

CARIBBEAN DEVELOPMENT BANK

THE ROLE OF THE SECURITIES MARKET IN
MOBILISING RESOURCES FOR THE REGION

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INTRODUCTION

Article 2.1 (g) of the Caribbean Development Bank's (CDBs) Charter empowers it to take the initiative to stimulate and encourage the development of the capital market within the Region. This role is in consonance with CDB's broad objective of regional economic cooperation. But it is one of the roles which has not been attempted, presumably because the market has not dictated the need for securities. However, because private companies often find it difficult to meet the equity component of CDB's recommended debt equity ratio, CDB will have to find or suggest alternative sources of financing. It is therefore appropriate to begin discussions on the importance of the securities market.

While the traditional commercial banks may represent important channels for savings, bank deposits generally represent immobilised funds. The banking institutions are generally subjected to a set of regulations which limit their activities in converting savings into long-term financing. The remedy lies in broadening the range of assets in which intermediaries may invest. In addition, given the current inclination for greater participation by the private sector in capital formation, alternative means of intermediation must be explored. This Paper will be concerned with the role of the securities market in that process.

1. FINANCIAL INTERMEDIATION

There is now a general agreement among academics and practitioners alike on the relationship between financial development and a country's capacity to produce an increased volume of goods and services. Arising from a study by Gurley and Shaw,* a statistical observation was made suggesting that as a country undertakes structural transformation, the rate of growth of the financial assets will exceed the growth of output or real income. Financial assets are herein defined to cover claims against financial and non-bank financial institutions. For instance, savings deposits at banks as well as equity shares in companies are both included in this definition.

If the course of financial development of a country is charted and defined by the total value of assets as a proportion of the Gross National Product, the phenomenon illustrated by Gurley and Shaw will result. In this regard, both the United States of America and Japan have had similar experiences. But in Japan, where the phenomenon was more marked the ratios of financial assets to GNP moved from 10% in 1885 to 150% in 1970s. On the other hand for many third world countries that ratio would be about 10%. This relationship has more significance than a mere statistical observation and extends to the impact that increasing financial intermediation has on economic growth. As an economy grows and becomes more complex, additional opportunities for division of labour are created. This growth would necessitate greater transactions effected through money as the medium of exchange.

*Financial Structure and Economic Development, Economic Development and Cultural Change, Vol. 15, No. 3, April 1967.

Financial development is also influenced by the division of labour or function between savers and investors. For instance, within an economy there are sectors which generate an economic surplus, generally referred to as savings. There are other sectors which borrow that surplus and invest it, and thereby expand the economy's productive capacity. The rate at which capital is accumulated will depend on the efficiency with which savings can be transformed into investments.

The growth in financial assets is further influenced by the division of labour between savings and the function of financial intermediation. In the course of inter-mediation the related institutions would provide the incentive for savings by paying a deposit rate to ultimate lenders. On the other hand a charge through interest rate is imposed on the ultimate borrowers. It is this spread between the deposit rate and lending rate which provides the compensation for the risks associated with financial intermediation. Inherent in the function of intermediaries is that of maturity transformation, wherein borrowing can be short and lending long. The ability to make this transformation stems from the aggregation of household savings and the confidence that not all lenders will seek withdrawal at the same time. Furthermore, through an ability to build a portfolio of risky investments in different firms, the intermediaries are able to offer lower-risk returns to investors.

Considerations of financial development should not be restricted to banking institutions but should also include the development of joint-stock companies and the securities market for mobilising industrial and commercial capital. Maturity transformation is also

realised in the securities market. When an investor puts money into long-term securities, liquidity is provided through the market for the sale of second-hand securities.

One common approach in the development of financial assets and institutions emphasises the demand side of financial services. It is argued that the creation of modern financial institutions, be they banks or securities market, is a supply response to the demand for financial services by investors and savers. In essence, institutions evolve in order to supply a demand which already exists. But there is another slant to the debate on the factors influencing the growth of financial services. This approach emphasises the supply-leading phenomenon, wherein financial institutions and the supply of their assets and liabilities are provided in advance of demand. In effect, financial development is encouraged and promoted as the base from which resources can be transferred from one sector to another to stimulate investment.

