Development Centre Studies

Capital Markets in the Dominican Republic

TAPPING THE POTENTIAL FOR DEVELOPMENT

OECD DEVELOPMENT CENTRE

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Foreword

Financial and capital markets play a key role in financing economic activities, leading to higher growth and economic development.

This study can be considered as a white paper that provides an assessment of the current structure of the capital market in the Dominican Republic and offers recommendations for the sustainable development of this market.

This report was drawn up at the request of the government of the Dominican Republic and was funded by the Superintendency of Securities of the Dominican Republic. It falls within the framework of the OECD Development Centre's ongoing work on Latin America and the Caribbean and the analysis of financial markets in emerging economies and forms part of the Development Centre's efforts to identify obstacles and define strategies for the development of its member countries.

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As part of this project, the workshop "Deepening the Dominican Republic Capital Market" was held in November 2011 with key public and private stakeholders from the Dominican capital market. This workshop was attended by officials from the Central Bank, the Ministry of Economy, Planning and Development, the Ministry of Finance, the Superintendency of Securities and the Superintendency of Pensions. From the private sector, the workshop was attended by executives of the Stock Exchange, the major issuers, financial intermediaries and financial associations involved in the capital market. Comments and discussions from the workshop and subsequent bilateral meetings on the chapters of this report were key inputs.

In particular, the OECD Development Centre received the invaluable support of the Superintendency of Securities of the Dominican Republic, whose contributions were vital to the success of this research. The comments and discussions with the Superintendent of Securities, Guarocuya Félix, were indispensable in the drawing up of the report. A second key contribution was made by the quantitative and qualitative data provided and numerous discussions with members of the Prospective and Strategic Planning Department, especially with Carmen Sancho, Rosaura Quiñones and Juan Ernesto Jiménez. Finally, the officials of the Superintendency of Securities are thanked for their comments in the various stages of the preparation of the report.

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Preface

The recent international financial crisis has underscored the need for sound supervision and regulation of the financial system and the capital market. A suitable institutional and regulatory framework make it possible to distribute resources effectively for the development of an economy. As in other Latin American and Caribbean countries, the depth of the financial markets in the Dominican Republic remains low. The aim of this report is to identify measures for achieving an efficient and proper management of the capital market in this country.

To determine the challenges of providing suitable access to capital markets, this report focuses on three aspects. First, it describes the policies implemented after the financial crisis of 2003-04 in the Dominican Republic. Second, it examines the interaction between the key public and private actors of the financial markets. Third, it emphasises the importance of suitable public policies for supporting the development prospects of these markets. With regard to these policies, this report focuses on the management of public debt and the regulation and supervision of the financial markets.

The report emphasises co-ordination failures of public policies that prevent a higher capital market penetration. First, monetary and fiscal policies should be better co-ordinated at a time of vulnerability in the balance of payments. Second, public debt management should be properly co-ordinated between the Central Bank and the Ministry of Finance. Third, an institutional framework should be established with the aim of increasing co-ordination between the various supervisors of the financial markets. Finally, the operational framework of the capital market requires greater coherence to facilitate the development of its infrastructure.

Mario Pezzini
Director
OECD Development Centre
July 2012

Executive summary

This report examines the overall situation of financial markets in the Dominican Republic and offers recommendations for achieving greater depth and improving the institutional framework of the capital market. A healthy capital market is crucial for the development and sustainability of the economy. Factors such as an organised issuance of public debt and a yield curve facilitate long-term financing and risk management for economic players. Furthermore, the sustainable development of a corporate bond market reduces companies' financing costs. It also allows the banking sector to specialise in debtors with higher information asymmetries.

The Dominican Republic has made considerable progress in the development of public and private debt markets. As a member of the International Organization of Securities Commissions (IOSCO), the Superintendency of Securities currently applies international standards to foster an organised market. Recent years have seen improvements in the institutional framework of the public debt market, particularly in 2006 with the creation of the General Directorate of Public Credit (Dirección General de Crédito Público) within the Ministry of Finance. This directorate uses a trading platform that allows for formal and transparent auctions of bonds issued by the Ministry of Finance. Recently, domestic debt securities issued by the Central Bank have been dematerialised and submitted to an auction process. The corporate bond market in the Dominican Republic shows efficient levels of dematerialisation, accounting convergence and risk assessment at time of issue in comparison with other emerging economies. The number of issuers with outstanding securities rose from 3 in 2005 to 20 in 2011. Meanwhile, pension funds, the country's main institutional investor, have seen their assets grow substantially from 1.0% of gross domestic product (GDP) in 2003 to over 6.0% of GDP in 2010.

However, the channels and the amount of financing of the Dominican economy are low in relation to the country's income level, and rank below

the economies of both the region and the OECD. This is explained by the low level of banking penetration (commercial credit accounts for less than 15% of GDP) and the low development of the capital market. The private debt market represents less than 1.5% of GDP versus 10% of GDP in the main Latin American countries. Furthermore, there is no stock market in the Dominican Republic.

Unlike most emerging economies and OECD countries, the Dominican Republic has two public debt issuers. The Central Bank, the largest domestic issuer, is involved in the securities market primarily for monetary purposes and the Ministry of Finance issues securities as part of its fiscal policy. These different objectives of issuance and the lack of co-ordination between the two issuers have led to an inadequate structure of yields and maturities for public debt. For issues with the same maturity, differentials of over 400 basis points are observed in the yields. These shortcomings in public debt management have resulted in high yields and the absence of a risk-free benchmark curve. These factors negatively affect the private debt market, the stimulus provided by institutional investors in the real sector and the possible creation of an equity market.

While the private bond market has made progress and exhibits sustained growth, it is still limited and sluggish in terms of concentration, maturity, indexation of the interest rate and currency denomination. The primary market has a complex issuing process and is subject to failures in co-ordination and information exchange between the different superintendencies, particularly when private issuers desire to tap institutional investors. In these cases, issuance approval often takes three months or more, nearly triple the average in Ibero-America. The secondary market has low liquidity and price-formation difficulties due to the inefficiency of key components in the market infrastructure, such as the trading platform and the clearing, settlement and information systems.

Pension funds have concentrated their investment in public debt securities, especially those of the Central Bank, which are attractive because of their risk-return ratio. For example, for the period 2008-11, while the return on special investment certificates from the Central Bank (20% per year) was twice that of corporate bonds, their volatility was only half. As a result, pension fund administrators have kept their investment in Central Bank securities at the allowable limit, which gradually increased from 35% of the portfolio in 2008 to 50% in 2011. In contrast, investment in debt issued by the real sector represents only 5% of the pension-fund portfolios.

The key recommendation for a development of the capital market is to improve the management of the primary public debt market:

- In the short term, greater co-ordination is needed between the Central Bank and the Ministry of Finance in their issuing processes and debt should be managed by a single issuer. One fundamental goal of this co-ordination is to build a risk-free benchmark curve.
- In the long term, as is the case in most of the region's economies and the OECD, the Ministry of Finance should be the sole issuer of government bonds.

Additional strategies need to be implemented for sustainable growth of the capital market. Specifically, this would require:

- In macroeconomic terms, better management of the risks inherent in the balance of payments, by implementing counter-cyclical instruments for commodity prices.
- In the financial system, deeper and broader access to credit, especially for small and medium-sized enterprises. Furthermore, it is necessary to continue including supervisory and regulatory measures for a sustainable development of the banking system, such as counter-cyclical regulation for provisions. Finally, the risks inherent in the financial system must be further studied and analysed. In that context, it would be advisable for the Central Bank to prepare a financial stability report covering the aforementioned issues.
- Better communication and effective co-ordination between the Superintendencies of Banks, Insurance, Pensions and Securities in order to streamline and simplify the issuance approval process and to avoid potential overlaps and even conflicts between different regulations. It would be advisable to establish a co-ordinating committee comprising independent experts and regulators.
- Improved functioning of the primary and secondary private debt market. It is crucial to reduce the approval time for an issuance, to standardise the required documentation and to simplify the investment process for institutional investors. A centralised system for information, deposits, clearing and payments should be developed. Finally, market regulation and discipline should impose drastic penalties on free-of-payment transactions and should encourage trading through markets with electronic price formation.
- The development of comprehensive financial literacy programmes aimed at both unbanked individuals and investors who are unfamiliar with non-traditional instruments.

- In the expansion of markets, the involvement of a greater number of institutional investors, such as closed-end investment funds and mutual funds, and an increase in the variety of investment vehicles available. It is advisable to continue the international co-operation with other countries to foster synergies, with emphasis on improving supervisory and regulatory standards.

Chapter 1

The state and general framework of the financial markets

Abstract

Sustainable capital market development fosters economic growth. The Dominican Republic has undertaken macroeconomic, financial system and capital market reforms that have been favourable to the economic stability. Nevertheless, the penetration of the financial system and the securities market is low with respect to the country's level of development. Failures in the co-ordination of public policies relating to the financial markets are preventing their growth. The economic and political context adds momentum to the process of adopting reforms aimed at developing the capital market.

This report aims to review the functioning of the capital market in the Dominican Republic and presents the main recommendations for improving its effectiveness and efficiency. This chapter discusses the achievements related to this market and the main obstacles to its development, which are linked to co-ordination failures. It also highlights the political economy of reforms as a key to further development of the capital market. The report continues by emphasising two aspects for achieving greater depth in this market: the macroeconomic environment (Chapter 2) and the solvency and development of the financial sector (Chapter 3). It focuses on the two main instruments of the Dominican capital market: the public debt market (Chapter 4) and the private bond market (Chapter 5). Chapter 6 examines the role and status of institutional investors, placing emphasis on pension funds. Lastly, Chapter 7 explores three key tools for the development of this market: financial literacy, the use of new financial instruments and co-operation with other markets.

The analysis and recommendations presented in this report are aimed at the deepening of the capital market, which is crucial for the sustainable development of the Dominican economy. The development of the financial and capital market has a positive impact on economic growth (Levine, 2004). The organised issuance of public debt and a yield curve with high liquidity facilitate long-term financing and risk management for economic actors. A corporate bond market provides well-established corporations with low-cost funding, allowing the banking sector to specialise in debtors with greater information asymmetries. At the same time, it increases the possibilities of financing innovative projects and major infrastructure works. Furthermore, by issuing long-term fixed-rate bonds in local currency, companies are protected from the risk of rollover, which led to high costs in past crises in the region (Borensztein *et al*., 2008). In the long term, corporate bond markets can have a counter-cyclical effect on access to credit, as in sovereign debt crises and systemic banking crises (Bolton and Freixas, 2008).

The improvements made by the Dominican Republic in macroeconomic and financial system management have influenced the development of the capital market. Of the several measures that have been achieved and the factors involved, the following aspects are noteworthy. The government has approved reforms to improve the systems of public policy planning and financial management that bring more transparency to the budget processes and increased co-ordination of macroeconomic policy between the Ministry of Economy, Planning and Development, the Ministry of Finance and the Central Bank. The regulatory and banking supervision framework has followed the guidelines issued by the Basel Committee to properly measure the risks for

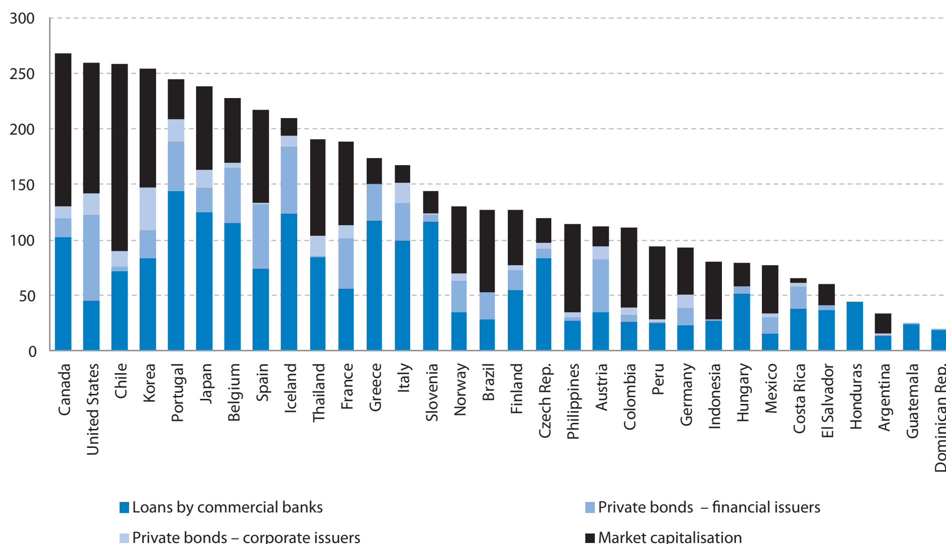
capital requirement, which has led to a healthy and solvent banking system in comparison with the aftermath of the 2003-04 banking crisis.

Likewise, in recent years there have been improvements in the institutional framework of the public debt market. In 2006, the legislation relating to public debt management enabled the creation of the General Directorate of Public Credit (Dirección General de Crédito Público) within the Ministry of Finance as the governing body of the public credit system. The purpose was to establish a centralised agency to manage public debt and to be in charge of the issuance and placement of securities, bonds and other financial obligations. The Directorate of Public Credit uses a trading platform that allows for formal and transparent auctions of bonds issued by the Ministry of Finance. Additionally, domestic debt securities recently issued by the Central Bank have been dematerialised and submitted to an auction process.

Finally, progress has been made in the regulatory framework and the deepening of the capital market. The Dominican corporate bond market shows satisfactory levels of dematerialisation, accounting, convergence and risk assessment at time of issue in comparison with other emerging economies. The Superintendency of Securities is an ordinary member of the International Organization of Securities Commissions (IOSCO), which has facilitated the process of implementing international standards to promote an organised market.[1] The number of issuers with outstanding securities has risen from 3 in 2005 to 20 in 2011. Likewise, pension funds, the leading institutional investor in the capital market, have seen their assets grow substantially from 1.0% of gross domestic product (GDP) in 2003 to over 6.0% of GDP in 2010. Meanwhile, efforts to achieve greater dissemination of financial education and the enactment of a legal framework for the development of new instruments (such as the recent mortgage securitisations and mortgage bonds) corroborate the Dominican government's interest to promote sustainable development of the capital market.

Nonetheless, the channels and the amount of private sector funding remain low in relation to the income level of the Dominican economy. Although there is evidence that too much financial depth can affect economic growth (Arcand *et al*., 2011), the low financial depth in the Dominican Republic leaves room for further economic development thanks to the future dynamism of financial markets.[2] Like the rest of the countries in the region (except for Chile), the level of funding in the Dominican economy is low compared with that of OECD countries (Figure 1.1). This low level, even in comparison with other countries in the region, is due to the low banking penetration and, above all, the underdevelopment of the capital market. Regarding the latter issue, the private debt market represents only 1.3% of GDP and the equity market is non-existent.

Figure 1.1. **Level of development of financial markets** (% of GDP in 2010)



Note: Selection of OECD and non-OECD countries. The balance of loans provided by commercial banks includes credit from commercial banks to non-financial corporations and households.

Source: World Bank (*World Development Indicators*), Bank for International Settlements (BIS), Bloomberg, International Monetary Fund (Financial Access Survey) and national sources.

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Tackling the structural obstacles outlined in this report would pave the way for the development of an equity market. It is expected that in the course of 2012 some companies will float part of their capital. In fact, several of the companies interviewed expressed interest in participating in a prospective equity market. While there are expectations of placing shares in the medium term, efforts must now be concentrated on overcoming the fundamental weaknesses of the capital market. A solid foundation will contribute to the healthy development of the capital market as a whole, including the equity market. Thus, consolidating the recommendations presented in this study would help lay the groundwork for the prospective development of the equity market.

Towards improved policy co-ordination for the capital market development

Shortcomings in the co-ordination of public policies prevent further capital market penetration. Four types of shortcomings can be considered. First, macroeconomic stability is fundamental for the development of the capital market. Monetary and fiscal policies must be better co-ordinated in a context of vulnerability in the balance of payments. Second, public debt management should be properly co-ordinated between the Central Bank and the Ministry of Finance. Third, it is necessary to establish an institutional framework to increase co-ordination between the various supervisors of the financial and capital markets. Finally, the operational framework of the capital market requires greater coherence and co-ordination to facilitate the development of its infrastructure.

Having sufficient independence and co-ordination of monetary and fiscal policies is crucial to capital market solvency. The primary objective of the Central Bank is price stability. Therefore, it becomes vital to implement an inflation-targeting policy that provides independence from the Central Bank, a single target variable (inflation), a principal instrument of intervention (interest rate) and a flexible exchange rate. Empirical evidence in the Dominican Republic reveals Central Bank interventions in the foreign exchange market that would affect the principles of an inflation-targeting policy. The current plan to eliminate the quasi-fiscal deficit and recapitalise the Central Bank amounts to a transaction with government bonds that requires very close co-ordination between fiscal and monetary authorities, within the framework of independence from fiscal policy. Deviation from the goals originally agreed upon would delay the consolidation of a single issuer in the public debt market, and would send mixed signals to the other market participants.

In order to inject dynamism into the private bond market, there must be better co-ordination in the management of domestic public debt. In the short term, the Central Bank and the Ministry of Finance should maintain constant communication to co-ordinate the characteristics of the securities issued, such as maturity, denomination and issue dates. It is also essential to have only one system for placement in the primary market that allows a convergence of bond yields. In order to improve the efficiency of a bond market, it is necessary to reduce the levels of fragmentation and have a robust and secure market infrastructure. To this end, debt management should be transferred to a single issuer and consolidated within the Ministry of Finance. In the medium term,

as domestic sovereign debt management is handled solely by the General Directorate of Public Credit, the Central Bank's role in developing the public debt market will be limited to repo transactions on these securities for conducting monetary policy.

Because of the institutional structure, a system of strict inter-organisational co-ordination and communication is required to avoid information asymmetries between regulatory agencies. Regulation and supervision of the financial markets in the Dominican Republic are divided into four superintendencies: The Superintendencies of Banks, Insurance, Pensions and Securities. Effective co-ordination in prioritising policy objectives and the instruments used to pursue them is therefore decisive. This co-ordination requires consistency in the accountability of the institutions regulating the financial system and capital market. The OECD Principles of Corporate Governance emphasise that the possibility of overlaps and even conflicts between different supervisory regulations should be kept in check to avoid regulatory vacuums. It is advisable to establish a co-ordinating committee whenever there are multiple regulatory bodies present within the financial and capital market. This committee would comprise independent experts and regulators. Finally, the superintendencies need highly trained personnel in order to work effectively, and must give them sufficient autonomy and resources to fulfil their duties in a professional and objective manner (OECD, 2004).

