

The Asset Management Industry in Europe: Competitive Structure and Performance Under EMU¹

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The institutional asset-management industry is likely to be one of the largest and most dynamic parts of the global financial services sector in the years ahead. As of 1996, the global total of assets under management was estimated at close to \$30 trillion, comprising some \$8.2 trillion in pension fund assets, about \$5.3 trillion in mutual fund assets, \$6.4 trillion in fiduciary assets controlled by insurance companies, and perhaps \$7.5 trillion in offshore private client assets.² Not only will this already massive industry experience an extraordinary rate of growth in comparison with other segments of the financial services sector, but cross-border volume — both regional and global — is likely to take an increasing share of that activity. Much of the action will be centered in Europe, which remains well behind the United States in institutional asset management and where many of the global pension problems reside, even as the rapid growth of performance-oriented managed funds alter the European financial landscape under EMU — including traditional approaches to corporate control.

Within this high-growth context, asset management attracts competitors from

¹Updated version to be presented at BSA Gamma Foundation Conference on the Future of Asset Management, Lugano, Switzerland, 17 June 1999. Previous version in Jean Dermine and Pierre Hillion (Eds.) *European Capital Markets With a Single Currency* (Oxford: Oxford University Press, 1999).

² Source: Financial Times, *Global Fund Management*, April 24 1997, and Chase Manhattan Bank.

an extraordinarily broad range of strategic groups—commercial and universal banks, investment banks, trust companies, insurance companies, private banks, captive and independent pension fund managers, mutual fund companies, and various types of specialist firms. This rich array of contenders, coming at the market from several very different starting-points, competitive resources and strategic objectives, is likely to render the market for institutional asset management a highly competitive one even under conditions of large size and rapid growth.

The underlying drivers of the market for institutional asset management are well understood. They include the following:

- A continued broad-based trend toward professional management of discretionary household assets in the form of mutual funds or unit trusts and other types of collective investment vehicles, a development that has perhaps run much of its course in some national financial systems but has only begun in others.
- The growing recognition that most government-sponsored pension systems, many of which were created wholly or partially on a pay-as-you-go (PAYG) basis, have become fundamentally untenable under demographic projections that appear virtually certain to materialize, and must be progressively replaced by asset pools that will throw-off the kinds of returns necessary to meet the needs of growing numbers of longer-living retirees.
- Partial displacement of traditional defined-benefit public- and private-sector pension programs backed by assets contributed by employers and working individuals—under the pressure of the evolving demographics, rising administrative costs, and shifts in risk-allocation by a variety of defined-contribution schemes.
- Reallocation of portfolios that have—for regulatory, tax or institutional reasons—been overweighted to domestic financial instruments (notably fixed-income securities) toward a greater role for equities and non-domestic asset classes, which not only promise higher returns but also may reduce the beneficiaries' exposure to risk due to portfolio diversification across both asset classes and economic and financial environments that are less than perfectly correlated in terms of total investment returns.

The growth implied by the first three of these factors, combined with the asset-allocation shifts implied by the fourth factor, will tend to drive the dynamics and competitive structure of the global institutional asset management industry in the years ahead.

EMU is likely to have a number of important implications for the global asset management industry. It will have an impact on total asset returns and the potential for international portfolio diversification, for example, by eliminating national currencies, interest rate differentials and divergent monetary policies within the region covered by a common currency. It will give rise to a whole new class of government securities denominated in euros that will be broadly equivalent to municipals in the U.S. context. These securities will be rated, priced and distributed to increasingly dominant, performance-driven institutional asset managers, and will have to compete with an expanding array of euro-denominated corporate bonds, asset-backed securities, equities and other investment alternatives available to institutional investors in a single capital market that will eventually rival that of the United States in both size and competitive structure. This, in turn, will enhance market liquidity, transparency, performance-orientation, and benchmarking standards by which both asset managers and issuers are assessed. And it will shift competitive relationships among universal banks, full-service investment banks, specialist and generalist fund management companies, insurance companies and other players in the fund management business,

including highly experienced non-domestic competitors in various national markets that were previously sheltered from foreign competition.

This paper assesses in some detail the three principal sectors of the asset management industry—mutual funds, pension funds, and private clients, as well as foundations, endowments, central bank reserves and other large financial pools requiring institutional asset management services. In each case, the European experience is compared with that of the United States as well as, where appropriate, Japan and certain emerging-market countries. This is followed by a discussion of the competitive structure, conduct and performance of the asset management industry. Finally, the European dimensions of the issue considered in each section of the paper are brought together in an impact-assessment with respect to the evolution of the European capital market, including the implications of a single currency.

1. Asset Management in a Financial Intermediation Framework

The asset management services that are the focus of this paper are depicted in Exhibit 1, as follows:

- First, retail clients have the option of placing funds directly with financial institutions such as banks or by purchasing securities from retail sales forces of broker-dealers, possibly with the help of fee-based financial advisers. Alternatively, retail investors can have their funds professionally managed by buying shares in mutual funds or unit trusts (again possibly with the help of advisers), which in turn buy securities from the institutional sales desks of broker-dealers (and from time to time maintain balances with banks).
- Second, private clients are broken-out as a separate segment of the asset management market in Exhibit 1, and are usually serviced by private bankers who bundle asset management with various other services—such as tax

planning, estates and trusts—placing assets directly into financial instruments, commingled managed asset-pools, or sometimes publicly-available mutual funds and unit trusts.

- Third, foundations, endowments, and financial reserves held by nonfinancial companies, institutions and governments can rely on in-house investment expertise to purchase securities directly from the institutional sales desks of banks or securities broker-dealers, use financial advisers to help them build efficient portfolios, or place funds with open-end or closed-end mutual funds.
- Fourth, pension funds take two principal forms, those guaranteeing a level of benefits and those aimed at building beneficiary assets from which a pension will be drawn (see below). Defined-benefit pension funds can buy securities directly in the market, or place funds with banks, trust companies or other types of asset managers, often aided by fund consultants who advise pension trustees on performance and asset-allocation styles. Defined-contribution pension programs may operate in a similar way if they are managed in-house, creating proprietary asset pools, and in addition (or alternatively) provide participants with the option to purchase shares in publicly-available mutual funds.

