11.437 Financing Community Economic Development
Class 9: Capital Markets & Capital Market Imperfections

1. What does the theory of competitive markets tell us about potential capital market imperfections?
2. What does the institutional structure of capital markets imply about actual market imperfections & capital supply problems?
3. What are the implications for community economic development?
4. Example: Financing home mortgages for low-income households

**Theory of Perfect Competition and Market Imperfections**

Theory of competitive markets tells us that capital will be efficiently allocated to investments offering the highest returns. If capital markets operate efficiently, then intervention to ensure capital for community economic development should not be needed. It is the existence of capital market imperfections that generate the need for interventions to ensure supply of capital for community economic development. The question of capital market imperfections is not simplify a theoretical one, it is a central issue for the design and operation of development finance programs. Economic development finance policies and institutions must address market imperfections to expand the supply of capital, that would not otherwise be available, to have an economic development impact.

When a local finance program substitutes or subsidizes capital for projects or enterprises that will be financed by private capital market institutions, they do not generate additional economic development. They are simply substituting one source of capital to another or subsidizing a particular use or class of users.
Theory of perfect competition in microeconomics helps identify the potential sources of capital market imperfections

Assumptions underlying the model of perfect competition that ensure an efficient allocation of capital by markets

- Many buyers and sellers
- Perfect information/insignificant information costs
- Insignificant transaction costs
- No externalities (all costs and benefits are reflected in prices)
- Participants are rational benefit maximizers
- Prices reflect true resource costs

These assumptions suggest potential causes of capital market imperfections:

- Lack of competition--monopoly or oligopoly situations
- Lack of information or high costs to gain information
- High transaction costs
- Non-rational investors behavior, e.g., discrimination
- Regulatory and tax distortions
- Externalities – all costs & benefits are not reflected in prices, i.e., private financial return is very different from social returns. It may be deemed socially desirable to intervene in capital markets to achieve a public or social end.
Institutional Structure of Capital Markets

While theory provides valuable insights, we must look to the actual institutional structure and operation of capital markets to evaluate the nature and prevalence of capital market imperfections and how they influence the supply of capital.

1. Capital markets serve to channel savings and "surplus" financial resources in the economy, i.e., funds from the suppliers of capital to the users or demanders of capital.

2. Capital markets are the collective set of institutions through which savings are accumulated and channeled to households, businesses and governments and through which the suppliers of capital receive their return.

Capital markets are organized institutionally into two basic types: public markets and private markets

A. "Public" capital markets:

Stock markets - equity investments in businesses
Bond Markets - debt investments in governments, businesses and financial assets (e.g., home mortgages)
Money Markets – short-term debt for businesses & governments

Major intermediaries for public markets:

- Investment Banks who underwrite new stock and debt sales and package financial assets into securities and bring them to market (the derivatives market)
- Brokers who arrange sales of existing securities between buyers and sellers
- Dealers who buy and sell securities

Largest buyers in the public markets include mutual funds and
institutional investors (pension funds, insurance companies, etc.)

Largest sellers in the public markets include corporations for equity markets, large corporations & governments for debt markets

Key characteristics of "public markets:

- Standardized investment instruments
- Readily available information on investments
- Liquid investments that are easy to buy and sell
- Regulated by federal government (SEC) and states

To sell debt or equity in public markets, a firm must undertake several expensive and complex steps:

- Hire an investment Banker
- Prepare legal documents that define the security & its risks
- Complete disclosure information
- File with SEC and state security divisions
- Secure a credit rating (for debt securities)
- Offer and sell securities

Cost is a minimum of several hundred thousand dollars and is not feasible for firms needing less than several million dollars in capital.

What do these characteristics imply about the capital market imperfections in public markets?

- Highly competitive--many buyers and sellers
- Extensive readily available information on firms
- High transactions costs limit the availability of public markets for most small firms and small scale development projects
- Cyclical factors & "herd mentalities" effect capital availability
B. Private capital markets & how they differ from public markets

An institutional intermediary exists between buyers and sellers--suppliers and users of capital are matched on an institution’s balance sheet; the intermediary institution manages investments and risks for depositors or investors.

