DISCUSSION PAPER PI-0212

The European Pension Management Industry

E Philip Davis

October 2002

ISSN 1367-580X

The Pensions Institute
Cass Business School
City University
106 Bunhill Row London
EC1Y 8TZ
UNITED KINGDOM

http://www.pensions-institute.org/

THE EUROPEAN PENSION MANAGEMENT INDUSTRY[1]

E Philip Davis
Brunel University
West London

Abstract: This paper seeks to assess the current status and future prospects for private pension management in Continental Europe, with a particular focus on the nature of competition among managers of pension assets. It is shown that the pension fund sectors in Continental Europe are relatively small and the industry to date has tended to be oligopolistic and segmented on a national basis. Similar comments apply to the investment fund and life insurance sectors also. This situation has tended to lead to higher prices and lower returns than could otherwise be obtained. Regulatory, fiscal and demand-side differences are at the time of writing holding back a Pan European asset management market, despite three years of EMU. Nevertheless, future pressures are likely to induce greater competition, notably on a cross border basis. These include not only evolving effects of EMU itself but also the indirect effects on asset management via banking, EU Directives and the further pressures for pension reform.

JEL classification: G22, G23

Keywords: pension funds, asset management, European financial markets

---

[1] Department of Economics and Finance, Brunel University, Uxbridge, Middlesex UB3 4PH, United Kingdom (e-mail 'e_philip_davis@msn.com', website: 'www.geocities.com/e_philip_davis'), Visiting Fellow at the National Institute of Economic and Social Research, an Associate Member of the Financial Markets Group at LSE, Associate Fellow of the Royal Institute of International Affairs and Research Fellow of the Pensions Institute at Birkbeck College, London. The article draws in part upon Davis and Steil (2001), copyright in which is held by the authors and MIT Press. I thank Mike Orszag for helpful comments and advice.

Introduction

This paper seeks to assess the current status and future prospects for private pension management in Continental Europe, with a particular focus on the nature of competition among managers of pension assets. Industrial aspects of asset management are introduced in Section 1, while Section 2 provides data on pension fund assets in Europe, viewed in the wider context of institutional investment and overall financial structure. Whereas the bulk of private pensions in EU countries are provided by companies and hence has a wholesale basis, there is a growing importance of retail based pensions based on mutual funds, and life insurers play a significant role in provision and management of pension products. Accordingly, in Sections 3 and 4 we consider the current situation in wholesale and retail asset management in Continental Europe. In Section 5 we look at future pressures on pension fund management in Continental Europe.

1 The industry of asset management

In discussing the industry of private pension funding it is natural to focus primarily on the management of assets. Asset management is a service provided to an institutional investor such as a pension fund, which involves the process whereby assets collected by institutional investors are actually invested in the capital markets. Managers may be in the trust department of banks or securities houses, in separately capitalized fund management firms owned by banks or insurance companies, in independent fund management firms, or internal to large pension funds or life insurers themselves. The types of asset management can be divided into wholesale management (management of assets on behalf of an institutional investor such as a pension fund) and retail management (management of assets, by mutual funds or for personal pensions, directly on behalf of the household sector).

A further subdivision is between generic, specialised and balanced asset management. Generic management refers to strictly quantitative and nondiscretionary operations in asset management such as indexation, immunization of portfolios and provision of annuities. Specialized management involves the manager carrying out only discretionary security selection (choice of individual securities within given asset categories), with asset allocation (choice of markets and instruments to invest in) being carried out by the sponsor, advised by consultants. Balanced management entails the asset manager carrying out, on a discretionary basis, both asset allocation and security selection.

As is detailed in British Invisibles (1997), the function of asset managers may be divided into front office functions and back office functions. Front office functions include the following:

- Marketing new products and developing products

- Fund management, the main focus of this paper, including strategic fund management (long-term asset allocation and risk management), operational fund management (security selection, tactical asset allocation, decision making, and implementation), research (fundamental and technical economic and company analysis), trading (buying and selling investments, pretrade broker liaison), and cash management (placing deposits and foreign exchange)

Back office functions include the following:

- Transaction processing and settlement (deal administration and control, post-trade liaison with brokers and custodians), safe custody (security safekeeping and control), and stock lending (arranging and processing loans)
- Systems support: systems maintenance (operational and technical maintenance of existing IT) and systems development (planning and implementation of new IT and major enhancements to existing systems)
- Accounting and administration: investment accounting (provisions of valuations and client reports, tax reclaims, management information), performance measurement (provision of investment performance reports, attribution analysis of returns), and mutual fund administration (client dealing and associated administration, including contract notes, distribution and trustee-director liaison)
- General administration: compliance (regulatory reporting and in-house monitoring activity), financial accounting (corporate accounting and reporting), and corporate management (training, personnel, and staff and premises management)

The degree to which these functions are bundled together differs across regions. They are more bundled in Continental Europe, where fund management often includes execution of trades, investment advice, custody, and marketing, all typically provided by a universal bank or life insurer. In contrast, these services tend to be provided separately in the Anglo Saxon countries. The degree of bundling also varies between sectors, with life insurers typically providing more bundling than pension funds and mutual funds.

As discussed in Davis and Steil (2001, Chapter 3), asset management can be analysed like any other industry according to the nature of competition. Using the structure-conduct-performance paradigm, one may classify sectors as monopolistic, oligopolistic, monopolistically competitive or perfectly competitive. Taking into account sunk costs, potential competition and strategic interactions between firms, the additional cases of contestable markets and strategic competition may also be discerned. The nature of the industry differs markedly between countries. Overall, the nature of competition in the market is typically related to that market's technology, regulation, and demand. Davis and Steil found that UK and US retail asset management and US specialised wholesale asset management were characterised by monopolistic competition (few economies of scale, many firms, non homogeneous

product but no supernormal profits). UK wholesale asset management and US generic asset management were seen as contestable markets (few firms, economies of scale, but competitive behaviour owing to potential competition and hence no supernormal profits).

