Asset Management in Europe: The Way Forward

A position paper written by the Investment Management Association to accompany publication of a report by Dr Friedrich Heinemann

"Towards a single European market in asset management"

20 May 2003

Executive summary

- ***A single European market for asset management would offer material economic benefits of at least €5 billion a year. A market without existing impediments to cross-border trade could produce an increase in the overall size of a pension of about 9%, or €120,000, for the average investor.***

- ***Those benefits will not be fully realised until a single market for asset management services is created, in which there are no impediments to cross-border trade.***

- ***The creation of a single market is some way off. In most countries, over 90% of investment funds are still supplied domestically: British investors buy from British providers, French from French, German from German and so on.***

- ***The persistence of local markets and the lack of cross-border trade is not because the asset management industry is unwilling to compete on a cross-border basis – on the contrary, it is straining at the leash to do so.***

- ***A range of measures taken by practitioners themselves, by national authorities and by EU institutions would help overcome barriers encountered by the industry in seeking to operate cross-border.***

- ***This position paper is intended to initiate a debate on appropriate reforms to achieve a single market in asset management. It proposes a programme of actions to be undertaken by policy makers and asset managers that would remove obstacles to cross-border trade.***

Background

The European asset management industry…

The European asset management industry is responsible for over €10 trillion of consumer savings in a variety of financial products including pension funds, life funds and investment funds (2003, CEPS). Furthermore, the European asset management industry is growing fast: between 1995 and 2000, investment fund assets grew by over €2 trillion and pension fund assets by over €1 trillion[1].

The importance of asset management is increasing as demographic demands lead to greater reliance on private pension provision.

Asset managers play a crucial role intermediating between those who demand/consume capital (notably private enterprises and government institutions) and those who supply/save capital (notably individuals), whose interest in savings is met by asset management products which provide diversified returns on equities, bonds, cash and other financial instruments.

The Financial Services Action Plan…

The European Union has undertaken an ambitious programme of policies (the Financial Services Action Plan, 'FSAP'), to create a single wholesale market for capital. Estimates suggest that if the FSAP is successful, it could increase EU-wide real GDP by €130 billion over ten years and boost employment by 0.5% (2002, London Economics).

Much of the FSAP has been focussed on those engaged in raising capital and operating markets (the 'sell side'), which was a logical first step since their activities most directly affect the cost of capital and, therefore, economic growth. However, in recent years structural change in the financial services industry has meant that asset management has increasingly been recognised as a distinct financial services sector in its own right. This has given added weight to the voice of users of financial markets (the 'buy side') who provide investment services to consumers.

The Heinemann Report…

It is for this reason that the IMA commissioned Dr Friedrich Heinemann of the Zentrum für Europäische Wirtschaftsforschung ('ZEW', a leading economic research institute based in Mannheim, Germany) to ascertain whether further reforms were required to improve the provision of efficient savings products by the asset management industry – and, if so, which and in what areas.

Specifically, Dr Heinemann was instructed:

- To identify the economic benefits of the provision of efficient savings products in a single European market; and
- To identify the barriers that are preventing those economic benefits from being realised.

[1] Although markets have fallen between 2000 and 2003, consumer savings held by the investment management industry remain of significant size.

Dr Heinemann based his research on quantitative and qualitative data obtained from, amongst other sources, asset management companies accounting for approximately 30% of total cross-border investment fund sales in Europe.

On 7 May 2003 the European Commission published its Internal Market Strategy[2] to improve the operations of the internal market by 2006 and make Europe better off. Among the priorities were improving implementation and enforcement of Internal Market law and making the free movement of services a practical reality. Commissioner Bolkestein referred to potential being wasted "it's as if we are driving a Ferrari in second gear".

This position paper seeks to contribute to that debate, to consider how the EU can move up a gear in achieving a single market in asset management, in order to satisfy the objectives of the Lisbon Council[3] and support the European Union's ambitious growth targets.

[2] Communication from the Commission: Internal Market Strategy, Priorities 2003-2006 (IP/03/645)

[3] At the Lisbon Council, the European Union set itself the objective of becoming the most competitive and dynamic knowledge based economy in the world by 2010.

