Capital Availability and Capital Market Imperfections

- Centrality of addressing market imperfections
- What the theory of competitive markets says about potential capital market imperfections
- How the institutional structure/operation of capital markets informs market imperfections and capital supply problems
- Role of class, gender and race in capital markets
- Implications for economic development finance
- Dual practice framework
- Example: financing home mortgages for low-income households

Market Imperfections in Theory

- Theory: “perfect” competitive markets allocate capital to the most productive users
- Perfect markets require:
  - Many suppliers and users of capital
  - Perfect information/insignificant information costs
  - Insignificant transaction costs
  - Costs and benefits are reflected in prices (no externalities)
  - Participants seek to maximize economic returns
- Imperfections and capital supply gaps occur when these conditions do hot hold
- Political and policy case for development finance
  - Better productivity and economic growth
  - Social benefits

Capital Markets in Practice

- Capital markets: set of institutions that accumulate and channel savings to households, businesses and governments and provide a return to suppliers of capital
- Institutional structure and operation of capital markets shapes supply gaps
- “Public” vs. “Private” capital markets

Public Capital Markets

- Standard investment instruments
- Extensive public information
- Liquid investments
- Direct investor purchase of securities
- Regulated by states & federal government (SEC)
- Stock market supplies business equity
- Bond markets supplies debt to governments, firms and households
- Money markets supplies short-term debt
- High transaction costs to access public markets
  - Several \$ hundred thousand, $\geq$10% of small issues
  - Gatekeepers' interests and biases limit access

Private Capital Markets

- Intermediary institution between capital users and suppliers
- Direct placement and negotiation of financing between capital user and intermediary
- Depository intermediaries: commercial banks, savings banks, credit unions
- Non-depository: commercial finance companies, life insurance companies, venture capital funds
- Geography affects supply
- High fixed information costs & opacity
- Regulatory influences on supply
- Non-rational behavior and investment bias

Capital Markets: Recent Trends

- Increasing role of public markets and decreasing assets held/originated by depositories
  - Mortgage banks & brokers, pension funds, mutual funds
- Bank consolidation and growth in in venture investment has created larger intermediaries and minimum transactions
- Automation of business lending (credit scoring)
- Growth of “fringe” & predatory financial services in low-income and minority neighborhoods
  - Sub-prime mortgages grew tenfold in 1990s

Race/class/gender and Capital Availability

- Long history of disparity in access to capital and exclusionary policies
  - FHA mortgage policies
  - Red-lining of low-income neighborhoods
  - Segregated financial institutions and networks
- Inequality in income, wealth, & education limits access to informal and formal capital
- Institutionalized discrimination in financial institutions & products serving communities
  - Nexus of residential & financial segregation
  - Sub-prime loans are 3X more likely in low-income area; 5X more likely in black neighborhoods, independent of income
- Large racial disparities in lending decisions and pricing remain

Economic Development Implications

- Several common capital supply gaps result from capital markets imperfections:
  - Lack of institutional equity for most small businesses
  - Limited availability of small commercial loans
  - Limited availability of long term debt
  - Disparities in access to capital exist based on geography, personal wealth, race and gender
- Private capital markets and intermediaries are most critical sources for community economic development
- Need to understand how market, regulatory and internal factors shape regional capital supply by private financial institutions for community economic development

Dual Approach to Development Finance

- Perfect operations/practices in private sector capital markets
  - Risk sharing tools and policies
  - Bank and financial institution regulation
  - Addressing information and transaction costs
- Create alternative financial institutions
  - Revolving loan funds
  - Venture capital funds
  - CDFIs
  - Micro-enterprise Funds