Davis and Steil also reported results of a questionnaire on the nature of competition in global asset management. Briefly, the responses to the questionnaire show that the key elements of competition in asset management are returns relative to other firms, and reputation with customers and advisers. Entry barriers in both domestic and foreign markets include existing firms' distribution channels, relationships, and reputations, with foreign entry being seen as a tougher hurdle than domestic entry. Marked consolidation and globalisation are foreseen. Benefits of size are mainly by way of reputation, with lower operating costs being offset by costs of the market impact of large trades. The future is seen as being strongly influenced by mergers, advantages of large firms, and participation of commercial and investment banks in asset management.

2 European pension funds and institutional investors

We now turn to an assessment of the nature of the private pension fund sector in Continental Europe. In the EU, pension funds in 2000 accounted for around 30% of GDP, while insurance company assets were over 50% of GDP and investment funds 40%. The total value of institutional assets in Europe was around Euro11 tn, which implies annual revenue of around Euro 40 billion.

As shown in Table 1, the size of pension fund sectors differs markedly between countries, with Denmark, the Netherlands and Sweden as well as Switzerland standing out in Continental Europe, and the UK and Ireland also having major pension fund sectors. Since our main focus is on Continental Europe, it is worth noting that the value of institutional funds under management in Europe is dominated by the United Kingdom, which accounts for around 30% (see also Institutional Investor (1999)). Accordingly, the size of pension fund sectors in the Euro zone is less than in the EU as a whole. Note however that in some countries, retirement assets are also accumulated in the form of life insurance and investment fund assets so the overall size of "private funding" exceeds that included in the pension funds column. There is also a likelihood of double counting in a table such as this, since as discussed below, insurance companies are important managers of pension fund assets and also pension funds are important investors in investment companies.

Walter (1999) suggests that in recent years, the main drivers of institutional asset management in Continental Europe – and in particular private pension asset management - include

- the trend toward professional management of household assets;

- the recognition by households and most governments that pay-as-you-go pension systems are unsustainable as they stand, leading to precautionary saving and some reforms stimulating funding, such as in Germany;
- the move from defined benefit to defined contribution pensions in the private sector;
- and the shift of portfolios into equities and foreign assets.

Despite Walter's point, there is still a predominance of defined benefit occupational pensions and generally highly restrictive regulations in respect of portfolio choice for pension funds (and life insurers), which limit shifts into equity and foreign assets, see Davis (2002a).

Owing to the dominance of pay-as-you-go pensions (Davis 1995), scope for expansion of private pension funding is arguably even greater in Continental Europe than in the relatively mature markets of the US and the UK, where pension systems already have major funded elements. Pension saving is likely to increase sharply over the next twenty years as individuals seek to provide for their retirements.[2] These elements help to explain the considerable attention being paid to European markets by the industry in general. The scope for change is enhanced by EMU, as outlined in Section 5.

European pension fund management has traditionally been strongly based on domestic bond investment, linking, inter alia, to:

- the relative risk of taxation being imposed on equities, which is less feasible for anonymous bearer bonds;
- historic-cost-based accounting systems;
- portfolio regulations (Davis 2002a); and
- investor caution resulting from past experiences of equity risk (e.g., after World War II when equities became worthless in many countries; see Jorion and Goetzmann (1999)).

Notably in Spain, Germany, and France, there has been suspicion of international investment, for example, owing to concern about currency risk, liquidity risk, and lack of information. But there are signs that this is changing to a more equity-based and internationally based approach, as the appreciation of the benefits of diversification and the long term yield pickup available from equities becomes more widely appreciated (despite the current bear market), and EMU has eliminated currency risk for the participating countries. Portfolio indexation is growing rapidly, albeit accounting for only around 4% of assets in 1999 (although indexation is more prevalent in the Netherlands, Ireland, and Switzerland).

3 The structure, conduct and performance of wholesale asset management in Europe

---

[2] Indeed, Intersec predict annual growth in pension assets in the European Union of around 14% in coming years.

A key point is that many markets for pension fund management are dominated by a small number of banks and insurance companies. Furthermore, EU capital markets and pension fund management sectors remain fragmented. In most countries, it is still domestic managers who are dominant, while they in turn are little represented abroad.

This segmented pattern remains although some barriers to cross border competition have been eased by EU Directives. The Investment Services Directive (ISD) has, since the beginning of 1996, offered a European "passport" to asset managers, thus permitting a level playing field in cross-border marketing of investment management (excluding mutual funds; see Section 4). It also imposed capital requirements on investment firms that are intended to allow firms in difficulty an orderly run-down period of three months[3]. The basic requirements for approval under the ISD are that directors must be of good reputation and have adequate experience, the firm must be a legal entity, at least two people must take part in the decision-making process, and the head office must be in the same member state as the registered office. On the other hand, loopholes in the Directive have been widely used for protectionist purposes (see Steil 1996). Insurance companies also benefit from Single Market Directives, which allow services and products to be offered across the European Union. Single banking licenses under the Banking Directives are valid also for institutional investment, for the case of banks including asset management and advice and trading in securities. (We discuss investment companies in Section 4, and progress on a Pension Funds Directive in Section 5.)

In Continental Europe, managers tend to be balanced, offering investment management services for whole portfolios, as in the United Kingdom, rather than specialists as in the United States. However, generalization is risky, as the sectors are by no means homogeneous. In the Netherlands, Sweden, and Switzerland, the size of capital markets—and institutional sectors—is comparable with that in the Anglo-Saxon countries. But structurally and behaviourally, the wholesale asset management sectors are rather different. In several countries, it is the bank of the pension fund sponsor that would be the investment manager, for relationship reasons, almost regardless of performance. Moreover, half of pension funds in Europe are insured (although the insurer may delegate part or all of the asset management to other institutions) —typically offering a guaranteed return of around 4% (Financial Times 1999). In Spain funds must be managed either by a bank or an insurance company.

