



Maldives Finance Forum 2016

Capital Markets Modernization and Reform:

Strategic Choices for Small-Scale Markets

Required Ingredients

Robert H. Singletary, Principal

Lenzie • Fisher • Hendry, LLC

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Topics for Today

This presentation explores the available design choices for expanding and modernizing the Maldivian capital markets. It focuses especially on the options available to small-scale economies and seeks to provide both an outline of the theoretical alternatives and practical business advice on making the decisions specific to the country.

The topics:

- Domestic Content Markets
- Hybrid Markets
- Offshore Markets
- Impacts on Other Financial Sector Segments

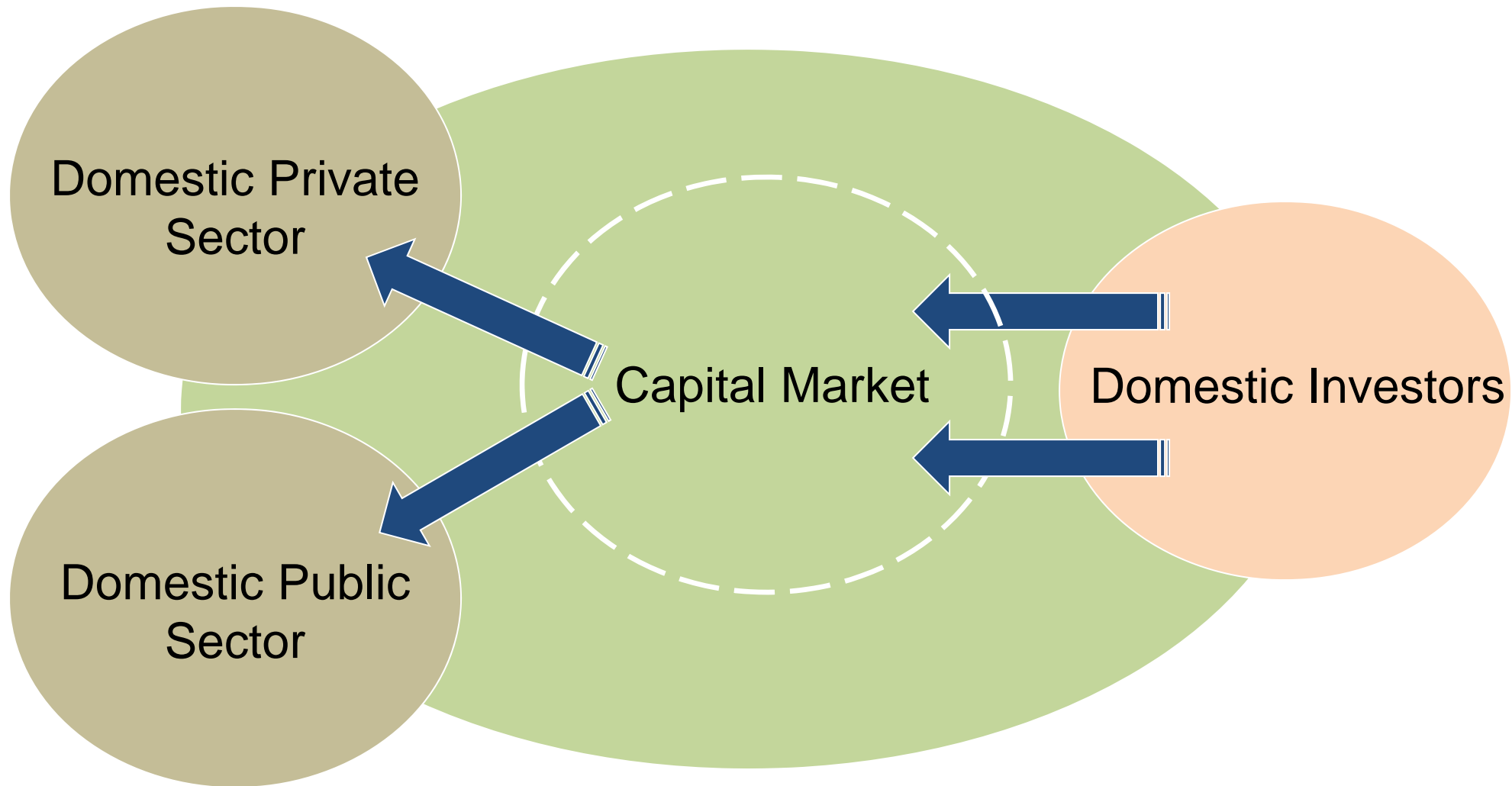
The Original Concept - Capital Formation for the Real Sector

In the early stages of capital market development programs, the work was guided by a fairly basic concept.

The idea was to marry the domestic investors with the domestic private sector. There was hopeful talk of attracting foreign investors. The main private sector focus was on the real sector (as opposed to financial sector).

The idea of channeling funds to the public sector was a secondary focus (the governments' capital markets were seen as a “parallel universe”).

