

Role of Securities and Investments in Developing the Local Financial Services Sector

Permit me to begin with a clear unambiguous point.

I submit to you that there is a direct correlation between the level of development of a country's financial system and in particular the securities market within that financial system and overall economic development.

I have said it before many times over that the realization of Vision 2020 will not be truly possible unless and until we also have a developed and robust securities market that is able to mobilize investment capital to fund long term business objectives and by extension economic growth.

If the target for a developed securities market is 2020 then time is running out on us very quickly indeed. Neither the stock market nor the bond market is at the stage where you can conclude that the size of the market, the level of depth and for that matter the level of sophistication is progressing at an appropriate pace.

I ask you to pause for a minute and reflect on China. It is the largest country on earth in terms of population, cities that took more than a century to develop in places like the United States are being conceived and created in China in less than 10 years. It has now surpassed Germany as the second largest economy in the world and is the engine of growth as the world lumbers out of recession.

China has all of this going for it and yet it is still referred to as an emerging market.

Part of the reason China is an emerging market relates to the fact that it's financial system in general and its securities market in particular is still underdeveloped and such development is a prerequisite to being ranked amongst the developed world.

You may scoff at this perspective arguing that because of its size China will eventually be able to do what it wants with or without a developed securities market. To those who may hold that view consider the financial meltdown in the US in September 2008. Systemic banking failures have occurred in many countries around the world at varying times. In around 6 – 9 months after a major financial collapse

the US banks were able to raise capital (both debt and equity) and are now in the process of repaying the bailout provided by the US taxpayer.

Without a properly developed securities market a country is unlikely to recover as quickly and more importantly will be unlikely to raise foreign capital with any degree of consistency.

That is why developing the securities market is so critical to us here in Trinidad and Tobago.

You see Ladies and Gentlemen a properly developed financial sector needs to have both a well developed banking sector as well as a well developed securities market. Both sectors allow for the mobilization of capital. Bank capital comes in the form of savers and capital in the securities market comes in the form of investment.

There are times when a bank based financial system is more appropriate than a securities based financial system and vice versa. Yet these comparatives are relevant only on a sector by sector or company by company basis. From the perspective of the overall economy both systems are an absolute necessity and let me submit that right now in Trinidad and Tobago

we are too far skewed along the lines of a bank based financial system and this has created significant challenges related to the mobilization of investment capital that is so far hindering our development.

Let me explain.

Banks typically form very close relationships with its borrowers. It is part of the process of lending. In an environment where there is information asymmetry about a project, for example not wanting to disclose information to a wider audience for competitive reasons, bank financing is the most appropriate vehicle.

However if you are dealing with standard borrowings of a size that covers the fixed cost of raising capital then it is better from the perspective of economic development and a more robust allocation of capital to tap the securities market for such financing. In fact in a properly functioning financial system capital raised via the securities market tends to be cheaper than bank financing so there is also an intrinsic benefit to the recipients of capital.

The securities market better facilitates the financing of innovation and innovation leads to increases in productivity, which in turn translates into economic

growth and with that comes a level of economic prosperity. Two examples make this point clear. During the Industrial Revolution in the 1800s the UK securities market was able to allocate capital towards innovation much more efficiently than in other countries eventually resulting in the UK leading the Industrial Revolution and then becoming the global power at the turn of the nineteenth century.

The ability to access capital via the securities market by the technology sector in the US from 1980 onwards may have spawned the Internet bubble but it also facilitated the tremendous growth in productivity that has taken place over the past 30 years. I suggest that were the US technology sector completely reliant on bank financing instead of looking at US corporations such as IBM, HP, Cisco, Microsoft, Google and Facebook we may be looking to some other country for the technology solutions of today.

A couple years ago the Government of Trinidad and Tobago identified 6 sectors for development with the aim of diversifying the local economic away from oil and gas. Many of these are in the service sector so there is a direct relevance to today's forum. However to date these sectors and so many others are stuck because they are almost totally reliant on Government funding for support. They are not yet at

the stage where they can attract bank financing and do not have access to the necessary levels of equity capital. In addition even where the equity capital may exist, presumably in the form of venture capital, the absence of a properly developed and functioning securities market means that the exit strategy for the initial providers of equity capital is at best tenuous and so the entire process hardly gets off the ground.

