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CAPITAL MARKETS IN LATIN AMERICA: TRENDS, PROSPECTS AND POLICY RECOMENDATIONS

Latin America has experienced both resurgence and significant development of institutional investors, such as private pension funds, insurance companies and investment funds. However, in the majority of countries, the securities market has remained stagnant and the corporative bonds market has not as yet a sizable presence, while public bonds show a relatively improved development. Even though an important part of these trends is due to structural reforms carried out in Latin America, this statement centers in identifying those among them which react to efficient market response and those which are due to imperfections, distortions and/or regulatory restrictions which curb efficient market operation. With regard to the latter, the statement presents recommendations as to the policy measures which, in the opinion of the Latin American Shadow Financial Regulatory Committee [LASFRC], should be adopted in order to improve the operation of capital markets in the region.

1. Why are Capital Markets so important?

The critical challenge to Latin America is to achieve a sustained process of economic development. Provided that macro and micro policies be the appropriate ones, the role of efficient capital markets constitutes a suitable means of easing the process towards savings and investment. Capital markets contribute to output growth as well as to the improvement of economy efficiency by complementing, but not substituting, the role of banks.

Experience shows -- and various recent empirical papers confirm it – that financial development improves capital productivity in divers ways: 1] it supports projects with a higher rate of return; 2] output scale, technology and optimal funding structures are attained thereby; 3] it renders possible the creation of new enterprises through "risk capital"; 4] it improves the financial integrity of companies listed in domestic and foreign markets due to the fact that they have to comply with standards regarding accounting practices, domestic controls, transparency and dissemination of financial data; 5] it gives rise to new approaches to risk management and distribution; 6] it furthers propagation of the growing share of individuals in capital ownership

2 What should be the target of economic policy regarding Capital Market Development?

This section identifies LASFRC approach to the fundamental criteria regulating economic policy with respect to capital markets.

LASFRC considers that the objective of economic policy concerning capital markets, should be based in maximizing the well-being of final agents participating therein [issuers and investors] and not necessarily in that of financial intermediaries *"per se"*. In other words even though there be in every country agents requiring funding and others with investment needs, this should not perforce be tantamount to proliferation of financial intermediaries at local level providing the whole gamut of financial services. It is the view of LASFRC that policy actions should be aimed at facilitating financial transactions of issuers and investors in terms that prove advantageous to both. Also in the opinion of LASFRC -- depending on the special characteristics of each country, including its relative size -- this objective does not necessarily imply that all financial services should originate within the domestic sector. As is the case in non-financial markets, it is possible that the final economic agent be served best if some financial services are "imported".

3. Capital Markets in Latin America: Where are we?

During the last decade, Latin America underwent important development in local capital markets. LASFRC has identified seven recent trends:

The first trend is that, although financial markets in Latin America still consist mainly of banking systems, the region has witnessed the important development of institutional investors, such as private pension funds, insurance companies and investment funds. In the vast majority of cases, this development has been in response to implementation of structural reforms, in particular the transformation of social security systems into individual capitalization regimes. The new private pension funds, which have long-term liabilities, have contributed significantly to the generation of a growing domestic demand for assets with long-term maturity structures and this in turn has given rise to previously non-existent funding sources. During the last decade, Latin America has experienced important developments in domestic capital markets. The Committee has identified seven recent trends.

Consistent with the upsurge of a new source of long-term assets demand, the second trend which characterizes recent events in the region, is the development of a normative and regulatory legal framework for institutions which is essential for the purpose of strengthening and developing the availability of negotiable instruments in domestic capital markets, such as shares and corporative bonds.

The third trend that has accompanied this evolution refers to the fact that the privatizations process observed in the region has attracted new actors to the market, particularly foreigners, with a significant potential for making tradable financial assets available.

In spite of these efforts, however, the development of stock and bond markets has been very uneven, and this constitutes the fourth trend. For example, in most of the countries, the number of companies listed on the local stock exchange has remained stagnated and the corporative bond market has not developed a significant presence[1].

