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Towards a Single European Market in Asset Management

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List of abbreviations

CAP	Common Agricultural Policy
CESR	Committee of European Securities Regulators
DTC	Deposit Trust Company
ECB	European Central Bank
ECJ	European Court of Justice
EFC	The Economic and Financial Committee
ESC	European Securities Committee
FEFSI	Fédération Européenne des Fonds et Sociétés d'Investissement
FIN-NET	Consumer Complaints Network for Financial Services
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
G30	Group of Thirty
GSF	Groupe Spécial Fonds
IFA	Independent Financial Advisor
ISD	Investment Services Directive
NSCC	National Securities Clearing Corporation
OA	Open Architecture
SEC	U.S. Securities and Exchange Commission
SICAV	Société d'Investissement à Capital Variable
OPCVM	Organisme de Placement Collectif en Valeurs Mobilières
STP	Straight Through Processing
TER	Total Expense Ratio
UCITS	Undertakings for Collective Investment in Transferable Securities

Executive summary

Part A The vision

Ten years after the “completion” of the single market, national borders continue to define and restrict economic activity, even within the Eurozone. This is particularly true of the market for asset management, where a significant gap persists between the future vision of a single market and the current reality.

This report envisages that a single market for asset management would exhibit the following features:

- A consistent and flexible legal and regulatory framework which avoids excessive or repetitive regulation;
- Absence of fiscal discrimination against foreign asset management products;
- Sufficient consumer education and comparable information on financial products to minimise consumer discrimination against foreign asset management products;
- No competitive discrimination against third-party asset management products (whether foreign or domestic) by distributors;
- Sufficient information and institutions to reassure consumers of the reliability of cross-border contracts;
- Continuous improvement of the pan-European infrastructure which facilitates transactions between asset managers and consumers; and
- Openness of non-European markets to European asset management products, and vice versa.

A single market that fulfilled this vision would provide significant economic benefits to both consumers (e.g. cost savings) and society (e.g. higher economic growth due to faster and more efficient capital accumulation).

It is hard to make any general statement about the asset management market, since in reality it comprises a large number of sub-markets and products (from standardised fund products for retail clients to individualised segregated services for institutional clients). This report has a certain – though not exclusive – focus on retail investment fund products, for which more data is available and, more importantly, the distance between vision and the reality is greater than in the wholesale market.

Part B The current state of the market

The study assesses the current state of the single market by analysing aggregate data and one-to-one interviews with leading investment management companies with significant cross-border business.

Aggregate data paints an ambivalent picture of the current degree of integration:

- While there is some growth in the volume of cross-border investment fund sales, national markets are still predominantly dominated by domestic suppliers. In most European countries the market share of foreign investment funds (by asset value) rarely exceeds 20%.
- There is strong evidence that third party distribution is driving cross-border business in European investment funds.
- European UCITS have enjoyed some export success outside of Europe, for example in Asia and Latin America. However, the world's largest market, the US, is practically inaccessible to European UCITS due to regulatory constraints.
- In most European countries, banks still dominate the distribution of investment funds. Furthermore, banks still largely prefer to sell in-house products: more than 80% of all investment fund assets are attributable to in-house funds. However, this picture is beginning to change. Survey respondents indicated, on the one hand, that the dominant position of banks is beginning to be challenged, and, on the other hand, that the banks' movement towards 'open architecture' will increase the distribution of third-party cross-border products .

Part C The issues in detail

There is no simple answer as to why the European market for asset management is still segmented by national borders. However, interviews with asset management firms engaged in cross-border business indicated that certain 'man-made' barriers are a greater obstacle to the single market than 'natural' barriers like language, including (and in order of importance): taxation; distribution; fund mergers; infrastructure; and registration. Other (largely consumer related) barriers such as consumer culture or lack of consumer confidence were generally considered less significant obstacles to a single market.

- **Taxation:** Tax discrimination against foreign investment funds was deemed the most significant barrier to cross-border business. Interviewees attributed the highest weighting to taxation independently of their particular business model. This assessment is consistent

with empirical research: countries with fiscal regimes which radically discriminate against foreign UCITS are practically closed to cross-border business.

- **Merger of funds:** Existing research leaves no doubt that the fragmentation of European markets along national borders results in sub-optimum average fund sizes. Consumers pay the bill for small funds in the form of high cost ratios. Tax and regulatory barriers restrict the ability of asset managers to increase average fund sizes by merging, eliminating or restructuring existing fund ranges. For example, some regulatory regimes place prohibitive conditions on mergers which would move assets to other domiciles, whereas some fiscal regimes treat cross-border mergers as a taxable event.
- **Distribution:** Asset managers typically rely on third-party distributors of investment funds (including banks and others) to enter new markets. Interviewees identified insufficient willingness and competence on the part of the sales staff of third party distributors as significant obstacles to the single market. Those supply side barriers are reinforced by insufficient financial literacy on the part of retail investors to demand appropriate advice from distributors and products from cross-border asset managers. Although the market downturn since the year 2000 may temporarily set back the trend towards open architecture, ultimately it is expected to resume and may even be reinforced by the recent experience of consumers.
- **Infrastructure:** There is a relatively large gap between the current state of the infrastructure that processes transaction between asset managers and their clients (which is characterised by inconsistent and repetitive protocols and standards), and an economically ideal infrastructure (which would be characterised straight through processing). Movement toward an economically ideal infrastructure would remove a costly barrier to cross-border sales of investment funds. There are reasons to believe that “the market” will move toward an optimal solution of its own accord, without any intervention from legislators other than to remove legal and regulatory barriers that restrict the market from finding this solution.
- **Registration:** Fund registration (i.e. the requirement to register a UCITS fund in every host state in which it is actively marketed, irrespective of having already been registered in its home state) is regarded as giving rise to unnecessary additional expenses which put cross-border investment funds at a cost disadvantage to domestic investment funds. While the direct registration fees paid to domestic regulators are relatively low, indirect fees paid to local lawyers and accountants can be significant.
- **Consumer culture:** Whilst cultural differences impact the means of distribution, they only represent a moderate barrier to the development of a single market. National prefer-

ences for certain asset classes, time horizons, and cost arrangements can all be accommodated by asset managers.

- **Consumer protection:** Consumer protection standards (for example, regulating the marketing and advertising of investment funds, and supplementary advice and information publication) vary significantly between EU member states. Cross-border investment fund business is only moderately inhibited by the variety of regulation. Consumer confidence in cross-border business can be strengthened through institutions such as cross-border complaint networks, compensation schemes, codes of conducts or well defined standards on advice. While asset managers do not agree on the importance of unified standards in *all* of these areas, they *do* agree that any standards should be defined by the industry itself rather than the legislators (since the industry has the best information about adequate rules).
- **Information issues:** The asset management industry (and, indeed, the broader financial services industry) is characterised by information asymmetry between the investor and the provider. National regulations and market practices manage that asymmetry by establishing investor information standards (for example, relating to fund costs and performance). The variety of national information standards makes it difficult to compare investment funds on a cross-border basis, and therefore inhibits the single market. The simplified prospectus (constituting a single, fully harmonised pan-European document – possibly along the line of the FEFSI proposal - that can be used for the cross-border marketing of UCITS in all countries) would be a useful step in reducing the variety of information standards.
- **Transparency:** Fees and charges are often not transparent to consumers and hence not comparable between different investment funds, particularly on a cross-border basis. Similarly the reported performance of investment funds is rarely comparable on a cross-border basis. Almost all interviewees argued that the asset management industry should standardise such information to improve transparency and comparability (incidentally arguing that regulators and legislators were less well equipped and resourced for this task).
- **Legislative and regulatory issues:** Even though the revised UCITS directive is expected to promote the single market for investment funds, significant shortcomings remain. For example: potentially diverse implementation between member states; tax discrimination; and regulatory discrimination. Similarly, the draft directive on occupational retirement pensions leaves a lot to be desired since it provides member states with a lot of discretion, for example, to impose qualitative restrictions on the asset allocation of pension funds or to fiscally discriminate against cross-border contributions.

Part D What needs to be done

There is a broad consensus amongst asset managers, regulators and legislators on the benefits of a single market. However, there is less consensus on how to achieve those benefits. Legislators are naturally optimistic that legislation and directives will be sufficient to promote future integration. In contrast, the asset management industry places more emphasis on better coordination, stricter enforcement and standardised implementation of existing legislation in the post-FSAP era. This report finds that such issues cannot be generalised: different problems require different solutions, sometimes legislative, sometime interpretative, sometime judicial. Therefore, our case-by-case recommendations are:

- **Taxation:** Tackling tax discrimination against foreign investment funds must be prioritised if one takes a single market seriously. To date, the asset management industry and Commission have been reluctant to tackle discrimination for different reasons (the former because it is concerned about alienating member states, and the latter because of conflicting priorities). However, ultimately it is the Commission's responsibility (as guardian of the Treaties) to address this issue and adopt a more aggressive judicial approach.
- **Fund mergers:** Two distinct problems need to be addressed: first, the treatment of fund mergers as taxable events and second, protectionist regulatory conditions on outward-bound cross-border mergers. Responsibility for correcting the former lies with member states, and for correcting the latter with the Commission (for example, by proposing a future UCITS amendment to simplify and harmonise the rules for relocating investment funds within the single market).
- **Distribution:** Competition will naturally force suppliers to open up their distribution network to third party products. Improving consumer literacy is likely to mildly accelerate this process. Improving national regulation of advice in order to promote unbiased and objective distribution is likely to be more significant. Progress towards more open distribution is closely linked to progress towards a more efficient European infrastructure.
- **Infrastructure:** Today, fragmentation of infrastructure places a costly burden on cross-border sales of investment funds. An efficient, pan-European infrastructure would require a significant initial investment, during the course of which investors would face uncertainty as to which standards would finally prevail. Although the market may take a long time to resolve these issues, it is better placed than other parties to arrive at an effective solution. Therefore this report recommends that improvements in infrastructure be primarily left to market forces and competition between leading infrastructure service providers, with a secondary role for the European Commission to speed up the process by removing any legal and regulatory barriers.

- **Registration:** Current UCITS registration practices inhibit the single market. A straightforward solution would be to take the European passport literally: a fund accepted as a UCITS in its home state would be immediately marketable elsewhere in the EU without further registration requirements. This would be a significant breakthrough and should be considered seriously in future debates about the UCITS directive.
- **Transparency/information requirements:** The simplified prospectus as introduced by UCITS III is a helpful step in the right direction. However, it does not solve the problem of heterogeneous national requirements on full prospectuses. Future reforms should establish a harmonised full European prospectus that would be sufficient in each member state (and which would complement the preceding recommendation to abolish registration of UCITS in every host state). The asset management industry can speed up this process through self-regulated harmonisation of cost and performance reporting. In addition, it is important to improve the education of consumers.
- **Evaluation of legislation:** What is definitely needed prior to any further legislation is a more critical evaluation of past legislative measures. This is particularly important with respect to FSAP initiatives, the effects of which should be properly monitored and measured before moving on to further legislative programmes.

Introduction

Despite ten years having passed since the “completion” of the single European market in 1993, many markets remain national rather than European in nature (even within the Eurozone). This is particularly true of certain financial services markets. The past decade has shown that the creation of a single market cannot be achieved through the regulatory stroke of a pen, but rather is an ongoing process that requires constant reflection and adjustment by market participants and legislators alike.

This report contributes to those reflections on the single market for asset management in general, and the market for investment funds in particular. There is no doubt that a more competitive and integrated market for asset management is highly desirable: it would contribute to the smooth functioning of European capital markets (thereby decreasing the cost of capital and increasing the European growth rate); and it would play an important part in financing solutions to Europe’s impending pension funding crisis.

But unfortunately, in spite of an overwhelming theoretical consensus on these advantages, progress towards more integration is by no means certain. The market faces three obstacles: first and foremost, the protectionist habits of the past; second, recently established barriers which (intentionally or not) have set back the cause of integration; and third, the recent bear market which might (temporarily) induce investors and regulators to more cautious and inward looking behaviour.

Even where action is explicitly intended to foster the single market for financial services, as in the case of the FSAP, progress is not guaranteed. Political compromises during the legislative process and inconsistent enforcement of European rules sometimes frustrate further integration. Therefore, such legislation should to be subject to careful cost-benefit analysis.

This report adopts a two-step approach to describing a single market for asset management. The first step (Part A) develops a vision for the single market for asset management. The vision acknowledges that an ideal single market may not be realistic under current conditions, whilst stressing that substantial benefits can nevertheless be realised if anachronistic obstacles are overcome. The main finding of the first step is that policy makers can approximate the benefits of the single market by increasing integration *and* competition.

The second step (Part B and Part C) draws on empirical data to explain why today’s market diverges from the vision. The empirical data comprises aggregate market data and detailed insights from extensive interviews with leading asset management companies. This data not only describes the barriers to the single market but also ranks the most obstructive of those barriers – a ranking that could usefully inform future policy initiatives in this area (Part D).

Any statement about the “asset management industry” is necessarily a generalisation, since the industry is extremely heterogeneous; it ranges from retail business with standardised fund products to wholesale business with individualised services for institutional investors (for a definition of “asset management” see section A.2). This report focusses on fund products for a number of reasons. First, more data is available on the cross-border sales of funds than other asset management products and services. Second, all available data suggests that further integration of fund markets will be more problematic than institutional asset management markets (i.e. the analytical focus on fund products is due to a research strategy to concentrate on those markets where barriers to integration are most severe).

In writing the report the ZEW research team benefited from interviews and written questionnaires among IMA member companies with significant cross-border activities (see box), whose participation is gratefully acknowledged. The combined market share of those companies is approximately 29% of the total European cross-border fund market (based on estimations on cross-border net sales in 2002 of those companies who sold funds in at least five countries and who recorded positive net sales in 2002.)¹ This significant market share allows us to draw general conclusions about the market as a whole.

We would like to thank Sheila Nicoll, Jane Lowe and Travis Barker (IMA), Alan Ainsworth (chairman of IMA’s European Strategy Committee), Diana Mackay and Rodney Williams (FERI Fund Market Information), Magnus Spence and Angela Hornberg (Sector Analysis Ltd) who contributed through their advice, experience and data support. A number of organisations helping with data deserve credit (see box). Furthermore, we acknowledge research assistance from Holger Nieswandt, Lasma Strausa and Heiko Truppel.

¹ Source for these estimates: FERI Fund Market Information. The 29% market share estimation is calculated taking into account only those companies with positive cross-border net sales in 2002. The calculation on the basis of all companies (including those with negative net sales) shows our sample has a market share of 103% - which means that the companies in our sample were more often able to reach positive net sales than the average in 2002.

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Part A The vision

A.1 A single market in a general sense

Despite being a cornerstone of European integration there is still no clear cut definition of a “single market”. Definitions which only stress the absence of *legal* barriers to the free movement of goods, persons, services and capital, appear to be inadequate: everyday experience shows that national borders continue to be important to cross border trade even in the absence of legal barriers because economic restrictions segment European markets into national sub-markets. Thus it might be tempting to define a single market as one where internal national borders do not give rise to legal *or economic* impediments to cross-border transactions. Unfortunately, even this definition would be too strict: differences in language or national consumer preference, for example, constitute economically relevant restrictions to cross-border business but have to be taken as given under current circumstances. Therefore, the definition of a single market should be based on an exhaustive classification of the obstacles to cross-border business and a subsequent determination of which of those obstacles are not compatible with a single market in one’s understanding.² This approach results into a negative definition, i.e. of what a single market should *not* look like.

Table 1 summarises different classes of obstacles. Tariffs, quotas, and discriminatory tax regimes are clearly inconsistent with a single market, whereas differences in consumer culture are fully compatible with a single market – otherwise one would have to wait until the Last Judgement for the single market to arrive!

Other cases are more ambiguous. Regulatory barriers might either arise as a consequence of different consumer preferences, or alternatively as a non-tariff trade restrictions in disguise. In such cases it is necessary to prove that national divergences from common European standards of regulation are in the interest of consumers and can be justified in terms of a cost-benefit-analysis. If such proof is not forthcoming then this indicates the possible abuse of consumer protection regulations for protectionist purposes (see also box).

² In Heinemann/Jopp (2002) a distinction was made between „natural“ and „policy-induced“ obstacles. Here, the approach is more refined. It is now taken account of the fact that certain „policy-induced“ obstacles might be well justified and that some „natural“ obstacles (e.g. market infrastructure) could be the consequence of a market failure and should therefore not be taken as given.

Regulation – often the official objectives are not the true driving forces behind it

Since Stigler (1971) it has become well established that regulation is not solely driven by the legislators' desire to maximise general welfare. Regulation can also be used to protect the private interest of influential interest groups since it offers scope for intransparent off-budget redistribution. For a politician seeking reelection it is much easier to do favours for lobbies through protectionist regulation than through direct subsidies. The redistributive effects of subsidies are easily understandable for voters while the redistributive consequences of regulation are very hard to recognize. Therefore, politicians will tend to favour less transparent regulation since it is associated with lower voter resistance (for an introduction to this literature see Mueller, 1997).

The officially proclaimed justification for certain legislation is not necessarily the true motivation for the intervention into market processes.

Similarly, although market infrastructure may act as a bottle-neck on integration this might nevertheless be an efficient outcome. After all, it would not be efficient to construct a tunnel towards an island with a hundred inhabitants even if this would increase integration. Thus, the pertinent question to ask about infrastructure is whether inefficient supply is due to market failure.

A similarly ambiguous assessment applies to distribution channels. Distribution channels favouring local producers may be the efficient consequence of product characteristics e.g. with regard to transport costs. However, automobiles producers, for example, may intentionally use their oligopolistic power to manipulate distribution channels for a profit maximising strategy of market segmentation.

Ambiguous obstacles to the single market often exhibit path-dependency. Today's interdependent regulation, distribution and market infrastructure often reflect circumstances of past decades. Fixed cost problems and network phenomena might preclude a fast adjustment of anachronistic structures to new circumstances. The European cross-border payment system is a good illustration: while its fragmentation might have been acceptable (and efficient) in an era with a low frequency of cross-border transactions it is an inappropriate infrastructure after the advent of the Euro. Nevertheless, market forces alone were unable to succeed in a fast transition towards pan-European cost efficient systems, so the European legislator felt the need to speed up the process through the regulation of cross-border payments.