The structure of the asset management industry encompasses significant overlaps between the three types of asset pools to the point where they are sometimes difficult to distinguish. We have noted the linkage between defined-contribution pension funds and the mutual fund industry, and the association of the disproportionate growth in the former with the expansion of mutual fund assets under management. There is a similar but perhaps more limited linkage between private clients assets and mutual funds, on the one hand, and pension funds, on the other. This is particularly the case for the lower-bound of private client business, which is often commingled with mass-marketed mutual funds, and pension benefits awarded high-income executives, which in effect become part of the high net-worth portfolio.

The following three sections of this paper will consider the development of

mutual funds, pension funds and private banking as the three principal types of asset management institutions dominating the global and European financial environment.

2. 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).

Exhibit 2 shows 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.³ 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 Exhibit 3. 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.

³According to the OECD, personal financial assets in Europe have grown at an average rate of about 11% in the decade ending 1996, compared to about 8% in the United States and Japan, with an disproportionately high growth rate of over 18% in the case of Italy during this period.

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.⁴

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 Exhibit 4, 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

⁴ Investment Company Institute, *Mutual Fund Fact Book* (Washington, Investment Company Institute, 1996).

most of the continental European countries explains the high concentration of mutual fund distribution via branch networks.⁵ 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

⁵For example, German mutual fund distribution is dominated by the major banks, with DWS (Deutsche Bank) controlling a 24% market share, DIT (Dresdner Bank) 14.1%, and ADIG (Commerzbank and the merged HypoVereinsbank) 21.1%. However, foreign players such as Fidelity of the U.S. and Bank Julius Baer of Switzerland appear to be making significant inroads even as local competitors strive to improve investment performance, increase the range of products available, and enhance their non-European (particularly U.S.) funds marketed to German investors.

with retail commercial banking products is likely to boost the share of bank-based 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 counseling 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.

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 and 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 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—as 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.⁶ Arguments *against* further concentration include shifts in performance track-records and the role of mutual fund supermarkets in distribution, which increase

⁶ A 1996 money management IQ test designed to calibrate basic investing skills was passed by less than 20% of respondents. Another survey indicated that only a small minority of mutual fund investors actually perused the prospectus, or even a summary of the prospectus, before they invested. See Michael L. Goldstein et al., *The Future of Money Management in America* (New York: Bernstein

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 favorable, 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.

Research, 1997).

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.⁷ 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 nonfinancial 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

⁷ Davis International Banking Consultants, *Trends in European Asset Management* (New York: Smith Barney, 1996).

competitive structure of the mutual fund industry, particularly in large, integrated markets such as the United States and—with currency unification—the European Union.

Comparative Regulation of Mutual Funds

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.⁸

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

⁸ Sana Siwolop, “Regulating Financial Advisers: Are the States Up To It?” *The New York Times*, June 29, 1997.

questions whether such directors can fulfill 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 come to an 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.⁹

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 centers 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.

⁹ For a discussion, see Jonathan Story and Ingo Walter, *Politics of European Financial Integration* (Manchester: Manchester University Press, and Cambridge: MIT Press, 1997).

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 offense. 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.¹⁰

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. The effort was led by France, together with Belgium, Italy and Spain. All four countries also argued that the absence of tax harmonization would

¹⁰ Richard Levich and Ingo Walter, "Tax-Driven Regulatory Drag and Competition Among European Financial Centers," in Horst Siebert (ed.) *Reforming Capital Income Taxation* (Tübingen: J.C.B. Mohr / Paul Siebeck, 1990).

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 that 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 center 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 Sociétés 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 center 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 1989.¹² 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 center won out. But that there were no provisions, he suggested, in EU law for cooperation between tax authorities.¹³ Evasion and/or avoidance of its EU partners' taxes was thus implicitly

¹¹ "The Switzerland of the Future," *The Banker*, November 1988.

¹² *Financial Times*, October 2, 1989.

¹³ The Economic and Social Council expressed concern that capital be invested in tax free bonds, J.O.

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 reexamine 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.¹⁴ 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 Luxembourg.

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

No. C. 221/29. The European Parliament also regretted that the EU had been able to reach an agreement on an EC system of taxation on interest, J.O. No.C. 68/145. 19.3.1990. See also *Les Echos*, 19.6.1990.

¹⁴ *Les Echos*, September 15, 1989.

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 to eliminate the suction of the massive fiscal hole in the middle of the EU—in the memorable words of former EU President Jacques 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 than the U.S. federal government could afford permitting one of the states declaring itself a domestic version of Luxembourg.

3. 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 are depicted in Exhibit 5 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.¹⁵

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 inevitability.¹⁶ The global epicenter 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

¹⁵ There are a number of dissenting opinions with regard to this high-growth scenario, however, some of which suggests that the growth in pension assets may actually decline from the rates achieved in the 1990s. These forecasts are based on the presumption that Germany's system of defined benefit plans with limited dedicated external asset pools is basically sound (and carries a high weight in the European total), and that enabling legislation to change PAYG systems like France and Italy will be politically difficult and slow to develop. Davis International Banking Consultants, *Trends in European Asset Management* (New York: Smith Barney, 1996).

¹⁶ For a more detailed discussion, see John Turner and Noriyasu Watanabe, Private Pension Policies in Industrialized Countries (Kalamazoo: W.E. Upjohn Institute for Employment Research, 1995).

region.¹⁷

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 labor 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.

¹⁷ For a discussion, see Jonathan Story and Ingo Walter, *The Politics of European Financial Integration: The Battle of the Systems* (Manchester: Manchester University Press, and Cambridge: MIT Press, 1997).

Alternative Approaches to Old-Age Support

There are basically 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.
- *Defined benefit programs.* Pension benefits under such programs are committed to public or private-sector employees by their employers, based on actuarial benefit formulas that are part of the employment contract. 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*. They may thus be tapped by the employer 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 Labor.
- *Defined contribution programs.* Pension fund contributions are made by the employer, the employee, or both into a fund that will ultimately form the basis for pension benefits under defined contribution pension plans. 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, for example be allowed to select from among a range of approved investment vehicles, notably mutual funds, 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 in 1997 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

¹⁸Data: InterSec Research Corporation, 1997.

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.¹⁹

While the American pension problem is cause for concern—and is being more or less adequately 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.²⁰ Exhibit 7 shows the percentage of the labor 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

¹⁹ For a survey, see Walter M. Cadette, "Social Security: Financing the Baby-Boom's Retirement," The Jerome Levy Economics Institute, Working Paper No. 192, April 1997. See also 1994-96 Advisory Council on Social Security, *Report of the 1994-96 Advisory Council on Social Security: Findings and Recommendations* (Washington, D.C.: U.S. Government Printing Office, 1997).

