THE OUTLOOK FOR THE DEVELOPMENT OF THE INVESTMENT FUNDS IN THE REPUBLIC OF CROATIA

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Abstract

During the nineties, investment funds recorded rapid development in most developed countries and became important agents on the financial markets. In the developing and transitional countries the investment funds industry, although it too has recorded accelerated rates of growth, is still essential lagging behind that of the developed countries. In Croatia the investment funds started developing with the appearance of the private investment funds; however, they did not, contrary to expectations, make a very significant contribution to the development of institutional investors on the capital market. The market is driven primarily by banking or financial conglomerates, which also dominate the investment fund industry. Today the Croatian investment fund market is a very enterprising and dynamic segment of the financial system and hence the establishment of adequate regulation and supervision as well as the development of the capital market must be the main determinants of its further growth and development.

Key words: financial institutions, investment funds, development, Croatia

1 Introduction

Studying financial institutions at an international level we can find a number of different terms that typically characterise investment funds, which makes it quite difficult to consider and compare such institutions at a global level. But the most important forms that are met in most countries in which such institutions have appeared in the market are

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closed-end and open-end types of investment fund. Hence in this paper investment funds will be analysed according to this categorisation, for they are to be found on the Croatian market too.[1]

Investment funds are financial institutions that have an increasingly important role in the capital markets of many countries, and in some countries indeed they have become the main entities affecting events on the financial markets and outside them. These institutions are best developed in advanced countries, above all in the USA, not only from the point of view of total assets that they manage, but also in the sense of the very rich array of kinds of funds, the large and ramified distribution channels via which they market their shares, as well as in the sense of the regulations, the supervisory bodies and organisations that monitor their operations. In Europe the investment funds market is also well developed, particularly in the member states of the EU, which is endeavouring to unify this area to the greatest extent possible. Hence what are called UCITS[2] funds were developed, that is open-end investment funds targeted at the general public, according to a definition that the EU has accepted in order to harmonise the various titles and definitions in the individual member states.

In the transition countries investment funds are at the beginning of their development, and in origins are connected with the privatisation process. Croatia also as part of its coupon privatisation initiated the work of the privatisation investment funds, which were later turned into closed investment funds, or holding companies. But today the Croatian market, like the markets of most of the other transition countries and the developed countries too, is dominated by open-end investment funds, in terms of both numbers and of the value of the total assets they manage. Hence in this work the emphasis will be placed upon the open-end investment funds, considering their importance and the dynamic development that they have been recording in the last few years.

2 Definition and categorisation of investment funds

In the literature, a great many definitions of investment funds can be found, as well as the various terms that are used in the practice of the different countries. Thus the Investment Company Institute, an organisation that tracks investment funds in the US and elsewhere in the world, while publishing aggregate data always stresses that regional differences have to be taken into consideration, for some countries put closed-end funds into this group, and some do not; some include into it funds that are operated by insurance companies or pensions funds that work in the same way as the investment funds (Fernando et al., 2003). Common to all these definitions is that the investment funds are considered financial organisations, or intermediaries for the collection of resources from a large number of investors that are then invested into various kinds of assets.

[1] As well as open-end and closed-end funds, in the domestic financial market there are also the pensions funds. According to the Mandatory and Voluntary Pensions Funds Law (NN 49/99), they are a special kind of fund that collect and invest resources only for the sake of ensuring the payment of pensions and hence, because of a number of other specific features related to their operations, they will not be considered in the paper.

[2] UCITS - Undertakings for Collective Investment in Transferable Securities

According to the forms of the assets we can distinguish funds that invest into securities, into real estate and special financial forms or instruments (Prohaska, 1996). The most common are those investment funds that invest capital into securities and, according to what kind of securities prevail in their portfolios, they can be divided into equity, bond and mixed funds. This division is particularly interesting because in Croatia the supply of investment funds mainly consists of this kind of fund, to which the money funds should also be added, these belonging to the group of funds that invest into special financial forms (Prohaska, 1996).

