Promoting Integrated Caribbean Capital Markets – Role of Credit Ratings

ABSTRACT

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A vibrant and well functioning Caribbean capital market is necessary to reap real economic benefits and optimal allocation of scare capital resources. Over reliance on bank based systems lead to severe shortcomings including the inefficient allocation of capital. A well developed domestic bond market is of paramount importance in providing the diversification needed especially during crises as was seen recently in the Jamaican market. Issues such as government policy, exchange regime, reforms and deregulation, bankruptcy laws, disclosure and related regulations continue to hamper operations. This paper focuses on aspects of the information and disclosure practices, the current status compared to international best practices and some recommendations to overcome the current problems.

Some of the key initiatives necessary for promoting an integrated Caribbean capital market are improved transparency and disclosure standards, proper corporate governance standards, reduced dependence on bank based lending and a systematic development of the short term debt market especially asset backed securities given the growth in mortgages and other consumer credit.

In addition to the above initiatives, infrastructural and regulatory frameworks are of paramount importance for the smooth functioning of the markets. The two areas of strong growth in the Caribbean region are pension & insurance funds and mutual funds, as such, there is an urgent need for improved regulation of these segments to be on par with international practices. Due to its growing importance there is need for regional harmonization of a regulatory framework with emphasis on the valuation of bonds and mutual funds portfolios and disclosure practices of mutual funds.

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A. BACKGROUND

The capital market is the market for long-term loans and equity capital and it includes the bond and equity markets. Debt and equity are the primary means used by firms to finance their operations or investments. While equity markets provide companies with risk capital, bond markets support the capital structure of firms by providing debt funds. Compare this with the money markets which deal with short-term funds like government treasury bills and credit union shares, etc. The main players in the capital market are the issuers, the large institutional investors like the National Insurance Board, insurance companies, pension funds, trust funds, the Stock Exchange, the Unit Trust Corporation and venture capital companies. We may also want to include the supporting players – brokers, traders, investment bankers, etc.

Well-functioning capital markets are an important part of any modern economy and as such, its economic benefits cannot be over-stated. It could be argued that the slow development of capital markets in the Caribbean has had an important effect on the pace of economic development in the region. Empirical evidence suggests that countries with developed capital markets tend to have higher levels of capital formation, grow more quickly, provide better financial services to all segments of their populations, and enjoy greater prospects for long-term financial and economic stability. Bond issuers, investors, intermediaries and regulatory authorities all stand to benefit from an effective and efficient capital market.

B. INTRODUCTION

In the Caribbean context, where capital is relatively scarce and must be allocated efficiently to derive optimal economic benefits, the need for efficient markets is paramount. Not that the various market participants are unaware of the imperatives. Top bureaucrats, investment bankers, institutional investors, even small stockbrokers and retail investors acknowledge the benefit of a vibrant and well-functioning capital market. Yet, sadly even years after capital markets commenced operations in many Caribbean countries, we still find ourselves struggling with many issues hindering development of such efficient, deep and thriving markets. The issues that haunt our markets are not insurmountable. What is needed is a determined effort by regulators and market participants to resolve the issues through productive dialogue.

The issues that affect market development are diverse – ranging from government's fiscal and monetary policies (major factors impacting development of government bond market that provides the key benchmark for corporate bond market and also impacts equity markets), exchange rate regime (as it impacts the bond yields and risk premium demanded by foreign investors), financial sector reforms and deregulation, bankruptcy laws, taxation and stamp duty laws, market infrastructure for transaction and settlement and lastly information superstructure, disclosure practices and related regulations. It is also important that the market grow in an orderly fashion and with appropriate checks and balances in place to avoid systemic failures and the huge associated costs. Therefore, adopting an appropriate regulatory framework is essential to safeguard investors' interest and ensure a smooth functioning of the market.

In this paper we focus on some aspects related to the information and disclosure practices and a few regulatory issues that can help develop vibrant capital markets. We will evaluate the current status on these parameters in relation to the international best practices, how these issues affect capital market development and what can be done to overcome these problems.

C. IMPERATIVES FOR CAPITAL MARKET DEVELOPMENT

1. Improving transparency and disclosure standards – the backbone of financial markets

By their nature modern capital markets are prone to the risks arising out of information asymmetry. As the investor base is spread thin and wide, and each investor accounts for only a small percentage of the total capital raised by an issuer, the bargaining power of each individual investor and the resources and time available to investigate beyond public domain information is limited. Therefore, high standards of transparency and disclosure are the cornerstone of any strong, thriving market.

In most Caribbean markets, unfortunately, the level of disclosure is well below international standards. For example, the situation is almost appalling when it comes to the domestic private placement market for bonds. The "information memorandum" barely contains anything more than the terms of the issue and a very brief write-up, if any, on the issuer entity. What is surprising is that the same issuers open up their books and provide far more detailed information, comparable to any standard international bond offering, when it comes to foreign borrowing. Even public borrowing programs for government-owned entities, typically provide a 2-4 page offer document, falling well short of international standards.

