Oxera

# Current trends in asset management
## (MARKT/2005/25/G)

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# Executive summary

## Focus and objective

This report focuses on the evolution of the value chain within the European asset management (AM) industry through the identification and analysis of leading current trends and their implications. The study's fundamental objective has been to undertake consistent and structured research of the following issues:

– **where** in the value chain of the European AM industry the leading trends are occurring that are of significance for the strategic positioning of players along the value chain and across the marketplace;

– **how** and **why**, from an economic assessment standpoint, the trends are taking place in terms of specific drivers, incentives, underlying structural mechanisms, and strategic choices made by different types of player;

– **what** the implications of these trends are for the industry as a whole—in particular, with respect to emerging as well as existing risks to the AM industry itself, as well as in relation to competition, integration of financial markets across Europe, and the impact on the end-investor.

The analysis comprises four steps. The first involves identifying and analysing the key representative business models in the European AM industry across both markets and products today, as well as those evolving over time. The aim is to provide a framework for the analysis of the different segments of the value chain, identification of potential trends that might be business model-specific, as well as assessment of the risks in each segment.

During the second step, the value chain itself is analysed. Rather than looking at the different parts of the value chain outside of their operational context or on a stand-alone basis, segments and sub-segments are analysed in the context of the business models in which they operate.

Using the analytical framework in conjunction with the value chain analysis, the third step involves identifying, describing and reviewing leading trends in the AM industry in Europe in light of the available evidence.

Not all potential trends are of relevance to the study. To assess systematically all aspects of the industry's ongoing transformation, the methodology to select the trends of interest is based on the following criteria.

– **Direction and persistence**: each trend of relevance is expected to represent a medium- to long-term change in the AM industry, rather than a transient one.

– **Impact on value chain**: each trend of relevance is expected to have a significant effect on at least one major segment of the value chain.

– **Implications**: each trend of relevance is expected to have implications encapsulated within the scope of this study.

– **Substantial scope and coverage**: each trend of relevance is expected to be substantial in industry scope and geographical coverage.

As a final step, the specific implications of the trends of relevance to the study are analysed, including:

– the constituent embedded risks and risk correlations across segments;
– potential market inefficiencies (mispricings) and externalities;
– drivers of, and barriers to, competition;
– geographical dimension and cross-border financial integration;
– potential value transfers to the consumer.

## Sources of information

Structured interviews with the key decision-makers in the European AM industry represent the main primary information source for the analysis. Oxera has also had access to a dataset of quantitative and qualitative evidence industry assembled by ZEW/OEE (2006), aimed at providing the necessary data input for the analysis. In order to validate the identified trends and substantiate the conclusions on risks and implications, where data is missing it is substituted, where possible, with alternative sources and evidence from the Oxera interviews. Furthermore, to supplement the evidence from the interviews and the ZEW/OEE 2006 data, a comprehensive review has been undertaken of primary and secondary data sources available from other providers and the industry itself. These include recent surveys of asset managers, academic studies, practitioners' and consultants' reports, opinion articles, as well as presentations by AM firms on issues relevant to the study.

## Scope of the analysis

This study does not present a factual review of AM in general, nor does it represent a comprehensive description of the European AM industry today. In accordance with the Terms of Reference, the study focuses on trends and their implications, rather than the industry status quo. In terms of scope, as noted above, the analysis concentrates on trends that meet the specific criteria outlined in the methodology and are relevant to particular implications, as outlined below.

The systematic identification and evaluation of relevant risks that can be found across the segments of the value chain is another important objective of this study. In order to evaluate the risks, their potential frequency, impact and allocation (ie, ultimate bearers) need to be assessed. Based on these findings and on the identified industry trends, a further objective is to consider which risks are expected to grow in importance over time and which are likely to be of less concern, to the extent that such conclusions can be reasonably derived from the available evidence and accompanying analysis.

The study does not analyse market risks that clients face when purchasing different products. Unless the asset manager has guaranteed minimum investment returns, or negligence by the asset manager can be demonstrated, no responsibility can be borne by the AM firm in principle, and the potential effect on the AM industry can only be indirect.

Examination of developments and trends in product innovation (rather than analysis of individual products per se) forms an important part of the analysis of trends in the AM industry insofar as they affect the evolution of the value chain, or their effect on operational and/or systemic risks in the industry can be identified. However, changes in specific investment strategies—for example, the use of financial engineering techniques and the methods of application of other forms of financial innovation—have not been examined as they are outside the scope of this study. Such issues include developments in the nature of trading strategies by hedge funds, such as volatility trades, securities arbitrage transactions, methods for stock-picking, as well as potential assessment of other strategies, such as portfolio rebalancing or modelling of liability-matching products.

## Transformation of the AM industry

In the course of the research, Oxera has identified six overarching developments that underscore the leading current trends in the industry. These developments are significant generalisations of a more detailed list of trends presented below and analysed in the report. While they do not represent a summary of all the key developments identified in the report, they point at some of the most important issues considered.

– **The distribution of AM products is evolving towards open and guided architecture models**. Open architecture is reflected in the process of opening up the existing distribution channels to third-party funds (TPF) and the formation of a pan-European marketplace for TPF. Even though the largest distributors such as banks and insurance companies retain their dominant positions, they are increasingly allowing third-party products to be distributed via their proprietary networks. Where open architecture is not taking place, it is often substituted with 'guided' architecture, where distributors select a limited number of additional providers to increase and/or change the range of products they sell through their distribution network. Moreover, new distribution channels, such as independent financial advisors (IFAs) and non-independent networks of financial advisors (NINFAs), as well as Internet-based distribution channels, increasingly compete with conventional distribution models, although this process is slow and varies significantly by jurisdiction.

– **Vertical fragmentation is occurring alongside horizontal consolidation in different parts of the value chain**. AM firms are increasingly repositioning themselves away from integrated business models (where functions across the entire value chain are retained in-house) towards vertically disaggregated structures. This process is boosted by specialisation in a segment of the value chain, or, in some cases, in a specific product within that segment. This sometimes involves concentration on particular asset classes or investment strategies in the core AM segment of the value chain or specific functions in other segments, which affect the overall business model adopted by the firm. In cases of large players pursuing diversified strategies, this might involve the use of specialised internal units focusing on specific business areas. A parallel, yet related, phenomenon to vertical fragmentation is horizontal consolidation of players, especially at the level of large financial institutions, through mergers and acquisitions (M&As) as well as jointly owned but independently managed boutiques.

– **Demand for new investment products affects fund profiles**. There has been significant growth in assets under management (AuM) invested in hedge funds, and structured and alternative products. In addition to the leading providers, specialised AM firms, which have been increasing their market presence, have effectively 'commoditised' the hedge fund concept. This development is affecting the shape of the value chain as well as risks to the industry. Sophisticated investment strategies adopted by specialised funds and teams of asset managers generate pressure on back-office divisions, potentially leading to further outsourcing. The complexity of the outsourcing required emerges as an additional factor affecting further consolidation of the market for TPF administrators. At the same time, non-transparent fee structures and limited disclosure have the potential to create information asymmetries between investors, distributors and fund managers with regard to these alternative products.

– **Regulation facilitates cross-border financial integration, but increases costs** Various aspects of cross-border financial integration and efficiency are linked to specific regulatory actions, including the relationships between disclosure, registration, taxation, accounting, and institutional and organisational consolidation, as well as financial integration through wider exposure of AM firms' investment portfolios to foreign instruments. The Undertaking for Collective Investment in Transferable Securities (UCITS) III and Markets in Financial Instruments Directives (MiFID) are generally seen

in the industry as facilitating cross-border trade as well as financial integration. At the same time, substantial regulatory barriers for achieving further economies of scale remain in place. There are general concerns about how pan-European regulation is implemented at the national level, including, for example, notification procedures, as well as the degree to which UCITS III is perceived as a follower rather than a driver of changes in product innovation.

– **Pension reforms drive product innovation and developments in the value chain**. The increasing amount of pension funds available for investment and changes in the functioning of the market for pension funds as a result of pension reforms and the underlying demographic changes pose significant challenges to the AM industry in the field of product innovation and adaptation in some jurisdictions. A significant growth in funds under management might be rationally expected to follow the required increase in savings, and imply a change in incentives faced by the industry set by the market downturn at the beginning of the millennium. The industry response also has a bearing on developments in the value chain, facilitating the transfer of pension funds management into a separate business model.

– **Evolution of the marketplace through platforms**. Current trends are making retail distribution networks increasingly multilateral in their demand for core AM products, thereby creating strategic opportunities for new types of players—business-to-business (B2B) distribution platforms—which offer distributors a single point of access to a variety of product providers and high-quality infrastructure in order to facilitate trading. As more clients become connected, the platform evolves as an intermediary, integrating fund providers and distributors into a single 'market place'. On the one hand, this is likely to increase operating efficiencies in the back office and add value to the end-consumer through the creation of additional linkages between industry participants, and hence a more efficient allocation of funds in line with risk preferences. It is also likely to facilitate further open architecture and cross-border trade. On the other hand, depending on the magnitude of the network effect, the emergence of dominant platforms might have implications for systemic risks and regulation.

## Drivers of change

The downturn in the financial markets at the turn of the millennium had at least three fundamental effects that have transformed core AM and influenced the industry as a whole:

– falling revenues and profits due to poor performance and market downturn;
– investors' exploration of new markets based on financial markets innovation and increasing sophistication;
– new competitive pressures and industry rationalisation through the period of adjustment to the new paradigm.

### Changes in investor demand

A number of developments have increased the complexity of institutional investors' needs, as well as their incentives and ability to be more actively involved in the design and monitoring of their portfolios. Similarly, private banking clients have grown in sophistication and increasingly demand more products more closely tailored to their needs and risk appetite. Whether their fundamental investment needs have changed is arguable; however, their incentives to shop around for the best-performing products and funds, and diversify into alternatives such as hedge funds, increased substantially after the market downturn.

For retail investors, a direct increase in sophistication such as that for institutional or private banking clients is less evident. In most Member States, retail clients are still heavily reliant on their local banks for investment decisions. Although there appear to be some signs of

change, such as the growth of alternative distribution channels (eg, fund supermarkets), retail clients are not particularly prone to shop around for value for money. Nevertheless, while retail clients do not appear to be directly increasing in sophistication, developments such as the growth of open architecture in private banking and the increasing importance of assemblers/intermediaries in the fund manufacturing function are having an indirect effect by producing market outcomes similar to those that would have resulted had retail investors directly become more sophisticated. Moreover, demographics and the penetration of information technology might affect investor behaviour.

**UCITS III and the promotion of European financial integration**

In 2002 the European Commission introduced the Management Company and Product Directives, commonly referred to as 'UCITS III'. Overall, the changes brought about by these regulatory developments appear to have had a positive impact on the market share of the UCITS segment of the industry, although the evidence supporting this conclusion is not uniform. UCITS III regulations have allowed funds to invest in a wider range of financial instruments, and the industry has been taking advantage of this greater choice. Moreover, regulatory developments have at least partly facilitated European financial integration and reduced barriers for cross-border marketing of funds' units, as well as for cross-border provision of management services.

UCITS III has also provided greater flexibility in terms of individual investment restrictions. Research undertaken for this study confirms that many asset managers are adapting their range of funds to benefit from the increased investment opportunities offered by the Product Directive. One characteristic of the changing asset allocation of UCITS funds is the increasing use of derivatives, although the research has identified some barriers associated with the regulatory changes introduced by UCITS III that might prevent growth of UCITS relative to non-UCITS funds. To a large extent these could be associated with investment restrictions imposed by the new regulations, increasing the costs of compliance with regulation post-UCITS III, as suggested by industry commentators, and greater incentives to exploit any regulatory arbitrage opportunities arising as a result of UCITS III.

**Analysis of pension reforms**

To ascertain how pension reforms might affect the European AM industry, as a first step the analysis identifies and review the aspects of reform that might affect the AM industry. The study then identifies the potential drivers of implications for the AM industry, reviewing the evidence and mapping the specific aspects of reform onto these drivers. As a final step, an economic assessment is undertaken of the impact of the identified key drivers of pension reform on the AM industry.

As it might be too early to derive definite conclusions on the implications of pension reforms, the analysis concentrates on identifying the key linkages between aspects of reform and potential implications for the AM industry—ie, the identification of drivers of changes. The following leading drivers are identified during the research:

– increasing amount of funds available for the industry;
– potential substitution effect between the traditional AM products and pension products;
– development of a mechanism for transferring pension funds to the industry;
– stimulation of product innovation.

Certain aspects of pension reform (eg, changes in investment restrictions for pension funds and regulatory treatment of corporate pension deficits) might also trigger product innovation in the AM industry. One example of an investment strategy that seems to have emerged partly due to changes in accounting standards and partly to developments in pension regulation is liability-driven investments (LDIs). The case of LDIs underscores the importance of the transformation mechanism from a regulatory change to the industry business strategy.

## Trends in asset management

The research undertaken for the study has identified a number of changes taking place recently in the AM industry, which have an important impact on the ongoing industry transformation. Nevertheless, only some of these changes fulfil the criteria for the current trends of relevance to this study, as set out above. The key, leading trends identified during the research that are of interest from the perspective of the value chain transformation, implications for risks, and value creation to the end-consumer are summarised below.

### Summary of leading trends

| | Strength of evidence |
|---|---|
| Changing composition of UCITS funds | Strong to medium |
| Commoditisation of hedge fund investment strategies | Very strong |
| Emergence of structured and alternative products | Strong |
| Emergence of boutique-type business models | Strong |
| Adoption of the core-satellite strategy by mainstream providers | Very strong |
| Outsourcing of core AM and fragmentation of the value chain | Strong to medium |
| Concentration of the core AM function in large financial centres | Strong |
| Gradual opening up of traditional distribution channels | Very strong |
| Decoupling of core AM and distribution | Very strong |
| Evolution of IFAs | Medium |
| Multi-management as the growing distribution channel | Medium |
| Back-office outsourcing: a mature market? | Very strong |
| Developments in fund distribution and their impact on the back office | Strong |
| Emergence of platforms and transformation of the market place | Strong to medium |

### Trends in core asset management

The analysis of business models evolving in the European AM industry indicates certain high-level developments that have a significant impact on the shape of the core AM segment of the value chain. These include the separation of manufacturing and distribution into discrete businesses; the emergence of intermediaries (assemblers and aggregators) providing B2B services to manufacturers and distributors; and fragmentation of the core AM activity into 'pure' manufacturing and sub-advisory.

Against this background, the following strategies indicate some of the responses by industry players to the changing environment in core AM.

– **Diversification of the product range offered to investors**. As client demand has shifted away from traditional products, one strategy particularly popular with asset managers seeking to remain attractive to investors is to diversify their product range. In the retail market, more flexible investment restrictions following UCITS III have allowed firms to expand their regulated product range to meet the change in investors' demand. In the institutional market, continuous financial innovation appears to have resulted not only in greater choice for investors, but also in more widespread adoption of alternative investment techniques.

– **Development of structured and alternative products**. The analysis points to the conclusion that investor demand is one of the primary drivers behind the growth of structured and alternative products: investors' search for new sources of returns—which

began as a move away from the underperforming asset classes at the turn of the millennium—is now commonly seen as the central component of the overall investment strategy. Retail clients have also become increasingly active investors in structured products, particularly through capital-guaranteed and other investments with structured risk profiles, or, indirectly, through pension and other funds, for example. While structured products for retail investors are typically constructed to achieve relatively straightforward objectives: to protect a proportion of investor capital while providing limited exposure to alpha-driven investments, younger and/or more sophisticated investors appear increasingly to be exploring investment opportunities with leveraged exposure to risk.

– **Commoditisation of hedge fund-type strategies**. The emergence of alternative and structured products, as well as increasing investor exposure to these asset classes, can be seen as a development parallel to the 'commoditisation' of the hedge fund industry. The changing composition of UCITS towards more sophisticated financial products appears to be closely linked with the increasing adoption of the hedge fund model in the AM industry as a whole. Driven by the increase in AuM from diversifying investors on the demand side, as well as the prospects of high profit margins on the supply side, the hedge fund industry has experienced significant growth over a relatively short timescale. The expansion of hedge funds appears to be spreading to the retail sector (albeit slowly), despite the lack of explicit regulation. The increasing importance of hedge funds to the average retail investor also has significant implications for the risks faced by investors.

– **Adoption of the core-satellite approach**. In essence, this approach advocates a clear separation of the passively managed core portfolio from one or more actively managed 'satellites' focused on the search for 'alpha'. The evolution of the overall investment strategy based on the core-satellite approach has significant implications for the value chain, including the emergence of boutiques and outsourcing of core AM. It also results in a clear delineation of the sources of value for investors and more transparent alignment of pricing with different investment techniques.

– **The boutique-type business model**. Mainstream asset managers have adopted this model in response not only to the emergence of the core-satellite approach, but also to the process of commoditisation of the hedge fund concept. To meet the requirement to diversify their product range, some AM firms have restructured their internal investment activity to enable them to manufacture required products in-house. Efficient manufacture of these new products has often required a change to internal organisational structures, in the form of semi-autonomous boutiques. For large AM firms this response has increasingly involved the pursuit of alliances with specialist AM firms, acquisition and incorporation of boutiques in the company structure, and/or hiring of entire teams of external managers in order to develop the required investment skills and/or manufacturing capabilities in non-traditional asset classes.

– **Outsourcing of the core AM activity for particular asset classes**. An alternative strategy to offer an expanded product range is to buy additional products from another provider. This can prove cost-effective if the particular AM skills are not available in-house, or would be expensive to acquire. This has resulted in outsourcing of the core AM function on a limited scale and an increase in the linkages across the industry via assemblers and aggregators working with multiple providers.

– **Concentration of core AM activity in a few financial centres**. To meet the requirement from clients to reduce the costs and increase the quality of AM, activities are becoming concentrated in fewer locations in order to benefit from economies of scope and clustering effects. This is linked to the strategy of meeting pan-European demand from one location (or a small number of locations) to enjoy cost efficiencies through scale. Increasingly, local equities are the only assets managed locally by large

financial institutions; in many cases, the local offices become pure sales outlets, with the investment management function integrated in a few centres (or even one centre).

– **Specialisation in a small number of asset classes**. This is an alternative strategy to meeting the diversification of demand followed by small and medium-sized firms with the aim of achieving scale and expertise in a limited number of asset classes/investment strategies. This strategy can be a complement to that of larger AM firms outsourcing their core AM activity for particular asset classes, or relying on clients to meet their diversified demand by engaging multiple specialised asset managers, rather than hiring a single AM firm that can offer the entire range of products required.

**Trends in distribution**

The analysis finds evidence of emerging open and guided architecture models in the distribution segment of the value chain. However, this observation applies primarily to the retail sector, since the institutional sector has largely operated on the basis of open distribution for some time. Trends in distribution appear to have been triggered by several factors, two of which seem particularly important: changing investor demand, and the drive towards greater transparency.

Investors' changing demand, affected by prolonged bear markets and corresponding stagnation in the industry, has stimulated changes on the supply side, where managers have sought to develop new distribution channels. This appears to have been reinforced by competitive pressures and increasing demand for better value by investors disillusioned with traditional asset classes and the integrated 'silos' model. These pressures are likely to have forced some of the leading industry players to move their business models away from proprietary networks.

Demand for greater transparency—coupled with financial innovation, which has led to the development of new financial products—has encouraged new functional links to be forged between manufacturers and distributors in order to deliver new asset classes, such as alternative or structured products. Product wrappers and funds of funds (FoF), embraced by investors, have required new models of interaction between manufacturers and different types of distributor.

– **Gradual opening of traditional retail distribution channels**. While this trend has recently attracted considerable attention among market observers, it must be stressed that it cannot be described as either homogeneous or universal across Europe. Not only does such opening up take a variety of forms in the context of players pursuing different business models—and, hence, having different strategic interests along the value chain—but it also varies by degree in local markets. In some cases, it also meets resistance due to specific business interests. For example, some distributors consider the adoption of TPF as destroying their value for the group, and continue to retain the closed business model. Another group of distributors enters into strategic alliances with a limited number of external fund manufacturers and adopts the guided architecture model. Furthermore, there are case-by-case examples of open architecture business models where traditional distributors, such as banks, sell all available funds in the market to their clients.

– **Decoupling of core AM and distribution segments in vertically integrated business models**. Where present, the gradual opening of traditional retail channels, accompanied by developments in core AM (such as growth in outsourcing, as described earlier), appears to have led to a severance of the strategic and business linkages between these elements of the value chain. As a result, fund distribution and manufacturing are gradually becoming functionally separate, while often remaining parts of the same financial group. At the company level, the degree of such business separation or strategic decoupling appears to be linked to the extent to which distribution

is open to TPF, and, correspondingly, to the extent that the in-house core AM function competes with external providers. At the industry level, such decoupling is sometimes reported to lead to distributors having more power than manufacturers.

– **Growth of NINFAs**. Beyond the transformation of traditional retail networks, decoupling can take an alternative form: certain players that pursue the integrated business model develop networks of financial advisors, which might be seen as new distribution channels. From both the outside and inside, these networks are managed independently of the rest of the parent group. This business model typically operates in accordance with the open architecture principle, and, most importantly, is functionally separate from the in-house manufacturer.

– **Evolution of IFAs**. The position and role of IFAs vary significantly across countries. In 2005 IFAs distributed approximately 50% of retail assets in the UK, while in Continental Europe, on average, they accounted for only 7.9% of the overall retail distribution. Overall, evolution in the independent and multi-tied financial advisor (TFA) segment of the distribution market seems limited. IFAs as a group do not seem to exhibit substantial growth in Continental Europe, nor do their relatively high market shares seem to be significantly challenged in the UK. Looking forward, there are mixed opinions in the industry as to whether independent players will be able to retain their market shares relative to traditional channels if the latter become more open.

– **Multi-management and outsourcing of core AM as a growing distribution channel**. The growth in outsourcing of the core AM, in the form of multi-management or direct delegation of the core AM function, renders sub-advisory more important as a new distribution channel. In this context, a separate class of intermediaries—the 'assemblers' or 'aggregators'—has emerged, which combines the AM expertise of different providers into a single investment product. The emergence of intermediaries might have significant economic implications for the AM value chain, including new risks and new regulatory challenges. However, insofar as the intermediaries increase the number of available financial securities—and hence increase spanning of financial assets—they are likely to create value.

**Trends in the back office**

The main developments in the back-office part of the value chain include the following.

– The share of AM services outsourced to third-party providers (custody, transfer agency, administration) has been increasing over the last few years.
– There is evidence to support the conclusion that there is a mature market for back-office outsourcing in terms of services and products, despite the need for continuous innovation.
– Developments in the distribution of funds seem to create substantial pressure on certain back-office functions (ie, those undertaken by transfer agencies).
– These developments, together with lagged responses in the back office, might be responsible for potentially increasing operational risks in funds processing, and might be creating barriers for further development of open architecture and cross-border trade.

Since the back office provides the support function to the core AM, developments in these support services need to be linked with the evolution of the AM industry as a whole. Where challenges for the back office as the enabling function can be identified, these can be linked to specific implications, such as risks and value creation to both AM firms and end-investors, as summarised below.

| Developments in the AM industry value chain as drivers | Challenges for the back office as the enabling function | Implications |
|---|---|---|
| Increasing cross-border distribution<br>Increasing number of intermediaries<br>Evolution of assemblers | Distribution becomes increasingly multilateral<br>Challenges for processing systems<br>Requirements for greater synchronisation of standards and automation of processes | Lack of standardisation in order processing as a barrier to further development of financial integration and open architecture<br>Additional costs due to lack of standardisation and automation<br>Risks due to lack of automation<br>Increase in systemic risks, but greater quality of products |
| Increasing use of derivatives by UCITS funds | Challenges for risk management, pricing (largely applies to the over-the-counter derivatives) and control | Increase in operational risks<br>Implications for fund mispricing, breach of client guidelines, misdealing |
| Geographical concentration of core AM functions | Geographical concentration of brokerage/trading functions | Cost efficiencies from economies of scale; synergies |
| Strategic positioning along the value chain; outsourcing of non-core activities | Careful optimisation of the level of outsourcing (mature market) | Cost efficiencies from economies of scale, reduced operational risks<br>Management of liabilities and operational risks |
| Development of mature market for back-office outsourcing | Cost transparency of back-office elements<br>Re-coupling of back-office activities | Cost efficiencies from economies of scale, reduced operational risks |

Adoption of straight through processing (STP) across the industry leads to important cost efficiencies and mitigates certain operating risks. The emergence of institutional intermediate distribution platforms, largely using the STP technology, reduces the operating risks and leads to transformation in the industry value chain by creating an efficient 'market place'.

## Implications of trends for competition, value creation for consumers and risks in the European AM industry

One of the most widely observed changes in the competitive landscape of the AM industry is the gradual decline in manufacturers' bargaining power, with some evidence suggesting a shift from the manufacturing to the distribution segment of the AM value chain in both the retail and institutional markets.

In the institutional market, this trend is manifested through, for example, the emergence of the core-satellite approach, whereby investors can select different providers for the various components of their investment portfolio, and manufacturers themselves reorganise the core AM segment by separating the core and satellite investment functions. This is occurring in parallel with the growing role of intermediaries, including advisors, and, more generally, the increased sophistication of the average investor, which has reduced the scope for exploiting informational asymmetries.

In the retail market, some of the trends linked to the shift in bargaining power away from manufacturers towards distributors and intermediaries include the development of open and guided architecture in retail distribution; related to the above, the growing strength of IFAs

and NINFAs in selected jurisdictions; separation of AM manufacturing and distribution units, particularly among large financial groups; and the emergence of intermediaries to fill the gap left by the separation of manufacturing and distribution units.

The loss of bargaining power and the greater intensity of competition that have resulted from the developments described above are likely to manifest themselves through pressure on profit margins for AM firms, greater risks due to less stable business relationships, and specialisation. The analysis suggests that this is likely to give a further boost to the trend towards consolidation, cost-cutting and rationalisation that is already evident from the growth in M&As among leading European AM firms.

Potential further growth in M&A activity and the formation of alliances can be thought to counteract the loss of bargaining power experienced by manufacturers, and might improve the efficiency of the market, at least in the short to medium term. Furthermore, the loss of market power might be counterbalanced by pension reforms that inject increasingly greater funds into the AM industry, both directly as well as through life-insurance policies. At the same time, as investors become increasingly disillusioned with the relative performance of some alternative forms of investments, the search for new sources of 'alpha' is likely to intensify. Since efficiency gains from the recent industry transformation are unlikely to be substantially reversed, low-cost passive strategies and traditional asset classes with substantial economies of scale are likely to benefit large players. As the stimulus from the market downturn early in the decade fades away, the transformation of the core AM might slow down.

**Analysis of risks**

The systematic identification and evaluation of risks across the value chain has required their potential frequency, impact and allocation (ie, ultimate bearers) to be assessed. Based on these findings and on the identified industry trends, a further objective of the study is to determine which of these risks might be expected to grow in importance over time, and which are likely to be of less concern.

The starting points for the risk analysis in this study are an Oxera report published in 2001 (Oxera 2001) and a study by Bias et al. (2003). These identified and explored the frequency and potential impact of the most important operational risks in the European AM industry. The current study extends these analyses by exploring whether the identified operational risks are expected to increase or decrease as a consequence of the most important trends taking place in the AM industry identified in the course of this study. It also explores other risks such as systemic risks and the scope for mis-selling and commission bias, and discusses how these are evolving in the context of some of the most important developments taking place in the industry: open architecture, the growth of the TPF market, the emergence of intermediaries, and the availability of a wider range of complex products, among others.

**Operational risks in the European AM industry**

At a high level, all trends associated with increases in product complexity, specific rules and guidelines, or linkages between market players along the value chain can be expected to lead to greater potential for operational risks to arise.

Furthermore, the emergence of intermediaries in the context of the growth in the market for TPF, as well as the growing importance of open architecture distribution models, has potential negative consequences for the expected frequency of operational risks—particularly breaches of client guidelines and fund mispricing. While there is no direct evidence that risk management is inadequate to deal with these risks at present, the trends highlighted above present a clear challenge in this respect.

The greater M&A activity being observed in the industry might lead to an increase in the frequency of risks from taking over new businesses, as different systems and platforms are integrated, both domestically and cross-border. Such risks are more likely to arise simply because more corporate actions are taking place, not because each deal is necessarily exposed to greater operational risk.

**New sources of risk**

The following new risks, and risks applicable in the new context, have been identified during the course of the research:

- **scope for mis-selling and commission bias**—due primarily to the adoption of guided architecture distribution models;
- **informational problems for the end-investor**—due to the increase in the sophistication of products;
- **informational mismatch between manufacturers, distributors and end-investors**—caused by product sophistication, efficiency in information transfer, as well as a lack of clarity in the regulatory framework at both EU and national level in terms of responsibility towards the end-investor.

One trend that might affect the risk of mis-selling is the evolution of open and guided architecture. The gradual opening up of distribution channels reinforces the scope for mis-selling risks in three ways: lack of specific information, misunderstanding the product nature, and commission bias. There is, however, no conclusive evidence on how this risk is evolving, given the early stages of open and guided architecture.

In terms of the scope for informational problems to the end-investor, the fundamental issue is that the increased sophistication in the type of funds and products launched creates the potential for greater informational asymmetry between AM firms (manufacturers and distributors) and the end-investor. While it can be argued that the wider range of products available in the market is, broadly speaking, efficiency-enhancing and ensures greater spanning of financial products for the end-investor, they may not always understand the investment (or, indeed, other) risks they take when purchasing these products. Moreover, the separation of the manufacturing and distribution functions, together with the increase in the number of linkages driven by the opening up of distribution networks, has led to greater scope for breaches of client guidelines.

**Value creation for consumers**

The study also analyses the impact of identified trends, risks and changes in the competitive landscape across the different segments of value chain on the evolution of value to consumers of the implicit price/quality ratio acquired when investors purchase products and services in the AM industry. While price can be directly measured through the level of management and distribution fees levied on investors (albeit the multiplicity of the types of fee requires suitable cumulative measures to understand the overall effect), quality is a more elusive concept related to the idea of choice and product suitability to investors' needs.

**Pressures on the price of AM products and services**

The analysis indicates a potential trade-off between the scope for cost efficiencies and the scope for reductions in fees (price) that can be expected from two different market structures based on different prevailing business models.

In one market model (more prevalent in Continental Europe, including new Member States) comprising a few dominant distribution channels, typically banks, with large captive retail markets, there is limited evidence of fee-based competition. However, significant efficiency gains are possible from the emergence of dominant intermediaries linking leading distributors

with a large number of local and foreign fund providers. The value to consumers might be enhanced in this market through greater competition among traditional players responding to new business challenges, as in the case of Germany.

In a second market model (more typical of UK or Scandinavian countries), with no single dominant distribution channel and a strong independent distribution sector, there is greater scope for pass-through of price competition and efficiency gains. However, while this business model is likely to be successful because of strong TPF markets, dominant intermediaries with the potential to create substantial cost efficiencies are less likely to emerge than in the other market model, precisely because of the larger number of distributors that need to be signed up to the service.

Strong competition at the distribution level would be likely to exert pressure on fees, and on the extent to which both cost efficiencies and the benefits of more aggressive pricing strategies are passed on to investors via a reduction in fees. However, there is no clear evidence of increased competition in the retail market at present. Moreover, competition between distributors is likely to be motivated by informed and sophisticated end-investors who are willing to shop around for value.

**Implications for the quality of products**

Overall, the developments taking place suggest that the quality of products and services in the industry has increased. The gradual opening up of distribution channels is providing more options for investors to select the products of their preferred provider. Although too much choice might not always be in the investor's best interest, the possibility to select funds from different providers should, in general, represent an improvement in the customer experience.

Similarly, even in jurisdictions where dominant distribution channels have been slow to open up, the emergence of assemblers (both within mainstream AM firms as well as independent product re-packagers) has given a considerable boost to the TPF market. This has given end-investors indirect access to a much wider range of products from different local and foreign providers through FoF or manager of managers (MoM) funds and other structured products. These developments have increased the quality and sophistication of products to which the average retail investor has access, making it more likely that an investor will find the product that best suits their investment needs.

**Implications of pension reforms**

In general, pension reforms remain relevant to this study insofar as they affect the AM industry through:

- **changes to competitive dynamics**, including the potential effect on concentration levels among players and the distribution of value in the industry;
- **generating new business opportunities** by increasing the amount of funds available for the AM industry and triggering the introduction of new product types (eg, LDIs) and changing the distribution of financial risks in the industry;
- **creating strategic challenges** for players in the industry regarding potential repositioning of players along the value chain and potential substitution effects between pension and traditional AM products.

Pension reforms might also affect prices in financial markets and the allocation of capital in the economy, as in the case of the impact of LDIs on long-duration bonds. Although significant, this largely remains outside the scope of this analysis, but is relevant insofar as it might generate systemic risk for the economy, as discussed below.

The increase in funds under management and the mechanism for transferring funds to the industry might have an important impact on both the concentration in the AM industry and the distribution of value across the value chain and to the end-consumer.

At present, some evidence of increased dynamism in the industry is being observed through the development of new products such as LDIs or other structured products tailored to meet specific pension funds' needs—particularly in the context of increasing pension deficits to the pension challenge. At the same time, the move from defined-benefit to defined-contribution pension schemes is liable to trigger a whole new range of pension products, which could resemble traditional retail collective investment schemes.

Pension reforms might require AM firms to adapt their strategies in order to benefit from new opportunities. First, incentives for the development of third pillar pension schemes might lead to reallocation of retail assets from more traditional mutual funds to pension products, or generate a substitution effect; this might require players to reconsider their product mix strategies. Second, to attract pension assets, AM firms might need to acquire or develop specific internal expertise necessary for efficient portfolio management if regulations impose strict investment restrictions.

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# 1 Introduction

## 1.1 Objective

The objective of this study is to present a consistent and structured analysis of the following issues:

– **where** in the value chain of the European asset management (AM) industry the current trends are occurring that are of significance to potential risks and regulation of the AM industry;

– **how** and **why**, from an economic assessment standpoint, the trends are taking place in terms of specific drivers, incentives, underlying structural mechanisms, and strategic choices made by different types of players;

– **what** the implications of these trends are for the industry as a whole—in particular, with respect to emerging as well as existing risks to the AM industry itself, as well as in relation to the integration of financial markets across Europe.

To achieve this objective, a methodology has been developed and implemented on the basis of systematic analysis of different business models observed in the value chain (see section 2). This methodology has been applied to the information currently available from a variety of sources outlined below, to provide an independent critique of the importance of trends suggested in the existing literature, as well as to identify new phenomena taking place across the industry.

The analytical framework constitutes the main platform for the comprehensive economic analysis of the current trends in the European AM industry's value chain. In addition, this framework has helped to describe the underlying economic mechanisms—ie, asset managers' incentives (profitability, cost efficiency), the evolution of external drivers (clients' demand, regulation, and pension reform), and the strategic responses by asset managers to these drivers.

This approach also allows an assessment of whether these trends are of a structural (permanent) nature, or are transitory.

## 1.2 Scope of the analysis

### 1.2.1 Focus

The focus of this study is on the European investment funds industry—in particular, UCITS, but it also covers non-UCITS to the extent that they affect the shape of the industry value chain. Relevant trends in both the institutional and retail segments of the market have been analysed. Once specific trends have been identified and assessed, the relevant phenomena have been analysed in the appropriate context of UCITS or non-UCITS. This approach does not prioritise any potential developments according to product class, market segment, or type of investor.

The study does not present a factual review of AM in general, nor does it represent a comprehensive description of the European AM industry today. In accordance with the Terms of Reference, the study focuses on trends and their implications, rather than the industry status quo. In terms of scope, the analysis in this study concentrates on trends that

meet the specific criteria outlined in the methodology, including scope and coverage, expected or observed persistence through time, impact on the value chain, and relevance to the specific types of implication outlined below.

### 1.2.2 Current trends

This part includes the understanding and analysis of trends affecting the functioning of the AM market, as well as the incentives governing AM firms. The aim is to identify distinct industry segments of the value chain in which changes might be occurring and the main features of these trends, and to provide an evidence-based assessment of whether they are likely to be permanent or transitory.

### 1.2.3 Treatment of risks

The systematic identification and evaluation of risks that can be found across the different segments of the value chain form another important objective for the study. The evaluation of these risks requires an assessment of their potential frequency, impact and allocation (ie, ultimate bearers). Based on these findings and on the identified industry trends, a further objective is to assess which of these risks are expected to grow in importance over time and which are likely to be of less concern.

However, this study does not focus on market risks faced by clients when purchasing different products. Unless minimum investment returns have been guaranteed, or negligence by the asset manager can be demonstrated, no responsibility is to be borne by the AM firm, and the potential effect on the AM industry can in principle only be indirect, through reputation effects for example.

### 1.2.4 Impact of pension reforms

Pension reforms across Member States might have an impact on the development of the AM industry and could become a trigger for its accelerated transition. In this respect, it is necessary to consider the impact of the reforms on overall market size, and changes in the degree of competition, measured in terms of concentration levels, fees, and cost efficiency, where relevant.

### 1.2.5 Treatment of product innovation

Examination of developments and trends in product innovation (rather than analysis of individual products per se) forms an important part of the analysis of trends in the AM industry insofar as they affect the evolution of the value chain, or their effect on operational and/or systemic risks in the industry can be identified.

Selected trends (and associated implications) in product innovation included in the analysis are:

– diversification in the product range offered to clients—which may lead asset managers to specialise in particular asset classes and/or outsource the investment of specific products/assets to external managers where they have no competitive advantages;

– growth (or reduction) in the number of index trackers—which may, in turn, affect the size of the core AM segment of the value chain;

– growth of hedge fund-type products—which may lead to acquisitions or in-house creation of AM boutiques.

Changes in specific investment strategies through financial engineering and financial innovation have not been examined. For example, issues that fall outside the scope of the study include developments in the nature of trading strategies by hedge funds, such as volatility trades, securities arbitrage transactions, methods for stock-picking, as well as

potential assessment of other strategies, such as portfolio rebalancing or modelling of liability-matching products.

## 1.3 Key components of the study

1) **Development of methodology and analytical framework**—the analysis of trends in the value chain (sections 4–6) and of risks in the AM industry (section 7) has been conducted using a methodology that allows for a systematic treatment of these issues.

2) **Analysis of trends and drivers, and formulation of the initial hypotheses on risks**, based on research of secondary sources, inputs from Oxera's network of advisors, as well as desktop analysis undertaken by the project team.

3) **Interviews with asset managers**: the objective of this component was to validate and/or reformulate the hypotheses concerning trends, drivers and implications. Similarly, the input from the industry players has been used to fine-tune the conclusions from secondary sources.

4) The **high-level analysis of data from ZEW/OEE** has been used as a further check on the trends and drivers identified in the previous steps. Oxera is grateful to ZEW/OEE for their cooperation.

5) Finally, the risks and implications set out above have been analysed to **test the specific hypotheses concerning the impact of the identified trends**. The approach proposed to undertake this analysis is further discussed in the next section.

## 1.4 Analysis of risks and implications

The first part of the investigation focused on the identification and analysis of trends, based on extensive research of secondary sources (published studies and previous surveys of the European AM industry), as well as internal brainstorms between the project team and Oxera's internal network of expert advisors. This was supplemented with data from an interim report prepared by ZEW/OEE, where relevant and available.

Many industry representatives have been consulted with respect to these findings during interviews with asset managers in key executive positions. In addition to validating the applicability of these hypotheses, these interviews served to focus the analysis on trends that are of most relevance to the industry itself.

## 1.5 Sources of data

### 1.5.1 Structured interviews

Structured interviews with the key decision-makers in the European AM industry represent the critical, primary source of information for the analysis presented in this report. Appendix 4 outlines the programme of the interviews carried out so far, including the list of all interviewees and their affiliations; Appendix 5 presents the interview questionnaire used.

A wide range of AM players were invited to take part in the interviews, including AM arms of large financial groups, independent asset managers, small specialised boutiques, multi-managers, assemblers, and intermediaries in the core AM, distribution/front-office, as well as back-office segments of the value chain.

Specific references to the interviews as sources of information have been provided in the relevant sections of the report. In accordance with the agreed guidelines for conducting the

interviews, specific comments are not associated with either the person or the company being interviewed. Nevertheless, this information has been retained for the purposes of further analysis.

### 1.5.2 Data from ZEW/OEE (Lot 1)

In May 2006, Oxera received an interim report prepared by ZEW/OEE (Lot 1), which had assembled a dataset of quantitative and qualitative evidence on the European AM industry. The findings from the Oxera analysis of this dataset are incorporated in this report.

As ZEW/OEE note in their interim report, the data on many indicators researched for Lot 1 is either not available, or may be inconsistent for the purposes of cross-country comparison. For the purposes of this study, some of the indicators may not provide the time dimension necessary for identification of trends in the AM industry. To respond to this challenge, the missing data has, where possible, been substituted with alternative sources and evidence from the Oxera interviews.

### 1.5.3 Other primary and secondary sources

To supplement the evidence from the interviews and the data obtained by ZEW/OEE, a comprehensive review has been undertaken of primary and secondary sources of data on the European AM industry available from other providers and the industry itself. These data sources include surveys of asset managers undertaken in recent years, academic studies, practitioners' and consultants' reports, opinion articles, as well as presentations by AM firms on issues relevant to this study.

A selected list of these sources, referred to throughout the report, is presented in Appendix 7.

As part of the review of data available from other sources, analysis of the data assembled by CRA for the European Commission has also been incorporated into the relevant parts of this study.

## 1.6 Structure of the report

– Section 2 introduces the methodology, including the analytical framework for studying trends in the AM industry.

– Section 3 provides an overview of pension reform in Europe, identifying impacts on the AM industry, which are further discussed in the context of relevant trends.

– Section 4 delineates and investigates trends in the core AM segment of the value chain. Sections 5 and 6 present similar analysis of trends in the distribution and back-office segments of the value chain, respectively.

– Section 7 examines the implications of the trends identified in sections 4–6 for risks and competition in the AM industry, as well as for value creation to the end-consumer.

– Appendix 1 provides a summary of the key sources of evidence that support findings described in sections 4–6.

– Appendix 2 presents a static description of the value chain and its segments. It then reviews the main business models identified in the course of the research.

– Appendix 3 describes the key types of operational risk. The impact of trends on the magnitude and frequency of these risks is addressed in section 7.

– Appendix 4 lists the companies that participated in the Oxera interview programme, while Appendix 5 reproduces the interview questionnaire.

– A glossary of terms used in the report is provided in Appendix 6.

– The full list of sources, including but not limited to those used to support findings in sections 4–6, and reported in Appendix 1, is provided in Appendix 7.

# 2 Methodology

## 2.1 The concept of asset management

Asset managers offer a variety of services and act in a number of capacities for their clients. Clients include individuals, pension funds, corporates, insurance companies, banks, public agencies and charities. At one extreme, asset managers can provide advice to clients on portfolio allocations. However, advice-only services do not give the manager discretion over the clients' funds. At the other extreme, asset managers may have full power of attorney to manage clients' portfolios at their discretion. Where discretion is granted, asset managers initiate investment transactions and oversee their execution. Thus, managers place orders with brokers or dealers for the sale and purchase of securities and then monitor the transactions through to settlement.

Unless the portfolios of individual investors are very large, asset managers offer their services by pooling small investors' savings to create large portfolios, and managing these large portfolios as collective investment schemes (CIS) (investment funds, unit trusts, etc). For their savings, small investors receive units or other types of participation in these schemes.

Pooling brings benefits to both investors and their managers. For the managers, it reduces management costs by standardising advice and eliminating personal requirements of particular investors, and increases the overall amount in fees as the assets under management (AuM) grow. For investors, investing in CIS reduces management expenses through economies of scale, and provides highly qualified and specialised services at a considerably lower price. In addition, investors obtain diversification of risk, which they might not be able to achieve on their own investments.

In addition to the core AM function, asset managers undertake marketing and distribution activities, and perform middle- and back-office functions. Together, these three elements broadly comprise the majority of the AM value chain.

Depending on the level of integration between, or segmentation of, the elements in the value chain, several types of AM business model are relevant. Although the complete chain is usually necessary to deliver asset manager services to final customers, the way that chain is organised will have significant implications for the prevalence of different types of risk in the system, and who bears that risk. Importantly, therefore, different business models imply different types and level of risk, as well as different ultimate bearers of these risks. Understanding the relationship between the structure of the value chain and the distribution and amount of risk is important for the analysis of the implications of the trends in AM.

## 2.2 Overview of methodology

### 2.2.1 Plan of research

Since the AM industry is characterised by a diversity of structures, multiple business models and differentiated operating practices, any proposed methodology must explicitly address this heterogeneity. While this necessarily renders the overall analysis more complex, the understanding and successful mapping of this diversification into an analytical framework is critical to the understanding of current trends in the AM business.

Ensuring that the analytical framework can accommodate this complexity is also important for the next step of analysing the impact of the industry structure on the shape and form of individual elements in the value chain as they differ across jurisdictions and product markets. This is also necessary to capture the industry interaction with internal and external factors such as potential pension reforms. Failure to do so would result in either falsely generalising particular business model-specific trends to the level of the industry as a whole, or an inability to derive any specific conclusions due to potentially contradictory signals from different parts of the data.

To meet the above objectives, a four-step methodology has been adopted.

1) Identification of leading potential business models in the European AM industry, based on a micro-analysis of selected AM firms.

2) High-level analysis of the value chain, including the mapping of functional links between its segments onto an analytical framework developed earlier.

3) Identification of potential trends relevant to the scope of this study according to set criteria, followed by assessment of the corresponding evidence in each case.

4) Analysis of the implications of the identified trends for risks and potential market failures, as well as for European financial integration, market efficiency, and value creation to the end-consumer.

### 2.2.2 Analysis of business models

As a first step in implementing the above methodology, the overarching current business models in the European AM industry, across both markets and products, have been defined and investigated. In addition, the past and likely future evolution of these models has also been explored.

The business models identified can be understood as high-level business strategies adopted by producers of asset manager services. This initial step of the investigation has aimed to provide the necessary basis for mapping potential relevant trends onto the analytical framework across different segments of the value chain. The identification and mapping of relevant trends, which might be business model-specific, has been undertaken in accordance with a set of specific criteria, as set out below.

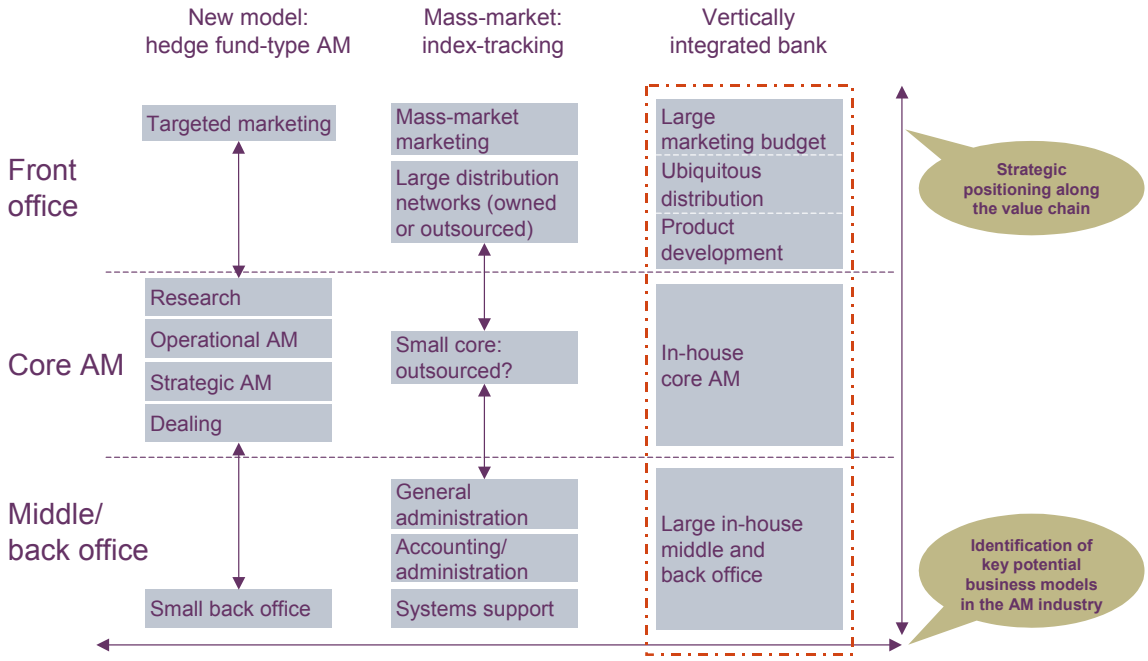
Most importantly, by approaching the industry from the key players' perspective, the objective was to facilitate the understanding of firms' motives, drivers, and future strategies, which is often neglected in high-level market analysis. These motives, drivers and future strategies can have a significant influence on the future development of the industry and are critical to a well-founded understanding of the current trends in the AM industry.

The methodology employed with respect to business models is depicted in Figure 2.1 below. The figure has been populated with a few stylised samples of hypothetical business models for illustrative purposes only. However, for the purpose of the investigation, six representative business models have been singled out:

– AM firms that are part of large financial groups;
– private banks;
– independent AM firms;
– independent boutiques;
– universal providers of back-office services;
– independent financial advisors (IFAs) and multi-tied financial advisors (TFAs).

These models are assumed to encapsulate the high-level strategic methods of delivery of the AM services across the EU, and are discussed in greater detail in Appendix 2.[1]

**Figure 2.1 Stylised AM business models**




Source: Oxera.

### 2.2.3 Analysis of the value chain

Rather than analysing different parts of the value chain outside their operational context or on a stand-alone basis, segments and sub-segments have been analysed, one by one, in the context of the six business models in which they operate, as introduced above. The analytical framework described below has been instrumental to this analysis. For example, it has allowed the role of a boutique model adopted by a large financial group to be distinguished from the fundamentally different role of an independent boutique facing an increasing number of intermediaries in the core AM segment.

The purpose of this analysis exercise was threefold: to describe the value chain; to understand the importance of each segment in the context of relevant business models; and to employ the analytical framework for the analysis of trends. A more detailed description of the value chain and a high-level analysis of the dynamics and channels of interaction between its component parts can be found in Appendix 2.

### 2.2.4 Analysis of trends in the core AM, distribution, and back office

The central part of the investigation has used the analytical framework described in section 2.3 to conduct the analysis of the value chain. The objective of this exercise was to identify, describe and review leading current trends in the AM industry in Europe in light of the available evidence.

– The process of identifying important trends was based on a set of specific criteria (detailed in section 2.4). These criteria reflected the benchmarks for the importance of each trend, its relevance to the scope of this study, its nature over time, as well as its

[1] The list of business models is not designed to be exhaustive—there are clearly multiple variations in these business models, as well as other niche strategies not captured by the classification presented here. However, the objective has been to concentrate on leading business models that represent a large part of the industry.

potential implications. The criteria have been developed to identify those trends that are both significant in terms of their likely impact on investors and likely to be persistent over time.

– The process of describing each trend was based on the analysis of the components of the analytical framework presented below and the channels of interaction between them (as presented in the description of the value chain in Appendix 2). This process relied on assessing the activity along the channels of interaction between players adopting different business models in order to place the trends in the context of strategic decision-making by industry participants.

– The process of reviewing each trend involved the identification and assessment of primary and secondary data describing changes in the AM industry, as well as other evidence in order to test the hypotheses constituting each trend. The balance of arguments as to whether each trend is taking place and whether it fulfils the criteria set out below has been presented, together with a description of each trend.

The results from this exercise are presented in sections 4 to 6 for the core AM, distribution and back-office segments of the value chain respectively.

#### 2.2.5 Analysis of the implications of the relevant trends

Having mapped out the important trends across different segments of the value chain in the context of the six identified business models, the resulting mapping has been used to analyse specific implications of those trends that are of relevance to this study.

The implications under consideration include:

– constituent embedded risks and risk correlations across segments;
– potential market inefficiencies (mispricings) and externalities;
– drivers of competition;
– potential value transfers to the consumer.

These are discussed in further detail in section 2.5.

## 2.3 The analytical framework

The research for this study has identified a wide range of sources with evidence that can be used to identify the current trends in the AM industry. These sources often differ in terms of their thematic and geographic coverage, as well as in their methodology of deriving the evidence.

Similarly, industry stakeholders (including policy-makers and the AM firms themselves) are often faced with a plethora of issues, apparent causal links, and country-specific features, the ramifications of which might be difficult to understand at a high-level of analysis across 25 Member States and across all parts of the industry. As a result, conclusions on the relative importance of different phenomena often vary according to a particular point of view.

In addition, because the AM industry is not based on a single business model and is subject to considerable country and market differences, the information on trends, persistence and causality from different countries and markets is often not uniform and may be inconsistent or confused.

The implication of the above is that a simple juxtaposition of the evidence from different sources is likely to result in a confusing, fragmented, and potentially incomplete picture of the overall changes taking place in the industry. The analytical framework developed for this study is designed to overcome this methodological problem by providing a transparent

template to examine each trend, as well as interactions between drivers, trends and their implications.

To analyse the information from the above-mentioned sources in a systematic fashion, one of the key characteristics of the framework has been to make a clear separation between the drivers of change in the industry, asset managers' strategic responses to these drivers, and the execution of these strategies, as well as their subsequent implications. Making this distinction should allow for a more coherent mapping of the linkages and interactions between the different trends currently observed in the industry.

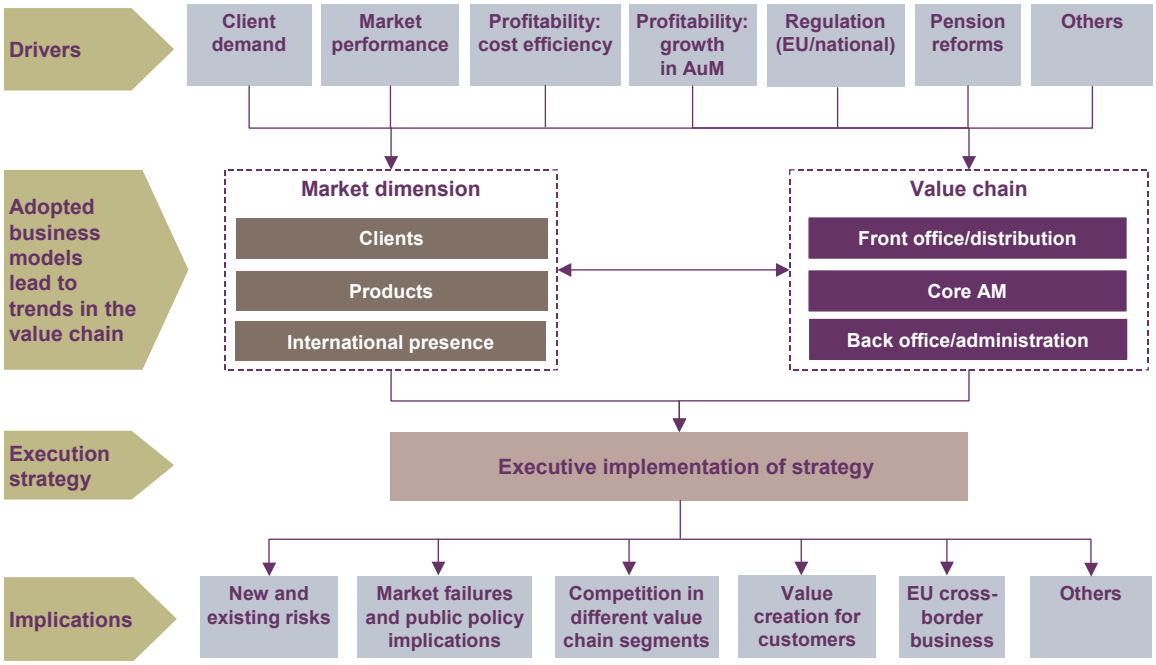
Another important element of the framework was to focus the study on analysis of trends that affect the shape and evolution of the value chain of the European AM industry. The study has sought, first, to address the major trends in all the principal jurisdictions, and, second, to identify pan-European processes that characterise more than one market.

The overall analytical framework for this study is illustrated in Figure 2.2. With this in mind, the trends observed in the AM industry can be placed into four categories:

– trends in the drivers of change in the industry;
– trends in business models and the shape of the value chain;
– trends in strategic decision-making and execution (implementation);
– implications.

This categorisation assists in the understanding and analysis of a large number of parallel trends that are discussed in the following sections.

**Figure 2.2 Analytical framework for the examination of trends in the AM industry**




Source: Oxera.

The framework presented above has, however, been implemented with some degree of flexibility. For example, it is not intended, nor would it be possible, to place all trends neatly into one of the four categories introduced above. In many cases, the nature of the trends being analysed does not allow for such clear-cut classification.

Additionally, the direction of causality does not always run clearly from drivers and high-level strategies to execution and implications. For example, increasing levels of operational risk due to product innovation could affect decisions to outsource certain non-core functions.

Moreover, some trends are likely to be mutually reinforcing—eg, transformations in the value chain (such as product development) caused by trends in client demand could trigger further changes in investors' preferences. This raises questions about their positioning in time and poses problems for clear identification of causes and implications.

Where the above-mentioned issues arise, they are highlighted in the analysis and dealt with accordingly. This does not affect the fundamental objective of the analytical framework to map industry linkages and focus on value chain developments, as described above.

## 2.4 Selection of relevant trends

Not all potential trends are of relevance to this study. The process of identifying relevant and significant trends has been a significant challenge to the project. In order to assess systematically all aspects of industry transformation to identify which are relevant, the methodology to select the trends of interest was based on a set of clearly defined criteria.

**Criterion 1: Direction and persistence**
Each trend of relevance is expected to represent a medium- or long-term change in the AM industry, rather than a transient one. While an industry as broad and as complex as the AM industry is prone to frequent fluctuations driven by the changing environment in financial markets, as well as changes in investor sentiment, most of these changes might either be reversed or become irrelevant in a relatively short period of time.

**Criterion 2: Impact on value chain**
Each trend of relevance is expected to have a significant effect on at least one major segment of the value chain. Many changes in the AM industry concern factors that do not have a direct or significant impact on the shape of the value chain, and therefore fall outside the scope of the study. For example, financial investment strategies based on a new method of stock-picking might have little impact on players' positioning along the value chain or their strategic choices in each segment.

**Criterion 3: Relevant implications**
Only trends that could be expected to have an impact on the issues identified in the scope of the analysis have been analysed in detail. These key issues in the terms of reference include risks, market failures, cross-border activity, competition, and value creation to the end-investor.

**Criterion 4: Substantial scope and coverage**
Only trends that are manifest in a substantial portion of the EU and that cover a significant part of the AM industry have been analysed in detail. While many potential trends might fulfil all the above criteria, their relevance might be limited to a single country, or concern a niche market within the AM industry. This study has focused on trends that are likely to affect the AM industry as a whole, directly or indirectly, and have an impact on the changes in the industry in more than one country.

The analysis of trends in sections 4 to 6 highlights the above criteria in the context of specific trends. Criteria 2 and 4 are of particular relevance in the context of the description of trends in each segment of the value chain.

## 2.5 Components of the analytical framework

### 2.5.1 Drivers

The identification of the role of different drivers of change in the AM industry forms a central part of the analytical framework. Some of the drivers listed in Figure 2.2 are essential economic factors that have been, and are likely to continue to be, driving forces in the industry—eg, cost-efficiency considerations and the commercial incentives on providers of AM services to seek to increase AuM.

Moreover, the importance of drivers of change and their impact can be intensified by other industry developments, such as market performance in traditional asset classes, as well as the changing patterns of retail and institutional investors' demand.

The identification of drivers serves another purpose: to assist in the understanding of why AM firms make particular decisions, in order to make an informed assessment of which of the current trends being observed in the industry are likely to continue in the near future, and which might be transitory (and hence fail the persistence criterion set out above).

Figure 2.2 presented a non-exhaustive list of drivers considered in this analysis. Selected examples of the important role of drivers in explaining the current trends in the AM industry are as follows:

– **client demand** and **market performance** shaping product innovation—for example, a combination of poor equity market returns and increased demand from clients for absolute returns are two of the main drivers behind the wave of new products being introduced in the market;

– **cost-efficiency** considerations behind outsourcing decisions—many such decisions, particularly in back-office functions, are in response to pressure to cut costs in 'non-essential' activities;

– **EU regulation** promoting the growth of cross-border business or affecting the level of competition between harmonised (eg, UCITS) and non-harmonised retail products;

– **national regulations** acting as barriers to the registration of cross-border funds—for example, national interpretation of the rules for the notification UCITS funds is one of the main barriers to the growth in EU cross-border funds;

– **pension reforms** leading to an increase in the availability of funds—a larger amount of funds available for the AM industry to invest is likely to alter the competitive dynamics of the industry, at both the national and pan-European level.

### 2.5.2 AM business models and the shape of the value chain

Analysis of the way each business model positions a given asset manager within different parts of the value chain in terms of adopted strategies constitutes the core element of the analytical framework as well as the main focus of the analysis of trends undertaken in this study. The objective of placing the AM firm at the centre of the analysis has been twofold, to distinguish between:

– critical trends (those having an impact on the value chain) and secondary trends in the industry, focusing on the former;

– trends affecting different types of AM firm, depending on their size as well as their strategic positioning along the value chain.

The AM value chain is described briefly below in the context of the analytical framework described in Figure 2.2. A more detailed analysis of the AM value chain and different business models in the industry can be found in Appendix 2.

The main activity of an AM firm can be described as the gathering of funds from retail and/or institutional clients and investing those funds in a wide variety of asset classes, with the objective of delivering the highest possible, risk-adjusted, returns to investors.

To perform this activity, an AM firm can organise its business (ie, it defines its business model) in many different ways. The delineation of an AM business model involves, first, a high-level strategic decision along two dimensions: which markets to address and what

structure/scope of the firm to adopt (ie, where in value chain the firm operates), as shown in Figure 2.2.

- The market dimension encompasses an AM firm's decision on which clients to target and what products to offer, as well as the decision on whether to target clients outside its country of origin (ie, international presence).

- Decisions taken on the market dimension must be backed by an appropriate organisational structure. The structural dimension of an AM firm's business model includes decisions on issues such as:

    - the degree of vertical integration along the value chain—ie, whether, in addition to core AM, a firm is active in distribution and/or back-office activities;
    - horizontal relationships with other players in the market along different segments of the value chain—eg, mergers and acquisitions (M&A), strategic alliances and joint ventures.

There is a strong interaction between these two dimensions. For example, a decision to expand the product range in order to attract new clients or increase AuM will require a corresponding decision in the structural dimension of the business. In particular, the AM firm could decide to pursue one or more of the following options:

- develop new products in-house;
- expand the range of third-party funds (TPF) it sells through its own distribution network;
- increase the range of multi-management products it offers, such as funds of funds (FoF), and manager of managers (MoM).

Moreover, the options that a firm can feasibly pursue along the market dimension are likely to be determined by the firm's existing organisational structure—eg, its level of integration along the value chain, its alliances with other providers and distributors, and the size of its core AM team.

