**Regulatory and Institutional Challenges**
**for Fund Management in the Caribbean**
**By**

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## 1. Introduction

The mutual funds industry has been the fastest growing segment in the financial services sector in Trinidad & Tobago (T&T) over the past five years. Collective Investment Schemes (CIS) across the Caribbean as well have been growing at a rapid pace.

According to a study[1] conducted by the Trinidad & Tobago Securities and Exchange Commission (SEC), funds under management in domestic mutual funds grew by approximately 500% between 2000 and 2005, increasing from TT$5 billion in December 2000 to TT$27 billion by the end of December 2004 (TT$34 billion by end of December 2005). By comparison the worldwide mutual fund industry grew by 35% over the same period.

For the first time in 2005 the total funds managed by mutual funds in Trinidad & Tobago exceeded the total bank deposits. Based on the 26.4% growth between 2003 and 2004, the SEC predicted at that time that funds managed by mutual funds may increase to $34 billion by the end of December 2005. During the same period bank deposits grew more modestly at 13.7% and were estimated to reach $31 billion by December 2005.

Despite this rapid growth, nearly 97% of the funds are managed by a mere four mutual-fund managers. More than 70% of all investments in Collective Investment Schemes are from institutional investors.

The SEC in its mutual fund guidelines document acknowledged that "this concentration in the industry has developed under a regime in which supervision and regulation are weak and fractured. In this environment, the standards and practices observed by individual fund providers and managers vary quite significantly leading to potential concerns at an industry level about fund governance, risk management, marketing and promotional practices as well as surveillance and reporting."

That essentially sets the stage for the issues that we will explore in this paper today.

[1] The following information is from the Mutual Funds Guidelines document published by the Trinidad & Tobago Securities and Exchange Commission (TTSEC).

In this paper, I would like to share with you some highlights of the various regulatory regimes that govern the mutual fund industry in the Caribbean and then explore some of the institutional challenges and cultural impediments faced by fund managers in Trinidad & Tobago. I would close with a brief review of the performance reporting standards for fund managers in the region.

## 2. Governance of Collective Investment Schemes

### 2.1 Fund Manager/Trustee/Custodian Roles

Mutual fund regulations are still in the process of developing in the region. Many jurisdictions do not have full fledged mutual fund legislations; only guidelines issued by the local SECs.

The various legislations in the region attempt to structure the mutual funds industry in different forms. For instance T&T outlines that the Trustee and the Manager of a fund must be separate and independent entities. The Trustee will be responsible for supervising the management and administration of the fund.

Barbados and OECS regulations also make it clear that the role of the Trustee and the Manager must be separated. The Barbados legislation in fact goes into considerable detail on how a manager can be chosen.

One can of course question how truly independent the trustee will be given the fact that such a trustee will be part of a financial institution competing with the manager. But such a separation of roles is considered best practice and we will have to see how best this practice works in the Caribbean where we do not have truly independent trustee who is not a manager and vice-a-versa.

### 2.2 Investment Powers for CISs

This is another area where there is strong similarity between T&T and the OECS, but a different approach on Jamaica's part. The differences could lead to potential hurdles in trying to create a uniform regulation system across the Caribbean.

T&T guidelines state what a CIS can and cannot purchase. There is a restriction concerning securities that cannot be readily liquidated.

The OECS spells out exactly what a CIS can invest in.
Jamaica chooses a different approach. Rather than defining a list of allowable investments, Jamaica has adopted an approach whereby a fund can be developed by abiding to a set of risk constraints – this would allow the manager to develop the best portfolio with the goal of producing a product that would best suit the needs of the investor. There are still concentration restrictions and a level of diversification standards, but Jamaica's approach is focused more on the portfolio risk rather than the risk of the individual instruments themselves.

In all three guidelines, there are certain restrictions and quantitative requirements that are not to be exceeded, which is standard in any market.

Though there are differences in the investment powers granted to the manager in the three jurisdictions, they all stress the importance of not holding illiquid securities in the funds.

There is also uniformity among the various jurisdictions with regard to auditing and producing of financial reports, etc. They all require these documents and reports to be released automatically or by investor demand, in a timely manner. There are also clear restrictions in terms of borrowing/lending from the fund.

