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SUSTAINABLE LOW-CARBON MULTICURRENCY INVESTMENT

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Finding right path on risk

Context of asset ownership is critical

Adrian Orr, New Zealand Superannuation Fund

Global Public Investors have been expanding into newer asset classes, searching for ever more elusive returns and striving for deeper, more efficient, capital markets while seeking the right policies to handle financial risks.

We should separate risk from uncertainty and volatility. The most fundamental risk facing a public institution is the failure to achieve its purpose.

The economic basis for official institutions providing public goods and services is well understood. Citizens cannot be excluded from accessing certain goods and services, and, further, these are not depleted when access is widened. Official institutions serve as insurance mechanisms, spreading and pooling risk across various cohorts of society. And they provide legal and regulatory frameworks, and look to maintain general financial integrity. The hoped-for result is a dynamic economy in which transaction costs are low; property rights are enforceable and transferable to best use; productivity of both labour and capital is high; and risks are shouldered by those best placed to manage them.

It is on this last point that the debate has recently become louder, with some justification. Central bank balance sheets have ballooned since the financial crisis. Further, GPIs, including pension plans and sovereign funds, have been expanding into newer asset classes, searching for returns in a world reluctant to offer them. Financial assets and liabilities have been overtaking physical counterparts on the books of service-providing public entities. A city or government increasingly no longer owns its prisons or schools. Instead, they may carry an operating lease or work with private enterprise to fund and operate new infrastructure. Meanwhile, good policy planning encourages the linking of public costs to public benefits, and therefore the linking of public assets to public liabilities.

These are all desirable developments as the world strives for deeper, more efficient, capital markets. Greater effort is directed towards quantifying unfunded, implicit and contingent liabilities to better 'match' assets funded from the common purse. These developments generate considerable questions. Have public sector risks skyrocketed now they are more closely tied to the market's daily impulses? How should governments ensure that assets and liabilities are managed sensibly across agencies?

The identification, measurement and understanding of the risks presented to a government's comprehensive balance sheet is a topic of increased attention and analysis. This is welcome. It is highly useful to have a consistent framework for assessing government exposures to risks like equity, credit, foreign exchange and interest rates. What is needed are tools to evaluate the availability of public 'insurance' against catastrophes that can place the balance sheet in negative equity. The important questions are whether fiscal stabilising instruments are effective in times of crisis, and whether there is sufficient capacity to build up and service additional debt if that is the preferred option.

We should separate risk from uncertainty and volatility. The most fundamental risk facing a public institution is the failure to achieve its purpose. The 'expenditure' of risk or 'willingness to accept' risk allows access to streams of returns (future goods and services) that are critical to fulfilling policy objectives. Risk is intrinsically linked to purpose. Equally, market volatility is not synonymous with risk. An equivalence is useful for some purposes, but the risk a certain amount of volatility poses to an owner is not absolute. It depends on the context of the ownership of the asset. An asset that poses a 'large' risk to the ambitions of one investor or agency may pose a 'smaller' risk to another. Context is critical.

There are hopeful signs from recent trends in the balance sheets of official institutions. We will gain from better understanding the risks they bring. But we must do so fully, consistently, and in sight of why these assets were acquired in the first place. I hope we will take inspiration from the contents of these OMFIF *Global Public Investor 2016* pages to carry out more contextualised conversations on the meaning and appropriateness of financial risks taken by official institutions around the world. ■

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