Session 3: Capital market development I (Developing domestic capital markets)

Presentation

Capital Markets

by

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UNESCAP Asia-Pacific Outreach Meeting on Sustainable Development Financing

Session 2: Capital Market Development

David I. Adelman
Managing Director, Goldman Sachs

Jun 10th, 2014
3 Things About Capital Markets

1. Why Capital Markets are Important
2. How Large are the World’s Capital Markets
3. What are the Challenges Facing Asia’s Capital Markets?
Why Capital Markets are Important
Structure of Capital Markets

CAPITAL MARKETS ARE MADE UP OF DEBT AND EQUITY MARKETS.
The purpose of capital markets is to match the demand for funds with the supply of funds. These markets fuel economic growth by allocating capital that can be used to create jobs, build infrastructure and finance innovative ideas.

Source: Goldman Sachs (www.goldmansachs.com)
Why Capital Markets are Important
Primary and Secondary Markets

Global capital markets consist of primary and secondary markets.

Primary markets create new securities. In primary markets, governments and companies raise cash by selling newly issued securities to buyers.
A variety of buyers and sellers come to the capital markets with different needs and objectives. Financial intermediaries play an important role in facilitating transactions in which there isn’t a ready seller to match with a buyer, or vice versa. Or when there are different characteristics of assets involved, such as different sizes. In these cases, the intermediary acts as a market maker, using its own capital or holding the assets until a buyer or seller can be found. This enables the buyer or seller to transact at that moment, regardless of market conditions.

Source: Goldman Sachs (www.goldmansachs.com)
# Why Capital Markets are Important

## Entrepreneurs

An entrepreneur is the founder of a company. In the start-up stage, the entrepreneur tends to raise funds from private sources, such as their own savings or borrowings, or that of friends and family members and co-founders. As the company grows, and needs greater amounts of capital, the entrepreneur can come to the capital markets to raise funds and potentially do an initial public offering (IPO).

### WHY BUY ASSETS

- To invest in the stock of their own company
- To buy stock in a publicly traded company that is a strategic partner
- To buy stock as a way to acquire a publicly traded company, as part of an acquisition strategy

### WHY SELL ASSETS

- To raise capital for growth and expansion plans
- To enable employees with stock grants and early investors to turn their shares into cash
- To create a means by which the company can be valued and compared with other companies or investments
- To create a liquid “currency” for acquisitions of or by other companies, and investments in the ownership of other companies

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**Examples**

- In November 2013, Twitter raised $1.82 billion with its initial public offering (IPO).\(^1\)
- The largest U.S. IPO ever was for Visa, raising $17.9 billion in March 2008.\(^2\)

Source: Goldman Sachs (www.goldmansachs.com)
Why Capital Markets are Important

Investors

| Entrepreneurs | Investors | Companies | Pension Funds/Endowments | Governments |

Investors can be individual investors or institutional investors. Individual investors buy and sell securities for their own account, such as to invest their savings to plan for retirement. Institutional investors, such as mutual funds or other asset managers, manage portfolios of assets to generate a return, often on behalf of individual investors investing their savings.

**Why Buy Assets**
- To put cash to work, to own stocks or bonds to generate an investment return
- To manage the risk associated with the holdings in their portfolio

**Why Sell Assets**
- To raise cash for short-term needs
- To exit an investment, and realize a gain (or loss)
- To manage the risk associated with the holdings in their portfolio

**Examples**
- On average, U.S. households directly invest $230 billion each year in stocks and bonds.¹
- U.S. households invest nearly $350 billion each year in mutual funds that buy stocks and bonds on

Source: Goldman Sachs (www.goldmansachs.com)
Why Capital Markets are Important

Companies

A company is "public" if its stock is traded on a public stock exchange. Listing on a public exchange by issuing stock is a way to raise funds in the capital markets. Companies can also go to the capital markets to borrow money from investors in the form of bonds, for which investors receive interest payments from the company.