The securities market also has a critical role to play in terms of establishing how a company should be managed. If you think about it any company accessing the securities market has to explain its decisions to the investor community. Those interactions provide management with feedback on the quality of the decisions that are being taken and overall leads to a better-managed company. A group of better-managed companies results in a better-managed and stronger economy.

In terms of the structure of the economy appreciate that these interactions help to mitigate systemic risks and the development and interaction between bank capital (money provided by savers in the form of deposits) and investment capital (which is mobilized through the stock and bond markets) provides a cushion in times of stress.

If you have a problem in the banking system the securities markets can be relied upon to fund the system as was the case in the US recently. If there is a problem with companies listed in the securities market in terms of accessing capital then bank capital can provide a stop gap measure until the market finds it feet again.

Riding on two wheels instead of trying to balance on one is clearly the way forward.

We do have a fairly robust banking system but the securities market is lagging too far behind. If we continue in this direction then we run the risk of accentuating a systemic imbalance that is already posing challenges to our economic development.

Permit me to ask this question aloud – Would there have been less risk of the CLICO and the CL Financial debacle if the company was listed on the Trinidad and Tobago Stock Exchange and were under the scrutiny of analysts and the investing public.

I submit to you that while there are no guarantees the present scenario need not have occurred. For one thing accounts for the subsidiary and the Parent could not have been filed in July and December for the years prior as took place in 2008 without some form

of sanction. They would have had to be filed and available to investors within 90 days. That in itself creates a more rigorous and robust financial reporting system which can only aid management in making better, timely and more relevant business decisions. Regular interaction with the market would have ensured a level of accountability beyond that of the financial regulators thus in effect creating two layers of scrutiny and as I indicated earlier the investing public would have been in a position to judge management decision making quite possibly leading to better decisions by management.

In the interest of market development it may be useful to consider the following proposal. It is my view that all entities that accept funds from the public, be they banks, insurance companies or investment companies that are above a certain threshold in terms of size be mandated to list their shares on the Trinidad and Tobago Stock Exchange.

The reasons should be clear based on the points outlined above.

Ladies and gentlemen the financial services sector is all about the mobilization of capital. A properly functioning securities market allows companies and the State to access investment capital and this is fairly

well understood even if it is not as yet well implemented.

What also needs to be understood and appreciated is that beyond the allocation of capital from areas of surplus to areas of deficit the capital markets has a role to play in the creation of wealth.

When an investment is made it is effectively an exchange of current purchasing power today with the expectation that you will be reimbursed with greater purchasing power in the future. The difference between the two amounts is your investment return.

However in Trinidad and Tobago this process is dysfunctional and has been so for some time. Investors are being asked to sacrifice current purchasing power today and place money into stocks, bonds and mutual funds. However inflation is such that the returns on these investments does not allow for a greater degree of purchasing power in the future.

This state of affairs cannot continue and investors are more and more voting with their feet by seeking investment opportunities outside of the country thus creating pressures on our foreign exchange reserves.

The final point I want to make relates to the interaction of the primary and secondary securities market. We have often focused on attracting new bond and equity listings and this is commendable but we do so without a clear recognition that a good primary market depends on the credibility, attractiveness and efficiency of the secondary market.

It is through the negotiations that take place in the secondary market that proper price discovery for the efficient pricing of primary issues takes place. In addition an owner of a financial asset will need to be satisfied that he can convert this asset into cash. If there are questions over ones ability to convert financial assets to cash, a process referred to as liquidity, then a market becomes less attractive.

I have often said that the absence of liquidity in the securities market is the most pressing issue that we need to face in the development of the local financial services sector. I contend that were we to address this issue in a meaningful way then some of the other issues will solve themselves.

If we are unable to address the liquidity factor then we will continue to be heavily skewed along the lines of bank financing and I have already warned of the systemic risks that such a path will carry.

Ladies and gentlemen I hope I have provided sufficient food for thought and I now conclude my presentation on the role of investments in developing the local financial services sector.

Thank You.