Greater co-ordination is required in the functioning of the capital market infrastructure. The process of placement in the private primary market must be well co-ordinated among the various public and private actors. For this purpose, it is crucial to reduce the approval time for an issue, standardise the required documentation and simplify the investment process for institutional investors in the primary market. With respect to the securities payment and custody systems, a centralised system for information, deposits, clearing and payments must be appropriately developed. Market regulation and discipline should impose drastic penalties on free-of-payment transactions and should encourage trading through markets with electronic price formation. Likewise, there should be an emphasis on promoting greater variety of investment instruments and actors in the secondary market, and developing a code of corporate governance.

Efforts aimed at improving public policies will enhance the dynamism of the Dominican economy. The priority of such efforts is to improve public debt management, which would have multiple benefits. First, it would reduce the country's financing costs. Second, public debt would be a reference for private debt issues (based on a risk-free curve). Finally, reducing the crowding-out effect on both interest rates and amounts issued would permit increased access to

financing for firms in the real sector of the economy. Enhancing the co-ordination of regulatory agencies, developing a code of corporate governance and improving issuance and transaction processes in the secondary market would reduce issuance cost and time for companies, thus facilitating capital market access for the country's productive sectors. Promoting financial literacy and new financial instruments (with proper regulation) would provide sustainable access to the capital market for new economic actors.

The political economy of the capital market reform

This report focuses on the measures that should be adopted by the public sector in order to improve the effectiveness of the Dominican securities market. However, it must also consider how these measures are to be carried out. This is the dilemma of the reform, a process that can be analysed in terms of a "reform cycle" involving five stages: planning, dialogue, adoption, implementation and sustainability. Although these stages do not always take place sequentially, it is useful to distinguish between them to evaluate the relative power of each actor and the efforts for reform, in order to avoid obstacles in the future. The OECD has extensively studied the process of political economy and the policy-making process of the reform in the different sectors of the economy, placing emphasis on the interaction of agents and the socio-economic and political context.[3]

Several aspects add momentum to the reforms aimed at developing the capital market to improve funding of the real sector. The lack of a capital market consistent with the level of economic development hinders the financing of the real sector. The political context of a new government traditionally generates support from the actors involved in the adoption and implementation of reforms. The uncertain international financial environment and the recent crises in emerging and developed economies further highlight the need for an institutional and regulatory framework that guarantees the functioning of the securities market. The financial crisis of 2003-04 forced authorities to take expedited action with a regulatory framework still in the process of being defined. However, the financial reforms after the crisis and the new economic stability now allow public debt transactions to be concentrated in a single actor. Finally, according to interviews with market participants and the results of the workshop held for this report, many of the public and private actors agree on the key measures needed for greater penetration and stability of the capital market.

Notes

1. The last annual conference of the IOSCO Emerging Markets Committee was held in the Dominican Republic in October 2011.
2. It is estimated that private sector credit has a positive impact on economic growth up to around 110% of GDP. After that point, an increase in credit starts to have a negative impact. Bank credit to the private sector and the stock of private debt issued in the Dominican Republic do not exceed 25% and 1.5% of GDP, respectively.
3. See Tompson (2009), OECD (2010), OECD (2011) for studies on "Making Reform Happen" in OECD countries and Dayton-Johnson *et al.* (2011) for a review of the reform process in Latin America.

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Chapter 2

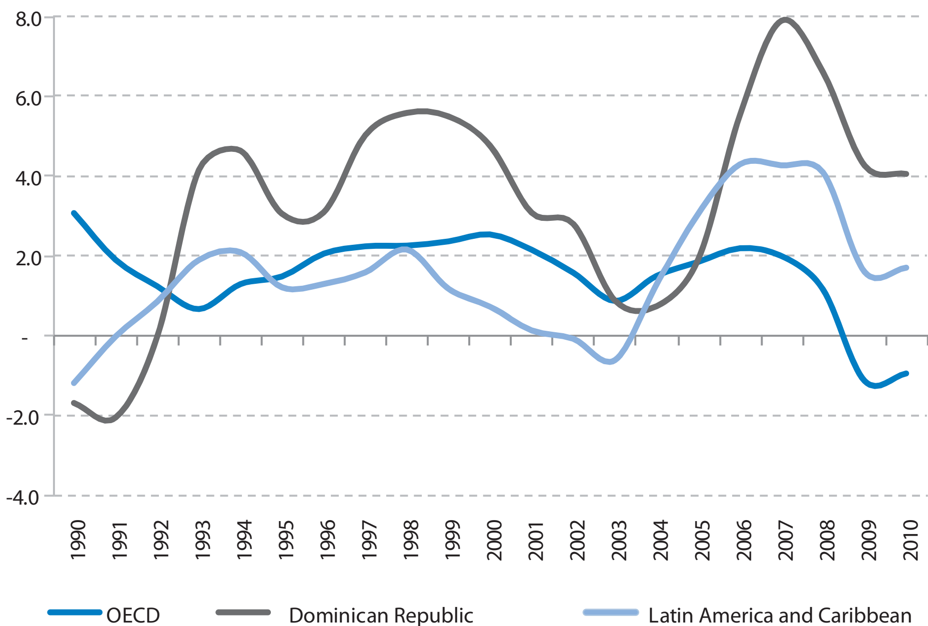
Macroeconomic context

Abstract

The bank bailout introduced by the Central Bank after the financial crisis of 2003 deteriorated its balance sheet and also affected the fiscal accounts of the central government. Regarding the balance of payments, the current account deficit was mainly due to the limited mechanisms available to the Dominican Republic, as a net importer of commodities, to counter price shocks on imports. It would be advisable to develop a fund with a counter-cyclical component to help mitigate shocks on the trade balance and to implement an inflation targeting policy aimed at eliminating Central Bank transactions in the exchange market through bond issues.

The Dominican Republic is a small, open economy and has been highly dynamic in the last few decades of rapid economic growth and trade liberalisation. The Dominican Republic experienced some of the fastest economic growth in the region, averaging 6% annually between 1990 and 2010. It was also able to increase its per capita income by 50% over a 20-year period (IDB, 2010). A portion of that growth was supported by the external sector, which doubled exports between the early 1990s and 2010, and the country received large inflows of investment that were used to finance several drivers of gross domestic product (GDP) growth, such as tourism. Following the financial crisis of 2003-04, per capita GDP growth recovered and in recent years has attained rates higher than those reported by economies of the OECD and others in the region (Figure 2.1).

Figure 2.1. **Per capita GDP growth in the Dominican Republic, Latin America and OECD countries** (%, 1990-2010)



Note: Three-year moving average.

Source: OECD Development Centre based on data from the World Bank *World Development Indicators*.

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In the last 20 years, the Dominican economy has undergone fundamental changes that have transformed the economy from one based on agricultural exports to one based on services. In the 1990s, significant changes were made in the structure of production, especially with regard to taxes, trade and foreign investment. After a sharp economic downturn in 1990, over the next five years the country underwent several structural reforms that substantially changed the economic fundamentals. At that time, the country was consolidating its transformation from an economy primarily based on agriculture and light industry to one based on services, most notably including telecommunications and financial services, in addition to tourism and free-trade zones because of their ability to generate foreign currency.[1]

The reforms were extended to the financial sector, allowing greater openness and flexibility of credit, as exchange rate policies were also relaxed. In the financial sector, important measures were implemented to align the domestic markets with international trends. Most notable in this regard was the reduction of obstacles to the operations of foreign banks and the consolidation of product and service provision by banks. In capital markets, the gradual relaxation of the exchange rate policy eliminated distortions in the dual exchange market. Additionally, the new Foreign Investment Act (Law 1695) eliminated restrictions on foreign capital investment in the country. Under this legislation, foreign direct investment tripled in ten years, from USD 89 million (US dollars) in the early 1990s to USD 953 million in 2000 and USD 2.37 billion in 2011, with the bulk of this money going to investment in the tourism sector.

The financial crisis of 2003-04 triggered a shock to the economy that resulted in a deterioration of the country's main macroeconomic and social indicators. In 2003, following the collapse of three commercial banks, which accounted for 26% of the financial system's assets, the country was embroiled in a period of high inflation (42.7% in 2003 and 28.7% in 2004), a sharp currency depreciation (113% between 2002 and 2003),[2] a deterioration of fiscal accounts with a deficit of 3.8% of GDP, and a general loss of confidence among economic actors. These circumstances, coupled with the effects of the oil price shock of 2003 and a bank bailout that represented 20.3% of GDP in 2003, led the economy to decline by 0.3% in real terms (BCRD, 2004).

Capital outflows caused an additional shock that produced an imbalance in the exchange rate and external accounts. The national economy was particularly affected by capital outflows when the sharp depreciation caused private-sector actors to transfer assets abroad. Meanwhile, economic uncertainty curtailed direct investment flows. The first current account surplus in 11 years, resulting from the positive impact of currency depreciation on exports, was insufficient

to avoid a balance of payments deficit of USD 546.5 million in 2003, equivalent to 2.7% of GDP.

The signing of a Stand-By Arrangement with the International Monetary Fund (IMF) helped finance the trade gap and initiated a programme of macroeconomic stabilisation. Amid this situation, in 2005 the country signed a two-year Stand-By Arrangement with the IMF ascending to SDR 437.8 million (special drawing rights).[3] This arrangement gave the country access to external resources that enabled a restructuring of the Central Bank's international reserves and provided finance for the central government. Moreover, significant financial reforms strengthened the system's overall position. The aim was to forestall a contagion effect from a shock of such magnitude.[4] These measures – which included new capital adequacy standards, supervision based on consolidated financial statements and a legal framework for risk prevention – help to explain the current solvency of the financial sector.

After the crisis and the implementation of major financial sector reforms, the country underwent a period of rapid economic growth. This growth, averaging 8.5% in 2005-08, was driven by telecommunications and trade, which grew by 21.1% and 11.5%, respectively. The macroeconomic climate coincided with an improvement in fiscal indicators and was boosted by the Stand-By Arrangement with the IMF, resulting in a surplus of 0.1% of GDP in 2007. Public finances also received a major injection of resources owing to the increasing price of nickel, which brought the government revenues of DOP 11.9 billion (Dominican pesos), a 200% increase over the previous year.

Although several external shocks have undermined the government's fiscal solvency, economic policy has maintained its macroeconomic stability. The sustained increase of the main commodities in the international markets exerted strong pressure on the country's fiscal and external accounts.[5] Meanwhile, the global economic crisis unleashed in late 2008 weakened the external demand for Dominican products and services, resulting in a year-on-year decline in exports of 18.7% in 2009, a fall in remittances and a slowdown in tourism. A new Arrangement with the IMF, covering the period from late 2009 until the first quarter of 2012, was aimed at securing funding to stimulate economic recovery because of the restrictive credit conditions. This Arrangement has ensured approximately USD 1.7 billion in financing, enabling the pursuit of public expenditure objectives. Under these conditions, the economy has managed to maintain relative macroeconomic stability, although this situation is contingent on the global economic situation.

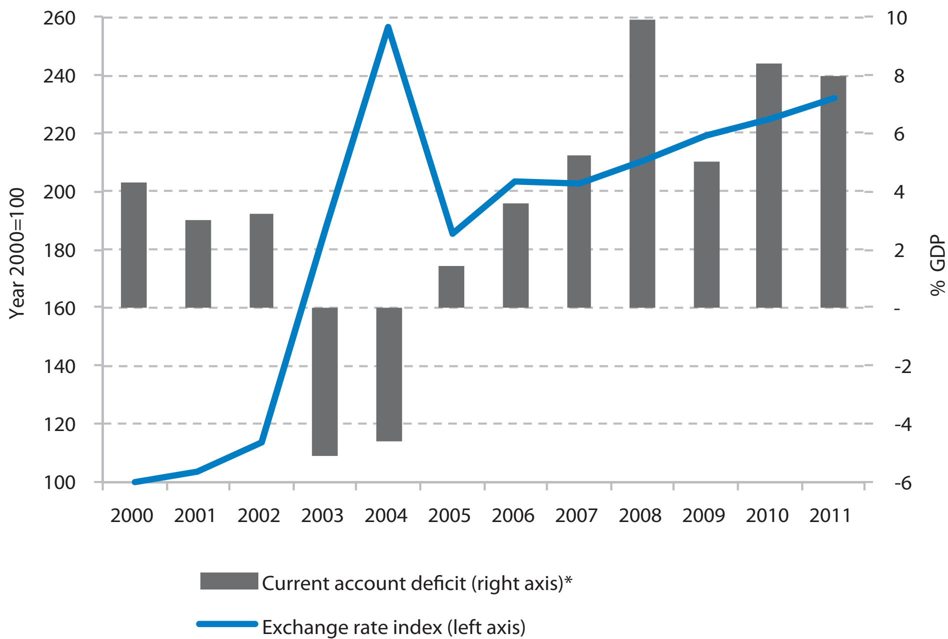
The impact of the 2003-04 crisis on the management of monetary and financial policy

The Central Bank played a major role in the financial bailout. During the financial crisis of 2003-04, the Central Bank responded with a bank bailout and backed depositors to mitigate the risk of a systemic crisis. In order to reduce the liquidity generated by the bailout, the Central Bank issued securities. These actions resulted in a deterioration of its balance sheet, leading to a quasi-fiscal deficit that has caused pressure in the management of both monetary and fiscal policy.

The issue of securities by the Central Bank provided a swift way out of the crisis, but it created an imbalance of monetary and fiscal aggregates that limited its ability to manage monetary policy effectively. The issue of "certificates of participation" at high interest rates made it possible to control the excess liquidity caused by the bank bailout. The Central Bank's outstanding securities increased more than eightfold in a 12-month period, from DOP 6.9 billion in December 2002 to DOP 60.0 billion in December 2003 (BCRD, 2004). This aggressive policy, while seen as necessary to preserve macroeconomic stability, ultimately eroded the Central Bank's overall position and also affected the central government's fiscal accounts.

The structural balance of external accounts puts pressure on the exchange rate and influences the management of monetary policy. Regularly facing deficit, from 2007 the current account balance has shown persistently high deficit levels, estimated at 8% in 2011 (BCRD, 2012), placing pressure on the exchange rate and threatening the stability of external accounts (see Figure 2.2). Much of this deficit is explained by the strong shocks in the prices of the main import categories, including oil. As a net importer of commodities, the Dominican Republic has few mechanisms to counter these shocks. Foreign direct investment accounted for only 36.7% of the current account deficit in 2010. With a high deficit in the trade balance, equilibrium in the balance of payments is maintained thanks to capital inflows. This uncertainty puts pressure on the exchange rate, bringing it to the fore in monetary policy objectives.

Figure 2.2. **Current account deficit and exchange rate** (2000-11)



Note: * Negative value represents a surplus in the current account (% of GDP).

Source: OECD Development Centre, based on data from the World Bank *World Development Indicators* and the Central Bank of the Dominican Republic.

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Recommendations and outlook

Proper management of the factors that weaken the balance of payments will improve investor perception in the capital markets. The Dominican Republic faces the inherent difficulties of being a net importer of commodities. However, a mechanism aimed at achieving savings in the event of an unexpected drop (rise) in the prices of major imported (exported) raw materials would generate a counter-cyclical component that could help mitigate shocks on external accounts.[6] The national tax structure therefore needs to be amended in order to ensure an appropriate level of financing of public policies and maintain an

acceptable macroeconomic balance. The tax burden in the Dominican Republic is low, even compared with that of other countries in the region (about 13% of GDP *vs.* about 20% of GDP in Latin America and over 30% of GDP in OECD countries). Increased promotion of clusters, innovation funds and highly productive sectors could accompany exports derived from the free-trade zones, which represent around three-quarters of total exports, according to official figures (see Attali Commission, 2010, for an in-depth analysis on recommendations for industrial and services policy for a more competitive economy). Additionally, these policies would have positive externalities for foreign direct investment, which could in turn finance the trade deficit. This would have an immediate impact on the development of capital markets thanks to an improved perception by national and international investors likely to participate in capital markets.

Setting an inflation-targeting objective would bring greater transparency to the management of monetary policy and would eliminate direct competition between public actors in the securities market. In its monetary programme for 2012, the authorities plan to implement a monetary policy based on inflation-targeting objectives to be implemented from 2012 (BCRD, 2010). Owing to the increasing instability of money demand, a monetary policy based on monetary aggregates is not very effective. Implementing an inflation-targeting policy involves independence of the Central Bank, a single target variable (inflation), a primary instrument of intervention (interest rate) and a flexible exchange rate. The current plan to eliminate the quasi-fiscal deficit and recapitalise the Central Bank amounts to a transaction with government debt securities requires very close co-ordination between fiscal and monetary authorities. The Central Bank's active participation in the government bond market with a monetary policy objective creates distortions and competition with the Ministry of Finance, which in turn participates in the market with financing objectives.

Notes

1. According to Pozo *et al.* (2010), the free-trade zones regime was developed as a measure to protect a segment of the local economy from the "legal, political and economic infrastructure". Under this regime, capital investment increased and free-trade zones became one of the main sectors generating foreign exchange. Free-trade zone exports accounted for USD 4.9 billion in 2011, about 8.6% of GDP.
2. The average monthly exchange rate went from DOP 17.8 to the US dollar in December 2002 to DOP 37.8 to the US dollar in December 2003. Additionally, it reached a maximum (monthly average) of DOP 50.4 to the US dollar in February 2004. After that, the economy began to feel the effects of the restrictive measures implemented by the authorities, leading to a 2004 year-end rate of DOP 29.3 to the US dollar.
3. In 2003 and 2004, the government had signed other Stand-By Arrangements with the organisation that were suspended owing to deviations from the originally agreed targets. The programme initiated with the Stand-By Arrangements covered the period 2004-07.
4. This period also saw the introduction of major reforms of the government's financial planning and administration system.
5. In July 2008, prices of wheat, soybeans and corn had increased by 38.3%, 90.6% and 99.7%, respectively, compared with the previous year. In response, the government used large subsidies to mitigate the rise in commodity prices.
6. Revenues from the mining of ferronickel and gold can fuel a fund of this type. Though these resources are fairly limited, allocating them to a counter-cyclical fund would prevent discretionary use of them and increase the reliability of fiscal policy. For example, in 2007 revenues from ferronickel mining tripled compared with the previous year, and the windfall gain was used to offset partially the increase in oil prices.