Table 1: Classes of integration obstacles

Class of obstacles	Example	Acceptable within a single market
Tariffs, quotas	Pre-1968 tariffs on internal trade of EC.	Clearly not.
Tax discrimination	Discriminatory tax treatment of life insurance contributions to foreign companies.	Clearly not.
Consumer culture	Portuguese language books do not sell in the UK, French consumers are more keen on cheese specialities than Austrian consumers.	Clearly yes.
Regulation	Exemptions from free trade in pharmaceuticals due to health protection.	Ambiguous: acceptable if it reflects different national consumer preferences and is not abused as protectionist tool.
Market infrastructure	Non-existence or insufficient transaction networks between countries.	Ambiguous: acceptable if the market infrastructure is not the outcome of a market failure.
Bias in existing distribution channels	Car distribution with discrimination against cross-border customers. Importance of distance in markets with high transport costs (for example cement trade).	Ambiguous: acceptable if bias is not the outcome of a market failure.

This systematic overview of the characteristics of a single market highlights the difficulties in defining an integration strategy, which must be developed on a case by case basis and require careful assessment of the extent to which obstacles can and should be removed.

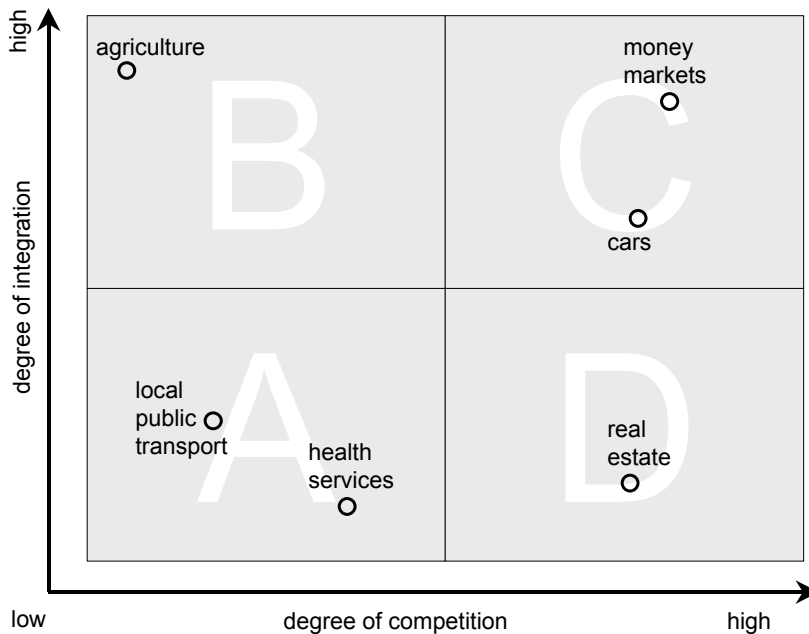
One has also to be aware of the fact that integration should not be maximised at any cost since integration is not an objective in itself. It is an instrument to increase competition, innovation, growth, efficiency in production and consumer welfare. Not every instance of increased integration is necessarily helpful in achieving those final objectives. This can be seen from the experience of the EU's Common Agricultural Policy (CAP) which has, without doubt, successfully created an integrated European market for agricultural products. However, CAP's highly regulated and interventionist approach has also created an integrated market with massive inefficiencies in which farmers have become dependent on taxpayers' money, consumers face distorted prices and the market is heavily protected from global competition.

Consequently, measures designed to promote the single market have not only to pass the integration test ("will it promote integration") but also the competition test ("will it promote or at least not harm competition").

Figure 1 illustrates this point by depicting a number of markets relative to their competitiveness and integratedness: car, real estate and money markets in Europe appear highly competitive although at different levels of integration. A important characteristic of a competitive European market is openness to external trade. The car market is a good example: while the statistics on car price differentials show that European integration far from perfect, competitive pressure is guaranteed by this market's openness to global trade. As previously described, the agricultural market exhibits a high degree of integration but low levels of competition. Certain service markets (for example local public transport or health services) are neither highly integrated nor particularly competitive.

This framework is helpful in developing an appropriate European integration strategy for asset management. If it turns out that asset management is still in quadrant A (low integration/low competition) than an appropriate policy strategy would be to move towards quadrant C (high integration/high competition), whilst avoiding quadrant B position (since here, it would be difficult to achieve the final objectives of full competition, efficiency and consumer welfare).

Figure 1: Integration and competition



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A.2 A single market for asset management

The preceding description of the desirable characteristics of a single market form the basis for a definition of the single European market for asset management.

One should be careful when using the term “asset management”, since it can have a variety of different meanings. In the broadest sense, asset management services comprise all forms of intermediated investment and thus include all investment services of banks, insurance companies and investment funds alike.³ The problem with this very broad definition is that it includes types of intermediated investment services which do not utilise any principles of portfolio optimisation (e.g. a plain savings account). In this study, ‘asset management’ is used in a narrower sense to mean investment services which utilise sophisticated portfolio management techniques by financial institutions for third parties. This definition encompasses the whole spectrum between highly regulated collective investment services for the retail consumer (most importantly, UCITS) and largely unregulated and often individualised services for big institutional or high net worth private investors.

Having defined our key term, we now seek to describe the characteristics of a single market for asset management. Two points should be made at the outset. First, that those characteristics must take account of asset management’s enormous sensitivity to economic incentives: any purely legalistic definition that does not take account of economic restrictions is meaningless. Second, the asset management industry is characterised by constant change and a high speed of innovation: while it would be unrealistic to attempt to paint a precise picture of the market’s future appearance, it would be reasonable to identify those characteristics that definitely do not belong to its future.

In this report’s understanding a desirable single market for asset management is characterised by the following features⁴:

- Existence of a consistent and flexible legal and regulatory framework for the European asset management industry. This framework should avoid any unnecessary or excessive regulatory and legislative stickiness which limits innovation and competitiveness. For example, consumer protection standards should differ according to the sophistication of customers with rules for institutional business being more liberal than those for retail business.
- Absence of fiscal discrimination of foreign asset management products. This does not require the harmonisation of national fiscal systems, but merely that those systems should

³ This wide definition is used, for example, in CEPS (2003, p.5): “The asset management industry comprises all forms of collective (institutionalised) and individual (discretionary) investment of savings by financial institutions for third parties in money and capital markets”.

⁴ For similar definitions see Eurofi (2002), City of London Working Group (2002).

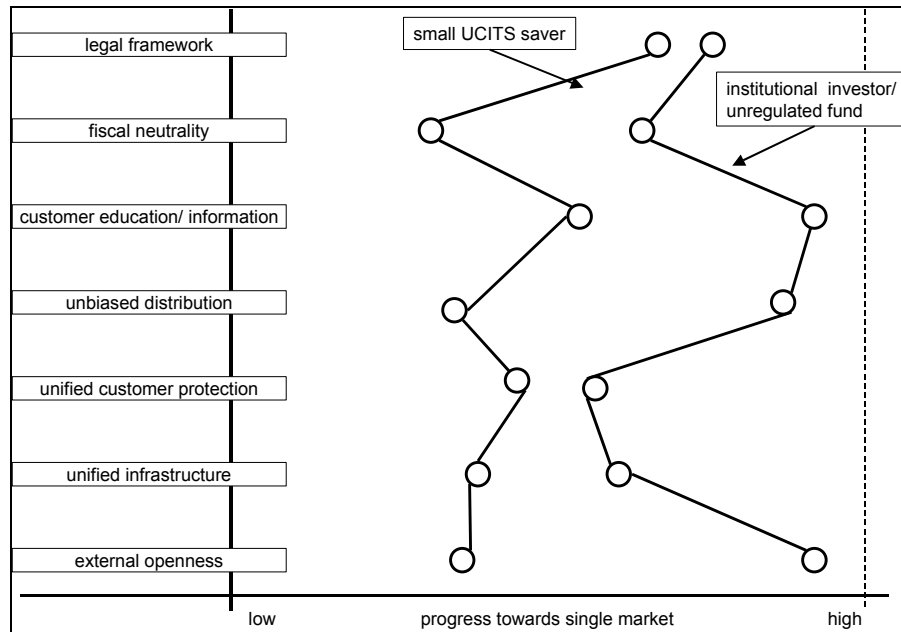
not assess domestic investors to different effective rates of taxation on the basis of the country of origin of a financial product. Fiscal neutrality is more than just tax neutrality since it also includes the equal treatment of foreign products in the context of subsidised investment schemes (e.g. in the context of pension plans).

- While cultural differences are compatible with a single market, consumer discrimination arising from poor information or inadequate education is not. Consumers within a single market may stick to different investment habits but they should have easy and low cost access to information on prices and performance of pan-European products. True consumer freedom of choice can only work with transparency and a minimal level of consumer literacy.
- A further important feature of a single market concerns distribution. A significant bias towards home made financial products in distribution channels is not compatible with a true single market in an industry where transport costs are practically irrelevant.
- Consumer trust in the reliability of cross-border contracts is essential for a single market in asset management. A single market is, however, not compatible with extensive divergence in national consumer protection standards that effectively shelters markets from foreign competition.
- While a unified market infrastructure (e.g. in clearing and settlement and transfer agency) is desirable for a single market in asset management, the fundamental economic obstacle towards this objective (e.g. the large initial investment required) cannot easily be resolved. A more realistic objective would therefore be that all responsible actors should support constant progress toward a pan-European infrastructure.
- A single market is not compatible with external protectionism (“fortress Europe”). Therefore, a single European market for asset management should not only be internally integrated but also fully linked to global capital markets.

One of the objectives of this report is to identify the distance between this vision and today’s reality for the asset management industry. However, it should be stressed that the distance between vision and reality differs in various heterogeneous sub-markets of the asset management industry. Figure 2 serves to illustrate this point by comparing the situation of two different segments: the retail market for small savers investing in UCITS and the wholesale market for big institutions investing in unregulated asset management products. Hardly any asset management sub-market in Europe could at present be characterised as a truly single market. However, the distance from this objective differs. Markets with institutional customers are in general much closer to the single market ideal than retail markets. Distribution biases towards domestic products, for example, are still much more powerful in retail than in wholesale mar-

kets where customers have a global perspective. In what follows, those differences have to be kept in mind when making general statements about the industry as a whole.

Figure 2: Distance of asset management sub-markets from single market



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A.3 Benefits of a single European asset management market

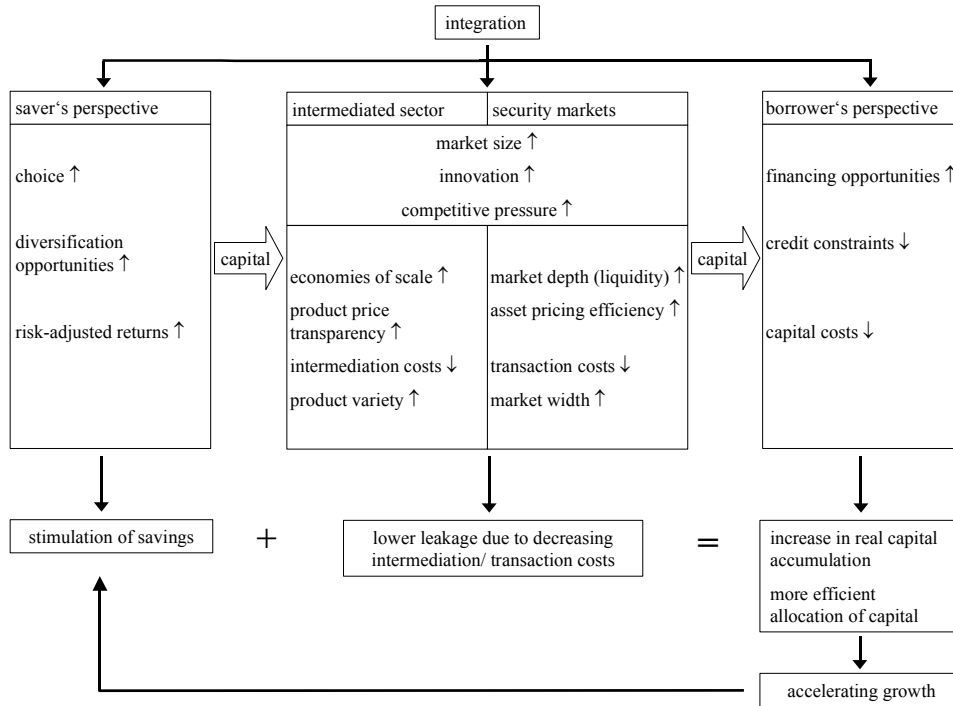
The positive link between financial market integration and growth has been proven by both theory and a growing body of empirical data (for recent surveys see for example: Neimke et al., 2003; Kappler/Westerheide, 2003; London Economics, 2002).

Figure 3 summarises the most important links between integration and growth: as the market grows, competition, innovation and price efficiencies increase and economies of scale and scope can be reaped. Therefore, intermediation and transaction costs are negatively related to the degree of integration. From the savers' perspective a more highly integrated market leads to wider product choice, greater diversification opportunities and an increase in risk-adjusted returns. From the creditors' perspective (household, company or public sector) a more highly integrated market leads to reduced risk-adjusted borrowing costs and increased financing options. Furthermore, due to the improved risk pooling capacity of a deep market the financing of highly specialised and risky investment is simplified.

These advantages translate into macroeconomic benefits. Less leakage of capital between savers and investors allow capital to accumulate faster. Growth is supported by a stimulation

of savings as a result of a more attractive supply of financial products.⁵ Furthermore, the more efficient allocation of by a competitive single market increases the marginal productivity of a given aggregate stock of capital.

Figure 3: Financial integration and growth



ZEW

⁵ It should be noted, however, that the effect of more efficient financial markets on the overall savings rate is ambiguous: lower credit constraints and better insurance services set incentives against saving (Pagano, 1993). Nevertheless, the statement that lower intermediation costs leave more savings capital for investment is unambiguous.

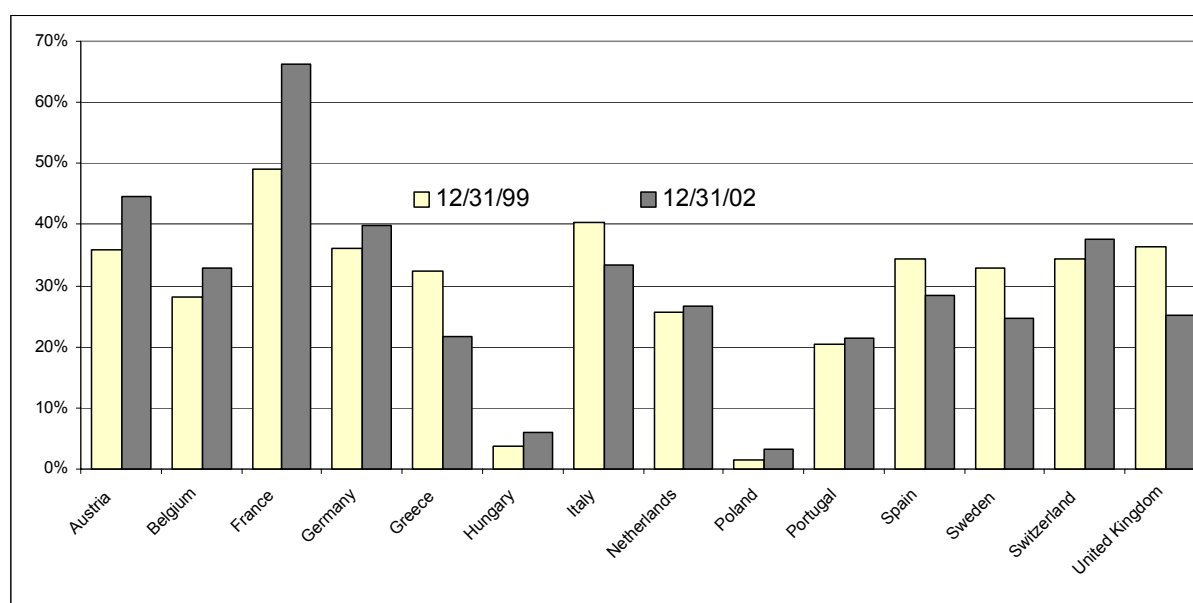
Box: Quantitative estimations on the macroeconomic benefits of financial integration

- Cecchini Report (Commission of the European Communities, 1988): Financial liberalisation could increase the European income by about 1.5% over a six-year period.
- European Financial Services Roundtable study (Heinemann and Jopp, 2002): Progress in financial market integration has a significantly positive impact on growth. Magnitudes of 40 bn. Euro are within the realistic range for the potential annual gain for the European GDP. Further positive effects comprise employment and the international role of the Euro.
- A study for the European Commission by London Economics (2002): The reduction in transactions and capital costs associated with integrated financial markets would increase the EU-wide real GDP by 1.1% in the long-run.
- A study by the Instituto Valenciano de Investigaciones Económicas cited in the seventh progress report on the FSAP (European Commission, 2002b): Interest rate savings in integrated retail financial markets could increase the EU GDP by 0.7%.

Many of these arguments are particularly relevant in the context of the asset management industry. By the end of the nineties non-financial investors (i.e. excluding banks and other financial institutions) had shifted financial resources into investment funds at the expenses of bank accounts (ECB, 2002). Although that trend has been stalled or even reversed by the recent market downturn (particularly in equity oriented markets) the industry still has substantial amounts of assets under management: for key markets those assets reach 30% or even 40% of GDP with a peak for France at 66% (Figure 4). Growth is expected to resume once current market turmoil comes to an end. Very high growth rates are expected in Eastern Europe post EU accession.

An appropriate integration strategy should pay attention to certain qualities of the asset management industry which account for its high rate of growth:

- An ability to construct diverse investment products that meet the differentiated needs of both private and institutional investors.
- An ability to offer even small investors access to highly diversified portfolios.
- An ability to make distant (in both a direct and a metaphorical sense) markets accessible for retail and wholesale investors where information costs would preclude any individual activity.

