6

Strengthening the Investor Base

The investor base is a key element in supporting the development of capital markets. Assets of institutional investors in the region have grown over the past few years and now account for about 45 percent of the region's GDP in aggregate. However, there is scope for further growth in institutional assets and for institutional investors to play a greater role in capital market development. For retail investors, it is important to develop the mutual-fund industry.

A broader base of investors is a key component needed to further develop the securities markets in East Asia. In particular, it is important to develop a wide, heterogeneous investor base with different preferences and risk appetites. Contractual savings (pension and life insurance) can affect the development of securities. First, they provide institutional arrangements for the accumulation of long-term capital; they may have a longer time horizon than other investors and may therefore require lower term premiums on fixed-income securities. Second, they may be active traders of securities, thereby contributing to the liquidity of capital markets. Also important is the development of a mutual fund industry that can cater to retail investors with different needs and risk appetites; this in turn can significantly contribute to trading and liquidity.

The assets of institutional investors in East Asia have grown over the past few years and at the end of 2004 amounted to US$1.5 trillion, or around 45 percent of GDP in the region as a whole (Table 6.1). Clearly, though, there is considerable variation in the size of the assets across countries—with the institutional investor base still very small as a percentage of GDP in China, Indonesia, and the Philippines.

Against this backdrop, this chapter looks at the role that the contractual savings sector can play in further developing the securities markets in the region. It then looks at the issues pertaining to the development of the mutual-fund industry, which accounts for about half the investor base and is particularly important for the retail investor segment.

Pension Funds

Pension systems in the region differ widely in their institutional design, coverage, maturity, benefit provision, value of assets under management, and asset allocation—all of which can directly affect the actual and potential impact of pension funds on the development of capital markets (Table 6.2).

The pension system in the Republic of Korea is part of a larger social security system that also covers social assistance and social welfare services. As such it is largely composed of public defined-benefit schemes. The National Pension Scheme (NPS)—whose assets are the largest, accounting for about 17 percent of GDP—

TABLE 6.1 Assets of Institutional Investors

Economy	Pension		Life insurance		Mutual funds		Total	
	US$ billions	% of GDP	US$ billions	% of GDP	US$ billions	% of GDP	US$ billions	% of GDP
China	28.0	1.6	136.0	7.9	27.0	1.6	191.0	11.1
Indonesia	5.4	2.1	10.5	4.2	11.1	4.5	27.0	10.9
Rep. of Korea	161.0	21.4	133.0	17.7	186.0	24.7	480.0	63.8
Malaysia	70.0	59.2	21.0	17.8	23.0	19.4	114.0	96.4
Philippines	7.9	9.2	2.7	3.1	1.4	1.6	12.0	14.0
Thailand	20.0	12.0	17.0	10.2	19.0	11.4	56.0	33.6
Hong Kong (China)	38.0	22.9	9.0	5.4	465.6	280.3	512.6	308.6
Singapore	68.0	61.2	33.0	29.7	28.0	25.2	129.0	116.0
Total East Asia	398.2	11.8	362.2	10.8	761.0	22.6	1,521.7	45.2

Sources: HSBC 2005; Dalla 2005, BNM, BOT.

Note: Figure for mutual funds in Singapore only includes Singapore dollar funds domiciled in Singapore.

serves employees of private companies and self-employed persons. There are three special occupational pension schemes: the Government Employees' Pension Scheme (GEPS), the Military Personnel Pension Scheme (MPPS), and the Private School Teachers' Scheme (PSTPS). Korea also has a private pension system composed of voluntary individual pension plans for the general public and a mandatory Retirement Allowance Scheme which, although not a pension plan, functions as a post-retirement protection mechanism for people working in workplaces with more than five employees. Korea's total pension assets amount to about 21 percent of GDP.

Malaysia's pension system comprises a series of provident funds, the largest of which is the Employees' Provident Fund (EPF). As of 1998, EPF accounted for more than 85 percent of the assets managed by the Malaysian provident fund system. Established in 1951, it is one of the oldest pension arrangements in the region (together with Singapore's) and is a mature system. In aggregate, pension funds in Malaysia amount to about 60 percent of GDP.

In Thailand, the pension system is small but complex, with a large number of schemes covering different portions of the working population but with low overall coverage. Private-sector employees are covered by the mandatory Old Age Pension Fund (OAPF), which is part of a larger Social Security Fund (SSF) managed by the Social Security Office. Central government officials are covered by the Government

TABLE 6.2 Asset Size and Type of the Most Important Pension Schemes

Economy	Pension assets *(US$ billions)*		Pension assets *(% of GDP)*		Most important scheme		
	Total	Most important scheme	Total	Most important scheme	Year established	Type	Benefits
Indonesia	11.5	Jamsostek 3.8	4.6	1.5	1995	DC	Lump sum
Rep. of Korea	161.0	NPS 128.6	21.4	17.1	1986	DB	Annuities
Malaysia	70.0	EPF 63.3	59.4	53.7	1951	DC	LS or PW
Philippines	10.0	SSS 3.5	10.2	3.6	1948	DB	LS or PW
Thailand	20.0	SSF 6.7	12.2	4.1	1990	DB	Annuities
Hong Kong (China)	38.0	MPF 15.5	23.3	9.5	2000	DC	Lump sum
Singapore	68.0	CPF 68.0	63.7	63.7	1955	DC	Lump sum

Notes: NPS = National Pension Scheme. EPF = Employees' Provident Fund. SSS = Social Security System. SSF = Social Security Fund. MPF = Mandatory Provident Funds. CPF = Central Provident Fund. DB = defined benefit. DC = defined contribution. LS = lump sum. PW = programmed withdrawal.

Pension Fund (GPF), which is an unfunded and non-contributory defined-benefit scheme. Local government officials are covered by their own individual defined-benefit schemes, while private teachers are covered by a separate provident fund. There are also two voluntary schemes for corporations and individuals: provident funds and retirement mutual funds respectively. Total pension assets amount to only around 12 percent of GDP.

Hong Kong (China) recently reformed its pension system with the introduction of the Mandatory Provident Funds (MPF), regulated by the Mandatory Provident Fund Schemes Ordinance. Thus the pension system in Hong Kong (China) comprises both pre-reform institutions and the new MPFs, and in total amounts to about 23 percent of GDP.

Singapore's pension system relies almost entirely on a single, state-managed mandatory savings system based on individual accounts. This system is administered by the Central Provident Fund, falling under the purview of the Ministry of Manpower. Two other mandatory but non-contributory pension schemes are in operation: one for government employees and one for the armed forces. There is also a voluntary retirement scheme, the Supplementary Retirement Scheme, introduced in 2001. Pension assets amount to 64 percent of GDP.

In the Philippines, the pension system mainly comprises the mandatory, publicly managed Social Security System (SSS), a scaled-premium, defined-benefit scheme that covers most private-sector employees, and the Government Service Insurance System (GSIS), which covers public-sector employees. Though the latter has larger assets, the SSS is more important given its extensive coverage of the private-sector workforce. The assets of these two pension institutions total 10 percent of GDP. Other branches of government, notably the military and police, are covered by a separate system; the Armed Forces of the Philippines' Retirement and Separation Benefit System (AFP-RSBS). Various individual pension instruments including pre-need pension plans and employer-sponsored provident funds also exist.

Overall, then, pension assets in the region are still relatively small. Only Singapore's Central Provident Fund (CPF) and Malaysia's Employees' Provident Fund (EPF) have assets that exceed 50 percent of GDP. However, since both these schemes also have non-pension related mandates, the amount of assets effectively connected to the pension function is smaller than might appear.[120] Pension funds in the other countries amount to less than 25 percent of GDP. And although Korea, the Philippines, and Thailand have national defined-benefit schemes (which, in view of their long-term liabilities, may be expected to have the strongest demand for fixed-income securities), these pension schemes are relatively immature, and their need for investment instruments is still quite small.

What is the current asset allocation of the pension funds in the region?[121] In general, based on available information, the asset allocation appears to be fairly conservative, being mainly confined to government securities and bank deposits (Table 6.3). The exception is Hong Kong (China), where pension assets are largely held in equities.

