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Importance of Mutual Fund Industry for Capital Market Development

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FOREWORD

In Asian countries, income levels have been rising against the backdrop of high economic growth, and household savings have been increasing. As more people have become able to allocate funds to investment, mutual funds are becoming increasingly important. Mutual funds can be purchased in small amounts and provide opportunities for efficient diversification, making an investment easier for inexperienced and novice investors. In ASEAN countries where capital markets are generally still in the developing stage, assets under management and the number of investors in mutual fund markets are steadily increasing. Although the history of the mutual fund markets is still short in the region, the several changes have occurred in recent years.

The first is the expansion of the types of mutual funds. Mutual funds have been mainly focused on domestic assets. However, the diversification and sophistication of investors' investment needs, with the easing of relevant financial regulations, have led to an increase of investments in foreign assets by mutual funds. In addition, although open-end mutual funds have been mainly offered in this region, the number of closed-end real estate investment trusts and exchange-traded funds is gradually increasing with stock exchanges' efforts to expand a range of their products for investors.

The second change is the diversification of sales channels for mutual funds. One trend is "open architecture". In countries where mutual funds have been sold mainly by asset management companies' affiliated banks and/or sales agents, distributors have started to handle products of various asset management companies. Another trend is the emergence of non-financial online mutual fund distributors. Investors' access to mutual funds has improved, as players outside banks, insurance companies and securities firms have begun to sell them on online platforms. Robo-advisors that enable effective diversification at lower costs are also expected to promote investment in mutual funds, particularly among IT-savvy millennials.

For the mutual fund markets in ASEAN countries to achieve sustainable development, promoting the financial literacy of the people is a major challenge. Generally, mutual funds play an important role of "democratizing" investments in capital markets, but they have not been widely recognized in each country yet. In particular, in some countries where the aging of society is rapidly progressing and the importance of retirement planning is increasing, governments' and financial regulators' policies and initiatives to encourage investment in mutual funds are attracting attention as an effective means of asset formation in the medium and long term.

This issue of Nomura Journal of Asian Capital Markets features articles that discuss the efforts, challenges, and future prospects for the development of the mutual fund markets in ASEAN countries.

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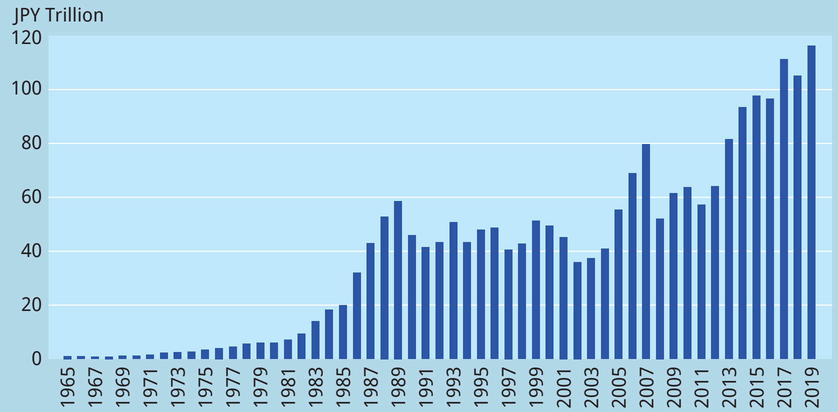
Investment Trusts Industry in Japan

Japan's Investment Trust Market

Investment trusts have existed in Japan since before the Second World War, but the foundations of today's investment trust market were laid in the 1950s. The Securities Investment Trust Act (the predecessor of today's Act on Investment Trusts and Investment Corporations, hereafter the "Investment Trust Act") was enacted in 1951 to establish investment trusts as a receptacle for the large supply of equity stocks created by the postwar dismantling of Japan's *zaibatsu* (family-owned business conglomerates) and by stock's use as payment in kind for property tax. The act was also seen as one means for promoting the democratization of securities investment in Japan. In addition, investment management companies entered into contracts with trust banks to oversee their assets under management (AUM) and protect investors. The act's enactment led Japan's four major securities companies to register as securities investment trust management companies. In 1957, the Securities Investment Trusts Association (now called the Investment Trusts Association, Japan) was established. In 1959, the Ordinance for Enforcement of the Securities Investment Trust Act was revised, requiring investment trust management companies to be separate entities from securities companies. As a result, Japan's four major securities companies spun off their investment trust businesses into separate companies. This can be considered as laying the foundation for today's investment trust industry in Japan.

Over the next 60 years, investment trusts in Japan have weathered several setbacks in the external environment, such as the slump following the bursting of Japan's economic bubble in the 1990s and a steep dropoff during the global financial crisis, and continued to expand, with the outstanding balance of AUM invested in publicly offered investment trusts reaching JPY 126.3 trillion as of end-September 2019 (Figure 1). As of end-June 2019, households' assets invested in investment trusts amounted to JPY 70.3 trillion, or just 3.8% of total household financial assets. While Japanese households' investment in investment trusts has expanded, its share of total household financial assets is much smaller than in the U.S., where households' investment in mutual funds (including Money Market Funds (MMFs)) as of end-June 2019 totaled USD 9.8 trillion, or 11.6% of total

Figure 1: Outstanding Balance of Publicly Offered Investment Trusts



Note: As of end-September 2019.
Source: Investment Trusts Association, Japan

U.S. household financial assets. This data indicates that investment trusts are not considered a core tool for asset formation by Japanese households, which can be considered a major issue for Japan's investment trust industry.

With Japan's birthrate declining and population aging at a rapid pace unseen elsewhere in the world, the importance of investment trusts as a repository for households' stock of financial assets should only increase. Many Asian countries are expected to face similar challenges in the future, as their birthrates decline and populations age. It may therefore be useful to look back at the history of the development of Japan's investment trust industry, its successful initiatives, and issues remaining to be resolved.

Product Diversification

From closed-end funds to open-end funds

The first investment trusts offered in Japan were closed-end funds. As noted earlier, Japan's postwar investment trust framework was created as a receptacle for a sudden increase in the supply of equity shares. To facilitate sales to individuals, new closed-end funds were established every month. For example, new funds with a two-year trust period and a one-month public-offering period were established each month. Japan's initial investment trusts were essentially limited-time savings products sold every month under the premise that stock prices would rise during that period. However, this model's premise became untenable after the collapse of Japan's bubble economy and stock market crash in 1990.*1

As a result, the investment fund market began to see increased issuance of open-end funds, which were already the mainstream in the U.S. and Europe. Open-end funds have fluctuating prices and accept new investments and withdrawals at any time. The number of open-end funds surpassed that of closed-end funds in 1999 and their AUM exceeded that of closed-end funds in 2003. Today, open-end funds account for about 90% of the outstanding balance of all investment trusts in Japan.

Introduction of real estate investment trusts

An amendment of the Investment Trust Act in 2000 removed the ban on real estate as an eligible asset for investment trusts, leading to the establishment of real estate investment trusts in Japan (J-REITs). J-REITs were established to provide small-lot investors with access to real estate investment and to increase the supply of risk money into the real estate market. J-REITs mainly take the form of an investment company (a corporate type investment trust) that lists on the securities exchange and operates a closed-end fund. By this structure, REITs can avoid fire-selling illiquid real estate assets in response to an increase in investor withdrawals, and investors can liquidate their holdings by selling their shares in stock exchanges. REITs must also distribute more than 90% of distributable income to investors as dividends, which are considered as an expense, thus reducing the REIT's taxable income.

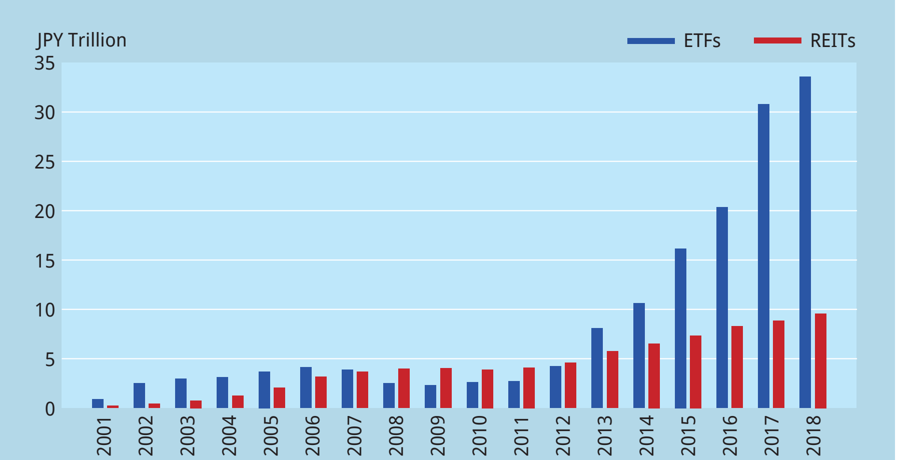
The J-REIT market began with the listing of two REITs on the Tokyo Stock Exchange. The market has since expanded, supported by the development of REIT indices, the establishment of REIT Exchange Traded Funds (ETFs), and the Bank of Japan's purchase of REITs as part of its quantitative easing policy since 2010. J-REITs' investments initially centered on office buildings and commercial facilities but have since diversified to include housing, logistics facilities, and more recently resort and healthcare facilities. In 2015, the J-REIT total market value surpassed that in Australia to become the world's second largest REIT market, after the U.S. market. As of end-2018, Japan had 61 listed J-REITs with a net asset value of JPY 9.6 trillion (Figure 2).

Introduction of ETFs

Japan's first ETFs appeared in 2001, when in-kind contribution type stock index–linked ETFs were listed on the Tokyo and Osaka stock exchanges.*2 The 2001 structural reform of Japan's securities market enacted as part of the Japanese government's emergency economic measures included revising ETF-related systems to promote long-term stable shareholding by individual investors. Since then, ETF offerings have become more diversified, with the listing of industry-specific ETFs followed by the lifting of the ban on commodity ETFs when the Investment Trust Act was amended in 2007 and the listing of leveraged ETFs and inverse ETFs in 2012. In addition, the Bank of Japan began purchasing ETFs in 2010.

This product diversification has supported the expansion of Japan's ETF market, with the net asset value of listed ETFs surpassing JPY 10 trillion in 2014 and continuing to rise sharply thereafter. As of end-2018, 183 listed ETFs had a net asset value of JPY 33.6 trillion (Figure 2). ETFs have become a popular investment tool for investors because they can be bought and sold at market prices during market trading hours and, perhaps even more importantly, because of their low costs. However, it has also been pointed out that the Bank of Japan's purchases of ETFs, which began in 2010 and now total around JPY 6 trillion a year, may be causing market distortions.

Figure 2: Net Asset Value of REITs and ETFs in Japan



Source: Investment Trusts Association, Japan

Diversification of Sales Channels

Bank sales channel

In 1996, the government of then-Prime Minister Ryutaro Hashimoto unveiled its plan for the "Structural Reform of the Japanese Financial Market: Towards the Revival of the Tokyo Market by the Year 2001" and implemented what has been called "Japan's Financial Big Bang." This reform intended to promote more effective investment of Japanese households' financial assets, which at the time amounted to more than JPY 1,300 trillion, and make better use of those assets in the Japanese economy. One of the reforms was the lifting of the ban on direct over-the-counter sales of investment trusts by banks and insurance companies in 1998.[*3]

After the ban's lifting, bank sales of investment trusts were mostly at the major city banks, but over-the-counter sales gradually spread to Japan's regional financial institutions as well. Under the current ultra-low interest rate environment in Japan, banks are having difficulty generating income through traditional deposit and lending activities. Accordingly, expanding fee and commission income has become an important issue for the banks. Japanese banks therefore have been strengthening their investment-related services, with a focus on the sale of investment trusts. In 2005, post offices also began selling investment trusts.[*4]

Bank sales of investment trusts expanded steadily after the lifting of the ban on direct sales by banks, thanks in part to the high level of public confidence in the banks. However, bank sales of investment trusts have slowed since the global financial crisis (Figure 3). One reason for this slowdown may be that bank employees, which were relatively unfamiliar with capital at risk products, had trouble explaining the product to customers when faced with sudden market fluctuations.

Wrap accounts

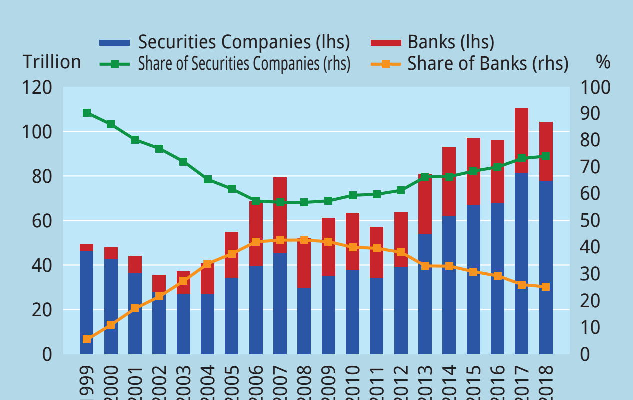
In recent years, wrap accounts have become an increasingly important channel for investment trust sales in Japan.[*5] Wrap accounts consist of a portfolio of multiple investment trusts provided to individual investors by securities companies and similar institutions that have registered as an investment adviser. Wrap accounts were first developed in the U.S.[*6] and later imported into Japan. In addition to traditional securities companies, wrap accounts now are provided to investors by trust banks, independent financial advisers (IFAs) and robo-advisers (see below). In most cases, wrap accounts serve as a platform enabling individual investors to access investment trusts managed by multiple third-party asset managers. Wrap accounts therefore provide asset management companies with a means for increasing fund inflows.

Asset managers' recognition of the need to shift to so-called "fee-based model", where their fees are based on investors' AUM, has supported the growth of wrap accounts. Instead of the traditional model by which asset managers generate a commission for each trade conducted for their clients, wrap account fees are based on the total AUM of the client's portfolio and assume goal-based financial planning. Accordingly, increases in portfolio value benefit both the investor and the asset manager, thus aligning their interests. Japan's Financial Services Agency has positively evaluated this "fee-based model", which is now becoming increasingly popular among individual investors. Investment trust sales companies also are increasingly aware of the need to shift from conventional brokerage services that use a commission-based model to "fee-based model" that generate stable income as their clients' assets grow. Wrap accounts have therefore increased notably since 2015, with total AUM reaching JPY 8.8 trillion as of end-March 2019 (Figure 4).

New sales channels: Robo-advisers and IFAs

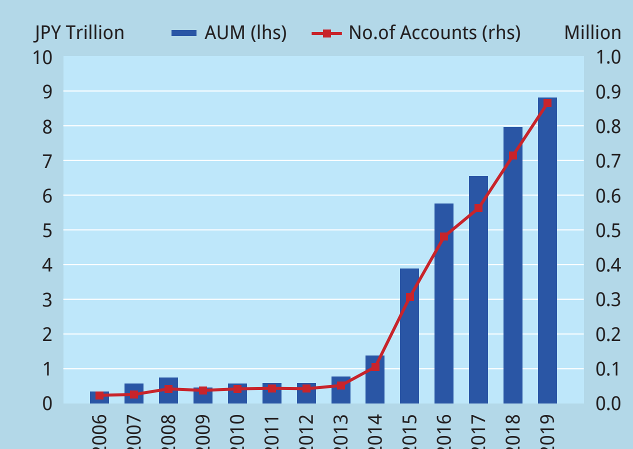
Recent years have seen the emergence of two new channels for investment trust sales – robo-advisers and IFAs. Robo-advisers are platforms that provide online discretionary investment services. Robo-advisers in Japan are modeled after the platforms developed in the U.S. and Europe. Online brokerage companies in Japan have expanded since the complete liberalization of stock trading commissions in 1999, but their expansion is limited because they essentially serve do-it-yourself

Figure 3: Sales of Publicly Offered Investment Trusts by Securities Companies and Banks and Each Channel's Share of Overall Sales



Note: The graph does not include direct sales by asset management companies.
Source: Investment Trusts Association, Japan

Figure 4: Wrap Account Numbers and AUM



Note: Discretionary and advisory accounts. Data as of end-March each year.
Source: Japan Investment Advisers Association

(DIY) investors capable of making all their own investment decisions. Robo-advisers provide investors with more in-depth support than that available from online brokers. Robo-advisers provide investors with an investment portfolio based on their answers to a questionnaire that asks about their risk tolerance, investment timeframe, and other investment-related topics. Portfolios mainly consist of low cost funds such as ETFs. This utilization of low cost funds, together with customer interface without human advisors, amounts to the most important feature of robo-advisers, which is to provide low-cost discretionary investment services. Robo-advisers are still in its infancy in Japan and have yet to achieve any widespread usage by Japanese investors. One possible reason for Japanese investors' hesitancy to use robo-advisers may be the lack of proactive recommendations in the online robo-adviser business model.

