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The Indonesian Mutual Fund Industry: Challenges and Opportunities

Indonesia Highlights

Indonesia is Southeast Asia's largest economy, rich in all types of natural resources as well as cultural diversity. A young and dynamic democracy, it is urbanizing and modernizing rapidly. Based on the 2018 OECD Economic Surveys report on Indonesia, in contrast with many emerging economies, around half of the population is under 30 years old, and the working-age population ratio is set to rise during the next decade. Two decades after the 1998 Asian Financial Crisis, and one decade after the Global Financial Crisis, Indonesians' living standard is far higher than before, and the economy is more resilient. Gross Domestic Product (GDP) per capita has risen by 70% during the past two decades. The end of the commodity price boom weighed on incomes and government revenues, yet GDP growth has remained stable at around 5%, and per capita income has increased by almost 4% annually on average from 2008 to 2018, according to the World Bank. Poverty rates have fallen in both rural and urban areas. Confidence in the national government is higher than in any Organisation for Economic Co-operation and Development (OECD) country. Prudent macroeconomic policies and progress in structural reforms have been recognized by credit rating agencies, and Indonesia has climbed up international rankings of competitiveness and business environment. Since 2015 Indonesia has leapt 34 places in the World Bank's Ease of Doing Business ranking to 72nd.

Indonesia's youthful demographics present both opportunities and challenges. Indonesia's working-age population grows by around 2 million annually. The working-age population is projected to increase to 68% of the Indonesian population by 2030. This alone boosts estimated potential GDP per capita growth by 0.3 percentage points annually until 2030. The challenge is to provide jobs for the growing workforce and to eventually shift the job mix to high-quality, high-productivity jobs in the formal sector, thereby enabling Indonesia to emerge as developed country.

Public Attitude toward the Financial Market

Rapid economic development, low public debt and a young population provide Indonesia with the perfect ingredients for a thriving mutual fund industry. Despite rising income levels, financial literacy remains an issue in Indonesia where only relatively few Indonesians are active investors and knowledgeable about investment products. Bank time deposits, real property, and gold are the most popular investment instruments for Indonesians. Those instruments are understandable choices considering the risk-averse attitude of the public following the 1998 Asian Financial Crisis that affected the public's trust in the financial system. More than 20 years have passed since the crisis and stability has been restored in the country, and with it the public's trust in the financial system has recovered. With better education and greater sophistication, awareness of the importance of better personal finance management is growing. More people are wary of the indirect impact of inflation on savings and the tendency of banks to lower interest rates. More Indonesians are also aware of the need to prepare for retirement and seek to secure their standard of living to maintain their lifestyle during retirement. Mutual funds are seen as an alternative investment product for the public and as an access point to participate in and tap the potential returns from the capital market. Capital market instruments provide attractive long-term potential returns for investors, ideal for long term financial objectives. Indonesia's stock market offers attractive long-term returns with 10-year compound annual growth rate (CAGR) of 16.4%, while the sovereign bond market returns 10.5% 10-year CAGR, compared to bank time deposit rates of around 5-6% per annum gross of tax (Figure1).

Development of Indonesia's Mutual Fund Industry

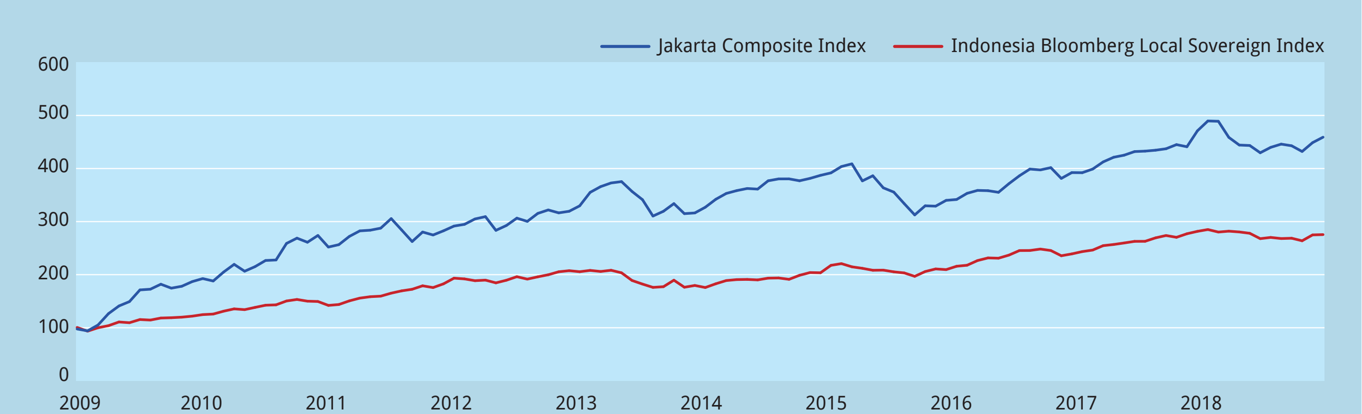
Indonesia's mutual fund industry is currently considered still in infant stage since the first mutual fund was introduced 23 years ago, a year after a new capital market law was rolled out by the government. As the population of the country is more than 271 million where young people would one day dominate and take a role in the country's economic growth, the investment management industry became one of the focuses of the regulator in the financial services sector. The government and regulator realize the importance of improving public financial literacy, especially in personal finance management and long-term planning to prevent overconsumption that would be counterproductive for the economy in the long run.