TABLE 6.3 Broad Allocation of Pension Fund Assets *(Percent of Total)*

Economy	Claims on public sector	Claims on financial sector	Corporate bonds	Equity	Foreign sector	Other	% of GDP
Indonesia	13.5	49.4	23.0	5.2	0.0	8.9	0.05
Rep. of Korea	43.5	0.9	11.1	3.2	2.8	38.5	19.8
Malaysia	38.5	8.8	31.0	19.7	n.a.	2.0	53.7
Philippines	15.0	--	--	33.0	--	3.8	--
Thailand	39.9	29.0	14.2	11.3	2.8	2.8	12.7
Hong Kong (China)	n.a.	20.0	--	54.0	--	26.0	9.5
Singapore	96.2	n.a.	n.a.	n.a.	n.a.	3.8	62.0

Notes: Hong Kong (China) figures are for Mandatory Provident Funds only. Figures include domestic and foreign investments. "Other" represents debt securities. Singapore figures do not include the investment schemes. Malaysia figures are for the Employees' Provident Fund only, and those for the Philippines are for the Social Security System only.

n.a. = not available. -- = no allocation to that category

This allocation pattern is broadly similar to fund allocations in emerging markets more generally, as surveyed by Hess and Impavido (2003), who look at the allocation of assets in 26 public pension funds. It contrasts with the pattern in the Organisation for Economic Co-operation and Development (OECD) countries, where public pension schemes invest 48 percent of their financial assets in equities (domestic and foreign), and 30 percent of their assets in foreign securities.[122]

Thus two main factors currently limit the contribution of pension funds to the development of securities markets. First, pension assets in most countries are still small. Second, the investment allocation of these assets is largely skewed towards government securities and bank deposits. The key questions are therefore:

- What is the potential for increasing the role of pension funds in developing capital markets (while maintaining their primary objective) through an increase in the size of assets?
- Broadening the investment allocations of pension funds could also provide a greater impetus to securities market development. To what extent could a loosening of investment regulations help? What other reforms or changes could be undertaken that would both advance the objectives of pension funds and encourage a greater use of capital markets?
- What other key elements do countries need to strengthen in tandem if investment restrictions are loosened and investment allocations broadened, to help ensure that the safety and soundness of the pension systems are maintained?

Increasing the size of assets under management

Potentially, pension assets may increase through several channels: (1) if there is scope for extending pension coverage; (2) through the reversal of any taxation regime that may be discouraging savings by taxing them twice; or (3) if there is scope to increase contribution rates.[123] These are discussed in turn.

Pension coverage

Pension coverage ratios vary considerably across countries (Table 6.4). The Hong Kong (China) pension system has the highest coverage, at 79 percent of the labor force and 41 percent of the total population. In the Philippines, the coverage of the Social Security System is quite high, at 74 percent of the labor force, but only one third of the members are active contributors. Coverage in Korea is also high; the National Pension Scheme (NPS) is open to all resident citizens aged between 18 and 60 years of age. In 1997, NPS covered only about 37 percent of the labor force, but mandatory coverage was extended in 1999 to the urban self-employed, employees in companies with fewer than five workers, non-income earners, and foreigners, bringing the coverage up to about 73 percent of the labor force. In Singapore, the Central Provident Fund covers 77 percent of the eligible population but only 56 percent of the labor force,[124] largely because foreign workers (who account for around 25 percent of the labor force) are excluded from the covered population. In Malaysia, the Employees' Provident Fund covers about 45 percent of the labor force. At the lowest end of the spectrum in terms of coverage is Thailand, whose Social Security Fund (SSF) is estimated to cover about 21 percent of the labor force. A few cate-

TABLE 6.4 Coverage Ratios of Pension Schemes

Economy	Active members *(thousands)*	Members/covered population *(%)*	Members/labor force *(%)*	Members/total population *(%)*
Indonesia	14,100	42.7	14.0	6.6
Rep. of Korea	17,070	n.a	73.0	37.1
Malaysia	5,070	n.a	45.5	19.8
Philippines	8,925	n.a	74.0	31.0
Thailand	10,351	72.0	29.0	16.8
Hong Kong (China)	2,832	95.5	79.4	41.2
Singapore	1,324	77.0	56.6	31.2

Notes: Korea: National Pension Scheme only. Malaysia: Employees' Provident Fund only. Philippines: Social Security System and Government Service Insurance System only.

gories of workers within the labor force are exempt from contributing to the SSF, but the main reason for the low coverage is that a large share of the labor force works in the informal sector. Including the Government Pension Fund, coverage amounts to about 29 percent of the labor force.

Pension coverage in East Asia is relatively good compared to the average in Eastern Europe and, in particular, Latin America (whose averages are 63 percent and 35 percent respectively). But compared to the more advanced Latin American countries and the OECD, where average coverage is 90 percent of the labor force, there is scope for increasing effective coverage in several East Asian countries and particularly in Indonesia, the Philippines, and Thailand. At the same time, it should be recognized that the share of the informal labor force is in these countries is still relatively large, making it difficult to increase coverage until more of these workers are brought into the formal labor market.

Taxation

It is important to give pension savings an equitable and consistent tax treatment in order to promote the accumulation of long-term savings for retirement. International experience—and economic logic—suggests that an appropriate tax treatment is achieved when contractual savings (through social security, occupational pension funds, and life-insurance companies) are taxed only once. There are two alternative ways to achieve this. The first is to collect income tax from the contributions to the contractual savings plan and to exempt from income tax the investment income from contractual savings institutions and from the distribution of plan benefits. This is known as the taxed-exempt-exempt (TEE) alternative. The second is to exempt from income tax both the contributions toward the purchase of a contractual savings plan and the investment income of the contractual savings institution, while making plan benefits liable to income tax—this is known as the exempt-exempt-taxed regime (EET).

These two alternatives are expenditure regimes in which the post-tax rate of return is expected to equal, in present-value terms, the pre-tax rate of return. Therefore, consumption is taxed at the same rate now as in the future. Such a tax regime is usually preferred, as it avoids taxing savings twice and encourages the accumulation of contractual savings for retirement purposes.[125] The choice between the two alternatives is usually dictated by fiscal considerations. TEE and EET regimes are in general not equivalent: other things being equal, taxation will be lower in the latter than in the former, owing to tax deferral.

In practice, the tax treatment of pension savings in East Asia is very generous. In Hong Kong (China), the exempt-exempt-exempt (EEE) rule is generally followed: contributions to the Occupational Retirement Schemes Ordinance ORSO and MPF contributions are tax-exempt.[126] Thailand follows the same rule for its public schemes. In Thailand's voluntary provident funds, tax exemption ceilings apply to contributions, and benefits arising from the investment of the funds are all exempt from tax. The EEE rule is also applied in the Philippines' Social Security Fund and Government Service Insurance System, exempting from taxes, fees, or charges all their assets, collected contributions (and all accruals thereto), income and investment earnings, and all benefits. In Korea, pension savings follow the EET rule for the National Pension Scheme and the EEE rule for the Government Employees' Pension Scheme. In Singapore, the tax treatment of savings through the Central Provident Fund follows the EET rule. Only annuities or lump sums under the Minimum Sum Scheme enjoy tax exemption. In Malaysia, the tax treatment of pension savings in the Employees' Provident Fund follows the EEE rule with varying deductibility ceilings on contributions.

In sum, taxation does not constrain the growth of pension assets in the region.[127]

Contribution rates

The contribution rates to pension schemes in East Asia are generally quite low, with the exception, at least in nominal terms, in Malaysia and Singapore (Table 6.5). Nominal contribution rates in Hong Kong (China) are only 10 percent of the total wage bill or 1.8 percent of GDP. In Thailand, nominal contribution rates to the Social Security Fund are only 6 percent of the covered wage bill (that is, the total wage bill of the population covered by the plan). In Korea in 2004, nominal contributions to the national Pension Scheme amounted to 9 percent of the covered wage bill and hence to only 2.2 percent of GDP; the contribution ceiling is around twice the average covered wage, indicating an effective contribution rate of less than 9 percent of the total wage. In Singapore, employees less than 50 years old contribute 33 percent of

TABLE 6.5 Nominal Contribution Rates of Main Pension Schemes

Economy	Scheme	Employee rate (%)	Employer rate (%)	Credited to retirement account (%)	Contributions from main scheme (% of GDP)
Indonesia	Jamsostek	2.0	3.7	4.4	0.2
Rep. of Korea	NPS	4.5	4.5	9.0	2.2
Malaysia	EPF	11.0	12.0	13.8	4.9
Philippines	SSS	3.3	6.1	9.4	0.7
Thailand	SSF	3.0	3.0	6.0	0.6
Hong Kong (China)	MPF	5.0	5.0	10.0	1.8
Singapore	CPF	20.0	13.0	7.0	8.5

Notes: NPS = National Pension Scheme. EPS = Employees' Provident Fund. SSS = Social Security System. SSF = Social Security Fund. MPF = Mandatory Provident Funds. CPF = Central Provident Fund.

the relevant wage bill, and total contributions to the Central Provident Fund represent only 8.5 percent of GDP. The special account that is used to finance retirement benefits receives only around 7 percent of GDP. In Malaysia, nominal contribution rates are 23 percent of the covered wage. While contributions are levied on total remuneration, only 60 percent of the proceeds (equivalent to 13.8 percent of the wage bill) are used to finance retirement benefits. As a result, in 2004, total contributions to the Employees' Provident Fund amounted to 4.9 percent of GDP. In the Philippines, the contribution rate to the Social Security System is only 9.4 percent, which works out to 0.7 percent of GDP. In the Government Service Insurance System, the contribution rate is much higher, at 21 percent (9 percent for employees and 12 percent for employers) and thus, even though the active membership of this scheme is only one fifth of that of the Social Security System, its contribution to GDP is almost as large.

