Plenary 3: Broadening the investor base: practical examples from country experiences

Over the last decade foreign investors have significantly increased their holdings of Emerging Markets (EM)’s government debt in local currency across all regions. Pension funds and insurance companies continue to be the main investor, but their share has declined in favor of investment companies and the official sector, including sovereign wealth funds and managers of Central Banks’ international reserves. Increased foreign investor participation has had multiple benefits in EMs, but it can also be a source of concern, as large capital flows may exacerbate macroeconomic volatility.

The benefits of increased foreign investor participation vary depending on the country, but generally include lengthening maturity of debt, improving market liquidity, and reducing borrowing costs. Risks can arise, however, as even small changes in global asset allocation can generate capital movements that may cause exchange rate overvaluation, asset price bubbles or credit booms, all of which can affect macroeconomic volatility. Some EMs are testing ways of mitigating these risks, ranging from short term measures, such as capital controls, to more structural policies aiming to strengthen the local institutional investor base.

Retail investors have rarely been an important source of funding of Government debt either in Advanced Economies (AEs) or EMs, except in the early stages of debt market development in some AEs (e.g. Canada, Sweden). However, an increasing number of AEs and EMs are offering retail investor programs on Government debt. There are two main objectives of these programs: i) strengthening the financial inclusion agenda and, ii) building a more stable and reliable investor base. In Italy, for example, retail investors hold 11 percent of the Government debt. Financial literacy, competitive distortions and distribution costs are generally the most important challenges to reaching sizeable volumes among retail investors. Distribution costs can also pose a major challenge in retail debt programs.

Tapping diaspora savings to fund Government debt has become part of the policy agenda of many EMs, but with limited success. For some countries, a key objective behind the effort of tapping diaspora savings includes accessing a stable investor category for hard currency, which would ensure a lower cost of funding and stable demand for Government debt. So far, however, there has been no evidence that diaspora instruments have generated lower costs. Distribution costs and securities regulations regarding public offers in host countries are major obstacles for the success of diaspora bond programs.

Shariah-compliant securities constitute another option to broaden the investor base beyond Islamic investors (a targeted investor class for a number of countries). The Sukuk market has been growing rapidly in recent years, spreading even into non-Islamic countries. Challenges include establishing a standard certification of compliance with Islamic principles, tax
treatment, accounting and insolvency regulations, low liquidity and risk of market segmentation.

Against this background, this Forum session discussed new trends and approaches to broadening the investor base beyond the core traditional institutional investors (e.g. banks, pension funds, insurance companies, mutual funds).

The Government of Hungary benefitted from increased non-resident appetite as it started to develop its domestic market, and was able to extend the yield curve to 10 years. This positive movement, which was also fueled by the non-existence of capital controls, reversed in 2008 due to the global crisis, with foreign investors selling about 25 percent of the debt portfolio, amounting to Hungary’s annual budget deficit. Since mid-2010 however, there has been a steady inflow of non-resident investment, up to the current level of 50 percent of the domestic market. The main benefit from non-resident investment was in bringing down yields when local investors were reluctant to invest long term.

Hungary also has an extended retail debt program which worked well in the early 2000s. The program reached almost seven percent of the domestic debt portfolio, but subsequently declined to four percent with the increase in competition from commercial banks. The behavior of retail investors differs from wholesale investors, as demonstrated by their continued appetite for government securities after the 2008 financial crisis. In Hungary, retail debt programs are being used to educate investors, obtain new sources of funding, and to act as a stabilizer when institutional investors withdraw from domestic debt markets.

In contrast, Colombia’s share of non-resident investors in domestic debt is below five percent. This is due in part to tax rules and procedures which can prove burdensome for non-residents. A tax reform is underway to simplify procedures with the objective of broadening non-resident access to local government debt, which would help to reduce the cost of funding. The authorities aim to increase efficiency in local markets and enhance reliability of the local yield curve (to reduce arbitrage opportunities between domestic and external Colombian bonds). These efforts are supported by the investor relations office which works towards exploring the different investor profiles and instruments to meet their investment objectives.

The Colombian government is working on alternative ways of investing in government bonds such as Exchange Traded Funds (ETFs). The challenge is to establish the distribution infrastructure to access Government bonds and avoid competition with savings instruments sold by banks, such as time deposits. The objective of the program would be to increase awareness of private sector investors about savings instruments and reduce the cost of funding. It is estimated that retail debt might not be a significant source of funding in terms of size but could help by raising awareness of different savings options.
In Egypt, most investors are interested in the short term, with about 10 percent of domestic debt stock held by the non-residents, mostly interested in T-bills, before the recent civil unrest. Massive sell-offs occurred as a consequence of the unrest. As with other countries, this category of investor helped increase liquidity in good times but their exit could not be controlled when market conditions became uncertain.

The National Bank of Egypt issues certificates of deposit with a maturity of 10 years with the objective of promoting savings and financing development projects. The authorities prefer to attract retail investors into the conventional government securities market, although there may be limited potential for this. In Egypt, mutual and money market funds are starting to get acceptance from retail investors with money market funds serving as a proxy for T-bills.

Egypt has also launched two diaspora bonds and recently announced a third. The Government decided to tap the expatriate community, given increased recent funding needs after the period of unrest. The challenges associated with attracting diaspora investors arise from geographic dispersion and different securities markets regulations in the targeted diaspora countries. This effort requires good understanding of the characteristics of the expatriate community, including its financial awareness and income level.

The Government of Egypt is currently preparing a law which will allow it to issue and regulate Sukuk bonds in the domestic and external market. This is a complicated issuance method as the underlying asset is public land and the supportive documentation must comply with Sharia rules. Egypt expects the Sukuk market to grow in the future and become a relevant source of funding.

The Government of Kenya is planning to use mobile networks as an alternative distribution channel for government securities. Mobile payments were launched in Kenya in 2007 and now roughly ten billion dollars are transferred every year in small payments. The project to distribute debt through mobile phones would use the same infrastructure that has been set to process bilateral payments.