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## Discussion Paper

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# THE ROLE OF INSTITUTIONAL INVESTORS IN FINANCING DEVELOPMENT IN ASIA AND THE PACIFIC

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**Discussion Paper**

Macroeconomic Policy and Financing for Development Division

**The Role of Institutional Investors in Financing  
Development in Asia and the Pacific**

by

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**Abstract**

The developing world needs the equivalent of USD 1 to 1.5 trillion per year in finance for infrastructure development expenditures to reach the millennium development goals by 2030. Given this challenge, what is the role of institutional investors in financing development in emerging and developing markets in Asia and the Pacific? The short answer is “currently small, but potentially significant”. This paper identifies a number of impediments to the growth of institutional investments in development project as well as corresponding solutions.

Impediments include the limited size of capital markets in many developing and emerging economies; the complexity of infrastructure projects; and political risks associated with financing projects where government policies and regulations are particularly important determinants of the return on the investments.

Solutions to these impediments require sustained efforts in a number of areas: securing a stable macroeconomic environment; maintaining a strong legal framework supportive of the enforcement of financial contracts; streamlining infrastructure project management making the process more transparent and hence less cumbersome for potential investors; encouraging public private partnerships; and insuring regulatory consistency and transparency as well as the rule of law in dealing with potential disputes related to infrastructure investments.

These solutions require sustained and consistent efforts over several years. Jurisdictions that are able to make progress in implementing the needed reforms will reap the benefits of a larger share of institutional investment funds being allocated to their development and infrastructure needs.

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## **I. Introduction**

The developing world needs the equivalent of USD 1 to 1.5 trillion per year in finance for infrastructure development expenditures to reach the millennium development goals by 2030.<sup>1</sup> While much of the resources must be mobilized through taxes and fees collected by governments in the economies concerned, and while some will be provided by official development assistance and international development banks, there are growing efforts to draw institutional investors into development finance. The OECD estimates that the size of assets under management by institutional investors had reached USD 80 trillion by 2012,<sup>2</sup> so if only a relatively small fraction of these resources were allocated to infrastructure development projects, the pressure to find finance for development would be significantly reduced.

However, the actual allocation of institutional investors to infrastructure finance is less than one percent of assets under management. This paper thus seeks to provide some insights into why this percentage is so low, and what may be done to increase it. To set the stage, the next section gives a brief overview of the institutional investor base and provides some general indications about what considerations are most prominent in determining their asset allocation decisions.

Section III discusses salient features of development projects, particularly infrastructure projects, which have an impact on potential investors' financing decisions, and therefore their allocation of funds to such projects. Section IV reviews the role of capital market development and bond financing in development finance in general and infrastructure finance in particular, and suggests measures that may be considered to support the growth of capital markets in Asia and the Pacific.

Public Private Partnerships as a model to involve institutional investors in the private sector in development finance is the subject of Section V. The section points to the underlying benefits from such partnerships, but also to potential hurdles that may limit their scope along with suggestions for overcoming them. Section VI turns to the potential role of impact investors, i.e. investors who are ready to forego a part of the pecuniary return on an investment project in exchange for the knowledge that the project will deliver 'reputational' benefits resulting from the social benefits that the project delivers.

Section VII draws together the main strands of the paper and offers a number of recommendations that follow from the analysis.

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<sup>1</sup> Inderst and Stewart (2014) and United Nations (2015).

<sup>2</sup> International Monetary Fund, OECD, World Bank (undated).

## II. Institutional Investors: Who are they and what do they do?<sup>3</sup>

Institutional investors manage large pools of funds. According to Çelik and Isaksson (2013) their assets under management stood at USD 84.8 trillion in 2011.<sup>4</sup> How much of these funds we may expect to be invested in developing and emerging economies requires an analysis of the investment decisions of different classes of institutional investors. The label institutional investor is itself attached to a wide variety of institutions each with its own distinct asset allocation profile. Pension funds and insurance companies have historically been institutions most closely associated with the label. However, a number of other entities have recently become increasingly important in terms of assets under management. Mutual funds, private equity funds, sovereign wealth funds, asset managers, investment banks, hedge funds and exchange-traded funds are all examples of institutional investors. This diversity has led to a definition of an institutional investor simply as an entity that is not an individual private investor.

The investment behavior, or asset allocation choices, of each type of institutional investor will be determined by a number of factors such as its ownership structure, its fiduciary mandates, its liability structure, and the regulatory framework in which it operates.

**Pension funds**, the quintessential institutional investor, has a (contingent) liability structure with a comparatively predictable time profile of pay-outs that depends importantly on slow-moving demographic developments. As a caveat to this assessment it should be noted that some funds leave significant discretion to account holders to determine which types of assets they would like to be invested in. In such cases the manager of a particular segment of the pension fund will need to be mindful of the possibility that account holders may switch from, say, a predominantly EME bond fund to a more equity-based fund. For such shifts not to be disruptive, the manager of the bond fund may need to hold a more liquid portfolio than she would in an environment where individual account holders in a pension fund were not able to shift asset holdings between alternative asset classes. An additional characteristic of many pension funds is that they are publicly owned. This raises the possibility that their ‘business model’ is influenced by factors other than the direct financial interests of the account holders. Examples would be requirements that the fund invest in ‘priority sectors’ of the economy to spur economic development, favor environmental and sustainable development projects, or invest in infrastructure.

**Insurance companies** are similar to pension funds in that their liability structure is relatively predictable as it can be calculated quite accurately using actuarial principles based on historical loss claims. As a consequence, the investment profile can afford to accept liquidity risks and focus on assessing longer-term credit risks.

