THE ASSET MANAGEMENT INDUSTRY IN EU ZONE

UNIVERSIDAD ESAN • LIMA • MCMLXIII • PERÚ

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RESUMEN

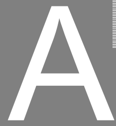
Durante la última década, las estructuras económicas y sociales de Europa han experimentado una transformación sustancial debido a la consolidación de la Unión Europea no sólo como bloque económico y comercial integrado prácticamente homogéneo, sino también por su importancia en el ámbito económico mundial. Dicho bloque, que reúne a cuatro de las siete economías más importantes del mundo, ha creado nuevos problemas y oportunidades. La industria europea de administración de activos, que es enorme en volumen pero de estructura diferente a la de su contraparte del mundo anglosajón, enfrenta el reto de nuevos problemas, al tiempo que aprovecha la mayor parte de las oportunidades que crean la Unión Europea y la globalización.

Este documento explora la actual situación de la principal industria de gestión de activos de Europa en un ámbito agregado. El trabajo describe inicialmente la estructura de la industria, sus principales subsectores y participantes, motores de ingresos y tendencias actuales. Se presta atención especial a las características de la administración de activos en Europa en comparación con la concepción estadounidense y británica. Mientras que para esta última la administración de activos es principalmente una arma de la industria financiera, en Europa continental tiene una connotación mucho más social. La manera en que las entidades europeas de administración de activos enfrentan las enormes presiones de las empresas estadounidenses que arriban al territorio de los negocios europeos y la interesante sinergia que crea el proceso son dos temas importantes de la investigación.

Según el concepto de responsabilidad social de la administración de activos prevaleciente en Europa continental, en tanto herramienta útil para el ahorro a largo plazo en lugar de negocio para generar ingresos millonarios, la imposición fiscal de la industria juega un rol fundamental, que en este documento se analiza en el nuevo marco legal de la Unión Europea. Otro aspecto esencial relacionado con esta industria se refiere al problema del envejecimiento de las personas y la gran presión que crea sobre los presupuestos gubernamentales. Ello está forzando a las autoridades a fomentar el ahorro privado de la población, que hasta ahora estaba acostumbrada a depender de las pensiones de jubilación del gobierno. Esto también ha creado un gran impacto sobre la evolución de la gestión de activos en la Europa contemporánea.

El documento espera ser no sólo una descripción exhaustiva de los datos y hechos de la industria, sino presentar información relevante que permita al lector formarse una visión integral del negocio de gestión de activos desde un punto de vista conceptual y también comprender las características particulares de esta industria en Europa y la fase por la que atraviesa. Desde una perspectiva latinoamericana, región en la cual aún se está desarrollando la gestión de activos, comprender cómo se organiza y opera el sector de gestión de la riqueza en un mercado maduro como el europeo puede constituir una fuente de referencias, ideas novedosas y conocimiento del negocio.

Palabras clave: fondos mutuos, fondos de pensiones, compañías de seguros, bancos privados, impuestos y refugios fiscales, poblaciones maduras, demografía de la dependencia, globalización y estandarización de la industria a nivel mundial, perspectiva social de la industria en Europa, comercio electrónico, internet y mercados virtuales de fondos.



BSTRACT

In the last decade Europe has experienced a fundamental transformation in its economic and social structures, due to the consolidation of the European Union not only as an integrated, mostly-homogeneous economic and trading block, but also for the importance of such a united block within world's economic backdrop. Such new economic order, which groups together four of the seven largest economies of the globe, has brought out new problems and new opportunities. The European asset management industry, huge in volume but different in structure to its Anglo Saxon counterpart, is facing the challenge to cope with those new problems while making the most of the opportunities that the European Union and the globalization has brought.

This paper explores the current situation of the asset management industry in Europe, under an aggregated scope. The work first describes the structure of the industry, its major sub-sectors and participants, revenue drivers and present trends. Special attention is given to differentiate the characteristics of wealth management in Europe as opposed to the American and British concept: while for the latter asset management is basically another arm of the financial business, for continental Europe has a much more social connotation. The way that European asset management houses are facing increasing pressure from American firms landing in European business territory and the interesting synergy that the process represents are both major topics of the investigation.

Under the continental European social responsibility conception of asset management, thought as a useful tool for long term savings rather than a millionaire revenue-making business, the taxation of the industry plays a very important role, which is analyzed under the new Union European legal framework. Another fundamental aspect related to the industry regards the problem of the aging population and the large pressure on governments budgets that this involves. This is forcing authorities to foster private savings among populations, so far largely used to and relaying in government retirement pensions. And that is having a large impact in the way asset management is evolving in Europe nowadays.

The paper does not expects to be an exhaustive description of data and facts about the industry; rather, it presents relevant information that permits the reader to figure out a concise holistic picture of the asset management business as a whole, conceptually, while on the other hand understand the particular characteristics of European asset management and its specific current circumstances. From a Latin American perspective, region in which asset management is still developing, understanding the way that is organized and works the wealth management sector in a mature market as Europe, may well be a source of reference, fresh ideas and business insight.

Key words: mutual and pension funds, insurance companies, private banking, taxation and tax havens, the aging problem: demographics of dependence, globalization and standardization of dependence, globalization and standardization of the industry worldwide, the European social perspective of the industry, e-commerce, internet and virtual funds markets.

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THE ASSET MANAGEMENT INDUSTRY IN EU ZONE*

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1. Current situation of the European asset management industry

1.1. Income statement structure of EU Asset Management firms

Europe's asset management market still offers opportunities for profitable growth despite increasing competitive pressures. The average operating profit is 21 basis points (hundredths of a percentage point) of the value of assets under management, though the level of profit in individual countries varies widely: from 9 basis points in Germany to more than 40 in Spain and Portugal.

This range of variation reflects differences in the net revenues of asset managers more than differences in their cost structures. Average net revenues (gross sales fees and income from management fees, less payments to distribution channels) are 35 basis points: 23 basis points for German firms, for example, and 53 basis points for Iberian ones. Many factors affect the level of revenue: the type of assets managed (revenues from equities are higher than those from fixed-income investments or money market funds); customer segments (retail fees are higher than institutional ones); investment styles (fees for active stock selection are higher than those for passive index tracking); revenue-sharing agreements with distribution channels; the ability to realize hidden fees from trading or brokering; and the transparency or stage of development of the market (the Benelux countries, for example, are further advanced than Spain).

Costs vary comparatively little across Europe, ranging from an average of 11 basis points of assets under management in the Iberian countries to 17 basis points in the United Kingdom. Distribution costs vary by channel, compensation costs by the maturity of markets, and back-office costs by types of client.

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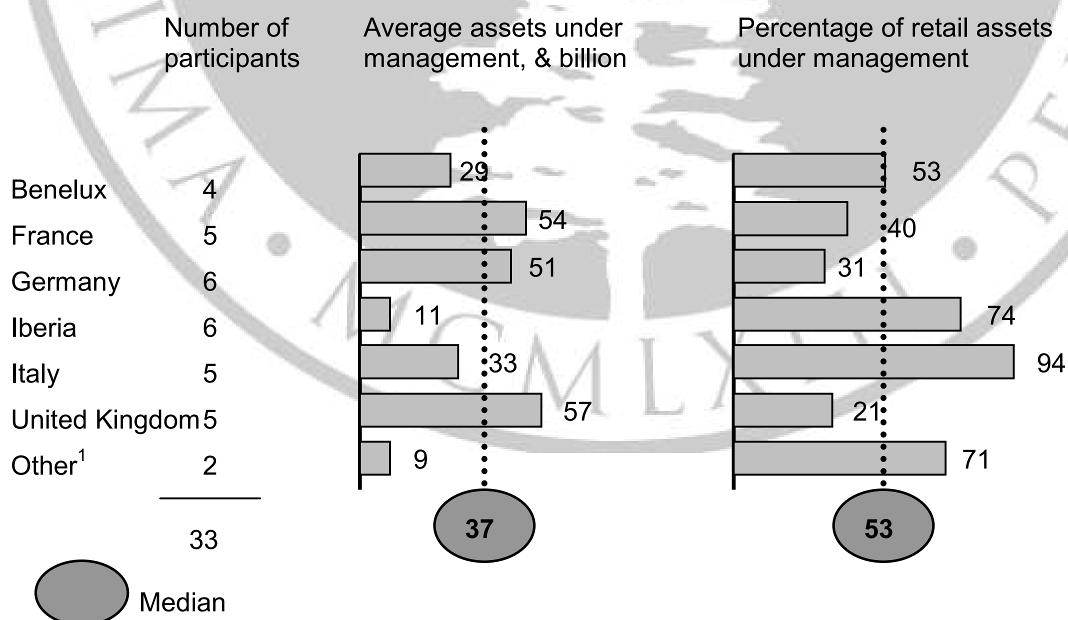
The mix of assets is among the main drivers of costs: equity funds, for instance, cost twice as much (5.1 basis points) to manage as fixed-income funds (2.6) and more than four times as much as money market funds. Nonetheless, the cost of managing equity funds is surprisingly similar from one country to another (Exhibit 3): differences in the value of the assets each staff member manages typically offset differences in costs per fund manager. UK fund managers must pay higher compensation levels, which are linked to the cost of doing business in the London market; French and German firms have to cover high social welfare costs. Not surprisingly, size matters in the asset management business, since its fixed costs are high. Large firms earn profits that are 25 percent (5 basis points) higher than those of their smaller domestic competitors. Economies of scale come mainly from sales and marketing as well as from information technology and support (Exhibit 4). In the retail business, up to 80 percent of total costs are fixed and thus don't rise with increases in the number of customers or the amount of assets managed.

Exhibit 1

McKinsey survey on asset management in Europe

Sample characteristics, 1998



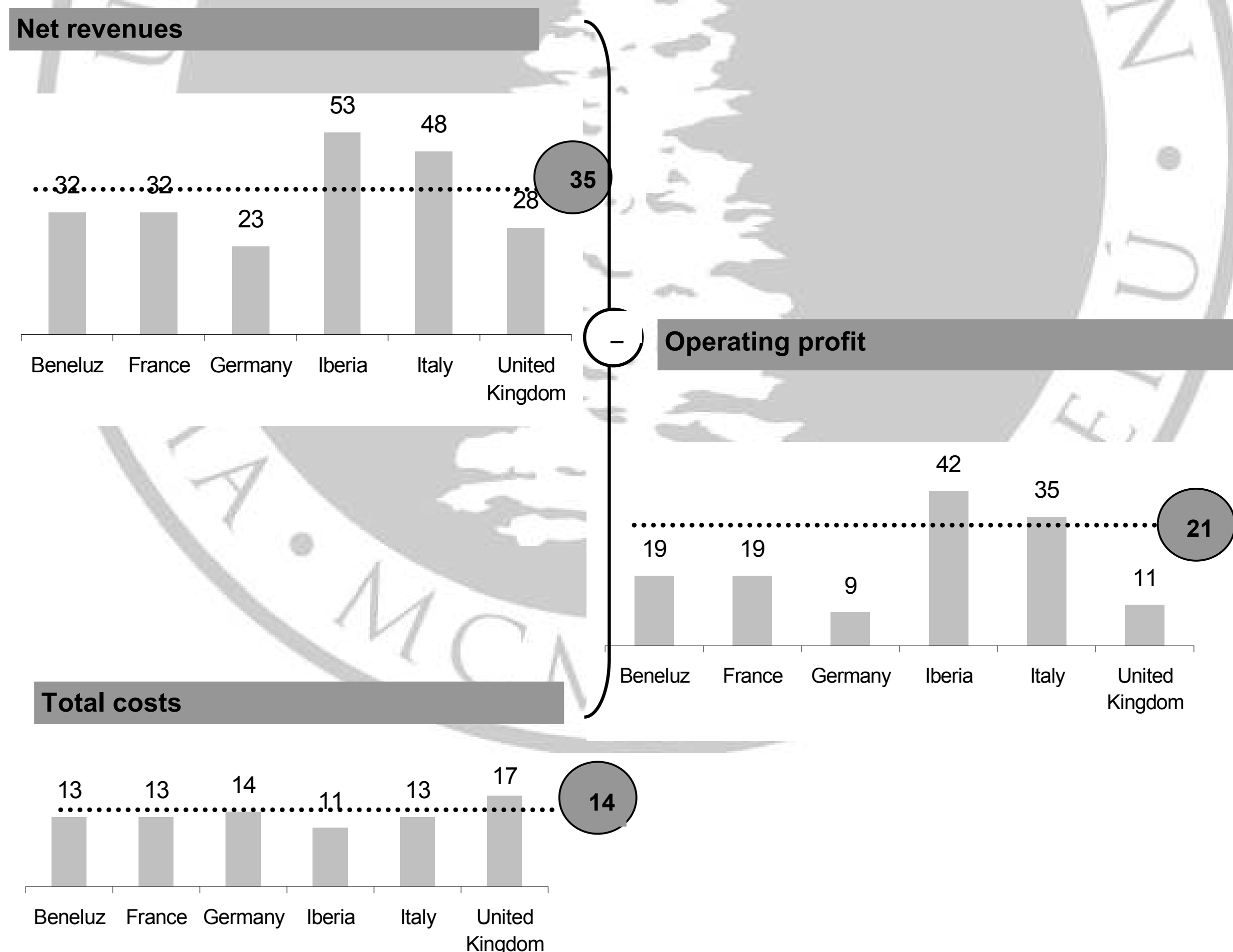
[1] Includes one participant from Denmark and one participant from Sweden.

