CENTRAL BANK OF
TRINIDAD & TOBAGO

Eric Williams Plaza, Independence Square, Port-of-Spain, Trinidad, West Indies
Postal Address: P.O. Box 1250
Telephone: (868) 625-4835; 4921; 5028; Fax (868) 627-4696; Telex: 22532; 22386
E-Mail Address: info@central-bank.org.tt
Website: www.central-bank.org.tt

"UNDERSTANDING CAPITAL MARKETS"

ADDRESS

at

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by

Ewart S. Williams
Governor, Central Bank of Trinidad and Tobago

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I would like to focus my remarks on the challenges facing the capital market of Trinidad and Tobago.

It is not easy to precisely define a country's capital markets. Let me take the easy way out and make the distinction between **money markets**, which are those arrangements that deal with short-term funds like commercial bank deposits, government treasury bill markets, credit unions shares and so on, and define our **capital market** as those institutions and arrangements that deal with longer-term instruments such as bonds, equities and mutual funds.

The main players in the capital market are the insurance companies, merchant banks, the National Insurance Board, the Stock Exchange, venture capital companies, and mutual fund management companies, securities companies and the supporting casts – bookers, traders, investment advisors, etc.

The main benefits of capital markets are:

(i) they support the mobilisation of domestic savings by providing investors with alternatives for investment and risk diversification;

(ii) they permit companies and governments to raise long-term resources at a lower cost;

(iii) they promote efficiency and competitiveness in the financial system; and

(iv) they create an avenue for the population to participate in the corporate sector and share in its wealth through the ownership of securities.

I should also note that over the last two decades or so, successive governments have taken important steps to reform the financial sector and develop the local capital market in Trinidad and Tobago. These have included, for instance:

(i) the establishment of the Trinidad and Tobago Stock Exchange and the Trinidad and Tobago Unit Trust Corporation in the early 1980's. Both these were seen as mechanisms for enhancing the flow of long-term savings and for facilitating the widening of the shareholder community.

(ii) In the 1990's, as part of a structural reform programme, we liberalised interest rates and removed restrictions on current and capital foreign currency transactions. We also upgraded the regulatory and supervisory framework, unfortunately, largely for the banking system through amendments to the Financial Institutions Act.

(iii) In 1994, we removed the special incentives applicable to the Unit Trust and opened up the mutual fund industry to other players.

(iv) In 1995, the Securities and Exchange Commission was established to provide some measure of regulatory oversight for the securities industry.

(v) More recently, in 2001, in the context of our privatisation programme, we saw the incorporation of the National Enterprise Limited (NEL) as a vehicle for divesting the shares of state enterprises.

While these initial reforms have been very important, they have not been sufficient to produce a capital market that makes a substantial contribution to **economic diversification**, which, in the final analysis, is critical for sustained economic growth.

Even after these **first generation reforms**, we now have a capital market that is **relatively fragmented, very thin** (in terms of the number of firms and investors) and with a limited range of securities. In addition to implications for resource mobilisation, the lack of development of our capital market **increases the vulnerability of our banking system which is now the predominant source of financing in our economy**.

In the U.S., the banking system accounts for 20 percent of total financial sector claims. In Trinidad and Tobago, **banks account for about 60 percent of total financial** system claims, and when one considers the concentration within the banking sector, the risk from this **excessive leveraging** becomes even higher.

The various segments of our capital market have evolved at markedly varied rates over the past two decades. For example, there have been considerable advances in respect of **collective investment schemes** (the mutual fund industry); we have made important strides as regard **the development of our debt markets.** However, by and large there has been limited progress in respect of our equity markets.

I would like to discuss these in turn.

First, the mutual funds market.

In 1997, there were five registered mutual funds with $3 billion under management. **As at the end of 2003**, there were some 60 funds with more than $20 billion under management. Also, while in 1997 the mutual funds market was almost exclusively equity-based, the market now includes equity funds, debt funds, money market funds, real property funds and various hybrids. Mutual funds have now become a major savings vehicle in Trinidad and Tobago. In fact, in the last two or three years, the growth in mutual funds exceeded that of bank deposits by a wide margin.

Unfortunately, the growth of the mutual fund industry has not been accompanied by a corresponding evolution in the regulatory structure governing the industry. Given the volume of funds involved, this has become an urgent priority.

As I said, there has also been a **significant expansion in our debt markets – not for corporate debt but for public debt**. Over the last five years or so, there have been close to **200 bond issues** registered by the Trinidad and Tobago Securities and Exchange Commission. The local quasi-government sector has accounted for about 36 percent, central government issues 18 percent, and regional governments and corporations 40 percent. The local private sector has accounted for less than 10 percent of the bond issues listed.

The government bond market is currently not transparently structured, as a limited number of institutions are allowed to bid for these instruments. The primary market is basically an underwriters' market where the underwriting institutions have a (soft) commitment to take a minimum of 75 percent of the issue, which most of the time is already pre-sold to institutional investors.

The bond market has spawned a number of **derivative-type products** – specifically, strips, certificates of participation and certificates of interest. These stripped securities can be sold separately to **different investors to match their needs for duration and maturity**. In this way high duration investors can buy the longer maturity zero coupon bonds, while short term investors can buy the short end of the strip. On the surface, stripping represents an attempt at establishing a structured yield curve. However, the stripping process does not involve a transparent pricing mechanism.

As suggested by the data, over the past five years, Trinidad and Tobago has been a major source of debt financing for regional governments and corporations which have raised some US$1.1 billion through foreign currency bond placements. These placements have been at maturities ranging up to 30 years, with most ranging between 10 and 20 years.

