Developing a Road Map for Engaging Diasporas in Development

A HANDBOOK FOR POLICYMAKERS AND PRACTITIONERS IN HOME AND HOST COUNTRIES

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Chapter 10: Capital Market Investments

Financial flows from migrants and their descendants are at the heart of the relationship between migration and development. Policy attention has focused on the largest and most visible of these flows migrants' remittances and, to a lesser but growing extent, the direct investments that diaspora entrepreneurs make in businesses in their countries of origin. The third major category of private financial resources that originate from diasporas, capital market investments, are much less understood and examined. Capital markets are absolutely fundamental to development, as they are the institutions that mobilize savings for investment, providing the long-term funds that power wealth creation (and, in financial crises, wealth destruction). They include markets for stocks (equities), bonds, loans, asset-backed securities (as in commodity markets), and a complex array of instruments derived from one or more of these (derivatives). Collectively, this kind of investment is known as indirect, or portfolio, investment.

Diaspora members have substantial financial assets beyond their current income, including savings and retirement accounts, real property, and investments in stocks, bonds, and other financial instruments.[394] Governments, banks, and businesses in countries of origin have a strong interest in creating financial instruments that can attract these diaspora savings into investments that contribute to sustainable development.

Diaspora investors tend to have different perceptions of risk than non-diaspora investors. Given their homeland connections, diaspora members may have better information about investment opportunities in their countries of origin and are less sensitive to exchange-rate risks than other investors, because they have domestic-currency obligations in their country of origin such as support payments to family members or running costs of domestic businesses, mortgages, or returns to domestic share-holders. They also may have a different time horizon. While most investors in emerging markets have a fairly short timeframe for profit expectations, many diaspora investors are willing to capture return on their investments over a longer period. They may even be willing to accept lower returns than they might otherwise secure, as a 'patriotic discount," on investments in the homeland.

It should be noted, however, that it is difficult, if not impossible, given available data, to identify mainstream capital market participation by diasporas. Investments made by diaspora members in conventional investment vehicles open to all investors are indistinguishable from other foreign investments. But governments and businesses in some countries of origin have created financial instruments especially designed to tap into the wealth of diaspora populations. While some are aimed at high-net-worth individuals, some are accessible to small-scale savers. Policymakers have not yet tapped the potential of devising reliable and investor-friendly mechanisms and instruments that allow migrants (and other small-scale savers) to invest in capital markets without undue exposure to risk.

1 Policy and Program Options

There are a variety of vehicles that governments use to mobilize diaspora wealth via capital markets. These include:

- Special deposit accounts denominated in local and foreign currencies;
- Transnational loans that allow diasporas to purchase real estate and housing in their countries of origin;
- Diaspora bonds allowing governments to borrow long-term funds from diasporas;
- The securitization of future remittance flows that allow banks to leverage remittance receipts for greater borrowing at lower interest rates.

This section discusses three of the above instruments, namely special deposit accounts, diaspora bonds, and transnational loans. Securitization of remittance flows is discussed in Chapter 6.

A. Creating a Special Category of Deposit Accounts

A number of countries, such as Bangladesh, India, and Tunisia, have introduced a special category of deposit accounts at commercial banks in countries of origin, where members of the diaspora can deposit their savings. Holders of such special accounts are given preferential interest rates as well as the option of having accounts denominated in a foreign currency. In some cases, interest from such accounts is fully or partly tax exempt. Economists Christian Dustmann and Josep Mestres estimate

that between 1992 and 1994, approximately 48 percent of immigrant households in Germany maintained savings in their countries of origin.[395]

Allowing diaspora members to set up savings accounts in their countries of origin not only allows banks to expand bank capitalization for lending and onward investment, but also offers diasporas the opportunity to participate in capital markets in their countries of origin. (In many countries, holding a bank account in a country is often a prerequisite for investing in capital markets.)

