

# Institutional Investors and Infrastructure Financing

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# Background

- Traditionally, infrastructure investments have been financed with public funds, given the inherent public good nature of infrastructure.
- Public deficits and increased public debt to GDP ratios have led to reduction in the level of public funds for infrastructure.
- The banking sector has traditionally played a major role in financing infrastructure projects in the region. However, bank dominant system increase the risk of an overexposed banking system.
- Capital markets would reduce the pressure on the banking system while also making available fresh equity to finance / refinance infrastructure projects.
- Much attention is being focused on the institutional investor, given the long-term nature of the liabilities.

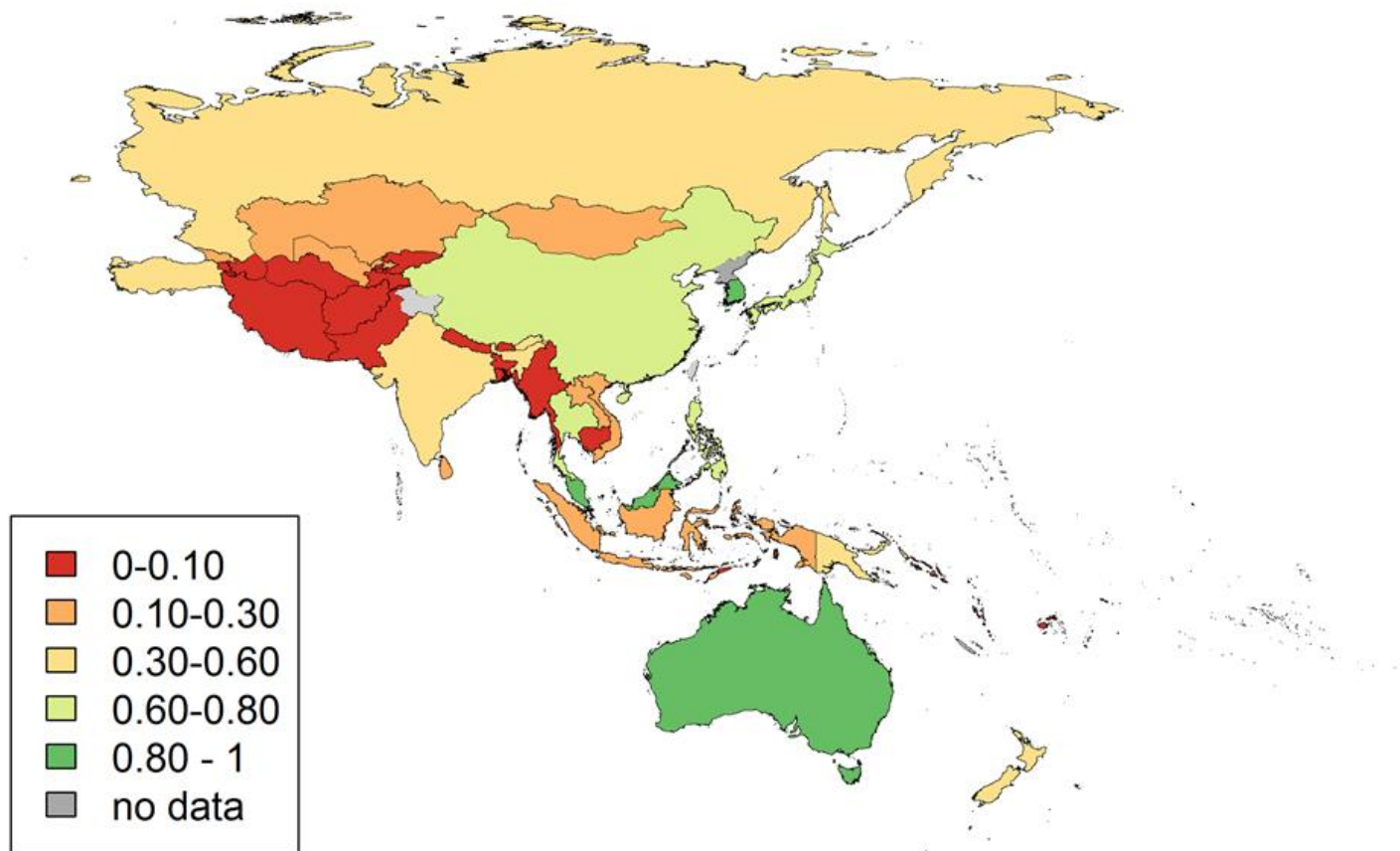
# Challenges

- Large international commercial banks, which had previously provided a significant portion of infrastructure financing have been deleveraging since the global financial crisis.
- Institutional investors at present allocate a very small fraction of their investments to infrastructure assets in both developed and developing countries.
- Most institutional investors, even those with long-term liabilities such as pension funds, life insurance companies continue to invest in liquid assets, often with a short-term investment horizon.