Source: McKinsey European asset management survey

Such a high share of fixed costs should give large, much focused players a huge competitive advantage. Nonetheless, we found that large Continental fund managers don't capture the whole benefit of scale: a weakness they must tackle. Increasingly, firms have to become specialist managers, offering small sets of products to large client bases instead of broad product ranges to smaller client bases. Continental firms will have to focus increasingly on specific investment styles, asset classes, regions, or industries and raise the amount of assets they manage within each product class. Only fund managers that do so can realize full economies of scale and beat Anglo-Saxon players with histories of narrower product offerings.

Exhibit 2

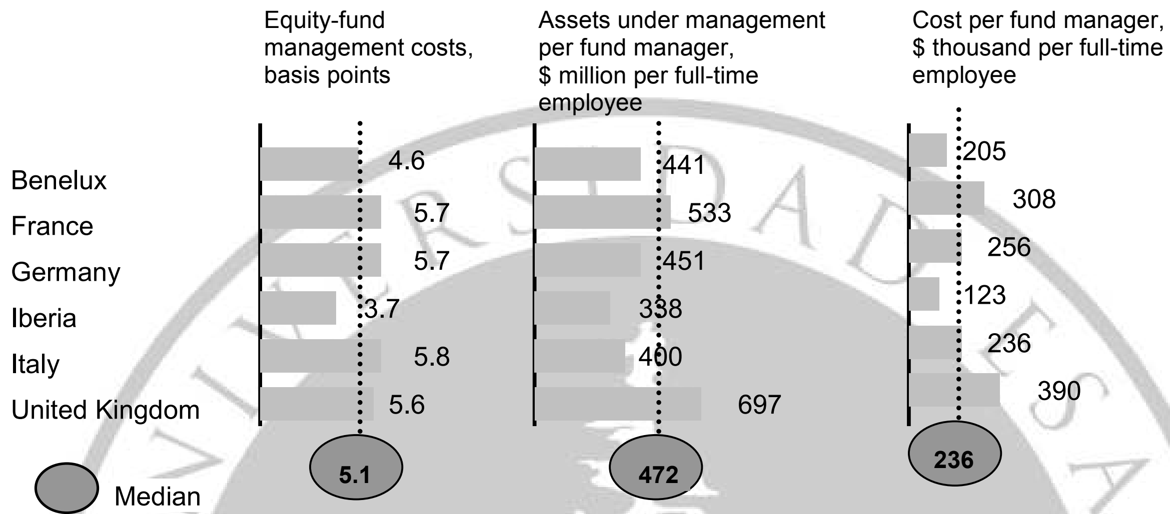
Operating profit by country
Basis points, 1998



Source: McKinsey European asset management survey

Exhibit 3

Equity-fund management costs by country, 1998

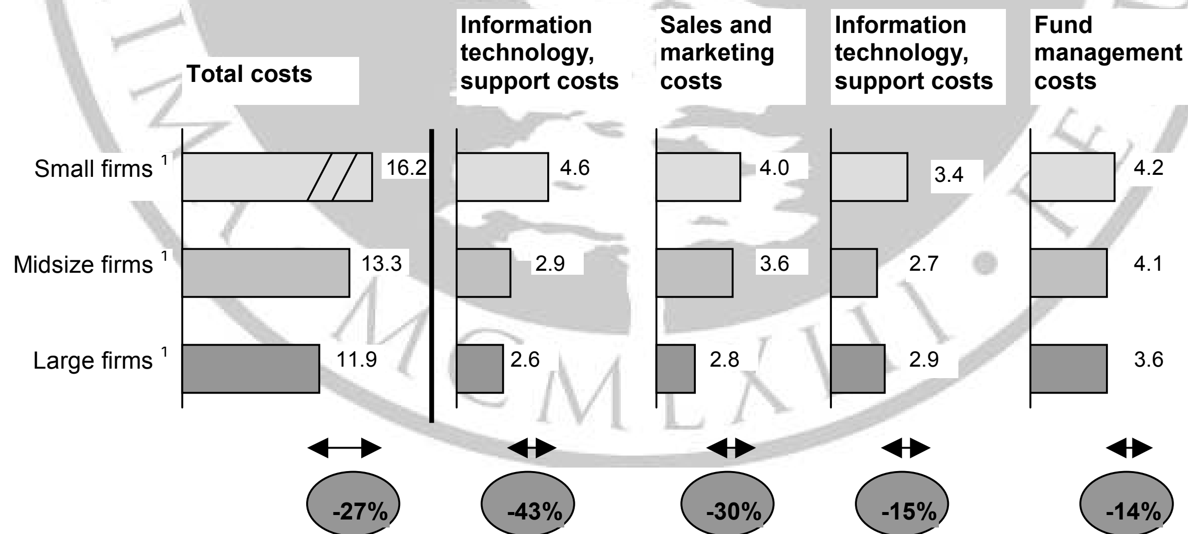


Source: McKinsey European asset management survey

Exhibit 4

Size matters: Cost structure of asset management firms

Basis points, 1998



Scale advantage: Percentage of costs large firms pay compared to small firms

[1]Small firms represent the lowest third of a country's companies in terms of asset size, midsize firms the middle third, and large firms the highest third.

Source: McKinsey European asset management survey

1.2. M&A Activity

The investment management industry continues to consolidate at a rapid pace. The key drivers of this activity are:

- to establish critical mass to leverage economies of scale and capital strength.
- to broaden distribution and customer bases; and to broaden the range of products offered.

This has driven up the prices of high quality fund -management operations, which are growing increasingly scarce. The above factors are resulting in consolidation amongst existing domestic players and a high level of cross border activity as the pan-European market develops. US players have started to take interest in the European market and have begun making acquisitions in order to establish a foothold. Despite the recent downturn in the equity markets this high level of M&A activity continues unabated as companies seek to position themselves as leading players in what continues to be the most promising future growth sector in financial services.

However, the integration of operations represents a key business risk facing M&A participants. This includes:

- the consolidation of distribution channels and back office functions;
- product branding;
- The retention and motivation of fund managers.

1.3. Retail Funds

In Europe the equity culture is growing, and projections show increasing ownership over the next few years although not yet at US penetration levels. In the year 2000 in Europe there was a positive fund flow, with Luxembourg, France and the UK consolidating their positions. Southern Europe has not faired so well with Italy and Spain showing deficits.

Internet trading has continued to attract new investors and new market participants, with an increasing number of banking institutions now seeking to enter the wealth management arena. In addition, the fund supermarkets now established allow investors and intermediaries' access to a range of providers' services, from information only providers to full service providers offering access to on-line dealing, settlement, and management of their own portfolios. A number of these supermarket providers are now looking to expand into Europe and establish their operations in key locations, thereby opening up new opportunities for European consumers to benefit in the same way as UK investors.

In the shadow of adverse market conditions, what would have been a bumper end to the fiscal year, turned out to be less than expected for management companies and brokers alike. Although sales rallied, as the tax year-end neared, it did not meet earlier expectations.

On the positive side, there is increasing interest from both providers and investors in ethical issues, underpinned by the introduction of the new FTSE4Good index, representing listed companies meeting predetermined ethical criteria. However, while the framework for ethical investment and ethical index tracking continues to develop, the proliferation of ethical funds is likely to be restricted by the limited number of listed companies available for investment.

1.4. Pension Funds and Institutional ownership

Most Euro linked countries provide the largest share of their old-age pension benefits through compulsory pay-as-you go systems. These pensions are generally funded by current contributions from the existing active workforce. The existence of a 'demographic time-bomb' whereby the ratio of older people to workers is increasing has been well documented.

Facts and Figures

Net sales in 2000 (US$ m)

Country	Total	Equity funds	Bond funds	Bal funds	Money funds	Others
Austria	(361)	(806)	328	128	(11)	-
Czech Republic	(155)	35	(15)	(175)	(31)	30
Finland	3,983	2,316	211	1,202	225	-
France	35,007	39,882	(7,365)	3,105	(2,171)	1,296
Greece	1,490	49	408	192	848	-
Italy	(6,297)	36,406	(48,367)	5,108	603	-
Luxembourg	156,441	120,103	7,266	11,394	(6,031)	-
Norway	2,508	1,339	(104)	(4)	1,235	-
Portugal	(839)	123	(304)	62	(1,045)	332
Spain	(20,319)	6,061	(12,670)	(4,058)	(9,501)	-
Sweden	9,647	7,260	237	2,369	53	94
Switzerland	8,810	8,196	(970)	1,508	138	(324)
UK	27,750	23,938	4,201	238	77	(239)
Total	217,674	244,963	(57,143)	21,069	(15,611)	1,188
Total Europe	206,512	235,331	(56,055)	19,740	(16,953)	1,481

Source: FEFSI

Retail Share ownership in Europe (population in millions)

	1999	2000	2001F*	2002F*	2003F*
France	5.2	5.8	6.3	6.8	7.2
Germany	5.0	7.2	8.7	10.3	12.0
Italy	3.6	4.2	4.8	5.5	6.3
Netherlands	1.9	2.1	2.4	2.6	2.8
Spain	2.1	2.4	2.5	2.9	3.1
Sweden	4.3	4.6	4.6	4.7	4.7
Switzerland	0.8	1.0	1.1	1.2	1.2
UK	12.7	13.5	14.3	15.1	15.8
Total Europe	35.6	40.5	44.7	49.1	53.1

*Forecast

Source: ProShare, Desutsche Aktieninstitut, JP Morgan Estimates

The main factors creating the time bomb include low birth rates and increasing life expectancy for pensioners. Indeed, the latest Annual Report from the European Central Bank (May 2001) paints a very grim picture of the years ahead unless radical reform of state pensions takes place.

More work is required before pan-European pensions become a reality, since it will not be easy to achieve a common set of standards applying to the diverse system of state and private pension provision that exists across Europe.

In the UK, the long awaited report by Paul Myners into institutional investment was published in March 2001. At the outset of the review it was widely seen that this was an attempt by the UK Treasury to force pension schemes to invest in private equity funds. However, Myners instead recommended a raft of measures that focus far more attention on investment decision making by trustees than previously. Ultimately, it is expected that the full implementation of Myners' recommendations could lead to greater investment by pension funds in alternative asset classes such as property, private equity funds, and hedge funds.

1.5. Passive vs. Active Asset Management

The pros and cons of active versus passive investment management have been discussed at length over the years. However, as the amount of assets under passive management in Europe has continued to increase, passive funds have become an accepted part of the investment landscape in both the retail and institutional marketplaces.

