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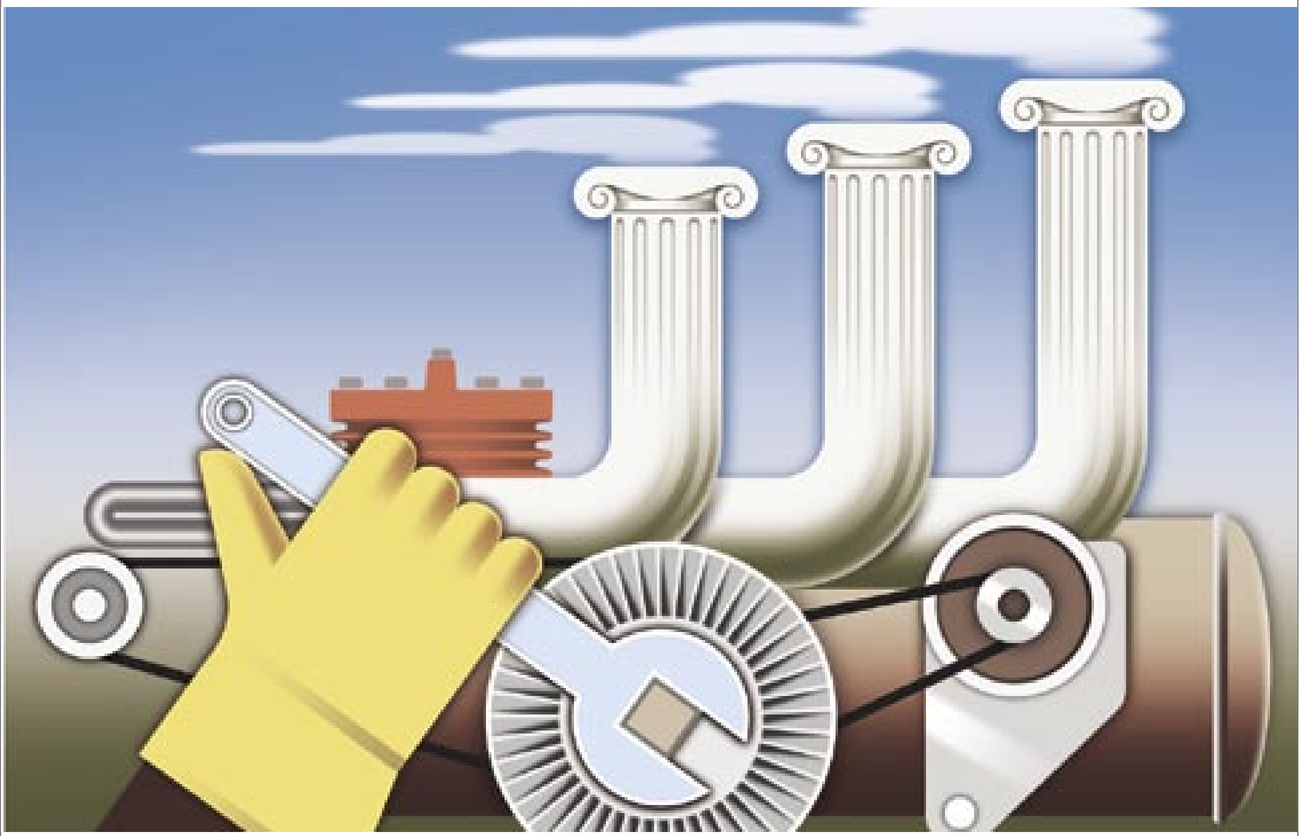

Lloyd Miller

Building world-class **capital markets**

Strong leadership is an essential ingredient.

Article at a glance

Countries around the world increasingly understand that thriving capital markets and strong economic growth are related.

The vital components of capital markets include a sound infrastructure, robust regulation, a good reputation, and high performance standards. But vision and political commitment make the difference between success and failure.

Vision and political commitment call for leaders with the stature, the authority, and the skill to assemble teams, to build consensus among diverse groups, and to promote the benefits of capital markets.

Three key requirements are clear objectives, a robust regulatory framework, and active steps to develop the market once a new regime has been established.

Building world-class **capital markets**

Ralph Heidrich, Alan W. Morgan, and Gregory P. Wilson

How can a nation transform its capital market into a dynamic, wealth-creating engine for the economy or even into a financial hub?

Vital components for this effort include patient reputation building, high performance standards, a resilient infrastructure, and a robust regulatory framework. But in our experience, vision, political commitment, and, above all, leadership make the real difference between success and failure. Just as those factors frequently determine the outcome of a corporate change initiative, so national efforts to build or improve capital markets bear fruit only when someone, or perhaps a group of people, articulates the need for reform and implements a carefully structured program.

Too few countries, however, are capturing the value from this opportunity. We believe that many more of them can share in the wider economic benefits of a transformed capital market—if they can exhibit the sort of determined leadership underpinning current reform in nations as diverse as Singapore, Malaysia, and Saudi Arabia.