### 2.5.3 Strategy execution

This element of the framework deals with the practical executive implications of the high-level strategy defined along the market and value chain dimensions. For example, in the case of trends in product innovation triggered by client demand, the AM firm would need to make practical decisions on the type of financial engineering, portfolio allocation and/or methods for stock-picking. Similarly, in the case of trends in the growth of multi-management products, AM firms would need agreements on the level of management fees charged, as well as the percentage of those fees that would be passed on to their clients.

Making a distinction between this element of the framework and the high-level strategy is very important for the analysis of trends in the AM industry. Identifying the leading approaches to 'strategy execution' allows for an assessment of whether the trends associated with the observed executive decisions are likely to be permanent or transitory.

Strategy execution trends are often observed in response to market or value chain high-level strategic decisions being made by market players; if the latter are expected to persist, similar conclusions can be reached about the former.

Not all trends identified in this part of the analytical framework are covered in the study. For example, trends in product development are analysed only insofar as they affect the evolution of the value chain, or their effect on operational and/or systemic risks in the industry can be clearly identified.

### 2.5.4 Implications

As noted above, given that the identified trends have many implications beyond the scope of this study, it is important that the detailed analysis of the implications of trends focuses only on relevant criteria.

The methodological approach adopted by Oxera in this context is therefore based on identifying the linkages between drivers and implications for each trend via developments on both the demand and the supply side. No implications are analysed outside of this realm.

The main categories of implications include the following.

- **New and existing operational risks for AM firms and, ultimately, for final investors**—the study covers a comprehensive range of operational risks, similar to those identified in Oxera (2001), as well as new sources of risk stemming from the most recent trends in the AM industry.

- **Non-operational risks**, including financial risks to AM firms, potential systemic risks, as well as selected risks to the end-consumer arising, for example, from market failure, but excluding investment risks that are driven by specific investment strategies.

- **The potential for new or existing market failures to have an impact on consumer welfare**—some of the trends may be creating new market failures or exacerbating existing ones. The study aims to identify these trends and discuss their implications for public policy and future regulation, without, however, undertaking a detailed risk assessment or cost–benefit analysis of specific regulatory options.[2]

- **Competition in different parts of the value chain**—one important endogenous development in the AM industry might be the changing nature of competition between AM firms across time. This, in turn, is likely to have an impact on fees for different products and, hence, on consumer welfare. Therefore, the likely changes in the overall competitive landscape in different segments of the value chain constitute an important dimension along which the implication of identified trends should be evaluated.

- **Value creation to consumers**—changes in the nature of competition and in the distribution of costs along the value chain will ultimately need to be assessed against variables relevant to the end-investor, such as the choice of products and the quality of products and services. Potential implications of current trends for the end-consumer have been considered in relative terms—ie, compared with the status quo—in light of the identified trends presented in sections 4 to 6. The objective of this exercise is to comment on the potential overall impact of trends on consumer welfare rather than explicitly to quantify any particular effect.

[2] For a discussion on the methodology of assessing the benefits of regulation, see Oxera (2006a).

# 3 Pension reform and implications for the AM industry

Significant reforms of Member States' pension systems have been considered across the EU, although few countries have actually adopted wide-ranging reforms. Nevertheless, both the ongoing as well as planned reforms are likely to have a significant impact on the demand for AM services within these Member States, and the AM industry can be expected to react to these changes in demand. This section outlines some of the key types of pension reform being undertaken, using examples from different Member States and jurisdictions, and draws out some potential implications for the AM industry. As the underlying problem of EU pension provision is driven by long-term changes in Member States' demographic profiles, the impact of pension reform on the AM industry is unlikely to be transient. The consequent trends are likely to be long-lasting, and hence important for the long-term structure of the AM industry and value chain.

The effects of pension reform on the AM industry are analysed in three steps.

1. An overview of the key challenges to the existing pension systems in Europe, to identify the macro-dynamics of the reforms (the European pension challenge).

2. Identification and review of the aspects of pension reform (including drivers and processes) that might affect the AM industry, based on a high-level analysis of the economic aspects of pension reforms across EU Member States.

3. Economic assessment of the potential impacts of the key aspects of pension reform on the AM industry in terms of the scale, significance and timing of these impacts.

Pension reforms are likely to be driving some of the current trends in the AM industry across different segments of the value chain. At a minimum, such reforms intensify or dampen specific existing trends discussed further below; in the medium to long term, the reforms might create new trends, which could have a significant impact on the AM industry. In light of these interactions, the economic analysis of the impact of pension reforms on the AM industry forms an integral part of the analysis of current trends (outlined in sections 4–6). This approach allows for the identified trends to be considered in conjunction with the pension reforms as some of the key drivers and analysed accordingly.

This section presents a high-level introduction to the European pensions challenge (section 3.1), as well as the main objectives of the ongoing pension reforms (section 3.2) from the perspective of the AM industry. Selected examples of the types of pension reform being implemented across Member States that are of relevance to the trends in the AM industry are highlighted in section 3.3. A review of the areas where the pension reforms are likely to have an impact on AM is provided in section 3.4.[3]

## 3.1 Background to the pensions challenge

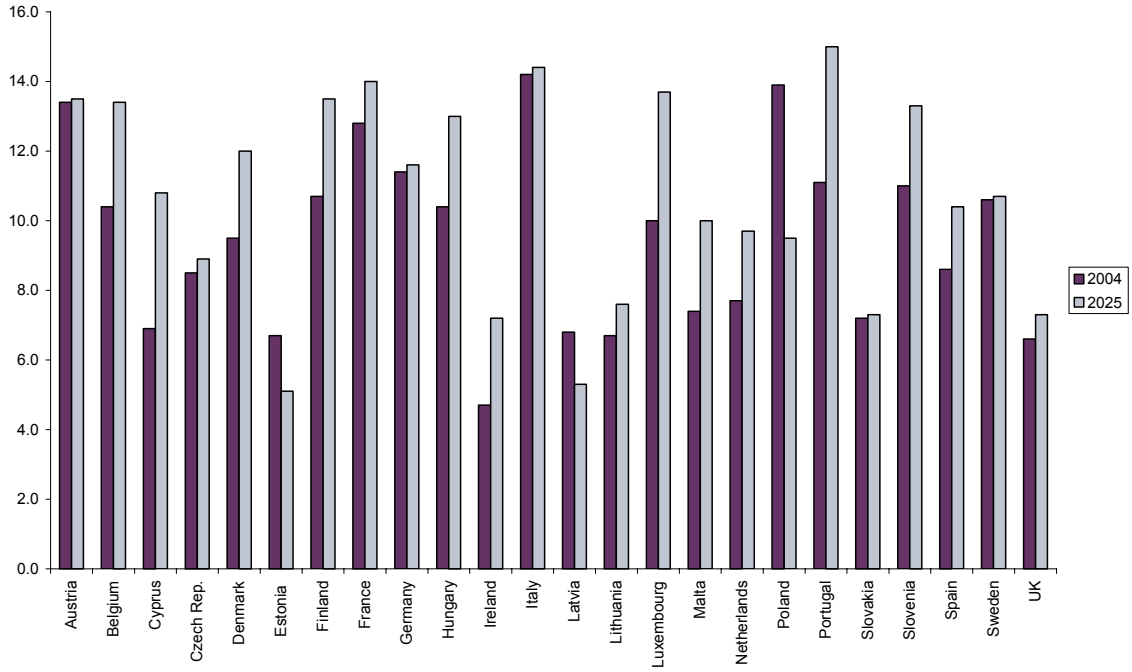
Pension reforms are under way in several Member States, triggered by the substantial increase in the 'dependency ratio'—the number of people of retirement age relative to those of working age. The ageing population and the shrinking of the workforce, which is mainly due to falling birth rates and increasing life expectancy, are putting pressure on state resources for adequate pension provision. The significant expected increase in the

[3] Most of the references in sections 3.1 and 3.2 are taken from Council of the European Union (2003). The references in section 3.3 are drawn from two studies: Allianz Global Investors (2004a and 2004b).

dependency brings to the fore the 'pension gap' problem: as the dependency ratio increases, it becomes more difficult to secure adequate government financing for contemporaneous pension payments—ie, pay-as-you-go (PAYG) schemes. In many cases, the base from which the pension payments can be drawn is shrinking as a proportion of total economic activity of a country, while the liability for payments is increasing as the proportion of the population eligible for pensions increases. Member State pension reforms are primarily aimed at addressing this problem.

The overall objective of the pension reforms is to ease the burden on the state pension systems, while ensuring a minimum level of income (and a reasonable standard of living) for those in retirement. Currently, public pension spending represents between 5% and 14% of the GDP of EU Member States, and is expected to increase significantly over the next 20 years (see Figure 3.1).[4]

**Figure 3.1 Public pensions (gross) as % of GDP**




Source: European Commission, DG Economic and Financial Affairs (2006).

In many countries, the core of the pension system is represented by defined-benefit, PAYG schemes that are managed by the government.[5]

The reforms generally stress the importance of private sector pension provision as a supplement to the current public PAYG schemes (the 1st pillar largely consists of PAYG schemes). In some cases, the reforms have introduced funded systems in the form of private occupational schemes (2nd pillar) and individual retirement provision schemes (3rd pillar). Several new Member States (eg, Poland, Hungary, Estonia, Latvia) have introduced universal, mandatory schemes that are managed by the private sector (1st pillar bis). The

[4] These numbers should be interpreted with case since there might not necessarily be a direct relationship between public spending on pensions as a proportion of GDP and the flow of funds to the AM industry, as the latter might be a measure of PAYG spending from taxation or equivalent, not from investments.

[5] PAYG schemes provide pension payments from current taxation (or similar instruments). Thus, those *paying* for today's pensions rely on the future payments of others to fund their own pensions, which will be paid in the future. In practice, only the public sector can run such schemes. This can be the state pension or employment pensions when the public sector is the employer. PAYG schemes are contrasted with funded schemes, where payments into a pension fund are invested now to provide the means to pay the *future* pension of those making the payments. Such investments can be at an individual level (personal pensions) or collective (occupational).

underlying logic of these reforms is to give adequate incentives (including coercion) to individuals, and to enable them to provide for their own future pensions and thereby reduce their dependence on state resources.

It is against this background that the impact of pension reforms has been investigated for this study, as a potential driver of change in the AM industry.

## 3.2 Overarching objectives of the pension reforms

To address the pensions problem, in December 2001 the Laeken European Council outlined 11 objectives that the pension reforms of all Member States should seek to address. These objectives fall under three broad aims: adequacy requirement; financial stability; and modernisation (ie, responding to the changing needs of the working population).

### Adequacy requirement

According to this broad aim, pension benefits should be adequate in terms of ensuring that those in retirement receive a minimum level of income, and as far as possible are able to maintain their standard of living prior to retirement. The Council identified three specific objectives that would enable the adequacy requirement to be met:

– preventing social exclusion and ensuring minimum pension guarantees;
– enabling people to maintain living standards;
– promoting solidarity between generations.

### Financial stability

This implies that pension systems should be financially viable for the state. To boost contributions and reduce reliance on the state, the Council recommended the following specific objectives:

– increasing the overall level of employment;
– extending the working lives of individuals;
– reducing public debt;
– introducing labour market reforms through a change in tax-benefit policies;
– adjusting benefits and contributions in a balanced way such that the active workers are not overburdened;
– boosting private provision of pensions through stronger 2nd and 3rd pillar schemes.

### Modernisation

The need to modernise existing pension systems to reflect changes in society and the labour market involves adapting to more flexible employment and career patterns, ensuring greater equality of men and women, and improving the transparency of the pensions system through regular monitoring.

## 3.3 Analytical framework for the analysis of pension reforms

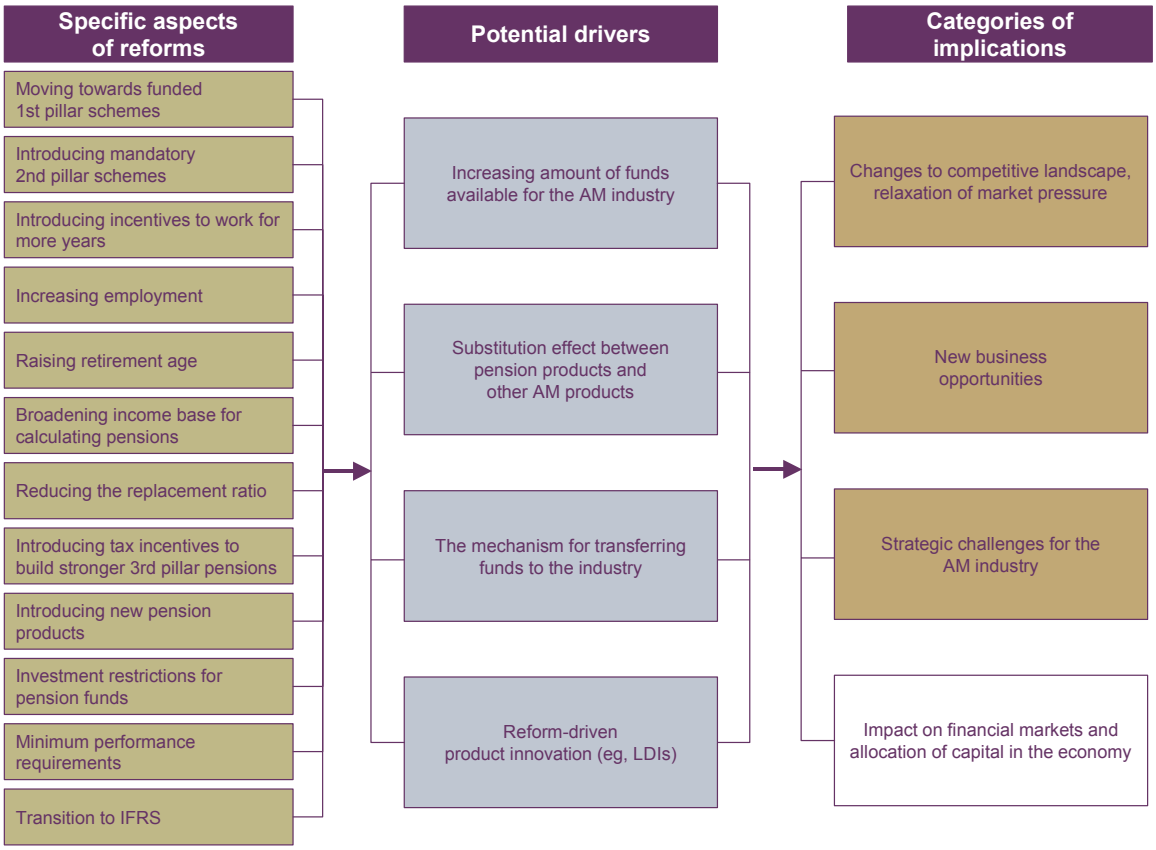
The analysis concentrates on examining the aspects of pension reform that might represent drivers for changes in the AM industry. Given that many reforms are in the early stages of implementation, have been in place for a relatively short period of time, or are still awaiting policy approval, their implications remain mainly hypothetical. The analysis involves the following key steps:

– identification and review of important aspects of pension reforms that could affect the AM industry;

– identification of potential drivers of change for the AM industry and review of evidence and mapping of specific aspects of reforms on these drivers;
– assessment of the implications of the identified key drivers of the pension reforms on the AM industry.

A schematic overview of the analytical approach is shown in Figure 3.2.

**Figure 3.2 Stylised illustration of the methodology for assessing implications of pension reforms**




Source: Oxera.

Given that it may still be too early to derive evidence-based conclusions on the implications of reforms, the following analysis concentrates on identifying the key linkages between aspects of reforms and potential implications for the AM industry; in other words the identification of drivers of change. In the course of Oxera's research, the following drivers were identified:

– increasing the amount of funds available for the industry;
– a substitution effect between the traditional AM products other than pensions and pension products;
– development of different mechanisms for transferring pension assets to the industry;
– stimulation of product innovation.

The next section discusses various aspects of pension reforms before examining the evidence exploring the impact of identified drivers on trends. Finally, the economic assessment of the implications of reforms is discussed.

## 3.4 Types of pension reform

The aspects of pension reform being introduced by Member States, as set out in Figure 3.2, are discussed below in detail.

### 3.4.1 Reducing pension benefits

To meet the growing pension gap and to make the public PAYG systems sustainable in the future, there has been a move towards reducing individual benefits. This has mainly been achieved by changing the way entitlements are calculated, and by lowering the maximum allowed pension, in the following ways.

- Broadening the income base for calculating pensions—previously, Member States calculated pension entitlements by taking income over a relatively short time span. However, by calculating the base income over a longer period, it is reduced, lowering entitlements where these are linked to prior contribution levels. For example, in Austria, the income base for calculating pensions was broadened from the average of the 16 best years to the average of the 40 best years of income, and, in France, it was increased from the average of the best 10 years to the average of the best 25 years.

- Reducing the replacement ratio—ie, the ratio of pension benefits to final salary (however calculated)—and thereby automatically lowering the benefits. For example, in Germany, the effective gross replacement ratio of the 1st pillar scheme will gradually be reduced from 70% to 43% by 2030. In the UK, the replacement ratio, which was 34% for men and 37% for women in 1999, is expected to fall to 25–28% by 2030.

Some countries are lowering the maximum 1st pillar pension benefits that individuals can claim. For example, in Austria, the maximum pension allowed to an individual after contributing for 40 years is gradually being reduced from 78.4% of the income base to 71.2% by 2009. In Germany, there has been a reduction in the benchmark pension level (the maximum state pension that an employee receives after paying contributions for 45 years) from 70% to 64.5% of the income level by 2030.

### 3.4.2 Strengthening the contribution base

Efforts are being made to increase contributions and the contributing base. The latter implies an increase in workforce, which would mean that more people would contribute towards financing pension entitlements. Measures to increase the workforce include the following.

- *Introducing incentives to work for more years (or disincentives to retire early)*—if individuals work longer, this would not only increase the overall pension contributions but also potentially reduce the benefits to these people, as their pensions would have to be provided over a shorter period. In particular, such measures include:

  - additional benefits to people if they work beyond retirement age (which partially offsets the cost reduction in pension payments due to a shorter pension period);
  - a (more significant) reduction in pension entitlements if they retire early;
  - an increase in the number of years of contributions needed to qualify for a full pension;
  - abolition of the generous early retirement pension;
  - removal of early retirement schemes;
  - tightening of the eligibility criteria to obtain access to pensions.

For example, in France, after paying contributions for 40 years, individuals obtain an additional benefit of 0.75% if they work beyond retirement age. The corresponding figure for Austria is 4.2%. Similarly, in Portugal, for every year that individuals retire early, the pension will be reduced by 4.5%.

– Increasing the overall level of employment will widen the contributing base. Member States are seeking to achieve this by lowering unemployment benefits and by raising the employment rate among young people and women.

– Increasing the retirement age—these measures are being undertaken because of the considerable increase in life expectancy. Specific measures include raising the retirement age for women, which is usually lower than for men. In Austria, for example, the retirement age for women is now the same as for men.

### 3.4.3 Move from defined benefits towards defined contribution[6]

Moving from defined benefits to defined contributions would reduce the pressure on pension providers, given that there are no guaranteed returns to the beneficiaries. If the assets invested in a defined-contribution scheme do not provide a good return, this translates into a shift in the performance risks from pension providers to beneficiaries. By contrast, with a defined-benefit scheme, it is the provider who must bear the risk of underperformance.

The upside of this development is that it might also help promote longer working lives, given that the benefits received upon retirement are linked to the total contributions made and the age of retirement. Thus, under a defined-contribution scheme, the pension available rises automatically if retirement is delayed.

Historically, employers have offered defined-benefit schemes because they were more attractive for employees. Employees knew up front what level of pension benefits they could expect upon retirement and the risk of underperformance was borne entirely by the company. However, the downturn in financial markets at the beginning of the 2000s and increases in the replacement ratio for many pension funds have triggered a shift in pension schemes from defined benefits to defined contributions.

For pension funds, the advantages of this shift are clear—employers' contributions decrease and the risk shifts to employees. Moreover, the defined-contribution scheme creates a direct link between contributions and benefits, allowing a direct match of assets with liabilities, because liabilities are defined as the assets that are available.

Many countries have seen a significant move from defined-benefit to defined-contribution schemes (eg, Estonia, Hungary, Italy, Latvia, Poland, UK). Moreover, this shift has been observed in both public and private pension schemes. An example in the public sector is the 1995 'Dini' reforms in Italy. While the public system remained strictly PAYG, the reform introduced notional accounts for each worker, which linked future pension benefits with contributions during their working life. The expected result of the reform is a reduction in the replacement ratio for a 60-year-old individual from 67% in 2004 to 48% in 2050.

In the private pension system, the UK occupational pension market is rapidly moving from defined-benefit to defined-contribution schemes. According to the 2003 National Association of Pension Funds survey (NAPF 2003), 26% of private sector defined-benefit schemes were no longer available to new entrants. The average employer contribution to a defined-contribution scheme is now 6% of income, as against 16% in 2003 in a defined-benefit scheme. The difference in contributions will result in lower final pensions for beneficiaries.

### 3.4.4 Incentives for building stronger 2nd and 3rd pillars—a supplementary means of financing pensions

Member States are taking initiatives to strengthen the 2nd and 3rd pillar reforms, not only to provide a supplementary means of financing pension entitlements, but also to address the 'savings gap'—the concept that individuals save less than they should if they are to secure

[6] For an excellent exposition on this subject, see Leclair (2005).

an adequate level of retirement income. Since many countries are reducing the replacement ratio of state pension benefits, it is becoming increasingly important that private provision of income for retirement is increased if total retirement incomes are not to fall. As a result, Member States are introducing reforms to incentivise people to save more for their retirement, such as tax incentives and new pension products.

### Tax incentive examples

– In the UK, the Finance Act 2004 replaced the many complicated rules on taxation of private provision of pension income with one set of rules. The objective was to provide employees with incentives to increase their contribution to private pension schemes by making taxation rules easier to understand and implement.

  One feature of this reform is that invested funds can grow free of tax,[7] and there is no limit on tax relief for employer contributions. Moreover, personal contributions can obtain tax relief on up to 100% of earnings, or on a gross contribution of up to £3,600 a year, whichever is greater. Occupational pension schemes must be externally funded if people are to maximise tax benefits, although there is no compulsion to do so.

– Under the 'Plan d'Epargne Retraite Personnel' (PERP), introduced in France, 10% of the previous year's gross earnings (the maximum amount of contribution under the social security ceiling) can now be invested tax-free. The aim has been to incentivise high-income earners, who pay high marginal tax rates, to invest (more) in PERPs.

– The German 2001 'Riester' reforms introduced subsidies and incentives for saving in private pension schemes, doubling the limit for tax-free employer contributions. Later, in 2004, the 'Rürup' reforms further changed the legal and tax framework for occupational pensions, introducing deferred taxation under which contributions and interest earnings became exempt from taxation, while the benefits were taxable. Moreover, to increase employees' contributions, tax exemption was granted up to €5,400.

– In Italy, pension funds are currently subject to an 11% tax on annual earnings, payable at the end of each year. The Application Decree is likely to reduce this tax rate to 6.25% or to abolish it entirely.

### New pension product examples

– In the UK, personal pension plans (PPPs), introduced in 1988, allow employees to establish a pension scheme with an external provider. Employers are also providing group personal pensions because of the flexibility and cost effectiveness of such schemes. This is a mixed arrangement between the 2nd and the 3rd pillars. All these personal plans are on a defined-contribution basis. The UK has also introduced the Stakeholder Pension (standardised pension schemes), with the aim of promoting private savings for pensions. The employer selects the provider and benefits are based strictly on an individual's contributions.

– In Italy, the 2004 reforms require that the assets of the termination indemnity payments (TFR) be transferred to occupational pension funds. The TFR serves as an additional pension benefit after retirement, and, for some, it provides a pension of 10–15% of their final pay. The new regime has made it mandatory for employers to invest the TFR of their employees into a pension fund, which must be legally separate from the company and must employ an external asset manager.

[7] The Finance Act provides income tax relief by allowing employees to deduct the amount of any Employee Class I National Insurance Contribution they paid.

– France has introduced new products such as the PERP, which are in addition to existing products for the self-employed and civil servants.

### 3.4.5 Regulation

Selected examples below illustrate the types of regulatory reform being undertaken by Member States.

#### Separation of occupational pension funds from employers and members, leading to the emergence of specific legal institutions

In the UK, for defined-contribution pension schemes, a third-party investment manager must be appointed. This manager must be a legal entity separate from the employers and the members of the scheme. For defined-benefit schemes, their management does not have to be transferred to a third-party service provider. According to the 2003 NAPF survey, 6% of private and public funds manage their investments in-house.

In Italy, the 'open pension funds', which relate to the self-employed, have to be invested by external managers such as banks, insurance companies or AM companies.

#### Investment restrictions for pension funds

Some Member States have imposed restrictions on investment, usually to ensure the safety of pension funds, using either qualitative and quantitative restrictions, or both.

For example, quantitative restrictions have been imposed in Portugal, where there are minimum and maximum levels of investments that can be made in different asset categories (eg, a maximum of 55% can be invested in equities), and in the Netherlands, where company pension funds can invest a maximum 10% of their assets in a sponsoring company. The UK and Ireland, by contrast, have qualitative restrictions in the form of the Prudent Person rule, which limits the risk that pension funds can take when making investment decisions. Some Member States also place quantitative restrictions on *international* assets.

#### Minimum performance requirement

Some Member States place a minimum requirement on the performance of the portfolio (with pension funds). For example, France imposes a requirement that the funds grow by at least 2.5% a year. This has an impact on the choice of assets investment managers invest in bonds rather than equities. In Denmark, if a pension fund fails to meet investment standards, managers have to explain to their regulatory authority how they plan to recover their investments. Moreover, in Sweden and Denmark, 'traffic light' systems link the requirement on a pension scheme to its level of solvency. As solvency decreases, prudential requirements tighten.

## 3.5 Pension reforms as drivers for change in the AM industry

These pension reforms are likely to generate important drivers for trends in the AM industry. Whether reforms have actually led to trends relevant for this study remains to be seen, but a number of developments can already be identified. This sub-section describes the key drivers for change; potential trends that appear to result from these drivers are reviewed in the next sub-section.

### 3.5.1 Increasing the amount of funds available for the industry

Nearly all the pension reforms discussed above have the ultimate objective of increasing the total amount of pensions paid out of funded schemes, rather than from PAYG mechanisms. As funded schemes hold current assets that are to be used to pay for future pensions, the

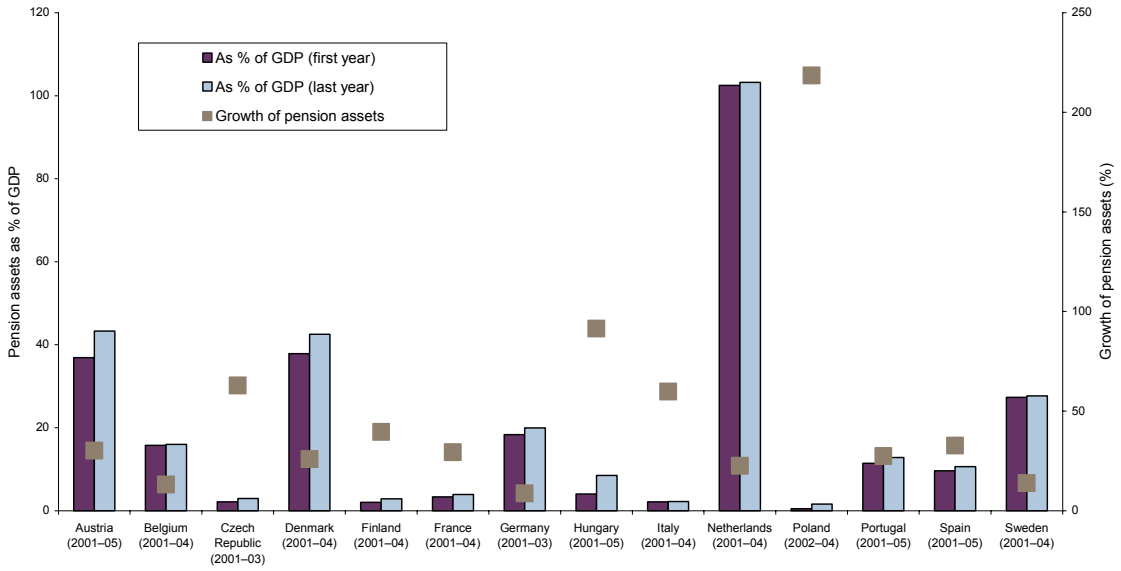
size of funds invested in pension schemes or other long-term investments that can provide income upon retirement will necessarily increase. Insofar as these reforms are aimed at strengthening the 2nd and 3rd pillar pension schemes, the pool of assets available to the AM industry is likely to increase. In addition, the introduction of externally managed demographic reserve funds to support the 1st pillar (eg, the French Pension Reserve Fund) also increases the amount of assets available for the industry to invest.

Particular aspects of reforms that are likely to increase the amount of funds in the AM industry include:

– moving towards funded 1st pillar scheme and transferring the management of funds to the private sector (eg, France);
– introducing mandatory 2nd pillar pension schemes (eg, Poland);
– providing tax incentives to build stronger 3rd pillar schemes (eg, the UK);
– incentivising contributions to the 2nd pillar defined-benefit schemes by providing additional powers to the regulator to take actions in cases of scheme deficits (eg, the UK).

Figure 3.3 shows the evolution of households' assets invested in occupational or pension funds (as a percentage of GDP).

**Figure 3.3 Occupational or pension funds**




Source: Questionnaires to central banks, OECD and ECOWIN data, as reported by ZEW/OEE (2006).

Two important observations emerge from the chart.

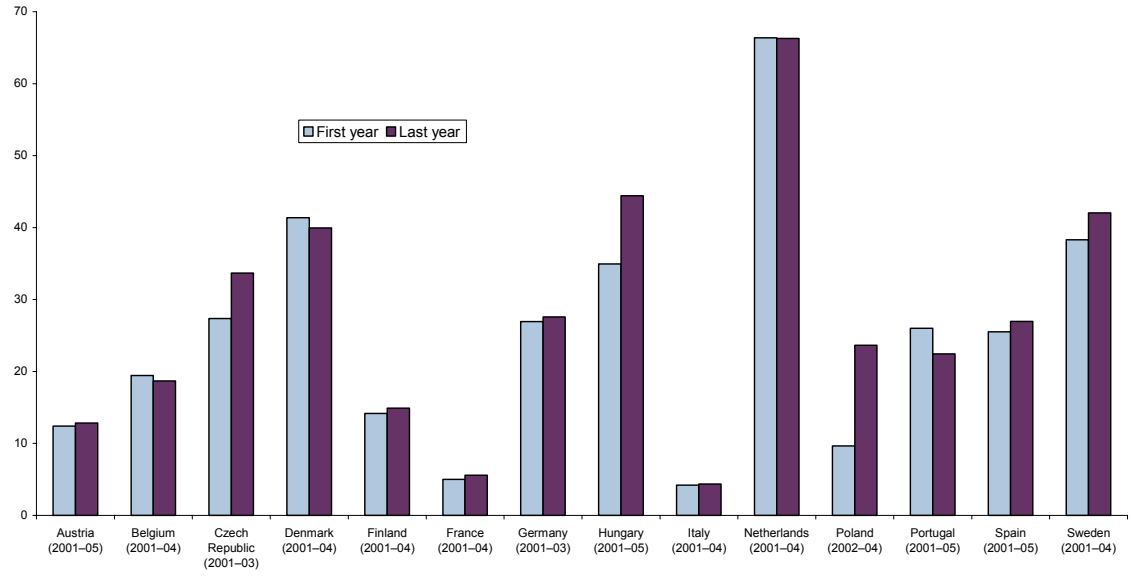
– Across all countries, pension assets have increased over the last few years. The largest growth of pension assets can be observed for Eastern Europe countries, the Czech Republic, Hungary and Poland. Pension assets have also increased as a proportion of GDP, with the largest growth observed in Austria and Denmark.

– Countries also differ in terms of the magnitude of pension assets relative to the size of their economies. The Netherlands is characterised by the highest ratio of pension assets as a percentage of GDP in 2004, and Poland by the lowest (even though it exhibited the largest growth in pension funds over recent years).

A consideration of the allocation of households' total investments provides insight into the impact of incentives to boost pension savings. In most of the countries, the ratio of pension

assets as a percentage of households' total investments increased; while, in Belgium, Denmark and Portugal, it decreased (see Figure 3.4).

**Figure 3.4 Occupational or pension funds as % of households' investments**




Note: Households' investments are calculated as the total of households' assets allocated to life insurance products, occupational or pension funds, and UCITS and non-UCITS.
Source: Questionnaires to central banks, OECD and ECOWIN data, as reported by ZEW/OEE (2006).

Notably, a certain proportion of pension savings might be channelled to the AM industry through channels other than occupation or pension funds (and thus will not be picked up in Figures 3.3 and 3.4). For example, in France, the transfer of the demographic reserve fund (related to the 1st pillar) to private management is unlikely to be reflected in statistics on occupational or pension funds. Also, in certain countries (eg, the UK), investment-type life insurance contracts are often used for pension savings. This might generate a downward bias in the estimated impact of reforms on pension assets, as shown in the figures above.

### 3.5.2 Substitution effect between traditional AM products and pension products

Certain aspects of pensions reform might lead to pension products becoming a substitute for the other AM products (and potentially for UCITS funds). For example, the introduction of more favourable tax treatment of pension investments[8] might trigger reallocation of long-term retail investment into pension products.

Also, as some industry representatives have indicated to Oxera, strict regulation imposed on pension funds (in particular, with respect to investment restrictions) is believed by regulators to benefit the end-consumer by reducing the risk of mis-selling and increasing asset transparency. If so, this might attract highly risk-averse clients, but might also render pension products less attractive than alternative investments.

Given that pension products are characterised by a long-term investment horizon, and are often based on a passive asset allocation strategy, they are unlikely to compete with products that are marketed outside of this realm (long-term passive investments). However, pension products might gain higher market shares at the expense of other products that operate in the same market and do not enjoy specific benefits introduced by reforms. For example, a retail investor holding a UCITS fund for saving purposes might consider

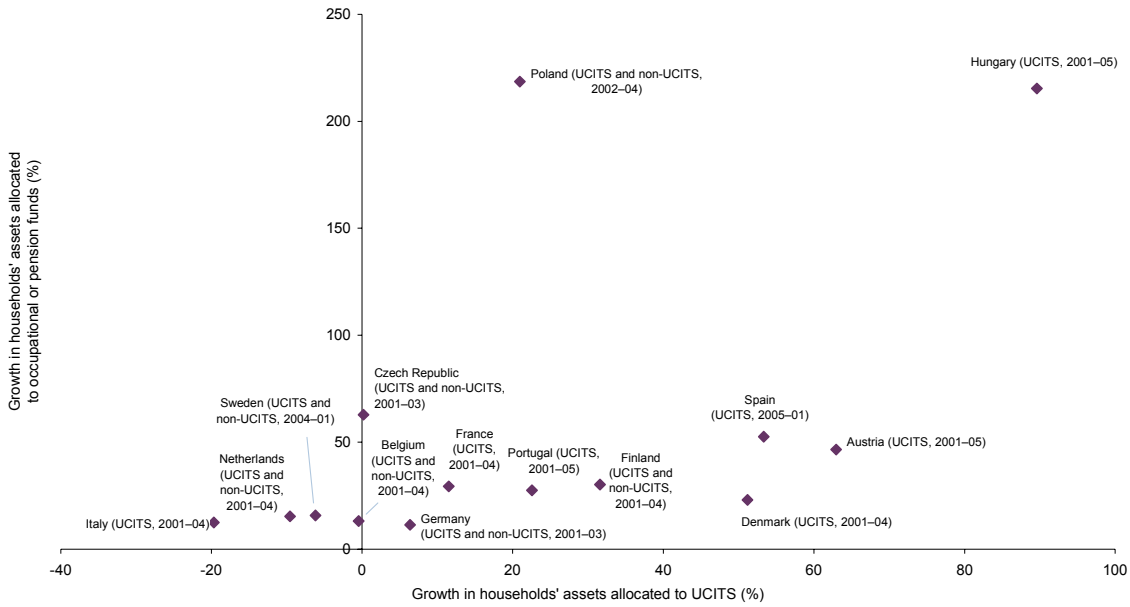
[8] For example, in the UK, 25% of the pension benefits paid to individual investors after retirement might be released from income tax.

reallocating their savings into a pension product to enjoy tax benefits. Higher transparency due to stricter regulation might also contribute to this decision.

Figure 3.5 shows a cross-country scatter plot of the growth of assets allocated to UCITS compared with those allocated to occupational or pension funds. Under the assumption of a substantial substitution effect, an inverse relationship would be expected between the growth of pension assets and assets allocated to UCITS; however, the evidence does not seem to support this assumption.

On the one hand, there are examples where high growth of pension assets is associated with low to modest growth in assets allocated to UCITS (eg, the Czech Republic and Poland). On the other hand, the Hungarian economy provides an example of where growth rates in both were exceptionally high. Given the large number of factors that might affect results shown on the scatter plot below, the overall impact on pension assets represents a cumulative effect rather than the 'pure' impact of pension reforms. For example, the UCITS III regulatory developments are likely to have boosted the UCITS segment of the market, thereby potentially mitigating the substitution effect of pension reforms. Nevertheless, no robust evidence can be identified to support the proposition that pension products are, in general, displacing other categories of AM products.

**Figure 3.5 Growth in assets allocated to UCITS compared with assets allocated to occupational or pension funds by country, 2001–05 (%)**




Note: Where data is not available for 2001–05, the closest period is used. In addition, where data on assets allocated to UCITS is not available, UCITS and non-UCITS are used.
Source: Questionnaires to central banks and OECD data, as reported by ZEW/OEE (2006).

### 3.5.3 Mechanism for transferring pension assets to the industry

The mechanism for transferring pension assets from investors to manufacturers might have significant implications for trends in the AM industry. For example, the organisation of the bidding process for public pension savings (eg, the French demographic reserve fund) might affect the quality of the competitive process between managers of pension assets.

Another example could be drawn from considering how elements of the industry value chain compare in terms of the nature of the competitive process: the degree to which distributors of retail pension products might enjoy better market positions than providers might affect the distribution of value, generated by increases in private pension savings, along the industry value chain.

At present, the usual way for pension funds to flow into the AM industry is from individuals purchasing personal pensions, or from institutional pension funds acting collectively for a group of employees in funded employment-based pension schemes. However, pension reform in Member States raises the possibility that alternative mechanisms might be developed that could result in significant flows of funds into the AM industry. In particular, reforms may create real funds that are directly or indirectly under the control of governments, or their agents. One such mechanism is the bidding process used in the French demographic reserve fund to allocate funds to asset managers.

However, even if traditional mechanisms are used, the potential size of these funds could have an impact on the competitive and organisational dynamics of this part of the value chain. In particular, if these flows of funds are large compared with other remaining flows, any party acquiring these flows could come to dominate the AM industry.

### 3.5.4 Product innovation

Certain aspects of pension reform, such as investment restrictions for pension funds and regulatory treatment of corporate pension deficits, might trigger product innovation in the AM industry.

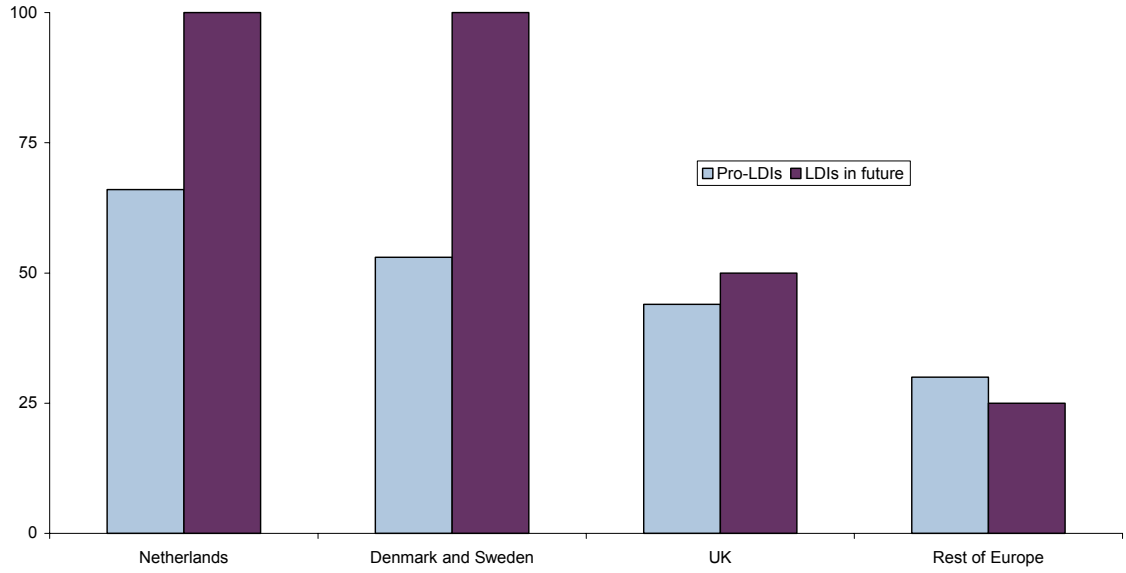
Liability-driven investments (LDIs) are an example of such innovation. In essence, these investment techniques aim to match assets with a specific profile of liabilities—eg, defined benefits of pension schemes. Recent growth of LDIs can be traced partly to changes in accounting standards and partly to developments in pension regulation.

The degree of penetration of LDIs varies across Europe and often depends on the extent to which regulation requires pension schemes to value their liabilities using market discount rates, which results in gains or losses when a mismatch between assets and liabilities is identified (based on market value). However, LDIs have become an important component of AM in many jurisdictions. According to JP Morgan's Liability-Driven Investment Survey (June 2006), 66% of respondents (corporates, local authority pension schemes, industry-based schemes and plans regulated as insurance companies) in the Netherlands are pro-LDI,[9] 53% in Denmark and Sweden, and 44% in the UK.

The survey also provides evidence that LDI-type strategies are expected to be used in the future. For example, 54% of the pro-LDI respondents in the UK believe that between 25% and 50% of pension funds would adopt such a strategy over the next five years.

[9] Pro-LDI indicates that respondents have implemented an LDI strategy, are in the process of implementing one, or are thinking about doing so (JPMorgan 2006).

**Figure 3.6 The use of LDIs in Europe, 2006 (% of survey respondents)**




Note: 'LDIs in future' indicates pro-LDI respondents' estimation of market penetration in the future. In the UK, for example, 54% of the UK pro-LDIs thought that between 25% and 50% of pension funds would adopt LDI in the next five years. In the Netherlands, the equivalent figure was 45%, in Denmark(Sweden 71% and in the rest of Europe 50%.
Source: JPMorgan (2006).

## 3.6 Implications for the AM industry

The impact of the proposed pension reforms remain relevant to this study insofar as they could affect the AM industry by:

– **changing the competitive dynamics**, including the potential effect on concentration levels among players and the distribution of value in the industry;

– **generating new business opportunities** through increasing the amount of funds available for the AM industry and triggering the introduction of new product types (eg, LDIs) and changing the distribution of financial risks in the industry;

– **creating strategic challenges** for players in the AM industry regarding potential repositioning of players along the value chain and potential substitution effects between pension and traditional AM products.

Pension reforms might also affect prices in financial markets and the allocation of capital in the economy, as in the case of the impact of LDIs on long-duration bonds. Although significant, this largely remains outside the scope of this analysis, but is relevant insofar as it might generate systemic risk for the economy.

Whether such impacts are likely is discussed in more detail below.

### 3.6.1 Concentration in the AM industry and the distribution of value

The increase in funds under management and the mechanism for transferring these to the industry have an important impact on the concentration in the AM industry; they also affect the distribution of value across the value chain and to the end-consumer.

One of the key implications of the reform of Member States' pensions is that there will be increasing flows of funds into the AM sector. This increase in flow could affect the structure

of the AM business in a number of ways, but the precise impact might depend exactly how these pension reforms are organised. In particular, some of the reforms could create very large funds. If these funds are distributed to the AM sector in one, or only a few, mandates, the sector might need to increase its concentration in order to be able to handle such large mandates.

For example, large and growing pension funds (eg, demographic reserve funds or large occupational schemes) might employ asset managers on the basis of large-scale mandates or potentially exclusively target large AM firms. This could limit the set of players that would effectively compete for a substantial pension asset to those that are sufficiently large. These developments could lead to further consolidation across the AM industry.

In some of the new Member States (eg, Poland, Hungary, Latvia and Estonia), which are characterised by relatively concentrated AM industries, the introduction of mandatory pension funds as part of pension reforms initially led to a number of AM firms participating in the scheme. However, there have since been several mergers between AM firms[10] and a correspondingly further increase in industry concentration.

By contrast, if new funds are split into many small mandates, it would not be necessary for the industry to increase its level of concentration to meet this new demand. In addition, the increase in the flow of funds and the subsequently higher level of AuM implies that, to the extent that economies of scale exist, more funds, or more distribution networks, will be able to reach the minimum efficient scale. Thus, the increase in the flow of funds could also act to reduce concentration in the industry.

#### Distribution of value

Given that the AM industry is characterised by some economies of scale, increasing the amount of AuM triggered by pension reforms is likely to lead to a reduction in management costs up to a certain level when measured as a percentage of AuM, provided that the increase in AuM manifests itself in an increase in the *size* of funds rather than in the *number* of funds.[11] Whether this additional value is passed to the end-consumer will depend on the level of competition in the industry. In particular, this could be related to the level of concentration among players at different points in the value chain.

The nature of the competitive process across the various elements of the industry value chain is likely to determine the distribution of this increase in value as a result of realisations of economies of scale between manufacturers and distributors. However, one of the trends identified suggests that market power is shifting to distributors, in which case some of the advantages of economies of scale in AM could, to some extent, end up with distributors.

Further implications of trends identified in this study for value creation to end-consumers are discussed in greater detail in section 7.

### 3.6.2 Potential reversal of trends

A substantial increase in AuM might also result in the reversal of trends initiated by the market downturn in 2001–02. The downturn in the financial markets experienced at the beginning of the 2000s was one of the main catalysts of developments in the industry over the past few years.

The key developments that were at least partly triggered by falling AuM seem to include financial innovation, decoupling of core AM and distribution elements of the value chain,

[10] Evidence from interviews.

[11] For an analysis of economies of scale in AM, see Oxera (2006b).

commoditisation of hedge funds, potential redistribution of value from manufacturers to distributors, and increased competition between manufacturers.

Against this background, it might be reasonable to expect that the increasing amount of funds made available for the AM industry due to pension reforms could result in a reversal of these developments. Growth of AuM could reduce the pace of increase in product innovation and efficiency, as well for further specialisation along the value chain.

Two main factors are likely to determine whether the 'reversal' scenario or its certain transformation might actually materialise.

– The strength of decreased AuM in 2001–03 as a driver of trends in the industry.

  The decline in AuM was not the only driver of trends in the industry, nor is it clear whether it was the key one. For example, the evolution of investor demand might have been another important driver behind the developments in the industry. Thus, the more important the impact of a decline in assets, the more significant would be the expected impact of a growth in assets.

– The quality of competitive process in the industry.

  As demand for AM products increases (ie, AuM increase), the role of competition within the AM industry is likely to become an important determinant of the effects of any significant pension reforms. In particular, whether increased AuM might slow down the rate of improvement in efficiency and product innovation is likely to depend on competitive pressures for various players. One of the difficulties is, however, that the increased flow of funds caused by pension reform and the reduction in AuM caused by the telecoms, media and technology (TMT) bubble are clearly not simple reversals of the growth in demand for AM products.

### 3.6.3 New business opportunities and introduction of new product types

At present, some evidence of the increased dynamism in the industry is being observed in the development of new products such as LDIs or other structured products tailored to meet specific pension funds needs—particularly in the context of increasing pension deficits and the pension challenge described above. At the same time, the move from defined-benefit to defined-contribution pension schemes is likely to trigger a whole new range of pension products, which could resemble traditional retail CIS (ie, mutual funds).

Investment restrictions and minimum performance requirements for pension funds are likely to have an impact on the choice of asset classes by managers, leading to more investment in assets such as index-linked bonds and real estate.

Developments in product innovation are explored in section 4.5–4.8. When describing trends in product innovation, links between pension reforms as drivers and particular trends affecting the value chain are outlined. The trend towards increasing use of liability-matching strategies is examined in greater detail in section 4.8.

### 3.6.4 Strategic challenges for the industry

Pension reforms might be expected to require AM firms to adapt their strategies in order to benefit from the new opportunities. Certain aspects of reforms that aim at boosting 3rd pillar pension schemes (eg, through the introduction of tax benefits for pension products), as well as specific regulations imposed on pension funds (eg, investment restrictions and minimum performance requirements introduced in certain Member States) could lead to two strategic challenges for the industry:

– incentives for the development of 3rd pillar pension schemes might result in a reallocation of retail assets from more traditional mutual funds to pension products, or

generate a *substitution effect*, although the evidence so far is not conclusive. This might require players to reconsider their product mix strategies in order to meet changes in consumer demand.

– to attract pension assets, AM firms might need to acquire or develop in-house specific expertise necessary for efficient portfolio management under the conditions where regulations impose strict investment restrictions.

AM firms might also need to change their strategies to be able to satisfy the evolving demand of corporate pension schemes. Certain aspects of reform lead to a situation in which corporations (or, more often, investment consultants representing their interests) require particular services from managers of their pension schemes, such as LDI-type investment strategies. As a result, a number of pension fund managers indicated to Oxera that they are faced with the strategic decision as to whether to acquire additional new specialist AM skills. This appears to be particularly challenging for pension funds that historically allocated a substantial proportion of their assets into equities and were largely equity specialists.

### 3.6.5 Impact on financial markets and allocation of capital in the economy

Pension reforms might have a fundamental effect on the allocation of capital in the economy at the country, as well as the EU, level. Although potentially significant, this effect of pension reforms largely remains outside the scope of this analysis, but will be relevant insofar as it might generate systemic risk for the economy, as discussed below.

The main driver seems to be the regulatory requirement (eg, in the Netherlands, Denmark, Sweden, UK) for pension schemes to value their liabilities using market rates.[12]

Changes in accounting treatment of pension schemes' liabilities (driven by transition to IAS 19 in 2005 in Europe and implementation of FRS 17 in 2003 in the UK) and developments in pension regulations in certain countries have created incentives for pension schemes and correspondingly pension fund managers to change allocation of their portfolios.

Given that IAS 19 (and FRS 17), which is used to value liabilities for regulatory purposes in certain counties, requires the use of market rates on long-term bonds, pension funds have incentives to reallocate their investment positions into long-term bonds in order to match the risk profiles of their assets to their liabilities.

The fact that total pension assets are substantially larger than the market for long-term corporate and government bonds could create excess demand. Therefore, relatively low elasticity of supply of long-term fixed-income securities might lead to failures in financial markets (bubbles in the long-term end of the yield curve) and expose pension funds and beneficiaries of pension schemes to systemic risks. In the UK, for example, pension funds seem to be reallocating their positions to long-term fixed-income securities, and yields on long-term government bonds are historically very low since the introduction of the FRS 17. It remains to be seem whether UK provides an example of:

– systemic failure, potentially driven by changing accounting standards and developments in pension regulation; or

– temporary supply–demand imbalance, which will be normalised by, for example, increased supply of long-term bonds; a natural, though significant, evolution of financial markets.

[12] See JPMorgan (2006).

# 4 Identification and analysis of trends in core AM

Core AM constitutes the core function of the AM value chain and includes a broad range of activities, such as investment research, management of investment portfolios, buying and selling investments, and pre- and post-trade broker liaisons.

The evolution of the AM value chain over recent years has been linked to numerous internal drivers and external pressures, which present a complex picture of parallel developments that are difficult to analyse systematically. The aim of this study has been to disentangle different processes in this context and investigate their interactions in light of supporting evidence from a variety of sources. The analysis focuses on the extent to which aspects of the evolution of the AM value chain can be described as persistent rather than transient, and have resulted in permanent changes in the way market players have positioned themselves along the value chain. Insofar as the changes occur across different segments of the value chain, the investigation has explored the links between core AM, distribution and the back office.

The overarching objective of the analysis presented below has been to delineate the trends of interest from available evidence according to the methodology presented in section 2 and to describe their economic ramifications, including associated risks and implications for the value to the end-investor. The next three sections focus on identification and description of trends; the implications of the trends are discussed in more detail in section 7.

Although the evolution of the AM industry is closely interlinked across the segments of the value chain, it is helpful to analyse developments in core AM first, given the central role of this segment for the industry as a whole.

## 4.1 Drivers of change: market downturn and changes in investors' demand

### 4.1.1 Market downturn and its implications

The downturn in the financial markets experienced at the beginning of the millennium must be considered one of the main catalysts of a significant evolution of the core AM segment of the value chain.[13] This downturn had at least two fundamental effects that can be hypothesised to have transformed core AM, and made a potentially permanent impact on the industry as a whole:

– falling revenues and profits due to poor performance, market downturn, and competitive pressures;

– investors' exploration of new markets based on increasing sophistication and financial markets innovation.

First, during 2000–03, the growth in AuM stagnated as asset prices fell and the net revenues dropped significantly, affecting asset managers' operating profits.[14]

[13] The ZEW/OEE data (2006, pp. 72–3) shows a substantial fall in returns for equity, bond and money market funds from 2000 to 2003.

[14] The ZEW/OEE data (2006) shows that, for the EU 19 region, the growth of net assets of UCITS and non-UCITS funds fell from 36.5% in 1999 to –7.0% in 2002, and has recently been averaging around 10–12%. EFAMA (2006, p. 19) shows that the net inflows into UCITS in 2005 are still below those of 2000, the year before the downturn.

The impact of these market developments has been broadly judged by analysts to have been substantial. For example, a recent study of profitability of the European AM industry indicated that AM firms' revenues fell by as much as 26% in 2001, causing their operating profits to fall by 56%.[15] The significance of this change of industry fortunes might be best seen in the context of the subsequent recovery—the industry is yet to return to the level of profits it achieved prior to the downturn. In general, however, the growth in profits for the industry has been correlated with market upturn since the end of the TMT bubble.

Second, increasing investor sophistication and rapid financial innovation have led to the development of new financial products, securities and financial technologies that have enabled persistent market inefficiencies to be exploited, as well as the spanning of available securities to be increased.[16]

There is broad consensus that these new opportunities, together with increasing investor independence, growing education and market awareness, have resulted in both institutional and, albeit to a lesser extent, retail investors diversifying away from traditional asset classes, such as simple portfolios of bonds and equities, to alternative investments.

The net effect of these developments has been that both institutional and retail investors are demanding a wider range of investment products. While institutional investors are searching for new sources of 'alpha', beyond traditional categories of funds, retail investors may seek to buy structured products, especially those that feature capital guarantees. Asset managers have to respond to this increase in the scope of demand by being able to provide a much wider range of funds to their customers. Hence, the focus of (successful) investment management appears to be shifting towards a multitude of newly developed investment strategies such as capital-protected products as well as arbitrage or volatility exposure techniques, and other investment strategies tailored at investors' needs. Some, but not all, of these strategies are often broadly associated with the emergence of the hedge funds industry as a catalyst of financial innovation, although the scope of the term 'hedge fund' industry is not strictly defined and loosely applied to many innovative investment techniques.

An important aspect of this evolution has been the development of structured products, which have increased spanning in securities markets. Structured products, in the broadest sense, have allowed for tailored exposure to risk and rewards that was not possible using traditional investment portfolios; they have also allowed for exposure to risk that was less explored before, such as volatility risk.

### 4.1.2 Interaction between retail and institutional markets

Another major development in the industry has been a blurring of the boundaries between retail and institutional AM. Oxera has investigated the relevant trends in the AM industry irrespective of their primary focus on either of the retail or institutional sector, although the subsequent analysis has been conducted in the relevant market context.

For example, the greater sophistication of both institutional and retail investors appears to have shifted the bargaining power to the demand side of the industry, increasing the competitive pressures on asset managers. In the case of the institutional market, this has resulted in narrower mandates and more competition between managers to be awarded these mandates (BIS, 2003, p.19). Asset managers get multiple mandates from the same client, and the mandates often cover a wider range of products. In many cases, the mandates are using CIS traditionally developed for retail clients (Funds Europe, 2005b). In the case of the retail market, client demand for the best-performing funds is gradually forcing

[15] McKinsey & Company (2005a), reported in ZEW/OEE (2006).

[16] Although efficient markets assume that markets exist for all assets, in practice there are many missing assets. Increased spanning refers to the growth in the number of available markets as new securities allow for trading of assets for which markets have not existed in the past.

traditionally tied distribution networks to open up, exposing asset managers to more direct competition than before, especially with respect to their own, traditional client base.

### 4.1.3 Changes in investor demand

This study has identified indicators of ongoing changes in investor demand, and, in particular, the increasing sophistication of some investors, as a key driver for some trends taking place in the AM industry. Changes in investor demand as a driver interact with industry's responses to this process, such as exploration of market opportunities for new products, which often jointly stimulate trends.

At a high level, a strong case can be made for the increased sophistication of investors, as evidenced by the growth in the complexity of products, the diversification of asset allocation towards alternative investments, and the emergence of new distribution channels. Still, it is important to clarify what the trend towards greater sophistication implies, and how it differs by type of investor: institutional, private banking and retail investors.

The degree of sophistication can be seen to have two aspects.

– Complexity of investment needs matched by available products refers to an investor's particular financial needs that it intends to address through the purchase of an AM product—for example, a fiduciary obligation in the case of insurance companies or pension funds, or saving for retirement in the case of a retail investor. Development of new products has stimulated investors to search for alternative investments and match their risk profiles more closely with the available securities.

– Knowledge and information about products and financial markets, and the capacity to make use of this knowledge, refer to whether investors have the necessary information to make informed decisions about the investment products and asset classes in which they invest. More knowledgeable investors are thus able to shop around for the best products, build their own portfolios (or be in a position actively to contribute to the construction of the portfolio) and, in the case of retail clients, explore alternative distribution channels such as fund supermarkets.

In terms of the both complexity of investment needs and knowledge about financial services products, institutional investors do tend to be more sophisticated than both private wealth and retail investors, while private wealth investors are in turn more sophisticated than retail investors. An institutional investor, such as a pension fund, invests its assets in AM products to meet its short- and long-term liabilities. The complexity of the need to match assets and liabilities—and, therefore, the complexity of the products designed to meet this need (eg, LDIs)—is usually greater than typical private banking/retail investor needs (eg, saving for retirement or achieving a particular capital growth target) and their associated AM products.

Similarly, the resources in terms of the knowledge and information about financial markets that institutional investors have at their disposal to actively participate in the design of their portfolios and monitor the performance of their asset managers are far greater than private banking or retail clients' resources.

A number of developments have had the effect of increasing the complexity of institutional investor's needs, as well as strengthening their incentives and ability to be more actively involved in the design and monitoring of their portfolios. These developments include changes in accounting standards for pension funds (for corporate pension schemes) or the search for alternative investments and absolute return products following the market downturn of 2000–03. As discussed in further detail below, these developments can be linked to significant changes in the shape of the industry's value chain—in particular, to an

increase in the degree of competition among manufacturers, as well as adoption of 'new' strategies by manufacturers, such as the core-satellite approach.[17]

Similarly, private banking clients also appear to have raised their level of sophistication. Although it is arguable whether their fundamental investment needs have changed, their incentives to shop around for the best-performing products and funds, and diversify into alternatives such as hedge funds, increased substantially following the market downturn. As a result, it is particularly in the private banking segment where the trend towards open architecture in distribution might have been expected to develop more strongly.[18] Moreover, facing the prospect of losing valuable private investors to a competitor, it is likely that the AM firms have not hesitated to sell the best-performing TPF either directly or through white-label FOF. These implications have been explored in the context of the analysis of the core AM segment of the value chain.

In the case of retail investors, a direct increase in sophistication such as that described for institutional or private banking clients is less evident. In most Member States, retail clients are still reliant on their local banks for investment decisions. Moreover, although there are some signs of change, such as the growth of alternative distribution channels (eg, fund supermarkets), most asset managers interviewed by Oxera indicated that retail clients do not appear particularly prone to shop around for value for money.[19]

However, there is also some evidence that drivers of investor behaviour are differentiated by country. In particular, a distinction can be drawn between 'push' markets, such as Germany, where the asset managers might play a greater role in leading clients' choices of products, and 'pull' markets, such as the UK, where product design might be more of a response to investors' demand. Although this distinction is necessarily a considerable simplification and generalisation of the actual situation in respective markets, which might be much more differentiated, there is some evidence that this distinction is driven by the market structure. In particular, the characteristics of the distribution channels might be responsible: 'push' markets appear to be more prominent in jurisdictions where traditional distributors such as banks and insurance firms dominate; whereas 'pull' markets exist where IFAs represent a significant component of distribution.

Nevertheless, while there is no strong evidence that sophistication of retail clients is increasing *directly*, many asset managers interviewed by Oxera pointed towards developments that might be having the *indirect* effect of producing market outcomes (in terms of the intensity of competition at the manufacturing level and increases in value creation for consumers). Such outcomes are similar to those that might have resulted if retail investors were directly becoming more sophisticated.

For example, it is important to investigate the extent to which the trend towards open or guided architecture in the private banking market described below has been gradually moving towards the retail market, intensifying the competitive pressure of the manufacturing segment of the value chain. Similarly, the increasing importance of assemblers and intermediaries in the fund manufacturing function (eg, in the selection of funds/providers that will be used to build FOF products) is hypothesised to have had the effect of increasing competition between manufacturers. In addition, assemblers and intermediaries might have allowed retail investors to benefit from the knowledge and expertise of these market players. In essence, intermediaries and assemblers could be performing a function similar to that undertaken by consultants in the institutional market.

[17] The adoption of the core-satellite approach is certainly not 'new', having emerged over several years. Nevertheless, it constitutes an important change from the older, more traditional conduct of AM business, and is therefore of interest for this study as a longer-term phenomenon. This approach characterises the presented analysis with respect to all trends insofar as it attempts to distinguish between short-term and more permanent changes in the industry.

[18] Indeed, Oxera analysis has confirmed this hypothesis. This is discussed in further detail below.

[19] The UK and Scandinavian markets might be exceptions to this general observation.

Finally, it is important to bear in mind that, in the retail market, certain aspects of product sophistication—in particular, the use of Internet fund supermarkets—might represent a gradual process related to the pace with which the demographic characteristics of the market are evolving. More specifically, fund supermarkets might not have had a high market share in the recent past because most users are young customers with relatively limited amounts of asset to invest. In time, as their asset base grows, fund supermarkets and, more generally, open architecture platforms, might be expected to increasingly dominate the AM distribution landscape. This view appears to be shared by the industry.[20]

## 4.2 Overview of trends in core AM

Analysis of business models evolving in the AM industry in Europe has highlighted some high-level developments that are likely to have a significant impact on the shape of the core AM segment of the value chain:

– separation of manufacturing (core AM) and distribution into discrete businesses, or business units when they remain in the same ownership;

– emergence of intermediaries, for example, assemblers and aggregators, providing business-to-business (B2B) services to both manufacturers and distributors;

– fragmentation of the core AM activity into 'pure' manufacturing on the one side, and sub-advisory on the other.[21]

Against this background, the following strategies have been identified as some of the most important responses by industry players to the changing environment in the core AM segment of the value chain. This assessment has been based on desk research using primary and secondary sources, including surveys of AM firms and investors, strategic presentations by industry representatives, professional press and reports. It has also been supplemented and validated by a structured interview process undertaken for this study.