Figure 4: Assets European investment funds/GDP

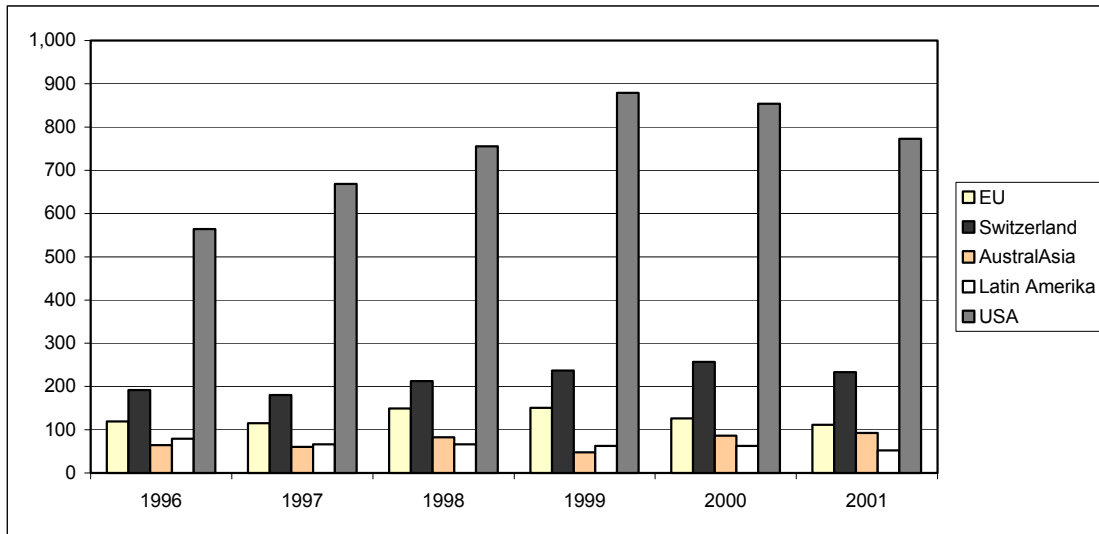
Calculated from FEFSI and OECD data

A competitive asset management industry is therefore particularly capable of constructing products which increase the risk-adjusted rate of return of most investor groups and thus of stimulating of the savings rate.

A precise quantification of the economic consequences of deeper integration of the European asset management industry is difficult. However, it is possible to give quantitative insights to certain parts of the chain between integration and growth.

It is possible to quantify the benefits of economies of scale in the asset management industry. Today's fragmented European market results in an average fund size that is small compared to US standards (Figure 5). Information about the link between average fund costs and fund size from a thorough SEC study can be used to quantify the cost of today's fragmented European market. According to Heinemann (2003) and based on the market size of 2001 costs of about 5 billion Euro could be saved annually if integration resulted in European funds reaching the same average size as US funds.

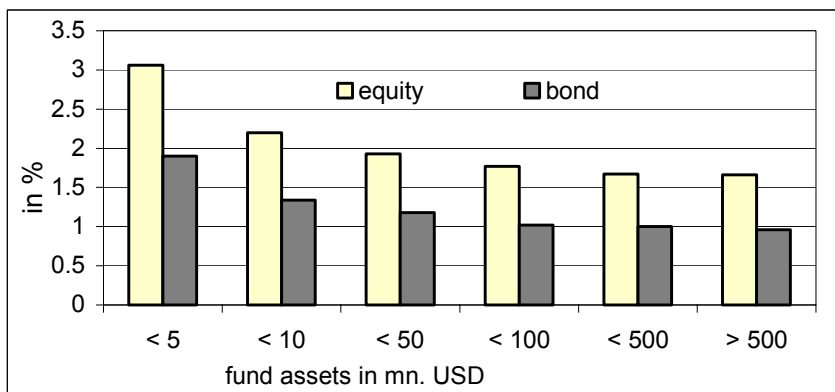
Figure 5: Average fund size (in mn. USD)



Own calculations based on data from FEFSI and ICI, data refer to open-end funds.

A Fitzrovia study (Fitzrovia, 2002a; see Figure 6) confirms the significance of economies of scale in asset management. There is a clear negative correlation between funds size and total expense ratios of otherwise identical funds domiciled in the same jurisdiction (Luxembourg).⁶ For actively managed equity funds the TER of the smallest class (< USD 5 mn.) is 84% larger than the TER of the largest class (> USD 500 mn.). For bond funds the differences even amounts to 98%.

Figure 6: Total expense ratio and fund asset size

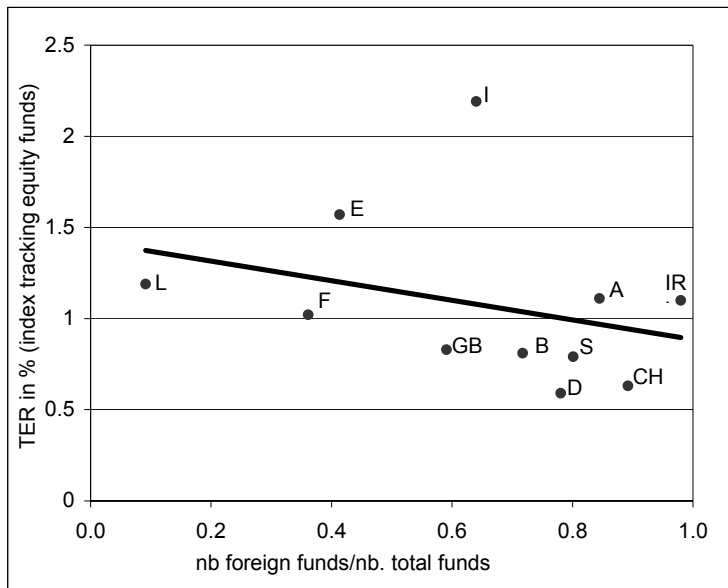


Source: Fitzrovia (2002a), data refer to April 2002.

⁶ It is interesting to note that in the Fitzrovia study the economies of scale do not become visible in the management charges that do not differ significantly between funds of different size – a result pointing to the importance of TERs.

The economies of scale argument hints to a long-run link between integration and consumer welfare: greater integration will gradually lead to larger average fund sizes which should induce cost savings. In addition, there is a short-run link: the presence of foreign asset management groups should immediately increase competitive pressure and force all competing companies to apply stricter cost controls. A simple exercise backs the empirical relevance of this reasoning (Figure 7): for highly standardised products (equity index trackers) there is a negative correlation between the share of foreign funds in a country and the average TERs in the respective market.

Figure 7: TERs (index tracking equity funds) and share of foreign funds



Calculations based on TER data from Fitzrovia (Fitzrovia, 2002b) and data on fund numbers from FERI Fund Market Information. TERs are weighted averages for index tracking equity funds.

Part B The current state of the market

As well as setting out a vision of the future market for asset management in Europe, an appropriate integration strategy must also assess the present degree of integration in order to develop effective policies to close the gap between that future vision and that present reality.

There is insufficient data to perfectly assess present day integration, particularly with regard to the provision of pan-European unregulated asset management products and services. The situation is better with regard to regulated fund products, though even here there are serious problems identifying comparable and standardised market data. These limitations must be kept in mind when presenting a picture of the current level of integration.

The structure of this part of the report reflects the preceding definition of a single market. A single market is not only characterised by a high degree of internal integration (B.1) but also by an open external regime (B.2) which is crucial to foster competitiveness. Section (B.3) looks into distribution trends which significantly impact the development of cross-border business and section (B.4) briefly describes the most important recent legislative decisions.

B.1 Internal integration

B.1.1 Foreign market shares

A straightforward measure of internal integration in the European fund market is to count the numbers and/or asset based market share of foreign funds present in each national market. Although market share would be the more revealing measure, there is greater availability of data on the number of funds. Figure 8 summarises data on the number of funds which were collected from national investment fund associations and registration authorities. It allows us to draw conclusions regarding cross-country comparisons and the current trends.

In all European countries, the number of both foreign and domestic suppliers generally increased to a (more or less) large extent between the mid-1990s and 2001/2002. The number of funds is clearly correlated with a country's size. An outstanding number of foreign funds are available to investors in Germany as well as Austria, Switzerland and the UK.

The German fund market has undergone a particularly rapid development since the mid-1990s. The high number of domestic funds in Germany includes more than 5000 German 'special funds' which are used by institutional investors and are not sold to the general public.

Since 2001, the growth of non-Irish and Irish funds, as well as funds administered in Ireland⁷ has been particularly high. In addition, the number of foreign funds has increased in some small markets like Portugal, the Netherlands and Italy.

But this data also support earlier findings (e.g. Heinemann, 2003) that investor choice in certain small markets is still limited by a low number of registered funds compared to the big countries. Denmark is an extreme example: due to the highly discriminatory Danish tax regime, the market is effectively closed to foreign investment companies. Thus, in February 2003 only 17 foreign funds were registered in Denmark.

A large number of foreign registered funds does not necessarily imply a substantial amount of cross-border business since registration of a foreign fund does not guarantee market success. Therefore, it is essential to complement data on the number of foreign fund registrations with data on foreign market shares based on asset values. Table 2 presents such market share data, where available. With the exception of Ireland the fund number based market shares are larger than the asset value based market shares. This means that market success is not in proportion to the registration of foreign funds. Foreign funds in Switzerland, Ireland and Belgium have enjoyed a relatively high asset value based market share since the early nineties. Interestingly, in Belgium that share has started to decline, albeit from a high level by European standards.

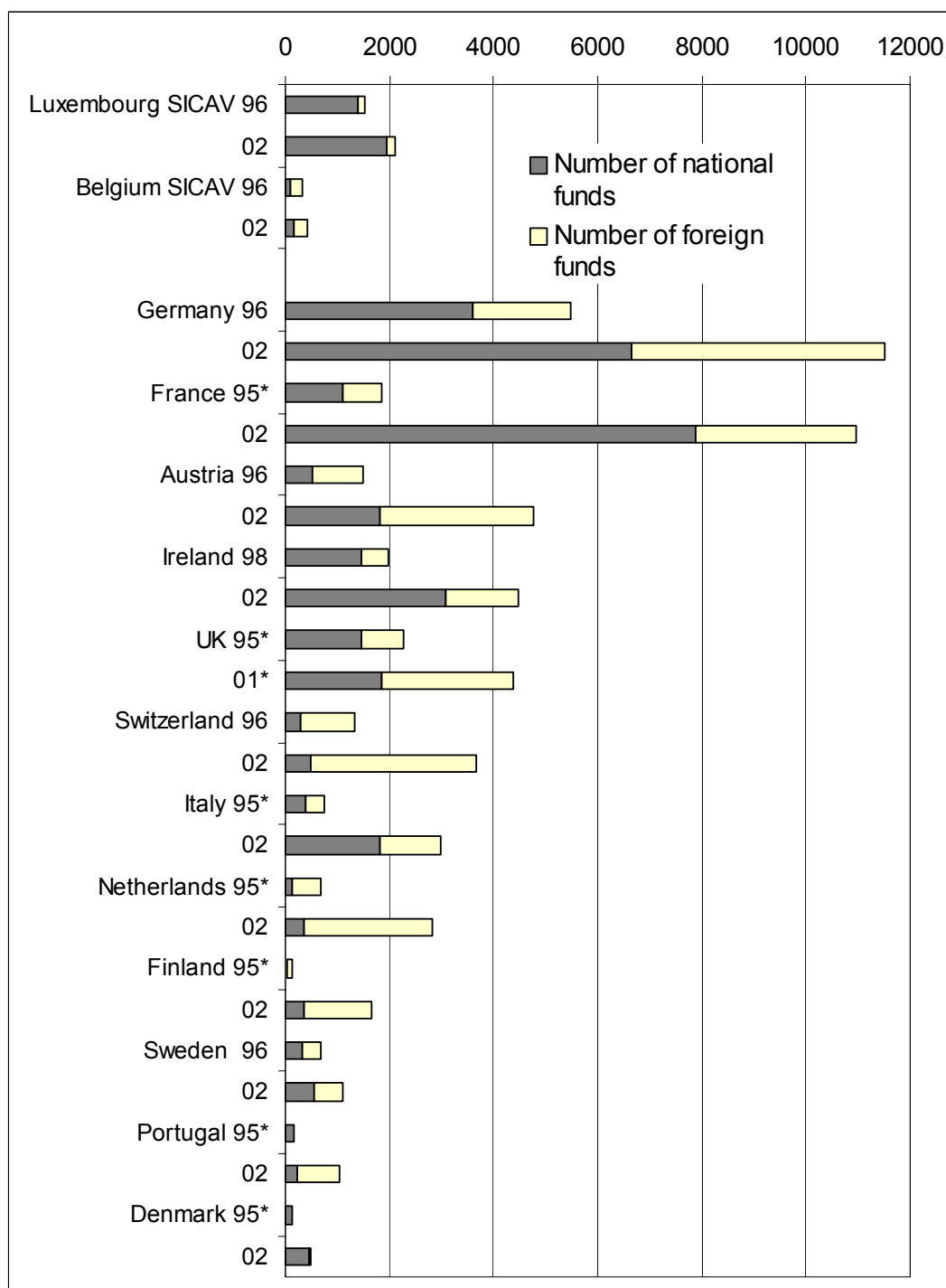
The situation is very different in other countries where the asset value based market share of foreign products even today hardly exceed 20% (although even this represents some progress since 1992). Over the nineties asset value based market share of foreign investment funds increased slowly and steadily, particularly in Italy. With only 3.7%, the foreign market share in France is still remarkably low despite being one of the leading EU fund markets.

These insights correspond to other piecemeal information from the literature: according to FERI (2002: ch. 21) the French market is mostly approached from „within“, i.e. foreign companies establish a domestic presence rather than serve the market from abroad. The Spanish authorities only accepted the sale of Irish domiciled funds in 2001 (FERI, 2002: ch. 15) partially accounting for the very low asset values of foreign funds in Spain in Table 2.

Data from the Portuguese fund association CNVM shows that assets sourced from Portugal by foreign groups represent less than 1% of domestic fund assets by the end of 2001 (FERI 2002: ch. 27). The same applies to Greece: though the ratio of foreign to domestic funds is relatively high, estimated sales are low due to tax discrimination as well as the reluctance of Greek banks to actually sell foreign products (FERI, 2002: ch. 23).

⁷ In addition to domestic funds, Dublin also provides administration and back office services to non-Irish domiciled fund originating e.g. from the Cayman-Islands (FERI, 2002: ch. 15).

Figure 8: Number of funds registered for sale in EU-countries (end of year)



Source: CSSF, CBF, BaKred, COB, FMA, DFIA, Lipper, SFA, Assogestioni, AFM, BOF, Svensk Fondstatistik, CNVM, IFR. Data marked by * is provided by Lipper.

Note: In general, the number of funds includes subfunds, excepting Belgium and Luxembourg which count an umbrella SICAV as a single fund, ignoring the numerous subfunds. German and Austrian numbers include 'special funds' for institutional investors. The Italian number of funds only applies to Assogestioni-members. The Irish number of funds captures non-Irish and Irish funds administered in Ireland (as of mid-year). The number of Swedish funds refer to those covered by the Svensk Fondstatistik.

Table 2: Market shares of foreign funds based on asset values (in bn. Euro) and on number of funds

Country	Year	net asset value			number of funds		
		foreign funds	national funds	foreign share	foreign funds	national funds	foreign share
Belgium (SICAV)	1992	17.93	5.61	76.16%	n.a.	n.a.	n.a.
	1998	44.88	53.07	45.82%	250	132	65.45%
	2002	47.52	80.05	37.25%	277	158	63.68%
Switzerland	1992	39.64	20.39	66.04%	442	229	65.87%
	1998	138.68	64.47	68.27%	1556	356	81.38%
	2002	191.92	78.81	70.89%	3166	500	86.36%
Italy (members of Assogestioni)	1992	2.56	31.33	7.56%	n.a.	n.a.	n.a.
	1998	22.83	372.27	5.78%	n.a.	n.a.	n.a.
	2002	97.94	368.02	21.02%	1179	1815	39.38%
Ireland	1998	41.66	58.04	41.79%	511	1457	25.97%
	2002	141.45	292.55	32.59%	1406	3085	31.31%
Sweden	1992	3.03	11.78	20.48%	156	279	35.86%
	1998	12.07	46.55	20.59%	480	366	56.74%
	2002	18.38	58.09	24.04%	534	558	48.90%
Spain	1998	3.63	211.88	1.68%	n.a.	n.a.	n.a.
	2002	6.54	193.64	3.27%	n.a.	n.a.	n.a.
Finland	2002	2.90 ¹	11.61 ¹	20.00%	1323	341	79.51%
France	2002	29.00	749.60	3.72%	3084	7874 ²	28.14%

Source: CBF and ABOPC-BVICB/Belgium; SFA/Switzerland; Assogestioni/Italy; DFIA/Ireland; Svensk Fondstatistik; Harju und Syryilä (2001) and BOF/Finland; COB/France (net asset value of “OPCVM à vocation générale”).

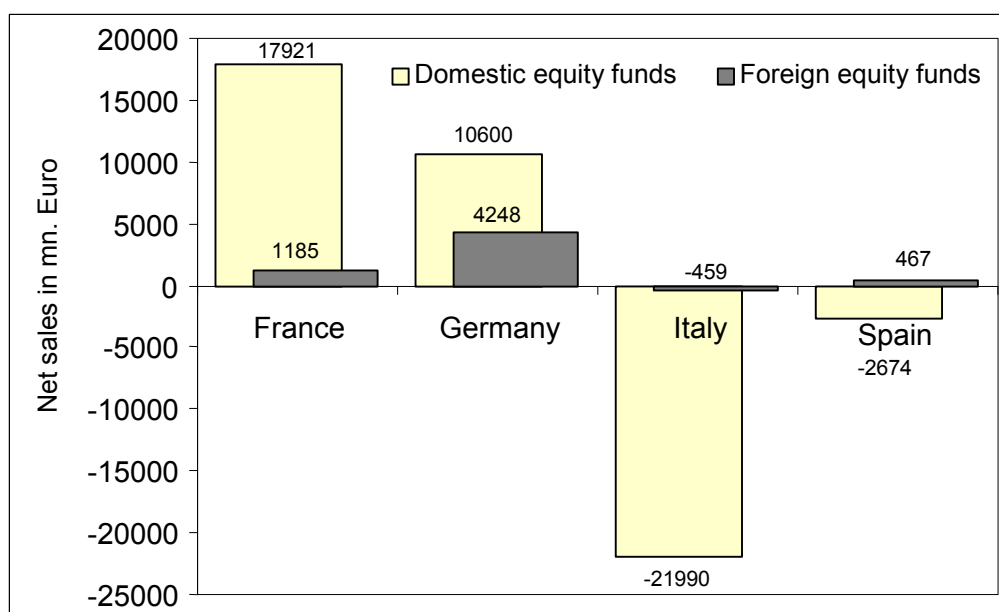
Note: ¹ refers to data from 2001. ² refers to data from third quarter of 2002.