As I said earlier, **the least advance has been made in the equity segment of the market**. Here, while market capitalisation has increased substantially and the market has registered a rate of return exceeding that of mature markets (this has been the case for almost all emerging markets), **the institutional characteristics of the market, as well as the trading patterns, have changed little over the last two decades**.

Currently, there are **35 listed companies** on the stock exchange, the same number as obtained twenty years ago. While in more developed markets, derivatives of debt, equity and real property securities are becoming an increasingly larger share of market transactions, **in Trinidad and Tobago ordinary shares and a small volume of preference shares are the only securities traded.**

Between 1997 and 2003, of a total of $2.7 billion raised through the stock market, only about $650 million was raised through IPO's; the balance represented Rights Issues (i.e. to existing shareholders of the company). Thus there has been limited correlation between the issuance of new equity capital and the formation of new business enterprises.

Several factors have been advanced to explain the continued weaknesses and the lack of development in our local equity market. These include:

(i) the bias in the fiscal system towards debt as opposed to equity financing;

(ii) a reluctance by private companies to dilute control and to disclose sensitive information to outsiders;

(iii) an individual investor population that is risk averse and lacks confidence in the market;

(iv) an archaic share settlement system, based on the physical delivery of share certificate, which involves a protracted time period for the transfer of ownership;

(v) a lack of confidence in the mechanism of share price determination of the Stock Exchange. This would seem to be perhaps the major problem.

A recent survey suggests that a **majority of market actors feel that insider trading and price manipulation are very** prevalent on the stock exchange. There is a general feeling that insider trading may be linked to the small size of the market and the prevalence of interlocking directorships of firms in the market.

The market participants felt that the two most non-transparent aspects of the pricing mechanism were (i) the rule whereby a share price is allowed to move without trading activity, and (ii) the prevalence of "off-the-floor transactions".

"Off-the-floor" transactions in listed equities are permitted in most Caribbean jurisdictions. In order to discourage these transactions, there is a 5% stamp duty in Trinidad and Tobago, a 7½ percent tax in Jamaica and (I think) an 18 percent tax in Barbados. These transactions are permissible but their very existence adds to the perception of non-transparency of the market.

To the best of my knowledge, the practice whereby the prices of securities can change in the absence of trades is unique to our market. Obviously, under this system the index may not be a true reflection of activity in the market.

What steps are being taken to address these issues and spur the development of the market?

Firstly, **to improve the operation of our debt market**, the Central Bank and the Ministry of Finance are working on the development of a structured, efficient, liquid market in government securities. This is to be achieved through replacing the current underwriting mechanism by a market auction system involving an expanded list of participants who would need to be prepared to make a secondary market in government securities.

The restructured government securities market would facilitate the construction of a **yield curve** and provide benchmarks for the wider bond market. A market-determined yield curve would introduce greater transparency in the current system of bond stripping mentioned earlier.

Secondly, in January 2003, the Trinidad and Tobago Stock Exchange implemented the first phase of its development programme, with the establishment of the **Central Securities Depository**. This system enables securities currently traded on the exchange to be cleared and settled without the necessity of the physical delivery of certificates. **Change in beneficial ownership is made via electronic book entry**. The exchange is working to introduce an **automated trading system** before the end of the year. Once introduced, this system, along with the central depository system, will constitute a new securities trading, clearing and settlement platform. This new system will rely on a set of rules to automatically match orders entering the system from trading workstations resident on the trading floor or from a brokerage house. **The rules will allow more efficient price discovery and trade execution and will also keep the public informed as to activity in and the price of transactions in the market place**. The rules will also be designed to protect against manipulation and other improper trading practices. Under this new system also, the pricing anomaly to which we referred – the movement of prices without trades – will be removed.

We are in the process of **enhancing the regulatory framework** for the capital market through amendments to existing legislation. The new legislation, which is expected to be presented to Parliament before the end of the year will, inter alia:

(i) introduce international standards for disclosure (the plan will be to move to quarterly reporting for listed companies instead of semi-annual reporting as currently exists). **Incidentally both Jamaica and Barbados already have quarterly reporting**;

(ii) improve corporate governance; and

(iii) increase taxes on off-the-floor transactions.

The new legislation would also give the SEC additional and enhanced powers to prevent unsafe and unsound practices in the conduct of the securities market, to conduct routine on-site inspection and off-site monitoring of securities companies and investment businesses, to supervise collective investment schemes and those acting as arrangers and sales agents, and to detect, investigate and enforce the provisions of the SIA in respect of market abuses in the shares of public companies.

The regionalisation of the stock exchange has been advanced as one way of addressing the smallness and illiquidity of national stock exchanges. This could present major challenges because of differences in legal systems, foreign exchange restrictions in some countries, and differences in accounting and reporting standards. In the meanwhile, efforts need to be made to increase the number of cross-listings (we currently have three such) and to integrate the individual country trading platforms.

Risk assessment, like liquidity, is a critical element of capital market development. As you know, the **Caribbean Regional Credit Rating Agency** is about to be established. This would address an important shortcoming and provide a common benchmark to evaluate the credit quality of issuers.

The examples of several developing and emerging market countries in Latin America and the Caribbean underscore the serious challenges faced by countries now trying to develop their capital markets. Globalization and the advent of the internet technology have increased this difficulty since investors can easily have access to the mature capital markets via the internet. We in Trinidad and Tobago face unique challenges because of the pronounced dual structure of our economy in which the large energy sector companies are able to raise funds from abroad and have little access to our domestic markets, while small- and medium-sized start-up companies, which are expected to generate new employment, are unable to obtain financing on appropriate terms.

While these difficulties are real, the new legislation and, in particular, the enforcement of the provisions contained therein would go a long way to address the major issue of low market confidence and contribute to the further development of capital market development.