

THE POTENTIAL FOR A SECURITIES TRADING SYSTEM IN THE OECS

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## TABLE OF CONTENTS

- I. INTRODUCTION
- II. THE ROLE OF FINANCE IN THE DEVELOPMENT PROCESS
- III. SUPPLY OF SECURITIES
  - Private Sector Financing
  - Public Sector Financing Requirements
- IV. DEMAND FOR SECURITIES
- V. PREREQUISITES FOR DEVELOPMENT OF A REGIONAL SECURITIES MARKET
  - A Formal Market Mechanism
  - Legal Infrastructure
  - Acceptance of a Securities Market
  - Inducing Companies to Issue Public Share Capital
  - Persuading Savers to Invest in Securities
  - Information Campaign
- VI. THE INSTITUTIONAL FRAMEWORK FOR AN OECS SECURITIES MARKET

## I. INTRODUCTION

This Paper sets out a proposal for the development of a securities market in the seven countries comprising the Organisation of Eastern Caribbean States (OECS). It is based on desk research at the Caribbean Development Bank (CDB) and discussions held with officials of the Eastern Caribbean Central Bank (ECCB). Discussions were also held with government officials, bankers, officials of insurance companies and social security schemes. In addition a review was made of available reports on the subject matter, in particular the "OECS Capital Markets and Financial Institutions" as well as reports on regulations, statutes and corporate incentives.

The point of departure of the Paper is an implicit assumption that the development of a securities market is desirable for mobilising local resources and for channelling them into productive activities. In recent times this subject has gained considerable appeal among the political directorate, following the proposal by Michael Manley, the Prime Minister of Jamaica, for the creation of a Caribbean Community Stock Exchange. This present forum itself facilitates the exploration of capital market possibilities, and is intended to enable technicians to focus attention on identifying policies, financing instruments, and the institutional framework tailored to the needs of the Region.

This Paper should be regarded as an attempt at a general assessment of the current state of the OECS securities market and a suggestion for an approach to its development. The emphasis will be on the economic role of a securities market in financing development of the sub-region and the institutional framework for its development. The term "securities market" is defined here as a market for both equity and debt securities by companies, public enterprises and governments.

Chapter II of the Paper will deal with the role of finance and outline the reasons for developing a securities market. Chapter III will address the supply side of the market with respect to the availability of and potential for government and corporate securities. Chapter IV will examine the demand side, with emphasis on the role of institutional and household savers. Chapter V will cover the prerequisites for developing a Regional securities market. Finally, Chapter VI will recommend an institutional framework for a Regional securities market.

## II. THE ROLE OF FINANCE IN THE DEVELOPMENT PROCESS

The financing of development in the OECS has generally posed a problem for the respective countries. That problem stems largely from the application of fiscal and monetary policies and the institutional machinery for mobilising resources and channelling them into development activities. Traditionally, public sector financing requirements for development have been mobilised largely through government revenue, bilateral donors' grant-in-aid and commercial and multilateral development bank lending. In the case of the private sector, its financing requirements are met mainly through equity and commercial bank borrowings. However, in recent times, domestic public savings have assumed growing importance as a source of development finance. In addressing the need for increased resources, governments have instituted tax reform measures and installed more efficient revenue collection methods and expenditure control systems.

Another option open to governments is to activate policies and mechanisms aimed at increasing the rate of savings by households and corporations. The public is induced to increase its savings and to hold more of its savings in bills and bonds, through upward variations in interest rates. Moreover, higher interest rates tend to encourage more economical use of capital and thus reduce the deficiency of resources for development. In addition, households have shown a preference to hold savings in the form of direct claims on financial institutions rather than in the form of direct claims on government and corporate sector. Consequently, if these financial institutions provide incentives through higher interest rates, these will tend to increase the volume of household savings.

The scope of development activity in the OECS has also been limited by the foreign exchange constraint or the deterioration in the capacity to import. For most of the OECS, the current level of official reserves will cover only a few months imports' needs and based on current trends in the exports of agricultural commodities, a decline in foreign exchange availabilities is expected. Compounding the difficulties, the United States of America (USA) and the United Kingdom (UK), established traditional donors, have both signalled their intentions to reduce their level of foreign

capital to the Region. Governments are aware of these problems and have sought to undertake measures to restructure the financial system, and thereby enhance the mobilisation of resources for development.

At the time of independence in the 1970s and 1980s, some countries in the OECS inherited a relatively underdeveloped financial system which was comprised mainly of foreign-owned banks providing short-term commercial and trade finance. There was apparent consensus among the governments that it would be necessary to widen and deepen the financial systems to ensure that resources are mobilised and allocated in accordance with the countries' development needs. Each country proceeded to create new financial institutions, particularly indigenous commercial banks, development banks and national provident funds. Governments themselves borrowed heavily from the domestic financial system and from abroad to finance budget deficits and the needs of state-owned productive enterprises. Through the issue of treasury bills and bonds, a system of short-term debt financing was instituted. However, in the process of building a capital base of an economy investments of a wide range of maturities will be required. Governments and companies will require short-term resources to meet recurrent expenditures and working capital. In addition, resources will be needed for longer periods for capital formation.

