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vol.81 (10.June.2010)

Financial institutions begin to prepare for the advent of Japanese ISAs

Nomura Research Institute, Ltd.

Financial institutions have started preparing for the advent of Japanese individual savings accounts in 2012. To provide a diverse range of services conducive to expansion of the Japanese ISA user base, financial institutions must be ready to evaluate the ISA system's effectiveness soon after its inception. To do so, financial institutions and tax authorities must compile objective statistics.

With the fiscal 2010 tax reforms now promulgated into law, small investors have been granted tax-free treatment of investments in publicly traded equities, effective from January 2012. More specifically, individuals will be permitted to open tax-free investment accounts subject to contribution limits. Modeled after the UK's individual savings accounts (ISA), these accounts are called Japanese ISAs. Coincident with Japanese ISAs' advent, the tax rate on dividends and capital gains from publicly traded equities and equity investment trusts will be raised from 10% to 20%. This change makes the Japanese ISA an attractive wealth-building vehicle for individual investors.

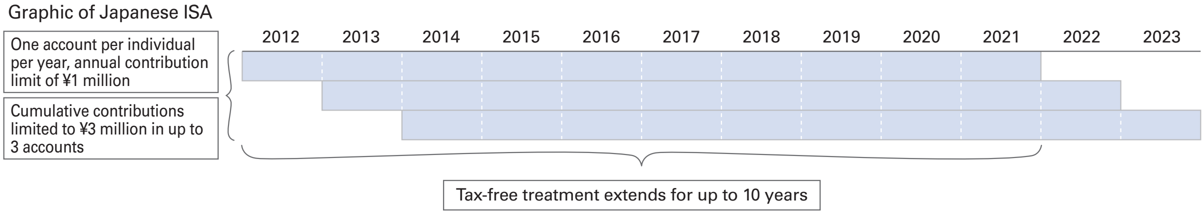
Japanese ISAs' main characteristics are summarized as follows (see exhibit below). Eligibility to open a Japanese ISA is limited to residents aged 20 and older. Eligible individuals may open up to one tax-free ISA per person per year at a bank or securities brokerage, but only during the three years through 2014. The financial products eligible for purchase in an ISA are limited to publicly traded equities and equity investment trusts. Funding of such purchases is limited to ¥1 million per year (three-year cumulative total of ¥3 million). Dividends and capital gains from assets held in ISAs will be nontaxable for up to 10 years. Assets held in the accounts may be sold at anytime, but such sales will be deemed to constitute withdrawal of the sales proceeds from the account. Proceeds from the partial or full liquidation of financial assets in an ISA consequently cannot be reinvested in other financial products within the account (unlike in tax-qualified pension plans, asset switching is not permitted).

Exhibit. Overview of Japanese ISAs

Highlight	Tax-free treatment of dividends and capital gains from assets in ISA
Inception date	January 2012*, when the reduced (10%) tax rate on dividends and capital gains from investments in publicly traded equities will be abolished (ISAs may be opened during the 3 years through 2014, with tax-free treatment extending for 10 years)
Eligibility requirements	Eligibility is limited to Japanese residents aged 20 or older (as of January 1 of the year the ISA is to be opened)
Eligible products	Publicly traded equities, equity investment trusts
Contribution limit	¥1 million per year
Number of accounts	Individuals may open one ISA per person per year at a financial institution (e.g., bank, securities brokerage)
Withdrawals	Assets may be withdrawn tax-free at anytime

*The application period for opening an ISA in a given year is from October 1 of the previous year through September 30 of the year.

Graphic of Japanese ISA



Source: NRI, based on Financial Services Agency and Government Tax Commission data

Financial institutions' response to Japanese ISAs

Financial institutions are not compelled to offer ISA services, but the vast majority of securities brokerages and banks that sell investment trust products will likely do so, partly because ISAs are advantageous to their customers. Another reason is that by capturing customer accounts ahead of competitors, financial institutions will gain a competitive advantage by building enduring relationships with customers. Individuals are legally permitted to open a new ISA with a different financial institution every year, but due to the extra hassle of holding assets at multiple financial institutions, most Japanese will likely open subsequent ISAs at the same financial institution at which they opened their first ISA. Once a customer opens an ISA at a given financial institution, she will likely keep her core asset holdings invested at that financial institution.

Nonetheless, some within the Japanese financial industry have reservations about ISAs. One contention is that ISAs are a threat to financial institutions' profitability. Another frequent criticism is that the maximum investment per customer is small at only ¥3 million because the period for opening ISAs is limited to three years. Additionally, opening a Japanese ISA will reportedly be more time-consuming and involve more red tape than opening a conventional account. When a financial institution receives an ISA application from a customer, it must contact the tax authorities to determine whether the customer has already opened an ISA with another financial institution during the same year. The financial institution may not start processing the customer's application until it has received authorization to do so from the tax authorities.

Consequently, financial institutions will presumably seek to minimize their investment in ISA services, even at the cost of sacrificing customer convenience to some extent. For example, financial institutions may limit their ISA product offerings to funds purchasable in yen amounts specified by the purchaser. They may also otherwise restrict their product or service offerings, such as by not offering automatic reinvestment of fund dividends. Some financial institutions may even limit the channels available for placing buy and sell orders.

Additionally, financial institutions are likely to initially refrain from offering services that entail investments beyond a certain scale, even if the service is regarded as an effective means of cultivating new customers. One example is workplace services. In the UK, some financial institutions[1] have in fact started to newly offer workplace services in anticipation of ISAs becoming a permanent institution. Without knowing whether Japanese ISAs will be extended beyond the initial three-year period, Japanese financial institutions are unlikely to launch services that involve costly preparations, such as workplace services.

Objective data needed to evaluate ISA system

To develop various ISA services and expand the ISA investor base, the Japanese financial institutions should hasten to prepare to debate the ISA system's future from 2015 onward. The industry should present its conclusions a year or two before the end of the initial three-year period for opening ISAs. Financial institutions accordingly must begin to evaluate the ISA system soon after its inauguration.

To facilitate an unbiased discussion based on objective evidence, financial institutions need to compile reliable data on ISAs' prevalence. In the UK, HM Revenue & Customs (HMRC) annually reports the number of ISAs, the amount of ISA contributions, and the value of ISA assets, both in aggregate and broken down by gender, age bracket, and geographic region. The Investment Management Association, a UK industry organization, likewise publishes monthly statistics on investment trust sales for ISAs.

Similar statistics are needed in Japan also. Currently, with both the tax authorities and private financial institutions focused on operationally preparing to accommodate ISAs, they may not have the latitude to think about collecting objective data. However, providing objective evidence and laying the groundwork that will enable discussion of the ISA system's future course will lead to the development of a widely used ISA system and services. Such preparations must not be overlooked.

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Note

1) For example, Legal & General and Standard Life have launched services that enable employee stock ownership plans to utilize tax-free ISAs called "corporate ISAs."

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