Asia-Pacific
Economic Cooperation

2014/FDM1/030
Session: 5

Asia Region Funds Passport: A Study of Potential Economic Benefits and Costs

Purpose: Information
Submitted by: Policy Support Unit, APEC Secretariat

APEC
CHINA 2014

Finance Deputies' Meeting
Bo'ao, China
18-19 February 2014

Asia-Pacific
Economic Cooperation

Asia Region Funds Passport: A Study of Potential Economic Benefits and Costs

APEC Policy Support Unit

February 2014

Advancing Free Trade for Asia-Pacific **Prosperity**

Prepared by:

Quynh Le
Asia-Pacific Economic Cooperation Policy Support Unit
Asia-Pacific Economic Cooperation Secretariat
35 Heng Mui Keng Terrace, Singapore 119616
Tel: (65) 6891-9600 | Fax: (65) 6891-9419
Email: psugroup@apec.org | Website: www.apec.org

and

Volguard Financial Markets Division
101B Telok Ayer Street, #03-01, Singapore 068574
Email: FMD@volguard.com | Website: www.volguard.com

Produced for:
Asia-Pacific Economic Cooperation
Finance Ministers Process (FMP)

APEC#213-SE-01.15

The authors would like to thank Dr. Denis Hew and Dr. Akhmad Bayhaqi for their comments on earlier drafts. The views expressed in this paper are those of the authors and do not necessarily represent those of APEC Member Economies.

Summary

Background to the study of Potential Economic and Costs of the Asia Region Funds Passport

- The Asia Region Funds Passport (ARFP) is a proposal for a multilaterally agreed framework allowing the cross-border marketing of funds amongst participating economies. The ARFP would streamline the process of offering a managed fund in a participating economy.
- Membership in the ARFP would be open to all APEC economies in the Asia region, at the discretion of individual economies.
- Over the past few decades, Asian financial wealth has increased at an impressive rate, riding on the region's strong economic performance. As of 2012, Asia had become the second wealthiest region in the world, collectively holding USD 45.2 trillion, equivalent to 33% global financial wealth.
- The asset management industry in Asia has not fully profited from the region's rising prosperity. In 2012, Asia's total Assets under Management (AuM) amounted to only 16% of world's AuM.
- Since the 2008 Global Financial Crisis, there has been an accelerated effort by governments in Asia towards unifying legislative standards to make them more aligned with international standards. This trend towards regulatory convergence, coupled with the region's growth in investible funds and rising investor sophistication, signifies that the creation of an Asian Passport vehicle scheme – such as the Asia Region Funds Passport – has become more viable and desirable.
- Relevant literature confirms that there is growing support for the Asia Region Funds Passport and that such a scheme would stimulate cross-border investment in the region and bring about significant benefits to investors, and also in terms of development of the local funds industry and to regional economies.
- The objective of this study is to evaluate the business case for introducing the Asia Region Funds Passport into Asia. It will examine the current state of mutual fund industries in order to evaluate the types of benefits that the ARFP can bring into the region. The potential gains from the ARFP will be assessed against the potential risks so that decision makers can implement specific measures to maximize the net benefits.
- It should be noted that given the heterogeneity of individual funds industries in Asia, the degree of benefits and risks that the ARFP can bring to individual economies will vary.

Assessing the initial position and current dynamics of the funds industry in Asia

- The Asian funds industry is characterized by a large degree of diversity in terms of the pace of development and the size of the market. The mutual fund industries in Australia; Hong Kong, China; Korea; Japan; Singapore and Chinese Taipei are relatively well developed. Some markets also are of significant size. Australia's industry, with USD 1,677 billion AuM, is the third largest in the world whereas the markets of Japan and China are among the top 10 largest. At the other end of the scale, the funds industries in Indonesia and the Philippines are small, not only in terms of the absolute size but also in relation to their GDP.
- The divergence of the funds industries in Asia reflects many factors, including the different in regulations, tax incentives and the overall infrastructure. Key drivers of

growth in the managed funds sector in Australia; Hong Kong, China and Singapore have been the universal pension systems; a high proportion of affluent individuals in the population and strong insurance sectors.