The industry is highly dependent on the banking industry as the distributors of mutual funds. Total third-party deposits in the banking industry is around IDR 5,289 trillion (USD 0.37 trillion) while the total assets under management (AUM) of the mutual fund industry is only around IDR 494 trillion. Therefore, the opportunity to shift Indonesians from investing in traditional banking products to capital market products, especially mutual funds, is still huge and promising.

In the past, mutual funds were seen as somewhat an exclusive product, only available to priority bank clients with high net worth. This is no longer the case as a campaign by the regulator positioned mutual funds as an easily accessible investment instrument for the public with a low minimum investment requirement. Some mutual funds can now be had with minimum investment of IDR 10,000. Lately, a wave of digitalization and new financial technology also played an important role in promoting and creating a supportive ecosystem to market and introduce mutual funds to the public. As result, the number of retail investors in mutual funds increased significantly, though the total number of investors still represents less than 1% of the total population of the country. These digital and financial technology startups are hungry for creative ideas to market investment products and believe there is opportunity untouched by the conventional channel. Some digital channels such as Bareksa, Ajaib, Tanamduit and Bibit aggressively promote and attract young investors to start investing from an early age through educational advertising in social media. This method has successfully boosted the number of retail investors. Some unicorn e-commerce marketplaces such as Bukalapak and Tokopedia have also started to sell mutual funds on their platforms. Indonesia is a country where 60% of the population is below age 40, and more than half of the population is mobile internet users. In this environment, the industry believes that distribution through the digital channel is the future of the industry and sees it as a major channel for the industry's growth. Traditional distribution channels such as banks and insurance agents will continue to play an important role since their clients who are mostly high net worth individuals and the old mass affluent continue to prefer direct personalized service rather than through digital channel.

As the most populous Muslim country in the world, Islamic-compliant mutual funds are also issued by the market players. However, the growth of Sharia mutual funds was rather uninspiring at the outset. This situation changed in 2016 when the government opened the opportunity for investment managers to invest 100% of AUM in Sharia-compliant offshore instruments. This regulation triggered an almost doubling of the AUM of Sharia mutual funds, from IDR 15 trillion in 2016 to IDR 28 trillion in 2017. This new type of fully offshore mutual fund is attractive for Indonesian investors as it allows exposure to global equities and diversifies their portfolios. The regulation also opens up opportunity for investment managers that have Sharia-compliant capability to issue mutual funds with 100% offshore underlying instruments or to enter into cooperation with external managers that have expertise in managing Sharia-compliant funds. The leading players on this field are foreign houses that already have an established presence in Indonesia such as Manulife Investment Management, Schroder Investment Management, BNP Paribas Investment

Figure 1: Indonesia's Equity and Bond Market Indices



Note: Rebased to 100 as of the end of 2008.
Source: Bloomberg

Partners. Meanwhile local managers that lack the global investment capability generally have to collaborate with foreign fund houses that have global Sharia investment capability but do not have a presence in Indonesia. Most managers do not plan to work with external managers, given the restrictive regulatory environment that prohibits financial institutions such as pension funds, insurance and social/health security funds to invest in offshore instruments directly and indirectly. Feeder funds and fund on funds currently are still prohibited by the law. There is a plan to loosen the restriction of fund on fund; however, it would be subject to the amendment of the capital market law by the parliament.