WHY BUY ASSETS

- To invest the cash on its balance sheet, to generate income until that cash needs to be used
- To buy foreign currency to conduct its operations in other countries
- To buy stock of another listed company, as part of a strategic partnership, or in order to acquire another company
- To buy back its own stock, to raise the price of shares available to the public by reducing supply or to prevent some shareholders from gaining a controlling interest in the company
- To manage the risk associated with the holdings in their portfolio

WHY SELL ASSETS

- To raise cash for different corporate uses, or to realize gains
- To sell foreign currency it has acquired through operations in other countries, to convert it into its home currency, or it may enter into a contract to manage the risk of future fluctuations in other currencies it needs for its operations
- To sell an ownership stake in another company, to raise funds or to reflect a change in a partnership or agreement
- To issue additional shares to the public, to raise funds for growth or expansion, such as to build a new factory, to create jobs, or to meet other operating needs
- To manage the risk associated with the holdings in their portfolio

Examples

- In 2012, companies raised $1.36 trillion in corporate debt and $278.9 billion in equity in the U.S.1,2
- In 2013, Verizon Communications sold $49 billion of bonds in the biggest company debt offering ever.3
- Verizon will use the proceeds to finance its $130 billion buyout of Vodafone’s 45% stake in their Verizon Wireless joint venture.4

Source: Goldman Sachs (www.goldmansachs.com)
### Why Capital Markets are Important

**Pension Funds / Endowments**

<table>
<thead>
<tr>
<th>Entrepreneurs</th>
<th>Investors</th>
<th>Companies</th>
<th>Pension Funds/Endowments</th>
<th>Governments</th>
</tr>
</thead>
</table>

A pension fund pays benefits based on contributions and investments from employers and employees. Endowments, funded by donations, are used to help fund a not-for-profit institution’s (such as a university’s) operations.

### WHY BUY ASSETS
- To invest to earn a return to meet their needs
- To manage the risk associated with the holdings in their portfolios

### WHY SELL ASSETS
- To generate cash needed for short-term use
- To realize gains and lock in profits
- To manage the risk associated with the holdings in their portfolios

### Examples
- U.S. pension funds in 2012 were important market participants. They held $8.8 trillion in stocks, or 16.8% of the global equity markets, and $4.5 trillion in bonds, or 4.5% of the global bond market.¹ ²
- U.S. colleges hold $408 billion in endowments. They help fund scholarships, financial aid, professor salaries, as well as research and extracurricular activities.³

Source: Goldman Sachs [www.goldmansachs.com](http://www.goldmansachs.com)
Why Capital Markets are Important

Governments

Governments include central banks, federal agencies, municipalities, multinational institutions, state-owned enterprises and sovereign wealth funds. The capital markets, in particular debt markets, are an important source of funds for these institutions to raise money for large projects, such as bridges, hospitals and roads. Sovereign wealth funds are investment funds owned by a country that invest to benefit that country’s economy and people.

<table>
<thead>
<tr>
<th>Entrepreneurs</th>
<th>Investors</th>
<th>Companies</th>
<th>Pension Funds/Endowments</th>
<th>Governments</th>
</tr>
</thead>
</table>

### WHY BUY ASSETS
- To invest cash or funds to generate a return

### WHY SELL ASSETS
- To raise funding for public projects, such as roads and, such as in the case of sovereign wealth funds, to hedge portfolio risk

### Examples
Between 2003 and 2012, U.S. counties, states and other municipalities have raised $3.2 trillion for infrastructure through issuing municipal bonds.¹

The participation of governments in capital markets funds the services and infrastructure that keep towns and cities running, from hospitals to roads to utilities.

Source: Goldman Sachs (www.goldmansachs.com)
Why Capital Markets are Important
Capital Markets are about The Real Economy

CHINA MERCHANTS BANK RIGHTS OFFERING

Enhancing Capital and Supporting Business Growth

Through its support for China Merchants Bank, Goldman Sachs promotes entrepreneurship in China. We helped China Merchants Bank, the nation’s sixth-largest commercial bank, replenish its capital base by acting as Joint Sponsor and Joint Lead Underwriter for a $5.5 billion rights issue. Completed in October 2013, this transaction was the largest rights offering globally in 2013 and the largest rights offering in Asia outside of Japan since 2011.