²⁰ Data: InterSec Research Corporation and Goldman Sachs & Co.

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.²¹

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.

²¹ First Consulting, *European Pensions* (London: AMP Asset Management, 1997).

Today's conventional wisdom is that the pension problems that are centered 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 differ 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 focused 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 is monetization by the European Central Bank of some of the incremental public debt.

Asset Allocation and 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.

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 sectoral 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 benchmarks.²²

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 1980.²³ 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

²²Jane Martinson, "Management Revolution," *Financial Times*, November 21, 1997.

²³Brian Reid and Jean Crumrine, *Retirement Plan Holdings of Mutual Funds*, 1996 (Washington, D.C.: Investment Company Institute, 1997).

differentials in attracting assets.²⁴ 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.²⁵

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.

4. Asset Management for Private Clients

²⁴ Sources: JP Morgan, U.S. Department of Labor, *Pensions and Investments*, EBRI.

²⁵ Source: *Pensions and Investments*.

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 trillion²⁶—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. Exhibit 10 provides a rough estimate of sources and destinations of private wealth held outside the home-country of the investor.

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. 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

²⁶ Chase Manhattan, 1994 estimate.

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 “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.²⁷
- *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 particular 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

²⁷ See Ingo Walter, *The Secret Money Market* (New York: Harper Collins, 1990).

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).²⁸

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. Competitive Restructuring of the Asset Management Industry

²⁸ As long as a decade ago, Dr. Marcus Lusser, then President of the Swiss National Bank, conceded the diminishing value of banking secrecy. In his opinion, the strengthening of the EU was bound to weaken Switzerland as a center for the management of private wealth. He advised bankers in Switzerland to concentrate on the institutional investment management sector in the future. "Good-bye to Complacency," *Financial Times*, December 19, 1988. In conversation, Swiss private bankers appear to agree that upwards of two-thirds of assets under management of OECD-based private clients could disappear if Swiss banks reported assets and income to home-country tax authorities.

We have noted that various kinds of financial firms have emerged to perform asset-management functions — commercial banks, savings banks, postal savings institutions, savings cooperatives, credit unions, securities firms (full-service firms and various kinds of specialists), insurance companies, finance companies, finance subsidiaries of industrial companies, mutual fund companies, financial advisers and various others. Members of each *strategic group* compete with each other, as well as with members of other strategic groups. There are two questions. First, what determines competitive advantage in operating distribution gateways to the end-investor? Second, what determines competitive advantage in the asset management process itself?

One supposition is that distribution of asset management services is both scope-driven and technology-driven. That is, it can be distributed jointly with other types of financial services, and thereby benefit from cost economies of scope as well as demand economies of scope (cross-selling). This would tend to give retail-oriented financial services firms like commercial and universal banks, life insurance companies and savings institutions a competitive advantage in distribution. At the same time, more-specialized firms may establish cost-effective distribution of asset management services using proprietary remote-marketing techniques like the mails, telephone selling or the Internet, or by “renting” distribution through the established infrastructures of other financial intermediaries like banks, insurance companies or mutual fund supermarkets. They may also gain access through fund management consultants and

financial advisers.

Asset management itself depends heavily on portfolio management skills as well as economies of scale, capital investment and technologies involved in back-office functions, some of which can be outsourced. Since fiduciary activities must be kept separate from other financial services operations that involve potential conflicts of interest, either through organizational separation or Chinese walls, there is not much to be gained in the way of economies of scope.

Inter-sectoral competition, alongside already vigorous intra-sectoral competition, is what will make asset management one of the most competitive areas of finance, even in the presence of rapid growth in the size of the market for asset management services. Certainly the dynamics of competition for the growing pools of defined benefit and defined contribution pension assets in various parts of the world, and its cross-linkage to the mutual fund business, has led to various strategic initiatives among fund managers. These include mergers, acquisitions and strategic alliances among fund managers as well as between fund managers, commercial and universal banks, securities broker-dealers, and insurance companies. This is reflected in Exhibit 11, which presents the volume and number of mergers and acquisitions involving asset managers, both in total and managers of open-end mutual funds only, covering the 12 ½ year period from 1985 through the first half of 1997. Altogether, there were over a thousand transactions valued at \$36.5 billion, of which 242 transactions worth \$15.7 billion involved mutual funds—note that the average size of mutual fund transactions

was much larger than the average size of the overall deal-flow. About 70% of the total M&A value involved European targets, and 25% involved U.S. targets. Geographically, British asset managers represented the largest single target group, with 260 transactions worth \$12.3 billion during this period, with the predominant buyers representing continental European institutions, mainly banks and insurance companies. There was roughly the same volume of activity within continental Europe, with 231 transactions valued at \$12.5 billion. U.S. acquirers were mostly confined to domestic transactions, and only represented about 1/4 of the volume of intra-European transactions. Note also that in the case of mutual fund acquisitions, the focus of transactions again was within continental Europe. These data suggest that M&A market action and strategic repositioning substantially reflects the economic drivers of the asset management industry's restructuring. The action, both with respect to pension funds and mutual funds, is in Western Europe.

Market valuations of asset management companies have been quite high in comparison with other types of firms in the financial services industry, and this has been reflected in prices paid in M&A transactions. At midyear 1996 in the United States, when the price to earnings ratio (based on expected 1996 earnings) for the S&P 500 stocks averaged 16.2, the price-earnings ratios of the top-ten domestic commercial banks with strong retail banking businesses averaged 10.3, and the top life and casualty insurance companies averaged price-earnings ratios of about 10, the top-eight publicly-owned investment banks (including JP Morgan and Bankers Trust)

only 7.9 while the price-earnings ratios of the top-9 asset managers averaged about 14. The average share-price to book-value ratio for the top ten US commercial banks in 1996 was 1.83, for the top investment banks it was only 1.27, while for the top-9 asset managers it was 4.64.