The factors driving the large inflows into passive management are likely to persist for many years, especially given the growing trend to use passive management for defined contribution pension investment. The last 12 months, to 31 March 2001, has seen a good comeback from active UK pension fund managers. Investment returns before fees highlight that they beat the FTSE All-Share Index by 1.8%. Longer term,

however, they remain marginally behind that of the index return even before their fees are deducted.

1.6. Alternative Investments

These are interesting times for investment managers involved in managing alternative investment funds. In particular, there has recently been a surge of investor enthusiasm for private equity funds and hedge funds. There are two main reasons for the sudden interest in these vehicles. Firstly, with the move into a low inflation environment, many investors believe that equities will not give anything like the high real returns achieved during the last twenty years. Secondly, equity markets around the world are getting more correlated with each other and this could mean increased risk. An allocation of an investment portfolio to alternative investments at the expense of equities could help balance out these increased risks.

Looking at private equity funding in a European context, unsurprisingly the main destination of private equity funding has been the UK, with France and Germany some way behind. The recent economic downturn has undoubtedly slowed down the flow of funds into private equity funds but the longer-term picture remains favourable. Given the massive scale of the UK pensions industry, raising the current negligible allocation of private equity to a weighting comparable with US pension funds, would potentially have a very beneficial impact on the private equity fund industry.

Hedge funds have continued to grab the headlines. Recent average returns from hedge funds have been higher than long only investors during the recent stock market downturn, and this is focusing investors' attention on whether to invest in hedge funds.

At the same time, numerous new hedge funds are being launched, including some by very well respected brand name investment managers. This will inevitably give the hedge fund industry more credibility, which is something that it desperately needs given its reputation for high fees and lack of transparency.

1.7. E-commerce Asset Management

The expected growth in use of the internet by fund managers has at last come to fruition. The use of e-commerce is evidenced by the large increase seen in funds under management and account holders by managers providing e-commerce facilities. The type of business provided to individuals is predominantly execution only with fund managers and e-supermarkets providing selection tools with their sites. Some provide on-line or face-to-face advisory service as an added benefit.

Consumer fears over the security of the internet are continuing to restrict growth. However, there are signs to show these fears are beginning to be overcome. Also, payments continue to be an issue with the use of debit cards constrained by the referral rate of debit requests.

The lack of a single international standard for electronic trading of mutual funds between professionals continues to restrict cross border growth. Supermarkets are filling this sector by starting to provide cross border funds.

In the asset management arena, another use of the internet is the provision of up to date information. The provision of information to institutional clients on an ‘as now’ basis is the major area of growth. The future lies in the provision of information and receipt of instructions via the internet. The ability to personalise the information to suit the client’s needs is the area where technology will focus in the future.

1.8. Wealth management on line

Wealth Management is the provision of a total solution to an individual of all his required financial needs. Until recently, this has only been on offer to the High Net Worth Individual (HNWI) and on a traditional basis. As the move of responsibility for long-term care (health and pensions) and savings for such moves from governments to the individual, there will be more demand for cost effective Wealth Management offerings.

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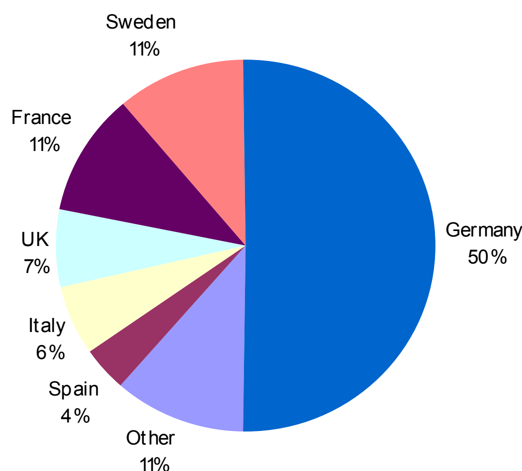
Percentage of European On-line Broking Market



Source: J. P. Morgan, 22 February 2001

Some e-portals provide almost complete financial services from mortgages and loans to pensions and investments. However, these portals link to other providers who transact and hold the business relationship with the individual.

This is similar to the intermediary relationship with funds rather than the supermarket relationship where the client is serviced by the supermarket, whatever funds they hold.

Exhibit 5

Location of HNWIs by region (%)

Source: Merril Lynch, 14 May 2001

The market is already seeing a change in the delivery of the Private Banking services to HNWIs with internet enquiry and transaction requests being provided. However, other drivers are forcing the pace of change in the financial services arena:

- Changing background of HNWIs towards more technologically literate individuals;
- increased mobility of clients, who require immediate access to services;
- Service expectation of HNWI is a full product range including outsourced products which are integrated into one provide;
- the size of market is growing and disposable wealth is increasing.

From a technology viewpoint, the integration of diverse systems and delivery on an on-line basis is a challenge. With the need to interface to multiple different companies and products, a standard will be hard to identify and so multiple links will be needed.

The security demand will be paramount as the information held will be the total financial picture for an individual rather than just one part of his portfolio.

1.9. Performance measurement

The timely release of the Global Investment Performance Standards (GIPS) in April 1999 signalled a new era in the ability for asset managers to market investment performance across borders, and has been adopted by a significant number of European fund-management houses. As of April 2001, approximately 25 countries have adopted, or are in the process of adopting, the GIPS or establishing a local investment performance standard. These standards, referred to either as CVGs (Country Version of GIPS) or TGs (Translation of GIPS) continue the momentum and drive towards a worldwide uniform methodology for the calculation and presentation of the performance track record of funds.

In addition to the continuing trend to achieve uniformity of calculation and presentation, a further trend within performance measurement is the move towards greater scrutiny of how these returns are being achieved. The recently released Myners report in the UK in April 2001 further highlighted this trend, and effectively called for trustees to perform more in depth level of analysis, to arrive at a greater awareness of how funds are being managed, and greater identification of the contributions made by the individual investment decision and the particular strategies being adopted.

Both these trends have in turn contributed to the need for a greater level of sophistication in the underlying systems which are relied upon for the collation of fund data and the generation of fund track performance. As of April 2001,

approximately 35 fund management houses in the UK market alone were reported to be either in the developmental stages of an in-house performance system, or in the midst of the implementation of a bespoke or a generic solution developed by one of the growing number of software houses servicing the industry.

2. Pension Funds

The pension fund market has proven to be one of the most rapidly growing sectors of the global financial system, and promises to be even more dynamic in the years ahead. Consequently, pension assets have been in the forefront of strategic targeting by all types of financial institutions, including banks, trust companies, broker-dealers, insurance companies, mutual fund companies, and independent asset management firms. Pension assets in 1995 in countries where consistent and comparable data are available (Australia, Canada, Japan, Switzerland the United Kingdom and the United States) were estimated to amount to $8.2 trillion, roughly two-thirds of which covered private-sector employees and the balance covered public-sector employees. Total Western European pension assets at the end of 1994 had an estimated market value of about $1.6 trillion, with the United Kingdom accounting for almost half the total and the Netherlands second largest with a 17% share.

The basis for such projected growth is, of course the demographics of gradually aging populations, colliding with existing structures for retirement support which in many countries carry heavy political baggage. They are politically exceedingly difficult to bring up to the standards required for the future, yet doing so eventually is an inevitability16. The global epicentre of this problem will be the European Union, with profound implications for the size and structure of capital markets, the competitive positioning and performance of financial intermediaries in general and asset managers in particular, and for the systems of corporate governance that have existed in the region.

2.1. Demographics of Dependency

The demographics of the pension fund problem are very straightforward, since demographic data are among the most reliable. Exhibit 6 provides data for the so-called "dependency ratio" (roughly, those of retirement age as a percent of those of working age). Unless there are major unforeseen changes in birth rates, death dates or migration rates, for the EU as a whole the dependency ratio will have doubled between 1990 and 2040, with the highest dependency ratios being attained in Italy, Germany and the Netherlands, and the lowest in Ireland. While the demographics underlying these projections may be quite reliable, dependency ratios remain subject to shifts in working-age start- and end-points. Obviously, the longer people remain out of the active labour force (e.g., for purposes of education), the higher the level of sustained unemployment, and the earlier the average retirement age, the higher will be the dependency ratio. In recent years all three of these factors have contributed to raising the EU's dependency ratio, certainly relative to that in the United States, although there are early signs that may eventually stabilize or be reversed under pressure of the realities of the pension issue.

2.2. Alternative Approaches to Old-Age Support

There are three ways to provide support for the post-retirement segment of the population:

Pay-as-you-go (PAYG) programs. Pension benefits under this approach are committed by the state based on various formulas (number of years worked and income subject to social charges, for example) and funded by current mandatory contributions of those employed (taxes and social charges) that may or may not be specifically earmarked to covering current pension payouts. Under PAYG systems, current pension contributions may exceed or fall short of current disbursements. In the former case, a "trust fund" may be set up which, as in the case of U.S. Social Security, may be invested in government securities. In the latter case, the deficit will

tend to be covered out of general tax revenues, government borrowing, or the liquidation of previously accumulated trust fund assets.

Exhibit 6

Projected dependency trends in E.U. countries vs. U.S.

(Population aged 65 and over as a percentage of population aged 15-64)

Country	Old age dependency ratios	
	1990	2040E
Belgium	21.9	41.5
Denmark	22.2	43.4
France	21.9	39.2
Germany	23.7	47.1
Greece	20.5	41.7
Ireland	18.4	27.2
Italy	20.4	48.4
Luxembourg	20.4	41.2
Netherlands	17.4	48.5
Portugal	16.4	38.9
Spain	17.0	41.7
U.K.	23.5	39.1
U.S.	19.0	38.5
Japan	22.7	44.9

Source: EUROSTAT, World Bank, OECD and EBRI.

Defined benefit programs. Their employers, based on actuarial benefit formulas that are part of the employment contract, commit pension benefits under such programs to public or private sector employees. Defined benefit pension payouts may be linked to the cost of living, adjusted for survivorship, etc., and the funds set-aside to support future claims may be contributed solely by the employer or with some level of employee contribution. The pool of assets may be invested in a portfolio of debt and equity securities (possibly including the company's own shares) that are managed in-house or by external fund managers. Depending on the level of contributions and benefit claims, as well as investment performance, defined-benefit plans may be over-funded or under-funded. The employer may thus tap them from

time to time for general corporate purposes, or they may have to be topped-up from the employer's own resources. Defined benefit plans may be insured (e.g., against corporate bankruptcy) either in the private market or by government agencies, and are usually subject to strict regulation, e.g., in the United States under ERISA, which is administered by the Department of Labour.

Defined contribution programs. The employer, the employee, or both into a fund that will ultimately form the basis for pension benefits under defined contribution pension plans make pension fund contributions. The employee's share in the fund tends to vest after a number of years of employment, and may be managed by the employer or placed with various asset managers under portfolio constraints intended serve the best interests of the beneficiaries. The employee's responsibility for asset allocation can vary from none at all to virtually full discretion. Employees may be allowed to select among a range of approved investment vehicles, notably mutual funds, and based on individual risk-return preferences.

Most countries have several types of pension arrangement operating simultaneously, for example a base-level PAYG system supplemented by state-sponsored or privately-sponsored defined-benefit plans and defined-contribution plans sponsored by employers or mandated by the state.

As of the end of 1997, 54 countries had defined-contribution pension systems of some kind, ranging from nationwide compulsory schemes to funds intended to supplement state-guaranteed pensions. Assets in these funds are expected to grow at a rate of 16% per year outside the United States, compared to a U.S. growth rate of 14%, with the fastest growth (24% annually) expected in Latin America and European pension pools growing at a rate of 14%18. Overall, global pension pools are likely to grow from $8.5 trillion in1997 to perhaps $13.5 trillion in 2002.

The collision of the aforementioned demographics and heavy reliance on the part of many European countries on PAYG approaches is at the heart of the pension problem, and forms the basis for future opportunities in this part of national and

global financial systems. In the United States, for example, the PAYG attributes of Social Security and projections as to the future evolution of the trust fund have been highlighted by a number of commissions to study the problem, and the conclusions have invariably pointed to some combination of increased retirement eligibility, increased Social Security taxes, increased taxation of social security benefits, and means-testing of benefits so that those who have saved more for retirement on their own would receive smaller benefits or be taxed at higher rates on the benefits they receive.