Over the last decade the Caribbean Region has witnessed a marked increase in scope of financial services manifested through increases in loans, the formation of new financial institutions and the implementation of economic policies specifically designed to facilitate and encourage the mobilisation of savings. The overt objectives of broadening the financial infrastructure are economic development and growth. It is generally argued that the provision of financial services would satisfy the prime pre-condition for active participation of businesses in agriculture, industry and services. But the growth in financial assets and the emerging financial institutions are expected

to provide tangible benefits through an acceleration in the rate of savings, and the economies in the rate of transmitting surpluses to investors. In addition, there is expected to be an improvement in the allocation of savings; that is, an increasing assurance that savings are directed to where the expected rate of return from them are the highest.

2. FINANCIAL INTERMEDIATION IN THE REGION

Compared to other Third World countries at similar levels of development, the Caribbean can boast of a well-diversified financial sector. The financial system currently operating in the Region is composed of central banks, commercial banks, development banks, life insurance companies, finance houses and credit unions. These institutions provide the environment wherein borrowers (primarily governments, industrial and commercial companies) are introduced to lenders (institutional and individual). In different ways they perform the function of financial intermediation wherein the differing portfolio requirements of lenders and borrowers are reconciled and thereby provide a higher level of savings and investments.

The predominant medium of financial intermediation in the Region is through commercial banks. Compared to other financial institutions, the commercial banks are well organised to mobilise resources for lending. But they have had a preference for short-term lending. The Region's high propensity to save through financial instruments has been enhanced by the almost full monetisation of the economies and the expansion in the banking institutions operating in the islands. The commercial banks remain the traditionally most important source of credit to both the public and private sectors. However, in the process of building the capital base of an economy, investments of a wide range of maturities will be required. For instance, firms will need resources for working capital to be used over a short-term period. In addition, resources will be needed over longer periods for financing

machinery and other fixed capital. Consequently, if finance within the macro-economy are to be mobilised and allocated efficiently, the transactions must be carried to maturities which allow for the fulfillment of the purposes for which the resources are demanded. Moreover, the system should allow for continuity and the flexibility to allow entry of other investors.

Another important means of intermediation and source of savings is found in the non-bank financial system, particularly pension funds and insurance companies. These agencies receive regular savings of policy-holders or subscribers but are also expected to make payments to meet pension or insurance liabilities. Generally the inflow of contributions exceed the outflow of payments, thereby providing a steady stream of funds which can be made available for investment. But these institutions are not obliged to invest in the business sector or in company securities. However, since commitments are calculable or known in advance, there is the capacity for non-bank financial intermediaries to enhance the growth of the securities market.

Essentially the securities market, of which the stock exchange is a key component, is a market where Governments, industry and commerce meet their long-term capital requirements through the issue of stocks and shares, bonds and treasury bills; and where these securities are fully tradeable among investors. At present there are three formally established stock exchanges in the English Speaking Caribbean - Barbados, Jamaica and Trinidad and Tobago. The Jamaica Stock Exchange was the first one established in 1969 followed by Trinidad and Tobago in 1970, and more recently in 1987 the Barbados Stock Exchange was

formed. The stock exchange by virtue of its capacity to mobilise resources through new issues has the potential to become an engine of economic growth. But the presence of a formal institutional arrangement does not by itself translate into increased use of the securities market as a source of finance. Investors must be able to evaluate the costs and benefits of the financial instruments.

The securities market is both primary and secondary. The primary market is one in which new securities are issued and the secondary market is one in which existing securities are traded. The existence of the secondary market enables the stock exchange to perform the vital function of financial intermediation. The securities which are traded on the stock market may be common stock, preferred stock or bonds issued by governments or corporations. The securities market in the Region is either at the embryonic or nascent state. Its role in the mobilisation of resources for capital investment, though important, is not fully appreciated and developed.