The current state of asset management and the 'single' market

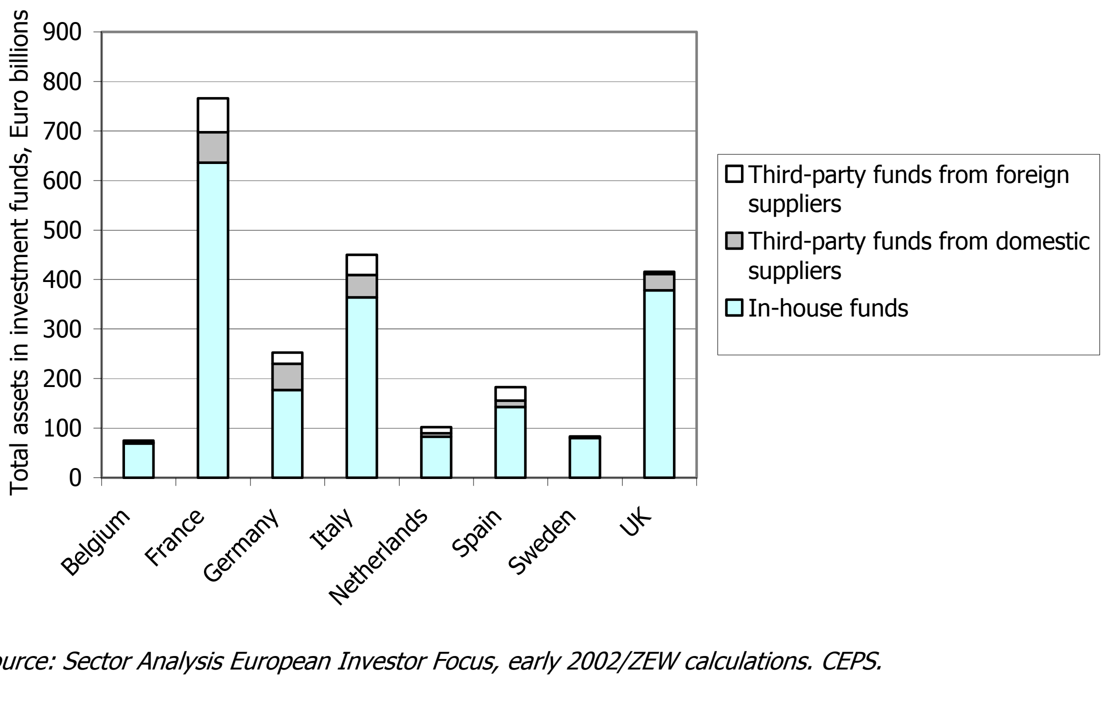
The success of the UCITS Directive…

Dr Heinemann's report establishes that there is a growing market for asset management in Europe (comprising segregated asset management services provided to institutional investors and pooled fund management services which are particularly suited to individual consumers). A significant part of that market has coalesced around the UCITS Directive[4], which enables investment funds established in one Member State to be marketed in others. UCITS are, uniquely, the only financial product defined in European legislation. The term has become synonymous (even beyond the EU) with a savings product that combines simplicity, transparency and security (through appropriate investor protection safeguards).

The lack of progress towards a single market…

However, despite the fact that the UCITS Directive was agreed 18 years ago and despite the recent growth of cross-border business (particularly out of Luxembourg and Dublin), in most countries the market for asset management services is still essentially local: British investors buy from British providers, French from French, German from German and so on (see figure 1).

Figure 1
Market share of third-party funds from foreign suppliers



Source: Sector Analysis European Investor Focus, early 2002/ZEW calculations. CEPS.

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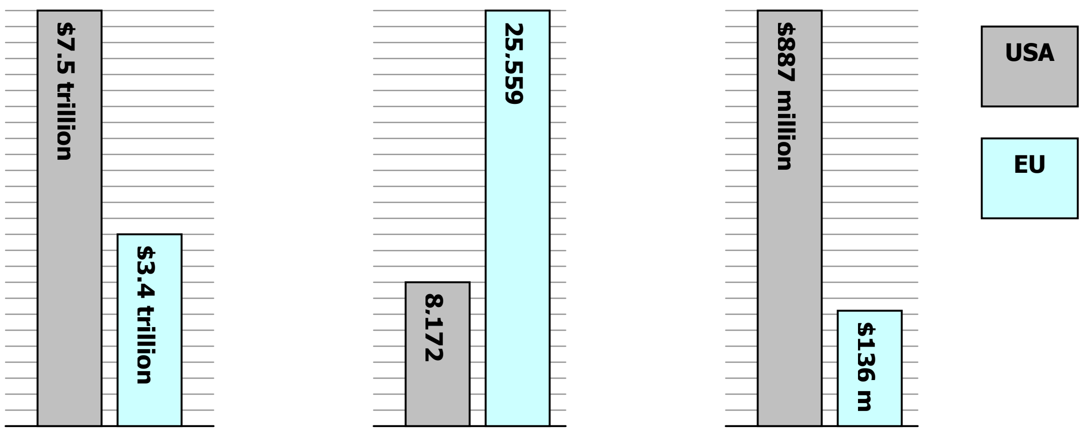
4 A Directive on Undertakings for Collective Investment in Transferable Securities 85/611/EEC ('UCITS Directive')