In a globalized economy, where potential investors have a wide array of options available, we cannot hope to attract new investors and widen the market unless we take a quantum leap in our disclosure standards.

Information on some of the key parameters that international investors take for granted but is not made readily available to local investors include:

- The business and regulatory environment affecting the issuer entity
- A comprehensive write-up on the company's operations and recent developments
- Detailed financial performance
- Details about current outstanding debt obligations and maturity profile

Admittedly, 'private placement' markets are less regulated in almost all countries, since only 'Qualified Institutional Buyers' (QIBs), which are expected to be savvy investors with adequate expertise and resources, are allowed to participate in these markets. However, typical information available for even a private placement issue in other markets is significantly more that the mere 'term sheets' that investors get in our markets. Moreover, the definition of QIB and what constitutes 'private placement' is not uniform across countries.

It is critical that regional regulators work together to harmonize the definitions and regulations in this area, as the private placement market has seen rapid growth and now accounts for a large portion of money raised in the domestic markets.

Another relevant point that must be borne in mind while evaluating the transparency and adequacy of information is that most issues in the local market do not carry a credit rating. Ratings provide a great deal of information compressed in simple symbols and also a detailed rationale for assigning the rating. Increasing use of ratings and improving the disclosure standards through appropriate regulation is an absolute must for development of a healthy capital market. Absence of such information hinders many potential investors from entering the market. Moreover this also affects scientific risk-based pricing of debt issuances. Inadequate penetration of ratings, which are globally accepted tools for pricing, has resulted in certain anomalies. Each of the five clusters in the table below throws up some kind of anomaly or another.

For instance, a Government of Trinidad and Tobago 15 year bond issued in September 2004 with a coupon rate of 6.1% that compares with an Airports Authority of Trinidad and Tobago (AATT) 15 year bond issued in January 2005 with a coupon rate of 5.75% should raise some questions. And this occurred in a period when interest rates were on the rise! Another case in point is the almost 8% spread in the 2003 bond issues of KFC and the AATT. Such a wide differential is difficult to comprehend even assuming that AATT's debt was guaranteed by the government. A careful review of the data for Trinidad and Tobago reveals that the coupon rate for bonds registered by the TTSEC during 1997-2003 varied from 5.45% to 12.25% with a median interest rate of 9.90%. Surely, investors value these debt based on their estimates of various parameters, credit quality being just one of them. However, in the absence of ratings the market loses the ability to have a consistent and reliable benchmark to understand whether investors are appropriately compensated for the risk carried.

Trinidad and Tobago
Capital Market Activity
/Selected Issues/

Borrower	Date of Issue	Currency	Tenure	Coupon
Guardian Holdings Ltd	Dec-03	TT$	5	6.30% Fixed
Govt. of Jamaica	Oct-03	TT$	5	8.00% Fixed
T&T Airports Authority	Jul-03	TT$	5	5.45% Fixed
KFC	Jun-03	TT$	5	13.00% Fixed
Govt. of St. Lucia	Mar-03	US$	10	7.75% Fixed
Setar N.V. of Aruba	Mar-o3	US$	10	7.00% Fixed
Govt. of St. Kitts/Nevis	Mar-03	US$	10	7.50% Fixed
Trinidad Cement Ltd.	Aug-04	TT$	10	9.81% Fixed
Govt. of T&T	Aug-04	TT$	15	6.15% Fixed
Govt. of T&T	Sep-04	TT$	15	6.10% Fixed
T&T Airports Authority	Jan-05	TT$	15	5.75% Fixed

Source: Annual Economic Survey, Central Bank of Trinidad and Tobago.

To ensure that Caribbean countries move towards a common integrated market that will derive benefits of scale and diversification, the regulators and market participants must take on this challenge in a well-coordinated manner. Regulators must lay down a clear roadmap for achieving significant improvement in information disclosure by establishing minimum standards or benchmarks and moving forward to meet international best practices.

2. Corporate governance for listed companies

Blatant governance failures in many large North American and European companies in the last few years have brought the focus sharply on the issue of corporate governance and transparency in the capital markets across the globe. Adopting best global governance practices and upping the disclosure and transparency levels are critical for improving investor confidence and developing capital markets. Improving regulations in this area, particularly the application of 'corporate governance ratings,' can go a long way towards the development of healthy and vibrant capital markets.

