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What asset management industry should do to expand bank-facing fund business

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Executive Summary

While Japanese banks' fund holdings are growing, meeting banks' regulatorily mandated informational requirements imposes a heavy burden on asset management companies. The asset management industry as a whole should develop uniform risk-weighting standards and standardize report forms in anticipation of prospective regulatory tightening and to better serve its bank clients.

Japanese banks' fund holdings have been growing in recent years, roughly doubling since September 2012. Their domestically domiciled fund holdings alone now exceed ¥10 trillion. In response to such growth, asset management companies are looking to expand their bank-facing fund businesses.

When investing in funds, banks rely on asset management companies to provide various information required for regulatory filings, particularly reports mandated by capital adequacy regulations (the Basel Accords). To expand fund sales to banks, asset management companies must strengthen the Basel-compliant reporting services they provide to banks.

Currently, however, such reporting services impose an onerous workload on asset management companies. The Basel rules pose compliance challenges for asset management companies in three broad respects.

Practical challenges of compliance with Basel rules

The first challenge is the difficulty of interpreting regulatory notices and complying with regulatory reforms. Basel-compliant reporting requires thorough familiarity with Financial Services Agency (FSA) notices and Basel Committee on Banking Supervision[1] (BCBS) documents. Asset management companies must classify their funds' individual securities holdings based on these documents, determine the securities' risk weights and ascertain the extent of any double-gearing. These tasks are extremely labor-intensive.

The risk-weighting process involves classifying individual securities into various categories prescribed by regulatory authorities, such as equities and public sector

NOTE
1) The BCBS was established as an international forum for cooperation on banking supervisory matters.

securities issued by entities other than foreign sovereigns. For example, risk-weighting of securities in this latter category involves researching the issuer's investor relations materials and its parent company, if any, to identify any government-owned equity stakes in the issuer that exceed a prescribed materiality threshold.

Double-gearing determinations entail ascertaining whether issuers of equity securities held by a fund are financial institutions, which include not only banks but nonbank financial service providers such as leasing companies. Double-gearing determinations consequently often pose difficulty, particularly in the case of foreign securities. This difficulty increases asset management companies' workload.

Additionally, attribute-based classifications used for Basel-mandated reporting are defined differently than equivalent classifications used by asset management companies in their other business processes. Asset management companies consequently must develop separate processes specifically for Basel-mandated reporting. They must also gather separate information specifically for Basel-mandated reporting due to differences in information standards. Basel-mandated reporting thus requires completely separate processes not compatible with reporting for other purposes. This is one reason it is burdensome for asset management companies.

Another difficulty stems from the fact that FSA notices predominantly pertain to domestic bonds. Asset management companies consequently must independently interpret foreign fund information based on FSA notices, but ensuring the accuracy of their interpretations is a challenge. Additionally, such interpretations tend to qualitatively vary depending on the level of expertise of the staff involved. Many asset management companies are keenly aware of their current internal limitations in this regard.

The second challenge is that due to the subjective nature of such independent interpretations, different asset management companies sometimes arrive at different interpretations of the same securities. When banks receive discrepant information on the same security from multiple asset management companies, they ask the asset management companies to rectify the discrepancy. In such cases, the asset management companies must investigate and reconcile their differing interpretations. This process also is very time-consuming.

The third challenge is that banks each have their own forms that they require asset management companies to use for reporting. Complying with banks' differing requirements is another burden. Banks' report forms differ in terms of not only format but also required informational content. Additionally, their content has been increasing in breadth in recent years in the wake of regulatory tightening. This trend is another factor behind growth in asset management companies' compliance workloads.

While asset management companies face such reporting challenges, complying with Basel rules is by no means easy for the banks that receive their reports either. As noted above, asset management companies differ in terms of their interpretations of regulatory requirements and their reports' level of detail. To verify the content of asset management companies' reports, banks also independently gather information and investigate discrepancies. Banks currently feel burdened by this verification process.

In sum, the three challenges discussed above are industry-wide issues. They cannot be resolved by asset management companies individually improving their back-office efficiency.

What is needed to resolve these challenges

To resolve such administrative challenges posed by Basel-mandated reporting requirements, the asset management and banking industries as a whole need to minimize their industry-wide workloads by standardizing compliance processes. In broad terms, such standardization requires two steps.

First, the asset management industry must establish uniform, industry-wide standards for interpreting regulatory notices and making risk-weighting and double-gearing determinations. Instead of individual asset management companies independently making such determinations, the industry as a whole should formulate clear-cut, transparent rules and consistently classify securities based on a common framework. One conceivable way to do so would be for asset management companies to formulate rules through consultation with each other, collectively classify individual securities using a framework provided by a third-party provider and share the classification results on an industry-wide basis[2). Widespread use of such a service by many asset management companies could eliminate the discrepancies in risk-weighting and double-gearing determinations that currently occur due to differing interpretations of regulatory requirements and differences in qualitative data inputs used to make such determinations. In addition to lessening asset management companies' compliance workload, such an approach should also eliminate the burden of reconciling discrepancies in report content that arise between asset management

2) NRI plans to offer an IDS/BIS service from spring 2016.

companies and banks and resolve the aforementioned challenges facing both.

The second step is to standardize report formats on an industry-wide basis. To do so, the asset management industry would need to develop universal forms that fully meet banks' information requirements. This is another area in which an appropriately delivered third-party service could be a viable solution[3]. For asset management companies, eliminating the time-consuming process of complying with individual banks' different report specifications should enable them to deliver their reports more expeditiously. Meanwhile, banks would be able to easily obtain required information in a uniform format irrespective of which asset management companies they purchase funds from.

3) NRI is preparing to offer expanded BIS reporting services from fiscal 2016.

If such standardization can resolve the administrative challenges described above, asset management companies would be presented with a major opportunity in the bank-facing fund business, where their expansion has hitherto been constrained by the heavy workload involved in servicing bank clients. The Basel rules are slated to become even more stringent going forward. In 2017, the so-called look-through approach to funds' equity holdings will become mandatory in principle[4]. Once it does, banks will become more rigorous in risk-weighting funds from the standpoint of capital efficiency. Asset management companies will have to research securities' attributes and make risk-weight determinations for their funds' securities holdings in more detail than in the past. Their workload consequently could keep increasing. In anticipation of the look-through approach's adoption, the asset management industry would be well advised to promptly proceed with standardization to improve back-office efficiency.

4) When the look-through approach to equity holdings of funds owned by banks becomes mandatory in principle from January 2017, funds with nontransparent asset holdings will have a higher risk weighting than they currently do. The look-through approach will consequently have to be applied to funds-of-funds also.

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