Several countries may have scope to increase their nominal and/or effective contribution rates while keeping their pension systems affordable and able to provide adequate income-replacement rates.[128] It is these two considerations, rather than the need to help develop capital markets, that should drive decision making on pension contributions, even though it is clear that increasing the contribution rates would enlarge the volume of savings that pension systems intermediate.

Diversifying investment allocations

Except in Hong Kong (China), regulations on the investment of pension funds are quite conservative and often have quantitative floors for government securities.[129]

In Thailand, the investment rules of the Social Security Fund and Government Pension Fund are governed by a ministerial regulation and by the investment policies established by the Social Security Office and Government Pension Fund (GPF) boards. For the GPF, the rules include a 60 percent investment floor in "highly secure securities," which appear to exclude equity and non-rated corporate debt. Various investment ceilings apply to other securities; for instance, no more than 10 percent of assets can be invested in equity or in foreign assets. On the basis of these rules, GPF designs its strategic allocation of up to 70 percent of assets in cash, deposits, and government fixed-income securities; up to 15 percent in private-sector instruments; up to 5 percent of assets in foreign equity; up to 5 percent in foreign-debt instruments; and up to 5 percent in real estate. Its investment policy does not refer to risk management or benchmarks. For the voluntary provident funds and retirement mutual funds, the investment regulations restrict fund managers to investing in securities approved by the Securities and Exchange Commission (quality assets concept), with investment limits set up by these funds' own investment policies (diversification concept). The investment limits are designed to ensure that investments in grade securities issued by any company do not exceed 15 percent of net asset value (or 20 percent of net asset value for those financial institutions under Central Bank supervision). A company's investment in non-investment grade securities may not exceed 5 percent of net asset value and should be lower than 15 percent in aggregate.

In Malaysia, the investment policy of the Employees' Provident Fund (EPF) is regulated by the EPF Act of 1991, the Trustee Act of 1949, and by the EPF policy guidelines set by the fund's investment committee (Asher 1999). EPF is required to keep 70 percent of its assets in Malaysian government securities, but the government has waived this requirement due to the shortage of these securities. EPF is allowed to invest up to 25 percent of its assets in equities. Foreign investments are also allowed, but at present only a very small share of assets is invested abroad, mainly in Asian bonds and equities.

In the Philippines, the Social Security System (SSS) charter gives the SSS Commission the power to manage and invest the reserve funds in line with the basic principles of safety, good yield, and liquidity. The key ceilings for investment are 7.5 percent for foreign-denominated investments, 40 percent for private securities, and 30 percent for government financial institutions and corporations. The SSS's actuary is required to submit a valuation report to the SSS benefit program at least every four years. In the Government Service Insurance System (GSIS), the Board has the power to invest the reserves according to parameters identified in the GSIS charter. GSIS must make available at least 40 percent of its funds for loans to its members (the actual proportion is currently around 45 percent)—a requirement that limits the ability of this pension scheme to contribute funds to the development of capital markets. Periodic actuarial valuation is required but no time frame is suggested; GSIS is also required to provide an annual report on all its investments to Congress.

In Korea, no detailed regulation applies to the National Pension Scheme, but the investment universe of the National Pension Corporation (NPC) is defined by the Fund Management Committee according to the National Pension Act and ministerial ordinances. NPC's investment strategy is regularly reviewed by external professional advisers. Investment regulations allow the corporation itself to manage domestic bonds and equities as well as foreign bonds. The same regulations require NPC to outsource the management of foreign equities, real estate, and private equities. External asset managers are selected through public competitions following the transparency standards contained in the procurement guidelines applicable to public contracts. Consulting firms are used to select foreign asset managers.

The conservative investment regulations generally observed in the region are typical of those governing public pension schemes in emerging economies. Hess and Impavido (2003) survey the investment regulations of public pension funds in 26 emerging markets and find that the use of restrictions and mandates is widespread, with the most common restriction being on foreign investments. They find that 57 percent of the funds face prohibitions on investments abroad, 14 percent face prohibitions on equities, and 19 percent on loans. Some 60 percent of the funds operate under at least one type of mandate. These mandates include requirements to invest in government bonds, whether national, state, provincial, or municipal (48 percent of the funds surveyed); in social projects such as housing (24 percent); and in general economic development (32 percent).

The OECD countries have much looser rules for pension funds. Among 29 OECD countries (excluding Korea), nine have no limits on any investment categories (equity, real estate, bonds, investment funds, loans, or bank deposits). Thirteen have no limits on equity investment, eight have a limit of at least 50 percent, and five have limits between 50 and 25 percent of total assets in equities. Regulations regarding bonds are also flexible, and 22 countries have no limits on bond investments. Nineteen countries have no limits on bank deposits. In five countries that do limit bank deposits, the limits are usually below 20 percent, in recognition of the low profitability of such investments.

As discussed above, in several cases the actual investment allocations of pension assets in East Asia seem to be even more conservative than the restrictions permit. What policy changes could encourage a greater use of securities markets while advancing the goals of the pension funds themselves?

Liability-based management

For public defined-benefit schemes, such as those in Korea, the Philippines, and Thailand, an important beneficial reform would be to account for pension liabilities when pension rights are accrued.[130] Under these countries' current accounting rules, like those of most other countries in the world, public pension liabilities are not recorded, while public contributions are recorded as government revenues (under social contributions) and pension payments are recorded as transfers to retirees. If pension liabilities were to be accounted for when pension rights accrue—with the contributions that give rise to such rights treated as financial transactions and pension payments treated as reductions in pension liabilities—this would help to highlight the fact that, from the perspective of the sponsor of a defined-benefit plan, pension-fund management is an asset-liability-management problem, and has long-term risks. Such accounting reforms are now being undertaken in Europe.[131]

For defined-benefit schemes, the adoption of an asset-liability framework would likely encourage greater investments in securities. Managers of such funds have traditionally focused on investment management, managing their assets against a return benchmark for an asset class. This approach may be appropriate for defined-contribution schemes with no guarantees.[132] But it is not appropriate for defined-benefit schemes, given their predetermined liabilities or obligations. Rather the focus should be on liability benchmarking—whereby a liability index is constructed and assets and liabilities are managed with regard to the correlation between the two.

Liability management and investment management can produce very different asset allocations. For instance, in a fund that is managed with regard to return benchmarks, one would expect to observe a large share of equities if mean reversion in equities exists. In a fund managed against a liability benchmark, one would observe a large share of fixed-income instruments of long duration, since the liabilities of a defined-benefit pension fund behave very much like a laddered bond portfolio.[133] Pension funds around the world are increasingly focusing on asset-liability management, and in particular, on the relative duration of assets and liabilities.

A revision of accounting standards would require that pension liabilities be measured and evaluated in a way that is consistent with the measurement and evaluation of assets, and this in turn would encourage the adoption of funding rules and strategies for managing assets through liability benchmarking.

Thus the adoption of these accounting rules in Korea, the Philippines, and Thailand, given their public defined-benefit pension schemes, could have an important impact on capital market development, especially on the development of long-duration fixed-income securities. However, as discussed below, for the changed rules to have their full impact would also require an increased supply of long-term bonds. At present, with the relatively short supply of long-term bonds, even a modest increase in the allocation of pension assets into such long-term securities would be problematic, because liquidity constraints could lead to substantial short-term price volatility.