But the most important categorisation is that according to which open-end and closed-end investment funds are distinguished. A closed-end fund is a joint stock company and issues shares the number of which is fixed; it does not buy them back from the investor, and so the shares have to be sold on the open market if the investor wishes to recoup the money invested (Samodol, 1999). An open-ended fund however is ready at any moment to issue new shares, but it is also required at the application of the investor to buy them back, i.e., redeem them, at their market net worth. This feature is one of the reasons why the open-ended funds have recorded much more vigorous growth than the closed funds.[3] The closed funds do not enable shares to be withdrawn, and the market value of shares may be considerably lower than the current net worth (Kidwell et al., 2003). What is more, it is typical of a closed-end fund that the shares are sold with a discount of the fundamental net worth that sometimes can reach up to 40% for funds that invest in shares, while the discount of the closed-end funds that invest in bonds is much smaller (Samodol, 1995).

3 Investment funds in the world today

At the end of 2004, the more than 55,000 investment funds in the world contained \$16.2 billion's worth of assets, which is an increase of 37% over the last five years (Investment Company Institute, 2005a). Of the overall assets, a half is accounted for by investment funds in the USA, a total of \$8.1 billion, and the whole of the Americas accounts for 55% of the total. Second place is held by Europe, with 34% of total value of assets, and Africa, Asia or the Pacific countries with 11%.

According to structure of investment, equity funds prevail in the world, having 45% of the total assets, then money funds, 21%, bond funds with 20% and mixed with 9% (Investment Company Institute, 2005b).[4] It should also be said that this structure varies greatly according to regions or countries. Thus in the USA equity funds prevail, with about 50% market share, while in the EU, although they are also in the lead in terms of total value of assets, they still constitute a smaller percentage (36% at the end of 2004) and are not very far in front of the bond funds that in previous years were dominant in the market (Delbecque, 2004). In the transition countries bond funds dominate, with the exception of the Czech Republic and Croatia in which the major part of the assets is in the money funds (---, 2004).

[3] Apart from that, an open fund does not have legal personality but is a separate asset at the account of a deposit bank that is managed by an investment fund management company and hence does not attract profit tax. This is one of the reasons for the great abundance and sudden growth of the open-end investment funds.

[4] The remaining 50% relates to other unclassified funds.

In the USA there was an explosive growth in the assets of the equity funds, mainly because of their good performance. As the gap between bank deposit interest and the yields produced by the equity funds widened to the advantage of the latter, increasing numbers of investors showed a tendency to invest in the equity funds (Fernando et al., 2003).

In Europe and other regions the growth of equity funds remained behind that in America for the stock markets were less developed and there was not so much space for investment and attaining attractive yields. With the development of the stock market in Europe too the structure gradually began to change in favour of the equity funds. In the last few years in the EU there has been an apparent trend towards the reduction in the rate of growth of the money funds, and an accelerated rate of growth of assets in the long-term funds (equity, bond, mixed). Long-term UCITS funds (comprising almost 80% of total assets of the investment funds) recorded a net growth in assets of 198 billion euros during 2004, which is 13 billion euros more than in 2003, when the growth came to 185 billion euros (Delbecque, 2004).[5]

Several factors have impacted the development of given kinds of funds in given regions. Equity funds are more developed in common law countries (i.e., Anglo-Saxon countries), and bond funds in countries with the civil law system (Fernando et al., 2003). This is because common law countries have more transparent accounting systems and standards and provide better protection for the rights of investors, who in such conditions are more inclined to invest in funds with a more risky investment strategy. Equity funds are a small proportion of the transitional markets, because their stock markets are fairly shallow and undeveloped. Levine (2003) thinks that there is a correlation between legal institutions and the effectiveness of stock markets. The level to which legal institutions protect private rights of ownership and the rights of small shareholders will explain the differences that exist among countries in the sense of the degree of development of the stock markets. In countries in which the legal institutions do not provide effective protection of stockholders, the prices of domestic shares move the same way for all shares, because there is less information about the individual prices of shares. Apart from that, according to Fernando et al, (2003) in countries with an average income the equity funds have a small share because of the lack of trust in the integrity of the local capital market, low investor risk tolerance and because the richer and larger investors in these countries tend to use the foreign funds.

In the last few years there has been a patent trend towards a reduction in the number of funds, although the value of their total overall assets has risen. This is primarily the result of the mergers of the given funds, taking advantage in this way of economies of scale. This trend is particularly marked in the USA, where the number of investment funds fell from 8,305 at the end of 2001 to 8,044 at the end of 2004, although the total assets rose by 1.2 billion dollars (Investment Company Institute, 2005a).

