# Collective Investment Schemes in Asia: The Current Situation[1]

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## 1. Introduction

In Asian countries, "collective investment schemes" (CISs) may be called different names such as "mutual funds," "unit trusts" and "investment trusts." Collective investment scheme assets are growing rapidly in industrial countries, and Asia is no exception. This presentation discusses the current situation of collective investment schemes in Asia and related issues from the point of view of the development of capital markets. Because of time and material constraints, the analysis of issues must be centered around Japan's experiences. However, the conditions and the major issues are similar in most Asian countries.

In this presentation, I will first make some general comments about collective investment schemes and why they are important in Asian capital markets. Then, after reviewing the current regulatory reforms regarding such schemes and the fund management industry, especially in Japan, I would like to introduce a couple of ongoing innovations in the Asian collective investment scheme market.

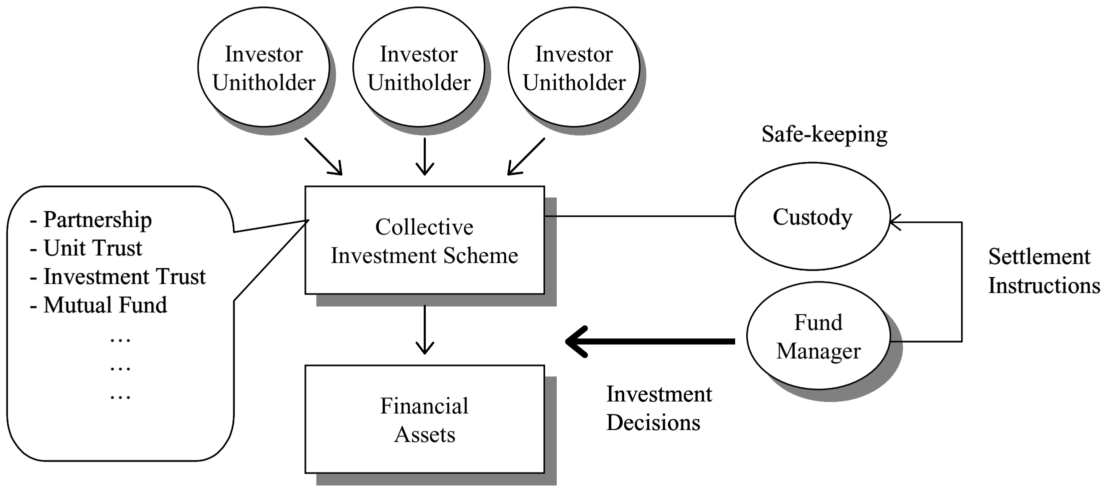
## 2. Definition of a Collective Investment Scheme

"Collective investment scheme" is a general term and appears to lack a clear definition. I would like to define the term as "a certain fund for which a professional manager makes investment decisions." Usually a collective investment scheme is a tax-transparent or a tax-exempt entity, so the net income from investment activities is passed on to investors. Investors in collective investment schemes may have "shares" or "units" in a corporate-type fund or "trust certificates" in a contractual-type fund. The fund could have a closed-end structure or an open-end structure. Units are not traded in the public market, but are usually redeemable based on the current net asset

[1] This paper is based on a presentation delivered by the author at the Third Round Table on Capital Market Reform in Asia organized by the OECD and the Asian Development Bank Institute, held in Tokyo from 10 April to 11 April, 2001. The author participated in a session on "Development of Collective Investment Schemes and Pension Funds," chaired by Dr. William Witherell, Director of Financial, Fiscal and Enterprise Affairs, OECD.

value of the fund. The history of the development of such schemes differs from country to country. If you look at the most popular collective investment schemes in each Asian country, it is clear that there are some markets, like Singapore and Hong Kong, that are dominated by corporate-type funds and some, such as Korea and Japan, that are dominated by contractual-type funds.

**Figure 1 Conceptual Flow Chart of a Collective Investment Scheme**




Source: Nomura Research Institute

## 3. Importance of Collective Investment Schemes in Asian Capital Markets

Why might collective investment schemes be important in Asian capital markets? We can imagine several reasons, including the following.

### (1) Diversification of Household Financial Assets

Firstly, collective investment schemes are suitable for shifting personal financial assets to diversified investments. While the high private savings rate in Asian countries is driving household asset accumulation, Asian personal financial asset management is highly dependent on bank deposits, and its money management is quite risk-averse. Well-developed collective investment schemes will provide another option for retail investors, and such investments with long horizons may effectively change risk capital flows and activate securities markets.

