GFDR 2015 – Long-Term Finance

Chapter 1: Conceptual Framework, Stylized Facts, and the Role of the Government

GFDR SEMINAR SERIES

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Objectives

- Explain why we care about long-term finance and discuss what underpins its use.
  - Present the conceptual framework for thinking about long-term finance.
- Present basic stylized facts about the users and intermediaries of long-term finance.
  - More granular data from users and intermediaries will be presented in other chapters.
- Discuss in very broad terms the role of the government in promoting long-term finance.

What is long-term finance?

- Common definition considers any source of funding with maturity exceeding one year.
  - This corresponds to the definition of fixed investment in national accounts.
- The G20 uses a maturity of five-years to define long-term financing.
- In the end, what can be called long-term finance depends on the purpose of the financing.
- Throughout the report, we try to offer as granular data as possible on debt maturity.

What are the benefits of long-term finance?

- Allows users of finance – firms, households, and governments- to reduce rollover and interest rate risks.
- Raises households' welfare by allowing them to smooth their consumption over time and by facilitating lumpy investments such as in housing.
- Permits households to address the welfare considerations of various life cycle challenges such as saving for retirement, for education, for emergencies, etc.
- Enables firms to undertake lumpy and large investments (such as in plant and equipment) that might be critical for their growth and performance.
- Long-term finance is also critical for investments in infrastructure.
  - Infrastructure development has been found to have a positive and significant impact on long-run growth and a negative impact on income inequality (Calderon and Serven, 2014).

When might long-term finance not be desirable?

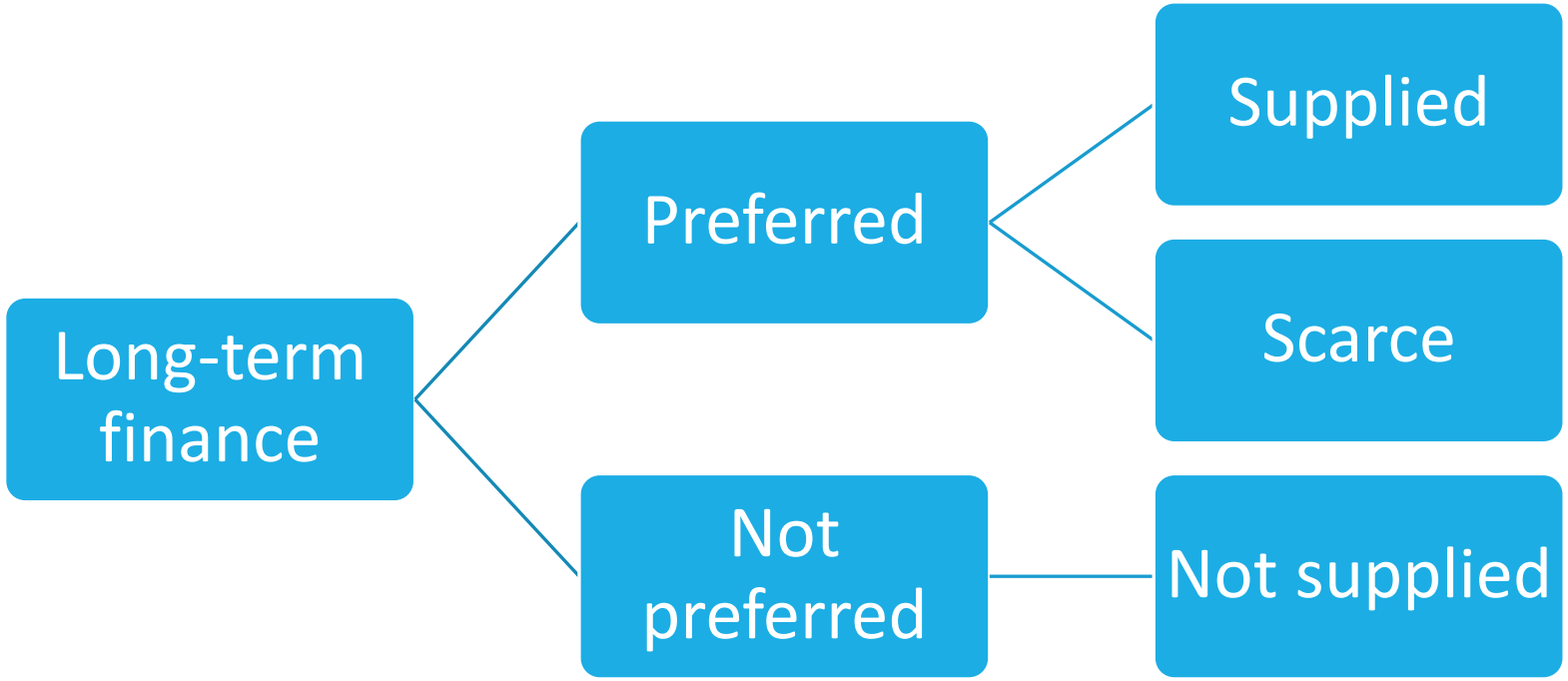
- When borrowers have short-term financing needs.
  - Firms tend to match the maturity of their assets and liabilities, hence the faster the returns to investment are realized, the shorter the optimal payment structure will be (Hart and Moore, 1995).
- When short-term financial contracts improve the lender's ability to monitor borrowers.
  - Rajan (1992); Rey and Stiglitz (1993); Diamond and Rajan (2001).
- When a firm or a household anticipates improvements in its financial situation and prefers short-term financing so as not to be locked in a contract that might not reflect the medium or long-term prospects.
  - Diamond (1991).