4 Investment funds in Croatia

When the Investment Funds Law (NN 107/95) was passed, the legal conditions were provided for the development of investment funds in Croatia but their real development

[5] The remaining 20% relates to non-UCITS funds, i.e., mainly closed-end and special investment funds.

did not start until the passing of the Privatisation Investment Fund Law (NN 109/97) and the launching of seven privatised investment funds (below PIFs), via which a large part of the state-owned corporate sector was transformed into private property. Samodol (1999) says that "about at least 90% of defunct firms got into the PIFs. What adds a particularly negative economic touch to this state of affairs is the fact that the shareholders of such moribund funds were those who had suffered in the war." Thanks to these very PIFs, many members of the public made the acquaintance of the institution of investment funds in the wrong way, and today still for them investment funds are unreliable and highly undesirable financial institutions. This is one of the factors restricting their further growth in the sense of demand.

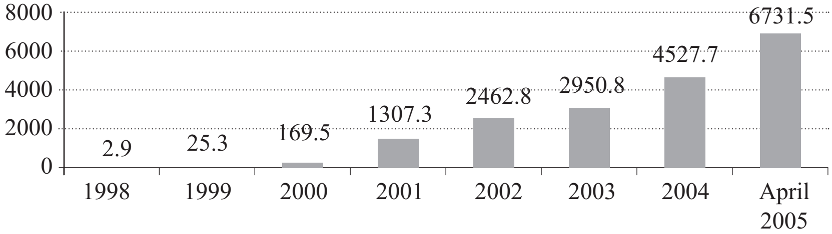
A mistake was made when the PIFs were allowed to transform themselves instantly into closed-end investment funds without any obligation previously to make their portfolio compliant with the Investment Funds Law and then by their further transformations into holding companies, through which they entirely evaded the supervisory jurisdiction of the Securities Commission. Many PIFs enlarged their assets by exchanging shares with the Croatian Privatisation Fund, which was allowed them in 1999, in which individual funds in exchange for insolvent shares or shares from insolvent firms obtained very valuable shares in well-performing firms. It was precisely through share swaps that some of the PIFs obtained a majority holding in some of the privatised firms, and were later transformed into a holding company, because they were unable to make their portfolio compliant with the Investment Funds Law. Thus the contribution of the PIFs to the development of the capital market in Croatia was nugatory.

Nor was it very different in the other transition countries. In the first years of the transition in the countries that joined the EU in 2004, the operations of the PIFs were weakly statutorily regulated, which created plenty of room for abuse of the rights of small shareholders (Bakker, 2003). In Slovenia these funds, as in Croatia, were on the whole aimed at the concentration of ownership in a few top firms in which they attempted to maintain their positions (Mrak, Rojec and Jauregui, 2004). Because of the great value of the portfolios, these management companies acquired enormous political influence, and the whole outcome of the process could have ended up completely to their advantage and the disadvantage of the small and primary shareholders and to the development of the capital market, which happened in Croatia.

The Croatian investment funds market was first of all generated by large groups of banks, which by starting fund management firms and open-end investment funds were able to expand the range of their products. This was for them a new way of collecting capital, which was increasingly concentrated precisely in such groupings. Today there are in the Croatian market 43 open-end and four closed-end investment funds. The closed-end funds have not essentially developed in the last few years, but the development of them is also poor in the other transition countries and in the developed countries as well.[6] Two of the closed-end funds are the one-time privatisation investment funds, and the other two are classic closed-end funds.

[6] In the USA 95% of the total assets of the investment funds is accounted for by open-end funds (Mutual Fund Fact Book, 2005)