Economists agree on the value of well-functioning capital markets, yet many politicians and leaders still need to be convinced. The clear correlation between deep capital markets (as measured by bonds and equities volumes) and economic development (as measured by per capita GDP, for instance) needs to be spelled out. Other benefits of mature capital markets include better price discovery, faster and less costly market corrections, and the ability to hedge and benchmark performance on financial systems that are heavily weighted toward bank lending. In our view, countries whose leaders have made a concerted effort to promote change will have a clear advantage over many other countries that embark on growth strategies without a solid plan for developing their capital markets.

Leaders must do more than recognize the importance of well-functioning capital markets and quantify the proposed changes in terms of lowering the cost of debt or increasing participation across all investor segments. Even an understanding of the familiar impediments to reform (volatile and inconsistent economic policy, underdeveloped commercial law, the slow pace or absence of privatization, lack of talent, poor regulation, and inadequate pension systems, market makers, and infrastructure) is unlikely to be enough. Effective leaders must sustain the political will of the country over time—after all, a capital market transformation can take years to implement—and avoid the kind of reform fatigue that we have seen in some countries. A prolonged effort is required to create a virtuous upward cycle of capital market development, to introduce legislation, to design or redesign regulatory agencies, and to overcome inertia and other obstacles.

In Singapore, for example, Prime Minister Lee Hsien Loong, then deputy governor of the Monetary Authority of Singapore (MAS), identified the need to develop a modern capital market following the 1997 financial crisis. From his position at MAS, he managed the policy, legal, tax, and regulatory changes that have raised the contribution of the capital market—and of the financial system as a whole—to Singapore's economy. Since then, the financial-services sector's share of Singapore's GDP has averaged 6.7 percent, putting it in the same league in 2004 as the United States (7.7 percent) and above both the United Kingdom (5.7 percent) and the European Union (5.2 percent).

Meanwhile, in Malaysia Zeti Akhtar Aziz, the governor of Bank Negara Malaysia, has led the way. Most recently, she championed the creation of the Islamic Financial Services Board, aimed at achieving the highest international regulatory, supervisory, and corporate-governance standards for the country. She also promotes Islamic finance, not only in Malaysia, but also around the world. As deputy governor of the central bank, Zeti was instrumental in developing the country's master plan to strengthen its banking sector over time.

In Saudi Arabia, the latest country to recognize the need to develop its capital markets, a clear leader has emerged: Jammaz Al-Suhaimi, the former deputy governor of the central bank and now executive chairman and CEO of Saudi Arabia's new regulatory organization, the Capital Market Authority. An influential proponent of reform, he helped pass the new capital market law while still at the central bank and also created the CMA.

These leaders have the stature, authority, and skill to assemble teams of experienced professionals and build consensus among diverse interest groups. Moreover, each one has the credibility and experience to promote the wider benefits of capital market reform, thus creating a common goal for parties with otherwise conflicting interests.

We find that efforts to change capital markets succeed when leaders manage three key issues effectively.

1. Setting clear objectives

An essential first step is to define the objectives for both the market and the regulator. Saudi Arabia recently established clear, simple regulations covering the wider economic benefits of capital markets, including employment, investor protection, and financial stability. The CMA's development plan—including investment guidelines, competition safeguards, and a role for education and professionalism—is also a useful model.

2. Understanding the regulatory imperative

Leaders must decide, among other things, whether their country's new regulatory regime will be based predominantly on principles, like the United Kingdom's, or on rules, like Singapore's. Should institutions be allowed to fail or is some sort of lifeboat imaginable? An optimum legal structure also needs to be established at the outset. Many countries prefer to bring their existing laws into line with the supervisory demands of the modern market. Others, such as Singapore and Saudi Arabia, start with a clean slate and incorporate best practices from around the world. Finally, leaders must ensure that the organizational design of the regulator is clearly aligned with its precise mission, which can include such elements as authorization, corporate finance, supervision and surveillance, enforcement, and investor protection.

3. Actively developing the market

Countries that simply reestablish the regulatory regime don't capture the full value of pro-growth reform. Successful leaders should take at least three steps: stimulate the development of new asset classes other than equities; encourage pension fund reform, such as expanding the range of assets available for investment, thereby attracting institutional investors; and promote privatization, which can stimulate capital markets by providing an IPO stream and by exposing inefficient enterprises to the private sector's expertise. Key factors for successful privatization include focusing on one clear objective at a time, keeping the market informed, and structuring transactions to reach certain target groups.

Regulators, meanwhile, should be encouraged to monitor and understand developments in other jurisdictions by communicating with colleagues and conducting regular peer reviews. Furthermore, countries can benchmark the progress of their capital markets against others in the region and against global trends. Likewise, market participants should hone their skills continually to meet customer needs and to improve their understanding of new regulatory requirements for risk management, corporate governance, compliance, and financial transparency.

Countries around the world increasingly understand the economic benefits of thriving capital markets. But financial, market, and regulatory skills alone are not enough to capture those benefits. Strong, visionary leaders must articulate the case for change and manage the transformation. Q

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