The manager selection process differs sharply from that in the Anglo Saxon countries, where consultants dominate it. In the Netherlands, members of the fund board itself who are investment professionals and have a background in academia or finance may manage the selection process. There, there is intense competition among asset managers. In Switzerland, there may be a senior bank

---

[3] Franks and Mayer (1989) question the need for capital requirements for asset managers, suggesting they are an inappropriate barrier to entry and that consumer protection would be better served by conduct-of-business rules (some of which are also mandated under the ISD).

representative on the board who selects and recommends managers. Perhaps reflecting this, 80% of pension assets are in pooled vehicles managed by Swiss banks, and about 20% are in segregated funds.

Size of asset managers differs widely, largely reflecting the size of the domestic markets; hence in countries such as Ireland and in Scandinavia, firms are generally quite small. In Southern European countries, including Spain, Italy, and Portugal, there are only six companies that feature in the largest 150 in Europe. Since managers are usually balanced, this implies inefficient scale and a potential benefit from consolidation of the industry. In a survey by McKinsey (2000) the average firm size was around $55 bn in the UK, France and Germany but only around $30 bn in Benelux and Italy, and $10 bn in Iberia. Broby (1997) argued that the minimum efficient scale for fund managers was around Euro 5 billion, for which the equivalent today may be around Euro 7 billion. Meanwhile, McKinsey (2000) show that large firms in Europe have profits 25% higher than small ones, largely reflecting a 4.3 basis point (bp) cost advantage relative to assets (11.9 bp compared to 16.2 bp). The main contributors to this difference are not fund management costs per se but IT and support costs (2 bp difference between large and small), sales and marketing costs (1.2 bp difference).

One reason consolidation to increase efficiency is slow is the difficulty of takeovers; rather few independent fund managers are available, most being linked to or part of banks or insurance companies. Takeovers of asset managers in any country may face problems such as loss of valuable staff. But cross-border takeovers of fund managers in Continental Europe have particular difficulties. These include different accounting traditions, which hinder assessment of the worth of a fund, management business, and integration of business. Taxation, use of market data, and advertising rules on presentation of performance also vary widely.

Turning to fees, according to Harrison (1997), in the mid 1990s fees for wholesale business such as pension fund asset management were 100–200 bp of funds under management per annum in Belgium, 25–75 bp per annum in Denmark, and 10–20 bp for large funds in Ireland; in the Netherlands, equity managers may charge 25 bp and bond managers 12.5 bp or less. In Switzerland, fees were 50 bp, but overall costs also included income on turnover charges, and turnover may be 50–75% per annum.

A more recent and systematic assessment of fees for pension fund management is given by Watson Wyatt (2000) who looked at the fees from a $100 mn domestic balanced mandate. As shown in Table 2, among EU countries, fees are lowest in Ireland and the Netherlands and are high in France and Switzerland. In Germany fees are comparable to the UK but they may exclude hidden charges (see below). In principle the fee should be linked to asset allocation, with bonds being cheapest and international equity dearest. In fact the low fees for Irish and Dutch funds suggests that the market is more competitive than domestic markets elsewhere, possibly sufficient to offset high costs. High costs

in the US were seen as due to the “no favoured nation clause” and willingness to pay high fees for active specialist management.

Differences in fees do not coincide with national differences in equity fund management costs, according to McKinsey (2000); costs were estimated to be 5.7-5.8 bp in France, Germany, Italy and the UK, 4.6 bp in Benelux and only much lower at 3.7 bp in Iberia. Differences in the value of assets under management tend to offset costs per fund manager. This contrast between variable fees and common management costs again suggests a role for market power.

There is a widespread problem of hidden fees, as noted by John (1999) summarizing a Towers Perrin survey. This also seems likely to reflect market power by sellers and related governance failure, otherwise buyers would insist on transparency. In the survey, there is particular criticism of German asset managers for hiding management, transactions, and safekeeping costs. Universal banks, that dominate investment management in that country, do not separate out the cost of services; they have cut visible asset management fees to ward off competition while keeping hidden charges high. Clients may “think they are paying less than 20bp for management services but end up paying 160bp, mainly due to high commission charges.” Only large international investors have been able to negotiate lower fees. Belgium is also singled out for criticism, and only the Netherlands approaches Anglo-Saxon levels of transparency of charges.

Clearly, there are considerable variations, but also in most cases, overall fees are above those in the UK quoted in Davis and Steil (ibid). There is also more scope for conflict of interest when, for example, the asset manager is a subsidiary of the bank providing the transactions services. Growth of global custodians, as well as more competition in asset management after EMU, may help to remedy the situation.

Use of performance measurement for pension fund managers is much less common in Continental Europe than in the US and UK, although there are also sharp differences between countries. Broadly speaking, most funds use a measurement service in Ireland, and this is also becoming the rule in Belgium and the Netherlands. In Switzerland, it is beginning to catch on, although the bulk of performance measurement is undertaken by the banks on their own behalf. In Germany, performance measurement is rare for pension funds (Pensionskassen) but more common for wholesale corporate investment funds (Spezialfonds). To a considerable extent in Switzerland and Germany, it is the investment management firm that measures its own performance, with scope for falsification (although reportedly practices have improved since the 1980s). Until recently, in Scandinavia, Austria, Italy, Luxembourg, Spain, and France, performance measurement was virtually unknown. Even in such an important and mature market as Denmark, banks used their own past performance claims for competitive purposes, rather than independent performance measurement services (Harrison 1997).

One reason for the absence of performance measurement may be relatively undiversified asset composition in bonds, which requires less performance measurement than more sophisticated portfolios. Prescribed asset returns, such as 4% for Swiss pension funds, make performance less important than risk control. In addition, the fund is not always independent of the sponsor; or, as we noted above, there may be representatives of the investment manager on the fund board; hence their performance is less often questioned.