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Chapter 3

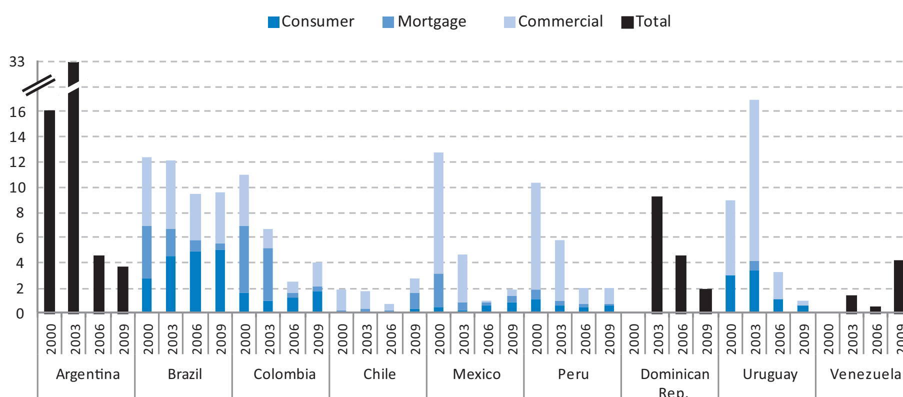
Characteristics and challenges of the financial system

Abstract

The Dominican financial system has weathered the current international crisis thanks to its sound management of fiscal and monetary policies and the improved framework for regulation and supervision of financial intermediaries. The main challenge is to increase banking penetration by guaranteeing the solvency of the financial system. While high interest rates make it tougher for businesses to obtain credit, deposit rates are negative in real terms. It would be advisable to continue improving the regulatory framework, for instance by implementing stress-testing criteria, counter-cyclical rules for provisions and improvements in systemic risk management. Likewise, in order to improve the information and assessment of risks inherent to the financial system, it would be advisable for the Central Bank to draw up a financial stability report.

Since the reforms carried out following the financial crisis of 2003-04, the Dominican financial system has been characterised by stability and solvency. As in the rest of the region, the Dominican financial system has weathered the current crisis remarkably well. This contrasts with what occurred in the country in 2003 and the general situation throughout much of the region, where banking crises have come at a high price.[1] The banks have been bolstered by improved regulation and supervision backed by soundly managed fiscal and monetary policies. One initial indicator of this improvement is the credit quality of bank loans (Figure 3.1). Since the banking crisis, the ratio of non-performing loans to total lending has dropped significantly and currently stands at around 2%. Although Brazil, Chile, Colombia, Mexico, Peru and Venezuela have felt the impact of the crisis through an increase in non-performing loans, in the Dominican Republic the number of such loans remains low, particularly in comparison with emerging economies outside the Americas.[2]

Figure 3.1. **Ratio of non-performing loans to total loans**



Note: Owing to differences in accounting and national supervisory systems, the data are not strictly comparable between countries.

Source: OECD Development Centre, based on national central banks and supervisory entities.

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Having adequate levels of loan-loss and capital provisions provides a safety cushion for potential economic shocks and reaffirms the solvency of the system. The ratio of provisions to non-performing loans has remained comfortably above 100% since 2005 (*vs*. 30% in mid-2003) and, as in other Latin American countries, it is once again far above that of other emerging countries.[3] Meanwhile, the solvency ratio, which takes into account the risk profile of the

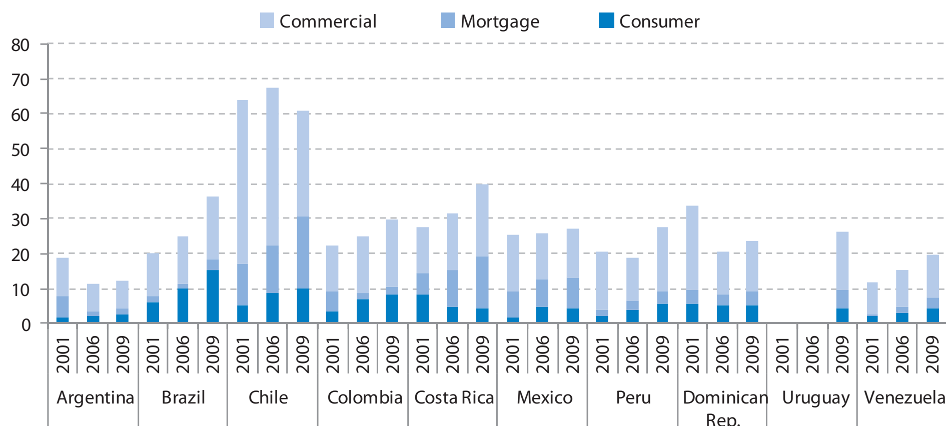
underlying assets, has been around 17% since 2004 (*vs.* 12.5% in 2003), placing it above the world average (15%) and the levels required by the Basel Committee and the Dominican authorities (8% and 10% respectively). Additionally, since 2007 the inclusion of market risk in the measurement of the solvency margin is a step forward in controlling market risk.[4]

Foreign currency exposure is concentrated in commercial loans to large firms and entails an exchange rate adjustment with respect to the income of these enterprises. Currency mismatches, which arise when the financial obligations of households and companies are denominated in a currency other than that of their income, create potential exposure for the private sector and therefore pose a risk to the stability of the financial system.[5] In the Dominican Republic, about 20% of the loans granted by the financial system are denominated in US dollars. Large enterprises take up 96% of these loans in USD, which account for about 40% of total loans to these enterprises. One key factor explaining this high percentage is the financing rate, because the interest rate in Dominican pesos remains high in comparison with the interest rate in USD (about 17% *vs.* 7% in the first quarter of 2012), a sign of implicit expectation of currency depreciation.

Banking depth and concentration

Banking penetration in the Dominican economy is low, even when compared with that of similar economies and the rest of the region. Although the banks are solvent, the biggest lingering deficiency is the low banking penetration. Latin American banks are largely solvent, but this does not mean that the financial system is contributing all that it could to economic development. As in the other Latin American countries, the ratio of commercial credit to gross domestic product (GDP) is relatively low compared with that of other emerging economies. Prior to the financial crisis of 2003-04 it was around 25% of GDP, whereas it is now below 15% of GDP. Because of the corporate credit crunch, the Dominican Republic was the country in the region that showed the sharpest fall in banking penetration after the crisis (Figure 3.2). While financial depth (the ratio of total loans to national income) has improved since the crisis (going from 19% in December 2004 to 24% in December 2010), private sector credit remains low.

Figure 3.2. **Financial depth** (%, total loans as a percentage of GDP)



Source: OECD Development Centre, based on national central banks and supervisory entities.

As witnessed elsewhere in the region, banking concentration in the Dominican Republic is high.[6] Banking concentration has been increasing to the extent that the top 10 banks now account for about 90% of financial system assets (*vs.* 75% in late 2000). Drawing from an analysis on the distribution of the loan portfolio, it is relevant to note that with a Gini coefficient of 0.76, the concentration is higher than in Chile, Colombia and Peru, yet it is even higher in other countries of the region (such as Brazil and Mexico). The top five banks account for more than 75% of net income. Among the region's leading economies, Chile and Peru exceed this percentage. The Dominican Republic has a Gini coefficient of 0.78 in the distribution of net income, which is higher than that of Argentina, Brazil, Chile, Colombia and Mexico, and similar to that of Peru.

The local banking sector shows high levels of profitability because of the high interest rates. After negative returns in 2003, the current levels surpass even those of other emerging economies. As with other economies in the region, this is partly due to the financial income (see Table 3.1, column 3). Whereas in the Dominican Republic income from loan interest for the top 10 banks is 15% of the gross loan average, in some Latin American economies and other emerging economies it is below 10%.

Table 3.1. **Indicators of profitability and income** (%)

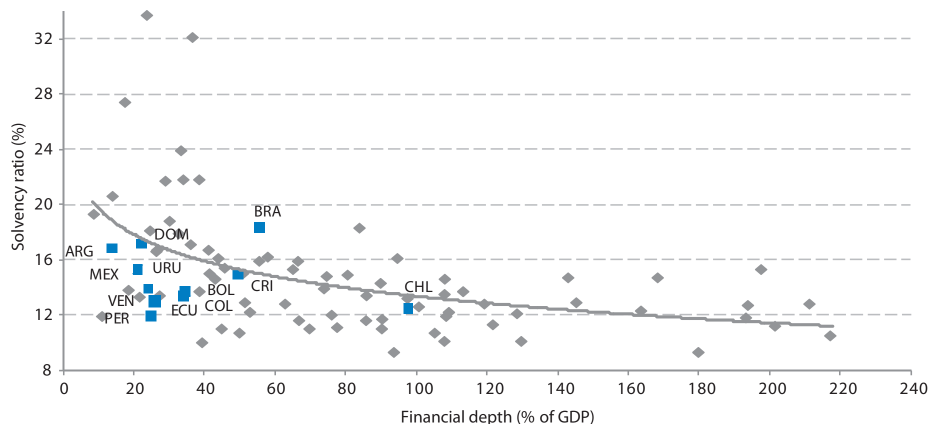
	Return on average assets (ROAA)	Return on average equity (ROAE)	Loan interest income/average gross credit	Net income / average total assets
Brazil	1.76	21.77	14.74	1.84
Chile	1.43	17.85	7.71	1.44
China	1.06	19.6	5.13	1.06
Colombia	2.01	18.73	8.88	2.03
Korea	0.46	5.51	4.88	0.53
Dominican Rep.	2.09	17.82	15.47	2.09
Mexico	1.54	13.59	12.64	1.54
Peru	2.03	19.88	12.99	2.14
South Africa	0.92	8.95	9.34	0.92

Note: Average of top 10 banks in assets. Latest year available.

Source: OECD Development Centre, based on Bankscope (December 2011).

Financial depth is closely related to the capital adequacy of banking systems. Figure 3.3 compares the ratio of private loans as a percentage of GDP (a measure of financial depth) with the solvency ratio (a measure of capital adequacy). With the exception of Chile, the region has low financial depth (35% *vs.* 76% for the rest of the world), while the region's solvency ratio (14.5%) is close to that of the rest of the world (14.8%). Because of its low banking penetration, the Dominican Republic has a higher solvency ratio than several Latin American economies. In general, the two measures are not independent, with high solvency ratios being explained in part by low financial depth. This is particularly evident for the Dominican Republic. Solvency ratios above 20% are observed only for countries with a financial depth below 40% of GDP. Likewise, most countries with a solvency ratio higher than 15% have a financial depth below 100%.

Figure 3.3. **Solvency ratio and financial depth**



Note: Blue squares indicate Latin American countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, the Dominican Republic, Uruguay and Venezuela). Financial depth is defined as the ratio of domestic private loans to GDP; the solvency ratio is defined as bank regulatory capital to risk-weighted assets.
Source: OECD Development Centre, based on IMF and World Bank *World Development Indicators.*

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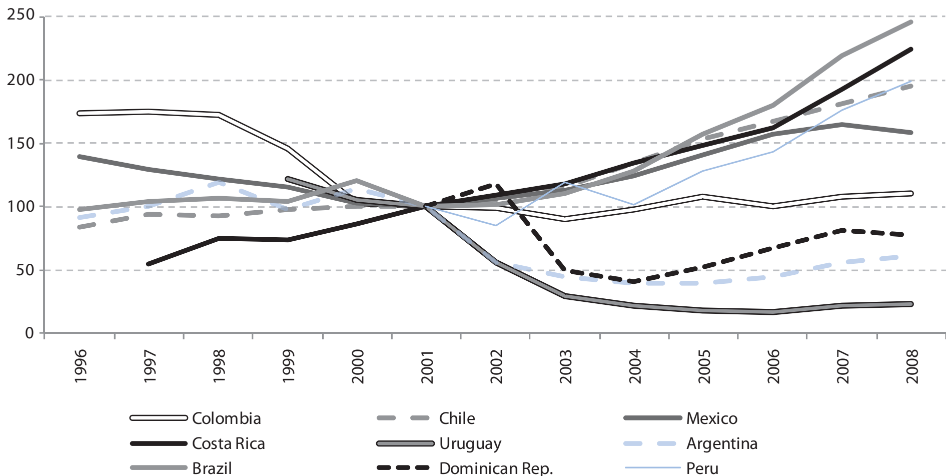
Lending growth will have to be linked to the private sector's capacity to pay. Measuring this as the ratio of household loans to labour income at the national level reveals how past banking crises have wrought damage throughout the region (Figure 3.4). In the Dominican Republic and the other countries affected by the crises (Argentina, Colombia and Uruguay), the ratio remains even today below its pre-crisis level. On the other hand, with sound financial supervision and regulation the ratio can expand sustainably. In Brazil, Chile, Costa Rica and Mexico the loans-to-income ratio has grown steadily over the last eight years without jeopardising loan quality or the solvency of the banking system.

Figure 3.4. **Ratio of household loans to labour income** (1996-2008)



Note: Base year 2001.
Source: OECD Development Centre, based on national central banks, ECLAC (Comisión Económica para América Latina y el Caribe) and supervisory entities.

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Improving the financial system of an economy is crucial for national growth and development. Financial systems can provide information on funding opportunities and thereby contribute to allocating productive capital to the economy (Levine, 2004; World Bank, 2007). Furthermore, financial development and capital raising are closely inter-related, since financial instruments channel the investment towards more profitable activities, having positive effects on GDP growth (Acemoglu and Zilibotti, 1997). In sum, economic growth and poverty reduction are closely linked to financial development.[7] The high solvency ratios in the region are linked to low ratios of loans to GDP, suggesting that the degree of financial intermediation is below the optimum level.

Recommendations and outlook

While the Dominican financial system has regained its stability, the major challenge is to improve access to credit in an environment of prudent banking regulation and supervision. The financial system has become more solvent since the banking crisis of 2003-04. Nevertheless, improvements are still needed in the

areas of supervision and regulation, and particularly in banking penetration, which remains under 25% of GDP, lagging behind the levels of other developing and emerging economies.

Making continued improvements to the supervision and regulation of the financial system is a necessary condition for its successful development. While some progress has been noted in this regard, some measures still need to be adopted and implemented. The inclusion of market risk in the solvency ratio and the commitment to continue the process of adopting Basel II are key factors for adapting to international frameworks. Furthermore, there are a number of regulatory measures that could help consolidate the financial system and increase its stability. These measures include implementing stress-testing criteria, counter-cyclical regulations for provisions like those implemented elsewhere in the region (see OECD, 2010a), improving systemic risk management, as Basel III aims to promote, and establishing a well-defined crisis resolution framework (for example, deposit insurance programmes).

The risks inherent in the financial system must be further studied and analysed. Promoting analysis and dissemination of information on the solvency of the financial system and, most importantly, the potential risks for businesses and households can be useful for anticipating potential vulnerabilities of the financial system. In this regard, as witnessed in the OECD area and the main countries in this region, it would be advisable for the Central Bank to prepare a financial stability report covering the aforementioned issues.

High interest rates are one of the obstacles to the channelling of credit, and reflect a high level of operating costs for the financial sector. The financial intermediation margin in the Dominican Republic is an obstacle to financial deepening. High interest rates make it tougher for small businesses to obtain credit, while deposit rates are negative in real terms, offering little incentive for banking penetration. Public policy actions can help reduce these margins. Among other factors, the cost of regulatory compliance (as with reserve requirements) is one of the barriers to lowering interest rates. Moreover, facilitated by a well-regulated sector, the tax burden remains high. In mid-2011, legislators approved a tax on the assets of financial institutions that, in conjunction with the increased corporate income tax rate, increased operational costs, which tend to be passed directly on to users. The tax on the assets of financial institutions (1% of assets, deductible from income tax) is supposed to be transitory and to remain in force only until 2013. Making this tax permanent would prevent the financial system from achieving greater depth.[8]

Notes

1. Examples of this are the crises of the 1980s and, more recently, those of Ecuador in 1998, Bolivia in 1999, Colombia in 1999, Peru in 1999, Argentina in 2001 and Uruguay in 2002. In addition, external shocks, such as the crises of Asia in 1997 and Russia in 1998, have created instability in the Latin American financial systems. All of these crises are characterised by their long and costly impact on the public sector (Reinhart and Rogoff, 2010).
2. The average ratio of non-performing loans to total loans in 2009 for emerging economies in Asia and Central and Eastern Europe was 4.7% and 11.2%, respectively (IMF, 2010a).
3. The Latin American average of bank provisions to non-performing loans was 165% in 2009, above the Asian (108%) and Central and Eastern European (75%) averages for that year (IMF, 2010b).
4. Nevertheless, solvency margins vary substantially according to the type of intermediary. Whereas for full-service banks the level is close to 14%, for savings and loan associations, savings banks, credit corporations and the National Bank for the Promotion of Housing and Production (*Banco Nacional de Fomento de la Vivienda y la Producción*) the levels are 31%, 18%, 19% and 47%, respectively.
5. See OECD (2010a) for the case of certain Latin American countries where the foreign currency exposure is high.
6. According to calculations using the *Bankscope* database for Argentina, Brazil, Chile, Colombia, Mexico and the Dominican Republic.
7. King and Levine (1993), Levine and Zervos (1998) and Beck *et al.* (2000) documented the way in which financial development is associated with higher economic growth. In addition, Beck *et al.* (2004) showed that financial development also leads to lower levels of poverty and inequality. Although this relationship is not linear and there are limits to the positive effects (see Arcand *et al.*, 2011), the low rate of banking penetration in the Dominican Republic suggests that a positive impact on economic growth can be expected.
8. See OECD (2010b) for an analysis of the impact of the financial transaction tax on the banking penetration in Colombia.

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Chapter 4

The public debt market

Abstract

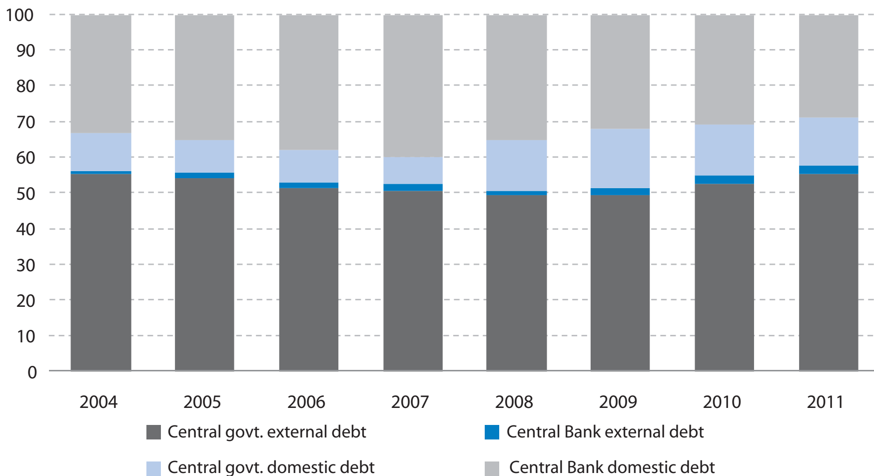
The Central Bank is the largest issuer in the domestic market, doubling the number of securities issued by the central government. The lack of co-ordination and different aims of these two operators in the issuance of internal debt lead to high interest rate differentials for the same maturity. The two institutions should maintain constant communication to co-ordinate the issue dates and features of the securities. There should also be a gradual transfer of securities to a single issuer. For the development of a private market, it is necessary to create a risk-free benchmark curve based on government bonds of the same denomination and a single issuer. In the long term, as for most countries in the region and in the OECD, government debt management should be handled by a single operator.