Bank accounts that are denominated in foreign currencies can offer some advantages to diasporas. First, in offering such foreign-currency denominated bank accounts, banks are the ones that shoulder the risk of foreign exchange. If account holders hold currency in local denomination, they are the ones who bear foreign currency risks. Foreign currency deposit (FCD) accounts have often been used by domestic savers to maintain the real value of their savings during times of macroeconomic instability. Some banks may also offer two types of FCD accounts: current and fixed-term deposit accounts. Current deposit accounts allow account holders to withdraw funds whenever they choose, while fixed-term deposit accounts, in return for higher rates, impose some time restrictions on when account holders can withdraw their principal without paying a penalty.

In recent years, a number of developing and emerging economies — including Albania, Ethiopia, India, Kenya, Nigeria, Sri Lanka, and Turkey — have liberalized their banking regulations to attract diaspora savers to FCD accounts.[396]

National Bank of Ethiopia. In 2004 the National Bank of Ethiopia created FCD accounts specifically targeting members of the Ethiopian diaspora to invest domestically. National Bank of Ethiopia Directive No. FXD/31/2006 created a foreign currency account that nonresident Ethiopians and nonresident foreign nationals of Ethiopian origin (and their respective businesses) could open. These accounts are denominated in three currencies — the US dollar, British pound, or euro — but banks can also accept deposits in other convertible currencies, including the Canadian dollar, Saudi riyal, Japanese yen, Australian dollar, and United Arab Emirates (UAE) dirham.[397] Those residing abroad can open accounts either in person or by post. The minimum amount required to open an FCD account is $5,000 or its equivalent in any of the accepted currencies, and the maximum deposit amount is $50,000. Among other things, holders of FCD accounts can use them as collateral or a guarantee for loans or bids

and to make local payments in Birr. According to the directive, interest is not paid to nonresident foreign currency current accounts, but banks have the freedom to set their own interest rates for nonresident foreign currency fixed accounts.

Central Bank of the Republic of Turkey. The Central Bank of the Republic of Turkey also offers foreign-currency-denominated fixed-term deposit accounts and “Super FX” accounts for Turkish passport holders residing abroad. FCD fixed-term accounts can be denominated in euros, US dollars, British pounds, or Swiss francs; require a minimum deposit of the equivalent of $1,000 for at least two years; and pay an annual interest rate of 0.25 percent for all currencies. Super FX accounts are available in euros and US dollars; require a minimum deposit of €5,000; must be held for one, two, or three years; and earn annual interest rates of 1 percent for accounts denominated in euros and 0.25 percent for those held in US dollars.[398] Eligible individuals can open accounts at the bank’s branches in Turkey and at partner banks in the Netherlands, the United Kingdom, Germany, France, and the United States.

India’s NRI Deposit Accounts. Nonresident Indians (NRIs) have the option of holding their savings in foreign currency or in rupee-denominated accounts in India. As of March 2010, NRIs held an estimated $14.3 million in foreign-currency-denominated accounts and $33.6 million in rupee-denominated accounts.[399] The Foreign Currency (Non-Resident) Account (Banks) scheme can be denominated in British pounds, US dollars, Japanese yen, euros, Canadian dollars, and Australian dollars. The accounts are available for fixed terms of not less than one year and not more than five years. The accounts can also be used to obtain loans in India and abroad, both in domestic and foreign currencies. Loans made in India to the account holder must be used for personal purposes or for carrying out business activities; direct investment in India on a nonrepatriation basis by way of contribution to the capital of Indian companies; and acquisition of real estate in India for personal residential use. However, loans cannot be used for on-lending, for carrying out agricultural or plantation activities, or for investment in real estate businesses.

