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Long-term financial instruments: how to develop and why we need them?

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■ Summary

Moldova, like other developing countries, faces a relatively short maturity of financial instruments. The average weighted maturity of state securities in circulation is only 6.5 months. The average weighted maturity of the portfolio of new loans granted throughout the banking sector in 2016 made up 29 months, while the average duration of loans granted to legal entities in developed countries is 58 months. Meanwhile, about 92% of the total new deposits attracted by local banks in 2016 have a term of up to 1 year. Thus, economy of the country is constrained by the lack of long-term credit instruments that would otherwise enable efficient long-term investments: real estate projects, infrastructure projects, etc.

The problem of maturity of financial instruments has two aspects: lack of the supply of instruments with long-term maturity and low demand from the population for such instruments. A basic precondition without which it is impossible to extend the maturity of financing is to ensure stable macroeconomic conditions.

In addition to ensuring macroeconomic stability of the country, the state can adopt a number of targeted policies to extend maturity of financial instruments, such as:

- Increasing the share of Government Securities (GSs) with a maturity of 3 years, with subsequent issuance of GSs with a maturity between 5 and 10 years, depending on the demand on the market.
- Extending the list of primary dealers who have access to primary auctions of GSs and creation of a secondary free market with direct access of buyers and private sellers, including individual ones, who would convince GS holders that these instruments are liquid and can be sold at any time.
- Implementation of tax policies favourable toward capital market development, at least equivalent to the treatment applied to interests related to bank deposits.
- Creation of framework for appearance of new intermediates of long-term resources by supporting private pension funds (Pillar III) and progressive implementation of mandatory pension funds (Pillar II).

The prerequisite before implementing the policies described in this note is related to ensuring macroeconomic stability of the country. Any isolated attempt of authorities to address any particular problem such as short-term maturity of government bonds, lack of private pension funds, or maturity mismatch between loans and bank deposits, without a clear multidirectional set of actions, will lead to failure.

■ Defining the problem

To ensure a qualitative and sustainable economic growth, the financial system shall be able to channel savings of household and companies into financial flows with a long maturity, so that the real economy needs in terms of investments are met in a manner as efficient as possible. International records show that promoting and developing financial instruments with a longer maturity, can provide prerequisites required for a faster development of various economic sectors. On the one hand, regarded as **savings instruments** in the form of investment funds or private pension funds, they provide greater risk diversification and complement the product supply, which is currently represented almost only by bank deposits. On the other hand, being regarded as **investment instruments**, they make possible more effective funding of long-term investment projects and with a longer repayment term, such as those from construction and real estate, energy and infrastructure sectors.

A fundamental prerequisite without which it is impossible to extend the maturity of financing is to ensure conditions of stable macroeconomic conditions. First, both investors and consumers present in an economy need stability and predictability in order to determine the course of their decisions. Although it is not the main impediment, an environment with an exaggerated inflation can discourage long-term investments, suppliers of financial resources requesting a greater risk premium to protect themselves from potential risks arising from loss of purchasing power. Second, poor governance of state institutions, instability in the financial system and shortcomings in the judiciary system are important obstacles in extending the maturity and the term of financing. Moreover, international experience shows that countries that tried to implement only policies for extending the maturity of financial instruments without addressing structural deficiencies of the economy failed to achieve the original objective.

In this sense, the problem of maturity of financial instruments can be divided into two separate issues: lack of supply of instruments with long-term maturity and low demand from the population for these instruments. **Thus, although we face constraints on supply side as well as demand, both of which are interconnected, this study comes to break this vicious circle by identifying mechanisms that can be used to modernize long-term financial intermediation, impediments that inhibit development of this process, while also describing their benefits for the national economy.**