When can long-term finance be scarce?

When market failures or policy distortions prevail, such as:

- Information asymmetries can prevent the creditor from knowing the true capacity and willingness to pay of the borrower and cause rationing.
- Coordination problems may trigger a “maturity rat race” in which lenders shorten the maturity of contracts to protect their claims and shorten the average maturity of debt contracts available.
  - Bolton and Jeanne (2009); Brunnermeier and Oehmke (2013).
- Incentive problems (caused by compensation or benchmarking rules) can also give rise to short-term bias in financing contracts.
- Policy distortions, such as the absence of a stable macroeconomic environment or adequate legal framework can also reduce the amount of long-term finance used in the economy.

Long-term finance – Summary of conceptual framework

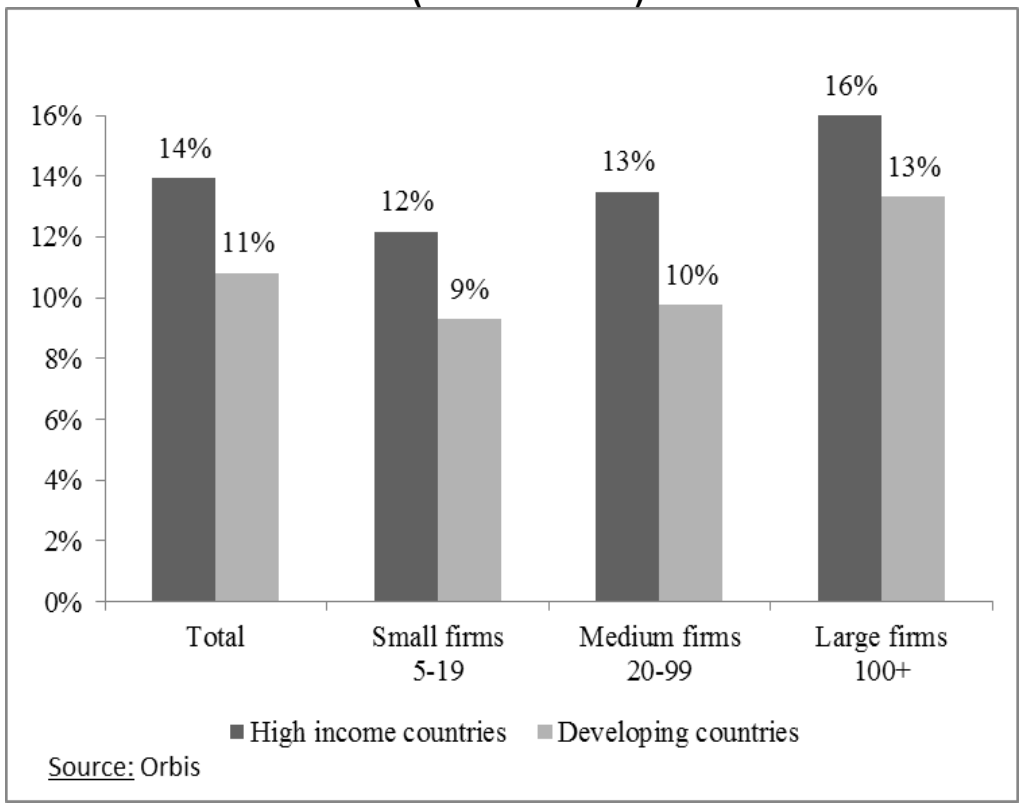


The issue of long-term finance can be understood as a risk-sharing problem between providers and users of finance.