Institutional clients' investable assets experienced massive growth in the past five years, rising from IDR 1,984 trillion in 2014 to IDR 3,318 trillion in 2018. Institutional investors are generally pension funds, social/health security funds, life insurance companies, and banks. In terms of risk appetite, some pension funds prefer to invest in low-risk instruments such as money market funds because they are not managed by professional investment managers and tend to be risk-averse. Apart from investing in mutual funds directly, institutional investors also tend to appoint external investment managers and have dedicated funds.

Generally, pension funds in Indonesia are quite rudimentary in terms of investment management. Many pension funds still utilize a certain annual target return set by the fund sponsors, thereby exposing the fund to unnecessary risks, while some others tend to be quite risk-averse, avoiding volatility while sacrificing long-term growth. A top-down educational approach is required to advance the industry, starting from the fund sponsors down to the pension fund managers in order to create a more coordinated objective and investment strategy and expectations. Recently, the industry was introduced to the Liability Driven Investing (LDI) strategy, a philosophy completely opposite the traditional return-based strategy. LDI proposes an interesting concept for the pension fund industry, although its implementation may require some time as local LDI capability needs to be developed and further market deepening may be needed.

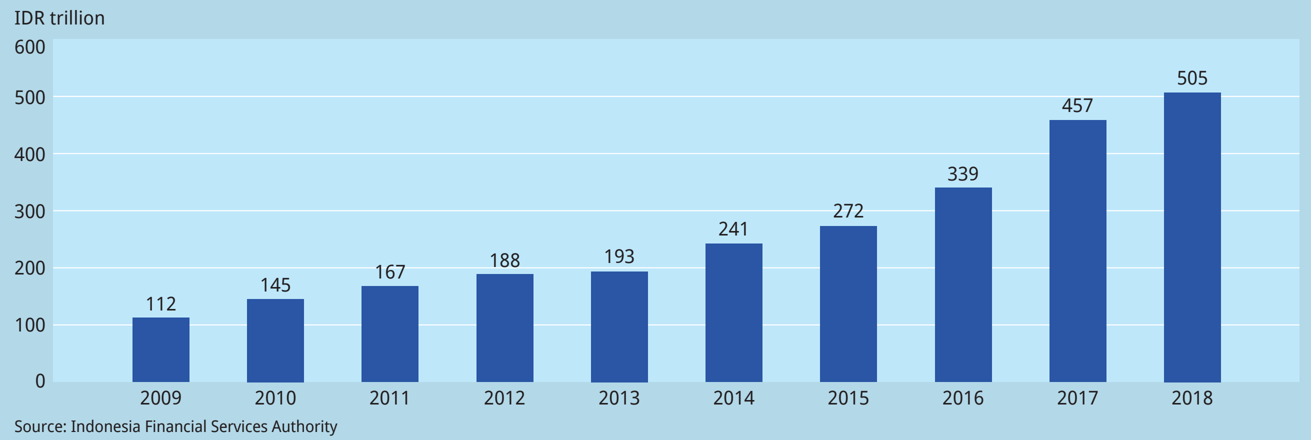
In all, Indonesia's mutual fund industry enjoyed a period of high growth in the past 10 years. Total AUM of the industry more than doubled from IDR 241 trillion in 2014 to IDR 505 trillion at the end of 2018 (Figure2).

Mutual Fund Types in Indonesia

Indonesian investors typically demand high return from investment managers, which partly is due to the high interest rate on time deposits offered by banks (5-6% subject to 20% final tax). Managers with proven track records in providing returns and the reputation of the brand become the top criteria for mutual fund distributors. The fee for managers varies for different asset classes. The fee for bond funds is around 150-175bps on average, for equity funds it is around 250-275bps, for balanced funds around 150-200bps, and for money market funds around 75-100bps. For exchange traded funds (ETFs) the management fee is around 100-150bps however the manager must share 50% with the dealer participant as there are limited market makers in this space.