The commercial banks will remain the dominant institution in the financial system of the OECS. These banks are well organised to mobilise resources for lending; however, they can be made more efficient by increasing the competition they face. The entry of new banks and the development of alternative financial institutions can stimulate competition. Non-bank financial intermediaries (NBFIs) such as pension funds, social security schemes, and insurance companies are potentially important sources of long-term finance. However, there are regulations specifying the investment pattern for resources held by NBFIs, the emphasis being on government bonds, savings deposits and possibly mortgage certificates. Some investments, notably direct equity subscriptions, are excluded. The rationale for these regulations is partly to protect the insured by minimising risk, and partly to ensure a flow of financial resources from the private sector to Government. Notwithstanding the need for investor protection, there are

institutional changes that can be implemented to increase the supply of long-term finance to the private sector.

More importantly, the OECS can benefit from the creation of a securities market. A recent study undertaken for the ECCB, "OECS Capital Markets and Financial Institutions", concluded that the current business environment, the smallness of the OECS economies, and the small number of investors meant that the conditions were not right for the Region to develop either an internal capital market or one tied to the world capital market. Because of the narrowness of the individual national markets, it is advisable that all OECS securities could be made available to an investor in any OECS country without the requirement for exchange control or licencing. There are however, fundamental reasons for developing a securities market which transcend the current size of the national markets. The following are some of the prime reasons:

- (a) attracting foreign investment;
- (b) creating public corporations with professional management rather than management by family groups;
- (c) stimulating new savings;
- (d) encouraging divestment of government-owned enterprises;
- (e) channelling savings into productive capital; and
- (f) creating wider ownership of shares.

A securities market can provide a flexible means for liquidity management, increased competition for commercial banks, and an effective instrument for monetary policy. In addition, a securities market can be a source of long-term finance both debt and equity and foster sounder capital structures for corporate entities. At present a securities market cannot be said to exist in the OECS. There is no established institutional machinery through which buyers and sellers can readily trade in securities. However, due to a desire to expand its capital programme, the requisite

resources cannot readily be obtained by conventional means. Alternative sources will therefore be required.

A supply-leading approach is proposed, such that the institutions would be set up and equipped even before the demand for their services appear. Steps should also be taken to stimulate savings throughout all the economies in the OECS and to develop instruments by which savings can be channelled into desirable investments. It is incumbent on the established financial institutions to facilitate the transition from the conventional loan method of financing to participation in a securities market.



### III. SUPPLY OF SECURITIES

Private sector corporations, governments and public corporations are likely to be important factors in the development of a securities market. Through their borrowing operations, the public sector can create opportunities in which the issuing of securities becomes a major means of raising finance. Similarly, the private sector should also be actively involved in the search for cost-effective means of financing its long-term capital programmes.

#### Private Sector Financing

Companies raise money for investment and working capital both from internal and external sources. Profits are the major source of internal finance. On the other hand, external funds consist mainly of bank borrowings and the issue of ordinary shares. Throughout the OECS statistics are unavailable concerning the ownership structure and the distribution of equity securities of particularly private companies. However, OECS enterprises are generally owned by:

- (a) foreign interests;
- (b) members of a family; and
- (c) small groups of persons.

Most of these enterprises are not organised as public companies, but as individual proprietor/partnerships and private companies. There is a tendency amongst these business concerns to avoid diluting their control by seeking capital from the public. However, in each country there is a limited number of publicly owned companies. A rough estimate suggests that there are about thirty (30) companies whose shares are available for purchase or sale operating in the OECS. A financial profile of selected public companies operating in some OECS countries is given in Appendix 1.

In each country, there are about 3-6 companies whose shares could be actively traded if an organised market were in place. These companies represent a broad range of business including general wholesale, building materials, alcoholic beverages, soap, cosmetics, and dairy products. In

addition there are a few financial institutions, particularly banks and finance companies which are owned by a substantial number of shareholders. These corporations have demonstrated an ability to offer stable and attractive incomes.

The established public companies could serve both as incubators for innovative business ideas and as a source of investment opportunities. It is reported that Windward and Leewards Brewery Limited is embarking on a large capital expansion programme, for which new resources are required. Dominica Coconut Products Limited has also embarked on a diversification and expansion programme which includes production of cosmetics and opportunities in the hotel industry. Similarly, the improved financial performance of the indigenous commercial banks in Antigua, Dominica and St. Lucia has helped the growth of confidence in these institutions. The total issued shares in all three banks are now fully subscribed and there are plans being formulated for a new issue by the National Commercial Bank of Dominica.