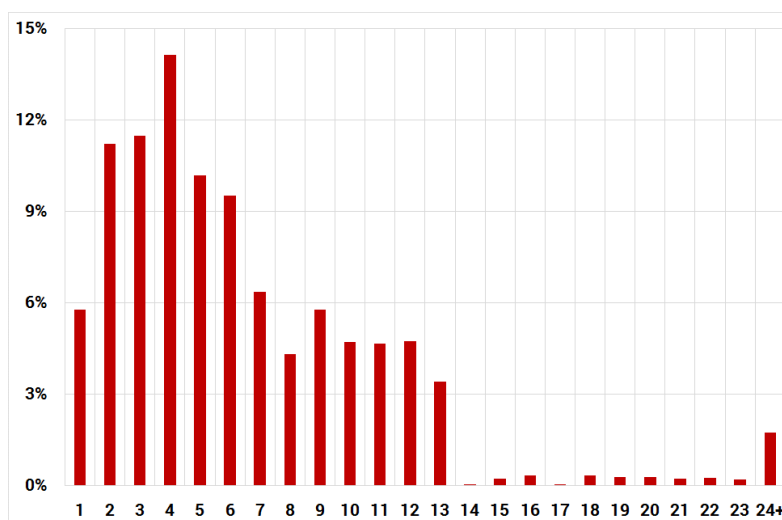
■ Overview of the current situation

The most common long-term financial instruments are banking products – loans; and capital market instruments – bonds and corporate shares. Developing countries often face a relatively short maturity of existing instruments in the banking sector, while the capital market instruments are extremely limited. The financial system of Moldova is in a relatively early stages of development. At the end of 2016, the bank and non-bank loan portfolio accounted for around 30% of the GDP, the insurance sector is dominated by compulsory insurance and banks prevail on the capital market in the role of intermediaries and issuers of shares.

Capital market

A feature that proves poor development of the local capital market is the relatively short maturity of government securities (GSs). According to the data presented by the NBM¹, the weighted average maturity of GSs in circulation is only 6.5 months, 62% of GSs are due in less than 6 months and only 2% in over two years (Figure 1).

Figure 1. Balance of government securities by maturity, in months, % from the total



Source: Author's calculations based on the NBM data

Extension of maturity of GSs should not be an isolated purpose followed by the authorities. Implementation of measures that would follow the country's macroeconomic stability lead inevitably to an increase of GSs' maturity. Demand for long-term GSs is actually an indicator of local market perception of the country's economic prospects. That is why, given the historic instability of Moldova's economy, the periods when bonds were issued with a maturity of 3 years were very short, and each time they were associated with periods of economic growth and relative price stability.

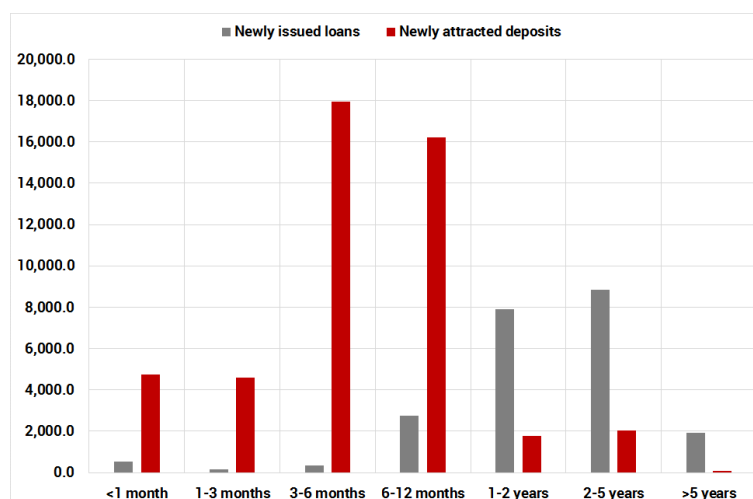
Banking instruments

Data provided by the National Bank shows that the weighted average maturity of the portfolio of newly granted loans throughout the banking sector in 2016 is approximately 29 months². The largest share consists of loans with a maturity between 1 and 5 years – about 75% (Figure 2). In the same time, the weighted average maturity of the portfolio of newly attracted deposits for the same period is about 7.5 months, significantly less than the maturity of financing instruments in the banking sector. The share of new deposits of up to one year reached 92% of the whole portfolio. The average weighted maturity of the portfolio of new loans granted to legal entities in 2016 is 27 months. Therefore, a major constraint of the local banking sector hindering development of long-term credit instruments (eg. real estate projects, infrastructure projects) is the inability to attract deposits /long-term savings.