While the American pension problem is cause for concern (and is being relatively addressed by government, employers, and individuals on their own) it pales by comparison to the problems confronting Europe and to a lesser extent Japan. With a population of some 261 million people at the beginning of 1995, the United States had accumulated pension pools worth $3.76 trillion. Western Europe, with a population almost twice as large, had accumulated pension assets of only $1.61 trillion. Japan's population and pension accumulations at that time were 125 million and $1.12 trillion respectively. Exhibit 7 shows the percentage of the labour force in various countries covered by occupational pension schemes, with countries such as Italy, Belgium and Spain highly dependent on PAYG state-run pension systems with little asset accumulations and countries like the Netherlands, Denmark and the U.K. having long traditions of defined benefit pension schemes backed by large asset pools. The French system involves a virtually universal state-directed defined-benefit scheme which, given the demographics, is heavily under-funded.

These very different EU systems, in turn, are reflected in pension assets per capita and pension assets as a percent of GDP, shown in the last two columns of Exhibit 6. Among the EU countries only Denmark, the Netherlands, and the U.K. appear to be in reasonably good shape. German companies have traditionally run defined benefit plans, with pension reserves booked within the balance sheets of the employers themselves as opposed to externally managed asset pools, backstopped by a government-mandated pension fund guarantee scheme.

Exhibit 7

U.S. vs. European Pension Assets and Populations 1994

Country	Population (millions)	% of labor force covered by occupational pension schemes	% of Pop. Over 65	Pension Assets		
				Pension Assets ($ Billions)	Per capita ($000)	Pension assets as % of GDP
Belgium	10.1	5	15	17	1.7	8
Denmark	5.2	NA	16	105	20.2	72
Finland	5.1	NA	14	28	5.5	29
France	58.1	80	15	NA	NA	NA
Germany	81.2	65	15	285	3.5	14
Ireland	3.6	NA	11	15	4.2	28
Italy	57.0	5	11	50(a)	0.9	5
Netherlands	15.4	82	13	380	24.7	116
Portugal	9.9	NA	13	5	0.5	6
Spain	39.2	3	15	10(a)	0.3	2
Switzerland	7.1	92	15	187	12.3	73
U.K.	58.3	55	16	775	3.3	76
U.S.	261.0	55	13	3760	14.4	56

Sources: William Mercer; EBRI, World Bank, EIU Limited 1995, InterSec and Euromoney; E.P. Davis, Pension Funds (New York: Oxford University Press, 1995); World Bank, Averting The Old Age Crisis (Washington, D.C.1994)

Even a number of the Eastern European countries seem to be ahead of their Western European counterparts such as Germany and Italy in designing viable pension systems as well, most of which follow a defined contribution model. Hungary and Poland, for example, have drawn on experience of Chile and other Latin American countries in reforming their PAYG systems. In the case of Hungary, the PAYG system will be phased-out gradually and new entrants to the work force must join one of a number of new private pension schemes. Workers under the age of 47 may choose between the state system and private schemes, while those 47 and older are expected to remain with the state system, thus easing the transition process. This is expected to make a major contribution to future capital market development, as well as creating a permanent constituency for economic reforms.

Today's conventional wisdom is that the pension problems that are centred in Europe will have to be resolved in the foreseeable future, and that there are only a limited number of options in dealing with the issue:

Raise mandatory social charges on employees and employers to cover increasing pension obligations under PAYG systems. It is unlikely that a any degree of uniformity in the EU can be achieved in this regard, given the aforementioned large inter-country differences in pension schemes and their financing. The competitive effects of the required major increases in employer burdens, especially in a unified market with a common currency, are unlikely to make this a feasible alternative. No more palatable is likely to be saddling employees with additional social contributions in what are already some of the most heavily taxed environments in the world.

Make major reductions in retirement benefits, cutting dramatically into benefit levels. This is unlikely to be any more feasible politically than the first option, especially considering the way many PAYG systems have been positioned as "contributions" (not taxes) which would assure a comfortable old age. Taking away something people feel has already been "paid for" is far more difficult politically than denying them something they never had in the first place. The sensitivity of fiscal reforms to social welfare is illustrated by the fact that just limiting the growth in pension expenditures to the projected rate of economic growth from 2015 onward would reduce income-replacement rates from 45% to 30% over a period of 15 years, leaving those among the elderly without adequate personal resources in relative poverty.

Significant increases in the retirement age at which individuals are eligible for full PAYG-financed pensions, perhaps to age 70 for those not incapacitated by ill health. This is unlikely to be any more palatable than the previous option, especially in many countries where there has been active pressure to go the other way, i.e., to reduce the age of eligibility for PAYG retirement benefits to 60 or even 55. This is compounded by a chronically high unemployment rate in Europe, which has been widely used as a justification for earlier retirements.

Major increases in general taxation levels or government borrowing to top-up eroding trust funds or finance PAYG benefits on a continuing basis. Again, this is an unlikely alternative due to the economic and competitive consequences of further increases in tax rates, major political resistance and Maastricht-type fiscal constraints that are likely to obtain in the EU. Even if they do not, the fact is that national states maintaining PAYG systems (under a single currency and without the ability to monetize debt) will have to compete for financing in a unified, rated bond market, which will constrain their ability to run large borrowing programs to something akin to those of the states in the U.S.

Major pension reforms to progressively move away from PAYG systems toward defined-contribution and defined benefit schemes such as those widely used in the U.S., Chile, Singapore, Malaysia, the U.K., the Netherlands, Denmark and certain other EU countries. Each of these differs in detail, but all involve the creation of large asset pools that are reasonably actuarially sound. Where such asset pools already exist, more attention will have to be focus on investment performance, with a shift away from government bonds toward higher-yielding assets in order to help maintain benefit levels.

Given the relatively bleak outlook for the first several of these alternatives, it seems inevitable that increasing reliance will be placed on the last of these options. The fact that future generations can no longer count on the "free ride" of the present value of benefits exceeding the present value of contributions and social charges as the demographics inevitably turn against them (in the presence of clear fiscal constraints facing governments) requires fundamental rethinking of pension arrangements in most OECD countries, notably those of the European Union. Alternatively, the fiscal deficits required by unreformed national PAYG pension schemes in those EU countries that are part of a single-currency zone would imply higher interest rates across the euro-zone than would otherwise be the case and/or higher levels of inflation if there were monetization by the European Central Bank of some of the incremental public debt.

2.3. Cross-Links with Mutual Funds

Whereas there are wide differences among countries in their reliance on PAYG pension systems and in the degree of demographic and financial pressure to build actuarially viable asset pools, there are equally wide differences in how those assets have been allocated.

As depicted in Exhibit 8, the United States (not including the Social Security Trust Fund) and the United Kingdom have relied quite heavily on domestic equities, 48% and 56% respectively. The largest 15 pension fund managers in 1997 had about 50% of equity assets invested in passive funds, versus about 5% in the case of mutual funds. The share of asset-allocation to domestic bonds is highest in Germany and Denmark, followed by Portugal, Switzerland, and the Netherlands. Foreign equity holdings are proportionately highest in Ireland, the Netherlands, and Belgium (each with small domestic stock markets). Foreign bond holdings play a major role only in the case of Belgium. Equity holdings among European $1.9 trillion in pension assets (mid-1996) varies widely, ranging from 75% of assets in the U.K., 42% in Belgium, 34% in the Netherlands, 13% in France, 11% in Spain.

Exhibit 8
Pension fund asset allocation
(End-1994)

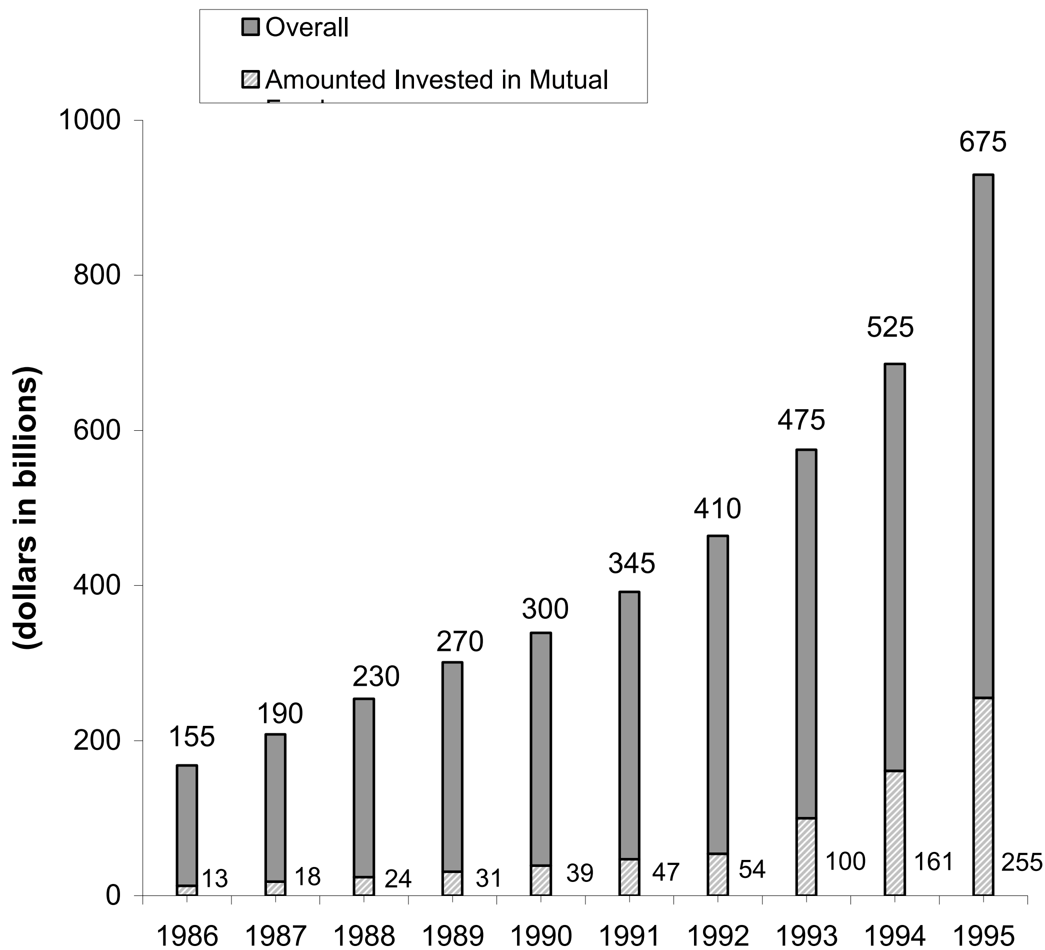
Country	Domestic equities	Domestic bonds	Foreign equities	Foreign bonds	Real Estate	Cash
Belgium	217	22	33	18	4	6
Denmark	14	70	3	2	9	2
Germany	6	72	3	4	13	2
Ireland	25	19	42	3	6	5
Netherlands	9	49	20	7	13	2
Portugal	3	58	6	7	1	25
Switzerland	8	54	5	5	19	9
U.K.	56	7	26	5	4	2
U.S.	56	26	12	2	4	8

With the euro, regulations that require pension funds to match the currency of their assets with the currency of their liabilities drop away within the single-currency zone, which will greatly broaden the equity opportunities open to fund trustees. In some cases currency-exposure restrictions have forced pension fund equity allocations to be overweight in certain industries (such as petroleum in the Netherlands) due to the importance of a few companies in national equity market capitalization, in which case the euro will permit significantly improved sector asset-allocation in pension portfolios. This suggests large increases in cross-border equity flows in Europe, and the creation pan-European pension-fund performance benchmarks to replace existing national benchmarks22.