– **Diversification of the product range offered to investors**—as the demand from clients has shifted away from traditional products, one strategy followed particularly by large asset managers looking to remain attractive to investors is to diversify their product range. In the retail market, more flexible investment restrictions introduced by UCITS III have allowed firms to widen their regulated product range to meet the change in investors' demand.

– **Adoption of the 'boutique' model by mainstream providers**—in order to meet the requirement to diversify their product range, some AM firms have restructured their internal investment activity to enable them to manufacture all, or a large proportion, of the required products in-house. Efficient manufacture of these new products has often required the adoption of different internal organisational structures, in the form of internal (but often semi-autonomous) boutiques.

– **Outsourcing of the core AM activity for particular asset classes**—an alternative strategy to meet the requirement for a wider product range is to buy additional products from another provider. This can be a cost-effective way to increase the product range where the particular AM skills are not available in-house or would be expensive to acquire.

– **Concentration of the core AM activity in a few financial centres**—to meet the requirement from clients to reduce the costs and increase the quality of AM, one

[20] Evidence from Oxera programme of structured interviews.

[21] These include outsourcing solutions such as FoF and multi-management aimed at filling the gap in the product range.

strategy has been to concentrate AM activities into fewer locations to benefit from the economies of scale and clustering effects. This is linked to the strategy of meeting pan-European demand from one (or a small number of) locations to enjoy cost efficiencies through scale.

– **Specialisation in a small number of asset classes**—this is an alternative strategy to meeting the diversification of demand followed by small and medium-sized firms with the aim of achieving scale and expertise in a limited number of asset classes(investment strategies. This strategy can complement the strategy of larger AM firms outsourcing core AM activity for particular asset classes, or relying on clients to meet their diversified demand by engaging multiple specialised asset managers, rather than hiring a single AM firm that can provide the entire range of products needed.

Additionally, trends in product development have been identified that appear to represent either a response to changes in consumer demand, or are a requirement of the strategies outlined above. The most important of these are:

– limits to the growth of the UCITS segment of the AM industry;
– increasing allocation of UCITS funds into alternative products and the 'commoditisation' of the hedge fund investment strategies and similar products;
– growth in assets invested in alternative products;
– development of LDI products;
– growth of non-UCITS products, such as certificates and structured products, in the retail market.

Each of these trends is described and analysed in greater detail below. Most trends interact closely with those described in the next part of the report, which examines distribution and the back office.

## 4.3 UCITS III and the promotion of European financial integration

The aim of the original UCITS I Directive (85/611/EEC), introduced in December 1985, was to harmonise fund supervision and investor protection requirements relating to UCITS funds among Member States, and ensure that UCITS established in one Member State may be marketed freely in others without having to obtain a second authorisation (European Commission, 1985).

The proposed regulatory framework faced substantial difficulties in achieving its primary objective of removing barriers for cross-border financial integration. For example, the divergence of marketing rules across Member States created obstacles for cross-border marketing of UCITS funds, while the lack of harmonisation of regulation of fund managers created barriers for conducting AM business across the EU from a single location. At the same time, the limited range of permitted financial instruments that could be used in UCITS funds weakened the marketing possibilities of these funds.

In response to these challenges, in 2002 the European Commission introduced Council Directives 2001/107/EC (Management Company Directive) and 2001/108/EC (Product Directive), commonly referred to as 'UCITS III' (European Commission, 2004a). These Directives were to be transposed into Member State laws, regulations and administrative provisions by the second half of 2003, with the measures adopted scheduled to come into force in the Member State no later than February 2004.

To facilitate European financial integration, the Management Company Directive introduced the 'European passport', to enable management companies to operate throughout the EU. Pan-European divergence of marketing rules was addressed through the introduction of the simplified prospectus. The Product Directive further contributed to simplification of cross-

border marketing of UCITS funds through the introduction of a simple notification procedure. However, as stated by EFAMA (2006, p. 77):

> There is full agreement on the need for a significant streamlining of the notification procedure, which has degenerated into a fully-fledged registration, involving lengthy waiting periods (often much longer than the two-month period mentioned by the Directive), costly adaptations to national requirements, and subject overall to greater uncertainty.

The Management Company Directive also attempted to increase investor protection, establishing additional regulations to control the 'substance' of the AM firm—in particular, the prohibition of letter-box entities. It also introduced Capital Adequacy Requirements for management and investment companies, as well as the requirement to adopt comprehensive internal risk management solutions.

Regulatory developments introduced under UCITS III were also aimed at making UCITS funds more flexible in terms of the allowed asset allocation. For example, the Product Directive expanded the range and type of financial instruments permitted under UCITS I, and redefined the individual investment restrictions, with a view to providing more freedom in the choice of investment strategies that could be used by UCITS funds. In particular, under UCITS III, it is possible to establish money market funds, derivatives funds, index-tracking funds and FoF.

## 4.4 Development of the UCITS segment of the AM industry

The introduction of UCITS III is likely to have a lasting impact on the evolution of the UCITS segment of the AM industry, and to some extent other segments. As shown in Figure 4.1 below, according to FERI data (fund market),[22] the UCITS market segment relative to the total net assets of UCITS and non-UCITS funds decreased slightly from 91.0% in 2001 to 88.7% in 2004. In 2005 UCITS funds experienced a slight increase in market share, to 89.8%. In absolute terms, AuM in UCITS funds grew from approximately €1,960 billion in 2001 to €3,010 billion in 2005.[23]

According to EFAMA (2006, p. 20), the net flows to UCITS represented, on average, around 8% of the annual change in the growth of assets; the remainder being due to market appreciation(depreciation.

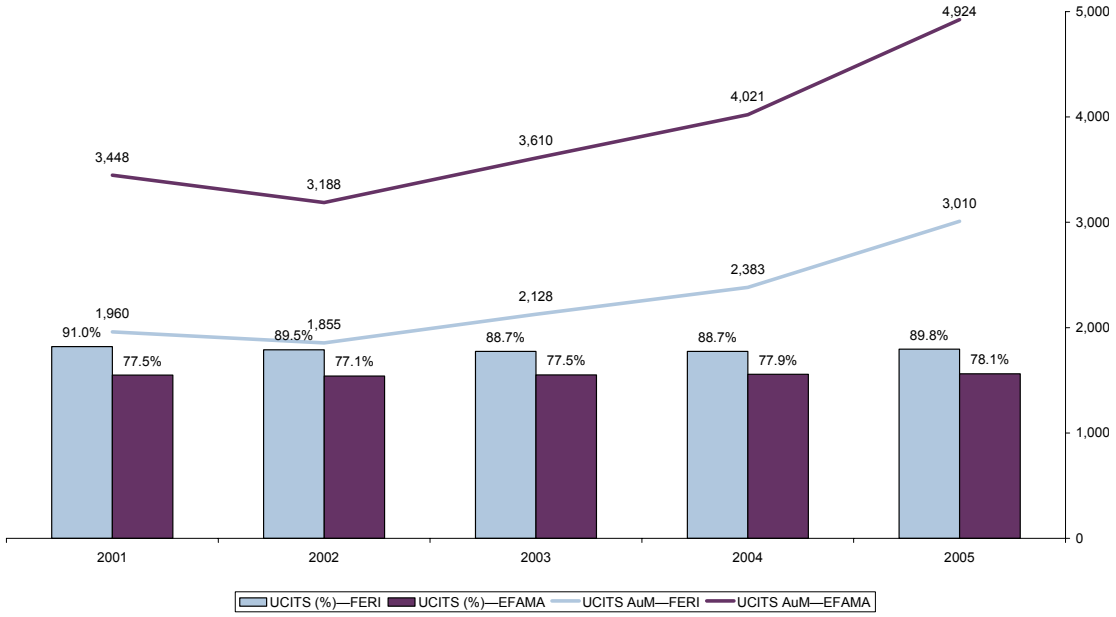
Analysis based on EFAMA (fund domicile[24]) data differs from FERI in terms of the absolute value of UCITS funds from the market share of UCITS and the evolution of the market. According to EFAMA, the market share of UCITS increased from 77.5% in 2001 to 78.1% in 2005, while AuM in UCITS funds grew over the same period from €3,448 billion to €4,924 billion in 2005. Total assets of UCITS reached €5,183 billion in 2006 according to the latest data from EFAMA (2006, p. 16).

[22] The term 'fund market' was established by FERI to present the most accurate and logical view of a particular market. In most cases it is comprised of domestic assets and round-trip assets (ie, funds registered in host centres such as Dublin or Luxembourg but only sold back into the domestic market). (FERI Market Definition rules, as reported by ZEW/OEE 2006.)

[23] FERI Fund Market, as reported by ZEW/OEE (2006).

[24] Country in which a fund is registered for regulatory purposes (taken from ZEW/OEE data).

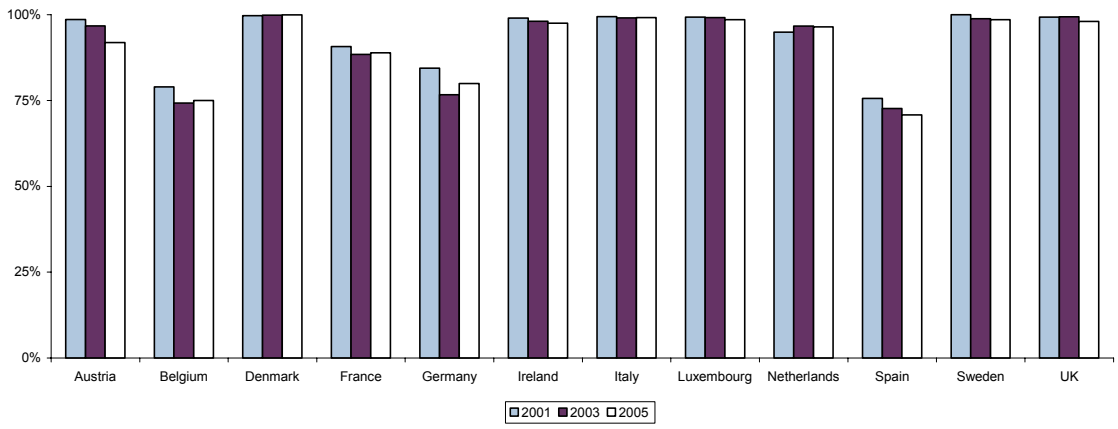
**Figure 4.1 Market share (%) and AuM (€ billion) in UCITS funds in the EU (excluding FoF), 2001–05**




Note: For the reconciliation of EFAMA and FERI databases, see ZEW/OEE (2006).
Source: FERI Fund Market and EFAMA Fund Domicile data, as reported by ZEW/OEE (2006), and Oxera calculations.

At the level of individual Member States, as shown in Figure 4.2, from 2001 to 2005 market shares remained relatively stable in Denmark, Ireland, Italy, Luxembourg and UK market shares of UCITS, ranging from 99.1% to 100% (the largest change of 1.3% is observed for the UK). In Austria, Belgium, France, Germany, Spain and Sweden, UCITS market shares fell over the period (the highest fall being in Austria, from 98.6% in 2001 to 91.9% in 2005). In the Netherlands UCITS grew by 1.5% from 94.9% in 2001 to 96.4% in 2005.

**Figure 4.2 Market shares (%) of UCITS funds in total retail funds under management in EU Member States (excluding FoF), 2001–05**




Source: FERI Fund Market data, as reported by ZEW/OEE (2006), and Oxera calculations.

The available evidence indicates that, at the European level, after the application of UCITS III regulations in February 2004, the UCITS market segment increased from 90.3% in 2004 to 91.3% in 2005 according to FERI Fund Market, and fell from 71.2% in 2004 to 70.8% in 2005

according to EFAMA.[25] The latest EFAMA data indicates that the net assets of UCITS have remained stable as a percentage of the total net assets of UCITS and non-UCITS, at 78.7% in 2005 compared with 78.5% in 2004 (EFAMA 2006). Some diversity can also be observed across the Member States.

### 4.4.1 Drivers of the future growth of UCITS

UCITS III regulatory developments have brought about changes (drivers) that are likely to boost the UCITS segment of the industry.

– UCITS III regulations have allowed funds to invest in a wider range of financial instruments and have provided greater flexibility in terms of caps on individual investments. This gives UCITS funds the ability to offer a more diversified product range, increasing the scope to satisfy investor demand (institutional as well as retail). In addition to boosting the size of the UCITS segment of the market, more flexible asset allocation requirements are likely to affect the composition of UCITS funds.

– Another driver for the growth of UCITS III is the fact that regulatory developments have at least partly facilitated European financial integration and reduced barriers for cross-border marketing of funds' units, as well as for cross-border provision of management services. This indicates that UCITS benefit from cheaper cross-border distribution as well as more effective cross-border management of UCITS funds, and correspondingly they achieve cost efficiencies associated with greater economies of scale.

### 4.4.2 Barriers for the growth of UCITS

As shown in Figure 4.1 above, AuM in UCITS funds grew substantially in absolute terms both before and after the introduction of UCITS III. However, when analysing the evolution of the UCITS segment of the retail market, it is important to assess the dynamics against non-UCITS products that are not subject to regulation. In relative terms, the UCITS market share has in general experienced less clear-cut dynamics.

Oxera research identified some potential barriers associated with the regulatory changes introduced by UCITS III that might prevent growth of UCITS relative to non-UCITS funds. To a large extent they appear to be associated with investment restrictions imposed by UCITS regulations, increasing costs of compliance with regulation post-UCITS III, as suggested by the industry commentators, and greater incentives to exploit any regulatory arbitrage opportunities arising as a result of UCITS III.

#### Binding investment restrictions

Even though one of the aims of UCITS III was to make investment restrictions more flexible, these restrictions still appear to be lagging behind the financial innovation in the industry. As such, they represent a barrier binding the ability of UCITS funds to offer a more diversified product range to meet consumer demand.

The existence of restrictions that are binding on the composition of UCITS funds, combined with the speed of financial innovation and the rapid evolution of investor demand, could suggest that asset managers will be facing difficulties with satisfying investor demand with UCITS products.[26] UCITS are therefore saddled with a binding barrier that harms their ability to compete with non-regulated, non-UCITS-compliant products. This might be one of the explanations for the stagnation (and in certain countries decline) in UCITS relative to non-UCITS share of the collective investment funds market.

[25] As reported by ZEW/OEE.

[26] See section 4.1 on the evolution of investor demand.

The European Commissioner for Internal Market and Services, for example, has commented that the UCITS model does not appear able to keep pace with product innovation (European Commissioner for Internal Market and Services, 2005). Comments on the European Commission from the IMA and EFAMA provide some further evidence in support of this proposition.[27]

In addition to limiting the allowed asset allocation strategies, industry commentators have raised concerns that investment restrictions might affect financial innovation. For example, according to EFAMA (2005):

> trying to achieve investor protection on the production side mainly through product regulation is restrictive and inhibits innovation.

Similarly, the IMA (2005b) commented:

> we also acknowledge that formal investment limits can inhibit financial innovation.

This suggests that the benefits of formal investment restrictions in the form of higher investor protection need to be balanced against the risk of jeopardising product development in the retail sector.

### Increasing costs of compliance with regulation

Liberalisation usually has implications for the type of regulation that is required. Thus, asset allocation restrictions that are less binding (although potentially not enough to keep up with financial innovation) are introduced at the same time as additional investor protection measures, leading to an increase in the costs of compliance. Several aspects of the changes in UCITS III regulation compared with UCITS I might lead to cost increases. In particular, UCITS III:

- amends the rules on delegation of management activities and establishes additional requirements on the 'substance' of the AM firm (eg, 'letter-box' entities are no longer allowed);
- introduces Capital Adequacy Requirements;
- requires additional investor protection in the form of a comprehensive risk management process, according to which management companies are required to monitor and calculate the overall risk of a fund's position at any time.[28]

In its responses to the Green Paper, the IMA highlighted that the UCITS III Management Company Directive would substantially increase the costs of operating a UCITS III-compliant AM firm. Part of this cost increase is due to the new capital requirements. In particular, these requirements hit high-volume UCITS, such as money market funds and exchange-traded funds, which at the same time are at the less risky end of the operational risk spectrum.

According to the IMA, the more significant reason for the increase in costs is the presence of governance, risk management and infrastructural requirements, which, although they can be delegated, are intended to confer 'substance' on the management company in the Member State in which it is established.[29]

Similarly, the industry representatives have raised analogous concerns directly. For example, Christophe Girondel, Nordea Asset Management, suggested that:

[27] European Commission (2005a), EFAMA (2005), and IMA (2005b).

[28] In addition to the requirements introduced by the EU Directives, requirements at the national level by the majority of Member States are likely to trigger cost increases.

[29] IMA (2005b); similar evidence was provided in ISSA (2005).

> UCITS III is offering a new investment horizon, but it is also creating additional constraints on the industry, such as stronger risk management processes and wider information through the simplified prospectus requirement. It opens a wide range of opportunities, but constitutes a burden, or rather an investment, at the beginning. (*Financial News* 2006a)

With regard to the simplified prospectus, the industry has made it clear that:

> There are two main reasons for the failure of the simplified prospectus: first of all its lack of focus on the average investor, and then its inconsistent implementation at national level (EFAMA 2006)

#### Increasing regulatory arbitrage

Regulatory arbitrage can be achieved by launching products that are similar to UCITS funds in terms of their investment characteristics and capability of being marketed cross-border in the form of less regulated and correspondingly less expensive vehicles.

During the interview programme, several firms expressed concerns about the declining ability of UCITS funds to compete with less regulated non-UCITS funds, such as certificates, securitised derivatives, unit-linked insurance products, or structured notes. Indeed, for some interviewees, this is one of the most important business risks in the UCITS segment of the AM industry. A French asset manager, for example, stated that the more regulation or harmonisation attempts were imposed on UCITS funds, the more competition this will generate from similar, but unregulated, products, such as investment certificates.

## 4.5 Certificates and life insurance policies as retail investment vehicles

According to the IMA's response to the European Commission, the UCITS prospectus and simplified prospectus require greater disclosure of their costs than equivalent disclosure documents (where they exist) for unit-linked products and certificates. It is the IMA's understanding that the recent growth in the sales of certificates in Germany and unit-linked contracts in Italy was driven, at least in part, by such regulatory arbitrage. The evolution of certificates and life insurance policies as investment vehicles is discussed in greater detail below.

### 4.5.1 Investment certificates

Competition from certificates is a significant development in Germany, for example, where, in the first half of 2005, banks sold more than 14 billion new certificates (measured by number of contracts) to investors.[30] This represented an increase of 25% compared with 6% for mutual funds since the beginning of the year (Ernst & Young, 2005).

The major reasons for the success of certificates are their short time to market and flexibility: they can be tailored to fit investors' market expectations, risk tolerance and investment horizon (Ernst & Young, 2005). Time to market is a fundamental driver of growth in the certificates market. For example, Jorg Brock, Commerzbank, states that a new investment idea can be produced in less than a week with a certificate; in the case of a fund, between six and eight weeks are needed (PWM, 2005a).

Oxera interviews have provided evidence that, due to the nature of certificates, their wide usage might be associated with additional risks for investors. In addition to the generally well-understood investment risks present for almost all financial instruments, investments in certificates can be associated with particular risks (eg, counterparty and credit risks) that may be unclear to retail investors.

[30] Evidence from Oxera programme of structured interviews.

### 4.5.2 Evolution of life insurance policies as retail investment vehicles

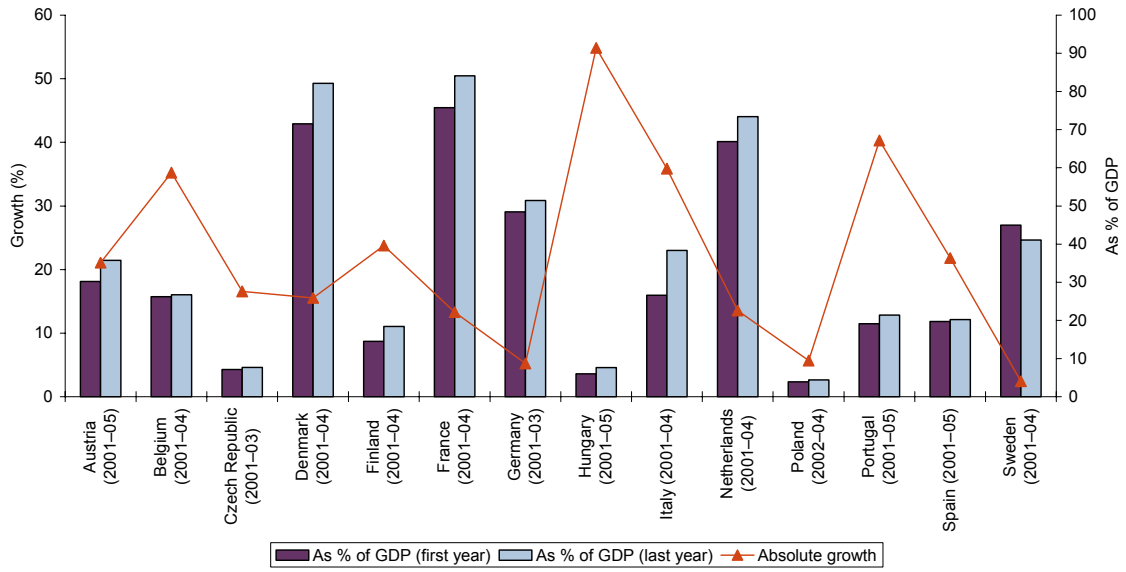
In addition to certificates and traditional products, such as CIS and individual pension schemes, retail investments can be made via investment-type life insurance policies. It is therefore important to consider potential trends in this segment of the industry also as an alternative to UCITS. Moreover, certain specific characteristics of life insurance policies as investment vehicles (eg, their regulatory environment compared with UCITS regulations) make this product particularly relevant for the study.

Figure 4.3 depicts the evolution of households' assets invested in life insurance products. Two observations emerge from the analysis of the available evidence.

– The amount of assets invested in life insurance products has increased over recent years across almost all countries considered, with the largest absolute increases seen in Hungary, Portugal and Belgium. Life insurance assets as a percentage of GDP have increased in all countries except Sweden, with the largest growth in Italy and Denmark.

– There are substantial cross-country differences in the amount of life insurance assets relative to size of economy, which cannot be explained by differences in GDP growth. France, Denmark and the Netherlands are characterised by the highest ratio of life insurance assets as a percentage of GDP in 2004, while eastern European counties Poland, Hungary and the Czech Republic by the lowest (even though Hungary exhibited the largest absolute growth in life insurance assets over recent years).

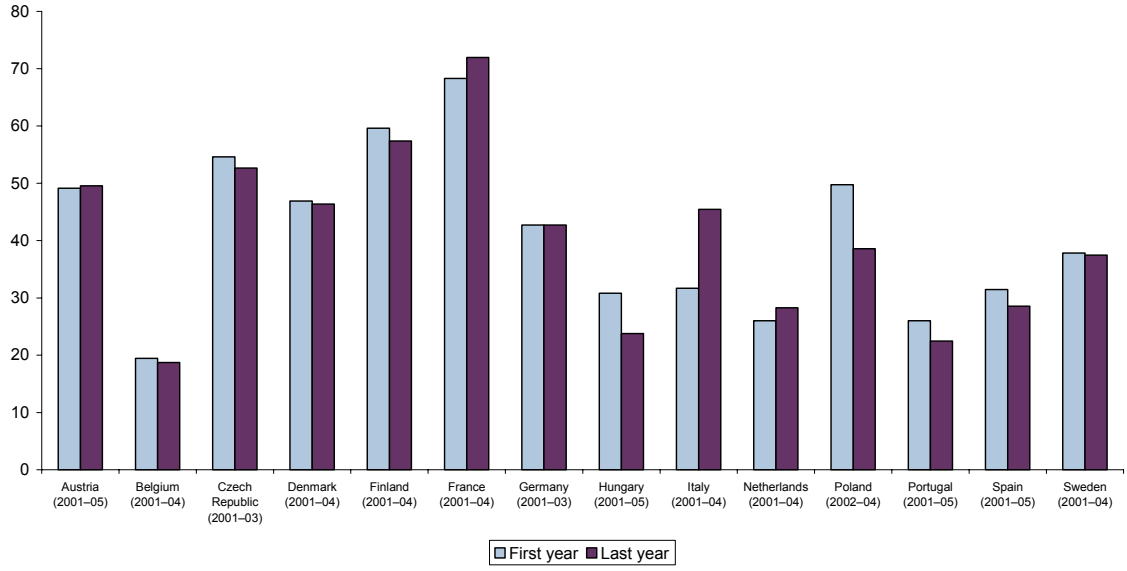
**Figure 4.3 Life insurance products**




Source: Questionnaires to central banks, OECD and ECOWIN data as reported by ZEW/OEE (2006).

The analysis of the evolution of life insurance assets as a percentage of total household assets provides some important observations on the distribution of households' investments. According to Figure 4.4, this ratio has recently fallen in most countries, with the largest decreases in Poland and Hungary; only in Austria, France, Italy and the Netherlands did allocation to life insurance products as a proportion of total households' assets increase.

**Figure 4.4 Life insurance products as % of households' investments**




Note: Household investments are calculated as the total of household assets allocated to life insurance products, occupational or pension funds and UCITS and non-UCITS.
Source: Questionnaires to central banks, OECD and ECOWIN data as reported by ZEW/OEE (2006).

As described in section 4.4, industry commentators pointed out that UCITS regulatory developments might provide an incentive to exploit regulatory arbitrage opportunities between regulated UCITS funds and other unregulated investment products (or, more accurately, products that are not subject to UCITS regulations). In other words, regulatory costs might be affecting competition between UCITS and non-UCITS products.

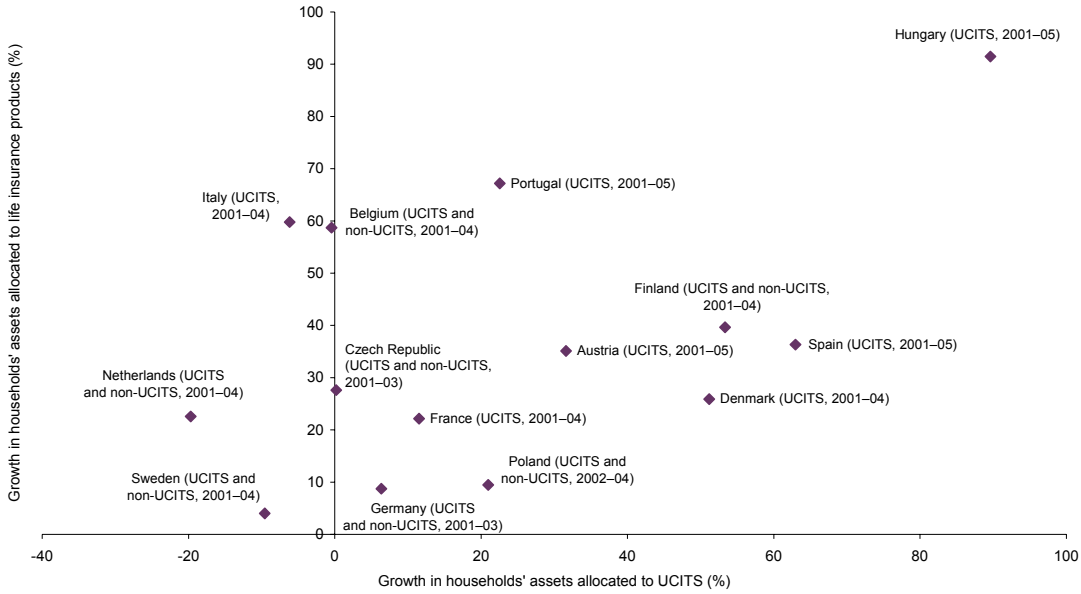
One specific product class where regulatory arbitrage opportunities may exist is investment-type life insurance policies. Insofar as these policies are not subject to UCITS regulatory requirements (eg, disclosure requirements), they might be associated with lower costs for the provider (direct operating costs as well as indirect costs, for example owing to the shorter time required to launch a new product).

This cost differential might make life insurance policies more attractive for providers, and, if the lower costs are reflected in lower prices, more attractive to investors. In addition, because of potentially lighter regulation, it might be easier to tailor the investment-type life insurance policies to specific investor requirements, making them even more attractive for end-consumers. These factors might in turn generate competitive advantages for manufacturers of insurance policies compared with manufacturers of UCITS funds.

Figure 4.5 compares the growth rates of assets allocated to UCITS with assets allocated to life insurance products across countries, indicating the magnitude of the potential substitution effect between retail investments in regulated UCITS funds and in less regulated life insurance products. The presence of substitution could be indicative of the existence of regulatory arbitrage opportunities.

There are a number of examples where the high growth rate of life insurance assets (Italy, Belgium, Portugal) is indeed associated with low-to-modest growth in assets allocated to UCITS; however, this relationship does not seem to hold systematically for other countries.

**Figure 4.5 Growth in assets allocated to UCITS compared with those allocated to life insurance products (%), 2001–05**




Source: Questionnaires to central banks and OECD data as reported by ZEW/OEE (2006).

It might be informative to consider the case of Italy where the presence of regulatory arbitrage opportunities has been specifically highlighted by a number of industry observers. For example, IMA suggested in its responses to the Green Paper (2005b):

> We believe that further attention needs to be given to whether the disclosure requirements of UCITS have tilted the regulatory balance in favour of 'substitute products'. This is not an academic concern. We understand that the recent growth in sales of certificates in Germany and unit-linked contracts in Italy was driven, at least in part, by such regulatory arbitrage.

This statement appears to be indirectly confirmed by the available evidence. According to Figure 4.5, relatively high growth of life insurance assets in Italy (approximately 60% from 2001 to 2004 which is ranked third among considered countries after Hungary and Portugal) is associated with decreased allocation to UCITS products.

On balance, however the results of the analysis presented in Figure 4.5 do not present strong evidence to support the hypothesis that there is a significant systematic substitution effect and thus provide no specific evidence for systematic regulatory arbitrage, at least for the time being.[31]

## 4.6 Changing composition of UCITS funds

Product Directive (2001/108/EC) expands the range and type of financial instruments permitted under the UCITS I Directive. Under UCITS III, for example, it is possible to establish money market funds, derivatives funds, index-tracking funds and FoF. In addition to the increased set of allowed asset classes, UCITS III provides greater flexibility in terms of individual investment restrictions within any particular fund.

Evidence from secondary sources has confirmed that many asset managers are adapting their existing range of funds to make them UCITS III-compliant in order to benefit from the

[31] It is important to recognise that potential substitution effects might be occurring for investment-type life insurance products only. Moreover, specific product characteristics are also likely to affect the strength of potential substitution. Therefore, the results of the analysis in Figure 4.5 are conditional on the level of aggregation.

increased investment opportunities offered by the Product Directive. One of the particular characteristics of the increased flexibility of asset allocations for UCITS funds is their increasing use of derivatives.

### 4.6.1 Economic drivers for the increasing use of derivatives by UCITS funds

The increasing use of derivatives by UCITS funds seems to be largely driven by demand-side developments. One development in the institutional market is that hedge funds have become mainstream investment vehicles. This relates to the concept of the 'commoditisation' of the hedge fund industry, which suggests that the product range of UCITS funds needs to be able to evolve accordingly if these funds are to compete for institutional assets.[32]

In response to this challenge, the use of derivatives by UCITS funds will narrow the gap between the diversity of products that can be offered by non-UCITS funds (including traditional hedge funds) and those that can be offered under the UCITS regulatory structure. In particular, it was suggested that UCITS III regulatory developments—especially the inclusion of derivatives in the set of allowed financial instruments—allowed UCITS funds to cover around 75% of the hedge funds' typical product range.[33]

According to Elizabeth Para of State Street, due to the adoption of a more flexible investment policy under UCITS III—and, in particular, the opportunity to use derivatives—UCITS funds are likely to become increasingly attractive to institutions. Ms Para noted that: 'Institutions take a lot of comfort in a fund being regulated' (*Financial News*, 2005d).

Another driver, related to the previous one, are the developments in the retail segment of the market where hedge fund-type strategies are gaining wider popularity among retail investors. This development in the retail market seems to have been driven, in turn, by developments on the institutional side, where hedge funds have ceased to be seen as alternative and have entered the mainstream. Therefore, to remain competitive even in their primary retail market, UCITS funds seem to be increasingly attempting to diversify their product range through the use of derivatives.

### 4.6.2 The use of derivatives by UCITS funds

Due to limited availability of relevant data, it is difficult to quantify and assess the changes in the use of derivatives by retail UCITS funds. However, according to Julian Ide, ABN Amro Asset Management, as a result of the UCITS III regulations, many 'traditional' UCITS funds are moving towards the hedge fund space in terms of investment objectives and policy guidelines (PWM, 2006a).

At the same time, some of the leading fund management groups are beginning to increase the offer of UCITS III funds. For example, according to *Financial News*, part of the strategy of Goldman Sachs Asset Management is to launch 19 UCITS funds in 2006, which is associated with the expanded range of financial instruments allowed under UCITS III, and, in particular, derivatives (*Financial News*, 2006d).

Similarly, the pan-European evidence from a *Financial News* poll of more than 200 European fund management companies in 2005, indicated that over 70% were using derivatives compared with 48% in 2004. In addition, respondents noted that they were increasingly using these instruments due to more flexible UCITS III rules (*Financial News*, 2006f).

Notwithstanding the absence of actual data concerning the volume of derivatives used, the indications are that the additional flexibility of UCITS III is being reflected in the increasing

[32] Jason Good, Deutsche Bank, as quoted in *Financial News* (2006d).

[33] Guy Monson, Sarasin Chiswell, as quoted in *Financial News* (2006d).

diversity of types of UCITS funds and encompasses the use of hedge fund-type investment strategies.

## 4.7 Commoditisation of hedge funds as key alternative products

The changing composition of UCITS towards more sophisticated financial products appears to be closely linked with the increasing adoption of alternative products in the AM industry. In this sense, alternative products include both the more 'traditional' alternatives (such as private equity or real estate) as well as the 'new' alternatives (such as structured products). The growth in alternative products and new investment techniques can be broadly linked to the emergence and development of the hedge fund industry, which arguably has acted jointly with private equity as catalysts for change. This is reflected in the progressive adoption of the innovation drive that is characteristic of the hedge fund industry and the alpha focus typical of the private equity in the AM industry as a whole.

In the light of these developments, this report discusses the hedge find industry below and follows with a discussion of other alternative products in section 4.8.

### 4.7.1 Impact of the hedge fund industry

Driven by the growth in AuM from investors with increasingly diversified demands, as well as the prospects of high profit margins for asset managers on the supply side, the hedge fund industry has experienced significant growth over a relatively short period of time. This growth has been characterised by rapid increases in both the number of funds as well as the total AuM within hedge funds.

Oxera interviews have confirmed the hypothesis that the impact of the hedge fund phenomenon on the AM industry extends beyond the simple demand-side substitution effect (ie, the move away from traditional assets into alternatives described above), which makes the increased use of hedge funds significant for this study.

Specifically, and critically for this analysis, the expansion of the hedge fund industry, as well as the emergence of the array of alternative products on the back of investor demand, has meant that asset managers have been required to develop a strategic response to the hedge fund phenomenon. This response appears to have included restructuring of the core part of the AM function, accompanied by adaptation of industry business models to the new environment. Furthermore, this response has become prevalent not just in the UK, where most European hedge funds are located, but increasingly so across Continental Europe.

Moreover, the growth of hedge funds appears to be increasingly spreading to the retail sector, despite the lack of explicit regulation. Although an assessment of the advantages and disadvantages of regulating the hedge fund sector is beyond the scope of this analysis, the increasing importance of hedge funds to the average retail investor has potentially significant implications for risks, as discussed in section 7.

### 4.7.2 Development and growth of the hedge fund industry

There is overwhelming evidence pointing at the significant growth of the hedge fund industry over recent years. For example, a survey of alternative investments reported that, among the European asset managers surveyed, the proportion making investment allocations to hedge funds has more than doubled, from 15% in 2001 to 35% in 2005 (Russell Investment Group, 2006). In terms of AuM, the share of hedge fund allocations from European managers has more than tripled, from 1.7% in 2001 to 5.3% in 2005.

Invesco and the Financial Reporting Council (FRC), in their 2005 survey of European institutional investors, reported similar results.[34] For example, 22% of survey respondents said they used multi-strategy hedge funds (the most popular type of hedge fund), with French institutions being the most enthusiastic users (51%). Moreover, pension funds (31%) were twice as likely to invest a proportion of their assets in multi-strategy hedge funds than insurance companies (16%). A similar pattern of significant and growing exposure has been observed for the second most popular type of hedge fund, long–short equity strategies, with 13% of pension funds having invested a proportion of their assets in this type of hedge fund. As a corollary to this, it is worth pointing out that pension funds have been three times more likely to use long–short hedge funds than insurance companies (4%).

If anything, these results underestimate the overall exposure of European investors to hedge funds since they exclude data on the use of hedge funds in the UK, which is by far the largest and most developed hedge fund market in Europe. According to the US Securities Exchange Commission and UK Financial Services Authority (FSA), over 80% of hedge funds worldwide operate from either the USA or the UK. This implies significant imbalances in the development of the hedge fund industry across Europe. Oxera has found limited evidence in support of the hypothesis that the UK is losing its position as the European centre of the hedge fund industry, even though hedge fund industries have grown in numerous Continental European countries. Indeed, there is evidence that London continues to represent one of the most attractive locations for financial innovation in the AM industry (Oxera, 2004).

### 4.7.3 Analysis of industry drivers

A 2005 survey of the key players in the AM industry (including managers of hedge funds and funds of hedge funds, mainstream fund managers, hedge fund administrators and pension funds) identified five factors explaining the substantial growth in the hedge fund industry.[35] Ranked in order of importance, these five factors are:

– prolonged bear market in 2000–03;
– growing investor interest in capital-guaranteed products;
– investor disillusionment with mainstream asset classes;
– high absolute returns on hedge funds;
– flow of top talent into the hedge funds sector.

Figure 4.6 below summarises the responses of various types of industry player in this survey. It is interesting to contrast the views of asset managers (both hedge fund and mainstream asset managers) with those of investors such as pension funds. For example, pension funds appear to attach much greater importance to the poor performance of equity markets in explaining the growth of hedge funds. Moreover, even though it is not one of the top five drivers, the proportion of pension funds mentioning the 'investor appetite for risk' as a driver (at around 40%) was almost twice that of asset managers.

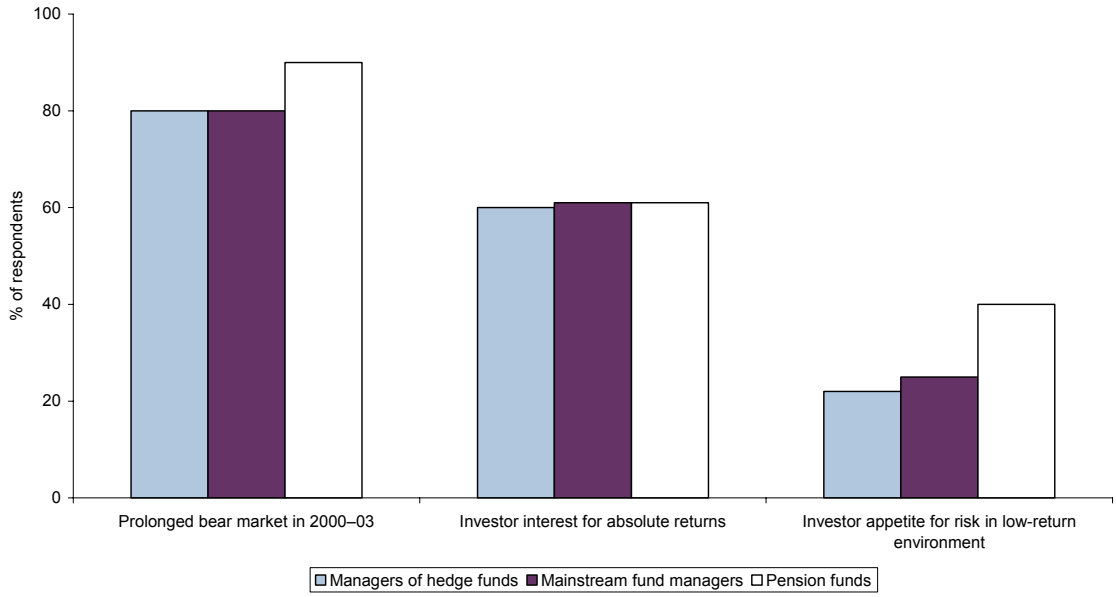
This, and related evidence analysed by Oxera, appears to be pointing at the likelihood that investors' demand for hedge funds—as well as for alternative products more generally, as described below—will be persistent, at least in the medium term.

Some evidence in support of this hypothesis can be found when comparing interviewees' views regarding the key factors that drive future growth in the hedge fund industry. For example, all industry players surveyed ranked 'increased investor demand for absolute returns' as the most important driver. At the same time, while the interviewees from pension

[34] Invesco–FRC (2005). The survey included 98 financial institutions (pension funds, insurance companies, banks, etc) from France, Germany, Italy, Belgium and the Netherlands.
[35] KPMG–CREATE (2005).

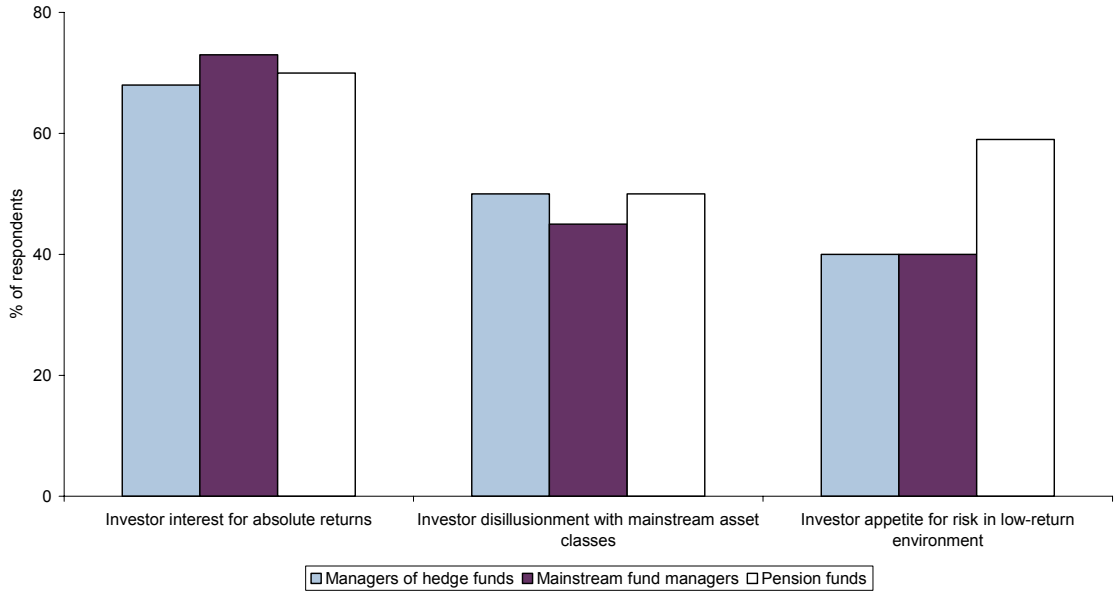
funds ranked 'investor appetite for risk' in second place, the hedge funds and mainstream managers ranked it only fifth and fourth place (see Figure 4.7).

**Figure 4.6 Factors fuelling the growth of hedge funds in the past three years**




Source: KPMG–CREATE (2005).

**Figure 4.7 Factors fuelling the growth of hedge funds in the next three years**




Source: KPMG–CREATE (2005).

This evidence corresponds with the observation that has emerged from the interviews, which suggests that the growth of the hedge fund industry is part of a wider trend of investors' search for absolute returns.[36] This seems to be accompanied by perceived underperformance of traditional asset classes (particularly in the bear market of 2000–02) and the increased appetite for more exposure to alternative products that are perceived to be

[36] The fact that investor demand was one of the drivers behind the growth of the hedge fund industry is widely supported in the secondary sources: see, for example, Rediff.com (2005).

more risky investment strategies. This realignment can be linked to the move in asset allocation towards a wider range of alternative products, in addition to more 'traditional' hedge funds.

### 4.7.4 Recent developments in the hedge funds industry

A key catalyst behind the industry growth has been the strong performance achieved by a large number of funds since the beginning of the decade (the majority being in the 11–20% band according to KPMG–CREATE's survey respondents). This has rapidly attracted sophisticated investors and appealed to a broader range of investors, even if the exact techniques employed by the industry were initially little understood.

More recent statistics, however, show that the overall growth rates in assets managed by hedge funds have been declining (Russell Investment Group, 2006), while the returns generated by the industry have also been falling (KPMG–CREATE, 2005). Some suggested that this is largely due to capacity constraints.

Since it is broadly agreed that strategies to generate alpha are not easily scalable, especially those that employ arbitrage techniques targeted at small asset classes, the growth in AuM in hedge funds could now be limiting the ability of hedge fund managers to achieve the superior returns that largely drove the industry forward during the early stages of its development. However, this hypothesis relies on the premise of limited potential for market innovation in the future.

The interviews and the evidence from secondary sources presented above would seem to suggest that, provided hedge funds offer returns above the market benchmark, investors are likely to continue to increase their exposure to hedge fund-type risk. However, some market observers have suggested that the future rates of return for hedge funds are unlikely to be as high as they were in the early 2000s, and might even fall to levels characteristic of more traditional investment classes. Were this to happen, the growth of AuM in this asset class could easily falter.

One reason typically offered in support of the above hypothesis relies on the premise regarding one of the key drivers behind the hedge fund phenomenon—the prolonged bear market of 2000–03. If the market downturn discussed earlier has indeed been a primary reason for investors to stimulate the growth of the hedge funds industry, the demand for this asset class might be expected to saturate, or even fall, in future. Similarly, on the supply side, it is suggested that capacity constraints pose the most significant challenge to the industry. This view is supported by the evidence from Oxera interviews and is further discussed below.

There is also some evidence from the market analysis by the Russell Investment Group to support this tendency for the growth on hedge fund exposure to slow down. According to the European investment managers who took part in the Russell Investment Group survey, the proportion of assets allocated to hedge funds is expected to increase from 5.3% in 2005 to 7.2% in 2007—a 17% compound annual growth rate. This is, however, smaller than the growth rate of 21% observed between 2003 and 2005, or indeed the 46% growth rate during the period 2001–03.

One major cause of this apparent deceleration might be that hedge funds are said to exhaust economies of scale at considerably lower levels of AuM than other types of funds, due to the fact that specific hedge fund investment techniques often exploit market inefficiencies. To the extent that these inefficiencies are short-lived, economies of scale are likely to be particularly small in the short run—in the longer term continuing innovation and search for arbitrage opportunities are necessary for the industry to grow.

This view is often said to be supported by a simple observation that assets deployed by a hedge fund manager in a hypothetical arbitrage transaction aimed to exploit a niche market

inefficiency are likely to influence the price of the underlying securities against the arbitrage position, and hence reduce the potential achievable returns. It is argued that this is less likely to be the case in traditional, liquid markets that characterise other asset classes.

Moreover, as the efficiency of financial markets improves owing to financial innovations and increasingly more effective arbitrage, there might be a growing number of hedge funds and a higher level of AuM that are targeted at a finite set of already identified arbitrage opportunities. If this were the case, this scenario would necessarily imply a fall in the average returns to hedge funds.

As one of the interviewees noted to Oxera: 'the growth in allocations to the hedge fund industry has not been matched by new alpha-generating strategies and hence the ability to increase the industry's capacity'.

Oxera research indicates that many industry players share this perspective. Moreover, market-wide evidence seems to support this view: when questioned about the major risks that the industry will face in the next three years, more than 70% of hedge fund managers mentioned poor returns (KPMG–CREATE, 2005, p. 27).

### 4.7.5 'Commoditisation' of hedge funds

The analysis presented above, including the accompanied evidence, points at the 'commoditisation' of hedge funds as the emerging phenomenon in the industry and potentially the latest stage of the development and evolution of hedge funds.

The term 'commoditisation' can be broadly understood as the economic process by which the hedge fund industry is reaching the state of maturity in terms of scale, technology, and share of global AuM—ie, it is commoditised by being standardised and universally adopted.

While the initial development of hedge funds has attracted considerable attention and high returns, the hypothesis that hedge funds are now commoditised implies that the more recent, universal adoption of hedging techniques, sector maturity, as well as weaker performance are not transient features of this market. Similarly, potential satiation of investor demand for hedge fund products implies commoditisation, as hedge fund products establish themselves as a constant, stable component of an investor portfolio.

Many mainstream asset managers have been moving into the hedge fund space over recent years. This appears to have been driven by the need to remain competitive in an industry that has rapidly increased its exposure to hedge fund-like investment techniques. Driven by a combination of previously unsatisfied client demand and the prospect of higher profit margins, a significant proportion of large asset managers in Europe have adopted a multi-strategy approach in recent years, which involves exposing their clients to hedge funds. While this exposure might not increase in the future at the same rate as in the recent past, it now characterises an important proportion of investment portfolios.

Oxera has identified evidence in support of this trend not only among secondary sources (Russell Investment Group, KMPG, specialised press[37]), but also in the interviews. For example, some interviewees noted the significance of the phenomenon of 'herding' behaviour in gaining exposure to hedge funds. Moreover, increased competition from mainstream managers is forcing a change in the way hedge fund businesses are run—moving from a 'boutique' style to a more 'industrialised' business model.

### 4.7.6 Potential implications of the commoditisation of hedge funds

One aspect of the growth in the demand for hedge funds and their move into the mainstream of interest to this study is the way this has affected the strategic positioning along the value

[37] See, for example, Financial News (2006b), FT Mandate (2005a) and Funds Europe (2006b).

chain, and the organisation of the supply side, adopted by different asset managers within their business models.

Several potentially important aspects of the commoditisation phenomenon have been identified that have significant structural consequences for the value chain beyond contributing to higher returns.

– **Outsourcing of the core AM function**—universal exposure to hedge funds requires more or less every asset manager to include hedge funds in their portfolio. In the absence of in-house expertise, the dynamic evolution of the hedge industry in general, and the often prohibitive costs in the absence of the necessary economies of scale, one approach that is increasingly being adopted to include a hedge fund in the portfolio appears to be the outsourcing of the core AM function for this asset class.

– **Exposure of retail investors**—while institutional investors and private wealth management may typically be assumed to be characterised by a significant level of investment sophistication, retail investor exposure to hedge funds poses some challenges concerning their ability to make informed decisions and decide on optimal risk/reward trade-offs. Therefore, in the absence of regulation, the entry of hedge funds into the retail market raises questions regarding investor protection. This issue is further addressed in section 7.

– **Emergence of new risks**—the implications of the established position of the hedge fund industry in terms of risk are not well understood. It has been suggested that hedge funds might be linked to increased systemic risks, information risks, as well as operational risks. However, financial innovation in general, led by the hedge fund industry, should increase market efficiency. These issues are further addressed in section 7.

– **Development of in-house, hedge fund boutiques**—hedge funds and mainstream asset managers appear to be responding to the developments described above by adapting their business models. This issue is further addressed in the next section.

The hedge fund managers surveyed by KPMG–CREATE (2005) have indicated that, in order to grow their business, they must make the transition from a single-strategy boutique status to a more 'industrialised' multi-strategy or multi-manager business model. The asset managers interviewed for this study have largely agreed with this statement, although some noted that, in practice, this process of commoditisation (sometimes also described as 'industrialisation') of hedge funds involves the formation of alliances with mainstream asset managers for particular asset classes. This would imply that small boutiques are focusing on specialisation in these classes and are achieving scale in those asset classes through alliances and joint ventures with mainstream asset managers, whereas other, larger boutiques rely on adopting 'multi-strategy' approaches.

These conclusions are supported by evidence from strategic responses of mainstream asset managers. Traditionally focused on mainstream, highly scalable asset classes (ie, bonds and equity indices), these asset managers are now developing capabilities in alternative asset classes—including hedge funds—in response to investor demand for product diversification and managed exposure to new risks.

According to a significant proportion of the interviewees, a level of consolidation in the AM industry is expected as asset managers either acquire or form alliances with hedge funds and other specialised manufacturers of new products to widen their product base.

## 4.8 Emergence of structured and other alternative products

The emergence of alternative and structured products, as well as increasing investor exposure to those asset classes, can be seen as a development parallel to the commoditisation of the hedge fund industry described above, in particular with respect to the part that encapsulates the increasing penetration of hedge-type strategies ('traditional' alternatives) in the retail sector.

This section is organised as follows: following a short introduction, section 4.8.2 describes the characteristics of the trend in the institutional market. The next two sections describe LDIs and their implications for the value chain. LDIs represent a particular type of structured product, which is increasingly used by pension funds, for example. Growth of alternative products in the retail sector is described in the next two sections. Given that regulation is an important driver of developments in the retail sector (as well as in the industry as a whole), the impact of UCITS III regulatory developments is also addressed. The impact of UCITS III on product innovation in the retail sector is discussed in more detail in section 4.4. Discussion of the implications of the trend for the value chain concludes the section.

### 4.8.1 Introduction

The evidence from primary as well as secondary sources[38] appears to be pointing at the conclusion that investor demand has led to the growth of 'hedge fund-like' investment as well as other alternative products, as mentioned above. The interviews have confirmed that investors' search for new sources of returns—which began as a move away from the underperforming asset classes at the turn of the century—is now commonly seen as the central component of the overall investment strategy.

Market-wide evidence supports this observation. For example, the Russell Investment Group survey indicates that the AM industry broadly expects the proportion of total AuM allocated to private equity and real estate to increase, from 4.5% and 9.8% respectively in 2005, to 6.1% and 10.5% respectively in 2007 (Russell Investment Group 2006).

There are several important features of this development. First, it can be associated with increased investor sophistication, especially at the institutional level, as well as appetite for new, potentially more risky, investment techniques. Second, it can be linked to the increased exposure to new and potentially less well-understood risks, such as volatility risks, which have been mentioned in a number of interviews with leading asset managers, as well as more sophisticated risk tailoring, for example in the case of LDIs.

In combination with the process of commoditisation of hedge funds, the growth of other alternative investments can be seen as the next step in the development of new industry products. Moreover, insofar as these might be tailored to the retail investor, they can be broader than the hedge funds or private equity traditionally perceived as niche markets. On a mass-market scale associated with the retail investor, broad evidence supports the overarching conclusion about the increasing proportion of funds' allocations to alternative asset classes, such as structured products, exchange-traded funds (ETFs) and certificates in both the institutional as well as the retail market. This trend appears to be affecting the industry across all Member States, but less so for the new Member States (it is particularly prominent in the most developed countries).[39]

The development of new alternatives necessarily raises questions about the sharing of information, transparency and systemic risks. At the same time, alternative products are

[38] See, for example, Structured Products (2005), CSTIM (2006), AIMA (2005), Funds Europe (2006c), Funds Europe (2005b), ISSA (2005).
[39] Evidence from Oxera programme of structured interviews.

likely to improve market efficiency and increase spanning of financial securities, and hence represent a further development of financial markets.

The growth of alternative investments in general therefore constitutes one of the most significant areas for risk analysis. The implications of alternative investments with regard to risks and potential market failures are further analysed in section 7.

### 4.8.2 Alternative products in the institutional market

In the case of institutional investors, broad evidence seems to suggest that allocations to alternative products are likely to grow further. For example, the Invesco–FRC survey (2005, p. 16) of asset managers has identified that 'alternative' alternatives—the new or complex asset types that are difficult to categorise—represent the fastest-growing asset class among Continental Europe's institutional investors. This asset class includes:

– tailored structured products;
– the inclusion of options and/or futures in investment portfolios;
– investments in ETFs;
– continued growth of asset-backed securities (ABS);
– the development of socially responsible investments (SRIs);
– the increased popularity of certificates;
– warrants.

The above categorisation of products includes significant potential overlaps. For example, it is typical to consider ABS as structured securities. Indeed, structured securities more generally appear to represent the largest share of all new asset classes—they are reported to be used by one-third of the institutions in the Invesco–FRC survey. This category also includes a wide variety of sub-products, which are difficult to classify since they tend to be tailored to meet a specific client's requirements or to exploit particular market inefficiencies. Among the most popular are index-based structured products, structured swaps, structured mutual funds, and credit debt and loan obligations (CDOs/CLOs).[40] The growth of CDOs/CLOs has been particularly significant in recent years, although their use is often confined to large, sophisticated investors and banks.[41]

It is important to stress that the majority of asset managers interviewed by Oxera have pointed at the parallel growth in sophistication of institutional investors, which might be seen as a potentially risk-mitigating factor. This issue is further addressed in section 7 on risks and implications of trends.

### 4.8.3 Liability-driven investments

One structured product that has become increasingly popular in a number of jurisdictions (the UK and the Netherlands in particular) is LDIs.

LDIs focus on the management of exposures defined by specific profiles of liabilities. An investment portfolio is then constructed to match these liabilities. Such liabilities might constitute, for example, liabilities of pension funds. The objective of LDIs is to match the expected profile of returns to the profile of liabilities in order to minimise asset–liability mismatch, and hence minimise the mismatch risk.

[40] Invesco–FRC (2005), p. 19.

[41] Although the growth of structured finance (or any other type of financial product) in general is not a subject of this study, it is important to note that structured products represent an increasingly important source of value for the AM industry. In this context, tranching (ie, structuring of different bond tranches with different characteristics), which often constitutes the core of structuring in securitisation transactions, is often linked with the demand for certain type of risk from the investors. For example, a AAA-rated, Euro-denominated, 20-year tranche might be created in an issue specifically to cater for the needs of a certain type of investor. For further details see Firla-Cuchra and Jenkinson (2005) on tranching and the development of structured finance products according to investors' risk appetite, market efficiency, or information available to the end-investor.

A number of market observers point to the changes in accounting standards across Europe (eg, IAS19 and FRS 17, which requires pension funds to report assets and liabilities at current risk-adjusted market values), as one of the primary drivers for the development of LDIs. These changes in pension accounting in the EU are part of the transition to International Financial Reporting Standards by listed companies. The implication of these changes appears to have been that:

– firms' liabilities have to be estimated using market-based discount rates tied to long-term bonds;
– any pension deficits/surpluses need to be reported in companies' profit and loss statements.

In principle, LDIs seem to meet the apparent need to match assets closely to long-term liabilities, which has been seen as the fundamental objective of pension funds in general, along with any other institution with fiduciary responsibilities. However, critics have pointed out that LDIs are often designed to hedge risk in accordance with accounting standards rather than optimal portfolio management, and imply a lack of regard for the economic reality of pension funds.[42]

In countries with developed occupational pension schemes, such as the UK, changes in the valuation of liabilities, introduced by new standards, have drawn substantial public attention to the issue of financeability of future pensions in the light of contemporaneous market valuations of pension assets. This has prompted the changes leading to 'mark-to-market' valuations and reporting of funds' current positions.

### 4.8.4 Implications of LDIs for the value chain

Potential implications of the growth in LDIs for the management of the core function of the value chain include:

– an additional requirement for specific skills to undertake asset–liability matching, although some interviewees have indicated that the development of a small team with the right skills is usually sufficient even for very large portfolios;

– substitution of traditional asset classes such as equities with fixed-income portfolios characterised by closely defined benefit profiles. Recent evidence includes reported rebalancing of the UK educational sector superannuation fund;

– increased demand for structuring from external providers, including investment banks, with the potential risk of marketing pressures from such providers;

– potential inefficiencies in investment strategies, including the focus of risk management efforts on the short-term value implications of the overall portfolio volatility;

– costly management of the net present value of the net long-term liabilities due to their long duration, subsequent implications for fees and the long-term value to the end-investors.

LDI strategies will have implications for the way in which asset managers compete for mandates in the institutional market. In particular, they lead asset managers to move away from traditional active management strategies. Increasing allocation to LDIs also has implications for the profile of risk and return achieved by pension funds. It might be too early, however, to present a complete, evidence-based understanding of these potential implications, and the policy debate on the desirability of LDI strategies is still developing.

[42] See, for example, Financial News (2006c).

### 4.8.5 Growth of alternative products in the retail market

Retail clients have become increasingly active investors in alternative products,[43] particularly through structured products, or, indirectly, through pension funds which are themselves investing in alternative products.

Structured products for retail investors are typically constructed to achieve relatively straightforward objectives: to protect a proportion of investor capital (ie, capital guaranteed) while providing limited exposure to alpha-driven investments. The latter component may involve the use of derivatives to achieve higher leverage, although a portfolio's overall exposure is often tightly managed.

Such products have proved popular in countries such as France and the UK (as well as other European countries), where they were introduced during the downturn in equity markets to limit the impact on the value of household wealth. It is often reported in this context that the market downturn has produced a long-lasting effect in the form of persistent demand for capital-guaranteed products, which appeal to a typically risk-averse retail investor.

Evidence from interviews appears to indicate that the demand for such products is not transient and remains strong, despite overall recovery in the equity markets.

Insofar as investors appear to value highly the capital protection property offered by structured products, the overall market risk exposure of households adopting capital-guaranteed products is likely to have diminished. Moreover, as highlighted by a French asset manager, these products have added the benefit of flexibility to investor portfolios:

> If an investor wants to take additional risk, he or she can reduce their allocation to the 'guaranteed' portion of the product, and increase their market exposure in a more transparent fashion.[44]

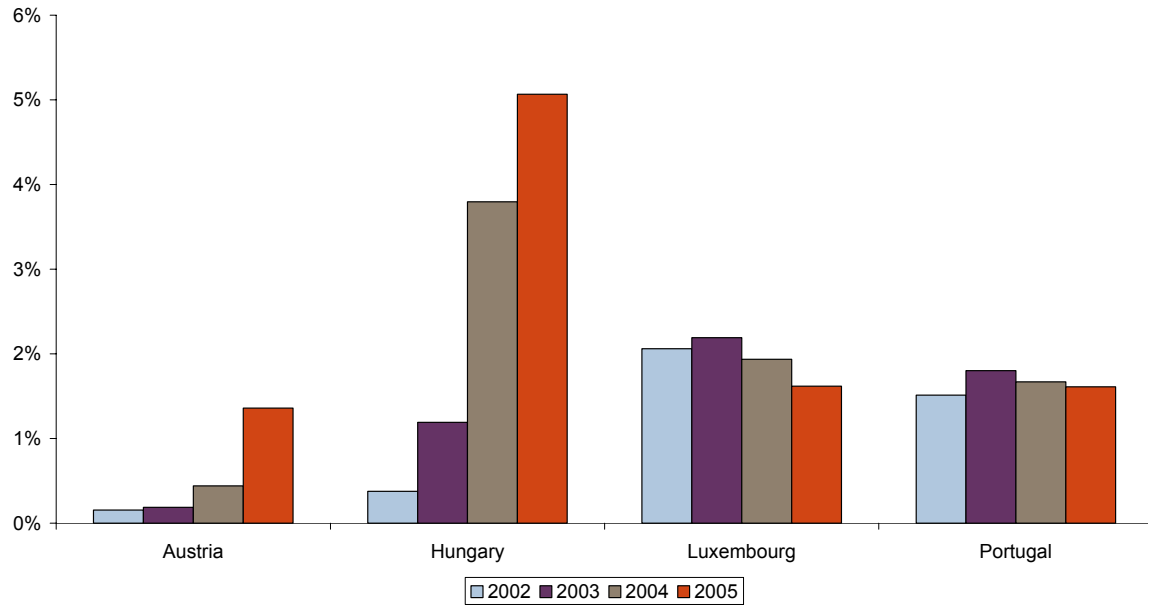
While capital-guaranteed products are often structured to remove the underlying risk of one part of the portfolio, in some cases they involve exposure to counterparty risk through hedging.