There are also strong signals in the growth of public awareness of equity financing. The High Impact Agricultural Marketing Project (HIAMP) has provided US\$12 mn venture capital fund for businesses such as food processing, exotic fruit, root crops, fishing and cut flowers. In addition the Caribbean Financial Services Corporation (CFSC) was specifically set up to provide long-term financing in potentially viable projects. As at the end of September 1989, CFSC had made loans amounting to US\$13.3 mn for 33 projects in 6 countries of the OECS. In addition, CFSC provided equity amounting to US\$0.6 mn for two projects. Another source of equity financing is available through the European Investment Bank (EIB). Under the Third Lome Convention, EIB was mandated to deploy 600 million ECUs for risk capital operations in the Africa, Caribbean and Pacific (ACP) countries. These programmes could form the pillar for the growth of a securities market. One condition that should be included is that as soon as the sub-projects have reached a level of maturity, the equity provided by the financing company should be offered to the public.

On the evidence of a recent survey by the Private Sector Task Force (PSTF) of CDB, there is demand for financing by the private sector, manifested by a number of innovative proposals for expansion and product diversification within existing enterprises. In addition, according to the national industrial development corporations in some countries, the manufacturing sector is showing signs of increased activity which will provide new investment opportunities. The initial cost of developing these enterprises will be high and may be beyond a firm relying largely on its own resources. That sort of operation would justify the flotation of a new issue for raising the required capital.

Table 3.1 shows the sectoral distribution of the planned investment by the private sector in some OECS countries. The figures represented are the minimum requirements because it does not include private sector investment projects for which financing has already been secured by the sponsors.

TABLE 3.1: PRIVATE SECTOR PROJECTS IN NEED OF LONG-TERM FINANCING  
IN SOME OECS COUNTRIES  
(US\$ mn)

Sector	Dominica	Grenada	Montserrat	St. Lucia	St. Vincent and the Grenadines	Total
Agriculture	-	-	0.49	-	-	0.49
Mining and Quarrying	-	-	-	-	1.24	1.24
Manufacturing	9.33	12.20	0.24	0.46	17.75	40.48
Housing	32.03	-	-	2.21	-	34.24
Tourism	1.70	11.48	3.16	15.40	9.05	40.79
Financing	-	-	2.00	-	-	2.00
<b>TOTAL</b>	<b>43.56</b>	<b>23.68</b>	<b>5.89</b>	<b>18.07</b>	<b>28.04</b>	<b>119.24</b>

Source: Private Sector Lending: Problems and Prospects CDB - Private Sector Task Force, October 1988.

In the OECS there are many enterprises in the manufacturing and distributive trades with assets in excess of \$5 mn. These enterprises offer attractive possibilities to widen share ownership. However, in most cases these firms are family owned, and the families do not wish to dilute their control. Thus, increasing the opportunities for wider share ownership will require the private sector to gradually transfer a proportion of their shareholdings to the general public.

The private sector's share in the total investment of the OECS for the period 1989-92 is estimated at US\$350 mn. It is expected that a large proportion of that will come from debt financing or from internally generated resources being ploughed back. The local development banks, indigenous commercial banks, finance companies and CDB may be the main sources for financing the projected private sector capital programme. However, companies should be encouraged to offer their capital to the public. One measure is to make a public offering of stock a condition for debt financing.

There are opportunities that would warrant the raising of resources by issuing equity securities. The major cotton producers in the Caribbean, namely Barbados, Antigua and Barbuda, St. Kitts and Nevis, and Montserrat, along with SCOTOLL Limited of Canada, have set up the Caribbean Sea Island Cotton Company (CARISCOT), to develop a vertically integrated industry, from the growing of cotton to the manufacture and marketing of garments. Two subsidiary companies will also be formed to undertake garment manufacturing. The Sea Island Cotton Fabric and Fashions (SEACOT) will begin operation in early 1990 and the Caribbean Sea Island Cotton Spinning Company (CARISPIN) will start operation one year later. It is expected that there will be share flotations on the Barbados Stock Exchange for the three companies. In view of the participation of some countries of the OECS there is an ideal opportunity for the respective companies to raise the resources required in the OECS market. An organised securities market would facilitate the flotation of equity in the OECS group.

#### Public Sector Financing Requirements

There are a number of measures that government may institute to affect the level of disposable income of the population, notably, income tax, national insurance rates, capital gains tax, and transfer tax, etc. Generally, revenues yielded from taxes and rates charged for public services have fallen short of the resources required each year for the planned capital public expenditures and the gap has to be met by borrowing through the issue of securities. Moreover, government securities constitute the medium through which the ECCB exercises its instrument of credit and monetary control through open market operations. ECCB's purchases and

sales of government securities affect the reserve position of the commercial banking system, and this, in turn, influences the availability and cost of money. In addition, businesses, financial institutions, households, may reduce their cash balances at commercial banks by investing in income earning assets, notably treasury bills and bonds. In a secondary market these assets can be readily converted to cash with little risk of loss.

Just how much the governments of the countries of the OECS have borrowed in recent years is shown in Table 3.2 which shows the aggregate public sector investment programme (PSIP) financing for the period 1982-85. Domestic borrowing is in the form of treasury debt. The treasury makes new issues of securities (notes, bills, bonds) either to raise new funds to cover a deficit in the budget or to refinance outstanding issues reaching maturity or for new capital projects. For example, Pointe Salines International Airport was partially financed through special issue of International Airport Bonds. However, governments have also been raising money by other means such as privatisation of their utility companies and the issue of national savings certificates. The public share offering in respect of Dominica Electricity Services Limited, and the St. Lucia Government Savings and Development Bonds are two examples.

