

Capital markets and pensions in South Asia

Susan Thomas

<http://www.igidr.ac.in/~susant>

April 15, 2006

Framework

- Our main focus is on the implementation of a top quality defined contribution pension system
- Much of this proves to be germane for a “funded” DB system also.

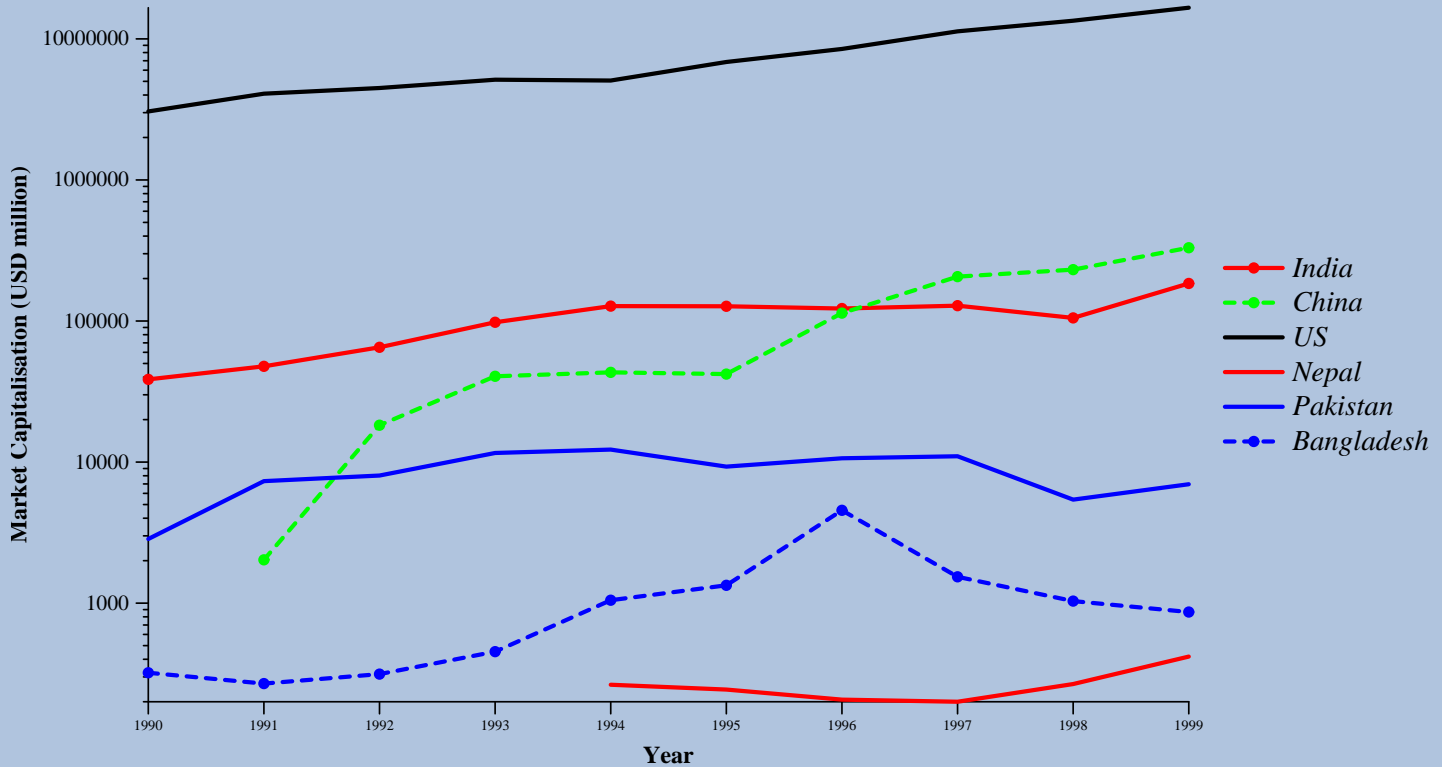
Domestic financial sector development

Can the domestic financial markets support pension investment?