Although public debt is relatively low, it shows a high level of growth in absolute terms. The Dominican public debt, issued by two government bodies (the Central Bank and the Ministry of Finance), is estimated at 37% of gross domestic product (GDP) in 2011, a similar figure to that observed over the previous five years (34% of GDP on average for the period 2006-10).[1] This level is low compared with that of the OECD area.[2] However, because of the small tax burden in the Dominican Republic and the strong absolute growth (between 2005 and 2011, the stock of consolidated debt climbed to over 90%, topping USD 20 billion in 2011), the debt is perceived as risky by investors and affects the development of the private debt market.

The structure of public debt has remained stable, with its main components being the securities of the Ministry of Finance in the foreign market and those of the Central Bank in the domestic market. While central government issuances in the internal market have increased (10% of total public debt in 2004 *vs.* 13% in 2011), the Ministry of Finance is still placing about 50% of total public issues in the foreign market. In the domestic market, Central Bank issuances are more than double that those of the central government (Figure 4.1). The remaining maturities for the bonds issued by the Ministry of Finance and the Central Bank are 4.8 and 4.1 years, respectively. According to information from the Bank for International Settlements (BIS), the remaining maturity for OECD countries and the main countries in the region (Argentina, Brazil, Colombia, Chile, Mexico, Peru and Venezuela) is 5.2 years and 4.9 years respectively.

Unlike the main countries in the region, the Dominican Republic has a high foreign currency debt exposure, at over 50% of total public debt. While the liquidity boom observed prior to the international financial crisis fostered a reduction in exposure in foreign currency and even local currency issues in the international market by some of the region's countries (OECD, 2008), foreign currency exposure accounts for over 50% of government debt in the Dominican Republic. In 2011, about 75% of public debt in foreign currency is derived from obligations to bilateral and multilateral agencies. A rise in foreign currency exposure would increase currency mismatches for the national budget and thus cause a situation that would lead to a deterioration of the country's fiscal account balance.

Figure 4.1. **Composition of public debt**



Note: Estimates for 2011 of external debt issued by the Central Bank (consolidated data not yet available). Central government debt includes central government debt and non-financial public sector debt.
Source: OECD Development Centre, based on data from the Directorate of Public Credit (Dirección General de Crédito Público) and the Central Bank.

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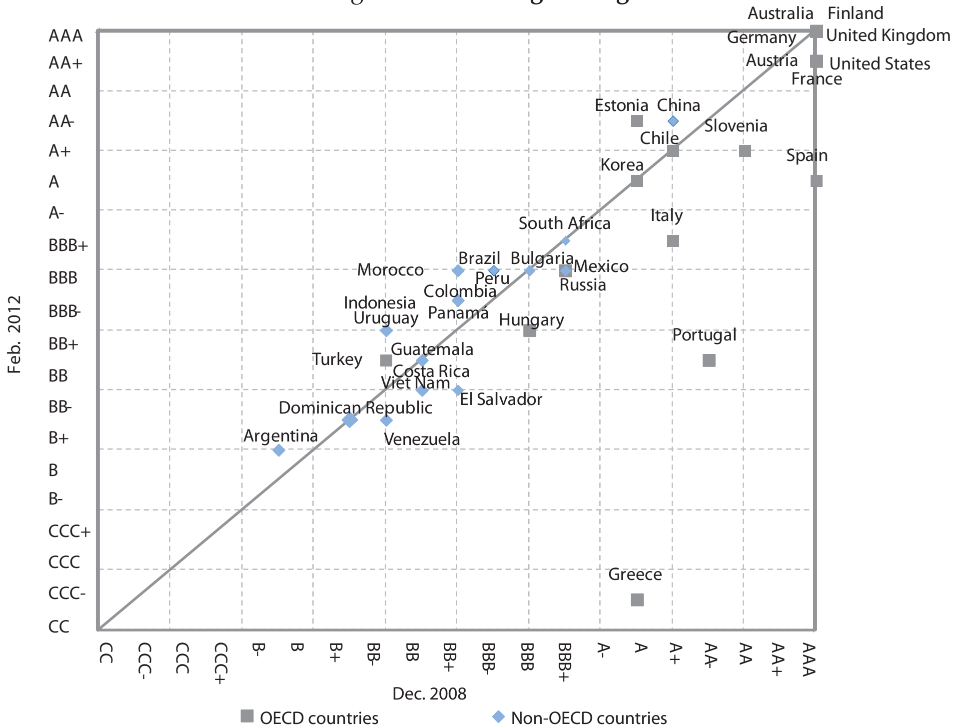
The Dominican sovereign risk

The high foreign currency exposure and balance of payments risks affect investors' perception of the Dominican debt in comparison with that of most countries in the region. The exchange rate and balance of payments risks addressed in Chapter 2 significantly harm sovereign risk. Though investors' perception of sovereign risk has declined in recent years (the credit default swap [CDS] spread rose to more than 1 400 basis points in March 2009), it is still above that of most countries in the region. The CDS spread for the period February 2011 to January 2012 stood at about 415 basis points for the Dominican Republic, whereas for El Salvador, Costa Rica, Guatemala, Brazil, Colombia, Peru, Mexico and Chile this indicator was (in decreasing order among these countries) between 375 and 115 basis points. As for the region, only Argentina and Venezuela had a higher perception of default risk (785 and 1 000 points, respectively, for the same period).[3]

Likewise, the Dominican sovereign rating has remained stable and low compared with that of most countries in the region. In contrast with some high-income countries of the OECD, the sovereign rating has improved or remained stable in most of the emerging economies (Figure 4.2). From late 2008 until early 2012, the sovereign rating of certain high-income countries of the OECD (such as Austria, France, Greece, Italy, Portugal, Spain and the United States) has been downgraded, in some cases dipping below investment grade. In some emerging economies, proper management of public finances and monetary policy, along with close supervision and regulation of the financial system, led to an improved rating during the same period. In Argentina, Brazil, Colombia, Panama, Peru and Uruguay, sovereign ratings have improved over the last three years.[4] In the Dominican Republic, the rating has remained largely stable and below investment grade. The sovereign rating assigned by Standard & Poor's fell to B in 2009 but returned to its 2008 rating of B+ in July 2011. This places the Dominican Republic below Central American countries and only above Argentina in the region.[5]

Figure 4.2. **Sovereign rating**



Source: Standard & Poor's.

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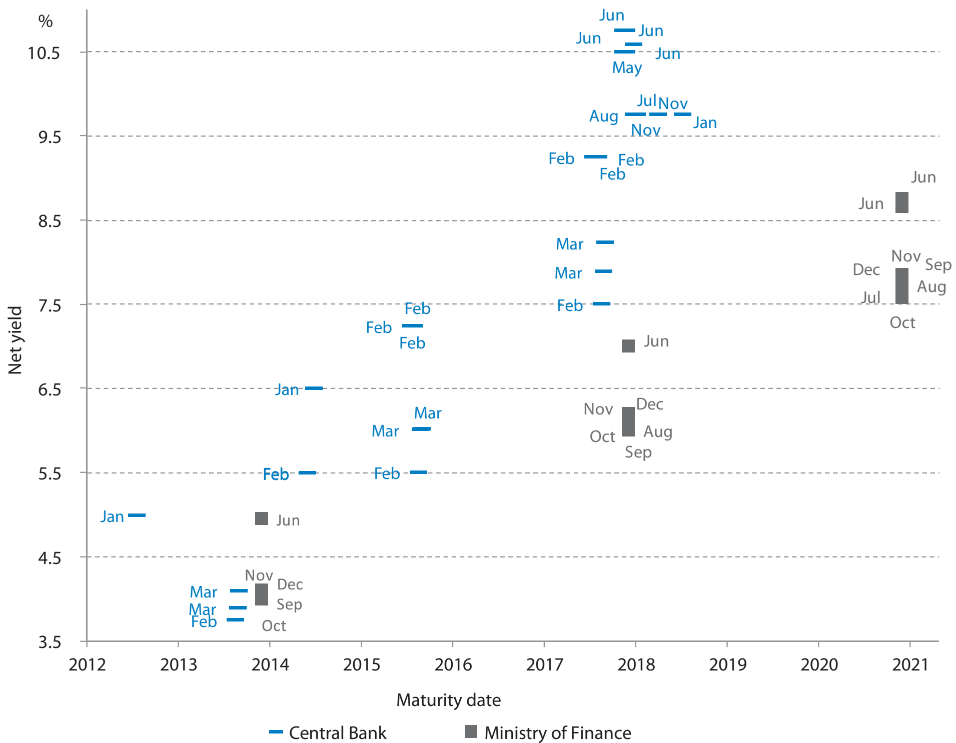
Two actors in the domestic debt market: the Central Bank and the Ministry of Finance

Unlike in the OECD countries and most emerging economies, the largest issuer of public debt in the domestic market is the Central Bank. While the Ministry of Finance has started to play a role in the development of the domestic debt market, the Central Bank is still the main issuer. The Dominican Republic has a higher proportion of Central Bank issues in the total domestic public debt than all the Central American economies (see Shah *et al.*, 2007). In 2006, the Directorate of Public Credit (Dirección General de Crédito Público) was created within the Ministry of Finance as the governing body of the public credit system. The purpose was to establish a centralised agency to manage public debt and be responsible for the issuance and placement of securities, bonds and other financial obligations (Public Credit Law No. 0606).[6] Nevertheless, the Central Bank continues to play a decisive role in public issuance through various issuing vehicles, and therefore in the asset management of institutional investors (see Chapter 6). As noted in Chapter 2, one of the main strategies used by the Central Bank in its monetary policy is to attract liquidity through the securities market, which explains why it accounts for about 70% of public issuance in the domestic market.

Different objectives in the bonds issued by the Central Bank and the Ministry of Finance lead to different yields. While the issues by the Directorate of Public Credit are aimed at the financing of fiscal policy, the issues by the Central Bank are primarily geared toward stabilising the monetary aggregates and the exchange rate in its monetary policy. Thus, the Ministry of Finance has greater incentives to place securities at a low interest rate. Figure 4.3 compares the annual yields of issues by the two actors.[7] For each maturity, those of the Central Bank tend to be higher than those of the Ministry of Finance. For example, for issues of 2011 with maturity in 2018, the yield spread with respect to the Ministry of Finance may exceed 350 basis points. Thus, while the Central Bank places securities at rates over 18.5%, the Ministry of Finance does so at rates close to 15% (see Annex 4.A1 for an analysis of gross returns). According to interviews with market participants, there is no substantial credit risk for the Central Bank that explains this spread. However, there is a perceived need to attract liquidity (occasionally in foreign currency) in order to ease the pressure on the exchange rate. Figure 4.3 also shows less variation in the yields of the Ministry of Finance than in those of the Central Bank.

Figure 4.3. **Annual net yield on securities issued by the Ministry of Finance and the Central Bank** (2011)



Notes: The Central Bank securities included correspond to dematerialised certificates and Central Bank notes. The series labels indicate the month of the auction. The discount rate used to calculate net yield corresponds to the interbank rate published by the Central Bank.

Source: OECD Development Centre, based on data from the Directorate of Public Credit (Dirección General de Crédito Público) and the Central Bank.

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The lack of co-ordination in the issuing strategies of the two public issuers may explain certain shortcomings in their debt management. In addition to the placement of securities at different rates, there is a lack of harmonisation in the characteristics of the securities, the methodology and date of placement in the primary market and the maturity. Some cases exemplify this situation in the debt market. For example, there is a significant accumulation of 2015 and 2017 maturities by the Central Bank and the Ministry of Finance. However, for

2016 there are no scheduled maturities for the debt issued by the Ministry of Finance, and the Central Bank has concentrated its maturity dates solely in the first quarter of 2016. There have also been some cases of concentration with regard to the issue date. For instance, on 1 June 2011 the Central Bank and the Ministry of Finance both issued public debt, and there was no further issue that month until the Central Bank issue on 29 June. This market would achieve greater efficiency with better co-ordination of the term structure, dates of placement in the primary market and characteristics of the securities.

The differences in the instruments and yields of the Central Bank issues reveal the need for better management of this debt. Since 2005, the Central Bank has used various instruments for public debt issues: Central Bank bills, Central Bank notes, physical investment certificates and, from 2011, dematerialised investment certificates. Figure 4.4 shows the discrepancy between the yields on securities issued by the Central Bank for each maturity. For issues placed in the same year through the same type of instrument, high interest rate spreads can be observed. For example, for securities issued in 2007 through Central Bank notes with a 2010 maturity, there are spreads above 400 basis points.[8] These high spreads may be due to the restricted participation in the auctions and the limited dematerialisation of these securities.[9] In 2011, securities with maturity in 2018 show spreads higher than 300 basis points between the Central Bank notes and dematerialised certificates. This reveals different issuance costs for the same credit risk and maturity, indicating failures in the domestic sovereign debt market with potential extra costs for the national budget and trading arbitrage by market participants.

Figure 4.4. **Annual net yield on securities issued by the Central Bank** (2005-11)

Notes: The Central Bank securities included correspond to Central Bank notes and dematerialised and physical issues of special investment certificates. The discount rate used to calculate net yield corresponds to the interbank rate published by the Central Bank.

Source: OECD Development Centre, based on data from the Central Bank.

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Recommendations and outlook

In the short term, it is necessary to improve the co-ordination of debt management between the Central Bank and the Ministry of Finance. The Central Bank's active participation in the public debt market with a monetary

policy objective creates distortions and competition with the Ministry of Finance, this last participating in the market with financing objectives. The result is a significant crowding-out of the private sector, which is in an unfavourable position to compete for interest rates. It would be advisable for the two institutions to maintain constant communication and to co-ordinate the characteristics of the securities issued, such as maturity, denomination and issue dates. It is also essential to have the same system of placement in the primary market in order to achieve yield convergence. These measures will tend in the short term towards a homogenisation of the instruments used by the two actors and a single yield curve. This co-ordination should operate under an established institutional framework, with regular meetings of a committee formed by various members, including experts and debt management officials from the Central Bank and the Ministry of Finance.

In order to improve the efficiency of a bond market, it is necessary to reduce the levels of fragmentation and achieve a robust and secure market infrastructure (OECD, 2002a). Public debt should be managed by a single issuing body and the securities of the Central Bank should be transferred to the Ministry of Finance. While the Ministry of Finance finances this transfer by issuing fixed-rate debt in local currency, the Central Bank uses the transfer to pay the principal and interest on the securities at their maturity. Increased confidence in the securities of the Ministry of Finance could consolidate public credit transactions and enable a secondary market for these securities, thus helping to eliminate the distortion in the market created by different instruments issued by government bodies. A gradual transfer of securities to a single issuer would represent a step towards the public debt management practices of OECD members and countries in the region.

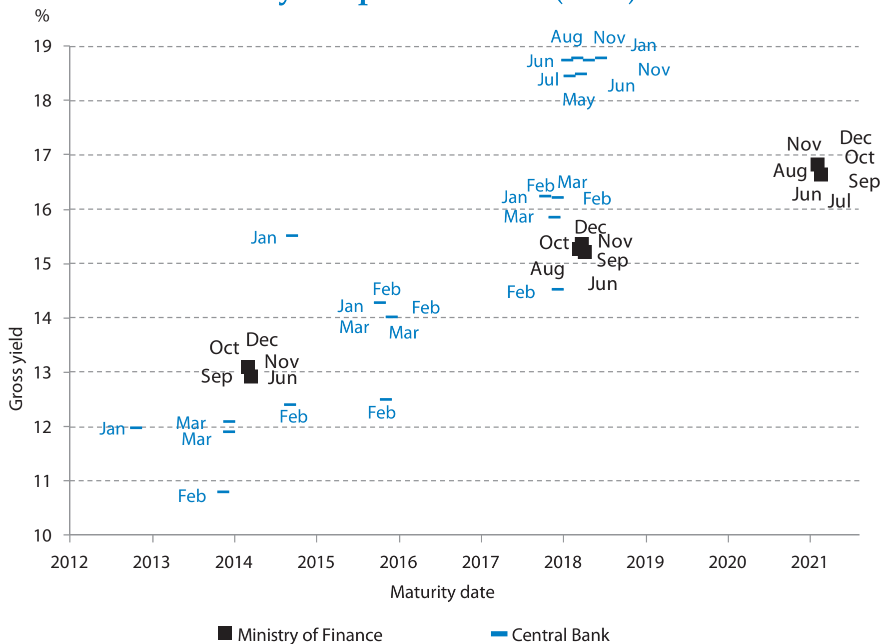
The implementation of a suitable institutional structure to allow efficient co-ordination between the Central Bank and the authority responsible for public debt management is part of the basic infrastructure for developing the bond market. As sole responsibility for the management of domestic sovereign debt is gradually handed over to the General Directorate of Public Credit, the Central Bank's role in the public debt market will be limited to transactions of these securities in the secondary market (OECD, 2002b). A suitable development of a repo market is therefore pivotal for promoting the liquidity of the securities issued by the Ministry of Finance and allowing the Central Bank to manage monetary policy properly. The debt management agencies should have sufficient operational autonomy to manage policies and programmes so as to minimise borrowing costs subject to risk preferences (OECD, 2002a). A benchmarking

system could play a role in evaluating the performance of the sovereign debt management agency.

Several conditions are necessary for the efficient development of a primary market. OECD policy dialogue on debt management in emerging economies defines elements to be considered for the development of a strong debt market. These elements are: *i)* an issuing strategy based on regular auctions; *ii)* the issuance of benchmarks, which in the case of the Dominican Republic should currently be limited (given the market size) to bonds issued in local currency in order to avoid the issue of new inflation-indexed or dollar-denominated securities into the market;[10] *iii)* abolition of privileged access by governments in the primary market for sovereign debt; *iv)* a transparent debt management framework that includes an accountability system; and *v)* a primary dealer framework with the capacity to develop markets (OECD, 2002b).[11]

A proper public debt management is essential for the development of the corporate debt market. The experience of the OECD economies shows that the development of an efficient and properly managed government bond market precedes and facilitates the development of a private bond market (OECD, 2002b). Creating a risk-free curve with a long-term horizon based on government bonds of the same denomination from a single issuer would provide crucial information on market expectations for interest rates, inflation rate and Dominican sovereign risk. In order to adopt the standard methodologies for estimating this curve, the Dominican market will need to increase the liquidity and the issue of new benchmark securities with different maturities.[12] Investors surveyed in emerging economies agree that this curve is essential for calculating the price of private bonds (Borensztein *et al.*, 2008). Some of the main countries in the region, such as Brazil, Chile, Colombia, Mexico and Peru, have successfully created this curve and now the main challenge is to extend the maturity (with recent positive experiences as in Peru).[13] The curve should be established without a rapid increase in public debt which, owing to a crowding-out effect, hinders the development of the private debt market.[14]

Annex 4.A1. **Annual gross yield on securities issued by the public sector** (2011)



Note: The Central Bank securities included correspond to dematerialised certificates and Central Bank notes. The series labels indicate the month of the auction.