# State of Capital Markets

- Asia is home to diverse financial systems that vary in depth and sophistication, ranging from developed countries with sophisticated financial markets to emerging markets and low-income economies where markets are still its infancy.
- The map in the next slide provides a snapshot of the depth of financial market development in the region based on the index developed by the International Monetary Fund (IMF).
- Central Asian countries as well as those in the Pacific have particularly underdeveloped capital markets with many of them having neither bond market nor stock exchanges.
- Capital markets might need to be developed in these countries before they can play a significant role for infrastructure development.

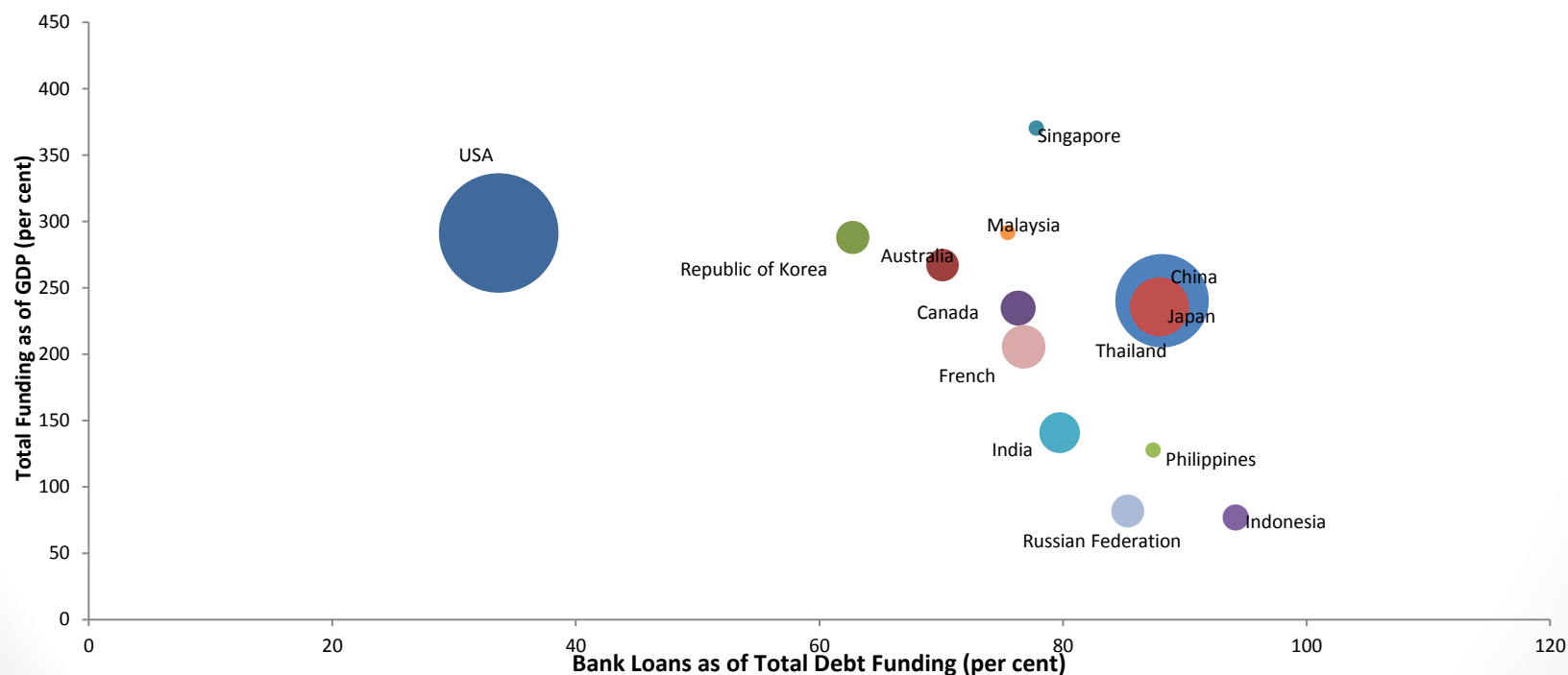
# State of Capital Markets



Source: IMF

# Bank dominant financial system

Since most of the countries have underdeveloped equity and bond markets, Asian financial sector is dominated by Banks.



