

# **BANKS AS A DISTRIBUTION CHANNEL FOR COLLECTIVE INVESTMENT SCHEMES**

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## 1.0 Introduction

A collective investment allows people to participate in a wider range of investments than would be feasible for most individual investors and increases economies of scale in order to reduce investment costs. Collective Investment Schemes (CIS) refer to investment funds that pool together savings from a wide range of investors both retail and institutional to be invested in a number of different financial assets.<sup>1</sup> The CISs offer flexible, simple and convenient means of investing in companies and their growth. They offer retail investors expert investment advice and participation in investment opportunities.<sup>2</sup> This allows retail investors to invest relatively small amounts and diversify their risk exposures, because their funds are invested across a variety of industries and asset classes.

Total net assets in worldwide open-ended unit trust funds alone hit US\$ 9.3 trillion as at the end of 2017, more than double their level in 2008.<sup>3</sup> In Uganda, CIS's assets under management stood at US\$ 34.26 million (UGX 126,958 million) as at end of December 2018.<sup>4</sup> With this, the market in Uganda remains small, partly because of the limited size of the securities market in Uganda, but also because of the lack of awareness among retail investors.

A trend among emerging economies is the distribution of CIS products by commercial banks. However, there is no commercial bank in Uganda that distributes CIS products, because the Financial Institutions Act (FIA), 2004 under Part II Section 4, prohibits banks from carrying out any other business other than banking in Uganda without a valid license granted for that purpose.<sup>5</sup> This therefore implies that in order for banks to distribute CIS products, the FIA would need to be amended so as to specifically provide for the distribution of CIS products.

The objective of this paper is to explore the banks' dominance of collective investment schemes' distribution in most emerging market economies and the possibility of replicating the same in Uganda.

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<sup>1</sup> International Organization of Securities Commissions. (n.d.). *Collective Investment Schemes in Emerging Markets*.

<sup>2</sup> International Organization of Securities Commissions. (n.d.). *Collective Investment Schemes in Emerging Markets*.

<sup>3</sup> [http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2018/2018\\_factbook.pdf](http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2018/2018_factbook.pdf)

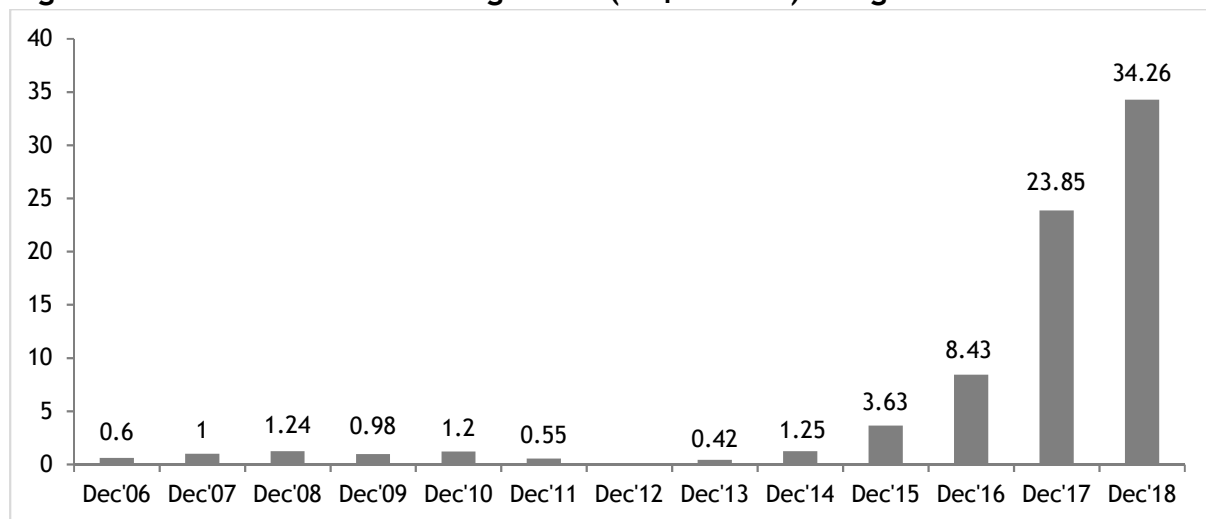
<sup>4</sup> CMA Market Supervision Department.