- A supportive investment environment also plays an important role. For example, on top of the concessionary corporate tax rate, Singapore's introduction of the Resident Fund Scheme, the Enhanced-Tier Fund Management Scheme and the offshore fund scheme has provided its fund industry with an advantageous edge.
- The Asia Pacific as a whole holds about 15% of European fund assets. In some of Asia's more open fund markets – such as Hong Kong, China; Singapore and Chinese Taipei – there is evidence of a strong appetite for offshore funds as a way to diversify investor portfolios. In Chinese Taipei, offshore funds account for 89% of total funds.
- Some markets, however, impose restrictions on the offer of offshore funds. In these markets, a majority of funds (95% in China; 96% in Indonesia and 81% in Korea) are invested in local funds, highlighting a large concentration risk and a lack of alternative investment options for investors.
- In general, however, funds from Asia have been disproportionally disadvantaged from benefiting the region's growing demand. In 2011, Asian funds accounted for USD 400 billion of cross-border fund traded in Asia. This is less than the USD 500 billion of Undertakings for Collective Investment in Transferable Securities (UCITS) products being traded in Hong Kong China; Singapore and Chinese Taipei. In comparison, UCITS funds account for 75% of the EUR 7,500 billion European funds market.
- Empirical evidence from the United States shows that the Total Expense Ratio (TER) - a proxy for the costs to manage funds - has an inverse relationship with fund size. The large size of the US funds markets, together with a well-developed fund management industry, has allowed the industry to achieve economies of scale.
- An examination of the relationship between TER and fund size in some key funds industries in Asia reveals only some markets are equipped to attain economies of scales.
- In Chinese Taipei, the existence of economies of scale is evident through the fact that as the expense ratio decreases the fund size increases. On the other hand, there is little evidence of economies of scale in other Asian funds markets. In Indonesia and Korea, for example, a large percentage of funds are small in size and are therefore not able to achieve economies of scales. As a result, the costs of managing funds in these economies are quite high. Indonesia's asset weighted expense ratios are high at 2.6% on aggregate. This compares unfavorably with the expense ratio of the few EU funds available locally (0.9%).

Assessing the benefits arising from adopting an Asia Region Funds Passports

- Using a conservative assumption of 20% increase per annum in AUM over the 5 years following the introduction of the ARFP, a simulation exercise indicates that there will be significant savings in TERs across all the examined Asian markets. The expected benefits range from 8 basis points in the case of Australia to as high as 100 basis points in the case of Indonesia. Thailand, Singapore and Chinese Taipei could experience savings ranging from 12 to 37 basis points.
- Currently investors in some Asian economies have limited products available to them. This is partly due to strict regulations in these economies which have discouraged fund managers from distributing their products across borders. Without a broad range

of foreign products to choose from, investors have to park the bulk of their funds in local products. This results in a suboptimal allocation of investments as well increased concentration risks.

- The results of the Modern Portfolio Theory Modelling across some key markets in Asia show that the presence of more cross-border products such as the ARFP will allow investors to achieve better diversification of assets and a more optimal portfolio.
- The benefits of a more optimal portfolio can be transferred to investors in the form of better returns for risks. For example, under the ARFP, for every 1% increase in volatility, the expected returns increase by 2.3%. In comparison, for every 1% increase in volatility, the expected returns increase by only 0.22% in China or 0.9% in Korea. Hence, the significantly lower volatilities for the same level of return provide further support to the claim that the ARFP will benefit investors.
- The Sharpe ratios for selected Asian markets provide another assessment of the performance of these industries from a risk-return perspective. Typically, a low Sharpe ratio indicates that the risk is too high for achieved returns. High Sharpe ratios indicate that the returns are in excess of the low risks assumed. Funds in China and Korea have higher levels of volatility in 2012. As a result, the Sharpe ratios for these economies are low (0.32 for China and 0.38 for Korea).
- On the other hand, some Asian markets have performed well in 2012. The Sharp ratios for Australia and New Zealand were 2.24 and 2.31 respectively. Funds in some emerging markets such the Philippines and Thailand which have seen high returns have also scored well, with the Sharp ratio of 2.53 for the Philippines and 2.38 for Thailand.
- The wide divergence in the performance of mutual funds across different markets indicates that a regional-wide ARFP fund that comprises a combination of funds from all these economies would achieve superior performance and be able to compete well with other established products such as UCITS. Indeed, the simulation exercise estimates that the Sharpe ratio for the ARFP would be 2.77, higher than that of any individual Asian local product.
- The ARFP – which will represent a milestone towards deepening financial integration in Asia – can bring significant benefits to the wider regional and global economy. By helping to channel resources from surplus markets to markets where capitals are in short supply, the AFRP essentially will support the recycling of savings towards productive investments that are critical for Asia's future economic growth.
- The benefits can also extend beyond financing investment needs. The ARFP can introduce to local funds industries foreign technical know-how, competitive pricing and higher standards of disclosure and performance. This promotes efficiency in the local fund industries, resulting in greater global competitiveness of the Asia funds management industry.
- Under the right environment, the thriving of the asset management industry can become a vital source of growth in itself. One of the measureable contributions of the Asia Region Funds Passport to the economy is the potential increase in the employment numbers in the funds industries in Asia.
- An essential feature of the Asia Region Funds Passport is that it increases the demand for funds to be domiciled in Asia. This would offer increased jobs opportunities, not only to manage the fund but also to service the fund structure. It is estimated that for every one full-time employee working directly in the asset management industry for a locally domiciled fund, there are 4.6 jobs in the industry for servicing the fund structure.