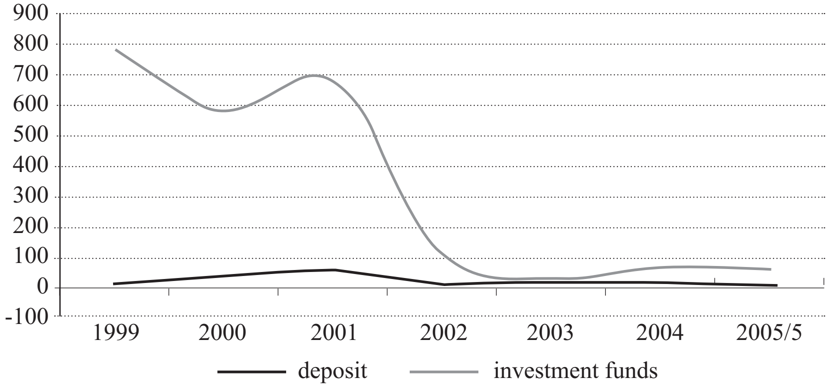
Graph 1 Trends in the assets of the open-end investment funds in Croatia in the 1998-2004 period (in millions of kuna)



Source: CROSEC (2005a) (May 10, 2005)

According to CROSEC data, assets managed by the closed-end funds came on March 31, 2005 to 1.4 billion kuna, while the assets of the open-end funds had by the end of April climbed to a value of 6.7 billion kuna, an increase since the beginning of the year of 2.2 billion kuna or almost 50%.

Graph 2 Trend of the rate of growth in the assets of the investment funds and deposits in the period from 1999-2005

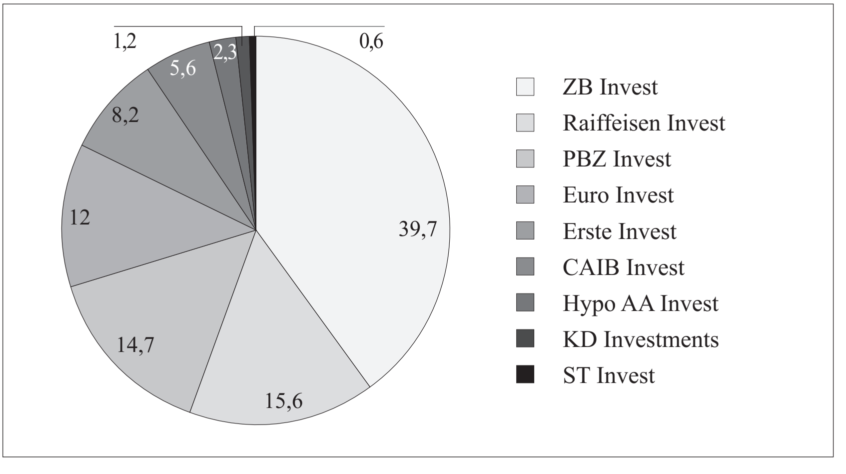


Source: HNB (2005a); CROSEC (2005b); author's treatment.

If the growth rates in the assets of the open-end funds and the deposits in the banks are compared, it is visible that the assets of the open-end funds have recorded much greater rates of growth. They have fallen rapidly in the last few years, only because the market in 1998 and 1999 had just started to develop and in these years there was vigorous asset accumulation in the funds.

Open ended funds are still small in terms of proportion of GDP, and this puts the Croatian market behind some of the other transition countries. At the end of 2004, this figure was about 2.7% and at the end of 2003 only about 2.1% in Croatia. For example, though, even at the end of 2002, in Hungary and the Czech Republic the assets of the open-end funds amounted to about 5% of GDP (Bakker, 2003), and in Romania 4%, although just a few years earlier they had been less than 1% of GDP (Ramin-Michel, 2005). Poland had a somewhat lower proportion, at 3% of GDP, but it should be taken into consideration that these figures refer to 2002. At the end of 2002, the assets in the Turkish open-end funds were equivalent to 3.5% of GDP, as against 2.5% only one year earlier (Raina and Bakker, 2003). For the sake of comparison, in 2002 the assets of the open-end investment funds in the EU came to about 50% of GDP (Bakker, 2003), while in the USA in 2001, the assets of the open-end funds came to almost 70% of GDP (Raina and Bakker, 2003). Although the assets of the open-end investment funds in the transition countries are making rapid strides in growth, these countries still lag much behind the developed countries and a lot of time will be needed for the transition countries of the developing countries to attain the level of the developed countries and for the bank-centred financial systems to be changed to the advantage of other financial institutions.

Graph 3 Market share (per management company) in Croatia as of December 31, 2004



Source: CROSEC (2005a); author's treatment.