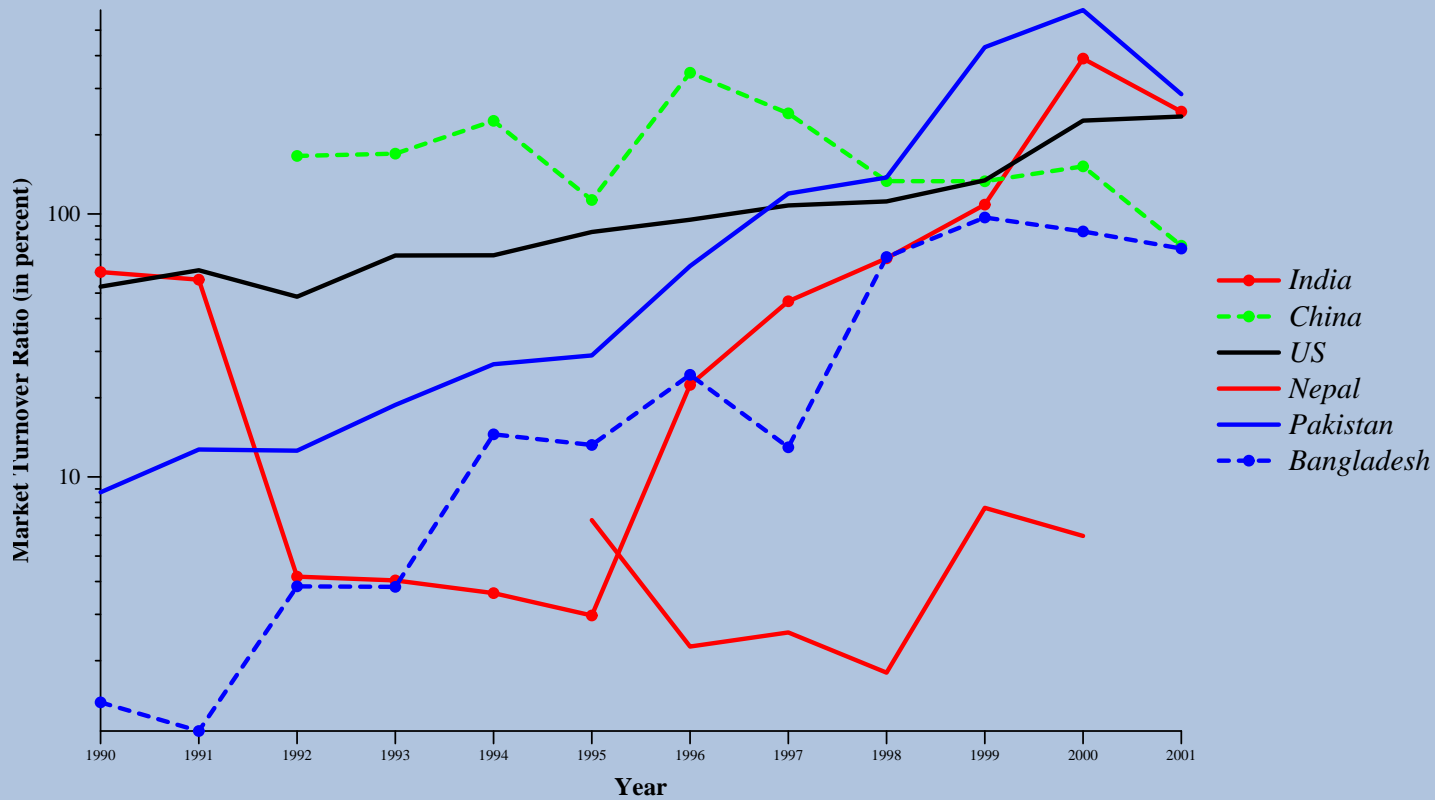
- Are there assets to address a variety of investment schemes?
- Have the domestic financial markets size and liquidity?
- Is there an availability of professional fund managers?
- Is there regulatory capacity on fund management?

1. Where are we in South Asia?

Size of the markets



Turnover ratio



Availability of assets

Asset	Bhutan	Bangladesh	India	Pakistan	Nepal	SriLanka
Equity	Y	Y	Y	Y	Y	Y
Bonds		Y	Y/N			
Index funds			Y			
Derivatives –						
Equity:			Y			
Int. rates:						
Exchange						
OTC			Y	Y		Y
Real estate						

Annuities

- All the South Asian countries have at least one state run life insurance company.
- India opened up the insurance sector to private participation in 1999 – this has caused a significant growth in the annuity policies sold.