Consequently, the market as a whole has failed to realise the full economic benefits of a truly single market for asset management, even though it is clear (from looking at markets in which significant cross-border flows of investment funds occur) that those benefits are real and achievable. Those benefits include:

Economies of scale. Asset management is characterised by economies of scale: as assets under management grow in volume, average costs tend to fall. European asset managers are unable to enjoy significant economies of scale because small, local markets restrict the average size of investment funds (see figure 2). Dr. Heinemann estimates annual costs savings of €5 billion per annum if the European asset management industry were able to realise similar economies of scale to those enjoyed by their peers in the USA (see section A.3 of his report).

Figure 2
Average fund sizes



Size of the market
The US market is twice as big as the European…

Number of funds
…but the European market has three times as many funds as the US…

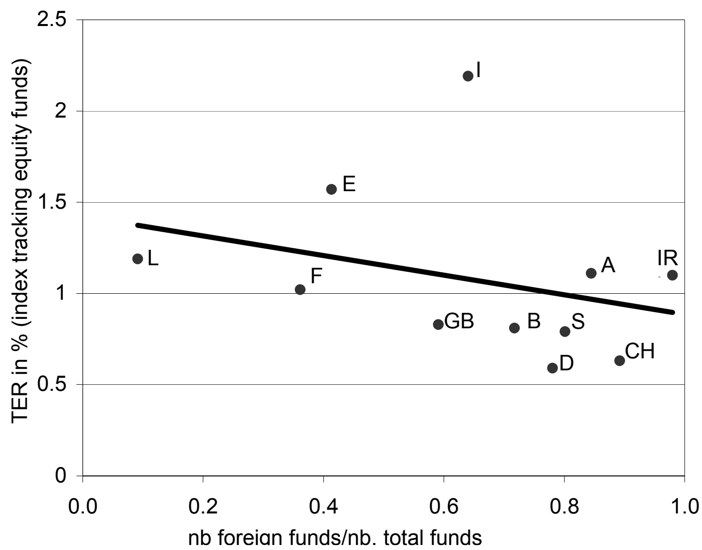
Average fund size
…therefore, the average US fund is six times larger than that in Europe

Source: FEFSI, ICI, PricewaterhouseCoopers

Specialisation. Asset management is characterised by externalities: when operating functions are physically concentrated in one or two locations, average costs tend to fall as supplementary service providers 'cluster' and compete for business in those locations. For example, concentrating the domicile of investment funds in Luxembourg and Dublin has increased competition between fund administrators and custodians. European asset managers are unable to fully realise the benefits of externalities because of the requirement to service markets locally.

Competition. Both asset managers and their customers benefit from competition in the provision of asset management services. Asset managers benefit if they are able to earn additional revenue by competing in cross-border markets. (Indeed, the premise of the entire single market project is that removing cross-border barriers to competition increases economic growth by promoting productivity). Customers of asset managers benefit if they are able to choose between competing providers, since this brings pressure to bear on price and product innovation. Dr Heinemann provides evidence of the inverse relationship between cost and competition (see figure 3). The benefits of competition in Europe are currently limited to the extent that domestic markets inhibit cross-border competition.

Figure 3
Cost relative to cross-border competition



Source: Fitzrovia (Fitzrovia, 2002) and FERI Fund Market Information. Total expense ratios ('TERs') measure the total expenses of an investment fund relative to its size.

Product development. Asset management products enable investors to diversify their investments and, thus, increase their risk adjusted returns. However, local markets tend to inhibit product development, to the detriment of consumers (who suffer limited product choice) and producers (who suffer limited export returns). If product development were to increase, then the risk adjusted returns of savings products could be better tailored to clients' differentiated needs.

