



Cost Benefit Analysis the Participation of Indonesia in Asia Region Funds Passport

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ABSTRACT

APEC Finance Ministers' Forum initiated the Asia Region Funds Passport (ARFP), a framework of multilateral cooperation to facilitate cross-border fund market. ARFP is the concept of cross-border distribution and operation of collective investment schemes. Indonesia is expected to join in this framework. This study attempted to elaborate the cost and benefit of joining this framework from Indonesia's perspective. We conclude that Indonesia could get some benefit to elevate its economic, however, there are a few potential disadvantages. On the other hand, there are also some constraints, particularly the domestic rules including capital market act and tax regulation. Indonesia needs to adjust that regulation and it requires enormous efforts and quite long period. We recommended two options: First, join earlier and Indonesia would have a chance to propose some inputs in the ARFP regulation draft and keep its interest on the track. The second option, Indonesia doesn't need to join the ARFP. But, the government have to adjust its basic regulation. Indonesia must develop its mutual fund's industry, so it could compete in the global market. The most important thing is adjusting some articles in the capital markets act, so it could open branches in other countries.

Keywords: ARFP, Fund Passport, Mutual Fund, APEC, Cost Benefit

JEL Classifications: F38, G23

1. INTRODUCTION

The Asia Region Funds Passport (ARFP) would provide a framework for multilateral cooperation to facilitate cross-border fund market using passports as an identification tool. In the long run, this passport could facilitate Asia's fund to the European market by recognizing the agreement between Asia and Europe. The Passport concept was introduced by the Australian Financial Centre Forum in 2010 in the "Johnson Report," described the development of Australia as a financial services center. This idea has been promoted by the European Commission in order to hedge the private equity, real estate, and investment fund, managed by the Alternative Investment Fund Managers Directive (AIFMD).

The cross-border financial system involves dual legal system, producing different terms, that could be uncommon or unfamiliar. Besides the financial systems complexities could be not similar and the rule (law) is constantly changing. Summers (2000) concluded that a good financial system could give a great contribution to

the economic development and cross-border capital flows could provide huge benefits too, but it potentially had a big collateral damage. It needs hard work and creative thinking to handle the gap between member countries.

ARFP concept is relating to cross-border distribution and operation of collective investment schemes (CIS). This scheme could allow marketing the mutual fund products throughout Asia by a single authorization of its member. ARFP was designed to provide better protection for investors and make the financial sector more efficient. Investors could get benefits from that condition such as reducing the risk. It would improve the financial industry development and encourage the integration of regional economic further. APEC Policy Support Unit study (2014) proved that the ARFP implementation could reduce the investment cost about the US \$20 billion per year and offer a higher return on investment at the same or lower risk. ARFP was expected to encourage the pooling of local funds and followed by creating 170,000 jobs in APEC member countries for the next 5 years.

On the one hand, ARFP is the concept of cross-border distribution and operation of CIS. This scheme would enable the products of the fund manager may be approved by the market products throughout Asia, on the basis of a single authorisation from one member passports. At the same time, ARFP is designed to provide better protection for investors. ARFP would be successful if it is able to produce the financial sector more efficient and less expensive in the region. Investors will benefit from the greater efficiency and level of risk will decrease. It will also promote the development of the financial industry and contribute to the further integration of the regional economy. The results of the APEC Policy Support Unit study (2014) showed that the implementation ARFP expected to save costs in the investment management of US \$20 billion per year and further can offer a higher return on investment with the same risk level or lower. ARFP also expected to encourage the pooling of local funds that could create 170,000 jobs in APEC member countries within 5 years.

But still, there are costs and risks related to the ARFP. The risk is inherent with cross-border financing solutions; shocks in one market might have an impact on the other markets. The fungibility of money and losses in some markets may impact on the efficiency of the transmission and intermediation. Even the development of financial markets in many developing countries, particularly in Asia, wasn't free from shocks the financial sector derived from developed countries (Quynh, 2014).