Besides gaining access to distribution and fund management expertise, the underlying economics of this deal-flow presumably have to do with the realization of economies of scale and economies of scope, making possible both cost reductions and cross-selling of multiple types of funds, banking and/or insurance services, investment advice, high-quality research, etc. in a one-stop-shopping interface for investors—despite a good deal of evidence that investors are quite happy to shop on their own with low-cost fund managers. Empirical evidence of either economies of scale or economies of scope in this sector is lacking, although the plausibility of scale economies exceed that for scope economies. In any event, there has been little evidence so far that M&A activity in this sector has led to lower fees and charges to retail investors.²⁹

Exhibit 12 provides some indication of the relative size of the 36 top asset managers. Overall, countries with traditional reliance on funded pension schemes and mutual funds marketed to retail investors—the United States, Japan and the United Kingdom—were home to 72 of the top-100 asset managers and 76% of the assets

²⁹ Charles Gasparino, “Do Mutual Fund Mergers Hurt Small Investors?” *Wall Street Journal*, July 8, 1997.

under management.³⁰ Continental European countries captured only a fourth of the top spots and 22% of the assets, although this is likely to change as PAYG pension programs increasingly give way to dedicated asset pools and as financial market integration stimulates a competitive battle among different types of financial institutions for asset management services. Specifically, within Europe, 31% of assets are managed in the United Kingdom, 20.3% in Switzerland, 16.5% in Germany, 15.6% in France, 8.4% in the Netherlands, the balance in Liechtenstein, Denmark, Spain, Belgium, Sweden and Italy.³¹

6. Institutional Asset Pools and European Capital Market Development

The impact of EMU of European financial markets in the context of a growing role of performance-driven asset managers is likely to run the gamut from the composition of financial assets and the scope available for portfolio diversification to competition among financial centers and corporate governance.

Composition of Financial Assets

The role of a burgeoning European asset management industry in promoting disintermediation in an increasingly unified financial market is unlikely to differ very much in character from what has occurred in the United States, except that its pacing

³⁰“Watson Wyatt World-500,” Pension Age, September 1996.

³¹ *Institutional Investor*.

may be quite different under distinctly European institutional and regulatory conditions.

Europe, with roughly twice the proportion of financial assets on the books of banks and other financial intermediaries than the United States, will go through much the same process, of financial disintermediation that characterized the United States in the 1970s and 1980s. A recent study suggests that the aforementioned, gradual shift from banking to securities transactions is likely to be accelerated by EMU because the factors that underlie this development, by reducing transactions and information costs (both heavily driven by technology) and making available new products to end-investors, cannot be fully exploited in a fragmented foreign exchange environment, i.e., one characterized by widespread currency-matching rules bearing on issuers and investors. This includes a range of financial instruments that are broadly available in the United States but have been unable to reach critical-mass needed for trading efficiency and liquidity in Europe “If EMU has the side-effect of bringing those assets to the market, then the playing-field will tilt a little. If technology shifts the ‘management expenses’ goal posts as well, then we may be in a new ball game.”³²

The rise to prominence of institutional asset managers in Europe will do a great deal to enhance financial market liquidity. Mutual funds—whether part of defined contribution pension schemes or mass-marketed as savings vehicles to the general public—and other types of money managers are so-called “noise traders” who must buy and sell assets whenever there are net fund purchases or redemptions, in addition to

³² Graham Bishop, *Post Emu: Bank Credit Versus Capital Markets* (London: Salomon Brothers Inc.,

discretionary trades to adjust portfolios. They therefore tend to make a disproportionate contribution to capital market liquidity. Mutual funds alone account for the largest share of U.S. equity turnover, for example, with the trades of the largest mutual fund company (Fidelity) estimated to account for 12-15% of daily stock trading and generating some \$200 million annually in dealing commissions.

Overall, it is likely that EMU will favor the asset management industry, both in terms of market share in the financial intermediation process and in terms growth prospects. Asset managers will be less affected than banks in terms of the cost-implications of EMU and will benefit disproportionately from the increased depth and breadth of the European capital market that a single currency implies. At the same time, they will be favored by the fiscal implications of Maastricht-type criteria, which will place greater pressure on governments to accelerate the transition from PAYG pension schemes to various types of defined contribution programs.³³

The Market for Markets and the Location of Financial Activity

Given their size and the performance pressures bearing on them, institutional asset managers try to focus their trading on financial markets that are marked by the following characteristics:

1997).

³³ For a discussion of the overall capital market effects of EMU, see JP Morgan, *EMU: Impacts on Financial Markets* (New York: JP Morgan, 1997).

- A high degree of liquidity, notably for block trades, and good after-hours capabilities.
- Low transactions costs, notably for commissions and spreads, clearance and settlement services, back-office operations, custody services, telecommunications and other financial infrastructure services.
- High levels of transparency in securities transactions and in the securities themselves, including strong regulatory and enforcement capabilities to ensure honest dealing and a level playing field.
- A broad product range of underlying securities and derivatives, and strong innovative capabilities.
- A uniform accounting and legal infrastructure that meets global standards.
- A major equities component of capital markets, of prime interest to both pension funds and mutual funds, running from large-cap global companies to IPOs and private equity, with strong turnover and deep investor participation.

The EU in 1997 still had a highly fragmented system of 32 stock exchanges and 23 futures and options exchanges among which only one market, London, came close to meeting the needs of major institutional asset managers and their probable future evolution. In the presence of electronic links and low-cost transactions services to institutional investors this market fragmentation should disappear relatively quickly, especially under pressure of a single currency.

The battle among EU equity markets will perhaps be the one most heavily affected by the behavior of highly performance-oriented asset managers. Already the Investment Services Directive (ISD) has permitted exchanges to place trading screens in other financial centers. Easdaq has been in the process of creating a pan-European over-the-counter exchange patterned on NASDAQ in the United States to attract new,

high-growth companies. National markets in Frankfurt, Paris, Brussels and Amsterdam have been trying to do the same thing and link-up in the form of EuroNM to compete with both NASDAQ and Easdaq, even as comparable initiatives are underway among the Nordic countries. The rapid growth of institutional asset management in Europe, however, is likely to promote a fairly rapid shakeout of these competing market initiatives based on how they meet the aforementioned criteria, certainly under conditions of a common currency—with perhaps two or three OTC and organized exchanges accounting for the vast bulk of European trading activity in the medium-term future. The large, integrated U.S. market supports only one major exchange, and one major OTC trading system, alongside a number of specialist exchanges in New York, Philadelphia, Chicago and San Francisco plus continued challenge from electronic exchanges such as the Arizona Stock Exchange (AZX). The U.S. "equilibrium" market structure may well be an inappropriate indicator for a future integrated European market supporting the rapidly growing needs of institutional asset managers.