Data obtained from FERI Fund Market Information allows us to determine the market strength of cross-border companies in equity funds during the recent bear market. Figure 9 presents net sales of equity funds in the period between January 2001 and November 2002. Net sales in four continental markets of 20 international investment groups (“member groups”) are compared with net sales of their respective domestic competitors. Sales of this member group account for about 60% of all European cross-border sales. The chosen period coincides with the beginning of the downturn of international capital markets. Market success of the cross-border companies differs significantly between the four countries. In France member sales accounted for 6.6% of total sales compared to 40.1% in Germany. In Italy domestic equity funds experienced a much sharper decline in net sales in the observed period compared to the member group, and in Spain member funds even succeeded in maintaining positive net sales in contrast to their domestic competitors suffering from outflows.

Although this kind of flow data allows only limited conclusions it indicates that cross-border companies were relatively successful in equity fund sales even in the middle of the severe bear market. It should, however, be stressed that “relative success” may simply represent a lower rate of decline than one’s competitors.

Figure 9: Foreign versus domestic net sales of equity funds in four continental markets between January 2001 and November 2002

Source: FERI Fund Market Information.

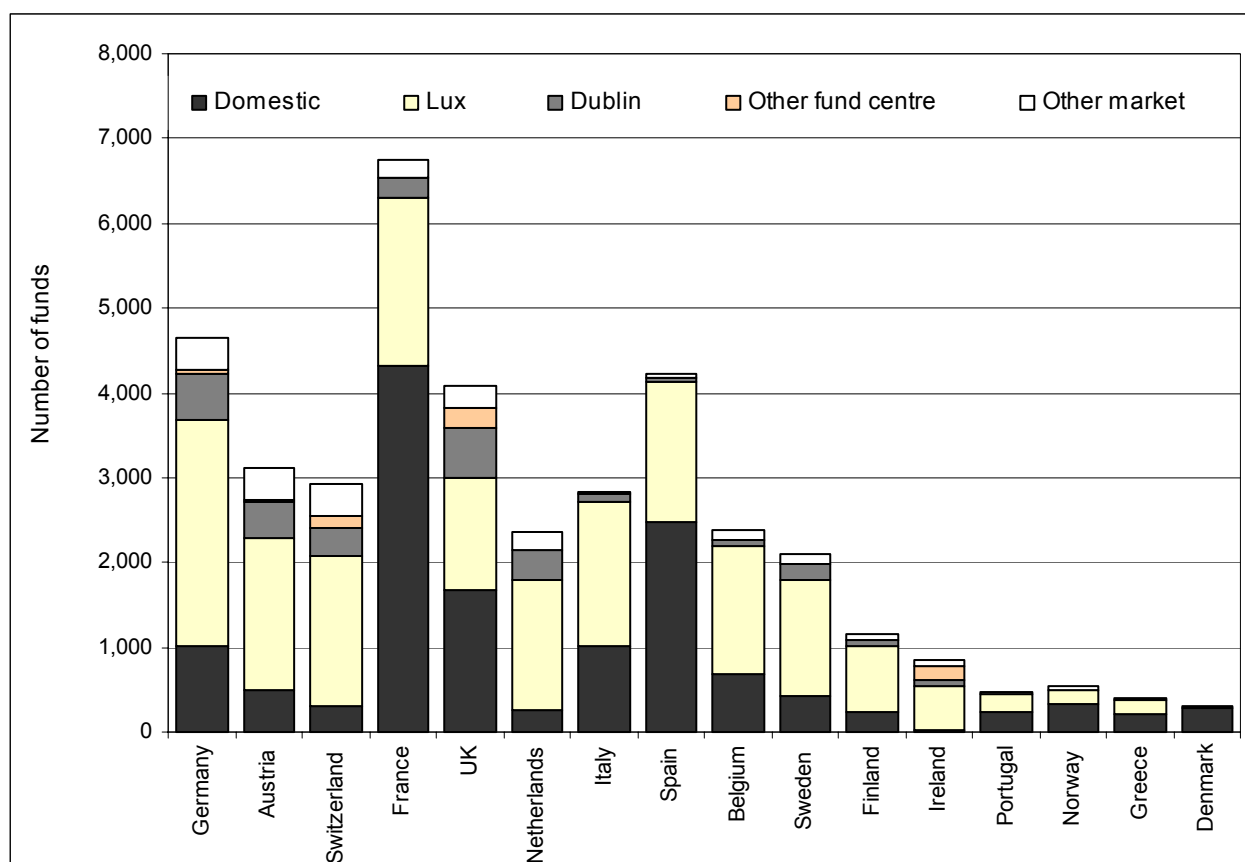


Note: 20 international investment groups are defined as “member” groups. Data on monthly net sales of equity funds of this member group in France, Germany, Italy and Spain are collected from January 2001 to November 2002

B.1.2 Round-trip fund activity

One important characteristic of cross-border fund sales in Europe is the significance of Ireland and Luxembourg as “cross-border platforms”. In general foreign fund promoters dominate Ireland and Luxembourg whereas national investment groups are of minor importance.⁸ For instance, in 1997 only 4.2% of the asset value of Irish funds belonged to funds promoted by the Irish national fund industry, and by 2002 this share has declined even further to 2.1% according to data obtained from DFIA. The situation in Luxembourg is similar: the value of assets of Luxembourg funds promoted by national investment companies is 1.4% in 2002 (not differing much from 1.7% in 1995) (CSSF, 2002).

⁸ In addition, few foreign funds are offered to the Luxembourg domestic investor. These mostly originate from Germany and Switzerland, though the number of Swiss funds (and thus the total number) fell drastically between 2001 and 2002.

Figure 10: Funds available in each European market (March 2001)

Source: Lipper.

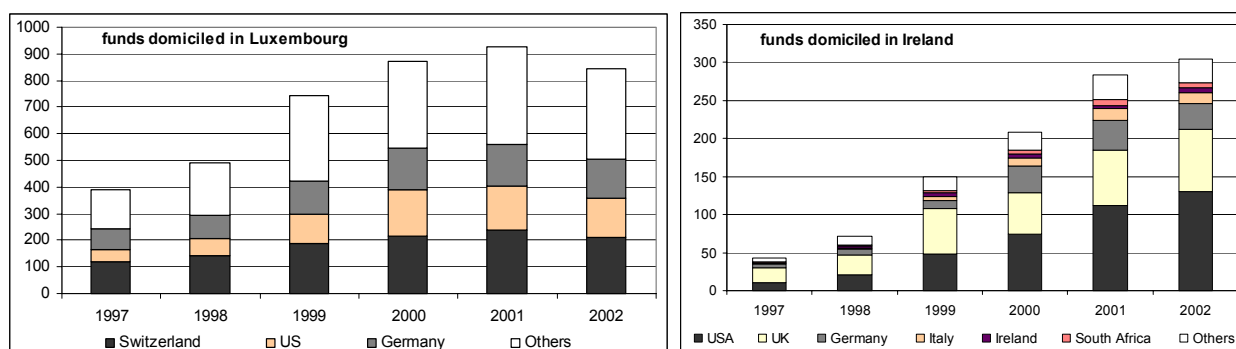
Figure 10 shows the importance of Ireland and Luxembourg for cross-border sales, since a high number of foreign funds registered for sale in other EU-countries originate from these two countries. ‘Round-trip’ business is an important part of the story: those countries with high numbers of Irish or Luxembourg registered funds are, more often than not, the country of origin of companies with substantial shares in those two fund domiciles (see Figure 11). Companies of German, UK or Italian origin who promote Irish funds account for more than 40% of the total asset value of the Irish fund industry.⁹ Of the total asset value of Luxembourg funds in 2002, almost 50% were sold by German, Italian, Belgian, British and French promoters.¹⁰ Since these funds are usually registered for sale in the country of their promoter, many Luxembourg and Irish funds are „round-trip“-type funds.

⁹ German promoters of Irish funds attracted about 11% of total asset value of Irish funds by 2002, UK promoters more than 27% as well as Italian promoters nearly 5%.

¹⁰ 17% have been sold by German promoters of Luxembourg funds, nearly 11% by Italian, 9% by Belgian, and 6% by UK as well as more than 5% by French promoters.

However, round-tripping does not completely account for the role of Luxembourg and Dublin. The promotion of funds in both jurisdictions is also a way of accession to the EU market, especially for Swiss and US investment companies (see B.2 for details).

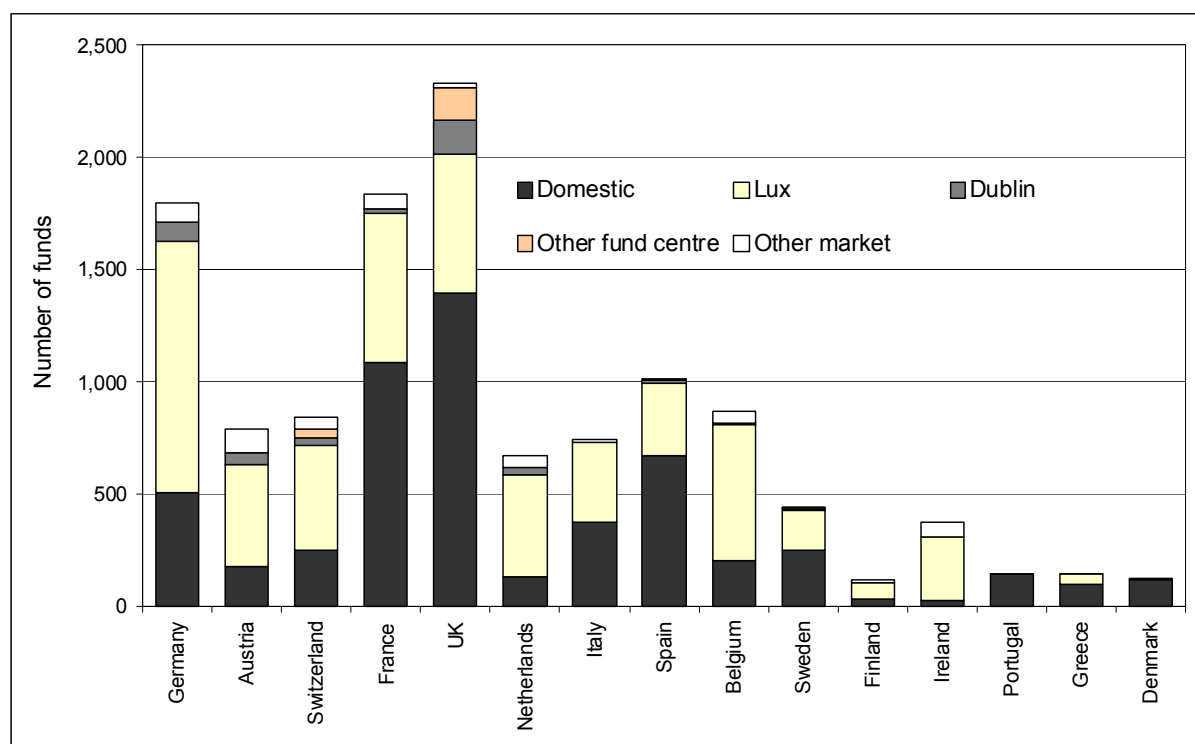
Figure 11: Geographical representation of funds by promoter origin (net asset value in bn Euro).



Source: Fitzrovia International, CSSF, DFIA

Comparing today's situation with that of 1995 provides evidence of the importance of "real" cross-border fund sales which seem to be increasing, whereas round-tripping seems to be diminishing. In 1995 (Figure 12), foreign funds available for sale in EU-countries mostly originated from Luxembourg, other than in the UK where a significant number originated from Ireland. By March 2001 (Figure 10) the situation had changed. Although Luxembourg remained important, Ireland's share had increased sharply. And, more importantly, the direct sale of foreign funds originating from countries other than these two "cross-border platforms" is much larger today. Recent data on the single market show the increasing importance of true cross-border business: among more than 4800 non-domestic funds registered in the German market in 2002, only 23% were round-trip funds in the sense that they were sold to Germany by foreign branches of German investment companies (according to data from BVI and BAK-red).

Fischer (1999) also stresses that the "proportion of round-trip funds among foreign funds sold steadily decreased from 52% to 26% over the last five years" [i.e. before 1999]. In 1999, more than 1000 funds (representing 6% of the total EU fund population) were registered for sale in more than 6 countries. Fischer states that the initially slow development of true cross-border activity was due to the long delay in fully implementing the UCITS Directive in most countries.

Figure 12: Funds available in each European market (1995)

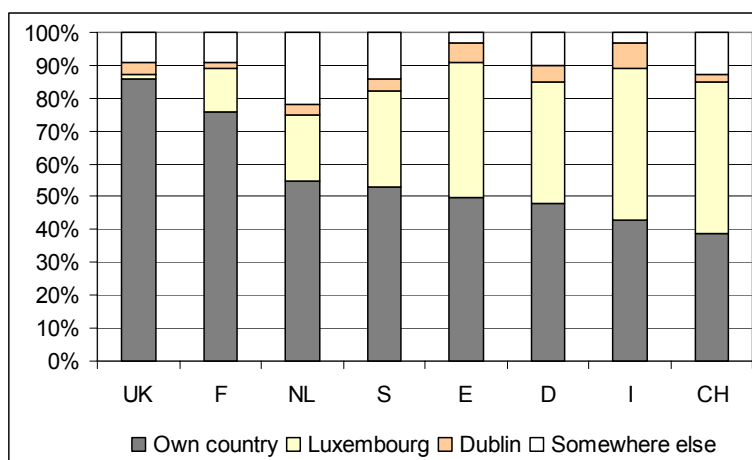
Source: Lipper.

B.1.3 Cross-border sales of third-party funds

Distribution trends are critically important to cross-border business and are thoroughly analysed in section (B.3). However, one point can be deduced from the aggregate data: that sales of third party products are driving cross-border business in the European fund market. This can easily be seen from the domicile of third-party funds (Figure 13).

The average EU share of foreign domiciled funds in all third party funds assets is about 45%. Again, Dublin and Luxembourg account from the largest share. Shares of foreign third party funds are the highest in Switzerland, Italy and Germany whereas they are particularly low in France and the UK.

The importance of third party distribution to integration is supported by the high correlation between foreign market share of the total fund market (Table 2) and foreign market share of third party products (Figure 13). Switzerland has traditionally been relatively open, as is reflected in its high cross-border fund sales in third party as well as all funds. However, France has a relatively low share of foreign third party funds and an even lower share of foreign funds in total fund assets. Spain is unusual: while the share of foreign funds in total fund assets is very low (3.3%), it is rather high in third party funds.

Figure 13: Third party funds by domicile (% of third party fund assets), July/August 2002

Source: Sector Analysis (2002: 25).

Note: Data refers to a survey of Sector Analysis in July/August 2002 (Panel Feedback Survey). 250 telephone interviews amongst universal banks, portfolio managers, insurance companies, pension plans and independent financial advisors were conducted to get insights in their buying behaviour of third party funds.

The percentage of third-party funds which are regulated by national authorities (i.e. have undergone the national registration procedure) shown in Table 3 differs considerably between EU-countries. While in countries like France or Luxembourg the share of unregulated funds is negligible there are other countries like Belgium or Netherlands where unregulated third-party funds have a substantial share.

Table 3: Percent of third party-funds regulated by national authorities (2002)

Belgium	Netherlands	Sweden	UK	Spain	Switzerland	Germany	Italy	France	Luxembourg	Europe
62%	66%	68%	87%	87%	91%	92%	95%	98%	99%	91%

Source: Sector Analysis, European Investor Focus, beginning 2002.

Note: Data refers to a survey of Sector Analysis, beginning 2002 (European Investor Focus Survey). 1000 interviews amongst universal banks, portfolio managers, insurance companies, pension plans and independent financial advisors were conducted to get insights in their buying behaviour of third party funds.

There are a number of reasons for this diversity. First, national legislation is less accommodating towards unregulated products in some countries than others. It does not come as a surprise that in a country like France, where marketing restrictions for unregulated products are extremely severe, unregulated products play hardly any role at all. Second, in countries with a relatively low number of registered foreign funds, consumers will look more intensively for unregistered alternatives. This could explain the fact that unregulated products are relatively more important in smaller countries.

Whichever explanation is of more importance, the share of unregulated products is a useful measure of integration in addition to that of registered products.

B.2 External integration

A “fortress” Europe closed to external competition would not be compatible with a single market according to this report’s definition. Therefore, it is important to determine how the European fund market is linked to the global market. External openness can to a certain extent work as a substitute for internal integration since it should have a positive impact on the competitive pressure in the market.

B.2.1 Exports

Interviewees were generally optimistic about the global sales potential of European funds. They mentioned in particular promising developments in Asia¹¹ (especially Hong Kong, Singapore and Taiwan) the Middle East and the British Commonwealth (e.g. Australia, New Zealand, South Africa). Hong Kong even accepts European regulatory standards and permits UCITS to be publicly sold. Markets which lack a well-developed regulatory framework, such as Latin America and Mexico, also constitute interesting potential markets for European UCITS. For example, interviewees report that there are fewer legal hurdles to sell UCITS in Mexico than in France.

Figure 14 presents data from FERI on the export of EU funds, based on monthly net sales between January 2002 and November 2002 of 19 internationally active investment companies which account for about 60% of cross-border business in Europe. This data shows that European fund products are successful in a number of markets outside of Europe.