Source: OECD Development Centre, based on data from the Directorate of Public Credit (Dirección General de Crédito Público) and the Central Bank.

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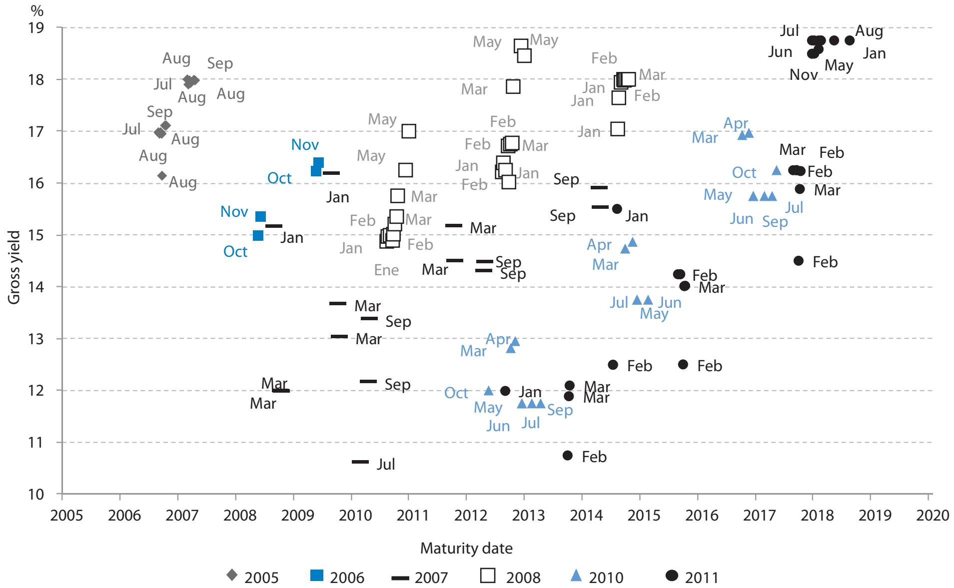
Annex 4.A2. **Annual gross yield on securities issued by the Central Bank** (2005-11)



Note: The Central Bank securities included correspond to Central Bank notes and dematerialised and physical issues of special investment certificates. The series labels correspond to the month of the auction.

Source: OECD Development Centre, based on data from the Central Bank.

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Notes

1. This amount corresponds to public sector debt with the economic actors, including commercial banks and suppliers, as well as debt issued by the Central Bank in the domestic and foreign markets. It does not include intra-governmental debt.
2. Central government marketable debt in OECD countries is expected to be 75% of GDP in 2012 (OECD, 2012).
3. Also, the CDS spread is higher in some OECD economies owing to the deterioration of public finances and the context of international crisis. During the same period, Greece, Portugal and Ireland saw their default risk approach 2 900, 685 and 550 basis points, respectively.
4. For an analysis of the macroeconomic situation of countries in the region before and during the crisis, see OECD (2009) and OECD (2010).
5. See Fitch Ratings (2012) for a detailed analysis of the strengths and weaknesses of the macroeconomic factors that affect sovereign debt and therefore the Dominican Republic's rating.
6. Additionally, the new Dominican financial framework allows the Ministry of Finance to consolidate debt transactions and provides greater predictability for public credit transactions. Since 2009, backed by the new legal framework, the Ministry of Finance has been holding periodic auctions partially to finance government transactions, creating a market for government debt.
7. To compare securities with different issue dates, the net yield corresponds to the spread between the interest rate of the Central Bank or the Ministry of Finance and the interbank rate. See Annex 4.A1. for an analysis of gross yield, *i.e.* without deducting the interbank rate.
8. The spreads between the Central Bank's issues shown in Figure 4.4 are discounted for the evolution of the interbank rate published by the Central Bank. See Annex 4.A2. for an analysis of gross yield on these issues, without discounting the interbank rate.
9. Only institutional investors can participate in the auctions. Additionally, dematerialised securities have only been issued since 2011, consequently price formation was previously minimal. It is estimated that only about 25% of Central Bank securities are dematerialised, but the institution is currently in the process of dematerialising all of its securities.

10. While the issuance of inflation-indexed securities may be seen as a sign of commitment from the government to reduce the inflation rate (as experienced in several economies in the region and in the OECD), the downside is the proliferation of different instruments, which could affect liquidity and the establishment of a risk-free benchmark curve.
11. Some of these aspects have been examined by the tax authorities (see Ministerio de Hacienda, 2010).
12. In line with preliminary studies on estimates of the zero-coupon yield curve elaborated by the Ministry of Finance at a fixed rate in local currency (Reyes, 2011), the bootstrapping methodology or the Nelson-Siegel model could be implemented in the future with the emergence of new issues and greater liquidity in the market.
13. However, according to surveys, more than half of the emerging economies lack an efficient benchmark yield curve for valuing corporate securities. Major constraints to establishing this curve are the lack of a proper debt management and lack of regular and scheduled issuance programmes (IOSCO, 2011).
14. Within the region, the case of Colombia is notable for this crowding-out effect (Aguilar *et al.*, 2008).

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Chapter 5

The private debt market and capital market regulation

Abstract

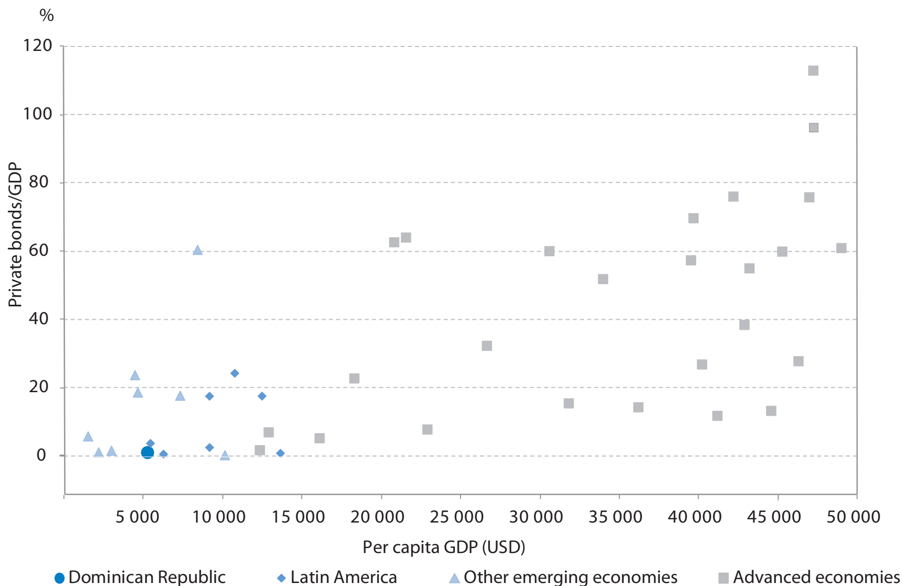
Despite experiencing sustained growth since 2005, the private debt market is lagging behind in terms of size, maturity and concentration in comparison with the global trend. In the primary market, the lengthy issuance process discourages firms from issuing securities. Moreover, issuers face substantial requirements and additional delays before their securities can be purchased by institutional investors. In the secondary market, it is necessary to increase the effectiveness of the trading platform and the clearing and settlement system, and to introduce a centralised information system in order to boost liquidity and enable price formation. Communication and co-ordination between the different superintendencies should be improved to reduce transaction costs for the market operators. The risks incurred by financial groups must also be suitably managed.

The private debt market is growing. The first private bond issue occurred in 2005. Since then, the total amount of private debt as a percentage of gross domestic product (GDP) has climbed steadily, from 0.1% in 2005 to 1.3% in 2011. Moreover, the number of tranches of securities issued has increased each year, from 7 in 2005 to over 30 in 2011.[1] In the same period the issued value increased from DOP 1.02 billion (Dominican pesos) to over DOP 5 billion. The largest issuer in the market is Grupo León Jimenes, representing 28% of total issuance.[2] Of the total amount of outstanding securities, 36% was issued by financial institutions and 64% by non-financial institutions. Among the non-financial corporations, the sectors that have issued corporate bonds are energy production, manufacturing, and hotel and food services (23%, 14% and 4% of total outstanding securities, respectively).

Nevertheless, the value of this market is below that of the main countries in the region (1.3% of GDP *vs*. 10% of GDP on average for the region).[3] Meanwhile, the leading countries in the region have less-developed corporate bond markets than the emerging economies in Asia (World Bank, 2012). The size of the Dominican Republic's corporate bond market, given its level of GDP per capita, is low compared to global trends and the leading countries in the region (Figure 5.1). The Dominican corporate bond market is also small compared to the value of commercial credit in the country's financial system (about 15% of GDP, see Figure 3.2).

The private bond market lags behind that of other countries in the region and advanced economies in terms of maturity, concentration and interest rate indexing. The average maturity of bonds issued between 2006 and 2011 was 3.9 years, while in the region and the G7 economies it was 6.8 and 9.4 years, respectively.[4] Market concentration is considerably higher. While the five largest issues of the last decade in Chile and the G7 countries accounted for about 30% of total issuance, in the Dominican Republic they accounted for 67% (the largest issue accounted for 40% of total issuance). In addition, the issuance of fixed-rate corporate bonds accounted for about 55% of total issuance,[5] whereas in the other emerging economies it accounted for 86% (IOSCO, 2011).

Figure 5.1. **Ratio of private debt to GDP and GDP per capita** (Dec. 2010)



Note: The selected Latin American countries are Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. The other (middle income) emerging markets are China, India, Indonesia, Malaysia, the Philippines, South Africa, Thailand and Turkey. The advanced or high-income economies included are Australia; Austria; Belgium; Canada; the Czech Republic; Finland; France; Germany; Great Britain; Greece; Hong Kong, China; Hungary; Iceland; Ireland; Italy; Japan; Korea; Netherlands; Poland; Portugal; Singapore; Slovakia; Slovenia; Spain; Sweden and the United States.

Source: OECD Development Centre, based on the World Bank and the Bank for International Settlements (BIS).

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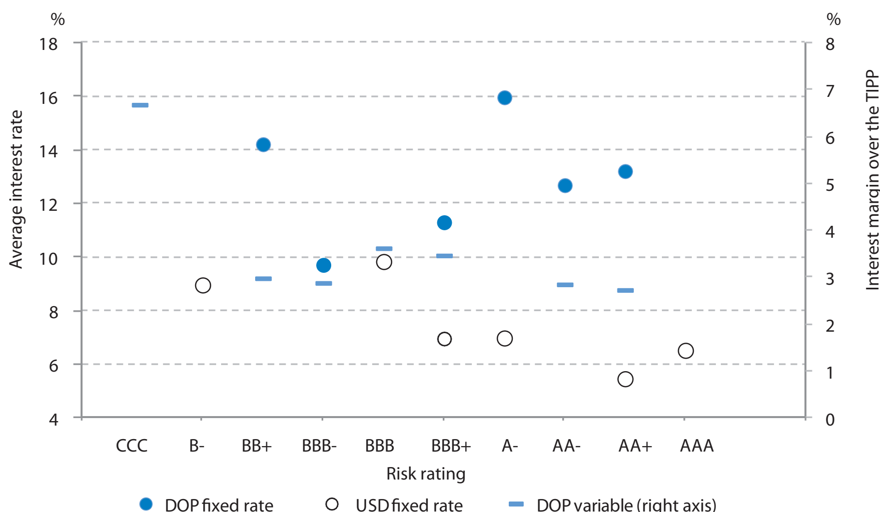
A significant percentage of issuances are denominated in US dollars. These issuances account for 40% of the total issued value. Ideally, companies whose income is not in US dollars should place issues in local currency to avoid exposure to exchange-rate risk, with their debt denomination matching that of their income. A comparison of fixed-rate yields in Dominican pesos and US dollars shows that companies tend to issue at lower interest rates in US dollars, regardless of the risk rating of the securities (Figure 5.2).[6] To determine whether it is advantageous to issue in foreign currency, there is more to consider than just the reduced cost of financing. Expectations of an exchange rate depreciation and exchange rate volatility should also be taken into account.

Figure 5.2. **Average annual interest rate on the securities issued according to risk rating**
(%, 2005-11)



Note: Corresponds to the interest rate in the primary market. There have been no variable rate issues in USD. The left axis refers to the interest rate on fixed-rate securities (in US dollars and Dominican pesos). The right axis refers to variable-rate issues and represents the interest margin over the TIPP (weighted average deposit interest rate) benchmark rate for full-service banks.

Source: OECD Development Centre, based on Superintendency of Securities.

StatLink http://dx.doi.org/10.1787/888932652605

The small private bond market is affected by the rapid growth of the public debt market. The trend in many emerging economies is the one of nascent corporate bond markets with few issues and secondary markets with low liquidity. While these markets do not reach the level of banking systems as a source of financing for the real sector, there is high growth in the government bond market (Borensztein *et al.*, 2008; IOSCO, 2011). In most Latin American countries, the government bond market has grown at a faster rate than the corporate bond market.[7] In the Dominican Republic, the positive effects of the government bond market on the corporate bond market have been limited because of an inadequate bond market infrastructure and the lack of a benchmark curve. In contrast, the high performance of government bonds has crowded out the demand of corporate bonds (see Chapter 6 for a comparison between the yields of government and corporate bonds).

Primary and secondary markets: key challenges

In the primary market, the bond issuance process entails a high fixed cost for most companies, thereby reducing the number of potential issuers. The process for issuing government bonds is long and complex. Moreover, although the Superintendency of Securities (Superintendencia de Valores, SIV) provides a detailed guide, preparation of the prospectuses is not completely standardised and their content varies only with respect to bonds' maturity. This situation leads to excessive issuance costs for most companies. Moreover, it can discourage larger companies from issuing, because they may have access to international markets with faster and more efficient processes.

Periodic reporting requirements for issuers of corporate bonds in the Dominican Republic are high in comparison to those in the rest of the region. In addition to an annual update of prospectuses, Dominican regulations require annual and interim (quarterly and monthly) financial reports. The quarterly reports must be accompanied by reports that are not required in most Latin American countries: a report on compliance with the terms of issue, a monthly balance sheet, an income statement, a cash-flow statement and a report on the debt rating revision. In Spain, Portugal and Uruguay interim reports are required only every six months and many countries do not require monthly reports (IIMV, 2010).

Because of the current institutional structure, corporate bond issues face additional requirements if market operators include pension funds and financial institutions. In addition to the SIV authorisation, issues must be approved by the Risk Rating and Investment Limit Commission (Comisión Clasificadora de Riesgos y Límites de Inversión, CCRLI) of the pension funds. This contrasts with the practices in both advanced and emerging economies, where the authorisation processes for issues and prospectuses tend to be simpler for issues aimed exclusively at institutional investors. In countries with the most advanced securities markets of the region, such as Brazil and Chile, less information is required when a corporate bond issue is aimed at institutional or qualified high net worth investors (IIMV, 2010).[8] This measure increases the number of issuers by reducing the issuance cost, while increasing investment options for institutional investors. Because these actors have great experience and market knowledge, the social cost of a limited increase in their portfolio risk may be small compared with the social benefit derived from increased access to financing of new businesses.

The majority of corporate bond issues have not been done via auction. The auction process is the main issue mechanism in advanced markets and emerging economies, and is generally the most effective. It can potentially provide cheaper financing due to the competition it creates and is more transparent than other techniques (OECD, 2002). Failure to use this mechanism may hinder access to cheaper financing. The regulation should therefore specify the type of auction to be held (multiple price or uniform price) in order to lower the cost of financing and prevent manipulation by the bidders.

In the secondary market, buying and selling of corporate bonds through free-of-payment (FOP) transactions reduces transparency and hinders the valuation of securities. According to interviews with market participants, much of the secondary market bond trading is done by FOP transfers. This type of transaction is used because of the lack of a clearing and settlement system, which requires several payments to be made when the same instrument is traded several times in one day, even among the same parties. FOP transfers do not require transaction prices to be reported to the SIV or to a centralised information system. The secondary market therefore lacks transparency and an efficient price-formation system. Unlike other problems in the bond market, this does not arise in most emerging economies, where half of the transactions are made through a stock exchange. Additionally, in two-thirds of countries, secondary market bond trades are reported and in more than half reporting is compulsory (IOSCO, 2011). Nevertheless, it should be mentioned that although trades are reported, most emerging economies also lack systems for circulating prices and information. In fact, fewer than half of them have a centralised information system for historical trade data.

An organised secondary market for corporate bonds in which transactions are made and prices are set via public platforms is virtually non-existent in the Dominican Republic. Currently there are two systems for over-the-counter (OTC) transactions: the Dominican Republic Stock Exchange (BVRD), which is exclusively for stockbrokers, and the Bloomberg platform (started in September 2011). However, in the BVRD, corporate bonds represent less than 15% of all securities traded.[9] Also, many other transactions posted on the BVRD website are handled by brokers without going through the exchange's trading platform and are only reported after the transaction is completed.

The limited variety of available instruments and players constrains liquidity in the secondary market. Although the country already has strong regulation that meets the International Organization of Securities Commissions (IOSCO) requirements for Collective Investment Institutions (CIIs), the participation of mutual funds and venture capital investors, insurance companies and investment

banks is virtually non-existent. Their participation would increase competition in the market and boost its liquidity (OECD, 2002). It is also necessary to develop derivatives and risk management instruments, including the establishment of futures and forward contracts on government debt, as well as swaps. With proper regulation and supervision, these would increase the possibilities for risk diversification, hedging and liquidity in the system (OECD, 2002).

While the above challenges are key to developing the private debt market, some developments have been made in the regulatory framework and market functioning. In particular, the following positive aspects should be highlighted. First, there are satisfactory levels of dematerialisation of corporate bonds. In contrast with the government bond market, all private bonds are dematerialised, increasing market efficiency and boosting liquidity in the secondary market. Second, the Dominican Republic will benefit from a high degree of accounting convergence as the International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB) become mandatory in 2013. Finally, the SIV is an ordinary member of IOSCO, enabling the study and implementation of international standards to promote an organised market.

Towards better co-ordination of the institutional and regulatory framework

The institutional structure of the Dominican regulatory system poses challenges for the prioritisation and implementation of a coherent policy for financial and capital markets. Regulation and supervision of the financial and capital system in the Dominican Republic are divided into four superintendencies, which are responsible for the proper functioning and stability of financial activities: the Superintendencies of Banks, Insurance, Pensions and Securities. In this institutional design, it is critical to co-ordinate effectively the prioritisation of policy objectives and the instruments used to pursue these objectives; this task is the responsibility of the Monetary Board as the agency in charge of regulating the monetary and financial system. The accountability of the institutions involved in the regulation of the financial and capital systems must also be coherent.