- It is estimated that if the 2,200 funds that are currently under management in Hong Kong, China were all domiciled currently, it would increase size of professionals employed in the industry to 22,000, from the current 4,000 employees. Assuming each of these additional professional earning an average wage equals to GDP per capita, the creation of 18,000 new jobs would add USD 662.3 million into the economy, an equivalent of 0.3% of GDP.

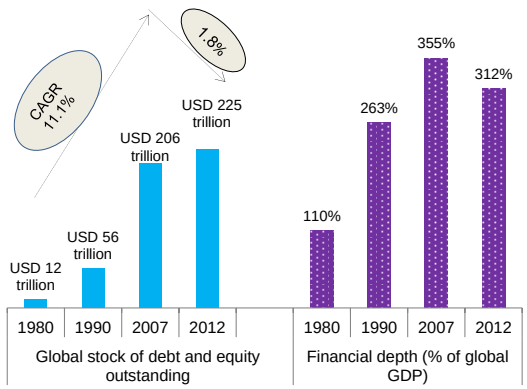
Policy makers, however, need to mitigate some risks in order to reap the full benefits of the ARFP

- Adopting the AFRP can bring risks. These risks are inherent with any cross-border financing solution in which shocks in one market can be amplified and transmitted to other markets. The speed and scale with which illiquidity and losses seen in some markets could be translated to other markets is often greater with enhanced interconnectedness and efficiencies of the transmission and intermediation process.
- However, many economies in Asia can no longer afford inefficient financial markets which have resulted in the persistently low investment rates in the region over the past decade. The deepening integration of financial markets will not only help to promote financing of investment but would also mitigate the risks associated with large and volatile capital flows into the regions.
- Governments need to tune the pace of regional financial integration according to the development of their economies. As the benefits of the ARFP can only be optimized if the region possesses the requisite infrastructure and institutions, Asian economies need to work together to upgrade and harmonize regulations and market practices and develop mutually recognized regional standards.
- Regulation oversight may result in inadequate protection for investors. The Madoff fraud in 2011 – which caused significant losses to the European UCITS – is an example of how regulatory failure to keep up with the pace of the investment environment can have acute negative consequences.
- Regulators in Asia, however, can learn from the European experience. In advancing the ARFP, policy makers should strike the right balance between achieving market efficiency and investor protection. Emphasis should also be placed firmly on minimizing systemic vulnerabilities and maximizing market transparency. Furthermore, as many asset management firms and their products are now complex and operate under multiple jurisdictions, there is an increasing impetus to put in place an institution that can coordinate the work of different regulatory agencies.

CHAPTER 1: INTRODUCTION

Over the past three decades, one of the most notable developments in the global economy has been the rapid growth of global financial assets. In the period between 1980 and 2007, the value of the world's financial assets[1] rose by more than 17 times, from USD 12 trillion to USD 206 trillion[2] (Figure 1). However, the 2008-09 Global Financial Crisis (GFC) dramatically brought a halt to this rapid expansion in global capital markets. Since 2007, world financial assets grew at an average annual rate of 1.8%, reaching USD 225 trillion in 2012, a sharply slower growth rate than the 11.1% per annum growth achieved in the period 1980 – 2007. The share of financial assets to world's GDP also fell from its peak of 355% in 2007 to 312% in 2012. Cross-border capital flows were also affected, falling from USD 11.8 trillion in 2007 to USD 4.6 trillion in 2012, reversing the progress made following years of financial integration.

Figure 1: Evolution of global financial assets



Source: Boston Consulting Group

Some of the effects of a slowing growth momentum are to be welcomed as they represent a healthy correction of bubbles in some asset markets. There is a risk, however, that the global economy could be negatively affected if the retrenched growth of the financial markets has an impact on financing for households and firms. In particular, large banks in advanced economies may focus on domestic activities and curtail cross-border lending. In some emerging markets where banks have been the vital source of credit, slower cross-border bank lending impacts the overall economy, especially if households and the corporate sector have difficulty in securing finance for business investment, homeownership and investment in innovation and infrastructure. A lesser degree of global financial integration could also result in inefficient utilization of financial resources and exacerbate financial imbalances in the global economy. In economies with high savings rates, investors would face shortages of good investment opportunities and lower returns. Furthermore, growth would be constrained in markets where capital is in short supply.