The profit performance of Continental asset managers (including retail as well as wholesale business) is summarised by McKinsey (2000) in a survey of 33 companies with average assets of $37 bn across the EU. As shown in Table 3, the average operating profit relative to assets was 21 basis points, with much higher levels in Italy and Iberia and lower in the UK and Germany. The relative performance reflected differing net revenues (gross sales fees and income from management fees, less payments to distribution channels) and not cost performance, which was quite similar (although costs were highest in the UK). McKinsey (ibid) noted that the revenue performance can vary for reasons other than simple market power, notably proportions of retail business, equities and active management (which are relatively costly). For example, the average cost of equity funds is 5.1 bp while fixed income costs 2.6 bp and money funds 1.2 bp. On the other hand, revenue sharing agreements with distribution channels and ability to realise hidden fees from brokerage or trading as well as lack of transparency, the other possible explanations, do have a market power implication.

To summarise, in most Continental European countries, the key contestable or competitive features that are present in the US and UK are weak or absent. This has ensured not only that rankings are maintained, but also that there is excess profitability. For example:

- there is much less new entry, even at the niche level;
- relationships are much more important, particularly where an industrial firm has relationships with a financial conglomerate or "relationship bank" in all areas of business (there often being no independent trustees);
- there is less performance evaluation and/or it is less sophisticated;
- prescribed asset returns make performance of even less importance, while bringing risk control, the province of insurance companies, to the fore;
- the bargaining power of fund managers is greater, given the lack of local alternatives,[4] as well as their absolute size (e.g., universal banks and life insurers); and
- regulatory barriers may (especially prior to EMU) have prevented new entry either directly or by preventing pension fund investment in the securities markets, where potential entrants have a comparative advantage.

[4]This of course begs the question of why foreign managers are not seen as alternatives.

Moreover, expertise in the traditional investments of European funds—domestic bonds—is less widespread than equity/international investment, where a variety of international houses are ready to enter. In this sense, it is portfolio restrictions, not just restrictions on foreign entry, that are barriers to competition. EMU and the EU Directives are removing this historic advantage, as we discuss below.

With regard to paradigms of industrial organization, it is suggested that the Continental wholesale asset management sectors are oligopolies, partly as a consequence of regulatory factors as noted above, but also owing to structural entry barriers entailing significant sunk costs (e.g., owing to strong relationships). Note that several of these points suggest failures in governance which distort asset management away from members' interests – which are themselves partly linked to market power. Market power means that the firms concerned obtain higher profits than in a competitive market. It will be interesting to see how long pension fund sponsors on the one hand and consumers on the other will be content with such structures, given the shortfall in performance. Some movements are underway already that have begun to change the market situation in Continental wholesale asset management, not least in the light of EMU, see Section 5.

4 The structure, conduct and performance of retail asset management in Europe

Although the bulk of EU private pension management is wholesale, the growth of personal pensions means that the retail sector is also relevant, while precautionary saving arising from uncertainty over the future benefits of social security should not be disregarded. Investment companies and life insurance are the sectors concerned.

We deal first with investment companies (mutual funds), which are widely used as an investment vehicle by pension funds, as well as being vehicles for accumulation of individual pensions in some countries such as Sweden and Germany. Mutual fund assets in Europe stand at around $3.5 trillion, over 30% of the global total (see Table 1). France and Luxembourg have the largest sectors, followed by Italy. It is owing to its status as a tax haven that Luxembourg has developed as the major centre for EU mutual fund companies, with most of the inflows to its mutual funds coming from elsewhere (especially Germany and Belgium). The distribution between different types of fund differs sharply between EU countries, with equity funds dominating in the United Kingdom but being less important elsewhere, although the weight of equities is growing. The French market features a sizable money market fund sector (historically for tax reasons), while in Italy, there is a preponderance of bond funds, reflecting investor preferences and the less developed state of equity markets than elsewhere.

On the retail side in Continental Europe, the absence of an independent broker network[5] provides a barrier to entry; financial institutions typically offer only their own products, and their customers have

[5] Independent distributors account for 5% of sales in France and 15% in Germany.

historically been rather unadventurous. In Germany and France, the five biggest banks have market shares of 60% or more, and banks as a whole have shares of 80% and 70%, respectively; the rest is largely accounted for by domestic life insurance companies. Ninety percent of all mutual fund sales in France and the Netherlands and 95% in Germany take place via banks and insurers. Entry to domestic retail markets is hindered by the density of the bank branch network, combined with a lack in most countries of other sales channels such as the U.K. financial advisers. Only in Italy, apart from the United Kingdom, do independent advisors play an important role (accounting for around 50% of sales, with the other 50% via bank branches). Sweden is an exceptional case, where the government deals directly as a monopsony with asset managers in distributing funds from the compulsory funded part of state pensions. This ensures very low fees.

Large banks and insurance companies, while they may be willing to sell products of smaller overseas fund managers, may for defensive reasons refuse to sell the products of large or global firms. On the other hand, smaller banks, which do not have their own asset management subsidiaries, are proving increasingly willing to sell foreign products. It is notable that Fidelity and other U.S. firms entered the German market partly by direct selling but also by selling through the small local savings banks (Sparkassen); Schroders are selling products in Italy via regional banks. Fidelity has begun direct sales in Germany, using German nationals based in the United Kingdom as telephone salespeople.

An important force for liberalization of the EU investment funds industry is the 1985 UCITS Directive, which opened the way for cross-border marketing of mutual funds authorized in a member states. Under UCITS, general rules are specified for mutual funds' investments and sales. The home country is responsible for regulatory requirements for fund management and certification, while rules regarding disclosure and selling practices are a host country matter. 90% of mutual fund assets must be invested in publicly traded companies, the fund may not own more than 5% of a single company's stock, and there are limits on borrowing. Real estate, commodity, and money market funds are excluded from the Directive. There remained problems with UCITS, notably the requirement to publish prospectuses and the like in local languages, protectionism against foreign managers as a consequence of the host country basis of marketing regulations, and exclusion of funds of funds (i.e., mutual funds that invest solely in other funds) and some cash and venture capital funds. These are being addressed in a new Directive, discussed in Section 5.