Source: Authors' calculation based on data from BIS, ADB, World Bank.

# Limitations of Bank-Based Financial System

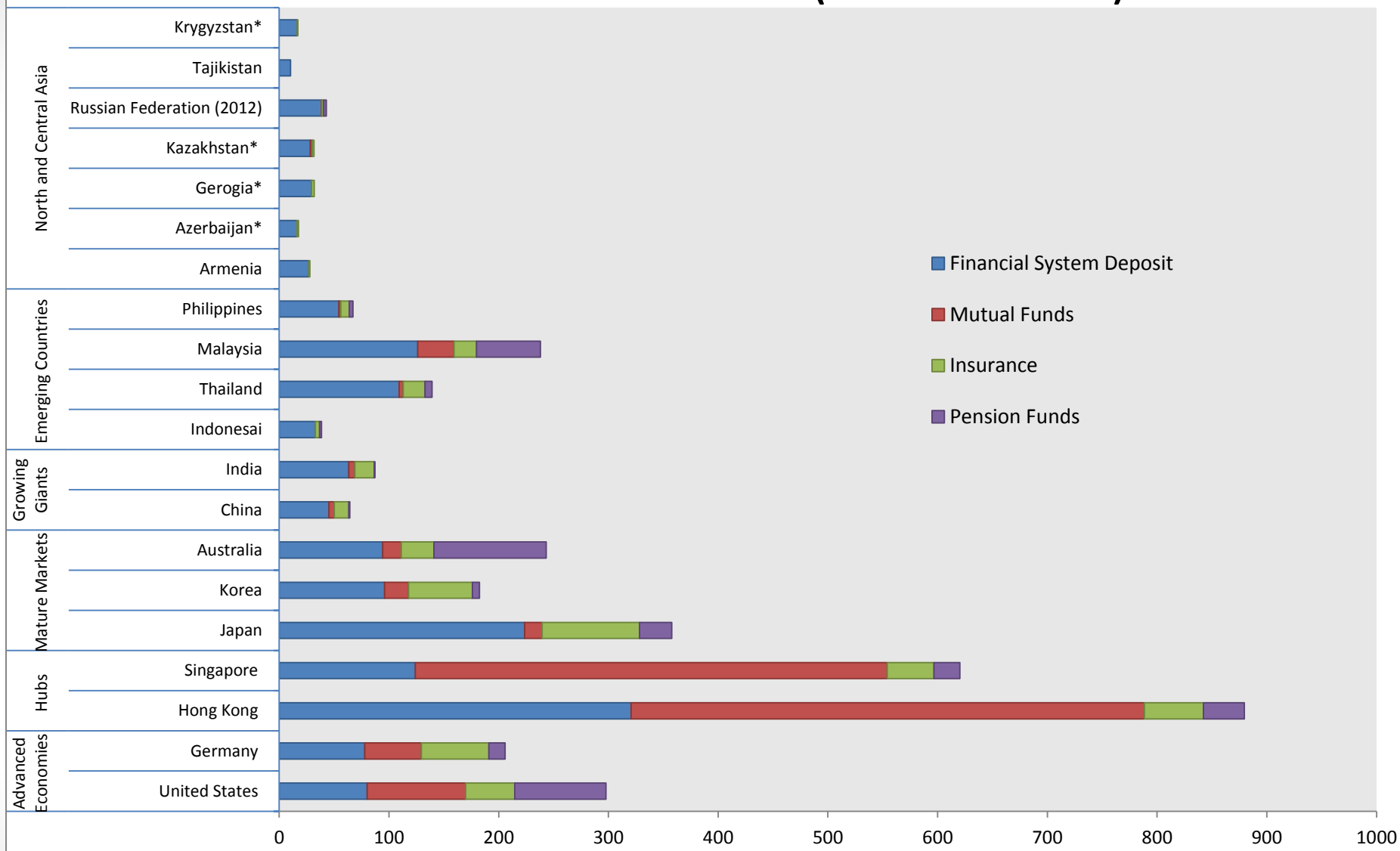
- Refinancing risks, Single borrower limits, Provisions and Basel III are limitations of bank-dominated system.
- These limitations illustrate why bonds are a useful alternative to loans for infrastructure financing.
- Bank financing should nevertheless continue to play a key role in the initial phase of an infrastructure project.