B. Offering Diaspora Bonds

In recent years, governments have been increasingly using their consular networks to sell diaspora bonds, designed to tap into diaspora assets. The issuance of diaspora bonds is a form of innovative financing that can help developing countries support infrastructure projects. Issuers of diaspora bonds gain access to fixed-term funding, often at

discounted interest rates due to a "patriotic discount," or the difference between the market interest rate for government debt and the interest rate that diasporas are willing to accept given their attachment to their country. However, Israel, India, and other countries learned that this "patriotic discount" is often small in reality and sometimes does not materialize. The larger advantage of issuing diaspora bonds is that they can mobilize relatively small amount of funds from the diaspora into substantial resources for development.[400] Importantly, the default risk normally associated with international sovereign-debt holdings may be reduced for diasporas. Diasporas view the country's ability to pay interest and principal in local currency as relatively strong and thus find diaspora bonds attractive.

A number of governments have issued bonds to raise capital among their diasporas. Israel has issued diaspora bonds annually since 1951 through the Development Corporation to raise long-term infrastructure investment capital. Egypt reportedly issued bonds to Egyptian workers in the Middle East in the late 1970s. India issued diaspora bonds in 1991, 1998, and 2000 to avoid balance-of-payments crises and to shore up international confidence in India's financial system during times of financial sanctions or special needs. Sri Lanka has offered Sri Lanka Development Bonds since 2001 to a number of investor categories including nonresident Sri Lankans, while Ghana offered Golden Jubilee savings bonds in 2007. Finally, Ethiopia issued the Millennium Corporate Bond in 2008 to raise capital for the state-owned Ethiopian Electric Power Corporation (EEPCO) in an effort to expand its distribution grid.[401]

A number of other governments, including a rather desperate Greek government, have tried to raise money through the issuance of diaspora bonds. In March 2011 Greece announced that it was looking to raise $3 billion in a series of quarterly sales, primarily from wealthy members of its diaspora population, and began bond sales to investors in the United States. Credit rating agencies, including Moody's, have downgraded Greece, giving it a junk rating. Though members of the Greek diaspora, which numbers 11 million, may have emotional attachment to their homeland, more is required to draw substantive investment. The government needs to market its bonds with care and wisdom, enticing members of the diaspora with long-term visions of development and economic growth.

Further, the World Bank is advising a number of countries, such as Kenya, Nigeria, and the Philippines, on the issuance of diaspora bonds. Despite improvements in credit ratings among a number of developing

and emerging economies, governments must still face the challenge of convincing members of their diaspora to purchase government bonds. It is particularly difficult to get individuals who have fled countries due to oppressive governments to invest in their countries of origin. Ethiopia, for example, has failed to raise enough money through its issuance of diaspora bonds.[402]

Golden Jubilee Savings Bonds. In 2007 the Ghanaian government issued $50 million worth of five-year "Golden Jubilee" savings bonds, available for purchase at approved financial institutions until June 2008, to both Ghanaians living in Ghana and abroad. Its objective was to raise money for infrastructural development projects in all ten regions of the country, raise awareness of the importance of saving, and diversify financial instruments on offer to the market. Holders of the accrual bonds do not receive the fixed 15 to 15.5 percent interest, compounded semiannually, until redemption.[403] Unfortunately, according to Strategic African Securities Limited (SAS), the lead advisors of the bond, Ghana's efforts, such as Ethiopia's in 2008, failed to produce substantive results as it managed to raise only 20 million of the expected 50 million Ghana cedis.[404]

State of Israel Bonds. State of Israel bonds are securities issued by the Israeli government through the Development Corporation of Israel that are marketed to the Israeli diaspora in particular to help build the nation's infrastructure. Sixty years after David Ben-Gurion established the program in 1951, State of Israel bonds have raised over $33 billion.[405] Today, Israel considers the issuance of these bonds as a stable source of overseas borrowing and an important mechanism for maintaining ties with its diaspora. Investors have a number of options including multiple maturity and minimum subscription options that sell for as low as $100 and as high as $100,000. With capital inflow generated through the issuance of these bonds, the government has spent over $26 billion for transportation, energy, telecommunications, water resources, and other essential infrastructure projects.[406]