Indonesia's financial industry is still in the deepening stage. Since the middle of the 1990s, it had gone through two big shocks: First, the financial crisis in Asia 1997-2000, which have an impact on the Indonesian economy but followed by rapid growth from 2001 to 2004. Second, in 2004, the Indonesian economy get astonished by the rising of the oil prices. The inflation rate reached more than 18% in November 2005, triggering a sharp increase in the interest rates. Then, the value of fixed-income funds declined, brought investors into the panic situation. Recently, the stability and improvement in economic growth, make the Indonesia's capital market rise again. Debt funds in 2012 accounted for 39% of the total number of the mutual asset, but only 26% of the total value of fund assets.

ARFP would propose the CIS to its member, in line with the setting framework. This paper tried to elaborate the cost and benefit of joining this framework from Indonesia's perspective.

2. LITERATURES REVIEW

2.1. The Impact of Passport Fund Regulation

The trends of globalization have encouraged mutual funds, traditionally operate only in one country, to seek opportunities in other markets. Mutual funds, based in the United States, were interested in selling the funds to Europe and other countries, and vice versa, mutual funds in Europe was also interested in penetrating the US and other markets. Both, the US and Europe, had the potential to become the market for worldwide products, direct to retail investors. In the operating mutual fund's perspectives, funding arrangements are very important to help investor reaching their goals. But, the operational arrangements

should be consistent, both for domestic and cross-border mutual funds.

The most effective approach, the US mutual funds get the access to the European market, was utilized fund regulatory regime in the European Union (EU). If the fund manager would like to sell to the professional investors, they could establish a fund in the EU under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive or AIFMD. UCITS Directive allowed mutual funds to offer their products more efficient and easier throughout the EU. Likewise, the most effective approach for the manager mutual fund from the EU. Reaching retail investors in the US, they could establish a fund under the 1940 Act. According to that rule, mutual funds from the outside US should use private placement regime to access the US market.

Fund regulatory regime in EU and US had a significant impact on the growth of mutual fund industry. In the last two decades (1993-2013), the progress of mutual fund industry in that region was so rapid. US mutual fund assets in that period increased about 600%, while the EU mutual fund industry grew faster about 642% (ICI Global Report, 2014).

Studies on the impact of fund passport regulation have been completed and some of them were related to the reporting system. International Financial Reporting Standards (IFRS) asserted that the harmonization of accounting standards will enhance the comparability of financial statements. It will promote the cross-border investment flows more advanced. Fond et al. (2010). The results proved that IFRS had increased the comparability only in the countries, who implemented it in a credible manner. The increasing was even better in companies who had the consistency of accounting reporting standards.

The increasing of comparability would enhance cross-border investment. This was consistent with the academic literature as well as professional investors' view. The main factor, why investors are reluctant to make a cross-border investment, was the high cost and processing the foreign companies information (Kang and Stulz, 1997; Bradshaw et al., 2004; Chan et al., 2005; Covrig et al., 2007). Likewise, professional investors often found big constraints to cross-border investment, time-consuming reconciliation of differences in accounting standards across countries (Morgan Stanley Dean Witter, 1998).

The increasing of cross-border trade created new challenges in the supervision arrangements. Violations, such as fraud, market manipulation, insider trading and other illegal activities, complicated with the development of modern telecommunications. Cross-border shopping influenced the authority of a country, particularly markets in developing countries. Therefore, the market adjustment is necessary in order to assess the character of cross-border transactions, as a basis for taking the action against any violations. Cooperation and information across jurisdictional boundaries are essential to ensure an efficient and transparent market, in order to mitigate the potential systemic risk.

In February 2003, the Technical Committee of International Organization of Securities Commission had conducted the survey about cross-border trade intermediary activity, covered three areas of concern: The jurisdiction rules; detection and regulatory cooperation; consumer protection, investor compensation, and bankruptcy. The result proved that cross-border regulations are quite shocking. Overall, cross-border trade intermediary, both foreign and domestic, must be licensed or registered. Many brokerages filed a license in a country, but physically only present in their own territory. The broker is running a securities business remotely.

