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Asset Management as an Economic Driving Force
Drivers of the Korean Economy - The Role of Finance and Capital Market

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SSgA.

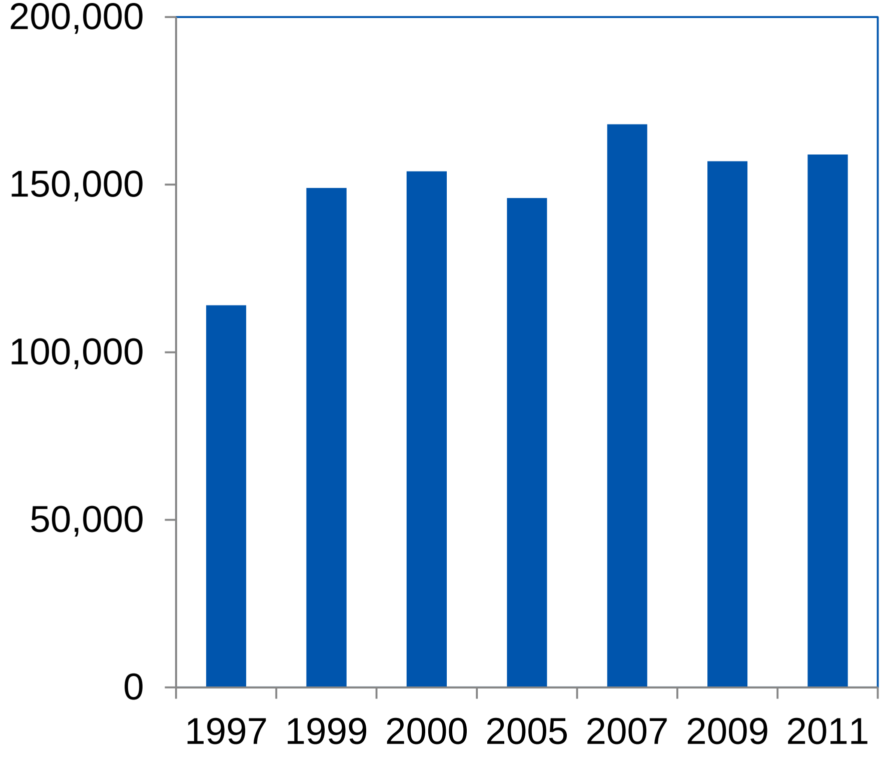
Outline of presentation

1. Direct contribution: asset management as a part of the economy
2. Indirect contribution: asset management's role in efficient financial intermediation
3. Unintended consequences: does asset management create systemic risks to economy?

Direct Contribution to the Economy

Direct contribution is not large by most metrics. E.g.: employment

Number of Employees in U.S. Funds Industry(1)



Number of Employees in European Funds Industry(2)

	Number
Direct jobs	***90,000***
Indirect jobs	***415,000***
Total jobs	***505,000***

Source: (1) 2013 Investment Company Fact Book, Investment Company Institute; (2) European Fund and Asset Management Association, Asset Management in Europe Facts and Figures June 2013
Notes :(1) ICI estimated number of employees of fund sponsors and their service providers; (2) Full-time equivalent jobs

….. However, Indirect Effects are Significant

Asset managers are responsible for a large proportion of the financial economic architecture

Worldwide Total Net Assets of Mutual Funds

Market	Assets (US$ billions)
Americas	**15,140**
Europe	**8,230**
Asia Pacific	**3,322**
Africa	**145**
World Total	**26,837**