¹<http://bnm.org/bdi/pages/reports/dop/DOP12.xhtml>

²<http://bnm.org/bdi/pages/reports/dpmc/DPMC4.xhtml>

Figure 2. Newly issued loans and newly attracted deposits by maturity in 2016, mln. MDL



Source: NBM

This is an issue of countries with economies in the early stages of development. According to the World Bank data, the average length of loans issued to legal entities in developing countries in 2015 was 23.3 months, whereas in developed countries - over 58 months³. The related problem that is also acute in Moldova consists in the source of funding bank loans. Since there is no capital market for corporate bonds, and the stock market for shares shows signs of life only if there are intentions to concentrate control packages, banks are required to take the risk should the rate of return fall as a result of mismatch between maturity of loans and deposits. To reduce that risk, banks use a floating interest in most cases, which puts pressure on debtors. Floating interest is not a problem in itself. Difficulties arise if major fluctuations of this interest appear, being caused by macroeconomic instability, and the lack of long-term predictability. As a result, in times of economic shocks with increased inflation, businesses are constrained not only by worsening economic conditions, but also by increase in loan interests.

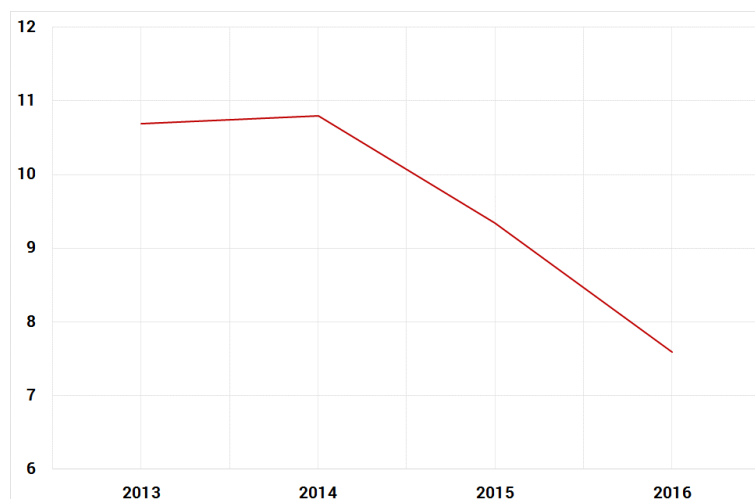
Supply of financial resources

Banks are the backbone of financial intermediation, especially in developing countries. In advanced economies, significant supply of long-term financial instruments is not generated by bank deposits, but rather by pension funds, investment funds, insurance companies, etc. Their lack or under-development in Moldova can be explained by a number of factors including low discretionary incomes of the population that does not allow significant savings. In addition, the population does not trust everything related to the financial system. After losing their savings at the collapse of the Soviet Union, faulty management of investment funds established based on patrimonial bonds, and several rounds of depreciation of the national currency, the population seems reluctant in trusting the system. This is also proven by the short-term of bank deposits, which are preferred by most people due to the possibility to withdraw these deposits in short terms.

³<http://www.worldbank.org/en/news/press-release/2015/09/14/long-term-finance-shortage-post-2008-crisis-blunts-progress-in-developing-countries>

The possibility of new crises in the banking system and also the persisting risk of inflation, feed people's reluctance regarding financial investments. For example, following the liquidation of the three systemically important banks and high inflation in the period 2015-2016, the average weighted maturity of newly attracted deposits dropped by almost 30% compared to 2013 (Figure 3).