Increased annuitization

For defined-contribution schemes such as those in Hong Kong (China), Malaysia, and Singapore, an argument could be made for increasing the annuitization component. This would improve both the inter- and intra-generational risk-sharing properties of the systems. From the perspective of capital-market development, increased annuitization would expand the potential of the pension system, by increasing the set of professional institutional investors and the demand for long-duration fixed-income securities.

What measures need to be taken in tandem if pension funds are to shift some of their assets away from safer but lower-yielding bank and government instruments toward a more diversified portfolio?

Governance framework

The first set of measures concerns the governance framework of pension funds, which will strongly affect the capacity of the funds to undertake such a diversification.

The governance framework in almost all the pension institutions in the countries covered is based on tripartite, representative boards. Most of these institutions require their board members to have pension and fund management expertise, but their "fit-and-proper tests" are relatively weak. Directors on some boards are not remunerated, so it is difficult for institutions to hire and retain qualified directors. A large share of the directors in most institutions consists of ex-officio government representatives.

The economic literature finds that inconsistent performance of pension funds is associated with poor governance. In more developed countries, a direct link between governance and investment performance cannot be established, although governance indirectly affects performance by determining key investment strategies. Representative governing bodies tend to produce more conservative investment policies than do governing bodies composed of professional and qualified directors.

In developing countries, poor governance often reflects an inability to insulate fund management from political risk. In these countries, this appears to be an important determinant of poor performance.

Two specific governance problems are likely to have a detrimental impact on fund performance in developing countries. The first of these relates to the control structure of public pension plans, which is generally designed to give equal representation to a large number of stakeholders on the board of directors. Multiple and unclear plan mandates induce a strong bias in a fund's control structure. In practice the presence of social mandates, together with appointment procedures that can be less than transparent, weak "fit-and-proper" tests for directors, and the presence of ex-officio directors, often means that governments have a stronger influence on boards' decisions than do other stakeholders, including employers and employees. This means that the control structure of public pension funds is in practice not aligned with the residual-claimant structure of the funds.

The second governance problem relates to the collective action of plan stakeholders. Traditional delegated monitoring mechanisms such as takeovers clearly do not apply to public pension funds. This means that public pension boards lack the complementary support of other governance mechanisms that are commonly used in corporations. In public pension funds it is likely that an increased use of independent directors and the introduction of explicit behavioral controls can strengthen the monitoring function of boards. Both of these expedients should reduce the conflicts of interest between directors and management and increase the overall transparency and accountability of fund management to plan members.

The complex stakeholder structure of public pension funds suggests that no single governance framework would meet the needs of all funds. But, as the residual claimants of public pension funds, active members—and taxpayers more generally—should be granted more control over boards' decisions than they have typically had in the region. This can only be achieved if the law or plan documents specify clear commercial mandates, and if the use of independent, qualified, and professional directors is maximized.

Risk management

The second area for supportive policy changes is a strengthening of the framework for managing risks. In all the region's pension schemes, this framework focuses almost exclusively on asset management, with varying degrees of sophistication depending on the flexibility of the investment rules and the development of local financial markets. Most funds use value-at-risk type risk metrics to measure the sensitivity of investments to price movements. The usefulness of these risk metrics in practice often depends on the liquidity of the underlying instruments and therefore on the quality of the information conveyed by prices. Moreover, only credit risk is managed actively. Interest rate risk is not managed—even in the defined-benefit schemes—although the largest portion of the assets in the portfolios of the surveyed schemes is sensitive to interest-rate risk. Neither is foreign-exchange risk, mainly because thus far only an insignificant proportion of assets are invested abroad.

Hong Kong (China)'s pension sector is an exception in terms of governance and risk management. The governance framework clearly centers on the role of the qualified trustee with strong fiduciary duties. The regulatory framework contains well-defined and strong "fit-and-proper" tests for such trustees. While this feature, per se, does not ensure professionalism, it clearly facilitates accountability and provides an unambiguous legal basis for recourse against any eventual mismanagement.

In Korea, the National Pension Fund has a tripartite governance structure, so there is a potential for politicization of the fund's management. But the investment-regulation and risk-management standards established by the risk-management committee of the National Pension Corporation have promoted investments in secure and liquid, though not necessarily profitable, assets. The Corporation manages credit risk by limiting its equity exposure to stocks listed on the Korean exchange KOSDAQ, and by limiting its corporate-debt exposure to instruments issued by companies whose credit rating is no lower than "A-" according to at least two domestic credit-rating companies. Individual issuer limits also apply. NPC is restricted from holding more than 10 percent of the number of issues for each equity category of any given issuer, and from investing more than 10 percent of its assets in any given issue. Similar limits guide the management of credit risk arising from foreign issuers. In this case, NPC is also allowed to trade in derivatives to manage the foreign exchange risk. No other forms of risk are explicitly managed.

Malaysia's Employees' Provident Fund is also governed by a tripartite board but differs from other funds in the region in that a separate body is charged with setting the investment strategy and developing the risk-management framework. EPF is now developing and implementing a formal risk-management framework, which is expected to revolve around a value-at-risk system with an optimizing routine to select a more efficient asset allocation. The framework will provide recommendations for a risk-governance structure. EPF is also selecting a system to help in the analysis of market risk.

In the Philippines, the Social Security Commission of the Social Security System (SSS) and the Board of the Government Services Insurance Scheme (GSIS) are constituted according to their respective charters. Members of the Commission are selected by the President of the Philippines, and the broad criteria used for this process are reflected in the limited technical capacity of the Commission to understand complex technical issues and take appropriate policy decisions. The Board of the Government Services Insurance Scheme is also appointed by the President, but the GSIS Charter requires that four of the eight appointee members be from the banking, finance, investment, or insurance sectors and that one be a recognized member of the legal profession. Neither the Social Security Commission nor the Board of GSIS uses a formal framework for risk management. However, the 2006 corporate plan of SSS provides for the establishment of risk-management and compliance units.

Finally, in Thailand, the board of the Social Security Fund comprises representative and ex-officio members. Minimal "fit-and-proper" tests are defined in the Act that governs the appointment of advisers appointed by the Minister of Labor and Social Welfare (who can appoint up to five such advisers as experts without voting powers). However, no such tests are specified for the members of the board. Fund managers focus on asset-risk management and more specifically on credit risk. Important risks, such as inflation or interest rate risks, are not yet managed.

To conclude, therefore, pension funds have the potential to play a greater role in the development of securities markets in the region. As they begin to invest in a wider range of securities, it will be important to ensure that they have appropriate governance structures and stronger technical expertise at their disposal than they do now.

This consideration is particularly important with regard to the use of derivatives. For instance, as pension funds begin to hold greater amounts of foreign securities, they are likely to need to use derivatives for exchange-rate hedging. Other types of derivatives, such as credit-default swaps,[134] which are often held as a means to raise the returns on an asset portfolio, are more complex and their risks are more difficult to assess. Hence their use should only be considered once the requisite risk-management skills have been developed.

Insurance Sector

The asset size of the life insurance industry is still relatively small in most countries of the region (Table 6.1). Looking ahead, the potential importance of the insurance industry for capital market development will depend more on the size of assets than on investment regulations, because in general the latter are not binding. Of course, the size of these assets will depend on the scope for further developing the industry's coverage and products.

Increasing the size of assets

The most commonly used measures to assess the level of development of the sector are insurance penetration (measured as the insurance premium as a percentage of GDP) and density (measured as the premium per capita). There is still substantial scope for further development, particularly in China, Indonesia, the Philippines, and Thailand (Table 6.6).

Distribution channels are an important factor in increasing the coverage of insurance. In most insurance markets in the region, distribution has been built on the agency-sales-force model, often extending to large numbers of sales forces (with varying degrees of productivity, reflecting the extent to which agents work full- or part-time). As such, in many countries, a large reach is extended over a small area.

