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SOVEREIGN WEALTH FUNDS

A new role in the new normal, post the global crisis

by Jaya Patten

Asset and liability management

- Relook at new mandates for SWFs
- Importance of governance, transparency and trust
- Enhanced role of SWFs

ECONOMIC LANDSCAPE POST THE GLOBAL FINANCIAL CRISIS - THE NEW NORMAL

The global financial crisis has ushered in a new "normal". To be clear, it was not caused by the crisis. Both economists and policymakers are still figuring out this new paradigm. They feel a bit like a kid who is just off a merry go round; on firm ground but it still feels like spinning.

Central banks have undoubtedly played a key role in alleviating the damages from the financial crisis. They have been so good that politicians have come to rely far too much on central bankers for economic stimulus. The good thing is that central bankers are making it abundantly clear that they don't have a magic wand and have already provided all the help they can. Reviewing Mohamed A. El-Erian's book, the Economist[1], points out the uninspiring state of the economic debate. No one can agree on precisely what needs to be done.

The current slump in oil and commodity prices coupled with the slowdown in China will further exacerbate the contractionary effects of any potential unwind of quantitative easing in the leading economies. Such are the headwinds facing the Malaysian economy in 2016.

Against this backdrop of usual macroeconomic challenges, the new normal is characterised by three discerning considerations as regards economic growth, i.e. A slower pace of growth (domestic and global); A single-mindedness on equitable, inclusive and sustainable growth and finally; Governance.

"The world is on a bumpy journey to a new destination and the New Normal."
Mohamed A. El-Erian

It will take time for policymakers and politicians to adjust to this new normal. However slower growth and lower fiscal revenue will make it harder for governments, especially those who have been used to dish out fiscal largesse to maintain political and social stability. Currency volatility and potential further weakness of the Ringgit will further complicate matters for the Malaysian Sovereign Wealth Funds ("SWFs") and associated institutions. This note suggests ways in which the Malaysian SWF sector could be empowered to play a new role in economic management to overcome these domestic and international challenges.

> **"In this new normal, they [SWFs] will be called upon to play a different and more significant role in economic management to safeguard social cohesion and stability."**

NEW ROLE FOR THE MALAYSIAN SWFS IN THE NEW NORMAL

SWFs have traditionally been the guardian and steward of the nation's silver mandated to deliver higher risk adjusted returns over the long term. In this new normal, they will be called upon to play a different and more significant role in economic management to safeguard social cohesion and stability. In the case of Malaysia especially, the timing is ripe.

From their humble beginning in 1994 (custodial role) to a more proactive investment mandate since 2004, it is time to reorganise and align the various capabilities and objectives. This would require reviewing the various institutions and directing or redirecting the various entities to focus specifically on their own objective. They would need to restructure and evolve to cater for four distinct sets of objectives:

- a more innovative and adventurous investor and proactive funds manager mandate;
- a developmental mandate to deliver inclusive and equitable growth and ensure the lower social strata have access to finance in order to foster self-sufficiency and spur social mobility;
- an "innovation / incubator / venture capital" mandate - to search for future growth opportunities and nurture a culture of entrepreneurship and creativity - providing financial resources to support the ebullient social strata; and
- a turnaround / restructuring mandate.

In the process, it will give the policymakers the opportunity to institutionalise good governance and trust in these institutions. SWFs will always be subject to the highest level of scrutiny from both the domestic public and the international community. Their lackings, by either omission or commission, are understandably fodder for political mudslinging. Nevertheless, the needs for transparency and accountability have often to be balanced against two ineffable realities:

- The need for discretion, and at times secrecy, mooted by business and strategic considerations;
- The need to bow down to political pressures for the sake of the greater good or national interest.

This is where good governance helps. If one says what one does and does what one says, people will still question the judiciousness of any decision but they will have no bones to pick with the decision making process. Governance is like a currency. A weak currency can't be bolstered and a strong one can't be denigrated. Poor governance is often a harbinger of bad management. The financial scandals around Libor, foreign exchange (FX) and subprime have made that amply clear. Good governance is not an obsession with international league tables. It is about protecting the bottom line.

The first mandate, proactive manager, is not too dissimilar to what SWFs have been used to do. It is a natural progression.

- Given the volatility in the leading global stock markets, the low expected returns and prospects of lower government bond yields for longer and currency volatility, the asset allocation benchmarks need to be reassessed;
- Performance metrics need to be objective and transparent. More importantly, they need to be compared to a replicable benchmark. What does good look like? It needs to be obvious and unequivocal;
- Equally important, lessons need to be learnt from below-par performance and remedial action explained;
- Tail risk hedging should be considered to protect the existing portfolio in the face of the macro economic uncertainties.