Despite UCITS, domestic product regulations in Continental Europe often have a protectionist effect. For example the new German pension product known as the Altersvorsorge Sondervermögen,[6] introduced in 1998, is restricted to investing in mutual funds whose managers are based in Germany. France applies a similar restriction to its Plan d'Épargne Action (Eaglesham 1998). The new German

---

[6]This is basically a balanced fund with equity proportions to be between 21% and 75%, limits of 30% on foreign assets, and no use of derivatives permitted. There are no tax advantages.

"Riester pensions" to be eligible for government subsidies must take a form that no conventional life or UCITS product could take without major adjustments. Hence each supplier of pan European products must set up a particular variant for Germany (Heinemann and Jopp 2002).

As the Economist (1997) noted, a more significant barrier may be, on the one hand, caution regarding the risks of equities, as outlined in the section above, and, on the other, at least historically, a lack of interest in relative performance. Whereas an institutional fund manager in Europe can expect 3% more assets if performance is improved by 10 bp, for retail clients the return is only 1% more clients (see also Moon et al. (1998)) Reflecting these features, foreign managers have a rather small share of European markets. According to Moon et al. (1998), they accounted for 4% in Germany and 1% in France, although they have captured 19% of the market in Italy. More recent figures quoted in Heinemann and Jopp (2002) suggest that foreign shares are generally below 10%.

On the other hand. the overall economics and costs of the sectors are not different from those of the US and UK. Notably, Dermine and Röller (1992) found results for economies of scale and scope for French mutual funds similar to those for the US, with economies of scale present for small and medium fund complexes but not for large fund complexes. Heinemann and Jopp (2002) note that the average size of EU funds is small owing to segmentation, (Euro 176 mn compared to Euro 910 mn in the US), leading to wasteful higher average costs. McKinsey (2000) comment that even large EU asset management firms do not take advantage of economies of scale in retail funds (since fixed costs are 80% of the total), indicating X-inefficiency sustainable owing to market power.

As we have noted, sale of mutual funds tends to be through bank branches that have, at least until recently, offered only their own funds. Reflecting imperfect competition, fees for mutual funds in Continental Europe (apart from the Swedish case) are higher than those in the United States and the United Kingdom, and they remain even more subject to the hidden charges noted above than wholesale funds.

As noted, cross-border competition is only just developing, hindered by distribution problems. Broby (1997) sets out some criteria for successful penetration of Continental retail markets. These include the quality of the parent's name and its prominence in the country concerned (which can obviously be enhanced by advertising); past performance of funds, risk adjusted, in terms of the local currency (which U.S. and U.K. funds often find a major advantage); risk and volatility being tailored to local preferences; investment selection being carefully explained (e.g., benefits of international diversification); financial backing and safety of assets in the case of cross-border sales of funds; a competitive pricing structure for the country concerned; an efficient and consumer-friendly dealing system; and comprehensive service more generally. Clearly, local knowledge is essential for many of these. Product literature in the local language offers considerable benefits, which, surprisingly, are not

always taken advantage of. Walter (1999) sees targeting of specific client segments and superior products to traditional vendors as essential by for effective cross-border competition.

Life insurance must also be considered in the context of private pension funding, since life insurers tend to be the principal sellers of personal pension products and also providers of annuities for defined contribution pensions. Life insurance products more generally are an important form of saving, which may be directed to ensuring retirement security owing to concerns over public pension schemes (although income and lifestyle protection are also key determinants of life insurance demand). In 2000, life business grew 17% in Europe, and 10% per annum over 1990-99 (Swiss Re 2001). Table 4 shows the premium volumes in EU countries, indicating considerable scope for growth in Continental Europe if they were to catch up with the UK premium/GDP ratio.

The market structure is concentrated in most EU countries, with only Germany and the UK having a 5-firm concentration ratio of significantly less than 50%, see Table 4. As for investment companies, the degree of cross border competition is minimal, owing to consumer preference and tax barriers (such as limitation of tax benefits to contracts with domestic firms). Regulatory barriers to cross border sales have been eased by the Third Life Directive, but host country regulations may still differ under the so-called "general good principle" leading to effective barriers to entry. Swiss Re (2000) for example show that cross border life business accounts for 0.7% of total life premia for Belgian firms, 0.2% in Germany and 0.1% in France and Italy. Only the offshore centres Ireland (28%) and Luxembourg (94%) show much higher figures.

High concentration and low cross border competition are priori indicators of potential power to fix high prices at the expense of consumers. Whereas some of the same sales channels are used as for mutual funds discussed above, there is also a major importance of tied sales forces, which will only sell products of a single firm. The degree of price competition is difficult to discern, but in most countries is marginal, with firms selling products based on past bonus performance.

Indeed, as noted in Davis (2002b), pricing regulations apply to life products such as annuities in a number of EU countries, where annuities are priced according to supervisory guidelines on a "technical rate basis", with the guaranteed rate being equal to only 60% of the government bond yield and changed infrequently (Blake and Hudson 2000); any excess over this is paid in the form of a revaluation of the initial annuity. This is the case for example in Belgium, France, Germany and Italy, while in France there is also a separate ceiling of 3.5% (Cardinale et al 2002). The Netherlands permit insurers to offer higher guaranteed rates for 15 years, before reverting to the guaranteed rate. Besides "consumer protection", this system provides a prudential safety margin, arguably at a cost in terms of lower incentives to maximise returns. Competition may be limited to second order aspects such as expenses – as well as bonus record.

An important innovation in the life insurance sector is so-called bancassurance – insurance companies controlled by or subsidiaries of banks (Swiss Re 1998). Mergers are driven largely by pursuit of economies of scale and scope, with better access to capital and human resources. Some of these benefits may also be obtained by joining together in a holding company, and to a lesser extent in a joint venture where a bank acts as an intermediary for insurance products. To the extent that the mergers are cross border they have increased integration and potential competition. While in 1993 12% of life premia in Europe were written by foreign controlled firms, in 1999 it was 21%.

Despite the good performance in 2000, life insurance growth has tended in recent years to be lower than that of pension funds and investment companies, perhaps reflecting consumer disenchantment with low returns, despite tax advantages and (compared to investment companies) lesser downside risk of traditional insurance products. Accordingly, pressures to enhance overall returns (including lower fees) seem likely to grow.