The Original Concept - Capital Formation for the Real Sector



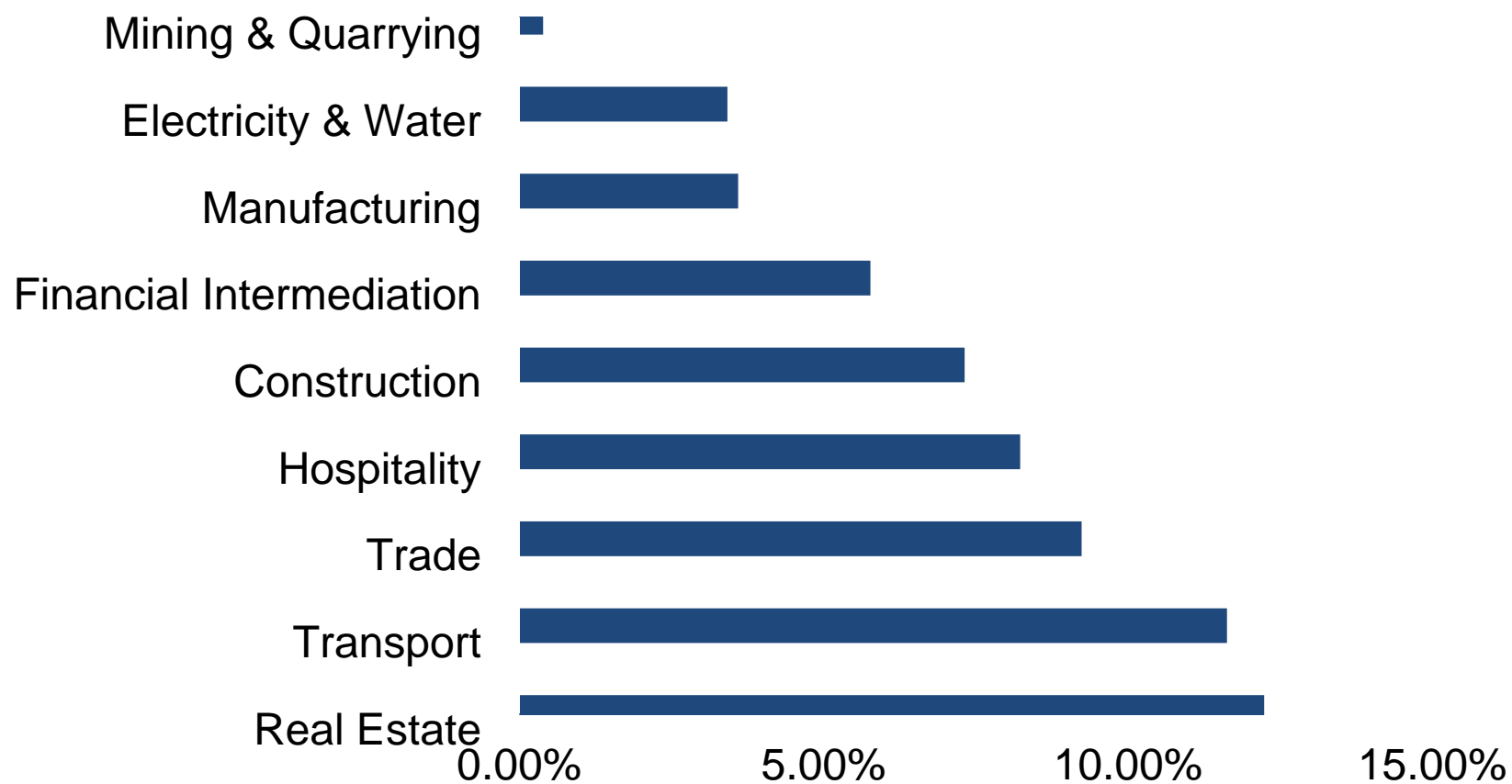
Market Stall

For many of these “stand-alone” markets the realities of “scale” soon set in:

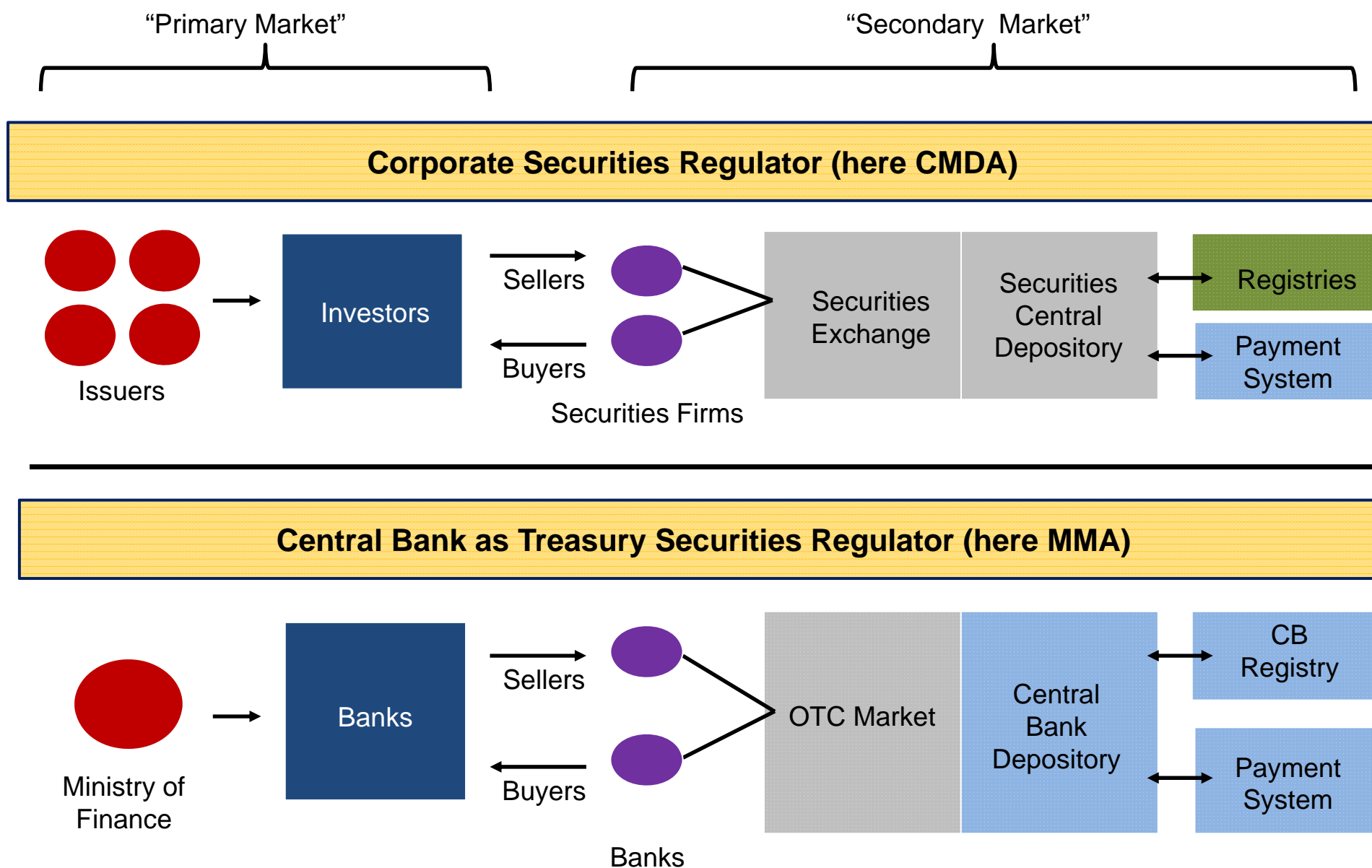
- There were a limited number of Real Sector issuers
 - Due to the size of the country’s GDP
 - Due to the composition of GDP
- Separate systems for treasuries became entrenched.
- Retail investor interest was limited.
 - Low per capita incomes
 - Low financial literacy
 - Geographical dispersion within the country.

