WORLD ECONOMIC FORUM

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Breaking the Logjam of Capital Allocation

Discussion paper prepared by the Global Agenda Council on Financing and Capital

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The role of financial institutions in modern society is to provide financing and capital to meet the needs of individuals, companies and society, and ultimately provide the support for an efficient functioning economy and to facilitate sustainable growth and prosperity.

Financial institutions face a series of impediments that inhibit capital from flowing to where it is most needed. Indeed, the world is awash in financial capital: corporate balance sheets are at an all-time high, consumers are deleveraging and money is clustered in large institutional pools.

And yet, it is not finding its way to SMEs, upstart entrepreneurs and underbanked individuals, where the opportunities for sustainable economic growth are perhaps the greatest. There is an acute mismatch between the suppliers of capital (who are mostly very large) and the demanders of capital (who are mostly very small).

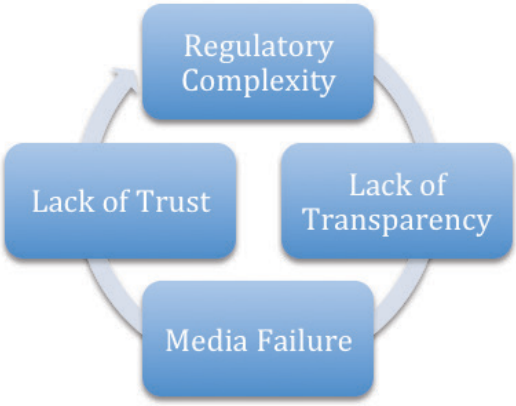
Profound diseconomies of scale in transaction costs make it difficult for large capital providers to access these small stakeholders. In part, the capital takes the wrong form: the mismatch in size is often coupled with a mismatch in investment time horizon.

Of course, competitive markets have a way of evolving to capture profit opportunities. Thus, this situation cannot persist. Over time the forces of competition will drive innovations that connect capital to its best use. But it may take wholesale structural failure before the bottlenecks that impede the flow of capital are addressed.

The real question, therefore, is: what can be done to catalyse this change?

A Vicious Cycle of Stagnant Capital

Four distinct economic and political factors work to create a cycle of stagnancy in financial markets.



1. Unduly complicated regulatory compliance burdens
The burden of regulatory compliance lies at the heart of the problem; compliance raises the fixed cost of investment. This, in turn, raises the minimum efficient scale at which a capital provider can deploy capital. Because compliance costs are so high, it is impossible for large capital providers to write small checks. Yet the small end of the investment sector is where the greatest social and economic good can be created.

Compliance costs encourage perverse economic behavior. This is because compliance costs are measured in dollars, or pounds or euros, while investment returns are measured in percentages. An investor who faces high-fixed investment costs and is choosing between a small, high-return project and a large, low-return project has an incentive to choose the project with the lower return because the return is being earned on a larger base, and is therefore more likely to satisfy the fixed investment cost.

2. A lack of trust in financial institutions and regulators
It is no secret that the global economic crisis resulted in a significant deterioration of trust in financial institutions and regulators. The lack of public trust has only been worsened by the fact that many people do not believe that the issues highlighted by the crisis have been sufficiently addressed to change the behaviour of banks. However, this environment makes it difficult for financial institutions to try new models that may help overcome barriers to capital allocation through innovation.

3. A lack of transparency
Fueling this lack of trust is a lack of transparency. Opaque financial institutions create distrust by leaving the public to wonder what is really going on. One of the key drivers of this can be found in the ambiguity of many rules. For example, the SEC has a rule in place that anything material needs to be disclosed, but what does “material” really mean?

4. A failure on the part of the media
In today’s hypercompetitive, 24-hour news cycle, the media’s primary job is too often to find a villain rather than doing analysis and finding an explanation. This exacerbates the lack of public trust in financial institutions. It does nothing to help transparency, and in fact may make things worse by urging companies to become more opaque to avoid media scrutiny. It also fuels bad regulation; they act as information intermediaries between regulators and the public they serve.

These issues are interconnected. A lack of trust in both regulators and financial market actors fuels regulatory complexity, but the complexity itself exacerbates distrust because it creates opaqueness. A lack of transparency heightens media concerns, encouraging them to find scapegoats for financial crises rather than search for structural explanations to the problems we face as a society. And, not surprisingly, the heightened sensationalism created by the media in turn fuels continued mistrust.

Breaking the Logjam

These distortions have exacerbated the size mismatch by creating institutions that were even larger than they were before, and regulatory burdens that make lending to SMEs and individuals burdensome.

Investing in SMEs requires extensive due diligence, which can be highly labour intensive. To break the logjam, innovations in the financial services are needed that allow capital to be channeled from large actors to smaller community and regional players so that the minimum efficient scale of a borrower more closely matches the population of underfunded SMEs.

This innovation must occur at the organizational level as well as the contractual level. On the first front, organizations are needed that intermediate between large and small. Contractual innovation is also required to change the incentives of those who make loans. With standard debt contracts, lenders receive no piece of the upside of taking a risky investment; their upside is capped when the loan is repaid. Attaching warrants to loans for SMEs can help to create stronger incentives for lenders to perform tricky due diligence by giving them a piece of the upside in the investments they make.

Encouraging organizational and contractual innovation can help break the vicious cycle in which a lack of trust and regulatory complexity impede the efficient flow of capital.

This report is published on behalf of the members of the Global Agenda Council on Financing and Capital.

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