3. THE EXISTING SECURITIES MARKET

An analysis of the securities market in the Caribbean is necessarily restricted to Jamaica and Trinidad and Tobago. Both countries have had a relatively long history of securities market operation. In the case of Jamaica three types of securities are quoted on the stock market namely ordinary common/preference stocks, debenture loan stocks and Government bonds. The Government bonds though not listed are however traded over the counter, with supervision by the Central Bank.

Table 1 presents data to highlight the development of the securities market in Jamaica during the years 1978-1986. Over the period 1978-1980, the market experienced marked fluctuations both in the volume and value of shares traded in the secondary market. But it was in 1980 that the market began to impact on investors in providing resources for business expansion.

TABLE 1: VOLUME AND VALUE OF STOCKS TRADED
JAMAICA STOCK MARKET - 1978-1986

Year	Volume ('000)	Value (J\$'000)
1978	13,818	10,092
1979	4,833	2,217
1980	7,390	5,101
1981	4,196	3,332
1982	5,542	10,156
1983	5,185	9,820
1984	9,744	26,017
1985	37,571	117,146
1986	59,252	376,700

Source: Jamaica Stock Exchange.

The dramatic growth point occurred in 1984 when the volume of stocks traded almost doubled during the previous year. During 1985 and 1986, the resource mobilisation capacity of the market was successfully tested. The volume of stocks traded in 1985 and 1986 reached 37,571 units* and 59,252 units* respectively (see Table 1).

The Jamaica stock market in the 1980s could be categorised as bullish. This suggests that investors were inclined to purchase shares with the expectation of an increase in share prices and eventual resale. The growth in the securities market in the second half of the 1980s was influenced by several factors. Of prime importance is the increased confidence in the economy and the making of an environment conducive to private sector investment. In addition, that period witnessed the resumption of regular reporting on the performance of companies listed on the stock market. Companies were beginning to show growth in their profit levels and the returns accruing to shareholders were more attractive when compared to other forms of investment.

While the Jamaica stock market has performed its secondary function extremely well, the performance of the primary market has not been encouraging. At the end of 1986, the stock exchange reported share price quotations for 36 companies holding ordinary shares and 14 companies for which preference shares were issued. Twenty-three companies raised capital from the public on the stock market during 1983-1987. Of these, only three companies were new to the market; the others are existing companies which were simply adding to their old

*Each unit equals 1,000 shares

share capital. There is certainly scope for greater use of the stock market by local companies for raising capital for new business ventures or for expansion. The resultant over-subscription on new issues by Sèprod and the Jamaica Banana Producers Association in 1985 and 1986 respectively, is evidence of the under-utilisation of the securities market.

The performance of the securities market has been affected by the distortions arising from the economic difficulties affecting Jamaica. High rates of inflation and unemployment, fiscal deficits and balance of payments problems have all affected the ability of the securities market to mobilise funds. The low level of business activity which prevailed in the 1970s and early 1980s impacted on the performance of the primary securities market; consequently, other means of raising funds were developed. But other factors attributable to the prevailing corporate culture have contributed to the under-utilisation of the securities market. The corporate tax system tends to favour debt financing as opposed to equity. In addition local entrepreneurs generally do not favour opening up their operations to outside shareholders as a means of raising capital.

In Trinidad and Tobago, the main motivation for the creation of the Stock Exchange was to promote local ownership of private companies. But the growth of private share-ownership and the overall performance of the stock exchange have been slow. Following a five-fold increase in the number of transactions in 1982, there has been a continuous fall in the transactions index reaching 125 in 1987 (see Tables 2 and 3). On the other hand the securities market has taken on an added role of

facilitating official borrowing on the domestic market. Arising out of the fiscal deficit and the difficulties experienced in raising resources on the international capital market, the Government has had to access the securities market through the issuing of treasury bills and development bonds. In recent times, local companies have also used the securities market actively. But they have demonstrated a preference to raise capital through borrowings in the form of long-term bonds. For their part, investors have responded readily to issues of long-dated securities. For instance, new security issues by the Home Mortgage Bank in 1987 was increased beyond the targeted amounts so as to accommodate excess demand. Other issues have been over-subscribed.