The data from ZEW/OEE (2006) provides evidence on the evolution of structured products in the retail market, although it covers only a limited number of countries (Austria, Hungary, Luxembourg and Portugal). As shown in Figure 4.8 below, structured funds (typically capital-protected funds) have become more popular in Austria (their share in UCITS and non-UCITS AuM increased from 0.2% in 2002 to 1.4% in 2005) and Hungary (0.4% in 2002 and 5.1% in 2005) and have lost market share in Luxembourg and Portugal.

[43] The increasing number of structured products in the retail sector is recorded in a number of secondary sources, including, for instance, www.trustnet.com.

[44] Evidence from Oxera programme of structured interviews.

**Figure 4.8 Share of structured funds in total AuM in UCITS and non-UCITS funds, 2002–05 (%)**




Source: EFAMA data as reported by ZEW/OEE (2006).

Capital-protected funds represent only one component of the diversified spectrum of structured products. These products will form part of equity funds and will therefore not be captured in the data presented in Figure 4.8 above. This evidence is therefore at best indicative.

The interviews confirmed that asset managers across Member States continue to expand their sales of structured products in the retail market. A large proportion of asset managers have indicated in this context that they have recently launched some form of 'standardised' structured product. The reported objective has been not only to attract demand from retail investors keen to protect their base capital, but also to serve specific needs that cannot be met with a portfolio of traditional mutual funds. UK asset managers have been reported to be particularly active on this front.[45]

An opinion shared by many interviewees was that they expected to see further launches of structured products targeted at retail clients. This was reported to be driven not only by client demand, but also by asset managers seeking to leverage their new investment capabilities developed from offering structured products to institutional clients. This could be interpreted as a strategy on behalf of asset managers to fill in the spare capacity and achieve the optimal scale of operation in order to recover the fixed costs associated with developing or acquiring specialist capabilities.

Some interviewees have also indicated that asset managers as well as distributors face additional incentives to sell structured products beyond investors' needs, due to attractive margins and retrocession fees (the proportion of the management fees that remains with the distributor). One senior asset manager, for example, described in detail the level of persistence of the marketing effort on behalf of investment advisors to sell structured products.[46]

[45] See, for example, http://www.trustnet.com/general/news/display-story.asp?scope=structured&id=76989.

[46] The evidence supporting the proposition that sales of structured products deliver higher margin for asset managers can be found in Funds Europe (2005a), for example.

While this observation is broadly confirmed by fees observed in the market place and reported significant marketing efforts, it has received mixed comments from interviewees. For example, some have stated that although structured products do exhibit higher management fees than other products, this is largely explained by the higher manufacturing costs of these products.[47]

There was consensus among most interviewees regarding the nature of the challenge faced by asset managers developing structured products for the retail market. For example, in some cases, convincing retail investors that behind the apparent complexity of a structured product there is a relatively simple investment proposition is likely to require significant investment of time and effort by sales teams, which might add to the overall level of costs and hence fees (assuming that the associated costs are passed through to the end-consumers).

### 4.8.6 Development of alternative products and UCITS III regulation

As noted in sections 4.3 and 4.4, UCITS III regulation through Directive 2001/108/EC of the European Parliament and of the Council (the 'Product Directive') extended the list of eligible assets in which UCITS funds can invest. Under this Directive, UCITS funds can now invest a capped proportion of their assets in:

– transferable securities and money market instruments;
– bank deposits;
– units of other investment funds;
– financial derivative instruments;
– index-tracking funds.

Evidence from secondary sources and Oxera interviews has confirmed that many asset managers are adapting their existing range of funds to make them UCITS III-compliant and to benefit from the increased investment opportunities offered by the Product Directive.

### 4.8.7 Implications of alternative products for the AM value chain

The growth in demand for alternative products appears to have prompted strategic developments and potential realignments in the core components and organisation of the AM value chain.

One of the most direct effects reported in the course of the Oxera interviews is asset managers' need to expand the product range offered to institutional and retail investors in order to remain competitive in an increasingly crowded and innovative market place. The importance of expanding the product range might be magnified by the gradual move towards open architecture (discussed in greater detail in section 6.3) in the retail market and the potential increasing bargaining power of institutional investors.

Similarly, the increasing demand for alternative products might constitute one of the main drivers of another fundamental trend, namely outsourcing of core AM.[48] Section 4.10 below expands on this point.

As many asset managers point out, the increased demand for alternative and structured products renders outsourcing of the core function to external managers more attractive, particularly if in-house skills are not available in the short term, or if such skills can be acquired externally at relatively low cost. Apparent competition in the 'alpha market' would render such outsourcing efficient, given the ability to shop around for the best value.

[47] See CRA International (2006), p. 54. This shows that capital-protected funds have the highest costs per AuM in the core AM function at around 70 basis points (bp) more than twice as much as equity funds (around 32bp).

[48] Outsourcing, in this context, refers to the development of a range of sub-advised products, such as FoF, fund of hedge funds or multi-management products.

Broadening of choice from among external asset managers (ie, better access to multiple, alternative providers) appears to have resulted in an increase of the power of distributors, product wrappers, and assemblers relative to manufacturers, although the size of this effect is difficult to estimate.

## 4.9 The core-satellite strategy and the boutique-type business model adopted by mainstream providers

### 4.9.1 The boutique concept

The process of commoditisation of the hedge fund industry, together with clients' demand for alternative products and absolute returns, appears to have required a strategic response from all industry players, irrespective of their size, according to Oxera's analysis. The need for such a strategic response appears to have been stimulated and magnified by the increasing adoption, particularly by institutional investors, of the 'core-satellite' investment strategy, as described below. As these processes have often developed in parallel, causality might be in both directions with mutually reinforcing trends.

For large AM firms this response appears to have involved the increasing pursuit of alliances with specialist AM firms (boutiques), acquisition and incorporation of boutiques in the company structure, and/or hiring of entire teams of external managers in order to develop the required investment skills and/or manufacturing capabilities in non-traditional asset classes.

This section describes the emergence of the boutique model and its implications for the shape of the core AM value chain.

**Box 4.1 The boutique concept**

The concept of an AM boutique typically refers to a specialised team of asset managers focusing on particular investment strategies and characterised by significant degree of freedom in terms of internal organisation, accompanied by outsourcing of all other components of the AM value chain.

This description requires further explanation since the concept of an AM boutique is prone to misinterpretation. One of the most accurate interpretations was offered by a French asset manager in the course of Oxera interviews: 'the boutique concept should only be used when referring to very small, highly specialised players and not for large firms whose investment strategies and internal processes could be classified as "industrialised".'

In a more general context, a boutique concept can also be used to describe an AM firm or a particular investment unit within a larger organisation that specialises in just one or a few specific asset classes. These might include traditional asset classes, such as equities, on the basis of the provision of some broadly defined, innovative management approach.

The perception of a unique investment strategy appears important since some managers have indicated that references to a boutique might be driven by the marketing efforts. Nevertheless, in a majority of cases analysed by Oxera, there appeared to be a genuine specialisation in addition to brand management.

To the extent that a given 'boutique' requires specialist skills over and above those required for passive or more traditional AM, it is often free to operate under its own investment guidelines, and, hence, might be subject to less stringent and alternatively specified management controls when part of a large AM business.

In general, the precise distinction between 'pure' boutiques and specialised AM firms/units does not appear to be critical for assessing the implications of this trend for the development of the AM value chain. Where the distinction might be important, however, is with regard to managers' remuneration and their incentives. According to some industry representatives, managers in independent, alpha-seeking boutiques are generally paid higher base salaries, as well as gaining a higher proportion of the returns that they generate than their counterparts acting within the realm of a more traditional AM business model.

Examples of boutique-type strategies include concentration on, for example, quantitative investment techniques, entrepreneurial aspects of companies when stock-picking, or hedge fund-type strategies.

### 4.9.2 The adoption of the core-satellite approach

In addition to commoditisation of hedge funds and the growth in alternative products, another fundamental driver of change in the core AM segment of the value chain identified by Oxera is the adoption by institutional investors of the core-satellite approach.[49]

In essence, the core-satellite approach advocates a clear separation of the passively managed core portfolio from one or more actively managed 'satellites' focused on the search for 'alpha'. While this report does not concentrate on investment techniques, the evolution of the overall investment strategy based on the core-satellite approach has potentially significant implications for the organisation of the value chain that is of interest for this analysis.

The rationale for the core-satellite approach can be described in terms of three main factors:

– increased efficiency of the manufacturing process as a whole;
– enhanced linkages between performance and value-adding activity;
– greater transparency in the AM strategy overall.

Under the assumption that an average, active asset manager is unlikely to consistently obtain returns above the market average, but still commands an average management fee, this strategy reportedly aims to achieve similar (or higher) returns at a lower cost by separating the low cost of the 'core' allocation to the market benchmark from smaller allocations from the more expensive, separately and actively managed 'satellites'.[50]

### 4.9.3 Implications of the core-satellite approach

The emergence of the core-satellite approach could result in institutional fund owners (and their consultants) becoming more involved in the strategic asset allocation decision and/or investment monitoring.

This might imply a move towards the narrowing of asset mandates—ie, less discretionary and more constrained investment mandates. In other words, the core-satellite approach might be driven by *funds* becoming more involved in the overall asset allocation decisions. This translates into funds offering the AM firms more, but smaller units of investment (ie funds) with *individually narrower* mandates. The AM's organisational response is to create smaller, more tightly focused, units of management—namely, boutiques—as this is the efficient way of dealing with the shift of individual fund size/mandate combination.

For asset managers, this implies that the bargaining power might be shifting to fund owners who are now in a better position to select asset managers for the different components of the disaggregated portfolio. This function is also more often performed by assemblers.

[49] See, for example, Thought Leadership Summit (2006), CSTIM (2006), Funds Europe (2004).

[50] Particularly because they face tight tracking error constraints (ie, the allowed deviation from a particular benchmark). See Bank of New York (2005), p. 15.

A direct implication of this development might be that the degree of competition among asset managers to be awarded the new narrow mandates has effectively intensified. Oxera interviews have found some evidence in support of this hypothesis.

For the AM supply chain, the potential consequences of this approach include the evolution of the organisational structure of the core function of the value chain, with the strategic business models of large, mainstream asset managers mirroring the core-satellite investment approach. This can be linked to the process of large AM firms setting up specialised, internal boutiques (that is, 'alpha'-generating units focusing on the 'satellite' component of the investment strategy) in order to complement their reformed and streamlined passive (core) investment teams.

### 4.9.4 Development of the boutique business model

The organisational structure of most of the asset managers interviewed for this study reflected some element of the boutique-based organisational model.

This specific evidence is confirmed by market-wide evidence from the survey of asset managers conducted by KPMG and CREATE in 2004, in which almost 70% of respondents believed that the adoption of the boutique operating model would be likely to boost operating profits over the next two years and hence appeared attractive.[51]

One important difference in the way boutique models are adopted is captured by the way in which specific boutiques have been developed within the wider company structure. There are essentially two ways in which AM industry players have embraced the boutique model: via external acquisition, or via internal restructuring.

In general, the latter appears to have been the more widely adopted path.[52] This might be due to the lower cost of internal development, although there is no specific evidence to support this hypothesis. Internal restructuring might also be seen as the first step in the transition towards the boutique-style organisational model in general. More specifically, the decision to acquire external firms might be perceived as preferable once the internal core AM structure of the business has been reorganised as a collection of specialist units.

When acquisitions have been the preferred route to adopt the boutique model, the brand of the acquired boutique often appears to have been critical to the deal.[53] In the majority of cases analysed by Oxera, the acquired boutique has reportedly retained its name as well as organisational structure, and has been kept at arm's length from the acquiring organisation in terms of internal management, while being integrated into the common value chain.[54]

From the perspective of the acquirer, the gains from the preferential and, in some cases, exclusive (as stressed by some asset managers interviewed by Oxera) access to the boutique's investment capabilities appeared to have been critical to the deal, while aimed at satisfying particular clients' requirements. In some cases, the brand appeared to have been a particularly attractive component of the goodwill associated with the target.

[51] Primary source: KPMG–CREATE (2004a), p. 19. Supporting evidence can also be obtained from secondary sources, such as CSTIM (2006), Funds Europe (2004).

[52] This evidence is confirmed by KPMG-CREATE (2004a): one in two medium-sized and large asset managers interviewed for the survey has moved to a boutique-style model, while only one in 20 firms has acquired stakes in formerly independent boutiques.

[53] Evidence from Oxera programme of structured interviews.

[54] For example, Axa acquired Framlington, an equity fund specialist, and Rosenberg, a quantitatively driven global equity specialist, and retained both brands. A similar strategy was followed by BNP Paribas with Fauchier Partners, an alternative investments boutique, and FFTW, a global fixed-income specialist.

From the perspective of the acquired boutiques, the benefits appear to include:

– economies of scale;
– access to established infrastructure in other parts of the value chain;
– the 'guarantee' of a more regular access to a broader group of investors via the parent company, without the need to renegotiate contractual terms in an increasingly volatile market place; and
– retained degree of independence.

Internal restructuring, however, has the immediate advantage that it does not require significant investments, although it is characterised by other challenges, as highlighted by many of the Oxera interviewees.

The most critical issue in this context appears to be human capital: organising the business around specialised teams of managers is based on the premise that the organisation can find those managers in the first place. If the necessary skills cannot be identified within the organisation, managers need to be purchased from independent boutiques or rival AM firms, which appears to have proved difficult.

The problem faced by restructuring firms is that in order to entice successful managers to switch from independent boutiques, they require similar remuneration levels with reduced exposure to risk.

Some AM firms have sought to overcome this problem by changing to the cultural mindset of the organisation. This includes devolving accountability to each investment boutique in the organisation; more closely linking pay to performance; providing boutique-style incentives; such as shares/units in the funds managed by each manager; or even spinning off internal units to make them resemble more closely the structure of independent boutiques.[55]

While UK asset managers have tended to be more disposed to make such changes, particularly with respect to the remuneration incentives,[56] most asset managers in Continental Europe explicitly stated that although their organisation had elements of the boutique model, paying higher salaries to managers of the specialised units was usually difficult.[57] This corresponds to the significant concentration of independent boutiques and hedge fund-like managers in the UK.

### 4.9.5 Vertical segmentation and horizontal consolidation in core AM: ramifications of the core-satellite approach and boutique-type business model

It could be argued that the adoption of the boutique model has been the response of mainstream asset managers not only to the process of commoditisation of the hedge fund concept, but also to the emergence of the core-satellite approach.

Furthermore, the development of boutiques must be assessed against the background of parallel developments in the core AM function of the value chain, which are likely to have had an impact on internal reorganisations:

– increasing specialisation in a limited number of asset classes, driven by competitive pressures to deliver absolute returns (as discussed in the previous sections);

[55] See, for example, KPMG (2004a), p. 45.
[56] Evidence from Oxera programme of structured interviews.
[57] Evidence from Oxera programme of structured interviews.

– ‘vertical’ segmentation of the core AM value chain as firms enter the sub-advisory business—ie, outsourcing of core AM functions (described in the next section);[58]

– ‘horizontal’ consolidation through the formation of alliances between different asset managers and increased M&A activity.

In particular, the trend in specialisation appears to be closely linked to the trend in outsourcing of the core AM function to external managers through, for example, the indirect sale of TPF (eg, FoF or MoM arrangements). Specialisation is hypothesised in this context to be the strategic response of small and medium-sized firms, while core AM outsourcing tends to be characteristic of larger asset managers, and this distinction is broadly confirmed by interviewees.

The core-satellite approach in institutional AM, combined with the gradual move towards open and guided architecture in retail distribution channels, presents small and medium-sized independent AM firms, with both a challenge, as competition between managers intensifies, and an opportunity, as demand for third-party products in sub-advised solutions continues to grow.

In this context, the AM firms appear to be responding to this challenge through increased specialisation in asset classes where they have competitive advantages, in order to become the preferred providers in core-satellite and FoF/MoM funds.

In contrast, the majority of large leading players in Europe’s AM industry interviewed for this study stated that they are adopting a multi-strategy model, which involves vertical segmentation of the core AM value chain between the manufacturing of proprietary products and the assembly of products through sub-advised solutions for non-core asset classes. Simultaneously, some mainstream asset managers are forming alliances to jointly manage passive asset classes where scale is the key driver of profitability (eg, index trackers).[59]

Such vertical segmentation of the core AM value chain appears to consist of two fundamental processes:

– the adoption of sub-advisory solutions for particular types of institutional mandate—for example, those where the client itself suggests the use of external managers for specific asset classes;[60]

– the development of a range of own-branded FoF/MoM products for retail clients, where the share of such products of total funds under management has increased significantly in recent years (ZEW/OEE 2006).

It is also critical in this context to recognise the distinction between functional segmentation (based on product specialisation and the core-satellite approach) and ownership consolidation among large- and medium-sized firms (M&A activity).

These developments have important implications for the organisation of the value chain as whole, including distribution, which are discussed further in sections 6.3 and 6.6. The related consequences for risks and potential market failures are addressed in section 7. Finally, the outsourcing of the core AM and its implications for the value chain are discussed in greater detail in the next section.

[58] The proposition that the adoption of boutique-type internal structures and core-satellite management strategies leads to horizontal fragmentation is also supported in the secondary sources. See, for example, Everyinvestor.co.uk (2005).
[59] Evidence from Oxera programme of structured interviews.
[60] Evidence from Oxera programme of structured interviews.

## 4.10 Outsourcing of core AM and fragmentation of the value chain

### 4.10.1 Sub-advisory services

At the most fundamental level, the concept of core AM outsourcing appears to run counter to the principal objective of the AM business, and might be seen as unsustainable in the long run. It might be difficult to understand how a business can pursue an exit strategy from its core function.

Moreover, the trend of the adoption of the boutique model discussed above appears to be geared at asset managers being able to manufacture and manage the widest possible range of products in order to gain market share from competing providers.

Nevertheless, the outsourcing of core AM is growing quickly, as evidenced by the growth in assets invested in FoF/MoM funds—in 2005, the total net assets of FoF in Europe was €284,254 billion, 41% higher than in 2004 (ZEW/OEE 2006, p. 62).

### 4.10.2 Drivers of core AM outsourcing

The decision to outsource the AM function appears to be largely driven by processes similar to those behind the adoption of the boutique model; namely, greater client demand for alternative products and the focus on the core-satellite approach that has increased competition between asset managers.

A recent survey of asset managers conducted by PWM in association with Goldman Sachs Asset Management reported that among European firms that were outsourcing core AM, 53% mentioned the main drivers behind their decision as being to 'complete the product portfolio' and 33% 'client demand for an enhanced product range' (PWM and Goldman Sachs Asset Management 2005).

A significant proportion of the mainstream asset managers interviewed by Oxera confirmed these findings. They pointed out that they offer sub-advised solutions within their specialised product range and, among those that did not, that they were strongly considering outsourcing some asset classes where they considered other manufacturers to have competitive advantages.

Overall, many asset managers interviewed agreed that meeting consumer demand purely from within their own manufactured products for diversification, absolute returns, and increased choice, while finding the best value, was becoming increasingly more difficult for a single organisation, especially in the highly innovative environment of contemporary financial markets. Some interviewees explicitly indicated that their clients would consider it appropriate for them, for example, to manage European equities and outsource Japanese or US equity as well as non-traditional asset classes to third parties specialising in those areas.[61]

Another important driver of outsourcing has been the changes introduced by UCITS III regulation. UCITS III provides the opportunity to broaden the product range by allowing the creation of UCITS-compliant FoF. This appears to have significantly boosted growth in FoF.[62] Moreover, in a more recent PWM survey, around 40% of respondents indicated that the broader range of instruments allowed by UCITS III is likely to encourage even further outsourcing of core AM functions (PWM Research, 2006).

Greater functional linkages in the AM marketplace (allowing for greater choice of providers), combined with the search for the best value driven by competition, appear to be increasingly

[61] Evidence from Oxera programme of structured interviews.

[62] See, for example: PWM (2006b).

dominating the logic of asset managers' attempt to offer a broader range of products. These AM firms, which pursue the multi-management strategy, appear increasingly attracted to shop around for skills in developing specialised products. However, this approach is typically limited to sophisticated, high-value-added components of the investment portfolio.

In terms of the geographic spread of this trend, outsourcing of the AM function appears to have developed strongly in the UK and Scandinavia, followed by France, Italy and Spain. Further signs of growth of core AM outsourcing can be observed in Germany.[63]

For example, in terms of the market for UCITS FoF—a subset of the whole outsourcing market—the UK experienced the highest growth rate in 2005 (50%), which represented a total of €31.6 billion of total net assets in FoF. However, the largest UCITS FoF markets are France and Germany, with €78.0 and €42.7 billion of total net assets respectively.[64]

### 4.10.3 Outsourcing and size

Outsourcing of core AM seems to be largely confined to mainstream asset managers. For small AM firms, specialisation—with the objective of becoming the preferred provider in outsourced solutions—is the strategy of choice. Indeed, according to a worldwide profitability study by McKinsey, specialised asset managers who achieved scale within their 'specialist' asset class were obtaining around 36% of pre-tax profit margin—8 percentage points above the average (McKinsey & Company, 2005b). This compares favourably to the pre-tax profit margins of large AM players—above 30% (also above the average).

Recent developments in the AM industry, however, present medium-sized firms with a dilemma: specialise, as small firms appear to be doing; or grow their business to adopt the large AM business models of multi-strategy managers.

According to McKinsey, in addition to these two 'profitable' strategies (being large and at scale, or being specialised), the third 'profitable' business model is that of a multi-boutique—firms that achieve scale within each boutique and overall scale across the institution. These firms differ from mainstream multi-boutique asset managers, in that they do not enjoy the same scale in more passive investment strategies, such as index trackers.

### 4.10.4 Analysis of potential implications of outsourcing for the value chain

One of the most important implications of the core AM outsourcing trend and its drivers—hedge fund-type 'commoditisation' and demand for a wider range of products, the core-satellite approach and the shift in bargaining power down the value chain—might be that, as one interviewee put it to Oxera: 'The AM business is no longer exclusively about manufacturing.'

For an increasing number of large financial groups active in most segments of the AM value chain, diversification of the business model is a profitable strategy.[65] Diversification might allow large financial groups to extract value from all elements of the value chain and to be exposed to diverse business strategies with different strategic objectives and risk profiles, such as:

- manufacturing—high-margin, high-risk business based on attracting the most talented people;
- distribution—attractive margins and less risky than manufacturing; and
- multi-management/intermediary—low profits and low levels of business risk.

[63] See also FT Mandate (2005b).

[64] ZEW/OEE data.

[65] Evidence from Oxera programme of structured interviews.

The potential, distinctive feature of this development is that, in response to competitive pressures, the industry appears to be characterised by progressive strategic vertical segmentation of the value chain, where each player looks to extract value by focusing on their core competencies according to their own business model.[66]

This fragmentation might be resulting in one or more of the following developments:

– segmentation between AM manufacturing and distribution units, particularly among large financial groups;
– development of open and guided architecture in retail distribution;
– emergence of intermediaries to fill the gap left by the separation between manufacturing and distribution units.

The segmentation between manufacturing and distribution appears to be caused by divergence in the strategic interests of both segments of the value chain.

In this context it is useful to analyse a hypothetical case of a large, vertically integrated financial institution with a bank network and an independent AM manufacturer selling its products mainly through the bank's distribution network.

In response to client demand for a diversified product range and funds with a strong track record, the distribution arm would have an incentive to offer the most competitive products available in the market, regardless of who manufactures them.[67] The incentive is even greater if rival distribution networks are beginning to open up. From the manufacturer's perspective, however, the case for opening up the distribution channel to other manufacturer's products is less obvious, as the immediate effect is to introduce competition in the proprietary distribution channel.

Some large European players have resolved this tension by focusing on the core competencies of the group instead of diversifying their exposure to different business strategies present across the value chain. For example, some players have decided that their strengths lie in distribution, and have spun off their AM arm while re-branding it, in order to focus the brand asset on gathering funds from customers through a guided architecture distribution model.[68] Others have concentrated on the manufacturing side of the business, but appear to be moving down the value chain by setting up multi-manager and B2B open architecture units, which are operated independently from manufacturing unit.[69]

A parallel phenomenon that appears increasingly more prominent (as the segmentation of the value chain continues) is that of distributors gradually moving towards the adoption of open, or most likely, guided architecture platforms. This development is discussed further in the section devoted to distribution.

In this context, it is important to analyse the consequences that open and guided architecture (in conjunction with the trends being discussed so far) might have on the core AM segment of the value chain—in particular, on the emergence of B2B intermediaries.

The move towards open architecture has created a situation where a single relationship between a manufacturer and its proprietary distribution channel is being replaced by a complex web of relationships. The costs can be quite large, in terms of the negotiation of bilateral contracts with each manufacturer/distributor as well as investments in system upgrades in order to manage multiple contracts. Specialist intermediaries may be able to

[66] Evidence from Oxera programme of structured interviews.
[67] Insofar as it is responsible for a separate profit-and-loss financial statement.
[68] Evidence from Oxera programme of structured interviews.
[69] Evidence from Oxera programme of structured interviews.

generate savings for both manufacturers and distributors by achieving economies of scale in contract negotiations and administration services.

In essence, these intermediaries are industry players acting as an additional, wholesale distribution channel from the perspective of the manufacturing business and as a service provider from the distributors' perspective.[70]

From the perspective of the manufacturer, these players add value since they are able to negotiate attractive contract terms with a large network of distributors, allowing the manufacturer to focus on its core activity. From the perspective of the distributor, the role of intermediaries is to act as wholesale buyers of funds from manufacturers and then resell these funds to distributors packaged together with ancillary services, such as fund selection and analysis, and administration tools. Hence, intermediaries allow distributors to focus their business further on their core competency (asset gathering) and completely outsource fund selection and product manufacturing to firms further up in the value chain.

## 4.11 Concentration of the core AM function in large financial centres

A common theme identified during the structured interviews undertaken by Oxera is the trend in concentration of the core AM functions in a reduced number of locations or investment centres—mainly London, Frankfurt and Paris, in the case of European investment centres.

### 4.11.1 Drivers triggering the concentration of core AM

The fundamental drivers for concentrating the core AM function in a few strategic locations were reported by the majority of interviewees to be:

– gaining access to a qualified pool of expert labour;
– being close to markets with strong performance and liquidity; and
– potential scale economies achieved from concentrating similar activities in one location.

These findings are broadly in line with previous research conducted on this topic, which identified issues such as the price/quality ratio of financial infrastructure—which includes the liquidity and performance of markets and the availability of a highly productive workforce the quality of life for employees, and the regulatory regime as key factors determining the location choice of the core AM function (Oxera, 2004).

The interview programme confirmed that the observed consolidation process in the European AM industry (as evidenced by greater M&A activity)[71] is increasing the concentration process of core AM in a few locations. For example, as reported by some interviewees that had recently acquired other European AM firms, the core AM activity of the acquired firm had been (or soon would be) relocated to one of the investment centres of the acquiring firm.[72] Nevertheless, the consolidation process in the AM industry has been relatively slow.

A final point in this regard is that the observed consolidation in the AM sector (in particular, for vertically integrated players) has been driven mainly by developments in the market for corporate ownership in the banking sector. For example, one common reason for the merger of AM firms is the M&A transaction between their parent banking groups. Large-scale mergers of funds have typically been seen in the context of a wider merger of fund management companies, which in turn has usually arisen because of a merger of large financial groups.

[70] Evidence from Oxera programme of structured interviews.
[71] Evidence from Oxera programme of structured interviews, and Putnam Lovell NBF Securities (2006).
[72] Evidence from Oxera programme of structured interviews.

### 4.11.2 Characteristics of the concentration of core AM functions

The Oxera analysis appears to confirm that the trend towards concentration of core AM functions is characteristic of certain functional and geographic variability. For example, when core AM is transformed into global activity, certain functions are usually retained at the local level. A number of interviewees indicated that the management of local equity funds is an example of an activity that adds more value if undertaken by local teams (eg, a separate team domiciled in Spain, Germany, France, etc). There is less evidence that the same is happening at a fairly low level of aggregation (eg, teams working with Eastern European stocks located in Warsaw)—regional functions are often concentrated in London, Frankfurt or Paris.

The trend towards retaining a degree of management of local equities at the local level, observed in countries such as UK, France, Germany, Italy and Spain, is further underlined by the evidence from Central and Eastern Europe where AM industries are less developed. In these countries local markets are characterised by relatively little demand for foreign funds and significant investor allocation to local equities. Thus, for players that consolidate their core function in financial centres and retain at the local level only the management of local equity funds, the share of business undertaken by local teams compared with global teams is higher in Eastern Europe than in countries with a more developed AM industry.

According to evidence available from secondary sources such as industry commentators and Oxera interviews, on the one hand this is driven by the specific characteristics of these markets (eg, strong performance of local instruments and country-specific political risks); on the other hand, given that the majority of such countries have joined the EU recently, there might be a time lag before core AM functions are reallocated to one of the investment centres. In Poland, for example, global players such as Citibank, ING and Pioneer, with strong management teams located in the leading European financial centres, also retain relatively large local Poland-oriented AM teams.

### 4.11.3 Institutional versus functional concentration

The presence of economies of scale, as suggested by EFAMA[73] and various secondary sources,[74] creates significant potential for cost efficiencies to be achieved through the integration of the core AM component of the value chain in a limited number of large investment centres with a well-developed infrastructure and access to qualified labour. However, due to suggested regulatory barriers—in particular, those not removed by the management company passport—the industry's potential to benefit from the integration via the institutional channel is limited. Therefore, in response, integration is taking the form of reallocation of functions and activities—ie, functional concentration of the AM activities in investment centres—while, from the institutional perspective, management activities are undertaken locally (ie, funds are typically managed by local AM firms that delegate the decision-taking process to the consolidated core AM function).

UCITS III regulatory developments attempted to lower barriers for management companies in order to enable them to offer their services cross-border through the introduction of the management company passport. However, concerns were raised during the interviews about the ability of management companies to provide passports for their services in practice.

In addition, according to the Committee of European Securities Regulators (CESR) guidelines, published in February 2005, CESR members agreed that they could permit an open-ended investment company to designate a management company only in the same EU

[73] According to EFAMA the 'real' management company passport is a high priority for most of its members, since it can contribute to reducing costs and operational risk (EFAMA, 2005).

[74] See, for example, Financial News (2006a) and Financial News (2006d).

jurisdiction. According to KPMG, the result of this decision effectively removes the ability of a management company to independently passport its services to other Member States.[75]

This is confirmed by the comments from the industry. For example, Philippe Couvrecelle of Natexis suggests that the only services that can be passported cross-border are fund marketing and sales (through the 'fund passport'), while the core activities of AM cannot. In his opinion, 'the day that passport becomes a real passport, everything changes, the industry will experience further concentration of the core AM activities in one location, and this location will be London' (*Financial News*, 2006a).

### 4.11.4 Implications for fund distribution

The developments towards geographical consolidation of the core AM functions cannot be considered in isolation from developments in fund distribution.[76]

Related to the functional concentration of the core is the construction of pan-European funds. For example, as reported by Oxera interviewees, as a result of some cross-border merger transactions among AM firms, core functions have been consolidated into one entity in conjunction with the integration of local funds into fewer funds domiciled in one jurisdiction (usually the one with the most attractive regulatory regime).

It therefore seems that if the distribution strategy of a given player is based on funds domiciled in one Member State and distributed across the EU via the notification procedure (fund passport), additional incentives are provided to consolidate the core activities in one location as well. This is because the need to manage local funds transforms into the need to manage fewer pan-European ones. The choice of domicile for funds seems to be affected by the attractiveness of the regulatory regime, while the location choice for the core function appears to be driven by factors such as performance, liquidity of capital markets and access to qualified labour.[77]

There are, however, a number of barriers for the development of pan-European funds (in addition to obstacles not removed by the Management Company passport that were discussed in the previous section), including difficulties associated with cross-border notification of funds under the UCITS III regulation.[78] Other obstacles are created by divergent local taxation and characteristics of local demand. The EFAMA, for example, indicates that, even if the current difficulties encountered in UCITS cross-border registration are solved, the need to set up local funds will remain (for example, due to local investor preferences, type of client, and tax regulation).

### 4.11.5 Implications for the back office

Concentration of core AM activities leads to developments in the elements of the value chain that provide support functions—ie, the back office. The back office responded to the reallocation of core AM to investment centres in a similar way. Functions that are inseparable from core AM activities are also reallocated. This applies in particular to trading (execution of the trade decisions), dealing (deal administration and control), and post- and pre-trade liaison with brokers.

[75] The underlying evidence and interpretations are available at http://www.kpmg.ie/industries/fs/funds2005/ucits/management_directive.htm

[76] See section 6 for a detailed discussion of the trends in the distribution component of the value chain.

[77] See Oxera (2001) for more detailed analysis of these issues.

[78] See section 5.2 for more details.

# 5 Identification and analysis of trends in distribution and the front office

## 5.1 Distribution channels

### 5.1.1 The evolution of main distribution channels

There are multiple venues or distribution channels through which funds can be marketed to investors. An AM firm might aim to distribute funds directly to investors (eg, via a website), or through a proprietary network of sales offices of a financial group (eg, a bank or insurance firm).

Alternatively, a fund manager might decide to rely on the distribution network of a third party. The main third-party distribution channels available to an AM firm are as follows.

- **Distribution through a bank network (retail or private) or through a similar network of an insurance firm**—banks and insurance companies are often perceived as traditional distribution channels since, in most European countries, the majority of retail funds were historically distributed to investors via these channels. The importance of this distribution channel is discussed further in section 5.4.

- **Funds can be sold through the network of IFAs**—ie, independent distributors that are not associated with a particular AM firm or financial group (although this definition differs by country). The development of this channel in Continental Europe is discussed further in section 5.6.

- **Via the non-independent network of financial advisors** (NINFA)—a more recent development in the distribution segment (discussed in greater detail below), NINFAs typically operate an open architecture model. They also belong to a financial group that has retained at least selected core AM segments in-house. Examples include Xelion in Italy (part of UniCredito), comdirect in Germany (part of Commerzbank), or Cortal Consors operating in several European countries (part of BNP Paribas). The emergence of this channel is further discussed in section 5.5.

- **An open architecture retail fund supermarket platform**—a distinctive feature of fund supermarkets is that their fund sales process is based on a 'non-advice' principle (ie, no direct contact with an advisor), and therefore retail investors investing through fund supermarkets should be relatively well informed and reasonably sophisticated. The importance of this channel is further discussed in section 5.8.

- **The multi-management channel**, including FoF, MoM and product wrappers, can be used to access assets of institutional investors and, in particular, assets of other investment funds. More generally, this distribution channel is associated with the development of intermediaries in distribution, including assemblers, aggregators and product wrappers. The emergence of this channel is further discussed in section 5.8.[79]

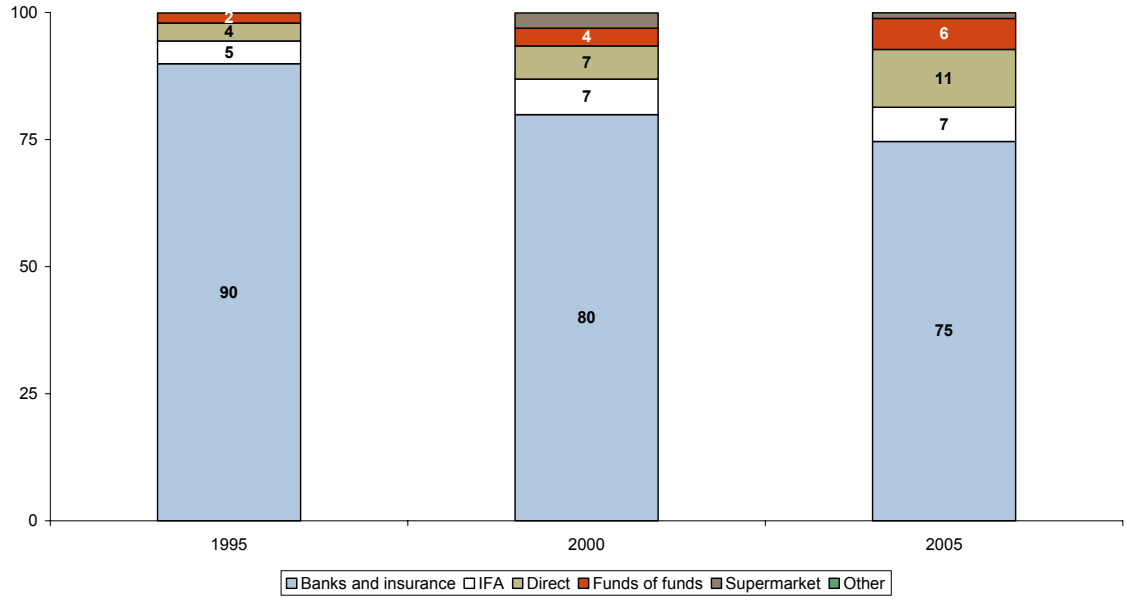
At the pan-European level, according to FERI Fund Market data (as reported by ZEW/OEE 2006 and presented in Figure 5.1 below), the networks of banks and insurance companies

[79] Alternatively, since it is possible to access FoF and MoM funds from a supermarket, IFA, or a bank, the multi-management channel might not be perceived as a separate distribution channel per se, but a separate channel of interaction within the value chain (see Appendix 2 for a more detailed description of the value chain).

have traditionally dominated distribution. However, there is strong evidence to support the conclusion that their market share is declining over time. According to FERI, the market share of banks and insurance companies fell from 97% to 75% between 1990 and 2005 in six European countries (France, Germany, Italy, Spain, Switzerland and the UK). At the same time, the market share of the direct distribution channel is reported to have increased from 2% to 11% and the share of IFAs from 1% to 7%.[80]

In addition, Oxera's analysis of primary sources has broadly confirmed the growth of distribution through new channels such as FoF.[81] At the market-wide level, according to FERI, the market share of this channel has grown from close to 0% in 1990 to 6% in 2005.

**Figure 5.1 The evolution of market shares (%) of distribution channels in Europe, 1995–2005 (FERI data)**




Note: The banks and insurance distribution channel includes retail and private banks and insurance companies. The data includes funds sold in France, Germany, Italy, Spain, Switzerland and the UK.
Source: FERI Fund Market Information Ltd, data as reported by ZEW/OEE (2006), and Oxera calculations.

In addition to FERI data, Oxera has analysed data collected by Cerulli Associates, as reported by ZEW/OEE (2006), in search of evidence to support the above hypotheses. The Cerulli data covers only selected countries (France, Germany, Italy, Spain, Sweden, Switzerland and the UK) for the period 2002–04. Some rather general, market-wide forecasts by Cerulli are also available for 2005–09 from the ZEW/OEE database.

While a direct comparison between FERI and Cerulli is, in principle, problematic due to slightly different data samples, the difference reportedly only involves Sweden (included in Cerulli). Nevertheless, the diminishing importance of traditional channels is not clearly confirmed by Cerulli. According to Cerulli, the market share of traditional channels did not change over the period from 2002 to 2004.

However, Cerulli also notes that the IFAs and TFAs (offering a limited, pre-selected range of products) have increased their market share from 15% to 16%, while the market share of

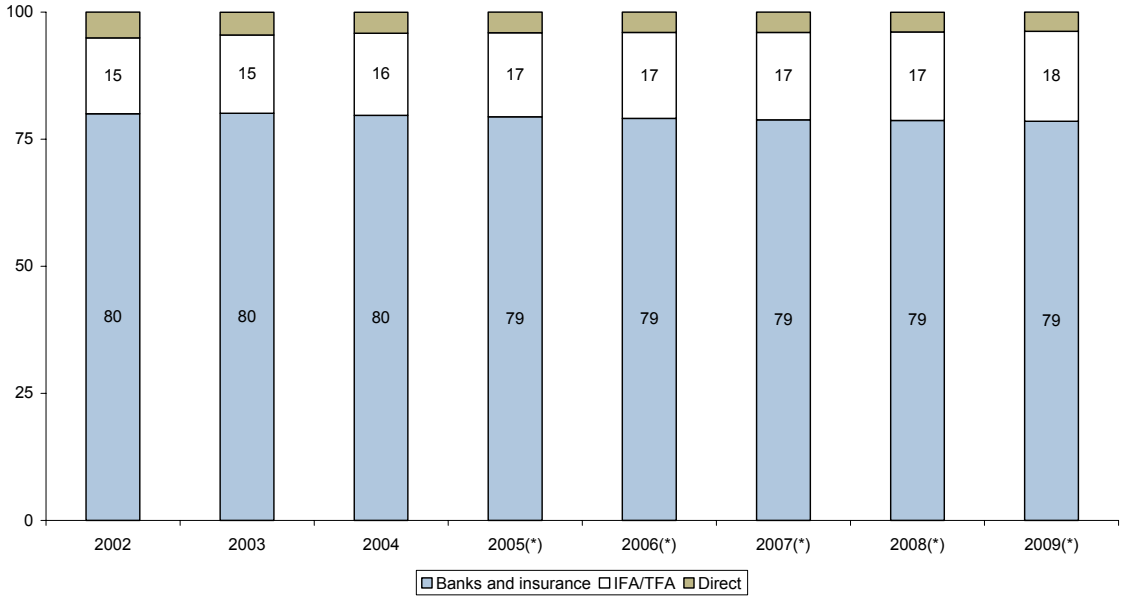
[80] This category includes direct distribution to institutional clients.

[81] Primary sources of data include direct statements by asset managers in the form of interviews, presentations or speeches. The full list of structured interviews undertaken by Oxera is provided in Appendix 4 (only one person per interview is reported, although almost all interviews included 2–5 representatives of a given organisation). Statistical evidence is treated as a separate source of information.

direct distribution remained stable from 2002 to 2005 (at approximately 5%), but is predicted to fall slightly to 3% in 2009.

According to these predictions, the market share of traditional channels is expected to decrease to 79% by 2009, while the share of IFA/TFAs is expected to grow to 18% (see Figure 5.2). The predicted change, therefore, appears remarkably small. As a consequence, it is difficult at this level of aggregation to attach great significance to this evidence if not supported by additional data.

**Figure 5.2 The evolution of market shares (%) of distribution channels in Europe, 2002–04 and forecast for 2005–09 (Cerulli data)**




Note: The banks and insurance distribution channel includes retail and private banks and insurance companies. The data includes funds sold in France, Germany, Italy, Spain, Switzerland and the UK.
Source: Cerulli Associates data, as reported by ZEW/OEE (2006), and Oxera calculations.

## 5.2 Cross-border fund distribution

The European AM industry is often perceived as being significantly fragmented. For example, the European Commission Green Paper explicitly highlights that the number of individual investment funds in Europe is almost three times higher than in the USA for a market size (in terms of total AuM) that is about half that of the USA (European Commission 2005a). Consequently, the average European fund size is considered sub-optimal. In light of this, it is often suggested that further industry consolidation might deliver substantial economic benefits, if there are significant economies of scale at the fund level.

In this context, the developments in cross-border integration of the distribution component of the European fund management industry value chain are one of the most important aspects of this study. Oxera research has provided evidence in support of the following developments:

– over the past few years, the magnitude of cross-border fund sales, when measured as the share of foreign UCITS in the total number of UCITS notified, has increased significantly;

– the market shares of the proportion of different distribution channels used for cross-border distribution have been changing. In particular, in Germany banks seem to have

increased the share in cross-border distribution, while in Italy, Spain, France and the UK other channels seem to be gaining market shares from banks;

– there seem to remain certain barriers for further growth in cross-border distribution.

Therefore, as fully integrated AM businesses become multi-national, they are increasingly able to sell products cross-border. This is a necessary condition to enable individual *funds* to grow, while leaving end-investors with the same *range* of funds to choose from.

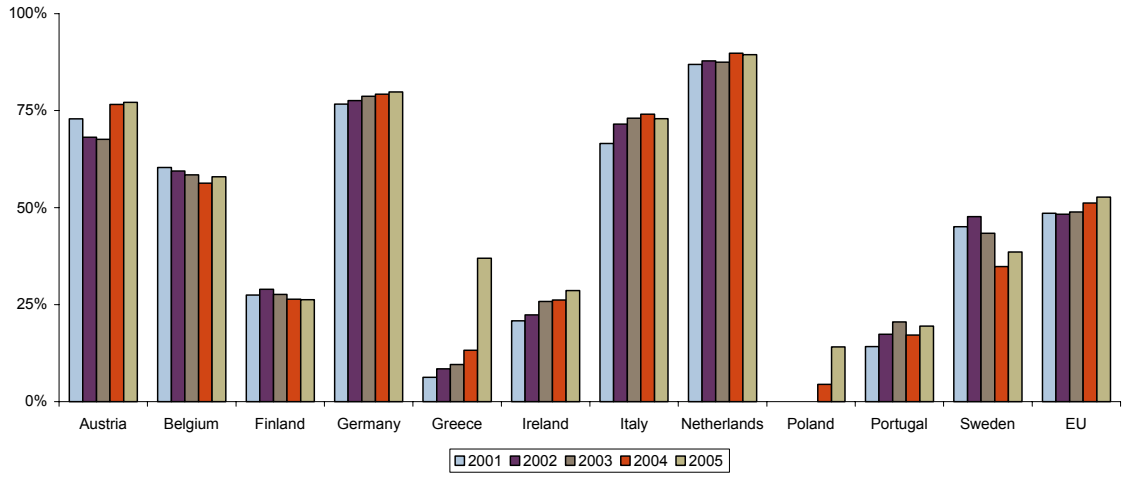
### 5.2.1 Increasing cross-border trade

The data analysed by Oxera indicates some characteristics of the evolution of cross-border fund distribution in Europe, although problems with data consistency and limited coverage reduce the level of confidence that can be attached to these findings.

According to Figure 5.3, the share of foreign UCITS funds in the total number of UCITS notified in the EU increased from 49% in 2001 to 53% in 2005. Given that these numbers include 'round-trips' or funds domiciled in Luxembourg or Ireland and then distributed exclusively in the country of origin (in order to exploit regulatory advantages), caution is advised when interpreting this as evidence of increasing cross-border distribution.

In terms of cross-country differences, for eight of the countries in Figure 5.3, the market shares of foreign UCITS increased in 2005 compared with 2001 (with the exception of Belgium, Finland and Sweden). Similarly, for eight countries, the market shares of foreign UCITS increased in 2005 compared with 2004 (the exceptions being Finland, Italy and Netherlands).

**Figure 5.3 Shares of foreign UCITS funds (%) in the total number of UCITS funds notified, 2001–05**



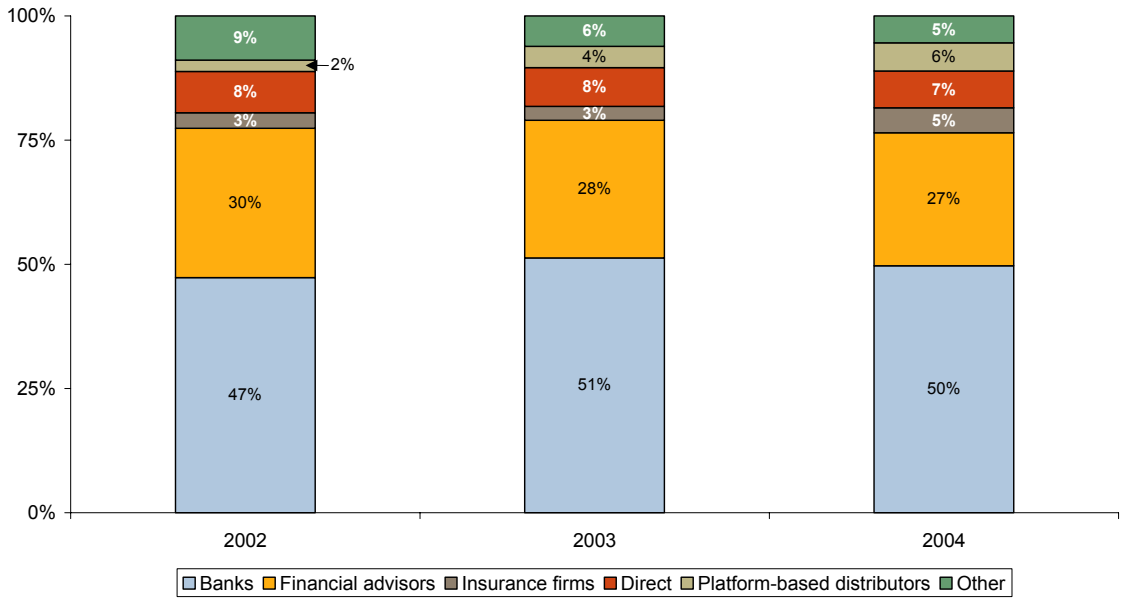

Source: Survey of European regulators as reported by ZEW/OEE (2006) and Oxera calculations.

### 5.2.2 The evolution of cross-border distribution channels

According to Cerulli data collated by ZEW/OEE (see Figure 5.4 below), traditional channels (banks and insurance firms) dominated cross-border trade in Europe in 2002. 50% of the mutual fund AuM of cross-border fund vendors was distributed via banks and insurance companies. By 2004, their market share experienced a modest increase to 55%.

The market share of financial advisors in cross-border distribution fell from 30% in 2002 to 27% in 2004 according to the same source, whereas that of platform-based distribution increased from 2% to 6%. At the same time, the percentage of cross-border trade (approximately 8%) via the direct sales channel remained stable.

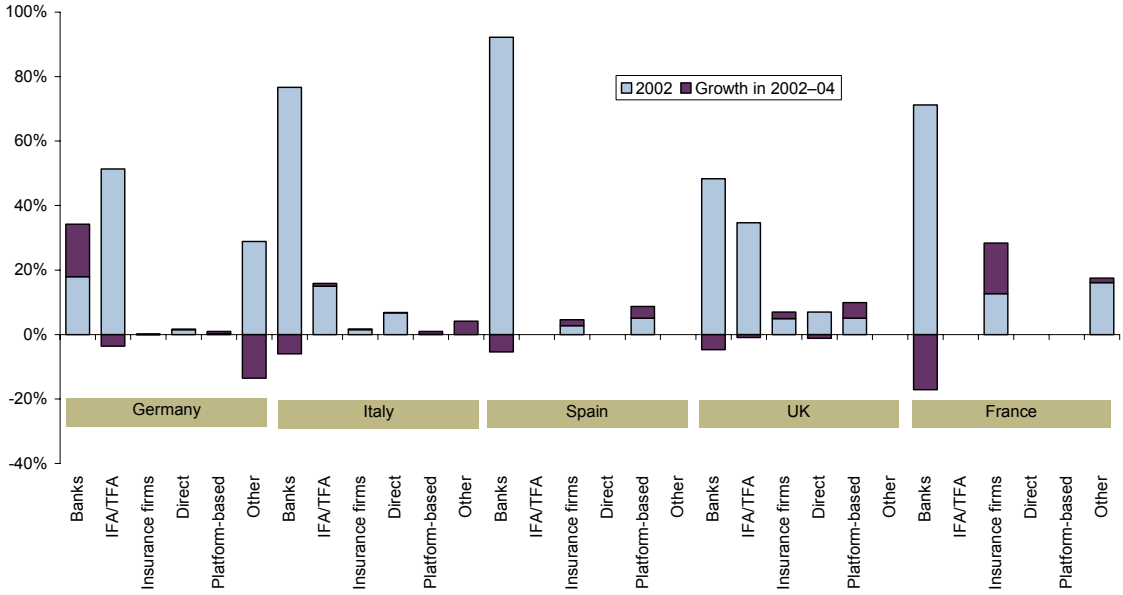
**Figure 5.4 Cross-border fund vendor survey respondents' mutual fund AuM market share (%) by distribution channel**




Note: The data includes funds sold in France, Germany, Italy, Spain, Switzerland and the UK.
Source: Cerulli Associates data as reported by ZEW/OEE (2006) and Oxera calculations.

According to Figure 5.5 below, in 2004 the leading cross-border distribution channel in Germany was IFA/TFA. However, the increase in cross-border sales from 2002 to 2004 (evident from Figure 5.3 above) seems to have largely taken place through the bank channel. On the contrary, in France, banks seem to have lost their market share in cross-border distribution, which was largely picked up by insurance firms. In Italy, Spain and the UK, banks have also experienced a slight fall in market shares, while platform-based cross-border distribution has increased.

**Figure 5.5 Market shares (%) of cross-border distribution channels by AuM, 2002–04**




Source: Cerulli Associates data as reported by ZEW/OEE (2006) and Oxera calculations.

### 5.2.3 Potential barriers for increasing cross-border distribution

The research identified two factors that might act as barriers for cross-border integration of fund distribution:

– potentially insufficient degree of open architecture among local distributors;
– selected aspects of UCITS III regulation.

These potential obstacles for cross-border distribution would represent 'true' barriers only if AM firms consider it commercially attractive to launch pan-European funds (ie, the same fund to be sold to investors in many or all of the EU countries) in the absence of these obstacles. Several factors, other than UCITS III regulation and developments in local fund distribution, could undermine the commercial attractiveness of cross-border distribution. These include country-specific and differentiated investor demand, as well as differences in tax regimes across Member States.[82] However, Oxera interviews confirmed that AM players consider launching pan-European funds capable of producing benefits from scale economies and greater financial integration even in the presence of factors such as taxation dichotomies and differences in demand.

#### The policy of local distributors with respect to third-party funds as a barrier

It is often suggested that one barrier for further financial integration through increasing cross-border distribution is the dominant position of certain types of distributor in Continental European (eg, banks and insurance companies) and the slow development of open architecture for these players. For example, the European Commission indicates:

> although the number of foreign funds in some Member States is an important proportion of the total number of funds available domestically, their market share may not be very significant. One of the reasons for this is the fact that big domestic financial groups, which control distribution networks, tend to offer in-house products (European Commission 2005)

According to Figures 5.3 and 5.5, increased cross-border distribution in Germany seems to be associated with greater market share of banks as a cross-border distribution channel. The gradual adoption of guided architecture by traditional distributors in Germany has created substantial opportunities for foreign fund manufacturers to enter the market (*Financial Times* 2006).

However, from 2002 to 2004, the share of foreign UCITS notified in Italy also increased, while the banks' share in cross-border distribution decreased. Thus, even though there seem to be certain linkages, the available data does not provide robust support for the proposition that a potentially insufficient degree of open architecture among dominant distributors presents a barrier for cross-border trade at the European level.

According to Oxera interviews with asset managers, the traditional distribution networks appear to be relatively more prepared to open up to foreign funds than to local ones, perhaps due to less direct competition from alternative providers abroad. On the one hand, this seems to be driven by strategic competition reasons, according to which foreign manufacturers are seen by distributors within vertical groups as creating less competition for their in-house providers than local AM firms. On the other hand, as retail funds distribution is significantly brand-driven, it is often a matter of business reputation and prestige to offer funds from well-established foreign providers.

The latter argument is particularly important for southern European counties where, commercially, it can be seen to be necessary to offer at least one of the Anglo-Saxon brands. For example, a number of fund manufacturers interviewed by Oxera suggested that they face

[82] See also EFAMA (2006), section 2.5.

substantially higher barriers when marketing funds through local third-party networks than selling them through third-party channels cross-border.

Intermediaries represent another important aspect of the relationships between cross-border fund sales and the structure of distribution systems. Oxera interviews have confirmed that the availability of intermediaries and assemblers facilitates more efficient cross-border fund sales by giving investors a greater choice of funds at a lower cost compared with the distribution channel attempting to provide the same range through direct relationships with the cross-border funds.

### UCITS III regulation and cross-border distribution

Oxera research appears to confirm that, even though the industry seems to acknowledge that UCITS III regulatory developments provide a useful framework for facilitating cross-border trade, certain aspects of the practical application of UCITS III are perceived as creating (or at least not removing) important barriers for cross-border sales of funds.

In particular, the costs and delays associated with different requirements across Member States with respect to the notification procedure and the content of the simplified prospectus are often cited as practical barriers for cross-border integration of fund distribution.[83] For example, according to Ms White of ABN Amro:

> although UCITS is intended to facilitate the cross-border distribution of products, there is still divergence among local regulators, making the overall scene muddy (*Financial Times* 2005).

The European Commission Green Paper (2005a) also supports the view that difficulties associated with the notification procedure are perceived by the industry as a significant obstacle for further financial integration. Similar opinions can be found in, for example, the IMA and EFAMA responses to the European Commission Green Paper (IMA 2005b and EFAMA 2005).

In addition to the practical difficulties associated with cross-border registration of UCITS funds, the industry often suggests that there are differences across Member States in the interpretation of UCITS III regulations regarding the use of derivatives (eg, whether these fall within the set of eligible assets).

Christophe Girondel of Nordea Asset Management suggested that a product containing derivative instruments might be approved in one country, but encounter resistance in another, with the regulatory authorities questioning the fund's compliance with UCITS III (*Financial Times* 2006). The Association Française de la Gestion Financière (AFG) also suggests that the absence of consistency in implementation of guidelines on derivatives creates significant cross-boarder barriers (AFG 2005). Although AFG emphasises problems with the implementation of guidelines on derivatives, its major concern relates to how derivative securities fit within the definition of eligible assets.

The European Commission 2005 Green Paper notes that: 'the ongoing work to clarify definition of eligible assets is certainly one important step to achieve a harmonised understanding of investment rules characterizing the UCITS product' (p. 13). The lack of uniform implementation of measures on allowed transferable securities in the original Product Directive was addressed in CESR consultation papers in October 2005 and January 2006. However, PwC notes that there remain profound international differences in the eligibility of transferable securities (PwC 2006b).[84]

[83] Such concerns have been expressed already in relation to UCITS I; however, the situation has somewhat deteriorated since UCITS III, with its new investment possibilities.

[84] The work of the CESR might be transformed into a binding measure in order to address the differences in implementation.

## 5.3 Overview of trends in the distribution component of the value chain

### 5.3.1 Drivers of change

Oxera analysis has found mixed evidence regarding the evolution of the entire distribution part of the value chain in the European AM industry. The evidence has been more clear-cut with regard to some aspects of distribution, such as the new channels and emerging open architecture. However, this observation applies primarily to the retail sector, since the institutional sector has largely operated on the basis of open distribution for some time (ie, institutional investors and high-net-worth individuals already have access to a broad range of products from different providers).

According to the analysis presented below, trends in distribution have been triggered by several factors, two of which are of primary importance.

– Investors' changing demand, affected by prolonged bear markets and corresponding stagnation in the industry, as described in the previous section, has stimulated changes on the supply side, where managers have sought to explore and develop new distribution channels that are cheaper or more efficient at gaining access to clients. This appears to have been reinforced by competitive pressures and increasing demand for better value by investors disillusioned with traditional asset classes and the old-fashioned, integrated industry model. These pressures are likely to have forced at least some of the leading industry players to move their business models away from proprietary networks.

– Demand for greater transparency, coupled with financial innovation, which has allowed the development of new financial products and required new skills, has stimulated the creation of new functional linkages among manufacturers and distributors in order to deliver new asset classes, such as alternative or structured products. The use of product wrappers and FoF, which has been embraced by investors, has also required new models of interaction between manufacturers and different types of distributor. These changing relationships are described in more detail below.

### 5.3.2 Gradual opening of traditional retail distribution channels

All the above drivers appear to have led to the initiation of one of the potentially most significant developments in the European fund distribution—the gradual opening up of traditional retail distribution channels to non-proprietary funds.

While this potential trend has recently attracted considerable attention among market observers, it must be stressed that it cannot be described as either homogeneous or universal across Member States. Not only does such opening up take a variety of forms in the context of players pursuing different business models—and, hence, having different strategic interests along the value chain—but it also varies by degree in local markets. In some cases, it also meets resistance due to specific business interests. For example:

– some vertically integrated distributors consider the adoption of TPF as destroying their value for the group, and continue to retain the closed business model and only sell products that they have manufactured themselves;

– another group of distributors, such as Deutsche Bank, enters into strategic alliances with a limited number of external fund manufacturers and adopts the guided architecture model. These distributors allow a carefully selected set of third-party products to access their customer base, but without really exposing their customers to products that would compete with their own, in house, products.

There are also case-by-case examples of open architecture business models, where traditional distributors, such as banks, sell all available funds in the market to their clients.

### 5.3.3 Decoupling of core AM and distribution segments in vertically integrated business models

Where present, the gradual opening of traditional retail channels, coupled with developments in core AM (such as growth in outsourcing of the core AM, as described earlier), appears to have led to a severance of the strategic and business linkages between these elements of the value chain. As a result, fund distribution and manufacturing are gradually becoming functionally separate, while often remaining parts of the same financial group.

At the company level, the degree of such business separation or strategic decoupling appears to be linked to the extent to which distribution is open to TPF, and, correspondingly, to the extent that the in-house, core AM function competes with external providers. At the industry level, such decoupling is sometimes reported to lead to distributors having more power than manufacturers.

No market-wide data is available to identify such institutional or structural transformations. Therefore, where available, Oxera has relied on primary sources to test the above hypotheses.

Beyond the transformation of traditional retail networks, decoupling has also taken an alternative form: certain players that pursue the integrated business model (ie, those retaining the core AM and distribution function in-house) develop networks of financial advisors, which might be seen as new distribution channels. From outside as well as inside, these networks are managed independently of the rest of the parent group. This business model typically operates in accordance with the open architecture principle, and, most importantly, is functionally separate from the in-house manufacturer.[85] This is discussed in greater detail in section 5.5.

### 5.3.4 Evolution of IFAs

The position and role of IFAs varies significantly across countries. The most fundamental difference arises when comparing the UK with the rest of Europe. In 2005 IFAs distributed approximately 50% of retail assets in the UK, while in Continental Europe, on average, they accounted for only 7.9% of the total retail distribution.