Largest Countries in Region

U.S.	13,045
Brazil	1,071

Luxembourg	2,642
France	1,473
Ireland	1,277
U.K.	986

Australia	1,667
Japan	738
China	437
Korea	268

South Africa	145

- Why is the role of asset management so important ……

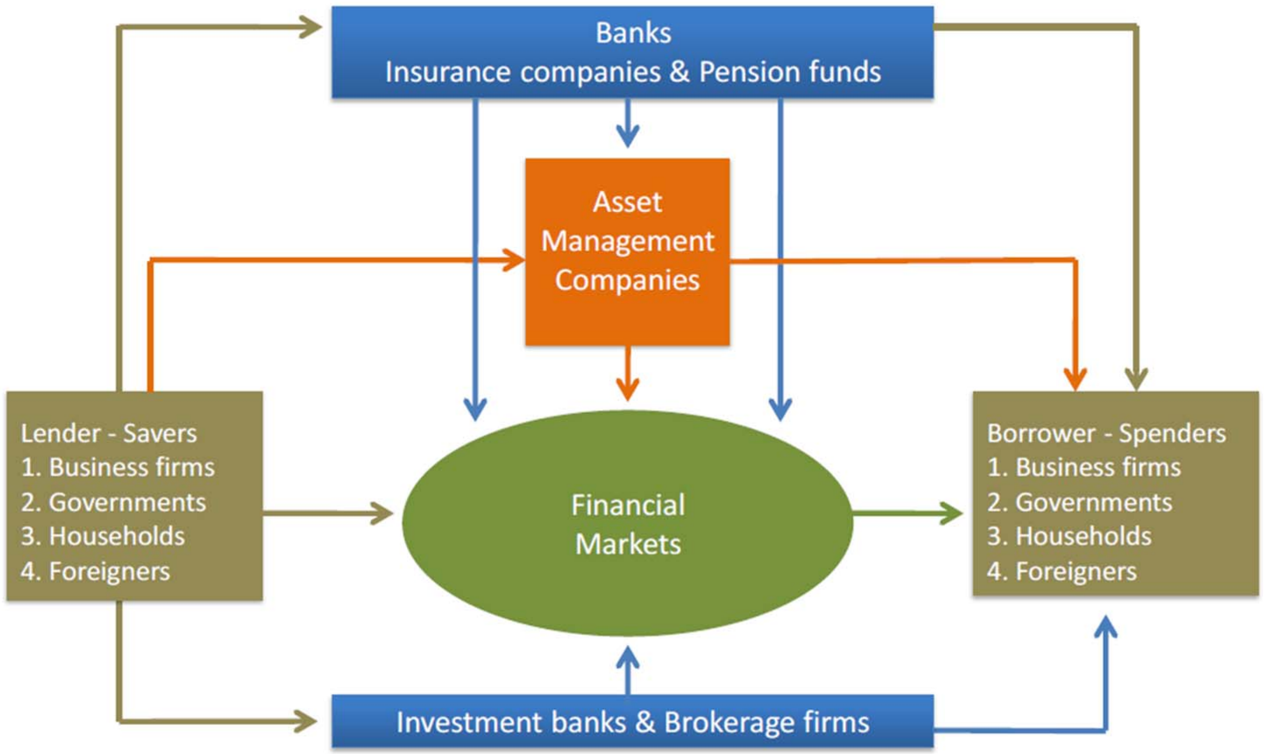
Source: 2013 Investment Company Fact Book, Investment Company Institute (extract); contributions from European Fund and Asset Management Association. Excludes ETFs

❷ Indirect Economic Contribution: Efficient Financial Intermediation

What is the purpose of financial markets in the real economy?

- Simplistically: allow the efficient, low-cost and unimpaired movement of capital between those with savings and those that require financing
- In summary, financial market development will reduce the cost of capital for businesses in the region and allow them to manage and hedge financial risk more easily

The Role of Asset Management(1)



Source: (1) European Fund and Asset Management Association , adapted from "The Economics of Money, Banking and Financial Markets", Frederic S. Mishkin. The information contained above is for illustrative purposes only.

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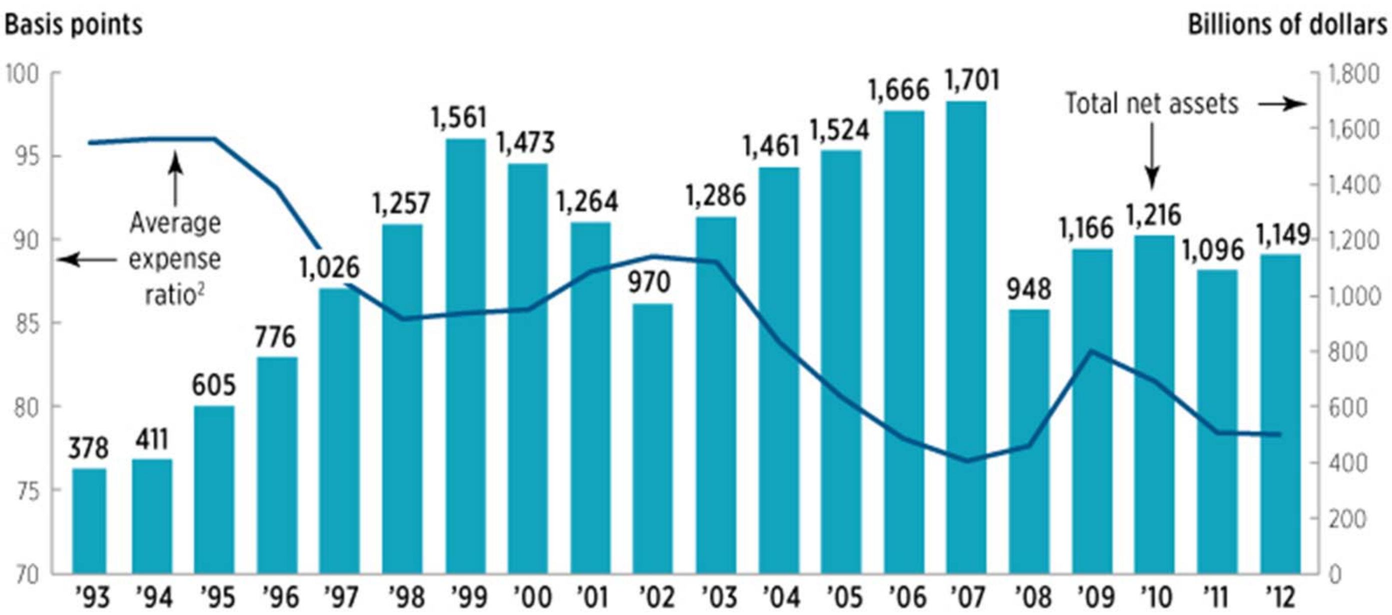
Financial Intermediation in Developed Markets