In China, given that country's size, it is natural that there are more regional differences in access. The China Insurance Regulatory Commission has been encouraging companies to ensure that their services are provided in all areas. For local Chinese companies there is a particular incentive to do so under the liberalization agreements of the market. The more advanced markets in the region have introduced bancassurance (that is, selling of insurance through a bank's established distribution channels), and although it is early in the experience, and both the authorities as well as market participants are taking a cautious approach, the signs are positive. Micro-insurance operations are also emerging, with examples from Indonesia attracting international attention as case

TABLE 6.6 Indicators of Development of the Insurance Sector

Economy	1997 Penetration	1997 Density	2000 Penetration	2000 Density	2004 Penetration	2004 Density
China						
life	0.8	6.1	1.1	9.5	2.2	27.3
non-life	0.6	4.7	0.7	5.7	1.1	12.9
total	1.4	10.8	1.8	15.2	3.3	40.2
Indonesia						
life	0.6	6.2	0.5	4.0	0.6	7.5
non-life	0.7	6.9	0.6	4.6	0.7	8.1
total	1.3	13.1	1.2	8.6	1.3	15.6
Rep. of Korea						
life	11.6	929.3	9.9	935.6	6.8	1,006.8
non-life	3.8	303.0	3.2	298.5	2.8	412.5
total	15.4	1,232.3	13.1	1,234.1	9.6	1,419.3
Malaysia						
life	2.2	99.0	2.1	86.4	3.5	167.3
non-life	2.2	99.8	1.6	64.6	1.9	89.3
total	4.4	198.8	3.7	151.0	5.4	256.6
Philippines						
life	0.7	8.0	0.8	7.5	0.9	9.4
non-life	0.8	9.1	0.6	6.0	0.6	6.1
total	1.5	17.1	1.4	13.5	1.5	15.5
Thailand						
life	1.2	26.2	1.5	29.8	1.9	50.8
non-life	1.2	26.3	1.0	19.4	1.6	41.4
total	2.4	52.5	2.5	49.3	3.5	92.2
Hong Kong (China)						
life	2.4	646.3	3.7	892.9	7.9	1,884.3
non-life	1.1	299.2	1.1	269.1	1.4	332.9
total	3.5	945.5	4.8	1,162.0	9.3	2,217.2
Singapore						
life	3.8	989.0	3.2	732.1	6.0	1,483.9
non-life	1.3	338.3	1.0	234.2	1.5	365.5
total	5.1	1,327.3	4.2	966.3	7.5	1,849.4

Source: Swiss Re, various issues.

studies. Diversifying distribution channels is likely to improve access to insurance products and to act as a vehicle for the sector's growth, enhancing its role as an institutional investor.

Growth in the range of insurance products offered is likely to further the sector's development and growth in assets. A relatively wide range of products, both savings and protection, are already available in all the markets. Savings products in both traditional forms and the more recently unbundled forms are present, along with various forms of pure mortality cover. Insurance for personal accident and health is becoming increasingly popular. Non-life insurance products are available, covering the full range of risks, to support commercial and domestic customers. Across the region, insurers show a capacity for product innovation, so the further development of products in each market may be expected to take its course and enlarge the insurance companies' role as institutional investors.

Increasing allocations to securities markets

A potentially important impetus to capital market development might come from consolidation of the insurance industry. In several countries in the region, the industry consists of many small players, in part because legal minimum capital levels for entry into the industry are low by international standards (Appendix Table 6.1). The small size of these companies prevents them from playing an important role in capital markets.

TABLE 6.7 Indicators of Concentration in the Insurance Sector

Economy	Year	Herfindhal index		Number of companies			
		Life	Non-life	Life	Non-life	Composite	Total
China	2004	1,803	3,684	n.a	n.a	n.a	n.a
Indonesia	2004	811	478	n.a	n.a	n.a	n.a
Rep. of Korea	2004	1,846	1,622	22	17	—	39
Malaysia	2003	1,683	460	7	26	9	42
Philippines	2004	1,439	424	34	97	4	135
Thailand	2004	2,527	439	24	71	—	95
Hong Kong (China)	2005	926	229	46	110	19	175
Singapore	2004	1,989	588	6	42	7	55

Note: The Herfindhal index is defined as the sum of squares of the market shares of each individual firm. It ranges from 0 (competitive or equally distributed) to 1 (monopolistic or dominated by one firm). Alternatively, it can range from 0 to 10,000, if percents are used as whole numbers (e.g. 75 instead of 0.75). World Bank comparisons across markets suggest that a Herfindhal index value of around 1,200 to 1,500 would be the natural range for non-life insurance markets, and because of greater economies to scale and lower concerns of risk aggregation, around twice that level for life insurance.

— = not available.

The Korean market is one of the few where the number of companies is not very large and the Herfindhal index is relatively high, suggesting that fragmentation is not an issue either in the life or non-life sectors (Table 6.7). By contrast, in Malaysia, the Philippines, and Thailand, a rationalization of the non-life sector might be beneficial, given the number of companies and the Herfindhal index value, while in Indonesia rationalization might be expected in both the life and non-life sectors. In these countries, consolidation would produce companies of a larger average size, better able to invest significantly in the securities markets.

In some countries, loosening investment restrictions for the insurance industry could help to stimulate the contribution of the industry to capital-market development. Investment regulation in the region ranges from an absence of specific rules in Hong Kong (China) to a very restrictive regime in China, which sets out limits for sectors and asset classes. Between these two approaches is the approach of permitting investments in a broader range of assets, but requiring additional capital for particular asset exposure, either explicitly or through admissibility rules. Where there are specific quantitative rules, they tend not to be fully prescriptive for all types of asset risks, but to set selective limits either at the global portfolio level or for specific issuers (and rarely both for every type of asset). The scope of investment regulations for life insurers is summarized in Table 6.8.

Several jurisdictions are moving to introduce more risk-based capital requirements. This, in turn, can be expected to enhance risk-management skills over time and to allow countries to move to less restrictive investment regimes. Focusing on capital regulations will also likely lead to consolidation of the industry in those countries that currently have a large number of small entities.[135]

Korea, the Philippines, and Thailand have indicated that they will move toward risk-based regimes. Malaysia has indicated that it will introduce a system of dynamic solvency testing. The move towards risk-based capital requirements reflects a keen interest throughout the region in strengthening insurance-solvency regimes in line with emerging international standards, and a concern that the pre-reform capital levels may not be adequate in many jurisdictions. A more risk-based regime would of course raise demand for technical skills in both the supervisory authorities and companies in many countries, which would need to be met as the industry develops. In sum, a smaller number of larger companies, coupled with a more risk-based capital regime and increased technical skills, would likely enhance the use of risk-management techniques. In turn, this would facilitate the move to a less prescriptive investment regime.

Mutual Funds

Given the important role that the mutual fund industry can play in deepening securities markets, developing the industry has become an important policy objective in the region.[136]

TABLE 6.8 Scope of Investment Regulations in the Life Insurance Sector

Economy	Scope of investment regulations for life insurers
China	Investments are subject to specific limits. These are being gradually relaxed from a situation where insurers could only invest in bank accounts and government bonds to one that now permits some foreign investment, corporate bonds, infrastructure bonds (through trusts and permitted vehicles), mutual funds, and domestic equities.
Indonesia	Limits apply to specific issuers for deposits, publicly quoted shares, bonds and notes, and investment funds. Overall limits apply to foreign equities and bonds, direct investment, real estate, and mortgages.
Rep. of Korea	Recent amendments have relaxed a system that had quantitative limits addressing both spread and portfolio composition. Remaining limits concentrate on global maximums, with the exception of a limitation on stock concentration by issuer.
Malaysia	Insurers have a minimum 25 percent obligation to invest in government securities. While other investments are not subject to specific restrictions, the interaction with the solvency regime is relevant. The authorities, for example, recently altered the limit that credit facilities, including loans and private debt instruments, can take into account for the purpose of meeting the minimum solvency requirements.
Philippines	Specific limits on admissibility apply. Issuer-based limits apply to bonds, debentures, and equity issues, and a global limit applies to real estate. There is an obligation to invest 25 percent of the minimum paid-up capital in government bonds.
Thailand	Detailed limits apply, setting entity level, global portfolio, and, in some cases, combined limits.
Hong Kong (China)	The authorities look to the company to form a prudent investment policy taking into account the advice of the actuary. There are no specific rules or prohibitions relating to particular investment classes.
Singapore	Insurance assets supporting domestic business are subject to regulations and quantitative global limits as well as limits relating to individual concentrations.

Mutual funds have grown quickly in most countries in the region, albeit starting from a relatively small base. Except in Thailand, their growth was faster than 20 percent during 2003–04 in all countries, with China and Indonesia seeing the highest growth (89 percent and 49 percent respectively).[137]

By the end of 2004, East Asia accounted for about 10 percent of the US$16,152 billion global net asset value of mutual funds (according to the Investment Company Institute). Assets under management were the largest in Hong Kong (China) (where they amounted to US$465 billion or 285 percent of GDP), and Singapore (US$349 billion or 326 percent of GDP). Both Hong Kong (China) and Singapore have set out to be regional centers[138] and a large proportion of the funds in both countries comes from abroad, by contrast with other countries in the region, where the bulk of the money invested is derived locally. After Hong Kong (China) and Singapore, assets under management are largest in relation to the domestic economy in Korea and Malaysia (20 and 25 percent of GDP respectively), followed by Indonesia, China, and the Philippines.