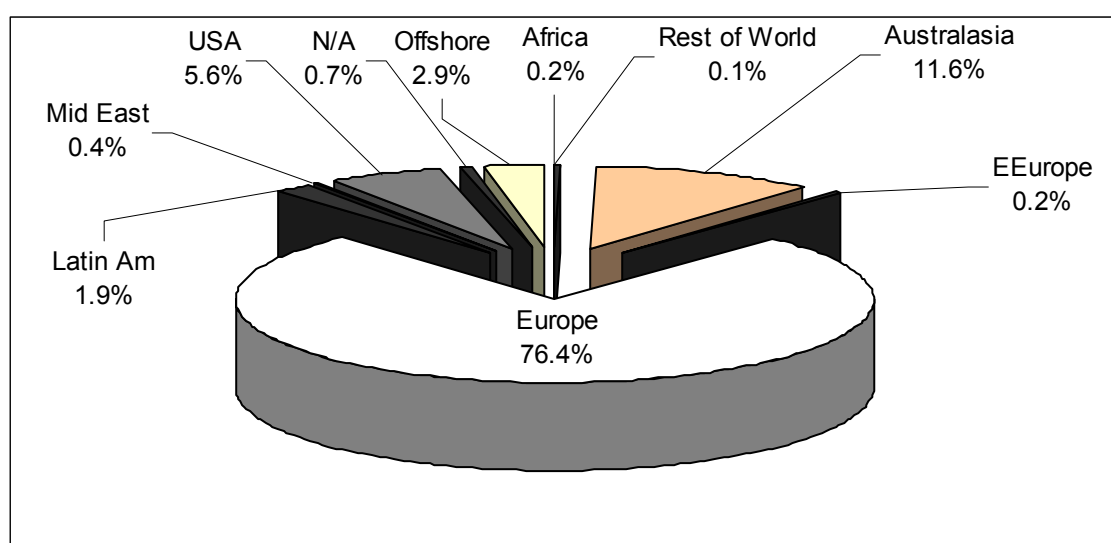
Australasia is the most significant non-European market for European UCITS with a share of 11.6% (14.8 bn. Euro) of all European UCITS sales. The reason for the small UCITS exports to the USA¹² lies primarily in the restrictive American regulatory system, which prevents foreign investment funds from entering the US market. As was stated several times in the interviews conducted, it is nearly impossible for non-SEC regulated products to enter the American market. Section 7d of the US Investment Company Act generally prevents foreign funds from being publicly sold in the United States. Although the SEC is entitled to grant permis-

¹¹ According to Data provided by FERI, in March 2001 1711 different European Funds were notified in Hong Kong, 175 in Japan and 50 in Korea, some of which are round-trips.

¹² The reported share of UCITS exports to the USA (5.6%) must even be considered to overstate real exports. It is partly based on statistical breakdowns of sales to global investors which could not be allocated definitely to one country. Therefore the number is probably biased upwards.

sions for foreign funds it is practically impossible for any European investment group to meet the SEC criteria for this permission. According to the SEC, such an authorisation has only been accorded very few times in the past. In addition, tax regulation issues are known to be so complex, that European funds would not be marketable in the US. On the other hand, European or other foreign investment companies are allowed to set up US based funds that comply with the requirements of the US securities laws. In addition, the SEC does not generally prevent private offerings of European funds, e.g. to institutional investors.

Figure 14: Export of EU-funds, Jan-Nov 2002



Source: FERI Fund Market Information, London. Note: The data is based on monthly sales between January 2002 and November 2002 from 19 companies which accounted for an estimated 60% of cross-border business. Total sales amounted to 127,7 billion Euro.

B.2.2 Imports

Non-European fund promoters are generally sceptical about the possibility of importing foreign funds into the European market. American companies in particular complain about difficulties in gaining access to the European retail investor due to the dominant position of domestic banks in distribution (Fischer, 1999).

As a matter of fact European holdings of US mutual funds are low. At the end of the first quarter 2000, EU citizens held only 79.5 bn. Euro out of a 7,081 bn. US investment fund market, which corresponds to approximately 1% of total holdings. In comparison, net assets of the European investment fund industry amounted to 4,524 bn. Euro at the End of 2000, of which EU citizens apparently held the lion's share.

The most successful way for foreign investment companies to tap the single market is through the establishment of European UCITS in an EU fund-centre such as Luxembourg and Dublin. Alternatively, co-operative partnerships are occasionally developed with established European investment groups.

As regards the first option, significant amounts are invested in European domiciled funds promoted by US asset managers (see above Figure 11). Dublin has grown significantly in importance because of US promoters, with net sales rising from 10 bn. Euro in 1997 to 129 bn. Euro in 2002, whereas in the same time period sales of funds of US promoters in Luxembourg increased from 46 bn. Euro to 149 bn. Euro, a figure still higher in absolute value than in Dublin, but declining by over 15% since 2000.

Adding up all European sales of investment funds from US promoters in Luxembourg and Dublin, the US market share in Europe¹³ turns out to be a respectable 6.5% which corresponds to the combined market share of Spain, Portugal, Greece, Denmark and Finland. Adding the sales of Swiss promoters in Luxembourg to the sales of US promoters in Luxembourg and Dublin, the result is a Non-EU market share of 11.4% - not taking into account South African investment companies (6.2 bn Euro via Dublin) and all other non-EU fund promoters. Considering additional foreign sales through co-operative partnerships with established European investment groups, it would appear that Europe is more open to foreign fund promoters than would have appeared to be the case at first sight.

B.3 Distribution trends

B.3.1 Distribution channels

The distribution of investment funds in Europe is still principally determined by three factors:

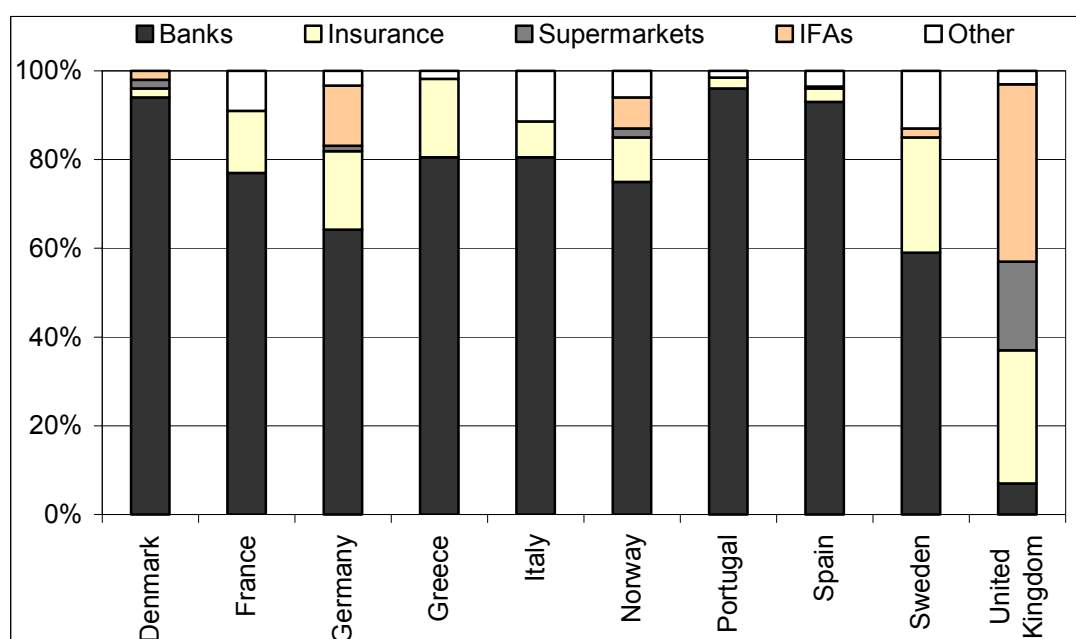
- Bias towards banks as the main distribution channel (see Figure 15). Banks clearly dominate the distribution of investment funds in all countries except the UK. The second most important channel is insurance, particularly relevant in the UK, Germany and France. Independent financial advisers only play a significant role in the UK where, among other reasons, specific regulations (“polarisation”) have favoured this channel. In all other countries except Germany and Norway their market share is negligible.
- Bias towards domestic suppliers (see Figure 16). In all European countries an overwhelmingly high share of investment funds are supplied by domestic suppliers. Shares of foreign suppliers (basis: funds under management, excluding the round trip funds of domestic

¹³ European market composed of all FEFSI members.

suppliers) are frequently below 10% excepting Spain (15,9%) and the Netherlands (13,1%). One further exception – which however is due to its function as a turntable in the European investment fund business – is Luxembourg (33,5%).

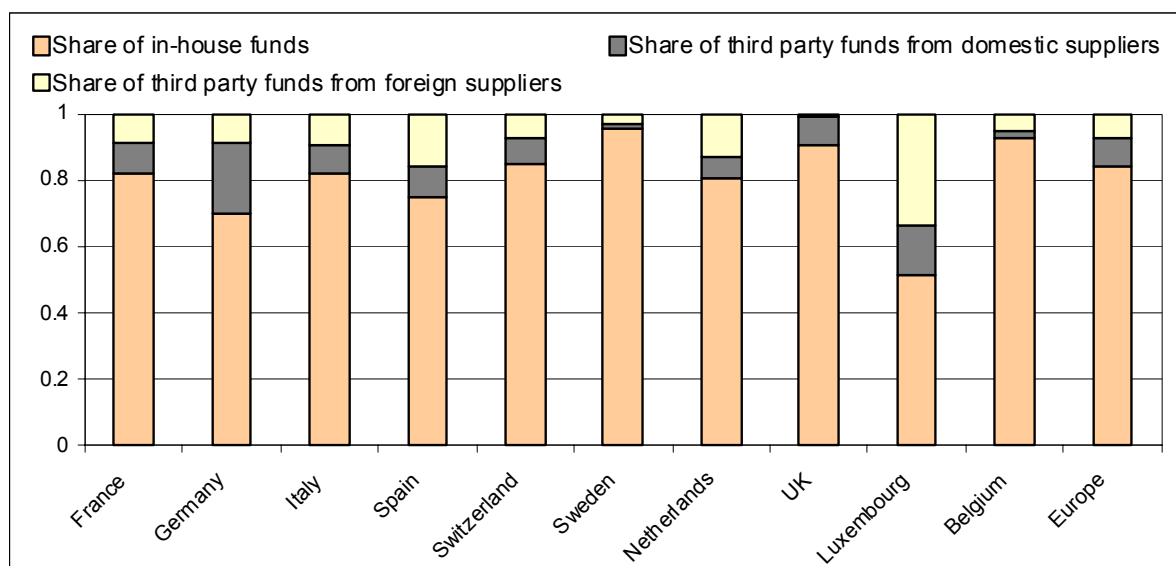
- Bias towards in-house funds (see Figure 16). More than 80% of all investment funds under management are in-house funds in 7 out of 10 countries. Third party shares are slightly higher in Germany and also in Spain. A major exception is again Luxembourg with nearly half of all funds under management provided by third party suppliers.

Figure 15: European Market for Investment Funds- Distribution Mix



Source: FERI European Fund Market Yearbook 2002; data refer to 2001.

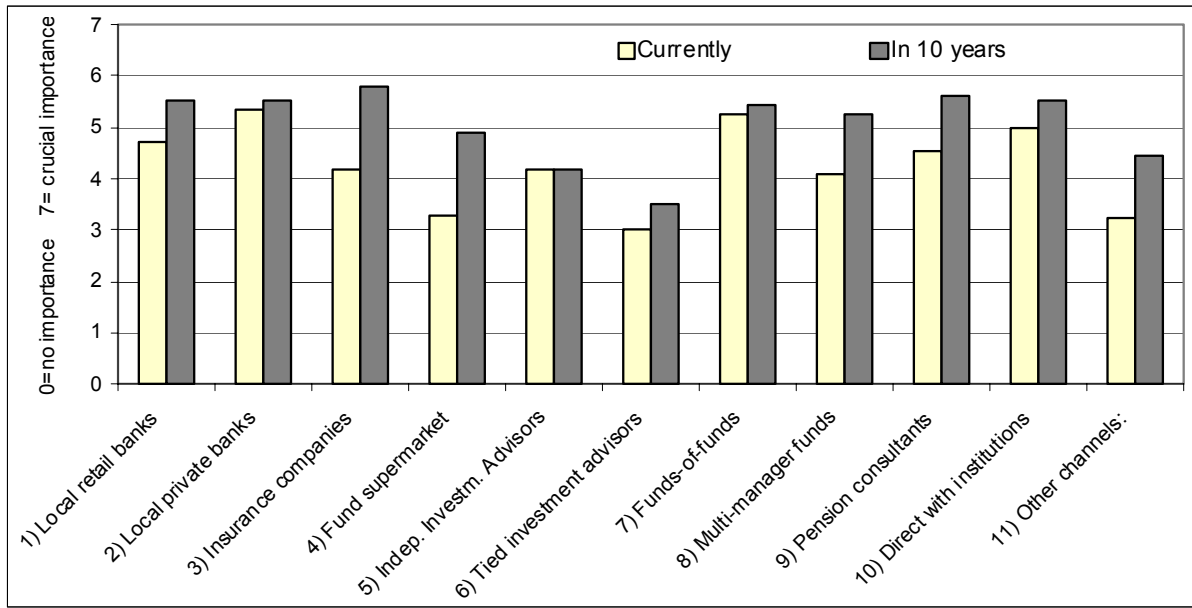
Figure 16: Shares of in-house funds, third party domestic and third party foreign suppliers (based on funds under management).



Source: Sector Analysis European Investor Focus, early 2002/ZEW calculations. In-house funds include round-trip funds with a foreign domicile. Therefore, their share not identical with share of domestic funds.

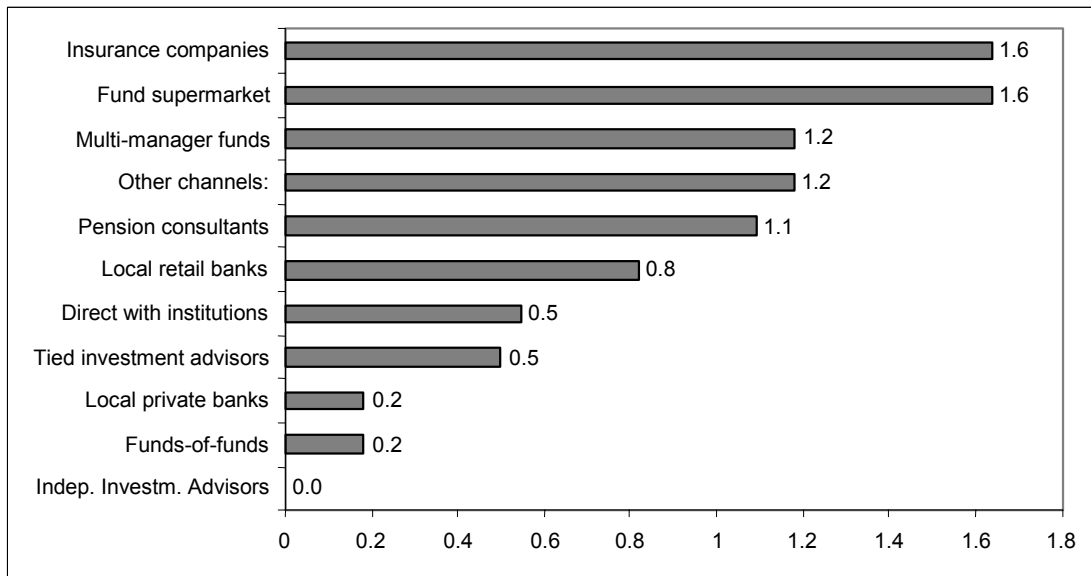
These numbers suggest that banks still essentially control the distribution of European investment funds. The dominance of universal banks – that manufacture and distribute their own investment products – in the distribution channels of the investment fund market in Europe is one likely cause of the bias towards domestic suppliers and in-house funds. As PriceWaterhouseCoopers/FEFSI (2001a, p.19) states, “[p]owerful local distribution networks, already providing a broad range of in-house products, are naturally inclined to sell products originating from their own group[...]”.

Figure 17: Importance of distribution channels between now and in 10 years



Source: IMA and ZEW Company Questionnaire 2003

Figure 18: Changes in the importance of distribution channels between now and in 10 years



Source: IMA and ZEW Company Questionnaire 2003

However, this picture is beginning to change. The investment managers interviewed for this study were asked to assess the importance of different distribution channels in Continental Europe currently and ten years in the future (see Figure 17).¹⁴

These are the key results:

- In our sample, banks are currently the most important channels (particularly local private banks), and direct business with institutions. Funds of funds are an important product-linked form of distribution.¹⁵ Least important are fund supermarkets and sales over the desks of tied investment advisors.¹⁶
- All channels will become more important in the future, with exception of independent financial advisors (IFAs), which are predicted to stagnate. This result is somehow counter-intuitive, since one might have expected some channels to increase in importance while others diminish, i.e. that rankings should reflect the *relative importance* of the distribution channels. While some respondents explicitly stated that their answers refer to relative importance, the result suggests that overall the majority of respondents answered with regard to *absolute importance*. The prediction that all channels will become more important therefore reflects the expected future expansion of the entire asset management market. The answers have to be interpreted in the following way: that the absolute volume of business coming from the IFA channel is expected to remain the same in ten years, while the volume coming from banks is expected to grow, and that coming from insurance will grow even more.
- Even though this question was not commonly interpreted by respondents, one can nevertheless derive some interesting conclusions. The most significant increases are to be expected in the insurance channel and in fund supermarkets. One competitive advantage of insurance companies is their widespread distribution network and their huge sales forces. The insurance sector is like “a sleeping giant”, already attracting enormous volumes of capital which are channelled into investment funds. Another competitive advantage is the preferential fiscal treatment of insurance products in some countries e.g., the tax relief for long-term life insurance contracts in Germany. A further example is the exclusion of insurance-based products from the EU savings tax directive (though this may be reconsidered at a later point of time). As PriceWaterhouseCoopers (2002a, p. 27) has noted, there

¹⁴ See also for Germany a comparison between 1998 and a 2005 forecast in Heinemann (2003), p. 101, based on BVI figures.

¹⁵ As this products itself is distributed via other distribution channels, this statistics necessarily involve a certain degree of double counting.

¹⁶ Here also obviously double counting takes place, as tied investment advisers work for banks, insurance companies, etc.

is a culture clash between insurance and investment funds businesses. Insurance companies insure against risk, while investment funds sell it. However, while this observation highlights the aversion of insurance customers from investment savings, it does not describe the real economic characteristics of the different products. Obviously capital accumulating insurance products – like life insurance – are not riskless and investment products do not necessarily bear more risk. A changing attitude towards risk and increasing financial literacy of consumers is therefore likely to promote unit linked insurance products. The promising prospect of the insurance channel must also be seen against the background of growing pension business where insurance companies traditionally have a significant market share. Most respondents in our survey pointed to the sale of third party funds in unit linked insurance products as fundamental to the future of insurance, particularly in the context of pension plans.