Efficient financial intermediation is firmly rooted in developed markets

- For example, the function of free markets to reduce the cost of intermediation has worked:

U.S. Domestic Equity Fund Expense Ratios(1)



- In part, this is due to competitive forces ……

Source: (1) 2013 Investment Company Fact Book, Investment Company Institute; includes share classes of domestic equity funds in continuous existence since 1993

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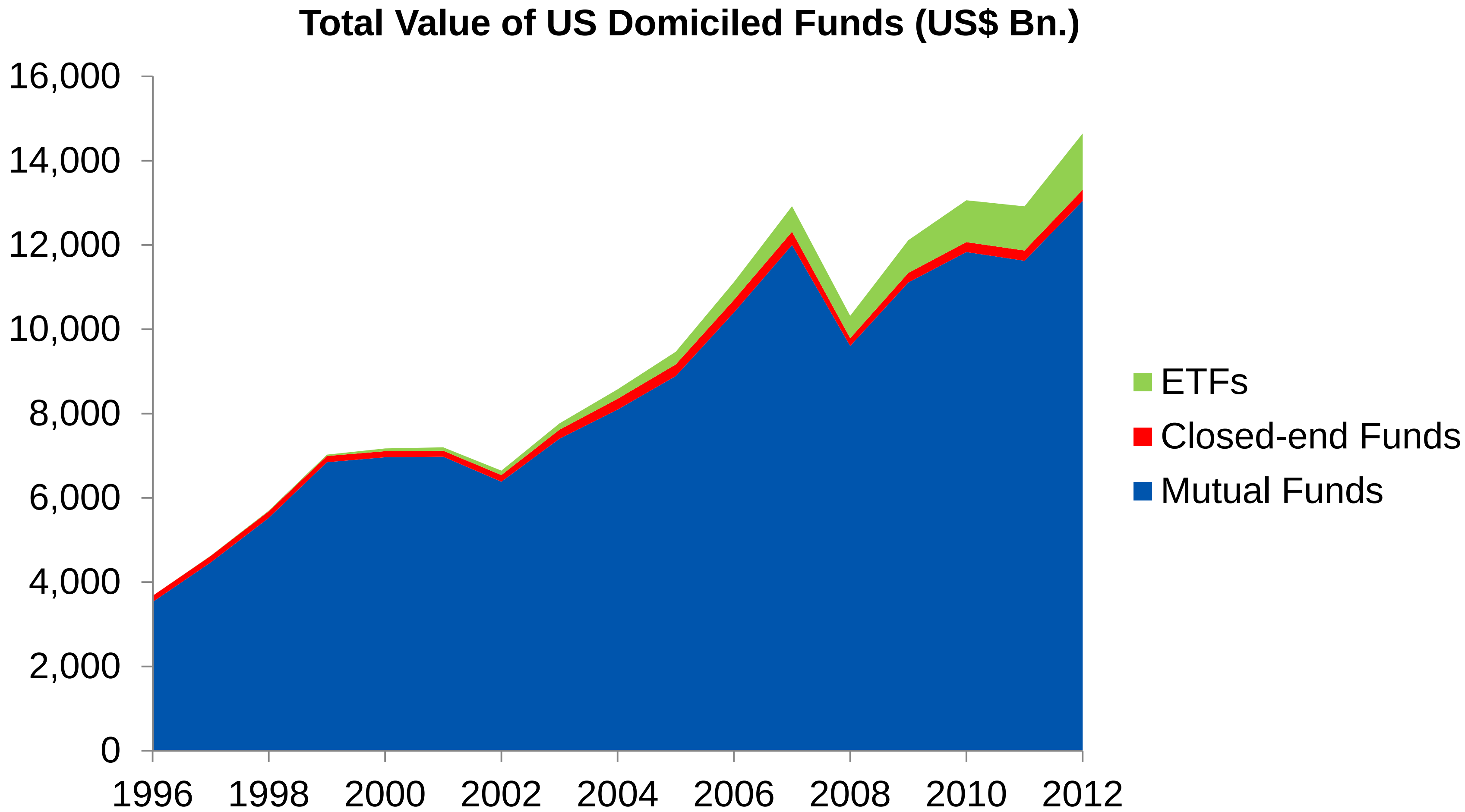
The Increase in Size and More Competition has Reduced Costs