The transaction supports the bank’s business growth and reinforces its leadership position in China’s banking sector. The rights issue seeks to enhance China Merchants Bank’s core capital adequacy ratio, thus helping the bank meet regulatory capital requirements. It seeks to expand the bank’s source of working capital and permit greater flexibility in managing capital. As part of its recapitalization, the bank aims to strengthen its internal risk management and lending procedures.

China Merchants Bank is a vital player in the country’s industrial restructuring and offers strong support for emerging industries and environmental and social practices. The bank promotes small and micro enterprise businesses, providing loans to these businesses of the equivalent of about $85 billion as of June 2013. As of the end of 2012, the Hangzhou branch of China Merchants Bank alone had issued loans for 34 conservation and emission reduction projects valued at 755 million RMB (US $123mm).

Source: Goldman Sachs (www.goldmansachs.com)
Why Capital Markets are Important
Capital Markets are about The Real Economy

CHINA LONGYUAN POWER GROUP
Addressing Asia’s Energy Needs

As the leading wind power operator in Asia and second-largest globally, China Longyuan Power plays an important role in China’s multipronged strategy to sustainably address its growing energy needs. Renewable energy plays a key role in this strategy. To this end, in November 2012, Goldman Sachs successfully priced $400 million in perpetual senior securities offered by China Longyuan Power. The proceeds of this transaction will go toward the company’s capital expenditures, including the development and expansion of their renewable energy business.

In August 2013, we assisted China Longyuan Power with the issuance of a $300 million bond. The proceeds of the transaction will be primarily used to develop and expand the Company’s renewable energy businesses and will also be used for working capital and general corporate purposes.

Source: Goldman Sachs (www.goldmansachs.com)
Why Capital Markets are Important
Capital Markets are about The Real Economy

RENUEW POWER 🌍
Enabling a Cleaner India Through Renewable Energy

ReNew Power, a leading wind farm developer and operator in India, was established with the goal of helping the country meet its renewable energy targets. Our funding of over Rs 1,300 crore ($250 million) — the largest investment in India’s renewable energy sector at that time — will enable ReNew Power to pursue its mission of expanding its wind portfolio, reaching 1 gigawatt capacity by 2015, and becoming the subcontinent’s leading renewable energy producer.

In July 2013, Goldman Sachs also entered into a power purchase agreement for its Crystal Downs facility in Bangalore with ReNew Power. The overall benefits of this project include green power, carbon credits and lower energy costs.

“The Bangalore wind power project showcases our continued commitment to growing the renewable energy sector in India, both as an investor and as a credit-worthy user of clean energy in support of our own 2020 carbon neutrality goal,” said V. Bunty Bohra, chief executive officer of Goldman Sachs Services in India.

Source: Goldman Sachs (www.goldmansachs.com)
Why Capital Markets are Important
Capital Markets are about The Real Economy

- US$132mm IPO on IDX (2013)
- First hospital IPO in Indonesia
- Largest healthcare IPO in Indonesia
- Vision
  - Affordable & accessible healthcare to all socio-economic segments in Indonesia
  - 5 Year Vision
    - Increase Bed Capacity from 3,400 to 10,000
    - Increase No. of Hospitals from 14 to over 40

Source: Goldman Sachs Investment Banking Division
Why Capital Markets are Important
Indonesian Demographics and an Underserved Indonesian Market

Relatively Young Population is Expected to Sustain in the Future…

Low Healthcare Spending per Capita Creates High Upside Potential…

Lack of Beds¹…

Global Average = 3.0

Total Healthcare Expenditure Expected to Increase

Global Average = 4.4%

and Qualified Doctors¹…

Global Average = 1.4

Source: Goldman Sachs Investment Banking Division
How Large are the World’s Capital Markets?
North America

Source: Goldman Sachs Research (www.goldmansachs.com)
How Large are the World’s Capital Markets?

European Union

Source: Goldman Sachs Research (www.goldmansachs.com)
How Large are the World’s Capital Markets?