<sup>5</sup> Financial Institutions Act, 2004

## 2.0 Collective Investment Schemes in Uganda

Following the enactment of the CIS Act in 2003, CISs were established in Uganda. There are currently 5 licensed CIS managers<sup>6</sup> in Uganda. The CIS industry has significantly grown over the last 6 years. Assets under management (AUM) increased from US\$ 0.42 million (UGX 1,559 million) in December 2013 to US\$ 34.26 million (UGX 126,958 million) in December 2018<sup>7</sup> as shown in Figure 1, however, this only represents 0.13 percent of Uganda’s Gross Domestic Product.

**Figure 1: CIS Assets under Management (US\$ million) in Uganda**



Source: Capital Markets Authority Uganda

Despite the growth seen over the last 6 years, the size of the Ugandan CIS industry is still small compared to CIS industries in other African markets. In Africa, South Africa has the largest CIS industry with AUM of US\$ 181,762 million. Within the East African region, Kenya leads with AUM of US\$ 603.96 million.<sup>8</sup>

**Table 1: CIS AUM among selected African Countries as at December 2018**

Country	AUM (US\$ million)	AUM/GDP (%)
Uganda	34.26	0.13
Kenya	603.96	0.76
South Africa	181,762	52
Tanzania	107.24	0.21

Source: Capital Markets Authority Uganda, Kenya Capital Markets Authority, International Investment Fund Association and Capital Markets and Securities Authority

<sup>6</sup> A unit trust scheme means a collective investment scheme under which the property is held in trust for the participants.

<sup>7</sup> CMA Market Supervision Department

<sup>8</sup> [http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2018/2018\\_factbook.pdf](http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2018/2018_factbook.pdf)

### 3.0 CIS Distribution Channels in Uganda

Most of the CIS managers currently rely on limited in-house human resources to market their CIS funds, limiting the reach of CIS managers to attract investors. The CIS (unit trust) regulations under Part IV Section 98 provide for the use of third-party distribution agents.<sup>9</sup> However, third-party distribution agents such as investment advisory firms, brokerage firms and banks are underutilized by the CIS managers in Uganda. This has in part hindered the growth of CISs in Uganda as it is costly for the CIS managers to build their own captive distribution channels such as a sales force or a branch network.

Some of the CIS managers are subsidiaries of insurance companies with already established distribution networks such as UAP, ICEA and Britam. These CIS managers have leveraged the sales team of their parent companies to widen distribution. However, the commissions offered for CIS products are less favorable compared to insurance products, therefore limiting the incentive to sell CIS products.

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<sup>9</sup> The Collective Investment Schemes (Unit Trusts) Regulations, 2003.

#### 4.0 Banks Dominance of CIS Distribution in other Jurisdictions

A survey conducted by the International Organization of Securities Commissions (IOSCO) in 2014 showed there was a wide range of distribution channels for CISs across Emerging Market Economies (EMEs). The channels include banks, securities brokers, financial advisers, sales agents and to a lesser extent insurance companies and fund supermarkets<sup>10</sup> as shown in Table 2.

**Table 2: CIS Distribution channels in select EMEs<sup>11</sup>**

Country	Banks	Insurance Companies	Securities Brokers	Financial Advisers	Sales Agents	Fund Supermarkets
Brazil	X		X	X		
Chile	X		X	X		
China	X		X		X	X
Colombia	X		X			
Costa Rica			X	X	X	
Hungary	X		X			
India <sup>12</sup>	X			X		X
Indonesia	X		X			
Kenya		X	X	X		
Korea	X		X	X	X	
Malaysia	X		X		X	
Morocco	X		X			
Pakistan	X		X	X	X	
Peru	X		X			
Saudi Arabia	X		X			
South Africa	X	X			X	
Turkey	X		X			

Source: World Bank Group. (2017) *Promoting competition in the distribution of mutual funds: Lessons for Securities Markets Regulatory Authorities in Emerging Market Economies*

In most EMEs banks directly or through their affiliates dominate the distribution of CISs, with 15 of the 17 countries surveyed using banks as a distribution channel, nevertheless no country uses banks as their sole distribution channel.