While the OECD does not provide specific recommendations on the organisational framework of the institutions supervising financial and capital markets, various aspects have been identified as necessary for the proper surveillance of these markets. The OECD Principles of Corporate Governance

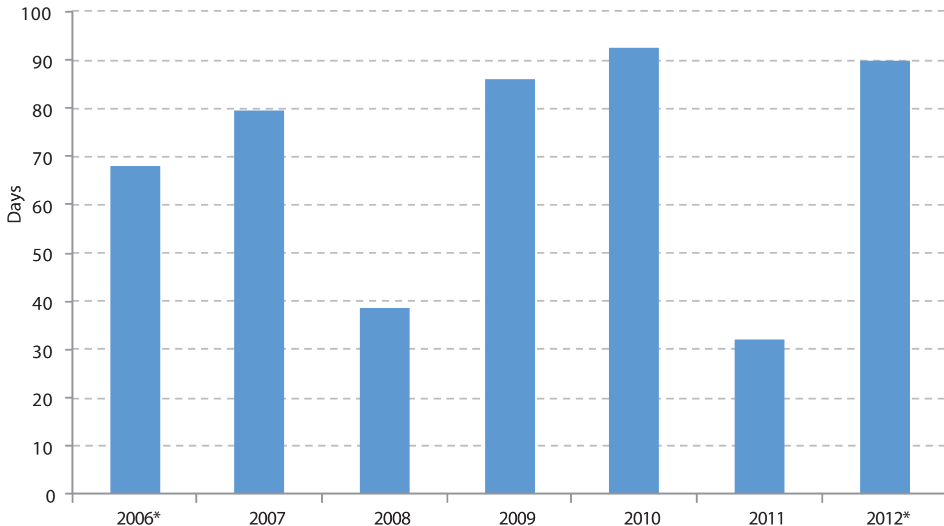
emphasise that the possibility of overlaps and conflicts between different supervisory regulations is another issue to be kept in check in order to avoid regulatory vacuums. These principles indicate that regulatory responsibilities should be vested with bodies that can pursue their functions without conflicts of interest and that are subject to judicial review. The superintendencies need fully qualified staff to conduct effective research work, and must give them sufficient autonomy and resources to fulfil their duties in a professional and objective manner (OECD, 2004). Several elements should be considered for co-ordination efforts to be successful. These include an initial willingness to co-operate of the parties, incentives for co-operation, the presence of an active leader and similarity of the participating organisations (Faerman *et al.*, 2001).

While the Dominican regulatory agencies have clearly defined responsibilities, they do not have total financial independence. With regard to responsibility, an ideal scenario would be to have agencies that are independent in their actions but fully accountable to the government. Countries that have adopted an integrated control system have done so by establishing an agency that is independent from the Central Bank. This separation has helped keep the regulatory focus on the agencies (Carmichael and Pomerleano, 2002). The state must develop decision-making mechanisms to ensure the operational and financial independence of the superintendencies (Abrams and Taylor, 2000), although this independence should not affect the convergence of objectives between the superintendencies' policies and the objectives and mechanisms of macroeconomic policy (OECD, 2010). Much of the SIV's revenue comes from resources deposited in the Central Bank. About 85% of the revenue comes from transfers from the Central Bank and 8% from the Ministry of Finance. Therefore, greater financial independence in the budget is important. The SIV is currently in the process of identifying new sources of income from services which would provide greater financial independence.

Although the faculties of each superintendency within their areas of competence are specified in detail, the exchange of information between them is inefficient. This is a key element for ensuring that the activities of financial institutions do not fall within the jurisdiction of any of the superintendencies, and for avoiding overlap between their policies (Abrams and Taylor, 2000). One example of the poor communication and co-ordination between the superintendencies is the time required by the CCRLI before the issues of corporate bonds may be purchased by pension funds: on average 70 days and in some cases more than three months (see Figure 5.3). This long delay is considered one of the main obstacles to the development of the corporate bond market (Shah *et al.*, 2007). Since SIV authorisation for issuance takes a maximum of 30 days, it

usually ends up taking three months or more for an issuer to place instruments that can be purchased by pension funds. This is nearly three times as long as the average among Ibero-American countries, which is about 25 days (IIMV, 2010). If issuers include financial institutions and securities to be purchased by pension funds, additional approval is required from the Superintendency of Banks, lengthening the process even further.

Figure 5.3. **Approval time of the CCRLI for private debt issuance**



Note: Average approval time for private debt issuance between the Superintendency of Securities and the Risk Rating and Investment Limit Commission (CCRLI) approvals. Securities to be purchased by pension funds. Includes only securities outstanding as of January 2012.

* Only one issue was approved for investment by pension funds in January 2012.

Source: OECD Development Centre, based on Superintendency of Pensions and SIV.

The current institutional framework is not suitable for the Central Bank to assume a leadership position among the regulatory committees. An independent Central Bank with an established inflation targeting policy could occupy a leadership position within these committees. In the European Union, the financial market is regulated by a committee (the European Systemic Risk Board), while in the United States the Federal Reserve is one of the ten voting members in the Financial Stability Oversight Council (FSOC) and the market

is legislated with regulations for banks and financial institutions designed by the FSOC. Owing to the lack of an adequate institutional framework for conducting monetary policy, the Central Bank would prove ineffective in leading a supervisory committee, as there could be an inverse relationship between financial supervision unification and Central Bank involvement (Masciandaro, 2006). In other words, the Central Bank's incentives may be contradictory, since it is a bank supervisor as well as being responsible for controlling inflation. The credibility of the Central Bank as both a financial regulator and the body responsible for monetary policy would thus be tarnished (Čihák and Podpiera, 2006). In general, there is an overlapping of banking supervision in monetary policy and vice versa (Tuya and Zamalloa, 1994).

The composition of the National Securities Council (CNV) could result in regulatory arbitrage and conflicts of interest. This body is composed exclusively of active members of authorities and corporations involved with the functioning of the stock market, thus ensuring that all its members have great experience and knowledge. However, this makes the CNV vulnerable to conflicts of interest, particularly because of the absence of regulation for setting standards of conduct in such cases.

Finally, the lack of an explicit code of corporate governance to establish clearly defined standards and practices, especially for issuing companies, is an obstacle to achieving greater transparency. This code also ensures protection for all creditors and increases investor confidence in the corporate bond market. This is important in economies such as the Dominican Republic, where the largest companies are family-owned. Having a high concentration of control and ownership in corporate issuers creates greater challenges for good corporate governance practices and requires higher levels of operational transparency and independence (IOSCO, 2011; OECD, 2004).

Recommendations and outlook

Improvements are needed in the primary market placement process. It is crucial to reduce the approval time for issues, to standardise the required documentation (such as the prospectus), to shorten the SIV verification period, and to simplify the investment process for institutional investors in the primary market. Auctions should be used more regularly as a technique for placing corporate bonds. One way to achieve this transition is by implementing hybrid offer regimes, a practice currently used by some of the foremost emerging

economies in corporate bond markets, such as Brazil, Chile, India, Malaysia and Thailand (IOSCO, 2011).

It is crucial to improve the infrastructure of the secondary market. Enhancements should be made to the centralised systems for handling information, deposits, clearings and payments. These factors are a major determinant of investor confidence in the market infrastructure (OECD, 2002). Collectively, they constitute one of the main obstacles to the development of bond markets in emerging economies (IOSCO, 2011). For example, there must be guaranteed information sharing between the trading platforms and the Central Securities Depository (CEVALDOM). As is planned for 2012, a trading platform with a safe and efficient clearing and settlement system must be implemented for the secondary market. Likewise, market regulation and discipline should impose drastic penalties on FOP transactions and should also encourage the use of a Bloomberg-type OTC electronic market. It is also expected that the draft Regulation on the Object of Trading, Functioning and Organisation of the Securities Market drawn up by the SIV will help promote the use of these platforms as transparent public trading frameworks.

In view of the multiple regulatory bodies in the financial and capital market, it would be advisable to establish a committee for promoting, co-ordinating and tracking quality reforms. This committee, comprised of independent experts and policy makers, would bring together different perspectives on the procedures for addressing the risks facing the market, especially systemic risk (Bank for International Settlements, 2011). Furthermore, the committee can also help identify the most appropriate tools to use (which may come from the various superintendencies) and the effective channels of communication and information exchange between regulatory agencies (Bank for International Settlements, 2010 and 2011). One of the main tools that have been found to contribute to regulatory quality in OECD economies has been the implementation of expertise and perspectives developed jointly between regulatory agencies, which has helped ensure a consistent regulatory framework (Hill, 2001).[10]

Fostering co-ordination among superintendencies will lead to reductions in administrative costs and support activities that could generate resources for the development of career plans. The adoption of harmonised policies ensures consistent supervisory decisions and reduces the administrative burden on each superintendency arising from a duplication of tasks and requirements (European Financial Services Round Table, 2009). The superintendencies can become more effective by establishing appropriate remuneration for supervisors, designing career plans and improving their competitiveness.

The Securities Council should include experts who are independent from stock market activities and a code of corporate governance should be developed. The Securities Council could include academics and should adopt regulations to provide standards of conduct for potential conflicts of interest. This would make policy formulation and market regulation more transparent. It is also essential to develop a code of corporate governance. Following the principles promoted by the OECD, the code should protect and facilitate the exercise of shareholders' rights, recognise the rights of stakeholders and ensure accountability and executive control of companies by the firms' council, while maintaining accordance with the legal and institutional framework of the economy (OECD, 2004). It would be advisable to adopt a national code that is subject to a "comply or explain" regime, as is applied in many countries of the region. In the long term, the introduction of appropriate standards and a culture of good corporate governance will enable a higher number of Dominican companies to participate in capital markets and facilitate the development of the equity market.

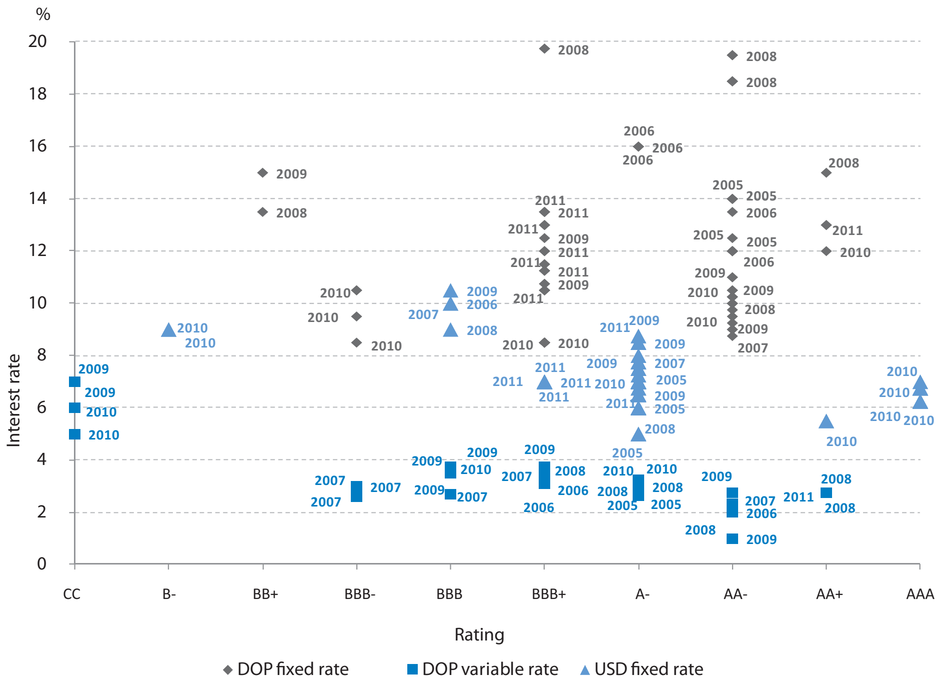
Annex 5.A1. **Private debt issues (2006-11) outstanding as of January 2012**

Year of issue	Issuer	Rating	Currency	Amount subscribed (DOP)
2006	BNV	AA-	DOP	882 500 000
	Adopem	BBB+	DOP	300 000 000
2007	Banco León	BBB-	DOP	400 000 000
	Banco Popular	AA-	DOP	4 079 000 000
2008	Industrias Nacionales	A-	DOP	1 000 000 000
	Cervecería Nacional	AA+	DOP	4 050 000 000
	BHD Valores	AA-	DOP	1 000 000 000
	Motor Crédito	BBB+	DOP	300 000 000
2009	BNV	AA-	DOP	271 000 000
	Multiquímica	BBB	DOP	242 748 000
	Industrias Nacionales	A-	USD	1 104 520 942
	EGE Haina	A-	USD	1 104 520 942
	Delta intur	CC	DOP	850 000 000
2010	Itabo	A-	USD	552 260 471
	Banco Ademi	BBB	DOP	500 000 000
	ALAVER	A-	DOP	800 000 000
	Cap Cana	B-	USD	364 455 093
	Parallax Valores	BBB-	DOP	294 520 000
	CEPM	AAA	USD	1 840 868 236
	Cervecería Nacional	AA+	USD	856 003 730
	Cervecería Nacional	AA+	DOP	286 750 000
	CEPP	A-	USD	920 434 118
2011	Valores León	BBB+	DOP	913 311 000
	EGE-Haina	A-	USD	1 840 868 236
	Cervecería Nacional	AA+	DOP	1 025 580 000
	Industrias Nacionales	BBB+	USD	1 472 694 589
				27 252 035 357.17

Note: Amount subscribed based on an exchange rate of USD 1 = DOP 36.82

Source: OECD Development Centre, based on Superintendency of Securities

Annex 5.A2. **Interest rates on securities issued according to risk rating**



Note: There have been no equity issues in USD. Number in labels represents the year of issuance.

Source: OECD Development Centre, based on Superintendency of Securities.

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Notes

1. Each issue is divided into tranches, and in turn each tranche is divided into series. Different series in the same issue can vary in placement date, amount issued, maturity, interest rate level and interest rate indexing. See Annex 5.A1 for a table with all issues between 2006 and 2011 outstanding as of January 2012.
2. Companies belonging to this group that have issued in the bond market are Cervecería Nacional Dominicana SA, Banco Múltiple León SA and Valores León S.A.
3. Average of 2000-09 for Argentina, Brazil, Chile, Colombia, Mexico, Peru and Uruguay (World Bank, 2012).
4. This is the Latin American average from 2000-09 for Argentina, Brazil, Chile, Colombia, Mexico, Peru and Uruguay (World Bank, 2012).
5. Only 17% of the total issuance is denominated in Dominican pesos at a fixed rate. Moreover, all issues have been callable bonds.
6. See Annex 5.A2 for total tranches issued, according to year of placement.
7. Only Chile, which in 1995 already had a public debt market that represented 60% of GDP, experienced a reduction in public debt while the private bond market expanded (Borensztein *et al.*, 2008).
8. In Dominican Republic, there is a simplified version of the prospectus that does not include information about the issuer. However, this only applies to issuers for which a full prospectus has been approved within the past 12 months, or when the issue is a tranche from an issuance schedule that has already had a full prospectus approved.
9. The Bloomberg trading platform offers lower transaction costs and operates one hour longer. It also increases the transparency and transaction capacity of the primary market.
10. In the United Kingdom, none of the regulators should require approval of the legislation by another regulator. However, they should be able to consult and consider the viewpoint of the other institution (HM Treasury, 2011).

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Chapter 6

Institutional investors

Abstract

Pension funds are the largest institutional investors, and are experiencing a sustained increase in value and investment horizon. Nonetheless, they invest about 90% of their assets in public debt instruments (mainly in Central Bank securities) or securities issued by financial intermediaries, which limits their effect as a stimulus to the real sector. This concentration is due to the risk-return ratio on government bonds compared with other investment options. Quantitative restrictions have prevented an even greater concentration in Central Bank securities. In the long term, it would be advisable to include new players such as mutual funds. However, if the current trend in public debt management continues, measures to foster market expansion will fail to increase significantly the impact of institutional investors on the real sector.

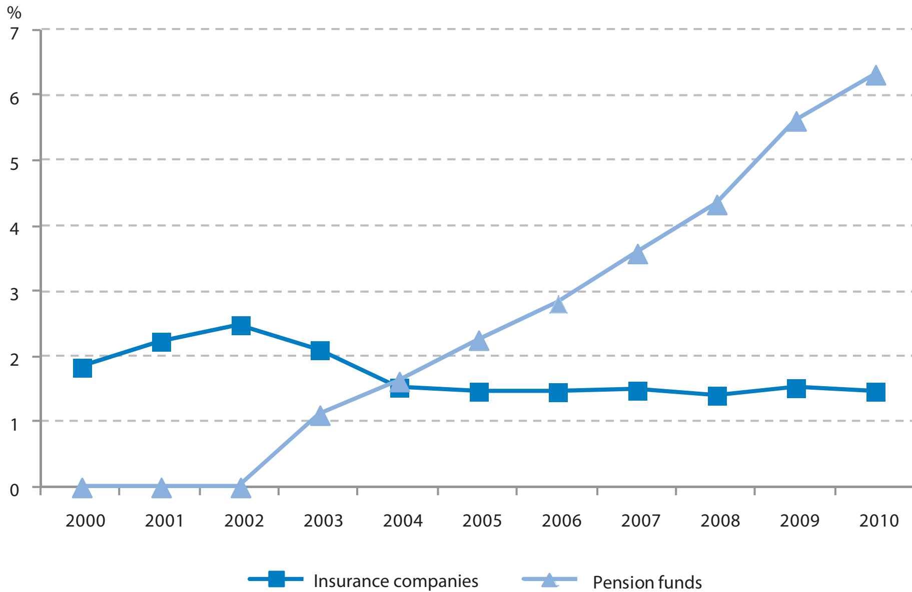
Institutional investors have great potential to stimulate and develop the capital markets and the economy in general. Their ability to build up substantial private savings enables them to act as intermediaries between lenders and borrowers, making them a key component for the functioning of financial markets. Thus, they play a crucial role for improving access to the financing and development of the real sector. As banks' incentives can vary with changes in the composition of credit, institutional investors are an alternative mechanism for ensuring the flow of resources towards private investment.