3. Reducing dependence on bank-based lending systems and encouraging banks to participate in capital markets

Disclosure-shy businesses, controlled by groups with complex holding structure (features that dominate the corporate landscape in the region), typically favour bank-based lending. However, such bank-dominated systems pose a challenge to the development of capital markets. At the same time, it is well known that over reliance on bank funding has severe shortcomings including inefficient allocation of capital. Well-developed capital markets, especially bond markets, provide the necessary diversification from traditional bank based lending. Lack of such diversification of funding sources proves especially crucial during crises as was amply evident in the Asian crises in the late 1990s. Even closer to home, it has been observed how fairly developed domestic bond markets in Jamaica helped the government to raise funds domestically and thus stave off a potential foreign exchange payment problem. This domestic funding option was not available to the Dominican Republic in its recent crisis. The Dominican Republic, whose external public debt to GDP was 22% (total debt to GDP was 50% which is considered moderate), was forced to default due to its lack of access to a vibrant domestic capital market. On the other hand, Jamaica, whose external debt was in fact much higher at 75% (total debt to GDP was 136%) was able to avoid default due to a vibrant domestic capital market, from which the government raised monies to meet maturing debt obligations, both local currency and foreign currency. It is precisely because of this flexibility which a healthy domestic bond market gives to a government, that such a factor can improve its sovereign foreign currency credit rating.

As bond markets develop, however, banks themselves become major participants by acting as both issuer and investor in debt paper. One of the ways to create liquidity and allow banks to churn the loans they hold through the capital market route is to encourage securitization. Developing a broad market for asset-backed securities (or securitized paper) also has other numerous benefits – ranging from better risk management, higher efficiency in lending businesses, flexibility in structuring paper to meet investor demand and managing capital more effectively. However, such markets can be developed only if the markets and underlying product features and documentation practices for the underlying assets themselves are well developed. Underlying assets in an asset-backed paper can essentially consist of two types of securities – retails loans (such as mortgages, auto loans, credit card receivables or other consumer financing) or corporate obligations (in the form of corporate bonds or loans). A cursory glance at the bank loan books of many Caribbean banks has shown healthy growth, especially retail asset such as mortgages and other consumer credits.

These retail loans are well suited for securitization. Banks also benefit if the securitization markets is developed as otherwise Asset Liability Management (ALM) issues - since most funding for banks is relatively short term – put a natural restriction in terms of the percentage of their balance sheet which can be deployed in long-term assets such as mortgages.

Clarity in regulatory framework governing issues such as "true sale" or "bankruptcy remoteness", taxation and accounting is necessary to encourage market participants to use these advanced financial tools. It is worthwhile to note that many countries, such as India, have enacted separate laws governing securitization to catalyze the growth of this market. Regulators in Caribbean countries should work closely on this issue to come up with a broad common framework that can help promote the development of the securitization market.

Credit ratings can also play an important role in developing the asset-backed securities market. Given the unique nature of asset-backed securities, investors in most markets – developed and emerging - use ratings as a primary tool for risk assessment. With CariCRIS, the Caribbean's regional rating agency, investors should now exercise the option of demanding ratings for such issues.

4. Systematic development of short-term debt market

Short-term debt markets (often referred to as money markets) are an important element of overall capital markets. A well-developed money market provides liquidity, is an important tool for transmitting monetary policy decisions and also offers corporates an alternative to bank finance for meeting short-term borrowing needs. While T-bills typically constitute the largest segment of money markets, corporate papers [in the form of Commercial Paper (CP) or Certificate of Deposits (CD)] are important elements of any well-developed short-term debt market. In most Caribbean countries the CP/CD market is underdeveloped or non-existent. In the case of Trinidad and Tobago, for example, of the 186 securities registered with the TTSEC between the period 1997-2003, only 9 were Commercial Paper issues valued at TT $1.5 billion. The situation is not very different in the other countries.

Value of Debt Issues Registered by the TTSEC[1]
1997-2003

Type of Issue	Number of Issues	Value (TT$Mn)
Bonds	107	26,322.3
Commercial Papers	9	1,513.6
Credit/Debt Derivatives	70	25,184.4
Total	**186**	**53,020.3**

Source: T&T Securities and Exchange Commission

An appropriate regulatory framework can support the orderly development of CP/CD market which offers healthy competition for bank financing and improves the overall efficiency of the debt markets. Experience of countries like India shows that the disintermediation offered by the CP market reduced the cost of bank borrowing, at least for top-tier corporates.

However, by their nature, investors in short-term debt markets have very limited appetite for credit risk and are highly 'confidence-sensitive' (i.e. timeliness and reliability of meeting debt obligation is critical). As a result, these markets are typically best suited only for issuers with high credit quality. In many developing markets access to CP/CD market is regulated and only entities with high ratings (on short-term scale) are allowed to tap this market.

[1] The TTSEC only registers public securities placements and placements by registered issuers. Under the existing legislation private issues by registered issuers do not require registration by the TTSEC.