## 3. Challenges for Fund Management in the Caribbean

### 3.1 Absence of institutional frameworks for efficient fund management

A strong and vibrant fund management industry is vital for the growth and development of any capital market. At the same time, a vibrant capital market is essential for a good fund management industry to develop. Therefore, fund management industry and the capital markets are intertwined in their fates and are mutually reinforcing pillars of any economy.

As we saw earlier the fund management industry has grown leaps and bounds in the past five to ten years, despite several market deficiencies.

**Stock Market**

Let's look at the stock market to start with.

One of the greatest benefits of a vibrant fund management industry to an economy is the increased level of activity in the local stock market. Yet the combined stock holding of all the mutual funds in Trinidad & Tobago is less than 3% of the total market capitalization of the Trinidad & Tobago Stock Exchange. However, the mutual funds account for more than 55% of the volume of trades last year.

The market has been rather insipid in the recent years and therefore, pension fund managers have kept themselves away from the market. If, however, the fund managers keep away from the market, how will the market come out of its doldrums and develop? This expectation of some external force from somewhere else to come and activate the market is unrealistic. Yet this cycle happens time and time again during every market cycle.

The second issue is with respect to the efficiency of the stock market. In order for any collective investment scheme to provide a daily calculation of NAV – Net Asset Value – it requires daily, accurate pricing information. In a market where few of the stocks are traded regularly, are the prices used in computing the NAV truly accurate? If a mutual fund were to liquidate even a percentage of its holdings at the NAV will it be able to realize a value even remotely close to its NAV? These are some seminal questions for us to consider.

The reason for the lack of reliability of the pricing is really due to a lack of liquidity of the stocks. When the market is going up everyone wants to hold on to their stocks and nobody wants to sell and when the market is going down everyone wants to sell but nobody wants to buy. We call this a "one-way street market". This has led to a deeply entrenched "buy and hold" mentality across the industry. This in turn makes fund managers weary of diluting their holdings in the fear that they may not be able to get back the stock if they want it at a later date. Since, everyone operates with this fear, no one wants to take the first step of breaking this vicious cycle, which, by the way, everyone agree needs to be broken. Question is who will break the proverbial Gordian knot.

The fund managers, especially the pension fund managers, have a huge role to play in breaking this vicious cycle by both divesting positions during the up market and taking long positions in the down market. After all they will be the biggest beneficiaries in an active stock market, as they will be able to see the market grow and they can reap the rewards.

In this regard, I thought we missed a golden opportunity to break this vicious cycle when two years ago the value of the stock portfolios in pension funds exceeded the regulatory ceiling of 50% and the Inspector of Financial Institutions enforced the law. By off loading some of their stock holdings over a period of time when the market was at its peak they could have begun the process of creating an active market and they would have been able to come back into the market when the prices fell. Once again, our narrow buy and hold mentality worked against our own good.

The third issue is with respect to the sheer number and volume of stock available for investment by a rapidly growing mutual funds industry. The growth of the number of stocks listed in the stock market or its volumes of trades is no where near to the growth of the mutual fund industry. One way to expand a small market with limited number of listings and volumes is through derivative instruments such as short selling, options or index linked products. Even though the stock exchange has spoken about some of these derivatives to be developed we have not seen much happening in this regard. These products can be good money spinner for the exchange as well as bring a greater degree of depth that is sorely lacking in the local stock market.

### Bond Market

Now let's turn to the Bond market.

Since 1997, most of the activity in the capital market has been in debt securities rather than equity securities, this despite record levels of trading in the stock market especially in 2003 and 2004, and this has been reflected in the investment portfolios of CISs.

A large part of mutual fund holdings is in bonds and fixed income instruments. However, in the absence of a vibrant bond market the management of this part of the portfolio of a mutual fund is severely constrained. What is required to alleviate this situation?

Managing a bond portfolio is rather different from managing a stock portfolio. The most significant part of managing a bond portfolio is the understanding of the risk of the portfolio and managing the risk elements. The two fundamental elements of risk in a bond portfolio are the credit risk and the market risk.

In order for a fund manager to manage the credit risk of his bond portfolio he needs independent credit ratings. As you are aware, we do not yet have credit ratings widely available on regional bonds and other fixed income paper. This situation hopefully should be addressed, as CariCRIS, the regional credit rating agency gains traction.

Another significant benefit of the development of a rating based investment culture is the potential to move away from approved lists for investments as promulgated by legislation (such as Schedule 2 of the Insurance Act) to a broad rating based approved lists. This will give more room for fund managers and at the same time help other issuers to come to the market and be accepted for investment by fund managers.