Market Stall

Sector Contributions to Organization of Eastern Caribbean States' GDP



Market Stall



Market Stall

Aggregate and Per Capita GDP Levels

	GDP (2014) (US\$M)	Population	GDP per Capita (US\$)
Mauritius	\$12,630	1,261,000	\$10,016
Saint Lucia	\$1,404	183,600	\$7,647
Antigua and Barbuda	\$1,221	90,900	\$13,432
Grenada	\$912	106,300	\$8,578
St. Kitts and Nevis	\$852	54,940	\$15,511
St. Vincent & the Grenadines	\$729	109,400	\$6,666
Dominica	\$524	72,340	\$7,245
Anguilla	\$320	13,452	\$23,814
Montserrat	\$62	4,922	\$12,655
OECS Total	\$6,025	635,854	\$9,475
Maldives	\$3,062	401,000	\$7,636
Sri Lanka	\$78,820	22,770,000	\$3,462

Updated Concept – Focusing on the Need for Investable Instruments

The more recent approach does not abandon the idea that the real sector needs capital formation.

But it focuses much more on the needs of the financial sector for investable instruments:

- Banks with excess liquidity need a place to invest excess deposits.
- Insurance companies need a place to invest reserved premiums
- Pension funds need to invest net contributions.

What Kinds of Investable Instruments Do the Financial Institutions Need?

Banks:

- Short-term investments that at least cover their cost of funds, or
- Longer-term investments to boost profits (but be careful market price swings)

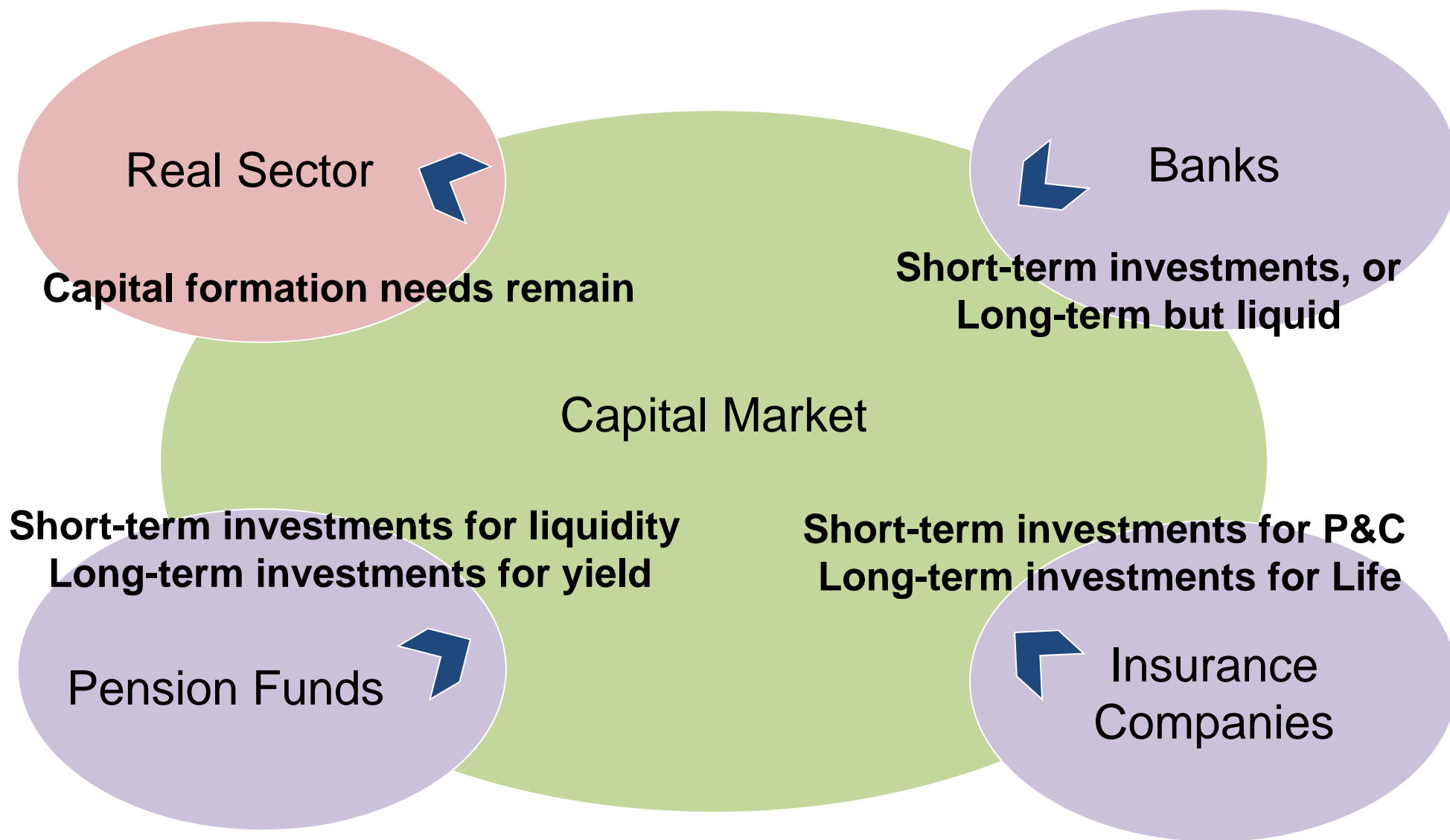
Insurance Companies:

- Short-term investments for Property & Casualty
- Longer-term investments for Life and Annuity products

Pension Funds:

- Longer-term investments for net contribution inflows.

Updated Concept – Focusing on the Need for Investable Instruments



Unsettling Questions

As the market “stalls” uncertainty sets in:

- Why are there not more local issuers?
- How can we get more investable instruments?
- What about attracting foreign investors?
- Is financial literacy the problem?
- Why not be an off-shore financial center?

Understanding the realistic choices for the way forward requires a measured approach to reach practical business decisions.

A Methodical Approach

Who are possible investors for this market?

- **Domestic Retail Investors:** These are Maldivian citizens and residents.
- **Domestic Institutions:** This includes domestic banks, pension funds and insurance companies.
- **Foreign Institutions:** These are foreign professional investment entities such as investment funds, banks and insurance companies.
- **Foreign Retail Investors:** These are the so-called 'high net worth' individuals.

A Methodical Approach

What kinds of securities can they invest in?

- **Domestic Securities:** securities of *local issuers* offered, sold and traded locally. Examples include more corporate debt, corporate shares and investment funds with local assets.
- **Foreign Securities Traded Locally:** These are securities from *foreign issuers brought to the Maldives*. Examples include unit investment trusts, covered bonds and closed-end mutual funds created in the Maldives using foreign assets.

A Methodical Approach

What kinds of securities can they invest in (continued)?

- **Foreign Securities Offered Off-Shore:** These are securities of *foreign issuers* offered, sold and traded outside the Maldives *but with accounts held in the Maldives*.
- **Foreign Securities with Foreign Accounts:** These are securities of *foreign issuers* offered, sold and trade off-shore *with the accounts held off-shore also*.

A Methodical Approach

Types of Investors / Products	Domestic Securities (local issuers)	Foreign Securities (packaged and traded locally)	Foreign Securities (offered off-shore w/ local accounts)	Foreign Securities (offered off-shore with foreign accounts)
Domestic Retail Investors	1	3	5	6
Domestic Institutions				
Foreign Institutions	2	4		
Foreign Retail Investors				

A Methodical Approach

What are the practical choices?

- **Analyze by Quadrant.**
- **Understand “who benefits”. Does the selected choice:**
 - Meet investors’ needs?
 - Increase revenues for the market intermediaries?
 - Increase revenues for the market system infrastructure (exchange, depository, registry)?
 - Create more jobs?
 - Increase tax revenues for the country?

Quadrant 1: Domestic Securities / Domestic Investors

Types of Investors / Products	Domestic Securities (local issuers)	Foreign Securities (packaged and traded locally)	Foreign Securities (offered off-shore w/ local accounts)	Foreign Securities (offered off-shore with foreign accounts)
Domestic Retail Investors	1	3	5	6
Domestic Institutions				
Foreign Institutions	2	4		
Foreign Retail Investors				

Quadrant 1: Domestic Securities / Domestic Investors

Outlook:

The entire reason for conducting the analysis is that *remaining in Quadrant 1 is not an option.*

Domestic retail investors have limited appetite for investing in domestic securities; they are not an engine for building the CM.

At the same time, domestic institutional investors have an unmet need for investable instruments. They have bought all of the available instruments; and, they are not trading what they own. Absent new offerings by domestic issuers, the CM must look elsewhere for expanding its business.

Quadrant 2: Domestic Securities / Foreign Investors

Types of Investors / Products	Domestic Securities (local issuers)	Foreign Securities (packaged and traded locally)	Foreign Securities (offered off-shore w/ local accounts)	Foreign Securities (offered off-shore with foreign accounts)
Domestic Retail Investors	1	3	5	6
Domestic Institutions				
Foreign Institutions	2	4		
Foreign Retail Investors				

Quadrant 2: Domestic Securities / Foreign Investors

Outlook:

Foreign investor interest in domestic securities depends on the number and amounts of domestic instruments extant. Same problem as Quadrant 1.

There is also the question of inducement:

- What should be the tax treatment for the foreign investor?
- Should the system provide for identity concealment?

These two major policy decisions pervade all discussions of any approach to bringing foreign participants into the market (to trade any category of securities).

Quadrant 2: Domestic Securities / Foreign Investors

Where Are the Incremental Benefits?	
Investors' needs better met?	Yes
Increased revenues for the market intermediaries?	Yes
Increased revenues for the market system infrastructure (exchange, depository, registry)?	Yes
More jobs created?	Marginal
Increased tax revenues for the country?	No

Quadrant 3: Packaged Foreign Securities / Domestic Investors

Types of Investors / Products	Domestic Securities (local issuers)	Foreign Securities (packaged and traded locally)	Foreign Securities (offered off-shore w/ local accounts)	Foreign Securities (offered off-shore with foreign accounts)
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Domestic Institutions				
Foreign Institutions	2	4		
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Quadrant 3: Packaged Foreign Securities / Domestic Investors

Global Depository Receipts (GDRs) and Unit Investment Trusts (UITs) are mechanisms to bring foreign securities into a local market for offer and subsequent trading in that market.

