

INTERNATIONAL **ASSET** MANAGEMENT
AND **INVESTMENT** FUNDS **REVIEW**
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JAPAN ASSET MANAGEMENT INDUSTRY ISSUES AND INITIATIVES NEEDED TO RESOLVE ISSUES FROM THE PERSPECTIVE OF THE INDUSTRY STRUCTURE

KPMG



 **Huiqin Zhong**
Manager

 huiqin.zhong@jp.kpmg.com

 03 3266 7500

 www.kpmg.com/jp

BIO

Huiqin is manager in Financial Services Group, providing a variety of advisory services to financial services companies in Japan including market research, commercial due diligence, business due diligence, operational due diligence, business projection review, and financial modelling. She has various project experiences to provide services to support M&A deals in the financial services sector.

Before joining KPMG, Huiqin had 7 years working experience at a major Japanese Bank. Huiqin has deep experience in risk management and regulatory reporting for both bank and bank holding companies.



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INTRODUCTION

- The global asset management industry has experienced significant growth in recent years. In the U.S., the world's largest asset management market, both custodians, who provide service and infrastructure for fund managers, and distributors, who capture customers, are aggressively entering the asset management space, and the industry is undergoing significant restructuring. On the other hand, the Japanese asset management industry, which holds the world's second largest household financial assets, has not seen a large influx of funds from a global

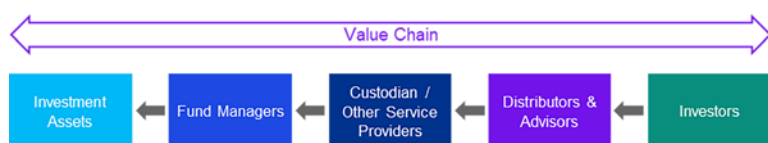
perspective, and there have been almost no new attempts. In this report, we will examine each component of the Japanese asset management industry's industrial structure, summarise their current status and challenges, and discuss necessary initiatives to resolve the industry's overall issues.

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Due to Japan's unique business requirements and licensing process, Japanese asset management firms are subject to high barriers to entry.

I. Current Status and Issues of Each Component of the Industry Structure of the Japanese Asset Management Industry

- The industry structure (Value Chain) of the asset management industry is shown in the figure below. The arrows represent the flow of money, with money flowing from right to left. In this chapter, we will discuss the current status and issues of each component of the asset management industry in Japan.



1. Investment Targets

- In recent years, alternative investments have been expanding rapidly in Europe and the U.S., and the market is expected to grow even more in the future. In Japan, on the other hand, investment in traditional assets remains the basic approach, with relatively few alternative investments, and neither the quantity nor quality of product development has expanded significantly.

- In addition, ESG investments have been attracting attention worldwide in recent years. In Europe and the U.S., industry standards for ESG investment have been established, and it is easier for fund manager that make ESG investments or ESG investment targets to gain trust by disclosing ESG-related information in accordance with industry standards. In Japan, on the other hand, ESG investment is still a relatively new investment approach, and the regulatory environment is not yet well developed. As a result, the sound development of ESG investment by Japanese asset management companies and the intake of ESG money from overseas have not progressed.

2. Fund Managers

(1) Weak Competitive Environment and High Barriers to Entry

- Due to Japan's unique business requirements and licensing process, Japanese asset management firms are subject to high barriers to entry, making it difficult for new players and foreign-affiliated firms to enter the industry. Insufficient competition among existing firms and the ability to earn profits without sufficient corporate effort have resulted in little shakeout or restructuring of firms. Because of this "protected" competitive environment, there has been no cost reduction through downward pressure on commissions, nor has there been Customer Experience-oriented functional development or organisational reform, as seen in the US and Europe.

(2) Power Relationship with Distributors

- In the value chain of the asset management industry in Japan, the influence of distributors is strong, and the market structure is such that market dominance is determined by whether or not a company has a strong distributor. This market structure can be seen in the fact that most of the investment trusts sold in Japan are structured and managed by asset management companies affiliated with distributors. As a result, asset management companies prioritise the development of products that will generate more commissions for the distributors rather than products that truly meet the needs of investors, creating a distorted market that is distributor-oriented rather than investor-oriented.

(3) Low Level of Information Disclosure

- Various disclosure regulations have been implemented in the UK and the EU to increase transparency in the asset management industry. As a result, information disclosure by asset management companies and managed funds has increased, leading to transparency of cost structures and a healthier industry, which has successfully attracted investment money. The industry as a whole has become a major success story. In Japan, on the other hand, the asset management industry has a low level of information disclosure, and cost structures, performance, and risk assessment are rarely explained. In such an obscure disclosure environment, investors are unable to determine whether the fees they are paying are reasonable and whether the management of the funds in which they are investing is appropriate, which makes it difficult for them to have confidence in the funds and discourages them from increasing their investment balance.