Lower intermediation costs due to size and competition (e.g. ETFs)



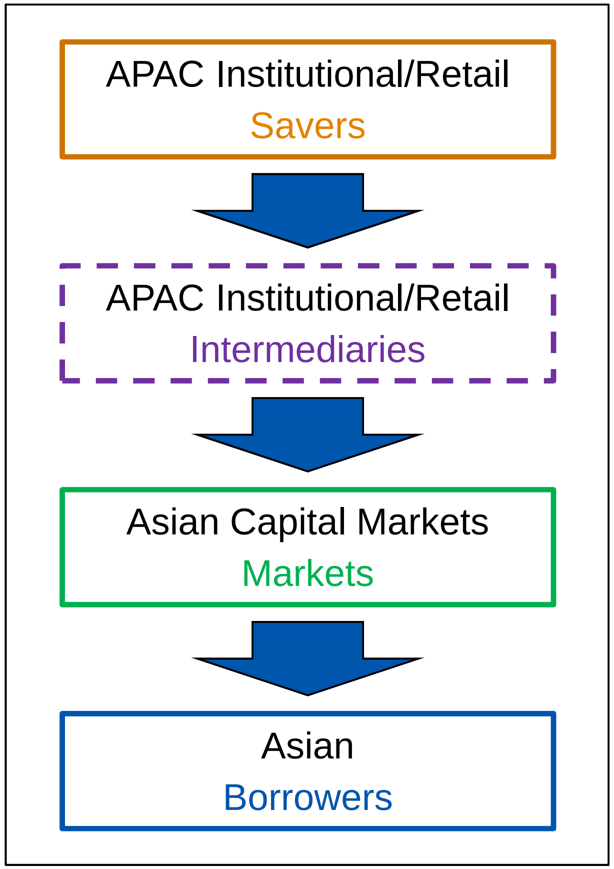
Source: 2013 Investment Company Fact Book, Investment Company Institute

….. However, in Asia-Pacific, Significant Barriers Still Exist

These barriers are not really about costs, but more about the ability for asset managers to intermediate