The three biggest banking groups (ZABA, PBZ and RBA) also dominate the fund industry market and tNNether manage 70% of the total assets. These groups also dominate the pension funds market, and have a considerable share in the insurance and house-saving markets. Since they manage large amounts of capital, which is increasingly lacking in transparency, for it is divided among the various non-banking financial institutions that they control and various organisations, the idea about the unified surveillance of financial institutions might increase its effectiveness.

5 Necessary changes in the statutory environment and harmonisation with the directives of the European Union

The further development of the fund industry in Croatia is to a large extent hindered by the existing statutory environment, i.e., by the current Investment Funds Law and is dependent on the way in which new statutory and sub-law approaches are adopted, and the content and dynamics of such instruments. The present law was passed in conditions completely different to those of today and does not meet the needs of a rapidly growing and sophisticated industry. Liberalisation of the foreign currency law and rapprochement with the EU have also increased the need for a new law to be passed.

If a comparison is made of the investment rules of the open-end funds in Croatia and EU law, harmonised regulations, derived from EU directives,[7] as well as divergences, can be seen in Croatian law (Maurović, 2002). Investment in the paper of one issuer is set at 5% of the value of the assets of the fund, as is stipulated in the EU directive. Acquisition of the bonds of a single issuer is also set at 5% of the value of the assets of the fund, in conjunction with cumulative fulfilment of the condition that the total nominal amount does not exceed 10% of the total nominal amount of all bonds of the same issuer that are in circulation. The borderline for investment in the bonds of a single issuer is also 5% in the EU, with the proviso that there is a different treatment of credit institutions.[8] For shares of the same issuer that a fund acquires there is the restriction that the right to vote from them does not exceed 10% of overall voting shares, just as in EU law.

Because of the inadequate development of the securities market and the few opportunities for investment a fund is allowed to invest at most 49% of the worth of the fund in deposits in financial institutions and other monetary resources. Deposits in credit institutions according to EU law can come to at most 10% of the value of the assets of the fund. Securities that are not quoted on the stock exchange or some other organised market can be acquired only up to 10% of the value of the assets. The EU directive allows investment in securities only that are listed on a stock exchange or some other organised market, and, in addition, only in securities that have not been recently issued (Section 5, Article 19/1, Dir. 85/611/EEC). In Croatia there are still opportunities for funds to invest in unquoted scrip because of the still relatively shallow capital market, or the small number of securities that are quoted on the market. But since further development of the financial markets in Croatia is anticipated, it is considered reasonable to exclude these possibilities for investing the resources of the investment funds, as well as the lowering the restrictions on investment in deposits to 10%. In the EU, investment in the shares of other investment funds is set at 10% of the assets of the fund, which must be brought in

[7] These are as follows: the UCITS Directive 85/611/EC (Amend. 88/220/EEC, 95/26/EC, 2000/64/EC), Directive 2001/107/EC: The Product, Directive 2001/108/EC: The Company (EFAMA, 2005). These directives do not relate to closed-end investment funds, but only to the open variant, i.e., to UCITS. For this reason in this part the rules of investment of the open-end funds are compared with the rules of the EU directive, and harmonisation of the existing law will mainly refer to the rules of investment for the open-end funds.

[8] In the EU a state member can raise investment to a maximum of 25% of the worth of the assets when the issuer is a credit institution, with the proviso that the total value of such investments may not exceed 80% of the assets of the fund.

here too, because of the potential difficulties in supervision, primarily when it is a question of distribution of risk if it has to be monitored over several levels.

One of the important matters that will be regulated in a new law is the issue of the operations of foreign investment funds in Croatia. Most developed legislatures demand that foreign financial agencies operate from their own country, or set up branches, obtain licenses and carry out registration in the land in which they are operating (Kaminsky, Lyons and Schmukler, 2003). Emerging markets, and the Croatian market too, should also follow this practice. It is very important for such markets that they should apply the maximum of regulatory authority to foreign intermediaries in order to minimise the risk of abuse and market manipulation, because in the initial stage of development they are highly vulnerable to such practice.[9] This is a matter that is particularly important for Croatia, because the financial sector has already in large part fallen into the hands of foreign financial conglomerates, which gives them a large influence on the domestic market and in the financial system. If one takes into consideration the high level of the foreign debt, which is also a crucial determinant of the stability of a country's financial system, it is clear that adopting appropriate measures in this segment is important not only for the investment funds industry and its further development, but for the whole financial system and the macroeconomic or business environment.[10]

