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Expectations for Japan-domiciled foreign-denominated funds

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Executive Summary

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Domestically domiciled foreign-denominated investment trusts are seen as a promising fund product that meets the needs of Japanese financial institutions, particularly banks. They also offer dividend tax advantages. While such funds can already be offered privately, several issues currently prevent them from being publicly offered to retail investors. These issues will hopefully be resolved so that foreign-denominated funds become a reality in Japan and gain popularity even overseas.

Japanese financial institutions, mainly banks, have been investing heavily in securities in recent years. They have a particularly keen interest in investing in funds that hold foreign-currency assets.

However, nearly all Japan-domiciled funds, including those that invest predominantly in foreign-denominated assets, use the yen as their base currency. Shares in such funds' must be purchased and redeemed in yen. If a financial institution wants to invest foreign currency holdings without converting them into yen, its only option is to purchase a foreign-domiciled fund denominated in the foreign currency it wants to invest.

Against such a backdrop, the first domestically domiciled foreign-denominated investment trust was launched in 2016 as a private fund.

Why Japanese financial institutions prefer domestically domiciled foreign-denominated funds

Around 1998, the Japanese fund industry first considered offering domestically domiciled foreign-denominated investment trusts as a vehicle for reinvestment of proceeds from foreign bond redemptions, but none was actually offered at that time. They were subsequently reconsidered several times but remained shelved for over 15 years because they would have entailed costly changes to the involved financial institutions' workflows and had no prospect of generating enough revenues to cover their costs.

What finally prompted the launch of a Japan-domiciled foreign-denominated fund after a 15-year delay was renewed awareness of two major advantages that

Japan-domiciled funds have over foreign-domiciled funds.

The first is a tax advantage. Tax rates on foreign-source income differ depending on whether a tax treaty exists between the countries involved. With interest rates at multi-decade lows, investors are seeking to earn even slightly higher distribution yields from their fund investments, partly by maximizing tax efficiency. A Japan-domiciled fund may be subject to a lower dividend tax rate than a foreign-domiciled fund, depending on the dividends' source country.

For a fund domiciled in, for example, the Cayman Islands, US-source equity dividends would be taxable at a 30% rate in the US because the US does not have a tax treaty with the Cayman Islands. A Japan-domiciled fund, however, would be taxed at a 10% rate on the same US-source dividends. Under the tax treaty between Japan and the US, US-source dividend income is taxed at Japanese tax rates if certain conditions are met. The difference between US and Japanese tax rates enhances Japan-domiciled funds' investment performance.

Dividend tax rates vary depending on the dividends' source country and other factors. By optimizing for these factors, a Japan-domiciled fund can gain a performance advantage over foreign-domiciled funds.

The second advantage, from Japanese financial institutions' perspective, is that information used for risk management is obtainable sooner from Japan-domiciled funds than from foreign funds.

Japanese regulators have been tightening risk-management regulations on banks' fund holdings in recent years. The FSA's annual reports and the BOJ's On-Site Examination Policy for Fiscal 2016 dictate that banks must ascertain their funds' risk profiles by risk factor. To comply, financial institutions are increasingly pressuring their investee funds to provide look-through information on fund holdings more accurately and faster.

If a bank owns foreign-domiciled funds, it must request such look-through information from an overseas fund manager. Overseas fund managers reportedly often fail to meet Japanese financial institutions' needs in terms of information disclosures' accuracy, timing and format. If Japan-domiciled foreign-denominated funds were available, many Japanese investors believe they could obtain faster, more user-friendly information disclosures because they would be dealing with

Japanese fund managers. If so, Japan-domiciled foreign-denominated funds would be a better fit for Japanese financial institutions in terms of regulatory compliance (e.g., look-through requirements) also.

Domestically domiciled foreign-denominated funds would of course benefit the Japanese asset management industry also. Given ongoing growth in financial institutions' demand for fund products, asset management companies can broaden their product offerings and improve their chances of landing new clients by launching funds that appeal to financial institutions' needs.

Expansion into public investment trust market

While Japan-domiciled foreign-denominated funds that meet financial institutions' needs are starting to become available in the form of private investment trusts, latent demand for foreign-denominated funds exists even among retail investors. For example, retail investors who invest in foreign government bonds may want to reinvest their bond redemption proceeds without converting them into yen. To build a full-fledged market for Japan-domiciled foreign-denominated funds available to retail investors, the asset management industry must offer such funds as public investment trusts, but it currently faces a number of barriers to doing so.

For Japan-domiciled foreign-denominated investment trusts to be publicly offered, their beneficiary certificates must be entirely paperless. Private investment trusts can feasibly issue paper beneficiary certificates because they have a limited number of investors. Public investment trusts, by contrast, must issue and subsequently administer large, indeterminate numbers of beneficiary certificates. They consequently have no alternative but to go paperless. However, workflows for Japan-domiciled foreign-denominated investment trusts have yet to be established. The fund industry must decide on such workflows and design them to accommodate paperless processing.

Additionally, publicly offered foreign-denominated investment trusts would require separate customer service workflows for fund distributors. The biggest challenge would be calculating taxes to be reported to investors. For Japanese retail investors, even those who have bought funds in foreign currencies, taxes are invariably payable in yen. Fund distributors therefore must calculate taxes on a currency-by-currency basis and report tax liabilities to their customers.

Lastly, existing laws need to be amended to legalize funds that manage assets denominated in multiple currencies. Financial statements also would need to be revised to accommodate foreign-denominated investment trusts and this revision, depending on its scope, could require another legislative amendment.

Such issues would require extensive discussions involving many parties.

Once the Asia Region Funds Passport[1)] (ARFP) is launched in December 2017, Japanese fund managers will be able to sell public investment trusts in five ARFP-participant countries. Foreign-denominated fund offerings are expected to be met with strong demand in these countries. If publicly offered Japan-domiciled foreign-denominated funds become widely available, the Japanese asset management industry would have realistic prospects of exporting the funds overseas. I hope that the issues described above are resolved in the near future and the Japanese asset management industry's domestically domiciled investment trusts gain widespread popularity even among overseas investors.

NOTE

1) The ARFP framework establishes common fund registration standards among participating countries to enable funds that comply with one participant country's standards to be easily sold in other participant countries.

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