[1] In most countries in the region only banks issue private bonds.

Moreover, the fifth trend is that a growing number of companies has found funding through international capital markets, more attractive. The transfer of bonds and shares listing [ADRs] to international stock exchanges and securities markets has reflected, without doubt, the increased regional integration with international markets. This responds to a strong competition for diminishing costs, taking advantage of the benefits of technological progress and the convenience for companies in the region of having a presence in world financial markets.

The sixth trend is the growing government funding though bond issues, both in local and in foreign currency. In fact, although the private bond market has not developed significantly, government bond issue has increased in most countries.

This development, combined with limitations as to portfolio composition of institutional investors, has brought about the seventh and last trend characterized by the fact that many actors demand financial assets, particularly, pension funds which continue to include a large percentage of government liabilities in their portfolios. In particular, Argentina, Colombia, Costa Rica, Mexico and Uruguay carry over 50%.

Recognition of these trends has made LASFRC wonder which components of those developments respond to efficient market response, which to structural reforms and which among them are the upshot of imperfections, distortions or regulatory tightening limiting the development of local capital markets.

4. Markets vs. Regulation: What Explanation is there for Recent Trends?

Some of the recent trends in regional capital markets as identified in section III, are due to structural reforms carried out in Latin America [trends one through three]. LASFRC considers that the remaining trends respond to efficient market response or to imperfections, distortions and/or regulatory tightening which hinder correct market operation. In particular, it is the opinion of the Committee that the trends referring to the private share and bond markets [trends four and five] reflect, in general, a more efficient allotment of resources, while those corresponding to a significant increase in government bonds and to the high percentage of such assets in private pension funds [trends six and seven] are the end-product of regulatory distortions and economic policy errors.

<u>Recent trends regarding private securities reflect efficient market responses.</u>

LASFRC is of the opinion that the recent trend in many companies within the region, to issue securities abroad and make use of financial services offered globally, implies the utilization of scale economies which obviously offer better terms to final economic agents in the market. Obviously there are functions in which the utilization of scale economies play a fundamental role when determining service costs. A typical example is custodian services. In a market internationalization process, access to custodian services provided by global entities such as CEDEL, EUROCLEAR, DTC, generates commission costs which are usually far lower than those within the purview of even the most efficient local custodian services, which typically cater to far lower operational volumes.

Seen from this angle, the decision of many companies to obtain funds through ADRs instead of listing in domestic stock exchanges which have higher transaction costs than those of the international option, could well be an optimal development, beyond regulatory alterations but rather responding to the characteristics of the market itself, such as the presence of scale economies. Due to the fact that LASFRC has not examined in detail the characteristics of individual countries, the Committee is unable to derive final conclusions determining in which country local stock exchanges would be most appropriate and those in which it would be preferable to develop regional stock exchanges or resort to the use of global markets for securities Nonetheless, the Committee recommends that individual characteristics of countries and markets be considered by the relevant authorities *prior* to the implementation of policy measures promoting local securities markets.

<u>Trends concerning the excessive stock of government bonds held by local pension funds reflect policy errors and regulatory distortions.</u>

Transition from a distributive system to one involving capitalization generates a significant deterioration of fiscal accounts insofar as contributions, formerly allotted to the distributive system and hence to the treasury, are allotted to private pension funds, while the Government is left with the load corresponding to the former beneficiaries of the system. Additional fiscal funding needs that stem from this reform have, in the vast majority of cases, been dealt with through public bonds placed with the recently created private pension funds, oftentimes inducing this process through regulatory requirements.

Consequent thereto pension funds in Latin America have invested a substantive part of their portfolios in public bonds. As has been already mentioned, with the exception of Chile and Peru, in the rest of the countries which reformed their pension systems, public bonds represent over 50% of the assets portfolio in pension funds..