IFAs are companies and/or individuals who are not employees of traditional securities companies or other financial institutions and provide their clients with unbiased investment advice from an independent position. In Japan, IFAs are modeled after registered investment advisers (RIAs) in the U.S. and traditional IFAs in the U.K.. In the Japanese system, IFAs are registered financial products intermediary who are then entrusted to provide investment advice to clients by a financial instruments business operator, such as a securities company. Account management and compensation for losses are the responsibility of the securities company. Although IFAs are expected to be independent and neutral, the IFA role is still rather new and there remains wide differences in the sophistication and expertise of the practitioners.

Measures to Promote Greater Use of Investment Trusts: Preferential Tax Treatment

Defined contribution pensions

Japan introduced defined contribution (DC) pensions in 2001. Contributions to and investments made in DC pensions are tax exempt, with taxation occurring only when the individual receives the pension benefits. The individual establishes a personal account and gives instructions on how the funds are to be invested. In general, investment options include various investment trusts. DC pensions have therefore become another sales channel for investment trusts. The U.S. 401(k) plans and Individual Retirement Accounts (IRAs) that served as a reference point for Japan's DC pensions helped drive growth of the U.S. mutual fund market in the 1990s and stimulate investment education.

Although the investment of pension funds should focus on diversified investment that leads to asset accumulation over the long term, about half of Japan's DC pension assets are allocated to bank deposits and insurance products that focus on principal protection. Although employers have an obligation to provide employees with investment education and many financial institutions that serve as pension fund managers also provide investment education to plan participants, current asset allocation indicates that these efforts have not been very successful. In 2017, Japanese version of DC default fund was introduced to establish a default fund to be used when plan participants do not specify how their pension contributions should be invested. However, a survey conducted about a half year after the method was introduced revealed that 70% of pension funds were still using bank deposits and insurance products as their default investment products.

Since Japan's introduction of DC pensions in 2001, plan participants have steadily increased, with the total reaching 8.47 million as of end-June 2019. In 2017, eligibility for participation in individual DC plans, called iDeCo for short, was expanded to include non-employed stay-at-home spouses (male or female) and public employees.

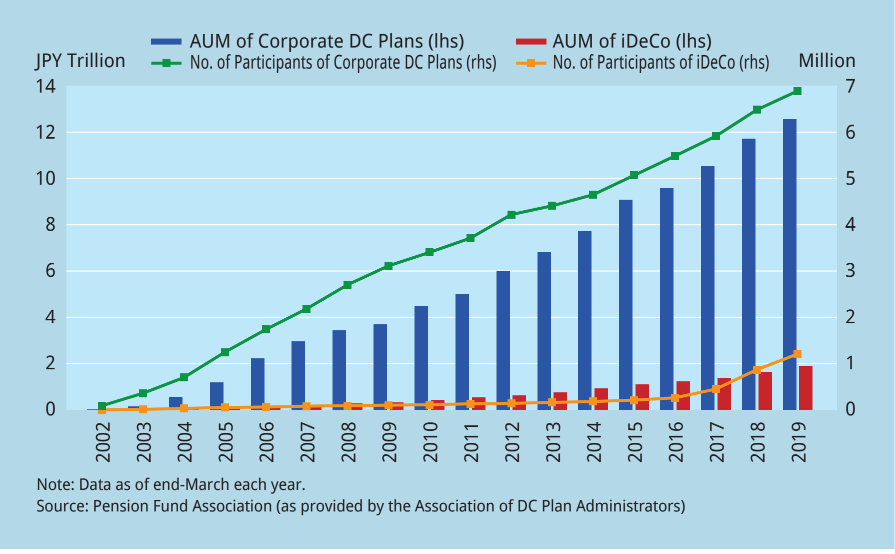
DC pension plan AUM totaled JPY 14.4 trillion as of end-March 2019 (Figure 5). This is a rather small figure compared with the JPY 77.5 trillion AUM in Japan's defined benefit (DB) pension plans,*7 even when considering the relatively short history of DC plans. DC plan contribution limits have been gradually raised since DC plans were first introduced, and personal contributions to corporate DC plans were introduced in 2012. Nonetheless, further expansion of the DC system is desirable. The current contribution limit is too low and needs to be raised for DC plans to play an important role in asset formation for retirement.*8

NISA

In 2014, Japan introduced a small-lot tax-exempt investment system for individuals modeled after the U.K. Individual Savings Account (ISA). The Nippon ISA, or NISA, is intended to support household asset formation and strengthen the supply of growth money. Under NISA, individuals can invest up to JPY 1.2 million a year in stocks, investment trusts, and other financial products. Dividends and other distributions as well as gains from the sale or transfer of assets in the account are not taxed for the maximum account holding period of five years (which allows individuals to invest up to JPY 6 million in a NISA account). Accounts for NISA can be opened for a limited time, from 2014 to 2023.

Two derivative types of NISA have also been established. The first is the Junior

Figure 5: DC Pension Plans' AUM and Participant Numbers



Note: Data as of end-March each year.
Source: Pension Fund Association (as provided by the Association of DC Plan Administrators)

NISA, established in 2016 and modeled after the U.K. Junior ISA. The Junior NISA was created to support asset formation for children's future. Tax exemption and the five-year holding period for accounts opened by 2023 are the same as for general NISA. However, the accounts must be opened in the name of minors 19 years of age or younger, and the annual investment limit is JPY 800,000 (for a total investment of JPY 4 million over five years). In addition, in principle funds cannot be withdrawn from the account until the account holder is 18 years of age.

The other derivative NISA is the installment-type NISA, introduced in 2018. These accounts encourage long-term investment based on regular monthly contributions of a fixed amount. While annual investment is limited to JPY 400,000 (approximately JPY 33,000 yen per month), new contributions can be made from 2018 to 2037 and maximum holding period has been extended to 20 years. Eligible investment products are limited to low-cost investment trusts. For example, equity investment trusts must be no-load funds with management fees below a certain level (0.5% for investment trusts linked to a domestic equity index). In addition, monthly distributions are not allowed.

As of end-June 2019, the number of accounts for general NISA was about 13.09 million with cumulative contributions totaling JPY 17.6 trillion. While these figures are small relative to the potential market size, they represent steady growth over the five years since NISA was first introduced.

The future expansion of the NISA system as an asset-building tool that can be easily accessed by a wide range of people is highly desirable. The main impediment to further expansion is the current limited timeframe for this initiative. Users of the U.K. ISA expanded after the system was made permanent. Similarly, Japan's financial industry has been asking the nation's tax authority to make NISA a permanent system.

Japan's Experience a Useful Point of Reference

In recent years, the middle class in Asian countries has been expanding. As their financial assets expand, so will their need for effective investment instruments, including diversification into overseas investments. Expanding the supply of growth money to domestic and regional industries also will be important. Investment trusts can play a very important role as a tool to realize these goals. Expansion of investment trusts as major institutional investors also is important for the sophistication of Asian securities markets.

Asian countries also are expected to experience further aging of their populations. While Asian societies are still young and in a growth phase, it will be important for them to establish systems that support long-term, diversified, installment-type investments. Diversification of investment products and system reforms that include beneficial tax measures merit careful consideration as means to achieve this goal. Asian countries also will need to keep pace with the digitalization of financial services that is occurring in the more advanced economies of North America and Europe. The lack of legacy systems should facilitate rapid change in Asian countries.

Of course, while we refer to "Asian countries" as a single group, they are actually a highly diverse group of countries with many differences. Some Asian countries are already expanding the use of DC pension plans, while REITs and ETFs are already available in some countries. The key points for development of the investment trust market in each county therefore will be different. The strong and weak points to be found in Japan's experience should provide a useful reference for Asian countries.

Notes

*1 Sugita, Koji. Hossoku kara man 60-nen wo mukaeru Nihon no tōshi shintaku – sono kiseki genjō to kongo no kadai – (Japanese only, unofficial translation: Investment trusts in japan – a history of the first 60 years, current situation and future issues), May 18, 2011.

*2 Nikkei 300 Index Exchange Traded Fund was traded on the Tokyo and Osaka stock exchange since 1995, but the nature of these investment trusts was different from today's ETFs and transaction volume was smaller as they were not allowed to use in-kind contributions and additional fund establishment was limited.

*3 The ban on over-the-counter sales of investment trusts by investment trust management companies renting space at banks was lifted in 1997.

*4 Today, post offices sell financial products, including investment trusts, as a financial products intermediary for Japan Post Bank.

*5 Rather than being a sales channel similar to securities companies and banks, wrap accounts actually are a product or service provided by securities companies and other financial institutions. However, for the sake of convenience, they are treated as a sales channel in this article.

*6 In the U.S., "managed account" is a general term that includes wrap accounts and various other individual accounts such as "rep as advisors" and "rep as portfolio managers". Japan also has several types of managed accounts, which are collectively referred to as "wrap accounts" in this article.

*7 According to data as of end-March 2019 announced by the Investment Trusts Association, Japan and including pension plans managed by the investment trust industry, the life insurance industry, and the National Mutual Insurance Federation of Agricultural Associations (JA Kyosairen).

*8 For example, an employee participating in a corporate DB pension plan can contribute JPY 27,500 a month; individuals participating in an individual-type DC corporate plan can contribute JPY 20,000 a month; and participants in other corporate pension plans and public employees can contribute only JPY 12,000 a month.

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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

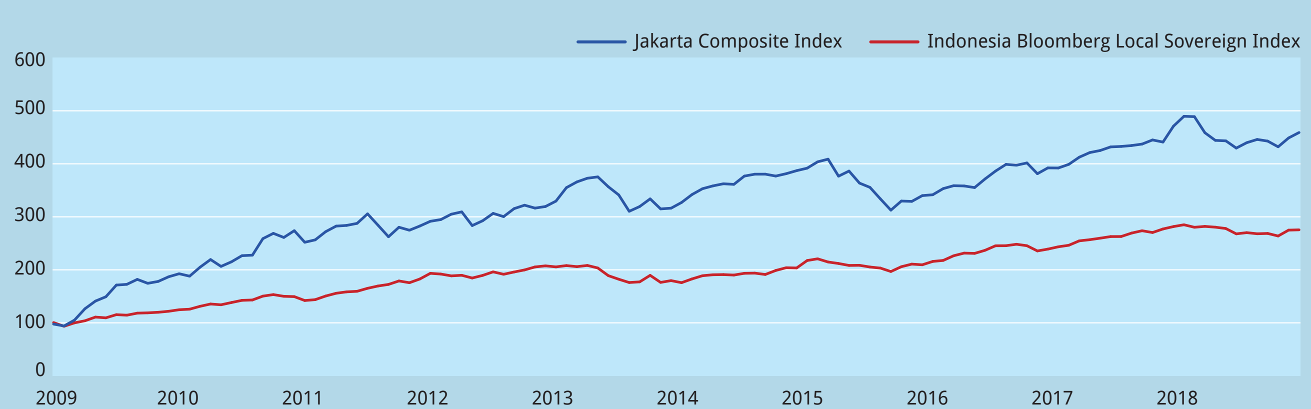
Indonesia's mutual fund industry is currently considered still in infant stage since the first mutual fund was introduced 23 years ago, a year after a new capital market law was rolled out by the government. As the population of the country is more than 271 million where young people would one day dominate 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.

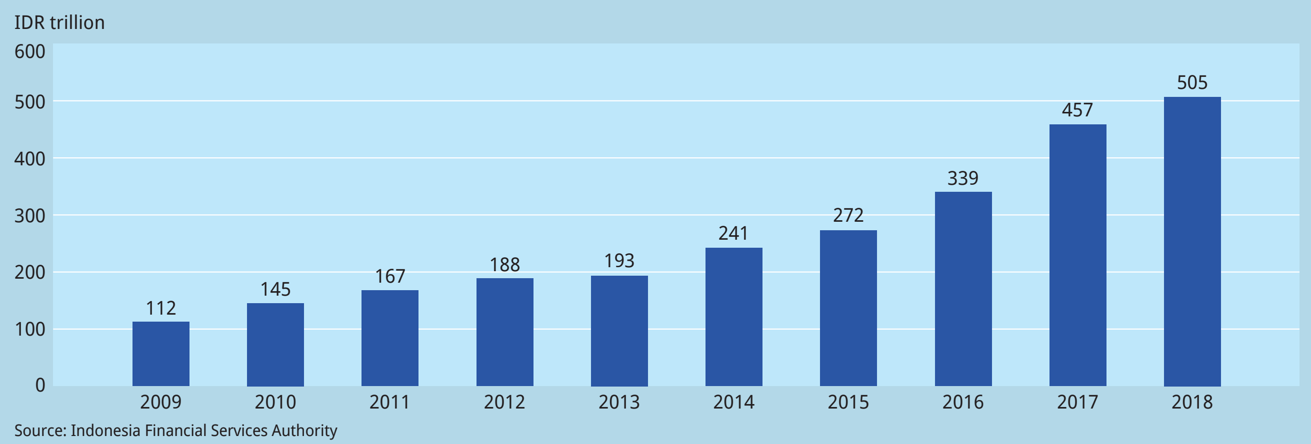
In all, Indonesia's mutual fund industry enjoyed a period of high growth in the past 10 years. Total AUM of the industry more than doubled from IDR 241 trillion in 2014 to IDR 505 trillion at the end of 2018 (Figure2).

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

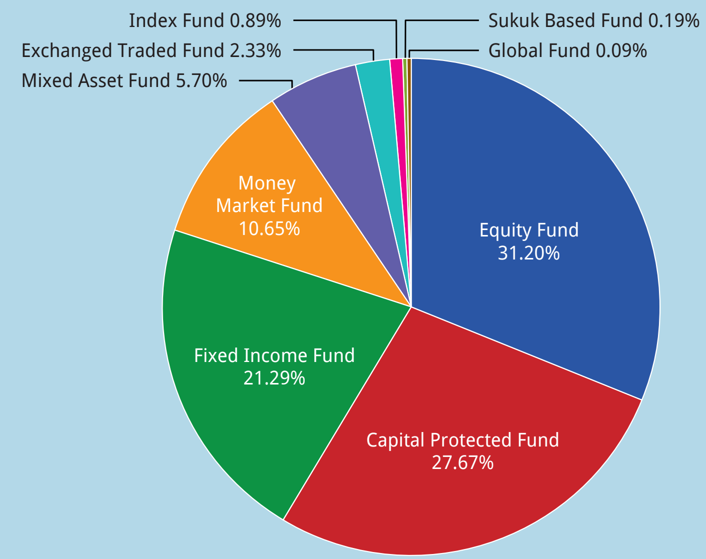
Figure 2: AUM in Indonesia's Mutual Fund Industry



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.

Institute for Capital Market Research Malaysia

INSTITUTE FOR CAPITAL MARKET RESEARCH MALAYSIA

The Evolving Business of Asset Management in Malaysia

The Changing Landscape

Global assets under management (AUM) is expected to rise rapidly in the near future, estimated to almost double from US$84.9 trillion in 2016 to US$145.4 trillion in 2025.*[1] This growth has been premised on the asset management industry being able to fill in the financing gaps which emerged post Global Financial Crisis (GFC) due to the regulatory constraints on banks. However, this growth is likely to be uneven between developed and developing markets, as Asia Pacific is anticipated to be the centre of this expansion with estimated growth at 11.8% from 2020 to 2025.

In tandem, the landscape for the asset management industry is also rapidly changing. Apart from grappling with cyclical macroeconomic and market uncertainties, the industry has to also navigate structural evolutions such as the advent of digitalisation, changing demographic trends and investors' preferences, talent shortages and tighter regulatory requirements that demand higher thresholds of accountability, governance and transparency. Globally, this has led to further industry consolidation, indicating that the global environment may disrupt existing business models of asset managers.

Amidst these changes, it is important to remember that the asset management industry remains one of the core constituents of today's financial markets, and plays a vital role for the overall economy. It fulfills the essential function of intermediating savings into investment channels, facilitating greater capital mobility, and can create wealth effects while ensuring inclusive participation in the capital market.