Quantifying the benefits of a single market…

Various academic reports (including Dr Heinemann's) have attempted to *quantify*[5] the aggregate economic benefits (i.e. increased economies of scale, externalities, competition and risk adjusted returns) of a single market in asset management. By comparing asset management between the European Union and the USA (an imperfect but reasonable methodology) such reports broadly converge on benefits to investors in the range of 40 basis points (or 0.4%) per annum[6]. Aggregated over time (as would be relevant in the case of pension savings products), such benefits are highly material: even assuming relatively modest growth an extra 40 basis points a year could increase a final pension by about 9%. What this means is that an individual who saved 10% of his salary throughout his working life could end up with a pension of about €120,000[7] more than it would otherwise be.

Barriers to a single market…

Left to their own devices asset mangers are naturally tending towards competing within a single market which should enable them and consumers to enjoy commensurate economic benefits. However, time and again those tendencies run foul of regulatory, fiscal and structural barriers which reassert local markets over the single market. Three important examples support this observation:

> ***Pension funds***. Changing demographics in Europe are putting state pension benefits under pressure and giving impetus to the growth of private pension funds. The appetite of those private pension funds for sophisticated investment products has 'institutionalised' asset management, leading to the commoditisation of 'core' asset management services (notably passive management mandates), specialisation in 'satellite' asset management services (notably active asset management mandates) and greater competition all round. However, regulations which: limit the discretion of pension funds to appoint non-domestic asset managers (for example, the requirement that Italian pension funds appoint Italian asset managers); restrict the freedom of pension funds to invest assets appropriately to meet their liabilities (for example, the requirement that Belgian pension funds invest in Belgian government debt); or deny tax relief on contributions to non-domestic pension funds (for example, in the Netherlands and almost all other member states), have inhibited the establishment of a single market for the provision of asset management services to pension funds. The impact of the recently agreed pensions directive[8] remains to be seen, but it is only a first step in opening up the European pensions market.

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[5] Dr Heinemann and other academics and policy makers consistently report the difficulty of obtaining full and comparable data on the financial services industry with which they can measure the economic benefit of different policy decisions in different countries. One of the recommendations of this paper is that data collation be standardised and improved to address that need (see 'The way forward' below).

[6] For example, SEC Report on Mutual Fund Fees and Expenses, 2001

[7] This is based on a 25-year-old earning €45,000, contributing ten per cent per annum for forty years, with a salary growth rate of four per cent per annum, and a fund growth rate of seven per cent. Regardless of the assumptions upon which this calculation is based the difference is roughly constant in percentage terms.

[8] A Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision P5_TA(2003)0086 common position

Product development. Investors increasingly demand specialised investment products to meet their differentiated needs, spurring competition in the development of new products. However: regulatory barriers to marketing products that do not meet the narrow requirements of the UCITS directive[9] (for example, the development in France of domestic funds which go beyond the UCITS requirements and the formidable obstacles to registering offshore non-UCITS investment funds in France); fiscal discrimination against products that do not satisfy stringent local tax rules (for example, the disadvantageous tax treatment of investment in non-distributing funds in the UK); and legal hurdles to the rationalisation of redundant product structures (for example, the prohibitive hurdles to merging Luxembourg funds with non-Luxembourg successor funds) have inhibited competition in product development.

Distribution. Asset managers who seek to sell investment funds on a cross-border basis, have to rely on existing third-party distribution networks (because of the prohibitive expense of establishing distribution of their own). However: the fiscal advantage of insurance wrappers (for example, in many countries such as Spain, Germany and France); the limited expertise of financial advisors (for example, in most countries, including Germany, Italy and Spain); and the structural power of domestic providers (for example, Greece), inhibit the growth of truly competitive market in distribution.

The natural preference of asset managers and their customers favours a single market, but they are held back by regulatory, fiscal and structural constraints. There is a pressing need for appropriate policies to resolve this hiatus in the evolution towards a single market in asset management.

[9] The original 1985 UCITS Directive restricted the single market for investment funds to straightforward equity and bond products. Although the revised 2002 UCITS Directive will expand that product list (in particular to money market and fund of funds products) key growth areas remain excluded.