- Fund supermarkets have two future roles. On the one hand they can be used to facilitate direct sales to retail investors by offering internet enabled electronic trading platforms. Here they benefit – probably more than other distribution channels – from the broadening internet penetration among private households. On the other hand – and this is the more important component of their business – they can be used by small intermediaries as service providers. Fund supermarkets are a convenient way for independent financial advisers and small banks to distribute funds without having a costly back office.
- 'Open products' such as funds-of-funds (that are already an important distribution channel) and multi-manager funds (that are expected to grow considerably in importance) are a useful way of opening distribution to third parties without losing control over the supplier-client relationship.¹⁷
- The rising importance of pension business is reflected in the growing significance of pension consultants as distributors of asset management services.
- Surprisingly, the importance of independent financial advisers is comparatively low and is expected to stagnate. The relatively low importance of IFAs is misleading, because it conceals a wide distribution of answers. While 4 respondents gave IFAs the second highest value on a scale from 1 to 7 in ten years, a further 4 interviewees attributed only 2 or 3 to it (see Figure 19). These diverse assessments are most likely due to differences in country and customer segment targeting by interviewees and different forecasts of future regulation. As Figure 15 shows, IFAs are currently particularly important in the UK. However, their market share will most likely shrink in the future if the polarisation regulations are abandoned.¹⁸ This regulation currently limits third-party sales by non-IFAs. Therefore in

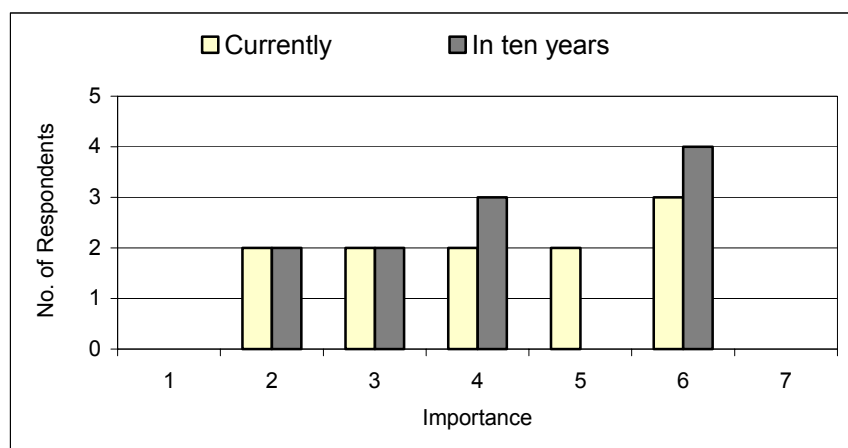
¹⁷ PriceWaterhouseCoopers (2002a), p. 14/15.

¹⁸ For a discussion of the polarisation regulation see Sandler (2002), chapter 4, and FSA consultation paper 121.

the UK the importance of IFAs is expected to diminish while in other countries – notably in Germany, where they already have substantial market share – their position is likely to become stronger. In the view of interviewees, tighter regulation and qualification of IFAs would increase their competence and support their ongoing importance as a distribution channel (see also section C.4 on the regulation of advice).

IFAs make higher service demands on fund managers than other distribution partners because they demand regular contacts with their account manager, road shows, training programmes etc. To service IFAs effectively, fund managers need to be geographically proximate.¹⁹ Moreover, fund managers can only support distribution partners who can deliver sufficient volumes. This was easy for many IFA in the bull market of the late 1990s, but less so in today’s environment. Because of the high fixed costs of distribution – i.e. costs incurred independently of the volume of assets under management – IFA intermediation is more profitable for large than for small portfolios, supporting the view that IFAs will increasingly focus on affluent customers.²⁰ Interviewees attest that those IFAs have best chances to survive that target high net worth investors who value advice.

Figure 19: Distribution of answers to question concerning current and future relevance of IFA



Source: IMA and ZEW Company Questionnaire 2003

¹⁹ PriceWaterhouseCoopers (2002a), p. 27.

²⁰ Sandler (2002), p. 46.

B.3.2 The trend towards open architecture

The figures above indicate that the banks' role as distributors of investment funds will change in the future. Interviewees predict that other distributors – e.g. insurance companies and fund supermarkets – will gain market share and become more important distributors of investment funds than banks. Also the share of proprietary products distributed by banks is likely to shift in favour of third-party investment funds as banks increasingly adopt 'open architecture' (OA). OA is characterised by a common infrastructure, open contractual space and shared investment culture.²¹ Moreover, OA in a broad sense does not only include the distribution of investment funds through non-proprietary channels, but also the outsourcing of asset management from one manufacturer to another. The relationship between OA and the distribution mix is twofold. On the one hand third-party sales via OA will result in a more diversified product mix for a given distribution structure. On the other hand, if the dominance of large distributors (like banks) is weakened, competition will increase and this will in turn promote third party sales (and OA) as an instrument to get ahead of competitors. These relationships between the distribution mix and OA, support the argument that OA will drive future cross border business. In the ZEW survey investment managers were asked if OA would result in a major breakthrough for cross border business within the next ten years. The response was positive, with an average value of 6 and a very narrow distribution of answers. No interviewee assigned a response of less than 5 to this question. These high values are plausible: third party distribution is a natural way to undertake market entry, because it is less costly for foreign suppliers to use non-proprietary channels than to build their own distributions networks abroad. Today more than 80% of export business is generated by third party sales.²² Moreover, consolidation of the supply side will assist pan-European players, who need a certain critical volume of assets for their business.

Nevertheless, although the overall trend points toward increased use of OA, there are important obstacles to overcome. Generally interviewees are sceptical about the speed of progress towards OA. They describe the process as being "more an evolution than a revolution", they observe countervailing tendencies "limiting the number of strategic partners which means OA is decreasing instead of increasing", or they state that "people are ignorant about it". These statements reflect a rather pessimistic mood towards OA. Section (C.4) provides more detail on potential obstacles to OA.

²¹ Promethee (2002), p. 37.

²² PriceWaterhouseCoopers (2002a), p. 23; see also section B.1.3.

B.4 Legislation – FSAP, UCITS III, Lamfalussy

Legislation plays a decisive role in shaping European financial markets. With regard to the European market for asset management and in particular the market for investment funds there are three major legislative measures that have been and will continue to be of major importance: the Financial Services Action Plan (FSAP) including the new UCITS directives and the Lamfalussy approach.

- The FSAP, set out in 1999, seeks to increase financial market integration in over 40 different areas. It is scheduled to be fully implemented by 2005. Among its measures are two new directives on Undertakings for Collective Investment in Transferable Securities (UCITS), together known as UCITS III, that entered into force in February 2002. Member states have to enact the directives by August 2003 and to guarantee implementation by February 2004.²³
- The new directives expand upon the 1985 UCITS I directive (85/611/EEC). One directive²⁴ (the so-called “Product Directive”) widens the categories of assets in which funds can invest (e.g. to include derivatives) and the types of investment objectives of funds (e.g. to include funds of funds, money market funds, cash funds and index tracker funds). The second directive²⁵ (the so-called “Promoter or Management Directive”) describes minimum standards of fund management companies (including the minimum level of own funds) and broadens the permissible activities of those companies. In addition, it introduces a simplified prospectus (see also section C.9).
- In addition to directives which addresses specific issues, there has also been a major innovation in the legislative process. The ‘Lamfalussy framework’ (in effect since February 2002) prescribes a process to draft, agree, implement and enforce financial services legislation. It distinguishes between: establishing ‘framework principles’ (level 1); ‘implementing measures’ (level 2); cooperation between national supervisors to improve implementation (level 3); and assessment and enforcement of member state compliance with EU legislation by the Commission (level 4).

At *level 1*, the Commission adopts a formal proposal for a directive/regulation after a full consultation process with the European Parliament and the Council of Ministers. The consultation process ensures that the Parliament and the Council retain control over the political direction and orientation of the directive/regulation.

²³ For a more detailed description of the 2002 UCITS amendments see, e.g., CEPS (2003) p.14-17 and FERI (2003).

²⁴ Directive 2001/108/EC of 21 January 2002.

²⁵ Directive 2001/107/EC of 21 January 2002.

At *level 2*, the European Securities Committee (ESC) assists the Commission by adopting the relevant implementing measures which are used to ensure that technical provisions are kept up to date with market developments. This corresponds to the 1999 Council comitology decision.²⁶

At *level 3*, the Committee of European Securities Regulators (CESR) carries out three tasks: first, it helps the Commission to draft level 2 measures; second, it promotes consistent implementation of EU directives, supervisory convergence and best practice in member states; and third, it provides an effective operational network to enhance day-to-day supervision, including exchange of information.

One of the primary goals of the Lamfalussy framework is to speed up the European legislative process so that financial regulation is able to adapt quickly to market developments and practices. Furthermore, the Lamfalussy framework aims at reducing the incremental costs facing EU-wide operating firms which currently have to deal with diverse supervisory practices and inconsistent implementation of directives between member states. This problem is a consequence of the fact that member states have a certain degree of freedom in transposing EU legislation into national law.

There are big expectations of these legislative measures. However, whether the FSAP, UCITS III and the Lamfalussy framework help to create a single European asset management market cannot be taken for granted, as the following analysis will show (section C.10).

²⁶ Comitology refers to the delegation of implementing powers by the Council to the Commission for the execution of EU legislation. Representatives of the member states, acting through comitology committees (level 2 committee) assist the Commission in the execution of the implementing powers conferred on it.

Part C The issues in detail

C.1 Overview of the obstacles

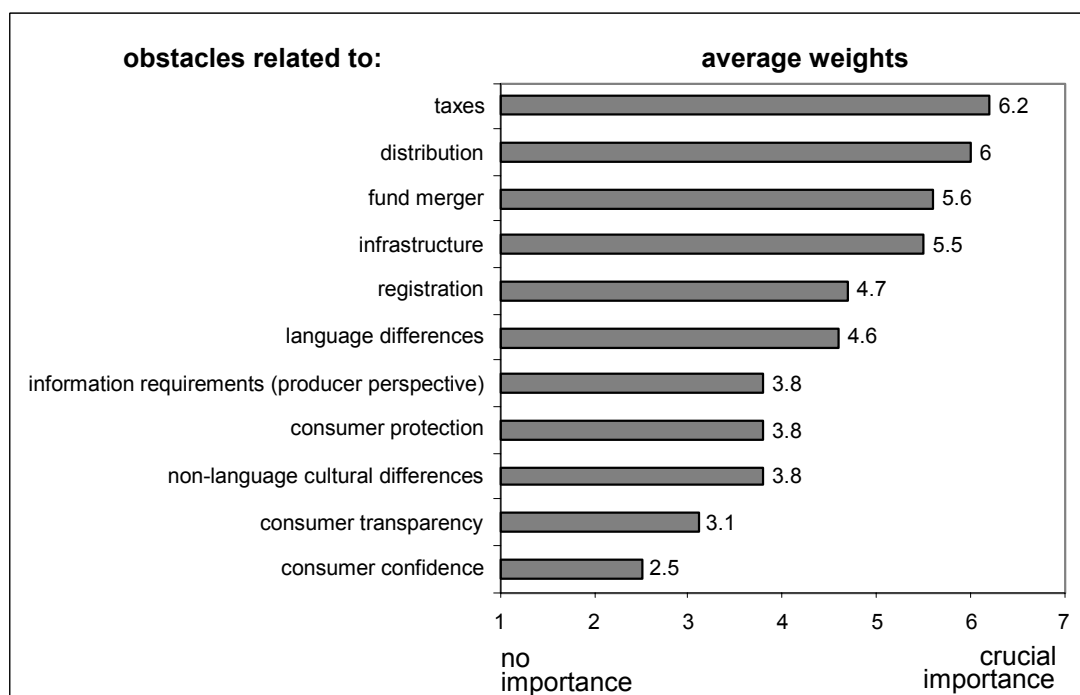
There is no simple explanation of why the market for fund products in Europe is still segmented along national borders. The definition of a single market (see section A.2) has already highlighted a variety of barriers to cross-border trade which correspond with the findings of other reports (see for, example, Heinemann/Jopp, 2002; PriceWaterhouseCoopers/FEFSI, 2001a). What is missing, however, is an analysis that ranks the barriers to a single market according to their relative importance. Such a ‘league table’ of barriers is a vital step before policy priorities can be formulated.

The interviews conducted for this study with leading cross-border companies were designed to produce such a ranking. Interviewees were asked to assign a weighting (between 1, “no importance” and 7, “major importance”) to each of the potential barriers to a single market. Figure 20 summarises the average weighting given to each obstacle. In addition to these quantitative answers, the companies gave several qualitative insights into the specific details – these helped to illustrate the practical issues behind the weightings.

Obviously one must be careful before jumping to policy conclusions based solely on the responses to these questions, even though the companies interviewed represent a material part of the cross-border business in asset management products. Some limitations of this data set are obvious. First, only producers were questioned. Due to their specific market perspective they could neglect issues that are important from a consumers point of view. Furthermore, the sample consists of only UK based companies. It may well be the case that continental companies have a slightly different perspective on some issues. Nevertheless, combining the interviews with other data as well as the existing literature provides a good basis to identify policy priorities.

Language is a good benchmark about which to ascribe relative weightings to the barriers to a single market. Most people are aware that the variety of languages in Europe is a significant problem to marketing funds on a cross-border basis, and yet language was considered *less* of a barrier to a single market than: fiscal discrimination; closed distribution; obstacles to fund mergers; inefficient infrastructure; and duplicate and costly registration.

The next section present a careful assessment of the barriers, based on the comments from interviewees, existing literature and other data sources. This lays the ground for the formulation of policy conclusions in the final chapter.

Figure 20: Weights assigned to obstacles

Source: IMA and ZEW Company Questionnaire 2003

C.2 Taxation

Taxation was ranked the most important barrier to cross-border business (mean: 6.2). Furthermore, there was almost no variation in the importance ascribed to taxation between interviewees, irrespective of their particular business model. Asked to identify the single most important policy to promote market integration, a majority suggested changes to taxation policy – although taxation was not considered to be a material barrier to cross-border institutional asset management.

The incidences and effects of taxation on cross-border sales have been described elsewhere. Recent reports (PriceWaterhouseCoopers/FEFSI 2001b, 2003) have identified in detail the most severe examples of fiscal discrimination, and industry practitioners have numerous ‘war stories’ of having to deal with discriminatory regimes – be it the Austrian “Sicherungssteuer”, the French “Plan d’Epargne en Actions” or the German “Halbeinkünfteverfahren”. The following quote describes the common view of cross-border practitioners: “you know the problem but you can’t underestimate the cost of the issue”.

Empirical evidence supports the interviewees’ assertion that fiscal discrimination is a major barrier to a single market: countries like Denmark, with particularly radical discrimination against foreign UCITS, are effectively closed to foreign funds.

However, one must be realistic about the speed and extent to which this complex and controversial issue can be resolved: even in the medium-term, far reaching tax harmonisation within the EU is unlikely (nor is it particularly desirable).²⁷ The asset management industry will have to continue to deal with varied tax systems in national markets for years to come. A more modest objective, however, would appear to be achievable: the elimination of fiscal discrimination against foreign financial products. This would pave the way for more cross-border business with standardised fund products.

This nuance means that, even if fiscal discrimination were to be entirely eliminated, taxation would remain a serious problem. For instance, different national tax systems would continue to constitute a barrier to the development pan-European wealth management services for high-net worth investors, since such services could not reconcile the demands of clients in different countries subject to different fiscal regimes for effective tax planning. Taxation is therefore unlikely ever to entirely disappear - further evidence that the single market will remain imperfect even in the most optimistic scenario.

Even eliminating fiscal discrimination is likely to prove an arduous task. Some member states not merely practice and defend discriminatory regimes, but have established such regimes in the *recent past* (PriceWaterhouseCoopers/FEFSI, 2001b and 2003), for example:

- Austria: from January 2001 a safeguard tax (“Sicherungssteuer”) has been applied to investors in foreign funds as a prepayment of income tax.
- Germany: until April 2003 the German Government planned to introduce a capital gains tax which, in combination with the so-called half-taxation system (“Halbeinkünfteverfahren”) would have added to existing German fiscal discrimination against offshore funds. Since the half-taxation system is restricted to domestic funds, foreign funds would have had to pay double the tax rate on capital gains compared to domestic funds. In the end, the German Government failed to reach agreement with the second chamber of parliament, the Bundesrat, and the proposals were dropped.

The German tax proposals provoked the first infringement proceedings initiated by the European Commission against discriminatory tax treatment of funds (European Commission, 2002c). This could signal a move of the Commission towards a more aggressive judicial approach.²⁸ Furthermore, the ECJ’s ruling in the Danner case in October 2002 signals the

²⁷ The agreement on the Taxations of Savings Directive is illustrative for the kind of limited progress that is achievable in regard to harmonisation: A more cooperative approach in regard to the enforcement of national taxing power (here: income from capital) without limiting national tax sovereignty.

²⁸ The failure of the new capital gains tax in Germany should not be relevant for the infringement case against Germany since this is related to the half-taxation system and its discriminatory impact on dividend income in a non-domestic fund.

Court's opposition to tax discrimination. In that case, the Court rejected the Finnish authorities argument that restricting the tax deductibility of payments to pensions schemes located in Germany was necessary in order to maintain the coherence of the national tax system.²⁹

C.3 Problems in merging funds cross-border

Existing research (section A.3) leaves no doubt that the persistence of local asset management markets and relatively low levels of cross-border sales results in funds that are, on average, below optimum size. Consumers foot the bill for sub-optimal funds in the form of higher cost ratios.

In coming years, increased pressure on costs is likely to lead to mergers between asset managers. This trend will enable funds with identical investment strategies to be eliminated, and fund ranges to be restructured in favour of fewer but larger funds. In this context, the problems associated with the intra- and inter-jurisdictional fund mergers are becoming pressing.

Interviewees clearly support this view, by assigning a significant weighting to the need to simplify cross-border mergers (mean weight 5.6).

A number of problems arise when attempting to merge funds. First, a fund merger is often an expensive and time-consuming project – aside from any further tax or regulatory issues. According to industry experience the problems often start with internal resistance within investment companies: whereas central management prefers to concentrate funds, fund managers tend to resist closures. However, a more relevant restriction is external and concerns customer sentiments. If investors get the impression that the merger will not result in an adequate alternative for the original investment they may decide to pull their money out. The way of reporting the pre-merger performance of merged funds in different member states constitutes another barrier to a truly single market. Finally, a merger is necessarily costly in terms of the associated technical processes related to transfers and custodian services.

Generally, the companies questioned indicated that the problems related to company decision-making, customer reaction and administrative effort are not critical. In particular, industry experience with past mergers generally shows that customer reactions do not constitute a major problem: if a merger is well prepared and communicated to investors properly, companies report only very limited withdrawals.

A more severe problem are the various regulatory and tax hurdles: while in some countries, such as the UK, the merger of domestic funds is generally regarded to run reasonably smoothly other national regulatory regimes are poorly developed with respect to merger pro-

²⁹ Rolf Dieter Danner v Finnish State C-136/00, see also: PriceWaterhouseCoopers/FEFSI (2003).

cedures. One example is the German regulation that requires a formal closing of the original fund prior to a merger (FERI Fund Market Information, 2003).