This potential is particularly attractive because many institutional investors have incentives to invest in long-term assets that are generally less liquid. Pension funds have cumulative assets and liabilities with a long-term structure. This not only ensures a stable supply of funds for the capital market and sufficient liquidity in the system (Meng and Pfau, 2010), but also creates a potential natural fit with long-term investment in infrastructure, given its assets provide protection against inflation risk (Inderst, 2009).[1] For this reason, the OECD identifies institutional investors as a key source of capital to meet global infrastructure requirements to 2030 (OECD, 2011a).[2]

Tapping the potential of institutional investors requires financial market depth, a wide variety of investment vehicles and proper regulation. The impact of pension funds can vary considerably, depending on the depth and sophistication of the financial system (Meng and Pfau, 2010). The regulatory measures should include a comprehensive prudential framework that adds security to the system, while providing sufficient flexibility for an efficient use of resources. Pension funds are the main institutional investors in the Dominican Republic. As pension systems have evolved towards partial or complete financing systems, pension funds have gradually accumulated significant amounts of assets.

Following the trend of other countries in the region, the system of mandatory retirement saving was introduced in 2003. Figure 6.1 shows that pension fund assets in the Dominican Republic went from 1.1% of gross domestic product (GDP) in 2003 to 6.3% of GDP in 2010. As the system is still new, this percentage remains below the average of OECD countries (67% of GDP) and even of some of the major countries in the region. As a percentage of GDP, in Chile pension fund assets represent 65%, compared with 17% in Brazil, 11.5% in Argentina and 7.5% in Mexico (OECD, 2011b).[3] Insurance companies, meanwhile, have maintained a limited role, with total assets stable at less than 2% of GDP. Nonetheless, insurance companies should see future benefits from the private pension system, because part of the savings is converted into annuities upon retirement.

Figure 6.1. **Assets of pension funds and insurance companies** (% of GDP)



Source: Superintendency of Insurance, Superintendency of Pensions, Central Bank of the Dominican Republic.

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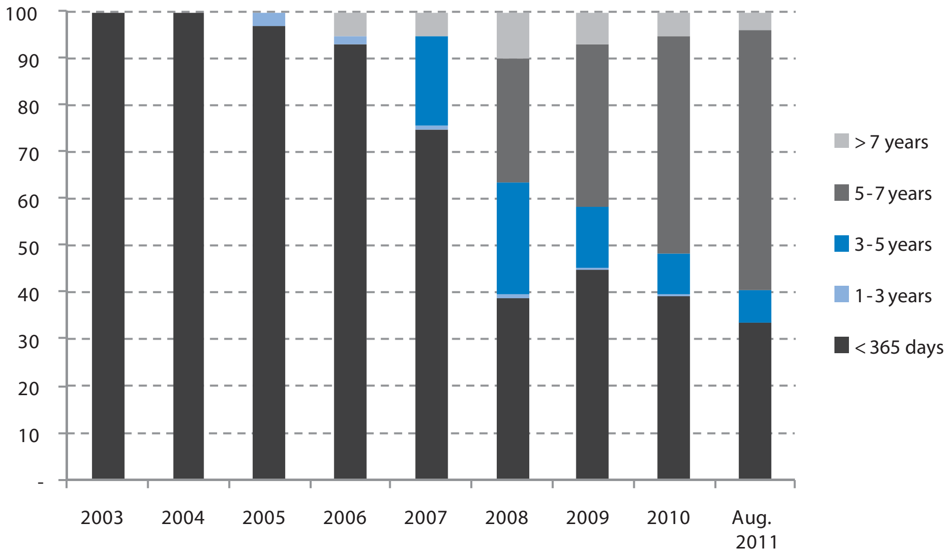
The Dominican pension funds are showing an increasing preference for medium- and long-term instruments. Given the absence of a stock market, practically all pension fund investments are in fixed-income instruments. Figure 6.2 shows the marked increase in the investment horizon within the past four years, predominantly in securities and notes issued by the Central Bank. Concurrently, the percentage of portfolios allocated to instruments with a horizon of less than one year dropped from nearly 100% in 2003 to 35% in 2011. The amount of securities with maturities of more than three years rose from zero in 2003 to 60% of the portfolio in 2011. However, the weighted average maturity of pension fund portfolios is around 4.2 years, which remains low compared with that of the regional leaders, such as Chile, where the average is 5.4 years.[4]

Figure 6.2. **Investment horizon of individual capitalisation pension portfolios** (%)



Source: Superintendency of Pensions.

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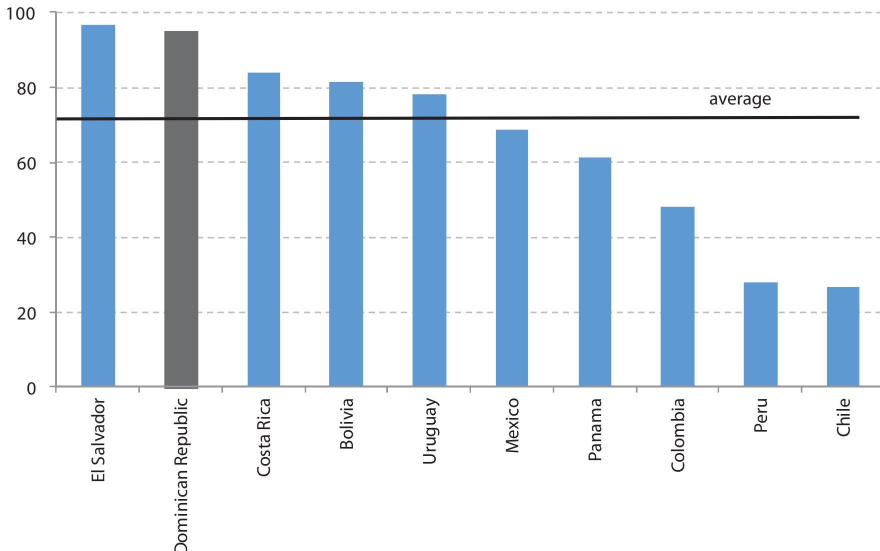
The regulatory framework for pension funds has fostered the channelling of pension fund resources to the real sector. Through various public investment instruments, pension funds have been promoted as a means to finance housing demand (SIPEN, 2006). As part of the national strategy to develop the mortgage market, legislators recently passed Law 189 of 2011, which is aimed at future investment in mortgage-backed securities. This legislation not only strengthens existing investment instruments, such as mortgage notes (*letras hipotecarias*) and securitised bonds derived from the securitisation of mortgage portfolios. It also creates new instruments, such as mortgage bonds and securities derived from trust operations (SIPEN, 2011a). Likewise, the SIPEN (Superintendencia de Pensiones de la República Dominicana) has sought inroads with various productive sectors of the economy, promoting the benefits of using pension fund resources as a financing alternative (SIPEN, 2011b).

Current obstacles and challenges

Pension funds have very little impact on the financing and development of the real sector. These instutitions invest almost exclusively in securities issued by the government and financial intermediaries (Figure 6.3). These instruments account for 96% of the pension fund portfolios which is well above the regional average. The Dominican pension funds invest 58% of their portfolios in public debt, nearly doubling the average figure for the OECD countries (30% in 2010, according to OECD figures). Consequently, the high growth of fund assets does relatively little to improve access to financing in the real sector and to add liquidity to the private debt market.

Figure 6.3. **Percentage of pension fund assets invested in public securities and financial institutions** (% of total assets)



Note: Latest available data (2011 for the Dominican Republic and 2010 for other countries). For the Dominican Republic refers to individual capitalisation pension funds. “Public securities” refers to securities issued by the Central Bank and the Ministry of Finance.

Source: OECD Development Centre, based on AIOS (International Association of Pension Fund Supervisors) and Superintendency of Pensions.

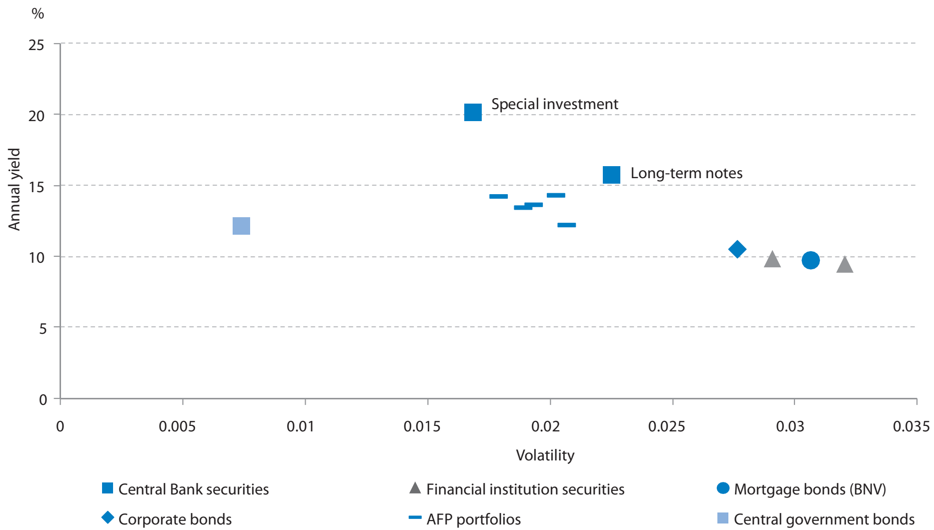
StatLink http://dx.doi.org/10.1787/888932652700

The concentration of pension fund portfolios in public debt instruments is explained by their risk-return ratio in comparison with other investment options. Figure 6.4 shows that public debt instruments performed better than private debt instruments in terms of increased yield and lower volatility. The most prominent case is that of the special medium-term investment certificates issued by the Central Bank. While their return nearly doubles that of corporate debt securities, their volatility is slightly more than half. Government bonds have a similar return to that of corporate bonds but are almost four times less volatile. This situation differs from the investment environment in OECD countries. For example, Annex 6.A1 describes the risk-return ratio of securities in the United States for the same period. Government bonds with maturities of ten and five years show six times less volatility than corporate bonds and their return is four times lower. While the risk-return ratio of Dominican corporate debt securities highly resembles that of high-yield corporate bonds in the United States (around 3% yield per volatility percentage point), the substantial difference comes from the excessive return on debt securities issued by the Dominican Republic's Central Bank (a 12% yield per volatility percentage point in the Dominican Republic compared with 3.5% in the United States for medium-term treasury bonds).

The diversification of pension fund portfolios does not match the risk-return ratio of Central Bank securities (Figure 6.4). To bring portfolios closer to the threshold of efficient diversification, investments must be almost exclusively in public debt securities. The yield of pension-fund portfolios (13.6% on average) does not match that of Central Bank securities (18%), though they have similar volatility (19% on average).

Pension funds have limited opportunities for diversifying private debt risk. Long-term Central Bank notes offer substantial opportunities for diversification as they have a low correlation with other debt instruments (for example, 0.24 with respect to the securities issued by the central government) and a highly negative correlation with private debt instruments (for example, 0.71 with respect to deposits and certificates from financial institutions). In contrast, private debt instruments have a high correlation with each other (for example, mortgage notes have a 0.93 correlation with corporate bonds) and with medium-term Central Bank instruments (with which mortgage notes and corporate bonds have correlations of 0.53 and 0.71, respectively). Annex 6.A2 presents an analysis of the correlation matrix for the different pension-fund investment vehicles. In general, the current market conditions, particularly those offered by public-debt issuers, give pension funds little incentive to invest in private debt or other securities of the real sector.

Figure 6.4. **Risk-return curve for pension funds and their investment instruments**
(average of 2008-11)



Note: Compiled from monthly data for the period September 2008 to September 2011. Volatility refers to the standard deviation. BNV refers to Banco Nacional de Fomento a la Vivienda y la Producción, AFP refers to Administradoras de fondos de pensiones (pension fund administrators).

Source: OECD Development Centre, based on Superintendency of Pensions.

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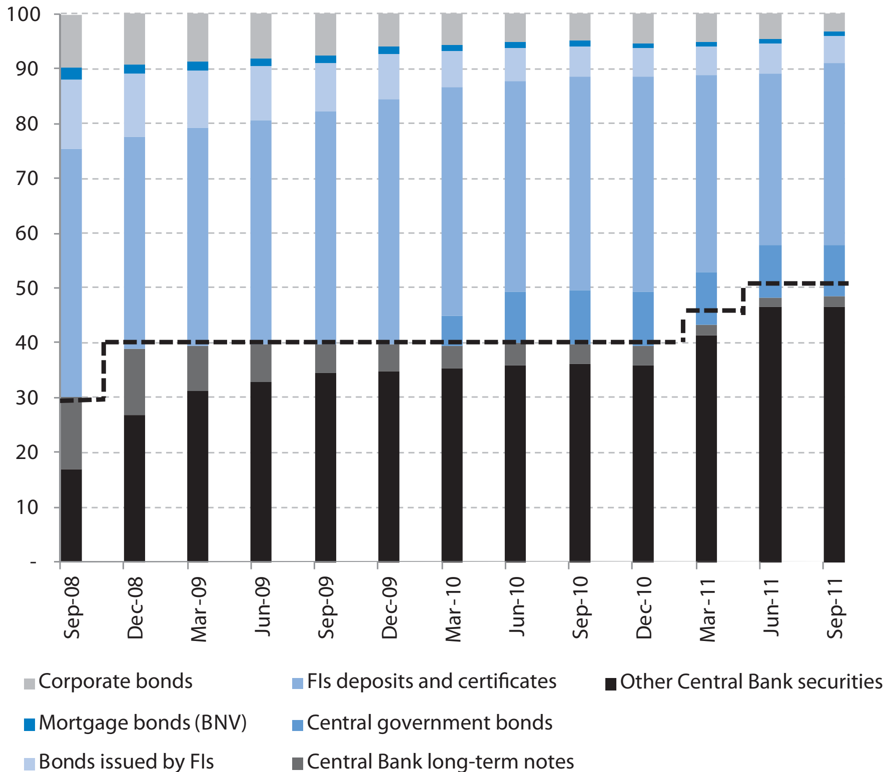
Regulations have restricted investment in government bonds in order to avoid an even larger proportion of these securities in pension fund portfolios. In 2007, Law 18807 authorised pension funds to invest up to 20% of their portfolios in Central Bank securities.[5] This ceiling has been increased several times and currently stands at 50%. After each increase, pension funds have responded immediately by increasing their participation in Central Bank securities (see Figure 6.5). Thus, pension funds keep their investments in these securities at the allowed limit. This trend was directly detrimental to pension fund investments in the instruments of financial institutions and to the already reduced investment in corporate bonds and mortgage notes. Therefore, unlike in the OECD economies, without restrictions Central Bank debt would almost completely crowd out investment in any other type of instrument. Similarly, there is a limit on foreign investments, which creates an additional risk due to the concentration in local assets.[6]

Figure 6.5. **Portfolio composition of individual capitalisation pension funds** (%)



Note: The dotted line represents the investment limit for the pension funds in Central Bank securities. FIs refers to financial intermediaries, BNV refers to Banco Nacional de Fomento de la Vivienda y la Producción.

Source: OECD Development Centre, based on Superintendency of Pensions.

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This restriction on investment in public debt contrasts with the practices of OECD countries and certain countries in the region. With few exceptions, OECD member countries do not impose any limits on investment in public debt (OECD, 2010).[7] Among the main countries in the region, Colombia and Chile apply a limit of this type. While Chile has a limit of between 40% and 80% according to the portfolio type of the pension funds, Colombia has a limit of 50%. Meanwhile, the Dominican Republic's 70% limit on investment in private debt is high in comparison with the main countries in the region.[8] Chile has

a limit of 60%, while Colombia has a limit of 10% on bonds issued by entities under the supervision of the Superintendency of Finance and of 30% for non-supervised entities (OECD, 2010).

The other quantitative restrictions follow the lead of OECD member countries with less advanced economic development. Dominican regulation provides for a limited number of investment options and the Risk Rating and Investment Limit Commission (CCRLI) has imposed a specific limit for each investment vehicle (Shah *et al.*, 2007). As a result, its regulatory framework is less flexible than that of OECD countries, of which half have no investment limits on any type of bonds (OECD, 2010). However, the CCRLI has gradually raised the ceiling on investment in various instruments – a similar trend to that observed in less developed OECD economies such as Chile, Hungary, Mexico and Turkey. In addition, the national regulation contains the main provisions recommended by the OECD and practised by most of its members (OECD, 2006). Since 2001, as a result of Law 8701 and the first CCRLI resolution, there have been limits on investment in securities from the same issuer or the same economic group, as well as a limit of 5% investment in assets with the potential to generate conflicts of interest (such as corporate assets of pension fund owners or executives). Finally, in keeping with the practices recommended by the OECD, the CCRLI has refrained from imposing any minimum rates on investment in specific instruments.

The Dominican regulations contain the prudential principles that the OECD advocates in its recommendations, even if they do not explicitly mention the prudent person rule. Law 87 of 2001 establishes Central Bank custody of pension fund investments and defines the member's right to a minimum return. The CCRLI restricts investment in low-liquidity assets through its resolutions and defines explicit risk controls on investment instruments. In addition, the Superintendency of Pensions requires pension funds to define and implement a clear investment policy when they are set up.

Recommendations and outlook

In the long term, investment opportunities for institutional investors must be increased and new actors, such as mutual funds, should be included. Direct investment in infrastructure is a suitable alternative with considerable benefits for the country's development. Consideration could also be given to allowing pension funds to invest abroad, because a concentration in Dominican assets

means less risk diversification for savers. However, it is crucial to understand the challenges and potential difficulties that this investment would involve for managing the macroeconomic issues mentioned in Chapter 2, particularly in relation to the balance of payments and the exchange rate. Furthermore, closed-end investment funds, mutual funds and mortgage instruments (securitisation and mortgage bonds) could allow greater risk diversification for pension funds. Finally, an explicit prudent person rule to complement the quantitative restrictions could be included in the pension fund regulation to make it more flexible.

However, if the current trend in public debt management continues, these measures will fail to increase the impact of institutional investors on the real sector. Institutional investors will concentrate their investment in Central Bank debt because the private sector does not have the capacity to issue instruments that compete with its risk-return ratio. Conversely, if the ceiling on pension-fund investment in Central Bank debt continues its upward trend, investment in the securities of financial institutions, mortgage notes and corporate bonds will be further crowded out. Likewise, there will be limited incentives to invest in new instruments.

Annex 6.A1. Risk-return ratio of public and private debt instruments in the United States (2008-11)

Source: OECD Development Centre, based on Thomson Datastream.

StatLink http://dx.doi.org/10.1787/888932652757

Annex 6.A2. **Correlation matrix between instruments** (2008-11)

	FIs deposits and certificates	FIs bonds	Mortgage bonds (BNV)	Corporate bonds	Central Bank long-term notes	Other Central Bank securities	Central government bonds
FIs deposits and certificates	1	0.84	0.92	0.76	-0.71	0.24	-0.15
FIs bonds	0.84	1	0.95	0.93	-0.51	0.53	-0.16
Mortgage bonds (BNV)	0.92	0.95	1	0.93	-0.62	0.53	-0.09
Corporate bonds	0.76	0.93	0.93	1	-0.53	0.71	0.09
Central Bank long-term notes	-0.71	-0.51	-0.62	-0.53	1	0	0.24
Other Central Bank securities	0.24	0.53	0.53	0.71	0	1	0.6
Central government bonds	-0.15	-0.16	-0.09	0.09	0.24	0.6	1

-1 a -0.26   -0.25 a 0   0 a 0.25   0.26 a 1

Note: Compiled from monthly data for the period September 2008 to September 2011. FIs refers to financial intermediaries, BNV refers to *Banco Nacional de Fomento de la Vivienda y la Producción*.