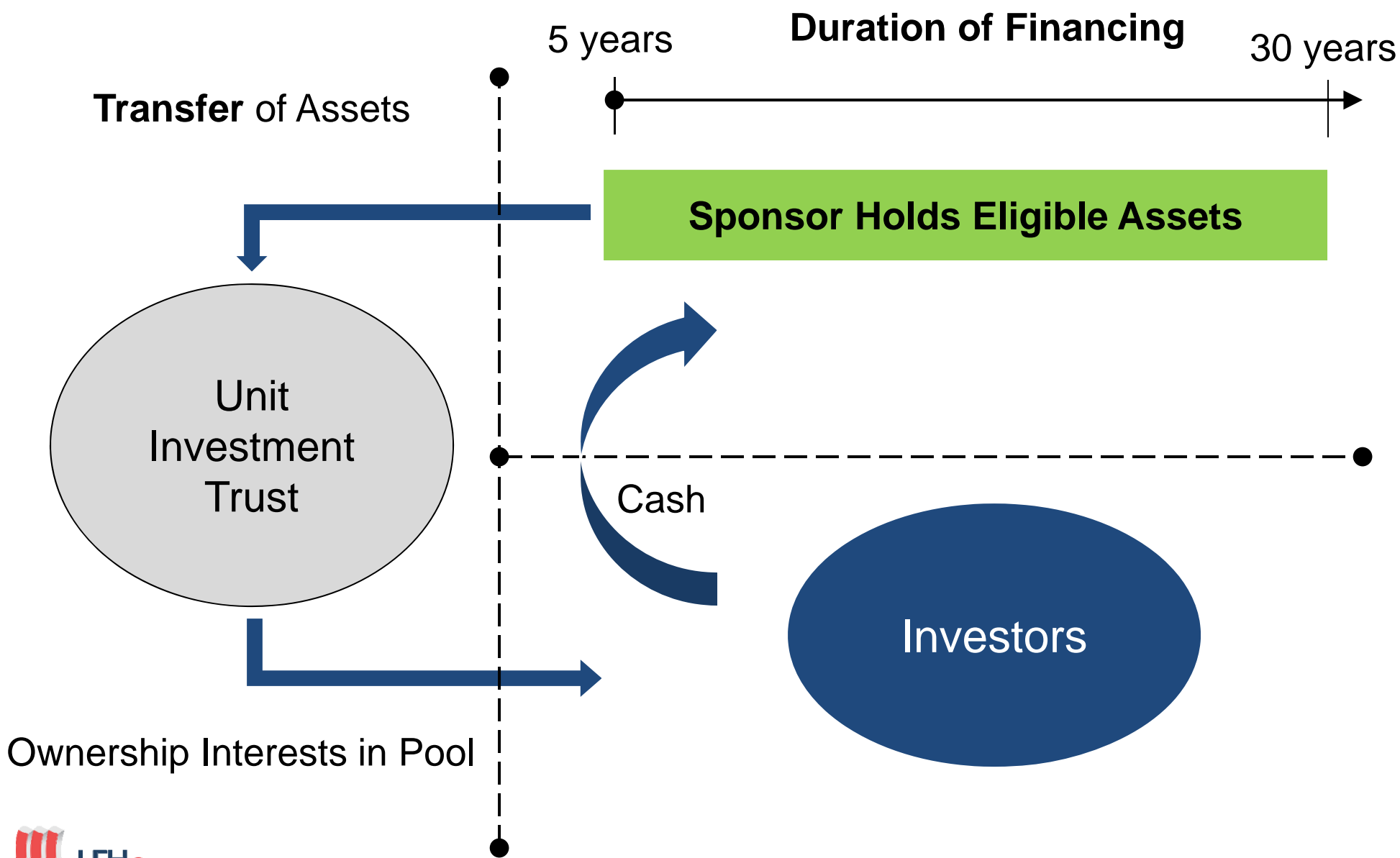
In both cases a 'legal wrapper' is used to purchase and house the securities; ownership interests in the wrapper are then sold in the local market.

Technically speaking, both GDRs and UITs are collective investment schemes.

GDRs hold only one class of security and tend to be used for equities.

UITs hold a pool of securities and tend to be used for debt.

Quadrant 3: Packaged Foreign Securities / Domestic Investors



Quadrant 3: Packaged Foreign Securities / Domestic Investors

Outlook:

Creating UITs (packaging debt securities) would meet the pent-up demand for fixed income investable instruments.

The pools can be highly tailored to investor preferences.

They are replicable based on level of demand, *i.e.*, several sequential offerings with differing content can be conducted based on market demand.

The tax treatment would be the same as for investment funds, *i.e.*, no double taxation.

Administration costs are low, thereby insulating against erosion of yields.

Quadrant 3: Packaged Foreign Securities / Domestic Investors

Special Issue for the Pension Funds (here MPAO):

Are hybrid securities (GDRs and UITs) “domestic” or “foreign” securities? Can the pension fund invest in them?

It depends on the definition in the pension fund law:

- Where is the issuer located?
- Where is the security offered?
- Where is ownership recorded?
- Where is the security traded?

Policy Question: Where does the pension fund’s capital go?

Quadrant 3: Packaged Foreign Securities / Domestic Investors

Where Are the Incremental Benefits?	
Investors' needs better met?	Yes
Increased revenues for the market intermediaries?	Yes
Increased revenues for the market system infrastructure (exchange, depository, registry)?	Yes
More jobs created?	Marginal
Increased tax revenues for the country?	Yes

Quadrant 4: Packaged Foreign Securities / Foreign Investors

Types of Investors / Products	Domestic Securities (local issuers)	Foreign Securities (packaged and traded locally)	Foreign Securities (offered off-shore w/ local accounts)	Foreign Securities (offered off-shore with foreign accounts)
Domestic Retail Investors	1	3	5	6
Domestic Institutions				
Foreign Institutions	2	4		
Foreign Retail Investors				

Quadrant 4: Packaged Foreign Securities / Foreign Investors

Outlook:

The idea of foreign investors buying foreign securities packaged and offered within the local market again brings into question the motivation of the foreign investor.