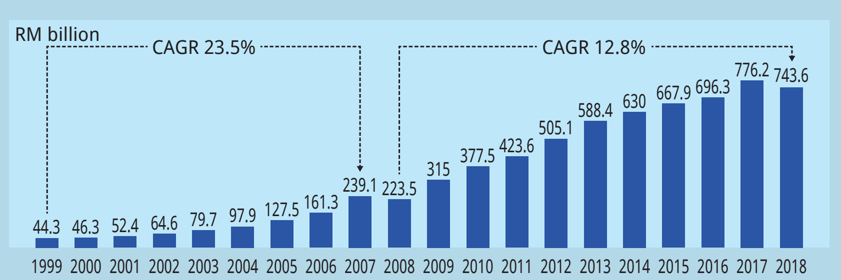
In addition, there are the non-financial positive externalities of enhancing the stewardship role and nurturing human capital development in the financial industry. Despite the structural challenges, it is imperative that policymakers continuously reassess whether the industry is aligned to these core functions in the overall economy.

Malaysia's State of Play

The Malaysian asset management industry has achieved strong growth over the last two decades, with total AUM experiencing a double digit compound annual growth rate (CAGR). However, CAGR of AUM has started to taper following the GFC, particularly in the last five years which saw single digit year-on-year growth with a contraction in 2018 (Figure 1).

While AUM growth is a reflection

Figure 1: Malaysia AUM, 1999 to 2018



Source: Securities Commission Malaysia

of headline figures, a cursory review of these aggregated numbers may mask certain important characteristics underpinning the industry's structure and dynamics.

The industry is highly concentrated with Malaysia's asset management industry being anchored by only a few large players. As at December 2018 there were a total of 80 portfolio management companies licensed by the Securities Commission Malaysia (SC), with the top five largest contributing 57.4% of total AUM in 2018.*[2]

Asset allocation remains mostly domestic, with a large focus on public securities. In 2018, 79.4% of the assets were allocated domestically, amounting to RM590.0 billion while assets allocated outside of Malaysia amounted to RM153.5 billion. The country has nevertheless seen an increase in foreign allocations from merely 16.7% in 2013 to 20.6% in 2018 (Figure 2).

The majority of the funds' allocations in 2018 were concentrated within traditional asset classes such as equities (47.2%), money market instruments (22.7%) and fixed income (21.4%). Only 1.5% of the assets managed are allocated for private equity and unquoted securities.

While the traditional equities and fixed income classes have taken the lion's share of the total asset allocations, the growth of other funds has been gradually picking up on a year-on-year basis with allocations in feeder funds (CAGR 17.4%) and private equity/unquoted securities (CAGR 8.0%). This suggests alternative asset classes, especially multi-asset solutions' feeder funds, private equity and private debt, have become more favourable as investors diversify their assets to reduce volatility and achieve specific outcomes.

Unit Trust Funds as the Biggest Segment

Prior to the GFC, unit trust funds accounted for more than 70% of the total asset management industry. By 2018 this has reduced to 57.3%, in line with the growth of wholesale funds and funds sourced through the Employees Provident Fund (EPF). However, unit trust funds remain the backbone of Malaysia's asset management industry as it is the largest contributor to the growth in assets, with Net Asset Value (NAV) increasing to RM426 billion, equivalent to 25.1% of stock market capitalisation in 2018. The majority of unit trust fund products remain concentrated in equities (69.4%) and money market (14.6%) strategies. As at December 2018, there were a total of 650 unit trust funds offered with majority similarly concentrated in equities (47.5%) and bonds (20.3%).

Broadening of Distribution Channels

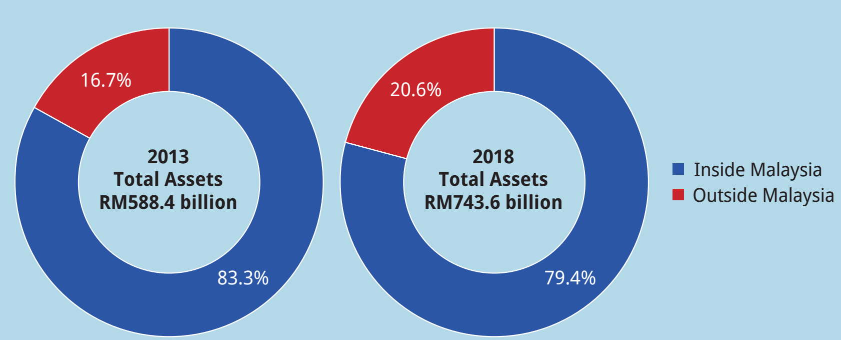
There are generally three different distribution channels for offering funds in Malaysia. The industry started off based solely on the agency model in the early 1990s where fund houses distribute their funds via their own agents or consultants. Unit trust agents and private retirement scheme agents have played a major role in developing the retail asset management industry, with growth in these two segments having provided employment and income opportunities for over 59,000 individuals in Malaysia.

However, according to market participants, this traditional agency-based model often requires clients to pay up to 5.0% commission to distributors and their agents. While the agency-based model has been successful in reaching out to retail investors, the lack of an open architecture system has led to concerns that the fee-based structure could be a cause for conflicts of interest, with clients' financial needs not being prioritised.

Faced with digital disruption and the rise of on-demand services, the industry has sought to introduce new channels to reach a broader audience. A supermarket for investment funds, Fundsupermart.com, was launched by iFast in 2008 following its debut in Singapore in 2002 and Hong Kong in 2007. The first roboadvisory, StashAway, entered the market in late 2018, introducing a purely digital platform with AI-enabled investment processes and lower management fees of 0.2%-0.8%. In August 2019, EPF launched its i-Invest online platform, which allows members to invest a portion of their retirement savings into approved unit trust funds. The online platform allows members to compare different unit trust funds, and to continuously transact and monitor their investments online. The relatively low fees of 0.5% on the i-Invest platform could potentially put pressure on the traditional agency model or other digital players.

As the industry seeks to broaden its customer base, some market participants have progressed to enlarge its distribution pipeline via partnership models. Through these models, agents are trained to approach clients more from a portfolio perspective--assessing client's financial goals, return expectations and risk appetite before recommending suitable asset allocations. Effort is then tilted more towards a client needs-based approach rather than merely pushing products.

Figure 2: Asset Allocation Composition between 2013 and 2018



Source: SC

Widening Range of Products

Although unit trust funds constitute the largest portion of the asset management industry, wholesale funds – which are sold to sophisticated investors*3 – have the fastest growth rate in terms of fund category, rising 53.6% on a year-on-year basis from 2008 to RM64.95 billion in 2018. The number of wholesale funds offered has increased significantly over the last decade, from just 29 funds in 2008 to a peak of 313 funds in 2016, before tapering off at 307 funds in 2018. This growth is reflected in the various ongoing efforts driven by policymakers to enhance efficiencies and promote greater competition in the fund market.

The concept of Real Estate Investment Trusts (REITs) was introduced in 2005 to widen the breath of products offered by asset managers. Since the debut of Axis REIT, the first Malaysia-Real Estate Investment Trust (M-REIT), in August 2005, the market has grown by leaps and bounds in terms of both NAV and number of listed REITs. Over the last decade, total NAV of M-REITs has experienced phenomenal growth from a mere RM5.93 billion in end 2008 to a considerable RM34.57 billion by 31 December 2018, which is close to six-fold. M-REITs have had a stable ride over the past decade as they are viewed as a preferred safe haven amid the current market volatility and a tool to increase liquidity in a traditionally illiquid real estate market, as well as an opportunity to enrich diversification in a mixed-asset portfolio.

First introduced to the Malaysian market in 2005, as of December 2018 there are ten Exchange-Traded Funds (ETFs) listed on Bursa Malaysia with a combined market capitalisation of RM1.98 billion. In seeking to optimise market efficiency, policymakers have established a taskforce to revisit some of the development issues in relation to the domestic ETF market. The taskforce has introduced several initiatives and recommendations aimed at attracting greater participation and incentivising issuances by ETF managers in the Malaysian market.

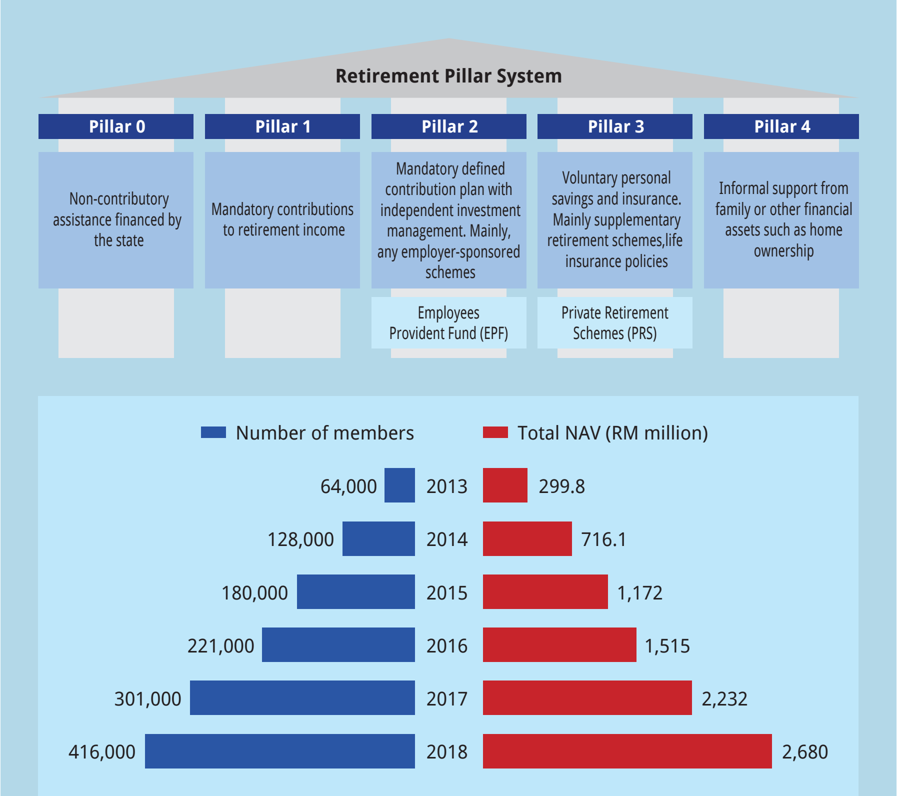
Private Retirement Schemes as a Means of Enhancing Retirement Savings

In line with global trends, it is estimated that 14.5% of the Malaysian population will be above 65 years of age by 2040, due to a combination of declining fertility rates and longer life expectancy.*4 Private Retirement Schemes (PRS) in Malaysia were established by the SC in 2012 to address the growing challenges in relation to adequacy of retirement savings as the country progresses towards an ageing population. The PRS is a voluntary long-term savings and investment scheme designed to assist saving more for retirement. It forms the third pillar in a multi-pillar pension framework established by the World Bank, complementing Malaysia's mandatory retirement savings schemes.

Each PRS offers a choice of retirement funds from which individuals may choose to invest in based on their own retirement needs, goals and risk appetite. Funds under PRS have expanded 55% CAGR to RM2.68 billion and the number of PRS members also grew significantly to 416,000 (Figure 3).

To date, there are eight PRS providers approved by the SC which offer retirement investment solutions designed for three different risk profiles, namely conservative, moderate risk and growth/risk takers. Members are permitted to switch funds anytime within the same scheme, or alternatively transfer their scheme to another provider on an annual basis. While the contribution is voluntary, withdrawal is however permitted once a year and some types of withdrawals could have an 8.0% penalty imposed on the withdrawn amount. As an incentive for contributors (both individuals and employers), they are accorded with the benefit of tax deduction up to RM3,000 on a yearly basis and employers' tax deduction for any contributions made above the EPF statutory rate of 13.0% with a maximum cap of 19.0%. In order to encourage greater savings amongst the younger generation, youth between

Figure 3: World Bank Pension Conceptual Framework, and PRS AUM



Source: World Bank, SC

20-30 years of age will be given a one-off RM1,000 incentive by the government if they open a PRS account with a minimum contribution of RM1,000.

Insights from the Industry

Amidst this fast-changing landscape, the Institute for Capital Market Research Malaysia (ICMR) collaborated with the Nomura Institute of Capital Markets Research (NICMR) on a research project that focused on the state of preparedness of Malaysia's asset managers for the structural evolutions of the industry. The research began with a compilation of data and trends over the last decade and an analysis of the overall landscape in Malaysia. In order to develop a comprehensive and holistic understanding of the asset management industry, ICMR and NICMR conducted eight focus group dialogues (consisting of 21 C-suite level personnel from licensed asset management companies) and interviews with three key institutions as well as engagements with the regulators.

Further, to ensure there was an objective and quantitative approach in undertaking this study, an online survey was rolled out to all licensed asset managers. Responses were received from asset managers that represented 78% of total AUM for 2017.[*5] The survey was structured around key structural challenges that had emerged from the dialogue and engagement sessions, namely shifting business strategies, changing demographic trends and investors' preferences, digitalisation, market regulation and talent. Some of the key findings from the survey include:

- In the next 12-24 months, it was highlighted that "changes in investors' preferences" was the most critical external shift affecting their businesses, followed by changes in regulatory requirements as well as macroeconomic and market conditions.
- In terms of the key customer segment asset managers are targeting over the next five years, 88% are targeting local clients, out of which the majority are targeting local institutional clients.
- 77% of asset managers foresee that there will be increasing demand by investors for both Sustainable and Responsible Investments (SRI) funds and private mandates. 71% also see a shift happening towards wholesale funds.
- In terms of asset class, while investors' preferences are moving towards non-domestic equities and alternatives, asset managers also highlight that these are precisely the areas where there exists a tremendous talent gap.
- While 89% of our asset managers concur that digitalisation will impact their business in the next 12 months, their digitalisation priority would focus on enhancing day-to-day middle and back office operations, as opposed to more disruptive technologies.
- In relation to the pervasive lack of talent in the industry, about 70% of asset managers agreed there was difficulty in finding capable professional talent.
- More than 50% of asset managers believe that streamlining regulations from different parities and flexibility to allocate assets in domestic and foreign markets are key areas that regulators could review to further facilitate growth of the industry.

Moving Forward

Based on jurisdictional studies, survey findings and feedback from our consultations, the report sets out nine interconnected recommendations that holistically address underlying structural issues, as well as specific industry challenges. The recommendations also leverage on NICMR's in-depth knowledge of the Japanese asset management industry to identify possible solutions. These recommendations were designed to be considered by both policymakers and industry players in a holistic manner.

In line with this, the recommendations were formulated with the overarching aim of strengthening the asset management industry across the value chain, while anchoring it with three strategic outcomes that reflect the core functions of the industry (Figure 4).

Figure 4: Overarching Strategic Outcomes

Promoting inclusive capital markets	• Regulators, asset managers and industry players alike need to be cognisant of the broad range of investors (both existing and potential) and their differing preferences. In order for the capital market to be truly inclusive, greater segmentation as well as tiering of regulation, widening of products and distribution channels is required.
Strengthening intermediation role	• Asset managers can play an important role in promoting capital accumulation by facilitating greater capital mobility for investors, both retail and institutional. Malaysian asset managers that can increase their market share abroad can also play a virtuous cycle in attracting more foreign capital into Malaysia, which will help enhance the vibrancy and liquidity of our capital market.
Enhancing value creation	• Given the ongoing structural of the asset management industry, asset managers will need to enhance their value creation for capital market stakeholders in order to survive. They will need to find innovative ways and rethink their strategies to obtain greater competitive advantage and shift from traditional business models.

Source: ICMR

Summary of Recommendations

Facilitating market diversity for revitalisation

For asset managers, diversifying the investor base and asset classes is an important facet to enable them to serve the growing needs of an evolving economic structure and increased societal demands in Malaysia. There is a need to look at how asset managers can internationalise and tap on the growing wealth in emerging markets, be it from government initiatives like regional harmonisation efforts and further domestic regulatory flexibilities, or private-sector driven like setting up of overseas offices, consolidation via mergers and acquisitions or through cross-border partnership structures such as strategic alliances or joint ventures. This is also important for the purposes of capital mobility, diversification and to reduce risks stemming from concentration in the domestic market. Asset managers play a key intermediary role in ensuring a good balance and a virtuous cycle of capital flows which will contribute to the growth of Malaysia's market. Underlying this, all market stakeholders need to ensure that there is a vibrant market with sufficient breadth and depth of both investors and high-quality issuers.