Recent research in international business emphasized the requirement to understand the dynamics and social behavior in cross-border partnerships (Aulakh et al., 1996). There must be mutual trust between partner companies, especially when the control based on the merits of ownership. Empirical findings supported the importance of the relationship between both determinants, trust, and performance, although different outcomes.

2.2. Research Methodology

This study would utilize qualitative methods, searching the ARFP information through the website and various reports. More information would get from some focus group discussions with stakeholders, such as the Otoritas Jasa Keuangan (Financial Services Authority), the agents of the mutual fund's industry and Bank Indonesia (Central Bank of Indonesia). We were also doing several in-depth interviews with the fund manager in this industry.

3. RESULTS AND DISCUSSIONS

3.1. The Development of Mutual Funds Industry in Indonesia

Indonesia's mutual funds want to be classified as not being well developed. We could see it by analyzing the declining of its agent. In the period of 2010-2015, the mutual fund selling agents increases only two, otherwise, the agents in the custodian bank and investment management company respectively decreased about three agents. Although the number of agents had decreased, the number of assets under management (AUM) in the mutual fund's industry had increased from USD 27.5 billion in 2010 to USD 33.4 billion (March 2015).

Compared with the countries that had signed statement of understanding, the number of agents mutual funds industry in Indonesia is very minor, slightly above the Philippines. But, the average AUM per agents in Indonesia is quite large, compared to those countries. The average rate of its AUM of Indonesian agents are higher than other countries, except Australia (Table 1). It indicated that the mutual fund's industry in Indonesia had the same level or above similar industries in those countries.

Though it only had a small amount of agents, the mutual fund's industry in Indonesia still had very good prospects. The financial deepening had objectives that the investors could have many options to invest along with its capabilities and expected return. And also, the capital market liquidity had advanced since received additional funds from investors. Analyzing the declining trend

Table 1: Comparison of Indonesia's mutual funds industry with the other countries member of ARFP

Country	Mutual funds	AUM (USD millar)	Average AUM per performers (USD millar)
Australia	2.718	1.588	0.58
Japan	5.921	822	0.14
South Korea	12.035	365	0.03
Thailand	1.322	102.1	0.08
Philippines	55	5.3	0.10
New Zealand	611	39	0.06
Indonesia	120	33.4	0.28

Source: CIA Factbook, Global-rates, World Bank, Austrade, ABS, Oanda, IBGE, Trade Economics, IMF, PwC Reports and Analysis and OJK. ARFP: Asia Region Funds Passport

of BI rate, mutual funds could be an instrument for Indonesian traditional investors to acquire higher return. They are expected to switch its from bank deposits or government bonds to the mutual funds.

The prospects of Indonesia's mutual funds also could be predicted from the structure of its population, based on its aging and income per capita. The Indonesian population was the biggest in ASEAN and fourth in the world. Its composition was dominated by the productive age, reached about 70%, for next two decades. The increasing quality of them, by education and enhancing technology literacy, was an asset to achieve high economic growth and sustainable development.

It was estimated that about 40 million Indonesian people would classify as the new middle-class in the period of 2010-2020. So, the aggregate number of middle-class reached about 135 million or nearly half of the population. The middle class was indicated with an adequate income level above the basic needs fulfillment level, represented there were the increasing of purchasing power. The demand for products and services of consumption, production, and investment was projected to increase in line with the middle-class growth.

Indonesia was one of the most prospective countries for foreign investment according to the description above. Economics Intelligence Unit Survey (2014) indicated that Indonesia also became one of the most promising potential growth, alongside Brazil, Russia, India, China and South Africa. Nowadays, Indonesia is still below other countries in ASEAN, but the outlook for Indonesia's economic growth could be much higher when the full potential could be optimized. American Chamber of Commerce Survey (2015) showed that Indonesia was a main investment destination in the southeast Asia region. Indonesia had recorded the second largest capital inflows in ASEAN, after Singapore, according to ASEAN foreign investment data since 2008.

