Session 5: Capital market development II (Institutional investors & connecting capital markets)

Presentation

Capital market development panel

by

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Capital market development panel

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What are the main risks of participation of foreign investors in capital markets in the region?

How can policy makers address these risks to reduce volatility and disruptions through proper regulation and an effective institutional framework?
Risks of participation of foreign investors in emerging capital markets

Impact of foreign investors on small emerging stock markets remains a highly contested issue among market participants, researchers and policy makers - volatility varies significantly by type of foreign investor transaction.

**Pros**

- **Part of broader financial reform.** Financial liberalisation typically includes policy measures for financial development, regulation, & exchange rate stabilization.

- **Increased market depth & liquidity, efficiency and lower cost of capital** through diversifying the investor base and reducing required return on capital.

- **Improved governance and transparency** as foreign investors demand a higher level of local standards and reduce information asymmetry.

- **Promote financial innovation, global awareness & investor education** by introducing new technology, market accessibility and investor strategies.

**Cons**

- **Contributes to exchange rate volatility in periods of stress.** Linked to size of foreign portfolio investor flows/holdings as proportion of local market activity.

- **Sentiment vs. fundamentals.** Momentum investors who buy when prices rise/sell when prices fall contribute to bubbles/crashes.

- **Risks of capital flight vs. risk mgt.** Optimizing risk/return via geographic diversification can contribute to capital flight when relative returns decline.

- **Stoke financial-asset price bubble.** Increased demand lowers expected returns contributing to misallocation of capital/resources; vulnerable if demand falls.

- **Similar investment styles & information sources.** Foreign investors trade with locals on new information/sentiment vs. trade with other foreigners for liquidity – can lead to ‘herd’ mentality.

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**Foreign participation & market depth in govt. bonds**

![Bar chart showing foreign share of LCY bonds and trading volume growth (2008-13).](source)

**Global Fin assets owned by foreign investors (US$tn)**

![Bar chart showing global financial assets by region.](source)
Issues for developing a regulatory & institutional framework

An integrated policy & regulatory framework and development of domestic institutional investor base should underpin local and foreign investor confidence and contribute to lower asset price, exchange rate and capital flow volatility.

Sustained macro economic stability is critical to capital market development. Capital markets struggle to develop in unstable economies. Hence, development of policies and regulations should in a consistent, integrated & complimentary manner, and in a progressive and predictable direction.

Focus on financial market & corporate integrity and efficiency. Uncertainty and information asymmetry undermine foreign investor confidence. Regulations & policies should promote market discipline and compliance with internationally accepted standards on accounting practices, transparency and governance.

Pension reform & development of local institutional investor base. Government led pension reform assists in aggregating domestic savings and deploying funds into longer term projects & attract foreign investment professionals. Reduces long-term fiscal burden and provides liquidity & raises expertise.

Robust banking system typically leads to sound capital markets. Research has shown deep capital markets and a sound banking system are complementary. When bank sectors are stressed and availability of credit falls, access and liquidity of capital markets also fall leading to increased asset price & exchange rate volatility.

Regulations to enshrine protection of investor rights. Regulations are ineffective without a solid institutional framework protecting the rights of investors (equities & bond holders). Development of mechanisms to enforce contracts & rule of law should encourage local & foreign investor confidence & participation.


Capital inflow mix* (US$tn, cumulative 2007-12E)

- Emerging Mkts: Loans 28%, Bonds 10%, Equity 56%, FDI 7.8
- Developed Mkts: Loans 25%, Bonds 33%, Equity 11%, FDI 23.9


Financial depth (Fin. Assets* % of regional GDP)

- Emerging Mkts: Equity 157, Govt. Bonds 28%, Financial Bonds 17%, Corporate Bonds 11%, Securitized Loans 45%, Non Sec. Loans 24%
- Developed Mkts: Equity 408, Govt. Bonds 21%, Financial Bonds 22%, Corporate Bonds 21%, Securitized Loans 6%, Non Sec. Loans 23%

Source: McKinsey Global Institute Financial Asset Database * 2Q12