In summary, as for wholesale management, retail management in most of Continental Europe is an oligopoly, partly as a consequence of historic regulation, but also owing to structural entry barriers entailing significant sunk costs, notably via control of channels of distribution. Market power means that the firms concerned obtain higher profits than they would in a free market. EMU may undermine these oligopolies, but the process is likely to be gradual.

5 Prospects for the future: EMU and the private pension fund industry

The fundamental pressures for growth of Continental European pension asset management are the aging of the population in the context of generous pay-as-you-go pension schemes (see Davis 1999). Changes are already taking place in the structure of asset management owing to deregulation, which will be enhanced by a new Pension Funds Directive and an amended UCITS Directive. There are a number of ways in which European Monetary Union (EMU) will tend to accelerate the growth of pension funds. Some autonomous developments are also relevant.

The European Commission drafted a Pension Fund Directive in the mid 1990s, but it was ultimately abandoned in the face of irreconcilable differences over the appropriate liberalization of international investment (see Davis 1996). The European Commission is currently introducing a new Directive on for occupational pension funds, with a prudent man principle and mutual recognition of supervisory systems (a single licence for pension funds), thus allowing cross-border provision of services and cross-border membership. Funding rules may still differ cross country. Separately, progress is also being sought on removal of obstacles to labour mobility such as vesting rules and appropriate coordination of tax systems with regard to pensions (abolishing tax discrimination on pension and life

insurance products offered cross-border). Notably for multinationals, a key issue remains such tax divergences that prevent a pan-European pension fund.

Complementing this, the UCITS legislation is being enhanced by new amendments dated 2002. They widen the investment possibilities of funds to use derivatives as well as allowing funds of funds, money market, cash and index funds. There is a simplified prospectus, facilitating cross border sales, and a wider range of permissible activities of the asset manager (allowing the firm to use a “passport” and not just the products).

The EMU context enhances pressure for reform of public pension systems, stimulating future demand for the private pension funding industry’s products. This links to fiscal integration in EMU, notably because in the context of an effective Stability and Growth Pact, there is much less scope than would otherwise be the case for governments to run large deficits to cushion rises in taxes when aging becomes an acute burden on social security. This is the case even if such deficits are desired as part of a strategy of reform that aims to distribute the burden of transition to funding between generations.[7] To avoid sharp rises in taxation, governments will seek to deal with their social security obligations and switch to funding of pensions at an earlier stage. Furthermore, owing to the so-called “no-bailout clause” in the Maastricht Treaty,[8] financial markets in general and rating agencies in particular are putting an increasing focus on general government obligations, of which pension liabilities are the largest part (De Ryck 1997).

In this context, Swiss Re (1998) note that if governments were to hold their social security contributions constant, and the public financed the “gap” relative to full pay as you go financing of current benefits with life insurance only, the ratio of premiums to GDP would more than triple in Italy, triple in Germany, double in France but be relatively unchanged in the UK. Of course, pension funds per se or investment funds may also fill the gap, but Swiss Re comment that the growth rates required for life insurance are within the range of past experience and are hence feasible.

Separately, companies in Germany with book-reserve pension liabilities are keen to shift to a fully funded basis. This reflects the ongoing shift to market value accounting, which will make such liabilities apparent, as well as the impact of such liabilities on their credit ratings, where ratings are increasingly crucial to the cost of capital in the securitising EMU capital market. The recent tax reform makes it easier for pension assets and liabilities to go into separately capitalized pension funds.

---

[7]Note that reforms that seek to distribute the costs of transition from pay-as-you-go to funding between generations may in principle involve heavy government borrowing and deficits. Pure tax financing leaves the entire burden on the current generation of workers. See Holzmann (1997)

[8]Both the monetary authorities and other fiscal authorities are debarred under the Treaty from rescuing a country in fiscal crisis.

Macroeconomic and financial conditions in EMU also favour growth of pension funds. Since monetary integration is giving rise to sustained lower inflation, at least in some countries, it will make it easier for defined benefit pension funds to finance inflation indexation, while pension benefits from defined contribution funds will also more readily retain their purchasing power (Dickinson 1992). Financial integration is also making funding more attractive by leading to a better risk-return trade-off being attainable. One aspect is increases in the range of instruments available, owing, for example, to broader availability of private equity as well as corporate bonds and securitised loans, the latter especially as the supply of government bonds diminishes. Increased liquidity and lower transactions costs resulting from market integration in EMU are increasing institutions' comparative advantage over bank intermediation. In due course, in a deeper securities market, there may arise financial innovations that are tailored to institutions' needs. These could include currently unavailable instruments such as bonds with returns linked to average earnings, which could be useful for life insurers and pension funds in matching assets to liabilities.

Independent of the Pension Funds Directive, regulations limiting international investment have ceased to be effective in the context of the euro zone, with accompanying increased correlation of national markets leading to sectoral investment across the whole of the euro zone.[9] Besides eliminating the effects of home bias and diversifying portfolios across the euro area, a sectoral approach necessitates a major restructuring of portfolios as for example industrial stocks are 45% of the German market and 11% of the Spanish market.

Partly as a consequence of the above-mentioned factors, EMU is leading to increased competition among asset managers that previously monopolized national markets, with those having pan-euro-zone expertise having a decisive advantage. Indeed, Mercer (2001) report that the number of domestic equity mandates fell 60% over 1999-2001, and domestic bond mandates by 92%. Since asset managers are increasingly competing in euro-area-wide investment, the scope to compare their performance also increases, thus strengthening forces of competition. An aspect of this is cross-border activity. Mercer (2000), for example, notes that in 1999–2000, forty-one of the top European money managers operate in five or more countries, whereas in 1996, the corresponding number was only seventeen. Global firms, including those from outside the EU, are themselves increasingly competitive in such a market. (Note that the top three global firms are from Switzerland and the US.)