There is no doubt that the 2008-09 GFC altered the global financial landscape and its contribution to global economic growth. Since 2008, policies have been developed to address some deficiencies in financial regulation that were exposed during the 2008-09 GFC. In particular, the Basel Committee of Banking Supervision in 2010 introduced a new capital adequacy framework, known as Basel III, with an aim to increase the resilience of banks during periods of stress and address system-wide risks that can severely impact the financial sector. Economies have also strengthened macro-prudential supervisory capabilities.

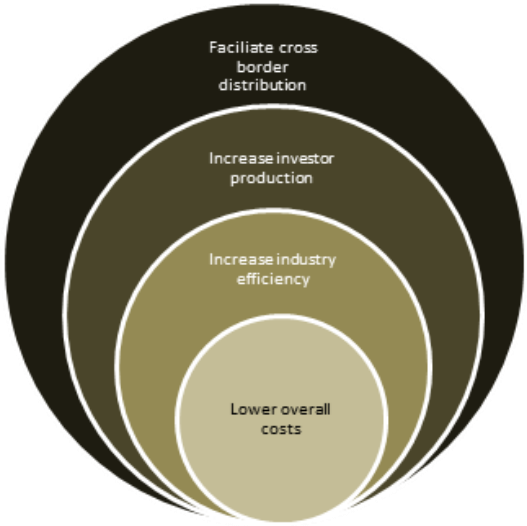
The financial crisis also created an urgent need to enhance the coordination of financial regulation across borders. It is vital now to build financial markets that are efficient in intermediating the demand and supply of credit across borders and at the same time are able

[1] Measured as the sum of the value of equity market capitalization, corporate and government bonds, and loans

[2] McKinsey Global Institute (2013), "Financial Globalization: Retreat or Reset?", March 2013.

to contain the dangers of cross-border capital flows. APEC policy makers have taken steps to address this issue. Among these is the ongoing work on developing an Asia Region Funds Passport. The aim is to utilize the Asia Region Funds Passport as a vehicle to support the further development and integration of capital markets as well as the efficient cross-border trading or "passporting" of funds across the APEC region.

Figure 2: The Asia Region Funds Passport aims to:



Currently, the majority of Asian funds are manufactured, distributed and administered within each jurisdiction, with limited transferability across borders. When implemented, the Asia Region Fund Passports framework will allow operators of collective investment schemes (CIS) based in passport participating economies to offer their schemes to investors in other passport member economies, ideally without the need to meet different licensing requirements and avoiding investment restrictions in each economy. The AFRP will improve efficiency by minimizing the number of additional applications/requirements that have to be met in order to offer those funds across the border. Increased efficiency brought about by the ARFP will be critical for the funds management industry in Asia to develop and contribute further to the regional economy. Concurrently, ARFP will help to safeguard the interests of investors through a common set of regulations agreed between all participating jurisdictions that will govern product issuers and products. The streamlining of regulations will be designed to provide a consistent level of protection for investors across participating jurisdictions.

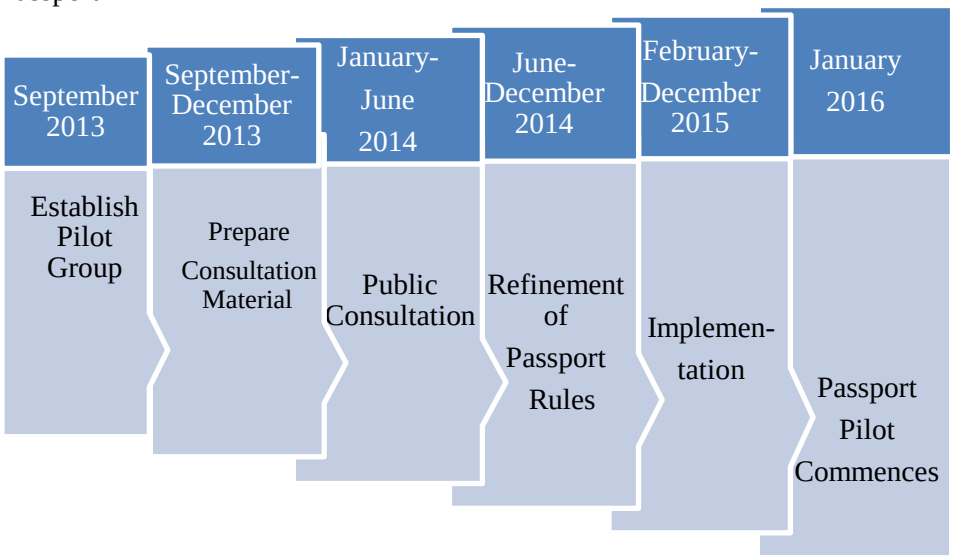
The concept of the Asia Region Funds Passport was initiated and introduced to the APEC Finance Ministers' Process by the Australian Treasury in 2010. Since then, a series of capacity building workshops have been held to help interested APEC economies to improve their technical skills in cross-border trading of financial products. Concurrently, relevant stakeholders and interested APEC economies have been engaged in policy dialogues to identify the features of a funds passport scheme; identifying the various policy and technical challenges; and looking at the options to develop the concept. On 24 September 2013, Finance Ministers from Australia; Korea; New Zealand and Singapore signed a Statement of Intent noting progress on the Asia Region Funds Passport[3]. These four economies have agreed to commence a pilot program for the Asia Region Funds Passport and have set out a timeline for its establishment (Figure 3). The decision to join the ARFP scheme is at the discretion of individual APEC economies. Membership to the Asia Region Funds Passport is open to all APEC members in the Asia region who meet certain criteria.