In EMEs, the dominance of banks is partly attributed to the low level of development of the capital markets compared to the banking sector, which in turn leads to a limited role played by non-banking financial intermediaries and in particular by independent players. In part, the dominance is also fueled by the

<sup>10</sup> Fund supermarkets refers to investment firms or brokerages that offer investors a wide array of mutual funds (CISs) from different fund managers through a single investing platform.

<sup>11</sup> Chile and Colombia were not part of the survey.

<sup>12</sup> India established the fund supermarket since the survey was undertaken.

advantage of having a large and captive client base to which banks can offer a wide range of financial services. Banks know a great deal about their customers as they hold data about their earnings, savings, expenditure habits and even, investment preferences. Additionally, many banks are part of larger holding companies or financial conglomerates, which may include affiliated securities brokers, asset managers and insurance companies, through which they can supply services that are additional to traditional banking.<sup>13</sup> Furthermore, CISs may invest in bank shares if the banks are listed on the exchange and also bank products such as certificates of deposit<sup>14</sup>, commercial paper<sup>15</sup> and repurchase agreements (repos)<sup>16</sup>.

There's a significant interdependency between banks and CISs in many EMEs. In Brazil banks not only dominate the distribution of CIS products to retail investors, their subsidiaries also manage these funds. Seventeen of the top twenty managers of CISs (accounting for 85 percent of assets under management) are bank owned. Similarly, in Morocco, seven of the top eight asset management companies are owned by banks and account for 87 percent of assets under management. Moroccan CISs provide liquidity to the banking sector in form of repos, term deposits<sup>17</sup> and certificates of deposits. They further hold an estimated 30 percent of AUM in bank corporate bonds and equity.<sup>18</sup>

#### 4.1 Brazil

Brazil has one of the largest CIS industries in the world, with US\$ 1.07 trillion in assets under management (AUM) as at the end of 2016, representing about 59 percent of GDP.<sup>19</sup>

CISs are created by administrators (CIS managers), most of which are subsidiaries of banks. Their parent banks act as distributors of CIS products to their customer bases. The top 10 administrators (CIS managers), which are all bank subsidiaries, account for 75 percent of assets under management in Brazil.

The administrator (CIS manager) may manage its own CIS funds or subcontract an

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<sup>13</sup> World Bank Group. (2017). *Promoting competition in the distribution of mutual funds: Lessons for Securities Markets Regulatory Authorities in Emerging Market Economies*.

<sup>14</sup> A certificate of deposit is a savings certificate with a fixed maturity date and specified fixed interest rate that can be issued in any denomination aside from minimum investment requirements.

<sup>15</sup> Commercial paper is an unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts payable and inventories and meeting short-term liabilities.

<sup>16</sup> Repos are a form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, and buys them back the following day.

<sup>17</sup> Term deposits are a type of account whereby the bank pays a fixed rate of interest, and in return, the funds are locked up for a specified period.

<sup>18</sup> World Bank Group. (2015). *Mutual Funds in Developing Markets: Addressing Challenges to Growth*.

<sup>19</sup> World Bank Group. (2017). *Promoting competition in the distribution of mutual funds: Lessons for Securities Markets Regulatory Authorities in Emerging Market Economies*.

independent investment manager to manage the investments. However, the administrator (CIS manager) remains responsible for the compliance with regulatory requirements. The administrator (CIS manager) appoints both the custodian and the investment manager. These may or may not be part of the same financial group as the administrator (CIS manager). It is not unusual in Brazil for all these functions to be carried out within the same financial group.<sup>20</sup> The distribution of CISs can only be undertaken by agents registered with the Brazilian Securities Commission (BSC) and certified by AMBIMA, the self-regulatory organization of the Brazilian securities market.<sup>21</sup> The agents include banks, brokerage firms, securities houses and individuals. Administrators (CIS managers) can be distributors for the funds they manage, provided they meet the same criteria of distributors.

#### 4.2 Morocco

CISs in Morocco had US\$43.42 billion in assets under management as at the end of 2017, which represented 39 percent of GDP. The CIS industry is mainly regulated by the Conseil Déontologique des Valeurs Mobilières (CDVM) and to a lesser degree, by the Ministry of Finance.<sup>22</sup>

The distribution of CIS products is carried out by banks and asset management companies (CIS managers). Most of the asset management companies (CIS managers) are subsidiaries of conglomerate banks similar to Brazil. Seven of the top eight asset management companies (CIS managers) are owned by banks and account for 87 percent of assets under management. Pension funds and other institutional investors are the main investors in Moroccan CIS funds, contributing more than 90 percent to the total assets under management.