Market risk, as you know, is the risk of change in price of a security due to movement in interest rates. This risk can only be managed if we have a reliable yield curve and regular, two-way price quotes on bonds. In order for this to happen, bonds will have to be traded regularly. I am pleased to note that the Central Bank is undertaking a major initiative in developing a bond trading platform using the Trinidad & Tobago Stock Exchange trading platform and the Central Bank's Bond Depository. When this comes into effect we are likely to see the beginnings of a more active bond market in the region.

Before we see active trading in bonds, however, we are more likely to see the repo market develop. Repos, as you are aware, are a first order derivative of a fixed income security, wherein a holder of a bond "sells" the bond for a fixed period of time with an explicit agreement to buy it back at a fixed price at a fixed date in the future. The reason why repos are likely to develop faster than bond trading is because repos provide the holder of the bond a convenient means of accessing liquidity against the bond without actually losing the ownership of the bond permanently. In a market that is fraught with buy and hold mentality, I feel this is likely to be a more palatable interim step before going full fledged into trading bonds.

## 4. Performance Reporting

Now I would like to turn my attention to the aspect of performance reporting by mutual funds.

All jurisdictions in the Caribbean require mutual funds to publish their financial statements in newspapers within a certain period. However, these statements do not give a transparent view of the actual performance of the fund itself from the investor point of view.

In Jamaica, ever so often, the local financial newspaper publishes an analysis of the performance of the various mutual funds there. Every time this report comes out, that day's paper is fully sold out. It is the same case even in the US when magazines such as Barrons or Business Week publish the mutual fund performance survey. Why is this the case?

The reason is mutual fund performance figures are NOT straight forward. Some mutual funds have loads or commissions that they charge either up front (front-end load) or at the back end (back-end load). When these funds report their performance it is not clear whether this performance is before or after taking into account the loads. Similarly, the performance figure may or may not include the management fees charged by the company that manages the mutual fund.

This is why, the CFA Institute has come up with a uniform standard for performance reporting which is called the Global Investment Performance Standards or GIPS® in short. These standards can help investors to evaluate performance of various fund managers on a uniform scale.

I would not wish to go into the details of GIPS itself as we have a far better qualified expert on this panel who will speak on that topic in detail. However, I wish to highlight some minimum standards that our mutual fund industry should aim to meet.

Three years ago when the stock market was at its peak, every mutual fund in the market ran full page advertisements highlighting their performance figures. These figures did not bear any reference to either the benchmark or a reasonable period of past performance. Therefore, while a mutual fund may claim to have attained a performance of, say, 18%, the fact that the market did 25% in that year is no where disclosed.

At a minimum we must require mutual funds to disclose at least five years of their total return. They must also provide details on the actual management fees and commissions that is applicable to be deducted from this return. Providing benchmark comparison must be made mandatory so that the investing public can compare the performance of the fund against an acceptable benchmark. This will make the development of the benchmark as a critical step towards creating benchmark based funds such as index funds, etc.

In addition, agencies such as CariCRIS and the financial media must provide independent performance assessment of the funds so that the public will have a better understanding of the mutual funds and their performance.

## 5. Conclusion

As we have seen, there is a need for harmonizing and strengthening many of the legislative frameworks for fund management industry in the Caribbean.

Secondly, there is a need for pension fund managers to break the vicious cycle of the “buy and hold” mentality and recognize the positive impact they can have in the development of the capital market. In this regard, the formation of an association of mutual fund managers in Trinidad & Tobago is a welcome move and will go a long way in raising the standard in this industry.

Thirdly, the fund managers need to push for greater use of credit ratings of bonds in order for bonds to qualify for investment in their portfolio. Also, the implementation of the bond trading platform is a critical step in the right direction. The lead taken by the Central Bank, the SEC and the Stock Exchange in this regard needs to be commended. I am sure that the newly formed Securities Dealers Association of Trinidad & Tobago (SDATT) would welcome this initiative as well.

Lastly, in order to provide greater transparency and integrity to performance claims by various fund managers, there is a need for uniform performance reporting standards to be adopted by the mutual fund industry.

I hope these comments will be used constructively by the fund management industry in the region to strengthen and deepen the capital markets of the Caribbean.

Thank you.

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