TABLE 3.2: AVERAGE ANNUAL PSIP FINANCING - OECS DURING 1982-85

Item	OECS	
	Amount (US\$ mn)	%
<u>Domestic Resources</u>	<u>54.7</u>	<u>44.3</u>
Current Account Surplus	(20.4)	(16.5)
Capital Revenue	(19.3)	(15.6)
Domestic Borrowing	(15.0)	(12.2)
<u>External Resources</u>	<u>68.8</u>	<u>55.7</u>
Bilateral Sources	(50.6)	(41.0)
Grants	36.8	29.8
Loans	13.8	11.2
Multilateral Sources	(18.1)	(14.6)
Concessionary Loans		...
Ordinary Loans		...
Commercial Borrowings	(0.1)	(0.1)
Total		<u>100.0</u>
Total Average Annual Amount	123.5	

Source: Author's Estimates

Based on preliminary estimates of medium-term budget forecasts for the sub-region, it is expected that public expenditures will increase over the next five years and large gaps in financing are expected. In addition, there are opportunities in the making for increased divestment of government utility corporations to the general public. Divestment of these enterprises would not only broaden the scope and opportunities for popular participation in the ownership of productive investment but could also relax the pressure on governments to provide subsidies and control tariff levels. It would also encourage savings and the channelling of such savings into productive activity. Through this government initiative, family holdings may be encouraged to divest. St. Vincent Electricity Company Limited (VINLEC) has given the Government of that country the option to subscribe to shares any time after December 31, 1989 by the conversion of the balance outstanding on a loan provided to the Government and on-lent to VINLEC. A similar option has been offered by Dominica Electricity Services Limited (DOMLEC) under the provisions of a debenture agreement in respect of a loan by the Government of Dominica to DOMLEC. It is reported that St. Kitts Telephone (SKANTEL), Anguilla Electricity Company, Cable and Wireless Grenada and Dominica Water and Sewerage Company are considering a public share issue to raise funds for their development programmes.

The Government of St. Lucia is embarking on a major capital programme to upgrade the Hewanorra International Airport. It is estimated that \$64 mn will be required. International donor agencies, as well as local and international banks, will be providing loan finance. This major development presents the opportunity for the government to issue debt securities such as development bonds to raise the necessary financing.

There may also be opportunities for public share offerings in Regional companies like LIAT (1974) Limited (LIAT) and Winera. The governments of the Region and particularly these of the OECS may wish to assess the feasibility of divestment of LIAT, the Region's air carrier. At least three member countries of the OECS have been vocal on the question of persistent inefficiencies in the services that LIAT offers. These same countries contend that private ownership of that carrier would offer scope for improvements. At the same time, the management of LIAT argues that the

company is under-capitalised, and that governments would be required to make new equity injections into its operations. It may well be opportune to give the public the opportunity to invest in that government-owned company.

Winera is another profitable company that may provide the opportunity to broaden its equity capital by the supply of securities to the public. This company is owned by the Governments of the Windward Islands and is the main supplier of carton boxes for exporting bananas. Details of its financial performance are not available, however, discussions with informed officials indicate that the company is financially strong. In the interests of wider public participation and ownership of companies, the Governments of the Windward Islands may wish to assess the responsiveness to a public offering of shares in Winera.

Table 3.3 estimates the future availability of financial resources from the traditional sources of PSIP financing. It must be noted that sources are unknown for 25% of the financing requirements. The securities market would be promoted as an alternative means of generating the resources required.

TABLE 3.3: ESTIMATED SOURCES OF PSIP FINANCING  
FOR COUNTRIES OF THE OECS  
(%)

Item	Countries of the OECS
<u>Domestic Resources</u>	<u>30.0</u>
Current Account Surplus	(15.0)
Capital Revenue	(5.0)
Domestic Borrowing	(10.0)
<u>External Resources</u>	<u>45.0</u>
Bilateral Sources	(20.0)
Multilateral Sources	(20.0)
Commercial Borrowings	(5.0)
<u>Unknown</u>	<u>25.0</u>
Total	<u>100.0</u>

Source: Author's estimates.

The assumptions presented above would suggest a substantial increase in the financing needs of both the private and public sectors. The opportunities are available for the issue of securities to generate resources in directly productive activities and thereby build a shareholding democracy in the OECS.



IV. DEMAND FOR SECURITIES

The current demand for securities may be divided into two major sectors:

- (i) the private sector which consists of the institutional investors, banks, insurance companies, pension funds and individuals; and
- (ii) the public sector.

However there is little expressed demand for equity securities. There are regulations which prohibit banks from investing their funds in equity securities; however, they do hold government securities. The insurance companies are also an attractive source of demand for securities, but again there are regulations specifying the kind of investments that they can hold, notably government bonds, mortgage certificates and savings deposits, but direct equity investments are generally excluded.