Source: OECD Development Centre, based on the Superintendency of Pensions.

Notes

1. See www.oecd.org/finance/lti for further information on the importance of long-term investment.
2. Global infrastructure requirements to 2030 are estimated to be of the order of USD 50 trillion (OECD, 2011a).
3. Data from 2009 for OECD countries and from 2007 for Argentina and Brazil (OECD, 2011a).
4. Weighted average maturity of investment in debt instruments. Data for Chile from September 2007, the last time the Chilean Superintendency of Pensions published these data in its monthly bulletins on the investments and returns of pension funds.
5. Initially, Law 8701 did not allow investment in public debt (Shah *et al*., 2007).
6. Extra precaution is necessary, considering the challenges that would be entailed by removing this constraint in the present macroeconomic and balance-of-payments context. The legislation provides for investment in such mechanisms, although there is a need for complementary rules that are in the design process.
7. Of the 34 OECD members, the only countries that place restrictions on pension-fund investment in public debt, excluding local and municipal government bonds, are Chile and Germany (OECD, 2010).
8. The key exception is the Brazilian regulation, which allows an investment of up to 80% of assets in corporate debt.

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Chapter 7

Financial literacy, new instruments and market expansion

Abstract

Financial literacy is a key element for capital market development. Therefore, a financial literacy campaign should be carried out for each type of saver, private companies should be involved by improving their understanding of the capital market, and the regulatory bodies could be kept highly qualified and competitive. Additionally, the government should strive to facilitate access to financing for small and medium-sized enterprises outside the traditional sources. In the long term, remittances could lead to the creation of two types of instrument: the securitisation of future remittance flows and "diaspora bonds". Finally, it is important to continue promoting new financial products and to seek a broader base of investors through co-operation with other stock exchanges in the region.

Financial literacy

Financial literacy is a key element for a sustainable capital market development. Financial services and products have increased in range and complexity, and the economic players need to understand them.

The growth in pension funds calls for specialisation of market actors to ensure the viability of investments. As a result of shifting reforms from welfare-based pension systems to individual capitalisation systems, workers will be assuming more responsibility for their accounts (OECD, 2005). It is necessary to ensure that individuals make informed decisions that allow them to maintain – and increase – the value of their portfolios over time.

It is relevant to identify the demand for financial products and services in order to define an effective policy for financial literacy. Because it is difficult to synthesise information on perceptions of these services, there are no standard mechanisms for comparing levels of financial literacy. However, countries can establish their own means for collecting information and pinpointing failures in literacy and the most effective mechanisms for addressing them. The OECD provides some guidelines for designing such questionnaires (OECD, 2005).

With regard to savers, in the Dominican Republic there is a need for a two-tiered financial literacy campaign. The first tier would be for the segment of unbanked individuals, with literacy focusing on the basic products of the financial system, such as savings accounts. The disincentives to use the banking system, such as misinformation about functionality and low deposit rates, must also be eliminated or reduced. The second tier should focus on investors who have investment capacity but are unfamiliar with the available instruments other than the traditional offerings of commercial banks and have an incomplete knowledge of finance.

There is a high potential to increase the number of private companies in the market. Considering the high interest rates of commercial banks and the expected improvement in public debt management (see Chapter 4), participation in the Dominican Republic's capital market is an attractive financing alternative for private-sector companies. However, these companies are often unfamiliar with the mechanisms for participation. Thus, a campaign aimed at businesses with the capacity to assume the costs of participation could prove effective, adding liquidity to the system and diversifying the range of products offered to investors, particularly institutional ones. Meanwhile, one way to help reduce the time taken for placement is to offer training for first-time corporate issuers.

It is also necessary to maintain highly qualified regulators. Because of the dynamic nature of the market over the last ten years, regulators must also be capable of adapting to changes. They must be able to: *i)* respond to the demands of the current participants; *ii)* achieve the involvement of new actors; and *iii)* reduce non-regulatory obstacles to efficient development of the stock market. To achieve this, it is crucial to have an adequate funding to enable the hiring, training and retention of qualified personnel.

Frameworks for access to financing by small and medium-sized enterprises

In many countries, small and medium-sized enterprises (SMEs) are an important source of job creation and wealth. In certain sub-sectors, such as technology, they can play an important role in innovating and changing production processes (OECD, 2000). For the Dominican Republic, several sources reveal that at least three-quarters of employment is generated through SMEs (Guaipatín, 2003; ONE, 2007).[1]

The growth of SMEs is often hampered by problems in obtaining credit. In the Dominican Republic, according to the World Bank, restricted access to credit for businesses (of any size) is the fifth obstacle that impairs the business climate (World Bank, 2012), while the *Global Competitiveness Report* lists it third (World Economic Forum, 2010). This limits the ability of SMEs to contribute to economic growth.

Regulatory restrictions and the underdevelopment of financial products limit the participation of SMEs in the financial and capital markets. Financial regulation, which was strengthened after the crisis of 2003-04, imposes high standards on banks. As a result, these companies were essentially precluded from bank financing owing to the increased loan requirements. Though the risk factors for creditors should not be neglected, an increased participation of SMEs in the capital markets would give them financing and bring new players into the market.

Clearly targeted government involvement could be an effective means of facilitating access to financing for SMEs, especially with measures to complement traditional financial channels. Credit guarantee schemes (CGS) act as a risk-transfer mechanism that enables small firms to overcome the information asymmetry and lack of collateral that result in limited access to financing.

Furthermore, providing non-financial support to improve information flows could remove certain non-regulatory barriers to market participation, while eliminating the potential moral hazard of direct government financing (OECD, 2006). Simplifying the structuring of issues could streamline the process and reduce costs of participation, while providing disclosure of the necessary information to ensure the security and transparency of the system. A mechanism such as direct financing for structuring a single issue of securities for a group of SMEs could help to open the market to this segment of the economy.

Adding new instruments may increase the number of participants in the market and further promote the channelling of credit. Securitisation of the credit or investment portfolios of a group of SMEs could be attractive as an alternative instrument for pension funds or new operators such as mutual funds. This requires investors with a higher appetite for risk and greater information transparency in participating companies. Moreover, the addition of public companies (even only a minority participation) would streamline the development of the equity market and offer a potentially attractive alternative to institutional investors, especially pension funds. Finally, defining alternative forms of participation could bring small businesses into capital markets, by reducing entry costs. An example of initiatives aimed specifically at small and medium-sized enterprises with high growth potential in the region is the alternative stock market (Mercado Alternativo para Acciones, MAPA) in Costa Rica; an example in developed economies is the Alternative Investment Market (AIM) in London. These systems have less stringent reporting requirements while providing a formal trading platform.[2]

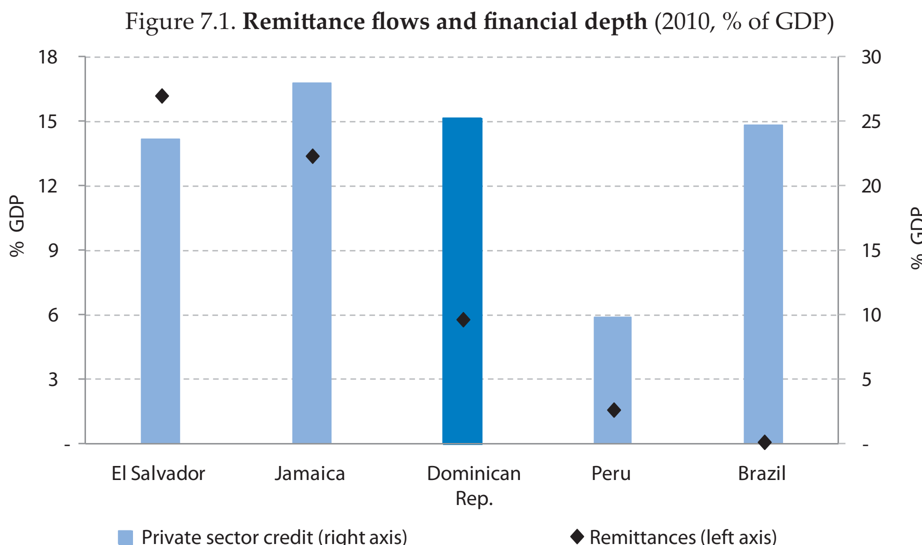
Remittances and capital market development

The significant flow of remittances to the Dominican Republic could potentially stimulate the capital market. Remittances in the Dominican Republic account for just under 6% of gross domestic product (GDP), and although their relative importance has declined, they are still an important vehicle for generating foreign currency revenue. As in many of the region's economies, low levels of domestic savings and underdeveloped capital markets make foreign lenders more reliable suppliers of capital than domestic sources (OECD, 2009). In this context, remittances could possibly supplement the inflow of capital, reduce the vulnerability of dependent families and give the economy greater stability in the balance of payments.[3]

From a financial standpoint, remittances – or the income received by migrants – are critical for two types of instruments: securitisation of future remittance flows and "diaspora bonds". The securitisation of remittances is achieved through a financial instrument whose interest and principal depend on flows (predominantly remittances) coming from abroad through the financial sector. Diaspora bonds are debt instruments specially tailored for and marketed to a community of home-country investors resident abroad. Securitised remittances depend on the remitted revenues of migrants, while diaspora bonds are a new investment vehicle for their capital.

A securitisation of future remittance flows is a debt instrument whose payment of principal and interest to investors is secured by flows of future receivables. Diversified payment rights (DPR) issues are the largest group of such transactions. These are securitisations of international wire transfers, typically arising from export-related financing, foreign direct investment, portfolio investment and workers' remittances. Remittances can be a significant part of DPR flows for the Dominican Republic. In recent years, a number of financial institutions from countries with comparable conditions to those of the Dominican Republic have successfully securitised such flows as a way of raising capital (see Figure 7.1).[4]

Figure 7.1. **Remittance flows and financial depth** (2010, % of GDP)



Note: Selection of countries that have securitised remittances.
Source: OECD Development Centre, based on data from the *World Economic Outlook*, IMF and Beck *et al.* (2000).

The development of securitised remittances requires careful regulation to minimise the risks associated with such transactions. Part of the future cash flows from remittances is committed to the payment of DPR debt service. As a result, issuers must pay the recipients of these remittances from their own reserves. A depreciation of the local currency or simply their own poor performance (perhaps due to losses in another line of business) can undermine the ability of a financial institution to meet its obligations to remittance recipients. Clear rules to regulate these securities and prudential best practices to limit the foreign currency exposure that banks can assume would allow these flows to be used securely.

Diaspora bonds set out to seek new money from the community of nationals resident abroad and are an alternative when access to traditional international markets is difficult. These securities are issued by the government and specifically structured to target this group. Through them, members of the diaspora can help their home country to raise the amount of available financing. From the issuer's point of view, the attractions are a potential reduction in external financing costs through a "patriotic discount", reductions in foreign-exchange risk premiums and, sometimes, lower regulatory and legal costs (OECD, 2009). Rather than a short-term implementation, this type of instrument can be a long-term alternative for developing the capital market in the Dominican Republic.

While diaspora bonds can reduce the cost of issuance, introducing this type of instrument should not affect improvements in public debt management. These securities, structured and issued specifically for nationals resident abroad, seek to raise new capital with potentially lower issuance costs. There is reduced empirical evidence on these securities, and their success depends largely on the financial capacity of the holders.[5] Taking the Dominican community in the United States as a case study, this type of instrument could be an alternative for the longer term. However, the median income of Dominicans (including those born in the United States) is still a third lower than the national median income, according to data from the *American Community Survey*. In addition, the introduction of a new public bond would delay the construction of a single risk-free curve, which is considered a priority need (see Chapter 4).

Co-operation between stock exchanges and market expansion

The low level of financial depth creates significant incentives for close co-operation between stock exchanges to exploit economies of scale. Relatively small financial markets limit the size of issues, price competitiveness, speed in the processing of transactions and the capacity for diversification, while increasing the concentration of risk (Shah *et al*., 2007). In Central America and the Dominican Republic, domestic saving is not deep enough to allow a higher level of private-sector growth. Taking advantage of similar economic structures, a process of integration between Central American markets could be an initial approach to expanding local markets, opening up access to financing and making the domestic markets more dynamic.

There are common factors that facilitate a process of co-operation and integration between stock markets in the region. A common language and a minimal time difference facilitate integration processes without adversely affecting their operations. Furthermore, the geographical proximity to the major international markets brings a steady flow of trade and capital that attracts regional finance groups and helps to generate the political will to promote regional mergers. Nevertheless, a comprehensive analysis should be made to compare the benefits of economies of scale against the costs of implementing and co-ordinating such frameworks.

The co-ordination of macroeconomic and institutional policies could help to remove the main obstacles to establishing a common operational framework in the capital market. The main obstacle to co-operation is the existence of different currencies. A lack of co-ordination between macroeconomic policies and different levels of debt (and their sustainability) also stand in the way of an initial linking of these markets. The first step is to achieve greater co-ordination of fiscal policy so that it has a more uniform effect on economies and helps to harmonise economic cycles.[6] Institutional dispersion is another obstacle to further integration: the presence of up to four different regulatory bodies adds costs to investor participation.

The international trend is toward the consolidation of stock exchanges, which can provide valuable lessons for the process of co-operation and integration in the Dominican Republic. As new information technologies reduce communication and transaction costs, the trend has shifted towards greater integration of financial markets (Babecký *et al*., 2007). The most notable example is that of NYSE-Euronext, formed by the merger between the New York Stock Exchange and Euronext, which itself stemmed from the merger

of the stock exchanges of Belgium, France, the Netherlands and Portugal. In less developed markets outside the region, the most recent case is that of the CEE Stock Exchange Group, a holding company whose subsidiaries comprise the stock exchanges of Budapest (Hungary), Ljubljana (Slovenia) and Vienna (Austria). In Latin America, the establishment of the Integrated Latin American Market (MILA) is an example of a common market for differing economies, such as Colombia, Chile and Peru. The Dominican Republic could use the provisions of the Free Trade Agreement with the United States and Central America (DR-CAFTA) as an incentive to adopt compatible regulation in order to achieve greater financial integration with its Central American partners. An example of this would be the regulations governing collective investment funds. In short, the objectives of these consolidation processes are to combine the benefits of a local market and the requirements for the internalisation of capital markets.

The Dominican Republic is currently striving to further co-operation with Central American economies. The Superintendency of Securities has already made progress on plans for co-operation with Panama. Its institutional framework supports regional integration and automatically authorises public offerings from foreign issuers. Meanwhile, the Central American Monetary Council is in the process of harmonising standards and best practices in the public debt markets. Since 2003, steps have been taken towards organising the primary and secondary markets, regulating collective investment, and establishing an infrastructure to standardise payment and settlement systems.[7] These actions are aimed at achieving the integration that will lead to an expansion of the potential market for investors and a deepening of the markets, which may include the development of an equity market in the Dominican Republic.

Recommendations and outlook

Financial literacy, the role of SMEs in the financial markets and the link between remittances and the capital market offer a new outlook for the healthy development of capital markets. It is important to carry out a financial literacy campaign for each type of saver, to foster the involvement of private companies through increased understanding of the capital market, and to keep the regulatory bodies highly qualified and competitive. The government should also strive to facilitate access to financing for SMEs outside the traditional channels. In the long term, remittances could lead to the creation of two types of instrument: the securitisation of future remittance flows and diaspora bonds.

As the primary and secondary markets become more efficient and effective, new types of instrument can be developed. New financial products must be promoted and the investor base must be broadened. Relatively small economies such as the Dominican Republic can explore the use of securities that have low fixed costs or that distribute costs among a large number of issuers, such as asset-backed securities, in keeping with the recent legislation regarding mortgage securitisation.

In the long term, it is necessary to increase the number of available investment vehicles and to deepen the financial market. Direct investment in infrastructure is seen as a suitable alternative with substantial benefits for the country's development. New instruments (along with mortgage securitisation and mortgage bonds) could allow greater risk diversification for pension funds and other institutional investors. Likewise, a deeper, more efficient financial market will enable institutional investors to play a more prominent role in the capital market and to have a greater impact on the financing of the real sector. The indicators of financial depth are below of those of a developed country (see Chapter 3).

Proper development of the capital market could be stimulated by co-operation with other stock exchanges in the region, provided that they meet equal or higher standards of supervision and regulation. There is currently no harmonisation in the legal framework regarding securities, listing processes, supervision standards, information disclosure and corporate governance standards. A successful integration process must define a minimum set of regional standards, especially regarding recognition of jurisdiction in order to guarantee the security of investments between markets.

A common regional securities market could be one of the best arrangements. One alternative is to integrate with countries with more developed capital markets, such as Colombia and Mexico. This approach would entail adopting existing standards and regulations instead of negotiating them. To this end, the public sector can initially provide great incentives for integration because the vast majority of securities in the markets are government bonds. These policies allow for greater integration and expansion of the potential market for investors and a deepening of the markets that could include the development of an equity market in the Dominican Republic.

Notes

1. This concept also includes micro-enterprises, or divisions with less than ten employees. The difficulty in dealing with these businesses is that they are often economic actors who choose self-employment because of the lack of employment in the labour market.
2. These platforms are effective for companies with high growth potential and are considered venture capital markets. Despite the lower formal requirements for participation, there is a need for high-productivity firms and investors with a higher appetite for risk. Intermediation by the regulatory agencies to facilitate this exchange is crucial.
3. In Latin America and the Caribbean, remittances have traditionally been less volatile than other external flows such as foreign direct investment, portfolio flows, official development assistance and exports (OECD, 2009). In fact, remittances can improve sovereign ratings because of their low volatility (Avendaño *et al.*, 2011).
4. See Chapter 5 of OECD (2009) for a detailed analysis of financial institutions that have engaged in the securitisation of remittances and their corresponding risk rating.
5. India and Israel have used this type of instrument; Israel launched its first issue in the 1950s. For more details, see Chapter 5 of OECD (2009).
6. There is currently a mechanism for co-ordination between the fiscal authorities in Central America and the Dominican Republic that fosters this scenario.
7. For more details, see resolution CMCA/CMH-RE-02/11/03, available at http://www.secmca.org/Docs_DP.html.

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Capital Markets in the Dominican Republic

TAPPING THE POTENTIAL FOR DEVELOPMENT

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