An important issue that needs settling by the new law is the protection of investors. This means a clear definition of the concept of fund, of different types of fund, the costs that are charged against the assets of the fund and the principles and methodolNNy for determining the value of the fund's portfolio. Countries with a high level of investor protection encourage trust in the investment funds, and investors are more willing to invest in them (Khorana, Servaes and Tufano, 2004). The authorities of the Securities Commission should be enlarged. According to the existing Securities Law (NN 84/02), the Commission is not responsible for the truthfulness of data in a prospectus, but only confirms whether the prospectus contains all the statutory information and then gives its imprimatur.[11] Since though it is precisely upon the foundation of the prospectus that investors obtain their information about the business operations of the funds, which affects in turn their investment decisions, it is clear just how important it is to check out the truth of claims made in them, and the Commission, as main supervisory body, should be able to guarantee investors accuracy of information.

[9] In Australia an intermediary that applies for an Australian Financial Services License must provide a detailed description of operations, details about kind of client, organisation structure, the names and qualifications of senior management, and the processes with which they are entrusted, risk information and so on. In Canada there is a different treatment of domestic and international intermediaries. Foreign intermediaries must, among other things, provide appropriate evidence that they carry out the same business in another country and obtain proof of registration for this business from that country (Kaminsky, Lyons and Schmukler, 2003).

[10] According to HNB data (2005), gross foreign debt of the public sector, and of the private sector the public sector guarantees, came at the end of 2004 to 122.7 billion euros, or 82% of GDP (HNB, 2005).

[11] By statute, a prospectus must obligatorily be published when a fund is started, and it has to contain information and figures on the basis of which investors are capable of making a reasoned judgement about the real state of affairs of the fund. The data the prospectus must contain are defined in Article 4 of the Investment Funds Law (NN 107/95).

6 Expectations and evaluations of further development in the investment funds in Croatia

It can be expected that the fund industry will develop more rapidly if the taxation law is such as to make the funds more attractive to investors than other possibilities (Khorana, Servaes and Tufano, 2004). Croatia now has a very indulgent Corporate Income Tax Law (NN 177/904, 90/05), according to which open-end investment funds are not taxable entities. This is an improvement over the previous Law (NN 12/00, 163/00) when profit was taxed at 20%. Apart from that, according to the new Individual Income Tax Law (NN 174/04) receipts from dividends and profits shares from equity held are not considered income, and accordingly do not attract income tax.

Supply factors, which some authors distinguish, are also very essential for the development of the fund industry. Among them the following may be adduced: cost and time necessary to set up a fund, the quantity and kinds of distribution channels via which shares can be sold and the banking industry.[12] In Croatia one limiting factor on further development certainly the inadequately developed capital market, in which there are a large number of merely formal quotations. Although in the Zagreb and Varaždin exchanges by July 2004 a total of 568 share issuers were quoted, there was active trading only about 200 of them (The Banker, 2005). The share market is still without depth, although in the last few years it has experienced gentle upwards movement.[13] The bond market in addition is weakly developed, and it is government bonds that prevail. The appearance of pensions and investment funds favoured the development of the bond market, primarily of government bonds, for the pensions funds are obligated to invest 50% of their assets in them.