D. SAFEGUARDING MARKETS AND SMALL INVESTORS

While the above mentioned initiatives can play a role in the development of capital markets, it is equally important that appropriate infrastructure and regulatory frameworks are put in place to ensure the smooth functioning of these markets. Any major turmoil or disruption can shake investor confidence and it takes a long time and substantial cost to restore the shaken confidence. We would like to highlight two areas which we believe are in need of urgent attention.

(i) Pension & insurance funds

In the last few years many Caribbean countries have witnessed strong growth in assets managed by insurance companies and private sector pension funds.

The strong growth experienced by these long-term institutional investors is clearly a key positive for local capital market development since they are major investors in debt markets. However, if such markets are not quickly developed the funds can chase assets without adequate risk analysis or may be forced to look outside the region to find suitable investments. The experience of some of the Latin American countries such as Chile, Mexico, and Brazil shows that in the absence of adequate local investment avenues the regulators were forced to increase the investment holding limits for overseas investments for pension funds. This would imply that the long-term capital which the region really needs flows out of the region.

It must also be borne in mind that these institutional investors have a fiduciary duty as they manage significant amount of public funds and have obligations to a large number of individuals. The potential systemic cost of failure of any such large institution can be significant. This is exacerbated in our region in the absence of any meaningful social safety net in most Caribbean countries. Therefore, ensuring healthy investment portfolios for such institutional investors is absolutely critical from a regulators point of view. It is worth noting that in many markets these institutions are tightly controlled. The investment portfolio of these institutions is one of the key areas regulators seek to control by prescribing prudential investment guidelines. For debt portfolios, these guidelines normally relate to the proportion of unrated/below-investment grade paper that can be held. With the rapid growth experienced by these institutions the risk is significant and real enough to warrant urgent attention from regulators.

(ii) Mutual Funds

Mutual Funds (MF) have increasingly become a preferred investment avenue in many Caribbean markets. For example, in Trinidad and Tobago the MF asset base is now over TT$25 billion and has surpassed total banking sector deposits. Since mutual funds are key participants in bond and equity market, such growth will be a key positive for developing capital markets.

However, here again we believe that the MF industry is under-regulated and the practices followed fall well short of international standards. Many Caribbean countries do not have a full-fledged separate regulation governing MFs. We believe that MFs have now reached a critical mass warranting a separate regulation governing all the key aspects. While the Trinidad and Tobago SEC is currently in the process of undertaking a comprehensive survey and formulating guidelines for governing MFs, it will be fruitful if there is a coordinated effort at the regional level to ensure harmonization of the regulatory frameworks. Some of the areas that need regulatory attention are:

a. Valuation of bonds and mutual fund portfolio

Given the highly illiquid secondary debt market in the region, Funds are forced to value debt based on their estimates of various parameters, including credit quality. In the absence of ratings the valuation is based on subjective assessment by the individual Fund. This can potentially lead to significant differences in valuation across Funds and therefore the NAV (Net Asset Value) calculation and returns provided to investors in the Funds. This poses significant risk, especially in case of any large-scale redemptions, if the valuations are not in line with realistic market value. Therefore, regulators must act before investors actually go through the pain. One of the ways to achieve this is to require rating/independent valuation portfolio. This would go a long way towards addressing this concern as well as providing improved transparency in the market.

b. Disclosure practices of Mutual Fund

Disclosure practices and transparency are other areas that deserve regulatory attention in the MF industry. For investors to make meaningful evaluation of investment options, Funds should adopt standardized approaches and methodologies in areas such as NAV calculation and performance presentation. Further, the frequency and quality of portfolio disclosure should be such as to allow investors to arrive at an informed opinion about likely future performance and risks. Current disclosure practices vary across Funds and leave significant room for improvement. Better disclosures will facilitate the standardization of the market and will also allow the development of independent rating/ranking products. Such products are widely used in most markets that boast a well-developed MF industry. While regulations may not, or even should not, attempt to address each and every issue, broad guidelines covering the important aspects can be extremely useful as a starting point. Encouraging the formation of a Self Regulatory Body (SRB) can help address many issues where detailed regulatory prescription may not be practical or advisable. In many markets such industry SRBs have played an effective role in improving the standards of conduct of all the industry players.

E. CONCLUSION

CariCRIS is of the view that development of integrated vibrant Caribbean capital markets is a key imperative that needs urgent attention of every regulator and market participant in the region. The need to act and do whatever is needed to achieve this goal has never been more pressing. Improving economic conditions in many Caribbean countries, favorable investment climate and rising private sector savings as evident from booming mutual fund/pension fund industry shows that conditions are ripe to reap the real benefits afforded by efficient capital markets. By channeling the capital resources optimally to deliver best economic returns,

capital markets can help us to leverage the resources available and propel Caribbean economies to a next level of sustainable growth.

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