Grand Ethiopian Renaissance Dam Bond. In 2011 Ethiopia launched its second diaspora bond, the Renaissance Dam Bond, to fund the construction of the Great Renaissance Dam, designed to be Africa's largest hydroelectric power plant. The issuance of its second diaspora bond, which looks to raise $4.8 billion, follows on its initial effort to raise money for EEPCO through its Millennium Corporate Bond. However, the first bond did not reach its financial targets due to risk perceptions among investors with respect to EEPCO, the government, and the political

environment in Ethiopia. The Renaissance Dam Bond is available in minimum denominations of $50 and transferrable to up to three people. Buyers are given the option of purchasing bonds with a five-year or a five-to-ten-year maturity as well as choosing between bonds with or without interest. Bonds issued in the local birr currency are available in five-year and over-five-year maturities. Five-year bonds have a 5.5 percent yield while over-five-year bonds yield 6 percent interest.[407] Moreover, the government is covering any remittance fees associated with the purchase of these bonds. The bonds are available in foreign currencies as well as in the local birr. The Commercial Bank of Ethiopia (through its branches), the Ethiopian embassies and consulates, and other representative offices are responsible for selling the bonds in foreign currencies. It remains to be seen how the diaspora bond fares, but this does not change the fact that it is an innovative mechanism for diverting investment toward public social service and infrastructure projects.[408]

C. Offering Transnational Loans to Diasporas and their Families

Members of the diaspora residing abroad are able to apply for and obtain small transnational loans in their countries of origin from banks or microfinance lenders. Financial institutions issue transnational loans for business expansion, home improvement, home purchase, and education expenses, but have found mortgage lending to be most successful. By obtaining transnational loans, migrants living abroad are able to provide credit to family members back home. In general, migrants cannot use assets that they possess abroad as collateral for transnational loans due to differences in bankruptcy laws and enforcement between countries.

Pag-IBIG Overseas Program. Several public and private entities offer transnational loans for a variety of purposes. The Philippine government's Pag-IBIG Overseas Program, for example, allows overseas Filipino workers to access short-term loans under the Multi-Purpose Loan Program (to help finance members' immediate medical, educational, or livelihood needs; minor home improvements including the purchase of furniture and appliances; and other related needs) and the Calamity Loan Program (for those in need of financing due a recent calamity). In addition, overseas Filipino workers can also access a housing loan under the End-User Financing Program or the Magaang Pabahay, Disenteng Buhay Program. To be eligible for a housing loan, overseas Filipino workers must be a member of the Pag-IBIG and have made remittance contributions to the Pag-IBIG Fund for at least 24 months at the time of the loan application.[409]

Microfinance International Corporation (MFIC). Since 2006 MFIC, a US-based financial services corporation, has partnered with microfinance lenders and remittance transaction operators in El Salvador, Guatemala, and the Plurinational State of Bolivia to provide transnational mortgage loans to immigrants in the United States and Spain. MFIC links remittances to housing microfinance. Partnering with two microfinance institutions (MFIs) — Apoyo Integral de S.V. and Sociedad Cooperativa de Ahorro y Crédito (AMC) — MFIC launched a pilot program in El Salvador in September 2006. Under the program, the MFIs and MFIC shared 50 percent of all risk and revenues for each transnational loan made to unbanked Salvadorans living in the Washington, DC metropolitan region for the purpose of home and land purchases, construction or home improvement, investment in existing businesses, or educational expenses. MFIC conducted loan interviews and credit analyses, verified and processed loans, and administered and collected loan payments. MFIs, on the other hand, appraised properties, evaluated business plans and any co-borrowers, dealt with loan documentation, and disbursed the loan. In general, loans ranged from $8,000 to $40,000, had terms of 10 to 15 years, used property or business assets in El Salvador as collateral, and charged interest rates of between 12 to 16 percent. The program brokered seven transnational loans with an outstanding loan portfolio of $132,000, but received 118 applications —29 of which were denied and 82 of which were ineligible.[410]

In 2010 MFIC secured a strategic partnership with Fedecredito, the largest federation of credit associations and workers' banks in El Salvador, to establish a transnational mortgage loan program that would allow Salvadorans residing in the United States to finance purchase of a house in El Salvador.[411] Under the program, clients could apply and repay the mortgage loan at Alante Financial, an MFIC-owned financial institution targeting immigrants in the United States.