A vision of the future single market for asset management

In the research on which this paper is based, Dr Heinemann points out the need to draw a clear picture of *both* the current state of the single market for asset management *and* a vision of the future before an appropriate policy agenda can be developed. We would agree with this. We would characterise the vision of the single market as one that prescribes inter-related roles and freedoms for consumers, asset managers, financial advisers, regulators and policy makers:

Consumers. From the consumers' point of view, a key aspect of the vision of the single market for asset management is greater product choice[10], innovation and performance, without compromising present levels of confidence and trust. Greater consumer choice would increase competition amongst asset managers, bringing downward pressure to bear on costs and increased pressure to maintain long-term consumer relationships.

An effective policy agenda which moves current market practices towards that vision, would include:

- *Adopting common standards in classifying funds and measuring performance so that consumers can compare the performance and cost of funds wherever domiciled;*
- *Removing tax and regulatory distinctions favouring one type of savings product over another (for example, fiscal rules which favour packaging investment funds into unit linked products, or which discriminate against using investment funds to deliver pension products);*
- *Widening the sources and quality of investment advice; and*
- *Developing and maintaining high ethical standards amongst market practitioners (for example, by agreeing codes of conduct).*

Asset managers. From the asset managers' point of view, a key aspect of the vision of the single market for asset management is lower barriers to market entry, permitting producers to compete in many different countries. Lower barriers to entry will increase competition, economies of scale and externalities. Also key is the ability to reduce costs by rationalising fund ranges where this makes economic and financial sense.

An effective policy agenda which moves current market practices towards that vision, would include:

- *Allowing asset managers freely to offer the same product in each of their target markets, in particular by ending tax discrimination against non-domestic savings products;*

[10] Greater product choice is not synonymous with a greater number of funds. Economies of scale are achievable in addition, through fund mergers and closures.

- *Rationalising the administrative demands placed on providers by national regulators;*
- *Encouraging the development of common protocols and standard settlement conventions; and*
- *Removing legal, regulatory and fiscal obstacles to consolidation of funds (for example, unrealistic and discriminatory approval thresholds are a major barrier to the merger of Luxembourg funds into non-Luxembourg funds).*

Financial advisers. In most European countries, the distribution of investment products and the accompanying advice is dominated by large banking and insurance groups. In the past, the dominant trend has been for these groups to sell products manufactured by the group itself. A true single market for asset management - particularly investment funds – would be characterised by a wide range of advice sources, including those independent of producer interests. It would also be one in which the necessary quality of advice was clearly established and where no product bias existed in the advice process.

An effective policy agenda which moves current market practices towards that vision, would include:

- *Improving the standard of financial advice provided by distributors and the financial literacy of consumers; and*
- *Encouraging the trend toward 'open architecture'*[11] *by distributors.*

Regulators. From the regulators' point of view, a key aspect of the vision for the single market for asset management is appropriate consumer protection with sufficient reassurance that such protection will not be seriously compromised if an investor chooses a service or product from outside his own national jurisdiction. Appropriate consumer safeguards should instil confidence in savings products without adding *unnecessary* costs which detract from competition and innovation.

An effective policy agenda which moves current market practices towards that vision, would include:

- *Encouraging effective cross-border co-operation between regulators to ensure common implementation and enforcement of EU legislation, wherever possible (for instance, to avoid as many legislative interpretations as there are Member States – currently fifteen but soon to be increased to twenty-five);*
- *Ensuring effective communication and cooperation between consumer protection agencies in different Member States;*

[11] Open architecture is the practice of offering third-party products alongside in-house products. For example, a bank which distributes third-party investment funds (in addition to its own in-house investment funds) through its branch network, is said to be practicing open architecture.

- *Removing unnecessarily repetitive regulatory processes (such as the requirement to register UCITS in home and host states – a single registration in a member state should be recognised by all other Member States); and*
- *Facilitating solutions to streamlining administration cross-border.*

Policy makers. From the policy makers' point of view (including the European Commission, European Parliament, European Council, European Court of Justice, and national legislative bodies) a key aspect of the vision of the single market for asset management is to develop a pan-European policy process and legislative framework that is consistent, rigorous, transparent and timely.