3. Custodians and Other Service Providers

(1) Business Practice Issues

- In the Japanese asset management industry, there are business requirements and practices that are unique in Japan and hinder the efficiency of custodians and the creation of a competitive environment. For example, in Japan, there is a long-standing practice of "double calculation of NAV," in which the NAV of a mutual fund is calculated by both the asset management company and the custodian, and the results are reconciled to

determine the NAV. This practice, which is unique from a global perspective, has created a major obstacle to entry into the Japanese market by top-tier foreign players that provide excellent services at low prices globally. As a result, the competition between existing providers is insufficient, and there has been little progress in cost reduction efforts and little progress in functional development or industry restructuring as seen in Europe and the U.S. Consequently, the high costs are passed on to investors.

(2) High Administrative Costs

- The Japanese financial industry has not been making progress in bringing IT in-house through industry restructuring and the acquisition of human resources. Japanese custodians have long been in the practice of paying high costs to outsourced vendors for IT development, and have not made progress in creating added value or developing new functions through the utilisation of IT. As a result, the business model has remained and not evolved from a global perspective, and has yet to provide new added value to asset management companies and the asset management value chain as a whole. This, combined with the aforementioned high barriers to entry for foreign firms due to Japan's unique business requirements, means that Japanese asset managers are forced to use outdated services at a high cost, without access to global standard custodian services that offer advanced services at a low cost.

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4. Distributors

(1) Sales Practices That Are Not Customer-Oriented

- In 2017, Japan's Financial Services Agency (FSA) published its Principles for Customer-Oriented Business Operations, which consist of seven principals, in order to promote stable asset building for the Japanese public. In accordance with the Principles, Japanese financial institutions are required to implement customer-oriented business operations in substance, not in form, depending on their circumstances. In reality, however, some sales practices remain that cannot be deemed customer-oriented, such as prioritising short-term sales commissions and giving priority to investment trusts affiliated with the company. As a result of this structure, asset management companies are more interested in developing products that are easy to sell and earn commissions for the distributors, rather than products that are truly needed by investors. This business operation that prioritises the interests of the distributors and disregards the interests of investors has become the usual practice, and because the business is not contributing to investment asset building, it has fallen into a vicious spiral that is also damaging the medium- to long-term corporate value of the business itself.

(2) Absence of Independent Investor-Oriented FAs

- In Europe and the U.S., qualifications and systems for providing independent investment advice that is not affiliated with any financial institution have been established and are widely used by investors in general. Independent FAs help to develop asset plans from the client's perspective and provide advice and financial products that contribute to asset building. In Japan, however, there is lack of qualifications and systems in place to provide such independent advisories, making it difficult for investors to seek out high-quality investment advisors. Although the FP qualification exists in Japan, FPs can only provide advice on overall asset building, and are not allowed to explain or offer the contents of financial products. There are also IFAs who can handle the contents of financial products, but IFAs are contractually in a position to sell financial products on behalf of financial instrument dealers, and since their income comes from sales commissions, they are structurally subject to the risk of conflicts of interest with their clients. Thus, the lack of infrastructure to provide independent investment advisors is one of the reasons for the lack of progress in asset building in Japan.

5. Investors

- Now that we have covered investment targets, fund managers, custodians and other service providers, and distributors, what are the features of investors at the top of the asset management value chain, and how do they view their own investment environment? In this section, we will focus on Japanese individual investors, whose asset building has not progressed well from a global perspective.

(1) Overview

- Japanese households have not been successfully able to achieve a "savings to investment" shift. Although Japan ranks second in the world in terms of the size of household financial assets, the percentage of risk assets under total assets is extremely low compared to Europe and the U.S., and asset building through investment is barely achieved. This has led to a lack of supply of money to the financial market and stagnation in the asset management industry.

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Independent FAs help to develop asset plans from the client's perspective and provide advice and financial products that contribute to asset building.

(2) Features and Preferences

- One of the features of Japanese individual investors is their relatively low level of financial literacy. In recent years, the financial literacy of individual investors has been improving due to the spread of education on investment and the ease of gathering information via the Internet, but they still have a lower understanding of finance and investment than in the West, and do not possess sufficient knowledge for proper asset building.