For alternative investments such as real estate investment trusts (REITs) and Infrastructure funds, the management fee is around 50-100bps. However, the number of listed REITs and infrastructure funds is still limited even though the opportunity is very huge. The regulator aims to develop this asset class by aligning with the government's program to finance Indonesia's infrastructure development. The government requires private sector funding to help finance a huge amount of infrastructure development. One way to attract investors is through the issuance of alternative investments such as municipal bonds, REITs, and infrastructure funds. The government issued a regulation that requires financial institutions such as pension funds, insurance, and social/health security funds to invest in alternative products that invest in government infrastructure projects. The industry believes that alternative investments, private asset and infrastructure funds will be an important growth area. One of the key features of mutual funds in Indonesia that is attractive for investors is that their return is net of tax, as it is already taxed at the fund level. This creates the opportunity to structure a product for tax efficiency purposes by securitizing assets under mutual

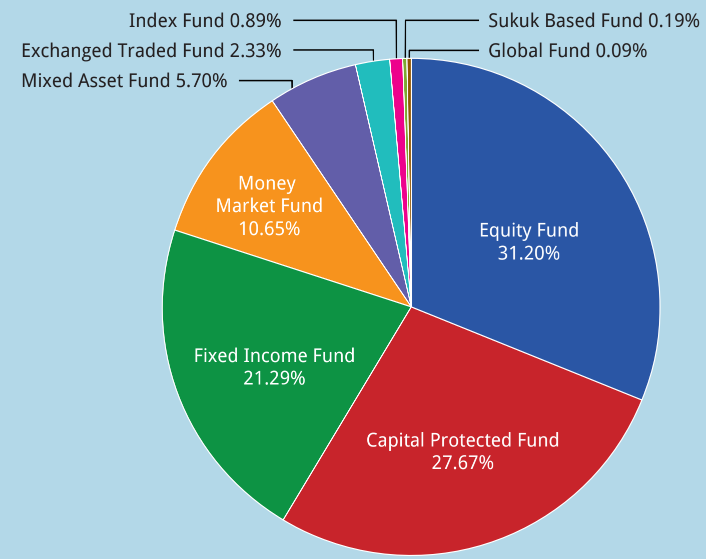
Figure 2: AUM in Indonesia's Mutual Fund Industry



Source: Indonesia Financial Services Authority fund products. The industry believes that this will provide greater role for investment managers to be involved in the infrastructure development of the country.

By asset class, the AUM of the mutual fund industry comprised of 31% in equity fund, 28% in capital protected fund (buy-and-hold fixed income underlying mutual fund), 21% in fixed income fund, 11% in money market fund, 6% in mixed asset fund and less than 4% in other classes including ETF (Figure 3). The large allocation to capital protected funds is due to the tax benefit from holding bonds in mutual funds. Direct investors in bonds are subject to a 15% tax on capital gains and coupons while mutual funds are only subject to a 5% tax (which will increase to 10% in 2020), providing a tax benefit for investors to package the bonds in mutual fund form. However, the normal tax rate will be applied to bonds in mutual funds from 2022 onwards, thus the tax benefit will no longer apply. Fund houses will need to adjust to this environment to find alternative mutual fund products that can attract investors, considering the capital protected fund class is a big chunk of the industry's AUM.

Figure 3: Share of Mutual Fund AUM by Asset Class



Note: Underlying asset is as of October 31, 2019.
Source: Indonesia Financial Services Authority

Legal Platform of Fund Establishment

Under Law No.8 1995 concerning Capital Market, there are two possible legal schemes for establishing a mutual fund. The first scheme is to setup a fund under Limited Liabilities Corporation form. Through this platform, the fund will be listed in the stock exchange for fund raising. The fund can be established either as a close-end or open-end fund. The basis of establishing a Limited Liabilities Corporation is a contract or agreement, where the initial shareholders must include at least two parties. This Limited Liabilities Corporation will enter a contract with an investment manager to manage the funds raised during the offering period (for close-end funds) or during the life of the fund (for open-end funds). This scheme for establishing a fund is not popular. Only one fund ever established under this scheme got listed in the stock exchange over the history of Indonesia's capital market. That fund was delisted from the stock exchange a few years after the financial crisis hit Indonesia in 1998. Since then there has been no fund formed under this scheme.