TABLE 2: INDICES OF THE STOCK MARKET SIZE AND GROWTH - (1981=100)

Year	No. of Transactions	Average No. of Shares Per Transaction	Unit Value of Shares Traded
1981	100	100	100
1982	545	52	141
1983	490	46	116
1984	352	48	78
1985	211	72	66
1986	189	140	50
1987	125	147	34

Source: Derived from data in the Central Bank of Trinidad and Tobago Statistical Digest, various issues.

TABLE 3: CAPITAL MARKET ACTIVITY - SECONDARY MARKET TURNOVER^{1/}
1983-1987

	1983	1984	1985	1986	1987
<u>Public Company Shares</u>					
No. of Transactions	25,836	18,557	11,124	9,994	6,574
No. of Shares Sold (mn)	71.9	53.7	48.5	84.9	58.9
Market Value (\$mn)	362.2	187.0	138.5	186.0	87.6
<u>Government Bonds</u> ^{2/}					
No. of Transactions	207	176	196	134	183
Face Value (\$mn)	131.6	66.4	132.2	41.3	123.2
<u>Treasury Bills</u> ^{2/}					
No. of Transactions	23	18	12	23	43
Face Value (\$mn)	50.1	223.1	115.9	142.7	165.8

Source: Central Bank of Trinidad and Tobago; Trinidad and Tobago Stock Exchange

^{1/}Data refer to the double transactions of buying and selling.

^{2/}Trading in Government Bonds and Treasury Bills is conducted under the aegis of the Investment Division, Central Bank.

There are various factors at work which have influenced the slow growth in private shareholding. There has been no real marketing push behind the well-meaning efforts to promote wider share ownership. Moreover, stock brokers have been more attracted to the more profitable deals obtained from institutional investors notably, pension funds, insurance companies and investment trusts, rather than small private subscribers. On the other hand the small investor does not have access to information and is generally incapable of analysing the market's performance so as to make a calculated decision about buying or selling shares. Consequently, share ownership is concentrated in the hands of institutional investors.

In more recent times, the Government has acted to broaden the private sector's participation in capital formation. Emphasis is now placed on market efficiency to facilitate the raising of debt and equity capital. The 1988 Budget included the so-called "Business Expansion Incentive Scheme". Under that Scheme an individual who invests up to TT\$200,000 in shares of a new enterprise, may claim 50% of this investment as a tax relief in the calculation of his income tax. The prime purpose of the scheme is to generate increased venture capital for private companies. Potential investors will not only have good tax opportunities but the private companies will have access to the financing necessary to expand their businesses and thereby help to stimulate the economy. It is expected that the new tax measures will release more resources for savings. With increased liquidity in the financial system, additional funds will be provided for both the public and private sectors.

In the case of Barbados the Securities Exchange commenced trading in 1987. There is therefore inadequate data to meaningfully assess its performance. The primary motivation for establishing the stock exchange was to maximise the use of investible resources. High priority is being given to broadening the public's awareness on investment matters and providing information on the listed companies. At the end of December 1987, there were 13 companies listed on the exchange. For the first six months of its operation 1,517,183 shares were traded at a value of BDS\$3,546,420 mn.

The OECS Sub-Region does not at present have a formally established stock exchange. But there is evidence of private sector

inclination to own shares and government securities as part of its investment portfolio. Some of the better known public companies in the islands have been able to secure equity capital from the ranks of small investors. In addition, the initiatives by the Governments of Dominica, Montserrat and St. Lucia to privatise some of its public utility companies have met with positive response from small investors. The environment is currently right for the sub-region to grow into a 'nation of security holders' and at the same time efficiently utilise the resources available.