The growing role of defined-contribution plans in the United States has led to strong linkages between pension funds and mutual funds. Numerous mutual funds (notably in the equities sector) are strongly influenced by 401(k) and other pension inflows. This is depicted in Exhibit 9 for the ten-year period 1986-95, at the end of which mutual funds controlled almost 40% of such assets. At the end of 1996, over 35% ($1.2 trillion) of mutual fund assets represented retirement accounts of various types in the United States. Some 15% of total retirement assets were invested in mutual funds, up from about 1% in 198023. This is reflected in the structure of the pension-fund management industry in the United States. The top-25 defined-benefit asset managers in 1995 were trust departments of commercial banks, with the top-10 averaging discretionary assets of about $150 billion each. There is little evidence of increasing market concentration in the fixed-income part of the trust business, with the top-25 firms controlling 62% of assets in both 1990 and 1995. However, the top-25 market share in the equities segment (which was roughly twice as large) rose from 29% in 1990 to 35% in 1995, presumably due to the importance of performance differentials in attracting assets24. Among the top-25 401(k) plan fund managers in 1995, three were mutual fund companies, ten were insurance companies, five were banks, one was a broker-dealer, two were diversified financial firms, and four were specialist asset managers.

Exhibit 9

Estimates of 401 (K) Pension plans invested in mutual funds, 1986-1995



Source: Investment Company Institute Mutual Fund Fact Book 1996, Access Research

European pension funds' retention of asset managers has changed significantly over the years. In 1987, banks had a market share of about 95%, while insurance companies and independent fund managers split the rest about evenly. By 1995, independent fund managers had captured over 40% of the market, banks were down to about 55%, and insurance companies captured the rest. There is also some evidence of increasing pension fund management concentration, at least in the U.K., where in 1995 six pension-fund managers accounted for about 70 percent of the market. Of these, five were actively managed funds and one (Barclays Global Investors) specialized in index funds.

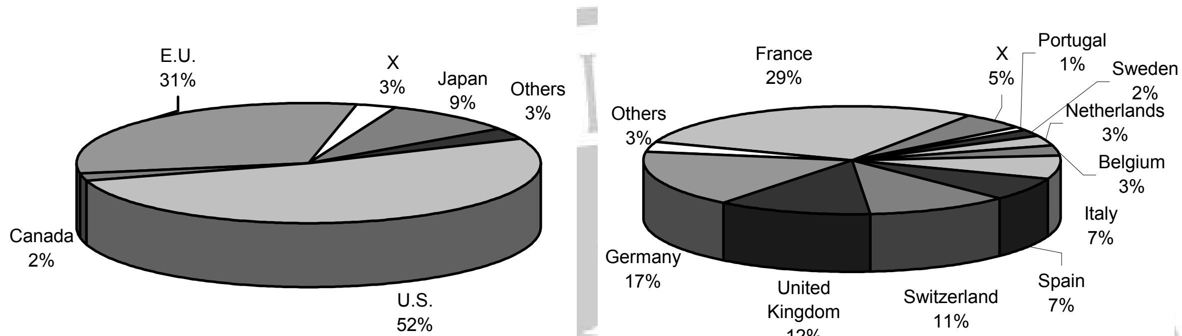
3. Mutual Funds

As it has in the United States, the mutual fund industry in Europe has enjoyed rapid growth during the 1990s, although there are wide differences among national financial markets in the pace of development, in the character of the assets under management, and in the nature of mutual fund marketing and distribution. The pattern of development in Europe has also differed significantly from the United States, where at the end of 1996 there were more than 6,000 mutual funds in total and over 4,500 equity mutual funds available to the public (more than the number of stocks listed on the New York Stock Exchange) with average annual growth in excess of 22% between 1975 and 1996 and almost $4 trillion of assets under management in all funds at the end of 1997 (about 13% of household net financial wealth, more than life insurance companies and about equal to the total assets of commercial banks). Only a part of mutual fund growth is attributable to new net investments in this sector of the financial system, of course, with the balance of the growth in assets under management attributable to reinvested earnings and capital gains. So the relative importance of equity funds and the performance of national stock markets is directly linked to observed differences in mutual fund growth patterns among countries and regions. Much of the growth is also attributable to the use of mutual funds for retirement savings, capturing roughly 17% of U.S. retirement assets in 1996 (see below).

The following graphics show the distribution of mutual fund assets in terms of market capitalization at the end of 1996. The United States accounts for slightly over half the assets under management, with the EU about 31% and Japan 9% of the total. Within Europe, France had the top position in 1994 with 29%, followed by Germany with 17% the United Kingdom with 12% and Switzerland with 11%. In Europe, mutual funds and unit trusts are roughly evenly split between money market funds, fixed-income funds and equity funds, but this masks the wide inter-country differences shown in the following picture:

Breakdown of Global and European Mutual Fund Markets, 1996

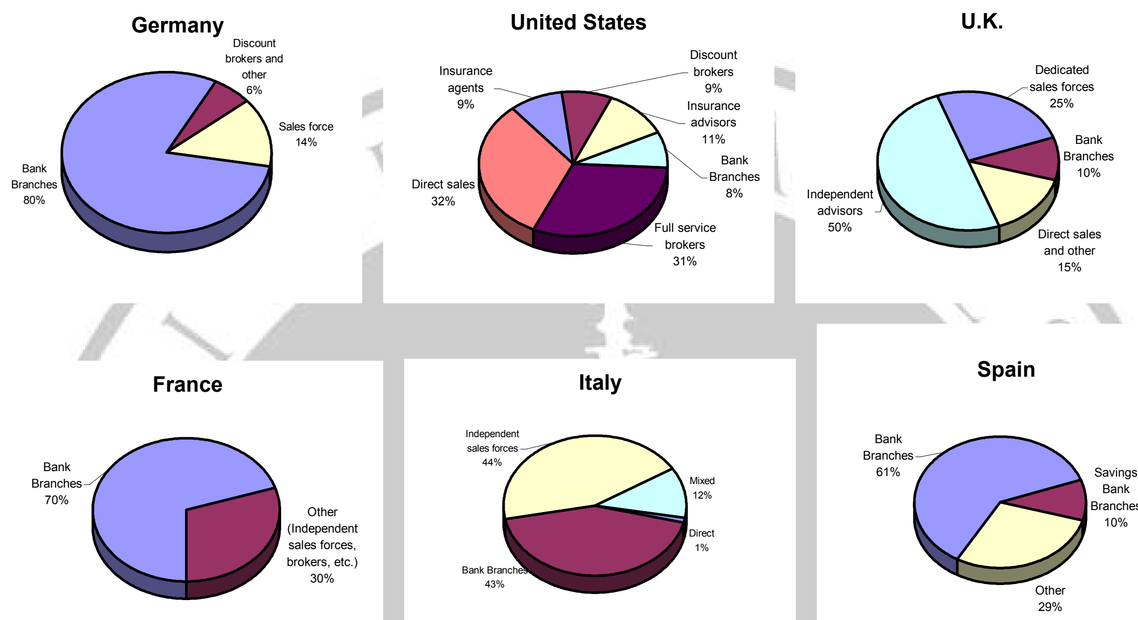
($5.3 Trillion)



The French market has been dominated by money market funds, in part due to tax advantages, while the British market has virtually been monopolized by equity funds. At the same time, fixed-income funds take a disproportionate share of the market in other European countries, notably in Germany, reflecting both investor preferences and the limited state of development of national equity markets in the countries concerned.

In the United States, on the other hand, mutual funds were traditionally invested mainly in equities in 1975, over 82% of the fund assets under management were equities and a mere 10% and 8% in bonds and money market instruments, respectively. By 1985 this picture had changed completely, with the equity component declining to 24% and money market funds capturing 49%, due both to relatively poor stock market performance in the 1970s and early 1980s, and to the substitution of money market mutual funds for bank savings products by households searching for higher yields at a time when banks continued to be limited by interest-rate regulation on deposits. By 1995, the U.S. pattern of mutual fund investments had shifted yet again, with equities accounting for 44% of the total, and money market and bond funds 28% each.

Estimated Mutual Fund Market Share by Distribution Channel in Major Markets, 1996



Source: EFID, Banca Fideuram, Investment Company Institute, Securities Industry Association.

3.1. Mutual Fund Distribution

There are also wide differences among countries in how mutual funds are distributed, which in turn are linked to comparative mutual fund growth and structure. As shown in the precedent graphic, European mutual fund distribution through bank branches dominates in countries such as Germany (80%), France (70%), and Spain (61%), with U.K. distribution concentrated among independent advisers and Italian distribution roughly split between bank branches and independent sales forces. The dominance of universal banks, savings banks and cooperative banks as financial intermediaries in most of the continental European countries explains the high concentration of mutual fund distribution via branch networks. One major exception to bank-based fund distribution was Robeco, a Dutch asset management company, which was highly successful in penetrating the retail market, only to be taken over by Rabobank after a brief joint venture to market each other's products.

In contrast, U.S. mutual fund distribution has been concentrated on full-service broker-dealers which maintain large retail sales forces capable of penetrating the household sector and which are compensated mainly on the basis of commissions earned and assets under management (AUM). In recent years, discount brokers have made substantial inroads in mutual fund distribution, compensating for reduced sales effort and limited investment advice by lower fees and expenses. Insurance agents account for 15% of U.S. mutual fund distribution, focusing on mutual funds with an insurance wrapper such as fixed and variable annuities and guaranteed investment contracts (GICs). Bank branches have played a limited role in the U.S. due to the legacy of regulatory constraints accounting for the relatively small 13% distribution share through bank branches although deregulation and cross-selling opportunities with retail commercial banking products is likely to boost the share of bankbased mutual fund sales in the future.

A key question is how mutual funds will be distributed in the future European unified financial market. Distribution without advice will clearly be most efficient over the Internet or other on-line interfaces with the retail client. This means that transactions services can be separated from investment advice, both functionally and in terms of pricing. Advice can be delivered only in part in disembodied form, with value-added depending partly on interpretive information on investments and partly on personal counselling that the client must be willing to pay for. With this advice increasingly likely to come from independent financial planners in many markets, traditional distributors of mutual funds are encroached-upon from both sides and have had to react in order to maintain market share.

It is also probable that the major American mutual fund companies like Fidelity and Vanguard will try to penetrate the European bank-based distribution channels that have traditionally prevailed in most countries, along with U.S. broker dealers like Merrill Lynch (having acquired the U.K.'s dominant Mercury Asset Management in 1997) and Morgan Stanley Dean Witter Discover, discounters such as Charles Schwab, as well as Citicorp as the only U.S. bank with a European presence of sufficient mass to use as a platform for mutual fund distribution. U.K. fund managers

and insurance companies will try to do the same thing on the continent, even as continental European banks and insurance companies strive to adapt their powerful distribution systems to more effective asset management and mutual-fund marketing, and to sharpen-up their product range and investment performance.

3.2. Mutual Fund Competition

Competition among mutual funds can be among the most intense anywhere in the financial system, heightened by the aforementioned analytical services which track performance of funds in terms of risk, return over different holding periods, and assign ratings based on fund performance. These fund-rating services are important, because the vast majority of new investments tend to flow into highly rated funds. For example, in the United States during the period 1993-96, about 85% of all new money was allocated to funds rated 4- or 5-star by Morningstar, Inc. These same highly rated funds captured roughly three-quarters of all mutual fund assets at the end of 1996. In addition, widely read business publications publish regular "scoreboards" among publicly available mutual funds based on such ratings and, together with specialized investment publications and information distributed over the Internet; have made mutual funds one of the most transparent parts of the retail financial services sector. These developments are mirrored to varying degrees in Europe as well, notably in the United Kingdom.

Despite clear warnings that past performance is no assurance of future results, a rise in the performance rankings often brings in a flood of new investments and management-company's revenues, with the individual asset manager compensated commensurately and sometimes moving on to manage larger and more prestigious funds. Conversely, serious performance slippage causes investors to withdraw funds, taking with them a good part of the manager’s bonus and maybe his or her job, given that the mutual fund company's revenues are vitally dependent on new investments and total assets under management. A gradual decline in the average sophistication of the investor in many markets CAS mutual funds become increasingly mass-market retail-oriented and interlinked with pension schemes (see below) performance

ratings, name-recognition and branding appear to be progressively more important in defining competitive performance in the industry.