Indeed, the U.S. locational pattern as it has evolved over a much greater span of time may also be a reasonable model of what will eventually develop in Europe: (1) A single wholesale market for transactions-execution (New York) not necessarily identical to the seat of monetary policy and financial regulation (Washington), with a reasonable argument to be made that a bit of "distance" between the markets and their regulators can be helpful. (2) Dispersed asset management centers (Boston, Chicago, Philadelphia, Stamford, San Francisco), and sometimes no centers at all in a business

where the necessary information, interpretation and transactions services can all be delivered electronically and in real-time. (3) Specialist centers focusing on particular financial instruments (Chicago, Philadelphia) or industries (San Francisco) that have their roots in history or ongoing economic developments.

With respect to the location of asset management activity in Europe *per se*, few comprehensive data are available, although it is likely that Switzerland (Zurich and Geneva) and London will continue to share the top spot, with very different businesses centered on private banking and institutional asset management, respectively. Other continental European asset management centers are far behind. In the equity sector, London ranks first with over \$1 trillion under management, followed by Zurich, Basel and Geneva combined with \$740 billion, Frankfurt with \$157 billion (excluding intercorporate holdings), Edinburgh with \$138 billion and Stockholm with \$89 billion. None of the other European financial centers rank in the top-25. These numbers compare with \$1.5 trillion managed in Tokyo and \$896 billion in New York.³⁴ Such rankings in the future are likely to shift as European financial integration continues, especially under a single currency, with greater polarization possible.

Portfolio Diversification and Globalization

Professional fund managers attempt to optimize asset allocation in line with modern investment concepts by taking advantage of the potential for domestic and

³⁴ *Financial Times*, "Survey of Global Fund Management," April 27, 1997.

international portfolio diversification inherent across the range of financial instruments being offered, as well as by using the most efficient (friction-free) available securities markets and infrastructure services. Both dimensions are likely to be affected by European financial integration and a common currency.

For EU institutional investors, national currencies will obviously disappear among participating EU countries as a source of portfolio diversification. So will variations in interest rates, with a single rate-structure prevailing in the entire region. Investors seeking sources of diversification across less than perfectly correlated exchange rates and interest rates will thus have to look outside the region covered by the euro, while external investors will lose any comparable diversification gains that may have existed within the region. The euro-zone becomes a single market-risk and sovereign risk “bucket” from the perspective of portfolio diversification.

EMU is also likely to increase correlations across equity markets covered by the euro, representing a continuation of the gradual increases in inter-market correlations that have already been observed.³⁵ This will force portfolio managers to focus relatively more heavily on diversification strategies involving non-European markets. The attractiveness of emerging market equities may therefore increase due to

³⁵ See, for example, François Longin and Bruno Solnik, “Is the Correlation of International Equity Returns Constant?” *Journal of International Money and Finance*, Vol. 14, No. 1, 1995. Portfolio diversification gains tend to be greater across global equity markets than across global bond markets, where they derive solely from less than perfectly correlated interest rate and exchange rate movements. Moreover, unlike the global bond markets, stocks tend to be more highly differentiated and subject to local trading conditions, although listings on foreign stock exchanges through depository receipts have made some foreign equities considerably more accessible to foreign investors.

potentially lower correlations between emerging market stock returns and the major market indexes such as the Standard & Poors 500 index, the French CAC-40 or the German DAX equity averages.

In terms of asset classes, we have already noted that EMU will create a new, generic type of fixed-income security that will be very similar to municipal bonds in the United States. Since national central banks and the possibility of debt monetization at the national level will disappear among EMU countries, borrowing requirements of national governments will involve rated debt instruments denominated in euros that will be available to institutional investors, with spreads differing among issuing governments based on the market's perceptions of the degree of risk involved. Since currency risk will be eliminated within the EMU region, the focus will be entirely on market risk and credit risk, and such "Euro-munis" will represent a major asset class in institutional funds pools for both EU and non-EU portfolios such as those managed in the United States and Japan.

Taxation remains a major problem in the creation of efficient pension asset allocations via international portfolio diversification. The reason is that governments often do not provide reciprocal tax exemption for pension assets invested abroad. For example, many countries exempt employee and employer pension contributions and pension fund earnings from tax, and subsequently taxed at prevailing personal income tax rates when it is distributed upon retirement — although some countries tax retirement income at concessionary rates as well. If part of a retirement fund is

invested abroad, however, the host country often treats the assets the same as all other financial assets, and levies taxes on interest, dividends and/or capital gains at regular withholding rates. Such differential tax treatment obviously biases asset-allocation toward domestic investments, and can significantly affect portfolio optimization. Several proposals have dealt with this issue. The OECD Model Tax Convention would tax dividend income 15%, interest income at 10% and capital gains at 0% without regard to the distinction between retirement and non-retirement assets. The U.S. Model Income Tax Convention would tax dividend income of foreign assets at 15% and exempt interest income and capital gains, but would also exempt all income on retirement assets as long as at least half of the participants of the fund are residents of the home country. Ideally, of course, there should be reciprocal exemption from tax of all retirement assets invested internationally together with reciprocal acceptance of certification of retirement plan qualifications.³⁶

Asset Managers, Shareholder Value and Corporate Governance

Assuming the rapid advance in prominence of institutional asset managers follows along the lines suggested in this paper, the capital markets will increasingly be the major source of external financing for European corporations in the future—as against the traditional, heavy continental European reliance (compared with American and British companies) on bank finance for debt and bank and corporate long-term

³⁶Paul Schott Stevens, “Selected Issues in International Taxation of Retirement Savings, *Investment Company Institute Perspective*, August 1997.

shareholdings for equity. Fiduciary asset pools managed against performance benchmarks by mutual funds and pension funds will create increasingly fluid sources of capital for industry, and a fundamental shift in the accountability of management and monitoring of corporate performance in Europe.³⁷

In such a system, industrial restructuring will increasingly be triggered by the emergence of a control premium between the existing share price of a corporation and the value that an unaffiliated acquirer (whether an industrial company or an active financial investor) perceives could be unlocked by changes in management strategies or policies.

Based on such a view of corporate underperformance, an investor may purchase a significant block of shares and signal his unhappiness with the company's performance, or perhaps initiate a full takeover bid for the target firm (which is now "in play"). Institutional asset managers can assume a critical role in such a scenario. They may agree that a control premium does indeed exist and themselves begin purchasing shares, thereby placing still greater pressure on management of the target company.³⁸

³⁷ For a full discussion, see Arnold Sametz, *The Power and Influence of Pension and Mutual Funds* (Amsterdam: Kluwer, 1998 - forthcoming).

³⁸ For a comparison between traditional market-based and institution-based approaches to corporate control, see Jonathan Story and Ingo Walter, *The Politics of European Financial Integration* (Manchester: Manchester University Press, and Cambridge: MIT Press, 1997).