Regardless good prospects, Indonesia still had a lot of constraints in the development of mutual funds industry. The main problem is the structure of the domestic market. Indonesian market controlled by 10 biggest fund managers (hold 85.23% of assets in the mutual fund's industry) although there were about 120 fund managers.

In other words, 8.3% of the agents dominated about 85.23% of the assets in this industry. They are Schroder Investment Management Indonesia (15.8%), Eastspring Investments Indonesia (12.82%), Manulife Asset Management Indonesia (12.62%), BNP Paribas Investment Partners (8.3%), Bahana TCW Investment Management (6.68%), Mandiri Investment Management (6.39%), Batavia Prosperindo Asset Management (4.42%), Panin Asset Management (3.08%), Danareksa Investment Management (2.88%) and Ashmore Asset Management Indonesia (2.44%).

Indonesia's investor for the future fund investment still had a chance to expand. Alexandri (2015) showed that mutual funds had not been a first option for the investors in Indonesia despite had been known for a long time. The new investor funds reached only about 2% (of the Indonesian population) or about 2.2% (of Indonesian gross domestic product [GDP]). Meanwhile, Malaysia, Thailand, and Philippines had reached 49%, 20%, and 19.5% respectively. Based on this condition, Indonesia still had a big opportunity to expand its fund investors. So, the investment managers were required to enhance their capacity, and be more creative in marketing their products. The most important thing, they had to be more professional in managing the fund so it would give more confidence to the investors.

Indonesia's regulator and supervisor of the financial sector (Financial Services Authority known as OJK) had priority mission to strengthen the domestic market. Those challenges could be handled, by increasing the supply and the demand side of the investment products and improving the governance of market. The first thing to do, in line with the financial deepening program, was preparing the regulation regard to the offshore funds. This is in line with the marketing initiatives of cross-border mutual funds as stipulated in the CIS.

3.2. Cost and Benefit Analysis

3.2.1. Expanding market share of mutual funds and lower transaction costs

ARFP would like to be the operator settings (CIS) for investors in ARFP member. Investors should obey the passport regulation. Hypothetically, an investor could get some benefits, especially bigger available market, and a higher rate of return, the result of cost reduction in the more competitive market. Thus, the passport will be beneficial to retail investors. One of the keys success was protecting the investors since the passport required investors' confidence. In the passport stated that the lack of certainty in the requirements, both the establishment and the CIS formation process that is applied consistently across member countries ARFP.

3.2.2. Improving liquidity and access to finance

The strength of the brand will assist marketing the products in the Asian region and worldwide. From an economic perspective, the passport will have more benefits, increasing the liquidity and financial access. Liquidity will arise, either from transactions in financial products or accessibility credit for corporates, financial institutions, and governments, through investment in companies and government bonds.

BNP Paribas Securities Service Research (2014) illustrated that total AUM of retail funds in three countries (Singapore, Malaysia, and Thailand) were around USD 240 billion in 2012. The unification of those countries under ARFP scheme created rapid growth of retail funds. Total AUM would raise around 33-70% or USD 317-402 billion in the period 2012-2018. Elaborating each country, Singapore enjoyed the greatest growth from USD 53 billion to USD 110 billion (about 90%), Malaysia will grow 67% (from USD 112 billion to USD 187 billion and Thailand will grow 57%, (from USD 73 billion to USD 115 billion). If Indonesia and Philippines had agreed to join ARFP, total assets of retail funds under management reached about 130% (from USD 19 billion to USD 44 billion) in Indonesia, while the Philippines' growth was predicted around 165% (from USD 9 billion to USD 23 billion).

Amy Cho (2014) concluded that ARFP could develop the financial industry and increased the saving amount in the form of local investments. Meanwhile, ARFP could attract asset management companies came to Asia, increasing their profile in this region. They expected the excellent growth of their investment through ARFP or similar initiatives.

Meanwhile, EY-Asia Pacific Wealth and Asst Management (2014) suggested that, at the macro level, ARFP tried to open the capital markets in Asia, allowed the flexibility of capital flows in the region and enhanced the economic integration of its member. ARFP also attempted to increase the competition and choices for investors. Then, it could generate cost reducing for investors and make the diversification of the products easier to achieve.