[3] Work on the Asia Region Funds Passport commenced in late 2010. By 2013, financial regulators and officials from thirteen APEC economies, including Australia; China; Hong Kong, China; Indonesia; Japan; Korea; Malaysia; New Zealand; the Philippines; Singapore; Thailand, Chinese Taipei and Viet Nam, participated in ARFP related workshops.

Some of the criteria[4] include:

- being signatory to Appendix A of the International Organization of Securities Commissions ("IOSCO') Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information; and
- having been assessed by the International Monetary Fund and/or World Bank as part of a Financial Sector Assessment Program as having broadly implemented the relevant IOSCO Principles on enforcement, cooperation and collective investment schemes.

Figure 3: The anticipated implementation timeframe for the Pilot Scheme on the Asia Region Funds Passport



Source: APEC

Studies have consistently noted that the ARFP will bring significant benefits for participating economies. Many of these studies quote the European experience with the Undertakings for Collective Investments in Transferable Securities (UCITS) as an example showing the benefits that could be unlocked under the introduction of the ARFP. In particular, UCITS has allowed investment funds once registered in a single member economy to be easily marketed across all other jurisdictions of the European Union, without lengthy authorization proceedings. Since its inception in 1985, UCITS has evolved rapidly to cover a wide range of financial instruments covering financial indices, closed-end funds, fund of funds and hedge funds. Although this growing complexity has significantly increased the inherent risk, UCITS is still a strong and reputable brand name recognized throughout the world, accounting for over 36,000 funds with almost EUR 6,690 billion[5] in assets, accounting for 70.2% of the total value of Asset under Management (AuM) in Europe.

At the ARFP technical and policy workshop in Bangkok in June 2012, participants noted that none of the reports and studies to date has elaborated a business case as to why Asian economies need to be party to an Asian regionally-based funds passporting scheme. Accordingly, the APEC Policy Support Unit was tasked by the APEC Senior Financial Official Meeting (SFOM) to undertake a study assessing quantitatively the potential economic benefits and costs deriving from the introduction of the proposed Asia Region

[4] See the Statement of Intent for the Asia Region Funds Passport for the full list of criteria
[5] As of the end of September 2013

Funds Passport for Asia, under the assumption that the region has the requisite conditions to bring the proposed fund to full fruition.

The study is organized as follows:

- Chapter 2 provides an overall assessment of the current state of the mutual funds industry in Asia. Four economies – China; Indonesia; Korea and Chinese Taipei – were selected as case studies due to the fact that they are representative of the diversity of the Asia funds industry. All are at different states in the development of their financial markets and have different degrees of financial openness.
- Chapter 3 quantitatively and qualitatively assesses the benefits that can be accrued from the introduction of the Asia Region Funds Passport into the region, under the assumption that individual Passport participating member possesses capable infrastructure and institutions that allow the benefits to be optimized. The focus of the assessment is on the potential gains from (i) improved efficiency, (ii) greater diversification, (iii) better fund performance; and (iv) stronger and more sustainable economic growth.
- Chapter 4 discusses the risks associated with the introduction of the Asia Region Funds Passport into the region.
- Chapter 5 evaluates the business case for introducing the Asia Region Funds Passport by weighing the benefits against risks. This chapter also suggests policy options that decision makers should take into consideration to optimize the benefits while minimizing the risks.
- Chapter 6 provides the conclusion.