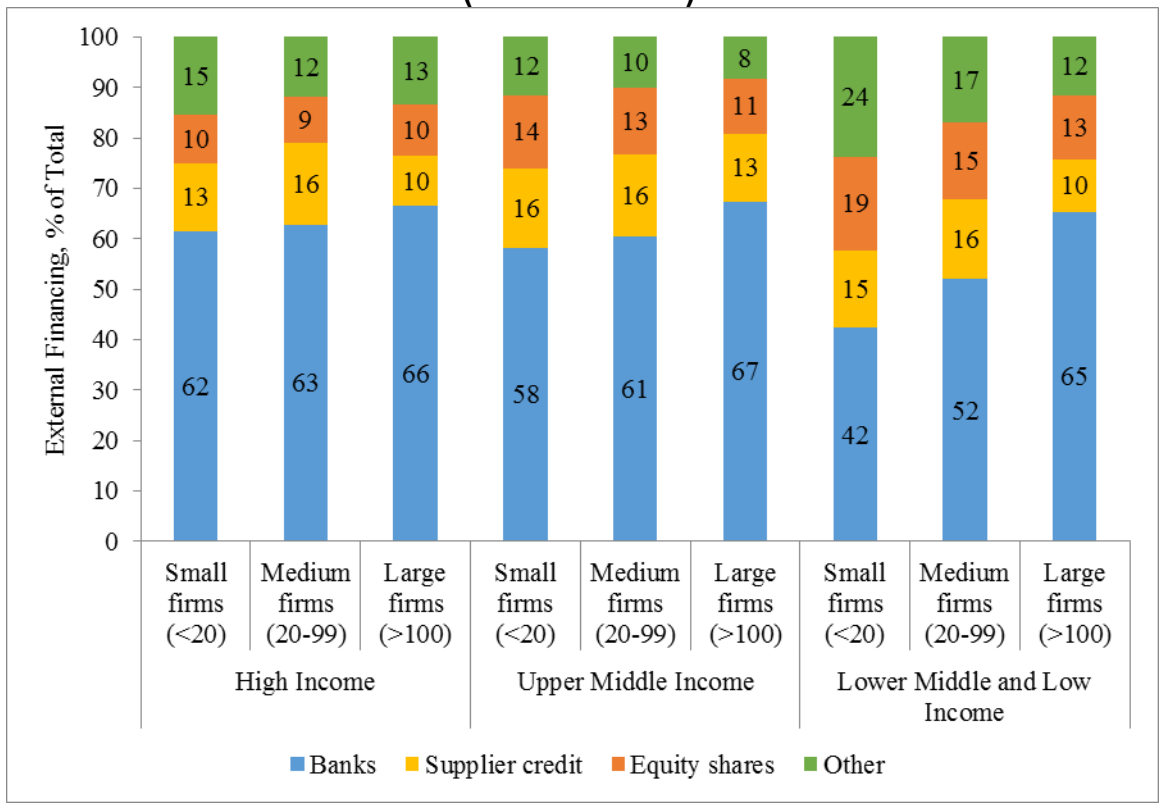
Firms' use of long-term finance

The use of long-term finance is lower among developing countries and among small firms. Banks are the main providers of long-term finance for all firms but informal sources are important for small firms.

Average share of LTD to assets (2004-2011)



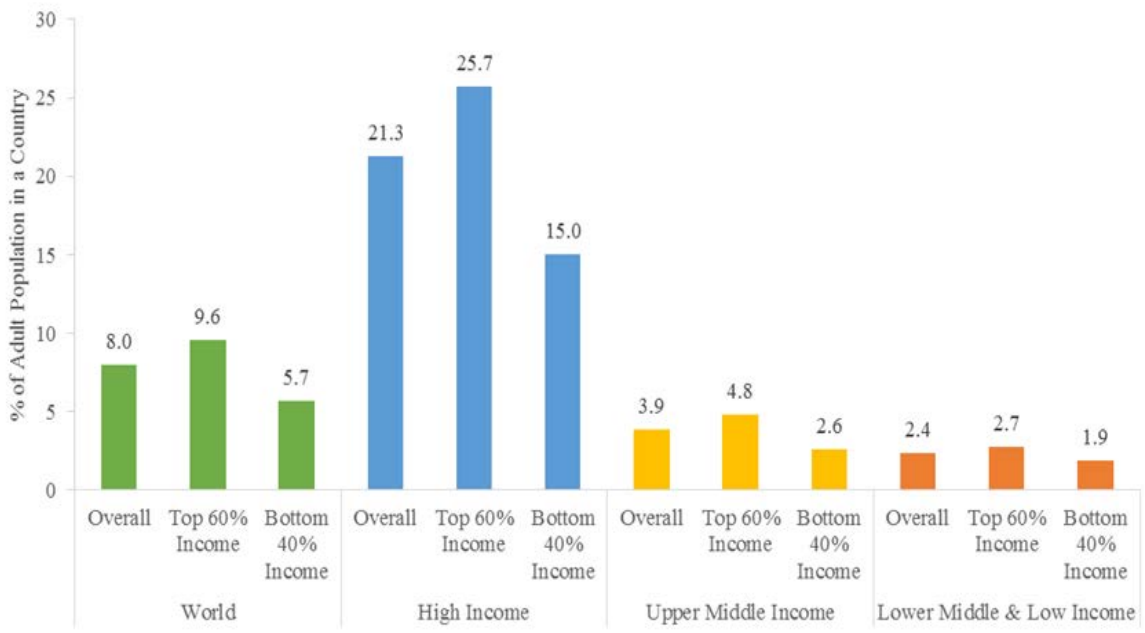
Sources of long-term finance (2006-2014)