# Institutional Investors

- The long-term nature of infrastructure projects matches the long-term liabilities of institutional investors.
- There is a high correlation between the size of the institutional investor base and the size of capital markets.
- Underdeveloped equity and bond markets prevent institutional investors to finance infrastructure investment.
- The region has diverse structure in terms of the size of its institutional investors.



## Institutional Investor Structure (% of GDP in 2014)



Source: World Bank, 2016, Global Financial Database

\*The insurance data of Kyrgyzstan and Azerbaijan represents 2013; the insurance data of Georgia represents 2012; the mutual fund data of Kazakhstan represents 2012

# Investment Modalities

Infrastructure Companies

- Stock market
- Corporate Bond

Infrastructure Projects

- SPV Listing
- Project Bond

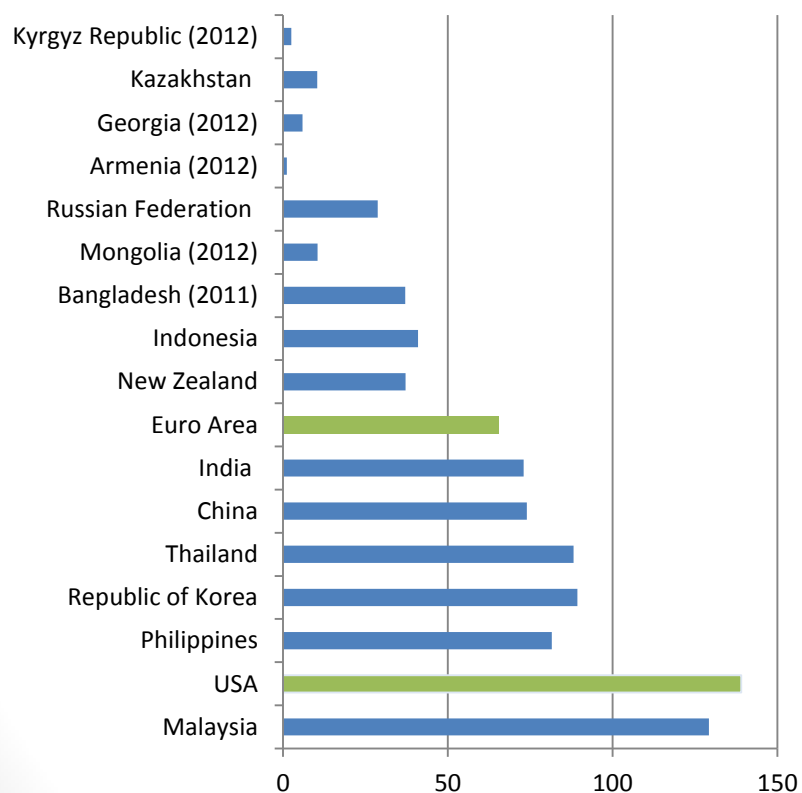
Infrastructure Funds

Municipal Bonds

# Investment Modalities

## (Infrastructure Companies-Stock Market)

Stock Market Capitalization of Domestic Listed Companies To GDP%-2015



Stock Market Turnover Ratio (2015)