The second scheme for establishing a fund, and a more common scheme in the market, is through a Collective Investment Contract (CIC) entered between an investment manager and a custodian bank. The contract binds the investors through the issuance of a prospectus as an offering document. The CIC is treated as an entity that has its own tax ID. The parties involved in this scheme are the investment manager and custodian bank. The obligation of the investment manager is to manage the assets of the fund in accordance with the investment policies set out in the prospectus, and the obligation of the custodian bank is to administer, maintain bookkeeping and control services to ensure fund management compliance and to act as the transfer agent. Under the law, the assets of the CIC are separate from the investment manager's assets and the custodian bank's assets. Therefore, a bankruptcy remote mechanism is applied. In the event of going concern happened with either the investment manager or the custodian bank, the regulator may appoint a replacement party to take over the obligation of each party, or the parties themselves may transfer their obligations to other parties. The CIC as an entity is subject to tax, and all taxation is calculated and reported based on the CICs financial statement. Therefore, the investment return received by the unit holders of the CIC is free of tax. Currently the CIC enjoys a tax incentive for holding bonds, where the rate of interest and/or discount of bonds earned is 5% up to 2020 and 10% from 2021 onwards. The normal tax rate for both for capital gains and interest for bonds is 15%. Other than managing a mutual fund as a collective investment scheme, an investment manager may also enter an investment management agreement with individual clients under a bilateral agreement. In which case the agreement mandates the investment manager to manage the fund in accordance with the investment policies set forth in the agreement.

Mutual Fund Industry Market Players

There are 97 investment management companies licensed by the Indonesia Financial Services Authority; however, the AUM of the mutual fund industry are dominated by the top 10 investment managers who represent 52% of the industry's total AUM. This creates the opportunity for foreign players to enter the market and compete. UOB Asset Management, a Singapore-based fund house entered into a sale and purchase agreement to acquire 75% of the shares of a local fund house, and Shinhas Financial Group also acquired a 75% stake in Archipelago Asset Management, a local fund house in 2018.

The regulator plans to re-classify the license for investment managers due to the fact that only the top 20 fund houses are actively promoting mutual funds to the public through third-party distribution channels, while the other fund houses tend to grow their AUM through bilateral mandates or exclusive funds. The regulator plans to issue a different investment management license classification based on the distribution channel focus. Thus, every fund house is expected to focus on its capabilities and enhance its service level according to its specialization. This initiative is expected to create industry efficiency since currently the same requirements are applied to all fund managers.

The regulator believes that to accelerate the growth of the industry, all stakeholders have to participate and be involved in designing the blueprint for the industry's growth. The regulator has established a task force to perform this task and invited all market participants to propose new ideas for development. The ideas proposed in the task force forum will be deliberated as the basis for publishing policies or regulations. By involving the market participants, the regulator believes that the regulations issued will be more applicable and effective in their implementation and would therefore be beneficial for supporting growth of the industry.

One of the latest results of this process is the implementation of the multi-share class mutual fund. This initiative was initiated by Manulife Investment Management in collaboration with Standard Chartered Bank as the custodian bank. The multi-share class allows one fund to have different features and fees depending on the client segment. Previously investment managers had to issue a new mutual fund if they wanted to have a different fee structure for the same fund, a process that requires time and costs to submit and register a new fund with the regulator. The multi-share class allows more flexibility and efficiency for investment managers to accommodate the needs of different investors that require certain features or fee structures.

Recent Regulatory Trends and Future Outlook

In 2016 the Indonesian government introduced a tax amnesty program in an effort to boost the tax base and compliance. An estimated USD 10.4 billion was repatriated from overseas. According to this program, repatriated offshore assets have to be invested in Indonesian territory for at least 3 years. As we are heading into the end of the lock-up period, the government needs to develop a new investment instrument to ensure the repatriated funds remain in Indonesia. To facilitate this the industry is pushing the regulator to issue a regulation that allows mutual funds to invest 100% in offshore assets thus allowing the funds to be managed by local investment managers instead of going to offshore managers. This would relax the regulation that previously only allowed offshore investment in Sharia-compliant instruments. The regulator is still considering this regulation; various perspectives are taken such as the capability of local investment managers to manage offshore instruments. The regulator certainly does not wish local fund managers to be utilized by foreign fund managers as feeders or distributors for funds established overseas, fearing that such move would undermine local investment managers' growth and development.

Apart from increasing product flexibility, the main focus of Indonesia's capital market is to deepen the market. The Indonesia Stock Exchange (IDX) intensified its efforts in recent years to deepen its markets to expand the local investor base. The first issue to be addressed is to boost domestic investor participation in the market, to reduce the market's exposure to a sudden inflow or outflow of foreign hot money. To achieve this, the IDX aims to raise public awareness through an educational campaign on the benefits of long term investing in the capital market products.