Overall, evolution in the independent and multi-TFA segment of the distribution market appears limited. IFAs as a group do not seem to exhibit substantial growth in Continental Europe, nor do their relatively high market shares seem to be significantly challenged in the UK. Looking forward, there are mixed opinions in the industry as to whether independent players will be able to retain their market shares relative to traditional channels if the latter become more open.

There is also evidence of expansion of IFAs in the new Member States. For example, in Poland, players such as Xelion and Open Source have undertaken considerable investment and expansion. However, this expansion has not yet translated into a significant market share—IFAs remain marginal in fund distribution in Poland.

### 5.3.5 Multi-management and outsourcing of core AM as a growing distribution channel

Recent developments appear to be pointing at a substantial growth in outsourcing of the core AM (as discussed in section 4.10 above), in the form of multi-management or direct delegation of the core AM function. This is significant for the analysis of distribution insofar as it leads to greater importance of sub-advisory as a new wholesale distribution channel.

In this context a separate class of intermediaries—the 'assemblers' or 'aggregators'—appears to be emerging. These players strategically position themselves as intermediaries

[85] Importantly, business models might include both types of distribution network: a traditional network that operates a closed or guided architecture, and a network of financial advisors.

(eg, product wrappers), combining the AM expertise of different providers into a single investment product. In this model, different components of investment products can be divided among multiple players on the basis of, for example, active–passive separation. The final product assembled from different providers is then marketed to either the end-investor or another distributor (eg, an IFA of a supermarket).

The emergence of intermediaries might have significant economic implications for the AM value chain, including new risks, new regulatory challenges and the impact on the value to the end-investor. However, insofar as the intermediaries make more asset classes available to investors, and hence increase spanning, they may create value. This is discussed in further detail in section 7, where the implications of trends for consumer value creation are analysed.

## 5.4 Gradual opening up of traditional distribution channels

### 5.4.1 Evolution of traditional and alternative distribution channels in Europe

The relative significance (as measured by market share) of channels varies across countries. In certain European countries, the traditional distributors (banks and insurance firms) are more dominant than in others; correspondingly, the market shares of alternative channels (IFAs, supermarkets and assemblers) are more prominent in certain jurisdictions.

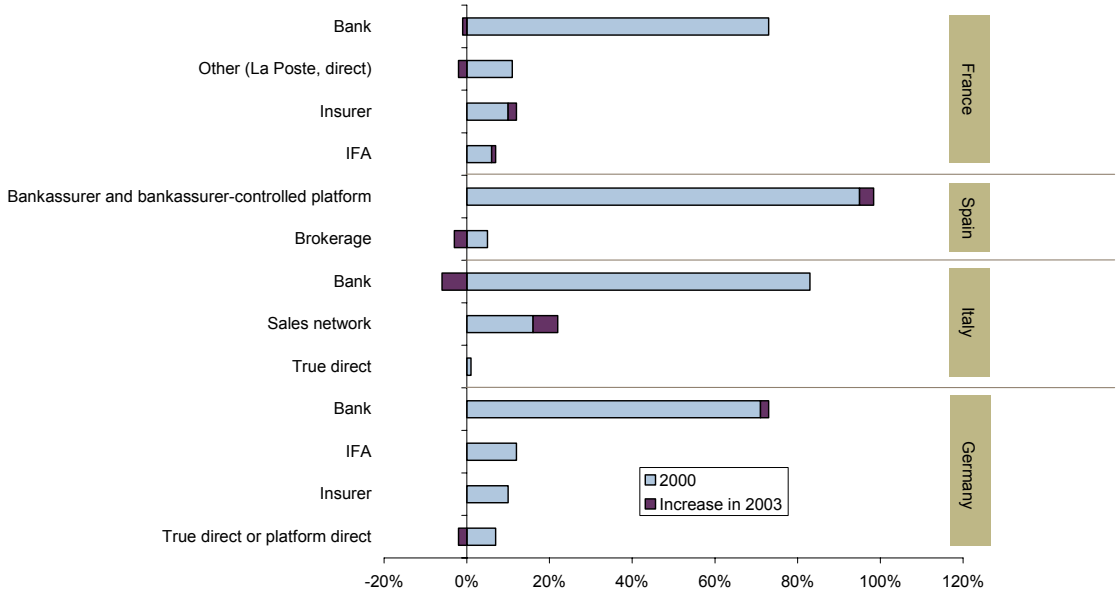
Due to potential inconsistencies in definitions of distribution channels reflected in different data sources, channel-by-channel comparison of distribution systems across countries is difficult. However, it is possible to highlight the most important differences, such as the significance of traditional channels in Continental Europe relative to the UK.

At a high level of aggregation, the data from Cerulli Associates, for example, allows comparison of the distribution systems in the UK and Continental Europe. According to Cerulli (as shown in Figure 5.6 below) banks in France, Germany and Italy were the dominant distributors in 2000. In addition, in Germany the market share of banks increased between 2000 and 2003 (from 71% to 73%).

In Spain, according to Cerulli data, banks and insurance companies controlled 95% of the overall retail fund distribution in 2000 and increased their share to 98% in 2003.

In this context, it is important to note the difference between retail or end-distributors and master distributors (such as Allfunds Bank). The growth of the latter has led to the increased importance of the function of an intermediary compared with direct manufacturer-to-distributor relationships. The implications of this change, where present, are likely to include enhanced selection of products available to the end-consumer, increased direct competition among manufacturers, and, in the longer term, potential for development of large, pan-European marketplaces for AM services.

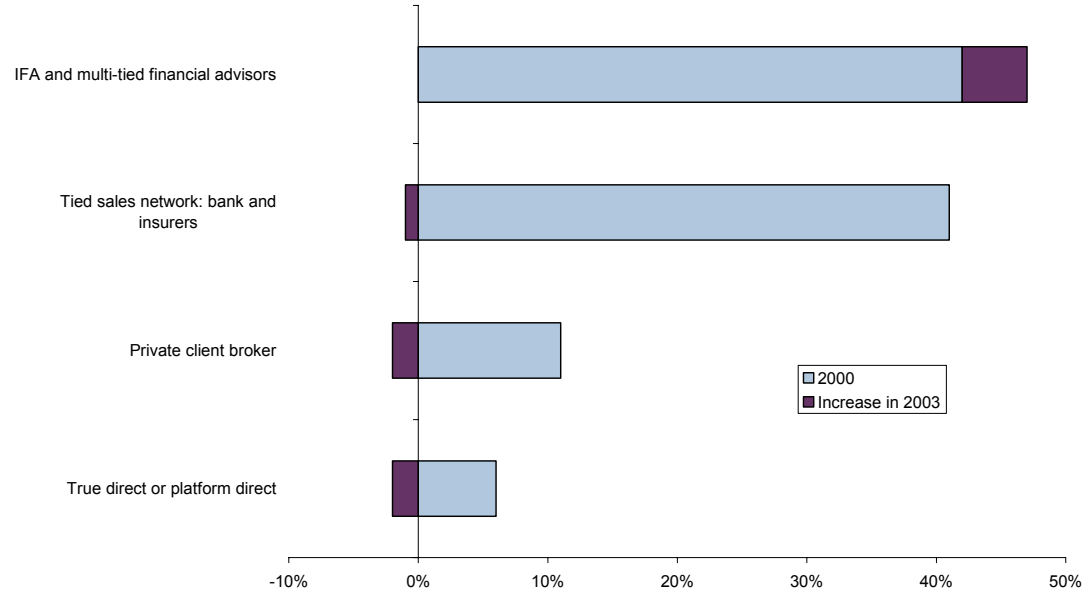
**Figure 5.6 Evolution of market shares (%) of distribution channels in selected European countries, 2000–03**




Source: Cerulli Associates data as reported by ZEW/OEE (2006) and Oxera analysis.

In contrast to Continental Europe, in the UK the traditional channels (ie, banks and insurers) historically lacked the dominant position relative to the IFAs and multi-TFAs. For example, in 2000 these channels each represented approximately 40% of total distribution. Since 2000—and, in particular, from 2000 to 2003—IFAs have further increased their market share by 5%, while that of banks and insurers has decreased by 1%.

**Figure 5.7 Evolution of market shares (%) of distribution channels in the UK, 2000–03**




Source: Cerulli Associates data as reported by ZEW/OEE (2006) and Oxera analysis.

### 5.4.2 Economic drivers triggering the decision to open up

Market observers have often suggested that the distribution networks of the traditional distributors are becoming more open and that the number of TPF sold by banks and insurers' proprietary networks is gradually increasing. Moreover, the magnitude of this development is often characterised as significant and referred to as 'pure' open architecture. However,

evidence gathered by Oxera from interviews appears to challenge this view, pointing more to a slow, gradual opening, often via the phenomenon known as 'guided' architecture, where true open architecture appears limited to the institutional market.[86]

In general, several considerations might motivate a distributor to sell external funds, including, but not necessarily limited to:

– greater net revenue from the retrocession fees compared with those captured from own manufacturers;
– wider choice available to the end-investor;
– the introduction of competition among manufacturers in order to uncover the best value and create a competitive spur to their own in-house manufacturers.

Although these motivations are characteristic of the part of the value chain that directly deals with end-investors and represent supply chain drivers, they are closely linked to the evolution of client demand. Indeed, the evolution of investor demand has been widely suggested by a variety of secondary sources of information analysed by Oxera.[87] Arguably, it represents the most important economic stimulus leading to the opening up of traditional channels.[88]

In particular, it has been suggested that:

– investors, while becoming more informed and sophisticated, increasingly base their decisions on the costs of investing in funds as well as funds' actual performance;
– demand for competitively priced and better-performing products is increasing.

Possibly influenced by the market downturn in 2000–03, these two developments in demand seem to add to investors' growing willingness to 'shop around' for funds across different providers.[89]

There is some market-wide evidence to support the above hypothesis. For example, the survey undertaken by PWM in association with Goldman Sachs Asset Management (2005) suggests growing client pressure for an enhanced product range, which might be redefining relationships between distributors and their clients (PWM and Goldman Sachs Asset Management, 2005). The analysis by PWM and Goldman Sachs Asset Management interpreted these results as one of the key drivers incentivising distributors to offer non-proprietary funds.

Although the Oxera interview programme provided broad evidence in support of this phenomenon, some interviewees expressed doubts about investors' abilities and willingness to be confronted with a plethora of choices.

More specifically, some asset managers have confirmed that retail investors' demand is evolving towards higher diversity and choice, and linked these developments to the specific opening-up strategies pursued by their respective businesses. Others, however, have indicated that particular characteristics of investor preferences, such as attachment to brand and risk aversion, suggest that investors are better served by a limited choice of investment products.

[86] While a precise definition of the differences between open and guided architecture might be difficult, guided architecture (as opposed to pure open architecture) typically refers to certain restrictions incorporated into the distribution strategy with regard to the product providers and manufacturers using a specific channel of distribution.

[87] According to Daniel Roy, CEO of Natexis Asset Management, 'the man on the street is paying more and more attention to the real quality of a product', as quoted in PWM (2006c).

[88] Selected evidence available at PWM (2005b, 2005c, 2005d and 2005e, 2006c, 2006d, 2006e, 2006f and 2006g), FT Fund Management (2006), ISSA (2005).

[89] For example, according to BNP Paribas (2006): 'in Europe, 55% of investors are having a look outside of their "primary bank" when buying financial products'. Similar views are often presented by other asset managers in publicly available strategy documents.

For example, interviewees from the Benelux countries could be described as the most conservative in this respect, whereas those from France, Italy and the UK have largely supported the above hypothesis. However, even the former have not questioned the value-added of limited opening up, or guided architecture. At the same time, neither group has predicted rapid transformation towards 'pure' open architecture.

The distinction between the choice of multiple products that are close substitutes (eg, different FTSE 100 tracker funds) and the choice between different asset classes might be important here. The demand for the latter, which fits in well with the guided architecture model, seems to be largely responsible for the opening up, although cost considerations might be contributing to the former. In the majority of cases, therefore, additional asset classes are 'bought in', but the consumer is not faced with access to a large number of versions of the same product, which might be characteristic of 'true' open architecture available through, for example, an Internet platform.

### Importance of brand for the selection of funds by retail investors in UCITS

Asset managers interviewed by Oxera have also indicated that brand is the critical component of successful distribution of funds to retail investors, and that any potential, gradual move towards open architecture is unlikely to diminish the importance of that aspect of fund distribution. It is useful to note some specific examples of comments by the asset managers interviewed with respect to the above assertions:

– a large Continental player indicated that the weakness of the fund manufacturer's brand in the UK is a significant barrier to the company's retail distribution;

– another interviewee indicated that Anglo-Saxon brands are perceived as particularly powerful in the French market, with important, consequent implications for the retail distribution strategy;

– an asset manager from Italy indicated that foreign funds are substantially more popular among local retail investors than national ones, which challenges some existing national business models in that country.

Overall, reliance on brand as the supply-side driver might imply that vertically integrated or tied distributors do not face immediate pressure to develop a product range that significantly differs from tied manufacturers' selection, which is often assumed to be fundamental to the open architecture model. Rather, it might be of importance to secure additional products from a key branded provider. If this is the case, these market characteristics might be seen as more consistent with limited opening up of the traditional distribution channels, or the guided architecture model.

However, Oxera has also found evidence of some players pursuing the open architecture model in order to secure the position of market leaders. In that respect, these players might act as a trigger of open architecture becoming a self-fulfilling prophecy.

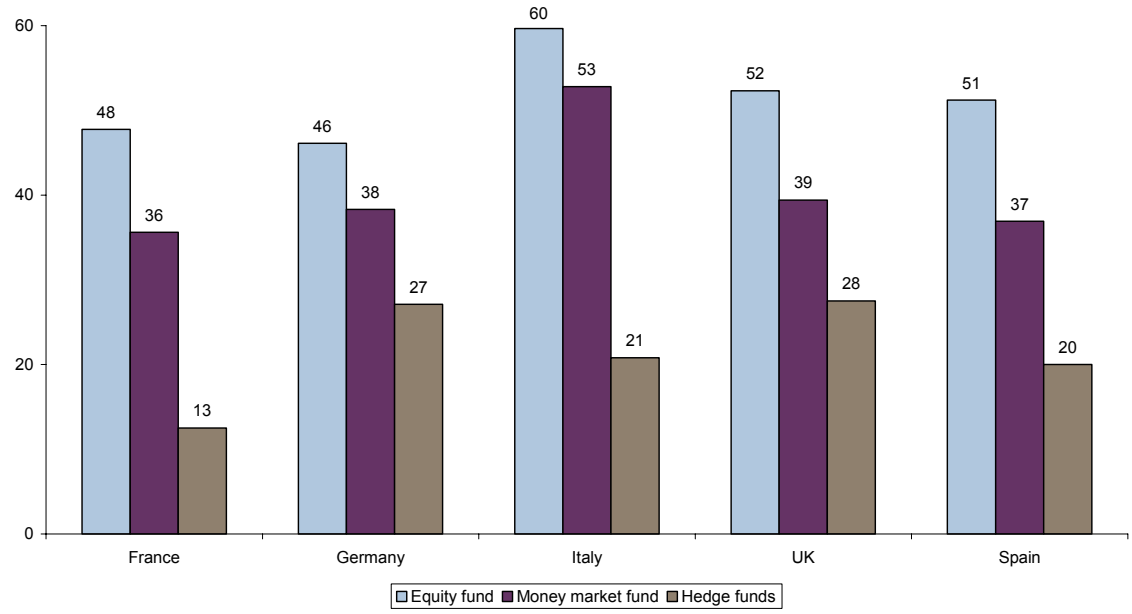
Apart from affecting the distribution model with respect to reliance on third-party products, investor reliance on brand might have an implication for retrocession fees (the percentage of management fee paid to distributor). AM firms with a strong brand might be able to negotiate lower retrocession fees when their products are distributed by third parties.

### Product choice

The hypothesis that a wider selection of products or the introduction of new products that can be offered to investors is also driving open architecture is supported by evidence from retrocession fees. In particular, 'attractive' new products appear to feature lower retrocession fees. In other words, distributors might be willing to accept lower fees in order to be able to offer clients alternative products such as hedge funds.

Figure 5.8 shows retrocession fees for equity funds (typically the most expensive type of fund in terms of the retrocession fees), money market funds (correspondingly, in general, the fund with the lowest retrocession fees, except for hedge funds), and hedge funds. According to the figure, retrocession fees for hedge funds are lower than for any other type of fund, including money market funds. This is consistent across a number of countries, including France, Germany, Italy, UK and Spain. In Italy, the difference in retrocession fees between hedge funds and money market funds reaches 32% of the total management fee; consequently, the difference between equity funds and hedge funds is even greater.

**Figure 5.8 Average retrocession paid to distributor (% of management fee), 2005**

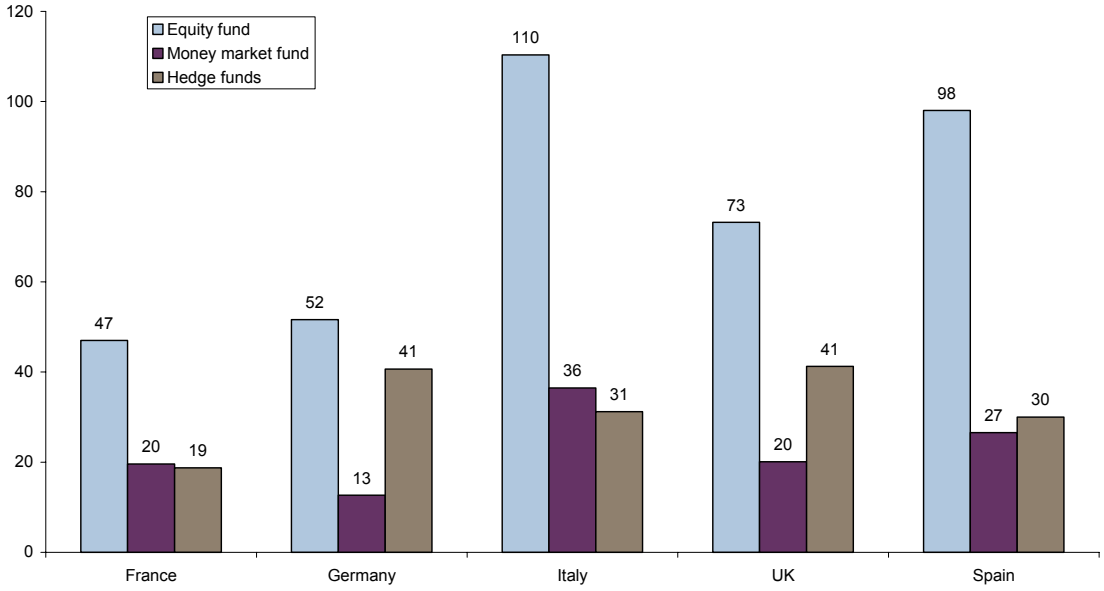



Source: Cerulli Associates data as reported by ZEW/OEE (2006) and Oxera analysis.

Hedge funds are also characteristic of relatively high management fees. According to Cerulli Associates, average management fees in France, Germany and the UK charged by hedge funds (1.5% of AuM) are the highest among all other fund types. Only in Italy and Spain do management fees for hedge funds rank second after equity funds.

When retrocession fees are expressed relative to AuM, which may be a more accurate indicator of how much the distributor actually gets paid for selling a product, hedge funds are characterised by having the lowest retrocession fees in France and Italy. In Germany, the UK and Spain, retrocession fees charged for distribution of hedge funds appear to be higher than for monetary funds, but still substantially lower than for equity funds (see Figure 5.9).

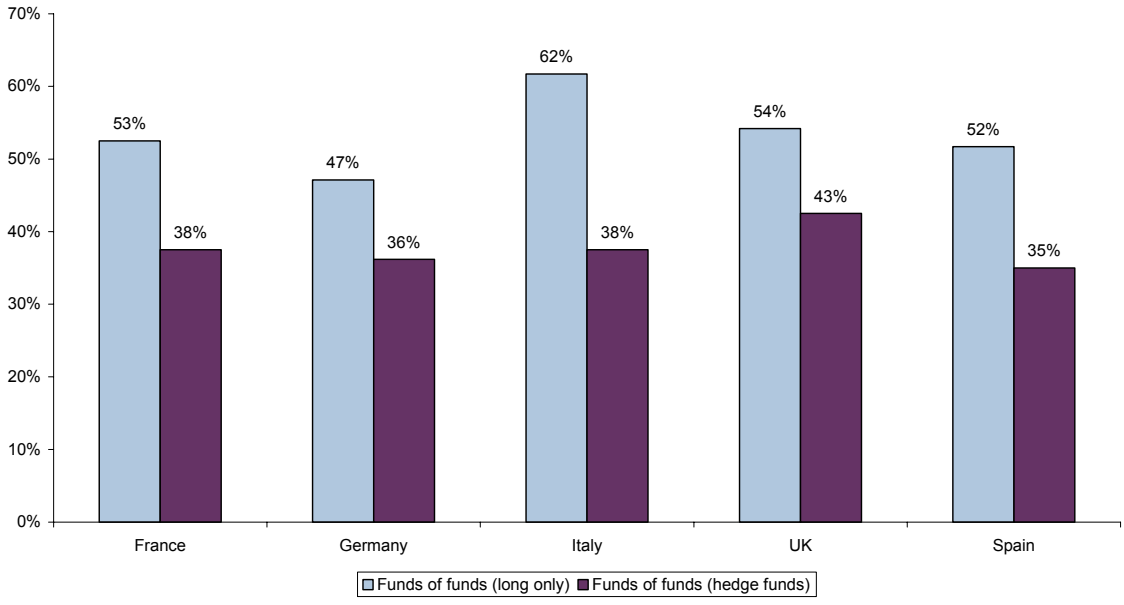
**Figure 5.9 Average retrocession fee paid to distributor (percentage points of AuM), 2005**




Source: Cerulli Associates data as reported by ZEW/OEE (2006) and Oxera analysis.

A similar relationship can be observed at the FoF level: retrocession fees charged for hedge funds are substantially lower than for normal FoF—the maximum difference, in Italy, amounts to 24% of the total management fee; the minimum is in Germany, at 10.9% (see Figure 5.10).

**Figure 5.10 Average retrocession paid to distributor (% of management fee), 2005**




Source: Cerulli Associates data as reported by ZEW/OEE (2006) and Oxera analysis.

### Passive investors and reliance on the local bank network

Some asset managers interviewed by Oxera suggested that investors are 'attached' to their local banks (eg, in France), and only reluctantly, if at all, 'shop around' for investments across different financial institutions. According to these interviewees, investors essentially

base their decisions on what is available in their local bank (particularly in regional areas, which are often seen as the main driver for retail demand growth), rather than undertaking price–quality comparison across providers (PWM and Goldman Sachs Asset Management, 2005).

According to Ralf Goetz, Head of Market Research, DVAG, the process of purchasing funds is to a large extent (70%) driven by links with the financial advisor, rather than independent and objective fund evaluation by the retail investor (PWM 2006e). This conclusion appears to be broadly supported by Oxera interviews.

A large AM player from the Benelux countries has indicated to Oxera that, at the high level, there is no clear evidence that Dutch investors are looking for wider product range or specific provider diversity. Rather, investors seem to exhibit preferences for a limited number of funds offered by their providers. According to Deutsche Bank, in Germany the reduction of complexity for retail clients is an important consideration for the determination of the distribution strategy.[90] When factored into the distribution strategy, this would suggest that limited access to TPF (guided architecture) is more attractive.

Overall, two parallel trends might be present:

– some investors demand greater product choice and exposure to alternative products. This results in distributors opening up their distribution channels to hedge funds, for example, while charging relatively low retrocession fees for those products; and, at the same time,

– many retail clients might not attach great value to a very wide selection of products—adoption of guided architecture might be helpful in this respect.

### 5.4.3 Regulation as a stimulus of third-party product distribution

In addition to economic drivers stimulating or discouraging companies from embracing the open architecture model, national regulation appears to influence the decision to open up in some jurisdictions.

For example, in Spain a change in national legislation in 2003 appears to have been a key driver in the decision of Banif, the private banking arm of the Santander Group, to open up its distribution network. Spanish investors (in this case, private banking clients), who until then had to pay a fee when switching investments from one fund to another, were allowed to benefit from the wide range of funds available without incurring additional cost. This stimulated clients' demand for open architecture, and encouraged Banif to widen its current portfolio of mutual funds (PWM, 2006d).

Although a comprehensive review of the impact of national regulation on distribution across all EU countries is beyond the scope of this study, it appears that, at least in some cases, specific national regulation might represent an important trigger.

### 5.4.4 Economic barriers to open architecture

From the perspective of a vertically integrated financial group or the traditional AM business model, there might be important considerations beyond client demand that constitute a barrier to open architecture.

More specifically, traditional distributors operate within an integrated business model. According to this model, the financial group typically includes an in-house fund manufacturer function (the core AM segment of the value chain) as well as the traditional fund distribution network (ie, retail outlets selling group products). Given the co-existence of distribution and

[90] Dominic Blum, Deutsche Bank, as quoted in PWM (2005d).

manufacturing segments under a single ownership, opening up of the distribution network might create a conflict of interest and might not represent the profit-maximising strategy for the group, especially in the short term.

In general, a financial group might benefit from increased sales from the wider range of providers and product classes offered, given competition among manufacturers. At the same time, there is a potential cost for internal manufacturers that might face margin decreases, greater competition and falling market shares. Thus, institutions choosing to sell external products often consider the opportunity cost of forgone profits on in-house products that are displaced by external funds.[91] Selling external funds that are not close substitutes for in-house products avoids this problem, while increasing the range of products that can be offered to customers. This type of profit-maximising strategy appears to be actively undertaken in practice. For example, external consultants often recommend the optimal profitability mix of proprietary and external products (eg, the two-thirds/one-third rule of thumb).[92]

Different strategies embraced by market participants in this context often depend on the player's long-term view about the degree of opening up in the market place as a whole. If the market is generally open architecture, a limited opening up may not be sufficient to retain customers. This suggests herding and follow-up behaviour that might in future trigger rapid adoption of open architecture when a certain threshold of market participation in the open model is reached.

Research undertaken for this study, supported by the structured interviews, indicates that:

– in many cases the decision to open up is part of the overall company policy, which balances conflicting incentives (distribution versus core AM)—ie, it does not maximise just the distributors' interests;

– the potential decrease in manufacturers' revenues is often weighed against the increase in distributors' revenues;[93]

– the decision to open up the proprietary distribution channel is often taken in conjunction with functional and strategic separation of distribution and core AM within the firm, or even leading to corporate separation of the different activities, resulting in fragmentation of the value chain.

A number of the large players in France, the UK and Italy interviewed by Oxera concluded that penetration of TPF would dilute the overall group value. On this basis, access to non-proprietary products was not allowed at this stage, although it has often been marked as an issue for potential review, indicating a degree of uncertainty among market participants regarding the optimal policy in an evolving market place.[94]

At the same time, some financial institutions, notably French and German players, indicate that a strategic decision has been made to proceed with the open architecture model on the basis of the same type of analysis.[95] In these cases, distribution of TPF represented a net benefit to the group, even if, for the internal provider, it resulted in a net cost, at least in the short run. Examples of such decisions include strategic positioning by Cominvest, the AM arm of Commerzbank, or DWS, the AM arm of Deutsche Bank.[96]

[91] Evidence from Oxera programme of structured interviews.
[92] Interview quoted in PWM (2005b).
[93] Evidence from Oxera programme of structured interviews.
[94] Evidence from Oxera programme of structured interviews.
[95] Evidence from Oxera programme of structured interviews.
[96] Interview quoted in PWM (2006e).

In the context of the above analysis, there might be a coordination problem associated with the first-mover disadvantage. More specifically, in the absence of reciprocal agreements, players who do not open up, but benefit from being able to sell their products into other parties' distribution networks, might have an advantage over those who open up their distribution channels.

### 5.4.5 Degree of penetration of third-party funds in traditional channels

In principle, there are several levels of penetration of a distribution network by TPF. The underlying determinant of the amount of non-proprietary funds to distribute coincides with the identification of strategic drivers to open up. Such drivers include:

– gap filling—distributors could adopt products to fill in gaps in the internally manufactured product range without exposing internal manufacturers to external competition;

– substitution—distributors could replace products in the range offered by their in-house manufacturer with external products due, for example, to poor sales or specific problems with in-house products;

– competition—related to the above, providers could add products that compete with their in-house products to seek to increase the incentives on their in-house manufacturers to become more efficient.

Important evidence regarding the extent of penetration of proprietary networks by TPF can be obtained from the analysis of depolarisation in the UK. For example, according to a survey of 19 AM providers in the UK (NERA 2002):

– nine indicated that they would consider external products in response to the regulatory allowance to sell third-party products (depolarisation);
– ten said they would not consider such products.

Of the nine positive respondents, all gave gap filling as a reason for opening up, five pointed at substitution, and only two referred to competition (several reasons per provider were allowed).

This evidence indicates that less than 50% of the respondents using in house distribution in the UK consider opening up in the first place. Moreover, the primary reason to access third-party products is gap filling. Nevertheless, the conclusions based on the above results must be treated with caution as the survey was undertaken in the UK only, and the respondents were asked to consider a particular regulatory development—depolarisation in 2002.

Although Oxera's interview programme found support primarily for the gap-filling strategy leading towards guided architecture and avoidance of direct competition between internally and externally manufactured funds,[97] two large asset managers indicated that they have recently embraced the open architecture model specifically *in order to stimulate performance of internal manufacturers*.[98] In this context, the value-enhancing competition driver clearly represents fragmentation of the value chain.

Other sources of information broadly support the above findings. For example, Daniel Roy, CEO of Natexis, indicated: 'we are also distributors of other people's expertise, when we

[97] The evidence supporting the gap-filling strategy can also be found in Funds Europe (2006b).

[98] Evidence from Oxera programme of structured interviews and publicly available secondary sources. A substantial number of interviewees indicated that they do not distribute TPF at all.

believe we don't want to do it by ourselves.' [99] Thus, in the case of Natexis, gap filling seems to be the primary motive behind opening up.[100]

This also suggests that only a limited amount of TPF is allowed to penetrate traditional distribution networks. This is further supported by the responses from other Oxera interviews. For example, a large AM player explicitly indicated that its distribution strategy is based on strategic alliances with a limited number of partners; only this limited number of TPF are then distributed through the proprietary network. This strategy fits closely with the definition of guided rather than open architecture.

Another example of guided architecture adopted by a traditional distributor is the case of ING. According to Michel van Elk, Chief Marketing Officer responsible for European distribution at ING IM:

> What we are really trying to achieve is to be a strategic partner for our distributors. … We want to expand our product range on their platforms.

He also estimated that:

> In the third-party space the vast majority, perhaps 90 per cent, of our customers are banks, mainly private banks.[101]

Oxera's programme of structured interviews also collated substantial evidence on the degree of development of open architecture in Germany. This evidence broadly supports the overall picture presented above.

At a high level, one key retail distribution channel—the savings banks—constituting approximately 62% of the retail German fund market, is following the closed architecture model by selling exclusively the funds from in-house manufacturers, such as DEKA, the AM arm of Deutsche Girozentrale Deutsche Kommunalbank, or Union, the AM arm of financial group, FinanzVerbund, which also includes DZ bank, WGZ bank and a number of other financial institutions.

At the same time, there are some specific examples of the open and guided architecture model, such as Commerzbank, with 6% of the retail funds market share. At Commerzbank every retail client can buy any fund available on the German market, but the bank recommends funds from a list of 12 preferred providers, constituting a hybrid between the open and guided architecture models.[102]

There are also a number of players (including Hypovereinsbank and Deutsche Bank)[103] that distribute TPF, but the extent of network openness can be described as very limited. Similar considerations have been discussed in secondary sources.[104]

Therefore, there is some evidence that the German market, similar to other European markets, has begun to move towards the guided architecture model, where distributors enter into strategic alliances with a limited number of third-party manufacturers, rather than provide free open access to their networks.

[99] At the time (April 2006), Natexis AM was the subsidiary of Natexis Banques Populaires and therefore represented a vertically integrated business model in which the core and distribution functions were strategically interlinked.

[100] Interview quoted in PWM (2006c).

[101] Interview quoted in PWM (2006f).

[102] Interview quoted in PWM (2006e).

[103] Another interviewee indicated that, following the acquisition of Hypovereinsbank by UniCredito, the former might strategically reposition itself in the value chain by adopting the closed architecture model.

[104] See FT Fund Management (2006).

However, Oxera has found no clear evidence so far to support the conclusion that this model might rapidly evolve into a full, open distribution model.

In general, open architecture is facilitated by contacts between multiple manufacturers and different distributors at the wholesale level. This allows distributors to consider new products for the product range that they offer in the first place before deciding what is actually offered to the end-investor. This is important since it represents a necessary, but not sufficient, step towards adopting open architecture.

Spain serves as an important example where a wholesale platform facilitates distributors' access to different products. In Spain, the majority (approximately 50–70% in 2005/06) of TPF are distributed through the intermediary platform of Allfunds Bank at the wholesale level. To some extent the platform represents the 'real' wholesale, open architecture model, since distributors can choose between approximately 140 providers (compared with an average of 6–8 preferred providers in the typical guided architecture model), while manufacturers have an opportunity to market their funds to leading fund distributors. Notably, according to the established pricing structure, manufacturers are charged for access to the platform, while participation for distributors is largely free or substantially less costly.

## 5.5 Decoupling of core AM and distribution segments in vertically integrated business models

The trend towards increased sales of TPF via traditional channels in the form of emerging guided architecture appears to be linked with the gradual, strategic decoupling of the manufacturing and distribution segments of the value chain in the formerly vertically integrated business models.

This trend is closely related to the strategy of AM companies, banks, and insurance firms in particular, based on devoting considerable attention in recent years to the analysis of their core competencies in the AM industry.[105] More specifically, many AM firms appear to have undertaken strategic reviews of their AM businesses as to whether the fund distribution and manufacturing segments can be separated functionally and/or institutionally. This process has led to considerations as to whether the segments could be decoupled from each other in order to form independent businesses pursuing different business models.

One potential implication of this trend is reported to be the increase in specialisation and stronger focus on the core skills of particular AM firms (see also section 4.10).

This transformation appears to be stimulated, at least partly, by strategic advice given to AM firms, as well as increasing competition among asset managers, particularly in the institutional market segment. Although no specific, market-wide evidence is available to support this hypothesis, apart from identified restructurings in selected cases, Oxera analysis of secondary sources and the evidence from the interviews appear to support these conclusions.

### 5.5.1 Strategic considerations of traditional business players on functional relationships between distribution and core AM segments

As explained in section 2, even in vertically integrated business models, the core AM and distribution segments can be linked by several different functional and institutional arrangements. These two segments of the value chain appear increasingly to be becoming decoupled, first and foremost, along lines that allow efficient interaction based on the pursuit of different business models and independent management for each segment, but under the joint ownership of a group holding company.

[105] Interview quoted in PWM (2005f).

There are at least two characteristic ways in which the overall fragmentation of the value chain can be achieved that are of direct relevance to such strategic decoupling:[106]

– vertically integrated players, focusing on their main competencies in the core AM segment, might decide to outsource some of the core AM function. This can be achieved through investments in FoF or MoM, or by entering into strategic alliances with other manufacturers;

– players might undertake functional 'decoupling' by restructuring the distribution segment of the value chain.

The latter might take the form of business development of a separate network of financial advisors operating on the basis of the open architecture model or the multi-tied model not being exclusively devoted to the AM products of the group. Such NINFAs are often set up as functionally independent business entities, which are said to deal with funds manufactured within the group by captive manufacturers, in the same way as with their market substitutes in the form of non-proprietary products.

At the same time, the more traditional distribution channels within the same group (eg, bank or insurance networks of offices) might remain relatively closed or pursue the guided rather than open architecture model. In this sense, NINFAs represent a new business model from the AM industry perspective, which is based on distribution that is functionally 'decoupled' from the in-house, core AM segment, but remains under common ownership.

It is important to recognise that, in line with the first of the above-mentioned characteristics of the potential process of value chain fragmentation, vertically integrated players make strategic decisions to limit their presence in the market for core AM where they do not see their comparative advantage over, for example, specialised boutiques. For example, it is often argued that insurance companies, universal banks, as well as regional banks drive the market for sub-advisory services (outsourcing of core activities).[107]

This indicates that the demand from vertically integrated players for outsourcing of the core AM function is likely to remain strong, as confirmed by Oxera interviews with selected asset managers. (See section 4.10 for a more detailed discussion of this trend with respect to the core AM part of the value chain.)

According to the second characteristic, financial groups take strategic decisions to focus on both sections of the value chain—fund management and distribution. The important aspect of this potential development is the break-up of strategic linkages and their replacement by commercial, or quasi-commercial, linkages, which might lead to the evolution of a new distribution business model (NINFA), or the opening up of the traditional distribution channel that is no longer strategically linked to the core AM value chain component.

In both cases, the core AM and distribution segments become more separate businesses, which are likely to pursue separate business models rather than a joint strategy. Examples of players that have adopted business models separated along the core distribution line include UniCredito in Italy, Commerzbank in Germany, and BNP Paribas in France. The above-mentioned business models and the essence of the core AM–distribution decoupling are addressed next.

### 5.5.2 Distribution models and value chain fragmentation

Changing client demand stimulating sales of non-proprietary funds and, reportedly, increasing competition in the core AM segment of the value chain represent some of the

[106] Interview quoted in PWM (2006g).

[107] Survey by PWM and Goldman Sachs Asset Management (2005).

most important drivers of the gradual, strategic decoupling of the distribution and manufacturing components of the value chain. As indicated above, the nature of this decoupling is likely to depend on the treatment of these two segments of the value chain as separate businesses.[108]

In principle, decoupling might originate from the decision to open up the traditional distribution network for non-proprietary funds. In this case, the in-house manufacturer is likely to face increased competition and, hence, be forced to search for alternative, third-party distribution channels elsewhere. When traditional channels fully open up (ie, adopt open rather than just guided architecture), in doing so they become functionally separated from the in-house core AM firm.

Oxera interviewees provide strong support for this reasoning. For example, a German AM player indicated that when its in-house bank, traditionally the main distributor, began to sell third-party products, the core AM segment initially faced declining market share and, in response, increased its reliance on third-party distribution channels.[109]

At the same time, evidence discussed in the previous section points to traditional distributors adopting open architecture on a case-by-case basis only, and often tending to pursue the guided rather than open architecture model. This implies that a strategic decision is often made for the distribution arm implicitly to support the in-house manufacturer. This, in turn, is not compatible with the strategic and functional decoupling of the distribution and core AM segments of the value chain.

### 5.5.3 Emergence of NINFAs and the fragmentation of the value chain

Despite different strategies associated with the adoption of guided architecture and the strategic decoupling of distribution and core AM, as described above, Oxera has identified business models where traditional channels are characterised by the guided architecture model while the NINFA model is developed in parallel. The decoupling subsequently takes place between the NINFA and the in-house manufacturer. In other words, AM firms sometimes adopt two distribution models at the same time: keeping its own tied distribution system operated along traditional lines; and creating a new distribution system operated at arm's length.

The NINFA business model can be characterised as having the following features:

– it typically belongs to a larger financial group, which includes a core AM in-house provider;[110]
– it largely operates on the basis of open or guided architecture, where funds manufactured internally are treated on the same or similar basis as the non-proprietary funds;
– sales of funds are often accompanied by advice to investors;
– the sales process can often be undertaken through an Internet platform.

### 5.5.4 Case studies

There are several examples of different business models related to the above considerations that have been adopted in practice.[111]

[108] Interview quoted in PWM (2006g).

[109] Evidence from Oxera programme of structured interviews.

[110] The fact that the player belongs to the financial group within the AM arm is reflected in the name: 'non-independent'.

[111] Other examples of large NINFAs include Boursorama operating in France and German, or DAB operating in Germany and Austria.

The case of **Xelion** provides a potential example of a clear separation along the 'core–NINFA' line, but arguably a more limited degree of 'decoupling' along the 'core–traditional network' line.

Xelion is the retail open architecture distribution channel of the Italian financial group, UniCredito, present in various European countries, including eastern Europe (Poland). As part of other activities undertaken by the financial group, UniCredito runs Pioneer, a large in-house AM firm.

Alongside Pioneer's funds, Xelion, as a distribution channel, sells a large number of funds that are managed externally, including externally managed FoF. In addition to open architecture distribution, Xelion offers investment advice to investors.

At the same time, the distribution strategy of the UniCredito financial group appears to be based on the traditional distribution channel, and the banking network in particular, following a more closed or guided architecture model. For example, the German banking network of UniCredito, the recently acquired Hypovereinsbank, distributes Pioneer's funds, but provides limited external access to its network.[112] In this case, there is a strong strategic and functional independence between Xelion, one of the distribution channels controlled by UniCredito, and Pioneer, the core AM manufacturer, which has been confirmed in the course of Oxera interviews. However, functional 'decoupling' between the core AM segment and the traditional distribution channels appears limited.

**Cortal Consors** is the retail distribution arm and brokerage firm of BNP Paribas, which operates in six European countries: Germany, France, Spain, Belgium, Luxembourg and Italy. Cortal Consors sells funds from a large number of manufacturers, including those manufactured by BNP Paribas Asset Management (which belongs to the same financial group) on the basis of the open architecture model. The sales process is typically supplemented by the provision of advisory services to investors. In addition to being a distribution channel, the company gathers funds through a number of external distribution channels, including IFAs.

At the same time, the BNP Paribas retail bank, a traditional distribution channel for the sales of BNP funds, also actively distributes non-proprietary funds on the basis of the open architecture model.[113] Thus, a functional separation appears to exist between the BNP Paribas AM firm and the captive distribution channels operating under the open architecture model. In this case, both channels appear to adopt open architecture.

In Germany, the NINFA business model is represented, for example, by **comdirect**. As an on-line bank, comdirect is listed, although Commerzbank AG retains a 79% stake. comdirect is active in three main business areas: brokerage, banking, and advisory services. Sales of investment funds are part of the banking business. Comdirect appears to operate an open architecture model, where funds from German as well as international manufacturers are sold alongside funds manufactured by Cominvest, the AM arm of the Commerzbank. Funds are marketed to investors through an Internet platform as well as through a network of offices on the ground.

Moreover, Commerzbank's traditional distribution channel, Commerzbank retail bank, also operates on the basis of the open architecture model.[114] Thus, in this case, decoupling of the core AM and distribution segments and the pursuit of open architecture by both comdirect and Commerzbank appears to be mutually reinforcing.

[112] Evidence from Oxera programme of structured interviews.
[113] Evidence from Oxera programme of structured interviews.
[114] Evidence from Oxera programme of structured interviews.

In the previous two examples, traditional channels appear to operate on the basis of the open architecture model. Thus, in each case, the asset manufacturer seems to be functionally separated from the NINFA, as well as from the traditional distribution network.

## 5.6 The evolution of independent financial advisors

This section discusses the evolution of alternative independent distribution channels: the IFAs. IFAs are different from the traditional channels (as described in section 5.3) because they are institutionally independent from AM manufacturers. Although practical definitions of IFAs occasionally vary by country, the principle behind their independence is typically associated with two factors—IFAs should:

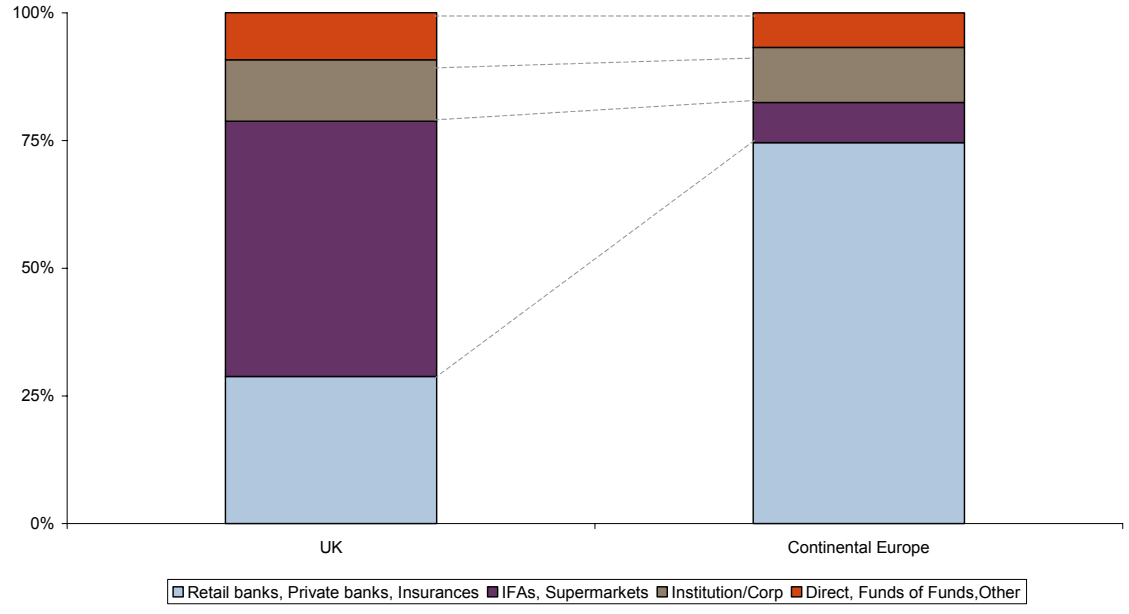
– not face any specific business incentives (other than investor demand) to distribute funds of any particular provider;

– view all funds as TPF, and consequently be regarded as an open architecture distribution channel.

### 5.6.1 The role of IFAs

The position and role of IFAs appears to vary significantly across countries. The most fundamental difference arises from the comparison between the UK and Continental Europe. On the one hand, IFAs distributed 50% of retail assets in the UK in 2005 (see Figure 5.11 below). The second-largest distribution channel in the UK was banks and insurance companies, with a market share of 28.8%. On the other hand, in Continental Europe, IFAs accounted for only 7.9%, on average, of the overall distribution in 2005; the market share of traditional channels was 74.6%.

**Figure 5.11 Distribution channels in UK and Continental Europe, 2005**




Note: 'Continental Europe' represents data for France, Germany, Italy, Spain and Switzerland. Cross-country averages for Continental Europe are shown.
Source: FERI Fund Market Information Ltd data, as reported by ZEW/OEE (2006) and Oxera calculations.

The observed differential between the UK and other European countries can be partly attributed to historical factors outside the AM industry: the introduction of the 'polarisation' regime in the UK appears to be one of the key drivers. Correspondingly, the absence of

favourable regulatory regime for IFAs and the traditional association of retail investors to local banks appear to have led to the current position of IFAs in Continental Europe.

To gain greater understanding of this differentiation, Oxera investigated the impact of the recent depolarisation in the UK and the evolution of client demand, as discussed above, on the significance of IFAs as a distribution channel in Continental Europe.

Overall, there appears to be mixed evidence on the evolution of the role and position of IFAs. A number of industry observers have suggested that banks will be increasingly dominating the retail fund distribution segment in both the UK and Continental Europe (PWM, 2005f). Others forecast a gradual increase in IFAs' market shares.[115]

### 5.6.2 Depolarisation as the economic driver affecting the evolution of IFAs in the UK

Given the recent developments in the UK regulatory regime, depolarisation might have had a significant impact on the market share of IFAs in the UK.

Under the polarisation regime, advisors could offer 'independent' or 'tied' advice. At the same time, independent advisors were mandated to offer products from the whole (or a large proportion of) market, while 'tied' advisors were limited to the products of only one provider. Since the removal of the polarisation restrictions in December 2004 (depolarisation), it has become possible for firms to offer products from the whole of the market, a limited number of providers, or a single provider.

Given that, due to depolarisation, traditional distributors can now decide to offer a limited number of third-party products, the impact of the change on the regulatory regime could be studied by analysing the potential redistribution of the market share from IFAs to traditional channels.

### 5.6.3 Evolution of IFAs in the UK

The factual evidence provided by ZEW/OEE on the evolution of distribution channels in the UK is limited. The data covers the period from 2000 to 2003. For later years (2004–09) only forecasts produced by consultants are available.

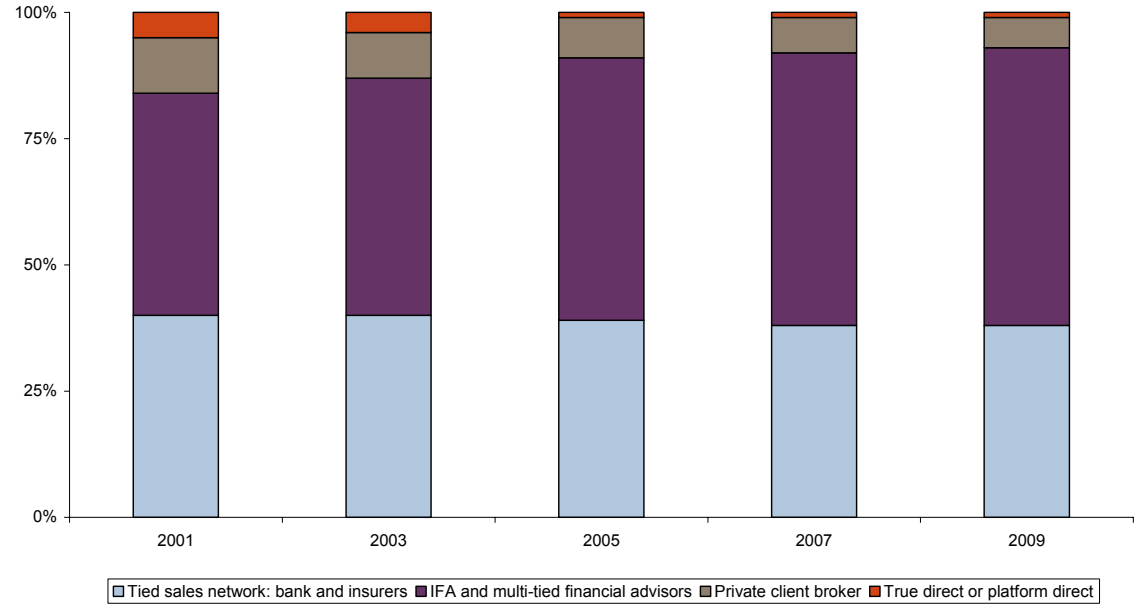
According to Figure 5.12, market shares of IFAs increased over the period from 2001 (44%) to 2003 (47%), largely at the cost of private client brokers and direct distribution channels. Banks and insurance companies have maintained a stable market position, at approximately 40%.

According to forecasts presented by ZEW/OEE (2006), IFAs' market share was predicted to increase from 47% in 2003 to 52% in 2005, and then to 55% in 2009. At the same time, the market share of traditional channels was predicted to fall slightly, to 39% in 2005 and 38% in 2009.

In addition, the market share of private clients' brokers and direct channels was expected to fall to 6% in 2007 and 1% in 2009, correspondingly.

[115] Cerulli Associates data as reported by ZEW/OEE (2006).

**Figure 5.12 Market shares of distribution channels in the UK, 2001–09**




Note: Actual data is shown for 2001 and 2003, and forecasts by the original data provider for 2005, 2007 and 2009. The distribution of market shares across channels for 2005 shown is different from that shown in Figure 5.11. This is driven by three factors: Figure 5.12 reports forecasts produced in 2003 and Figure 5.11 estimates produced in 2005; the data sources are different (FERI for Figure 5.11 and Cerulli Associates for Figure 5.12); and the way distribution channels are defined by FERI and Cerulli Associates does not allow for direct comparability.
Source: Cerulli Associates data, as reported by ZEW/OEE (2006), and Oxera calculations.

However, since these forecasts were produced before depolarisation, they are unlikely to reflect the impact of the change in the regulatory regime beyond rational expectations at the time.

Since the primary data on the evolution of IFAs in the UK is very limited according to ZEW/OEE, Oxera has considered a number of alternative sources, including secondary sources, regarding the evolution of IFAs in the UK.

While consistent data is difficult to obtain, industry commentators have often expressed specific views about the future of the distribution system in the UK. Willem van Someren Gréve, of Robeco Asset Management, for example, suggested that banks will become the dominant distributors and will eventually take over the leading position of the IFAs. The drivers behind this potential development were suggested to include the approach to investing in client relationships and the new opportunities open to retail banks by depolarisation:

> most independent financial advisors (IFAs) are not very good because they are too focused on distribution margins. The bank knows best what an investor can afford. A financial advisor just wants to make a quick product sale because he or she gets paid on a one-off fee basis. The bank makes its money from a customer over the period of a lifetime.[116]

The indirect evidence on the potential impact of depolarisation was provided by a survey undertaken by NERA in 2002. Ten out of 19 respondents representing vertically integrated players indicated that they would not consider allowing TPF to be sold via their distribution networks in the case of depolarisation. This represents indirect evidence that, in 2002,

[116] PWM (2005f).

depolarisation was not expected to result in substantial redistribution of market shares in the UK.

Additional evidence is provided by a survey of European fund distributors and manufacturers undertaken in April 2005 (Magnus Spence Financial Research Corporation, 2005), which found that IFAs are expected to remain the main distribution channel in the UK over the next five years.

### 5.6.4 Potential drivers of the evolution of IFAs in Continental Europe

In Continental Europe IFAs represent a significantly lower market share of distribution than in the UK. Correspondingly, there is potentially greater scope for growth of that distribution channel compared with the UK. Looking forward, demand- and supply-side drivers could be reasonably expected to trigger such growth.

#### Demand-side drivers

The evolution of demand-side drivers and the supporting evidence were discussed in section 4.1. The changes in the demand profile are being driven by two primary factors:

– investors seem increasingly to demand a wider range of investment products and of fund providers;

– greater emphasis seems to be placed on fund performance and cost than on the brand of the provider and/or recommendation from advisors.

Changes in demand, accompanied by limited willingness of traditional channels to open up to respond to the hypothetical changes in demand (see section 4.1 for evidence) might be expected to create some market opportunities for IFAs, although, if investors' needs are fully serviced by the guided architecture model, such opportunities might be limited. However, as investors look for the best value/cost ratio, IFAs might be expected to become attractive in the same way as they are in the mortgages market, for example.

#### Supply-side drivers

Supply-side drivers refer to developments in core AM that might have an impact on fund distribution—in particular, the development of IFAs. Prolonged bear markets in 2000–03 and the corresponding decrease in AuM have placed manufacturers in a position whereby they need to actively search for ways to boost sales. According to a global survey by KPMG (2003), the search for new distribution channels will be the primary source of growing AM business—this opinion was mentioned by around 60% of respondents. This indicates that there may be additional opportunities for alternative channels, such as IFAs, to increase their relative market share.

At the same time, there is no regulatory incentive for the development of IFAs in the form of polarisation in Continental European countries. This might limit the potential for this channel to develop to the levels observed in the UK.

### 5.6.5 Evolution of IFAs in Continental Europe

To provide a full overview of the evolution of IFAs in Continental Europe (conditional on data availability), Oxera has considered several information sources, including comments from industry stakeholders, surveys of market participants, and data provided by ZEW/OEE (2006).

For example, according to Willem van Someren Gréve, of Robeco Asset Management, in five years' time, banks throughout Europe are expected to reach an average market share of 70–80%, whereas the market share of IFAs is expected to decrease further. The main reason for this is reported to be similar to that outlined in the discussion for the UK.

In Germany and the Netherlands, Mr van Someren Gréve has predicted that potential gains in IFA market shares might be limited:

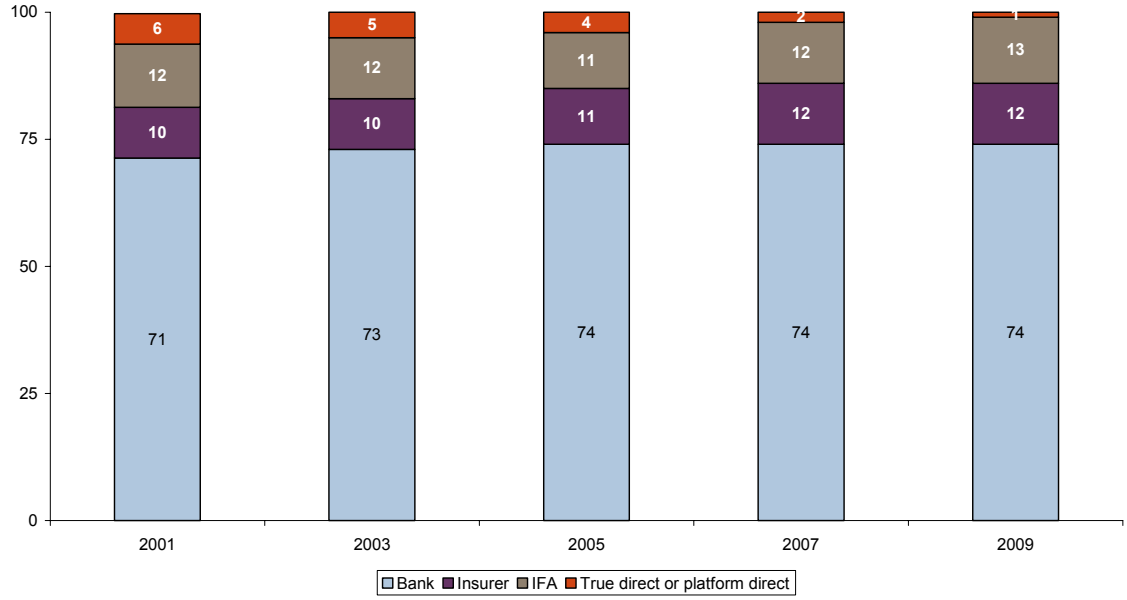
> Where banks over-dominate they will lose a bit of market share. Banks cannot make seven million people happy all at one time, so there will always be some customers who go elsewhere, thinking that the grass will be greener, only to find out that it is not after all.[117]

The survey of European fund distributors and manufacturers provides further evidence that banks are likely to remain dominant distributors over the next five years (Magnus Spence Financial Research Corporation, 2005). However, no direct evidence is provided on whether IFAs will gain or lose market share. In terms of cross-country differences, in Germany and Switzerland the future dominance of banks has been strongly underlined.

Oxera has also undertaken some analysis of the data provided by ZEW/OEE (2006) on this issue, although the available data appears limited. The data from Cerulli Associates covers the period between 2000 and 2003 only. For the period from 2004 to 2009 consultants' forecasts are available.

Figures 5.13 to 5.16 below present the evolution of distribution channels from 2000 to 2003 according to data collected by Cerulli Associates and its forecasts up to 2009.

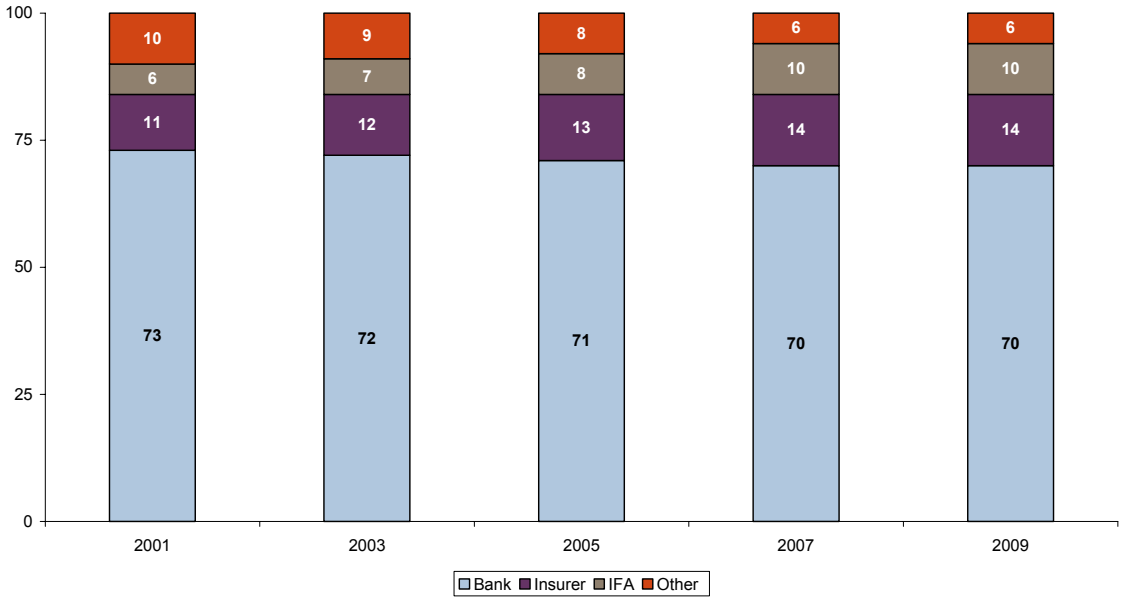
**Figure 5.13 Evolution of market shares (%) of distribution channels in Germany, 2001–09**




Note: Actual data is shown for 2001 and 2003, and forecasts by the original data provider for 2005, 2007 and 2009.
Source: Cerulli Associates data, as reported by ZEW/OEE (2006) and Oxera calculations.

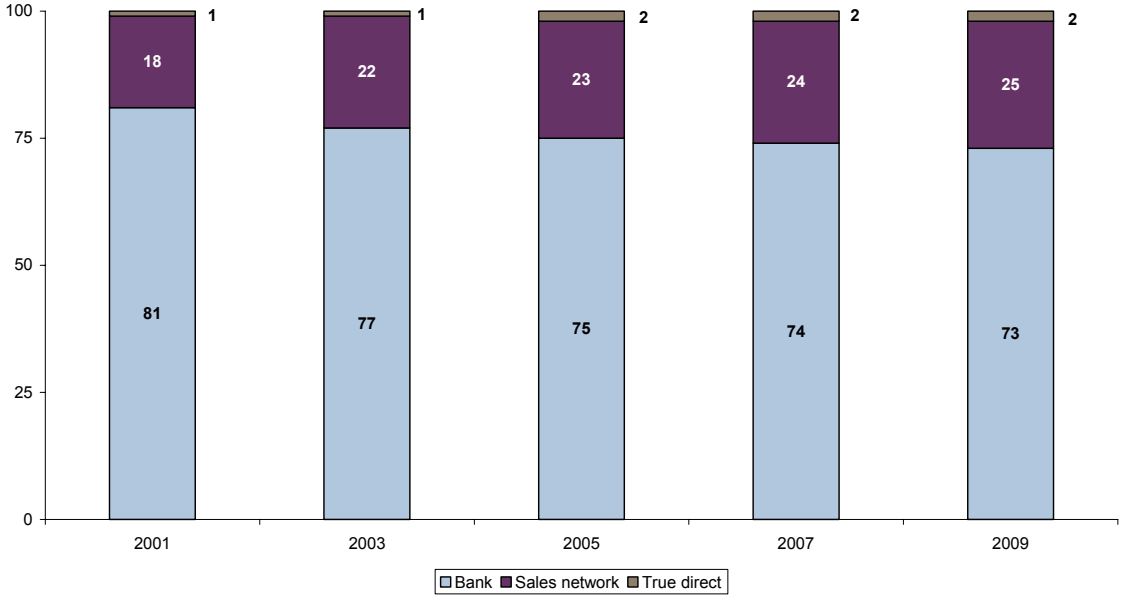
[117] PWM (2005f).