Household's use of housing finance

Survey data suggest that across the world only a small percentage of individuals has access to housing loans.
Shares are smaller for poorer individuals, especially those in developing countries.

Percentage of adult population with an outstanding loan to purchase a home

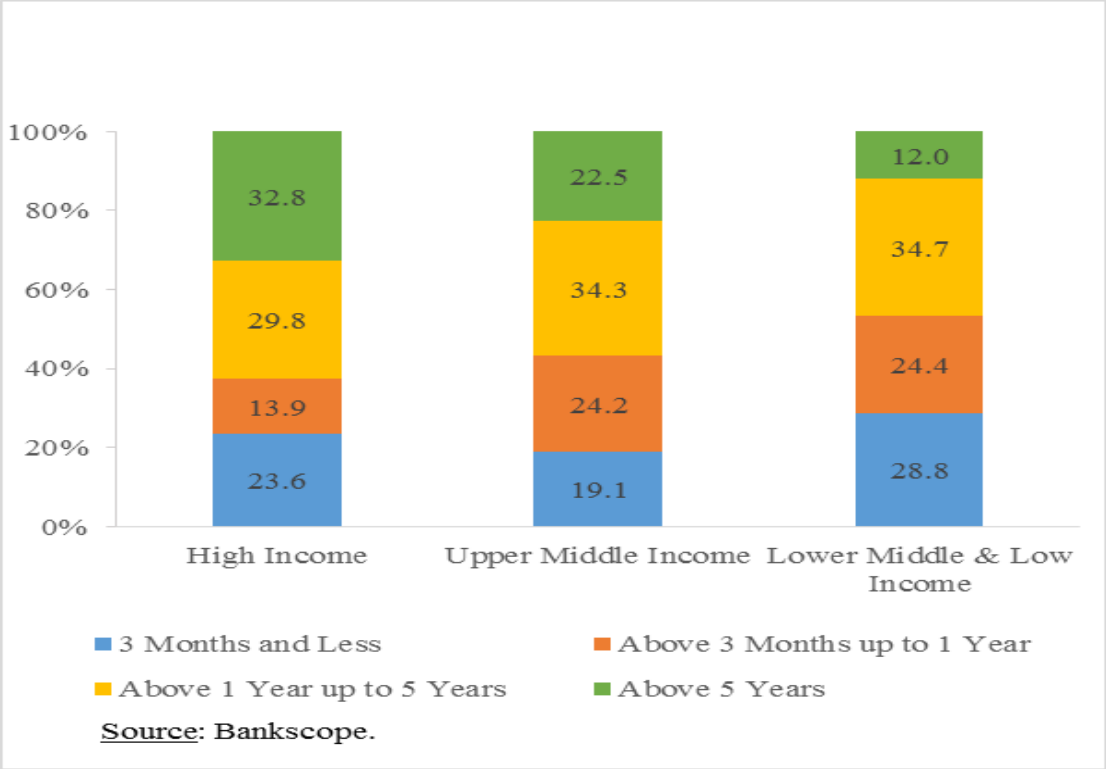


Source: WDI and Global Findex.

Bank lending maturity

The average share of bank loans with maturity > 5 years increases across income groups.