Cross-jurisdictional mergers are always much more complex projects than those that occur within one jurisdiction. But here again, there are differences between the member states. Luxembourg appears to have a particularly illiberal regulatory regime for cross-border mergers when the original fund is to be moved out of the country. The requirement of 100% consent from fund holders in this example is, in reality, unachievable.

In terms of taxation policy, the crucial issue is whether a merger constitutes a taxable event with regard to capital gains or other taxation (for example stamp duty in the UK). It is obvious that in a rational tax system a merger of two funds with highly similar asset structure should not qualify as a realisation of capital gains. Nevertheless, a number of countries have a different practice. Sweden, Denmark, Greece, Italy and Finland apply rules discriminating against cross-border mergers: whereas mergers between domestic UCITS are tax free, a tax charge at the investor level occurs for mergers between a domestic and foreign fund (Price-WaterhouseCoopers/FEFSI, 2003).

C.4 Distribution issues

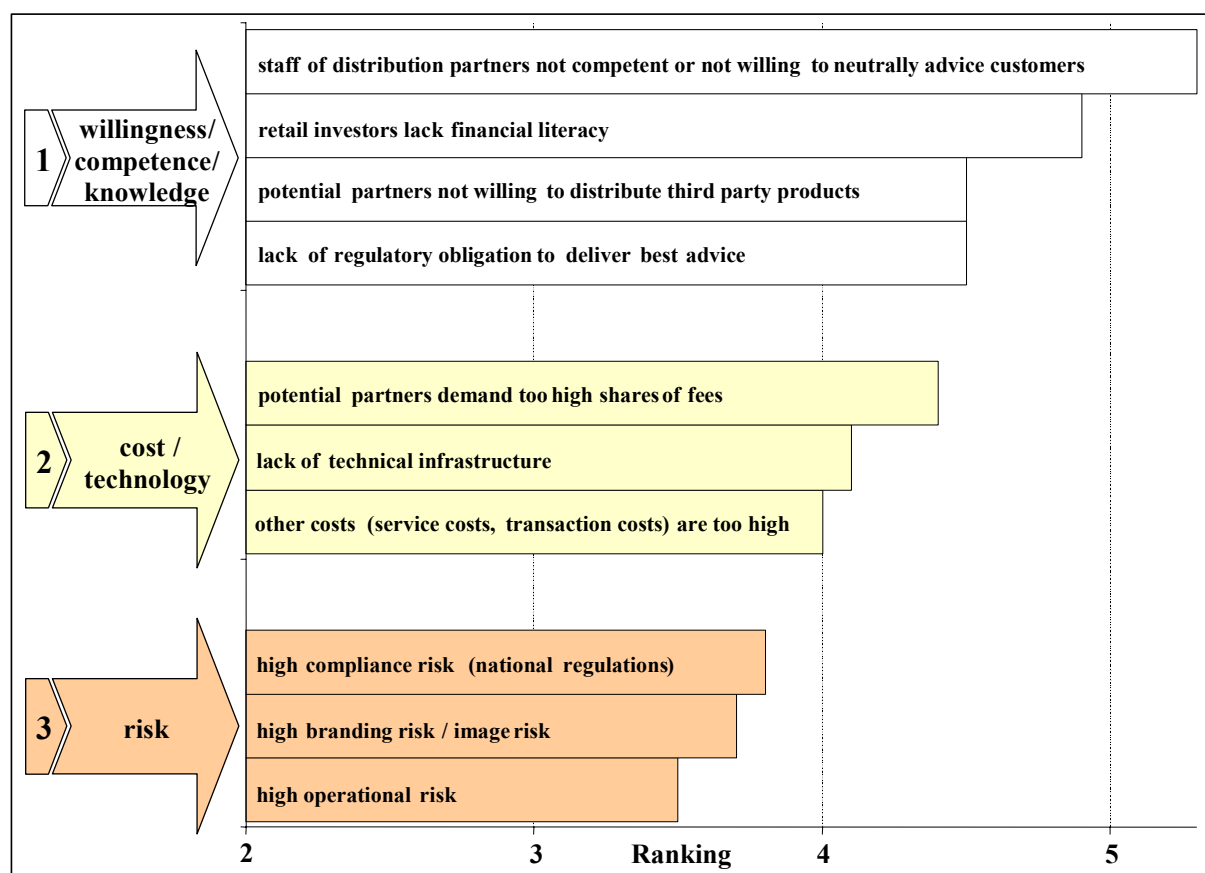
As stated in B.3, third party distribution is the main entry vehicle for fund suppliers to foreign markets. However, at the moment third party distributions in general, and foreign third party sales in particular, only have a small share of total sales. And movement towards open architecture (OA) – at least as seen from the perspective of foreign third party fund suppliers - is slow.

What are the reasons for this slow progress? It is possible to distinguish three blocks of possible obstacles: they are:

- knowledge, willingness and commitment,
- costs and technology and
- risk.

The survey responses show a very clear hierarchy among these groups of obstacles (see Figure 21).

Figure 21: Ranking of obstacles to open architecture



Source: IMA and ZEW Company Questionnaire 2003

Knowledge, willingness and commitment

The complex issues surrounding “knowledge, willingness and commitment” are seen to be the most important obstacles. The biggest barrier to OA in the opinion of the survey respondents is a lack of willingness and insufficient competence on the side of the sales staff of third party distribution partners. The lack of motivation of sales people to sell foreign products is partly induced by the way incentive systems work. As interview partners stated, the sales staff are frequently rewarded for selling in-house products but are not rewarded for sales of foreign products.

However, this is most likely not only a problem of a lack of financial incentives but might also reflect a mental or cultural barrier. Sales people trained for years to sell domestic products could not make a complete transition to selling foreign products (even if financial incentives for selling domestic and foreign products were equal). Another aspect of this problem is the frequent internal conflict between sales staff and their product development colleagues. This slows down the decision making process in most financial services companies. And it is not only a problem of staff competence or commitment: generally the propensity of suppliers with high market shares to sell third party products is regarded as low. There is a fear of strengthening competitors by selling their products through their own retail branches (al-

though it should be noted that they sometimes package them in funds-of-funds or sell them via the internet).

These supply side obstacles are reinforced by a lack of financial literacy on the side of retail investors. Therefore, the lack of willingness from sales staff is not actively compensated by pressures from informed consumers eager to buy best-of-breed products and thereby actively demanding distribution from third party products. With respect to this issue, the investment managers surveyed point to remarkable differences between member states: strong consumer demand for third party products does exist in the UK and in Germany, less so in France and in the Netherlands, and almost none at all in Spain. Regulation of advice does not pose a counterweight either: in some European countries, for example Germany, no regulatory requirements to offer best advice exist. Standardised qualification requirements for advisers – like the US Chartered Financial Analyst – are not obligatory (see also chapter on consumer protection (section C.8)).

So is there any light at the end of this tunnel? There does seem to be some hope stemming from the following, gradual, changes:

- The suppliers' attitude towards third party sales is changing. Distributors recognise more and more that selling third party products can be profitable – even more so than selling their own products (see also p. 55).
- Problems associated with a knowledge gap in sales partners are likely to be alleviated by a progressive simplification and standardisation of products. Frequently this is supported by a concentration on a shorter list of fund management partners and active head office guidance to the sales people.
- The increasing role of the financial press has an important part in improving consumers' financial literacy. There is an unstoppable move towards more publication of transparent information and a rise of a personal finance media that will help educate the consumer and that will encourage greater freedom of choice. This goes along with the growing acceptance of the fact that individual financial retirement planning is indispensable. The demographic crisis in state pension systems forces people to reconsider and intensify their saving efforts. In many countries – like France, the UK and Germany – government education programmes and/or advertisement campaigns support this process.
- Tighter regulation of advice is also being discussed. The new directive (2002/92/EC) on insurance mediation is a step towards improved quality of intermediation and advice in financial services. Moreover, investment advice has been included in the scope of the proposal for the new EU investment services directive (ISD). This will imply that “investment advisors become subject to initial authorisation and ongoing obligations established by the ISD. Proportionate and appropriate supervisory disciplines are warranted to deal

with the risk to investors of unsuitable advice or unprofessional/unethical conduct by advisors. Inclusion in ISD would, in particular, offer basic ‘conduct of business’ protections to investors when dealing with advisors authorised or located in another member state (via remote communication technologies).³⁰ Furthermore, persons or companies providing investment advice as their main or exclusive activity will be required to be licensed as an investment firm within the meaning of the ISD.

Costs and technology

The second major obstacle to open architecture is related to the costs for technological support. Both costs and technological progress in the area of operating third party sales, and particularly cross border sales, are interdependent. If the level of communication is slower and technological systems are not modern, they will add to the costs of third party and cross border transactions. The reverse is also true: more modern technological systems and standardisation will induce greater costs, as they require a substantial investment by asset management firms. To justify these initial costs a critical volume of assets must be exceeded that promises adequate returns on investment.

However, for manufacturers eager to distribute their products via non-proprietary channels, high distribution costs do not only arise from technological imperfections: manufactures have “to buy space on the shelves of distributors” – by paying them a high proportion of the initial charge and the management fee. As PriceWaterhouseCoopers (2002a) found out, rebates offered to external distributors are in some cases extremely high: “The high end rebates fluctuate in the 70-80% of management fee range”.³¹ This assessment is confirmed by this survey. As one respondent stated the real driving force behind OA may be profits: distributing banks can sometimes earn more by selling third party funds than by selling in-house funds. Banks can demand particularly high fees from foreign fund providers (a not uncommon formula is the whole initial charge plus 75% of management fees). Although this may not be profitable for the producers, it is accepted, as producers wish to be present in the national market and to show volumes.

Moreover, distribution costs have fixed components (for marketing, registration, accounting, tax reporting, local correspondents or representatives, tax representatives), which do not vary

³⁰ See Proposal for a Directive of the European Parliament and of the Council on Investment Services and regulated markets, and amending Council Directive 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC.

Available at: http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0625en01.pdf

³¹ PriceWaterhouseCoopers (2002a), p. 32.

with the volume of assets gathered. As a consequence, small national markets are less attractive to exporters. The volume attracted must be large enough to exceed the breakeven point.³²

Technical factors (see section C.5) contribute significantly to high costs of third party distribution. Intermediaries, surveyed by Sector Analysis, expressed dissatisfaction with the third party ordering process, varying from between 43% (Netherlands) and 7% of respondents (Sweden) across Europe. The average value for Europe is 20% of respondents. The most common problems that have been mentioned are lack of information (20%), low speed of ordering (12%), communication problems (12%), settlement problems (9%), and back office problems (5%).³³

The results of the ZEW survey are broadly similar. With an average value of 4.1, the lack of technological infrastructure due to the failure to standardise interfaces and the consequent delay in processing is seen as a relevant (although not the most important) obstacle to OA. In our interviews, it was stated that technological problems will become more relevant in the future when volumes increase and margins fall further. Operational platforms must be able to process large volumes at low cost, and service models must reflect the demands of the large retail financial institutions. The current fragmentation of technology platforms and information interfaces mitigate against the ability of fund management companies to realise the full value of these efficiencies and pass them on to their clients.

Risk factors: Compliance risk, reputational risk and operational risk

Risk factors are generally rated rather low as an obstacle to OA. All averages rank below the medium value 4. The risk category with the highest value attributed to it is compliance risk - meaning the risk of not complying with national regulations. This reflects the complexity and heterogeneity of national regulations. Moreover, regulation is in a constant state of flux and has to be continuously monitored – there is a risk of losing track and inadvertently violating regulations.

Other risk factors are ranked slightly lower: reputation risks arise from distribution partners that do not offer adequate advice to customers, that do not share the same investment culture and/or do not have a sound financial background.³⁴ This risk category is valued 3.7 on the average. This rather low value can be explained in the following way: although there exists a risk that the brand of the supplier is diluted and its reputation is misused there are control mechanisms (for example thorough due diligence examination of potential distributors by manufacturers). And, to a certain extent, customers are able to distinguish between the quality

³² PriceWaterhouseCoopers/FEFSI (2001a), p. 17.

³³ Sector Analysis (2002), p. 36 f.: The question was: “Do you find the process of ordering a third party fund so difficult that it discourages you from using third party fund suppliers?”

³⁴ See PriceWaterhouseCoopers (2002a), p. 35 f. and Promethee (2002), p. 37.

of a product and the quality of a distributor. Also, market competition and regulation will eventually drive out unsound distributors.

Operational risk is rated still lower - meaning the risk of failed transactions, technical errors, or communication failures. Although in many cases communication is still “a matter of fax” (Promethee, 2002) as transaction platforms and messaging formats are not standardised, errors arising from this complexity do not seem to be too severe.

Open architecture and the bear market

Obviously, there is a further temporary factor delaying the trend towards OA: the market downturn since 2000. Some of the survey respondents stress the impact of booms and busts in the capital markets on the development of OA. In the market upturn at the end of the 1990s incumbent suppliers opened up their distribution channels to retain customers – who were increasingly demanding high quality third party products at reasonable costs. The slump of the market caused a reversal of this behaviour: following the crash customers have frequently been disappointed with foreign third party products – that were often equity products incurring the highest losses of all asset classes in their portfolio. Distributors took a step back as well, because profits came under severe under pressure. They reduced the number of relationships with foreign suppliers to concentrate business on proprietary funds – not recognising the fact that selling foreign funds may be more profitable in some cases. However, these reactions to the equity market crash may only be short term. In the long run, customers might learn from the bear market experience and might increasingly focus on high quality investments – irrespective of a certain type of supplier or distribution channel. This is likely to foster third party sales and cross border sales and thereby drive OA. In sum: the current market downturn might temporarily dampen the movement towards OA. In the long term, however, if it does not actually reinforce moves to OA, it will certainly not stop it.

C.5 Infrastructure

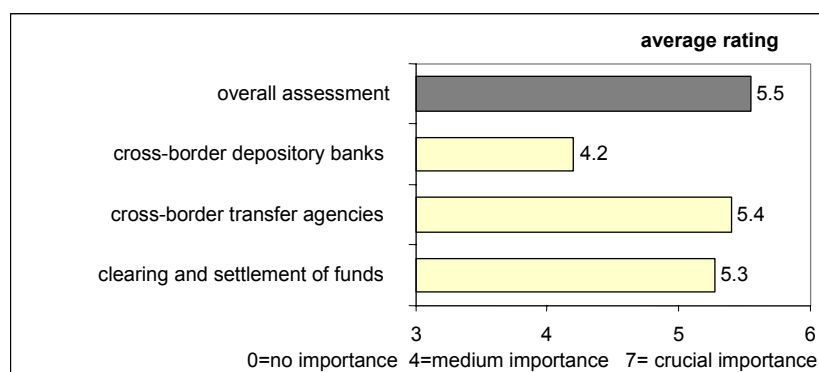
C.5.1 The vision: straight through processing

A cost-efficient and flexible infrastructure is an essential precondition for successful trade, particularly cross-border trade in investment funds. Currently, there is a relatively large gap between an economically ideal market structure for infrastructure services and the actual situation. The magic term for an ideal situation is “straight through processing” (STP)

STP means that the whole chain, from the initial order through to settlement, custody and reporting should be as automated possible. Thus, STP ideally connects fund distributors, transfer agents, fund processing hubs and fund managers via an electronic communication system that is based on a common communication standard. Today, as Kentouris (2002) writes, “STP is more like straight-to-the-printer” and often the fax is one of the major communication systems (see e.g. Promethee, 2002, p. 37).

In line with this view the respondents to the ZEW questionnaire are fully aware of the need for significant improvements in infrastructure. As Figure 22 shows overcoming deficiencies in infrastructure is considered to be of high importance for the growth of cross-border trade in investment funds.

Figure 22: Relevance of infrastructure deficiencies for cross-border fund business



Source: IMA and ZEW Company Questionnaire 2003

As there is a significant gap between an optimal procedure and the current situation, the major questions that have to be answered in the course of this section are: first, why is there a gap between an “ideal” and the current situation? And second, how and by whom could this gap be closed?

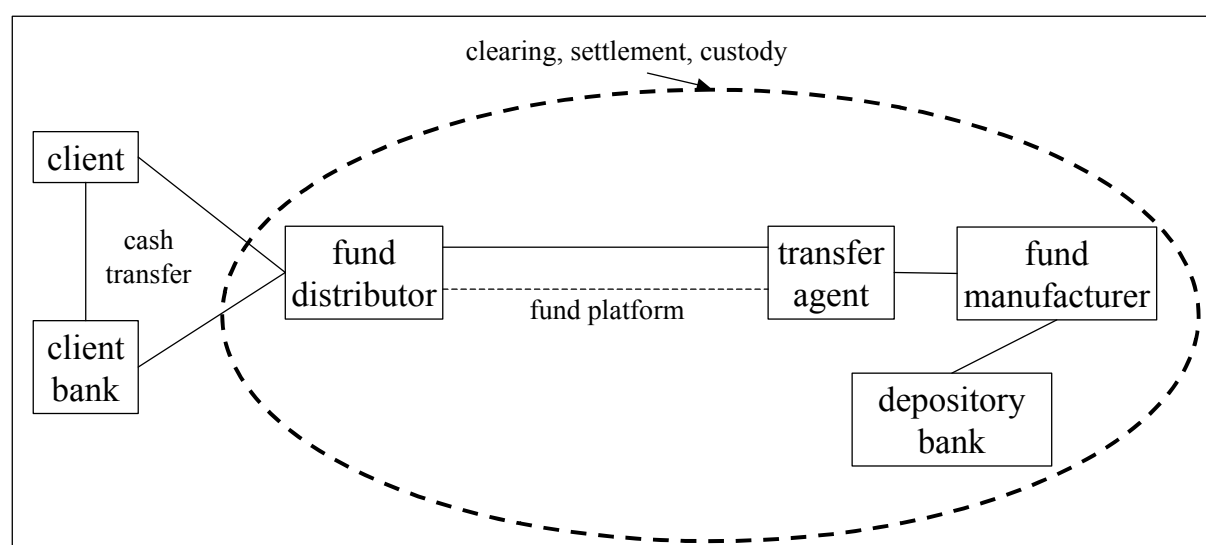
The first question is related to the market structures in European asset management and particularly the market in back-office services (such as transfer agencies and suppliers of fund platforms). Here, the economic theory of networks can provide important insights.