Going beyond mere capital with differentiated strategies

In light of increasing competition and changing structural trends, asset managers have to rethink their strategies and embrace different business models. Asset managers that look beyond the traditional role of mere capital intermediation and are willing to adopt specialised strategies will be able to differentiate themselves from their competitors, while also enhancing the long-term value of investee companies. This could include looking at ESG strategies and the convergence between Islamic and SRI value propositions, as well as embracing smart-beta strategies and other thematic investments.

Developing talent through internationalisation and reciprocal relationships

Throughout our engagements and survey, talent has been highlighted as a perennial issue, and this extends to even the ancillary services. Asset managers should look towards internationalisation efforts, including leveraging cross-border partnership structures or existing regulatory frameworks that allow for cross-border flexibilities. With increasing competition for the same sources of funds, there also needs to be a reassessment of the relationship between asset owners and asset managers to one that is more reciprocal in nature, with asset managers receiving more transparent, performance-based compensation in exchange for providing specialist skills to asset owners. There should also be a reassessment of the effectiveness of special schemes in bringing in talent.

Embracing the digital disruption

Digitalisation is rapidly disrupting many industries, including financial services and asset management. Asset managers will need to look beyond short-term profit to develop long-term digital strategies and make the necessary investments for the future. Digital strategies should also be tailored according to each asset manager's target clientele, with an eye towards the future generation of investors. There is a need for asset managers to be cognisant of and be prepared for the global shift towards digital platforms and roboadvisory models. Regulators and asset managers should also think of innovative ways in which asset management can harness other fintech and digital offerings, for instance microinvesting, digital-only banking and mobile payment systems. In addition, traditional asset managers can look toward tapping into accelerator programmes within the fintech and venture capital community to identify key challenges where fintechs and other startups can be leveraged to deliver innovative investment offerings and experiences to investors.

Making PRS a more attractive option

In order to enhance the value proposition of PRS, it needs to be an attractive option for investors in terms of returns and diversity while still providing the necessary mechanisms to ensure savings are available for retirement purposes. There is a need to look across the PRS value chain, including a harmonised review of regulations to allow for a more sophisticated and diverse range of products, increasing diversity of PRS providers, encouraging employers to adopt PRS, and a review of tax incentives. Leveraging on the findings of behavioural economics (e.g., automatic enrolment, switching to opt-out default options, enhancing awareness of expected income replacement rates, providing more nuanced and targeted default options) could also be key to spurring growth of PRS.

Widening product range

It is crucial to ensure that there is a wide range of products that can attract new customers and help investors diversify their portfolios while also driving market innovation. Infrastructure funds could be a means of channeling available financing to support national and regional infrastructure development, while also meeting the increasing demand from investors for funds based on non-traditional assets. REIT-ETFs are also another product that asset managers could consider, as it will allow investors to engage in the property sector while enjoying the long-term stability of ETFs.

Strengthening the value of distribution channels

There have been concerns that Malaysia's asset management industry has one of the highest fee structures globally, particularly for retail investors. With digitalisation of financial services and downward pressure on fees, investors are faced with an increasing array of choices, each with their own benefits and value proposition. While the agency model remains a key distribution channel to retail investors in Malaysia, it becomes all the more pertinent that unit trust agents strengthen the value of their services to remain competitive. Unit trust agents should look towards moving up the value chain and becoming Certified Financial Planners and Certified Financial Advisors for the purpose of providing comprehensive financial planning and advisory services for their clients. Not only will one-stop financial advisory give agents an edge and maintain their relevance in this changing world, but also agents who have a holistic overview of clients' portfolios will be able to better assess their risk appetite and help them move up the investment curve, while also introducing new monies into the asset management space.

Embedding financial literacy

While various policymakers, regulators and agencies have undertaken significant efforts on financial literacy, there is still a pressing need to address the existing gaps. The private sector should step in and play a more active role in promoting investor education beyond mere promotion and marketing of their products. Regulators and policymakers should also adopt targeted approaches for more effective outreach, including segmented benchmarking and application of behavioural economics principles.

Establishing a high-level task force to address regulatory and policy harmonisation

Establishment of a high-level task force to ensure cohesive regulatory and policymaking from the top could drive more effective change in the asset management industry. This will require a holistic assessment, input and coordinated efforts of multiple stakeholders including various ministries, government agencies, regulators, Government Linked Investment Companies (GLICs), and industry players.

Extracted from *The Evolving Business of Asset Management: Malaysia's Perspective* that was launched in June 2019. This report presented the findings from a joint research collaboration between ICMR and our research partner from Japan, NICMR. The full report is available online at https://www.icmr.my/the-evolving-business-of-asset-management/

Notes

*1 PwC (2017) *Asset & Wealth Management Revolution: Embracing Exponential Change*

*2 Securities Commission Malaysia Annual Report 2018

*3 Sophisticated investors are either accredited investors, high-net worth entities or high-net worth individuals, as defined by Schedule 7 of the Capital Markets & Services Act 2007.

*4 Department of Statistics, Malaysia (2016) *Population Projections Malaysia 2010-2040*, available online at https://www.dosm.gov.my/v1/index.php?r=column/ctheme&menu_id=L0pheU43NWJwRWVSZklWdzQ4TlhUUT09&bul_id=Y3kwU2tSNVFDOWp1YmtZYnhUeVBEdz09

*5 Survey excludes AUM of Permodalan Nasional Berhad (PNB). Separate engagement sessions were conducted with PNB.

INSTITUTE FOR CAPITAL MARKET RESEARCH MALAYSIA

The Institute for Capital Market Research Malaysia (ICMR) was established by the Securities Commission Malaysia as an independent think tank initiative that aims to promote sustainable development of the Malaysian capital market through providing focused, pragmatic and evidence-based research and solutions. ICMR undertakes research projects through a multi-stakeholder and collaborative approach, drawing insights and best practices from international experts as well as harnessing the knowledge and experience of Malaysia's regulators, policy makers, industry players and academia.

FUND MANAGERS ASSOCIATION OF THE PHILIPPINES

Investment Funds in the Philippines

Introduction

The Philippine Statistics Authority (PSA) estimated that the country's population would surpass 110 million by 2020 and, according to Commission on Population and Development Executive Director Juan Antonio Perez III, as of December 2019, the country's working age population reached 70.3 million or 64% of the total population. Importantly, this group has a median age of only 23.1 years, making it the youngest in the Asia Pacific region. Thus, these working-age Filipinos represent a sweet spot for the economy, conferring a demographic advantage to the country's growth. Moreover, through their financial decisions, they could have a multiplier effect on economic growth if they receive the proper education, guidance and support.

With this potential in mind, in September 2019, the Philippine House of Representatives approved House Bill No. 304 which covers the fourth package of the Duterte Administration's comprehensive tax reform program. The bill provides for a more efficient tax on capital income and financial intermediaries in the financial sector, including the tax provisions on Collective Investment Schemes (CIS). A CIS is any arrangement whereby funds are solicited from the investing public and pooled together for the purpose of investing, reinvesting and/or trading in securities or other investment assets or different classes thereof. There are three common types of CIS and these are mutual funds (MFs), unit investment trust funds (UITFs) and variable-universal life (VUL) insurance. They are governed by three separate regulatory bodies, the Securities and Exchange Commission (SEC) for MFs, Bangko Sentral ng Pilipinas (BSP) for UITFs, and the Insurance Commission (IC) for variable-universal lifes (VULs).

The Mutual Fund Industry

The MF industry is the most transparent and investor participative investment option in the Philippines. MF is an investment company which is made up of a pool of money collected from shareholders to invest in various securities like bonds, stocks, money market instruments, and other assets. The concept of MFs in the Philippines can be traced back to the early 1950s when the increasing prominence of off-shore funds worldwide led to the creation of MFs in the country. Since it was a new financial vehicle at that time, there was no law governing the establishment and operations of MFs. As a result, MF companies were registered as finance companies.

The lack of rules and regulations allowed for scams to plague the industry and for these finance companies to exploit investors. Some firms implemented long-term investment programs wherein they made the investor commit to a fixed payment scheme, pocketing the initial subscriptions within the first year as commission and obliging investors to make successive payments in the hope that they could breakeven. Some MFs even made profits off the excessive front-end charges ranging from 8% to a staggering 50%. Under these circumstances, many investors expressed their disapproval of the way these funds were being sold and managed. Eventually, the collapse of the stock market in the late 1950s brought about the closure of three of the four MF companies in operation, and the absence of regulatory oversight became glaringly obvious.

In light of this fiasco, the government enacted RA 2629 otherwise known as The Philippine Investment Company Act (ICA) in June 1960. This act, which derives many of its provisions from the US ICA of 1940, was designed to ensure the protection of investor rights. It grants the SEC authority to prescribe the regulation of investment companies and requires investment companies to register to operate as such by filing a registration statement with the SEC (Section 7). Likewise, it stipulates that securities issued by the investment companies must be registered under the Securities Act (now Securities Regulation Code) (Section 24). The ICA promotes stringent adherence to the Investment Policy by prohibiting activities such as the borrowing of money, issuance of senior securities, underwriting of securities issued by other companies, purchase or sale of real estate or commodities, and deviation from any fundamental policy recited in the IC's registration statement without shareholder approval (Section 12). Lastly, to regulate an industry formerly overrun by scams, it explicitly prohibits the guarantee of any obligation of whatever kind or nature to investors (Section 21).

The ICA requires investment companies to comply with certain standards which include regular public disclosure of financial statements, investment policies and objectives, and pricing and fees. While bolstering investor confidence in MFs, the ICA created rigid rules that hampered the development of the industry. Nevertheless, the MF industry began to thrive in contrast to the equities market which was beginning to show signs of deterioration brought about by the political instability of the existing dictatorial regime. MFs were heavily dependent on the equities market since the lack of other investment outlets limited diversification. When the Manila Stock Exchange took a 30% dive, the MF industry was severely affected causing the SEC to ban the sale of MFs in 1973.

In an effort to revive the industry, the SEC released the Implementing Rules and Regulations (IRR) of the ICA in 1989. Ten years later, the IRR was amended as The Investment Company Rule or ICA Rule 35-1. The IRR changed the existing provisions of the said law regarding organization and capitalization requirements, sale of securities, investment of the fund, redemption of securities, required net worth of investment managers and frequency of submission of required reports. In 2018, the SEC released the new ICA IRR to align the existing rules with global standards and practices and make investment companies more competitive globally. This shift was made to develop the Philippine capital market and help prepare investment companies to qualify and compete in international cross-border transactions. The notable highlights of the new ICA IRR of 2018 are the inclusion of the word "fund" in the corporation's name, minimum subscribed and paid up capital of PHP 50 million or at least USD one million under certain conditions, availability of a prospectus which shall state among other things, the initial minimum and subsequent investment, and allowance of a shelf registration program.

Throughout the decades, the MF industry has grown in several ways. The Philippine Investment Funds Association (PIFA), formerly known as the Investment Company Association of the Philippines, provides relevant statistics on the industry. Based on PIFA reports, net assets in the MF industry have grown from PHP 75.7 billion in 2006 to PHP 256.2 billion as of end-2018 (Table 1). In line with this, the number of investors and investor sophistication have also grown over the same period. The shift from fixed income-type funds to more equity-oriented funds indicates a rising risk tolerance of Filipino investors and the number of investment accounts has grown almost fourfold.

Despite these developments, MFs lag the other CIS like UITFs and VULs available in the market. There are still stumbling blocks that the industry must overcome in order to catch up to the other pooled investment vehicles. One of the issues they face is the relatively challenging regulations governing the MF industry. Because MFs need to be incorporated and registered with the SEC, setting up new funds is time consuming and costly. In contrast to other pooled funds, the investment universe and allowed range of products are more limited for MFs. Additionally, liquidity requirements for MFs are stricter than for their CIS counterparts. Consequently, fund managers are hesitant to launch new funds, which an is reflected in the low number of MFs, only 61, versus the 250 or so unit investment trust funds available in the market as of 2018.

Other reasons for the lackluster growth in the industry include the difficulty of pushing MFs to potential investors. The MF industry is primarily dominated by the large insurance companies or the insurance arms of banks in the Philippines. Although these groups have investment solicitors to tap retail markets, agents are less incentivized to sell MFs compared to insurance products which charge higher fees and thus yield higher agent commissions. MF players are also disadvantaged vis a vis banks which have large nationwide branch distribution networks.

Nevertheless, industry players have made giant steps forward. Local associations of fund managers – including the Fund Managers Association of the Philippines (FMAP), Trust Officers Association of the Philippines, and PIFA – whose primary mission is to help the investing public economically and at the same time adhere to ethical standards through continuous educational efforts and development of markets are in constant communication with regulators and industry participants to address some of the issues discussed. Outside of the industry, players in the fintech space are also generating creative solutions to distribute MFs and introduce Filipinos to investing. Some inroads have been achieved in getting the younger population into online investing with affordable minimum investment requirements, regular investing habits and in beginning to tap the unbanked population.

Table 1: Size of the MF Industry by Fund Type

Fund Type	2006			2018		
	AUM (PHP Billion)	# of Funds	# of Accounts	AUM (PHP Billion)	# of Funds	# of Accounts
Equity	6.6 (8.7%)	8	21,602	103.9 (40.6%)	21	238,192
Balanced	8.0 (10.6%)	7	21,833	26.9 (10.5%)	14	87,745
Bonds	60.6 (80.1%)	20	70,846	72.7 (28.4%)	22	70,556
Money Market	0.5 (0.6%)	3	394	52.7 (20.6%)	4	42,059
Total	**75.7 (100%)**	**38**	**114,675**	**256.2 (100%)**	**61**	**438,552**

Source: PIFA

Unit Investment Trust Funds

In its continuous pursuit of capital market development, the BSP introduced UITFs as one of the primary CIS in the market. As per BSP Circular No. 447, UITFs are defined as open-ended pooled funds under the administration and management of trust entities. The funds are principally anchored by a trust agreement, commonly known as the Plan Rules or Declaration of Trust. The trust agreement outlines the classification, investment objectives, limitations, trustees' investment powers, terms and conditions governing fund participation, and assigned trust fees and other expenses of each fund. Given the magnitude of the distinguishing elements for UITFs, there are more than 250 UITF products as of December 2018, offering a vast selection for investors with differing risk profiles.

In September 2006, the central bank mandated the shift of common trust funds (CTFs) to UITFs in observance of international best practices and in enactment of additional safeguards to investment outlets. Fundamental modifications in replacing CTFs with UITFs included the following provisions:

1) Adoption of mark-to-market valuation of a fund's assets;

2) Computation of beneficial interest represented by the net asset value (NAV) per unit; and

3) Omission of reserve requirements and single borrowers limit for the fund.

To ensure a fund's liquidity and capacity for mark-to-market valuation, UITFs may only purchase active and marketable securities. These provisions are essential to establishing UITFs as safer investments than CTFs since current market prices improve the transparency and credibility of a fund's assets. Furthermore, the institution of UITFs equipped the market with another investment alternative within the reach of both institutional and retail investors.