Historically, at least in the United States, there has been little evidence of increasing market- concentration in the mutual fund industry. There are 25,000 entities that run funds and/or give investment advice, of which some 6,000 have assets under management in excess of $25 million. The five-firm ratio has been between 32% and 34%, the top-5% ratio between 65% and 68%, and the top-10% ratio between 81% and 82% from 1990 to 1996.

Factors that seem to argue for greater industry concentration in the future are economies of scale and band-name concentration among progressively less sophisticated investors in taxable funds and mutual funds that are part of retirement accounts battling for attention among the enormous number of funds vying for their business. Arguments against further concentration include shifts in performance track records and the role of mutual fund supermarkets in distribution, which increase the relative marketing advantage of smaller funds. One factor that may promote continued fragmentation of the mutual fund industry is that size itself can lead to significant performance problems.

In addition to promoting their performance, when favourable, mutual fund companies and securities broker-dealers have aggressively added banking-type services such as checking and cash-management accounts, credit cards and overdraft lines. They provide user-friendly, integrated account statements and tax reporting. Client contact is based on easy access by telephone, mail and the Internet. In the United States, commercial bank competitors in the mutual fund business have thus seen their retail competitive advantage increasingly reliant on a fragile combination of high-cost branch networks and deposit insurance. Securities firms have likewise increased their mutual fund activity, presumably with the view that this part of the securities industry is more capable of supporting significant, sustained returns than is wholesale investment banking, such as debt and equity capital markets and corporate advisory services, where competition has become cutthroat, capital-

intensive, and subject to a high degree of earnings instability. Insurance companies have also considered the mutual fund business to be a strong candidate for strategic development, especially in the face of competition in their traditional annuities business and the cross-links that have emerged in some countries between the pension fund and mutual fund industries.

There have also been successful examples of direct fund distribution even in heavily bank-dominated European financial systems, such as Direct Anlage in Germany and Virgin Direct in the United Kingdom. Cortal Banque (affiliated with Banque Paribas) in France had a client-base of 150,000 and assets under management of $3 billion in 1995, built entirely through telephone sales and other direct media.

Examples of effective cross-border mutual fund distribution include Fidelity Investments of the United States and Fleming Flagship of the United Kingdom. Such cross-border incursions into idiosyncratic national markets requires high levels of product performance, excellence in service quality, and effective distribution techniques that are appropriate to the nation environment either on a stand-alone basis or in joint ventures with local financial firms. This suggests that highly targeted approaches which provide specific client segments with products superior to those available from traditional vendors is probably the only viable way to develop a pan-European approach to retail asset management.

Competition in the mutual funds business thus covers a rich array of players, ranging from commercial banks and securities broker-dealers to specialized mutual fund companies, discount brokerages, insurance companies and no financial firm. Such interpenetration of strategic groups, each approaching the business from a different direction, tends to make markets hyper-competitive. This is the likely future competitive structure of the mutual fund industry; particularly in large, integrated markets such as the United States and (with currency unification) the European Union.

3.3. Regulation frames within different E.U. Countries

In the United States, mutual fund regulations require strict fit-and-proper criteria for management companies of mutual funds sold to the public, as well as extensive disclosure of pertinent information. The National Securities Markets Improvement Act of 1996 makes the Securities and Exchange Commission responsible for overseeing investment advisers with over $25 million under management, with state regulators alone responsible for investment advisers with smaller amounts under management advisers who had previously been co-regulated together with the SEC. The large investment advisers falling under SEC jurisdiction account for about 95% of U.S. assets under management, although the vast majority of abusive practices and enforcement problems occur among the smaller firms.

Threat of regulatory action and civil liability lawsuits keep the pressure on U.S. mutual fund boards to take their obligations to investors seriously to insure that the fund objectives are faithfully carried out. Some fund management companies, however, nominate individuals to serve as directors of numerous (sometimes a very large number) of funds from among those managed by the firm, perhaps raising questions whether such directors can fulfil all of their responsibilities to their investors. Still, if they are thought not to be doing so, they can expect to be the object of suits brought by lawyers representing the investors as a class. All of this information is in the public domain, accompanied by the aforementioned high degree of transparency with respect to fund performance plus ample media coverage and vigorous competition among funds and fund managers. This means that investors today face a generally fair and efficient market in which to make their asset choices. If they fail to choose wisely, that's their own fault. Overall, the mutual fund business, at least in the more developed markets, is probably a good example of how regulation and competition can come together to serve the retail investor about as well as is possible.

In contrast to the United States, the rules governing the operation and distribution of mutual funds in the EU have traditionally been highly fragmented fragmentation that will gradually end in the years ahead. As of the mid-1980s, definitions of mutual

funds varied from country to country, as did legal status and regulatory provisions. Door-to-door selling was forbidden in Belgium and Luxemburg, for example, and strictly regulated in Germany. In Britain, on the other hand, direct marketing was the norm. Market access to clients varied between the extremes of high levels of impenetrability to virtually complete openness.

The EU directive governing the operation and sale of mutual funds Undertakings for the Collective Investment of Transferable Securities (UCITS) came into force on October 1, 1989 after 15 years of negotiation. It specifies general rules for the kinds of investments that are appropriate for mutual funds, and how they should be sold. The regulatory requirements for fund management and certification are left to the home country of the fund management firm, while specific rules governing the adequacy of disclosure and selling practices are left to the respective host countries.

Consequently, mutual funds duly established and monitored in any EU member country such as Luxembourg (and that are in compliance with UCITS) can be sold without restriction to investors in national financial markets EU-wide, and promoted and advertised through local marketing networks and via direct mail, as long as selling requirements applicable in each country are met. Permissible investment vehicles include conventional equity and fixed-income securities, as well as high-performance "synthetic" funds based on futures and options not previously permitted in some financial centres such as London. Under UCITS, 90% of mutual fund assets must be invested in publicly traded companies, no more than 5% of the outstanding stock of any company may be owned by a fund, and there are limits on investment funds' borrowing rights. Real estate funds, commodity funds, and money market funds are specifically excluded from UCITS.

3.4. European Taxation and the Mutual Fund Industry

Unlike the EU, U.S. mutual funds have operated in a comparatively coherent tax environment. There is a uniform federal income tax code, which requires mutual fund companies to report all income and capital gains to the Internal Revenue Service

(IRS) (normally there is no withholding at source) and requires individuals to self-report the same information in annual tax returns, with data reconciliation undertaken by the IRS. Taxable fund income is subject to regular federal income tax rates, while capital gains and losses are recorded as they are incurred in mutual fund trading and net gains attributed to the mutual fund investor and taxed at the federal capital-gains rates. Tax fraud, including the use of offshore accounts to evade tax, is a criminal offence. States and sometimes municipalities likewise tend to tax mutual fund income and capital gains (and sometimes assets) at substantially lower rates. Under the U.S. Constitution, the states and the federal government cannot tax each other. So there is a broad range of mutual funds that invest in securities issued by state and local governments with income exempt from federal tax as well as (usually) tax on the income from the state's own securities contained in the portfolio. Similarly, the states do not tax income derived from federal government securities. The U.S. tax environment, while complex, provides the mutual fund industry with opportunities for product development such as tax-efficient funds (e.g., investing in municipals and capital-gains-oriented equities) and imposes compliance costs in terms of the required tax reporting both to the IRS and to the investor client.

The European tax environment is far more heterogeneous by comparison, with the power of tax authorities stopping at the national border and (in the presence in many EU countries of very high tax rates on capital income) widespread tax avoidance and evasion on the part of investors. In the light of intra-EU capital mobility, the move toward a single currency and the UCITS initiative, narrowing or eliminating intra-EU differentials in taxation of capital income and assets and the establishment of a coherent tax environment that is considered equitable and resistant to evasion has been of growing interest.

In 1988, Germany announced consideration of a 10% withholding tax on interest and dividend income in what became an embarrassing demonstration that such taxes can provoke immediate and massive capital flight. Overall, Bundesbank estimates showed a total long-term capital outflow of $ 42.8 billion during 1988, even though the 10% withholding tax was only being discussed and had not yet been

implemented. An estimated $10.7 billion of German investment funds flowed into the Luxembourg bond market alone following the announcement that the tax was to be effective January 1, 1989. Investor reactions to the German tax bid-up the price of Euro-DM issues and depressed yields to the point where in early 1989 it was cheaper for PepsiCo to borrow DM in Luxembourg than it was for the German federal government to do so in the domestic Bund market. Four months later, on 27 April, the German authorities announced that the withholding tax would be abolished on 1 July 1989.

In February 1989, midway through the German tax debacle, the European Commission formally proposed a minimum 15% withholding tax (administered at source) on interest income of investments (bonds and bank deposits) by residents of other EU countries, as well as on Eurobonds. Non-EU residents were to be exempt from the withholding tax, as were savings accounts of young people and small savers who were already exempt from taxation in a number of EU countries. Member states were to be free to impose withholding taxes above the 15% floor. Governments could exempt interest income subject to withholding at source from declaration for tax purposes. Also exempted were countries that already applied equal or higher withholding taxes on interest income. Additional aspects of the proposal concerned cooperation in enforcement and exchange of information among EU fiscal authorities. Dividends were omitted from the proposals because they were generally less heavily taxed by EU member countries, and because national income tax systems were thought to capture this type of investment income relatively effectively.

Supporters of abolishing capital-income tax differences within the EU argued that tax harmonization was essential if financial market integration was not to lead to widespread tax evasion. France, together with Belgium, Italy, and Spain, led the effort. All four countries also argued that the absence of tax harmonization would weaken their currencies in relation to those of other EU members. All four had tax collection systems considered relatively weak in terms of enforcement and widely subject to evasion.

Opponents to the EU tax harmonization initiative, mainly the United Kingdom and Luxembourg as well as the Netherlands, argued that tax harmonization was both unnecessary and harmful to the functioning of efficient financial markets, and that substantial investments would subsequently flow outside the EU, especially to Switzerland and other non-resident tax havens. They argued that the proposal failed to recognize that Europe is part of a global financial market and those EU securities returns might have to be raised to levels providing equivalent after-tax yields in order to prevent capital outflows from becoming a serious problem. The United Kingdom was also concerned about the special role of the Isle of Man and the Channel Islands (which are fiscally "semi-detached" from the EU) and their treatment in any EU withholding tax initiative.

After two years of intense debate on the issue, the 15% EU withholding tax proposal finally collapsed in mid-1989 as Germany withdrew its support of the Commission's initiative and shifted to the opposition. The idea of harmonizing EU taxes was quietly shelved, with the Finance Ministers agreeing to seek alternative ways of cooperation and more effective measures against money laundering. Nevertheless, there remained little doubt that greater uniformity in capital income taxation and closer cooperation between EU tax authorities would eventually have to be revived although harmonization of withholding tax rates and enforcement remained constrained by the possibility of capital flight to low-tax environments outside the EU. At the very least, it was difficult to see how an active EU-wide mutual fund industry could develop under UCITS without a reasonably coherent trade environment.

Meantime, Luxemburg has remained the centre of EU tax attention. Funds registered in the country are exempt from local taxation. Investors pay no withholding tax on dividends, and a 1983 law recognized French-type Societies d'Investissements à Capital Variable (SICAVs). In March 1988, Luxemburg became the first EU member state to ratify the UCITS in a successful bid to become the functional centre for marketing mutual funds throughout the EU. By this time, Luxemburg had already attracted 132 foreign banks (of which 37 were German and 16 were Scandinavian, as well as 506 mutual funds, up from 76 registered in 198011) and had licensed 245

new funds by October 198912. The Luxemburg prime minister at the time (and now President of the EU Commission), Jacques Santer, pointed out that open competition in Europe's financial space would determine which financial centre won out. But that there were no provisions, he suggested, in EU law for cooperation between tax authorities. Evasion and/or avoidance of its EU partners' taxes was thus implicitly conceded as Luxembourg's principal source of competitive advantage in the European asset management industry.