The Ideal Market Structure – a Pan-Regional System of Efficient Capital Flows

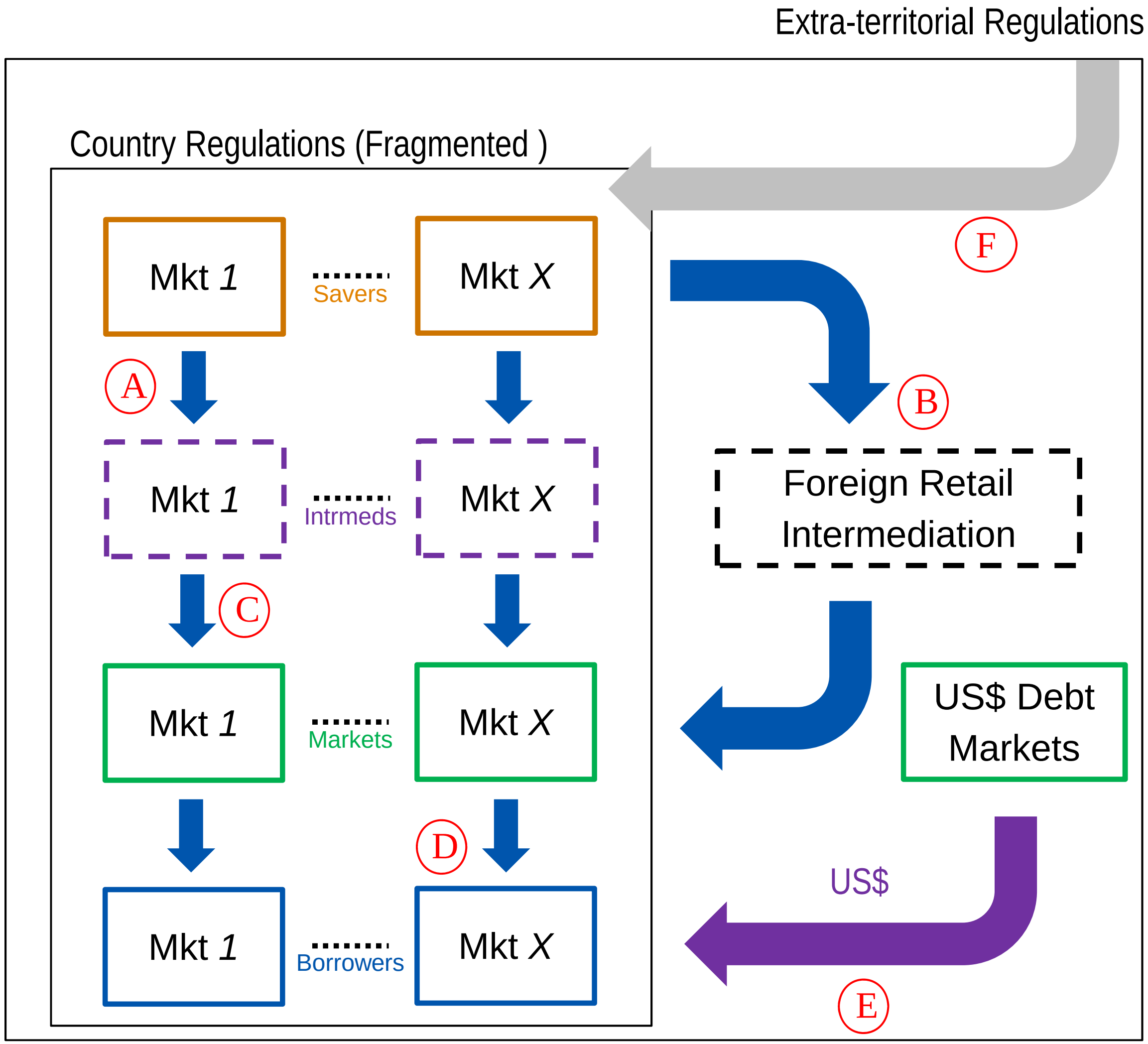
APAC Regulations



- Savers can invest across pan-regional capital markets through regional intermediaries
- Regional competition reduces intermediation (products and firms) costs
- Regional borrowers have access to regional capital markets
- Regional regulators define and agree on the scope of their oversight

APAC Financial Market Integration: the Reality

REALITY: relatively complex, fragmented and inefficient markets inhibits asset managers from acting as an economic driving force



A — Local savers mainly have access to products offered in their own local markets

B — Barriers to regional retail intermediation encourages foreign intermediation

C — Inefficient intermediation restricts investors' product choice

D — Borrowers mainly have access to their local markets

E — Limited cross-border APAC markets encourages US$ borrowing

F — Involuntary extra-territorial regulations

The information contained above is for illustrative purposes only.

Asset Management as an Economic Driving Force

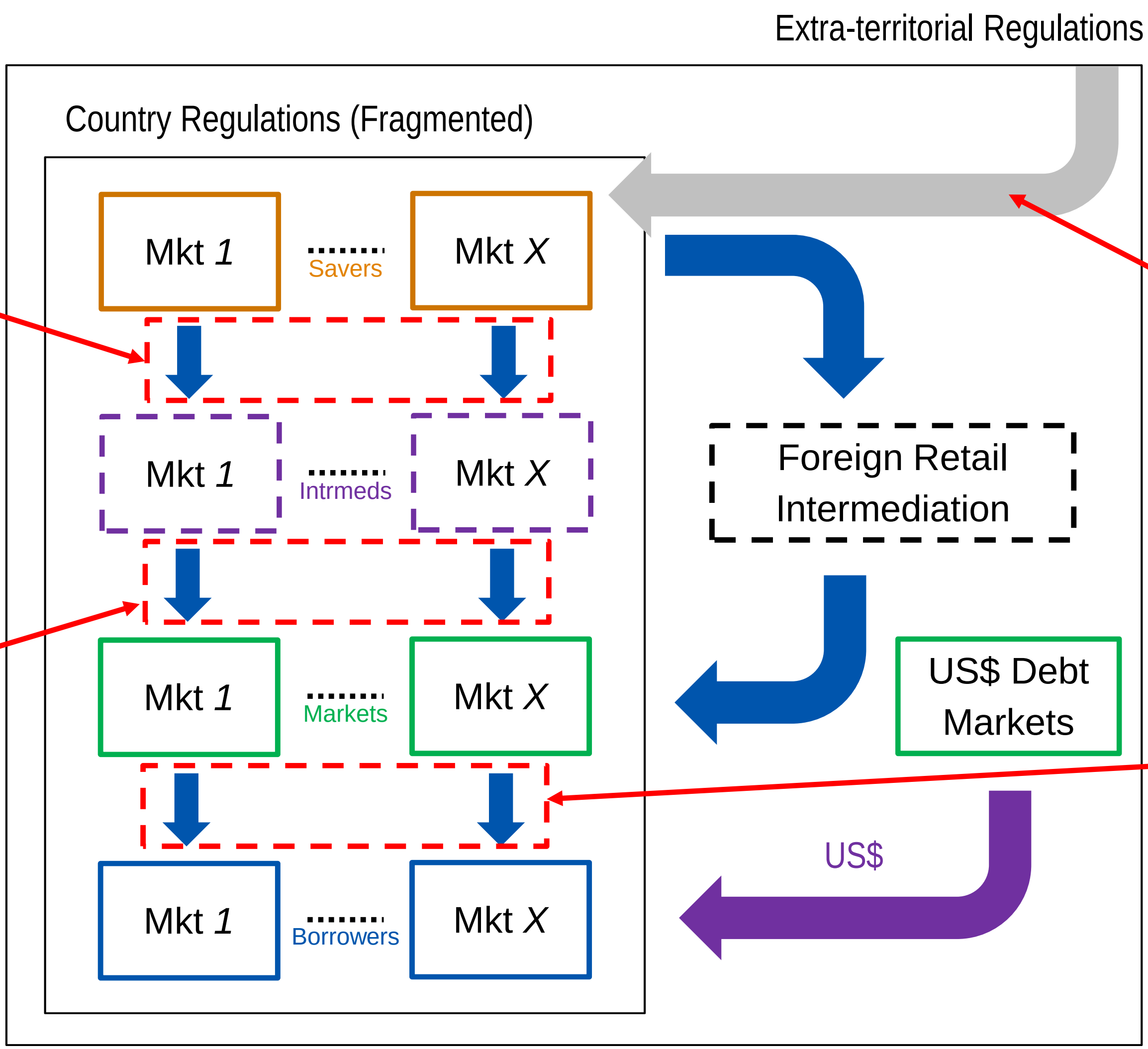
- Asset management is a positive force for driving efficient financial intermediation
- Simplistically: efficient financial intermediation provides capital and reduces its cost
- This allows roads to be built and large pension savings to be accumulated
- However, current barriers in Asia Pacific acts as an inhibitor in the region
- Asset managers cannot be the full economic driving force without further market integration
- The good news is that more is being done to improve integration …..