In many cases this means public bonds with a risk rating below “investment grade”. This implies that pension funds, in some Latin American countries, have invested large amounts in public bonds the repayment whereof is not guaranteed.

The possibility of a stumbling block is not merely theoretical, as shown recently by the cases of Argentina and Uruguay. In point of fact, when Argentina ceased having spontaneous access to capital markets in 2001, the government coercively modified conditions for debt securities in the hands of pension funds: it modified the maturities profile, changed dollar denominations to pesos at an arbitrary rate of exchange and established below-market interest rates for the new securities. Naturally these measures resulted in considerable loss of value to the pension funds portfolios.

In the opinion of this Committee this disquieting trend may well compromise confidence in pension funds and abort the incipient development of one of the main actors in regional capital markets. Consequently the Committee recommends:

a) Intensification of the fiscal effort particularly during the transition period from a distributive system to a capitalization structure.

b) The requirement that pension funds, when investing in public sector bonds [Central Government, Central Bank, public enterprises] do so in bonds that have equal or better rating that those with the lowest rating among eligible instruments and to set a ceiling to pension fund exposure to public bonds..

c) Diversification of pension fund investment, by prudentially enabling an investment percentage abroad that be non-speculative in nature

5. Other Regulatory Topics and Suggestions as to Future Analysis

The Committee has concentrated on a few important topics concerning capital markets in the region. There is however, one topic that must needs be mentioned, and that is the one concerning quality of regulation and supervision of markets.

In Latin America the vast majority of countries has a specialized agency per institute they oversee [banks, securities and insurance, pension funds] which is in charge of regulation and supervision of the financial system. This model, even though it has the benefit of specialization and lower costs, does run the risk of inconsistency among the various agencies involved in the overall set of regulatory standards. This may entail a very serious problem: “regulatory arbitrage”, as has recently been the case in Jamaica and in Chile. Additionally, when regulation and supervision are decentralized, the effort required to coordinate regulators generally delays capital market development.

Even though the manner to be adopted by regulation and supervision depends on market size, availability of specialized financial and human resources and manner in which the capital market is organized [i.e. on the basis of “financial supermarkets” or as a “holding” and affiliates], the Committee recommends that, as a minimum, there should be adequate coordination at the upper echelons, homogeneity in prudential norms and data requirements as well as efforts to consolidate supervision.

Additionally, the Committee recommends that the terms of reference of supervisors be modernized and adapted to the development of new capital markets in order to possibilitate the efficient application of a set of regulations which, though formally appropriate in many cases, have been of little help in preventing or solving problems and have, furthermore, failed in the attempt to minimize the occurrence of frauds in the financial sector. In this respect the Committee recommends that the juridical vulnerability to which are exposed regulatory authorities in certain jurisdictions be reduced.

Other topics that the Committee deems necessary to examine more closely are set forth below:

The as-yet-insufficient quality of standards regarding “corporative government”. This has meant that due to insufficient transparency, homogeneity and frequency of information concerning companies, individual savings through the purchase of shares and/or bonds is discouraged. Additionally, the insufficient protection of the rights of minority shareholders has the same effect. In particular, the Committee suggests analysis in greater dept of the consequences of the legislation regarding the “Public Offerings for Acquisition of Stocks” [Oferta Pública de Adquisición de Acciones -- OPA]

One of the problems to be found in the majority of capital markets in the region is the relative lack of liquidity of most long-term financial instruments. This is due, partly, to the fact that the “natural” holders of these securities [pension funds and insurance companies] generally hold them in their portfolio with a “forward” view, thus reducing transactions. Additionally, tax and regulatory elements have tended to diminish the incentive for operating with financial documents.

Part of the weakness in developing capital markets in Latin America is consequent to the inadequate and slow administration of justice regarding economic issues in general and financial elements in particular. Reforms and modernization in this sector would be of help in facilitating the use of new products, as well as in the development of new institutions and innovations that characterize financial markets.

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