2 Challenges and Lessons Learned

A number of financial instruments, including special deposit accounts, diaspora bonds, securitization of future remittances, and transnational loans, can help countries tap into the wealth of the diaspora. Such approaches enable governments to not only rely on migrants' current income but also on their savings and to focus more on long-term investments and capitalization of their markets. With the right mix of instruments and appropriate marketing, countries can potentially attract

more investment, which fosters the growth of domestic capital markets, raises sovereign creditworthiness, and creates a virtuous cycle leading to sustainable development. However, governments face a number of key challenges in promoting such instruments and making investment work for their national development.

A. Help Improve Transparency and Increase Faith in Local Financial Institutions and Businesses

Special category deposit accounts, diaspora bonds, the securitization of future remittances, and transnational loans are among the financial instruments whose potential have yet to be fully exploited. Multilateral institutions as well as public and private institutions can help developing countries improve their banking sector and raise credit ratings. One of the fundamental challenges for many countries that lack foreign investment is the perception of economic, political, or social risk among the diaspora and general investors. While members of the diaspora may have a desire to contribute to development in their countries of origin given their home bias, inherent political risks can hinder their contributions. Therefore, there is a need to address fundamental governance issues in parallel with encouraging investment in countries of diaspora origin.

B. Increase Knowledge and Expertise about Financing Vehicles Targeting the Diaspora

While debt instruments such as diaspora bonds can have a positive impact on a country's development (as Israel has experienced, for example), the majority of policymakers and diaspora communities have limited awareness about this financial instrument.[412] Moreover, governments are often deterred by complex regulatory requirements for issuing diaspora bonds abroad. For example, if a country wishes to issue diaspora bonds in the US retail market, it must register its product with the US Securities and Exchange Commission (SEC), whose disclosure requirements are relatively rigorous. In addition, governments must pay a relatively high fee to issue a diaspora bond in certain markets. In the United States, for example, fees can exceed $500,000. Governments should therefore strategically select countries whose regulatory requirements are less stringent than the United States, whose issuance fees are lower, and where large diaspora populations are present.[413]

C. Promote International Agreements on Regulation and Enforcement

The divergence of national bankruptcy laws can hinder the implementation of transnational loan programs and other financing vehicles. Governments should strengthen international cooperation to facilitate the transnational mobilization of assets, for instance, by agreeing on mutual enforcement of bankruptcy laws (which would enable banks to accept assets held abroad as collateral for lending) and harmonizing and sharing credit scores.[414]

D. Move Away from Stopgap Measures and Toward Long-Term Capitalization of Markets

If governments maintain attitudes and policies that favor short-term gain over sustainable long-term growth, they are unlikely to attract diasporas to invest in their countries. For example, when issuing diaspora bonds, governments cannot solely rely on "patriotic discounts" to raise sufficient capital to fuel development. Rather, they must assure and convince potential diaspora investors that their investments will produce positive returns and outcomes over the long term. Other possible options to attract investors would be to offer tax advantages for purchasers of diaspora bonds.[415]

E. Overcome Legal and Technical Issues in Issuing Financing Instruments

While transnational loan schemes can help migrant families purchase homes or start businesses in their countries of origin, there are a number of challenges that must be addressed. For example, MFIC found that the 50-50 percent risk-sharing arrangement between MFIC and MFIs was difficult to implement. It also found that if a client were to default on his/her loan, MFIC could take no legal action in the United States. Different institutions underwriting the policy also produced varying assessments on the level of credit risk of loan clients. Many clients also lacked key information on the valuation of property or businesses. Further, MFIC also faced other legal questions such as whether or not it was appropriate to offer a loan to an undocumented immigrant who otherwise qualified for one.[416]