Even in the absence of a potential acquirer putting the company in play, major institutional asset managers who, because of their size or portfolio constraints, find it difficult or impossible to dispose of their ownership interest in a company they feel is performing poorly can request a meeting with management about the firm's strategy, financial performance, and realization of shareholder value, and perhaps speak-out at annual general meetings. Concerns about unwanted takeover efforts and institutional investor dissatisfaction may in turn prompt management to undertake a self-restructuring, seek an acceptable merger partner ("white knight"), pay-out special dividends or initiate share repurchases, or find other ways to enhance shareholder value and efficiency in the use of capital to preclude the emergence of a control premium and hostile action.

Such a transition—from the traditional continental European corporate governance process with two-tier boards and large, friendly ownership stakes (*noyeux durs*) insulating management from the pressure of external shareholders seeking improved total returns to a more "contestable" model along Anglo-American lines—is an important possible consequence of the growing role of professionally managed asset pools. The potential benefits of such developments involve reduced cost-of-capital through higher share prices and improved access to global financial markets and a greater capacity for restructuring European economy in response to changes in technology, market competition and other fundamentals.

Investor-driven, market-based systems such as this will require much higher

levels of transparency in corporate accounting and disclosure than has been the norm in most of Europe, together with greater reliance on public information provided by management and systemic surveillance by research analysts working aggressively on behalf of investors. It implies arm's length financing on commercially viable terms by banks and financial markets, with financial institutions active in giving strategic and financial advice and sometimes taking transitional, non-permanent equity positions in (and occasionally control of) corporations in the process of restructuring.

It also assumes that the principal stakeholders in corporations (shareholders, employees, managers and customers) accept that the central claim to legitimacy of free, investor-driven capital markets is that they generally provide the most efficient way of augmenting economic wealth, as against less viable politically-driven allocation of capital. This approach assumes that government will not prove a light touch for corporate lobbies seeking to avoid restructurings or takeovers through access to the public purse as a less demanding and less disciplined source of capital. The labor market likewise needs to be supportive, so that work-forces can be adapted and reallocated both functionally and geographically with the minimum of friction. Government's major task will be to provide EU-wide macroeconomic stability together with the regulatory and legal structure within which open capital markets may function, and to supply an acceptable and affordable social safety net.

7. 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 can be drawn.

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 asset management (including private banking) is being marked for expansion by virtually every *strategic group* in the financial services sector—commercial and universal banks, private 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 assets, 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 through 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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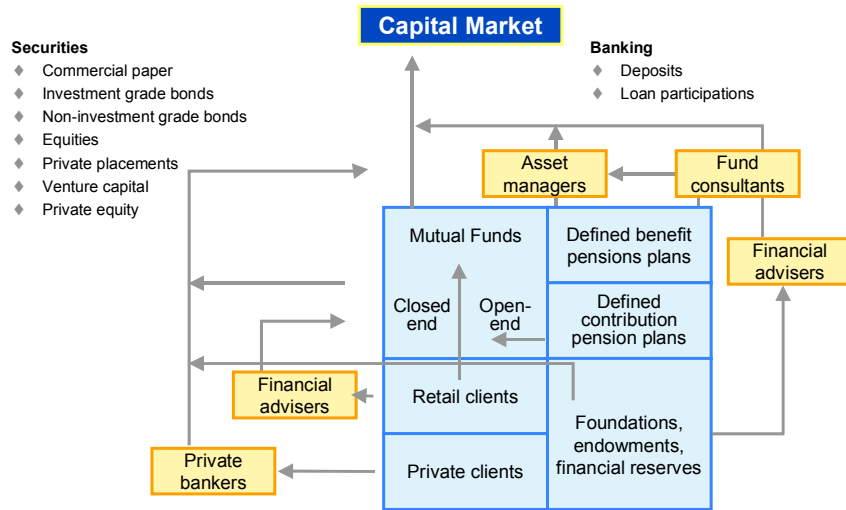
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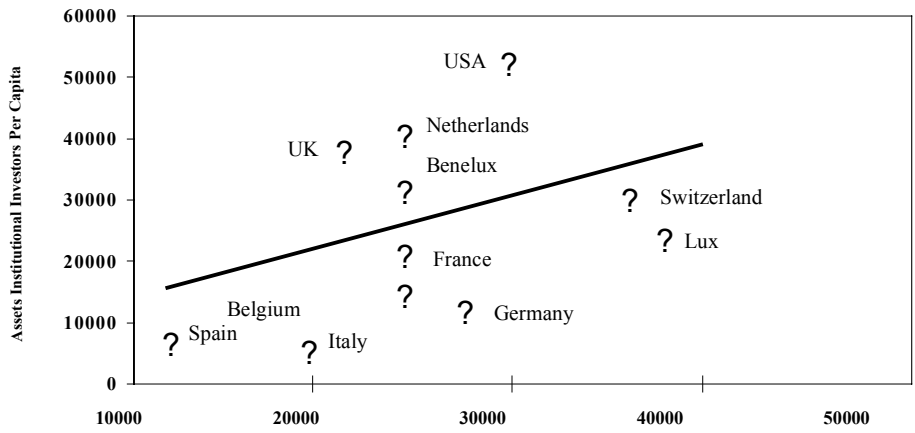
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1. Organization of the Asset Management Industry