A wide range of mutual fund products with different investment objectives and strategies is available to retail investors in Hong Kong (China), Korea, and Singapore. The variety of fund products in China, Indonesia, Malaysia, and Thailand is still relatively limited, although many new collective investment products have been introduced in recent years. Figure 6.1 shows the broad asset-class exposure across the region.

Overall, despite its recent growth, the mutual-fund industry has scope for much further development in most countries in the region, both in size and product diversity. But, as discussed below, the dramatic growth in assets under management has already been accompanied by problems in some countries, notably Indonesia. Thus it is also important that future growth take place within a well-regulated environment that attracts investors.

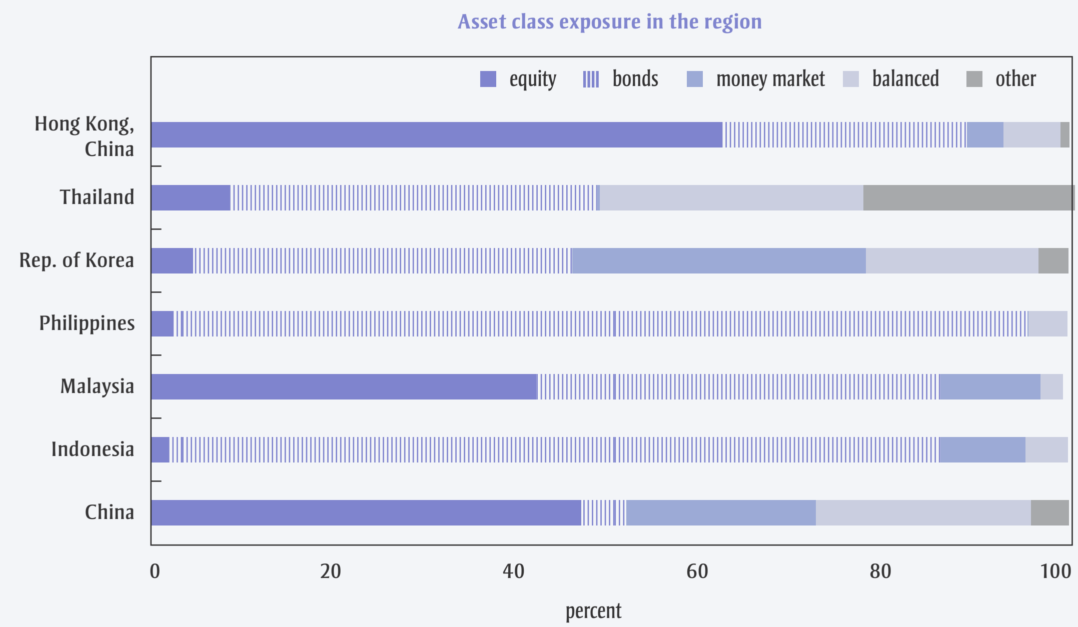
Developing the mutual funds industry on a sound basis

The region's experience points to four key elements that need to be put in place to develop the mutual fund industry on a sound basis.

Ensuring an appropriate and adaptable regulatory framework

When drafting fund laws and enabling different types of funds to flourish, it is important to consider what purposes the funds are to fulfill and to choose the structures that are best suited to local conditions. For example, is the primary purpose of the law to enable investments in liquid securities, or to enable investments in illiquid assets such as real estate? Is it

FIGURE 6.1 Asset Class Exposure of Investment Funds



Source: Cadogan Financial 2006.

to enable institutional investment in private equity or venture capital? Or, as is likely to be the case in most countries, is it a combination of these objectives, some more applicable now and others more applicable in the future? And clearly the laws need to be reasonably up to date if they are not to retard the development of the asset management industry.

A key point to note in this regard is that, while financial markets innovate constantly, laws once passed are difficult and time consuming to change. Though laws are needed in order to provide a clear legal basis for fund operation and regulation, it is preferable that they deal only with issues of principle and leave the details to subsidiary legislation. To accommodate changes such as new forms of funds or to allow for new investment powers such as derivatives, regulations can be adapted more easily than laws, but they remain governed by the key principles set out in the law. Hong Kong (China) and Singapore have followed this approach. In other countries, including the Philippines (Box 6.1), outdated legislation has sometimes hindered the development of the industry.

The liquidity of assets has a bearing on whether to allow closed-end or open-end funds. As was the case in China and Thailand, many emerging markets start with closed-end funds, which are a suitable choice in markets that are narrow and illiquid. However, when these funds are launched, they start at a premium, as investors treat them as another initial public offering (IPO); they then fall dramatically in net asset value (by as much as 50 percent in China) as the IPO fever wears off. This leads to pressures to create open-end funds in which investors buy and sell fund units or shares at their net asset value. However, it is difficult to create open-end funds that allow investors to buy and sell every day if the assets in which those funds invest cannot also be easily bought and sold in reasonable amounts.

Problems therefore arise with a rapid expansion of the open-end fund sector if there is an inadequate supply of suitable assets in which to invest. This tends to lead investors into lower-quality, more risky assets as the best assets get bought up, leading to unrealistically low yields and forcing managers to relax their criteria for asset selection in order to continue providing the kind of returns that investors demand. In turn, such assets tend to be harder to value and difficult to sell in times of need.

BOX 6.1 In the Philippines, Outdated Legislation Is Delaying the Growth of the Investment Fund Sector

The Philippines has been slow to revise its legislation on investment funds, despite the fact that the existing law is acknowledged to be out of date (for instance the Medium-term Philippine Development Plan 2004–10 recognizes the need to implement changes in the law). Currently the asset management industry rests on a law dating from 1960, RA 2629, otherwise known as the Investment Company Act (ICA) and the Implementing Rules and Regulations of the ICA, dating from 1989. Among the problematic aspects of the law are a lack of clear requirement for the segregation of fund assets; lack of regulation of investment advisers to the funds; lack of requirements for custodial supervision of the operation of the fund, and a lack of clear provision for valuation and pricing controls. These funds do not seem to enjoy the confidence of investors, many of whom prefer to invest funds domiciled in other jurisdictions.

A draft of a completely new law, the Revised Investment Company Act, which has as its intention "to revise RA 2629 to provide the legal framework and environment for capital markets development through mutual funds" was originally proposed in 2001 but remains pending.

Source: Cadogan Financial 2006.

Establishing and maintaining investor confidence

The most important factor in promoting the growth of the asset management industry is probably investor confidence. Ensuring investor confidence requires a focus on several aspects:

Clear legal definitions of the legal form of the fund, the primary duty of fund managers and custodians to act in the interests of fund investors, and the requirements for third-party supervision of the fund manager's conduct of the business of the fund. The choice of legal structure in which funds are permitted to be formed—whether as companies, trusts, or contractual pools—will partly depend on the legal environment within which they are created. Generally, countries with common-law systems will specify funds formed as trusts, while civil-code system countries enable a contractual form; both legal systems enable funds to function as companies (Table 6.9).

TABLE 6.9 Governance Structures of Mutual Funds

Economy	Corporate	Contractual	Trust
China		Y	
Indonesia	Y	Y	
Rep. of Korea	Y	Y	
Malaysia	Y		Y
Philippines	Y		
Thailand		Y	
Hong Kong (China)	Y[a]	Y[a]	Y
Singapore	Y[a]	Y	Y

Source: Cadogan Financial 2006.

Note: a. There may be limitations on the ability to publicly offer these funds—trusts are the main vehicle for domestic retail investment.

The key difference between these legal structures is in the form of governance.[139] A fund formed as a company will usually have a board of directors. These directors have a fiduciary duty to the shareholders of the company and it is they who appoint the manager of the fund and the custodian to provide the services to the fund, and who oversee the contractors' conduct of the fund's business. Their duties therefore are more wide-ranging than those of an ordinary company director.

In a fund formed as a trust, the fund trustee has a fiduciary duty to the investors in the fund, who are technically beneficiaries of the trust. The trustee has the task of overseeing the conduct of the business of the fund by its manager and of protecting investors' interests. Generally, fund law or regulation will also require the manager of the fund to act in the interests of fund investors.