Besides benefiting returns, competition should mean that the high fees and hidden charges noted in Section 3 should diminish. One factor putting pressure on costs is the popularity of indexation, with European indexed pension funds growing by 28% in 1998 and further following EMU. Passive managers apparently benefit from the lack of an entrenched equity culture. In EMU, active managers are finding it hard to compete with indexers, since the main focus of cross-border investment is on the

[9] Beckers (1999) showed increased correlation to be an established trend even before EMU.

top 200 shares in EMU, and it is harder to find undervalued stocks among such giants than among smaller firms. Also the scope for active management diminishes, owing to the loss of currency risk in EMU (Beckers 1999).

Banks in Europe are facing challenges to their traditional business under EMU that are leading them to expand their asset management activities to maintain profitability. This promises to enhance pressure for change in the asset management industry. An immediate aspect is the elimination of commissions for foreign exchange transactions within the euro area. Lower inflation in some countries due to monetary integration has reduced interest rate margins,[10] owing to the elimination of the so-called endowment effect profit from zero-interest sight deposits in a context of positive rates of inflation. Moreover, as financial integration increases, competition between banks for wholesale deposits and loans is also tending to intensify. For example, EMU gives multinationals the opportunity to consolidate treasury operations that were formerly spread across different currency zones (White (1998)). In addition, the transparency generated by the single currency is also allowing bank customers generally to compare rates and fees more readily across borders, thus threatening traditional relationship banking links. In the longer term, formerly insulated national retail banking markets in which domestic competition is already intensifying may also become subject to intensified cross-border competition in a single-currency environment.

The scope for disintermediation of traditional banking activities is increasing, as witness the rapid growth of corporate bond issuance by EU firms since 1999. By issuing bonds, firms are avoiding the “cost and relative inflexibility of the covenant burden of bank loans” (Bishop 1999). Lower-quality firms are also able to obtain bond market financing as the higher-yield bond market develops further. The integrated money markets generated by EMU are facilitating the use of commercial paper for short-term borrowing by companies and security repurchase agreements (repos) and commercial paper as alternative repositories for liquidity to bank deposits.

For all of these reasons, Continental universal banks are increasing their focus on asset management and other investment banking services as a result of EMU, as the means to ensure continuing profitability and taking advantage of their distributional advantages. This is particularly marked in countries such as Germany, where the major commercial banks are seeking to redefine their business focus toward investment banking and aim to downplay or even eliminate their traditional—and relatively unprofitable—domestic retail and corporate banking. (Most recently some banks have been seeking to sell or cut back on their asset management operations, but this cyclical pattern need not contradict the broader structural trend (see Gimbel (2002).)

---

[10]The margin is the difference between the average rate on loans and the average rate on deposits.

The thrust of the points made above is that the euro zone will increasingly feature much less banking activity and more securities market financing and institutional investment. In this context, the massive growth in bond issuance since EMU shows that the new securitised system is developing much more rapidly than had previously been predicted. Meanwhile, Pragma Consulting (1999) have predicted that pension assets in Europe will rise $2–5 billion per annum over the next ten years.

Some autonomous developments are also relevant. European countries are developing professional bodies of asset managers and analysts that, by contributing to the understanding of financial markets, risk, and return, are tending to enhance competition. The European Federation of Financial Analysts' Societies is in the process of developing a single European examination of fund manager competence. Further development of performance measurement, shifts toward equities/international investment, and use of derivatives are aiding competition. And the tendency toward cross-border acquisitions of fund managers (notably of UK managers by German and Swiss banks) is already facilitating consolidation at a European level, although the motivation of such mergers may be partly a desire to consolidate entrenched positions at home.

Continental European pension funds are often willing to invest in mutual fund shares (using bargaining power to reduce fees), hence reducing the sharpness of the distinction of the retail and wholesale sectors. Moreover, there is considerable interest in passive or indexed funds for cost reasons, in which foreign managers typically have a comparative advantage. According to Broby (1997) indexation is used by 15% of EU pension funds. Wells Fargo Nikko has attracted $6 billion in funds in the Netherlands despite strong local competition. Use of derivatives, mainly for risk control, is increasing; in 1995, the WM company reported that a third of 1455 European pension funds that it monitored made use of derivative markets (although most were in the United Kingdom). Related to this, there is an increasing focus on the so-called middle office, which seeks to monitor investment risk.

Conclusions

To conclude, we have shown that the pension fund sector in Continental Europe is relatively small and the industry to date has tended to be oligopolistic and segmented on a national basis. This has tended to lead to higher prices and lower returns than could otherwise be obtained. Regulatory, fiscal and demand-side differences are at the time of writing holding back a Pan European asset management market, despite three years of EMU (see CEPS (2002), Heinemann and Jopp (2002)). Nevertheless, future pressures are likely to induce greater competition, notably on a cross border basis. These include not only evolving effects of EMU itself but also the indirect effects on asset management via banking, EU Directives and the further pressures for pension reform. A topic of future research that is suggested by the work is the governance of pension fund asset management (who makes the decisions,

how they are made, rules on transparency and charging etc.). Although the competitive pressures outlined in Section 5 can be expected to reduce some of the egregious distortions of asset management away from members' interests, legal change may also be needed in some countries.

References

Beckers S (1999), "Investment implications of a single European capital market", Journal of Portfolio Management, Spring, 9-17

Bishop G (1999), "The euro's fourth quarter; completing a successful first year in the bond market", No. 7 of a series "Delivering the benefits of EMU", Schroder Salomon Smith Barney, London

Blake D and Hudson R (2000), "Improving security and flexibility in retirement; full technical report", Retirement Income Working Party, London

British Invisibles (1997), "City business series 1997 - fund management", British Invisibles, London.

Broby D (1997), "The changing face of European fund management", FT Financial Publishing

Cardinale M, Findlater A and Orszag M (2002), "Paying out pensions; a review of international annuities markets", Research Report 2002-RU07, Watson Wyatt, Reigate.