## Figure 5.14 Evolution of market shares (%) of distribution channels in France, 2001–09



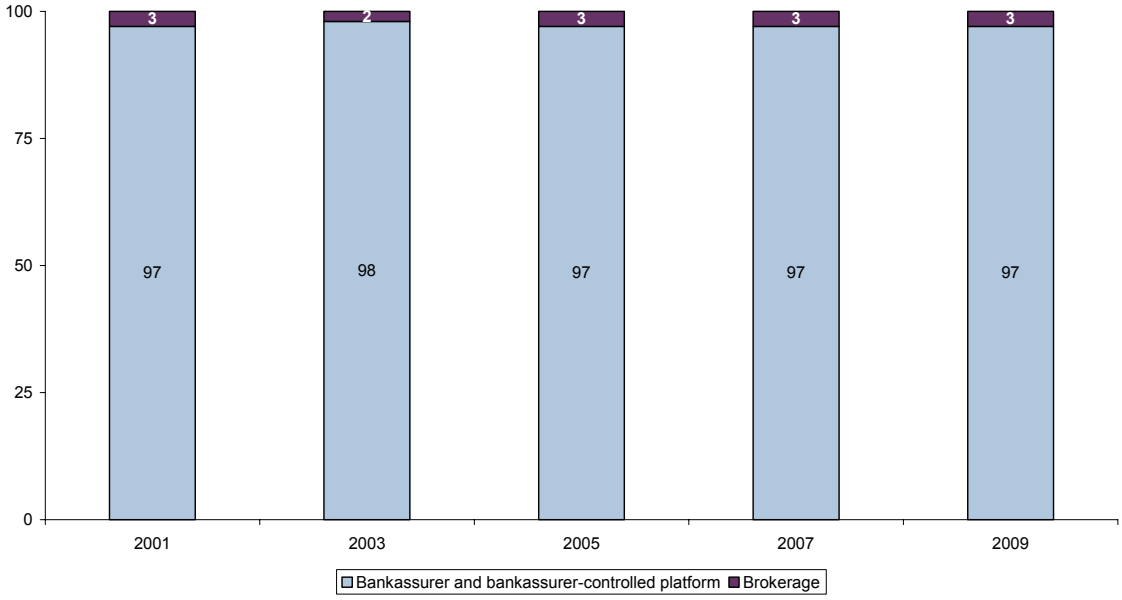

Note: See note to Figure 5.13.
Source: Cerulli Associates data, as reported by ZEW/OEE (2006), and Oxera calculations.

## Figure 5.15 Evolution of market shares (%) of distribution channels in Italy, 2001–09




Note: See note to Figure 5.13.
Source: Cerulli Associates data, as reported by ZEW/OEE (2006), and Oxera calculations.

**Figure 5.16 Evolution of market shares (%) of distribution channels in Spain, 2001–09**




Note: See note to Figure 5.13.
Source: Cerulli Associates data, as reported by ZEW/OEE (2006), and Oxera calculations.

Data for IFAs is available for Germany and France. Over the period from 2001 to 2003 the market share of IFAs in Germany appears to have remained stable, at 12%, and in France it increased from 6% to 7%. According to Cerulli forecasts, IFAs' market share is predicted to increase to 13% in 2009 in Germany and in France to 10%.

Overall, the role of IFAs is predicted by Cerulli to expand, although neither the actual growth from 2001 to 2003 nor the predicted change appears very significant.

In Italy, the data covers banks, 'sales networks', and 'true direct'. 'Sales networks' appears to refer to the networks of NINFAs such as Xelion.

Although NINFAs are not institutionally independent from the in-house group manufacturers and/or traditional group distribution channels, they can be treated as an alternative channel of distribution from the perspective of the overall distribution system. The share of NINFAs increased from 18% in 2001 to 22% in 2003, and is predicted to increase to 25% in 2009, underlying their growth potential.

In Spain, banks and insurance companies control approximately 97% of the retail fund distribution. Their share was relatively stable from 2001 to 2003, and is predicted to remain the same until 2009.[118]

## 5.7 Multi-management and outsourcing of core AM as a growing distribution channel

It is widely reported in the professional community that the European market for sub-advisory services (outsourcing of the core AM function) and multi-management functions (FoF and MoM) is growing substantially.

From the perspective of the outsourcing asset manager, multi-management and sub-advisory functions are potential platforms for outsourcing components of the core AM

[118] Around 50% of the third-party fund market in Spain is controlled by an institutional distribution platform: Allfunds Bank.

function. From the perspective of the AM firm providing AM services in a specific area, multi-management represents a new distribution channel.

Therefore, it appears reasonable to assume that the growth of core AM outsourcing (in the form of multi-management or sub-advisory arrangements) represents an important development in the distribution segment of the value chain. It can also be viewed, in conjunction with the increase in sales of TPF, as part of a larger phenomenon—the development of open architecture in funds distribution.

### 5.7.1 Strategic responses by the industry

To investigate this phenomenon, Oxera has analysed adoption of multi-management as industry's strategic response to the challenge described at the beginning of the report and concerning drivers of trends.

First, the evidence obtained allows an investigation at the general level of which business models appear to be most compatible with outsourcing of core as distribution channel. From the perspective of the core activity of fund management, selling products to intermediaries or other managers (for example, to MoM or FoF funds) is a new and potentially attractive way of distributing products.

Second, interviews with asset managers suggest that this development leads to the evolution of new types of player in the AM industry—the assemblers, aggregators and product wrappers. Although these terms occasionally refer to more specific functions undertaken within the multi-management context, their impact on the development of distribution appears functionally similar.

Intermediaries and asset managers acting as intermediaries use several criteria to select sub-advisors and providers of core AM services in specific product categories. According to the PWM survey (2006), long-term performance was cited by 69% of respondents as the most important factor for selecting the sub-advisor when outsourcing AM of selected product categories. The next two key criteria were reported to be the management team (49%) and specialisation (44%). Parameters such as size, product range and brand were not seen as critical.

This evidence seems to suggest that AM firms operating boutique-style business models, as defined earlier, are likely to be the major users of the multi-management and core outsourcing as the new distribution channel.

The results of Oxera's interview programme indicate that this new type of player is becoming increasingly active in the AM industry and its associated distribution function might grow in importance. More specifically, it appears that the role of an assembler as an intermediary and distributor of funds, which combines the process of wrapping and component-by-component assembly of new products managed by a number of providers active exclusively in the core AM segment, is increasingly dominant in the institutional market.

Further differentiation between providers can be undertaken on basis of the alpha–beta distinction of product specialisation. In this case, a share of funds is outsourced to managers that deliver the active 'alpha' component of AM and the rest to those providing passive management. The assembler, or wrapper, then combines the active and passive parts into one product and distributes to the investor or another distributor. This indicates the broad reach of assemblers and their role in increasing the number of functional linkages between manufacturers and distributors.

As a distribution channel, assemblers can be characterised according to several distinct features.

– The provider of AM services faces an intermediary (eg, the FoF), rather than the end-distributor. It is apparent that the functional nature of this channel makes it highly

competitive since assemblers are reported to research more actively and compare funds available in the market place in order to maximise the value of their particular FoF.

– The progressive growth of the intermediation channel creates additional opportunities for AM firms to distribute their management expertise. In particular, this is reported to reduce the need to set up their own costly retail distribution systems or attempt to enter existing third-party channels, which has proved to be a challenge to many asset managers. The latter might be associated with additional costs if the traditional channels are relatively closed.

– The open architecture nature of distribution through assemblers might also be seen as facilitating cross-border distribution.

From the financial markets' perspective, this development should lead to enhanced product range, greater spanning, and better tailoring of funds to specific risk appetites of different investors through the creation of additional linkages between industry participants and decreasing functional fragmentation. However, it is not clear whether it leads to greater market efficiency given the potential additional layers of costs it creates.

## 5.8 The role of on-line distribution

The sale of funds via Internet platforms might become one of the most important distribution channels in the future; however, current evidence indicates limited use of this channel. Nevertheless, independent, multi-tied and non-independent advisors often already offer this service; fund manufacturers, in the absence of a proprietary distribution network, might also market their funds on line.

Internet-based sales of funds appear to represent an increasingly important aspect of the distribution system as a whole, since they allow AM firms to access investors directly, bypassing end-distributors. To a larger extent, this could be viewed as the only way for AM firms without proprietary distribution network to circumvent the use of distributors as intermediaries, and to market funds directly.

On-line funds sales are generally not associated with the provision of advice. Therefore, investor demand for advice might be an important driver for the Internet funds distribution.

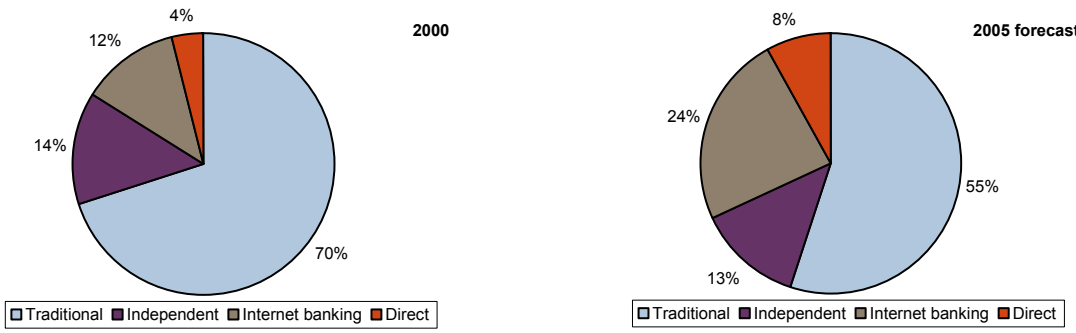
According to BNP Paribas: '40% of investors rate "fair advice", suited to their personal needs, as the most important requirement from financial institutions in Europe'.[119] This suggests that at least 40% of investors are likely to consider Internet distribution unattractive for several reasons.

The evidence regarding Internet distribution can be analysed largely on a case-by-case basis. Oxera interviews indicated that the Internet is not currently perceived as a significant distribution channel. Moreover, interviewees indicated that they do not expect it to become so in the future.[120]

According to data from BVI, the German Association of Investment Companies,[121] in 2000 Internet banking accounted for 12% of total funds sales in Germany; its market share in 2005 was forecast to increase to 24%, as shown in Figure 5.17.

[119] The BNP Paribas presentation in turn references Forester Research, January 2006.
[120] Evidence from Oxera programme of structured interviews.
[121] PwC (2002).

**Figure 5.17 Mutual funds market share (%) of distribution channels in Germany, 2000 and 2005 forecast**

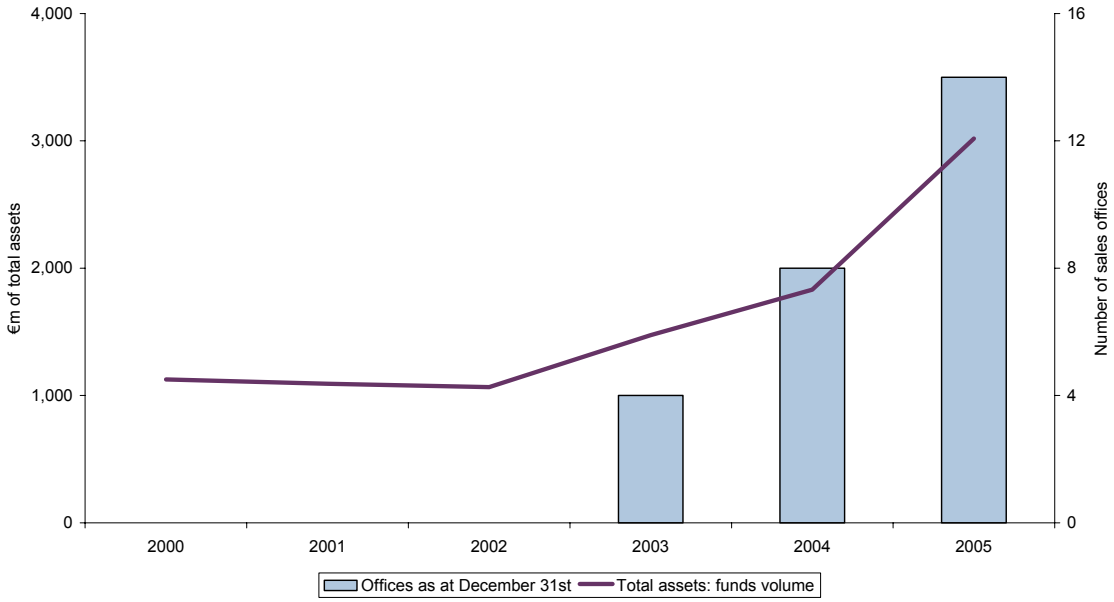



Note: 'Traditional' comprises banks (63% in 2000), building and loan associations (2%) and insurance (5%); 'Direct' refers to distribution from the AM company directly. The forecast produced in 2000 is reported for 2005. Even though different data sources are used in Figure 5.11 and 5.17 and market share estimates therefore vary, this difference can be approximately reconciled. Figure 5.11 does not show sales via the Internet banking channel separately. Adding up the share of Internet banking and the share of traditional channels in 2000 as per Figure 5.17 (82%) gives the number comparable to the share of banks and insurance firms as per Figure 5.11 in 2001 (81%). The difference in estimates of market shares of the direct channel and IFAs seem to be driven by the use of different data sources.
Source: BVI data and Oxera calculations.

In this context, it might be particularly informative to analyse any data available at the company level. For illustrative purposes, Oxera has considered the evolution of on-line funds distribution for the on-line bank, comdirect.

According to Figure 5.18, on-the-ground sales offices seem to be the major source of the growth of retail assets gathered by comdirect over the period 2003–05. This indicates that funds distribution might be more successful through face-to-face sales rather than the Internet.

**Figure 5.18 Total funds distributed by comdirect (€m of total assets) and number of sales offices, 2000–05**




Source: cominvest AG (http://www.comdirect.de/) and Oxera calculations.

Overall, there appears to be insufficient data to reach a firm conclusion on the evolution of the Internet as a distribution channel. On the one hand, Oxera interviews, evidence from the

case study, and the characteristics of investor demand, seem to suggest that the Internet is unlikely to increase in relative significance. At the same time, BVI forecasts indicate that the share of on-line distribution was expected to increase over the period from 2000 to 2005 (no projections are available for the period after 2005).

# 6 Identification and analysis of trends in the back office

In accordance with the methodology outlined above, trends in the back office are analysed in conjunction with their impact on strategies of AM firms. Given that the primary objective of the back office is to enable value creation in other elements of the value chain, the back office can be expected to evolve in response to trends in the core AM and distribution segments. Additional back-office trends can then be differentiated on the basis of their knock-on effect on the value chain.

– Trends in core AM and distribution (for example, customers' increasing concern with the costs of the AM processes) might require individual firms to increase efficiency in the back-office processes through **technological improvements**—for example, adoption of straight through processing (STP) methods instead of manual operations. Technological improvements could create value by reducing operating costs and decreasing risks; however, they are largely 'passive' developments that are unlikely to have substantial further impact on AM firms' strategic decisions.

– Trends in the value chain might also lead to the **emergence of new types of players** that provide back-office solutions as their primary business. In contrast to technological developments at the firm level, this is likely to have a significant impact on firms' strategies, in particular with respect to fund distribution, as well as potentially changing the 'topography' of the linkages in the industry and stimulating the evolution of the AM marketplace.

Therefore, the analysis of trends in the back office includes an overview of developments at the level of individual firms, as well as considering the impact of trends in other elements of the value chain on the infrastructure of the market for investment funds. In particular, the latter describes the evolution of the institutional distribution platforms.

Insofar as trends in the back office examine specific technological developments, they are not a focus of this report. Instead, the analysis below concentrates on the high-level economic implications of developments in the back office in terms of their importance for other parts of the AM value chain. Further implications of back-office trends are analysed in section 7.

## 6.1 Developments in the back office affecting individual firms' efficiency

Oxera interviews, desk research, as well as available data, indicate that the main characteristics of the back-office part of the value chain to date include the following.

– There is evidence to support the proposition that there is a mature market for back-office outsourcing, in terms of services and products.

– The share of assets outsourced to third-party providers (custody, transfer agency, administration) increased from 2001 to 2005.

– The market for back-office outsourcing, perceived as relatively concentrated, has become less concentrated over the same period.

– Developments in funds distribution seem to create substantial pressure on certain back-office functions (ie, those executed by transfer agencies).

– These developments, together with lagged responses in the back office, might be responsible for potentially increasing operational risks in funds processing, and might create barriers for further development of open architecture and cross-border trade.

A schematic summary of the issues related to the developments in the back office, which are of relevance to this study, is presented in Table 6.1. This shows developments in the value chain and their potential implications for operational risks, costs and value creation in the industry. For example, as described in section 5.4, traditional distribution channels are gradually opening their distribution networks and increasing the number of fund providers' products they retail. Where there is insufficient automation of fund processing operations, increasing multilateral distribution, as observed in the industry, might lead to greater operational risks as well as higher costs for both distributors and asset managers. The main trends are described in greater detail further below.

**Table 6.1 Developments in the back office: summary of the issues**

| Developments in the AM industry value chain as drivers | Challenges for back office as enabling function | Implications |
|---|---|---|
| Increasing cross-border distribution<br>Increasing number of intermediaries<br>Evolution of assemblers | Distribution becomes increasingly multilateral<br>Challenges for processing systems<br>Requirements for greater synchronisation of standards and automation of processes | Lack of standardisation in order processing might be a barrier to further development of financial integration and open architecture<br>Additional costs due to lack of standardisation and automation<br>Potential risks due to lack of automation<br>Potential increase in systemic risks, but greater quality of products |
| Increasing use of derivatives by UCITS funds | Challenges for risk management, pricing[1] and control | Potentially increasing operational risks<br>Implications for fund mis-pricing, breach of client guidelines, misdealing |
| Geographical concentration of core AM functions | Geographical concentration of brokerage/trading functions | Cost efficiencies from economies of scale; synergies |
| Strategic positioning along the value chain; outsourcing of non-core activities | Careful optimisation of the level of outsourcing (mature market) | Cost efficiencies from economies of scale, reduced operational risks<br>Management of potential liabilities and operational risks |
| Development of the mature market for back-office outsourcing | Cost transparency of back-office elements<br>Re-coupling of back-office activities | Cost efficiencies from economies of scale, reduced operational risks |

Note: [1] Largely applies to over-the-counter (OTC) derivatives.
Source: Oxera.

### 6.1.1 Back-office outsourcing: a mature market?

Outsourcing of back-office functions has always been a component of AM firms' strategic considerations. Oxera interviews indicated that recent developments have led to a situation where the market for third-party custody, fund administration and transfer agency seems to

have reached a stage of relative maturity.[122] This can be characterised by a number of elements:

– a relatively high and stable share of assets outsourced to third-party providers for back-office functions;
– well-established linkages between the AM firm interested in outsourcing and the independent providers of back-office functions;
– an established set of products and services, and relatively good understanding among potential clients of the available solutions;
– multiple advisory and consulting services available to asset managers with respect to back-office outsourcing;
– the existence of a number of well-defined standardised outsourcing strategies.

With regard to the level of outsourcing, as shown in Figure 6.2, 39% of total assets in the EU were outsourced to third-party global custodians[123] in 2005; third-party global transfer agents serviced 23% of European assets, while 25% of assets were outsourced to third-party global administrators. At the individual country level, the degree of outsourcing is substantially higher in selected cases. This provides evidence to support the argument that there is a pan-European market comprising global players alongside national markets.

Oxera interviews and secondary sources of information provide evidence that, as a result of clients searching for outsourcing solutions, a market has developed for consulting services, provided by consulting companies acting as intermediaries between clients and providers. The presence of these intermediaries contributes to market efficiency through the provision of differentiated forms of the 'outsourcing' product and the facilitation of product innovation.

According to many industry commentators, standard outsourcing strategies still allow the potentially heterogeneous requirements of various types of client to be met. These include 'lift-out' and 'component' outsourcing.

– Lift-out—the physical location of the client's back-office activities remains unchanged, but the activities and personnel are transferred to the provider. The provider then contracts the services back to client.[124]

– Component outsourcing refers to the gradual component-by-component transfer of the back-office functions to an external provider.[125] There could be one or more external providers for various component functions in the back office. In some cases, one function is outsourced to two separate providers.[126]

To summarise, customers considering outsourcing some back-office functions appear to have access to a developed, mature market with a well-defined set of available products. Nevertheless, this does not imply that the market for outsourcing is stagnant. In particular, some market participants point at the fact that many outsourcing services are still inadequate and there is considerable need for further innovation and development of new approaches.

[122] Evidence from Oxera programme of structured interviews.

[123] Global custody is a service whereby a single custodian assumes responsibility for the custody of a client's portfolio of international securities and cash—ie, the custody service extends beyond the custodian's and client's home base.

[124] For example, in 2005, Axa Investment Managers lifted out its entire middle and back office to be managed by State Street, along with 300 employees and £300 billion of portfolio assets. Also, in 2005, Standard Life Investments entered into a lift-out deal with Citigroup. See FT Mandate (2005c).

[125] For example, RCM, UK chose a component outsourcing strategy, while outsourcing its back office to the Bank of New York. See FT Mandate (2006).

[126] For example, a pension fund in the UK follows a dual custodianship model. See IPE (2006).

### 6.1.2 Back-office outsourcing: trends

#### Drivers for back-office outsourcing

The decision to outsource might be driven by an AM firm wishing to outsource in order to exploit potential opportunities for greater cost efficiencies. Also, given that the back office is largely a support function for other parts of the value chain, developments in core AM and distribution might pose new challenges to certain back-office functions and consequently trigger the decision to outsource them.

*Cost efficiency*

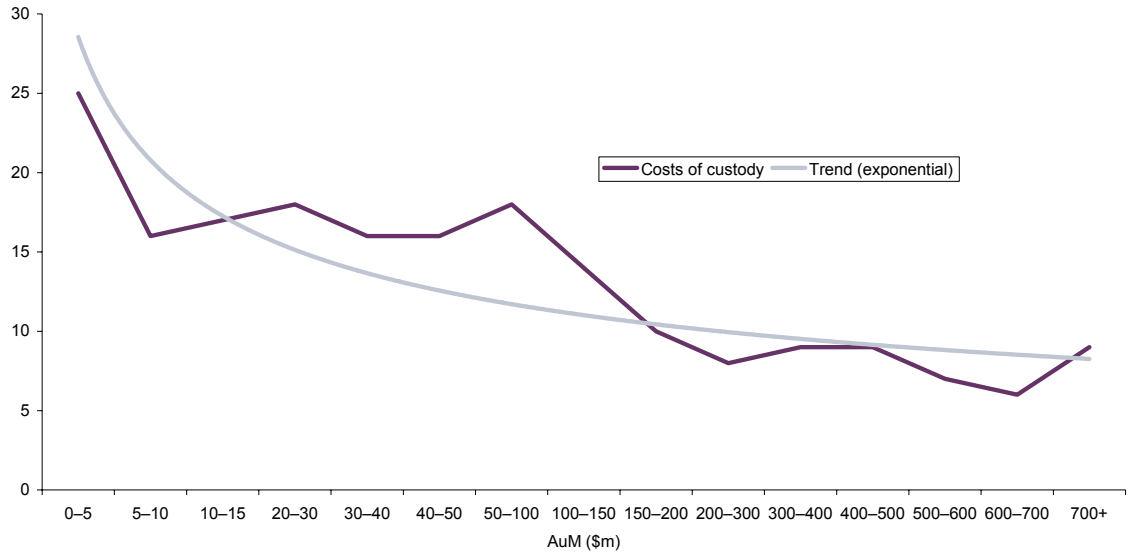
According to Oxera interviews,[127] a key driver of back-office outsourcing is the potential to achieve unit cost reductions. These might arise from several sources, including:

– transformation of fixed costs into variable costs: outsourcing contracts are typically structured to allow largely fixed costs associated with back-office functions for the client to be converted to variable costs (where the cost driver is the value of AuM outsourced);

– economies of scale: from the provider's perspective, the fixed nature of back-office costs might allow lower unit costs to be achieved through the accumulation of a larger portfolio of assets from a number of different asset managers if the provision of back-office functions exhibits economies of scale.

To illustrate the 'fixed cost' argument, Figure 6.1 depicts the estimated relationship between AuM in equity funds and the costs associated with a particular back-office function (custody). The figure suggests that, in relative terms, higher underlying AuM are associated with lower unit costs of custody. In particular, for equity funds with AuM less than $5m, the costs of custody represent 25% of AuM; while for funds with AuM within the range of $600–$700m, the costs decrease by more than four times in relative terms, to approximately 6% of AuM.

**Figure 6.1 Cost of custody by AuM for equity funds (bp)**




Source: Oxera analysis of Fitzrovia data as reported by CRA.

At the same time, Oxera interviews have provided evidence that challenges the cost-reduction potential of outsourcing. A number of interviewees indicated that outsourcing deals available in the market are not always associated with benefits from higher cost efficiencies.

[127] See also Bank of New York (2005), KPMG–CREATE (2004a), PwC (2003a), and Edhec (2003).

For example, a large AM player has indicated that they were not offered any deal that was cheaper than undertaking back-office functions in-house. Moreover, they suggested that they were not aware of any successful outsourcing deal at all.[128] According to this interviewee, the major reasons for outsourcing are 'negative'—eg, it might be an attractive solution if the in-house team lacks expertise or in the absence of the appropriate IT platform. These can be contrasted against 'positive' reasons, such as increasing operating efficiency and achieving cost reductions.

To summarise, even in the presence of economically sound arguments in favour of back-office outsourcing (eg, the potential for economies of scale), AM firms seem to have mixed views on whether, in practice, back-office outsourcing can generate cost reductions.

### Developments in other parts of the value chain

As noted above, the key role of the back office is to provide support functions for activities in other parts of the value chain. In light of this, developments in core AM and distribution might generate particular requirements for the supporting functions and thus trigger developments in the back office.

Oxera interviews provided evidence that certain trends in product innovation, occurring in core AM, might affect back-office functions. A number of interviewees suggested that increasing investments in LDIs create pressure on the fund administration and custody functions of the back office.[129]

However, no evidence has been found on whether wider penetration of LDIs is likely to increase outsourcing of back-office functions.

Industry commentators suggest that the same dynamics applies to hedge funds, and, in general, to structured products. In principle, this indicates that funds that follow sophisticated investment strategies require specialist administration skills (eg, pricing and client reporting), and that these might be more efficiently provided by specialist third-party administration firms.[130]

Moreover, Oxera interviews provided evidence that developments in the distribution part of the value chain might also affect trends in back-office outsourcing. In particular, increasing penetration of TPF (as part of the more general trend towards open architecture) and more intensive cross-border trade seem to have a substantial impact on, for example, the operation of transfer agencies.

However, there is no evidence to indicate whether the increasing complexity of distribution systems acts as a driver or barrier for outsourcing of transfer agency functions. The challenges posed by these developments are discussed in a separate section below.

### Barriers for back-office outsourcing

There are several sources of potential barriers for wider penetration of outsourcing deals.

First, potential economies of scale might fail to produce monetary benefits in practice. Industry commentators often suggest that this might be driven by the *heterogeneity of operating business models* across AM firms. When business models vary substantially, with corresponding variability in the underlying back-office platforms, providers are required to approach each customer on an individual basis. This does not allow the provider to spread the cost of back-office products across a wide range of customers, which is at the core of achieving economies of scale.

[128] Evidence from Oxera programme of structured interviews.

[129] This largely relates to transactions involving swap instruments.

[130] Evidence available at Finextra.com (2006b).

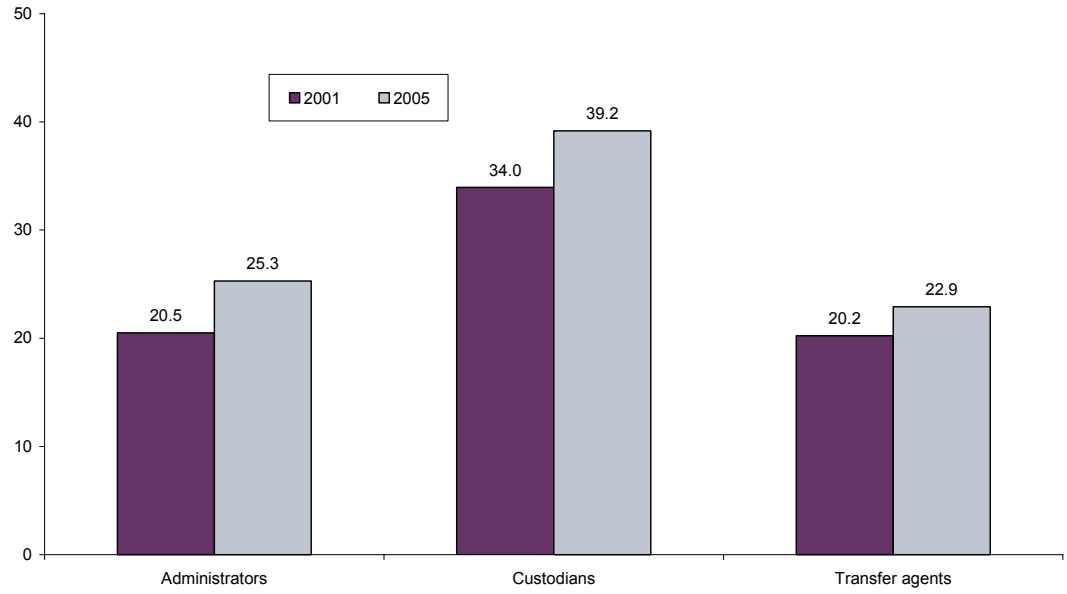
Second, Oxera interviews indicated that the *potential loss of control* over outsourced functions and related potential loss of flexibility in product innovation and breaking of functional linkages with the front office represent important aspects that dissuade clients from outsourcing.

Third, *regulatory requirements* that prohibit custody being outsourced to firms registered in a country different from where the fund is registered constitute a barrier to cross-border custody outsourcing.

### Trends in outsourcing across back-office functions

The primary source of information used to analyse the developments in outsourcing of back-office functions is the data reported by ZEW/OEE (2006). According to Figure 6.2, at the EU level, the share of AuM outsourced to third-party providers increased across all functions.

**Figure 6.2 Outsourced AuM in the EU (%)**

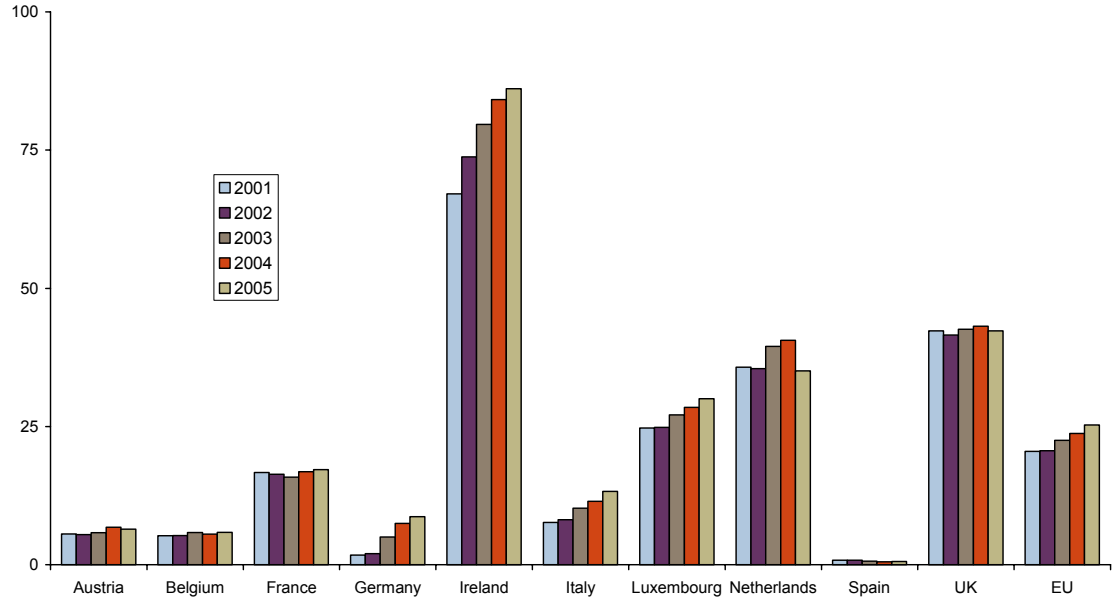



Source: FERI Fund Market Data, as reported by ZEW/OEE (2006) and Oxera analysis.

Custody appears to be the most widely outsourced function at the EU level. The underlying rationale seems to be that, according to regulatory requirements, UCITS funds are obliged to outsource asset safekeeping functions to external providers.

It is also informative to investigate the share of assets outsourced in the leading European jurisdictions. Figure 6.3 shows the evolution of fund administration outsourcing from 2001 to 2005 in ten European countries. Spain had the lowest share of outsourced AuM and Ireland and UK the highest.

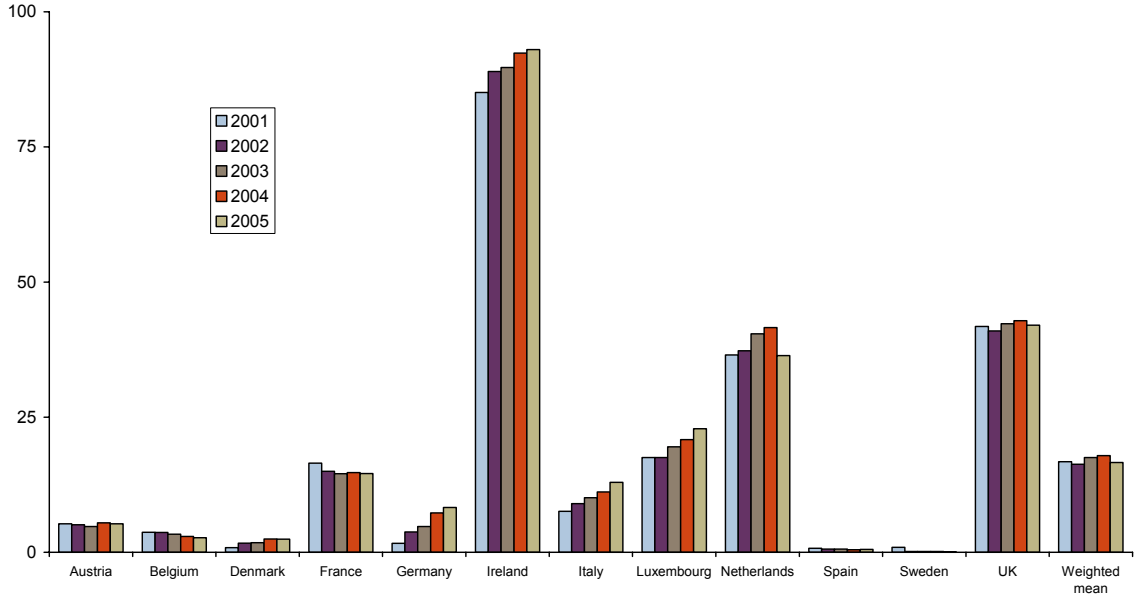
**Figure 6.3 Outsourced AuM, fund administration, 2001–05 (%)**




Source: FERI Fund Market Data as reported by ZEW/OEE (2006) and Oxera analysis.

The data can also be used to investigate the evolution of outsourcing of fund administration for dependent and independent AM firms[131] (see Figures 6.4 and 6.5). Evidence suggests that the latter are more likely to outsource their back-office functions than the former, with the most obvious differences observed in Austria, Belgium and Sweden.

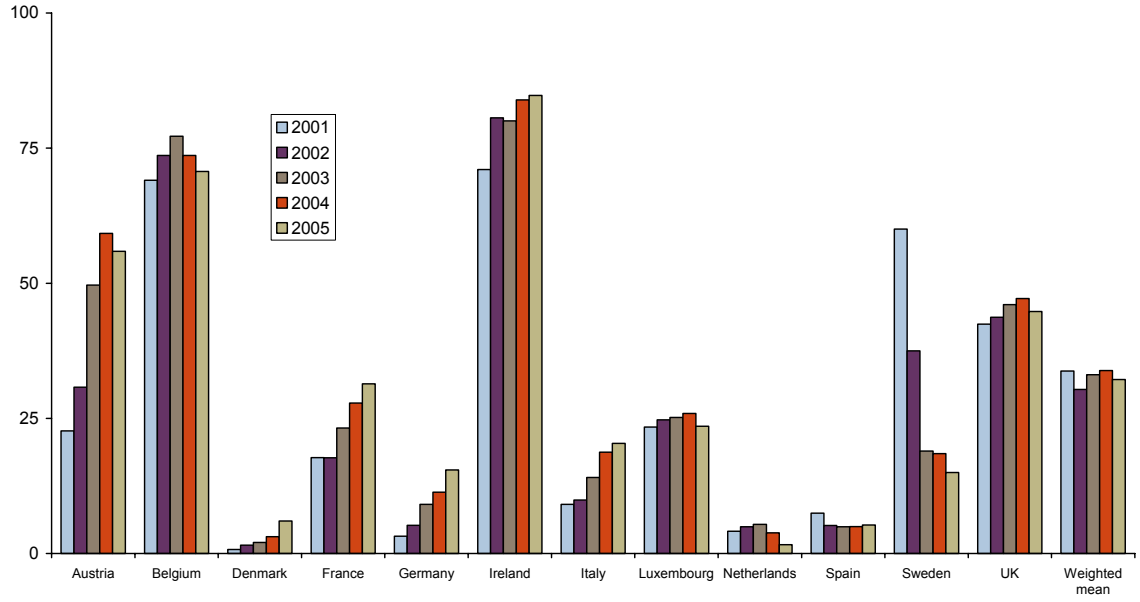
**Figure 6.4 Outsourced AuM, fund administration, dependent AM firms, 2001–05 (%)**




Source: FERI Fund Market Data as reported by ZEW/OEE (2006) and Oxera analysis.

[131] Dependent refers to entities that are part of a larger financial group (eg, a banking or insurance group). Independent refers to entities that are not part of a financial group. Therefore, independent could also be described as not belonging to a financial institution.

**Figure 6.5 Outsourced AuM, fund administration, independent AM firms, 2001–05 (%)**

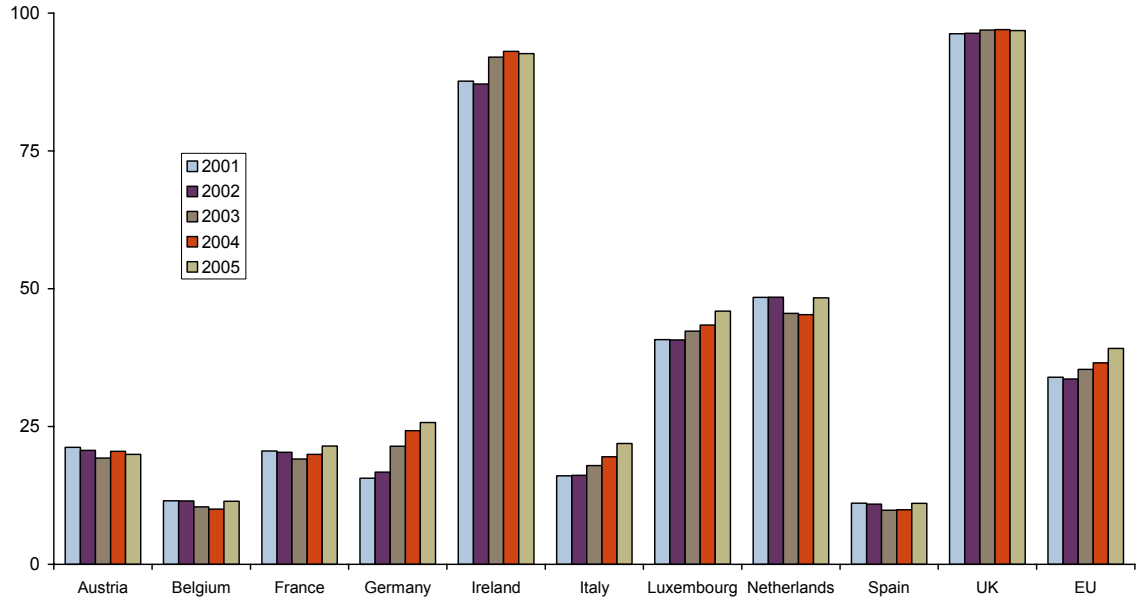



Source: FERI Fund Market Data as reported by ZEW/OEE (2006) and Oxera analysis.

Research undertaken for this study indicates that differences in outsourcing by independent and dependent asset managers could arise because the latter have an option of outsourcing fund administration within their parent group, while no such option is available to the former.

Figure 6.6 shows the evolution of custody outsourcing from 2001 to 2005 for ten European countries. The lowest share of outsourced AuM is in Spain and Belgium, and the highest in Ireland and UK.

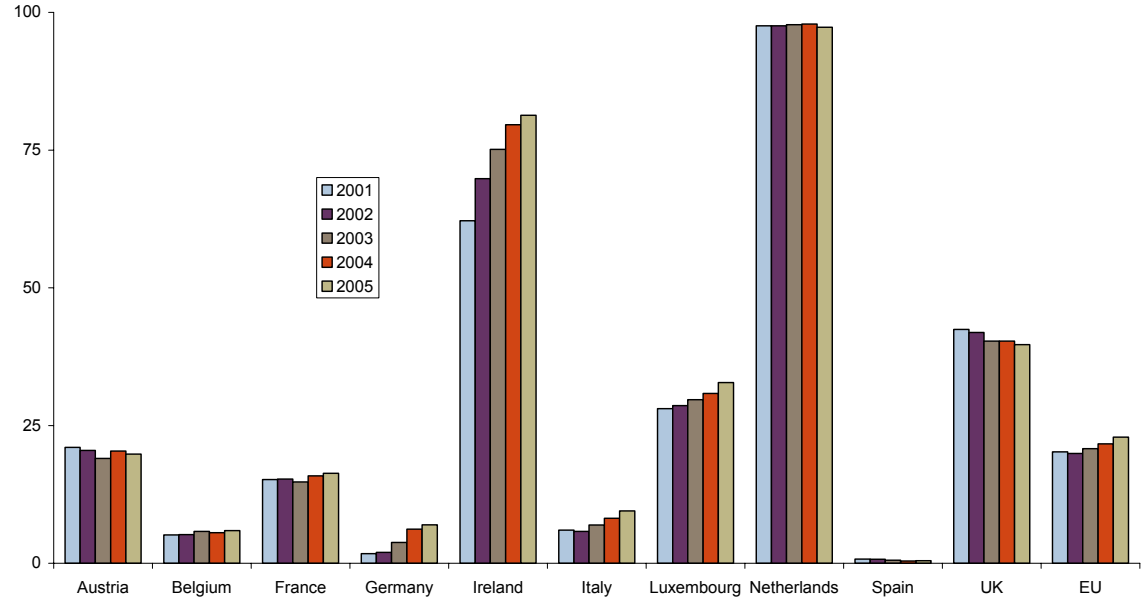
**Figure 6.6 Outsourced AuM, custody, 2001–05 (%)**




Source: FERI Fund Market Data as reported by ZEW/OEE (2006) and Oxera analysis.

Figure 6.7 shows the evolution of transfer agency outsourcing from 2001 to 2005 for ten European countries. The lowest share of outsourced AuM is in Spain and Belgium, and the highest in Ireland and UK.

**Figure 6.7 Outsourced AuM, transfer agency, 2001–05 (%)**

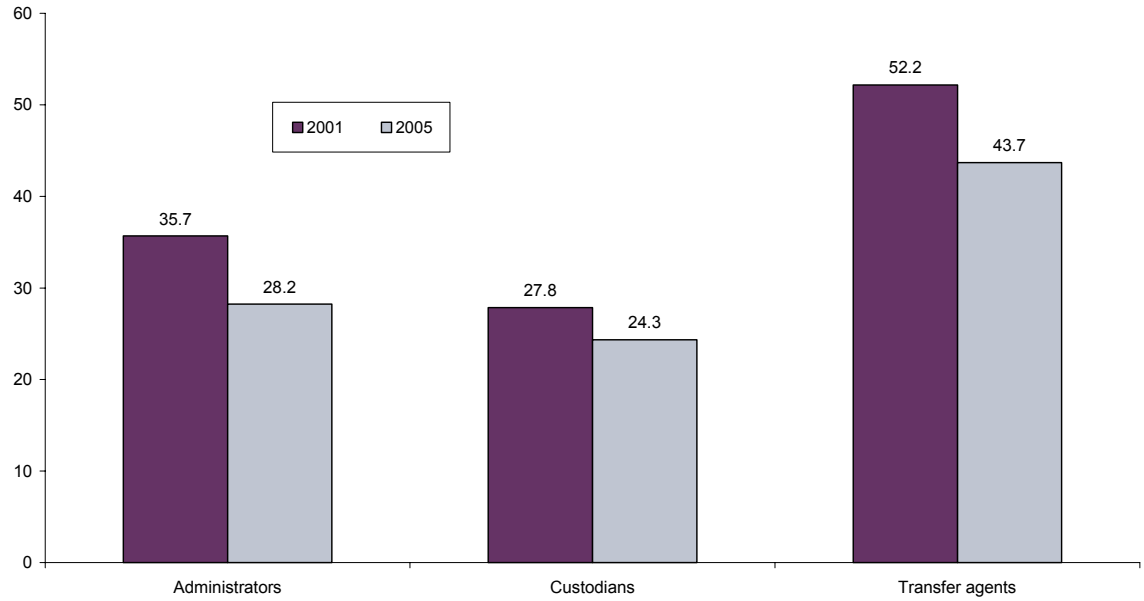



Source: FERI Fund Market Data as reported by ZEW/OEE (2006) and Oxera analysis.

To summarise, the evidence indicates that the evolution of outsourcing across counties has been largely similar (ie, increasing slowly), while there are substantial differences in the current degree of penetration of back-office outsourcing. In particular, outsourcing appears to be used less often in Spain and Belgium, and more often in the UK and the Republic of Ireland. In addition, dependent AM firms on average appear to outsource more than independent ones.

Industry commentators often suggest that the market for third-party, back-office functions is highly concentrated. According to FERI data, as reported by ZEW/OEE (2006), the market shares of the top five pan-European providers in 2005 ranged from 25% (custody) to 44% (transfer agency). Compared with market shares in 2001, concentration has decreased by a maximum of 8.5% points for transfer agency and a minimum of 3.5% for custody services (see Figure 6.8).

**Figure 6.8 Top five providers within the third-party market in the EU (%)**




Source: FERI Fund Market Data as reported by ZEW/OEE (2006) and Oxera analysis.

Cross-country data on the market shares of the top five and top ten custodians is shown in Table 6.2. According to the table, market concentration in certain countries in 2005 was relatively high—the top ten custodians accounted for almost 100% of the Dutch market, 99% of the UK market, 97% in Austria, 91% in Ireland, and 87% of the market in Luxembourg. The lowest market share of top ten custodians in 2005 was in Italy, at 69.2%.

Similarly, the top five custodians had a substantial share of the market—almost 100% in Netherlands, 80% in France, and 76% in Belgium. The lowest share is observed for Germany, at 51.6%. In all except one case (the Netherlands) the concentration of custodians has been decreasing. In the Netherlands, it has remained the same, at approximately 100% for both the top 5 and top 10.

**Table 6.2 Top five and top ten custodians within the third-party market (%)**

| | Share of top five custodians | | Share of top ten custodians | |
|---|---|---|---|---|
| | 2001 | 2005 | 2001 | 2005 |
| Austria | 77.6 | 73.4 | 98.6 | 97.2 |
| Belgium | 90.0 | 75.8 | 99.7 | 94.4 |
| France | 85.2 | 79.8 | 93.9 | 93.1 |
| Germany | 60.9 | 51.6 | 78.1 | 71.4 |
| Ireland | 87.3 | 72.8 | 97.2 | 90.7 |
| Italy | 57.9 | 48.5 | 81.9 | 69.2 |
| Luxembourg | 71.1 | 67.2 | 91.4 | 86.8 |
| Netherlands | 99.9 | 99.9 | 100.0 | 100.0 |
| Spain | 72.2 | 68.8 | 87.0 | 81.5 |
| UK | 68.3 | 68.0 | 99.0 | 98.9 |
| EU | 27.8 | 24.3 | 42.9 | 38.6 |

Note: The share of the top five and top ten custodians in the EU does not represent an average of all Member States, but rather the share of the top five and top ten custodians in total assets under custody in the EU.
Source: FERI data as reported by ZEW/OEE (2006) and Oxera analysis.

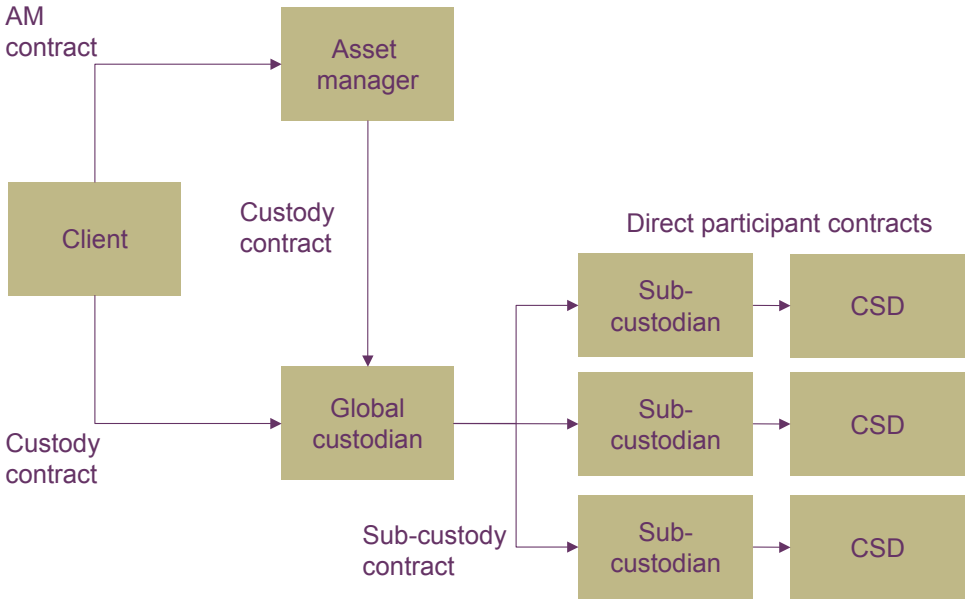
To summarise, there is evidence that, at the pan-European level, the degree of back-office outsourcing is increasing, with the magnitude of the increase ranging from 5.2% (custody) to 2.9% (transfer agency). There is also evidence that the market has become less concentrated over the same period.

### The cross-border market for third-party custody services in the EU

Another area suggested as being important during the Oxera interviews and intensively discussed by industry commentators is the market for cross-border third-party custody.

Global custody is a service whereby a single custodian assumes responsibility for the custody of a client's portfolio of international securities and cash—ie, the custody service extends beyond the custodian's and client's home base. In respect of overseas assets, the global custodian may perform its obligations either directly through its own overseas branches, or through a network of sub-custodians that provide custody in their own country. Either way, the global custodian gains access to the national central securities depositaries (CSDs) (see Figure 6.9).

**Figure 6.9 Global custody**




Source: Oxera

There is some evidence to suggest that the market for cross-border third-party custody is dominated by a few players, namely the global custodians. Industry commentators suggested a number of economic drivers that might be triggering greater market concentration related to the international scope for economies of scale:[132]

– increasing cross-border activity by AM firms and a corresponding increase in the number of funds registered in various countries;

– the need for asset managers to replace several small local custodians with a single provider to achieve cost efficiencies;

– growth in the retail brokerage industry leading to an increasing number of counterparties and driving demand for centralised clearing and custody services.

According to Figure 6.8, the market shares of the top five custodians in total assets under custody in the EU were 28% in 2001 and 24% in 2005. This suggests that, rather than becoming more concentrated, the market for global custody is becoming (slightly) less concentrated. (The top ten global custodians had market shares of 39% in 2005, and, compared with 2001, their market share has decreased from 43%.)

### 6.1.3 Trends in distribution and the impact on the back office at the firm level

Across Europe, significant pressures for back-office functions have been created by developments in fund distribution, which include:

– wider penetration of open architecture and, correspondingly, increasing sales of TPF;
– growing number of intermediaries, driven, among other factors, by the evolution of assemblers and product wrappers;
– intensifying cross-border trade.

The increasing number of intermediaries, such as assemblers, and the growth of third-party distribution, leads to greater complexity in the distribution network, making it increasingly

[132] Based on the research by www.globalcustody.net.

multilateral. This poses the following difficulties for back-office functions (eg, those of transfer agencies):[133]

– the need to consolidate sales and management information across an increasing number of elements of the distribution chain (intermediaries);
– calculation of trailer fees for each element of the distribution chain; and
– management of operating risks.

In addition to greater complexity, wider penetration of cross-border trade creates the need for cross-country adoption of the same, or very similar, standards of data procession. Largely driven by coordination problems, this leads to cost inefficiencies and might increase operational risks.

In an environment with a significant number of manual operations, these developments in distribution might be associated with significant operational risks, as well as potential cost inefficiencies. Industry commentators, as well as Oxera interviews, suggested that STP allows these problems to be mitigated to a certain extent.[134]

Oxera research indicated that, even though adoption of STP across the industry could lead to substantial cost efficiencies and mitigate certain operating risks, the current lack of process automation could be driven by the lack of synchronisation of standards, both cross-border and within countries. Process automation is associated with substantial investments in IT systems. Without cross-country agreement among platforms, transfer agencies and distributors on which data processing standards will be universally used across the EU, this type of investment carries substantial risk of becoming stranded.

## 6.2 Developments in the back office affecting market structure

Different trends in the back office affect the AM industry differently. Technological improvements at the firm level create additional value for the industry and end-consumers (eg, increasing cost efficiencies and reducing operating risks), but have a relatively minor impact on the industry value chain and business models adopted by individual players.

For example, replacement of manual operations with STP methods could eliminate duplicate steps and improve client service through reduced errors; however providers are unlikely to revise their distribution strategies as a result.

In contrast, emergence of new types of players might fundamentally affect the structure of the industry. It could lead to changes in the way markets for investment funds operate as well as have an impact on the strategies of individual firms; in particular it might change the way fund providers sell their products and affect the rigour of the due diligence process adopted by distributors. This section describes the emergence of one type of new player—*institutional distribution platforms*.

[133] Evidence from Oxera programme of structured interviews.

[134] 'To work towards this goal (increasing operating efficiency and decreasing costs) we need standardisation through automation first' (BNP Paribas, Euroclear, Fidelity International, Invesco, and International Financial Data Services 2005).

### Box 6.1 Key characteristics of institutional (wholesale) distribution platforms

Institutional (wholesale) distribution platforms:

- **act as intermediaries**: within the value chain institutional platforms are positioned as intermediaries between providers/assemblers and distributors;
- **are not focused on core AM activities**: in contrast to assemblers that operate in core AM, platforms are not primarily engaged in AM activities;
- **operate in the B2B environment**: in contrast to retail fund platforms, institutional platforms concentrate on services to institutions;
- **rely on open architecture**: sufficient development of open or guided architecture and/or FoF and MoM is a pre-requisite for the emergence of platforms;
- **rely on technology**: the process of value creation by platforms requires advanced technology that can support multiple interactions;
- **improve market efficiency**: platforms improve market efficiency by creating additional linkages between industry participants through a single point of contact;
- **are characterised by network effects**:[1] services offered by the platform become more valuable as more clients use it; thus the role of a platform might emerge into one similar to that of an *exchange*.

Note: [1] Network effects are defined as a change in the benefit, or surplus, that an agent derives from a good when the number of other agents consuming the same kind of good changes. For example, as fax machines increase in popularity, a given fax machine becomes increasingly valuable since it is more likely to be used.

### 6.2.1 The evolution of institutional platforms

Trends in fund distribution act as drivers for the emergence of an institutional platform of the type described above, and include:

- gradual opening up of traditional channels;
- growing number of intermediaries;
- increasing cross-border trade.

As a result of these trends, retail distribution becomes more multilateral. To mitigate increasing complexity, institutional platforms offer individual firms engaged in retail distribution access to many different funds by connecting to one platform, instead of connecting to all necessary providers of funds separately. In simple terms, instead of everyone connecting to everyone (as implied by open architecture), everyone needs to connect to the (one) platform. The result is fewer bilateral interactions in the distribution chain with a consequent reduction in costs and operating risks through the adoption of the multilateral approach.

The evolution of an institutional platform includes several phases. First, the platform offers a service analogous to that of a central institutional transfer agency. This increases cost efficiencies and potentially reduces operating risks, but is unlikely to affect the industry value chain. The impact on distribution strategies of providers and procurement strategies of distributors is also likely to be minimal.

As the number of clients connected to the network increases, the platform gradually expands the range of services. In the second phase it evolves as an intermediary, integrating fund providers and distributors into a single 'market place'. Providers are attracted by having access to infrastructure connecting a large number of distributors. At the same time, distributors, operating in the context of open architecture, have a range of providers to choose from. Due to the network effect, once a sufficient scale of operations is reached, access to the platform becomes highly valuable.

Institutional platforms offer two key services: an access point to a large number of counterparties, and high-quality infrastructure to facilitate trading. In this respect, their role has certain similarities with that of an exchange in the stock market.

### 6.2.2 Emergence of institutional platforms looking forward

The emergence of institutional platforms is a recent phenomenon. It is therefore too early to draw conclusions about the magnitude of this trend. One example can be taken from Spain, Italy and Portugal, where Allfunds Bank provides dealing, execution, administration, information and advisory services to fund providers and distributors.

The fact that Allfunds Banks is the leading player in the third-party fund market in these countries, and that, in 2005, it announced its intention to expand its operations to the UK, could be indicative of the success of this business model.

As described above, institutional platforms seem to be dependent on the degree of the development of open architecture, or at least guided architecture. In other words, demand for their services increases as the dominant distributors open up. Also, once a sufficient scale of operations is reached, platforms are able to enjoy network effects such that the services become increasingly more valuable as the number of customers increases. This suggests that, given that traditional distributors seem to be gradually opening up, institutional platforms might be expected to emerge/expand further.

On the one hand, this is likely to increase market efficiency due to operating efficiencies in the back office and the creation of additional linkages between industry participants. On the other hand, depending on the magnitude of the network effect, the emergence of dominant platforms might have regulatory implications.

Were dominant platforms to emerge, it might be necessary to take regulatory action to ensure a sufficient degree of competition between platforms. The current industry dynamics is such that competition is more intensive among providers than distributors. Therefore, it might be also important to ensure that any market power does not translate into unreasonable charges for access to platforms by providers.

# 7 Implications of trends for competition, value creation for consumers and risks in the AM industry

This section reviews the potential implications of the trends in the core AM, distribution and back-office segments of the value chain analysed in the previous three sections.

In accordance with the methodology outlined in section 2, the impacts of the trends identified by Oxera are examined with respect to three main categories of implications:

– potential changes in the competitive landscape within different segments of the value chain;

– the emergence of new operational risks as well as changes to existing risks to AM firms and end-investors;

– changes in the value creation to end-investors by the AM industry that can be inferred from the conclusions with respect to developments in competition and the evolution of risks identified earlier.

The analysis also explores the potential for new market failures (or significant changes in existing market failures) that could have an impact on consumer welfare.

One of the fundamental objectives of the analysis is to present a qualitative discussion of the impact of identified trends on the potential directional change (increase/decrease) in the value creation to consumers, where 'value' can be broadly understood as a measure of the price/quality ratio that end-investors are able to obtain when purchasing AM products and services across the EU.

In this context, the quality of an AM product is related to a customer's ability to choose a suitable product given their particular investment needs, while also being related to the level of investor protection against risks in the AM industry—ie, risks other than the investment (market) risk associated with particular investment strategies. Thus, the advantages of diversity of product available must be set against the impact of this diversity on new and existing risks in AM.

Changes in the price (and hence price/quality ratio) are likely to be affected by changes in the competitive landscape of the AM industry, as well as in the frequency and impact of risks. For example, whether upward or downward pressures on management fees are likely to be observed will depend on the intensity of competition in the market in the future and on whether any cost efficiencies that might arise are experienced by all or only some AM firms. Where efficiencies are company- or segment–specific, rather than shared due to competitive pressures, any gains are less likely to be fully passed on to the end-investors.

Since the value to end-investors can be significantly affected by the frequency and potential impact of new and evolving operational risks in the AM industry, the analysis of changes in these risks as a result of identified trends represents a key component of the investigation of the impact of the current trends on consumer welfare. In that sense, a significant element of the analysis is devoted to exploring the extent to which the trends discussed in previous sections are affecting the prevalence of certain types of operational risk known to exist in the AM industry. These risks have been explored in Oxera (2001) and Biais et al. (2003), and these two studies form the starting point for this analysis.

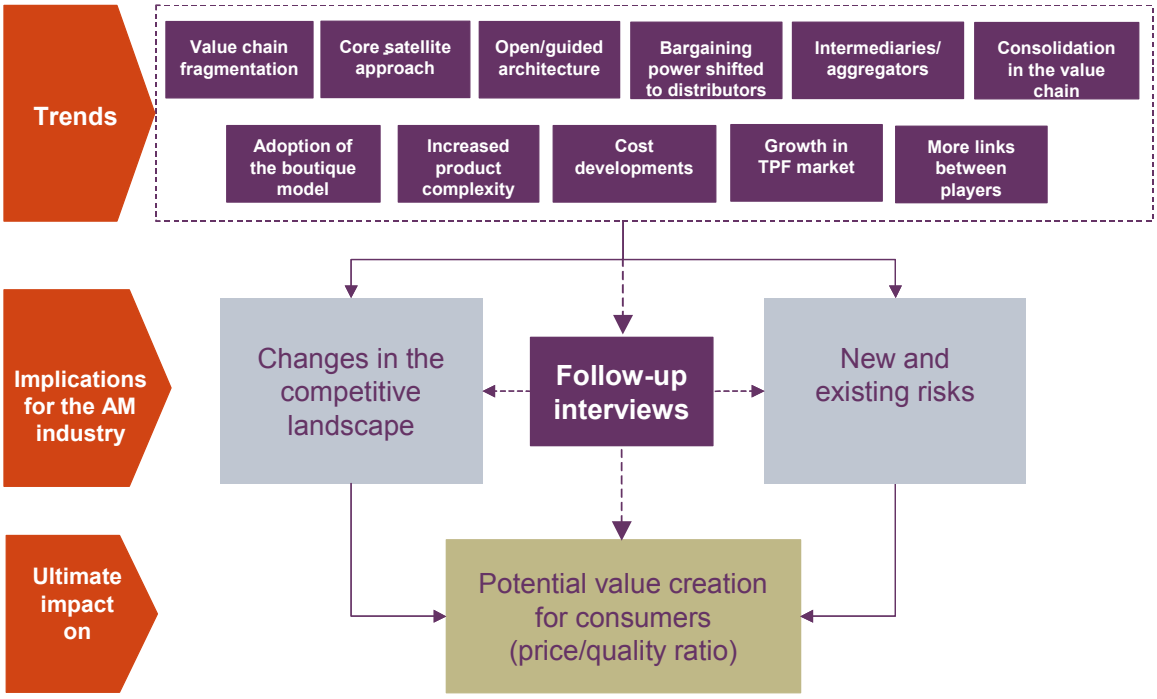
The main methodological approach used in this section is the verification of hypotheses using a programme of structured, follow-up interviews. To test both the validity of the trends

identified in sections 2 to 6 and the strength of any implications that might arise from those trends, the follow-up interviews asked key decision-makers in the AM industry to comment, analyse and, where necessary, critique, specific hypotheses formulated in the course of the research. The hypotheses covered the implications of the trends in the industry for the nature of competition in the market, the scope for specified risks to increase or decrease as a result of those trends, and their overall impact on the value creation to consumers. These hypotheses were derived using the conceptual framework outlined next.

