Risky business

Johan Bastin of CIMB Standard in Singapore talks to *Infrastructure Investor* about political and regulatory risk in Asia's emerging markets.

What does political risk mean in the context of the investment business you operate?

Political risk exists at two levels: you have general risk and then you have more specific political risk. At a general level it is about political succession, as that impacts the continuity of policy, for example, if the government changes and the new government decides it doesn't want private participation in infrastructure. The more specific risk is where you have arbitrary, unilateral decision-making on the part of governments which affects the stability of the legal and regulatory environment on the basis of which we invest. If we invest, we assume there is certainty and predictability in the regulatory environment. However, you can have an arbitrary, unilateral decision that can annul your assumptions. That can take the form of a government not honouring a performance obligation; it can also be related to government intervention, or the lack of it. For instance, there are illegal ramps on toll roads – governments have been asked to remove them, but they haven't. Similarly, you have illegal connections for power and governments allow them for political gains.

> *"Don't think that emerging markets have a monopoly on political risk"*

How can you measure political risk?

I don't think you can measure political risk, but I think there are two general rules to mitigate it. Firstly, the longer a regulatory and legal framework environment for private sector investment and operations has been in place, the less risky it is. Secondly, the closer to local government your investment is, the higher the political risks are. Local governments can be less competent and more arbitrary in their decision-making than central governments – the water sector is a good example. They are more vulnerable to pressure from the electorate and they also often lack the regulatory capacity and skills.

Are there any countries or sectors in Southeast Asia, a region CIMB Standard invests in, that you avoid altogether because you see political risk as a deterrent?

It is virtually impossible to manage political risk. I think what you would be looking for is specific political risk insurance provided by international financial institutions. A second thing is to seek the involvement of these institutions in your investment to help mitigate risk. Another thing to do is adopt a herd mentality in the sense that if there are a number of investors flocking into a sector, you have a critical mass that is politically more costly to harm which could help mitigate risks. If you are a pioneer investor in a particular sector, then you are more vulnerable to political risk.

We want to avoid countries that have just decided they want to promote private infrastructure financing or where we could be exposed to inexperienced authorities or regulators. Again, water is an example of such a sector. We want to see how the environment evolves in countries such as Myanmar and Laos. Thailand and Malaysia are reasonably stable, with the exception of the occasional windfall tax such as in Malaysia. In the Philippines, the water and power sectors have good and tested frameworks. Indonesia has been the oldest, most promising young kid on the block for decades now. There is no doubt that they have tremendous investment needs and there is no doubt that there is political willingness to encourage private participation, but they don't seem to be making too much headway in getting the legal and regulatory framework in place.

Which governments in the region have done the most to attract international capital?

Singapore without any doubt has done the most and is in a league of its own in Southeast Asia. Thailand and Malaysia have done a lot to attract international capital. The Philippines in certain sectors has done a lot. Indonesia has not yet taken full ownership of setting up the framework. There are promising signs and we are hopeful. But if they want to meet the ambitious targets they have set, then they have to step up efforts.

India and China are good examples of how political will and determination can help establish the environment for private investments quickly. I'm very impressed with the progress they have made. It's the same with China. Look at specific sectors such as wind; how quickly they have developed it.

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It is not rocket science to get good frameworks in place for power and telecommunications. There are models that can be adopted wholesale and some countries have done that. Some countries must be confused by the cacophony of advice given by various bilateral and multilateral organisations. Everyone is talking to some authority or the other but there doesn't seem to be a connection. You need a central organisation that has experienced people that can lead the task of setting up legal and regulatory frameworks.

Which industry or sectoral regulators do you interact with?

What we do is to seek opinions and clarifications from regulators at part of our due diligence. We talk to regulators and try to understand what their understanding is of the role of government in infrastructure development and of the regulation in place. We also want to get comfort in terms of the reliability of regulations. You get a feel of the regulators and how serious they are. As a private equity fund, you don't have much weight to do things after there is a problem. It's much more in the diligence phase where we can make an assessment of the strength of the regulator. You would typically meet with a number of institutions including the ministry responsible for setting up the framework, the transport ministry responsible for the sector, and provincial authorities, as they have an important role to play in land acquisitions and the like. It is like any due diligence; we try to have as many contact points as possible and then

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form an opinion based on these meetings. On average, it takes about a year to close a deal from the time we are first made aware of an investment opportunity. Doing it in less than six months is virtually impossible.

How stable do you think are the regulatory environments in which you operate?

I think they are reasonably stable. I don't see eminent signs of discretionary action or governments becoming irrational. If anything, I think the quality of public governance is improving. Governments here know they don't have a choice but to invite private participation. Nobody has to argue anymore about the need for foreign capital inflows in infrastructure. It is also understood that there is competition for these capital flows. At the moment, most of it is going to India and China and Southeast Asia has to work hard in order to divert some of that capital from those two countries. But overall, the regulatory environment in the region is reasonably stable.

Bastin: improving quality of public governance

Are there places in Asia where investors should expect a risk premium as compensation for regulatory risk?

In terms of a risk premium, at the macro level, you have to make a judgement. I would think there is a correlation between the credit risk rating of the country and the political risk; the lower the credit risk rating, the more political risk you have and the higher the risk premium you expect. In terms of sector, the rule I use is the more public good there is in a sector, the more political risk there is. When you are operating in a sector that is more 'private' and less regulated with less of a natural monopoly, for example, telecommunications, there is a higher commercial risk premium, but the political risk premium is lower.

What has been your most formative experience in the area of political and regulatory risk?

I have often been asked by journalists and investors: 'In the emerging markets you are investing in, are you not facing tremendous political risks?' My answer to that has been: 'Do you know the country where the political risk has been the highest?' The answers they give me are China or Russia. But the truth is that it was the UK. When the Labour party came into power in 1997, they slapped a windfall tax of several billion pounds on the water sector. The private water companies were making money because they were simply much better at mining inefficiencies than the public sector was. That is political risk. Don't think that emerging markets have a monopoly on political risk.

Johan Bastin is the Singapore-based CEO of CIMB Standard, a joint venture established by CIMB, one of Southeast Asia's major banking groups, and Standard Bank, a global emerging markets bank. CIMB Standard currently has three funds under management with total commitments of $460 million – including the Asian Development Bank- and Islamic Development Bank-sponsored Islamic Infrastructure Fund, which had an initial closing on $262 million in July 2009 and has a target size of $500 million.