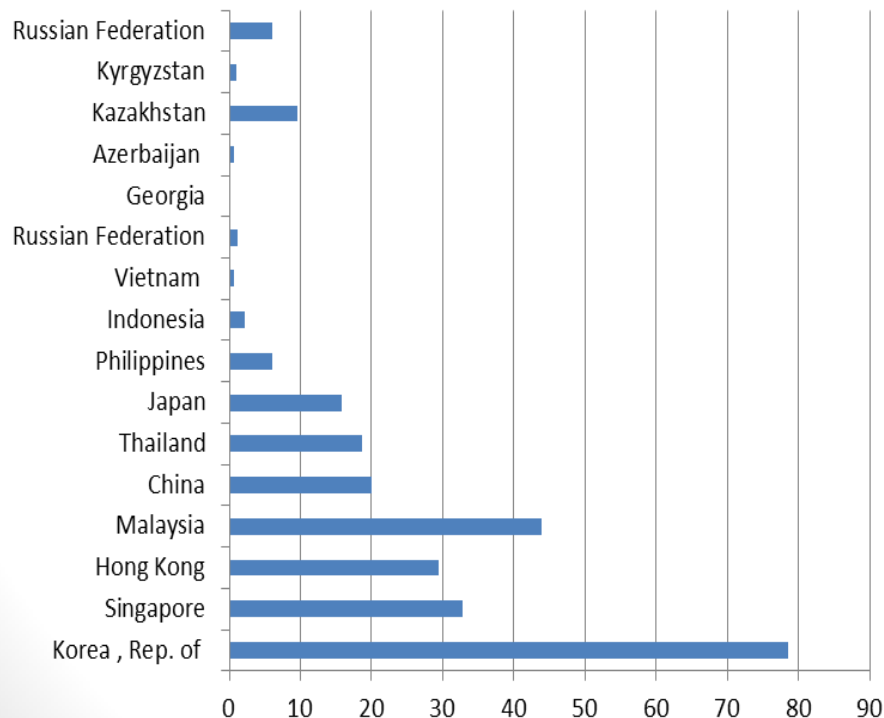
Countries	Stock Market Turnover Ratio (Domestic Shares) (2015)
Kyrgyz Republic (2012)	3.3
Kazakhstan	7.6
Georgia (2012)	0.2
Armenia (2012)	0.8
Russian Federation	29.8
Indonesia	21.2
Euro Area (2014)	87.9
India	50.9
Republic of Korea	149.8
China	480.2
World	162.9

# Investment Modalities

## (Infrastructure Companies-Bond Market)

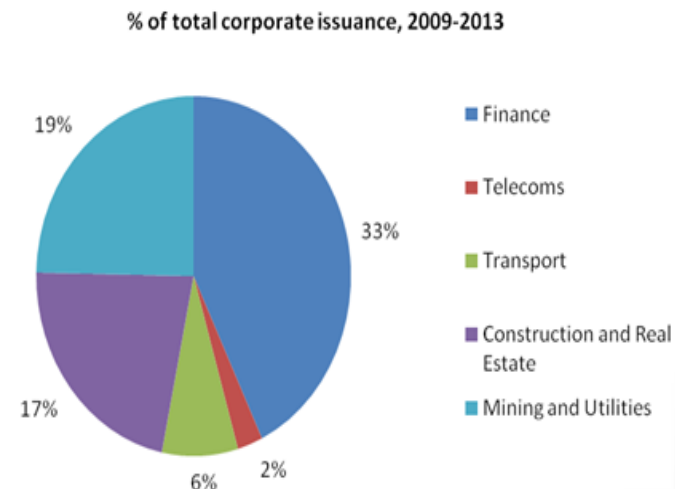
While US and Europe have \$22 and \$18 trillion outstanding corporate bond issues respectively, Asian has only \$3 trillion outstanding bond issues as of 2014

Corporate Bond Outstanding (GDP%-2015)



Source: World Bank, 2016, Global Financial Database and Sub-Regional Study North and Central Asia Financing Infrastructure, David Lezhava

Percentage of total corporate bond issuance in Asia



# Infrastructure Projects

## SPV Listing

- Establish a dedicated project company known as a “Special Purpose Vehicle (SPV) to acquire financing and implement project activities.
- This legally isolates the parent organization from direct exposure to the financial risks associated with a project.
- If the SPV is listed on the stock exchange, investors can invest directly in the project

## Project Bond

- Project bonds are a debt instrument used for financing stand-alone infrastructure projects, issued by SPV.
- The creditworthiness of this bond depends on the cash flow performance of the underlying infrastructure project.
- The volume of project bonds is \$36 billion in world (2013). In Asia, the volume ranged between \$1 billion and \$ 3 billion.
- Average maturity of the bonds is 8 years in Asia, compared to 15 years in advanced economies.

