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ON FINANCING FOR DEVELOPMENT

## Issue Brief Series

# Developing domestic capital markets

International Finance Corporation (World Bank Group)

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## **Introduction**

Domestic capital markets have an important role to play in mobilizing private capital to finance domestic development. By giving companies the ability to borrow domestically in local currencies, domestic capital markets can also reduce currency mismatches for borrowers, thus reducing systemic risks. At the same time, government bond markets create tools to manage macroeconomic and fiscal risk and provide important pricing benchmarks. However, the Addis Agenda also emphasizes that capital markets can increase risks in the real economy, for example, due to market herding and boom and bust cycles. The Addis Agenda stresses the importance of regulations aimed at reducing volatility and incentivizing longer term investment.

Domestic capital markets are a vital source of stable, sustainable finance and underpin a private sector associated with employment and economic growth. Yet capital markets are underdeveloped across the emerging market world, leading to illiquidity, elevated transaction costs, and other inefficiencies. Development banks can help foster stronger capital markets through local bond issuances, partial credit guarantees, anchor investments, risk sharing and securitization assistance.

## **Stocktaking**

The underdeveloped state of capital markets in many emerging market countries significantly reduces liquidity—the ability to quickly and easily buy and sell assets at stable prices—and elevates transaction costs. These inefficiencies limit price discovery and hamper investors' ability to diversify risk. Consequently, these economies struggle to allocate capital efficiently and channel funds to investments with the highest return to capital. Domestic firms pay a premium for capital, reducing investment, growth, and job creation, while foreign investors are deterred by higher costs and greater risk.

Deep and efficient domestic capital markets can address these issues while simultaneously helping to mitigate the impact of capital-flow volatility, reduce a country's reliance on foreign debt, and increase its resilience to economic and banking system crises. Developed capital markets also allow local institutional investors such as pension funds and insurance companies to access long-term investment sources other than government debt and cash deposits. In addition, they improve the quality and resilience of financial intermediation in an economy, particularly in economies with weak banking systems, and address infrastructure deficits and bottlenecks by mobilizing local currency funds in terms that better mirror infrastructure project cash flows compared to shorter-term traditional bank loans.

Despite the manifold benefits of robust capital markets, emerging market economies often struggle to develop them organically. Enter development finance institutions (DFIs), which can employ an array of methods, most notably domestic bond issuances, to assist development. Such interventions, however, can only be considered successful if the following developments follow:

- **Increased market liquidity:** Liquidity entails a diverse array of market actors who are able to quickly and easily buy and sell assets at stable prices. This creates efficiency and transparency through price discovery and risk mitigation, as investors in liquid markets can sell assets in secondary markets instead of holding them to maturity. Issuances in emerging markets help broaden the investor base, a pre-requisite for improved liquidity.
- **Diversification:** Stable local capital markets efficiently allocate capital from a broad and diverse pool of sources to an equally diverse set of investments. This allocation results from a matching of savings and investment whose maturities range from short to long term. Capital markets also involve both foreign and domestic investors, national and international markets.
- **Longer tenors:** Access to long-term finance is critical to firm success, particularly with infrastructure projects. Expanding a firm's capacity and future potential often requires long-term financing that can spread costs over the life of the investment or project, keeping debt burdens manageable and lowering the cost of the final good or service. Accurate pricing of longer tenors relies on the improved transparency that deeper capital markets provide via mechanisms such as extending benchmark yield curves.
- **Subsequent issuers:** The number and diversity of subsequent issuers is a critical measure of the impact and sustainability of a development bank's intervention. Successful interventions reduce information gaps and demonstrate the feasibility of new issues.

These developments also complement and reinforce the strengthening of market institutions. Developing a bond issuance requires significant technical assistance and cooperation between DFIs and local government bodies to establish an appropriate regulatory and institutional framework. The combined effort focuses on macroeconomic stability, a sound banking system, regulatory changes that enhance market discipline and competition and, of course, an institutional framework that promulgates rule of law, contract enforcement, and transparency.

There exist an array of mechanisms that can spur private sector development through stronger domestic capital markets. Different instruments approach this large, intricate issue in various ways, with the overall goals of reducing uncertainty, lowering borrowing costs, and stimulating growth.

#### **Examples:**

**RISK-SHARING AND SECURITIZATION** Allowing banks that originate assets to sell them into capital markets or to receive protection against losses on their portfolios enhances the credit rating of pools of assets and facilitates financial intermediation. Those activities also free up capital that lenders can use to extend additional credit to borrowers. Yet a lack of historical loss experience often introduces significant risk, making such transactions difficult. Development

finance institutions can facilitate these transactions by sharing the risk involved in the venture as well as supporting securitization through advisory work and investment. Securitization permits firms to access financing at potentially longer tenors and lower rates through the bundling of assets with predictable revenue streams, such as mortgages, into marketable securities. Those securities are divided into risk classes in order to provide different investors with risk/reward trade-offs consistent with their investing goals. IFC worked with South African Home Loans Ltd. to establish the first mortgage-backed securitization in the country, which will not only expand affordable housing stock but will also promote the entire housing finance sector.

**BOND ISSUANCES** Corporate bond issuances are an important marker of maturing domestic capital markets. Yet prospective investors, both domestic and international, face significant information asymmetries in emerging markets with small, shallow capital markets. In turn, actors and institutions in these settings have limited information about external actors such as institutional investors. Strengthening local capital markets through issuances addresses these problems by diversifying risk and reducing information asymmetries. DFIs work in an advisory capacity to support such issuances and may also provide anchor investments: IFC and DEG (German Investment Corporation) did so to support Bayport's corporate bond issuance in Zambia. A DFI committing to a portion of an issuance lends the development bank's imprimatur to the issuer, reducing execution uncertainty and boosting investor confidence.

**PARTIAL CREDIT GUARANTEES** Guarantees help clients obtain funding they might not otherwise have access to, typically covering up to 50 percent of an outstanding bond or loan and lowering the risk profile of the guaranteed instrument. In Mexico, IFC's guarantee promoted affordable housing by opening capital market financing to the homebuilder Vinte. Guarantees facilitate bond issuances, improve placement outcomes, and attract a more diverse investor base, all of which increase bond market activity and spur local capital market development.

Annex

Figure: Issuing Bonds in Local Markets – IFC Domestic Capital Market Development

