Oxera

Agenda

Advancing economics in business

Future secure? Why asset managers locate in London

The UK is the largest centre for asset management in Europe, with assets under management of at least £2.8 trillion, and the industry is a major source of income and employment in the UK economy. A recent Oxera study has examined the competitive position of the UK as a centre for asset management, and the major influences, including regulation and tax, which may affect this position in the future

Asset management is an integral part of the UK financial services industry. As well as receiving external economic benefits, such as employment, contribution to the balance of payments, and payment of tax, the UK financial services industry benefits from the presence of a large group of asset managers supporting the provision of deep capital markets.

Concerns have been expressed that UK competitiveness is being undermined, in particular by a heavy-handed regulatory regime and an ever-increasing compliance burden for the industry.[1] This raises important questions about the durability of the concentration of the asset management base in the UK—what drives location choice in what is potentially a highly mobile and international industry? Does regulation—or indeed tax and other government policies—present a significant threat of the industry shifting business to other jurisdictions; or are other factors at work that secure the UK asset management cluster going forward?

A number of studies have evaluated the factors determining location decisions of financial services firms and provide empirical evidence on the performance of the UK, and London in particular, as a financial centre. However, to date, little attention has been paid to the specifics of the asset management industry.

In this context, the Corporation of London and the Investment Management Association (IMA) commissioned Oxera to undertake research into the location choice of asset management firms, the strengths and weaknesses of the UK location, and the durability of the competitive position currently enjoyed by the UK.[2]

Asset management in the UK

Asset managers offer a variety of services and act in a number of capacities for their clients, which include pension funds, insurance companies, corporates, public agencies, charities and private individuals. Their portfolios may be managed on a segregated basis, but, unless these are large, asset managers also offer their services by pooling funds to create larger portfolios, and managing these as collective investment funds.

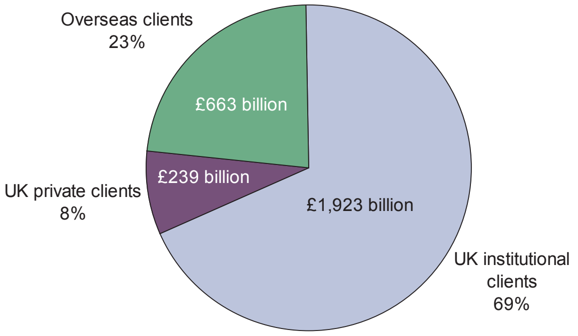
The UK is by far the largest centre for asset management in Europe, and is globally second only to New York in terms of size of assets managed. Although accurate figures are difficult to obtain, industry-wide estimates suggest that the UK asset management industry was responsible for assets of at least £2.8 trillion at the end of 2003.[3] Around 69% of assets were managed on behalf of UK institutional clients; nearly a quarter were managed on behalf of overseas clients; and UK private clients accounted for the remainder (see Figure 1 below).

Asset management makes a significant direct contribution to the UK economy:

– the value-added of the industry has been estimated at 0.5% of GDP or £4.9 billion in 2003;[4]
– the UK asset management industry also makes a significant contribution to the trade balance, with net exports estimated at £1.2 billion in 2003;[5]
– in terms of employment, data gathered by the IMA shows that, for a sample of 51 asset managers (representing 82% of UK assets under management), total staff numbers of the firms amounted to 23,290 in 2003. Industry-wide employment numbers are significantly larger.[6]

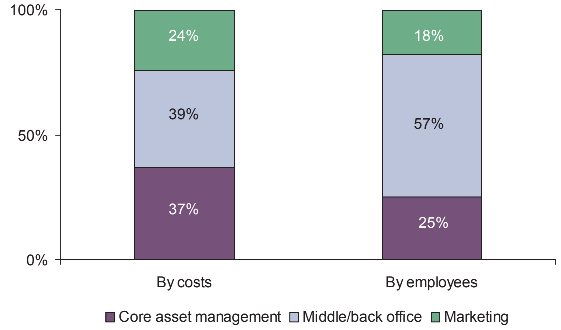
This article is based on Oxera (2005), 'The Future of UK Asset Management: Competitive Position and Location Choice', report prepared for the Investment Management Association and the Corporation of London, May, available at www.oxera.com.

Figure 1 Assets under management by client type, 2003



Source: IFSL (2004), *Fund Management*, City Business Series, August.

Figure 2 Breakdown of asset management functions by cost and employees



Source: Oxera questionnaire.