The months leading up to the prospect of uniformity in mutual funds management and distribution via UCITS had already led to moves in a number of high-tax member countries to liberalize constraints imposed on domestic mutual fund asset-allocation and re-examine levels capital-income taxation. For example, mutual funds in France were no longer obliged to hold 30% of their assets in Treasury bonds, and were permitted to focus exclusively on equities. Indeed, the 1989 French budget encouraged funds to convert into capital-appreciation vehicles which did not distribute interest as current income. Instead, accrued interest was paid in the form of capital gains subject to a 17% rather than a 27% tax, which reduced the incentive to shift assets to Luxemburg.

In the 1990s Germany, by now hard-pressed by the cost of reunification, once again went after interest income with a 30% withholding tax at source, triggering an estimated $215 billion capital outflow, mostly once again to Luxembourg. Helping their clients to flee taxation became good business for the German banks' Luxembourg affiliates' deposit and fiduciary accounts. This time, however, the German tax authorities reacted much more aggressively, investigating a number of banks and prominent individuals for aiding and abetting or engaging in tax evasion. Unlike its past position, German authorities in the 1990s have repeatedly called for intra-EU tax harmonization the eliminate the suction of the massive fiscal hole in the middle of the EU in the memorable words of former EU President Jaques Delors, "We will deal with Luxembourg when the time comes". There seems little doubt that, in the end, he will be right. A financially integrated Europe can no more afford a

haven for tax evaders that the U.S. federal government could afford permitting one of the states declaring itself a domestic version of Luxembourg.

4. Asset Management for Private Clients

One of the largest pools of institutionally managed assets in the world is associated with high net-worth individuals and families, generally grouped under the heading of "private banking." Total funds under management have been variously estimated at up to $10 trillion (significantly exceeding the size of the global pension asset-pool) although the confidentiality aspect of private banking makes such estimates little more than educated guesses. The following pie graphics provide a rough estimate of sources and destinations of private wealth held outside the home country of the investor.

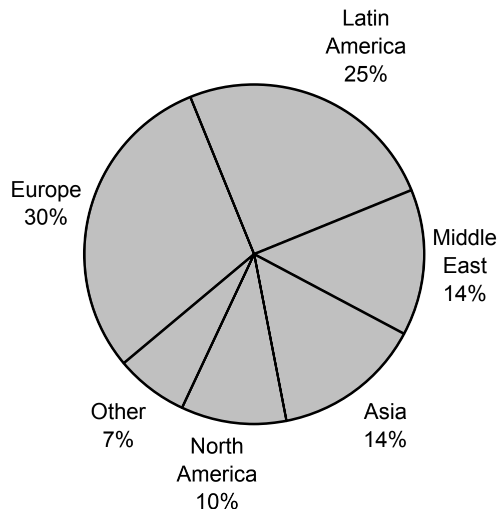
4.1. Private-Client Asset-Allocation Objectives

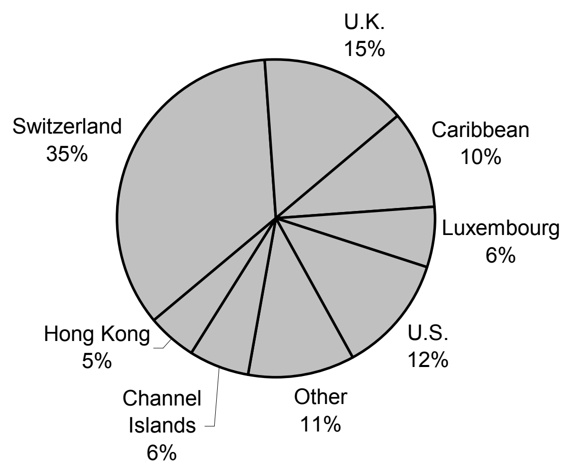
Private clients' asset management objectives are an amalgam of preferences across a number of variables among which liquidity, yield, security, tax-efficiency, confidentiality, and service-level are paramount. Each of these plays a distinctive role.

Yield. The traditional European private banking client was concerned with wealth preservation in the face of antagonistic government policies and fickle asset markets. Clients demanded the utmost in discretion from their private bankers, with whom they maintained lifelong relationships initiated by personal recommendations.

Exhibit 10

Global High-Net-Worth Assets, by Source Region	**Estimated Destination of Offshore Private Banking**
1996 total: $5,500 billion	Total onshore: $7.5 trillion Total offshore: $2.1 trillion





Source: The Chas e Manhattan Private Bank, 1996; Gemini Consulting, 1997

Such high net-worth clients have to some degree given way to more active and sophisticated customers. Aware of opportunity costs and often exposed to high marginal tax rates, they consider net after-tax yield to be far more relevant than the security and focus on capital-preservation traditionally sought by high net-worth clients. They may prefer gains to accrue in the form of capital appreciation rather than interest or dividend income, and tend to have a much more active response to changes in total rate of return.

Security. The environment faced by high net-worth investors is arguably more stable today than it has been in the past. The probability of revolution, war, and expropriation has declined over the years in Europe, North America, the Far East, and Latin America. Nevertheless, a large segment of the private banking market remains highly security-conscious. Such clients are generally prepared to trade-off yield for stability, safety, and capital preservation.

Tax-efficiency. Like everyone else, high net-worth clients are highly sensitive to taxation, perhaps more so as cash-strapped politicians target A the rich@ in a constant search for fiscal revenues.
International financial markets have traditionally provided plenty of tax-avoidance and tax evasion opportunities ranging from offshore tax havens to private banking services able to sidestep even sophisticated efforts to claim the state's share.

Confidentiality. Secrecy is a major factor in private banking: secrecy required for personal reasons, for business reasons, for tax reasons and for legal or political reasons. Confidentiality, in this sense, is a "product" that is bought and sold as part of private asset management business through secrecy and blocking statutes on the part of countries and high levels of discretion on the part of financial institutions .The value of this product depends on the probability and consequences of disclosure, and is "priced" in the form of lower portfolio returns, higher fees, sub-optimum asset allocation, or reduced liquidity as compared with portfolios not driven by confidentiality motives.

Service level. While some of the tales of personal services provided for private banking clients are undoubtedly apocryphal, the "fringe benefits" offered to high net-worth clients may well influence the choice of and loyalty to a partic7ular financial institution. Such benefits may save time, reduce anxiety, increase efficiency, or make the wealth management process more convenient. Personal service is a way for personal asset managers to show their full commitment to clients accustomed to high levels of personal service in their daily lives.

The essence of private banking is to identify accurately each client's unique objectives, and to have the flexibility and expertise to satisfy these as fully as possible in a highly competitive marketplace. On the assumption that the vast majority of funds managed by private banking vendors have not been accumulated illegally, the demand for financial secrecy in Europe relates mainly to matters of taxation and transfers of funds across borders. EMU will eliminate the latter among the participating countries, something that has long been a concern of virtually all

Europeans with assets to preserve. As noted earlier, tax issues will take much longer to address, and will probably always be a major driver of the international private banking industry.

In particular, substantial private assets have traditionally made the one-way journey to Switzerland, Luxembourg, Austria, or other locations where they can be concealed from local fiscal authorities while being prudently managed by trustworthy and reliable bankers or investment managers. This is likely to change. We have already noted that the tax-haven status of Austria and Luxembourg will sooner or later be eliminated under fiscal pressure from partner countries, and EU states will eventually to come together on rules regarding personal taxation and disclosure of tax information. Should this happen, the ability to conceal private wealth from tax collectors will diminish within the EU, and with it the "value" of secrecy as one of the services offered by EU investment managers. Only Switzerland will remain as a European haven for tax evaders (as distinct from those committing tax fraud as defined under Swiss law).

Competition among European and other private banking firms is likely to continue to intensify, and will have to contend as well with a serious effort on the part of American and other non-European asset managers to offer global real-time asset management services to European private banking clients. Others will be offering very sophisticated products, perhaps at lower cost than the European private banks have charged in the past. Some will be offering innovative mutual funds or shares in limited partnerships or other specialized investments. Certainly there will be a profusion of both services and those offering them. And the field of competitive struggle will be in marketing just as much as it is in product development and investment performance. Such competition is bound to lower fees and commissions for private-client asset management, and the inherent strength of the European banks' control over their high net worth clients will be tested.

5. The U.K. Investment Management Industry

5.1. Overview

The UK is Europe's largest investment management centre and investment management is recognized as one of the UK's success stories. Its leading position in Europe cannot be taken for granted, and a less favorable regulatory environment could easily drive the business elsewhere. The investment management industry is a global one. Just over half of the firms replying to the survey, or their associates, have investment management operations in other countries besides the UK; these firms account for two-thirds of the assets managed by FMA members in the UK. The funds managed globally by our members and their international associates are £7,000 billion, of which £2,100 billion is managed in the UK.

Non-UK ownership is extensive, such firms accounting for 40 per cent of the assets managed by FMA members in the UK and for over half their staff. Furthermore, 80 per cent of total assets managed by FMA members in the UK are managed by firms that are a part of a banking or insurance group; "independent" fund management firms or groups, all either UK or US owned, account for 14 per cent of the assets managed in the UK and 17 per cent of assets managed globally. The market is thus highly competitive and accessible to overseas ownership and to groups whose main business is not investment management.

The investment management industry has considerable influence on other sectors in the economy. It is a major client of the London Stock Exchange and of the brokers, and the needs of fund managers and their clients effectively drive the development of the securities markets.

It is an important customer of the banks for custody, payments and foreign exchange services. It also stimulates employment in the many service companies that supply it. Fund managers' asset allocation decisions have a major effect on the flow of funds to industry and on the balance of payments and the exchange rate.

Despite the large sums that it manages on behalf of clients and its role as a customer of other parts of the financial services sector, the investment management industry is small in terms of direct employment. The 69 firms replying to the survey employ just over 22,000 staff in the UK, of whom 11,400 are engaged in the management, administration or selling of investments. The largest number of staff employed by any firm is 1,360. The relatively small number of staff employed means that, if the regulatory environment became unfavourable, the business could easily be transferred to other centres. In a highly competitive and global business, decisions on location will inevitably be based on commercial considerations. The continuation of a firm but fair regulatory environment is essential.

The difference between the mean and the median reflects the weight of the larger firms in the distribution of assets under management, with the largest five firms accounting for 27.3 per cent of assets under management and the largest ten accounting for 47.0 per cent.

Assets under management - UK firm and International Group

(end-June 2000)

	No of firms	**Assets managed by UK firm**		**Asset managed World-wide**	
		(£ bn)	**(%)**	**(£ bn)**	**(%)**
International groups. of which:	36.0	1,338.0	(66.2)	6,273.2	(90.2)
UK-owned	*8.0*	*572.2*	*(28.3)*	*1,230.1*	*(17.7)*
Foreign-owned	*28.0*	*765.8*	*(37.9)*	*5,043.1*	*(72.5)*
Groups/firms managing assets only in the UK, of which:	33.0	681.9	(33.8)	681.9	(9.8)
UK-owned	*27*	*583.5*	*(28.9)*	*583.5*	*(8.4)*
Foreign-owned	*4*	*80.8*	*(4.0)*	*80.8*	*(1.2)*
Joint UK/foreign ownership	*2*	*17.6*	*(0.9)*	*17.6*	*(0.3)*
Total	**69**	**2,019.9**	**(100.0)**	**6,955.1**	**(100.0)**

5.2. Sources of Funds and Asset Allocation

Members were asked for a figure for funds sourced from the UK and for funds invested in the UK by the group of which they were a part or, where they were not part of an international group, by the UK firm alone. The results, based on replies from 64 firms, are summarised in the upcoming table. It should be noted that the figure for funds sourced from the UK does necessarily refer to the domicile of the ultimate owner of the assets but could refer to that of an intermediate owner, for example an insurance fund or unit trust.

Sources and uses of funds -international group
(end-June 2000)

	billion	%
Assets under management,	5,623.9	100.0
of which:		
Funds sourced from the UK	1,667.7	29.7
Funds invested in UK assets	1,262.5	22.4

Note: based on returns from 64 firms.