The custody of CIS funds is reserved to banks by law. Most of the asset management companies (CIS managers) use their parent company for the custody of the funds they have under management. Some brokerage firms also carry out the distribution.<sup>23</sup>

#### 4.3 Colombia

CISs in Colombia had US\$28 billion in assets under management as at end of June 2017, which represented 0.1 percent of GDP. Approximately 70 percent of CIS managers are subsidiaries of financial groups, mostly of banks. The remaining 30

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<sup>20</sup> World Bank Group. (2015). *Mutual Funds in Developing Markets: Addressing Challenges to Growth*.

<sup>21</sup> World Bank Group. (2015). *Mutual Funds in Developing Markets: Addressing Challenges to Growth*.

<sup>22</sup> World Bank Group. (2015). *Mutual Funds in Developing Markets: Addressing Challenges to Growth*.

<sup>23</sup> World Bank Group. (2015). *Mutual Funds in Developing Markets: Addressing Challenges to Growth*.

percent are mostly brokerage houses.<sup>24</sup>

Reforms were introduced in 2013 aimed at modernizing the framework for CISs, including CIS distribution channels. Distribution is regulated as a separate activity that can only be undertaken by the CIS managers themselves or by licensed distributors, which are other fund managers, securities brokers or banks duly authorized by the regulatory body in Colombia.<sup>25</sup>

Distribution can take place through three different arrangements: directly by an in-house sales forces of the CIS manager; a network contract whereby another fund manager, securities broker or a bank can distribute funds through omnibus accounts<sup>26</sup> (similar to nominee accounts in the UK and US); or correspondent agreements between local Colombian fund distributors and foreign fund providers to distribute foreign funds in Colombia.<sup>27</sup>

#### 4.4 Chile

Chile's CIS industry is one of the largest in emerging market economies. At the end of 2016, CISs had US\$ 46.21 billion in AUM, which represented 19 percent of GDP.

The most important channel of distribution of CISs in Chile is the banking network. Banks sell a range of funds, managed by their group's fund management arm. The banks have been driven by the need to offer customers a wide range of products.

Regulations allow the distribution of CISs to be conducted by the fund administrator (CIS manager) or by any third-party agent with which the fund administrator (CIS manager) has an agreement. Fund administrators (CIS managers) have third-party agreements with banks, stock brokers, investment companies, department stores, financial advisors and online platforms.<sup>28</sup>

However, the responsibility for the distribution of the CISs remains with the fund administrator (CIS manager). It is the responsibility of the fund administrator (CIS manager) to determine and monitor the suitability of any third-party agents that distribute its products. A fund management company has a duty to inform their regulator who its sales agents are. In turn, these sales agents must self-certify that

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<sup>24</sup> World Bank Group. (2017). *Promoting competition in the distribution of mutual funds: Lessons for Securities Markets Regulatory Authorities in Emerging Market Economies*.

<sup>25</sup> World Bank Group. (2017). *Promoting competition in the distribution of mutual funds: Lessons for Securities Markets Regulatory Authorities in Emerging Market Economies*.

<sup>26</sup> Omnibus accounts refer to accounts that hold more than one item. A minimum of two persons are required to create an omnibus account. All transactions occurring within an omnibus account appear under the name of the associated broker, leaving the details of individual investors private.

<sup>27</sup> World Bank Group. (2017). *Promoting competition in the distribution of mutual funds: Lessons for Securities Markets Regulatory Authorities in Emerging Market Economies*.

<sup>28</sup> World Bank Group. (2017). *Promoting competition in the distribution of mutual funds: Lessons for Securities Markets Regulatory Authorities in Emerging Market Economies*.

they are suitable and have sufficient knowledge of funds to be able to sell them.<sup>29</sup>

#### 4.5 Lessons from other Jurisdictions

Each country's collective investment schemes are an outcome of a combination of different factors, such as legal histories, cultural preferences, pension systems, and fiscal treatment which need to be considered when comparing the different distribution channels used. However, there is a common theme among the different jurisdictions mentioned above, which is that CIS managers use banks as part of their distribution system in order to widen their reach to potential investors.