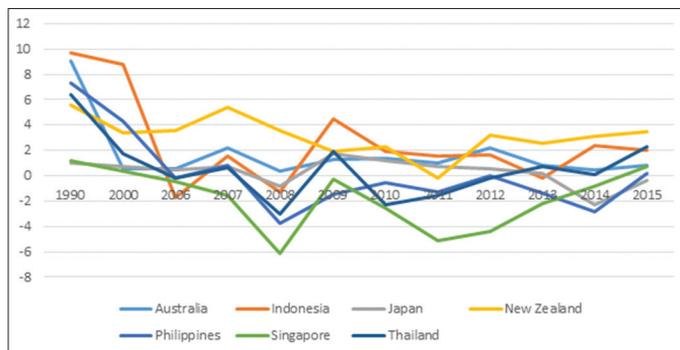
3.2.3. Creating jobs

APEC Policy Support Unit's study (2014) found that the implementation of ARFP was expected to reduce the investment management cost about the US \$ 20 billion per year. Then it would offer a higher return on investment at the same risk level, even lower. ARFP supposed to encourage the local funds pooling, creating 170,000 jobs for the next 5 years.

3.2.4. Encourage inflows of funds from abroad

There was a misunderstanding that if Indonesia joined ARFP, then the fund's outflow would happen because the domestic fund's manager could not compete with foreign agents. But, the participation of Indonesia in the AFRP was still in accordance line with deepening financial sector agenda, increasing supplies and demands. The strengthening of the mutual fund industry was not only about domestic demand but overseas demand too. Indonesia's market became open to the other investors.

Therefore, overseas investors could come into the market, especially from countries that had committed to join the ARFP. Theoretically, the investor would invest their funds in high returns products. Nowadays, the return on investment from Indonesia's mutual fund is more interesting than the other mutual fund products in Australia, South Korea, Japan, Thailand, and Singapura. It can be seen from Figure 1 about the comparison of real deposit interest rates (deposit rate minus inflation).

Figure 1: Real time deposit interest rate for several countries

Source: <http://www.tradingeconomics.com/country-list/interest-rate>

Scrutinizing Figure 1, ARFP would generate more foreign investors to acquire Indonesia's mutual funds. Otherwise, the Indonesian investor could buy foreign mutual funds. Since the return on investment from Indonesia's was higher than others, it would be foreign capital inflows in the long-run. Indonesia's financial sector should recognize that the increasing of foreign ownership might elevate the risk for the host countries (Summers, 2000). It changed the exposure of foreign investors in the local funds. Somehow, this risk should be relatively lower, caused by the reducing of cost transaction, and prevented foreign investors in the short-run. Indonesian mutual funds still were not an open market, since its foreign ownership only 18.07% currently.

If that possibility didn't happen and there was capital outflow, it could be dangerous for the Indonesia's financial system. Just in case, there was a global shock in the financial market, such as speculators needed liquid assets, Indonesian economy became very vulnerable. So ARFP required for some regulations that functioned as a brake for capital flows (e.g., Tobin Tax). It should be certain restrictions on ARFP's mutual funds.

ARFP would give benefits for Indonesian mutual fund industry, for example, it allows them to sell their products to its members. Moreover, it would create competition for agents in its members, especially who had given any restriction for its citizen investing securities in Indonesia. Likewise, Indonesia's product was allowed to be promoted under AFRP tax scheme, that could be more efficient (eg Roth IRA in the United States and Superannuation in Australia).

3.2.5. Benefits for investors

ARFP usually created benefits to the Indonesia's investors for (i) add the investment products range, includes access to the best-in-class investment and expertise across the region. (ii) An investment product, which is more adapted to the market and the region. That access would provide knowledge to the investment manager and encourage more opportunities for innovation in promoting their products. The accessibility also provided the scope for investment management, so they could develop the investment products, designed comprehensively for the region, (iii) improved economies of scale, more simple funding structure, and more competitor would reduce the fees, and (iv) increased scrutiny and governance of the fund. The concept of transparency in ARFP

regime would accordance to the international standards. It would offer more protection to the investors and ensure the investment products suit with investors' need.