### (2) Professional Management

Secondly, professional management of collective investment schemes could diversify the investor base of capital markets. As many academics suggest, the participants in Asian capital markets have tended to move in the same direction simultaneously, which may have created boom-bust cycles on several occasions. Thus, creating layers of institutional investors is expected to "deepen" these capital markets. On the other hand, it is debatable whether fund managers will really be able to win retail investors' confidence in Asia, in terms of performance and professionalism.

**(3) Development of Fund Management Industry**

Thirdly, especially from a policymaker's point of view, fostering a country's fund management industry seems to have many benefits for its domestic financial industry, such as the development of financial technology and the internationalization of market activities. Currently, many Asian countries are trying to make their fund management industry more competitive. Sometimes they try to create a more open situation in their domestic market, and those policies are closely related to the deregulation of collective investment schemes.

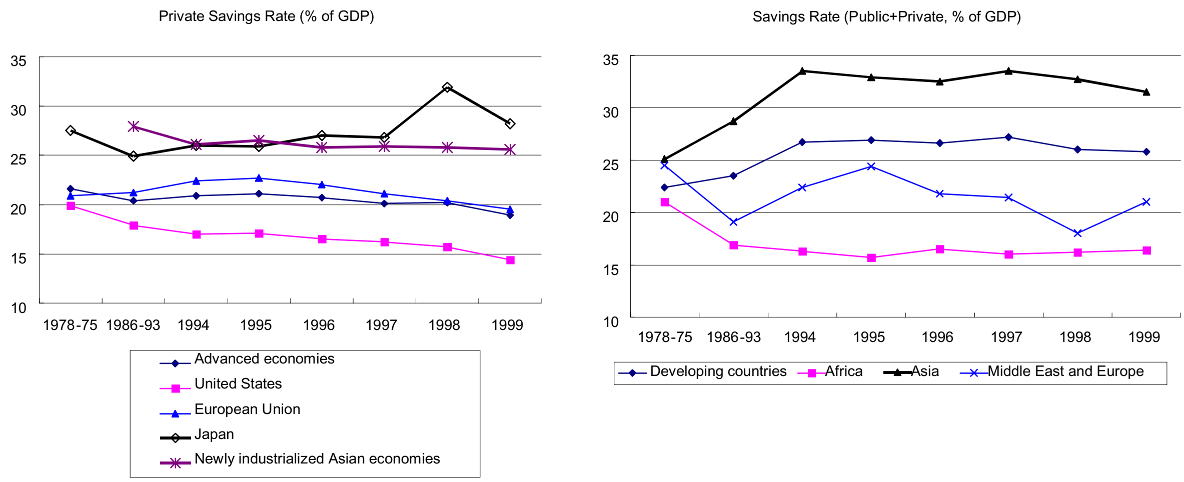
General conditions in Asian capital markets appear to be ready for the rapid growth of collective investment scheme assets. The high domestic savings rate is one of the most obvious phenomena in Asia, and financial assets are accumulating rapidly. Nevertheless, the allocation of household financial assets in Asian countries is very different from that in Western countries due to the risk-averse behavior of households in the former. For instance, in Japan, only 2% of personal financial assets is invested in investment trusts, while mutual funds account for 9% of US household financial assets. By and large, such a low penetration rate of collective investment funds is a common characteristic of Asian capital markets.

Although no comprehensive research is available, it is said that only 2-5% of the population of Asia invests in collective investment funds. In the United States, according to research carried out by the Investment Company Institute, over 80 million individuals own mutual fund units, which means that about 30-40% of the US population invests in mutual funds.

The statistics show that the assets under management of collective investment schemes in Asia has been growing rapidly during the past decade. That does not mean that collective investment schemes have been growing in popularity, but simply that overall household assets in Asia have increased.

The unpopularity of collective investment schemes in Asia is difficult to explain. Some writers have attributed it to cultural issues. Others have suggested that the capital markets in the region are biased. In Japan, the Postal Savings system plays a significant role in household asset gathering, which may have created a "safety zone" isolated from the competitive forces of the market. Also, securities houses and fund managers may not have made much of an effort to win investors' trust. Anyway, resolving this issue must be the most critical goal for Asian capital market policymakers.

**Figure 2 Trends in Private Savings Rates**




Source: IMF "World Economic Outlook," October 2000

## 4. Current Regulatory Reform of Collective Investment Schemes – Japan's Case

Collective investment schemes are currently undergoing regulatory reform in many Asian countries. We would like to focus on Japan's case and review the background and the major issues.