Competing fund managers

- Most of the countries have a dominance of the banking sector, and have recently started on building mutual funds
- Bangladesh reports around 15 or more mutual funds, 10 of which are listed on the stock exchange.
- Sri Lanka has a small set of local fund managers, which Pakistan appears to have as well.
- India has around 35 mutual fund managers, who have grown significantly in the last three years.

Regulatory architecture in South Asia

- The financial sector in Bhutan and Nepal have banks and a public sector insurance firm: here the regulator is the central bank.
- Sri Lanka has Securities and Exchange Commission (SEC) to regulate the equity market and the central bank that regulates everything else.
- Pakistan: Central bank for banking, SECP for everything else.
- India has an alphabet soup of regulators: RBI, SEBI, FMC, IRDA, PFRDA, DCA.

Accessing global markets

- All South Asian countries have rigid controls on outward flows.

Analysing the evidence

- India and Pakistan appear to have significant sized equity markets; the market size in Bangladesh could be adequate.
- The growth of the financial sector in India also appears to have reached a level of financial market preparedness to enable pension investment.
- A common weakness in all countries is the evidence of poor governance: in both Pakistan and India, there have been instances of fraud in fund management.
- None of the countries appear to have put in place reforms required to access global diversification on their portfolios.

2. Global diversification

Risk and return from purely local equity investment

From 1997 to 2006 –

	Weekly returns	
	Average	Volatility
Sri Lanka	0.238	3.02
Pakistan	0.442	4.11
India	0.343	3.51
US	0.071	2.44
UK	0.049	2.29
Japan	-0.028	2.92
Germany	0.085	3.51

The past will not repeat itself

- Future returns will not be the same as past returns
- Future volatility is more likely to mimic past volatility.

Case 1: Purely Pakistan equity portfolio

Volatility = 4.11% per week

Diversification within South Asia?

Correlations:

	Colombo	Karachi	India
Colombo	1.0000		
Karachi	0.1348	1.0000	
India	0.0627	0.1677	1.0000

Very low correlations : Opportunities for diversification.

Optimised portfolio across South Asia

- Weights: 32.4% in Sri Lanka, 32.4% in Pakistan, 35.2% in India.
- Volatility = 2.31% per week

Gains from diversification

Pure Pakistan	4.11% per week
Diversified in South Asia	2.31% per week

Why stop at South Asia?

Add in US, UK, Japan, Germany:

Pure Pakistan	4.11% per week
Diversified in South Asia	2.31% per week
Diversified across major markets	1.63% per week

Main lesson

- Some people complain about savings leaving the country
- It will require a modern framework for open economy macroeconomics
- Local finance companies will lose revenues
- **International diversification is in the best interest of the participant**

3. What happened in Indian finance

Areas

- Banking: Staved off an East-Asian style crisis
- Securities markets: Ignited liquidity in equity market
- Derivatives: Currency forward, equity futures, commodity futures
- Bond market: Big fiscal deficits → lots of issuance; but weak secondary market.

Portfolio flows + FDI now dominate the financing of the current account deficit.

Equity-market dominated financial system

- Full “ecosystem” of equity market:

VC	Electronic trading	Exchange insts.
Private equity	Stock derivatives	Mutual funds
IPO market	Indexes	FII's
ETFs	M&A market	Corp. databases
Corp. Governance	Index derivatives	Index funds

- Retained earnings plus small equity issuance dominates the financing of firms.
- Debt-equity ratio has dropped dramatically from 1990 onwards. On market value basis: Just 0.3.
- *Nominal* debt aggregated across all corporations has stagnated for last 6 years.

International comparisons

- Average transaction size tends to be small in India
- But number of transactions is good by world standards
- Ranking of exchanges by number of transactions: NSE #3, BSE #5.
- Ranking of derivatives by number of contracts: Nifty #7.

Where things stand

Companies which trade on 66% of days	2500
Their market capitalisation	Rs.31 trillion
Daily turnover	
Equity spot	Rs.150 billion
Equity derivatives	Rs.400 billion
Commodity derivatives	Rs.150 billion
Currency forwards	\$2 billion
