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Developing Local Capital Markets for Economic Development

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Capital markets, i.e. markets for publicly traded securities, are fundamental to the development of economies for several reasons. They provide governments and corporates with effective mechanisms for mobilizing long-term savings to invest in productive sectors. While a functioning capital market has obvious benefits to entities that are large enough to issue, it also addresses even the smallest capital needs.

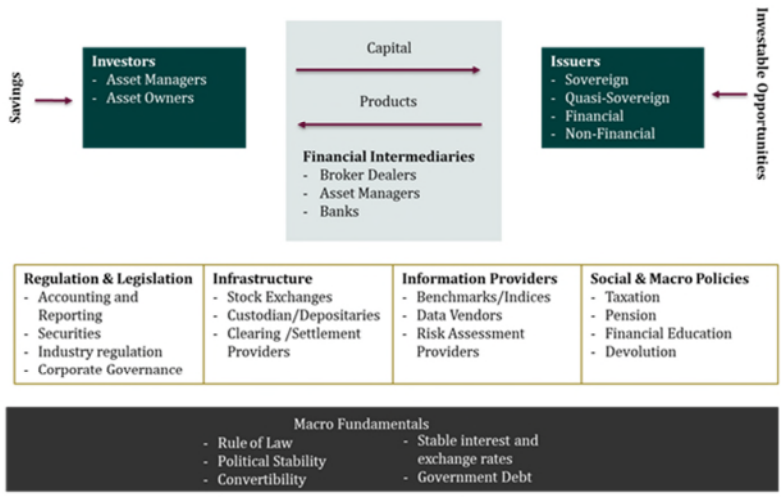
Capital markets are fundamental to economic development

The first corporate issuers in a capital market are generally financial institutions. The more efficient the market, the cheaper the rate at which financial institutions can fund themselves. And, as a result, they are also able to lend at cheaper rates. A microfinance borrower might have access to cheaper credit as a result. As the capital market develops, the microfinance institution itself might become an issuer, allowing it to access funding more cheaply. This would also render it more independent from foreign funders, as issuances can give it access to long-term capital in local currency.

Further benefits at the macroeconomic level include the fact that a working secondary sovereign bond market creates a yield curve that allows for risk-pricing across varying maturities. As such, bond markets are of particular importance to capital market development. Further, by typically providing higher returns on savings than bank deposits, countries with more developed capital markets require lower savings rates for the same level of benefits.

Capital markets are complex eco-

Bond market ecosystem



Source: LHGP

systems

A capital market is an ecosystem of numerous actors that relies on a certain environment to flourish. A strong indicator for whether a country has a functioning capital market is the size of its economy. This is because markets need a critical number of savings and investment opportunities to function. But an economy's large size is no guarantee for a functioning market if macroeconomic fundamentals, such as rule of law or a stable interest rate policy, are not implemented.

The main players in the ecosystem are issuers and investors. They can interact directly, or through intermediaries, such as mutual funds, banks or brokers. In an ecosystem, the same actor can play multiple roles: banks can act as issuers, investors and intermediaries. They might also offer infrastructure services, such as custodian or depositary services. Beyond macroeconomic fundamentals and competent actors, a capital market needs conducive regulation of the wider financial sector, including the insurance and pensions sectors, as these are important pockets for long-term investment.

Capital market intervention must be adapted to the level of market development

Given the multitude of factors influencing the ecosystem, each developing capital market is deficient in its own way, although some generalizations can be made. The most advanced developing capital markets in the top tier have large economies behind them but lack sophisticated products as regulators are often conservative, and the skill levels among financial actors is limited. Markets one tier below are based in much smaller economies. There, the bond market sees only limited issuance from non-financial institutions as there are only few institutional investors and banks buy to hold most sovereign bonds. Regulators are conservative but competent and macroeconomic fundamentals are mostly stable.

As we move further down the tiers, economies become smaller, regulators less competent, issuers – if present – are typically confined to sovereign and major financial institutions; institutional investors are negligible. Exceptionally large economies in this tier, such as Ethiopia, are held back by government policies.

Finally, there are countries marked by conflict and major political instability, which do not have any noteworthy capital market activity. Countries that do not fit into this tiering system are those that oversee small markets flushed with capital which may be derived from wealth in natural resources. In these markets, too much capital meets too little demand for investment. As a result, such capital markets are highly illiquid, as any issued bond is immediately purchased and held to maturity.

