in the market.

In the context of Trinidad and Tobago, the largest institutional investors are the National Insurance Board and the major pension plans. The National Insurance Board, Insurance Companies and Pension Plans are all governed by various pieces of legislation (the Insurance Act of 1980 in the case of Insurance Companies and Pension Funds). In both instances the respective pieces of legislation prescribe and circumscribe what securities the respective institutions may or may not invest in. To a large extent, these institutions are restricted from investing in foreign securities. Given these restrictions and the paucity of securities that come to the market these institutions are loathe to sell existing securities even where capital gains can be made since there are simply no new investment opportunities or the new securities do not conform to the pre-determined list of approved securities.

Additionally, some of these institutions tend to impose standards that are more appropriate to more developed capital markets with respect to the composition of their portfolios by insisting on investment grade securities.

3. Effective Absence of Foreign Institutions

Trinidad and Tobago Government has issued several eurobonds in the international capital markets. These securities are held primarily by the major local institutional investors (same as the locally issued bonds) and a few international institutional investors. These Bonds are highly, liquid and there is a vibrant secondary market and trading. A key to providing the answer to the question as to why there is such limited trading on the secondary market with respect to locally issued USD Government of Trinidad and Tobago Bond Issues can be gleaned if we compare and contrast these foreign Eurobond Issues with local issues.

Apart from the size of these issues the only major distinction between these issues and locally issued USD Government Bonds are the fact that they are also held by foreign institutional investors and the settlement system is electronic (via Euroclear and Cedel). This leads directly to another point which prohibits the development of secondary trading - the absence of foreign participants, antiquated settlement systems and improper pricing mechanisms.

No foreign institutional investors would trade in Bonds where the delivery system involves physical certificates. While efforts are on the way to improve the settlement of securities through the CSD, it will be sometime before this is fully implemented. Presently, the Securities (Bond) Market in Trinidad and Tobago is characterised by an antiquated trading system that requires the physical delivery of securities without adequate depository facilities. By virtue, of this fact most if not all, foreign institutional investors will not purchase these securities.

In addition to the lack of a modern settlement system the application of withholding taxes or interest income also militates against the involvement of foreign institutional investors in the local bond market as withholding tax is normally waived in respect of Government Eurobond Issues.

Another factor which contrast locally issued US Dollar Government Issues from their foreign counterparts pertains to their pricing structures. In this regard, in the past it was not uncommon to have issues come to the market simultaneously with similar maturity profiles but fundamentally different coupons. In this regard, Eurobonds tend to be issued with higher coupons Vis a Vis their local counterparts. This may point to the fact that the local issues are improperly priced.

4. Easy and automatic access by Local Investors to Foreign Markets

While it is difficult for foreign portfolio investors to participate in the local bond market for reason highlighted above the converse is a also true. A common problem in emerging markets is that domestic investors are easily able to invest in global markets (through various channels) thereby reducing the supply of investment funds (demand for local securities).

5. Absence of Market Makers

When considering whether to purchase a security, one of the primary consideration of any investors is what is the after sale service going to be like. In other words, what is the prognosis for off-loading this security in the event that there is an urgent requirement for cash. In an effective market, this is the role played by market makers and it lends fuel to the primary market.

As we indicated before, in Trinidad and Tobago the financial sector is dominated by the Commercial Banks. A network of brokers/dealers (market makers) to provide continuous markets in financial instruments does not exist. Where these entities do exist, they are quite small and their services are provided in conjunction with other financial services. In most instances market making is not their primary activity.

6. ***Summary and Conclusions: What is to be done in order to create a viable Bond Market In Trinidad and Tobago***

An examination of the Bond Market in Trinidad and Tobago suggest that the market is rudimentary and the secondary market almost non-existent. Part of the problem stems from the historical development of the capital markets and the Bank-centric nature of the financial sector.

Recommendations

1. Better transparency and information flow is needed with respect to trading and settlement. Efficient clearance and settlement systems.

2. Government can facilitate the process by issuing securities reflecting the full range of the maturity spectrum i.e. 180 days, 1 year, 3 years, 5 years, 10 years and 20 years thereby developing a credible yield curve which could be utilised in benchmarking.

3. Removal of the excessive and costly administrative procedures (SEC) and the lack of clarity with respect to the approval, registration and issuance process. More importantly, consideration should be given to the creation of a shelf-registration procedure whereby a seasoned issuer of securities is able to issue securities "off the shelf" to take advantage of market conditions.

4. Effectively encourage the establishment of market maker institutions.

5. Establishment of a Centralised Depositing (on its way already).

6. Need for a Regional Rating Agency – Independent credit rating agencies that evaluate and monitor outstanding credit risks and provide for critical information are absolutely critical as emerging markets move towards an increased level of maturity.

7. Removal or Revision of Anachronistic Regulation (VAV) National Insurance Board, Insurance Companies and Pension Funds).

8. Need to develop the Mutual Fund Market.

9. Harmonization of the Regional Stock Exchanges.

10. Removal of Withholding Tax for Foreign Investors.

11. Market Conventions (maturities, quotes, yields etc.) have to come as close as possible to international standards.

It is critical that steps be taken to broaden the composition of financial assets by institutional investors. This is particularly important in the context of the present Insurance Act and the NIS. Specifically the NIS should be allowed to invest in CARICOM Government Securities etc. etc.