For most of the countries, the securities markets are either poorly developed or non-existent. Therefore private companies or government corporations wishing to expand find that the resources cannot be obtained readily due to institutional inadequacies. In the Region where the financing system is commercial-bank oriented, loan financing is preferred. There are good economic reasons why companies which require finance prefer loan capital to securities issued to the public. The argument suggests that loan financing is a cheaper alternative because it reduces the tax burden on companies whose interest payments on debt are deductible against corporation tax. Inflation is also identified as an important influence on a company's decision to access commercial bank financing. For instance, if high inflation persists, over time the real value of the amounts borrowed will diminish, thereby reducing the real rate of interest paid on loans. Thus, companies are encouraged to incur debt since the debt servicing burden reduces with inflation.

The arguments presented could of course be rebutted to emphasise a greater role for the securities market as the source of finance for business expansion. There is not clear-cut distinction between a loan and a security. But there are features peculiar to securities and not to loans, notably transferability and liquidity. Generally, securities offer a higher rate of return and a potential for resale before maturity, but there is also greater risk than bank deposits. Investors who hold securities must assume liquidity, price and credit risks. However, there are forces at work to change the balance of risk between bank deposits and securities.

Savers who have traditionally used the commercial banking system are now holding more claims in pension funds, insurance companies and mutual funds. The growth in institutionalised savings is a direct result of the tax-exempt status of the institutions. But more importantly, they are equipped to provide portfolio diversification by holding all types of securities and thereby reduce financial risks. The potential for increasing the use of the securities market derives mainly from the institutionalisation of savings, improved techniques for analysing and managing risks and strong demand for liquidity.

If a company's management is reluctant to increase capital simply for fear of losing control, then this problem can be overcome by broadening the type of securities included in the company's capital. If a wide range of securities is available on the market, then the concern of family owners of enterprises regarding control can be dealt with through the market. Companies in the Region should also begin to access the investible resources available through bond issues. But the

missing link may well be the public (investors) confidence in the companies. It is therefore necessary that the public is informed about investment opportunities.

The securities market assumes a unique function in the capital formation process of an economy. At the level of a commercial or industrial enterprise, the centre-piece of an enterprise's resources is made up of some capital for which the owners accept the risk that the firm may go bankrupt. It is really after the project sponsors have accumulated the initial risk capital that the commercial or development banks will provide the credit to complete the company's financing. But any expansion in the capital base of the company can be obtained through a new share issue or through bonds. The securities market has the added advantage that the instruments which are traded can be readily converted to cash. When a security is compared to a deposit of equal maturity, the security offers the option of resale into the secondary market.

The concern about the possible insufficiency of available own funds for financing capital expansion is aired frequently at negotiations for commercial or development bank financing. It is recognised that surplus lending units have a preference for liquidity in their investments. But if adequate and appropriate resources must be provided to industry and commerce, the surplus lending units must be stimulated and encouraged to hold the liabilities of deficit spending units for longer maturities. One means by which this is done is to move into securities and set up the institutional machinery to conduct trading. Brokers operating through institutions would facilitate the

purchase of all the securities and sell the same for any investor, when conditions appear to be changing adversely.

4. CONCLUSION

One of the Region's Politicians, Mr. Michael Manley, has advanced his concern for the creation of a regional securities market in the same way as there is a regional development bank. He argued, "... any strategy of regional integration must include the creation of institutions which facilitate the most dynamic private sector participation. In that regard the creation of a regional securities market could be a priority institution".*

The securities market provides resources for productive investments through investors who want to benefit from income earnings and capital gains in exchange for risk sharing. But if that market is to develop as the major source of capital for businesses, the process of intermediation must translate into benefits for the parties concerned namely the company, the investor (shareholder or bondholder) and the investment bank or whatever institution performs the intermediation function.