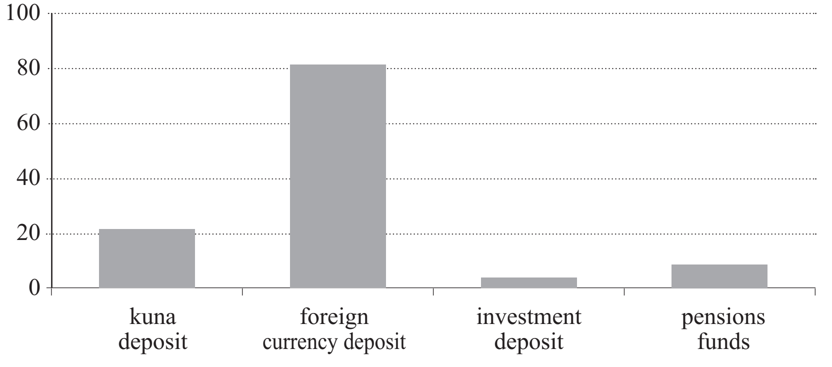
Investment funds are accepted faster in countries where the populations are more educated, richer and better informed, which better explains the weak development in poorer and less developed countries (Khorana, Servaes and Tufano, 2004). Demand side is also an important factor in development. In Croatia the problem is that the population is not well informed enough, that is, is not familiar with the way investment funds operate. Research carried out by GfK, a market research agency, showed, using a sample of above-average income earners, over the whole of Croatia, that people are still only superficially acquainted with the concept of investment banking or investment funds; however, the number of people who have never heard of people is declining – 17% in June 2002, 12% in December 2003 (GfK, 2004). Bank time deposits are still looked upon as a better form of investment than money placed in the investment funds. The reasons for this lie in the past. Bank loans were the main mechanisms for the socialisation of losses in socialism, and repeated in the nineties (Šonje, 2003). As the state went one totally or at least generously securing deposits, the banks still had a special treatment in the view of many people, and this has not changed much until this day.

[12] In the USA the growth of the investment funds took place at the expense of the banking sector; however in Europe (except in the UK) banks were the main launchers of investment funds. Constraints that relate to the banks' dealing in securities have negative consequences on their ability to offer investment funds.

[13] Market capitalisation of shares came in the first half of 2005 to almost 70 billion kuna, which is a rise of 11% as compared with the first half of 2004. At the same time, bond market capitalisation amounted to about 26 billion kuna, or more than 5% up on the first half of 2004. Also noticed is a growth in the CROBEX stock exchange index, which is up 15.4% on year beginning, while CROBIS rose in the same period by 1.9% (ZSE, 2005).

However, there have been certain changes to the advantage of other financial agencies in the last couple of years. Thus in 2003, of the total resources invested in various forms of savings, 40% went to the banks, and other forms, such as housing savings associations, investment funds, pensions funds and life insurance, attracted the remaining 60% (---, 2004). But in a comparison of investment in the investment funds and other competitive forms of investment, it is visible that foreign currency denominated savings accounts prevail. This is also a sign that there is a potential for a demand-driven development of the funds, considering the amount of assets invested in the banks.

Graph 4 Total assets invested in the investment funds and other forms in 2004 (in billion kuna)



Source: HNB; CROSEC; Hagena; author's treatment

Offering increasing numbers of products combining bank savings with investment in the investment funds, the banks are simulating investment in the funds in this way too. This is no surprise, for it is the banking groups that are the most frequent fund initiators, and it is in their interest to stimulate investment in the funds, because this allows them, as financial conglomerates, to earn greater profits at group level. Unification of supervision of non-banking financial institutions could make it easy to supervise them and improve the way they are monitored. According to the research of Martinez and Rose (2004) almost all countries in which the research was carried have adopted a unified model of supervision precisely because of the increasing importance of financial conglomerates and the decreasing differences between banking, insurance and other products, which means that the supervision of the finance system is made much more difficult if it is split up among several different agencies. Supervisory institutions encounter the problem of calculating overall solvency of such conglomerates, because they can artificially raise their asset base.

Accordingly, the essential determinants for the further development of the investment funds are the establishment of an adequate supervisory regime and changes in the regulatory framework for the operations of the investment funds, with particular stress upon protection of investor rights.

7 Conclusion

As in other transition countries, the investment funds in Croatia are recording high rates of growth in the worth of their assets. But any further vigour and direction of development will depend on the development of the capital market, with which the growth of the investment funds is tightly connected, on modifications in the statutory background, which has become inappropriate for the fund industry in its current phase of development, via which the operations of domestic investment funds abroad and foreign investment funds within the country will also be regulated. The manner in which these issues are settled will greatly impact the array of products. From the demand point of view, members of the public still are not well enough informed about the operations of the funds, and hence it is corporate investors that still prevail, while individuals keep most of their assets in bank deposits. A positive step in the development of this industry was taken when the taxation laws changed, according to which yields from investments in the investment funds do not attract income tax. The unification of supervisory institutions, if it results in more efficient supervision, will also have a positive impact on development, above all if it is related to better investor protection.

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