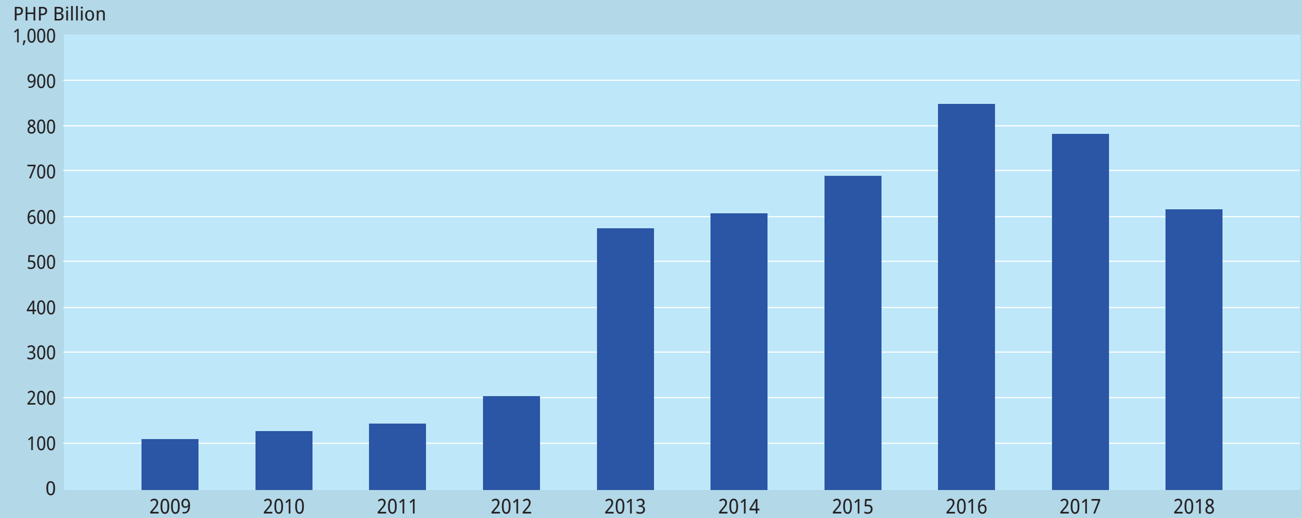
The BSP has implemented significant reforms as part of its initiatives to augment market-making activities and market penetration. As stipulated in the BSP Circular No. 853 (2014), UITFs may come in the form of feeder funds, funds-of-funds, or multi-class funds. Feeder funds primarily dedicate a minimum of 90% of their holdings to a target fund while the remaining portion is allocated in cash. The respective target funds may engage in financial derivatives for efficient portfolio management as per BSP Circular 999. On the other hand, a fund-of-funds is as a consolidation of different funds as 90% of its assets are apportioned in more than one collective investment scheme. The emergence of a multi-class fund in 2014 enabled funds with different share classes to be integrated into one UITF given that they follow the same investment strategy. According to former BSP governor Amando M. Tetangco (Montecillo, 2014), the employment of multi-class funds is directed for operational efficiency and economies of scale for collective investments. Each class in the UITF has a corresponding NAV per unit which is computed and released daily. In 2015, the BSP's Monetary Board approved the introduction of UITFs with unit-paying features which provide a non-guaranteed stream of periodic income to investors. The fund shall primarily earn through the dividends and coupon payments received from the income-generating instruments. The trust entity governs the income distribution as indicated in the trust agreement. Preceding this regulatory reform, income generated from investments could only be collected upon redemption of the principal investment. With this amendment, a fund participant can cash in on his investment income on a regular basis, albeit without a fixed return. For investors looking for cash flow, this was a welcome addition to the array of UITFs. As UITF products grow in sophistication, the investing public benefits from the enhanced diversification and improved market infrastructure of trust entities.

Market penetration of UITF products had increased over the past decade with the expansion of the sector's trust assets. Based on the reports published by BSP's Office of the Supervisory Policy Development, UITFs' assets under management (AUM) stood at PHP 615.7 billion as of December 2018 – a significant increase from the PHP 31.4 billion reported by 12 trust entities in June 2005 (Figure 1). Despite the notable increase between the two periods, the industry has also experienced troughs in its expedition for capital market development. The decline of CTFs in 2005 to 2006 represented the migration of investors to other trust products available in the market. Before the phaseout of CTFs, global risk-off sentiment prompted panic withdrawals in May 2006, causing the descent of UITF assets and huge redemptions by the investing public. Total assets in the trust industry plummeted, resulting in negative growth of 3.2% by end-December 2006. The adversities encountered during the UITF meltdown prompted enhancements in the account opening process and training requirements of UITF personnel. Despite the global financial crisis in 2008, the trust industry posted a 4.9% growth in total trust assets, signifying a reversal from its performance in 2006. However, investments in UITFs contracted by 39.2% as investors opted for investment management accounts (IMAs) and trust and other fiduciary accounts (TOFAs).

In light of the market volatility of the last decade, the prominence of UITFs improved remarkably given the different product offerings ranging from money market funds, equity funds, fixed income funds, and balanced funds, and others. Universal and commercial banks had always dominated the market in terms of their UITF market penetration. However, there was a notable contraction in 2017 and 2018 by universal and commercial banks, attributable to the emergence and growth of IMAs with traditional time deposits as underlying assets since inflationary conditions led to higher local interest rates on deposits. Rapidly rising interest rates at the time ensured fixed returns on these accounts compared to UITFs, which held a mixed bag of low-yielding assets acquired long before. With the new rules on the establishment of trust corporations introduced in 2016, the exposure of non-bank financial institutions increased. Among the different UITF products in the market, BSP's Supervisory Policy and Research Department reported that money market funds remain the leading investment product, accounting for 63.4% of the total AUM of UITFs as of December 2018, indicating that the majority of UITF investors still favor conservative products.

In the Philippines, financial inclusion and financial awareness have long presented challenges obstructing demand for collective investment schemes such as UITFs, MFs and VULs. The BSP Financial Inclusion Survey in 2017 revealed that 22.5% of Filipino adults have financial investments – bulk of which is

Figure 1: AUM of UITFs



Source: BSP

in contributions to government and private insurance systems and home development mutual funds (HDMFs). The HDMF, more popularly known as the Pag-IBIG Fund, is a Philippine government-owned and controlled corporation under the Housing and Urban Development Coordinating Council responsible for the administration of the national savings program and affordable shelter financing for Filipinos employed by local and foreign-based employers as well as voluntary and self-employed members. Direct investments in equities, bonds, MFs and UITFs represented only 3% of their holdings. As outlined in the survey, the low investment penetration can be explained by unemployment, perceived high costs, and lack of awareness and necessity. As of June 2019, the total number of participants in UITFs was reported to be 249,534, which represents a mere 0.3% of the total working population at the end of 2019 as estimated by the Commission on Population. In an environment of financial innovation and digitization, misconceptions emanating from traditional mindsets discourage people from allocating their disposable earnings to productive investment outlets. Moreover, the capacity and willingness to invest can substantially deteriorate given inherent market and economic risks. Both fixed income and equity markets suffer periods of unstable and low returns leading generally conservative investors to shy away from them. Nevertheless, proper education, close regulatory supervision and expansion of financial channels offer the potential for the underserved and unbanked population to achieve economic and social progress through UTIFs and other financial investments.

The Insurance Industry

The insurance industry in the Philippines traces its roots to the late 1800s and early 1900s when insurance companies began to set up shop in the country. In 1914, to ensure proper regulation of the burgeoning insurance market, the Philippine Legislature enacted the Insurance Act, and the Insurance Division of the Bureau of Treasury was tasked to supervise the insurance business. By the 1940s, supervision was moved out of the Bureau of Treasury and attached to the Bureau of Banking. As the industry continued to grow, the government recognized the need to establish an independent office to oversee all matters relevant to the insurance industry. Therefore, in 1949, together with the opening of the Central Bank of the Philippines, the Bureau of Banking was renamed the Office of the Insurance Commissioner through Republic Act No. 275.

Then, in 1974, Presidential Decree No. 612 instituted the Insurance Code of the Philippines, superseding the Insurance Act. Presidential Decree No. 63 renamed the Office of the Insurance Commissioner as the IC, and Presidential Decree No. 1460 in 1976 consolidated all insurance laws into a single code – the Insurance Code of 1978. Much later, 2009, Republic Act No. 9829 paved the way for the creation of the Pre-Need Code of the Philippines, which mandated the IC to regulate and supervise all pre-need companies conducting business in the Philippines. Finally, Republic Act No. 10607 in 2013, also known as the Amended Insurance Code, signed into law revisions to the Code intended to further strengthen the Philippine insurance industry and to ensure the economic viability and financial stability of insurance companies operating in the Philippines.

The stated vision of the IC is to foster strong, sustainable, and globally competitive regulated entities to serve every Filipino. Its mission is to implement prudent and progressive regulatory and supervisory policies at par with international standards. The IC has likewise set forth the following objectives:

1) To promote growth and financial stability of insurance, pre-need and health maintenance organization (HMO) companies

2) To professionalize insurance, pre-

need and HMO services, and develop insurance, pre-need and HMO consciousness among the general populace

3) To establish a sound national insurance market

4) To safeguard the rights and interest of the insuring public, pre-need and HMO customers

Organizations have also been established to nurture the interests of the insurance industry. The Philippine Life Insurance Association (PLIA), was established to promote the growth of the life insurance industry, develop ethical norms for underwriting and management of life insurance, and contribute to the socio-economic development of the country. In addition, the Philippine Insurers and Reinsurers Association (PIRA), which represents the interests of the non-life insurance industry, directs its efforts towards promoting the general welfare of non-life insurance, surety, and professional reinsurance companies doing business in the Philippines and the general public consistent with what the law provides, and propagating the concept, principles and benefits of the non-life and surety business. These associations are meant to be the voice of their respective industries to the regulator and other stakeholders. They conduct training, workshops and conferences to professionalize and police their members.

In terms of market structure, as of end-2018 the industry was comprised of 91 licensed insurance companies: five composite insurance companies, 25 life insurance companies, 60 non-life insurance companies, and one reinsurance company. Of the total, 22 are considered foreign owned, while the remaining 69 are locally owned.

Total assets of these insurance companies at the end of 2018 were reported at PHP 1.47 trillion, with PHP 1.25 trillion in life insurance, PHP 219 billion in non-life, and PHP 13.9 billion in reinsurance companies. Among life insurance companies, PHP 640.7 billion is classified as traditional life assets, with PHP 613.4 billion classified as variable life assets.

The aggregate net worth of the country's insurance companies at end-2018 was PHP 292.8 billion, with life insurance companies worth PHP 214.2 billion, non-life insurance companies worth PHP 73.7 billion, and the reinsurance segment's net worth PHP 4.8 billion.

Life insurance companies generated total premiums of PHP 228.6 billion in 2018, a 13% increase from the previous year. Of this total, PHP 170.2 billion was from variable life policies, while PHP 58.4 billion was from traditional life policies. The 2018 premiums are 14% and 9% higher respectively, compared to 2017. Total benefits paid in 2018 stood at PHP 73.7 billion. Non-life insurance companies earned PHP 49.3 billion in total premiums in 2018, a 9% increase from the previous year.

A key challenge facing the Philippine insurance industry is the low penetration rate. Premium volume as a share of GDP stood at 1.63% in 2018, and has fluctuated between 1.56% and 1.75% since 2014. For comparison, the average insurance penetration rate in the Association of Southeast Asia Nations (ASEAN) region was 3.6% in 2017, with the greater Asian region average at 5.6%, and the global average at 6.1%. While this low penetration rate in the Philippines represents a large gap in terms of insurance protection in the country, it also presents significant growth opportunities for all stakeholders in the insurance industry. To this end, a common and continuing advocacy of regulators, industry organizations, and insurance companies is to promote financial literacy and educate the general populace on the importance of securing the appropriate insurance coverage as part of personal financial management.

Insurance companies are likewise pursuing innovations by harnessing digital technologies to enhance the customer experience from policy purchase, to policy maintenance and benefit claim. In terms of product development, one trend currently being observed is the emergence of insurance products that encourage customers to adopt a healthier way of living. This direction is aligned with the pursuit of health and wellness as a top priority across the demographic spectrum.

With respect to the financial markets, the IC has worked to craft regulations that are aimed to support insurance companies in managing their investment portfolios. In 2019, for example, the IC issued circulars setting forth amended guidelines for securities borrowing and lending (Circular Letter 2019-45), for investments in real estate investment funds (Circular Letter 2019-27), and for investments in infrastructure projects under the Philippine Development Plan (Circular Letter 2019-19, amending Circular Letter 2018-74). Moving forward, the IC is expected to sustain its efforts in promulgating capital market development.

Variable Universal Life Insurance

VUL insurance is a permanent life insurance policy with a savings component that permits the investment of the cash value to marketable securities. It offers living, disability, and death benefits to the insured if the investor contributes to the premium at a prearranged payment scheme. The premiums are commonly held for a period of five to twenty years. VULs were first introduced in the Philippines by a subsidiary of a British financial services conglomerate in 2002.

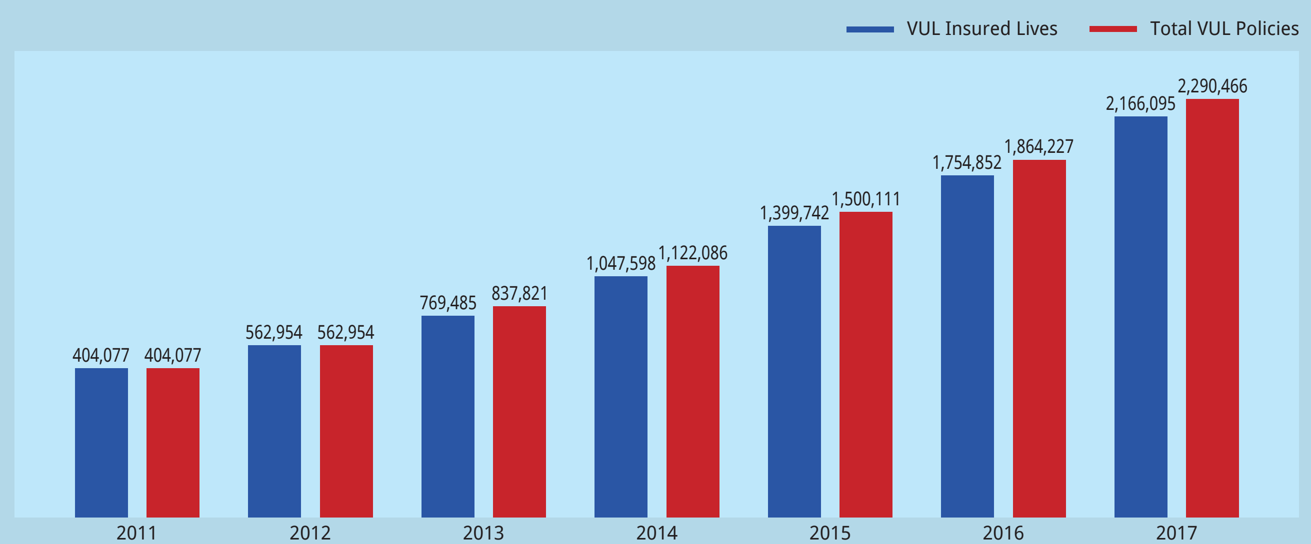
As mentioned above, the Insurance Code of 1978 consolidated all existing insurance provisions into a single code and provided for insurance companies to be regulated by the IC. VULs or variable contracts are discussed and defined in Title 10 of the Code as "any policy on either a group or an individual basis issued by an insurance company providing for benefits or other contractual payments thereunder to vary so as to reflect investment results of any segregated portfolio of investments or of a designated separate account in which sums received from such policies should be placed and accounted for separately from other investments and accounts". This code segregates VULs from other financial securities as defined in Securities Regulation Code and Investment Company Act and states that VULs are not subject to said Acts. In 2013, President Aquino signed RA 10607, otherwise known as the Amended Insurance Code, designed to strengthen the insurance industry and reinforce the previous code.

VULs have gained popularity among Filipinos in recent years. According to statistics from the IC, in 2017 the number of VUL policies was five times the number in 2011 and comprised about 44% of all insurance policies in force (Figure 2). Over the same period, the number of VUL agents grew from around 8,000 to over 40,000, or almost half of the entire pool of insurance agents. By 2018, approximately 70% of all policies sold in the insurance industry were VUL policies.

VULs lag slightly behind UITFs in terms of net assets but not in terms of growth and number of policy owners. Of the three CIS in the market, VULs have had spectacular growth, with a 19% cumulative annual growth rate (CAGR) in net assets over the five years ending in 2018 (Figure 3). The growth in net assets of the VUL industry is partly attributable to the nature and frequency of contributions from policy owners. Because a VUL requires a periodic premium payment to remain in effect, the investment portion of the VUL is also paid periodically. This is in stark comparison to MFs and UITFs where the challenge is to help investors build the habit of periodically setting aside money for their investments. VULs are also easier to market in comparison to MFs and UITFs, and there are significantly more VUL agents than there are certified investment solicitors. Based on current trends, we project that the total number of VUL policy holders in 2018 is over 2.9 million compared to the cumulative 800,000 or so investment accounts for MFs and UITFs.

