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

Presentation

by

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Objective

• In the short time we have today I want to make the case that pension funds are the key to capital market development in Pacific countries development.

• In doing so, I want to challenge conventional thinking about capital market development, and financial sector development more widely, and I am also hoping to stimulate the thinking of this group as to the appropriate institutional underpinnings for sustainable financing in Pacific countries.
Starting Point – the real economy

- The speaker from Goldman Sachs yesterday reminded us that discussions on capital market development cannot be isolated from the real economy.
- The Pacific is no different, but I do think that we have to isolate – decouple is a probably a better word – the Pacific from Asia when thinking about these developments in a capital market context.
- I am not downplaying economic linkages here – indeed the mobility of goods, capital and of course labour is critical to the economic development of the Pacific.
- Rather, I am saying that the institutional dynamics will be – have to be – different in the Pacific.

The realities of the Pacific

- Smallness, geographic isolation, communal ownership of much of the land.
- There is no escaping that reality, but this does not mean that the exercise is tractable. The exercise is one of determining where to get the traction.
- In our work at the Pacific Private Sector Development Initiative, we are putting a lot of emphasis on the adoption of personal property (secured transactions) frameworks.
- The developed world, by and large, was late to this party – NZ in the mid 2000s and Australia only in the last few years.
- I will not have time to take up this story today, but it has to be given more airplay in the sustainable financing story because the instrument is ideally suited to Pacific conditions.
Financial sector development

• Provident funds are unquestionably at the centre of financial sector development discussions in the Pacific.
• There is a point of intersection between these funds and almost every issue that worries central bank governors e.g.
  • Excess liquidity – through the large cash balances funds carry and the inability (or perhaps unwillingness) of tier 1 banks to lend
  • Systemic stability – financial, economic, and social - through the relative size of the funds, their role in the provision of a social safety net, implications for exchange rate stability from foreign investment activities.
• But care needed though not to ask too much of provident funds
  • They can’t become the underwriter of government bond issuance, or e.g. for development bank bond issuance, or the saviour of poorly performing SOEs whether through loans or equity.

### Asset Composition of Pension Fund in Developed Country – Australian Example

<table>
<thead>
<tr>
<th>Asset</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic equities</td>
<td>29</td>
</tr>
<tr>
<td>International equities</td>
<td>25</td>
</tr>
<tr>
<td>Bonds</td>
<td>14</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>10</td>
</tr>
<tr>
<td>Cash</td>
<td>10</td>
</tr>
<tr>
<td>Property</td>
<td>7</td>
</tr>
<tr>
<td>Private equity</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
</tr>
</tbody>
</table>
Balance Sheets of Pacific Funds

• This type of balance sheet structure is an aspiration for almost all Pacific funds; not even the larger funds in Papua New Guinea can aspire to this type of structure just yet.
• The exercise is one of replicating this type of asset and income diversification in the Pacific.
  • Non-listed equities are much more important to the Pacific funds, for example
• The need for funds to have an asset base that matches the long-term obligations to contributors can be a starting point for the wider discussion on the development of capital markets, and financial sector development more widely.

The maturity transformation

• For funds to develop – and hence the financial sector – funds have to be part of a maturity transformation that is at the heart of capital markets.
• More attention needs to be paid to this transformation in the Pacific.
• Some possibilities include
  • Participants in blended finance
    • Funds and whoever
    • Debt and equity arrangements with private and development financiers
  • With banks
    • Cannot deemphasise role of banks in Pacific in the way that capital market development in Asia is looking to reduce reliance on the banking system
  • Cross investments with other funds