# Infrastructure Funds

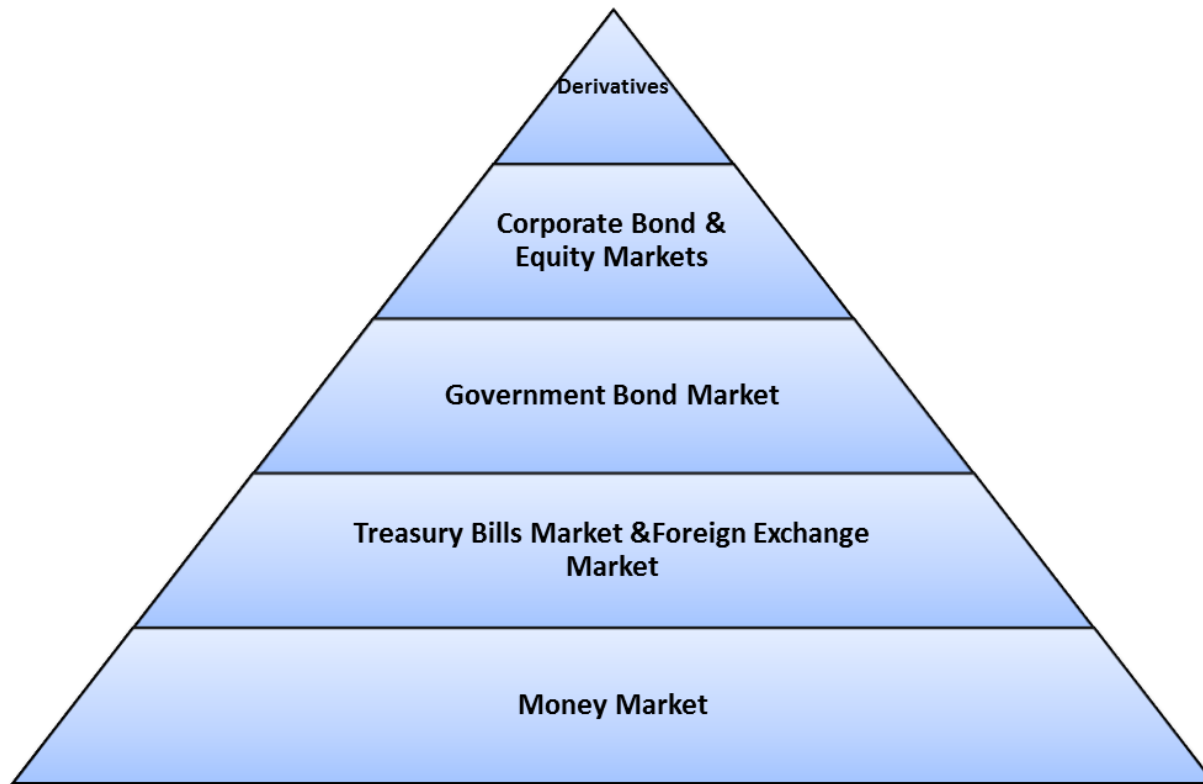
- Another intermediary mechanism between investors and infrastructure projects.
- Serve as a vehicle to pool resources, skills and experiences from different investors while achieving economies of scale.
- Specialized skills are required for structuring and assessing infrastructure investments.
- Rail Mass Transit Growth Infrastructure Fund (BTSGIF- Thailand) and the ASEAN Infrastructure Fund are examples of this funds.

# Municipal Infrastructure Bonds

- With rapid urbanization, municipalities are under strong pressure to deliver infrastructure services.
- Municipal bonds are debt instruments issued by local governments to finance infrastructure projects.
- These bonds normally attract funding at low cost given the implicit government guarantee and are subject to less stringent level of oversight than the corporate bond market.