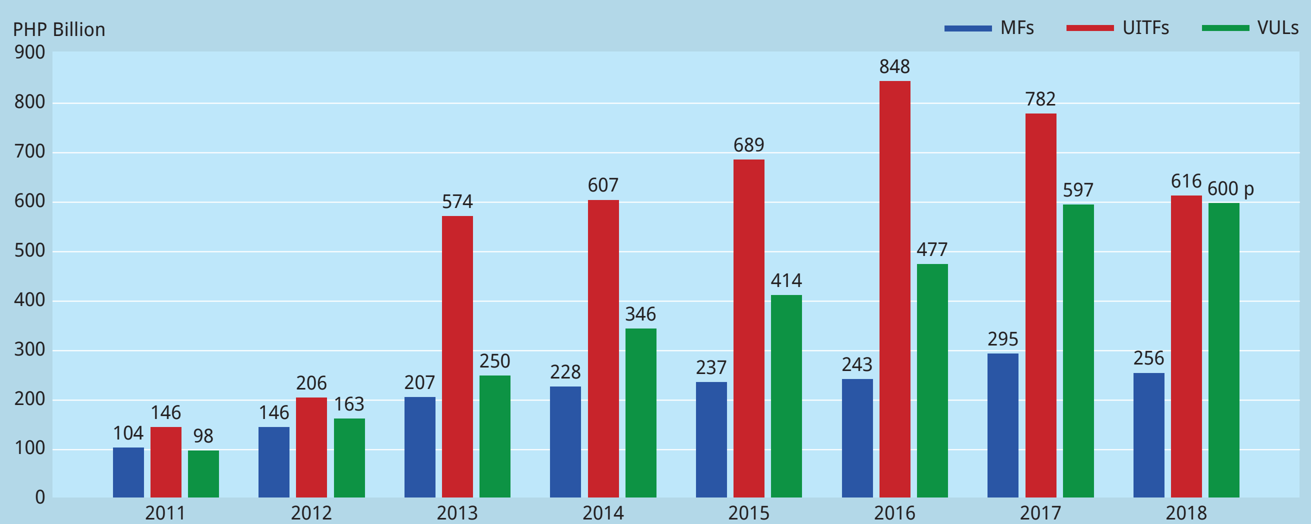
Just as the MF and UITF industries are contending with a lack of financial awareness, the VUL and insurance industry in general are battling with the lack of insurance consciousness in the Philippines. According to the PIRA Executive Director, Michael Rellosa, Filipinos tend to take an insurance policy only when

Figure 2: Number of VUL Policies and Insured Lives



Source: IC

Figure 3: AUM of CIS



Note: p – preliminary data.
Sources: PIFA, BSP, IC.

it is mandated or required for a loan. Generally, Filipinos see minimum value to having an insurance policy. Based on statistics from the IC, approximately 34.5 million people or 33% of the Philippine population has some form of life insurance coverage. Rellosa points out that this low penetration rate is unfortunate considering that the Philippines is prone to natural disasters such as typhoons and earthquakes.

Ongoing Initiatives and Future Outlook for Investment Funds in the Philippines

The BSP has initiated structural reforms and educational initiatives to strengthen financial literacy and deepen the capital markets. Firstly, the Economic and Learning Program of the BSP convenes all stakeholders in the system and reinforces financial education through public information campaigns and expos. Different programs are devoted to target audiences which are meant to strengthen financial literacy in response to prevailing market issues. Secondly, boosting investment demand comes with the responsibility to launch relevant products. In 2019, Real Estate Investment Trusts (REITs) became the most awaited issuance since the proclamation of Republic Act No. 9856 in 2009. REITs are publicly listed entities with revenue-generating properties such as offices, shopping centers, and hotels. They provide attractive returns to investors as companies engaged in REITs are mandated to distribute 90% of their retained earnings. However, the Implementing Rules and Regulations is still to be released.

Moreover, the expanding digital landscape in the country further complements the young and tech-savvy population. Online platforms permit users to invest as little as PHP 50, encouraging financial empowerment through sachet investing. Strengthening the push for financial inclusion, the SEC in Memorandum Circular No. 16 Series of 2018, otherwise known as the 2018 Guidelines on Anti-Money Laundering and Combating the Financing of Terrorism for SEC Covered Institutions, allows covered institutions to conduct a reduced Know-Your-Customer (KYC) due diligence process for low-risk customers. This ultimately reduces the hurdles for low risk clients to invest in pooled funds while ensuring that financial products are not used for money laundering operations. Additionally, the enlargement of the country's investor base will be driven by the upcoming relaunch of the Personal Equity and Retirement Account (PERA). Account opening and investing in PERAs are currently being aligned with the online processes implemented for regular UITFs, observing the same ease and flexibility. Accorded with tax incentives and prospects for capital growth, PERA accounts are not only designed for people nearing retirement but are also steered to the young population for timely financial planning.

With numerous investment products that cater to diverse investment needs, proper information dissemination is imperative for the sustained expansion of investment penetration. A bill for the establishment of trust agents is in the latter stages of finalization. The proposed legislation allows financial institutions, through their agents, to distribute and sell the respective products of their partners. Trust agents are akin to the certified investment solicitors of the SEC and the insurance agents of the IC.

The life insurance industry has grown phenomenally over the past years as more and more Filipinos are taking life insurance policies. Driven primarily by VUL premium payments, life insurance density, or the average spend of each Filipino on life insurance, has been growing by a little over 9% over the five years ending in 2017. Over the same period, the number of VUL policy owners has been growing by 32% annually. Furthermore, Moody's Investor Service noted that life insurance in the Asia Pacific region is backed by strong demand and a growing middle class. However, the report recommended the adoption of technology in the business models of insurers in order to remain competitive in the industry. In line with this, we believe the annual spend on insurance per capita will increase considering that the IC released Circular Letter No. 2018-07 in 2018 allowing mobile phone applications to sell insurance products. This opens the gates for insurance companies and tech companies to further expand the reach of the industry to those with limited access to traditional insurance channels.

Another initiative that will affect all pooled investments in the Philippines is the CIS Law. The CIS Law is being pushed in hopes of promoting the growth of pooled investments and spurring capital market development. The proposed law has provisions to widen the access of everyday Filipinos to securities ownership while ensuring that potential investors remain protected. Investor protection is enhanced as the CIS Law has provisions for strengthening governance requirements and improving the transparency of all CIS. Currently, there is an issue of regulatory arbitrage among the various CIS spanning the trust, MF and insurance industries due to different regulating authorities imposing different governing laws to the CIS and the entities they oversee. The CIS Law addresses this by establishing a harmonized regulatory and tax framework for all CIS. In doing so, proponents of the law hope to create an even playing field in the industry and promote a more competitive environment among CIS.

Conclusion

Despite massive developments, the Philippines' financial market still has a long way to go to catch up with its major Asian neighbors. While it is vibrant and robust, the market still lacks depth and breadth. The industry must confront the extensive effort necessary to service the currently underserved and unbanked segments. We believe that this effort – pursued along with the promotion of financial inclusion, digitalization, and proper selling by market constituents – will fortify investment demand, sustain investment confidence, and realize pervasive inclusivity. It will be a challenge to continue these proactive measures as the market evolves under promising demographic changes. Moreover, reforms must be implemented promptly and effectively in order to promote optimal growth of the Philippine economy as a whole.

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FUND MANAGERS ASSOCIATION OF THE PHILIPPINES

The Fund Managers Association of the Philippines (FMAP) was established in 1997 as an organization of equity and fixed income fund managers with the primary goal of fostering the development of the Philippine capital markets, particularly the investment management industry.

FMAP aims to promote professional fund management that adheres to best global practices and high ethical standards. It actively participates in dialogues with regulatory agencies in the formulation of policies and implementation of reforms to deepen the domestic capital market. We also uphold our corporate social responsibility through various activities to support our less fortunate citizens.

FMAP now has a membership base of 317 individual-members from 52 institutions comprising banks, insurance companies, mutual funds, pension funds, schools and domestic corporations.

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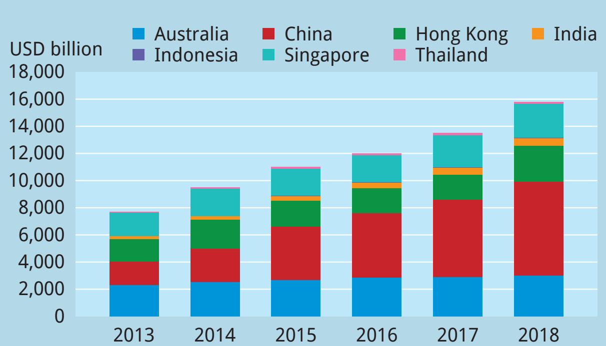
Market Structure of the Mutual Fund Industry in Thailand

Introduction

Mutual funds are an important investment vehicle for the saving public as they provide economies of scale, diversification, and investment expertise. In developed economies, the mutual fund industry is large – typically accounting for more than 50% of GDP. In Asia, the mutual fund industry is growing and provides diversification to global investors since its market performance does not move in tandem with developed markets. Wealth management activities are expected to grow faster in Asia Pacific than in any other region. In selected countries shown in Figure 1, the combined industry assets under management (AUM) reached about USD 11 trillion in 2015. This figure has grown at an average 18% annually for the past three years and sustained its upward trend to approximately USD 16 trillion in 2018.

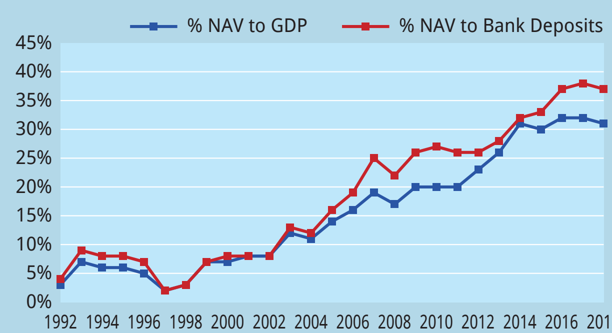
The Thai mutual fund industry took off in 1992 when the Ministry of Finance ended Mutual Fund Plc.'s sole market power. While still in its early stage, compared to more developed Asian economies, the Thai mutual fund industry has grown steadily. The ratio of Thai mutual funds' net asset value (NAV) to GDP grew at a compounded annual rate of 11.47% from 1992 to 2018 (Figure 2). The industry will likely continue to grow at a significant pace due to further liberalization of capital markets (financial and direct investment), establishment of the ASEAN Collective Investment Scheme (CIS) in 2014, and the increased demand for managed high-return investments for retirement as the Thai population ages. The Thai mutual fund industry also appears to be at an inflection point in recent years as regulators lifted restrictions to move the industry towards more regionalization. With these unique characteristics and recent regulatory developments, we describe three trends that are crucial to understanding the changing landscape and developing strate-

Figure 1: Industry Assets Under Management 2013-2018



Note: This figure is shown by Net Asset Value (NAV)
Source: Asian Banker Research.

Figure 2: Percentage of Mutual Fund NAV to GDP and Bank Deposits



Source: Association of Investment Management Companies (AIMC).

gic changes in the asset and wealth management industry in Thailand. They are: i) size, diversity, and market power of Thai funds, ii) perceptions of local fund managers and investors on fund investment, and iii) future opportunities, challenges, and regulatory expectations.

Size, Diversity, and Market Power of the Thai Mutual Fund Industry

The Thai mutual fund industry is dominated by fixed income funds (Figure 3). As of September 2019, the AUM of fixed income funds is THB 2,588 billion compared to the THB 1,467 billion AUM of equity funds. But equity grew at a faster rate, rising 21% between 2007 and 2019 compared to fixed income which grew 8.5%. The growth of AUM in equity funds is due not just to the increase in equity prices, which rose only 7.6% over the same period, but is mostly due to funds flow into equity funds. In more recent years, we observe a trend towards growing diversity in asset type, largely into equity and balanced funds. Despite a slower start earlier in the decade, balanced funds experienced 32% growth between 2013 and 2018 with assets rising from THB 89 billion in 2013 to THB 352 billion in 2018. Real estate investment trusts (REITs) also increased significantly as a substitute for property funds whereas infrastructure funds emerged in 2013. Together, they account for 13% of overall Thai mutual fund assets in 2018. It is important to note that we report the Association of Investment Management Companies (AIMC) categorization of funds by underlying assets. The classification is mutually exclusive, but does not allow us to track which proportion of funds are actively managed or if they are part of special funds group. We only know that tax incentivized funds like long-term equity funds (LTFs) and retirement funds (RMFs) account for roughly 12-13% of total fund assets. Furthermore, foreign investment funds (FIFs)*[1] have gained substantial market share in terms of assets from 13% in 2007 to 21% in 2018. The combination of growth in equity and balanced funds and increasing diversity of fund types has led to an overall decline in market share of fixed income funds, which fell from 59% of mutual fund NAV in 2007 to 49% in 2018. The industry remains resilient to adverse political and economic conditions, from international crises in 2008 and 2010 to local political conundrums including anti-government rallies circa 2010, a coup d'etat in 2014 and an election in 2019.

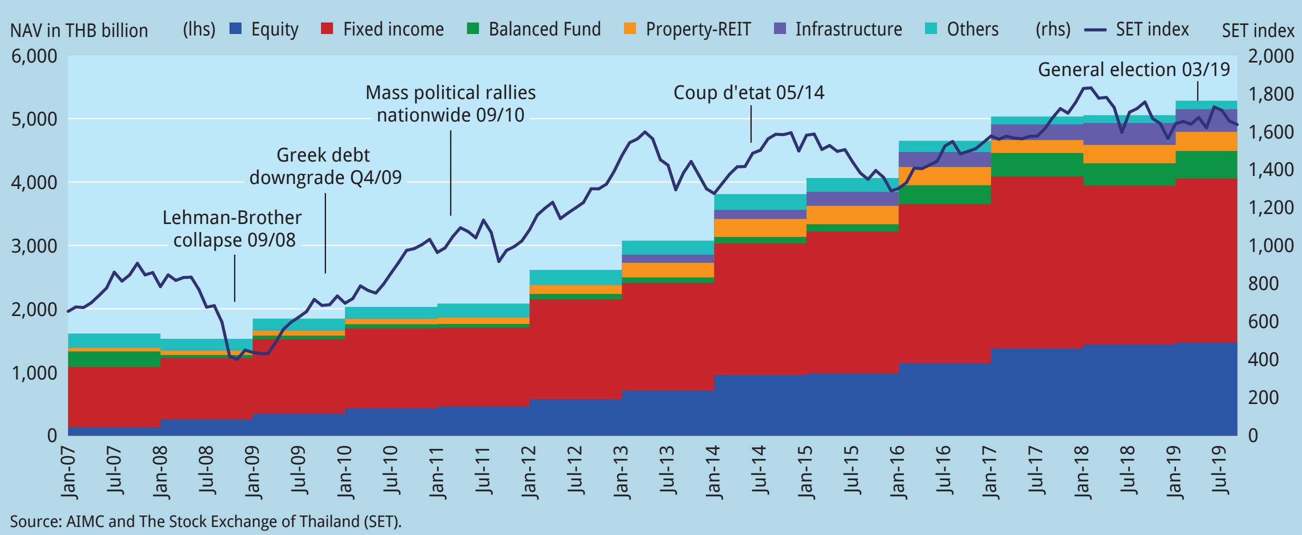
Figure 3 suggests that Thai investors

Table 1: Benchmark Optimal and Actual Portfolio Allocations from US, Global, and Thai data

	(1) US 1959-1984	(2) Global 1959-2018	(3) Thailand Agg. Mkt. 2018	(4) Thailand Optimum 2018	(5) Thailand Mutual Funds 2018	(6) Thailand MF Survey 2012
Stocks	61%	52%				
Real estate	4%	4%				
TOTAL EQUITY	65%	56%	53%	59%	36%	41%
Non-government bonds	12%	15%				
Government bonds	23%	30%				
TOTAL BONDS	35%	45%	47%	41%	64%	59%

Source: Data in columns (1), (2), and (3) are from Ibbotson et al. (1985), Doeswijk et al. (2018), and the World Bank, respectively. Column (4) is from the authors' estimates using Markowitz optimal portfolio analysis with monthly historical on Thai stock market and bond returns from January 2006 to December 2018 and a risk-free rate average of 2.83% annually. Columns (5) and (6) are data from AIMC and from Charoenrook and Pavabutr (2017).