During the last decade, the Japanese government has carried out major regulatory reform of investment trusts on three occasions. The initial two reforms mainly included the following issues:

(1) Liberalization of the licensing system,

(2) Expansion of permitted investments, and

(3) Disclosure and reporting.

These issues are basically the same as those being discussed in other Asian countries.

**Table 1 1990s' Reforms to Japan's Investment Trust System**

| Area | 1995 (Reform) | 1998 (Revised Legislation) |
|---|---|---|
| 1. Development of fund management business | • Changes to licensing system (allowing investment trust management firms to also function as investment advisory firms) | • Changed from licensing system to registration system<br>• Firms allowed to conduct securities business as well as investment trust management and advisory business |
| 2. Relaxation of regulations governing permitted investments | • Investments in derivatives for non-hedging purposes allowed<br>• Restrictions on overseas investments abolished | |
| 3. Disclosure | • Expansion and clarification of contents required in prospectus (at issue) and investment reports (required to be sent twice a year) | • Securities & Exchange Law-based disclosure system applied to trust beneficiary certificates (requirements to submit a securities issue registration statement on issue and have statutory audits) |
| 4. Product development liberalization | | • Lifting of ban on private placements<br>• Establishment of a corporate-type investment trust (investment corporation) system |
| 5. Establishment of Fair Trading Rules | • Ministerial ordinances and Investment Trust Association regulations (clarification of what constitutes a breach of fair trading rules, etc.) | |
| 6. Performance evaluation system | • Improvements to Investment Trust Association's system of publication of investment performance<br>• Provision of raw data to evaluation/rating agencies | |

Source: Nomura Research Institute

One of the results of this deregulation has been that the number of asset management companies in Japan has increased significantly, especially as a result of the aggressive entry of US and European companies. Therefore competition in this market has become much tougher.

December 1998 saw the start of the "Tokyo Big Bang" program, a comprehensive deregulation plan for Japan's financial markets. One of its major goals was the evolution of the investment trust system.

After the 1998 reform, the Japanese government initiated further discussion on creating comprehensive rules for collective investment schemes. In 1999, a "Collective Investment Scheme Working Group" was set up in the Financial System Council, an advisory board to the Ministry of Finance (in July 2000, authority over the Financial System Council was transferred to the Financial Services Agency).

The Working Group's objective was to revise two laws. One was the so-called Special-Purpose Company Law, and the other was the Investment Trust Law. The two revisions, which were based on the Working Group's recommendations, passed the Diet in May 2000 and came into effect last November.

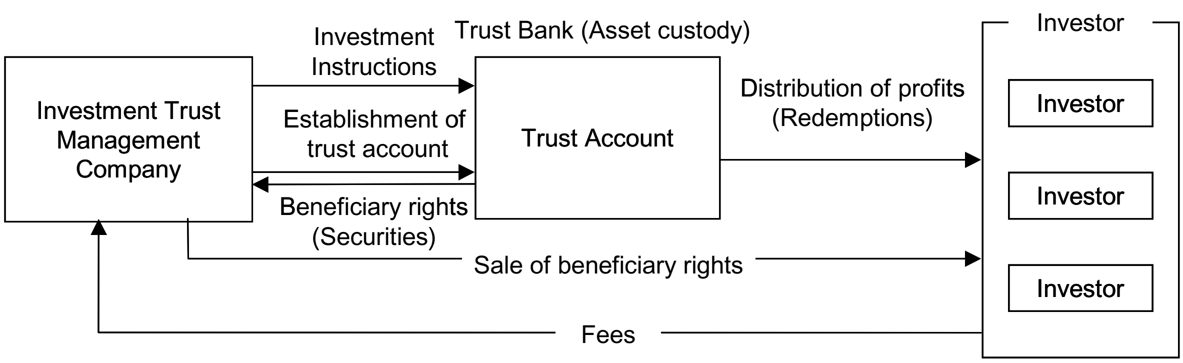
The new Investment Trust Law included two important changes. The first was to broaden the range of permitted investments. Under the former law, investment trusts were supposed to be collective funds for investment mainly in public securities, but now they can invest in almost all types of financial assets. The second change was to redesign investment trust schemes. After the 1998 reform, a corporate-type fund scheme was added to the contractual-type fund scheme. Moreover, the current law defines another contractual-type fund, so there are now three investment trust schemes in Japan (Figure 2).