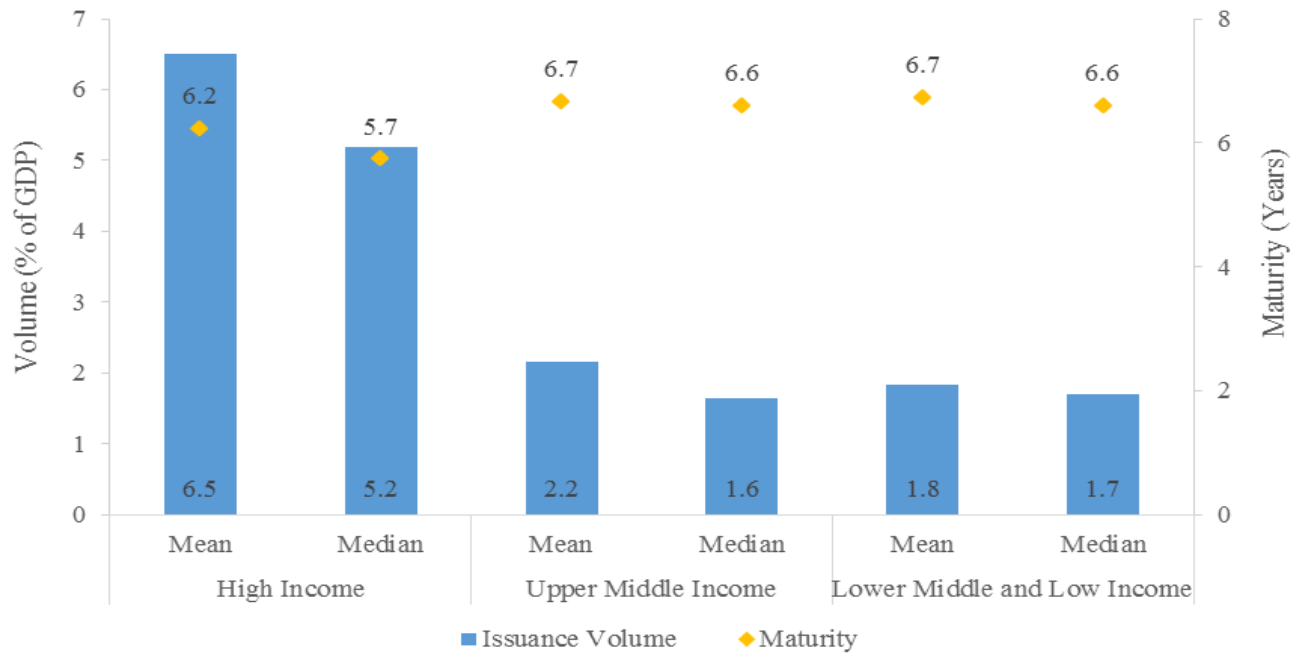
Loan shares by maturity bucket
(Average percentage for 2000-2013)



Syndicated lending

Volumes are higher in high income countries relative to developing countries, but the opposite is true for the maturity of syndicated loans.

Annual Issuance of Syndicated Loans (% of GDP) and Maturity (in years) (2000-2013)

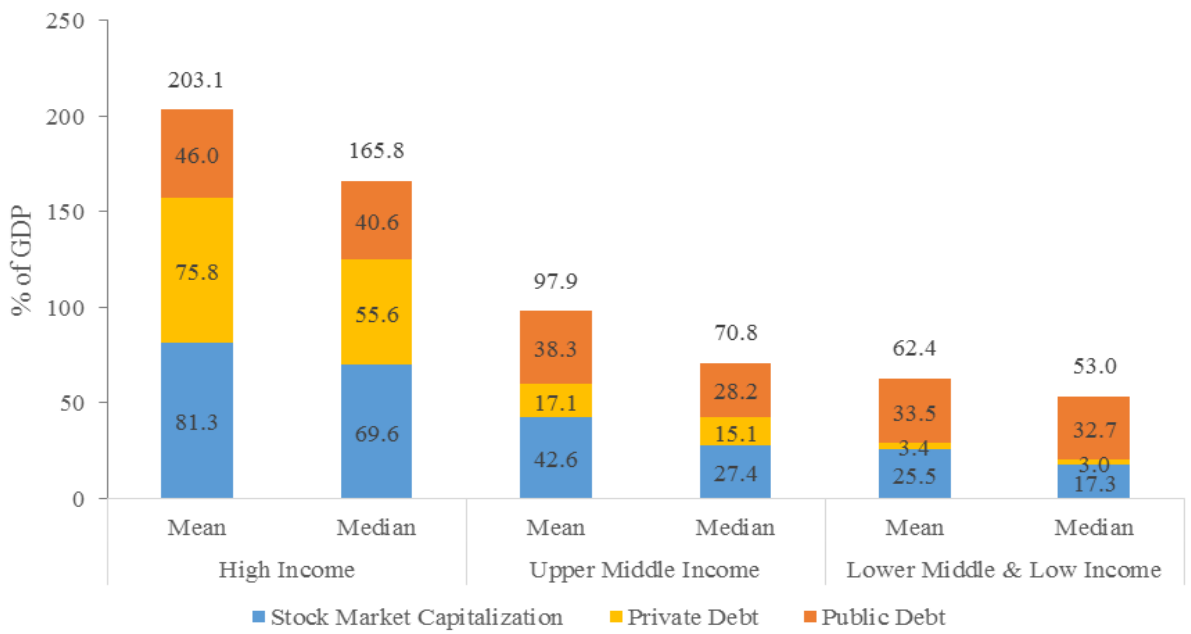


Source: WDI and Reuters.