2. Asset Accumulation in OECD Countries

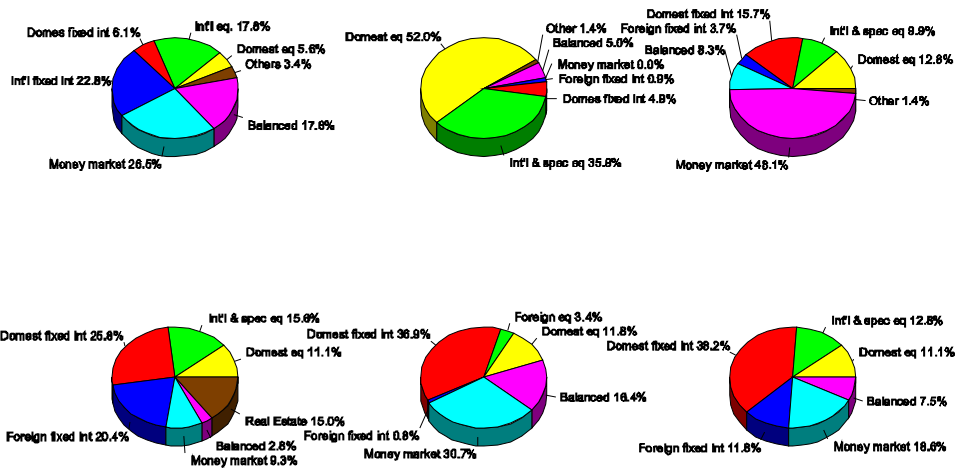


Source: OECD

GDP per capita

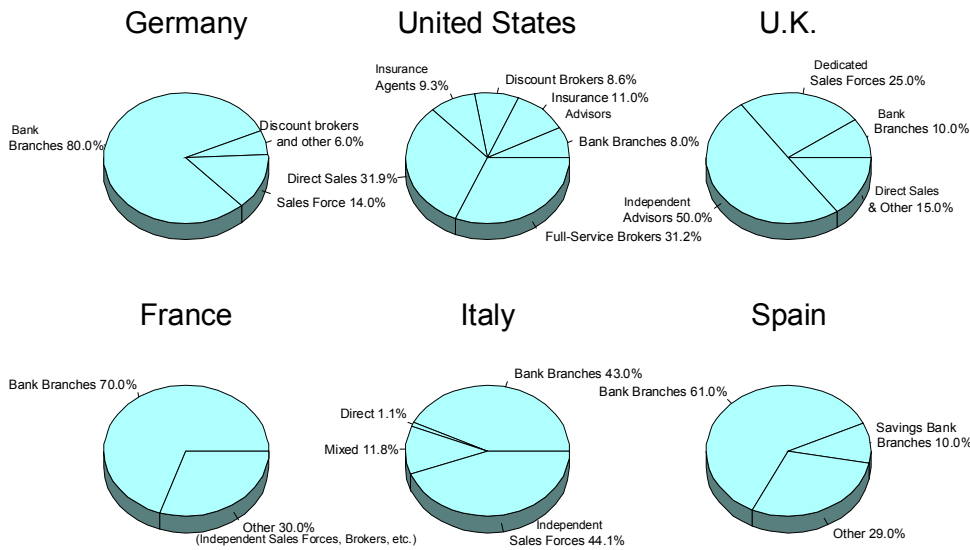
3. Mutual Funds:

Total Assets Under Management in Major European Markets, End-2000



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4. Estimated Mutual Fund Market Share by Distribution Channel in Major Markets, 2001



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

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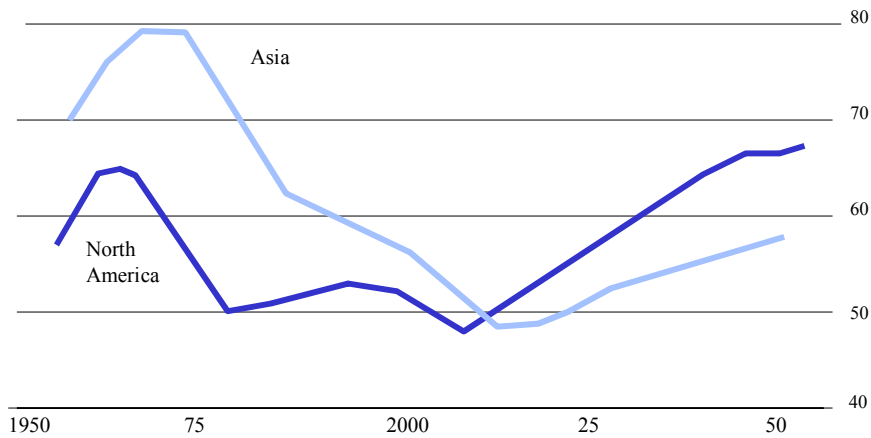
5. Global Pension Fund Statistics

Total Non Domestic Investment (USD Billions)

	Total			Private			Public		
	1995	2000	2005	1995	2000	2005	1995	2000	2005
Total North America	343	861	1,660	203	465	871	140	396	789
Total Europe	331	818	1,418	281	588	1,065	51	231	353
Total Pacific Basin	195	344	543	109	197	302	86	146	241
Total Latin America	0	5	15	0	5	15	0	0	0
Total Africa, Middle East and Asia	1	3	8	1	3	7	0	0	1
Total	870	2,032	3,644	593	1,258	2,260	277	774	1,384

Source: InterSec, 2002

6. Comparative Dependency Ratios

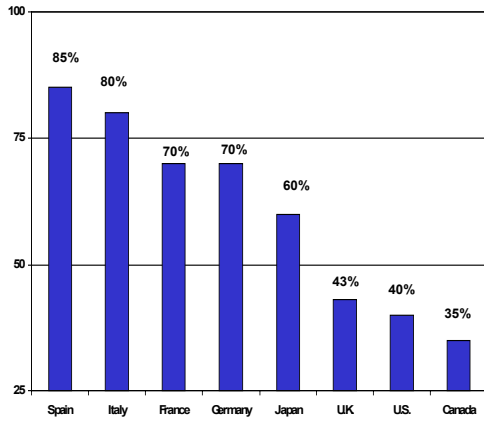


People aged under 15 and over 65 as % of people aged 15-65.