Japan

Market Capitalization Leaders (SUS)
Data based on market close December 31, 2013

<table>
<thead>
<tr>
<th>Company</th>
<th>Market Capitalization (bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Toyota Motor</td>
<td>$210 bn</td>
</tr>
<tr>
<td>Softbank</td>
<td>$105 bn</td>
</tr>
<tr>
<td>Mitsubishi UFJ Financial</td>
<td>$93 bn</td>
</tr>
<tr>
<td>Honda Motor</td>
<td>$74 bn</td>
</tr>
<tr>
<td>Sumitomo Mitsui Financial</td>
<td>$72 bn</td>
</tr>
</tbody>
</table>

Total Debt and Equity Markets by Region ($US)
Data as of December 2012

<table>
<thead>
<tr>
<th>Region</th>
<th>Debt Market (bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>$56,138 bn</td>
</tr>
<tr>
<td>European Union</td>
<td>$39,188 bn</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>$22,066 bn</td>
</tr>
<tr>
<td>Japan</td>
<td>$18,230 bn</td>
</tr>
<tr>
<td>Newly Industrialized Asian Economies</td>
<td>$8,260 bn</td>
</tr>
<tr>
<td>Australia</td>
<td>$3,303 bn</td>
</tr>
</tbody>
</table>

Source: Goldman Sachs Research (www.goldmansachs.com)
How Large are the World’s Capital Markets?

Australia

Source: Goldman Sachs Research (www.goldmansachs.com)
How Large are the World’s Capital Markets?
Newly Industrialized Asian Economies (Hong Kong, Singapore, Taiwan, South Korea)

Market Capitalization Leaders (US$)
Data based on market close December 31, 2013

- Samsung Electronics: $213 bn
- TSMC: $91 bn
- AIA Group: $60 bn
- Hutchison Whampoa: $57 bn
- Hyundai Motor: $57 bn

Total Debt and Equity Markets by Region (US$)
Data as of December 2012

- North America: $56,130 bn
- European Union: $39,180 bn
- Emerging Markets: $22,060 bn
- Japan: $18,230 bn
- Newly Industrialized Asian Economies: $8,260 bn
- Australia: $3,303 bn

Source: Goldman Sachs Research (www.goldmansachs.com)
How Large are the World’s Capital Markets?
Emerging Markets

Market Capitalization Leaders (US$)
Data based on market close December 31, 2013

- PetroChina: $229 bn
- Industrial & Commercial Bank of China: $214 bn
- China Mobile: $208 bn
- China Construction Bank: $107 bn
- Agricultural Bank of China: $135 bn

Total Debt and Equity Markets by Region (US$)
Data as of December 2012

- North America: $56,138 bn
- European Union: $39,188 bn
- Emerging Markets: $22,066 bn
- Japan: $18,230 bn
- Newly Industrialized Asian Economies: $8,260 bn
- Australia: $3,303 bn

Source: Goldman Sachs Research (www.goldmansachs.com)
What are the Challenges Facing Asia’s Capital Markets?

Capital Market Depth

- Increase overall depth of the region’s financial and capital market

Capital markets in developing countries still have significant room for growth

Source: McKinsey global institute financial assets database; McKinsey global institute analysis
What are the Challenges Facing Asia’s Capital Markets?
Equities Market

- **Market Accessibility**
  - Ownership Limits
  - Investment Quotas

- **Cost Efficiency**
  - Impact cost due to information leakage

- **Competition and Choice**
  - Increase competition within market structure providers (without fragmenting the market)
What are the Challenges Facing Asia’s Capital Markets?

Debt Market

- Depth and Liquidity
- Investment climate, corporate governance, transparency and tax laws
- Regionalization and Harmonization

Local and Foreign Bond Market Growth in Asia 2008 – 2018

Source: ASIFMA, BCG
Chart Source: ADB, AsiaBondsOnline
What are the Challenges Facing Asia’s Capital Markets?