3.2.6. Benefits for the investment management industry

Kearney's study (2015) showed that the investment management industry in Asia, including in Indonesia, would have many significant benefits of ARFP. Some of these benefits are: (i) An increase in size. Fund passports might increase AUM in Asia, then would increased high-quality investment products to the investors in that region. The growth in this industry was expected from the share increasing of investment products, not including the additional natural consequence of the market or system appreciation. (ii) ARFP was also expected to trigger more increasing demands and improve investment strategy, designed for the Asian market. Investors would have the access to more relevant designed strategy to the markets, rather than the general strategy aimed at entire Asia. More opportunities for investment managers based in Asia could offer in certain countries and utilized a regional strategy approach.

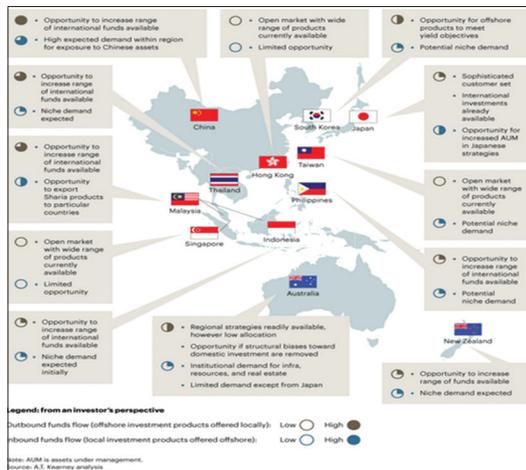
According to Kearney' study, the incremental impacts of ARFP would be different in every country. This would be influenced by the different characteristics and sophisticated level of the market. The potential impact of ARFP for each country could be seen in Figure 2.

Furthermore, according to the results of Kearney' study, ARFP fund passport in the Asian region was expected to get the momentum, such as investment credibility in this kind of industry. This was driven by the passports growth including more demands, more awareness and education, the creation of a passport product, and expansion into non-regional markets (Figure 3).

There were several potential risks (loss) if Indonesia decided to join the ARFP, such as the transaction costs might be potentially higher. There are doubts whether ARFP really would bring the expected benefits and provided adequate protection to the investors. This concern came from UCITS's experiences, who facilitated cross-border mutual funds distribution in Europe. UCITS often charged higher fees than on-UCITS funds. It reflected higher administrative requirements and costs, needed to distribute the mutual funds. Lang and Kohler (2011) estimated that the sales of mutual funds in the seven markets, not just one, would increase the total expense ratio of 30 basis points.

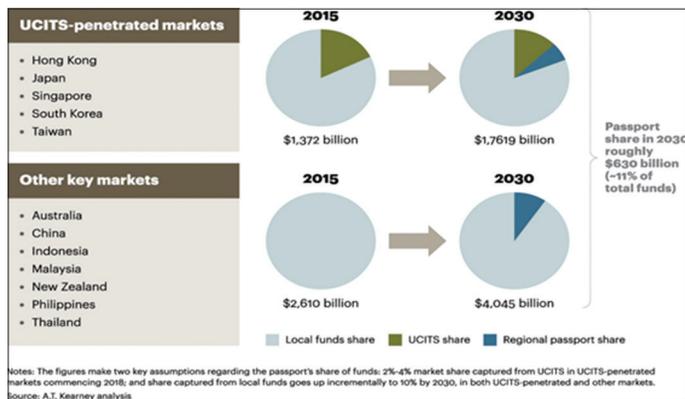
Despite AUM rapid growth, UCITS could not manage to consolidate funds market in Europe, as a result of the increasing of average AUM size. In 2012, the combination of mutual fund net assets reached about EUR 5.9 billion or the amount of 35,000 funds. Compare to the same industry in the United States, it had a net asset value of more than EUR 9.3 billion but the only amount of 7,000 funds. Thus, the average size of mutual funds in the United States was about 800% than mutual funds in Europe. The relatively smaller size in Europe have contributed to the cost and then the total expense ratio was more expensive. It was estimated that the average equity mutual funds in the European region had a total expense ratio of 1.75%, while the weighted assets