Figure 3. Average weighted maturity of newly attracted deposits, months



Source: Author's calculations based on the NBM data

At present, the Moldovan economy does not seem to be able to provide ways for intermediation of financial instruments other than the banking sector. Macroeconomic stabilization, provision of a perspective of sustainable economic growth, and creation of incentives for appearance of other structures on the financial markets are the basic prerequisites that can combat this negative trend.

■ Needs and long-term financing instruments of the economy

According to several international financial institutions, long-term financial instruments are considered instruments with a maturity of over 1 year. An objective estimations of an economy's needs for long-term financial instruments is an extremely difficult task, particularly because both the private and the public sectors need such resources. Additionally, in a free economy, suppliers of financial instruments and resources should determine the level of equilibrium, including the optimum price and length of financial instruments. In systems that are in early stages of development, where market mechanisms are not effective, the role of authorities is to determine the financing needs of the economy and to identify obstacles for efficient financial intermediation. Based on newly issued loans and deposits during 2016, the banking sector only faces a shortage of long-term funding resources of at least 14.8 billion MDL⁴ (Figure 1), while the total balance is much higher. This puts under considerable pressure both the financial sector and debtors facing interest volatility risks, and the risk of impossibility to roll over loans upon their expiry. The public sector also needs long-term financing resources, mainly in order to invest in infrastructure, education and innovation. Total required volume depends directly on strategies of authorities in each of these areas.

⁴ Scarcity of long-term funding was obtained from the difference of newly issued loans for a term over one year and new deposits for the same period of time.

Long-term financing instruments are divided in turn into governmental instruments, covering the need of the public sector and private sector instruments that address the needs of the real economy for long-term funding. The most common instruments in the local market are government bonds and bank loans. But even these instruments, as previously stated, are issued rather on short term. There is a number of long-term financing instruments, which are not used at present in Moldova. The reasons for not using them include bleak prospects for economic growth, underdevelopment of the market and lack of demand for sophisticated financing mechanisms, as well as existence of some structural barriers to be addressed in the next chapter. Long-term financing instruments include:

- **Corporate bonds** – interest bearing securities issued by businesses, with a fixed or variable interest and a maturity usually of at least 1 year. Through these instruments, companies borrow on the capital market at rates that are often lower than bank loan rates. However records show that corporate bond market cannot develop in the absence of a liquid market of long-term government bonds. GSs' yield serves as a basic reference for identifying optimum rate of any other capital market instruments.
- **Corporate shares** – securities representing shares in a company. In other words, a business can obtain funds by selling shares of its property. The advantage of issuing shares is no pressure to repay a particular amount of money, like in the case of contracting a bank loan or issuing corporate bonds. Although there is a stock market for shares in Moldova, in most cases it has been used to concentrate control packages, rather than to collect funds on behalf of issuers, or for free trading of investors. To make this financial instrument popular considerable liquidity, an advanced infrastructure in terms of security and efficiency, and policies that would foster appearance of active participants: institutional investors and ordinary citizens, are needed.

■ Recommendations

Long-term financial instruments can contribute to sustainable economic growth, raising productivity and living standards in at least two important ways: through reducing the refinancing risk by offering funds for a term appropriate to investment needs, and by ensuring effective and profitable mechanisms for channelling the funds saved by the population. The primary responsibility of the authorities is pursuing macroeconomic stability of the country by offering clear prospects for economic growth. Subsequently, implementation of some appropriate and effective policies to develop the financial system, can lay the foundations for extending the maturity of existing financial instruments and creation of new long-term instruments. This in turn can ensure the necessary prerequisites for an inclusive and sustainable economic development. Such policies should address the following issues:

