

# Long Term Finance Highlights

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## INSTITUTIONAL INVESTORS AND LONG-TERM INVESTMENT

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Traditionally, banks have been a key player in the financial system, transforming savings into financing for investment and consumption. Over time, disintermediation and the growth of capital markets have led to a shift in the structure of the financial sector, with institutional investors such as pension funds, insurance companies, mutual funds, and, most recently, sovereign wealth funds (SWFs) and public pension reserve funds (PPRFs)<sup>1</sup>, also becoming central players.

Beyond providing short-term finance for businesses' day-to-day operations and other temporary cash requirements, financial institutions, capital markets and institutional investors are also sources of long-term finance, that is, finance which is available for an extended period of time<sup>2</sup>. The importance of long-term finance lies in its pivotal role in satisfying long-term physical investment needs across all sectors in the economy and specifically in key drivers of growth, competitiveness and employment such as infrastructure, real estate, R&D and new ventures.

With over USD 85 trillion in assets globally, institutional investors are a potential alternative and complementary source of long-term financing, both via their investments in financial assets (such as stocks and long-term bonds) and their investments in real assets, such as infrastructure and real estate. But as argued by the OECD in a recent paper<sup>3</sup>, institutional investors do not always behave in a long-term capacity. Long-term investment has three main characteristics:

- **productive capital**, which provides support for infrastructure development, green growth initiatives, R&D, and new ventures, sustaining growth and development;
- **patient capital**, which allows investors to access illiquidity premia, lowers turnover, encourages less pro-cyclical investment strategies and therefore higher net investment rate of returns and greater financial stability;
- **engaged capital**, which ensures effective monitoring and risk assessment, leading to better corporate governance in investee companies.

Given the low interest rate environment and volatile stock markets of recent years, institutional investors are increasingly looking for new sources of long-term, inflation protected returns. Investments in real, productive assets, such as infrastructure and real estate could potentially provide the type of income which these investors require, supporting investment and driving growth. Such interest is particularly welcome at a time of weakness in the banking sector of advanced economies (particularly in Europe) and large debt overhangs and fiscal deficits in the public sector. To the extent that 'bad' deleveraging persists in the banking sector, in the form of restrained credit growth, there is likely to be a growing mismatch between the amount and time horizon of available capital and that of required infrastructure projects, particularly in emerging and developing economies (EMDEs)<sup>4</sup>. New banking regulations (Basle III) could also affect negatively the ability of banks to provide long-term financing

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for large infrastructure projects. The emerging infrastructure financing gap could slow down the world economy for years to come and abort attempts by EMDEs to set themselves on a high-growth path.<sup>5</sup>

In advanced economies, institutional investors have a long way to go in order to become major sources of finance for infrastructure projects. Some large Canadian and Australian pension funds have more than 10% of their assets allocated directly to infrastructure projects, but on average for the OECD, less than 1% of pension fund assets are invested in the asset class. Infrastructure bond investments, in particular, have dried up as monoline insurers<sup>6</sup> have withdrawn from the market. Many other obstacles remain before pension funds and insurers increase their allocations. Barriers include the small scale of many institutions, lack of internal expertise, inadequate financial instruments, and regulatory factors, such as investment restrictions and certain features of solvency regulations.

The situation in EMDEs is rather different, as financial sectors tend to be relatively underdeveloped. In most EMDEs, pension funds, insurers and mutual funds are still at a nascent stage of development, although there are important exceptions such as South Africa, which in relative terms (in relation to GDP) is among the ten largest pension fund industries in the world. On the other hand, banks in EMDEs were generally less affected by the financial crisis and growth in bank credit has continued. Hence, a possible offset to the decline in long-term financing from European banks for EMDE infrastructure projects is the growth in financing from local banks as well as from foreign banks based in other EMDEs. For instance, Chinese banks have been rapidly expanding their financing operations for infrastructure projects in EMDEs, particularly in Africa. Compared to five years ago, there are also comparatively more infrastructure transnational corporations (TNCs) from developing and transition economies in the list of top TNCs. The role of EMDEs in global financial intermediation is also expected to expand over time as their financial sectors develop. Such a development would be consistent with the fact that EMDEs have been the source of around half of recent global growth in recent years. Already, a clear shift in the dynamics of stock markets is in motion, as IPO volumes in EMDEs grow while those in more mature markets stagnate or even decline. Pension funds are also expected to grow rapidly in some Asian and African countries that have followed the Latin American trend of establishing mandatory funded pension arrangements.

Sovereign Wealth Funds (SWFs), many of which are based in East Asia and the Middle East - are also becoming major players in financial markets. Assets under management have been growing rapidly and in 2011 were more than USD 5 trillion. Real estate and infrastructure allocations among some SWFs are relatively high, of the order of 10% or more in countries such as Singapore. The rise in involvement by SWFs in international infrastructure deals is also increasingly discernable. Cross-border M&As in the sector by SWFs in 2011 reached \$6.4 billion, the highest level recorded to date (UNCTAD). A major advantage of SWFs compared to pension funds is that they do not have clearly discernable liabilities and do not need to meet solvency regulations. They can therefore withstand short-term volatility in asset values. Furthermore, SWFs tend to hold large asset volumes which allow them to afford a larger in-house fund management team, including specialists in infrastructure investments.

One challenge for SWFs, particularly when investing abroad, is that there are sometimes inward investment restrictions to institutions linked to foreign governments. Hence, as SWFs continue their outward expansion plans, there is likely to be growing pressure for them to improve their transparency and independence from government.

1 PPRFs are funds set up by govts. or social security institutions to contribute to the financing of the relevant pay-as-you-go pension plans.

2 "Long-term is defined as maturities of at least five year and refers to sources of financing that are generally relatively stable over time.

3 "Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies" by Della Croce, R., F. Stewart and J. Yermo (OECD Financial Market Trends Vol. 2011/1, <http://dx.doi.org/10.1787/19952872>), and a new OECD project on Long Term Investment ([www.oecd.org/finance/lti](http://www.oecd.org/finance/lti)).

4 European banks significantly scaled back their wholesale funding operations. In 2012, funding volumes declined by 38% to \$63.5bn.

5 The OECD estimates global infrastructure requirements to 2030 at US\$ 50 tn. Adapting to and mitigating the effects of climate change to 2050 will require USD 1tn a year, International Energy Agency (IEA) (2008), 'Energy Technology perspectives: Scenarios and Strategies to 2050'.

6 Monoline insurers are financial institutions focused solely on insuring bond issuers such as municipal governments against default. Bond issuers buy this insurance to upgrade the credit worthiness of their bonds. The financial crisis adversely affected the monolines, with some downgraded to junk status due to inadequate capital.