All countries of the OECS are currently operating social security schemes, in which employers make matching contributions to certain amounts deducted from employees' salaries. The social security scheme is one of the more active sources of demand for securities. At the end of the years 1986 and 1987, the Dominica Social Security Board reported the following balance sheet structure.

	(\$mn)	
<u>Assets</u>	<u>1986</u>	<u>1987</u>
Cash and Short-Term Funds	22.87	31.14
Receivables	1.98	1.76
Short-Term Investments	12.92	12.92
Long-Term Investments	15.76	16.36
Fixed Assets	2.15	2.14
Computerisation	-	0.09
	<u>55.68</u>	<u>64.41</u>
 <u>Liabilities</u>		
Payables and accrued expenses	<u>0.46</u>	<u>0.48</u>
Net Assets	<u>55.22</u>	<u>63.93</u>
 Represented by:		
<u>Reserves and Redundancy Fund</u>		
Pension Reserve	43.35	49.50
Short-Term Benefit Reserve	8.17	8.89
Employment Injury Benefit (Short-Term) Reserve	3.24	4.83
Redundancy Fund	<u>0.46</u>	<u>0.71</u>
	<u>55.22</u>	<u>63.93</u>

It is evident from the balance sheet that social security schemes can provide large amounts of funds for financing development. The long-term investments held by the Dominica Social Security Board is composed of Government of Dominica debentures, loans to statutory bodies, loans to credit unions and shares in DOMLEC. Short-term investments are largely Government of Dominica treasury bills.

Generally, investment by the household sector in the securities market is limited. Traditionally, individuals who have accumulated savings are inclined to invest in their own small business ventures, in real estate, or in government securities which have a fixed return of interest and a guarantee of capital repayment upon maturity.

In Antigua and Barbuda, Government's five-year bonds make interest payments at 7½% and the bonds can be redeemed at any time. However, bonds which are not redeemable can be purchased by the ECCB at discounted face value. In St. Kitts and Nevis, Government's six-year debentures pay 8% per annum. The most commonly issued government securities are treasury bills and these are held by both institutional investors and households. Discussions held with St. Lucia Government officials indicate that households have shown an interest in holding treasury bills. In recent times the market in treasury bills have been strengthened through the initiative of ECCB. ECCB has successfully introduced a facility for the discount of treasury bills utilising \$20 mn from its portfolio. The current arrangement allows commercial banks in one country to purchase securities issued by other governments.

It is instructive to note the attractiveness of rate of return on other forms of wealth, notably commercial bank deposit accounts and government securities and compare that with the returns obtainable on equity securities. An investor can obtain between 4-5% interest on a deposit account at a commercial bank, and between 6-8% on government securities. On the other hand, some industrial and commercial service companies are known to pay annual dividends of between 10-25%. The financial profile of public companies in Appendix 1, includes the rates of dividend payments for the respective companies. For example, Windward and Leeward Brewery Limited reported dividend payments of 20% in 1987 and 17.5% in 1988. ACB

reported rates of dividend of 20% in 1987 and 1988. These rates of return are more attractive than rates obtained on either government securities or commercial bank deposits. It is evident therefore that shares in corporate stock in OECS countries offer a highly competitive return.

It is also instructive to compare the tax burden on equity securities with other forms of wealth. There is little risk in holding wealth in the form of real estate land or property holdings, yet these forms of wealth are subject to generous income tax allowances through exemptions such as mortgage interest allowances, and are not subject to capital gains taxes. Another form of wealth, interest income, is not subject to much risk, however, it is largely free of income tax or capital gains tax. On the other hand, the returns on funds invested in the equity of directly productive enterprises are subject to corporation taxes, sometimes as high as 50%, and, in addition, that part of residual income distributed as dividends is further taxed at the personal income tax rate. It is therefore not surprising that the potential investors either avoid investing in productive activity, or where they do invest, their preference tends to be for a closed family operation.

Generally, investors are risk averse, however, the investment decision will be influenced largely by dividend expectations and capital gains. In discussions with average income earners, it appears that they are prepared to invest in shares of more established profitable companies if the shares are available. St. Kitts Breweries Limited, Trade and Development Company, (St. Kitts), Dominica Coconut Products Limited, Windward and Leeward Brewery Limited, were cited as the companies in which investors were prepared to purchase shares. A more cautious position would be taken about committing their savings in a new venture. Presumably investors hold that position because in a new venture dividends may not be paid during the first few years. Furthermore, in the absence of a securities market which places value on a company's stock, investors will tend to purchase shares for dividends rather than for capital gains. Another reason for the apparent lack of demand for equity securities is that the average national of a country in the OECS has little understanding of the operations of a securities market.