On the other hand, there are huge infrastructure needs both domestically and in the region. Given the headwinds in the global economy, funding for such projects will become harder to find. The savvier SWF have already moved on from pure back-seat investors to taking the lead on such projects, putting down the seed capital and providing the necessary due diligence to attract additional funding. This should also provide an opportunity for regional cooperation and possible mutualisation of risk at a regional level.

The second mandate, developmental focus, is a totally new role. It's a combination of the realisation that growing the pie is not enough if the 'have-nots' end up with less and the 'haves' keep getting a bigger slice and the acknowledgement that the development bank model has failed. Development banks have either been run far too cautious - on metrics akin to commercial banks - or been hijacked by the political masters to dole out funds to cronies. A social enterprise model with a market approach is what is required to help those at the bottom to get a foot on the ladder. This function will become increasingly binding. Failure to share equitably the fruits of economic growth and development will speed up the ticking social time bomb.

> "Governance is like a currency. A weak currency can't be bolstered and a strong one can't be denigrated."

The third mandate, innovation, is also not novel although the objective needs to be made more cogent and the means and capabilities aligned to expedite delivery. This is more in the spirit of the "future generation fund" philosophy. It should be targeted proactively at the younger generation. It can pave the way for new avenues and must facilitate the transition to an economy less dependent on the commodities and resources cycles. It also involves working closely with international private and public players in that space and preparing the grounds for a buoyant foreign direct investment sector.

The fourth mandate, restructuring, is the trickiest. The public in general and particularly people directly involved in ailing industries are always insisting on the need for government bailout. The reality is that some industries cannot and should not be saved. On the other hand some whose predicament has more to do with mismanagement and high leverage could be saved. The benefits of segregating this type of intervention will encourage transparency and accountability. This is essentially a negative carry trade. The risk budget needs to be pre-defined with clear exit strategies.

GOVERNANCE, THE NEW LEITMOTIF

Governance, transparency and trust are vital to ensure these four mandates can be carried out successfully without any distraction. It will ensure that scarce national resources (funds, risk and reputation) are managed professionally and efficiently. To be clear, investment is by nature risky. Getting investment decisions wrong and making bad market calls are par for the course. That's where transparency and good governance come in; these are precisely the 'get-out-of-jail' cards!

For practical and efficacy reasons, these four mandates should not be managed by a single institution. This will also foster better transparency, accountability and performance measurement. A federal model with four distinct institutions each focusing on its own mission but overseen by an umbrella organisation / board will ensure the essential coordination for maximum effectiveness. It does not require a 'Big Bang' approach. The four institutions can be drafted in by selecting from the existing ones, those whose current mandate is closest and most relevant to the stated objective. Each one can then gradually expand by absorbing other entities operating within its purview.

> "And yes it involves risk. Given the scale of the ongoing and prospective challenges, business as usual would be even riskier."

SWFS AND CENTRAL BANKS: NEW LYNCHPIN FOR ENCOMIC MANAGEMENT

The economic successes of the past two decades, before the crisis, have been made possible by the better role and feat of central banks in managing the economy. Monetary policy was targeted at the business cycle instead of the electoral cycle. Just like independent central banks have improved economic management, SWFs should be empowered to address the structural reform requirements in the new normal. Such a retooling may be too bold for some. It may take some SWFs out of their operational comfort zone. Politicians might initially feel that they are losing the hand. Actually, it helps their standing. Depoliticising investment decision making is a win-win for politicians, policymakers and the public. There are many investment lessons learnt from the 2008 crisis that are relevant to the new normal. Investments should be chosen with special attention to reputational, systemic and societal concerns as well as financial performance; even more so for SWFs.

References:
[1] The Economist, (2016, January 23). Shifting the Burden [Review of the book The Only Game in Town: Central Banks, Instability and Avoiding the Next Collapse] Retrieved from http://www.economist.com/news/books-and-arts/21688836-central-banks-need-do-less-and-politicians-more-shifting-burden

About the author

Jaya Patten
Senior Advisor

Jaya Patten was a trusted advisor to governments and public institutions during the global financial crisis with extensive experience in financial services and capital markets. He is currently a Senior Advisor with ASEAN Advisory Pte. Ltd.

Contact us

Chew Seng Kok
Executive Vice-Chairman
seng.kok.chew@zicoholdings.com
t. +603 2087 9606

Wong Ai Kim
Director
ai.kim.wong@zicoholdings.com
t. +603 2087 9608

ASEAN Advisory Pte Ltd
Consulting arm of ZICO Group
8 Robinson Road, #03-00, ASO Building Singapore 048544
t. +65 6438 7929 f. +65 6438 7926
www.zicoholdings.com

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