The packaged security needs to contain elements not available in the investor's home market.

Why invest in securities otherwise readily available in the home jurisdiction, absent tax or identity concealment benefits.

(The impacts of adopting tax breaks or identity concealment are discussed in the section on offshore markets below.)

Quadrant 4: Packaged Foreign Securities / Foreign Investors

Where Are the Incremental Benefits?	
Investors' needs better met?	Yes
Increased revenues for the market intermediaries?	Yes
Increased revenues for the market system infrastructure (exchange, depository, registry)?	Yes
More jobs created?	No
Increased tax revenues for the country?	No

Quadrant 5: Foreign Securities / Local Accounts

Types of Investors / Products	Domestic Securities (local issuers)	Foreign Securities (packaged and traded locally)	Foreign Securities (offered off-shore w/ local accounts)	Foreign Securities (offered off-shore with foreign accounts)
Domestic Retail Investors	1	3	5	6
Domestic Institutions				
Foreign Institutions	2	4		
Foreign Retail Investors				

Quadrant 5: Foreign Securities / Local Accounts

Outlook:

When domestic investors make off-shore investments using local accounts, it creates revenue benefits for the market intermediaries but it does not generate revenues for the CM infrastructure. For this reason, this is not a promising business line for the CM development overall.

It is unlikely that foreign investors will be interested in investing in their home countries' securities through local CM accounts unless there is a significant tax advantage or identity concealment aspect.

Quadrant 5: Foreign Securities / Local Accounts

Where Are the Incremental Benefits?	
Investors' needs better met?	Yes
Increased revenues for the market intermediaries?	Yes
Increased revenues for the market system infrastructure (exchange, depository, registry)?	No
More jobs created?	No
Increased tax revenues for the country?	No

Quadrant 6: Foreign Securities / Foreign Accounts

Types of Investors / Products	Domestic Securities (local issuers)	Foreign Securities (packaged and traded locally)	Foreign Securities (offered off-shore w/ local accounts)	Foreign Securities (offered off-shore with foreign accounts)
Domestic Retail Investors	1	3	5	6
Domestic Institutions				
Foreign Institutions	2	4		
Foreign Retail Investors				

Quadrant 6: Foreign Securities / Foreign Accounts

Outlook:

This Quadrant creates no benefit for the local capital market. There is no revenue created for either the CM infrastructure or its broker-dealer members. This business segment holds no potential for the development of the domestic capital market.

Quadrant 6: Foreign Securities / Foreign Accounts

Where Are the Incremental Benefits?	
Investors' needs better met?	Yes
Increased revenues for the market intermediaries?	No
Increased revenues for the market system infrastructure (exchange, depository, registry)?	No
More jobs created?	No
Increased tax revenues for the country?	No

All Quadrants: Summary of Who Benefits

Incremental Benefits	Q2	Q3	Q4	Q5	Q6
Investors' needs met?	Yes	Yes	Yes	Yes	Yes
↑ Revenues for brokers?	Yes	Yes	Yes	Yes	No
↑ Revenues for CM infrastructure	Yes	Yes	Yes	No	No
↑ Jobs created?	?	?	No	No	No
↑ Tax revenues?	No	Yes	No	No	No

So you want to be an offshore market ...

Questions to ask yourself:

1. What is my longitude?
2. What is my unique niche (time zone or neighbors)?
3. What kinds of tax incentives am I prepared to give?
4. Am I willing to grant identity concealment?
5. How much physical space do I have?
6. How strong is my IT backbone?

There is a big difference between wanting to be a global financial center as opposed to being an offshore account holder for a neighboring market.

So you want to be an offshore market ...

Considerations and Decisions

Tax Incentives?

1. Providing lawful tax avoidance
2. Implicitly allowing tax evasion

Identity Concealment?

1. Via offshore accounts (bank secrecy)
2. Via offshore companies (anonymous wrappers)

Benefits to the Host Country?

1. Job Creation?
2. Tax Revenues?

Downsides?