The constraints outlined above cannot be discounted. However there is circumstantial evidence to conclude that investors will purchase shares if the opportunity to do so is available. The responses by the nationals of Dominica, St. Lucia and St. Kitts and Nevis to public share issues are strong indications of investors' ability and preparedness to hold securities. At the end of 1988 there were 997 shareholders in Dominica Coconut Products Limited, comprising copra suppliers, factory workers and others with copra suppliers representing 68% of total shareholders. The distribution of shareholding in Windward and Leeward Brewery Limited is also very broad comprising a large number of St. Lucians with average income.

An observation was made earlier that investors have a preference for holding bank deposits over equities, in spite of the latter's high rate of return. Investors are also prepared to hold government securities which offer a guaranteed return and early redemption, in preference to equities. These observations suggest that liquidity is a determining factor in the instruments that investors hold. The apparent preference for the lower yielding more liquid securities, stems from inability to buy or sell equity securities. Other factors contributing to the apparent reluctance to hold shares are:

- (i) many investors lack the understanding of the rights to which shareholders are entitled;
- (ii) there is a mistaken perception that if shares are offered for sale then something must be wrong with the company; and
- (iii) there is little information available to enable the average investor to make a judgement on the performance of a company.

V. PREREQUISITES FOR DEVELOPMENT OF A REGIONAL SECURITIES MARKET

The projected public and private sector financing requirements and the savings potential within the NBFIs suggest that there is the potential for a securities market to develop in the OECS. The task will be difficult but if certain prerequisites can be met, a Regional securities market can be effective means of transforming savings into financing instruments with appropriate maturity and risk structures.

(i) A Formal Market Mechanism

Liquidity will be a key factor in the success of any securities market. It means that holders of a security are able to access the services of the market mechanism to sell that security to someone else. The OECS does not have a formal market mechanism and trading in securities is in a rudimentary form. In each country there are commercial banks, legal firms, accounting firms, which act as intermediaries in the purchase or sale of shares for their clients. These intermediaries do not provide a trading market for securities; however, they can be developed to facilitate the issue and purchase of both equity and fixed investment capital.

The marketing of securities requires intensive selling effort to achieve a wide coverage. It therefore requires financial institutions equipped with the capital and expertise and there must be a significant amount of securities to be sold. The initiative for the development of a securities trading scheme should come from the private sector. A head start can be made by financial companies taking equity positions in certain local businesses, and by publishing bids and offers of public corporations wishing to buy or sell stock.

When a company invites the public to buy its shares, that company's reputation may suffer if the market gives negative signals to the offer. One way of ensuring that all the shares offered are taken up is to employ underwriters. Generally, the underwriter will agree to take up any shares which the public does not take up. These securities can then be placed in a fund and subsequently an offer can be made to the public. As a compensation for this risk, the underwriter receives a commission.

(ii) Legal Infrastructure

Investor protection is a fundamental requirement for growth of securities investment. The trading scheme must be so designed that investors and participants are given maximum assurance and confidence of a smooth functioning of the market. In that regard, national investment authorities should be developed to protect the interests of all actors and ensure equal access by all types of investors to the market. In addition, it is necessary to establish appropriate regulations and standards which define the requirements for operations of public companies, information disclosure requirements, auditing standards and rules of conduct of stock brokers.

(iii) Acceptance of a Securities Market

There must also be evidence of creditworthiness before securities can be readily purchased by investors. The ease with which securities can be sold will depend on a number of factors. The most important single factor is likely to be the economic viability of the entity. This will depend on the expectation of future income, and the existing stock and distribution of its securities. In short, investors' preparedness to hold securities will be influenced by the borrowers' ability to repay and to generate profits. In addition, the financial position and the quality of economic management are relevant. In that regard, the national income flow, stock of wealth, liquidity, the existing level of debt outstanding and the existence and efficiency of a secondary market, will together influence the growth of the securities market.

(iv) Inducing Companies to Issue Public Share Capital

There is the tendency for family-owned firms to resist corporate expansion through a wider equity base. In order to overcome this constraint, incentives should be provided to stimulate firms to go public and place share issues on the market. For instance, the rate of corporation tax may be varied between "private" family held companies and those companies with a wide ownership obtained by a public issue of its shares.

However, in the definition of the incentives structure, the measures adopted must be kept in balance with the market's capacity to respond to the consequences. If the legislation induces a volume of share issues beyond the market's absorption capacity, there would be more damage than good to the stock market and to industry.

(v) Persuading Savers to Invest in Securities

The demand side of investment must be given equal attention by encouraging the habit of holding securities among potential savers. Individuals should be encouraged to save more by creating or expanding tax deferred savings plans such as individual retirement accounts. There are simple ways by which the relative attractiveness of securities can be improved. The tax codes bias toward debt financing should be lessened by ending or reducing the double taxation of dividends. Similarly, equity investment can be promoted by introducing a more favourable tax treatment for capital gains, especially for long-term investments.