- Another feature of Japanese individual investors is their preference for conservative investments such as bank savings accounts. The ratio of savings accounts to household financial assets is very high, which can be seen as an asset allocation with a certain rationality in light of the fact that the Japanese stock market has not grown much in the 30 some years since the burst of the bubble economy and that inflation has not progressed. However, the fact that Japanese households have not had as many successful experiences related to earning investment income as Western households has also contributed to their lack of interest in investing.

(3) Pain Points

- From the perspective of Japanese individual investors, asset management in Japan is viewed as having high fees and an unclear cost structure. This is the result of a complex combination of issues in each of the component parts described above.

- Another pain point is the limited range of products available to Japanese individual investors. While institutional investors and a few wealthy individuals have access to alternative investment opportunities in Japan, few doors have been opened for mass retail investors. In addition, the small number of listed ETFs has also been pointed out. In order to list an ETF in Japan, the investment fund must meet strict screening criteria, such as having to be highly liquid, etc. From an investor's perspective, the small number of ETF is a pain point because it limits the opportunity to purchase investment fund in the same way as purchasing stocks.

II. Initiatives Needed to Resolve Current Issues

- The issues in Japan's asset management industry exist in each component of the industry structure, and they affect each other in complex ways. In order to resolve them, the following industry-wide efforts, in cooperation with the regulatory authorities, will be needed.

1. Regulation

- The enhancement of information disclosure is an effective means of eliminating the information opacity that exists within the industry and creating a healthy competitive environment. It is important to improve transparency of cost structure and performance by mandating information disclosure through regulations and other means, and to create the conditions for gaining the confidence and trust of investors.

- In addition, easing regulations on exchange-traded funds (ETFs) and providing investors with a wide range of options to purchase them in the same way as stocks and to diversify their investments is considered important for expanding the investor base.

- Also, following the example of Europe and the U.S., the establishment of an independent FA system would be an effective means of developing an infrastructure to provide investment advisors on a neutral basis without being affiliated to a financial institution.

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Another feature of Japanese individual investors is their preference for conservative investments such as bank savings accounts.

2. Market Players

- It is important for Japanese asset management companies and custodians to change their unique business practices in preparation for accepting services provided by global top-tier custodians and service providers. The reduced costs and more highly advanced services resulting from this will contribute to the development of the entire industry.

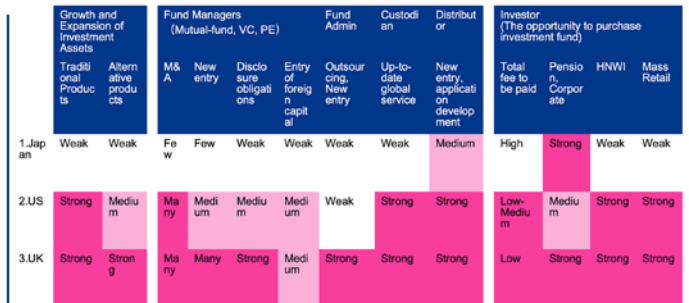
- To date, Japan’s asset management companies have failed to provide truly client-oriented products. In all times and places, an industry that cannot build win-win relationships with its clients will eventually decline. Japan’s asset management industry is no exception to this rule, and the current distorted state of equilibrium is unlikely to continue indefinitely. Japan’s asset management market players should seriously consider how to build win-win relationships with investors with a sense of crisis, and find a way to come up with an effective plan.

3. Investor Education

- In addition to the development of infrastructure as an external environment for investors to make appropriate decisions on investment, it is also essential to improve the financial literacy of investors themselves as a prerequisite for making appropriate decisions on investment. It would be effective for the public and private sectors to work together, such as incorporating financial education into the existing education system and for financial institutions to participating in the preparation of educational materials.

CONCLUSION

This article summaries the current status and issues in each component of the industry structure of the asset management industry in Japan, and discusses necessary initiatives to resolve these issues. The current status of each component and its comparisons with Europe and the U.S. are summarised in the figure below.



The issues described in this article are obstacles to the revitalisation and growth of the asset management industry in Japan, and are expected to be resolved as soon as possible. In recent years, the Japanese government has been implementing

a variety of policies to improve the soundness of the industry, and the situation is gradually improving. However, as shown in the figure above, in countries where the asset management industry has made progress, such as the UK and the U.S, regulators have taken the lead in developing

policies and regulations to enhance the industry, leading to the growth of the industry. We hope that the Japanese regulators will take the current industry challenges seriously and show strong leadership by introducing highly effective regulations and policies to break through the current state of the asset management industry in Japan.

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