Another initiative in the pipeline is the plan to lower corporate taxes for listed companies in the hope of encouraging private companies to go public. This plan could potentially help to deepen the Indonesian capital market by increasing the number of companies listed on the stock exchange. Internally, the IDX as the facilitator also continuously strives to increase the number of stock indexes that can be utilized as a reference for investors and investment managers to enrich their product lineup. The IDX also seeks to develop the derivatives market and educate its members to be able to play an active role as market makers for ETFs.

Other efforts by the regulator to deepen the market also include the plan for an Electronic Trading Platform (ETP) for over-the-counter government securities transactions and the plan to develop and establish an electronic book-building platform for the Initial Public Offering (IPO) mechanism. The regulator has also eased rules for IPOs by small and medium enterprises to facilitate IPOs for start-ups. The IDX recently has established a special board called the Acceleration Board to accommodate these small-medium enterprises and start-ups to raise funds through the capital market. To boost the country's digital industry, the IDX has launched the IDX Incubator program. Under the program, the IDX management will give training as well as provide workspace and other facilities to the start-ups to develop under supervision. They will learn how to develop ideas, launch products, grow a business, create business plans, establish Limited Liability Companies, prepare financial statements, and meet investors.

Various efforts to expand the distribution of mutual funds are also opened by the authority to allow each party that has an extensive customer network to participate as an agent of the mutual fund sales force. The use of digital platforms will play a key role in continuously growing the mutual fund industry and in educating people. Some efforts to enhance the regulations related to electronic transactions and payments and to integrate markets and create efficiencies through the use of the Integrated Investment Management System (S-INVEST) operated by the central custodian have been made. On the other hand, investor protection has also become the focus of the regulator by requiring the digital environment to be focused on investors' data and information protection, adequate information disclosure, and investor complaint handling.

Improving Public Financial Literacy

The regulator expects the investment management industry to play a larger part in promoting and educating the public on the importance of financial planning and investing for the future. In some ways it would benefit the industry as well, as increased awareness would eventually attract a larger investor base and aid in creating a deeper and more dynamic capital market. To achieve this target there are challenges and opportunities that the regulator and the industry face. The key would be to improve financial literacy and introduce mutual funds as an alternative investment product to traditional banking products. The regulator together with the IDX and other industry players collaborate to launch a campaign to raise public awareness of the capital market and improve financial literacy. The collaboration resulted in the national campaign for investing in mutual funds in 2019. This program targets achieving a total of 5 million mutual fund investors as set by the association in the blueprint for the development of the Indonesian investment industry.

On-Track for Future Growth

Overall, Indonesia's capital market and its mutual fund industry are a force ready to be unleashed. The country's demographic wealth and underdeveloped capital market present a set of opportunities and challenges. However, the challenges are not exclusively an Indonesian issue but rather a classic issue of a developing country's struggle to create a vibrant and well-performing capital market. Other countries journeyed through this period and successfully developed their capital markets. Singapore would be the closest neighbor and example for Indonesia. McKinsey & Company's research on Singapore's successful capital market development highlighted it as powerful example of the type of concerted approach policymakers can adopt. The key approaches are: to articulate long-term goals and build consensus; to create and empower regulatory institutions; to leverage a broad set of stakeholders; to develop talent and capabilities; and to invest in strategic promotional activities. Despite some internal philosophical issues that need to be addressed by the industry, Indonesia' capital market direction is broadly in line with the principles mentioned by McKinsey & Company and it is readying as a force to be unleashed.

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Heryadi Indrakusuma, an advisory board member of the Indonesia Investment Manager Association and works as a Director/Chief of Business Development and Advisory Officer of an investment management company in Indonesia. He was appointed vice chairman of the regulatory working group of the Acceleration for Development in Investment Industry task force created by the Indonesia Financial Services Authority to enhance and develop regulation of the investment industry in the Indonesian capital market. The task force members consist of professionals in the investment industry and Financial Services Authority officials and their mission is to continuously review existing as well as proposed regulations for further enhancement and development through the rule making process. He is also an external member of the IT and Risk Committee of the Indonesia Stock Exchange, a team member representing the investment industry in the establishment of an alternative dispute resolution body in the financial industry. He holds a Master Degree in Business Law from the University of Indonesia, a Bachelor Degree in Accounting from Airlangga University and holds Investment Manager and Securities Underwriter licenses issued by the Indonesia Financial Services Authority.