The demand for equity capital can be viewed as a derived demand similar to that of an input into production. But, there is a reservation price for equity which suggests that a business enterprise will seek equity finance if it is offered at a price less than the reservation price. On the other hand the supply of equity from investors will also have a reservation price determined by the risk and return profile of the investment portfolio, administration and

*"The Integration Movement", Caribbean Affairs, January - March, 1988, Vol. 1, No. 1.

transaction costs. It is assumed that an active market for equity capital will exist wherever the reservation price for investors plus the premium for the investment banking function is less than the reservation price of a typical business firm.

An appropriately defined institutional structure will be necessary in order to develop the securities market. But whatever institutions are established to undertake the financial intermediation function there are concerns that have to be addressed.

It is necessary to derive a new concept of Government's role in the establishment and operations of the securities market. The preferred view here is that Government should do more than just provide the machinery for regulations and control of the securities market. A development programme and a set of policies should be defined that will stimulate the market.

The long-term objective will necessarily be to provide the conditions wherein the securities market can operate competitively within itself and with other financial intermediaries. But since there is no securities market in many of the islands, and since the existing stock markets in Jamaica, Trinidad and Tobago and Barbados are still in the infant stage, a system of incentives to facilitate its development is justified. The aim is to encourage a switch from liquid savings into long-term investment. For instance, share in privatised public corporations can be offered at preferential prices to low-income earners.

It is not within the terms of this Paper to forecast changes in the taxation environment of the Region. But it would certainly be advantageous for all the participants in the securities markets if the benefits in the tax system can be passed on to the investors (shareholders and bondholders). Many of the islands still practice a system of double taxation, wherein a corporation pays income tax on corporate income but the subscribers to its equity must treat dividend as taxable income. Fiscal measures should be instituted where the double taxation feature of the corporate tax structure could be eliminated.

A household saver with only a small sum available and having no knowledge of the securities market may be reluctant to stake all of his capital into one company. But the savings of the householder, when aggregated, represent a large amount. A capital market contribution from the savings accumulating in the banking systems and the other non-bank financial intermediaries is a practical possibility. Those institutions which manage the savings of households should be stimulated to set up unit trusts, whereby a large number of marketable securities can be purchased for offering to the public. Through this medium, an investor can achieve a measure of diversification with a small outlay.

The financial instruments which are traded must provide liquidity to the investor and flexibility in financing for the firm. If these features are lacking then an illiquidity premium associated with private placements will be necessary to motivate investors who are used to the security of their savings in the banking institutions to invest

in stocks and shares. Moreover, investors will also require a secured position whereby a claim can be made on their capital prior to the firm in the event of bankruptcy.

In view of the increasing internationalisation of the securities market and the demand for capital, there should be free reciprocal access to the bond markets of countries in the Region. This will necessitate the elimination of exchange controls and thereby allow other countries to place issues on the domestic market. Any existing laws which discriminate against issues by companies in another country should be amended. But even where the restrictions to free reciprocal access to the national capital markets are removed, the conditions for securities floatation will also have to be improved. For instance, greater use can be made of techniques such as private placement of bonds. Moreover, techniques such as indexed-linked bonds, convertible bonds or 'participating' bonds, will enable issuers to benefit from increased opportunities for revenues.

Throughout the 1970s, while members of the Organisation of Petroleum Exporting Countries (OPEC) were generating huge surpluses, the international commercial banks served as conduits for resources to Third World countries. The role of financial intermediation was performed effectively to facilitate governments and corporate entities. However, in recent times that role has changed in the international financial community. The financing of companies activities has shifted from commercial banks to investment banks - through issuers and traders of securities. The emphasis is now on fee and commission income derived from placing debt equity instruments with investors. In

effect, the market is now performing a role which used to be the exclusive preserve of banks. This phenomenon, known as "securitisation", involves the repackaging of financial assets or a redirection of flows from credit intermediation into securities which can be sold readily on the capital markets.

The investors in the Region are used to the operations of the banking system and have demonstrated confidence in its operation. But there are deficiencies in the banking system in providing the required level of resources; consequently, alternative methods of finance are being sought. The debate is not whether to superimpose a securities market on the banking system but rather to define the relative importance of the securities market and maximise its contribution to resource mobilisation.

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