There are new forms of investments that should be examined. For instance, workers could be given an increased stake in their companies by promoting Employee Share Ownership Plans and giving workers more voice in management decisions. In addition, firms could offer corporate bonds which an individual would purchase with payments made over a designated period. In lieu of recovering coupon payments on the bond, a lottery would be operated with the winners receiving the face value of the bond at no further cost to the bondholder. In addition, some governments have experimented with national development bonds for generating resources for directly productive public sector ventures. Small investors should be encouraged to hold these securities. A related investment scheme can be linked to workers remuneration. The experience gained in payroll deduction for social security may be a useful base from which to widen participation in the ownership for the companies in which people work. The bonds or alternative securities certificate should be provided in small denominations and with a tax advantage for bond holdings, to be accessible to and encourage low wage employees. In the promotion of investment in utility companies, investors can be encouraged to buy shares through the issue of vouchers which entitle them to equivalent reductions in their bills.

(vi) Information Campaign

Information is the best tool for promoting an interest in securities. Underwriters and brokerage firms are important in seeking, analyzing and transmitting information to investors concerning the companies whose securities they buy and sell. This activity must be complemented by steps to create an interest in securities through published newspaper and radio advertisements outlining the virtues and benefits of securities.



## VI. THE INSTITUTIONAL FRAMEWORK FOR AN OECS SECURITIES MARKET

The OECS countries are keen to advance the cause of political unification. However, in addition to political unification, there must be equal and parallel measures to facilitate the realisation of economic objectives. One of the prime economic objectives of the Region is to sustain the levels of growth and development. It is generally agreed that a balanced expansion of an economy is conditional upon a requisite financial system. In view of the enlarged OECS economy and a more diversified production base, a securities market system would contribute to a more diversified financial system.

At the outset, it is necessary to distinguish the services offered by:

(i) the primary market; and

(ii) the secondary market,

and use these as the analytical tools to set a framework for the OECS securities trading scheme. The primary market is one in which new securities are issued. The secondary market is one in which existing securities are traded. The secondary market is particularly important as it represents the means by which investors' liquidity preference is realised.

In order to develop a Regional securities market, an appropriate institutional framework is required for undertaking the business of securities investment. The proposed securities trading scheme will be a simple system wherein public corporations and government securities can be registered with a separate division within the CB. In addition, the resource mobilisation programmes of public corporations and the respective governments will be publicised such that the investing public is aware of the available securities investment opportunities.

The market structure will be characterised by an over-the-counter trading through existing financial institutions or through independent brokerage services. The respective countries of the OECS have established national commercial banks or development banks. The operations of the institutions could be broadened wherein they offer a securities exchange service where persons wishing to buy or sell could notify the exchange service of the quantity and price at which they wish to buy or sell. The exchange service would act as a broker or buying and selling for its own account to maintain liquidity in the market and facilitate transferability. There is also a role for commercial banks in supplying individual investors with other services such as market analysis, and assist in educating the public about securities. Alternatively, independent retail brokerage services can be encouraged to provide the specialised functions of buying and selling securities and investment research facilities for clients.

The private sector should therefore seize the opportunity to establish the institutional framework for securities trading. The Region's existing financial intermediaries, accounting and legal firms must begin to determine how best to organise themselves to compete effectively in offering a number of essential services in the area of execution capability, securities research and financial advisory services to the investing public and to corporations that need to raise capital. Considerations may be given to a programme in which the national commercial banks and development banks could provide loans to financial firms for the purchase and resale of securities. These loans will be issued to companies which intend to manage or participate in underwriting securities until they can be sold to the public.

The role of coordinating the operations of the securities could be performed by ECCB through the national commercial banks or development banks. By virtue of its obligation to manage the Region's public debt, to advise on liquidity management in the financial institutions, and to set financial regulations ECCB has a pivotal function to perform in the market. The Treasury Bill market is one measure by ECCB that will help in expanding the securities market. It started with a \$20 mn face value of its holding of Treasury Bills originally issued by member governments. The active participation of commercial banks in the Treasury Bill market and the

potential for other financial institutions to participate, is indicative of the continuing high levels of liquidity at the disposal of these institutions.

In the design of the institutional framework for a securities market, the experiences of the countries with established markets must be taken into account. A securities market will be efficient at mobilising the savings and investment necessary to promote a country's development. Many enterprises with the potential for growth cannot increase their debt levels because of their limited equity base; other companies cannot start operations because of insufficient venture and equity capital. Hence there is need for increased resources which can be mobilised through a securities market. However, the same markets can be unstable and mistakes can be made. This underlines the importance of developing better systems of prudential regulation and supervision, and improving the flow of financial information. If there is the commitment to encourage market based decision making, then concomitantly measures must be put in place which will increase lenders' confidence that contracts will be honoured and the value of contracts will not be eroded. In addition, steps must be taken through a national regulatory authority as a safeguard against concentration of ownership within a few shareholders or proxy purchase of shares on behalf of non-OECS conglomerates.