**Sovereign Wealth Funds (SWFs)** invest national wealth for the benefit of future generation. The archetypical example is a fund that collects revenues from the sale of natural physical resources and invests these in financial assets. For the same reasons as insurance companies SWFs can afford to accept liquidity risk and invest in longer-dated somewhat illiquid securities thereby enhancing the expected return. Like some pension funds SWFs are state controlled and

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<sup>3</sup> Adapted from the subtitle of Çelik and Isaksson (2013).

<sup>4</sup> This figure is subject to two important caveats. It is likely to be an overestimate since some institutional investors, e.g. pension funds, allocate a portion of their assets to other institutional investors, e.g. hedge funds. This implies a degree of double counting, the extent of which is not known. On the other hand, only data from investment funds (e.g. mutual funds), insurance companies and pension funds located in OECD countries are covered by the data. These institutions manage the largest portion (USD 73.4 trillion) of the total for the industry as a whole.

can, subject to the applicable legal and governance arrangements, be used to support society's objectives such as environmental and sustainability concerns even if that entails foregoing financial returns.

Other types of institutional investors typically, although not always, tend to value liquidity properties more heavily since their liability structures are such that they face redemption risks to various degrees and of various severity. This is the case for example of certain **mutual funds**, **hedge funds** and **investment banks**, and also of some **private equity funds**. Regulatory requirements may also affect asset allocation decisions, for example when risk-based capital adequacy requirements assign higher risk weights to certain classes of assets.

An additional aspect that can be used to differentiate among institutional investors is the extent to which they use their investment as a way to influence the management of the company or project they are investing in. At one end of the spectrum would be the purchase of a long-term bond that has been issued to finance an infrastructure investment such as a port facility. Such a purchase does not imply any management control. Taking an equity interest in an existing infrastructure facility would imply direct ownership of a share of the facility and could also imply management oversight through board membership. How much management oversight is involved depends on the form of the equity interest. If it is obtained through a minority investment in a listed company on a stock exchange, the involvement is likely to be minimal. On the other hand, if it is obtained by acquiring a significant share of a private non-listed company, it is ostensibly weightier. A deeper degree of involvement in the management of the firm or project has the objective of improving efficiency and returns, but it also entails greater costs, as resources have to be allocated to the management oversight function. Investing in a greenfield infrastructure facility would typically represent yet greater management involvement and associated costs.

The degree of management control exercised differs substantially between types of institutional investors. The majority of institutional investors are passive in the sense that they have no interest in management control and only seek out infrastructure and other development finance assets because of their return and risk characteristics. World Economic Forum (2015) claims that out of the USD 75 trillion in assets under management by institutional investors, only about 700 billion are invested with the objective of exercising some management control. As exercising some management control can be very costly because it requires dedicated teams of staff with the necessary skills and knowledge, only the very largest investors are able to do it. A somewhat more common, and increasingly important method of exercising control, albeit indirectly, is for several smaller investors to pool their investments, and hire a dedicated asset manager to carry out the management oversight function. Private equity funds are likely to be the most involved in taking a hands-on approach to investing in infrastructure and development instruments.

Data on the size of holdings of Asian assets by institutional investors are fragmentary. ESCAP (2014) presents revealing data on the size of Asian institutional investors from a global perspective. These data show that the assets of private sector asset managers in the Asia-Pacific region amounted to 9.7 per cent of the assets of asset managers globally. Asia-Pacific pension funds accounted for 26.3 per cent of the world total, with the pension fund of the Government of Japan occupying the number one position among the world's pension funds by size. Asia-Pacific sovereign wealth funds held 44.8 per cent of the assets of such funds globally with the China Investment Corporation occupying fourth place and the fifth place taken by SAFE Investment Company. The assets of the three types of institutional investors together

accounted for 14.9 per cent of the world total.<sup>5</sup> When this figure is compared with the size of Asia-Pacific economies' combined GDP, which is approximately one quarter of world GDP, it can be concluded that institutional investors in Asia and the Pacific have room to grow, as financial deepening in the region proceeds.

Didier and Schmukler (2014) also contains information on the size of asset holdings of institutional investors, which corroborates that contained in the ESCAP study and provides some additional insights. Three generalizations can be made: first, institutional investors are significantly larger in advanced countries than in emerging markets measured by the size of their assets; second, institutional investors play a larger role in Asia than in other emerging markets, except for the pension funds that have a large presence in Latin America; third, insurance companies are the largest institutional investors in the Asian markets, but mutual funds seem to be growing rapidly and may soon catch up.

While comprehensive data on the country allocation and the allocation by asset classes of the institutional investors' portfolios are not available, Didier and Schmukler report, albeit based on patchy data, that most of the assets of the institutional investors in Asia, as in emerging markets in general, are in the form of government bonds and bank deposits. Corporates appear not to be attracting funding from institutional investors at present, either in the form of bonds or equity financing. This suggests both a limitation of the capital markets and an opportunity: the limited size and liquidity of the markets as well as institutional constraints may be a reason for the lack of interest among institutional investors, but, if this is the case, there is hope that growth of the markets and institutional reforms will make them more attractive for this class of investors.

In this context, one may ask whether foreign institutional investors are more or less likely to invest in domestic infrastructure and other socially beneficial projects than domestic institutional investors. On the one hand, foreign investors typically hold investments in a larger universe of assets than domestic investors. Therefore, they may view domestic (foreign for them) infrastructure projects as a convenient way to diversify risk. Domestic investors are more likely to be heavily exposed to domestic economic risks, which would make them less likely to take on further risks of a similar, or correlated, nature. On the other hand, domestic investors can be assumed to have more in-depth knowledge of economic conditions in their own country, and have more access to public bailout funds should a project underperform. This would make them more willing to accept the risk associated with domestic investments. On balance, it is not clear which type of investor is more likely to view domestic socially beneficial projects more favourably. A policymaker would be well advised to treat both equally.

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