In addition, asset managers make a wider indirect contribution through their links with banks, securities dealers and information providers. The scale of their operations means that they promote market activity and liquidity.

The asset management value chain

To refer to the 'asset management industry' disguises the multitude of activities that take place under this umbrella. Although very complex pictures of the industry can be drawn, its constituent parts—the asset management value chain—can be simplified into the following elements.

– *Core asset management*—constituting the core function and including investment research, management of investment portfolios, buying and selling investment, and pre-trade broker liaison.

– *Marketing and distribution*—encompassing all activities related to marketing, sales, and business development.

– *Middle- and back-office functions*—including all support functions, such as transaction processing, settlement, custody and stock lending, IT support, performance measurement, investment accounting, compliance, financial accounting, and corporate management.

Figure 2 provides estimates of the relative importance of the three elements of the asset management value chain, in terms of costs and number of employees, based on the sample of asset management firms that participated in Oxera's research study.

On average, middle- and back-office activities constitute the largest part of the value chain with 57% of employment in these activities and 39% of costs.[7] Core asset management makes up 25% in terms of employees, but a significantly higher proportion in terms of costs (37%), reflecting the higher wage rates of employees and the higher value-added generated in the core part of the value chain. Measured both by employment (18%) and costs (24%), marketing and distribution is the smallest element of the value chain.

Location choice along the value chain

Understanding the constituent parts of the value chain is fundamental to an examination of location choice. The factors affecting the location of core asset management, middle-/back-office and marketing/distribution activities differ markedly, and the performance of the UK in relation to these also varies.

What then are the factors that determine location decisions along the value chain, and how well does the UK perform? The main findings that emerged from Oxera's survey and interviews with asset managers can be summarised as follows.

– *Core asset management*—location is primarily driven by supply-side factors, including availability of qualified labour, the performance and liquidity of capital markets, and the quality of the financial infrastructure. On all of these, the UK performs well. Firms derive an advantage from clustering in one location and being in close proximity to a major financial centre.

  Of the 31 survey respondents, only three had moved core management activities outside of the UK over the past five years; during the same period, two companies moved such activities into the UK. Similarly, when asked to rate on a scale from 1 (very unlikely) to 5 (very likely) the likelihood that their company would relocate these activities outside of the UK in the next five years, the average score was 1.2.

– *Middle-/back-office*—the most important factors are the cost and availability of labour, rental and property costs, and financial infrastructure costs. Location is therefore driven mainly by cost considerations, and it is of note how poorly the UK (and London in particular) is rated in this respect by asset managers, particularly on labour and rental/property costs. The high cost of labour and property make the UK/London an unattractive location for middle- and back-office functions.

A substantial proportion of activities have already been relocated within companies or outsourced. Outsourcing has been particularly significant in relation to custody, transaction processing and settlement, stock-lending, and investment accounting. Most relocation to date has taken place within the UK (eg, from London to regional centres). A modest amount of relocation has also occurred within Europe or to the USA. To date, there is only limited evidence of outsourcing to low-cost locations such as India.

– *Marketing/distribution*—location is primarily driven by demand-side considerations. By far the most important influence is proximity to clients and a large pool of savings. The large pool of domestic savings means that the UK scores well in this respect.

How important are regulation and tax?

Regulation, and, to a lesser extent, tax rate highly among the surveyed asset management firms as two of the most significant influences on the choice of where to locate core asset management and marketing/ distribution activities.[8] To date, however, regulation and tax have not led to significant relocations of these activities outside the UK. Moreover, in some respects, the UK regime is actually perceived as being supportive.

Among the positive features, the UK tax system is seen to compare favourably with alternative European locations due to its generally lower corporation and personal tax rates. As regards regulation, asset managers praised the apolitical and principles-based approach of UK regulation, which is seen as striking a balance between what was referred to as the ‘typical’ style of regulation in many other European countries and the ‘rigid’, ‘more prescriptive’ and ‘litigious’ system in the USA. Asset managers also noted the benefits derived from the international reputation of the UK regulatory regime.

However, significant concerns were expressed by those surveyed as part of the Oxera research about how regulation and tax in the UK are developing, and how this may put the UK at a competitive disadvantage and could contribute to relocation in the longer term. In particular, firms noted the risk that the Financial Services Authority could become a cumbersome, bureaucratic body, prone to ‘gold-plating’ EU regulations. Other jurisdictions were perceived as taking a more flexible approach to implementing EU Directives, applying greater latitude and less stringency. The rate at which UK regulation has recently been changing was cited as a particular concern and described as ‘indigestible’ by one of the surveyed asset managers. Survey responses regarding tax included statements such as:

> the present government is apt to view financial services companies as a cash cow to raid when required—and is doing little to encourage retail investors to invest via tax breaks.