FINANCIAL PROFILE OF SELECTED PUBLIC COMPANIES  
OPERATING IN SOME OECS COUNTRIES

	<u>1987</u>	<u>1988</u>
<u>Dominica Coconut Products Ltd.</u>		
Authorised Share Capital (\$mn)	10.00	10.00
Issued and Fully Paid Shares (\$mn)	9.10	9.11
Share Premium (\$mn)	0.266	0.266
Appraisal Surplus (\$mn)	0.189	1.189
General Reserve (\$mn)	7.000	7.000
Retained Earnings (\$mn)	<u>19.207</u>	<u>22.750</u>
Total Shareholders Equity (\$mn)	35.761	39.312
Dividend Paid (%)	20	10
Dividend Amount (\$mn) <sup>1/</sup>	1.820	0.910
Investment Securities (\$mn)	16.289	18.666

	<u>1984/85</u>	<u>1985/86</u>	<u>1986/87</u>	<u>1987/88</u>
<u>National Commercial Bank - Dominica</u>				
Investment Securities <sup>2/</sup> (\$mn)	1.47	1.47	1.97	9.51
Authorised Share Capital (\$mn)	10.00	10.00	10.00	10.00
Shareholders Equity (\$mn)	3.72	4.20	5.66	9.11
No. of Shares Allocated	196,296	198,687	211,272	300,000
No. of Shareholders in Register	1,056	1,069	1,164	1,283
Net Earnings (\$mn)	0.9	0.7	1.66	3.01
Return on Share Capital (%)	61.5	35.1	112.0	136.0

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
<u>Antigua Commercial Bank</u>					
Investment Securities <sup>3/</sup> (\$mn)	N.A	N.A	N.A	11.149	11.624
Authorised Share Capital (\$mn)	<u>5.00</u>	<u>5.00</u>	<u>5.00</u>	<u>5.00</u>	<u>5.00</u>
Paid-Up Share Capital (\$mn)	2.01	2.12	2.40	2.61	2.88
Reserve and Capital Reserves (\$mn)	<u>4.56</u>	<u>5.87</u>	<u>8.16</u>	<u>11.28</u>	<u>15.28</u>
Total Shareholders Equity	<u>6.57</u>	<u>7.99</u>	<u>10.56</u>	<u>13.89</u>	<u>18.16</u>
Total Shareholders	4,365	4,428	4,514	4,607	4,782
Total Debenture Holders	<u>206</u>	<u>202</u>	<u>196</u>	<u>125</u>	-
Dividend Paid (\$mn)	0.252	.317	0.420	0.498	0.546
Rate of Dividend (%)	12.50	.00	17.50	20.00	20.00

1/ Investments comprise: non current certificate of deposit, shares in associated companies and shares in other companies.

2/ Investments comprise: share capital subscription to National Mortgage Finance Co. Ltd., Government of Dominica Treasury Bills, Government of Dominica 7½% Debentures, and IBRD Debenture Bonds.

3/ Investments comprise: ACB Mortgage and Trust Co. Ltd., Ordinary Shares, Government of Antigua and Barbuda Bonds and Treasury Bills.

	<u>1987</u>	<u>1988</u>
<u>St. Lucia Cooperative Bank Limited</u>		
Investment Securities <sup>1/</sup> (\$mn)	3.073	3.050
Authorised Share Capital (\$mn)	<u>2.000</u>	<u>2.000</u>
Paid Up Share Capital (\$mn)	0.978	1.024
Reserves (\$mn)	<u>4.123</u>	<u>4.995</u>
Total Shareholders Equity (\$mn)	5.101	6.019
Dividends paid at (25%) (\$mn)	0.246	0.256
Earnings Per Share	62.7¢	\$1.06
	<u>1987</u>	<u>1988</u>
<u>Windward and Leewards Brewery Limited, St. Lucia</u>		
Authorised Share Capital (\$mn)	<u>15.00</u>	<u>15.00</u>
Issued and Fully Paid Shares (\$mn)	5.60	5.60
Revalued Reserves (\$mn)	12.82	12.82
Retained Earnings (\$mn)	<u>8.53</u>	<u>12.18</u>
Total Shareholders Equity (\$mn)	26.95	30.60
Dividend Final (%)	17.5	25.0
Dividend Paid Final (\$mn)	0.978	1.39
	<u>1986</u>	<u>1987</u>
<u>Dominica Electricity Services Ltd. (DOMLEC)</u>		
Authorised Share Capital (\$mn)	<u>3.00</u>	<u>3.00</u>
Issued and Paid Shares (\$mn)	2.00	2.00
Retained Earnings (\$mn)	<u>3.295</u>	<u>3.962</u>
Total Shareholders Equity (\$mn)	5.295	5.962
Net Earnings Per Share (Basic)	26.4¢	43.4¢
Net Earnings Per Share (Fully Diluted) <sup>2/</sup>	19.1¢	28.9¢

Source: Annual Report and Statement of Accounts for Respective Corporations for the year ended December 31, 1988.

- 1/ Investments comprise: Shares in Beecham Group Limited (quoted); St. Lucia Government Savings and Development Bonds paying 10% coupon.
- 2/ Fully diluted earnings per share show the effect on earnings per share which would result if the 9.5% of Government of Commonwealth of Dominica debentures outstanding had been fully converted to shares.

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