CEPS (2002), "Obstacles to Pan-European asset management", Report of a Task Force, Centre for European Policy Studies, Brussels

Davis E P (1995), "Pension funds, retirement-income security and capital markets - an international perspective", Oxford University Press.

Davis E P (1996), "Pension Fund Investments", in B. Steil et al "The European Equity Markets, the State of the Union and an Agenda for the Millennium", The Royal Institute of International Affairs, London

Davis E P (1997), "Population aging and retirement income provision in the European Union", in Ed. B Bosworth and G Burtless, "Aging societies, the global dimension", Brookings Institution Press, Washington DC

Davis E P (2002a), "Prudent person rules or quantitative restrictions? The regulation of long term institutional investors' portfolios", Journal of Pensions Economics and Finance, 1, 157-191

Davis E P (2002b), "Issues in the regulation of annuities markets", CERP Working paper No 26/02, Center for Research on Pensions and Welfare Policies, Turin

Dermine J and Röller L H (1992), "Economies of scale and scope in French mutual funds", Journal of Financial Intermediation, 2, 83-93.

De Ryck K (1997), "EMU and pension funds", European Federation for Retirement Provision, Brussels

Dickinson G M (1992), "Prospects for the ECU and the impact of EMU on private pensions", in ed. J Mortensen, "The future of pensions in the European Community", published by Brasseys for the Centre for European Policy Studies

Economist (1997), "Europe's fund phobia", The Economist, 29 March 1997.

Financial Times (1999), "Financial Times Survey; Pension Fund Investment", FT, 21 May 1999.

Franks, J and Mayer, C P (1989) "Risk, regulation, and investor protection: The case of investment management", Oxford University Press

Gimbel F (2002), "Banks to sell investment arms", FT Fund Management, September 9 2002.

Harrison D (1997), "Pension provision and fund management in Europe", Financial Times Financial Publishing, London.

Heinemann F and Jopp M (2002), "The benefits of a working European retail market for financial services", Report to the European Financial Services Round Table, Europa Union Verlag, Bonn

Holzmann, R. (1997), "On economic benefits and fiscal requirements of moving from unfunded to funded pensions", European Economy Reports and Studies, 4/1997, 121-166

Institutional Investor (1999), "Euro 100 cross border express - Europe's largest money managers", November 1999

John O (1999), "Active investment management charges survey", Towers Perrin, London

Jorion P and Goetzmann W N (1999), “Global stock markets in the Twentieth Century” Journal of Finance, 54, 953-980.

McKinsey (2000), “Asset management in Europe”, The McKinsey Quarterly, 2000 Number 2: Europe, 8-11

Mercer W (2000), "European pension fund managers guide 2000", William M Mercer, London

Mercer W (2001), "European pension fund managers guide 2001", William M Mercer, London

Moon J J, Pizante L R, Strauss R K and Tukman J M (1998), "Asset management in the 21st century, new rules, new game", Investment Management Industry Group, Goldman Sachs.

Pragma Consulting (1999), “Rebuilding pensions, security, efficiency, affordability. Recommendations for a European code of best practice for European second pillar pension funds”, European Commission, Brussels

Swiss Re (1998a), “Life insurance; will the urge to merge continue?”, Swiss Re Sigma, 6/1998

Swiss Re (1998b), “Financial difficulties for public pension schemes; market potential for life insurers”, Swiss Re Sigma, 8/1998

Swiss Re (2000), “World insurance in 1999; soaring life insurance business”, Swiss Re Sigma, 9/2000

Swiss Re (2001), “World insurance in 2000; another boom year for life insurance, return to normal growth for non-life”, Swiss Re Sigma, 6/2001

Walter I (1999), “The asset management industry in Europe: competitive structure and performance under EMU” in eds Dermine, J and Hillion, P, eds. “European capital markets with a single currency”, Oxford University Press.

Watson Wyatt (2000), “Global investment review 2000”, Watson Wyatt Co.

White, W (1998), "The coming transformation of Continental European banking?", BIS Working Paper No 54.

Table 1: Assets of Institutional Investors (2000)

Percent of GDP	Pension funds	Investment funds	Insurance
Belgium	6	30	42
Denmark	24	20	78
Germany	16	12	43
Greece	4	25	1
Spain	7	30	13
France	7	55	61
Ireland	51	144	45
Italy	3	39	21
Luxembourg	1	3867	117
Netherlands	111	25	65
Austria	12	40	24
Portugal	12	16	20
Finland	9	10	57
Sweden	57	34	90
UK	81	27	107

Sources: EFRP, FEFSI, CEA quoted in CEPS (2002)

Table 2: Fees for a $100 mn balanced mandate

	Fees (basis points)
Ireland	18
Netherlands	18
Germany	27
UK	27
France	32
Switzerland	40
Memo: US	46

Source: Watson Wyatt (2000)

Table 3: European asset manager performance (basis points of assets under management)

	Operating profits	Net revenues	Total costs	Memo: % retail funds	Memo: equity fund management costs (bp)
Benelux	19	32	13	53	4.6
France	19	32	13	40	5.7
Germany	9	23	14	31	5.7
Iberia	42	53	11	74	3.7
Italy	35	48	13	94	5.8
UK	11	28	17	21	5.8

Source: McKinsey (2000)

Table 4: Life insurance premia in the EU (2000)

	US Dollars	US Dollars per capita	Percent of GDP	Memo: 5-firm concentration ratio (1998)
Belgium	12963	1254	5.7	55
Denmark	6527	1223	4.0	77
Germany	56257	683	3.0	32
Greece	1254	119	1.1	69
Spain	21905	556	3.9	46
France	84761	1437	6.6	46
Ireland	13030	1888	7.5	63
Italy	36679	638	3.4	54
Luxembourg	4664	540	1.3	Na
Netherlands	21596	1357	5.9	58
Austria	4965	607	2.6	51
Portugal	3544	354	3.4	49
Finland	9030	1744	7.4	99
Sweden	13500	1521	5.9	70
UK	179742	3029	12.7	29

Source: Swiss Re (2001), CEA