Direct placement and negotiation of financing occurs between the capital user and the supplier institution.

Major intermediaries in the private markets:
- Commercial Banks
- Thrift Institutions
- Commercial Finance Companies
- Life Insurance Companies
- Pension Funds
- Venture Capital Funds

Some of these intermediaries are publicly chartered and regulated, e.g., commercial banks and thrift institutions.

Process to secure financing in private markets is quite different:

- Determine the type of financing that is needed or desired
- Find the type of intermediary that provides it
- Prepare a proposal\request
- Contact intermediary to discuss financing
- Negotiate terms and legal documents
- Complete legal documentation and obtain funds

Government regulations and financial intermediaries’ decisions on
what markets to serve and credit and investment policies are key determinants of what the type and terms of available financing.

**What do the characteristics of the private markets imply about capital market imperfections?**

- Level of competition in supply depends on the number and type of private institutions serving your community
- Information costs borne by the supplier of capital rather than by the firm securing capital
- Lower transaction costs for firms/capital user to access capital
- Greater influence of regulation on capital supply, especially for depository institutions; this can result in risk aversion.
- Cyclical factors and "herd mentalities" can effect supply

Since private and public capital markets are inter-related, the connections between the two markets effects capital supply. The availability of venture capital is closely linked to IPO demand on public stock markets.

Strong linkages between private and public markets are extremely valuable to increase capital availability, reduce interest costs, access new investors, & increase the range of risks that borne by capital markets. A good example is home mortgage market. These benefits, however, may come at the cost of higher transaction costs, greater volatility, and reduced flexibility in credit policies and terms.
Implications of capital market structure and imperfections for community economic development

- Private capital markets and intermediaries are most important capital sources for community economic development.
- Need to understand the factors shaping private financial institutions and how these factors influence the supply of the capital for community development needs. Key influences are the market structure and regulatory policies.
- Several widespread capital availability gaps result from market imperfections:
  1. Lack of institutional equity capital for most small businesses
  2. Limited availability of small commercial loans
  3. Limited availability of long-term debt
  4. Absence of lending or investment in certain areas
  5. Absence of lending or investment for novel legal structures or business

Policies to address capital gaps and expand the supply of capital

Two broad types of interventions:

1. Policies to expand private sector allocation of capital, i.e. change the behavior of existing private institutions

2. Establishing new public or community-based finance institutions

Specific interventions need to reflect local/regional capital market conditions and the resulting capital market failures and supply gaps that need to be addressed.
Key issue in deciding which type of intervention is appropriate: Does the regulatory environment and private institutional/market structure support the serving development finance needs?

If yes: How can you "perfect the market" and facilitate the supply of capital to address community credit & economic development needs?

If no: What new institutional mechanisms are appropriate either to supply the needed capital or to mediate capital markets in a new way? How can they be structured to support and finance community economic development?

**Policies to Change the Behavior of Existing Institutions**

A. Regulatory Policies

- Community Reinvestment Act
- Bank CDC regulation
- Asset regulations

B. Risk Sharing Policies

- Loan guarantees
- Risk pooling mechanisms
- Incentives to target private investment for specific purposes

C. Reducing information and transaction costs

- Originating, packaging, underwriting or servicing loans for private lenders or investors
- Absorbing information and analysis costs for lenders and investors
Creating New Institutions and Programs

A. Public Sector Institutions
   1. Revolving Loan Funds
   2. Microenterprise Loan Funds
   3. Venture Capital Funds
   4. Royalty-based Investment Funds

B. Private Sector Institutions
   1. Commercial Banks and Bank Holding Companies
   2. Savings Banks
   3. Community Development Credit Unions
   4. Microenterprise Loan Funds
   5. Community Development Loan Funds
   6. Venture Capital Funds
   7. Royalty-based Investment Funds

There is often a need to combine both approaches to address different capital needs
Example: Supplying home mortgages to a low-income urban community

How do mortgage market operate? What are the major criteria to issue a mortgage?

What might be some of the gaps or obstacles to supplying mortgages for low-income households?  
What might options to address these?  
Through existing institutional structure?  
In what circumstances might new institutions be needed?