Identity Concealment

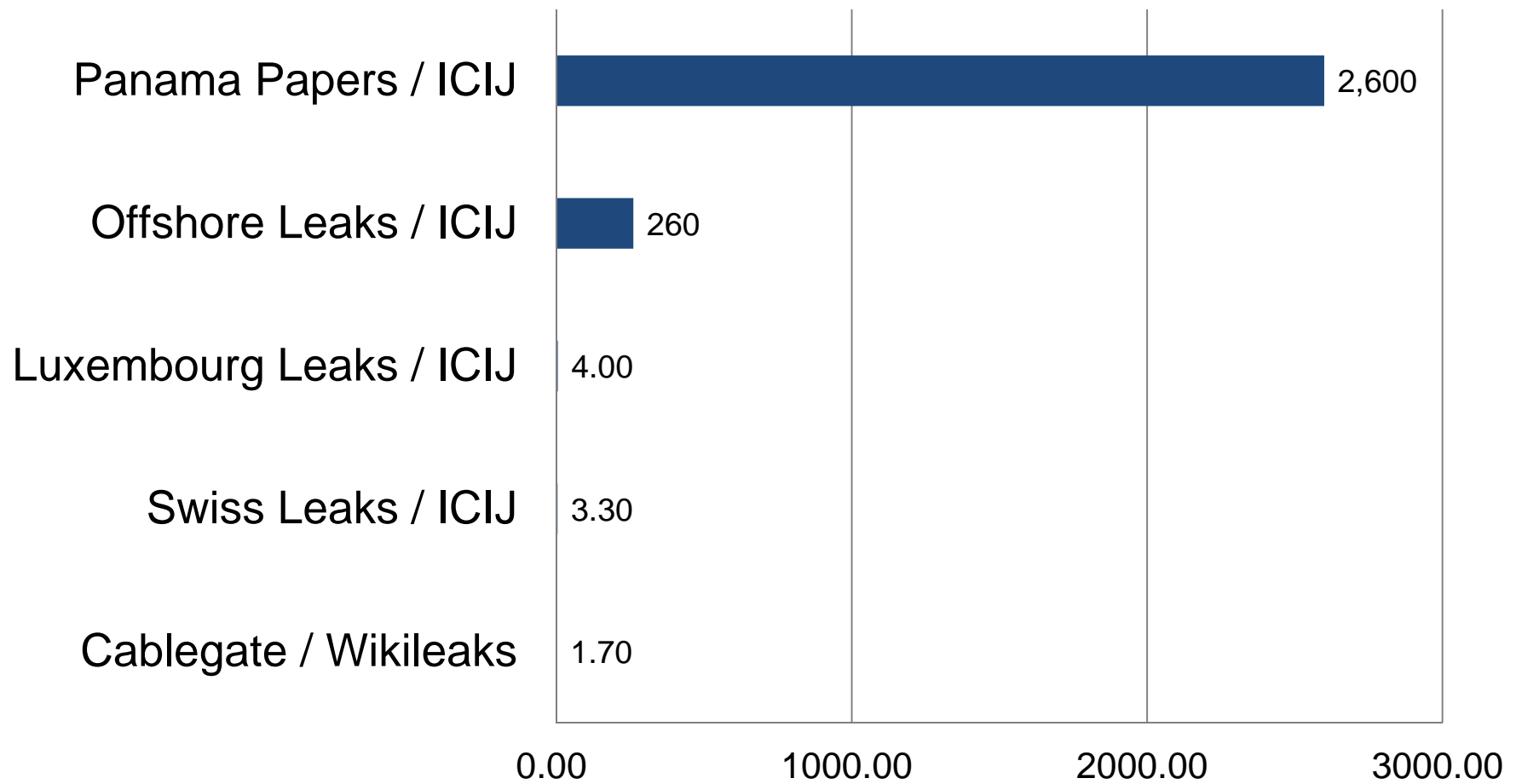
Reputational Impacts

The Evolution of Laws and Targets

- 1970 – Racketeer Influenced and Corrupt Organizations Act. Target: Mafia activity
- 1989 – Financial Action Task Force. Target: Money laundering. See also: list of "Non-Cooperative Countries or Territories"
- Since 2001 – numerous conventions and anti-terrorism laws. Target: Anti-terrorist financing.
- 2010 – Foreign Account Tax Compliance Act. Target: Tax evasion.

The Panama Papers ...

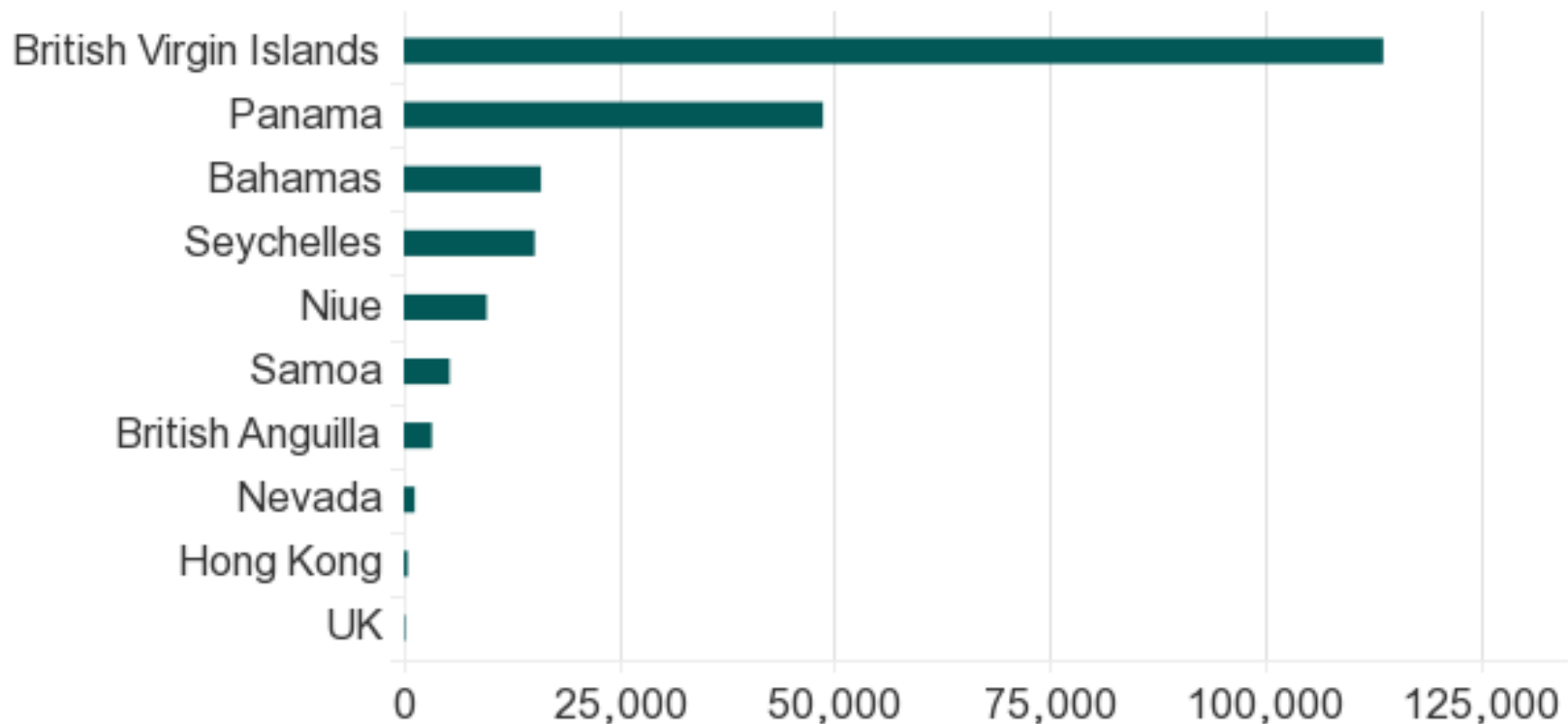
Size of Recent Data Leaks in Gigabytes



The Panama Papers ...