Capital markets

Especially, corporate bond markets, are significantly more developed in high-income countries

Capital Market Sizes, 2000-2011(% of GDP)

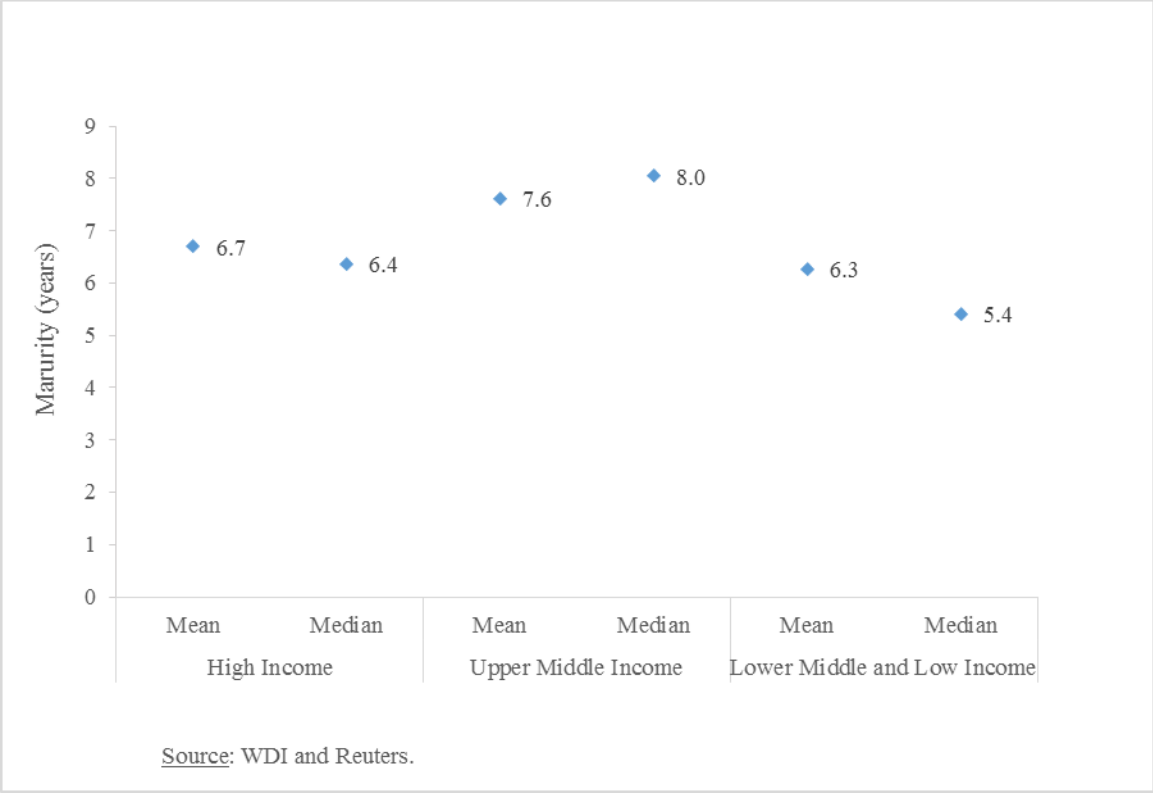


Source: WDI and GFDD.

Corporate bond maturity

The maturity of corporate bond issues is not clearly tied to country income.