A fund formed under a contractual pool has neither directors nor trustees—and hence no entity with a fiduciary duty to the fund's investors, unless such duties are placed upon the manager and the custodian of the fund by law and regulation. It is thus extremely important to specify these duties when drafting the laws and regulations governing such funds. Generally this is done by requiring both manager and custodian to act in the interests of the fund investors and by making the custodian responsible for overseeing the manager's conduct of the business of the fund.[140]

In those East Asian legal environments where the fund has a trustee (Hong Kong [China], Singapore, and Malaysia), the law and precedent of the trust ensure that the trustee will automatically act as a watchdog for investors' interests. Where funds are contractual (as in China, Indonesia, Korea, and Thailand) the duties of the custodian as a watchdog need to be defined in the law. Although these duties are hinted at in China, Indonesia, and Korea, none of these three countries has laws that give sufficient strength to custodians' responsibilities, so investors are weakly protected at this level. Thailand's law provides for a trustee that is separate from the custodian, whose duties are solely supervisory. In the Philippines, funds are corporate in nature and therefore the role of the fund directors should be similarly emphasized.

Rights of investors. It is also crucial for investor confidence that the rights of investors be well defined, particularly rights to redemptions and voting where relevant. One reason why problems have arisen in Indonesia is that the Capital Markets Law of 1995, which has been under review for some time, does not adequately specify the nature of a contractual fund and the rights of its unit holders. Although both corporate and contractual funds are allowed under the law, only contractual funds have come into existence in Indonesia, partly because they are less cumbersome and quicker to create for managers and more flexible and more tax-efficient for investors than corporate funds.[141] The law and regulations have been based on the assumption that the corporate type of fund would be the key form, and as a result have focused on specifying these funds, rather than the contractual form. This is a key weakness, since while an investor in a corporate fund buys shares and has all the rights of a normal shareholder, a purchaser of a unit in a contractual fund has no rights unless these are specified in law and regulation.

Ensuring equitable treatment of incoming, ongoing, and outgoing investors in open-ended funds through valuation, pricing, and issue and redemption rules is important. Equitable treatment of fund investors is a key principle that should be established in fund laws, but often is not. Fund managers can favor one set of investors over another, for instance by tipping off favored clients (often institutional clients or clients of affiliates of the fund manager) when they know net asset values are likely to fall, so the latter can redeem their holdings. It is also important to set rules that ensure investors are treated equitably in the valuation of assets and pricing of funds.

The valuation and pricing of units or shares in any collective investment scheme, whether it is a common mutual fund or a unitized pension scheme, is the most crucial of all administrative operations and, if not done correctly, it will damage at least one category of investor through dilution. This is what happened with the collapse of fixed-income funds in Korea in 1999 (Box 6.2).[142] Since then, however, with the adoption of mark-to-market valuation for all funds (from July 2000), regulations have been strengthened, including to enhance investor protection, and this is helping to restore investor confidence.

Disclosure to investors is crucial. Potential and existing investors should receive statements that give clear and fair information, including the prospectus, fund performance, fund charges and prices, and audited accounts. Here, comparability is key.

China, whose asset-management industry is very new, is giving increasing attention to protecting investor interests. Investors have the right to sue managers and/or custodians if incomplete disclosure leads to investor losses. Unit holders also have the authority to determine, for example, the renewal or early termination of fund contracts, increases in compensation to fund managers and custodians, and the replacement of fund managers and custodians. The recently passed Securities Investment Fund Act emphasizes the interests of investors more strongly than previous legislation.

In Malaysia, the supervisory authority has emphasized the relationship between disclosure policy and the development of the mutual fund industry and, as mentioned earlier, has adopted disclosure-based regulations to protect investors. There are also self-imposed regulations, with investment companies asking actuarial firms to assess their financial situation and inform investors.

Hong Kong (China), as an international financial center, strongly enforces transparency by disclosing the monitoring process, the information on the underlying funds, the relationship with the prime brokers, and the independence of the valuation agents. Singapore, too, has taken a disclosure-based approach under which investors make decisions based on information disclosed by fund managers, rather than using the merit-based approach (under which the regulators determine the suitability of the securities being made available to the public). Singapore also gives investors the right to require any reasonable information to make decisions. The Monetary Authority of Singapore has published disclosure checklists based on the International Organization of Securities Commissions

BOX 6.2 Collapse of Fixed-Income Funds in Korea in 1999

Korean mutual funds suffered a massive crisis of confidence immediately following the collapse of the Daewoo *chaebol* in July 1999. Managers and investors in fixed-income funds (within Daewoo and outside), which had been substantial holders of Daewoo debt, realized that Daewoo's default would reduce the value of their investments and rushed to redeem their shares. Funds were left with Daewoo bonds (and other corporate paper that could not be reliably valued, given the turbulent conditions of markets), which could not be sold to raise the money needed to pay investors redeeming their shares. This series of events exposed endemic flaws in both the regulatory system and in the way the funds had been managed and sold.

In particular, cost-based asset valuation had allowed unit prices to be manipulated to offer yields apparently higher than those available in the market, and high-pressure sales of units by brokers, coupled with "promises" of no loss, misled investors into believing that potentially volatile assets were no more risky than bank deposits. These factors—coupled with weak supervision, which had allowed asset-management companies to break the law—had led to a rapid increase in assets under management.

The government had to step in to prevent a systemic collapse of the bond market, and suspended those funds that had invested high percentages of their assets in Daewoo paper. Investors were only permitted to redeem in stages, according to a schedule that would permit an orderly disposal of assets. This bailout was costly to taxpayers, and fund management and securities companies, who were the principal owners, were compelled to contribute substantially to the cost of shoring up the industry.

The Korean government has since undertaken significant reforms to strengthen the mutual fund industry. From July 2000, mark-to-market valuation was adopted for all funds. Legislation, which had previously been fragmented, was substantially revised. The Indirect Investment Asset Management Business Act was promulgated in 2003 to consolidate and integrate the asset-management industry and enhance investor protection. Nonetheless, investor confidence took time to be restored.

Source: Cadogan Financial 2006.

(IOSCO) standards and issues a stop order if the checklists are violated.

Disclosure requirements vary across the region. They are strong in China, Hong Kong (China), Korea, Malaysia, and Singapore, and weakest in Indonesia and the Philippines.

Specific rules governing investment advice are needed, to ensure that proper information and advice are given. An area in which regulation is often weak—as in China and Indonesia—is the regulation of the distribution channels that sell investment funds to the public. Thailand has recognized this weakness and addressed it in revised and new regulations issued in the late 1990s. While laws usually categorize fund shares or units as securities, thus making their public offering subject to laws or regulations governing securities—or sometimes specific funds—it is common to find that individuals who sell funds are only required to have the bare minimum of knowledge or expertise. Responsibility for their conduct and accountability for their failures are often also poorly defined.

Unambiguous rules are needed to identify different categories of funds, and steps should be taken to avoid any portfolio abuses. Often longer-term bond funds, which are exposed to market volatility, have been sold as equivalents to bank accounts but with a better return. (This has been the case in China, Indonesia, and Korea in the past.) Then, when interest rates rise and fund unit proceeds fall, investors panic, and the result is a wave of redemptions leading to liquidity problems.

To avoid such problems calls for clear categorization of funds; disclosure of associated risks; and a rigorous regulatory regime, covering both firms and individuals that sell funds to investors, that sets standards for responsibility, competence, and the conduct of business. In this context, the mutual fund industry's code of ethics and standards of professional conduct are an important part of investor protection, particularly in view of the regional trend to replace the traditional merit-based method of regulation with the market-based method. A code of conduct upholds the discipline of market players, especially the asset-management companies. It sets out general principles and minimum standards of practice to guide the conduct of managers in the best interests of investors and the asset-management industry. In some jurisdictions, such as Hong Kong

(China), Indonesia, Singapore, and Thailand, codes of ethics and standards are issued by the supervisory organization. In countries such as Korea and Malaysia, they are issued by an association of investment-management companies as a form of self-regulation. In the Philippines, no explicit code of conduct exists.

Adopting a supportive policy environment

While enhancing investor confidence is a key element, the development of the industry can be further facilitated, or deterred, by government policies.

First, government commitment to develop the mutual fund industry and ensure consistency of policies is fundamental. A reputable, flourishing industry is unlikely to exist when the environment for developing funds—and their returns—is subject to arbitrary governmental or regulatory decisions.

Second, to succeed, mutual funds must be fiscally competitive with other products. Tax efficiency is an important factor for investors comparing the merits of an investment fund with those of a more familiar bank account or savings account, or saving through insurance or a pension fund. If investment funds are to thrive, they must face taxation no higher than on direct investment in the same underlying assets or in competing savings vehicles.

