Developing Capital Markets in Emerging Economies

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Carlos Serrano
Vice-President for Regulatory Policy
National Banking and Securities Commission
Discussion points

1. Increase in Financial Savings: Challenges
2. Supply vs. Demand Factors
3. Developing Corporate Bond Markets.
4. Looking ahead.
Emerging markets have shown an important increase in financial savings in the last decade.

This increase has occurred mainly due to: macroeconomic stability, demographic transitions, and pension reform.

This higher poll of savings creates, of course, important opportunities, but also presents challenges for securities regulators due to:

- “Retailization” of complex products
- Possible asset-price inflation in domestic instruments
This increase in financial savings can create incentives to sell complex financial products to retail investors.

Therefore, a key challenge – for both the industry and regulators – is to develop effective conduct of business practices.

These practices have to be based on the “know-your-client”, “know-your-product” and “suitability”.

Regulations also need to prevent possible conflicts of interest.

A key challenge for regulators in emerging markets is to supervise the way in which structures notes designed globally are sold to their retail investors. This is of particular importance as new regulations are changing business models of global banks.
On the other hand, if these increased financial savings are not matched by an equivalent increase in the supply of domestic financial assets, the result can be domestic asset-price inflation.

To avoid this, emerging markets have to:

- Foster the supply of domestic assets
- Design a flexible investment regime that allows domestic investors to acquire foreign financial assets.
When designing policies aimed at developing capital markets in emerging economies, it is fundamental to analyze whether the factors that impede such development are from the supply or the demand side.

Possible demand factors in emerging economies are:

- Low investor base, due to previous episodes of macroeconomic instability
- Low levels of liquidity
- Bad enforcement of contracts
- Insufficient demand from institutional investors due to low penetration of insurance, mutual fund and pension industries
- Over restricted investment regimes
- Low float levels that prevent entry from minority investors
Possible supply factors in emerging economies are:

- Low levels of competition in some segments of the economy
- “Family-type” structure in an important percentage of firms; original shareholders unwilling to lose control
- High transaction costs of issuing equity and debt instruments, in part due to underdeveloped investment banking industries
- Crowding-out by government debt
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Policy measures to promote corporate bond markets that have proven effective:

- Foster the development of non-public markets. This will eventually help to develop deeper public markets (India, Malaysia, Thailand)
- Introduce an independent analyst program (Malaysia)
- Promote development of market-makers
- Level-playing field vs. government debt from a tax perspective
- Of course, it is fundamental for governments to develop a benchmark yield curve by placing their own debt instruments in several different tenors
- On the other hand, attention must be paid in order to avoid a crowding-out scenario.
• Policy measures to promote corporate bond markets that have proven effective (cont):

✓ High levels of liquidity are needed to attract foreign investors to domestic corporate debt markets. In many EMs, foreign investors invest almost exclusively in government debt since it is much more liquid.

✓ In order to achieve this, regulations should be promoted to enhance pre and post trade transparency, regardless of trading venue (formal exchanges, electronic trading platforms, or OTC). In this sense, trade repositories should be required by regulations.

✓ Also, it is important for investors to have adequate hedging instruments. In this regard, markets for CDS instruments should be facilitated as they do not exist in most EM economies.
Policy measures to promote corporate bond markets that have proven effective (cont):

- Improved transparency is key in EMs. Better, and more timely disclosure by issuers (both corporate and trusts) will attract a larger investor base.

- Adequate clearing and settlement systems.

- An adequate corporate bankruptcy Law in lacking in many Emerging Markets. Investors need to have absolute clarity regarding their status in case of bankruptcy.
In order to attract a larger investor base, developing regional financial centers can be the answer.

Horizontal integration of capital markets can make sense because of economies of scale.

Integration does not necessarily mean a structure with a single market infrastructure. Systems with interconnected exchanges in which broker-dealers have access to trading screens in other markets are also a possibility.

Attention must be paid since the development of regional financial centers can result in lower trading activities for instruments that remain un purely domestic markets.