Figure 2: Potential impact of Asia Region Funds Passport



Source: Kearney Analysis (2015)

Figure 3: Economic impact of Asia Region Funds Passport



Source: Kearney Analysis (2015)

of equity mutual funds in the United States has a total expense ratio of 0.77% for the year of 2012.

Indonesia might not get the to benefit from ARFP at the same level to other member countries. The ARFP would deliver some benefits but it would not be the same among all participating countries. Based on the UCITS' experience, Luxembourg holds the majority of the authorization received by the fund in the EU cross-border distribution or marketing though its size of economies (GDP) was small compared to other countries in Europe. This caused by some factors, such as Luxembourg's reputation was preferred as a fund location and global standards for expertise in building and serving with the widest range. Thus, Luxembourg had been the domicile of choice for UCITS in Europe. Furthermore, UCITS had evolved to encompass a wider range of financial assets. Some of these assets may be issued and held outside the EU through sub-custody arrangements.

3.3. Potentially Lower Tax Revenues

Although the initiative ARFP supported by six countries across Asia, its development potential would also be hampered by tax issues. In the context of taxation, there had been an experience, which the fund mutual recognition agreement signed between Hong Kong and Australia in July 2008. It was not a single

product that was launched in both countries. This is partly due to taxation issues considered. ARFP is expected to adopt a neutral tax (tax neutrality). The purpose of tax neutrality are: (i) Maintain the rate of returns for the investors, (ii) eliminate barriers to tax in respect of cross-border distribution, (iii) maintaining tax neutrality through CIS, and (iv) maintain integrity by reducing evasion tax.

The tax sovereign principles guarantee that every country had autonomy to determine its taxation system. So, it created some differences in the tax treatment of mutual funds. Australia, South Korea, and Thailand are not imposed on the industry level, but on the income received by investors. On the contrary, Indonesia and Philippines, the tax imposed on mutual funds at both level, industry level, and investor level. If Australia, South Korea, and Thailand would like to apply the ARFP tax scheme, then there was a possibility that tax on mutual funds in Indonesia will be uncollectible. So, consequently, the Indonesia tax revenue potentially decreased in the long run, cause the tax compliance of individual taxpayers were still very low.

4. CONCLUSIONS AND RECOMMENDATIONS

This study concluded that ARFP would bring positive impacts to Indonesia. Several of its the benefits were expanding the market share of mutual funds; yielding lower transaction costs; improving the liquidity of mutual funds industry; facilitating access for financing; creating jobs; encouraging capital inflows from abroad. Those benefits should be very useful, both for investors and especially, industry mutual funds.

However, there are some potential losses if Indonesia decided to join the ARFP, such as the transaction costs could be potentially higher. Indonesia might not get the to benefit from ARFP at the same level to other member countries and potentially reduced its tax revenue.

Considering the analysis of the advantages and disadvantages, Indonesia had a lot of work to do if joined the ARFP. The first thing to do was preparing the regulation amendment, particularly the capital market act and the rule of taxation. They should be adjusted to meet the AFRP regulations, that had been agreed. But, it takes time too much and Indonesia could lose the momentum. If Indonesia did not join in early stages, it would be worse position in the negotiation process. Indonesia could not provide some recommendations or inputs in the ARFP's draft regulation, due to it's interesting, for example, the rule of mutual fund operation.

Otherwise, Indonesia has no intend to join, still, there were other options to deepen its financial market, in spite, it could have the opportunity cost. Indonesia's fund managers are likely to commence their representative office in order to sell their product worldwide. But, Indonesia has a lot of things to do. The most important thing is to reform its Capital Market Law, who have not been amended for more than 20 years.

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