Third, establishing a competitive environment while maintaining adequate entry and capitalization requirements can help to diversify products and enhance demand. As noted above, product diversity in mutual funds is still limited in most countries in the region. Since retail investors' goals and risk preferences vary widely, the ability to develop and offer products that match diverse target levels of risk and return is crucial for the growth and health of an asset-management industry, even a mature one. A good example is the recent introduction of the retail hedge fund in Hong Kong (China). In countries where the range of collective investment products is still relatively limited, such as China, Indonesia, Malaysia, the Philippines, and Thailand, the range of instruments that funds can invest in needs to be broadened—subject, clearly, to considerations of availability and liquidity, as mentioned earlier. Enhancing competition among fund-management companies is likely to provide an important impetus to the development of new products and growth of the asset-management industry.

Professionalizing advisory services can help in establishing competition in distribution channels. Throughout the region, banks are playing a strong and growing role in mutual fund sales. In both China and Indonesia, for instance, banks are estimated to sell 80 percent or more of the funds. Clearly, banks that have nationwide distribution facilities and existing customer bases are ideally placed to facilitate fund sales. Dominance by any one distribution channel enables that channel to extract more fees, commissions, and other benefits from fund managers who need the access it provides. This will not necessarily benefit consumers, who are likely to end up paying for this through higher annual sales fees or higher annual management fees.

Distribution channels are not easy to diversify, however. One possibility is to professionalize financial advice. If successful, this effort can give rise to a new distribution channel: firms whose sole business it is to undertake this activity.

To professionalize financial advice entails creating a regulatory regime that governs those agents who are permitted to give financial advice, the qualifications they must hold, and the way in which they conduct their business (including finding out about clients' financial positions and needs). It also requires standardized disclosure of commissions and fees received. Under such a regime, agents who sell funds—whether within banks or outside them—are constrained to identify their clients' needs and meet them in the best way possible at a stated cost that can be compared with that of other providers. This strategy is currently being considered in China. The provision of financial advice is only weakly regulated in many of the region's economies; Singapore and Hong Kong (China) are the strongest in this respect.

Hong Kong (China) and Singapore have gone further in facilitating the development of the asset management industry. They have structured government policy so as to encourage fund managers to manage funds from their own domiciles, even if those funds are in other countries. In Singapore, for instance, the Central Provident Fund (CPF) has committed itself to outsourcing the investment management of more than S$20 billion of its own assets, and has also allowed its members to select certain unit trusts to back their own funds (a similar concept to the 401k plan in the United States).

Ensuring regulations are enforced

In ensuring the stability, and hence ultimately the sustained development, of the asset-management industry, rules and regulations must be equitably enforced. The high-profile actions of the New York Attorney General in 2003, and subsequently of the US Securities and Exchange Commission, in relation to the U.S. mutual fund scandals associated with late trading and market timing, illustrate the importance of equitable enforcement for the stability of the industry: not only were the companies concerned fined and made to compensate investors, but they also suffered a loss of business.

There are many examples of a reasonably adequate regime being poorly enforced, including one from Indonesia, where a problem with fixed-income funds was in part exacerbated by poor enforcement (Box 6.3).

A further factor to bear in mind is that regulators need to enforce rules in a manner proportionate to the damage that a breach of the rules is likely to inflict on investors' interests. Admittedly, it is easier for regulators to focus on easily identifiable but low-impact regulatory breaches such as small arithmetical errors or gaps in reports or late filings, than to address much more fundamental problems such as incorrect or manipulated asset valuation, which may require high-profile and difficult decisions to be taken. But it is the latter that cause greater damage to investors, and imposing only small fines and modest sanctions for such behavior can bring the regulations themselves into disrepute.

Several factors may deter regulators from tackling substantive issues. The first is a lack of industry knowledge and experience, which is natural given that regulators are often drawn from civil-service backgrounds, but difficult to address unless salaries can be made sufficiently attractive to attract practitioners to work in regulatory agencies. The second is a lack of protection from legal action; this can be addressed by laws granting suitable immunity. Third

BOX 6.3 Enforcement Failure: Fixed-Income Funds in Indonesia

Fixed-income funds under management in Indonesia fell by 73 percent in 2005. Up until then, with declining interest rates, sales of fixed-income funds had been rising strongly, and at the end of 2004, near the peak of the market, they represented nearly 82 percent of total assets under management (valued on a cost/accrual basis). The rise reflected a steady increase in unit values, but also the fact that interest from fixed-income funds was taxed less heavily than bank interest. Funds were therefore offering higher interest than banks (whose staff sold most of these funds to investors). It is also likely that the sales persons implied that these funds were actually like bank accounts (where capital was not at risk) and with a better rate of interest.

New regulations by Bapepam, applicable from January 2005, required fixed-income funds to mark their assets to market rather than valuing them on a cost/accrual basis. In January, the largest fund-management company moved its fixed-income funds to a mark-to-market valuation system and suffered major redemptions as investors panicked when the value of the units fell.

From March 2005 onward, as the Indonesian economy and currency came under some pressure, the Bank of Indonesia raised interest rates. Those funds that marked to market saw their units fall in value and sustained substantial redemptions as a result. Those funds that did not do so—despite the regulatory requirements—saw continuing sales. However, particularly strong interest rate hikes in August and September and the level of redemptions on funds financially forced more funds to move to mark-to-market valuation, since they could not sell their bonds at the valuations at which they had been holding them. Overall, the values of fixed-income funds fell by 85 percent during the year, with around 60 percent of the fall due to redemptions and the rest due to reduced valuations.

The new mark-to-market regulations that were applicable from January 2005 were demonstrably not met by many market participants during much of that year. It did not appear that any regulatory action was going to be taken until, following the redemption crisis, a Parliamentary committee instigated an investigation of four market participants by the regulator, which subsequently fined them for various infractions. No action appears to have been taken yet against other market participants that may also have failed to comply. Thus not only was enforcement late, it may also have been uneven. There is a danger that this will reduce market participants' confidence and hence their commitment to the market.

It is probable that a high level of redemptions from fixed-income funds would have occurred anyway, had the regulators forced market participants to comply with mark-to-market requirements beginning in January, since the funds had been misrepresented as secure investments since neither sales agents nor investors understood fixed-income funds and their associated risks. To avoid the same problems in the future, it is important that sales agents' competence be improved, along with fund categorization and disclosure, particularly of the risks associated with the investments.

Source: Cadogan Financial 2006.

is a fear of political interference or of displeasing powerful market participants who could separate them from their jobs.[143] A high turnover of regulatory staff, who are commonly rotated across departments, ministries, or agencies, or headhunted by the market, can also reduce an agency's capacity to retain the necessary knowledge and expertise and thus the capacity to regulate effectively.

A final factor that can seriously compromise effective enforcement is fragmented regulatory mandates. Often the regulatory responsibilities for mutual funds, unitized pension systems, and unit-linked life assurance are divided between several regulators, on the assumption that the products offered are very different. This does not allow economies of scale to be reaped by asset managers who may have to obtain several licenses to operate different funds that are essentially the same, and who may even need to create different companies. If, for example, mutual funds exist, and are generally regarded as well regulated, it would make sense to use them as investment components for defined-contribution pension schemes, as happens to varying degrees and in varying ways in Hong Kong (China), Malaysia, and Singapore. This would enable managers to pass on the benefits of economies of scale to investors by lowering management costs. It would also bring savers who hold units through a pension scheme and who have longer-term investment horizons (since they cannot usually redeem until retirement) into the market, providing greater stability to the mutual fund industry.

The securities regulator usually regulates the activity of selling securities, which usually include fund units or shares. But it can be difficult for the securities regulator to exercise effective oversight over sales of mutual funds by banks, which are regulated by the central bank or banking regulator. This problem arises particularly where the securities license is held by the bank itself, rather than by a separate subsidiary that is directly licensed by the securities regulator and therefore answerable to it.

Korea, the third-largest market in the region, has recently overhauled various laws governing asset management and in 2003 introduced a single Indirect Investment Asset Management Business Act, with the goal of enabling all asset-management activities to be regulated at an equivalent level by unifying all asset-management-related regulations. Hong Kong (China) and Singapore have taken similar actions. Regulation remains fragmented in China, Malaysia, and the Philippines, but Indonesia is combining its non-banking and securities regulators. In Thailand, the Securities and Exchange Commission regulates both mutual funds and provident funds.