What is Being Done to Address Market Fragmentation?

Integration initiatives: past, current and future - reminder

[A] Allow collective funds to be offered across the region: Asia Region Funds Passport (ARFP)

[B] Improve intermediation and enhance investor choice across the region: Asian Bond Fund 2 (ABF2)



[D] How to deal effectively with extra-territorial regulatory effects?

[C] Allow local currency bonds to be offered across the region: ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF)

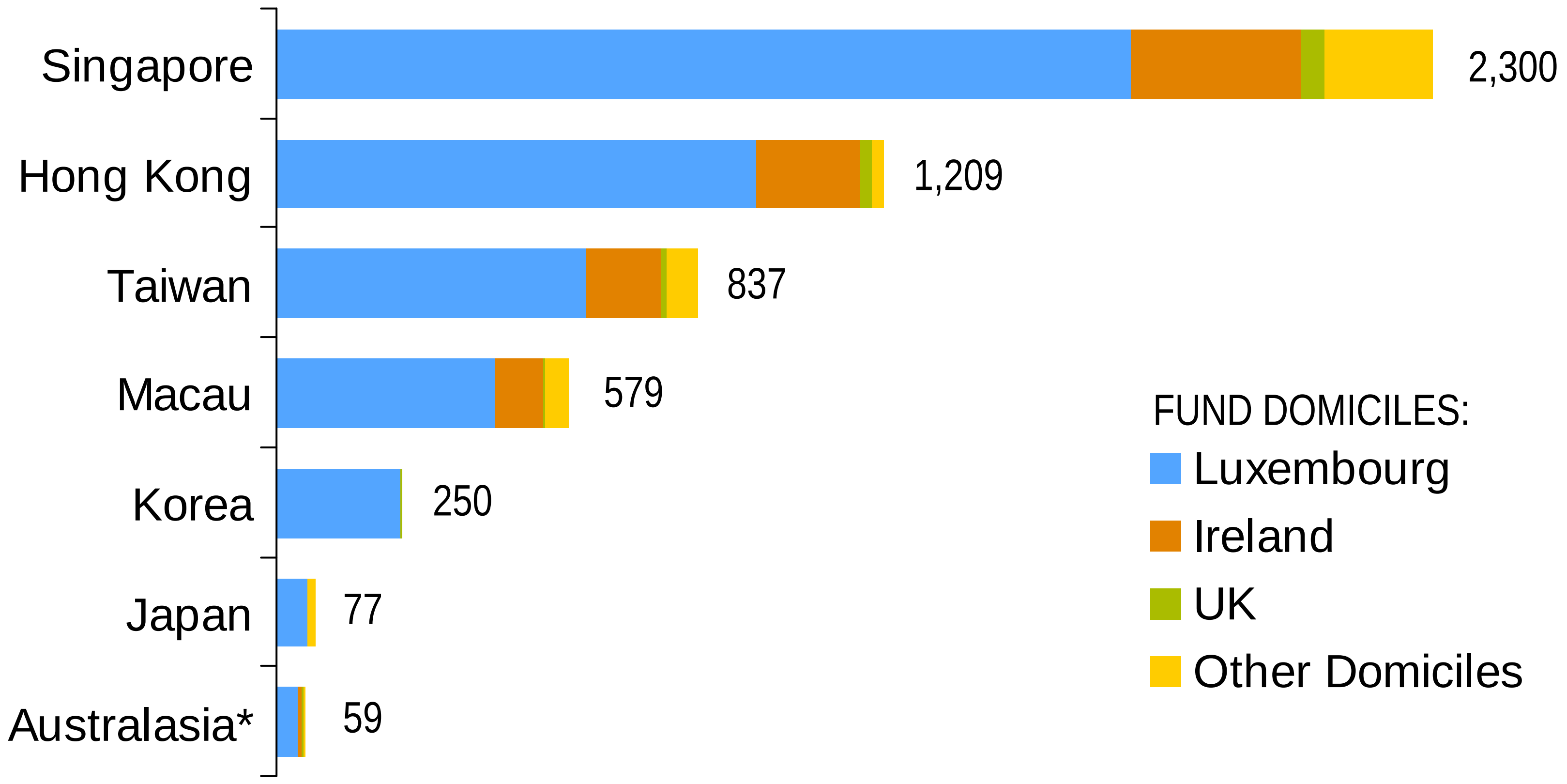
[A] Asia Region Funds Passport (ARFP)