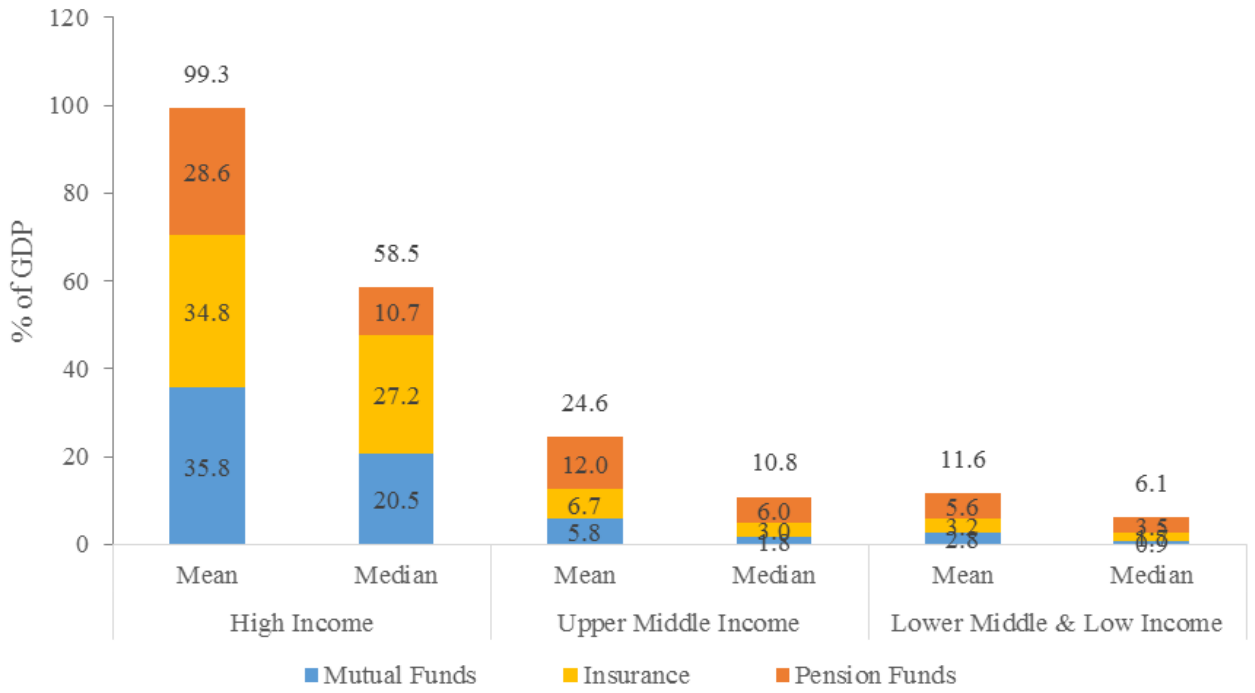
Maturity (in years) of Corporate Bond Issues, 2000-2013



Institutional investors

Over 2000-2011, the participation of pension funds, mutual funds and insurance companies in developing economies was still relatively small.

Institutional Investor Assets as % of GDP, 2000-2011

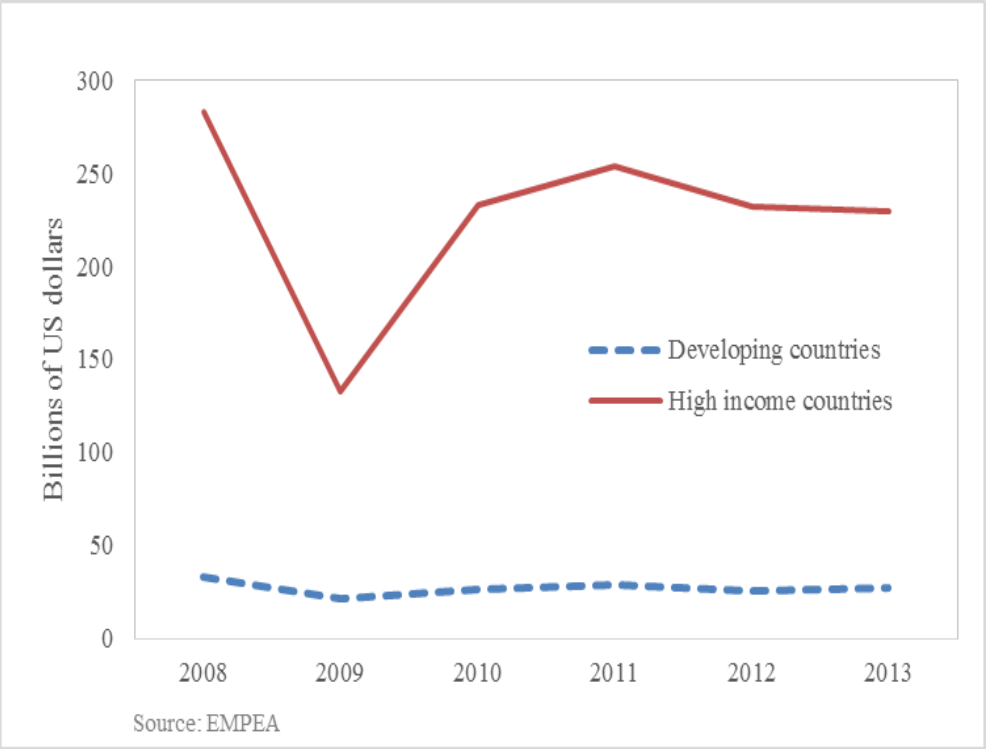


Source: WDI and GFDD.