The challenge of capital market development is how to bring a market from a lower to a higher tier. The levers for this process include improving the regulatory framework and macroeconomic fundamentals, improving capacities of individual actors, increasing investable capital and investment opportunities,; and steering capital into the most productive sectors.

Dar es Salaam stock exchange, Tanzania

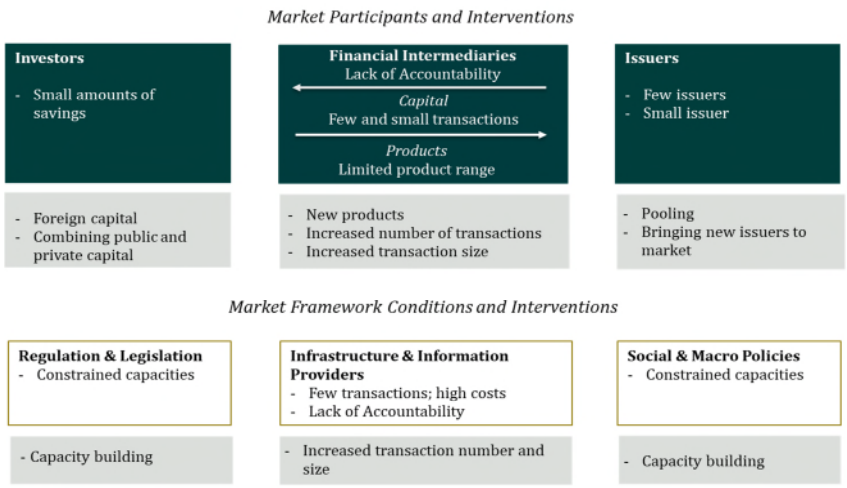
The three types of capital market interventions are capacity building, products and vehicles

Three types of interventions are available for affecting these levers: capacity building, direct investment into products, and investments into vehicles. Capacity building is typically financed by grants or through concessional loans extended to the respective governments. The two options involving actual investments largely differ in that investments into products are one-time transactions, whereas investments into vehicles are permanent structures that will close numerous transactions on the investors' behalf. This has additional benefits as highlighted in the following:

Capacity building interventions

Capacity building interventions can focus on numerous elements in the capital market ecosystem. They can be financed through grants and con-

Capital market characteristics and interventions



Source: LHGP

cessional or commercial funds. Capacity building can take the form of skill development at implementation level (e.g. though training or workshops) as well as support at the policy and structural level, i.e. strengthening of capital market regulatory framework or market infrastructure (e.g. an IDA loan can finance the procurement of trading infrastructure for a stock market).

Financial interventions mostly act by increasing investable (local and foreign) capital, diversifying investment opportunities, and steering capital into more productive sectors. In doing so, they increase the number of transactions in the market, which indirectly builds capacity among all involved actors: issuers, intermediaries, investors, regulators, advisers etc.

Since capital markets are ecosystems, developing one element can have a positive effect on others. The downside to this is that problems are generally multi-causal which makes solving a certain shortcoming with only one targeted initiative very challenging. In fact, evidence from other donors suggests that holistic interventions which include the wider financial market (i.e. not just entities involved in publicly traded securities) are the most effective ones.

Product-based interventions

When it comes to products, there are two forms of support:

(1) Products could be credit-enhanced by providing some form of a guarantee.

(2) Products could be supported through anchor investments signaling to the market that a serious investor has appetite for the asset. In essence, all capital market products are eligible given that more transactions help markets develop.

Typically, there will be a focus on a specific application of proceeds. In certain cases, this is linked to the nature of the product as is the case with green bonds or project bonds. Here, it is important that the level of market development is taken into acocunt (as e.g. project bonds are still in their infancy in markets as developed as South Africa).

Securitizations comprise a product that allows issuers to de-risk their portfolios by selling the cash flows of a certain asset to investors. They are particularly interesting as they can be tiered into different risk groups and thereby attract diverse investors in lesser developed markets. Here, an investment in a riskier tranche could facilitate the issuance of a more secure second tranche that might appeal to local or international investors.

Derivatives and debt products overall make for more interesting interventions as equity markets are generally more liquid than debt markets. Offering derivatives that protect investors from currency exposure such as cross currency swaps can considerably increase foreign investor appetite for local capital market products. Offering interest rate derivatives could support local institutions in managing their interest rate risk more effectively.

Vehicle-based interventions

One of the key features of vehicles is that they are more than one-off transactions, implying that they can build institutional knowledge and, more generally, can have a more lasting effect on the target capital markets. By providing tailored solutions to bottlenecks in specific markets and working with stakeholders, vehicles can address a wide range of impediments.