**Derivatives Market**

- Legal uncertainties and contract enforceability
- Extra-territoriality of US and EU regulations
- Potential fragmentation of Asian CCPs

### Value of OTC Derivatives Notional Outstanding (2012 - US $tn)\(^6\)

- **US**: 35%
- **Japan**: 8%
- **Europe/UK/Other**: 50%
- **Asia ex-Japan**: 7%

### Turnover of Asian (ex-Japan) OTC Derivatives Markets (2012 - US $tn)\(^7\)

- **FX**: 76%
- **Interest Rate**: 18%
- **Commodities**: 3%
- **Credit Default Swaps**: 1%
- **Equity Linked**: 2%

Sources:
2. See the Asian OTC Derivatives Markets published by ISDA in April 2013, BIS, Deutsche Bank.
6. BIS, ISDA, Bank of Japan, Office of the Comptroller of the Currency.
Thank You
Greater China: Liberalization

2013 Growth→2014 Outlook
Primary Market
- Year-long IPO ban rescinded in China
- Capital Raising by banks-prets, DCM
- Bond markets grow
Secondary Market
- Hotspots in F
commodity trading, flow
derivatives
- IRR Q1 Q1 increase
- Fund passport?

Japan: Sustainable Growth?

2013 Growth→2014 Outlook
Primary Market
- IPOs reached high since 2007
- Reform may drive CMIB activity for several sectors
Secondary Market
- Asset values to benefit from QE
- Return of retail flow via NISA tax shielded funds

India: Capital Inflow Continues

2013 Growth→2014 Outlook
Primary Market
- Capital raising shift from debt to equity
Secondary Market
- Stable government to lead strong economic growth
- Capital inflow continues

Korea: Focus on Cost Cutting

2013 Growth→2014 Outlook
Primary Market
- Challenging regulatory environ
- Shift to low-touch model
- Declining cross-border M&As
Secondary Market
- Falling trading volumes/fee margins
- Profitability pressures for domestic firms

SE Asia: Further Integration

2013 Growth→2014 Outlook
Primary Market
- Regional strategies for ASEAN players
- Build-out of CMIB capabilities
Secondary Market
- Trading link and clearing boost
- Increased cross-market liquidity

Australia: Turning a Corner?

2013 Growth→2014 Outlook
Primary Market
- Return of strong IPO pipeline
- Strong corp cash balance may drive M&A
Secondary Market
- Increasing ASIC scrutiny of high frequency trading and dark pools

Key CMIB Industry Revenue Trend
Positive ▲ Negative ▼
G20 Set the Framework for Global Financial Regulatory Reform Agenda

G-20 Leaders have committed to implement financial regulatory reforms across a wide range of areas, including:

<table>
<thead>
<tr>
<th>Area</th>
<th>Text</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Prudential regulation</strong></td>
<td>“[w]e have developed and begun implementing sweeping reforms to tackle the root causes of the crisis and transform the system for global financial regulation. …strengthening prudential oversight, improving risk management, strengthening transparency, promoting market integrity, establishing supervisory colleges, and reinforcing international cooperation.”</td>
</tr>
<tr>
<td></td>
<td>– <em>Pittsburgh Summit Leaders’ Statement, Sep. 2009</em></td>
</tr>
<tr>
<td><strong>OTC derivatives</strong></td>
<td>“All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”</td>
</tr>
<tr>
<td></td>
<td>– <em>Pittsburgh Summit Leaders’ Statement, Sep. 2009</em></td>
</tr>
<tr>
<td><strong>Recovery and resolution</strong></td>
<td>“We are committed to design and implement a system where we have the powers and tools to restructure or resolve all types of financial institutions in crisis, without taxpayers ultimately bearing the burden.”</td>
</tr>
<tr>
<td></td>
<td>– <em>Toronto Summit Leaders’ Statement, Jun. 2010</em></td>
</tr>
<tr>
<td><strong>Capital and liquidity</strong></td>
<td>“We endorsed the landmark agreement reached by the BCBS [Basel III] on the new bank capital and liquidity framework, which increases the resilience of the global banking system by raising the quality, quantity and international consistency of bank capital and liquidity.”</td>
</tr>
<tr>
<td></td>
<td>– <em>Seoul Summit Leaders’ Statement, Nov. 2010</em></td>
</tr>
</tbody>
</table>
Stages of Global Regulatory Reform Agenda

1. Development of Global Regulatory Framework
2. Establishment of Global Standards
3. National Implementation
4. Urgency to Complete Implementation
5. Assessing Impact of the Rules
6. Addressing TBTF
## Regulatory Priorities: OTC Derivatives Regulation