An effective policy agenda which moves current market practices towards that vision, includes:

- *Ensuring that different pieces of legislation are consistent (unlike, for example, current legislation which prescribes different marketing rules when selling investment funds over the internet as opposed to other means);*
- *Properly distinguishing the risks of asset management from other financial services in order to ensure the appropriateness of treatment (for example, when determining capital adequacy requirements);*
- *Requiring consistent interpretation of legislation and actively pursuing infringements by Member States;*
- *Consulting with interested parties to ensure transparency and timeliness of the legislative process ; and*
- *Obtaining data which allows accurate assessment of the effect of legislative proposals and measurement of milestones and benefits en route to the single market. Such data can also be used in cost-benefit analyses when new legislative intervention is proposed.*

The way forward

The following recommendations identify changes to policy and commercial practice which would help realise the vision of single market for asset management.

The recommendations emphasise better enforcement and more consistent interpretation of existing legislation. They *do not* call for significant new legislation (although some existing legislation may require amendment).

The recommendations recognise that there is significant scope for self-regulation and co-regulation. Consequently, they place the onus for action on a variety of parties, including the asset management industry and its trade associations, CESR[12] and the Commission.

The recommendations are intended to be neither prescriptive nor complete. Contributions and refinements are invited from other interested parties.

The recommendations are consistent with the recently published Internal Market Strategy[13], setting out the Commission's objectives for the single market in the period to 2006. Those objectives include 'completing and developing the FSAP, with particular focus on creating a single market in retail financial services', which the IMA endorses. A number of specific proposals in the Internal Market Strategy are incorporated into the recommendations.

Proposal	**Action**	**Timing[14]**
Fund mergers. National fiscal and regulatory regimes should not discriminate against cross-border fund mergers. For example, if, say, a Luxembourg domiciled fund merges with a French domiciled fund, then Luxembourg should impose no greater regulatory requirements than if the merger occurred onshore. Similarly, if, say, a Swedish domiciled fund merges with a German domiciled fund, then Sweden should assess tax in the same way as if the merger occurred onshore. It may be possible to address these issues in the proposed revision of the Merger Directive, announced in the Internal Market Strategy.	Member States and Commission	06/2004

[12] The Committee of European Securities Regulators ('CESR')
[13] Communication from the Commission: Internal Market Strategies, Priorities 2003-2006 (IP/03/645) http://www.europa.eu.int/comm/internal_market/en/update/strategy/2003-strategy_en.pdf
[14] 'Timing' shows the dates at which the IMA proposes to publish a follow-up to this position paper, reporting progress that has been made to meet the recommendations.

Proposal	Action	Timing[14]
Tax discrimination. National fiscal regimes should not discriminate between domestic investment funds and offshore investment funds. Reports by PricewaterhouseCoopers[15] identify the principal discriminatory regimes that inhibit the cross-border sale of investment funds. The Commission should specify to the asset management industry any further information it requires in addition to those reports in order to begin challenging those regimes. This issue should be addressed in the proposed Communication on the effect of ECJ case law on dividend taxation systems, announced in the Internal Market Strategy. That Communication is intended to help design a non-discriminatory dividend taxation system and must take account of investment funds. In particular, that Communication should consider the effect on dividend taxation of investing through an investment fund.	Industry, Member States and Commission	12/2003
Fund registration. Once a UCITS has been registered as such in its home state, there should be no need for further registration in all of the host states in which it is marketed. It may be possible to address this issue by amending the UCITS Directive or by considering it in the context of the proposed mutual recognition Regulation announced in the Internal Market Strategy.	Member States and Commission	06/2004
Pooling. Fiscal, regulatory and commercial obstacles to cross-border 'pooling' of assets should be removed. Pooling investment funds would allow asset managers to aggregate electronically the portfolios of investment funds in different countries, thereby leveraging economies of scale and facilitating risk control. The electronic pool should not constitute a separate legal entity, and therefore would not alter the regulatory or fiscal position of the underlying investment funds *ex ante*. Pooling pension schemes would allow multi-national corporations who sponsor occupational pension schemes in different countries to aggregate the portfolios of those	Industry, Member States and Commission	06/2004

[15] PricewaterhouseCoopers/FEFSI (2001) Discriminatory Tax Barriers in the Single European Investment Funds market: A Discussion Paper
PricewaterhouseCoopers/FEFSI (2003) Discriminatory Tax Barriers Facing the EU Fund Industry: A Progress Report