ARFP is an initiative sponsored by the APEC Business Advisory Council

- Increasingly, the retail markets, particularly through collective investments, will become an important component of capital market activity due to:
  - Asia Pacific economic growth
  - High savings rates
  - Demographics and development of pension programs
  - Increasing affluence and investment knowledge
- The ARFP concept is intended to improve market integration by increasing the cross-border intermediation of financial products
- For retail collective funds, a system of mutual recognition of fund products between different jurisdictions in the region will permit these products to be offered to investors across the region – this is the ARFP concept
- Currently, cross border activity does take place across the region, but mainly through European UCITS fund products …..

Asian Cross Border Intermediation is Outside of Asia

Asia-Pacific cross-border fund registrations (non-domestic funds) by domiciles



Source: PricewaterhouseCoopers, *Global Fund Distribution 2010*
**Includes Australia, New Zealand and Cook Islands*
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[B] Asian Bond Fund 2 (ABF2)

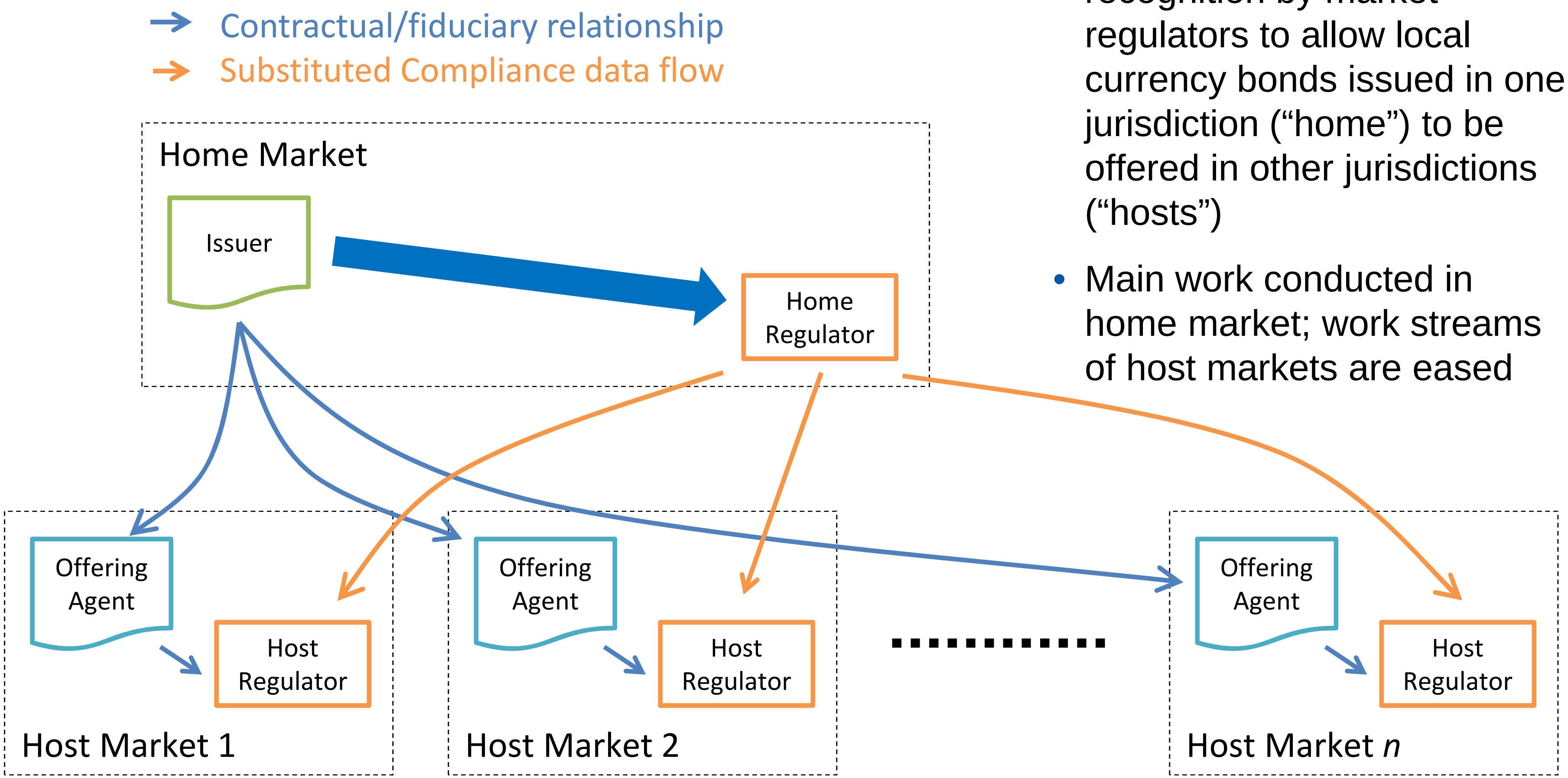
- One of the many objectives of ABF2 was to help enhance investor choice through a series of efficient market access funds (some structured as ETFs)
- The 11 EMEAP central banks in Asia-Pacific created ABF2 as follows:
  - US$1 billion in a pan-Asia regional fund
  - US$1 billion invested in a series of 8 single-market funds covering China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand
- All 9 funds are designed to become available to the public
- ABF2 enhances market intermediation in the region by providing an alternative market access choice for investors; a cross-listing strategy for ABF2 further enhances this benefit