Where companies that appear in the Panama Papers were incorporated

Number of companies

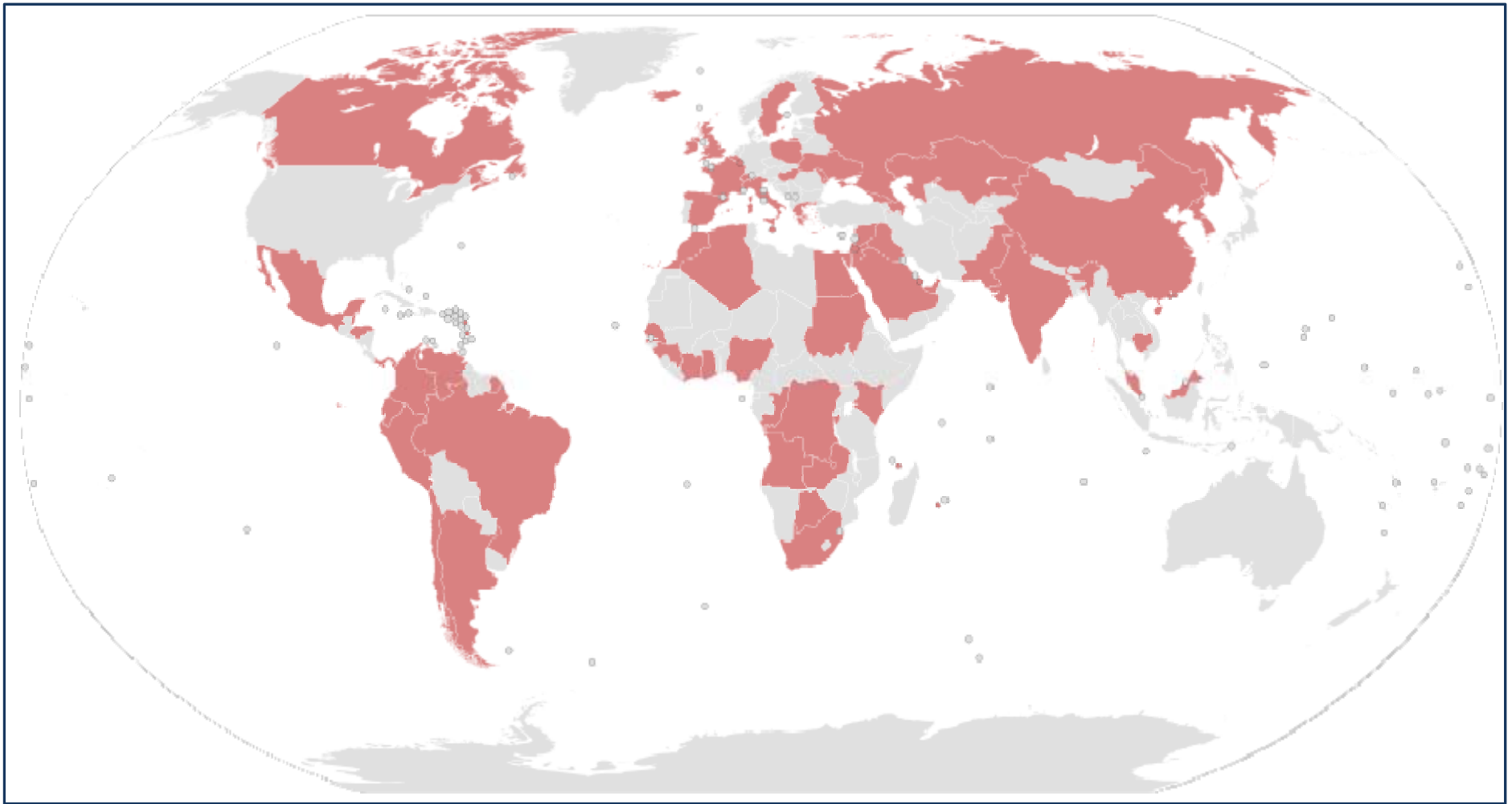


Source: ICIJ

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The Panama Papers ...

Countries with politicians, public officials or close associates implicated



Summary Thoughts

To thrive and grow

1. Securities markets in small scale economies need to look beyond domestic securities and domestic investors.
2. There needs to be a strong focus on creating the amount and variety of investable instruments that the domestic financial sector needs to absorb excess liquidity.
3. Hybrid securities should be considered. Pension funds should be allowed to invest in them as 'domestic' instruments.
4. Bringing foreign investors into the local markets may benefit the system and the brokers, but it cannot be expected to generate more taxes or employment.

Summary Thoughts

Considering an offshore strategy

1. Markets considering an offshore strategy must decide if they aspire to be a stand-alone financial center, or an offshore account location for neighboring markets.
2. Succeeding as an offshore location requires creating tax incentives (even holidays).
3. It also creates strong pressure to grant identity concealment. But this comes with reputational impacts that may spill over into the country's other international relationships. It is a shrinking and increasingly risky industry, with strong forces combatting it.



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Robert H. Singletary
RHS@Lenzie.org

152 Lake Mariam Road
Winter Haven, Florida
United States 33884

Titsian Tabidze, 1st Turn, #12
Tbilisi, 0179
Republic of Georgia

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