<table>
<thead>
<tr>
<th>Regulatory Area</th>
<th>Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Execution</strong></td>
<td>§ Certain products must be traded on regulated multilateral platforms (Swap Execution Facilities)</td>
</tr>
<tr>
<td></td>
<td>§ Potential margin compression for standardized products</td>
</tr>
<tr>
<td><strong>Clearing</strong></td>
<td>§ Mandatory clearing of rates and credit products; other products likely in future</td>
</tr>
<tr>
<td></td>
<td>§ Clearing creates business opportunities and reduces systemic risk</td>
</tr>
<tr>
<td></td>
<td>§ Capital costs of clearing could become significant</td>
</tr>
<tr>
<td></td>
<td>§ CCPs may become source of systemic risk</td>
</tr>
<tr>
<td><strong>Reporting</strong></td>
<td>§ Regulatory reporting of swaps to Swap Data Repositories (SDRs)</td>
</tr>
<tr>
<td></td>
<td>§ Real-time public trade reporting of certain swaps increases hedging costs for less liquid products</td>
</tr>
<tr>
<td><strong>Swap dealer regulation</strong></td>
<td>§ GS has registered 10 entities as Swap Dealers with the CFTC</td>
</tr>
<tr>
<td></td>
<td>§ May subject non-US clients to CFTC trade reporting</td>
</tr>
<tr>
<td></td>
<td>§ Business conduct standards, and new governance, compliance and risk management requirements</td>
</tr>
<tr>
<td><strong>Margin for non-cleared derivatives</strong></td>
<td>§ Initial margin requirements for non-cleared derivatives</td>
</tr>
<tr>
<td></td>
<td>§ Non-cleared swaps will become more expensive</td>
</tr>
<tr>
<td></td>
<td>§ Standardized products could gain popularity</td>
</tr>
<tr>
<td><strong>Cross-border rules</strong></td>
<td>§ Controversy over cross-border reach of U.S. rules, duplicative and overlapping rules across jurisdictions</td>
</tr>
<tr>
<td></td>
<td>§ May create uneven global playing field and/or liquidity fragmentation</td>
</tr>
<tr>
<td><strong>Timing</strong></td>
<td>§ Clearing, reporting and execution are live for CFTC products (90% of U.S. OTC derivatives market)</td>
</tr>
<tr>
<td></td>
<td>§ Clearing expected in EU in early 2015</td>
</tr>
<tr>
<td></td>
<td>§ Margin phase-in expected to start late 2015</td>
</tr>
</tbody>
</table>
Regulatory Priorities: Volcker Rule

<table>
<thead>
<tr>
<th>Regulatory Area</th>
<th>Summary</th>
</tr>
</thead>
</table>
| Proprietary Trading | - The Volcker Rule imposes certain restrictions on proprietary trading and investing in or sponsoring hedging funds or private equity funds by a banking entity and its affiliates  
                   - The Volcker Rule contains some significant exemptions, including market making, underwriting, risk mitigating activities; and trading in government securities  
                   - Policies, procedures and documentation to demonstrate that trading is in accordance with Volcker requirements |
| Metrics           | - Regulators plan to use the metrics to monitor patterns and identify activity that may warrant further review                                
                   - Limits set for each of the metrics, with appropriate monitoring and escalation                                               
                   - Metrics need to be calculated for the month of Jul 2014, and reported by Aug 30, 2014                                           |
| Covered Funds     | - The Volcker Rule also restricts investments in “covered” funds to 3% of fund size and to 3% of balance sheet in the aggregate            |
| Timing            | - Final rule was approved on Dec, 2013, and will come into force in Apr 2014                                                             
                   - Banks need to bring trading activities into full compliance by Jul 2015                                                           
                   - Covered Funds extensions possible to July 2017                                                                                     |
Key Themes to Watch

- "Too Big to Fail": Ongoing debate on whether large financial institutions can be resolved without burdening taxpayers

- **Consistency and Coordination**: As national authorities implement G20 commitments, cross border conflicts have emerged

- **Industry Scrutiny**: Lack of confidence in the banking sector remains an ongoing issue