Uganda should draw from the experiences of the reviewed jurisdictions, where CIS managers use banks as third-party distribution agents. The distribution of CIS products through banks' branch networks would allow CIS managers to significantly widen their reach by tapping into the established banking network and client base to grow their assets under management. This is because banks have a large and captive client base to which they can offer a wide range of financial services. Furthermore, banks know a great deal about their customers as they hold data about their earnings, savings, expenditure habits and even, investment preferences.

Banks currently cannot distribute CIS products, because the Financial Institutions Act 2004 under Part II Section 4 prohibits them from carrying out any other business in Uganda other than banking, without a valid license granted for that purpose.<sup>30</sup> Since there is no specific provision for a CIS distribution license under the FIA, banks cannot distribute CIS products on behalf of CIS managers. Therefore, in order for banks to have third-party distribution agreements with CIS managers, it is recommended to amend the FIA to provide for the distribution of CIS products on behalf of the CIS managers.

Furthermore, whether and how to regulate banks as third-party distributors needs to be addressed. The CIS regulations under Part IV Section 98 stipulate that it is the responsibility of the CIS manager to determine and monitor the suitability of any third-party agents<sup>31</sup>, which is similar to the model in Chile. However, the Chilean regulations further stipulate that a CIS manager has a duty to inform the regulator who its distribution agents are. Currently, CIS managers use only independent financial advisors and insurance sales teams, if they are part of an insurance group as third-party agents. Therefore, the use of third-party distributors has been limited so far. However, if CIS managers use banks as

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<sup>29</sup> World Bank Group. (2017). *Promoting competition in the distribution of mutual funds: Lessons for Securities Markets Regulatory Authorities in Emerging Market Economies*.

<sup>30</sup> Financial Institutions Act, 2004.

<sup>31</sup> The Collective Investment Schemes (Unit Trusts) Regulations, 2003.

distributors, then the third-party distribution system is likely to widen significantly and more oversight would be needed. Distributors of CIS products in Brazil and Colombia have to be duly licensed by the regulatory body. In the Ugandan context this requirement would likely impose an unnecessary burden on banks, especially since they are already regulated by the BoU. However, an agreement should be reached with the BoU to ensure that the banks are appropriately regulated in regards to their activities as CIS distributors.

In return for distributing CIS products, banks would receive commissions from the CIS managers for successful sales or be remunerated by way of fees payable by the client. The CIS managers and the banks should explore different commission and fee structures in order to ensure the right incentives for banks are set, while not making it too expensive for CIS managers and their clients. Banks should be encouraged to distribute CIS products in order to be able to offer more products to their clients, which would allow them to capture a greater wallet share of their clients as well as attract new clients. However, banks have a conflict of interest with their own saving products, such as fixed deposits that they offer to their clients. Therefore, CIS managers need to ensure the right incentives in terms of commissions or fees are set for banks to distribute CIS products to their clients. Furthermore, if one or two banks can be encouraged to distribute CIS products, the other banks would likely follow suit in order to avoid losing customers to the other banks.

Custodian banks already play an integral role in the CIS ecosystem in Uganda as they keep safe custody of CISs clients' funds. Since CIS managers already have a relationship with their custodian banks, CIS managers should approach their custodian banks first to discuss the potential interest of banks to distribute CIS products and what incentives would have to be offered. Additionally, four of the five CIS managers have parent companies that conduct insurance business. Therefore, they could also approach the banks that are already distributing insurance products on behalf their parent companies.

## 5.0 Conclusion

In a bid to foster growth in the CIS sector in Uganda and widen the CIS distribution network to attract more investors, banks should be encouraged to become CIS distributors. Given that banks have a large and established client base and nationwide branch networks, they are well placed to sell financial products, such as unit trusts, to their clients.

The following are the next steps:

- i) CMA to engage BoU on the steps that need to be taken in order for banks to distribute CIS products on behalf of CIS managers.
  - a. Amendment of the FIA to allow banks to distribute CIS products.
  - b. Ensure banks are adequately regulated with regards to the distribution of CIS products without creating a whole separate regulatory structure at the CMA.
- ii) CIS managers to explore the option of using banks as an avenue for the distribution of CIS products.
- iii) CMA to conduct a survey of CIS managers and their potential to use banks as a distribution channel and explore other challenges faced by CIS managers.