"Non-discretionary investment trusts" are one of the two contractual types and currently the most popular structure in the Japanese market. On the other hand, "discretionary investment trusts" are a newly established type of investment trust. Under this structure, trust banks, which played only a custodian role formerly, can manage their funds at their own discretion. The third type is a corporate-type investment trust, which is called an "investment corporation." The units of an investment corporation are similar to the shares of an ordinary corporation.

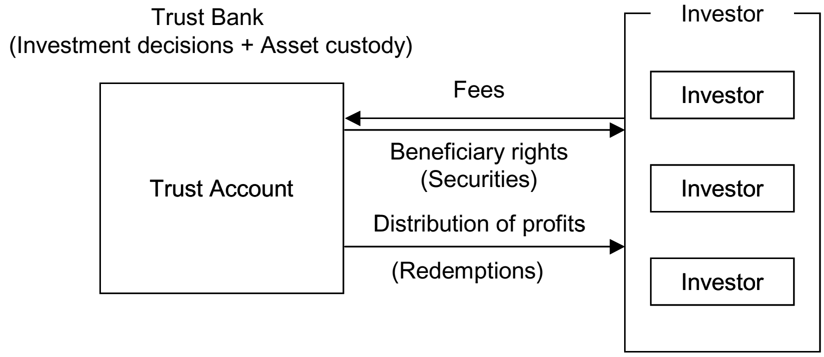
The investment corporation structure resembles a US mutual fund structure, presumably because Japanese policymakers borrowed the idea from the United States. At present, however, corporate-type funds are very rare in the Japanese market because of the hesitancy of existing asset management companies. One good piece of news for investment corporations was the 2000 reform that enabled a closed-end corporate-type fund to obtain debt capital by issuing investment corporate bonds. Anyway, the Japanese investment trust system has now been redesigned, and similar regulatory changes have been implemented in other Asian countries.

**Figure 3 Types of Investment Trusts in Japan**

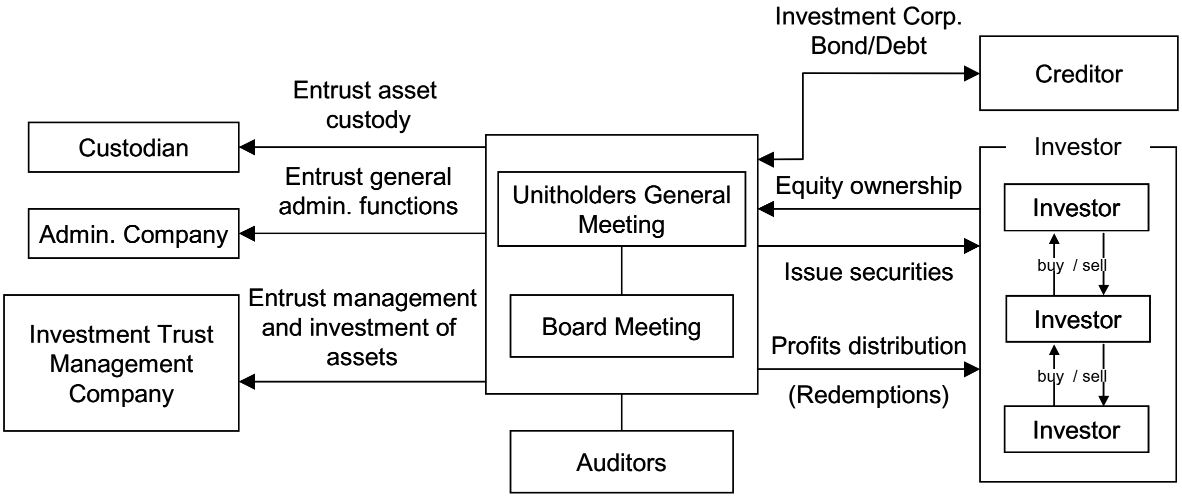
A) Non-discretionary Investment Trusts (Contractual-type)



B) Discretionary Investment Trusts (Contractual-type)




C) Investment Corporations (Corporate-type)
Source: Nomura Research Institute, based on the Japanese Financial Services Agency




## 5. Innovations in Collective Investment Schemes in Asia

Here we would like to focus on current innovations in collective investment schemes in Asia, especially on the product side.

### (1) Real Estate Investment Trusts

Real estate investment trusts, or property funds, are the first example of innovation that we should notice. These trusts are called REITs in the United States, where they are popular. Therefore, some Japanese experts call the newly permitted funds "J-REITs."