Proposal	**Action**	**Timing**[14]
schemes in a special purpose fund, thereby leveraging economies of scale and facilitating risk control. The special purpose fund should be fiscally transparent, and therefore in no way alter the regulatory or fiscal position of the underlying pension schemes *ex ante*. The Commission and industry should investigate the factors that inhibit pooling, which are likely to include fiscal treatment and the inability to provide cross-border depositary services.		
Infrastructure. Infrastructure providers (particularly transfer agents) should standardise the protocols required to process the buying and selling of shares in investment funds, in order to reduce the complexity (and costliness) of cross-border business. Initially, further analysis is required to describe the various processes undertaken by different infrastructure providers, and identify opportunities to standardise those processes.	Industry	12/2003
Public data. Asset managers should standardise the calculation and publication of data on fund classification and performance, costs and financial statements, in order to increase the comparability of investment funds. The IMA supports ongoing work to standardise fund classification and performance (by a pan-European industry group) and to standardise reporting fund costs (under the guidance of FEFSI[16]). The IMA believes that an industry-led forum should provide leadership and co-ordination for this work, and act as an impetus to work in other areas (notably financial statements).	Industry	12/2003
Financial advisers. The quality of financial advice should be improved by developing an industry-wide code of conduct/professional rules. This will benefit consumers in countries where the quality of advice is currently low. It will also benefit investment fund providers by increasing awareness of their products. It is also consistent with the Internal Market Strategy. Financial advice is covered by the revised Investment Services Directive, though detailed rules should not be prescribed in European legislation. Rather, industry and trade associations should develop codes of	Trade associations and national regulators	06/2004

[16] The Fédération Européenne des Fonds et Sociétés d'Investissement ('FEFSI') is the pan-European association of investment funds and companies.

Proposal	**Action**	**Timing**[14]
conduct/professional rules in this area.		
Industry data. The volume and quality of data about the activities of the investment management industry should be increased. This will help policy makers establish milestones for the single market for asset management and monitor progress towards those milestones. It will also help asset management firms develop an effective European strategy. IMA would be willing to facilitate meetings between industry, the Commission and other interested parties to determine relevant industry data, and to act as an honest broker in the collation and publication of that data.	Industry and Commission	12/2003
The regulatory environment. The regulatory environment needs to be simplified, in particular by: co-ordinating the interpretation of Directives by national regulators; and co-ordinating the drafting of Directives by the Commission. The industry has little interest in discussing the need for a pan-European regulator or regulatory system. Its concern is in securing a regulator that understands its business. Consequently, the Lamfalussy process should be given a chance to work. CESR should focus on: establishing effective co-operation between national regulators; establishing a transparent system to ensure consistent and effective enforcement of regulation; and ensuring proportionate regulation across Europe, with elimination of costly and unnecessary duplication. The incorporation of UCITS within CESR will assist in these tasks. However, it is important that CESR also considers and represents the wider asset management industry, which goes beyond UCITS (e.g. segregated pension fund management). The Commission should focus on ensuring that Directives apply consistent regulatory demands, wherever possible (for example, the E-Commerce Directive, Distance Marketing Directive, provisions in the simplified Prospectus Directive and proposed Sales Promotions Directive via-á-vis marketing). It may be possible to address these issues through certain proposals announced in the Internal Market Strategy. For example, the proposed Recommendation on Best Practices may significantly help to reduce inconsistencies between the interpretation of Directives	Commission and CESR and Member States	06/2004

Proposal	**Action**	**Timing**[14]
by Member States upon transposition. Similarly, the proposed Preventive Dialogue may help to identify such inconsistencies at an early date.		
Industry representation. The asset management industry needs to improve and unify its representation at the highest levels in the EU, to ensure that legislation is appropriate to the asset management industry as a whole, so that the interests of the 'buy side' are fully understood. For example, this is particularly important in the context of the forthcoming Capital Adequacy Directive, which must properly distinguish asset management from other financial services sectors which bear entirely different levels of operational risk. The prospective merger between FEFSI and EAMA will help in this regard, providing a unified pan-European trade association through which asset management practitioners will be able to make their voices heard.	Trade associations	09/2003
Consumer protection. Appropriate levels of consumer protection need to be agreed and facilitated for cross-border business. It may be possible to address this issue in the proposed Regulation on co-operation between national authorities responsible for the enforcement of consumer protection laws, announced in the Internal Market Strategy. Also, awareness of FIN-NET should be promoted.	Commission and national regulators	06/2004