Going offshore: investment funds

The one area of the asset management industry where the role of regulation and taxation has been significant relates to collective investment funds. Although the actual management of the funds remains located in the UK, the funds themselves have increasingly been established in, or shifted to, offshore locations. Among the asset management firms surveyed, all but one that offered such funds had domiciled at least some of them offshore. In Europe, the most popular fund domiciles are Dublin, Luxembourg and the Channel Islands.

Numerous forms of tax are relevant to domicile decisions, including withholding taxes, corporation tax, VAT, stamp duty and capital gains tax; however, it is VAT that is most relevant to the decision to locate funds offshore from the UK.

Domiciling funds offshore has also been encouraged by regulation. Asset managers generally praised the more responsive attitude of regulatory authorities in Ireland and Luxembourg towards the fund industry. The range of legal fund structures available, and the comparative ease with which certain types of fund can be established and approved by the authorities, make the legal and regulatory regimes of the offshore domiciles more attractive than the UK regime. The UK authorities were particularly criticised for failing to provide a regulatory environment suited to the requirements of more specialised products such as hedge funds.

Does offshore fund domicile matter from a UK policy perspective, especially since domicile only relates to the place where the fund is established ‘on paper’ as a legal entity, while the actual management activity remains located in the UK? It does. Luxembourg and, in particular, Dublin have seen substantial growth in employment in activities associated with the support and servicing of funds. Thus, even if the core asset management activity remains located onshore in the UK, offshore locations benefit from the creation of economic activities in related functions, including fund administration, custodianship, legal support, secretarial services, tax, accounting and auditing. This should not be considered surprising, as there would otherwise be little point in offshore jurisdictions taking a proactive approach to attracting funds managed abroad to domicile within their countries.

Outlook

Asset management is a diverse business, and its separation into its constituent parts allows different locations to specialise in different parts of the value chain. This process of specialisation is likely to continue.

Middle-/back-office functions are most prone to relocation away from the UK. There has already been substantial movement of these functions in recent years, and further relocation or outsourcing is expected in the next few years. This is likely to involve the transfer of at least some functions to low-cost locations outside the UK. Given the high proportion of asset management employment in the middle/back office, this could have considerable consequences for UK employment.

That said, core asset management and marketing/distribution appear quite securely located in the UK, at least in the short term and possibly longer. The availability of qualified labour and liquid capital markets ensure that the UK is an attractive place for core asset management operations. Likewise, the proximity to a large client base makes it advantageous to retain marketing/distribution functions in the UK.

Any threats to the UK's position appear to be longer-term in nature. The growing pool of savings outside the UK—eg, due to a catching-up of the pension markets in other European countries—is one prominent example. This could shift the marketing/distribution focus outside the UK and may allow asset management activities in other financial centres to expand at the expense of the UK/London.

Regulation and tax have, to date, not led to any significant relocation of activities, except when it comes to decisions about where to domicile investment funds. However, there are concerns that these factors could increasingly contribute to a longer-term decline in the competitive position of the UK industry. Many factors that contribute to the strength of the UK/London as a centre for asset management can be thought of as 'agglomeration' or 'cluster benefits'. Reliance on such effects makes any location vulnerable to contraction. Regulatory, tax or other concerns, such as physical congestion and poor transport infrastructure, could prompt some firms to relocate and then trigger an exodus of other firms in the longer term.

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[1] See, for example, Centre for Policy Studies (2005), 'The Leviathan is Still at Large', an open letter to John Tiner, CEO of the Financial Services Authority.
[2] The research was based on an Oxera survey of IMA member firms (31 respondents) and interviews with 20 of these asset managers. In addition, seven interviews were conducted with hedge fund managers, money market fund managers, outsourcing providers and an expert on legal and regulatory aspects.
[3] International Financial Services London (IFSL) (2004), *Fund Management*, City Business Series, August.
[4] Ibid.
[5] IFSL (2004), 'UK Financial Sector Net Exports', July.
[6] IMA (2004), 'Asset Management Survey'.
[7] The reported cost figures need to be interpreted with some caution, as respondents may have excluded some costs, such as those directly charged to funds.
[8] In contrast, regulation and tax were not found to be significant influences on middle-/back-office activities, although current VAT rules were seen as acting as a positive disincentive to relocate these activities through outsourcing.