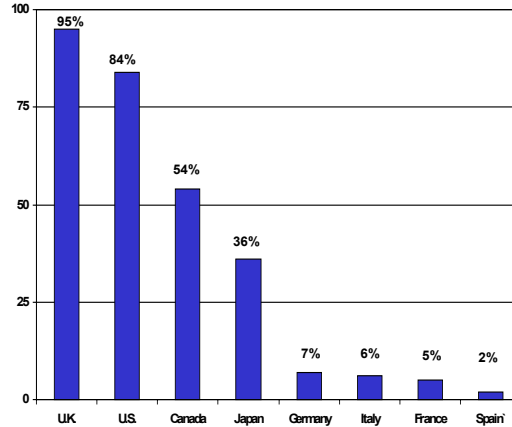
Source: UN

7. Retirement Promises and Pension Assets

Traditional Retirement Promise For Average Worker as a Percentage of Final Pay

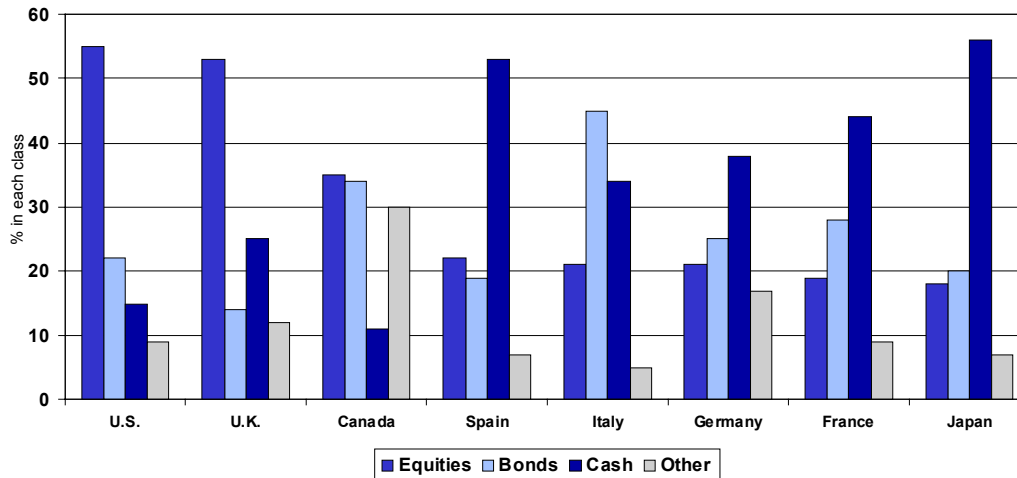


Funded Pension Assets as a Percentage of GDP (2001)



Source: InterSec Research, OECD

8. Institutional Asset Allocation, 2001 (pension, insurance, and mutual funds)



Source: Federal Reserve, Bank of England, Statistics Canada, Banco de España, Banca d'Italia, Deutsche Bundesbank, Banque de France, Bank of Japan, and GS Estimates

9. Asset Allocation of Pension Funds - 2001

	Cash	Dom. Bonds	Dom. Equity	For. Bonds	For. Equity	Loans & Mortg.	Real Est.	Oth.	Total
Austria	1.60	62.30	17.20	5.30	11.00	1.00	0.50	1.20	100.0
Belgium	3.40	23.60	20.10	14.10	32.70	0.00	4.70	1.40	100.0
Denmark	0.70	51.50	30.70	0.60	11.00	0.00	3.70	1.70	100.0
Finland	6.50	48.60	21.30	0.00	0.80	16.80	6.00	0.00	100.0
France	19.70	46.10	10.00	5.90	2.30	1.90	0.50	13.5	100.0
Germany	8.20	33.00	19.40	2.60	5.80	26.20	3.30	1.40	100.0
Ireland	6.60	16.40	27.30	7.40	32.20	0.00	5.80	4.40	100.0
Italy	16.30	25.40	2.70	3.10	0.30	10.00	42.2	0.00	100.0
Holland	1.80	18.60	19.20	16.10	25.50	13.30	5.40	0.00	100.0

9. Asset Allocation of Pension Funds – 2001 (cont'd)

	Cash & Equiv.	Dom. Bonds	Dom. Equity	Foreign Bonds	Forgn. Equity	Loans & Mortg.	Real Est.	Oth.	Total
Norway	3.80	62.70	20.70	0.00	2.20	3.80	1.70	5.20	100.0
Portugal	7.00	39.80	22.00	10.00	13.00	0.00	6.50	1.70	100.0
Spain	13.40	44.90	16.90	10.60	8.60	0.00	0.50	5.10	100.0
Sweden	1.60	71.60	15.30	4.90	1.80	0.00	4.70	0.10	100.0
Switz.	9.20	16.10	14.40	15.20	14.90	3.10	16.9	10.2	100.0
UK	3.40	10.80	50.60	3.80	23.10	0.20	4.90	3.20	100.0
Total Europe	4.90	19.60	34.20	7.30	19.20	4.40	7.00	3.50	100.0
Ex. UK & Ireland	6.70	27.40	16.30	11.60	14.80	9.50	9.80	4.00	100.0
US	4.70	22.70	53.10	1.10	10.00	1.50	1.90	5.00	100.0

10. Total HNW Liquid Asset Distribution

Total global liquid assets*	\$ 51 trillion
North America	32%
Western Europe	29%
Asia Pacific	25%
Latin America	6%
Central & Eastern Europe	5%
Missile East	3%
Africa	1%

* Deposits, bonds, stocks and mutual funds. Source: UBS AG, 2002.

12. Top 20 Worldwide Institutional Asset Managers 2002 (\$ millions)

Rank	Firm	Country	Total Assets
1	Fidelity Investments	U.S.	1,074,200
2	UBS	Switzerland	1,064,000
3	Kampo	Japan	826,890
4	AXA	France	788,000
5	Barclays	U.K.	782,592
6	State Street Global	U.S.	682,365
7	Deutsche Bank	Germany	589,000
8	Vanguard Group	U.S.	564,176
9	Credit Suisse Group	Switzerland	560,375
10	Merrill Lynch	U.S.	557,265

**12. Top 20 Worldwide Institutional Asset Managers 2002 (\$ millions),
cont'd....**

Rank	Firm	Country	Total Assets
11	Mellon Financial	U.S.	488,000
12	Capital Group	U.S.	455,871
13	Zurich Group	Switzerland	442,000
14	Morgan Stanley	U.S.	430,383
15	MetLife	U.S.	420,000
16	Citigroup	U.S.	393,296
17	Putnam Investments	U.S.	391,303
18	Allianz	Germany	384,200
19	AMVESCAP	U.S.	352,497
20	J.P. Morgan	U.S.	348,997

Source: Financial Times

12. Merger and Acquisitions Activity in the Asset Management Industry (1985- 2000, Millions of U.S.\$ and Number of Transactions)			
Total	Total Asset Managers	Open-end Mutual Fund Managers	
Global Target	71,252 (1,719)	15,082 (364)	
European Target	37,715 (736)	6,030 (186)	
U.S. Target	18,431 (569)	5,118 (114)	
Other Target	15,106 (414)	3,934 (64)	
Total Asset Managers	Total	European Acquirer	U.S. Acquirer
U.S. Target	18,431 (569)	5,743 (36)	12,038 (508)
U.K. Target	26,367 (350)	23,285 (304)	1,974 (23)
Cont. Eur. Target	11,348 (386)	10,573 (353)	9 (10)
Open-end Mutual Fund Managers	Total	European Acquirer	U.S. Acquirer
U.S. Target	5,118 (105)	1,849 (7)	3,225 (104)
U.K. Target	2,291 (33)	2,204 (28)	52 (3)
Cont. Eur. Target	3,739 (153)	3,579 (137)	9 (2)