## 7.1 Conceptual approach

To understand the implications of these trends on the value created for consumers, the conceptual framework depicted in Figure 7.1 was used. The analysis begins with an assessment of the potential implications of identified trends on the competitive dynamics of the industry (section 7.2). Section 7.3 then focuses on the analysis of the impact of changes on the balance of risks in the AM industry, and includes a discussion of how changes in the frequency of certain risks might affect value creation to consumers. Finally, the implications of the changes in the nature of competition for value creation to consumers, as well as other implications for value creation arising from the evolution of risks, are analysed in section 7.4.

**Figure 7.1 Analytical framework to assess the implications of identified trends for competition, risks and value creation to consumers**




Source: Oxera.

The arguments and reasoning behind the different asset managers' positions are explored below, and contrasted against Oxera's hypotheses. Where a majority of interviewees express a particular view and the available evidence for particular implications is judged to be robust, the subsequent analysis highlights and discusses identified implications. Where the follow-up interviews were less consistent, and/or the available evidence is less clear-cut, the discussion below presents the arguments for and against different propositions and assesses their relative merits.

Every effort has been made to test the presented hypotheses against publicly available evidence, as well as industry insights provided by asset managers on a confidential basis.

Nevertheless, any conclusions derived from the presented evidence, as well as any other evidence that might be available, must be seen as necessarily subject to interpretation.

## 7.2 Implications of trends for the competitive dynamics of the industry

Current changes in the competitive landscape of the European AM industry are examined below, in particular looking at how the processes identified earlier might affect the evolution of competition in this sector in the future. The overall focus of the analysis is on the forward-looking implications of the key trends identified during the research. Given the size and reach of the AM industry in general, the conclusions must be analysed in the context of the limited information currently available. In particular, for an industry as complex and multi-faceted as the AM industry, such industry-wide conclusions must be based on a certain degree of generalisation of available, and necessarily partial, evidence.

One of the most important changes in the nature of competition identified by those in the industry is the apparent loss of manufacturers' bargaining power compared with firms (or more separate internal operations) further down the value chain and closer to the client (eg, distributors and/or intermediaries/assemblers). The trends related to this development and their implications for the nature of competition in the AM industry are discussed in the next sub-section.

Increasing competition within the core AM segment, coupled with pressures on any particular asset manager to rationalise fund ranges, cut costs and achieve economies of scale (in line with the continuing trends in AM since the market downturn), are expected by those in the industry to lead to greater M&A activity. In turn, this might be expected to accelerate the trend towards consolidation in the core AM segment. The implications of this trend for the competitive dynamics of the industry are analysed in section 7.2.2.

Some aspects of pension reform being implemented in a number of Member States are also believed by the industry to have the potential to lead to changes in the competitive landscape by increasing concentration in the AM industry. These developments were explored in detail in section 4.4 and are therefore not covered here.

### 7.2.1 Changes in the organisation of the value chain and implications for the competitive dynamics of the industry

One of the most widely believed changes in the competitive landscape of the AM industry is the loss of bargaining power by (at least some) manufacturers. As explained in section 4 and confirmed by the follow-up interviews, it is widely held that bargaining power is shifting from the manufacturing side to the distribution/client side of the AM business, including an increase in bargaining power of institutional funds with respect to their asset manager(s).

In the institutional market, this trend is manifested through:

- the emergence of institutional funds taking a more disaggregated approach to letting their mandates, and selecting different providers of core AM services for the various components of their investment portfolio. Furthermore, manufacturers themselves reorganise the core AM segment by separating core and satellite investment functions;
- shorter mandates;
- the growing role of expert consultants; and, more generally
- the increased sophistication of the average institutional investor, which has reduced the scope for the asset manager to exploit informational asymmetries.

In the retail market, some of the trends that have been linked to the shift in bargaining power away from manufacturers towards intermediaries and distributors are:

– the development of open and guided architecture in retail distribution, which has the potential to give the distribution function greater freedom of choice in what it chooses to offer to customers;
– related to the above, the growing strength of IFAs and NINFAs in selected jurisdictions;
– operational separation of AM manufacturing and distribution units, particularly among large financial groups;
– the emergence of intermediaries to fill the gap created by the separation of manufacturing and distribution units, which act as sophisticated institutional investors on behalf of retail clients.

The implications of these trends (described in detail in sections 4 to 6) for the competitive dynamics in the AM industry are discussed below.

### Gradual opening of retail distribution networks

A trend confirmed by the follow-up interviews is that the retail distribution networks are becoming more open in some, but not all, jurisdictions, either due to the increasing use of independent distribution networks or because the traditional distribution networks are (slowly) adopting guided architecture or (more rarely) fully open architecture. As a result, the range of manufacturers available to retail investors when accessing any distribution network is increasing. In addition, all distribution networks are expanding their range of product types, either as a result of individual manufacturers producing a wider range of products or as a direct result of the greater range of manufacturers' products offered for sale.

The most significant implication of this trend is that consumers are, in principle, offered more choice, at both the product and manufacturer level. This development has the potential to make the product market more competitive, provided that consumers can effectively choose products that offer them the best value for money.

The implications for competition between *distributors* are less clear-cut. On the one hand, the availability of a wider product mix from any one distributor reduces the incentives to shop around for a different distributor; on the other hand, if consumers can effectively discriminate between products within a distributor's range, they should also be better able to discriminate between distributors. The evidence suggests that traditional distribution networks are not losing market share (see section 6).

This is partly a result of the traditional distribution networks responding to the demand for a wider range of products by either manufacturing a wider product range in-house or by moving towards open or guided architecture structures in their distribution networks. The resultant availability of a more diversified product range from traditional players decreases retail investors' incentives to consider alternative channels, which they often view more cautiously. Fuelled by investors' attachment to local sales offices, this has, arguably, reduced market opportunities for alternative channels to challenge the traditional distribution networks. For example:

– in Germany, the strategic response of retail banks (ie, the adoption of guided architecture) to losing market shares to IFAs appears to have been strong enough to reverse, at least partly, this development;

– in Spain, major banks have managed largely to preserve their dominant position, despite the emergence of institutional platforms. However, some banks have adopted the full open architecture model for a selection of their more sophisticated clients/investors (high-net-worth individuals and, increasingly, the higher end of the retail market) and have retained their strong position as a key distribution channel;

– in Poland, the particularly strong position of the local equity market that resulted in attractive returns to investors (despite comparatively high fee levels) has put few competitive pressures on manufacturers in the first place. Similarly, the entry of IFAs

and NINFAs, such as Open Finance or Xelion, has had a limited impact so far, despite reportedly significant investments by these companies in their distribution networks;

– across the new Member States, banks appear to be consolidating their leading position in the distribution of funds.

In this context, the extent to which traditional channels are opening their distribution networks is important to the effect of the evolution of competition between manufacturers in the retail market. The gradual adoption of guided architecture has already partly led to the emergence of preferred partners, thereby limiting sales opportunities for manufacturers not on the 'preferred' shortlist. Even under an open architecture model, competition between manufacturers to obtain 'shelf space' with distributors may distort the market if end-investors are unable to distinguish between good and bad products once they are on the shelves. The characteristics that gain the attention of the distributor (eg, commission rates paid to distributors) may not be the same as those that an end-investor would find attractive (eg, lower total transaction costs)—indeed, they may be diametrically opposed.

Nevertheless, in general the range of products offered to the end-investor has increased. While this development adds potential value to end-investors—because they should be able to find a product that more closely reflects their preferred risk profile and market exposure—the actual value of this choice has been questioned by some on the grounds of both investment and information risks.

Moreover, at least in some jurisdictions, it is not clear that investors are actively searching for a much wider range of alternative investment opportunities. Where this is the case, the enhanced offer from traditional channels—combining in-house products with a degree of financial innovation in the product range from selected alternative suppliers (eg, a wider range of guaranteed products) based on, for example, white-label funds—appears to be sufficient for these channels to resist moving to full open architecture, and addressing the challenge from distribution networks that already have access to a very wide range of products (eg IFAs, Internet supermarkets).

### Segmentation of the value chain

Competition among manufacturers is being further strengthened by the trend towards institutional separation of the manufacturing and distribution functions. For example, as discussed in sections 4 and 5, some of the largest European financial groups are spinning off their core AM businesses. In other cases, although the core AM function remains within the group, the implicit exclusive business links between the core and distribution segments of the value chain have been severed. That is, each unit is operated much more as an independent business with separate reporting lines and arm's-length relationships relative to other units.

The objective of this strategy is to focus each unit on its core competencies and to minimise any conflicts of interest between manufacturers and distributors that might hinder the development of their individual business. In other words, as discussed in section 4, in AM firms where this separation of functions has occurred, distributors who decide to open up to manufacturers outside their group can now do so more easily. Furthermore, manufacturing units might have less bargaining power to prevent this from happening. This gives manufacturers themselves the incentive to seek deals with distributors outside their own financial group in order to expand their market opportunities.

As a result, the relationships between manufacturers and distributors in general are becoming less secure, with a shorter lifetime. Traditionally, manufacturers could rely on a single distributor (eg, their own tied distribution network) to reach the end-investor. As this internal link is now broken and the distribution unit pursues its own strategic objectives more freely, without incorporating other units' interests in its objective function, manufacturers must build new relationships with a larger network of distributors. For distributors, this process involves, for example, a gradual opening up to TPF, as discussed in section 5 and 6. This

implies that manufacturers are less able to rely on a single, secure sales channel within the structure of a vertically integrated 'silo'.

The fragmentation of the value chain opens up the possibility of competition operating simultaneously between manufacturers and distributors, rather than between institutions supplying both. If competition rewards firms that supply what end-investors demand, this increase in potential competition should result in more pressure to align the elements in the value chain with end-investors' requirements. However, for this to work effectively, the incentives facing each layer should line up with these requirements—something that is not guaranteed.

### Emergence of intermediaries

Another trend identified during the research that has contributed to the shift in bargaining power down the value chain towards distributors has been the emergence of intermediaries between manufacturers and distributors. Breaking the institutional link between manufacturer and distributor creates a space for additional intermediaries to operate, who mediate between manufacturers and distributors to provide the mechanisms that enable distributors to evaluate products and manufacturers to gain access to distribution networks as well as to create new products.

The intermediaries include assemblers and aggregators (as well as consultants in the institutional market), who select funds of different providers and repackage them as FoF or use them as components for larger portfolios. In some cases, a distributor that has moved up the value chain fulfills the role of the intermediary. To a certain extent, sophisticated distributors, as well as independent intermediaries/assemblers, fulfil the same role in the retail market as consultants and sophisticated investors in the institutional market. As part of this trend, manufacturers are being partly 'intermediated' and their services becoming more of a commodity. Moreover, this process is intensified by the intermediary platforms (eg, Fidelity, Cofunds, Allfunds Bank) that facilitate the process of selecting funds in the TPF market, as well as boosting the trend in full or guided open architecture. This conclusion is supported by evidence from across the industry gathered during the structured interviews. The result is a growing role for intermediaries, which -increases product choice and competitive dynamics.

This, in turn, has the potential to lead to lower prices and/or higher product quality through financial innovation, provided that the interests of these new intermediaries are aligned with those of end-investors.

### Changing competitive landscape

The developments described above have several implications for the relationships between fund providers and distributors:

– given that banks and insurance firms retain their leading market positions, competition between distribution channels appears to remain limited;
– due to value chain segmentation and related supporting trends, manufacturers are required to compete with one another to gain space on the shelves of the limited number of distributors. If the dimensions along which they compete at this level are not aligned with the interests of end-consumers, this competition may not deliver benefits to end-investors;
– the emergence of assemblers and other intermediaries has increased competition among manufacturers based on comparative performance.

As an important indication of distributors' increasing power, Oxera interviews have indicated that retrocession fees have been increasing over the past few years. One example that may illustrate differences in bargaining power between fund manufacturers and distributors is the Spanish fund distribution segment. In principle, a leading intermediary in the market could

charge both manufacturers and distributors a fee for access to the platform, thereby extracting value from both the upstream and downstream segments of the value chain. In practice, however, it chooses to charge manufacturers only, while distributors can access the platform and some ancillary services for free.[135]

Overall, there is some evidence to support the conclusion that additional value is being created in the upstream segment of the value chain through increased, performance-focused, competition among manufacturers. In the retail part of the market, there is only limited evidence that this value might accrue to the end-investor—it may be that any additional value being created in the upstream part is being absorbed further down the chain. However, in private banking and the high-net-worth individuals' component of the market, investors could be benefiting more directly from the broader, competitive menu of investment products from different providers.

### Horizontal consolidation and growing linkages in core AM

The decline in bargaining power and the greater intensity of competition owing to the developments described above are likely to manifest themselves through pressure on profit margins for core AM firms. This is likely to foster the trend towards consolidation and rationalisation that is already evident from the growth of M&A activity among leading European AM firms. Again, the evidence from the structured interviews supports this conclusion.

It has been widely documented that the number of funds and their average size in the European AM market has been highly inefficient in comparison to, for example, the US market.[136] In the course of the structured interviews, several leading industry players indicated that they had plans to rationalise the number of funds they managed across Europe. Some noted that one of the fundamental synergy benefits of their recent cross-European acquisitions was the possibility of merging similar funds into single common funds managed centrally.

As the option of M&A or the formation of alliances aimed to achieve growth targets is becoming more of a priority in AM firms' business strategies, M&A activity in the industry might be expected to grow. At the same time, in an increasingly competitive environment, relationships with distributors in the retail market are more unstable. Furthermore, in the institutional and high-net-worth individuals' market, highly sophisticated buyers are becoming more willing to switch providers or select others for particular mandates. As a result, acquiring a core AM firm is often more cost-efficient than expanding into new markets through internal growth or obtaining new investment capabilities to expand the product range. This development was analysed in some detail in section 6 in the context of the adoption of the boutique model by mainstream providers.

This potential further growth of M&A activity within the core AM business and the formation of alliances can be thought to have two implications for the competitive landscape of the (core) AM industry.

– it will be counteracting the loss of manufacturers' bargaining power; and
– it is likely to improve efficiency, where potential efficiency gains from economies of scale remain significant.

The increasing concentration in core AM that may emerge from M&A activity might allow the core AM functions to regain some of their lost bargaining power with respect to distribution. However, the existence of more open and semi-open distribution channels (eg, Internet

[135] Allfunds Bank acts as an intermediary between fund providers and distributors; it had a share of approximately 50–70% of the third-party mutual fund market in Spain in 2005. In broad terms, the service offers access to the platform where distributors can choose mutual funds from around 140 providers, and providers can market their funds to leading retail distributors in Spain.
[136] See for example, European Commission (2005a), ZEW (2003).

supermarkets, and open and guided architecture), and the emergence of expert intermediaries who are better at evaluating the quality of the core AM product, may mean that even significantly increased levels of market concentration in core AM do not result in that activity regaining its former position relative to distribution.

The developments in core AM of expanding the range of products offered to the distribution segment, and the growth of highly specialised, independent, boutiques, suggests that competition in core AM is now being driven more by investment performance (ie, net returns) than by exclusive vertical links to distribution networks. Under these circumstances, increasing concentration (to achieve economies of scale) and fragmented specialisation (to exploit niche investment opportunities) may be a necessary response in order to remain competitive, but do not represent any real increase in the market power of the core AM activity.

Moreover, further mergers and the creation of less formal linkages between players in the core AM segment of the value chain can help to improve internal and market-wide manufacturing efficiency through the mechanisms outlined above (ie, economies of scale). In addition, the adoption of the internal boutique model by mainstream AM firms has resulted in an internal division and specialisation that allows firms to identify more clearly the source of value in a team (ie, which teams are outperforming their peers) and remunerate them accordingly.

This has the potential to improve the overall returns in core AM by identifying which strategies and boutiques are inefficient, and which are then taken out of the market. Similarly, the greater number of commercial linkages (as opposed to common ownership linkages) between market players across different segments of the value chain (manufacturers, intermediaries and distributors from separate financial groups) allows each segment to focus on its core competencies. Both developments could lead to greater efficiency in the AM value chain, which should translate into an increase in value for the end-investor.

### Overall implications for investors

The overall change in the competitive landscape appears to have three main elements:

– fragmentation of the vertical chain, with legal entities increasingly specialising in one, or a few, segments in the value chain;
– horizontal consolidation to achieve economies of scale at the fund level—individual funds are becoming larger—and possibly also at the distribution level;
– greater diversity of products manufactured and offered to investors.

These trends imply that end-investors are likely to be offered a wider variety of products by each distributor they approach. Provided that the end-investors have both sufficient information and information-processing ability, this increase in diversity should allow them to purchase products that match their needs more closely.

The fragmentation of the vertical chain gives distributors the *ability* to be more selective about whose product they sell. Where distributors' interests are aligned with those of end-customers, this should ensure that both the price and quality of what they sell offers good value for money to investors. However, if distribution becomes too concentrated, the lack of competitive pressure may enable distributors to gain at the expense of end-users. In addition, if consumers are unable to evaluate the variety of products available to them, then regardless of whether the distribution market is concentrated, distributors may be able to use their superior information to direct consumers to purchase the wrong, or unduly expensive, product.

## 7.3 Implications of trends for risks in the AM industry

### 7.3.1 Categorisations of risks

The implications of identified trends for the *evolution* of risks for AM firms and, ultimately, end-investors, are examined below, insofar as these risks are linked to changes in the value chain and fall within the scope of the risk categories addressed by this study.

Many types of risk are prevalent in the AM industry. For example, *business* or *commercial risk* refers to the risk borne by AM firms in their day-to-day commercial operations. These may include, for example, the success of a new product launch or the risk of a fall in demand due to poor market conditions.

*Performance risk* refers to the risk that the manager's asset selection or recommendation results in over- or underperformance of the investor's portfolio. This is considered to constitute business or commercial risks to the extent that AM firms compete with one another by signalling the quality of their products through reputation built on past performance. In line with the methodology presented earlier in the report, neither business nor performance risks are directly addressed in this analysis since they are a reflection of contemporaneous market conditions and business decisions by industry players, including their *executive* strategies. As these risks are related to the commercial and market dynamics, they fall outside the scope of this report.

By contrast, examination of the evolution of *operational risk* is a fundamental part of the analysis presented below. Operational risk refers to problems in the processing or servicing of client assets by the investment firm (or a third party). For example, there can be mistakes in the execution of client transactions, delays in settling them, errors in segregating client assets from firm assets, reconciliation or record-keeping errors, or expropriation of client funds. Operational failures can be unintentional and due to negligence, or the result of intentional and fraudulent misappropriation of client assets.

*Systemic risk* refers to the risk of a potentially significant impact on the operation of a market as a whole due to an event that relates to only one, or a small number, of market participants. This risk is addressed below to the extent that some of the identified trends are expected to influence the frequency of this type of event arising. For example, systemic risk might increase as a result of the greater number of linkages between market players in the context of open architecture, the emergence of intermediaries' platforms, or the concentration of assets in a few dominant intermediaries.

Another type of risk observed in the AM industry is *financial risk*, which refers to investor exposure to an AM firm's default or bankruptcy. This type of risk is limited for some products for the end-investor to the extent that, under national regulations, investor's assets are segregated from the asset manager's own assets. However, for some products (eg, bank deposits, insurance firms) assets are not segregated, and other risk reduction regulations may be in place (eg, state-backed deposit guarantees). Hence, where there is segregation, the potential loss to clients is restricted to disruption and inconvenience arising from the freezing of assets during insolvency and the need to transfer them to a new firm. However, to the extent that *operational risk* (eg, the failure to separate the assets of investors properly) or *systemic risk* can trigger an AM firm's bankruptcy, financial risks are analysed from the perspective of the end-investor. Moreover, there are risks to the end-investor that are not captured in the above classification, such as *mis-selling* and the *risk of commission bias* in the selling process, which can arise in a more acute form as a result of developments in open and guided architecture and, more generally, from growth in the TPF market.

### 7.3.2 Overview and methodological framework for the analysis of risks

The starting point for analysing risks is the Oxera (2001) and Bias et al. (2003) studies, which identified and explored the frequency and potential impact of the most important operational

risks in the European AM industry. This previous research is extended and updated here by analysing new risks implied by the current trends in the AM industry. Examples of new risks include:

– the *mismatch* in expectations between asset managers and distributors in terms of who is responsible (and bears the losses) when client guidelines are breached;
– the extent to which the sale of TPF and the trend towards open and guided architecture in distribution creates additional risks in terms of *mis-selling* and/or *commission bias* in product recommendation;
– the potential growth in *systemic risk* arising from the greater number of linkages in the market and the concentration of assets in the hands of a few large intermediaries or custodians/depositaries.

### 7.3.3 Operational risks in the European AM industry

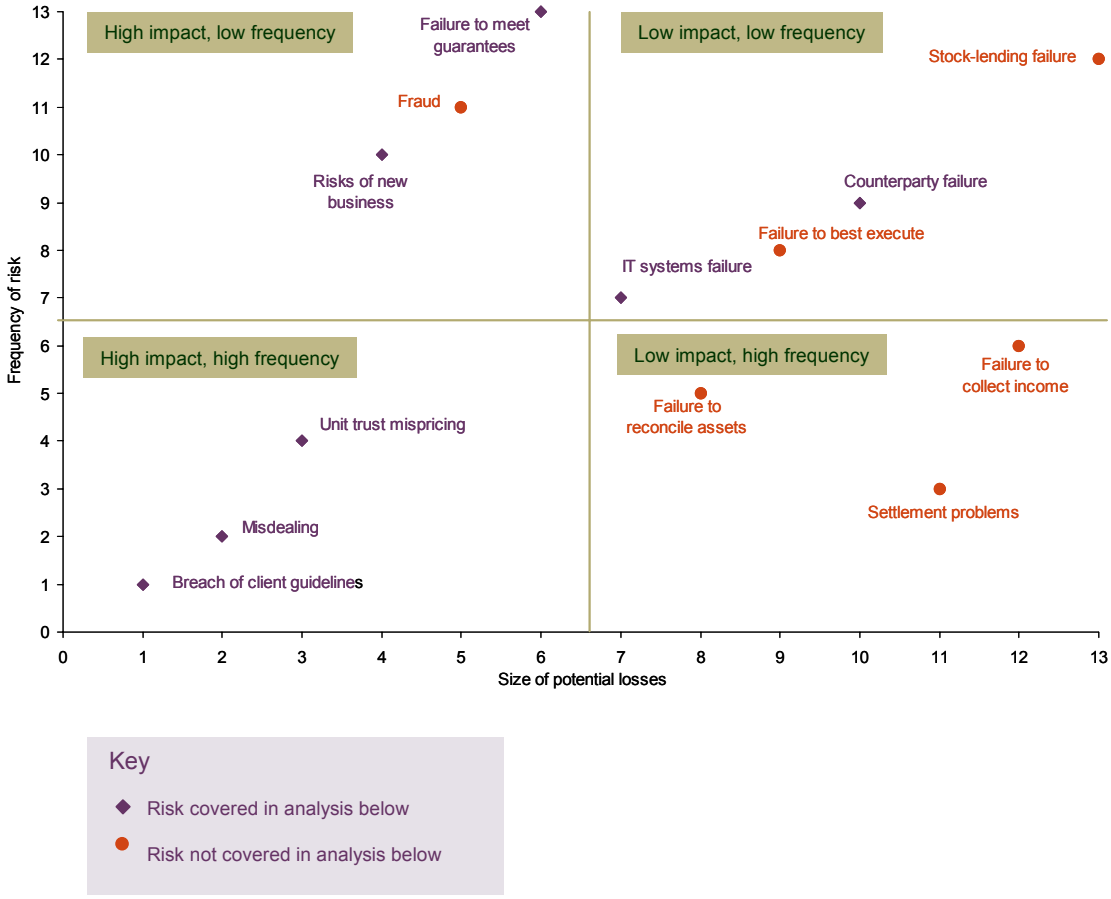
Oxera (2001) and Biais et al. (2003) asked a sample of European asset managers to identify the most important risks they considered to be part of their business operation. These are listed below, with each risk described in detail in Appendix 3:

– breach of client guidelines;
– misdealing;
– risks arising in the process of taking over new business;
– unit trust mispricing/net asset value (NAV) calculation error;
– subscription/redemption mistakes;
– fraud;
– failure to meet guarantees;
– IT systems failure;
– failure to reconcile assets under custodianship and internal records;
– failure to best execute;
– counterparty failure;
– settlement problems;
– failure to collect all income;
– stock lending failure.

Figure 7.2 below summarises the results of a survey conducted for the Oxera (2001) study, which asked AM firms to evaluate the frequency and potential impact (in terms of the size of losses) of all the operational risks listed above. The most important risks for asset managers—located in the lower-left (high-impact/high-frequency) quadrant—were identified as misdealing, fund mispricing and breach of client guidelines.

Other important sources of risk in terms of frequency (lower-right quadrant) are settlement problems and failure to reconcile assets under custodianship with internal records; while other important risks in terms of potential size of losses (upper-left quadrant) are the risks of taking over new businesses, fraud and failure to meet guarantees.

## Figure 7.2 Operational risks in the European AM industry

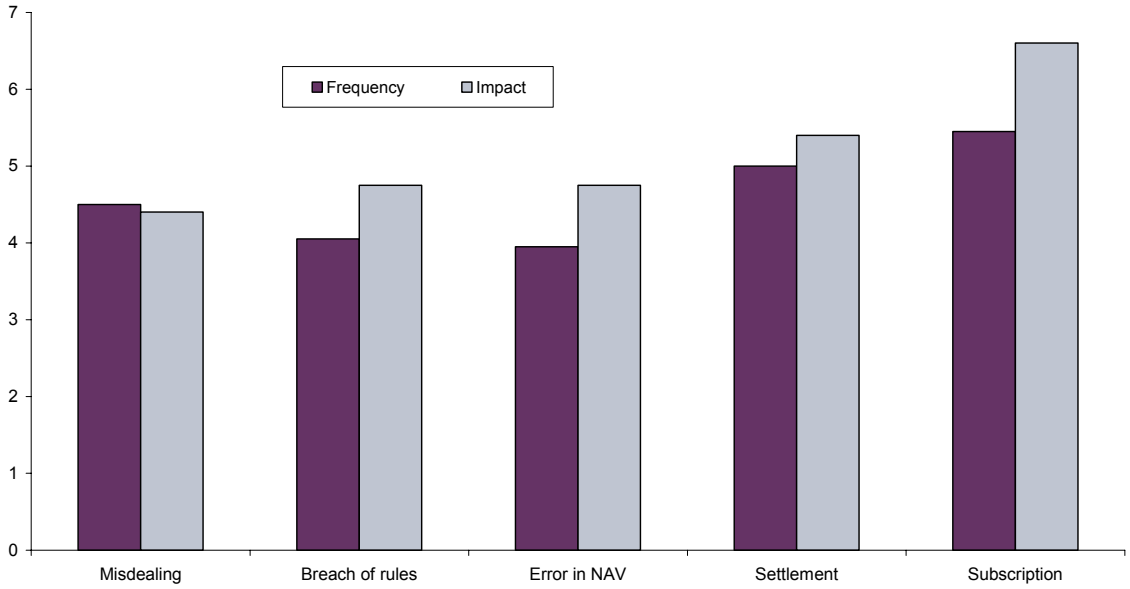



Source: Oxera.

Biais et al. (2003) reported very similar results, with Figure 7.3 showing that the four most frequent operational risks identified are the same as those shown in Figure 7.2. In addition, Biais et al. identified a further operational risk: subscription/redemption mistakes which are a specific source of risk in the fund management industry.[137]

[137] Unlike the Oxera study, which focused on AM firms offering both fund (ie, collective) management products and other AM products targeted at institutional clients, the Biais et al. (2003) study focused exclusively on firms offering fund management products.

**Figure 7.3 Operational risks in Biais et al. (2003)**




Note: The frequency and impacts are ranked on a 9-point scale, with the highest risk and highest frequency ranked as 1. The figures reported are the average scores for the five most significant sources of operational risk.
Source: Biais et al. (2003).

The analysis below discusses expected changes in the most important risks shown in Figure 7.2 in terms of size of losses (with the exception of the risk of fraud). Two risks in the upper-right (low-impact/low-frequency) quadrant are expected to become more important due to the trends taking place in the industry—counterparty failure and IT systems failure—and hence are also covered in the analysis below.

Key questions of interest are as follows.

– Are these risks becoming more frequent?
– Are their potential losses becoming larger?
– Are industry players aware of these risks?
– Are the right business or regulatory incentives in place to mitigate them?

Given that it is difficult to answer these questions precisely without a statistically robust pan-European examination, the approach adopted below is to explore the direction in which these risks are evolving, and might evolve, as a result of the prevalent trends identified in the study.

The analysis is based on hypotheses derived in the course of the research for this study and the process for verifying these hypotheses via the follow-up interviews. Interviewees were presented with a preliminary analysis of the potential for particular trends to increase or decrease the frequency as well as size of loss of different types of operational risk. They were then asked to critique these hypotheses and, if necessary, provide their own view on the issues raised. These hypotheses are summarised in Table 7.1 below, and discussed in greater detail in the subsequent analysis, together with the views of participants in the follow-up interviews.

**Table 7.1 Hypothesised impact of industry trends on operational risks**

| | | Hypothesised impact on risk (↑ increase; ↓ decrease) | |
|---|---|---|---|
| | Operational risks | Frequency of risk | Size of loss |
| Increased product sophistication and diversity | Breach of client guidelines, misdealing, fund mispricing, and counterparty risk | ↑ | ↑ |
| | Failure to meet guarantees | – | ↑ |
| Concentration of core AM in a few financial centres | Misdealing | ↓ | – |
| Manufacturing and distribution separated into discrete business models | Breach of client guidelines and IT systems failure | ↑ | – |
| | Risk from taking over new businesses | ↑ | ↑ |
| Open architecture (growth of MoM and FoF) | Breach of client guidelines | ↑ | – |
| Emergence of intermediaries (assemblers and aggregators) | Breach of client guidelines and fund mispricing | ↓ | – |
| | IT systems failure | – | ↑ |
| | Counterparty risk | ↑ | ↑ |
| Increasing M&A | Misdealing, failure to meet guarantees and risk from taking over new businesses | ↑ | – |

Source: Oxera.

### 7.3.4 Evolution of operational risks

At a high level of analysis, all trends associated with an increase in complexity, the need for more specific rules and guidelines, or more linkages between market players along the value chain might be expected to increase the scope for operational risks to arise. For example, the trend towards increased product sophistication and diversity can be linked directly to an increase in the frequency or potential impact of the following risks.

– *Breaches of client guidelines*—more complex and structured products require the definition of more detailed contracts with, for example, specific investment allowances. (Structured products include, for example, capital-guaranteed funds or products with otherwise risk-adjusted profiles.) With product sophistication, there is greater scope for these limits or particular contract clauses to be broken. This is exacerbated by any corresponding increases in the informational asymmetry between manufacturers and end-investors, as well as with the execution of the structuring process. While this type of risk might be mitigated by the reported growing investor sophistication in the institutional and private banking market segments, it is likely to have a greater impact in the retail segment.

– *Misdealing*—the scope for errors in issuing orders to brokers increases with product complexity, particularly when some of the products require dynamic asset allocation decisions or the continual trading of potentially opaque OTC products. The potential increase in the frequency of this risk might be counterbalanced by the growing concentration of core AM in a few financial centres, typically in cities where trading takes place and most brokers are located, and by the benefits of clustering, which could improve trading efficiency and reduce the scope for misdealing errors.

– *Unit trust mispricing/NAV calculation*—this risk has potentially significant direct consequences for value creation to end-customers. The problem of fund mispricing arises when investors buy (or sell) units in a fund at an under- (or over-) priced value,

either because of an unintentional operational error or due to an intentional strategy by the fund manager. The scope for unintentional errors might be expected to increase as fund managers launch UCITS III-compliant funds that can include derivatives in the portfolio. It is widely recognised that correctly pricing derivatives is more complex and prone to informational as well as operational errors.[138] However, some market observers note that trades in liquid derivative instruments should not increase such risks, provided that appropriate IT and control systems are in place.

Intentional pricing errors could also become more frequent. For example, pricing techniques that would be facilitated by the complexity and opacity of value calculations could allow for different assumptions to be introduced into pricing models to smooth fund volatility, and therefore appear less risky from the investors' perspective. These techniques could also allow for the use of insider information to buy at a low price (or short-sell at a high price), in the knowledge that the fund price will be corrected upwards (or downwards) shortly thereafter. However, Oxera has not found any specific evidence to support the conclusion that this practice is currently spreading.

– *Failure to meet guarantees*—the growing popularity of guaranteed products is expected to increase the size of any potential losses, should a failure to meet the guarantees occur in the presence of a particular market development. However, these events are reported to be very rare. These products are typically structured such that the guarantee relies on the appropriate level of investment in a low-risk instrument that ensures the necessary returns in future to cover the guaranteed portion of capital, or is based on an external guarantee from monocline insurers, for example.

– *Counterparty failure*—where a fund enters into a contractual relationship with another party (eg, a counterparty to a derivative contract), the risk of counterparty default arises, which might result in direct losses to the fund. In some cases, the counterparty is part of the same financial group as the manufacturer, which could increase the correlation of counterparty risk with other risks. Increased popularity of funds, such as guaranteed funds or structured funds that include contracts with external parties, renders counterparty failure risk more prominent.

### Impact of growing product sophistication

The follow-up interviews provided significant evidence in support of the proposition that greater product sophistication could increase the scope for breaches of client guidelines and misdealing. At the same time, the evidence on the impact on the magnitude of the expected risk increase is less robust. Some asset managers noted important considerations that tend to go against the argument that the frequency of operational risks other than breaches of client guidelines and misdealing might be increasing overall. This was particularly the case for fund mispricing and counterparty risks.

– While many asset managers are taking advantage of UCITS III regulations by including derivatives, this does not necessarily translate into greater frequency of fund mispricing risk. In most cases, the instruments used are listed derivative instruments with sufficient liquidity to ensure transparent, up-to-date and efficient pricing, and, in such cases, the risk of fund mispricing calculations is unlikely to increase.

– The size of a potential loss in the case of mispricing might increase, but only because the assets allocated to derivatives have grown in size, not because there is greater scope for operational risks to arise.

– The risk of mispricing calculations appears to be more clearly increasing in products where OTC (over-the-counter) derivative instruments are employed. For these

[138] See, for example, Bank of New York (2006).

instruments, pricing is less transparent due to illiquidity, and is therefore likely to imply lower market efficiency. (In particular, pricing information might not be readily available.) This is likely to be more prevalent in the institutional sector—while it is possible for an asset manager to construct a retail fund using OTC products in order to achieve a particular risk exposure, these instruments are more commonly used in the institutional market.

– The distinction between the use of listed and OTC derivatives may have implications for the expected change in the frequency and impact of counterparty risk. Where listed derivatives are used, the risk of counterparty failure would generally remain unchanged since AM firms would be exposed to the risk that the exchange's central clearing counterparty (CCP) defaulted. All things being equal, the CCP's default risk should not be affected by an increased use of listed derivatives by asset managers.

### Impact of manufacturing/distribution decoupling and open architecture

Another trend with the potential increase in the frequency of breaches of client guidelines is the growing separation between manufacturing and distribution into discrete business models. Problems relating to information asymmetry and communications between the manufacturing and distribution segments of the value chain can lead to difficulties in handling client information and therefore the risk of client guidelines being breached. Moreover, there is the potential risk of mis-selling if distributors are not sufficiently informed about product characteristics or insufficient information is passed on to the end-investor. Problems with making different IT systems communicate with each other might exacerbate this issue. This linkage has been highlighted by some asset managers in the context of the need for the development of compatible operational platforms, in particular across borders. Many asset managers see currently available platforms from external providers as inadequate to ensure sufficiently robust compatibility.

Breaches of client guidelines can also be linked with the growth of MoM and FoF, and more generally with the trend towards open architecture, as this can lead to similar informational problems. MoM/FoF increase the number of layers of interaction between players, expanding the scope for communication problems along the vertical chain of interactions.

When Oxera raised this issue in the course of the hypotheses verification exercise, many asset managers mentioned that responsibilities of manufacturers and distributors in relation to the end-investor remain unclear under the current regulatory frameworks, and this problem is likely to become more prevalent as existing distribution channels continue to implement the open or guided architecture models.

In the course of the structured interviews, the link between breaches of client guidelines and the trend towards the separation of manufacturing and distribution, as well as the growth of full or guided open architecture distribution models, received mixed support from interviewees.

First, it was highlighted that the risks associated with these trends could be thought of more as business risks than as operational risks, at least from the manufacturer's perspective. In particular, the separation of business models in the context of open architecture means that manufacturers are, in a way, losing control of the client relationship—their challenge is now how to remain close to the end-investor.

– For example, several asset managers have stated that the effect of these trends (separation of manufacturing and distribution, and open architecture) was essentially to remove the manufacturer from the end-investor, raising concerns about how to ensure that distributors that are selling the funds remain adequately informed about the product characteristics and are able to communicate them effectively to the end-investor. In the context of open architecture, this risk was thought to be even more significant.

Second, for AM firms where the manufacturing and distribution functions remain within the same organisation—even if with respect to strategic and business considerations they are operated independently—the potential risk of breaches of client guidelines arising from open architecture and/or the separation of manufacturing and distribution would just be transferred internally at the firm level without any change in its frequency or potential size. In these cases, informational problems would not be severe and risks would remain unaffected.

### Impact of intermediaries

The emergence of intermediaries in the context of the growth in the market for TPF, as well as the increasing importance of open architecture distribution models, has uncertain effects on the expected frequency of operational risks—particularly with respect to breaches of client guidelines and fund mispricing. Based on the available information, it is not possible to conclude at this stage whether the frequency of operational risks will change significantly.

On the one hand, the appearance of a large number of intermediaries, particularly product assemblers and aggregators who offer no additional services, is adding another layer of interaction in the value chain, increasing the scope for informational problems. On the other hand, intermediary platform models linking multiple distributors and manufacturers, and controlling a significant part of the market, can actually facilitate the communication process along the value chain, as well as increase the efficiency of key back-office functions such as execution and administration.

In that sense, particular types of intermediary offering ancillary services, such as universal platforms, have the potential to simplify procedures through contract standardisation. This reduces the scope for operational risks related to breach of client guidelines, while also increasing the transparency of fund pricing calculations. Nevertheless, their presence makes the industry more reliant on IT-based platforms, increasing the potential size of losses associated with an IT systems failure. That said, although increased reliance on IT has been broadly acknowledged by the industry in the course of Oxera's investigation, it has not been highlighted as a major source of new risk.

### Impact of horizontal consolidation

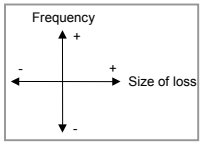
Finally, the increase in M&A activity being observed in the industry might lead to risks arising more frequently from taking over new businesses, as different systems and platforms are integrated cross-border. Such risks are more likely to arise simply because more corporate actions are taking place, not because each deal is necessarily exposed to greater operational risk.

Risks of this type, however, can be thought of more as business/commercial than operational risks—AM firms themselves have strong incentives to minimise the scope for operational failures to occur during M&A processes. Moreover, as such corporate actions become more common, these types of risk might arise less frequently, as firms become more efficient and learn from experience.

Table 7.2 below summarises the discussion in this section by showing the effects that the trends identified to be taking place in the industry are expected to have on the frequency and/or potential size of losses of operational risks.

## Table 7.2 Trends and implications for operational risks

**Key**




| Trends/risks | Breach of client guidelines | | Misdealing | | Unit trust mispricing/ error in NAV | | Failure to meet guarantees | | IT systems failure | | Counterparty risk | | Overall assessment | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Increased product sophistication and diversity** | More detailed contracts and limits are easier to breach | ↗ | Dynamic asset allocation creates increased opportunities for error | ↗ | Risk is limited due to the use of exchange-traded derivatives | ↗ | Limited increase in the size of loss because guarantees are achieved by investing in low-risk instruments | → | Systems that are handling more product types are more complex, so may be more prone to failure | ↑ | Risk is limited due to the use of CCP for exchange-traded derivatives | ↗ | Limited increase in frequency and size of losses | ↗ |
| **Concentration of core AM in a few financial centres** | Separation of the asset manager and the end-investor | ↑ | Increased trading efficiencies reduces frequency of errors | ↓ | | | | | Potential for risk-mitigating factors | ↓ | Potential for risk-mitigating factors | ↓ | Potential reductions in risk | ↓ |
| **Separation of manufacturing and distribution into discrete business models** | Communication problems along the value chain, although could be considered a business risk | ↑ | | | | | Potentially unclear responsibilities | ↑ | Fragmentation of the value chain and greater cooperation required with multiple players might increase IT risks | ↗ | | | Main source of risk is IT systems failure, but industry players have strong incentives to ensure proper IT links are in place | ↗ |
| **Open architecture (growth of MoM and FoF)** | More interaction between players; unclear responsibilities | ↑ | | | | | | | Challenges for system integration mitigated by emergence of platforms | | | | Increase in frequency of breaches of client guidelines | ↑ |
| **Emergence of intermediaries (assemblers and aggregators)** | Uncertain, as dependent on the type of intermediary | | | | Potentially greater transparency in calculations. Increases the expertise of the party facing the manufacturer—should reduce risk | | Potentially unclear responsibilities | ↑ | Greater concentration of assets in a few players increases the potential size of losses | → | Assemblers might rely more on third-party contracts, leading to greater potential for counterparty default | ↗ | Overall effect is uncertain | ↗ |
| **Increasing M&A activity** | | | Greater risk in the reorganisational phase to diminish later | ↑ | | | Decrease as stronger players are likely to provide implicit guarantees | ↓ | Uncertain effect | | Potentially reduced counterparty risk | ↓ | Overall effect is uncertain | – |
| **Overall assessment** | Increase in frequency of risk | ↑ | Uncertain effect | | Limited increase in frequency and size of loss | ↗ | Limited market-wide increase in size of loss<br>Reduction in frequency in larger merged entities | ↘ | Increase in both frequency and size of loss<br>However, the industry has the right incentives to ensure this risk is minimised | ↗ | Limited increase in frequency and size of loss | ↗ | Overall, likely limited increases in operational risks | ↗ |

### 7.3.5 Analysis of potential new sources of risk and market failures

In addition to the analysis concerning risks classified earlier, the research conducted for this study has identified the following potential new or additional sources of risk and market failure:

– *scope for mis-selling due to commission bias*—mainly in the context of the adoption of guided or open architecture distribution models;

– *informational problems for end-investors (ie, investors not understanding the product characteristics and/or the risk to which they are exposed)*—due to product sophistication;

– *informational mismatch between manufacturers and distributors*; lack of clearly allocated responsibilities.

#### Risk of mis-selling due to commission bias

Where a customer is sold and/or recommended a product that is ill suited to their investment needs, this is referred to as mis-selling. This risk may arise owing to an unintentional mistake by the seller/distributor (eg, an advisor recommending the wrong type of financial product), or an intentional misrepresentation of the product attributes in order to finalise a sale.

The gradual opening up of the distribution channels might increase the scope for mis-selling risks in three ways: lack of specific information, misunderstanding the product nature, and commission bias, which takes two forms:

– *product-based*, where a distributor/advisor recommends a *particular financial product* based on the level of commission it will receive;
– *provider-based*, where a distributor/advisor recommends the product of a *particular provider* based on the level of commission it will receive.

Product-based commission bias entails significantly higher mis-selling risks for the end-investor in terms of potential welfare losses.[139] At the same time, this type of commission bias may be less frequent for at least two reasons: it might be more detectable by informed investors or the regulator than provider-based commission bias; and being consistently involved in cases of mis-selling would have a strong negative reputational effect for the implicated distributors/advisors.

In some cases, however, mis-selling could coincide with investors' lack of information, biases (eg, for additional guarantees), or the lack of understanding of a product's true exposure to investment risk. In particular, this type of problem was specifically mentioned during the Oxera interviews. At the same time, in practice, it is very difficult to distinguish between mis-selling and meeting investors' true preferences.

Compared with product-based commission bias, provider-based commission bias could be much more prevalent because it is arguably more difficult to detect. Moreover, it might entail less reputational damage for the implicated distributors/advisors due to the relatively limited *direct* impact on consumer welfare.

There is no conclusive evidence on how this risk is evolving, given the early stages of the open and guided architecture phenomenon in most jurisdictions. However, one of the few

[139] For example, being sold a high-risk structured product when the most suitable product would have been a low-risk income-generating fund exposes the investor to greater risks than being sold an income fund from a second-tier AM firm. In the former case, the risks involved are the loss of a large proportion of the investment if the market develops adversely. In the latter case, the investor would, at worst, receive a lower rate of return and possibly pay higher management fees than they would have done if there had not been a provider-based biased recommendation.

empirical studies conducted on this topic found that, although commission bias was not widespread in the market, the independent distribution channels (ie, IFAs) in the UK were more likely to be involved in (product) commission bias than tied distribution networks (CRA 2002). This comparison is based on product-based commission bias since, by definition, provider-based commission bias cannot exist in the tied sector given that tied advisors can only sell the products of a single provider. Therefore, the same problem might arise as IFAs grow more prominent in other jurisdictions.

The risk of commission bias does not appear to be of primary concern to asset managers according to market consultations undertaken by Oxera, although more analysis would be required to reach a definite conclusion.

However, given the large range of funds in the market and way in which distributors (or other intermediaries) are increasingly choosing which providers to present to customers, the overall potential risk from provider-based commission bias is likely to be increasing. Whether this increased risk materialises will depend on how effective end-users are at recognising this bias, and whether the new or additional incentive misalignments are effectively addressed.

### Informational asymmetries and market failure

With regard to the scope for informational problems to the end-investor, the fundamental issue is that the increased sophistication in the type of funds and products launched creates a potentially greater informational asymmetry between AM firms (manufacturers and distributors) and the end-investor. More sophisticated products may be able to match more closely the requirements of investors, but this does not mean that all sophisticated products will do so equally. Unless investors can make an informed choice between different products, including an informed consideration of both price and quality, the very complexity of the products can increase the risks that investors will end up with the wrong product, or an imperfect example of the right product. These risks are magnified where those selling the product have misaligned incentives, as they have a perverse interest in the investor failing to understand properly the product's characteristics.

Thus, while it can be argued that the wider range of products available in the market broadly enhances efficiency and ensures greater spanning of financial securities (as discussed in section 6.4), clients do not always understand the risks they take when purchasing these products. Indeed, in a survey on the use of derivatives in the fund market (*Financial News* 2006e), fund management companies ranked '*lack of understanding by end clients*' as the third most important risk in derivatives markets.[140] In the course of the interviews, some asset managers described how they have used simplistic comparisons in their marketing campaigns to describe sophisticated investment products that are, according to the same asset managers, ultimately incomprehensible or at least difficult for the end-investor to understand. This increases the risk of misrepresentation of true risk exposure.

Nevertheless, it is questionable whether retail investors need to know the precise mechanics or investment techniques employed to construct a product. Arguably, they only need to know what the outputs of the product are (eg, target capital protection and % of capital guaranteed, in the case of capital-guaranteed products) and how much they will pay for it.[141]

However, some asset managers did highlight the need for transparency in the way the products' costs are communicated, in order to minimise the scope for misinforming the end-investor.

[140] The first two were 'lack of transparent pricing in the OTC market'—which has been discussed in the context of fund mispricing risks—and 'investment banks mis-selling complex products'.

[141] For example, in the interviews an analogy was made with the automobile market, where the average retail buyer does not know (and is not interested in) how the car's engine or computer works, provided the car takes them where they want to go.

Another risk identified in the interviews is a potential informational mismatch between manufacturers and distributors. As discussed above, the separation of manufacturing and distribution, together with increases in the number of linkages driven by the opening up of distribution networks, has led to greater scope for breaches of client guidelines. This is exacerbated by the lack of clarity in national and EU regulatory frameworks about the responsibility of manufacturers and distributors, respectively, compared with the end-investor in the case of losses caused by breaches of client guidelines and mis-selling scandals.

#### Overall conclusion on new sources of risk and market failures

Several additional or increased risks appear to emerge from the trends identified. Such increases in risk and potential market failures have been confirmed by the follow-up interviews, and arise from the more theoretical analysis of the likely changes in market dynamics caused by these trends. However, notwithstanding the potential increases in risks and market failures caused by these trends, they should be considered against the benefits that their existence might bring to end-investors.

## 7.4 Value creation to the end-investor

This section examines the impact of identified trends, risks and changes in the competitive landscape along the value chain on the evolution of the implicit value for money (price/quality ratio) achieved when investors purchase products and services in the AM industry.

Price can be directly measured through the level of management and distribution fees that are levied on investors (albeit the multiplicity of the types of fees requires suitable cumulative measures to understand the overall effect). Quality is a more elusive concept related to the idea of choice and product suitability to investors' needs and the achievement of maximum returns for a given level of investment risk (or the minimisation of investment risk for any given level of return). That is, quality concerns investment products that are offered to investors in accordance with investors' preference for a particular risk–return trade-off (in the basic portfolio design framework), as well as other characteristics that might be of value to AM industry clients.

In that sense, the quality or suitability of investment products is likely to increase with investors' ability to choose from a wider range of products, provided that investors are adequately informed about the risks they are taking and the rewards they can realistically expect when selecting a particular product. Although the analysis of the level of investment risk embedded in different products, including emerging investment products, is outside the scope of this study, investors' understanding of the level of underlying investment risk is the necessary component of the value and suitability considerations.

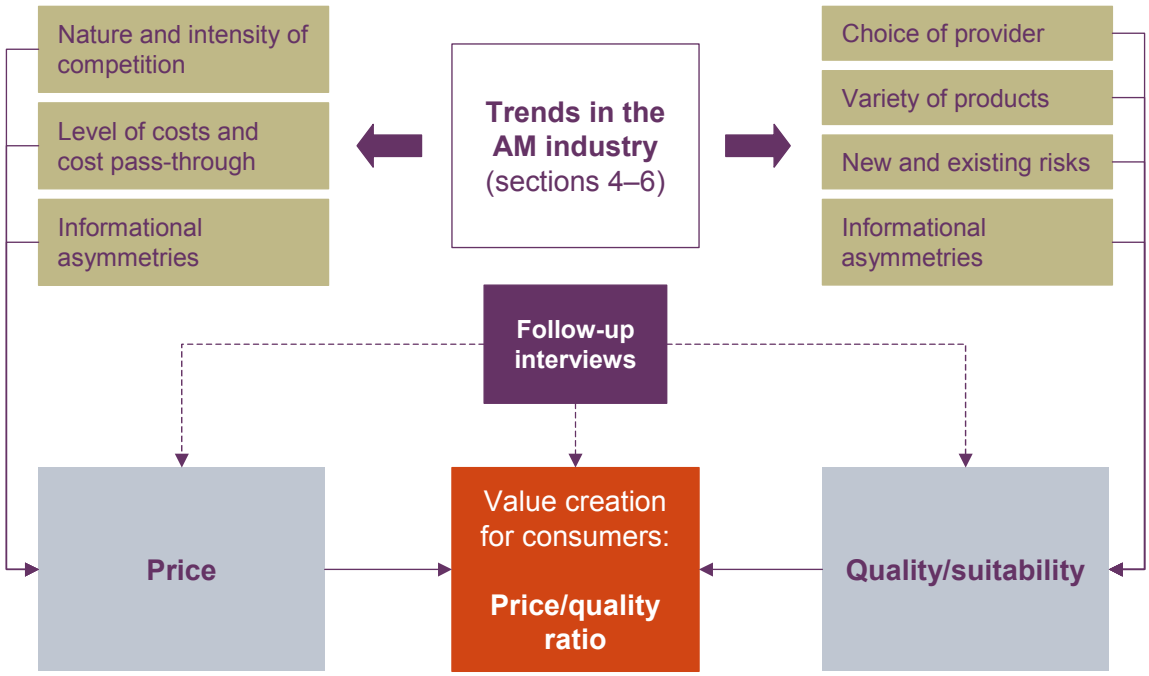
The analysis presented below approaches the issue of quality/suitability by exploring the implications of identified trends for some of the characteristics of the transaction between investors and AM firms. This involves consideration of the following issues, as shown on the right hand-side of Figure 7.4:

– the impact on choice and range/variety of products available to investors across different distribution channels—stemming from developments in core AM outsourcing and open and guided architecture, tempered by the investor's ability to exercise that choice effectively;
– informational asymmetries, if any, between investors, distributors and AM firms—caused by the degree of sophistication of available investment products, tempered by the information available to the investor;
– alignment of incentives along the value chain which influence the choice of investment products purchased by the end-investor—as a result of changes in different market players' bargaining power, tempered by the degree to which these players pass on the benefits of their bargaining power to end-investors;

– the scope for new and existing risks to affect the quality/suitability of the products, in light of the analysis in section 7.3.

The framework employed to analyse the impact on value creation to consumers is summarised in Figure 7.4. The starting point is the trends identified in sections 4–6 and their implications for the factors affecting the price (competition, cost pass-through, informational asymmetries) and the quality/suitability (choice, variety, risks, informational asymmetries) of AM products and services. The expected impact on price is analysed in section 7.4.1, with the corresponding analysis for the quality of products and services in section 7.4.2.

**Figure 7.4 Framework for the analysis of value creation to consumers**




Source: Oxera.

### 7.4.1 Pressures on the price of AM products and services

The overall level of fees paid by the end-investor would be expected to change if one or more of the following factors are changing:

– the degree of competition in each segment of the value chain (ie, among manufacturers as well as distributors);

– the overall level of costs in the industry (and, in the presence of super-normal profits at any level in the value chain, the degree to which they are expected to be passed on to the end-investor);

– the degree of informational asymmetry, market concentration and barriers to entry along the chain of vertical relationships in the industry (manufacturer—intermediaries—distributors—investors), influencing the relative bargaining power of each market participant.

As noted above, one of the more fundamental changes in the nature of competition in the AM industry has been the reported relative increase in the bargaining power of distributors compared with manufacturers. This has been attributed largely to the growth in the TPF market that has accompanied developments such as open and guided architecture and the separation of manufacturing and distribution. As a result, many products of the AM firms are seen as more of a commodity—they can be packaged in white-label FoF and easily replaced

by similar products/funds from other providers. At the same time, new, specialised manufacturers, including boutiques, focus on the search for alpha using unique strategies that can distinguish them from other providers. This is intensified with the emergence of expert intermediaries that facilitate the process whereby distributors (or end-investors) can easily compare and select funds from different providers.

The effect of this development on the relationships between segments of the value chain has been a claimed change in the allocation of the overall fund management fee between manufacturers and distributors (rather than in the overall level of fees paid by the end-investor, for which there is evidence that this has remained fairly flat). In other words, according to the follow-up interviews, the retrocession fee—the proportion that remains with the distributor—has increased over time, while the overall level of fees has remained more or less unchanged.[142]

Whether distributors have incentives to pass on to investors all or some of these extra revenues is likely to depend on the intensity of competition in the retail distribution market. The available evidence presented in section 6 and discussed in the context of the changing competitive dynamics in the industry indicates that, in most Member States, the distribution market continues to be dominated by a few large players, which are usually part of larger local financial institutions such as banks, and that the level of competition between distributors is not increasing significantly. Although any increased retrocession fees may be being passed back to consumers in the form of discounts, there is no consistent, accessible information supporting this conclusion. To the extent that there is vigorous competition between distributors for retail customers, it appears to be based on offering value-added ancillary services (eg, comprehensive financial advice involving mortgages, pensions and insurance in addition to AM products), rather than undercutting each other's fees.

A tentative conclusion emerging from the follow-up interviews was that the market was unlikely to see significant decreases in the fees paid by retail clients, at least in the short run, even though manufacturers' fees have decreased. Some downward pressure on the level of fees might be expected if alternative distribution channels, such as fund supermarkets (continue to) grow in importance, exerting pressure on traditional channels to pass through some of the increase in the retrocession fee they have been achieving. Some asset managers stated that, in the medium to long term, as younger investors with greater willingness to use the Internet enter the market, fund supermarkets will gradually increase in importance. In some countries (eg, the UK and Sweden), Internet fund supermarkets offering significant discounts on management fees and no up-front fees are already gradually gaining market share.[143] In most Member States, however, there is weak evidence for this trend.

With regard to the effect on costs, the trend towards consolidation at the manufacturer level—in terms of both concentration of activities in a few financial centres and the increasing numbers of fund and company mergers leading to larger funds—should lead to cost reductions as greater economies of scale are achieved. Another development with the potential to have a significant positive impact on cost efficiency in the industry is the emergence of intermediaries linking multiple manufacturers and distributors in a single operational platform, which can reduce the costs of enabling manufacturers and distributors to link up, especially in the light of vertical fragmentation of the value chain discussed earlier.

[142] Hard evidence on the change in retrocession fees is currently unavailable since only a single snapshot of this data has been collected (Cerulli Associates data, as reported by ZEW/OEE 2006). However, a number of asset managers interviewed confirmed that the trend in retrocession fess was, indeed, upwards. This effect might be reversed with respect to specialised providers and boutiques that use unique trading strategies. In fact, retrocession fees appear to be substantially lower for these manufacturers. The distinction between these two groups corresponds closely with the core-satellite dimension of investment strategies.

[143] In essence, Internet fund supermarkets are able to provide an 'execution only' service and can therefore surrender their up-front fee. Moreover, because they agree wholesale distribution deals with manufacturers, they are able to obtain better terms (higher retrocession fees), which are passed on to the end-investor.

Provided that the complete value chain remains competitive in general, these cost reductions should eventually be reflected in the prices faced by investors. However, given the characteristics of the interactions along the value chain (including potential incentive misalignments and information asymmetries), this process is unlikely to be instantaneous.[144]

The discussion so far suggests a trade-off between the scope for cost efficiencies and the scope for reductions in fees that can be expected from two different existing market structures, based on different current business models.

– Market type A (more prevalent in Continental Europe, including new Member States)—a few dominant distribution channels, typically banks, with large captive retail markets.

  In this type of market there is limited evidence of fee-based competition. However, significant efficiency gains are possible from the emergence of, for example, a dominant intermediary linking the few dominant distributors with a large number of local and foreign fund providers. The value to consumers might be enhanced in this market through greater competition among traditional players responding to new business challenges, as in the case of Germany.

– Market type B (UK and Scandinavian countries)—no single dominant distribution channel and a strong independent distribution sector.

  In this type of market there is greater scope for price competition and pass-through of efficiency gains (eg, Internet supermarkets cutting up-front fees and offering discounts on recurrent fees). However, while the intermediary model is likely to be successful because of strong TPF markets, dominant intermediaries with the potential to create substantial cost efficiencies are less likely to emerge than in market type A, precisely because of the greater number of distributors that need to be signed up to the service.

In both market types competition at the distribution level is likely to be the main mechanism exerting downward pressure on fees, and, possibly, on the extent to which both cost efficiencies and the benefits of more aggressive pricing strategies upstream are passed on to investors via a reduction in fees. Moreover, competition between distributors is likely to be motivated by informed and sophisticated end-investors who are willing to shop around for value.

In this context, the question of how investors can be empowered, and competition among distributors fostered, is a fundamental policy problem. At the heart of this complex problem is the nature of the informational asymmetry between investors (retail investors in particular) and firms in financial services industries. While this issue is beyond the scope of the current study, it would be expected to constitute a crucial element of any policy formation if it were felt that intervention were required to improve the market dynamics in this industry.

Finally, it is also worth noting that the growth of the TPF market across most European countries is increasing the level of fees paid by the end-investor for FoF/MoM or other packaged funds. In general, this is because, in order to package these products, an additional layer of intermediary must be remunerated, which adds to the overall level of fees that must be paid for by the end-investor.

While this development could be seen as a cause for concern, it must be assessed against the benefits that such packages bring to end-investors in terms of innovation, quality and choice. This and other implications for the quality of AM products are discussed in the following section.

[144] This would be an interesting area of future research when sufficient data to perform such a cost-pass-through analysis becomes available.

### 7.4.2 Implications for the overall value for money (quality) of products

Overall, the developments taking place suggest that the quality of products and services in the industry has increased. The gradual opening up of distribution channels is giving investors more options to select the product and provider of their choice. Although some industry participants suggest that too much choice is not always in the investor's best interest, the possibility to select from a wider range of funds and providers should represent an improvement in the customer experience.

Similarly, even in jurisdictions where dominant distribution channels have been slow to open up, the emergence of assemblers (both within mainstream AM firms as well as independent product re-packagers) has given a considerable boost to the TPF market. This has allowed end-investors to have indirect access to a much wider range of products from different local and foreign providers through FoF/MoM funds and other structured products.

In addition, intermediaries and assemblers can perform a valuable function for end-investors by narrowing the options from which consumers must choose to a more manageable number of funds. To the extent that the processes and criteria used by intermediaries (and distributors adopting the guided architecture approach) to select funds is transparent and not influenced by commission bias, the effect should be to create value for consumers.

These developments have increased the sophistication of products to which the average retail investor can have access, and, to some extent, has also increased the suitability of products. For example, recent years have seen the emergence of many types of capital-guaranteed products aimed at investors with several different risk profiles (products offering combinations of capital protection and exposure to financial markets). This makes it more likely that an investor will be able to find the product that best suits their investment needs. Nevertheless, there is little evidence that the current range of products offered to retail investors is optimal. For example, innovative offerings in the retail market have not developed as fast as in the institutional market. However, the new opportunities introduced by UCITS III regulation in retail investment funds could provide a significant boost to product innovation, which could in turn create additional value for the end-investor through improvements in the suitability of product offerings. At the same time, this process must be closely observed in light of the reports (discussed earlier) that, on occasion, investors might be encouraged to buy structured products against their best interests given their true preferences (ie, the risk of mis-selling).

The growth in the TPF market has been facilitated by some important changes in the core AM segment of the value chain, which have also increased the potential efficiency of the market, and, therefore, the innovation and product manufacturing processes. These developments are creating value for consumers by increasing the efficiency of the AM value chain.

– First, the separation of distribution and manufacturing into discrete businesses has placed greater pressure on manufacturers to obtain higher returns—ie, manufacturers can no longer rely on a captive customer base to sell relatively poor quality products; an outcome that might have existed when the manufacturing and distribution functions were part of the same organisation. As a result, competition between manufacturers is increasingly being based on delivering strong returns under any market conditions (alpha) and eliminating poor quality (or poorly focused) products from the market. This development can only be to the benefit of the end-investor, even if the direct effect of competition on fees is limited.