1. **Issuance of long-term GSs.** Currently, the weighted average maturity of GSs in circulation is only 6.5 months – an extremely low indicator. Because of the economic instability and high inflation, investors are focused on short-term instruments. With stabilization of the situation, the emphasis should be placed on extending maturity of GSs to ensure a long-term benchmark for other debt instruments. Therefore, authorities should focus on issuance of GSs with a maturity of 3 years, and then should introduce GSs with a maturity between 5 and 10 years, depending on the demand on the market. Issuance of bonds with floating interest could attract investors with long-term resources, and also make the authorities responsible for ensuring a stable macroeconomic

situation and a reduced increase in prices. This should be implemented in accordance with the commitments undertaken within the medium-term budget framework and also in combination with determined actions to maintain long-term macroeconomic stability.

2. **Increasing access for investors to private market of GSs.** A diversified base of investors can support high and stable demand for government bonds. There are several methods that could help authorities in attracting investors on that market. Demand may be supported by expanding the list of primary dealers who have access to primary auctions of GSs to include other institutional investors besides commercial banks. On the other hand, a greater impact may be produced by creation of a secondary market with direct access for buyers and private sellers, including individual ones that would assure GSs holders that these instruments are liquid and can be sold at any moment. Today, the fact that interest on GSs is exempt from income tax, to certain extent strengthens existing bank dealers' monopoly on the market. Actions to increase the access of investors to GSs, including through massive information campaign for citizens about this instrument, would bring additional savings to the budget due to the lower servicing costs of the state debt. Or precisely because of the difficult access to the GSs market, and the lack of knowledge of citizens, in 2015-2016, while interests on GSs exceeded 26%, the weighted average rate on new deposits attracted in the banking system was around 17%, leaving a considerable margin for intermediaries – banking institutions.
3. **Elimination discriminatory policies on the capital market.** The banking sector is favoured due to its sheer size and position in the society. Therefore, tax policies should not seek to additionally support this segment at the expense of the capital market. Currently, the interests on bank deposits and corporate securities are exempt from the income tax until 2020. In that situation, given the poor development of the corporate share market, it is important that its treatment be at least equivalent to the treatment of interests on bank deposits. This may be an additional incentive to start the development of the stock market.
4. **Creation of an efficient infrastructure for financial intermediation on the non-banking market.** Infrastructure of local non-banking financial market is very obsolete, and avoids using the most advanced information technologies. Non-banking market in Moldova will develop provided the procedures are as simple as possible, thus enabling investors to buy shares through remote transactions electronically. Rules of the game will need to ensure real transparency of financial statements and corporate governance. Although banks will continue to remain the backbone of financial intermediation, the authorities should focus on creating an efficient nonbanking market. The latter will contribute to strengthening the banking market itself, so that banks will have a potential source of additional long-term resources by issuing shares and corporate bonds.
5. **Creation of a framework for appearance of new intermediates of long-term resources.** Promotion of innovative and efficient policies in terms of creating investment vehicles such as pension funds, investment funds, etc. Small countries such as Moldova, lacking considerable own resources, and having a shallow financial system, have to undertake innovative actions creating a financing supply. An alternative about which Expert Group previously wrote⁵ is related to granting tax

⁵http://www.expert-grup.org/media/k2/attachments/Cum_poate_sistemul_privat_de_pensii_impulsiona_dezvoltarea_sistemului_financiar_RO.pdf

incentives to propel private pension funds (Pillar III). Tax deduction of contributions payable to the private pension funds could launch development of this segment of the financial market. Another previously formulated recommendation is related to progressive implementation of mandatory pension funds (Pillar II).

It is imperative that the problems identified are addressed simultaneously by the authorities in a determined manner, by promoting sustainable policies for development of long-term financial instruments market to ensure high economic growth, increase productivity and create jobs. Any isolated attempt of authorities to address any particular problem such as short-term maturity of state bonds, lack of private pension funds, or maturity mismatch between loans and bank deposits, without a clear multidirectional set of actions, will lead to failure.