# Policy Recommendations: Develop domestic market

## Sequencing of financial market development

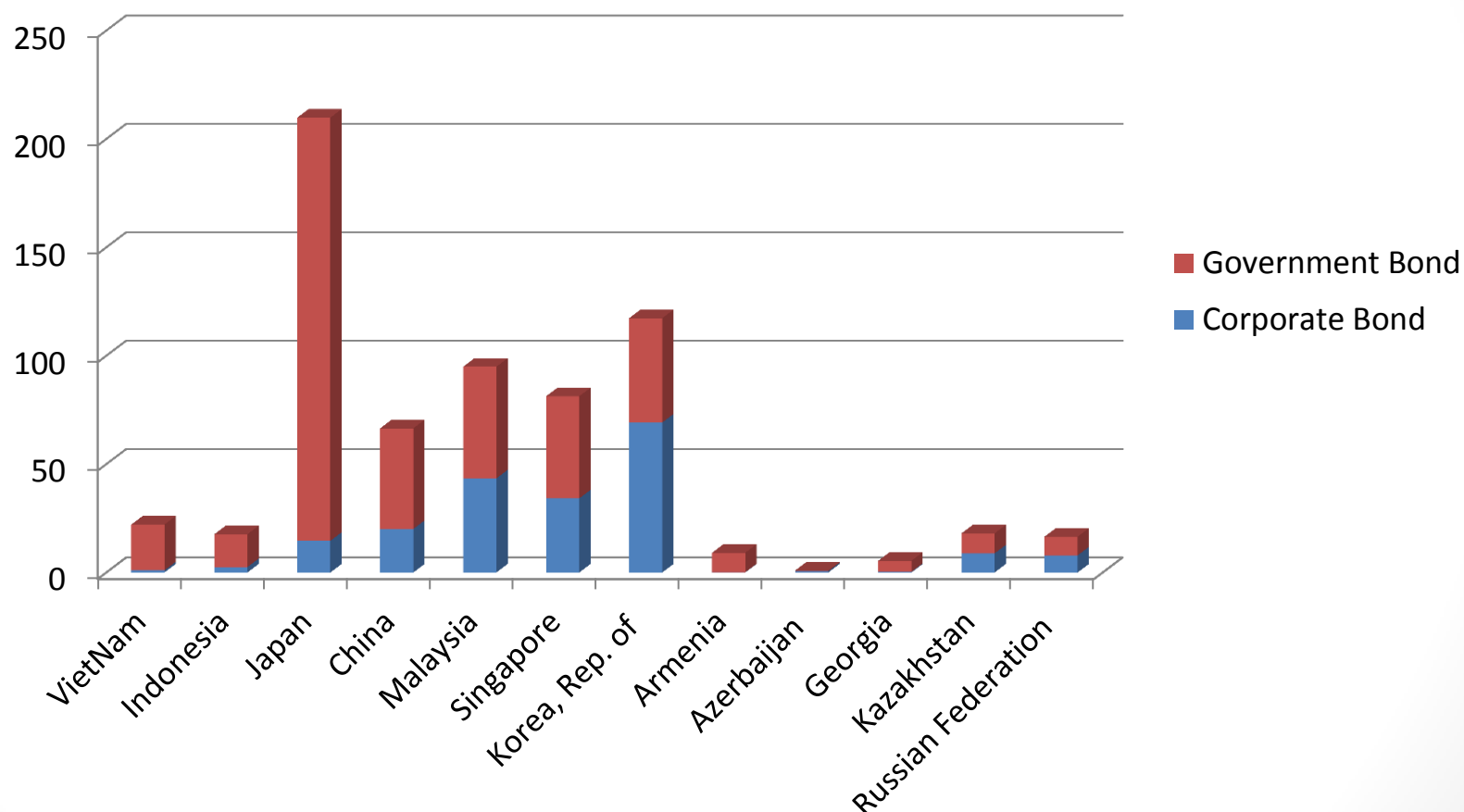


Source: Managing risk in financial market development: The role of sequencing, Cem Karacadag and others, 2003



# Policy Recommendations: Develop domestic market

Size of government and local corporate bonds (GDP%-2016)



Source: Asia Bond Monitor, ADB, 2017 and Sub-Regional Study North and Central Asia Financing Infrastructure, David Lezhava, 2016