For instance, in the absence of large issuers, vehicle-based interventions such as pooled bond facilities, can bring new issuers to market. This diversifies the issuer pool and ultimately increases access to funding.

Similarly, where most issuers' credit profiles do not meet the requirements of local institutional investors, providing guarantees will increase the number of issuances and the amount of institutional capital directed towards the corporate sector. Institutions, like InfraCredit in Nigeria, that specifically target investments into infrastructure, could be supported in expanding and replicating their model in other markets.

In markets with a shallow investor base, vehicle-based interventions can further be specifically focused on facilitating access for foreign investors, like the Frontier Clearing Fund, which guarantees counterparties in domestic and international interbank transactions.

Vehicles, such as the ALCBF (see box below), help issuers to come to market locally by providing technical assistance and anchor investments. This strengthens their access to long-term local currency financing.

In markets suffering from a lack of liquidity, a fund could help to buy issuances when liquidity is low and resell when there is sufficient investor capital. This would allow them to issue even during periods of low liquidity.

Vehicles require initial up-front capital, which is typically provided through donor grants complemented by sponsor contributions. From there, vehicles require a minimum amount of equity. While vehicles offering debt products might be able to leverage their capital base, equity-focused vehicles should only be funded through equity. Vehicles can be supported in two main ways:

(1) Enabling support, which allows the vehicle to be set up. This can take the form of an anchor investment either through equity or debt, or – in the case of a guarantee vehicle – a backstop (meaning that a guarantee provider will ultimately step in if the vehicle defaults to its clients – not its investors)

(2) Facilitating investment, which means that concessional funders facilitate investment from third parties by making the exposure to the vehicle more attractive. This may take the

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ALCBF

The African Local Currency Bond (ALCB) Fund provides anchor investment and technical assistance to first-time or innovative local currency bond issuances from financial institutions and companies operating in developmental sectors in African countries. As of June 2017, the ALCB Fund had invested in 18 bond issuances across 14 companies in nine countries, including Botswana, Ghana, Kenya, Cote d'Ivoire and Zambia.

form of a guarantee for investors or the vehicle's portfolio, or the provision of subordinated capital to the vehicle. The guarantee on the portfolio can be tailored so that it is only granted to specific borrowers whom the guarantor wants to benefit most from the vehicle.

An important challenge in setting up vehicles is that they need a diversified portfolio and a critical number of deals. Since most vehicles will be focused on a specific market segment (e.g. SMEs, utilities, etc.) while frontier markets are mostly very small, vehicles likely need to invest on a multi-country, regional scale. Taking this aspect into account along with the fact that equity is the fundamental building block of these vehicles, the most pertinent sources of funding for these vehicles are regional concessional funding programs.

Selecting the right intervention

In order to select the right form of intervention, it is important to bear in mind some lessons from existing funding programs. A key lesson is that intervention must cater to the level of development in a market – international best practice in risk management might be too complex to handle for banks with rudimentary risk management. Interventions focused on listing SMEs on stock exchanges have largely failed as there were not enough potential candidates and the benefits of the listing were limited. Capacity building is most successful when it is provided in a holistic way that includes the wider financial market.

Although individual donors might struggle to provide meaningful support in sovereign bond markets due to their large size, assisting these markets should not be dismissed altogether.

The reason is that many countries will graduate from IDA in the next five years, meaning that they will lose access to its concessional funding and increasingly rely on capital markets to finance themselves. IDA funding often corresponds to more than 20% of the local bond market. If countries need to replace this debt with local financing, it is highly likely that the local investor base will not be able to absorb this without considerable rate increases, which might make the debt burden unsustainable. Similar effects have caused reversals back into IDA programs for Zimbabwe, Nigeria, Cote d'Ivoire, Democratic Republic of the Congo, and Cameroon.

In particular, sectors that were previously funded by donors (e.g. health) might see their budgets cut if alternative sources of debt are not exploited. Thus, facilitating access to debt in the local and international markets will be an important form of development support.

This is only one example in which developing capital markets plays a fundamental role in the mobilization of private capital to achieve the Sustainable Development Goals (SDGs).

About the author

Alexander Maletz is an Executive Director at Lion's Head Global Partners (LHGP) specialising in emerging and frontier capital markets.
LHGP is an investment and advisory firm based in London, Nairobi and Lagos focusing on frontier markets globally and providing independent financial advice to governments, parastatals, corporates and development institutions.
LHGP is the fund manager of the ALCBF.

Photos

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