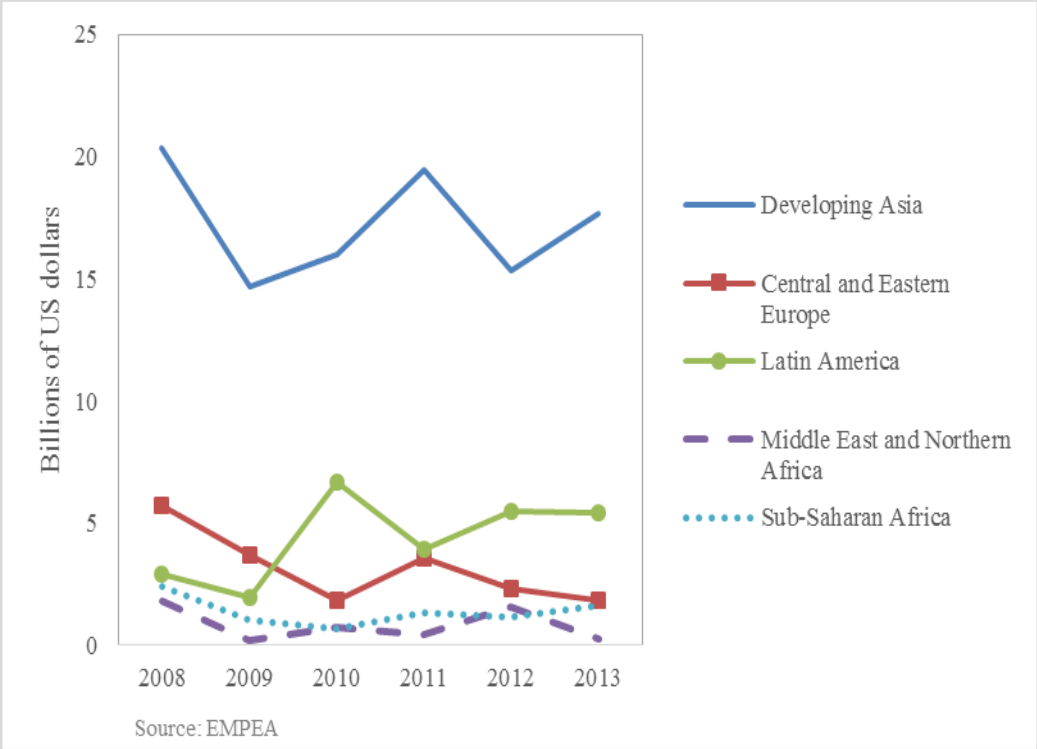
Private equity

While this is considered a promising source of long-term financing, it is still quite negligible in developing countries and very concentrated in some of these economies.

Private equity across income groups (in billion dollars)



Private equity across developing countries (in billions dollars)



The role of the government in promoting long-term finance: general guidelines

- Clear role for the government to intervene in the presence of market failures or policy distortions.
- The government can support the market for long-term finance through:
  1. Sound macroeconomic policies that keep inflation in check.
  2. Macroeconomic policies that render a sustainable level of economic growth and foster profitable investment opportunities in the economy.
  3. Establishing a sound legal framework that ensures contract enforcement and protects creditor rights.
  4. Ensuring the existence of competitive and contestable markets for financing.
  5. Reducing information asymmetries.
  6. Improving the quality of corporate governance and accounting standards.
  7. Providing a legal and regulatory framework that facilitates the development of efficient capital markets.
  8. Supporting the development of institutional investors, including setting the right incentives and removing unnecessary restrictions on their portfolio allocations so that they invest long-term.

Direct government provision of LTF?

- The evidence on the effects of the direct provision of long-term financing by governments is generally not encouraging.
- Where government-owned banks are involved in the provision of long-term finance, their mandate needs to be clearly defined, and ideally should not duplicate functions that can be provided by the private sector.
- To mitigate political interference, the corporate governance and risk management framework of government-owned banks needs to be especially strong.

Beyond direct provision of LTF…

There are a number of ways in which governments can have a positive impact on the market for long-term finance.

1. Provide loan guarantees and catalytic investments that crowd-in co-funding by the private sector.
2. Structure private-public partnerships (PPPs). This improves the incentive environment and reduces the risk that public spending crowds out private investment.
3. Where governments participate in markets for long-term finance as investors, they can delegate investment decisions to separate entities, such as privately managed sovereign wealth funds, whose incentives are better aligned with market incentives and less susceptible to political capture.