Figure 3: Mutual Funds by Fund Type and Equity Market Performance



Source: AIMC and The Stock Exchange of Thailand (SET).

are risk averse since they invest a lot in fixed income, but that is not the case. Table 1 column 3 shows that in aggregate the distribution of Thai investments is close to global and local mean-variance optimum. However, fund data and our survey in Charoenrook and Pavabutr (2017) show that mutual fund investment is tilted towards fixed income. Hence, it is the case that Thai investors invest more in fixed income through mutual funds and invest more in equity through direct investment.

The Thai fund market is dominated by domestic asset managers. As of Q3 2019 the 1,816 funds in the market are managed by 24 different investment firms: 11 Thai bank-related, 7 foreign, and 6 non-bank Thai firms.*[2] Table 2 presents the detailed tapestry of the mutual fund industry. Notable is the dominance of bank-related mutual funds.*[3] While these numbers seem to point to a move towards complete market dominance by local banks, we need to be aware that foreign banks have been acquiring strategic stakes in local banks to gain local brand recognition. For example, if we treat Thai Military Bank and Bank of Ayudhaya, which are strategically controlled by ING and Sumitomo Mitsui Financial Group respectively, as foreign, then the revised aggregate market share for Thai banks without sizable strategic foreign partners falls to 73%, a level close to that found at year-end 2007. "Thai banks" manage 94% of the fixed income funds which are the majority of the mutual funds.

To further analyze the within-group market power of local banks, we constructed a normalized Herfindahl Index for each year from 2007 to Q3 2019. Let N be the total number of local banks, the normalized index creates a value ranging from 1/N, when all firms have equal market share, to 1.0, when the market is monopolized by one firm. Table 3 reports for each year the normalized Herfindahl Index using only market share information of 11 the local banks. We find that the index on equity and fixed income funds for Thai banks is below 0.2, suggesting that no particular bank dominates these asset segments. The index results for infrastructure funds are notably larger, mainly above 0.3, but only because just four Thai banks have launched such funds thus far. The latest market share in the infrastructure segment is in favor of Siam Commercial Bank and Bangkok Bank asset management groups. To summarize these results, while we do find that local banks dominate the fund management scene, it is apparent that no particular bank dominates any of the mutual fund market segments.

Investors' Behavior and Fund Managers' Perceptions

In a World Bank policy paper, Fernando, Klapper, Sulla, and Vittas (2003) conducted a comprehensive study of determinants of mutual growth in forty countries around the world and concluded that growth in mutual fund sectors is determined by demand, supply, and regulation. The authors focused on the usual variables including GDP growth, the sizes of bond and equity markets, market trading liquidity, and the size of the national banking sector. We employ a different approach by drawing on fund managers' point of view from our survey of fund managers that appears in Charoenrook and Pavabutr (2017). We argue that fund managers and management teams have perspectives on investor behavior, market constraints, and regulatory effectiveness that can affect industry direction. We collected 83 respondents (more than half of the fund managers in the industry) in our survey and conducted personal interviews with ten top management personnel from various funds, including Kasikorn Asset Management, Siam Commercial Bank Asset Management, Bualuang Asset Management, and a few non-bank funds such as the Government Pension Fund, MFC, and Asset Plus.

Why aren't Thai mutual funds investing more in equity? Fund managers in our study view that regulation is the biggest hurdle, in particular the overall equity holding limit, which allows no more than 15% in a single equity security or not exceeding the asset weight in the benchmark index plus 5%. While the rule encourages funds to diversify, it seems to lead all equity fund performance to converge to the mean market return as no equity fund can deviate far from market weighted benchmarks. Morningstar's *Global Investor Experience* (GIE) 2017 report notes that most markets, with the exception of China, India, and Thailand, impose no limitations on what funds can invest in. The second most significant hurdle is equity market constraints due to insufficient liquidity. As of Q3, 2019, the market cap of SET and Market for Alternative Investment (mai) combined is THB 17,000 billion for all 715 firms. Size is heav-

Table 2: Mutual Fund Market Share by Asset Type and Association as of Q3 2019

	Equity	Fixed income	Balanced	Property	Infrastructure	Total*
Thai banks						
AUM THB billion	1,132	2,442	396	280	335	4,585
% Market share	77%	94%	91%	93%	94%	89%
Foreign						
AUM THB billion	113	98	21	5	0	237
% Market share	8%	4%	5%	2%	0%	5%
Non-bank Thai						
AUM THB billion	222	48	17	18	23	328
% Market share	15%	2%	4%	6%	6%	6%

Source: AIMC and authors' computations.

Table 3: Normalized Herfindahl Index* of Bank-related Mutual Funds in Thailand by Asset Type

	H* Equity	H* Fixed Income	H* Balanced	H* Property	H* Infrastructure
2007	0.064	0.108	0.255	0.155	.
2008	0.136	0.118	0.114	0.101	.
2009	0.103	0.150	0.144	0.133	.
2010	0.094	0.177	0.115	0.114	.
2011	0.097	0.190	0.098	0.110	.
2012	0.087	0.168	0.071	0.093	.
2013	0.090	0.174	0.064	0.176	0.431
2014	0.086	0.155	0.067	0.202	0.439
2015	0.073	0.139	0.077	0.202	0.394
2016	0.078	0.130	0.093	0.209	0.390
2017	0.076	0.118	0.142	0.132	0.388
2018	0.072	0.126	0.126	0.126	0.134
Q3 2019	0.070	0.120	0.140	0.134	0.319

Note: Define the Herfindahl index (H) as $H = \sum_{i=1}^{N} s_i^2$, where S_i is the year-end market share of fund management firm i in the market and N is the number of firms. The normalized Herfindahl index (H^*) is $H^* = \frac{(H-(1/N))}{(1-(1/N))}$.

Source: AIMC and authors' computations.

ily skewed towards a much smaller subset of SET 100 firms which account for over 75% of total market value. Next, consider the average free float of approximately 40%, leading to a relatively lower effective turnover. Clearly, there are neither enough stocks nor liquidity to go around, given that the average size of equity funds is around THB 2 billion and there are, in total, around 700 equity funds chasing after too few firms with investable liquidity.

The fund managers we interviewed and surveyed also believe that investors have more interest in fixed income funds as they are perceived as a close substitute for deposits. Mutual funds, which do not carry burdens related to non-performing loans, are able to offer attractive returns on deposit-like instruments.

How important is local brand and what do investors expect from funds? This is indeed a crucial question for foreign and local non-bank asset management companies alike. We learnt from our survey that local fund managers perceive that local investors rank brand more important than historical performance and product diversity. An earlier study by Chunhachinda and Nathaphan (2012) tested the determinants of Thai mutual fund growth and concluded that fund growth is significantly related to brand and distribution channels. Our survey respondents also view that improvement in the level of financial literacy can boost interest in equity funds. This finding corroborates results of a survey of government pension fund members conducted by Budsaratragoon et al. (2011) that found questionnaire respondents were highly risk averse and exhibited an exceptionally strong home bias in their asset allocation decisions. However, it is important to note that these observations apply to investors who identify themselves as having no financial experience. In our analysis stated earlier, we find that the aggregate allocation between equity and fixed income in Thailand as a whole is close to the mean-variance optimal allocation, suggesting that investors with the financial means and knowledge prefer to invest directly in the equity market and not through equity funds.

Besides brand reputation, fund managers perceive that investors also care about internet service and easy access to branches, but exhibit much less concern about fund expense ratios. Perhaps this is because Thai fund expenses have been rather low by international standards (See Morningstar GIE, 2017 and 2019), and fund managers in our survey indicate that they are not concerned about falling short of risk-adjusted performance targets.

Future Opportunities, Challenges, and Regulatory Expectations

Regulations play an important part in the evolution of Thai mutual funds.*4 Thai regulators have thus far adopted the path of gradual liberalization: balancing the needs of market stability by promoting institutional investors, providing retail investor protection, and strengthening the local financial sector before they are ready for more open international competition. We have seen that tax rules have a large impact on the growth of tax incentivized funds like LTFs and RMFs, which individuals can use to reduce otal annual income tax liability. The dominance of Thai commercial banks in the mutual fund sector is a consequence of initial stipulation that a mutual fund must be a Thai juristic person, must meet a sizable initial investment, and that the channels of fund marketing must be authorized by the Securities and Exchange Commission, Thailand (SEC), giving banks a standing advantage in fund marketing due to their recognized "brands" and their nationwide network of branches.

There are two key forces driving the move towards more loosening of regulations. First is that the aging population requires faster development of mutual funds to relieve the financial pressure on national social security systems to provide full retirement benefits.*[5] Local market impediments on trading liquidity, limited new supply of debt and equity, and holding limits on single stocks (not exceeding 15%) and sectors (not exceeding 25%) mean that growth and diversification opportunities from the local supply side may eventually fall short of demand. Second, is the establishment of the ASEAN CIS which was implemented in August 2014 and aims to establish a single market for goods, services, investment flows and skilled labor. Under the ASEAN CIS framework, fund managers in Malaysia, Singapore, and Thailand may offer collective investment schemes or funds to retail investors in the three countries under a streamlined authorization process. A related scheme is the Asia Region Funds Passport*[6] signed in February 2019, which allows mutual recognition of funds cross-border.

With these on-going developments, there is a clear trend towards regionalization and increased asset diversity of fund availability in Thailand. Beginning next year, the tax privilege to LTFs will end and be replaced by Sustainable Equity Fund (SEF) which must place 65% combined investment in ESG-certified listed firms (list will be re-evaluated by the SET semi-annually) and infrastructure funds (IFFs).*[7] In our view, this move suggests that regulators intend to use mutual funds to help achieve national development goals in targeted industries as well. We also expect to see a growing number of REITs, which are set up to replace existing property funds. Unlike property funds, REITs are allowed to leverage and must comply with international standards on asset appraisals.

Will the dominance of Thai commercial banks in the mutual fund sector remain unchallenged? Although the barriers to setting up foreign funds in Thailand are coming down, an important hurdle that remains is the issue that fund marketing is separated from the application to set up a fund. This means foreign funds must solicit and offer funds for sale through an SEC-licensed local partner. Already, some foreign funds or banks obtain a faster track to marketing channels, local brands, and captive clientele by acquiring a controlling or non-controlling stake in an asset management company or a bank.*[8] The former is not subject to prior authorization by the SEC. However, this tight marketing rule applies only to distribution of funds to retail investors. Foreign funds can market their products directly to institutional investors and high net worth individuals through private funds, which carry fewer investment restrictions. In the past two years, banks and their asset management arms have been slowly developing digital fund marketing platforms that offer open architecture for fund sales. Although most Thai banks currently do not sell other banks' funds through their branches, a small but slowly growing number have become more open to selling competing funds on their digital platforms, and the practice will definitely further reduce the importance of physical branches as marketing channels.

Conclusion

In terms of international competitiveness, Morningstar's GIE surveys in 2015 and 2017 attribute the improvement in Thai mutual funds' overall scorecard to their relatively low fund fees and expenses, favorable taxations, in particular tax credits provided to investors in long-term funds, and transparent disclosure of fund holdings. However, Thailand's scorecard on sales practices is the lowest among its other scorecard rankings due to the absence of an open architecture platform for fund sales and narrow distribution channels available mostly through commercial banks. Recently, though, we are witnessing digital platforms for open fund architecture that also enable asset and wealth managers to widen their reach and better understand investor behavior. This in our view, along with allowance of fund passporting, is likely promote regionalization by increasing opportunities for foreign asset management brands and for local investors to access more diverse investment choices. Though, admittedly, the path towards fully open distribution channels will be slow, the remaining hurdles will be the speed of Thai equity market development in terms of new listings. Otherwise, growth in equity funds will rely on international equity investments. In time, improvement in financial literacy could definitely divert more savings to mutual funds from bank deposits, which are now more than twice the size of the entire mutual fund industry.

Notes

*1 Thai asset management firms were allowed to set up FIFs since 2002, but strict regulations on licensing and a ceiling on fund size impeded their development. After 2005, the Bank of Thailand began to relax these restrictions and FIFs were included in the AIMC database from 2007 onwards. Today setting up FIFs still require approval from the SEC, and these funds must put more than 80% of AUM in foreign assets (most in the form of feeder funds).

*2 Since August 2003, local Thai financial institutions have been allowed to apply for fund management licenses, but only through separate entities which they own 75%. Subsequently, many banks set up an asset management arm where they hold majority control. We define an asset management company as foreign if the controlling shareholder is foreign and has a foreign origin. Data available on www.aimc.or.th.

*3 Bank related fund refers to mutual fund companies in which banks own more than 50%.

*4 The SEC and the Capital Market Supervisory Board (CMSB), a supervisory authority within the SEC organizational structure, are responsible for regulating funds and fund managers. The Thai central bank also regulates investment of offshore funds issued by foreign entities or which originated in certain foreign markets to monitor outflows of Thai baht and foreign currencies to pay for the purchase of foreign-issued securities or investment units.

*5 See National Statistics Office, the proportion of elderly population to total population will grow from 20% in 2021 to 32% by year 2040.

*6 Jurisdictions include Australia, Japan, New Zealand, South Korea, and Thailand.

*7 At the time of this writing the fund is called SEF. At print date, the fund has been renamed Super Savings Fund (SSF) with details expected to be released by the Thai

SEC within the first quarter of 2020.

*8 Singapore's United Overseas Bank (UOB) and Malaysia's CIMB made an early start by acquiring Bank Asia and Bank Thai in 2005 and 2008, respectively. In 2007, the Dutch bank, ING took a controlling stake in Thai Military Bank. More recently, in 2013, Japan's MUFG acquired 75% of Bank of Ayudhaya.

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Mutual Funds: Pathways to Promoting Sustainable Green Finance in Singapore

Introduction

Since the World Bank issued the first green bond in 2008 (Federal Ministry for Economic Cooperation and Development, 2018), the issuance of green bonds has taken off. The amount of green bonds was slightly lower than USD50 billion in 2015 but it had increased fourfold by October 2019 (Climate Bonds Initiative, 2019).

Despite active issuance of green bonds worldwide, there are still some challenges. They can be summarized as four challenges: the lack of contractual green protection (whether 'green' remains 'green' for the entire life of the bond); improper reporting of metrics and transparency or 'greenwashing'; issuer fatigue and confusion; and the lack of pricing benefits to going green (Baker McKenzie, 2019). Apart from these challenges, there seems to be a narrower base of demand for green bonds, and increasing the base of demand for green bonds can help the green bond market.

Most of the World Bank's green bond issuance is aimed at institutional investors (Federal Ministry for Economic Cooperation and Development, 2018) and most active in the green bond market are pension funds and insurance companies (European Commission, 2016). The green bond market is still small compared to the total bond market, and public investment is a suggested solution to promote demand for green bonds (European Commission, 2016). There is far more demand for green bonds than supply of green bonds at this moment (European Commission, 2016). As issuance of green bonds is expected to increase, however, the gap between demand and supply will narrow or even disappear. Increasing the base of demand for green bonds can provide more liquidity to the market and the greater liquidity could eventually invite more issuers and make the green bond market more competitive.

Investors can use mutual funds to invest in single- or multi-asset classes of stocks, bonds or other securities (Fabozzi and Modigliani, 2003). In general, investors may benefit from pooling their funds with others to own a portfolio of assets that they may otherwise be unable to buy on their own with the same investible amount. Mutual funds could "democratize" investment opportunities to enable investors to invest in a variety of securities. This helps investors achieve more varied returns and reduce risk through diversification.

The words "green investments" are often used interchangeably with terms like "sustainable" or "responsible" investments. In this paper, we examine the challenges of using mutual funds to provide investors with access to such investments. For consistency, we shall use the term "green" in this paper.

Prospects are good that Singapore's mutual fund industry can benefit from the growth of green investments. There is evident government support to push Singapore to the forefront of green investments. With the various initiatives, the mutual fund industry in Singapore is poised to grow in this segment and give small investors the chance to invest.

Following this introduction, this paper presents a brief discussion on green finance in the world along with a description of policy, incentives and obstacles to green financing in Singapore. It suggests how mutual funds can promote the green bond market and grow along with that market. Finally, it concludes with a summary of key findings and some recommendations on the role of mutual funds.

