Executive summary

This report examines the overall situation of financial markets in the Dominican Republic and offers recommendations for achieving greater depth and improving the institutional framework of the capital market. A healthy capital market is crucial for the development and sustainability of the economy. Factors such as an organised issuance of public debt and a yield curve facilitate long-term financing and risk management for economic players. Furthermore, the sustainable development of a corporate bond market reduces companies' financing costs. It also allows the banking sector to specialise in debtors with higher information asymmetries.

The Dominican Republic has made considerable progress in the development of public and private debt markets. As a member of the International Organization of Securities Commissions (IOSCO), the Superintendency of Securities currently applies international standards to foster an organised market. Recent years have seen improvements in the institutional framework of the public debt market, particularly in 2006 with the creation of the General Directorate of Public Credit (Dirección General de Crédito Público) within the Ministry of Finance. This directorate uses a trading platform that allows for formal and transparent auctions of bonds issued by the Ministry of Finance. Recently, domestic debt securities issued by the Central Bank have been dematerialised and submitted to an auction process. The corporate bond market in the Dominican Republic shows efficient levels of dematerialisation, accounting convergence and risk assessment at time of issue in comparison with other emerging economies. The number of issuers with outstanding securities rose from 3 in 2005 to 20 in 2011. Meanwhile, pension funds, the country's main institutional investor, have seen their assets grow substantially from 1.0% of gross domestic product (GDP) in 2003 to over 6.0% of GDP in 2010.

However, the channels and the amount of financing of the Dominican economy are low in relation to the country's income level, and rank below

the economies of both the region and the OECD. This is explained by the low level of banking penetration (commercial credit accounts for less than 15% of GDP) and the low development of the capital market. The private debt market represents less than 1.5% of GDP versus 10% of GDP in the main Latin American countries. Furthermore, there is no stock market in the Dominican Republic.

Unlike most emerging economies and OECD countries, the Dominican Republic has two public debt issuers. The Central Bank, the largest domestic issuer, is involved in the securities market primarily for monetary purposes and the Ministry of Finance issues securities as part of its fiscal policy. These different objectives of issuance and the lack of co-ordination between the two issuers have led to an inadequate structure of yields and maturities for public debt. For issues with the same maturity, differentials of over 400 basis points are observed in the yields. These shortcomings in public debt management have resulted in high yields and the absence of a risk-free benchmark curve. These factors negatively affect the private debt market, the stimulus provided by institutional investors in the real sector and the possible creation of an equity market.

While the private bond market has made progress and exhibits sustained growth, it is still limited and sluggish in terms of concentration, maturity, indexation of the interest rate and currency denomination. The primary market has a complex issuing process and is subject to failures in co-ordination and information exchange between the different superintendencies, particularly when private issuers desire to tap institutional investors. In these cases, issuance approval often takes three months or more, nearly triple the average in Ibero-America. The secondary market has low liquidity and price-formation difficulties due to the inefficiency of key components in the market infrastructure, such as the trading platform and the clearing, settlement and information systems.

Pension funds have concentrated their investment in public debt securities, especially those of the Central Bank, which are attractive because of their risk-return ratio. For example, for the period 2008-11, while the return on special investment certificates from the Central Bank (20% per year) was twice that of corporate bonds, their volatility was only half. As a result, pension fund administrators have kept their investment in Central Bank securities at the allowable limit, which gradually increased from 35% of the portfolio in 2008 to 50% in 2011. In contrast, investment in debt issued by the real sector represents only 5% of the pension-fund portfolios.

The key recommendation for a development of the capital market is to improve the management of the primary public debt market:

- In the short term, greater co-ordination is needed between the Central Bank and the Ministry of Finance in their issuing processes and debt should be managed by a single issuer. One fundamental goal of this co-ordination is to build a risk-free benchmark curve.
- In the long term, as is the case in most of the region's economies and the OECD, the Ministry of Finance should be the sole issuer of government bonds.

Additional strategies need to be implemented for sustainable growth of the capital market. Specifically, this would require:

- In macroeconomic terms, better management of the risks inherent in the balance of payments, by implementing counter-cyclical instruments for commodity prices.
- In the financial system, deeper and broader access to credit, especially for small and medium-sized enterprises. Furthermore, it is necessary to continue including supervisory and regulatory measures for a sustainable development of the banking system, such as counter-cyclical regulation for provisions. Finally, the risks inherent in the financial system must be further studied and analysed. In that context, it would be advisable for the Central Bank to prepare a financial stability report covering the aforementioned issues.
- Better communication and effective co-ordination between the Superintendencies of Banks, Insurance, Pensions and Securities in order to streamline and simplify the issuance approval process and to avoid potential overlaps and even conflicts between different regulations. It would be advisable to establish a co-ordinating committee comprising independent experts and regulators.
- Improved functioning of the primary and secondary private debt market. It is crucial to reduce the approval time for an issuance, to standardise the required documentation and to simplify the investment process for institutional investors. A centralised system for information, deposits, clearing and payments should be developed. Finally, market regulation and discipline should impose drastic penalties on free-of-payment transactions and should encourage trading through markets with electronic price formation.
- The development of comprehensive financial literacy programmes aimed at both unbanked individuals and investors who are unfamiliar with non-traditional instruments.

- In the expansion of markets, the involvement of a greater number of institutional investors, such as closed-end investment funds and mutual funds, and an increase in the variety of investment vehicles available. It is advisable to continue the international co-operation with other countries to foster synergies, with emphasis on improving supervisory and regulatory standards.

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