Source: EMEAP press release 16 December 2004

[C] ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF)

AMBIF is an initiative sponsored by the ASEAN+3 Bond Market Forum

Mutual Recognition & Substituted Compliance Illustration



- AMBIF is a system of mutual recognition by market regulators to allow local currency bonds issued in one jurisdiction ("home") to be offered in other jurisdictions ("hosts")
- Main work conducted in home market; work streams of host markets are eased

Source: SSgA. The information contained above is for illustrative purposes only.

[D] Extra-Territorial Regulatory Considerations

Examples: European Market Infrastructure Regulation (EMIR); Dodd Frank. A potential role for APFF to facilitate global regulatory dialogue?

- Given the limited impact of the financial crisis and the need for regional countries to develop their nascent capital markets, APAC has different priorities to the US and Europe
- A response to global regulations by stakeholders in the region is more effective
- Potential regional fora for the collective voice – coordination needed:
  - Asia Pacific Financial Forum (APFF)
  - Various initiatives under the ASEAN and ASEAN+3
  - Asian Bond Markets Initiative (ABMI) under ASEAN+3 and ADB
  - Asia-Pacific Economic Cooperation (APEC)
  - Pacific Economic Cooperation Council (PECC)
  - The 11 EMEAP (Executives' Meeting of East Asia Pacific) central banks in Asia-Pacific
  - Financial Stability Board (FSB) Asia Pacific Committee
  - International Organization of Securities Commissions (IOSCO) Asia Pacific Committee

3 Unintended Consequences: Systemic Risks to the Economy

Given the large market footprint of the asset management industry, can systemic risks arise?

Potential issues related to systemic risk from asset management:

- Social utility value from the potential risk
- Sales and distribution incentives
- Alignment of financial incentives – principal-agent problems

Alignment of Financial Incentives: Principal-Agent Problems

In general, asset management incentives are well aligned

- Much of the post-GFC regulatory framework address concerns over the income model in the financial services industry
- At the core of these concerns is the “principal-agent problem”:
  - One party (the principal) compensates another (the agent) for performing certain acts
  - What incentive structures will motivate the agent to act on behalf of the principal’s interest rather than the agents?
- In respect to the income model for financial service firms, simplistically:

Investment Banking (Transactionally Driven)

Annual Income = value of transactions per year X ***spread***
(high turnover) ***(potential principal-agent conflicts)***

Asset Management (Relationship Driven)

Annual Income = [retained client AUM + new client AUM] X ***% fee***
(client satisfaction) ***(good returns)*** ***(transparent)***

- The income model for asset management appears to be better aligned than investment banking in respect to principal-agent concerns

Asset Management Income Model

- The relationship driven asset management income model is structurally quite robust in avoiding principal-agent problems
- Recent trends have included a shift towards performance based fees:
  - Smaller fixed fee
  - Additional fee based on outperformance relative to benchmark
  - Common to have a cap on maximum fee and strict risk control guidelines
- These type of fee structures (with proper safeguards) can further align principal-agent interests
- However, asset managers are still rewarded by growing their AUM – this can lead to capacity challenges

Conclusions

- The asset management industry may not be a major direct contributor to the economy
- ….. however, as an agent for financial intermediation, the asset management industry is huge and is a major indirect economic driving force
- Asset management is a positive force for driving efficient financial intermediation that ultimately provides capital and reduces its cost
- However, current barriers in Asia Pacific's financial markets acts as an inhibitor
- Asset management cannot be the full economic driving force without further market integration in the region
- Significant progress has been achieved, but more can be done to improve integration
- Asset management may be a major driver, but its potential for creating systemic risks is limited

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