# Policy Recommendations: Strengthen financial integration

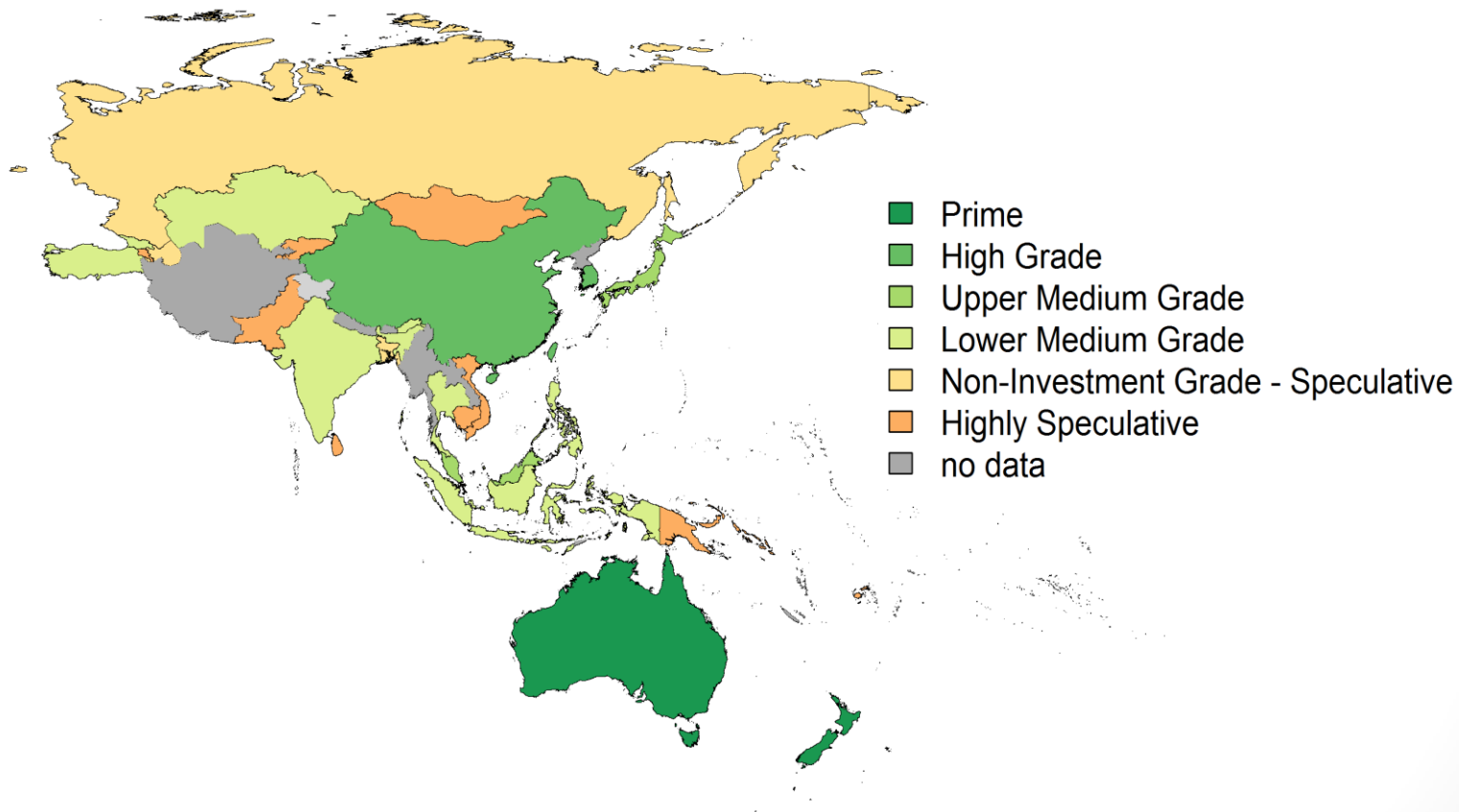
- Leverage offshore markets can provide alternative sources for infrastructure investment.
- Strengthen the financial ties with the regional and global financial markets. In this respect, to harmonize regulation, corporate governance and financial products with the objective of achieving mutual recognition of their trading transactions.

# Policy Recommendations: Facilitate foreign investment

## Key Impediments Facing Foreign Investors

- Capital Controls
- Lack of hedging instruments
- Low credit rating

# Sovereign Rating of Selected Countries



# **Policy Recommendations: Support domestic institutional investors**

## **Prudential regulations**

- Abolish imposing prescribed limitations and narrow investment mandates
- Adopt a principal-based approach

## **Credit enhancement mechanisms**

- Providing a guarantee
- Develop credit enhancement mechanism

# Policy Recommendations: Improve Investment Climate

- Develop entrepreneurial capabilities
- Establish local rating agencies
- Strengthen accounting standards, disclosure requirements and data transparency
- Review tax policies
- Improve governance and regulation

# Thank you

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