– Second, the adoption of the boutique model by many mainstream asset managers is allowing them to identify the sources of value within their organisations more directly, and therefore reward it accordingly. In other words, linking pay more closely with performance is putting the right incentives in place for greater transparency and accountability within AM firms, and this may feed through to the end-investor via higher returns than would have otherwise been achieved.

This highlights a dichotomy with respect to the value to the end-consumer derived from the growth of the product range on offer, particularly in the part of the market offering packaged TPF. On the one hand, the widening of the range of products available to the average investor increases the likelihood that a 'more suitable' product is selected. Similarly, the TPF market is associated with efficiency-enhancing developments (eg, performance-related pay, competition based on delivering returns) that should feed through to the end-investor in the form of higher-quality products. On the other hand, the level of fees that investors must pay for some of these products has risen because they involve more layers of intermediaries that must be remunerated—particularly for FoF/MoM products. The key question that needs to be answered is whether investors truly value the characteristics of these products more than the additional costs (fees) they are incurring.

This question might be difficult to answer by investors themselves, if there are significant informational asymmetries. From the analytical perspective, this question highlights an important consideration: provided that all necessary information is available to make a decision, the extra cost incurred by the investor when purchasing FoF/MoM or the product of an assembler should not raise market failure concerns—it would be like any other commercial transaction where consumers assess their willingness to pay against the actual cost of the good.

To assess changes in the quality of AM products and services, it is also important to consider the implications of the evolution of operational risks, as well as new sources of risk. As noted earlier, the main source of operational risk in the industry is the growth in the complexity of products, which is increasing the scope for risks such as breaches of client guidelines, misdealing and fund mispricing to occur.

The fundamental issue with this trend and its associated risks is the informational asymmetry between investors and the AM industry. If investors were perfectly informed about the risks associated with more complex products, they would price these risks accordingly and would only buy these products at an appropriately (reduced) price. Similarly, firms that invested in adequate risk management systems would be able to command a price premium over those firms that had not made this investment. However, the growing importance of distributors' and intermediaries' role in selecting funds sold to end-investors, including the use of white-label products and FoF, may be helping to resolve the informational asymmetry, at least at the manufacturing level. Arguably, distributors and intermediaries are much better informed about the risks of particular products and providers, and would be in a better position to price these risks, or, quite possibly, only use providers with adequate risk management systems.

Nevertheless, informational asymmetries between investors and distributors continue to be an important source of risk that might require further attention from regulators. In particular, the analysis in section 7.3 highlighted how developments in open architecture could lead to concerns of commission bias. While the experience of the UK shows that commission bias is not a frequent problem, it can still lead to losses of consumer welfare.[145]

On balance, the relatively limited frequency of commission bias needs to be assessed against the benefits brought about by the trend towards full or guided open architecture. In addition to the increased choice and variety of products, commission levels are only one of many criteria used by distributors to select funds, which include factors such as past performance of providers/individual managers, adequacy of manufacturers' risk management systems, and ancillary services such as product training. To remain on the distributors' shelves, manufacturers are therefore forced to compete on a range of criteria wider than price. These are developments that are likely to benefit end-investors.

[145] In the UK study, these losses were estimated at around £140m per annum.

## 7.5 Summary

A number of trends identified in sections 2 to 6 are likely to have significant implications for the level of competition in the AM value chain, the creation of value for investors by asset managers and the risks faced by investors (and, more generally, the economy as a whole) from the operation of the AM business. The main trends that have these implications are:

- a shift in the balance of commercial power away from manufacturing of AM products (seen most clearly in conventional products) to the distribution of products;
- the development of more independent distribution networks, breaking down the traditional vertical integration of AM businesses into their constituent parts, each operated as a de facto or de jure separate entity;
- the creation of additional layers of intermediation between the investor and the underlying investment;
- the increasingly widespread use of investment vehicles other than conventional (long only) equities and bonds.

The potential impact of these trends on competition and value creation is as follows:

- the shift of bargaining power to distributors will not necessarily deliver benefits to end-customers if competition between distributors is insufficient to force them to pass on to consumers any benefits that they gain from increased competitive pressure in manufacturing;
- the breakdown of the vertically integrated structures increases the potential for competition at different levels in the vertical chain. Combined with the addition of specialist layers between the underlying investment and investors, who are (relatively) expert in evaluating the output of the layer above, creates the conditions for a more effective selection process, and hence a more effective competitive process. However, making this process deliver benefits to end-investors requires the interests of these intermediaries and the end-investors to be closely aligned;
- the greater diversity of product types exacerbates the difficulty of achieving effective competition because it increases the potential information asymmetry between end-investors and product providers. However, to the extent that expert intermediaries can substitute for end-investors (and that their interests are aligned), the increase in the diversity of product types should make it easier for end-investors to gain access to products that match their needs more closely.

With respect to risks, the likely impacts are as follows:

- the fragmentation of the value chain can create additional risks for end-investors if the application of regulatory safeguards becomes uncertain in terms of where in the chain it is applied. End-investors, and the interested parties themselves, may not understand which party is responsible for complying with which rules;
- the fragmentation also increases the number of places where the incentives of the different providers can become misaligned with those of the end-investor;
- the fragmentation also creates more institutional/legal boundaries where operational risks can arise, and responsibility for the operational risks may become less clear-cut, should they occur;
- a similar increase in operational risks may occur as the products being sold become more complex, again creating more opportunities for operational risks to occur.

There is insufficient evidence to draw definite conclusions on whether these trends will produce an overall benefit to investors.

# A1 Summary of key sources of evidence

### Table A1.1 Core AM

| | Primary sources | Secondary sources | Oxera interviews[1] | ZEW/OEE |
|---|---|---|---|---|
| **Development of the UCITS segment of the AM industry** | | | | |
| Modest growth of the UCITS segment of the industry | | | n/a | The evolution of UCITS AuM |
| Binding investment restrictions as a barrier for the growth of UCITS | European Commissioner for Internal Market and Services (2005) | European Commission (2005a), IMA (2005b), EFAMA (2005) | n/a | n/a |
| Increasing costs of compliance with UCITS III | *Financial News* (2006a) | IMA (2005b), ISSA (2005) | Medium | n/a |
| Increasing regulatory arbitrage | PWM (2005a) | IMA (2005b), Ernst & Young (2005) | Strong | n/a |
| **Changing composition of UCITS funds** | | | | |
| Commoditisation of hedge funds as driver | *Financial News* (2006d) | | Strong | n/a |
| Increasing allocation to derivatives by UCITS funds | *Financial News* (2006d) | PWM (2006a) | n/a | n/a |
| **Commoditisation of hedge funds** | | | | |
| Substantial growth of hedge fund industry in 2001–05 | Russell Investment Group (2006), Invesco–FRC (2005) | Widely acknowledged in the industry | Strong | n/a |
| Investor demand as driver | KPMG–CREATE (2004a) and (2005) | Widely suggested in the secondary sources—eg, Rediff.com (2005) | Medium | n/a |
| Performance of hedge funds as driver | KPMG–CREATE (2005) | | Strong | n/a |
| Market downturn as driver | McKinsey & Company (2005a), Bank of New York (2005) | | n/a | The evolution of retail AuM |
| Hedge fund industry is reaching the state of maturity | Russell Investment Group (2006), KPMG–CREATE (2005) | *Financial News* (2006b), FT Mandate (2005a), Funds Europe (2006b) | Medium | n/a |
| **Emergence of structured and alternative products** | | | | |
| Investor demand as driver | KPMG–CREATE (2004a) and (2005), Russell Investment Group (2006), Invesco–FRC (2005) | Structured Products (2005) | Strong | n/a |
| Increasing exposure of retail investors to structured products | | Increasing number of structured products—eg, recorded at www.trustnet.com | Strong | The evolution of AuM in structured products |
| Higher margins for asset managers as driver for structured products in retail sector | | Funds Europe (2005a) | Medium | n/a |
| LDIs as instrument of hedging accounting standards | | *Financial News* (2006c) | Strong | n/a |

| | Primary sources | Secondary sources | Oxera interviews[1] | ZEW/OEE |
|---|---|---|---|---|
| Increasing use of structured and alternative products | KPMG–CREATE (2004a) and (2005), Russell Investment Group (2006), Invesco–FRC (2005) | CSTIM (2006), Structured Products (2005), AIMA (2005), Funds Europe (2005b) and (2006c), ISSA (2005) | Strong | n/a |
| **The core-satellite strategy and the boutique-type business model adopted by mainstream providers** | | | | |
| Increasing adoption of boutique-type internal structures by large AM firms | KPMG–CREATE (2004a) and (2004c), Funds Europe (2006d), | Funds Europe (2004) | Strong | n/a |
| Higher performance as driver for adoption of boutique-type internal structures | KPMG–CREATE (2004c) | | Medium | n/a |
| Increasing adoption of core-satellite approach | Thought Leadership Summit (2006) | CSTIM (2006), Funds Europe (2004) | Strong | n/a |
| Cost efficiencies as driver for adoption of core-satellite approach | Bank of New York (2005) | | Weak | n/a |
| Boutique business structures and core-satellite approach lead to vertical segmentation and horizontal consolidation of core AM segment | KPMG–CREATE (2004a) and (2004c), Funds Europe (2006d) | Widely acknowledged in the secondary sources, see Everyinvestor (2005) | Strong | n/a |
| **Outsourcing of core AM and fragmentation of the value chain** | | | | |
| Growth in assets invested in FoF/MoM | | | Strong support | The evolution of FoF |
| Client demand as driver for increasing outsourcing of core AM function | PWM and Goldman Sachs Asset Management (2005) | FT Mandate (2005b) | Medium | n/a |
| UCITS III regulation as driver for increasing outsourcing of core AM function | PWM Research (2006), number of articles on the PWM website | PWM (2006b), PWM and Goldman Sachs Asset Management (2005) | n/a | n/a |
| Growth in alternative products as driver for increasing outsourcing of core AM function | | PWM (2006a) | Medium | n/a |
| Increasing diversification of business models and separation of core AM and distribution | | McKinsey & Company (2005b) | Strong | n/a |
| **Concentration of the core AM function in large financial centres** | | | | |
| Concentration of the core AM function in large financial centres | | Putnam Lovell NBF Securities (2006) | Strong | n/a |

Note: [1] Strength of evidence assessed according to the scale: strong, medium, weak, n/a.
Source: Oxera.

## Table A1.2 Distribution

| | Primary sources | Secondary sources | Oxera interviews[1] | ZEW/OEE |
|---|---|---|---|---|
| **Gradual opening of traditional distribution channels** | | | | |
| Investor demand as driver | PWM (2006c), BNP Paribas (2006), PWM and Goldman Sachs Asset Management (2005) | | Strong | n/a |
| Changes in national regulation as driver | | PWM (2006d) | n/a | n/a |
| Impact on proprietary manufacturer as potential barrier | | PWM (2006e) and (2005b) | Strong | n/a |
| Gap-filling as primary motive | | NERA (2002), Funds Europe (2006b) | n/a | n/a |
| Certain traditional distributors remain closed, some follow guided architecture model, few examples of open architecture model | | PWM (2005b) (2005c) (2005d) (2005e) (2006c) (2006d) (2006e) (2006f) and (2006g), CSTIM (2006), ISSA (2005), FT Fund Management (2006), NERA (2002) | Strong | n/a |
| **Separation of core AM and distribution** | | | | |
| Increased outsourcing of core AM and growing open architecture as driver | | PWM (2006g) | Strong | n/a |
| Emergence of NINFAs | | BNP Paribas (2006) | Medium | n/a |
| Investor demand as driver | PWM and Goldman Sachs Asset Management (2005) | | Strong | n/a |
| Core AM and distribution become increasingly functionally separated | KPMG–CREATE (2004a) and (2004c) | PWM (2005f) and (2006g), PWM and Goldman Sachs Asset Management (2005) | Strong | n/a |
| **Evolution of IFAs** | | | | |
| Contrasting differences in IFAs' market shares in the UK and Continental Europe | | PWM (2005e), ISSA (2005) | n/a | Market shares of distribution channels in 2005 |
| Banks are forecast to dominate fund distribution in the UK | | PWM (2005f) | n/a | Contradicts Cerulli forecasts |
| IFAs are forecast to dominate fund distribution in the UK | Magnus Spence Financial Research Corporation (2005), | | Medium | Cerulli forecasts |
| New distribution channels are primary source of boosting AuM: driver for the evolution of IFAs in Continental Europe | | KPMG (2003) | n/a | n/a |
| Banks are forecast to dominate fund distribution in Continental Europe | Magnus Spence Financial Research Corporation (2005) | PWM (2005f) | Strong | Cerulli forecasts |
| **Multi-management as the growing distribution channel** | | | | |
| Boutique-type players are likely to be the major users of multi-management as distribution channel | PWM and Goldman Sachs Asset Management (2005) | | n/a | n/a |
| Emergence of assemblers | | | Strong | n/a |

Note: [1] Strength of evidence assessed according to the scale: strong, medium, weak, n/a.
Source: Oxera.

## Table A1.3 Back office

| | Primary sources | Secondary sources | Oxera interviews[1] | ZEW/OEE |
|---|---|---|---|---|
| **Back-office outsourcing: a mature market?** | | | | |
| High share of assets outsourced to third-party providers | | FT Mandate (2005c) | Medium | Data on back office outsourcing |
| Developed market for consulting services | | FT Mandate (2006) | Strong | n/a |
| Existence of a number of well-defined strategies | | IPE (2006), FT Mandate (2006) | Strong | n/a |
| **Back-office outsourcing and development of platforms** | | | | |
| Cost-efficiency as driver for outsourcing | | Bank of New York (2005), KPMG–CREATE (2004c), PwC (2003), Edhec (2003), Finextra.com (2006b) | Medium | n/a |
| Developments in core AM and distribution as driver for outsourcing | | Finextra.com (2006a) | Medium | n/a |
| Heterogeneity of operating business models as a barrier to cost efficiency | | | Strong | n/a |
| Potential loss of control as a barrier to outsourcing | | LogicaCMG.com (2004) | Medium | n/a |
| Increased share of outsourced AuM in the past five years | | | Contradicts some interviews | Data on back office outsourcing |
| Dependent AM firms outsource less than independent firms | | | n/a | Data on back office outsourcing |
| Decreasing concentration in the market for third-party back-office functions | | | n/a | Data on back office outsourcing |
| Decreasing market shares of global custodians | | | n/a | Data on back office outsourcing |
| Emergence of platforms and transformation of the market place | | | Strong | n/a |
| **Developments in fund distribution and their impact on the back office** | | | | |
| Developments in distribution apply pressure on the back office | BNP Paribas et al. (2005) | | Strong | n/a |

Note: [1] Strength of evidence assessed according to the scale: strong, medium, weak, n/a.
Source: Oxera.

# A2 Business models and the value chain

The analysis of the value chain in the context of different business models sets the scene for the subsequent analysis of trends in the AM industry. AM players with different business models are expected to respond differently to the drivers of change in the industry. Therefore, an understanding of how these players are organised along the value chain and the main incentives they face is an important pre-condition for the systematic treatment of trends.

Moreover, to understand the incentives of different industry players, it is important to analyse the channels of interaction and the functional linkages between the segments of the value chain. Issues such as conflicts of interest and the responsibility for risks are likely to be strong determinants, for example, of decisions to separate manufacturing and distribution activities, or to outsource specific non-core functions. That said, this analysis is not intended to be a factual description of all existing business models in the European AM industry, nor does it provide a comprehensive description of all possible channels of interaction that can affect players' decisions to reposition their business models. Rather, the objective is to provide an overview of the most representative business models observed in the industry and to explore some avenues through which these models might evolve and change in the near future.

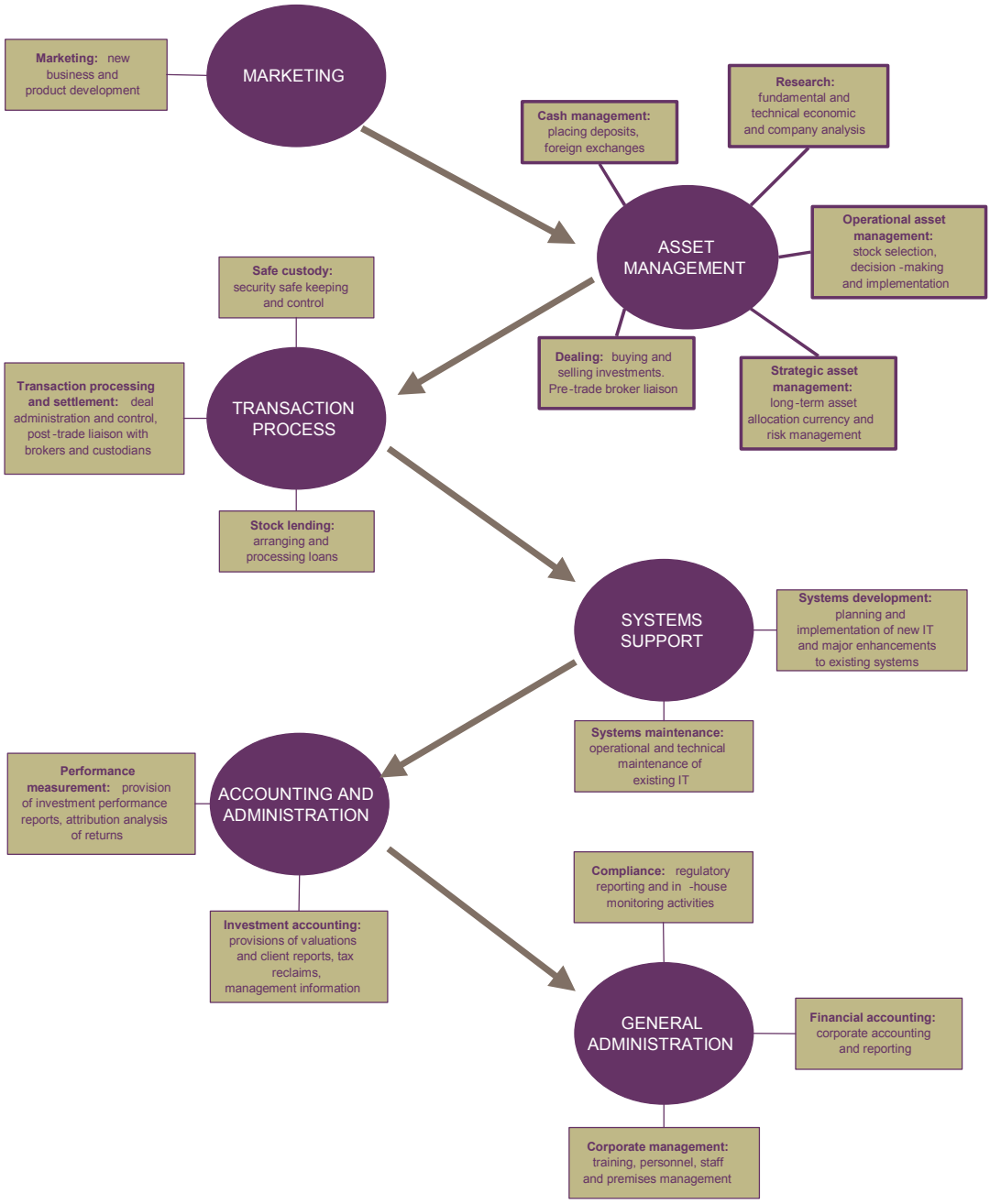
The first two steps in Oxera's methodology are examined below. Section A2.1 presents a high-level analysis of the value chain, mapping the functional links between the different segments. Section A2.2 then identifies the leading business models in the European AM industry, based on a micro-analysis of the selected AM firms.

## A2.1 The value chain

### A2.1.1 Composition

The basic AM value chain comprises three segments: core AM; middle and back office; and marketing and distribution. Figure A2.1 presents a stylised model of some of the key functions within the value chain in relation to each other.

**Figure A2.1 Example of a generic AM value chain**




Source: British Invisibles.

– **Core AM** constitutes the core function, and includes investment research, management of investment portfolios, buying and selling investments, and pre- and post-trade broker liaisons.

– **Marketing and distribution** encompasses activities related to marketing, sales and business development.

– **Middle- and back-office functions** include all trade support functions such as transaction processing, settlement, custody and stock lending, IT support, performance measurement, investment accounting, compliance, financial accounting, and corporate management.

The specific functions performed in each segment of the value chain have been described in great detail in other reports, including previous Oxera reports (2001 and 2005). As such, this

report does not describe each segment in detail, but focuses on analysing the dynamic characteristics of the value chain—ie, how its shape might change through, for example, fragmentation of the chain (vertical changes), or consolidation between different AM firms (horizontal changes).

Similarly, another aspect of the analysis of the value chain described below is the channels of interaction within and across the core AM, distribution and back-office segments. A thorough understanding of these interactions is fundamental for the systematic analysis of trends occurring in the industry.

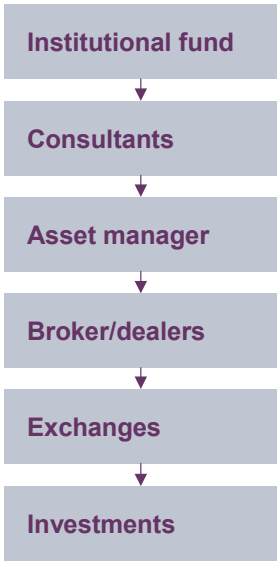
### A2.1.2 Dynamics of the value chain

To understand the dynamics within the AM value chain, it needs to be viewed in the context of three basic dimensions.

- **Fragmentation/consolidation**—the value chain is a flexible and evolving industry organisational structure, which can consolidate through, for example, M&A activity and/or alliances between firms active in any segment of the chain. It can also expand to the point of fragmentation through, for example, outsourcing or the formation of new business models.
- **Channels of interaction**—interactions along the value chain can take place across a large number of channels, including risk transfers, agency relationships and contractual obligations. In turn, these interaction channels can be driven by incentive structures and business models present across the industry.
- **Nature of interactions**—the interactions along the value chain can be both positive and negative from a welfare perspective; for example, transporting both risks and efficiency gains. Moreover, interactions through different channels can be correlated or separated.

Similarly, the analysis of trends, presented in the main report, includes an assessment of the links (ie, the channels and levels of interactions through them) between asset managers and other players in the vertical chain of financial relationships (ie, investors, consultants, brokers/dealers, etc). Figure A1.2 presents a highly stylised vertical chain of financial relationships, using the example of a pension fund or any other institutional fund. The pension fund trustee may seek the advice of a consultant in selecting an AM firm to manage the fund. The asset manager would liaise with a broker/dealer and initiate, for example, the purchase of specific securities listed on an exchange for inclusion in the fund's portfolio of investments.

**Figure A2.2 Stylised presentation of a vertical chain**




Source: Oxera.

The strength of the interactions within specific channels in this vertical chain of relationships may have implications for many issues, including:

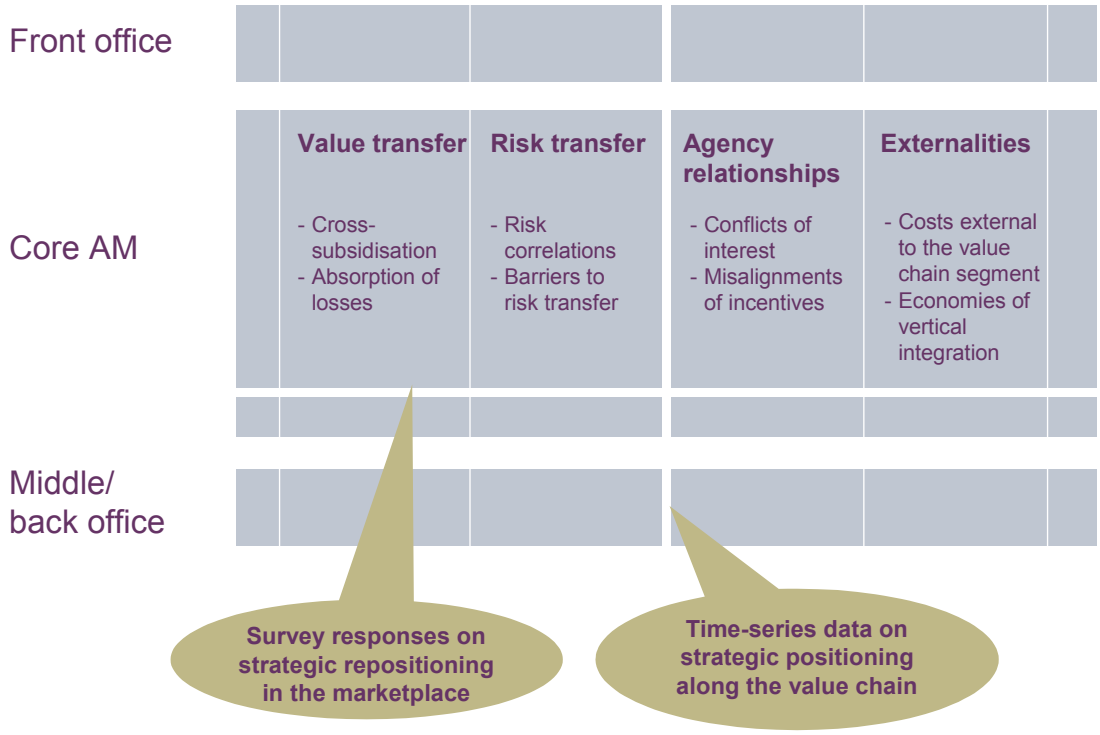
– the degree of competition in each segment of the value chain;
– the bargaining power of the asset manager—the consultant/pension fund relationship;
– the types of product that are likely to be developed;
– the choice of segment and location of particular AM institutions.

### A2.1.3 Channels of interaction

When analysing how the segments of the value chain interact, four channels of interaction can be singled out, as shown in Figure A2.3 below:

– **value transfer**—how the value of the business (measured in net present value terms, for example) is distributed across different segments of the value chain;
– **risk transfer**—where in the value chain operational risks are located and how they are transferred along the chain (for example, through contractual arrangements or outsourcing decisions);
– **agency relationships**—how differences in conflicts of interest or misalignment of incentives can trigger decisions to separate integrated business models;
– **externalities**—value creation through the internalisation of costs by vertically integrated firms.

**Figure A2.3 Channels of interaction in the value chain**




Source: Oxera.

Many of the trends analysed in sections 4–6 focus on AM firms' strategic decisions to reposition their business models in response to industry drivers. In most of these cases, the channels of interaction identified in Figure A2.3 play a key role in the decision.

An example of horizontal strategic repositioning in the market place is the case of mainstream providers developing a boutique model by acquiring or forming alliances with specialist AM firms. To complete the deals, firms must pay close attention to the agency relationship created between the parent company structure and the independent boutique.

Moreover, a contractual arrangement is necessary to designate responsibilities in the case of risks caused, for example, by operational failures.

Similarly, an example of a vertical strategic positioning along the value chain is the separation of the manufacturing and distribution activity in the context of the increasing importance of guided or open architecture. One of the drivers of this development has been the incentive misalignment with respect to the benefits of open architecture between manufacturers and distributors belonging to the same financial group. In addition, many asset managers are aiming to extract value from each segment of the value chain by running them as separate businesses with fundamentally different economic drivers.

This contrasts with organisational structures that remain vertically integrated. Advantages of this business model include the internalisation of costs and the possibility of operating a cross-subsidised model where a high-margin segment of the value chain (traditionally core AM) 'subsidises' operations in other segments of the chain.

These interactions are easier to understand when examined in the context of each particular business model. The following section describes the most salient business models in the AM industry identified during the course of the research.

## A2.2 Topology of business models

Firms in the European AM industry operate a diversity of business models. This study has explicitly considered this heterogeneity of structures as a fundamental component of the analysis that has enabled systematic and coherent assessment of the economic trends in the AM industry.

In particular, analysing the trends as strategic responses by players operating different business models has allowed the following specific issues associated with the diversity of business models to be considered:

- the adoption of particular business models by various players might, on its own, affect the value chain and generate important economic trends;
- if the diversity of business models is not controlled for, the results of the analysis might be substantially distorted in two critical respects:
  - false generalisation of particular model-specific trends to the industry as a whole;
  - the inability to draw any specific conclusions due to contradictory signals from different parts of the data.

To identify the prevailing business models, the models have been assessed across the spectrum of AM firms according to size, geographical location, country of origin, dominant types of investor, adopted distribution strategy, and, in particular, exposure to retail customers, characteristics of the investment strategy, presence across the value chain, and the approach to outsourcing.

From a practical perspective, it does not appear informative to establish precise borders for each business model and attempt to uniquely classify each player in the market as adopting a particular model. Potential overlaps and outliers, as long as they do not generate substantial biases for the analysis, would be consistent with the presented research.

## A2.3 Illustrative business models in the European AM industry

Six representative business models have been considered during the research:

– AM firms that are part of large financial groups;
– private banks;
– independent AM firms;
– independent boutiques;
– universal providers of back-office services;
– independent and multi-TFAs.

These were identified on the basis that differences between them should be of sufficient relevance to observe material differences in their strategic responses to the drivers of change in the industry.

### A2.3.1 AM firms as part of large financial groups

The characteristic feature of this business model is that functions across the whole value chain are typically dealt with within the group. AM firms belonging to large universal banks or insurance companies are examples of this model.

From the parent company's perspective, its main distribution for AM and other financial services is the proprietary network of branches/offices. Similarly, an in-house AM firm is responsible for the core AM functions, while the back-office function is typically combined across various parts of the group. In particular, the group has substantial exposure to the retail market through the proprietary network.

From the perspective of the AM firm in this financial group, the group's retail network typically represents the most important distribution channel, while the back office is perceived as being outsourced within the group.

There are several dimensions along which financial groups with proprietary AM firms might be further differentiated.

– **Separation between core AM and distribution**—the specific forms of separation might vary. For example, the proprietary distribution network might be active in selling TPF, while the AM arm might sell its funds through the distribution networks of financial groups. In this case, traditional distribution and core AM appear to be functionally separate. At the same time, the financial group might launch a network of financial advisors based on the open architecture model, in addition to the existing retail network.

– **The degree to which the proprietary AM firm adopts the boutique-type model**. The internal organisation of the core AM function—in particular, the existence of independent units dealing with various aspects of the investment process—might differ substantially across firms.

### A2.3.2 Private banks

These players are traditionally active in both the core AM and distribution segments of the value chain. A distinctive feature of this business model is that the distribution segment generally adopts the open architecture model.

Oxera interviews and research provided evidence that, looking forward, the growing degree of penetration of TPF in the distribution networks of private banks, the increasing competition in core AM, and the gradual convergence of preferences of retail and high-net-worth individuals are leading to a potentially decreasing relative importance of private banks in the AM industry.

### A2.3.3 Independent AM firms

These players are mainly active in the core AM segment of the value chain. Retail distribution is generally outsourced to external providers. Additionally, institutional investors are approached through direct channels, while back-office functions might be outsourced to third-party providers.

An important aspect that allows this model to be differentiated from similar models (particularly the boutique-type model) is that independent AM firms are larger and more diversified than boutiques (in terms of the asset classes on which the firm focuses).

### A2.3.4 Independent boutiques

Like independent AM firms, investment boutiques are also active in the core AM segment of the value chain. Three characteristics differentiate this model from other players, and, in particular, from independent AM firms:

– investment strategy—typically, independent boutique-type players are highly specialised in the management of one or two 'non-traditional' asset classes;

– organisational culture—boutiques are typically run in such a way as to allow managers complete freedom and full accountability for their actions. At the same, managers in boutiques are typically much better remunerated than their peers in larger firms;

– tendency towards outsourcing—this business model can be characterised as having a high degree of outsourcing of both back-office operations and distribution.

### A2.3.5 Universal providers of back-office services

The characteristic difference between these players and those discussed above is their concentration in the back office; they are typically not active in the core AM market.

These companies offer a range of services for outsourcing of back-office operations to AM firms operating any of the business models outlined above. Current developments in the European AM industry seem to point to the evolution of a number of dominant players in this market.

### A2.3.6 Independent and multi-TFAs

IFAs and TFAs are concentrated in the distribution segment of the value chain. They are typically institutionally independent from AM firms; correspondingly, from their perspective, any fund they market to investors is a TPF. This indicates that they operate an open or guided architecture model with varying degrees of penetration of TPF. In theory, IFAs offer the full range of products available in the market,[146] while TFAs offer funds from fewer providers.

The role of these players differs substantially across countries: in the UK, IFAs/TFAs represent the dominant distribution channel, while in Continental Europe their market share is typically relatively small.

[146] In practice, however, IFAs sell or recommend funds from a narrower list of funds, which is reviewed periodically.

# A3 Description of operational risks

- *Breach of client guidelines*—a breach of the guidelines set out by the client in their contract with the AM company. For example, a client may request that their portfolio does not contain any tobacco companies' stocks. Inadvertently purchasing tobacco stocks for this client would contravene the client's guidelines. To reverse the transaction, the AM company would have to sell the shares. In the meantime, the price of the share might have fallen, which could result in a loss for the asset manager.

- *Misdealing*—unintentional errors, for example in issuing orders to brokers.

- *Unit trust mispricing/NAV calculation error*—an incorrect valuation of client or fund assets.

- *Subscription/redemption mistakes*—operational errors occurring in the process of subscribing a new client to a fund (subscription mistakes) or liquidating an existing client's position (redemption mistakes). This is in addition to the risk of NAV calculation error resulting in consumer loss during the subscription/redemption process.

- *Risks arising in the process of taking over new business*—operational failures may occur when a client mandate has been acquired from another AM company. The previous asset manager may not have kept records up to date, potentially leading to discrepancies between what is reported and what is actually held in the client's account. This is a particular problem for businesses that are growing and are therefore taking on a relatively high proportion of new clients.

- *Fraud*—this occurs as a result of dishonest behaviour by employees or managers. Segregation of duties reduces the level of control that any individual may have over a single transaction, and therefore lessens the probability of fraud.

- *Failure to meet guarantees*—this arises when an asset manager is unable to provide the client with the return that was guaranteed on a particular product. This problem has a potentially large impact if there is a downturn in the stock market and the risks are either not hedged or imperfectly hedged.

- *IT systems failure*—this occurs as a result of a breakdown in computer systems. Installing back-ups to take over from the primary system may reduce any subsequent loss from failure of the IT system.

- *Failure to reconcile assets under custodianship and internal records*—this may arise when an asset manager is unable to reconcile the assets according to its internal records with those according to the reports from the custodian. To minimise the probability of such a failure, asset managers may conduct daily reconciliations of clients' accounts.

- *Failure to best execute*—failure to obtain the best price for a client.

- *Counterparty failure*—this arises when a third party to an asset manager, such as a broker, becomes insolvent. The risk of counterparty failure is particularly high in dealing with financial intermediaries in emerging markets.

- *Settlement problems*—these may occur, for example, when the AM firm has already paid the cost of purchasing stocks, but the broker, for some reason, is unable to deliver them. This problem can be limited to some extent with the introduction of a delivery-

versus-payment system, which means that an AM firm will only pay the cost of the transaction upon receipt of the stocks.

– *Failure to collect all income*—an example of this type of risk occurs in the event of a corporate action failure. For example, a client may hold stock in company A, which is being taken over by company B. Failure to complete the relevant documentation before a specified deadline may result in failure to transfer stock in company A into stock in company B. This could lead to losses, for example, if the stock value depreciates.

– *Stock lending failure*—this arises when the party that borrowed the stock is unable to repay the amount and collateral is insufficient to cover the total value of the stock lent.

# A4 Oxera interview schedule

The Oxera programme of structured interviews involved both formal as well as informal consultations with industry representatives across the EU Member States. The key structured interviews undertaken by Oxera are reported in the table below. However, in many of the interviews, a number of people participated, including follow-up contacts—the table below reports the names of the leading interviewee. Although the table refers to the country origin of the office with which the interview was arranged, many different jurisdictions relevant to the operations of the particular firm were covered.

| Country | Name of the firm | Interviewee | Designation |
|---|---|---|---|
| Austria | Capital Invest | Helmut Sobotka | Chairman of the Management Board |
| Austria | Sparinvest | Mag Bednar | Member of the Management Board, responsible for fund management, fund research, accounting and human resources |
| Belgium | Fortis | Richard Wohanka | Global CEO |
| France | AXA Investment Managers | Jean Pierre Hellebuyck | President of the AFG Corporate Governance Commission; Vice-Chairman and Chief Investment Strategist of AXA Investment Managers |
| France | Credit Agricole Asset Management | Thierry Coste | Head of Asset Management, Securities and Institutional financial services, Chairman and CEO of Credit Agricole asset management |
| France | BNP Paribas Asset management | François Delooz | Global Head of Risk Management Legal and Compliance |
| France | Barclays Asset Management France | Guillaume Touze | Director of Barclays Asset Managers |
| Germany | Cominvest-Gruppe | Peter Rabb | Head of Institutional Marketing |
| Germany | Meag Munich Ergo Kapitalanlagegesellschaft mbH | Dr Thomas Kabisch | Chief Executive Officer, Meag Munich Ergo Asset Management GmbH |
| Germany | Fidelity Investments | Klause Mössle | Managing Director of institutional business in Germany and Austria |
| Germany | HSBC Trinkaus & Burkhardt | Dr Rudolf Apenbrink | Head of institutional clients |
| Germany | AXA Investment Managers Deutschland GmbH | Robin Clark | Global head of regulatory affairs |
| Germany | Allianz Dresdner Global Investors | Mr Wolfgang Putz | Member of the Board, Chief Finance Officer |
| | | Mr Mike Enders | Director, Head of Controlling |
| | | Mr Marty-Jörn Klein | VP, Head Market Research & Analysis |

| Country | Name of the firm | Interviewee | Designation |
|---|---|---|---|
| Italy | Nextra | Francis Candylaftis | Chief Executive Officer |
| Italy | Sanpaolo IMI | Eugenio Namor | Chief Executive Officer, Sanpaolo IMI Asset Management |
| Italy | Pioneer Investments Gr. Unicredito IT | Dario Frigerio | Chief Executive Officer, Pioneer Global Asset Management SpA |
| Netherlands | ABP | Mr R Munsters | Chief Executive Officer |
| Netherlands | Aegon | Eric Rutten | Head of Asset Management, Netherlands |
| Netherlands | Fortis | Jan-Lodewijk Roebroek | Local Chief Executive Officer, Fortis Investments, The Netherlands |
| Netherlands | ING Investment Management | Angelien Kemna | Chief Executive Officer |
| Netherlands | ABN AMRO | Jan Jaap Hazenburg | Senior Vice President |
| Poland | ING | Sebastian Buczek | Chief Executive Officer, Towarzystwo Funduszy Inwestycyjnych ING |
| Poland | Pekao Pioneer | Tomasz Bankowski | Chief Executive Officer, Pekao Pioneer Powszechne Towarzystwo Emerytalne S.A. |
| Spain | BSCH | Innes Serrano | Chief Executive Officer |
| Spain | BNP Paribas | Javier Núñez | Director, Asset Management |
| Spain | Allfunds Bank | Juan Alcarez | Chief Executive Officer |
| UK | Invesco Perpetual | Blake Turvey | Chief Executive Officer |
| UK | Legal & General Investment Management | Kevin Gregory | Chief Operating Officer |
| UK | Insight Investment Management | Charles Farquharson | Head of Distribution & Director |
| UK | Henderson Global Investors | Kate O'Neil | Director of European Distribution & Hedge Funds |
| UK | Barclays Global Investors | Mr Lindsay Tomlinson, OBE | Vice Chairman |

# A5 Interview questionnaire

**Company:**

**Name:**

**Job title:**

**Contact details:**

**Oxera staff present:**

**Date:**

Oxera has been commissioned by the European Commission DG Internal Market to undertake a comprehensive study of the current trends in the European AM industry. As an important part of the study, Oxera is conducting interviews with selected leading players in the European fund management industry.

As one of the key actors in the fund management industry, you were approached to participate in this interview process. The objective of the interview is to solicit your views with regard to your company's strategic positioning along the AM value chain as well as to understand your perspective on more general trends occurring across the industry.

This short note gives an indication of the types of issues that we would like to raise in the interview. It also outlines the leading themes and the key areas of relevance to the study that we would like to discuss. Oxera is grateful for your time and cooperation—we greatly appreciate your perspective on these topics. Please note that all individual answers will be kept in the strictest confidence.

### Scope of the interview

The purpose of the interview is to solicit your views on the current challenges that are shaping the AM industry in your country as well as to enquire about your company's responses to these challenges. In particular, Oxera hopes to obtain your opinion with regard to the following key issues:

– the main drivers facilitating changes in the AM industry;
– trends in the industry with reference to developments taking place in different elements of the value chain;
– potential implications of current trends for the future development of the industry as well as for the end-investor.

The interview questions centre around seven key areas. For each area, this note outlines the leading themes that are of particular interest to Oxera and of particular importance to the study as a whole; for each, several examples of possible questions are listed for your information.

Furthermore, to present the broader context to this study and provide more information about the leading issues on which this analysis is focusing, the next section presents examples of the main hypotheses that Oxera is currently considering with regard to the developments in the European AM industry that will form the basis for interview questions.

### Background information about Oxera's analysis

Oxera's analysis will be undertaken on the basis of several major hypotheses regarding the key developments in the European AM industry. Five such leading hypotheses are listed below for your information. Each hypothesis comprises specific trends that are being considered in the analysis, together with a set of drivers and implications for the industry and end-investors in each case.

While outlining all the relevant trends under consideration is clearly beyond the scope of this short introduction, the next section presents some of the related leading themes in the interview context.

The purpose of raising those in the interview is to assess the relevance of the identified themes and hence of the specified hypotheses as well as to amend that list with potential new ones, where relevant.

### Distribution of AM products is evolving towards the open architecture model

Several key developments in the AM industry might be taking place in fund distribution. New distribution channels such as IFAs for Continental Europe and Internet-based distribution increasingly compete with conventional distribution models.

Another dimension of open architecture is reflected in the process of the opening up of the existing channels to third-party distribution. Even though the largest distributors such as banks and insurance companies retain their dominant positions, they are increasingly allowing for third-party products to be distributed via their proprietary networks.

### Vertical fragmentation might be occurring alongside horizontal consolidation in different parts of the value chain

AM firms might be increasingly repositioning themselves away from integrated business models, where functions across the entire value chain are retained in-house, towards vertically disaggregated structures. This process is further boosted by specialisation within different elements of the value chain. It might involve concentration in particular asset classes or investment strategies, which affect the adopted business model in the supply chain.

A parallel phenomenon to vertical fragmentation might be horizontal consolidation of players in the market for outsourcing services. This might particularly be the case in the market for third-party administration services where global providers are becoming increasingly dominant. Consolidation might also be taking place in the market for specific management services with respect to certain asset classes/investment products such as liability-driven investments.

### Demand for new investment products affects fund profiles

There has been significant growth of the AuM invested in hedge funds and structured products. Specialised AM firms as well as the leading providers, which have significantly increased their market presence, have effectively 'commoditised' the hedge fund concept. This development might be affecting the shape of the value chain as well as risks to the industry (as well as to the end-investors).

Sophisticated investment strategies adopted by specialised funds and boutiques generate substantial pressure on back-office divisions, potentially leading to further outsourcing. Significant complexity of the outsourcing required emerges as an additional factor affecting further consolidation of the market for third-party fund administrators. Moreover, non-transparent fee structures and poor disclosure in the hedge fund industry create potential information asymmetries between investors and fund managers.

### Regulation facilitates cross-border financial integration

Various aspects of cross-border financial integration are linked to specific regulatory actions. This includes the relationship between disclosure, registration, taxation or accounting and institutional and organisational consolidation as well as financial integration through wider exposure of AM companies' investment portfolios to foreign instruments. Some of the key developments in the EU regulation, which are relevant for the evolution of the value chain, concern cross-border integration at the fund level.

UCITS III Directive and MiFID are generally seen in the industry as facilitating cross-border trade as well as financial integration. At the same time, substantial regulatory barriers for achieving further economies of scale are still very much present and being voiced by the industry.

### Pension reforms drive product innovation and developments in the value chain

The increasing amount of pension funds available for investment and changes in the functioning of the market for pension funds pose significant challenges to the AM industry in the field of product innovation and adaptation in some jurisdictions (eg, the UK) but not in others. The industry response has an impact on the developments in the value chain facilitating separation of pension fund management into a separate business model.

## Interview questions

### Specific questions about your company

– Since when has your company been engaged in AM?
– Is your company part of a larger group?
– What is the divisional structure of your group and in particular what is the place of the AM division within this structure?

### Business model adopted in your company

*Leading themes*

– Strategic positioning along the value chain;
– investment strategy: specialisation in management of particular asset classes vis-à-vis multi-strategy approach;
– strategic responses to the pension challenge and pension reforms;
– the impact of regulation (MiFID and UCITS-III Directive).

*Example questions*

– What is your strategy with regards to your presence in different parts of the value chain? Do you consider taking more functions in-house/outsourcing in the future?
– How do you position yourself on the AM market? Do you regard yourself as a multi-manager or tend to specialise in particular types of investment product? Looking forward, do you consider making changes to your adopted strategy in that respect?
– Do you consider the impact of pension reform to be an important strategic consideration? What are the likely changes in you company's business model/strategy in response to challenges and/or opportunities posed by the ongoing pension reforms in your country?

### Business models adopted in the industry

*Leading themes*

– Business models of the key players including presence in different elements of the value chain; investment strategy: multi-strategy as oppose to specialisation in particular asset types/investment products;
– emergence of new players: growth of specialised alpha-oriented boutiques and the key developments with regards to beta-oriented businesses;
– business models of AM arms of foreign financial institutions and the role of open architecture.

*Example questions*

– Do the key players tend to strategically position themselves as multi-managers present across all the elements of the value chain? Is your company's business strategy different?
– Which business models do arms of foreign players tend to adopt? What is their strategy in the area of funds distribution?
– What are the new emerging business models—if any (eg, assemblers)?

### Trends in fund distribution

*Leading themes*

*Open architecture*

– The emergence of open architecture distribution model;
– the degree of penetration of TPF in the distribution networks of dominant distributors, eg, leading banks and insurance companies;
– emergence of new distribution channels, such as independent financial advisors or the Internet;
– the popularity of alliances to sell TPF;
– the potential impact of the above on risks including the risk of funds mis-selling.

*Cross-border activities*

– Development of cross-border fund distribution:

– the key barriers to further development of the cross-border fund distribution;
– the role of European regulatory developments (eg, MiFID and UCITS III);
– the role of national regulation.

*Example questions*
– Do leading distributors tend to open up their distribution network to third party funds? What is this trend driven by and why?
– Does your company distribute third-party funds? Does you company's fund 'manufacturer' compete with third party funds for the place in your company's distribution network?
– Is the share of independent financial advisors in the total amount of funds distributed substantial? Do you see it to increase in the future? Is Internet emerging as potentially important distribution channel?
– Is cross-border fund trade increasing? What do you think are the key barriers to further development of cross-border distribution?
– Is the emergence of the open architecture model associated with increasing risks for the end-investor? What are those risks? Is the risk of mis-selling increasing? Is the trend toward open architecture expected to result in lower distribution fees paid by the end-investor?

### Trends in product innovation

*Leading themes*
– increasing pressure on the AM companies to offer more diverse product range to investors driven by evolving demand and popularity of 'alternative' products;
– 'commoditisation' of hedge fund types of investment products;
– increasing popularity of certain particular investment products:
– structured products including liability-driven investment products;
– exchange traded funds.

*Example questions*
– Is diversity of investment products demanded by investors (retail and/or institutional) increasing? Is your company increasing the diversity of product range? How?
– Are hedge funds in general or, for example, arbitrage strategies becoming more popular as an investment product? Do you think this is going to continue?
– Is liability-driven investment gaining wider popularity as the investment product? Is this trend going to continue? What is the nature and the main drivers of this phenomenon?

### Trends in core asset management

*Leading themes*
*Strategic positioning in the core AM function*
– Increasing specialisation of fund manufacturing in selected asset classes/investment products by leading firms as well as new AM companies;
– adoption of internal boutique-type business models by mainstream providers;
– increasing outsourcing of core AM and growing investments in funds of funds and multi-managers;
– specialisation of independent AM firms in selected asset classes;
– emergence of new business models and types of players;
– fund mergers and fund pooling;
– key barriers for limited growth of fund mergers and fund pooling techniques at the national level and cross-border.

*Potential impact of pension reforms*
– Product innovation driven by pension reforms;
– changing business models in response to pension reforms, in particular separation of pension funds management in a separate business model.

*Specific implications of the above*
– Outsourcing of the core AM functions and of operational risks;

– potential horizontal consolidation as a result of the increasing specialisation of players in product types/investment strategies.

*Example questions*

– Is there a trend towards increasing popularity of 'boutique-style' business structures, according to which management of particular investment products/asset classes is separated into individual business models? Has your company created such internal 'boutiques'?
– Are investments in funds of funds and/or managers of managers becoming more popular? Are there more funds that directly outsource core AM activities? What is the driver behind this phenomenon?
– What do you think are the key barriers for fund mergers at the national level? Are they different from those that appear to be of key importance when cross-border mergers are considered?
– What are the key barriers for further adoption of the funds pooling techniques?
– What are the key strategic developments in the core part of the value chain in response to pension reforms?
– Do you think that outsourcing of the core AM functions to a third party is associated with higher risks? What risks? Is there increasing concentration in the market for management of particular investment products/asset classes?

### Trends in back-office

*Leading themes—outsourcing*

– Presence of significant barriers to further back-office outsourcing;
– increasing demand for back-office outsourcing services driven by sophisticated investment strategies (eg, liability-driven investments) and regulatory developments (introduction of MiFID);
– consolidation of the market for third-party administrators and the evolution of global custodians;
– the evolution of operational risks present in back-office functions;
– dissemination and availability of information, and presence of information risks;
– control of the value chain.

*Example questions*

– Is there a trend towards increasing outsourcing of back-office functions beyond those required by regulation? What are the key barriers to increasing outsourcing? Does your company outsource a significant number of back-office functions?
– Is the market for custody services becoming more concentrated? Can similar trends be observed in the market for third-party administrators?
– It has been suggested that there is a relationship between the complexity of investment strategies and the decision to outsource back-office functions. Is there growth in outsourcing of administration function of funds invested in, for example, hedge funds and structured products?
– Are the additional regulatory developments facilitating the demand for wider outsourcing of back-office functions?
– Are risks present in back-office operations increasing? Is the increasing popularity of outsourcing changing risk profiles? With regard to which risks?

### Concluding questions

– Would you be willing for Oxera to contact you again for follow-up questions?
– Can Oxera send you the survey?
– Would you like us to send you Oxera's final report?

# A6 Glossary

| | |
|---|---|
| ABS | Asset-backed security. A securitised interest in a pool of assets |
| Aggregators | A class of intermediaries (eg, product wrappers). Aggregators combine the AM expertise of different providers into a single investment product. The final product can be marketed to the end-investor, another distributor or a master distributor |
| Assemblers | See 'Aggregators' |
| Asset-liability matching | See 'LDI' |
| AuM | Assets under management |
| B2B | Business to business |
| Balanced funds | Funds that invest in equities, bonds and money market instruments |
| Bond funds | Funds that invest at least 80% of their assets in fixed interest rate securities (FERI classification) |
| BVI | Bundesverband Deutscher Investment-Gesellschaften eV, the German Association of Investment Companies |
| Capital-guaranteed funds | Funds that offer protection of invested capital. Two generic categories of such funds could be distinguished: guaranteed funds, whereby the investor is protected by portfolio design; and funds that use external guarantees |
| CDO | Collaterised debt obligation. A security backed by a diversified pool of one or more debt obligations (eg, investment-grade and high-yield corporate bonds, bank loans, ABS, residential and mortgage-backed securities) |
| CESR | Committee of European Securities Regulators |
| CIS | Collective investment scheme. An investment scheme (company) that offers to invest funds raised from investors in a mix of securities. See 'Investment companies' |
| CLO | Collaterised loan obligation. When an underlying pool of debt obligations is in the form of bank loans, a CDO is referred to as a CLO. See CDO |
| Closed-ended funds | Investment companies that have a fixed capitalisation. To buy the shares of a closed-ended fund, there must be someone willing to sell their shares. An investment trust is an example of a closed-ended fund. See 'Investment trusts' |
| Commoditisation of hedge funds | The process by which hedge funds have entered the investment mainstream. The term 'commoditisation' can be broadly understood as the economic process by which the hedge fund industry is reaching the state of maturity in terms of scale, technology, and share of global AuM. See 'Hedge funds' |
| Core-satellite approach | A strategy of separation of the passively managed core portfolio from one or more actively managed 'satellites' focused on the search for 'alpha' |
| Country of fund domicile | See 'Fund domicile' |
| CPPI | Constant proportion portfolio insurance. See 'Capital-guaranteed funds' |
| Defined-benefit pension scheme | The benefits given to scheme members are determined by a fixed calculation based on the member's number of years of service and salary. Any risk associated with meeting the agreed level of benefits is borne by the scheme/sponsor |
| Defined-contribution pension scheme | The member, and potentially the employer, of the scheme invests contributions. The benefits received by the member upon retirement will be determined primarily by the level of contributions made, the performance of the chosen investments and the means chosen to generate an income from the accrued fund on retirement. The risk of funding therefore lies wholly with the scheme member |
| Dependency ratio | The number of people of retirement age relative to those of working age |
| Derivatives | Financial instruments, such as futures and options, the value of which depends on the value of other commodities, indices or individual securities |
| Derivatives funds | Funds that invest mainly in derivatives or structured products |
| ECOWIN | Provider of Economic and Financial Market Data |

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| EFAMA | European Fund and Asset Management Association |
| Endowment life assurance | A form of life assurance taken out for a term less than the whole life and in which payment is due either upon death during the term, or, in any case, at the end of the term. A variation is endowment assurance with profits, in which the payment is raised in line with the growth in profits through the allocation to the policy of bonuses |
| ETF | Exchange-traded funds |
| FERI | A London-based independent research house and provider of data and analysis of the European mutual fund markets |
| FOF | Funds of funds. Funds that invest their assets in other investment funds |
| FRS 17 | Financial Reporting Standard 17. This accounting standard, used in the UK, sets out how companies and other entities report the cost of providing pensions and other post-retirement benefits to their employees. It broadly replicates the standards used in IAS 19, except that it does not permit the spreading of actuarial gains and losses in the same way. It requires scheme assets to be valued 'marked to market' and liabilities to be valued using a discount rate based on the prevailing AA corporate bond yield |
| Fund domicile | Country in which a fund is registered for regulatory purposes (= domicile of the fund). Notably, the data published by EFAMA and reported in the Fact Book presents fund assets by country of domicile. Also, one of the rules of UCITS funds is that the depositary must be located in the same country as that in which the fund is domiciled |
| Fund market | This term has been established to present the most accurate and logical view of a particular market. In most cases, it comprises domestic assets and round-trip assets. Round-trip funds are funds that are registered in host centres such as Dublin or Luxembourg but are only sold back into the domestic market (eg, Austria funds domiciled in Austria plus funds domiciled in Luxembourg/Ireland of which the parent company is in Austria) |
| Fund notification procedure | The notification procedure requires that the UCITS fund informs the competent authorities of the home and host country of their intention to market the fund in another Member State and that the fund provides the host country's authority with additional documentation (eg, simplified prospectus, fund rules, annual reports, marketing arrangements) |
| GAAP | Generally accepted accounting principles |
| Guided architecture | Fund distribution model according to which distributors enter into strategic alliances with a limited number of third-party manufacturers, rather than provide free open access to their networks. See also 'Open architecture' |
| Hedge fund | Funds that can take both long and short positions in any instrument, in any cash or derivative markets without restrictions by regulators |
| Hedging | Protecting an existing position or commitment by using one type of investment to offset adverse market movements |
| IAS 19 | International Accounting Standard 19, which is applied across the EU as part of IFRS. This standard sets out how companies must report the cost of providing pensions and other employee benefits. Its requirements are very similar to those of the UK FRS 17, but it allows actuarial gains and losses to be smoothed out more through amortisation or by ignoring them if they fall within a 10% corridor |
| IFA | Independent financial advisor |
| IFRS | International Financial Reporting Standards |
| IMA | Investment Management Association (UK) |
| Index funds | Funds that attempt to match exactly the day-to-day fluctuations of a market index; sometimes called 'tracker funds' |

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| Intermediaries | Industry players acting as an additional distribution channel from the perspective of the manufacturing business and as a service provider from the distributors' perspective<br><br>From the perspective of the manufacturer, these players add value since they are able to negotiate attractive contract terms with a large network of distributors, allowing the manufacturer to focus on its core activity. From the perspective of the distributor, the role of intermediaries is to act as wholesale buyers of funds from manufacturers and then resell these funds to distributors packaged together with ancillary services, such as fund selection and analysis, and administration tools. Hence, intermediaries allow distributors to focus their business further on their core competency (asset gathering) and completely outsource fund selection and product manufacturing to firms further up the value chain |
| Investment companies | Companies engaged in investing the pooled funds of investors into various investment outlets, including stocks, bonds, options, commodities, property and money market securities. There are two types of investment companies: closed-ended and open-ended (funds) |
| Investment funds | A general term for collective investment vehicles. See 'Investment companies' |
| Investment trusts | Closed-ended investment companies that issue shares to investors and invest the proceeds in a portfolio of securities and shares in other companies. Like unit trusts, they are regulated by a trust deed, the trustees being separate from the management. They differ from unit trusts in that, for example, the capitalisation is fixed and shareholders share in the profits of the company managing the trust |
| Laeken European Council | European Council meeting at Laeken, Belgium, December 14th and 15th 2001 |
| Large exposure | Refers to any exposure to a counterparty or group of connected counterparties that exceeds 10% of a firm's own funds |
| LDI | liability-driven investment. An LDI strategy is any strategy that manages the assets of a fund relative to its liabilities. Such a strategy aims at closely matching assets and liabilities of the fund in order to minimise the associated risks. Invariably, the LDI strategy uses some form of hedge to isolate and remove unwanted risk so that the portfolio of assets targets risk (and return) commensurate with the liability and risk profiles |
| M&A | Mergers and acquisitions |
| Managed accounts | Accounts set up and managed on behalf of private clients |
| Mandated portfolio management | Discretionary AM on behalf of a third party |
| Market failure | Market failures arise when the interests of firms and society fail to coincide. Essentially, there are three reasons why markets may fail: asymmetric information, externalities, and monopoly power. Regulation may be justified in the face of any of these market failures |
| MoM | Managers of managers. Fund managers that invest in a portfolio of stocks and shares, with the portfolio managed by appointed investment managers |
| Money market funds | Funds investing at least 90% of their assets in money market instruments (certificate of deposit, treasury bills and bank deposits) with a short average maturity (typically under six months) (FERI classification) |
| NAPF | National Association of Pension Funds |
| NAV | Net asset value |
| NINFA | Non-independent network of financial advisors. NINFAs typically operate an open architecture model. They also belong to a financial group that has retained at least selected AM segments in-house |
| Non-UCITS | Fund that does not comply with UCITS regulations and is regulated in accordance with specific national requirements (eg, hedge funds, private equity funds, real estate funds) |
| Notified for sale | See 'Fund notification procedure' |

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| Open architecture | Fund distribution model according to which non-proprietary funds can be accessed through a particular distribution channel. In its pure version, it is assumed that a distribution channel that adopts an open architecture model markets all funds available in the market to its clients. The model where a limited number of non-proprietary funds are marketed to clients is referred to as guided architecture. See also 'Guided architecture' |
| Open-ended investment companies | Investment funds that sell their shares directly to investors and are ready to buy back their old shares at their current NAV. The capitalisation of open-ended funds is not fixed; they expand and contract as investors invest in or leave the funds. Typically, open-ended investment companies are structured as a company rather than as a unit trust. They are common in Continental Europe and the USA, and have been permitted in the UK since 1997. They qualify as UCITS |
| Open-ended investment funds | See 'Open-ended investment companies' |
| Open-ended investment vehicles | See 'Open-ended investment companies' |
| Operational risks | Risks that arise in the process of discretionary management of clients' assets |
| OPCVM | Organisme de placement collectif en valeurs mobilière. The French term for UCITS which comprises *fonds communs de placement* and *SICAVs* |
| PAYG | Pay as you go. In the context of this report, PAYG refers to pension schemes financed from current income rather than pre-funded in advance |
| Pension funds | Funds set up to pay pension benefits to retired employees of a corporation, government entity, or other organisation |
| PERP | Plan d'Epargne Retraite Personnel. Pension product introduced in France as part of pension reforms |
| Pooled investment scheme | See 'Collective investment schemes' |
| Portfolio management companies | Entities that undertake all types of discretionary AM |
| PPPs | Personal Pension Plans |
| Prudent person rule | A legal maxim restricting the discretion in a client's account to investments that a prudent person seeking reasonable income and preservation of capital might buy for their own portfolio. Also called the Prudent Man Rule |
| Public funds | German open-ended investment funds that issue their shares to the general public |
| Put option | An option providing the holder with the right to sell an investment at a future date at a price agreed now |
| Real estate funds | Funds investing at least 80% of the assets directly in real estate (FERI classification) |
| Replacement ratio | Ratio of pension benefits to final salary |
| Segregated funds | Funds that are managed for a single client and therefore not pooled. See 'Mandated portfolio management' |
| SICAV | Open-ended investment company, for example, in France |
| Special funds | A special or institutional fund is a mutual fund targeted to a few investors, such as pension funds, insurance companies and high-net-worth individuals. An institutional fund here is therefore defined as a non-retail fund |
| SRI | Socially responsible investment |
| Stakeholder pension | A new form of private pension which forms part of the UK government's overall pension policy (introduced on April 6th 2001), the central objective of which is to change the ratio of state to private pension provisions |
| STP | Straight through processing |
| Structured funds | Products with a specifically designed risk/reward profile (eg, guaranteed/capital-protected funds) |
| Substitution effect | In the context of this report, this either refers to a movement away from traditional assets to alternative investments; or to the process by which pension products might substitute other AM products such as UCITS funds |

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| Systemic risk | This refers to a situation where financial difficulties in an institution could spread to other market players |
| TMT | Telecoms, media and technology |
| TFR | Termination indemnity payment. Additional pension benefit after retirement in Italy, which can amount to 10–15% of final pay |
| TPF | Third-party fund |
| Tracker funds | See ‘Index fund’ |
| UCITS | Undertaking for Collective Investment in Transferable Securities. Open-ended collective investment vehicles that fall under the 1985 European Community UCITS Directive |
| Unit trusts | Open-ended collective investment vehicles that invest funds subscribed by the public in securities, and in return issue units that they will repurchase at any time. The trust is regulated by a trust deed, the trustees being separate from the management. Each investor owns a unit, the value of which depends on the value of the funds owned by the fund. Unit trusts in the UK and Ireland are similar to mutual funds in the USA or the open-ended investment companies in Continental Europe. They qualify as UCITS |

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