The main characteristics of J-REITs are as follows. First of all, J-REIT funds will invest in commercial real estate, and most of net operating profit will be distributed to unitholders. Net income will not depend on capital gains on the underlying assets, so J-REITs promise to be a stable, relatively high-yield cash machine. Secondly, they will be tax-transparent. Double-taxation can be avoided if an investment trust pays out over 90% of income available for dividends. Thirdly, regardless of whether they are corporate-type or contract-type, J-REITs must be managed externally. In that respect, they will resemble US "old REITs" before the 1986 reform. Australian property trusts are also similar to the J-REIT structure. Finally, J-REIT units will be traded on a stock exchange. The Tokyo Stock Exchange has drawn up listing rules and almost completed its preparations for the start of trading.

The creation of a J-REIT market has become a controversial issue, and views and responses are quite complex. The major players would appear to have different expectations on J-REIT as follows.

Demand from retail investors promises to be quite strong. They are likely to be attracted by features such as the liquidity of a public market, small trading lots and professional management. On the other hand, many retail investors still feel uneasy about the overall condition of the real estate market. Also, they may not like to have an exposure to short-term fluctuations in unit prices.

The basic motivation of institutional investors, on the other hand, is likely to be to want to diversify into alternative assets that could alter the weight of shares and JGBs in their portfolios. Life insurance companies may want to replace their existing real estate portfolios. However, institutional investors may see some disadvantages in J-REITs. For example, there are no benchmarks to measure J-REIT performance. In addition, some Japanese institutions may still prefer to invest in real estate directly.

Anyway, J-REITs have attracted a great deal of attention from many companies despite the long recession, and the first J-REIT fund will probably be listed this summer. The introduction of similar property funds is also under discussion in Korea, and the Singapore government has already established regulations and guidelines for property funds. What we must say here is that a collective investment scheme can sometimes be a powerful tool for activating a stagnant market. The J-REIT market will provide an interesting case study of this.

**(2) Defined Contribution Pension Plans**

The second expected innovation in collective investment schemes is defined contribution pension plans. As Asia experiences rapid aging and an underfunding problem in existing pension plans, some countries are seriously considering introducing defined contribution plans modeled on US 401(k) plans. This is likely to have a number of consequences. Without going into any details, it is clear that pension fund management will be more open to private fund managers. As well as expanding the playing field of professional fund managers, this could create a more competitive market environment.

### (3) Exchange-Traded Funds

The third innovation in collective investment schemes is exchange-traded funds (ETFs). An exchange-traded fund is a listed fund or investment trust and has a stock portfolio that closely tracks the performance and dividend yield of certain stock indices.

The American Stock Exchange is famous for listing over 80-90 such funds. One existing exchange-traded fund in Asia is the “tracker fund of Hong Kong (TraHK),” which tracks the Hang Seng Index and currently has a net asset value of approximately HK$27-30 billion.

The case of the tracker fund of Hong Kong is more than just a story about an exchange-traded fund. It actually provides a unique case study from a regulatory standpoint. During the Asian financial crisis, the Hong Kong government bought up stocks as a defense against attack by hedge funds. The tracker fund was regarded as a way of disposing of such governmentally owned stock without disrupting the market.

Japanese regulators and stock exchanges have started to study exchange-traded funds. They are also one possible exit strategy if a government agency purchases the shares of commercial banks as proposed in the Emergency Economic Package announced in April 2001. Moreover, the Singapore Exchange (SGX) recently announced that AMEX-listed exchange-traded funds would be listed and traded on SGX from May 2001.

## 6. Conclusion

Collective investment schemes have many benefits, but they are still underdeveloped in Asia. There are many reasons for this, and some may say they are partly related to cultural issues: Asians are not accustomed to letting others manage their money.

However, Asian countries have recently been making efforts to eliminate barriers to the development of such schemes, and to encourage product innovation.

Recent deregulation has partly succeeded and created more competitive and innovative markets. The emergence of real estate investments trusts and exchange-traded funds is interesting, sometimes even exciting, for investment bankers and investors. But it may raise new regulatory issues. Therefore, there will be many issues to discuss and resolve regarding collective investment schemes.

Finally, a well-developed collective investment scheme is a social good. Sometimes Asian securities markets overly act or react to certain events and create unstable market conditions. To think about broadening the investor base by fostering collective investment schemes may be meaningful for the healthy development of capital markets in Asia.