Green Finance in the World

Green bonds are defined as "any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible Green Projects…and which are aligned with the four core components of the G[reen] B[ond] P[rinciples]" (International Capital Market Association (ICMA), 2018, p.3). The four core components are: use of proceeds, process for project evaluation and selection, management of proceeds, and reporting. Eligible green projects include, but are not limited to, the following: renewable energy, energy efficiency, pollution prevention and control, environmental sustainable management of living natural resources and land use, terrestrial and aquatic biodiversity conservation, clean transportation, sustainable water and wastewater management, climate change adaptation, eco-efficient and/or circular economy adapted products, production technologies and processes, and, finally, green building (ICMA, 2018).

The size of the green bond market in 2017 was USD161 billion (Chang, 2019) and was expected to reach USD250 billion in 2018 (Climate Bonds Initiative, 2018). However, the green bond market only reached the milestone of USD200 billion in October 2019, and more issuance of green bonds is expected to come in 2020 (Climate Bonds Initiative, 2019). The top five issuers of green bonds in 2019 were the Dutch State Treasury Agency, KfW, Industrial Bank, the Republic of France, and ACWA Power (Silk Road Fund) (Table 1).

The main uses of the proceeds from green bond issues are energy, low-carbon buildings and low-carbon transport, using 33%, 30% and 22% of proceeds, respectively. The US is the most active issuer of green bonds followed by France, China, Germany and the Netherlands. Supranational came after the Netherlands (Climate Bonds Initiative, 2019).

Unlike in the US, Europe and China, the green bond market in Southeast Asia is still in an early stage. Singapore was the first country in the region that issued green bonds with issues by two companies. City Development Limited issued green bonds with a total value of USD100 million in 2017 and DBS Group Holdings Limited (DBS) issued green bonds with a total value of USD500 million in 2017 (Chang, 2019). Following Singapore, four other Association of Southeast Asian Nations countries issued green bonds, namely Indonesia, Thailand, Malaysia and the Philippines. Indonesia is the largest issuer of in ASEAN (Azhgaliyeva, Kapoor and Liu, 2019). Sindicatum in Singapore issued green bonds denominated in Indian rupees worth USD400 million in 2018 and in Philippine pesos worth USD20 million in 2019 (International Institute of Green Finance, n.d.).

Multinational banks or government-related entities were the major issuers of green bonds from 2007 to 2012 (Federal Ministry for Economic Cooperation and Development, 2018, p.30). For example, the investors in the green bonds issued by France in 2017, which totalled EUR7 billion with a maturity of 22 years, were asset managers, banks, pension funds, insurers, official institutions and hedge

Table 1: Top Ten Issuers of Green Bonds Issuers in 2019

Issuer	Amount Issued (billion)	Issue Currency	USD Equivalent (USD billion)	Sector
Dutch State Treasury Agency	5.99	EUR	6.66	Energy, Buildings, Transport, Water
KfW	3.00	EUR	3.36	Energy, Buildings
Industrial Bank	20.00	CNY	2.91	Energy, Buildings, Transport, Water, Waste
Republic of France	2.47	EUR	2.77	Energy, Buildings, Transport, Waste, Land Use, Adaptation & Resilience (A&R)
ACWA Power (Silk Road Fund)	2.69	USD	2.69	Energy
Industrial and Commercial Bank of China	2.50	USD	2.50	Energy, Transport, Water
Societe du Grande Paris	2.00	EUR	2.27	Transport
Republic of Poland	2.00	EUR	2.24	Energy, Transport, Land Use
National Treasury Management Agency	2.00	EUR	2.21	Energy, Buildings, Transport, Water, Land Use, A&R
KfW	2.00	USD	2.00	Energy, Buildings

Source: Climate Bonds Initiative

Table 2: Breakdown of Investors in France's Green Bonds Issued in 2017

Investors	Share (%)
Asset Managers	33
Banks	21
Pension Funds	20
Insurers	19
Official Institutions	4
Hedge Funds	3
Total	100

Source: Federal Ministry for Economic Cooperation and Development

funds. The breakdown of their shares is shown in table 2 (Federal Ministry for Economic Cooperation and Development, 2018, p.33-34).

There are four instruments for sustainable finance other than green bonds. They have similar characteristics but differ mainly in their objectives. They are: sustainability bonds, social bonds, green loans and sustainability-linked loans. All these instruments appeared to work well and complement to green bonds in fulfilling the objectives of financing green projects (International Institute of Green Finance, n.d.).

Going global can be a way to strenghen the green bond market in Asia. Three ways to achieve this goal are harmonization, policy support, and demonstrative issuance. Financial support as issuing bonds and verifications are costly (International Institute of Green Finance, n.d.).

Green Financing in Singapore: Policy, Incentives, and Obstacles

Singapore has focused on policy initiatives and incentives to provide the impetus for the growth of green financing. While there exist obstacles to Singapore's ambitions, the country is well-positioned to implement appropriate policy measures that are augmented by a slew of incentives. These could provide the catalyst for the mutual fund industry to benefit from the growth in green investments.

Singapore has issued clearly defined policy guidelines in relation to environmental, social and governance (ESG) factors in investing, such as the Association of Banks in Singapore's (ABS) "Guidelines on Responsible Financing," which specifies three principles of responsible financing. The first principle requires senior management to disclose their commitment to responsible financing. The second principle dictates the governance of responsible financing. The third principle concerns the capacity building of responsible financing. In addition, the Singapore Exchange asks all listed companies to comply with the ESG principles strictly (Chang, 2019).

Singapore offers a few incentives in relation to green bonds. The Monetary Authority of Singapore (MAS), the central bank, provides the Green Bond Scheme to help bond issuers to reduce the cost of issuing bonds and of getting external reviews (Chang, 2019). The Green Bond Scheme does not apply to those green bonds issued outside Singapore by Singapore-registered companies (Federal Ministry for Economic Cooperation and Development, 2018).

There are still obstacles to the expansion of the green bond market in Singapore. As in other countries, the issuers of green bonds are mainly large companies; small and medium-sized enterprises do not have access or capacity to issue green bonds. The lack of awareness of green issues in general and of green bonds specifically remains, and raising the awareness of green bonds is a critical step to activating the green bond market in Singapore (Chang, 2019).

How Mutual Funds Can Be Utilized to Promote and/or Secure Green Finance – Potential

As described above, the Singapore government and MAS have demonstrated a clear intention to promote green investments. However, several remaining issues hinder the broader penetration of this investment philosophy and a few issues stand to dim the promising prospects of growth.

First, a lack of awareness of the availability of collective investment schemes that allow retail investors to make green investments still present. The green bonds issued in Singapore so far have been targeted at high net-worth and institutional clients (City Development Limited, 2017; DBS, 2017). Due to the higher minimum investment sizes, such direct investment opportunities are out of reach for retail investors. Even if retail investors can fulfil the minimum transaction size, they are unlikely to be able to achieve portfolio diversification by owning multiple green assets. Mutual funds can help provide the access to such investments with the benefit of portfolio diversification as well.

Second, the nature and sheer size of green financing often force issuers and companies to prefer a small number of large investors as opposed to having to handle many small investors. The requirements for verification of the green standards for each project also make it much harder for non-institutional investors to conduct due diligence. Such intricacies make it inherently harder for retail investors to invest in green projects. Herein lies the important role that mutual funds can play to provide investment opportunities in green finance to retail investors.

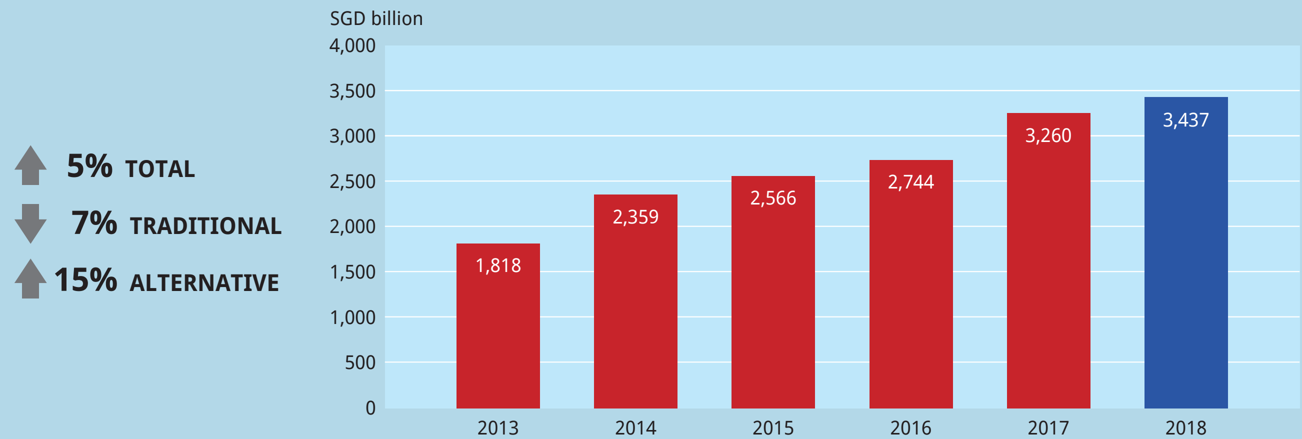
Third, without the opportunity to invest, the concept of green investments will remain far-fetched to many retail investors. This will limit green financing to "big ticket" institutional investors, excluding small investors. Thus, mutual funds can play an important role to "democratize" green investment.

Fourth, the generic concept of green investment remains abstract and, maybe even confusing, to retail investors. There are still no standard terms, so people continue to be confused by the various terms used within the segment. This includes definitions, standards for each type of green financing to be achieved and a lack of transactional turnover in green investment.

MAS 2018 Singapore Asset Management Survey

According to MAS's 2018 Singapore Asset Management Survey, overall assets under

Figure 1: AUM in Singapore



Source: MAS

management (AUM) in Singapore rose 5% with a 15% increase in alternative assets being offset by a 7% decline in traditional managed funds (Figure 1).

The MAS survey also showed that globally, ESG investments grew 34% in two years to USD30.7 trillion. The guidelines for ESG investments in Singapore were first presented in 2015 and revised in 2018 by ABS (ABS, 2015 and 2018). Asset managers and institutional investors have since increased their efforts in tandem to integrate ESG considerations into their investments, with the aim of safeguarding reputational risks and generating long-term value through better alignment of their portfolios with global developments in ESG.

In line with a growing global call for financial institutions to promote green finance, Singapore has taken steps to implement sustainable practices and provide incentives. MAS is actively working with industry players to direct capital towards effective investments in climate action and sustainable activity. MAS is a founding member of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), which seeks to enhance the role of the financial system to manage risks and mobilise capital for green and low-carbon investments in the broader context of environmentally sustainable development (Chang, 2019).

The MAS survey showed that Singapore's share of ESG-managed assets stood at 27% of total AUM in 2018, up from 23% the previous year. SGD6 billion worth of green bonds have also been issued by local and foreign companies since the introduction of the Green Bond Grant Scheme in June 2017. The Green Bond Grant Scheme was enhanced and renamed the Sustainable Bond Grant Scheme in February 2019 to include social and sustainability bonds while also lowering the minimum issuance size requirement. These changes augur well for mutual funds with green investments.

Conclusion

This overview of green finance in Singapore shows that there has been commendable progress. However, it is evident that more needs to be done, especially in making green investing more accessible to the masses. If the right steps are taken, Singapore's mutual fund industry can stand to ride on the future growth of green investing.

In conclusion, the following recommendations may help to further propel Singapore's mutual fund industry in the area of green investing. First, Singapore needs to clearly define the concept of "green". Second, it should release more information on the ESG performance of bond issuers to enhance transparency on the quality of green projects or green financial instruments. Third, it needs to create demand for green investments. Tapping on mutual funds for investors is one way of creating the demand.

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Introducing Nomura Foundation

Nomura Foundation (the Foundation) is a public interest incorporated foundation formed in 2010 from the combined resources of three existing foundations established by Nomura Group, Japan's largest securities company. The Foundation aims to support a dynamic and sustainable economy and society by promoting the social science disciplines, enhancing international understanding, and fostering young academic and artistic talent. It focuses on four program areas: Social Sciences, Foreign Student Scholarships, Arts and Culture, and the World Economy.

The World Economy program supports research, conferences, and publications related to the macro economy and capital markets.

In the macro economy area, the Foundation has organized conferences together with experts from the Brookings Institution (US), Chatham House (UK), the Development Research Center of the State Council (China), and Bruegel (Belgium) as well as Nomura Securities and Nomura Institute of Capital Markets Research to share research on such topics as monetary and financial institutions, fiscal stability, and demographic change and sustainability.

In the area of capital markets, the Foundation has organized conferences

Panel Discussion at the 2015 Forum

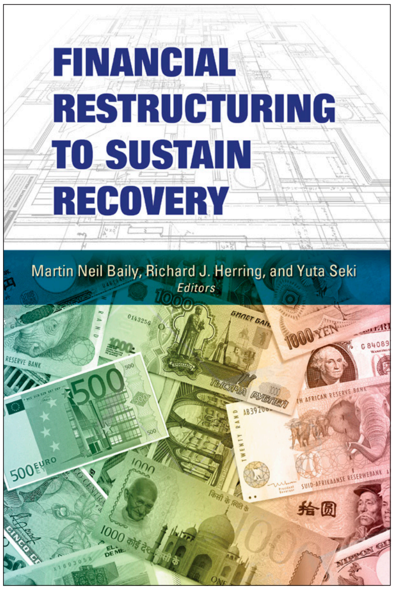
and roundtable discussions in conjunction with the Brookings Institution, the Wharton School, the Development Research Center of the State Council (China), China's Center for International Knowledge on Development and Nomura Institute of Capital Markets Research. It has also provided financial backing for several conference volumes published by the Brookings Institution, *Capital Markets in India* published by Sage, Inc., and the quarterly Japanese-language journal *Chinese Capital Markets Research*.

Research papers and presentations prepared for conferences and the content of print publications are available on the Foundation's website http://nomurafoundation.or.jp/en.

With the expanding importance of Asia in the 21st century global economy, the Foundation has been increasing its support of intellectual interactions among experts at think tanks, universities and government agencies in the region. As part of this effort and recognizing the importance of capital market development in promoting economic growth and prosperity in Asian countries, the Foundation started publishing *Nomura Journal of Asian Capital Markets* in 2016.

Cover of *Chinese Capital Markets Research*

Lord Mervyn King at the 2015 Forum



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Introducing Nomura Institute of Capital Markets Research

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Nomura Institute of Capital Markets Research (NICMR) was established in April 2004 as a subsidiary of Nomura Holdings to build on a tradition begun in 1965 of studying financial and capital markets as well as financial systems, structure, and trends. NICMR develops original research and policy proposals by specialists based upon knowledge of actual business practice.

NICMR publishes some of its research output in Japanese in *Nomura Capital Markets Quarterly*, and posts some items in Japanese, English, and Chinese on its website.

NICMR's core mission is to contribute to reform of Japan's financial system and securities market in order to foster establishment of a market-structured financial system. Structural changes, particularly population aging, are having a major impact on Japan's economy and society. Addressing the challenges created by these changes calls for reforming social security, tax, and public finance systems. One of Japan's most valuable resources is the JPY1,800 trillion in financial assets held by households. Establishing a market mechanism-driven money-flow that makes efficient, effective use of these assets is critical to the country's future.

NICMR's research focus extends well beyond Japan to encompass current issues in capital markets around the world. In addition to research offices in New York, London and Beijing, NICMR established a research office in Singapore in 2015 to strengthen its Asian research platform.

The continued growth of Asian economies including China is generating huge funding needs for infrastructure and creating an urgent need for indirect financing systems and robust capital markets in the region. Promoting the development of Asian capital markets is a key for the future of Asian financial systems and economies. Moreover, it is important that Asian perspectives and regional differences are recognized in the post-global financial crisis environment of closer cooperation among financial regulators making rules and global standards.

NICMR's recommendations for developing financial and capital markets in Asia are based on analyses of past experience in developed economies. In particular, Japan offers useful lessons on the importance of direct finance for supporting new businesses and of investment services to cater to the needs of a growing middle class.

NICMR has also been working to strengthen its sustainability initiatives. To this end, it established the Nomura Research Center of Sustainability in December 2019. The new research center will focus on objective and practical research into areas of sustainability closely related to the financial and capital markets in major regions including Asia.

As a member of the Nomura Group, a global financial group based in Asia, NICMR strives to contribute to the development of financial and capital markets in Japan and the rest of Asia through fundamental research and experience-based policy recommendations.

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