5.3. Institutional Ownership

Most of the UK Mutual Funds' are part of a wider financial services group. The following table shows that firms that are part of banking and insurance groups accounted for over 80 per cent both of assets managed by the UK firm and of assets managed globally. Firms or groups dedicated entirely to investment management, all of which are either UK or US owned, accounted for just 14 per cent of the assets managed in the UK and 17 per cent of assets managed globally. Only one of the ten largest UK investment management firms (on the basis of assets managed by the UK firm) is part of a dedicated investment management group: five are part of an insurance group and four are part of a banking group.

Institutional Ownership (end-June 2000)					
	No of firms	**Assets Managed by UK firm**		**Assets Managed by International Group**	
	No	**£ bn**	**%**	**£ bn**	**%**
Insurance group	18	838.5	(41.5)	1962.1	(28.2)
Banking group	25	808.7	(40.0)	3737.5	(53.7)
Fund management group	14	278	(13.8)	1156.9	(16.6)
OPS firm (pension fund)	12	94.6	(4.7)	98.6	(1.4)
Total	**69**	**2,019.9**	**(100.0)**	**6,955.1**	**(100.0)**

5.4. U.K. Staff Numbers

Such as the next table shows, the investment management industry is relatively small in terms of staff directly employed, although it plays an important role in stimulating employment in other service sectors that supply it.

UK staff numbers (end-June 2000)	**Total**	**Investment staff**	**Investment managers**	**Investment admin**	**Sales**	***Other***
Total	22,236	11,384	3,715	5,604	2,290	8,629
Highest	1,360	722	225	538	221	1,160
Average (mean)	322	167	54	82	34	127
Average (median)	220	136	45	48	15	41
Lowest	2	2	2	0	0	0

Note: figures for the total and for investment managers are based on returns from 69 firms: figures for the other headings are based on returns from 68 firms.

Respondents employed 22,200 staff in the UK, of whom over half were employed in the management, administration or selling of investments. They employed a total of 3,715 investment managers. The highest number of UK staff employed by any firm was 1,360 and the lowest was two. Mean employment was 322 and the median 220. The number of investment managers employed ranged from 2 to 225, with a mean of 54 and a median of 45.

6. Summary and Conclusions

The focus of this paper has been the structure, conduct and performance of the asset management industry, with special reference its evolution in the context of European financial integration and creation of an economic zone covered by a common currency. The industry was positioned in a domestic and global flow-of-funds framework as "collective investment vehicles," with emphasis on its three principal components (mutual funds, pension funds and assets under management for high net-worth individuals) and their interlinkages. There are six principal conclusions that I can draw:

First, the asset management industry is likely to grow substantially in the years ahead. Institutionalization and professional management of household discretionary assets through mutual funds has probably run its course for the time being in terms of market share some countries like the United States and the United Kingdom, but has barely begun in many of the continental European countries that have traditionally been dominated by bank assets. Demographic and structural problems in national pension systems will require strong growth in dedicated financial asset pools as pay-as-you-go systems become increasingly unsupportable fiscally, and alternative means of addressing the problem show themselves to be politically difficult or impossible to implement. There are, however, substantial differences of view as to the timing of these developments within national environments, since pension reform is politically difficult to carry out and the political willingness to do so is difficult to predict. In both mutual funds and pension funds, and their linkage through participant-influenced defined contribution pension schemes, the center of global growth is likely to be Western Europe.

Proliferation of asset management products, which is already exceedingly high in the United States and the United Kingdom, will no doubt be no less impressive in the remainder of the EU as financial markets become more fully integrated, especially under a common currency. There will be a great deal of jockeying for position and

higher levels of concentration, especially in the fast-growing pension fund sector, that will begin to permeate the mutual fund business through defined contribution plans, given the importance of economies of scale and the role of pension fund consultants. However, as in the United States the role of fund supermarkets, low-cost distribution via the Internet, as well as the very large contingent of universal banks, insurance companies and non-European fund management companies is likely to prevent market structure from becoming monopolistic to any significant degree. Fund performance will become a commodity, with few differences among the major players and the majority of actively managed funds underperforming the indexes. This implies a competitive playing field that, as in the United States, will be heavily conditioned by branding, advertising and distribution channels, which in turn are likely to move gradually away from the traditional dominance of banks in some of the EU markets. All of this implies that asset management fees (historically quite high, particularly in continental Europe) will come under pressure as competition heats-up, to the benefit of the individual investors and participants in funded pension plans.

Second, despite the prospects for rapid growth, the asset management industry is likely to be highly competitive. In addition to normal commercial rivalry among established players in the European national markets for asset management services, these same markets are being aggressively targeted by foreign suppliers from other EU countries as well from outside the EU, notably Switzerland and the United States. Moreover, virtually every strategic group in the financial services sector commercial and universal banks, private, is marking asset management (including private banking) for expansion banks, securities firms, insurance companies, mutual fund companies, financial conglomerates, and financial advisers of various types.

Normally, the addition of new vendors in a given market would be expected to reduce market concentration, increase the degree of competition, and lead to an erosion of margins and trigger a more rapid pace of financial innovation. If the new vendors are from the same basic strategic groups as existing players, the expected outcome would be along conventional lines of intensified intra-industry competition. But if, as

in this case, expansion-minded players come from very different strategic groups, the outcome may involve a substantially greater increase in the degree of competition. This is because of potential diversification benefits, possibilities for cross-subsidization and staying-power, and incremental horizontal or vertical integration gains that the player from "foreign" strategic groups may be able to capture. And natural barriers to entry in the asset management industry, which include the need for capital investment in infrastructure (especially in distribution and back-office functions), human resources (especially in portfolio management), technology, and the realization of economies of scale and scope, are not excessively difficult for newcomers to surmount. So the degree of internal, external and inter-sectoral competition in this industry is likely to promote market efficiency for the benefit of the end-users in managing discretionary household asserts, pension funds, the wealth of high net-worth individuals, and other types of asset pools in Europe.

Third, the rapid evolution of the European institutional asset management industry will have a major impact on financial markets. The needs of highly performance-oriented institutional investors will accelerate the triage among competing debt and equity markets in favor of those that can best meet their evolving requirements for liquidity, execution efficiency, transparency, and efficient regulation.
In turn, this will influence where firms and public entities choose to issue and trade securities in their search for cost-effective financing and execution. At the same time, the growing presence of institutional investors in European capital markets will greatly increase the degree of liquidity due to their active trading patterns, and create a ready market for new classes of public-sector securities that will emerge under EMU. And it will intensify competitive pressure and enhance opportunities for the sales and trading activities of banks and securities firms, and for the role of product development and research in providing useful investment ideas.

Fourth, cross-border asset allocation will grow disproportionately as a product of institutional investors' search for efficient portfolios through international diversification, although such gains will disappear among those financial markets covered by EMU. However, IPD is inherently a global process, so that the gains will

depend on intermarket correlations of interest rates, exchange rates, equity-markets and other asset classes worldwide. With the EMU zone as essentially one "bucket" with respect to currencies and interest rates, IPD options will shift to other asset classes, including emerging market debt and equities. Arguably, much of this has already occurred as intra-EMS rates have converged in anticipation of EMU. This development will tend to promote the market share of passive funds, and increase the need for portfolio management skills applied to diversification outside the EMU region.

Fifth, the development of a deeper and broader pan-European capital market spurred by the development of the institutional asset management industry will fundamentally alter the European market for corporate control, into a much more fluid one focused on financial performance and shareholder value. This in turn has the potential of triggering widespread and long-overdue European economic restructuring and creating a much trimmer, more competitive global economic force willing and able to disengage from uncompetitive sectors through the denial of capital promoting leading-edge industries though venture capital and other forms of start-up financing. Such a transformation will hardly be painless, and will depend critically on political will and public support for a more market-driven growth process.

Finally, developments in institutional asset management will pose strategic challenges for the management of universal banks and other traditional European financial institutions in extracting maximum competitive advantage from this high-growth sector, in structuring and motivating their organizations, and in managing the conflicts of interest and professional conduct problems that can arise in asset management and can easily cause major problems for the value of an institution's competitive franchise. The fact that institutional asset management requires a global perspective, both on the buy-side and on the sell-side, reinforces the need to achieve a correspondingly global market positioning for many financial institutions, although technology and the changing economics of distribution virtually assures the survival of a healthy cohort of asset management boutiques and specialists.

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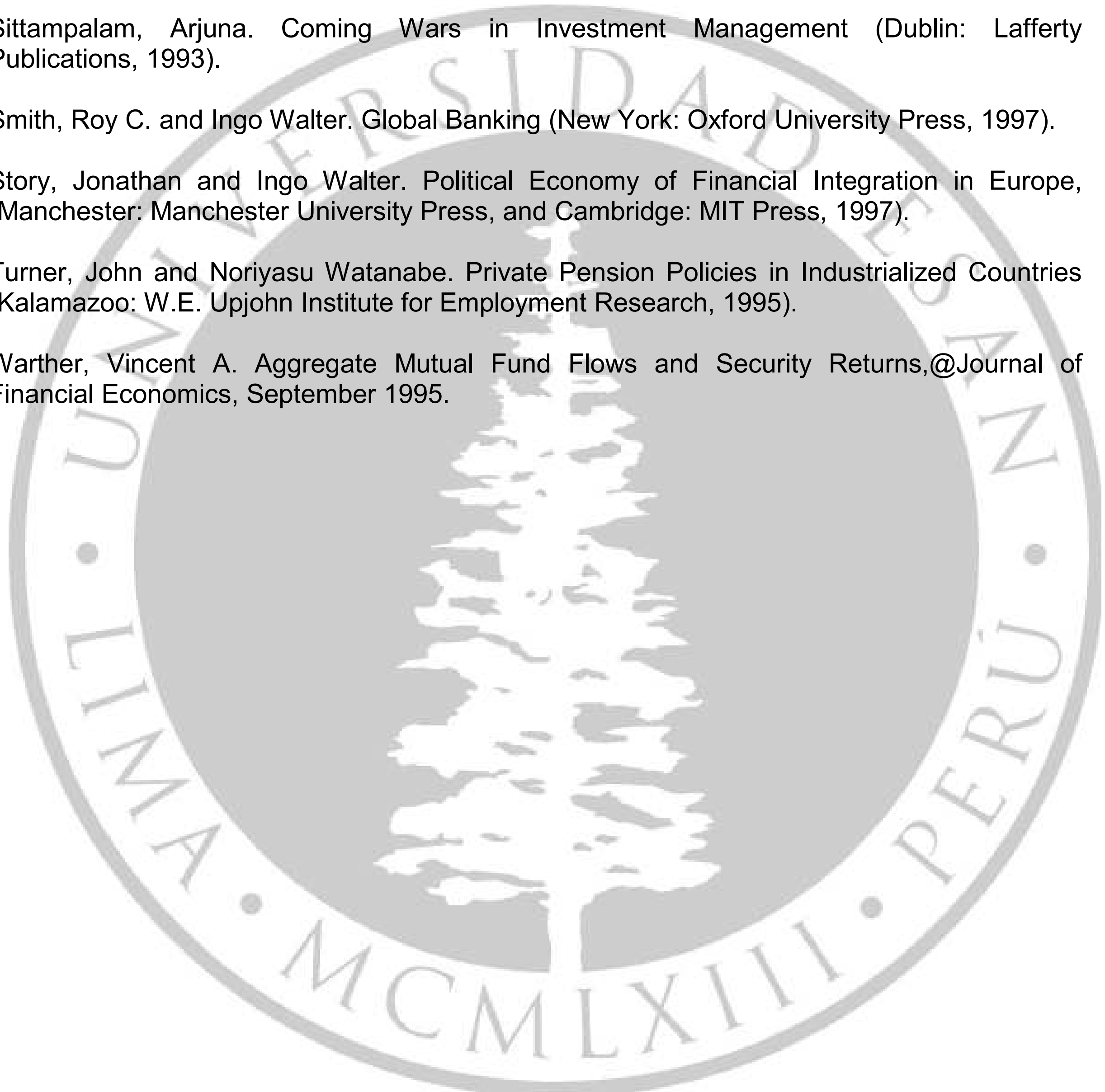

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