The answer to the second question should show whether “the market” is able to narrow this gap or whether political action is needed to solve the problem. We deal with these two questions consecutively.

C.5.2 Current fragmentation

The respondents to our questionnaire consider problems with the infrastructure as serious obstacles for future growth in cross-border trade of investment funds in Europe and thus, also as obstacles to a single European market for financial services. Some even characterise cross-border trade in investment funds as a “nightmare”. The most important issues are problems with clearing and settlement of funds and with the services of transfer agencies. In contrast, problems with the services of individual fund platforms seem to be only of medium importance. Figure 23 shows the main elements of the transaction chain from the order of the client to the manufacturer.

Figure 23: Transaction chain



ZEW

What are the reasons for the problems with the current situation concerning infrastructure services for investment funds? First, the suppliers of order routing services (like Cedelbank, Clearstream (Vestima), CREST, Euroclear (FundSettle), to name just the largest companies) offer different processing systems that are not compatible with each other. There are no standard sets of data (“protocols”) that have to be transmitted during the whole process (although the new SWIFT protocols could become the common standards for the fund industry). Thus, a basic requirement for automation is currently not being met. The situation seems to be particularly unsatisfactory in the retail business.

In terms of the settlement of funds, there are a number of very basic standards that are still missing. For example the valuation of investment funds and the settlement times are not standardised across European countries.

The discontent of the respondents with the structures in the market for transfer agents probably stems from the problems with clearing and settlement. In the following we use a narrow

definition of the transfer agent business: transfer agents are defined as providers of back office and account management support services related to the processing of fund orders (such as handling of subscriptions, redemptions, and maintenance of share registers) for all types of funds. Transfer agents usually also handle payments and products associated with funds (for example payment of dividends or withdrawal plans for pension fund plans).

In this definition transfer agents are also users of the clearing and settlement infrastructure and face similar problems as fund distributors. There are also transfer agents like FETA (First European Transfer Agency) that build their own STP-infrastructure systems. But, to clarify the analysis, this part of their business should be separated from their core business.

As there are several different infrastructure systems used in the market, transfer agents currently have to use all of them in parallel. Thus, the administrative costs of transfer agents are probably higher compared to a situation of a standardised infrastructure. This might be an important cause for complaints about the transfer agent market in Europe.

In contrast to the current market structure for infrastructure services, most respondents to our questionnaire have the vision of an ideal market structure that is characterised by a full centralisation of the infrastructure. A centralisation could significantly reduce the marginal costs for the administration of the whole fund order process.

But is a full centralisation an optimal solution from the viewpoint of economic theory? And if so, is it a feasible solution?

We know from the economics of networks, that networks usually exhibit network externalities. This means that the value of the network for the users increases with the number of users. In the case of infrastructure for the cross-border trade of investment funds this is clearly an argument for an open architecture as the highest value of the network “infrastructure” is reached when all parties involved in the fund trading process are also users of the same infrastructure system. This argument is particularly applicable to electronic platforms but also to clearing and settlement systems.

In addition, the infrastructure services might be considered to be a “natural monopoly”. This market form is characterised by increasing returns to scale and, therefore, decreasing average costs per trade. This means that the processing of an additional order reduces the average costs of all orders processed by the system. Usually this market form is caused by huge initial investments for the build-up of the infrastructure system. As a consequence the average costs are mainly driven by the reduction of the average fixed costs of an additional fund order. Whether a natural monopoly is really the correct characterisation of the optimal market is an empirical question that can only be answered by the estimation of a production or cost function. Although this is clearly outside the scope of our study the cost structure of infrastructure services (high fixed costs, low marginal costs) indicate that probably only a few suppliers are

sufficient for the market. The “natural monopoly” argument is particularly relevant for clearing and settlement, fund administration and custody, and (to some extent) the transfer agent business. The market structure will tend to move towards a “natural monopoly” when the services of the market are limited to standardised and automated activities. The more additional services are offered, the more the market structure could deviate from a monopoly.

These are similar arguments as those that are used for the optimal market structure for clearing and settlement of securities in Europe (see Lannoo and Levin (2001)). From an economic point of view the clearing and settlement of investment funds can be considered as a special part of the clearing and settlement for securities. An important result of the Giovannini report (Giovannini (2001)) is that the fragmentation of clearing and settlement in Europe adds significant costs to the European investors. The European Commission has recently started a process for the reorganisation of the clearing and settlement market in Europe. The first part of this process was a survey sent out by the Commission to market participants to get more information about specific problems with the existing situation. The respondents to the EU survey identified the lack of common IT protocols and interfaces as the most important barrier to cross-border trade in securities (see European Commission (2002a)).

Market participants and researchers either demand a centralisation of clearing and settlement in Europe (“natural monopoly”) or they are in favour of common IT protocols and an interconnection of the different systems (“open architecture”), see for example Giovannini (2001), Lannoo and Levin (2001, section 4.4), Promethee (2002, section 3), Werner (2003).

C.5.3 Four options - and one solution

First, as stated above, the reorganisation of the market structures for clearing and settlement of securities and investment funds are closely linked. The reason for this linkage is that from an economic point of view the market characteristics are quite similar and secondly, that the major market participants are the same for both market segments. Nevertheless, it is worthwhile to discuss the possible solutions for the investment funds separately. In principle there are four available options. These options refer particularly to clearing and settlement, electronic platforms for investment funds and – in general – to the evolution of common IT protocols in the market.

Option 1: Leave it to the market

As the infrastructure for clearing and settlement of investment funds exhibits network externalities and – at least – to some degree also increasing returns of scale, the market could end up in a monopoly. The rationale behind this prognosis is straightforward: market participants

will find it more profitable to join that infrastructure system which already has the largest number of participants and, therefore, should also have the lowest average costs. As the different infrastructure systems offer a large set of additional services this argument does not hold in its pure form but should, nevertheless, be a relatively good approximation of the market dynamics.

This market solution has some clear benefits. The market itself has a tendency to end up in a monopoly (i.e. a fully centralised infrastructure). This also solves the problem of different IT protocols and interfaces: in the market equilibrium only one supplier will survive and the standards set by this supplier are then the common standards for the whole industry. In fact, the standards could converge relatively quickly as suppliers of additional services will soon adopt the standards and interfaces of the “winning” infrastructure. Good real-life examples are the markets for personal computers and computer operating systems. The IBM-type personal computers and the Microsoft operating system have evolved as the market standards and all additional hardware and software components had to adopt the standards of these “winning” systems.

But there are also costs of a pure market solution. A natural monopoly is a very unsatisfactory market form as the prices are too high – as is the usual case in monopolies - and there is almost no scope for potential competition (as new market entrants are in a very disadvantageous position due to the network externalities and high entry costs which work in favour of the monopolist). As a consequence the monopoly provider has to be regulated. Thus, although during the adjustment process the EU legislator does not have to interfere, a regulatory body has to be established at the end of the process. An additional cost factor is that the adjustment period could be relatively long with the consequence that the market participants have to use different infrastructure systems in parallel for a significant time. But the adjustment period could be shortened by a merger of two or more of the major market players, such as Euroclear and Clearstream.

Option 2: Common standards and interconnection

The setting of common protocols for the infrastructure combined with an interconnection of the different infrastructure systems would be a significant step towards an optimal solution. In contrast to the pure market solution the adjustment period would be relatively short. Thus, the market participants could gain the benefits of a large network in the short-term. A precondition, however, is that a standard-setter is needed to make this solution work. The standard-setter could either be “the market”, an industry association, or the European Commission (or a combination of all three “forces”).

Promethee (2002) proposes that the European Commission should initiate the standardisation process by stimulating an industry-wide dialogue. They refer to the market for mobile telephones as a close analogy to the market for investment funds. They propose the foundation of a “Groupe Special Fonds” (GSF) which should consist of all market participants, namely banks, insurance companies, transfer agents, fund managers, fund advisors etc. together with the relevant EU institutions. At the end the process should result in common European communication standards for the investment fund market. The proposal of Promethee has the advantage that the market participants that were part of the GSF GROUP would largely drive the process. The EU would only initiate this process.

The weakness of the proposal is that it is not clear why the market participants should be willing to participate in the industry-wide dialogue when they are not currently willing to cooperate. According to the analysis of Promethee the market is in a situation called “prisoner’s dilemma”: each of the players chooses an individual but sub-optimal solution although a co-operation would result in a better outcome for all players. The optimal solution can only be reached in two ways: either the players are forced to co-operate, or the players learn that co-operation is better.

Fortunately, however, there are signs that the market participants are actually moving towards co-operation. As the European Commission (2002a) reports the market participants see progress in this area and particularly mentioned projects like ISO 15022, the Group of Thirty (G30) and the Committee of European Securities Regulators (CESR). There is also an initiative of SWIFT in co-operation with the European investment funds industry to find a solution for the market.

Thus, the setting of common standards and the interconnection of infrastructure systems might be an outcome of the market process. But this market driven process might also end up looking like the “natural monopoly” solution, or could even get stuck in a very long adjustment period. Yet it is difficult to find an alternative to a market driven process as it is unclear how the European Commission, or an industry organisation, could move the market towards an optimal solution when the market itself is not already moving in this direction.

Option 3: European NSCC

The clearing and settlement of securities and investment funds in the United States is centralised in the National Securities Clearing Corporation (NSCC). Interestingly, the NSCC is the result of a foundation of the major market participants, banks and investment companies among others. The reason for founding the DTC (Deposit Trust Company), a predecessor of the NSCC, in 1968 was a market crisis caused by an overload of paperwork. The DTC conducted the main operational tasks, provided the custody services and centralised the post-

trade processing of institutional trade. Since 1976 the DTC is part of the NSCC, which comprises all clearing and settlement activities in the United States. In 1986 Fund/SERV was established as the industry standard for the processing and settling of investment funds. Fund/SERV automates and centralises the order entry, confirmation, registration and settlement of all transactions between the manufacturers and the distributors of investment funds.

The respondents to our survey are strongly in favour of a European “NSCC”. Clearly, this would move the market structures close to optimum. Although such an organisation – as a monopoly – rules out competition, the needs of the market participants might be sufficiently represented, as the major market players would establish a European NSCC. The establishment of this organisation could be the result of the market process as described for option 2. But this is a rather unlikely result. First, in contrast to the situation in the United States of the 1960s and 1970s, there are strong suppliers of infrastructure services in Europe that already offer standardised electronic solutions. This means that the market is much more developed than in the US at the time when the NSCC was established. And therefore, the potential for cost savings is also much smaller in Europe. Second, a European NSCC could only be created by a merger of the big market players in the market for clearing and settlement such as Clearstream, Cedel, Crest and Euroclear.

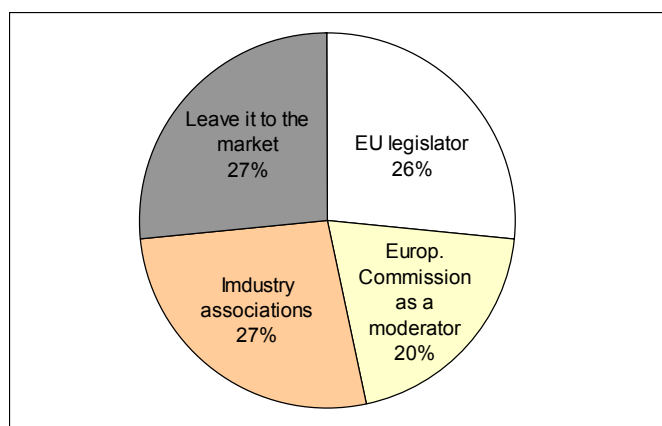
In addition, it is unlikely that there could be a clearing and settlement institution for investment funds only. The main task of a European NSCC would be clearing and settlement for securities and thus the decision for a centralised clearing and settlement institution is only to a small extent influenced by the special problems of the investment fund sector. But, clearly, a new market structure for clearing and settlement for securities would also determine the solution for the sub-segment of investment funds.

Option 4: The EU Commission decides

Another option is to assign the responsibility to the EU Commission. The Commission is currently working on a restructuring of the market for clearing and settlement in Europe. But this process seems to be still at an early stage. Nevertheless, clearing and settlement of investment funds would be only a small part of this restructuring process. The Commission itself is in favour of a market solution for the “technological and systems aspects” of clearing and settlement (European Commission, 2002a). Thus, this takes us back to options 1 and 2 again.

The results from the question “Who should have the main responsibility for achieving a more integration friendly infrastructure?” gave no clear answer (see Figure 24). There is no clear majority for any of the four choices.

Figure 24: Preferred assignment of responsibility for infrastructure development



Source: IMA and ZEW Company Questionnaire 2003

The results of the Commission Communication (see European Commission, 2002a) concerning clearing and settlement in Europe show a more complex picture. The market should, according to the respondents, solve barriers that relate to technological aspects. In contrast, the European Commission should tackle legal, fiscal and regulatory barriers. This also seems to reflect the preferences of the European Commission.

Summing up: The appeal of the market solution

The process for the build-up of market-wide “straight through processing” infrastructure system, including the market for clearing and settlement, is still at an early stage in Europe. There are good reasons to expect that “the market” will be able to find an optimal solution for the technological problems, such as IT infrastructure, common protocols for electronic trade, and the clearing and settlement of investment funds. In this process the European Commission should have the task of removing legal and regulatory barriers that restrict the market from finding this solution. This seems to also be the opinion of the respondents to the survey from the European Commission (2002a) and of the European Commission itself.

Other possible solutions to the problems associated with the market structure, such as the set-up of a European NSCC, are unlikely to evolve. Only when the major clearing and settlement institutions, like Euroclear, Clearstream or CREST, decide on a merger, could a European NSCC be realised. But in this case there would also be the need for a regulator to oversee such a monopoly.

In addition, the future infrastructure of clearing and settlement of securities in Europe will determine the optimal solutions for the sub-segment of investment funds. Therefore, the solutions for this sub-segment should be developed in accordance with the expected future changes of the market structures for clearing and settlement of securities.

It seems that “the market” is on the way to set common protocols for a Europe-wide infrastructure network which then should operate as open architecture. Political action is only needed when the market process ends up in a “natural monopoly” or is stuck in a very long adjustment period.

Yet it is difficult to imagine an alternative to a market driven process, as it is not clear how the European Commission or an industry organisation could move the market towards an optimal solution when the market itself is not already moving in this direction.

C.6 Registration procedure

For a majority of companies the fund registration procedure is often regarded as an important barrier to entry to various markets (mean weight 4.7). The details of the registration related problems have been evaluated in detail in PriceWaterhouseCoopers/FEFSI (2001a): national registration authorities require specific additional information and often require translated documents. Problems are aggravated by the fact that additional requirements are sometimes not clearly specified and this often leads to delays – sometimes even beyond the formal 2-month maximum of the UCITS directive.

There are countries where these problems are more acute: according to the statements of many company representatives, registration is particularly onerous in Italy (“Italy is a nightmare”). A number of complaints have also been voiced in regard to Spain, France and Switzerland.

Switzerland (as a non-EU country) is a particularly interesting case. It seems that Swiss authorities apply EU UCITS regulation in an asymmetric manner (“Switzerland is arbitraging the UCITS directive”): when exporting funds to the EU the Swiss framework is claimed to be UCITS consistent, but when importing foreign funds the Swiss authorities are said to apply specific rules in an inflexible way. This is in relation to the prospectus, the requirement of local representatives, and requirements concerning distribution arrangements and even the naming of funds.³⁵

While the direct costs in terms of fees for the registration and maintenance charged by domestic authorities are negligible³⁶, the questioned companies stress that other costs are more substantial: high amounts of costly internal and external (mainly local lawyers) manpower have to be devoted to the registration procedure.

³⁵ PriceWaterhouseCoopers/FEFSI (2001a), p.9 gives an illustrative example of this inflexibility: So it occurs that a “global” fund has to be renamed “world” fund. It is obvious that such requirements are hardly justifiable on grounds of consumer protection and lead to substantial costs and time delays.

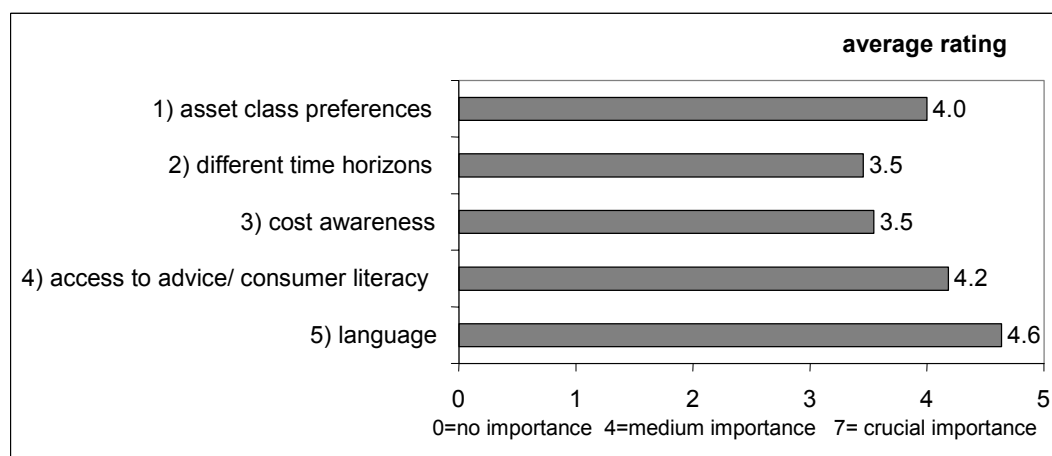
³⁶ For a detailed country list of charges see PriceWaterhouseCoopers/FEFSI, (2001a), p. 16.

These difficulties with registration slow down pan-European sales strategies. Apart from the cost factor companies report that they simply do not have the capacity to deal with all European registration authorities at the same time. The consequence is often that the first steps only concern the most promising markets so that the smaller EU countries are left behind – a description that is fully compatible with the integration indicators (section B.1) showing that the supply of foreign funds is relatively poor in smaller EU markets.

C.7 Consumer culture

There clearly exists a class of barriers to cross-border business that cannot – and maybe should not – be changed. One example of this class of barrier would be differences in consumer culture. Cultural barriers inhibit the development of a pan-European marketing strategy for fund products.

The following assessment was made about the importance of cultural differences (see Figure 25): differences in asset class preferences, in the time horizon, in cost awareness, as well as in access to advice/consumer literacy, were all valued as being of medium importance. The mean of the answers with respect to language differences is 4.6, making the assessment of this issue slightly more important than other cultural differences. Certainly, it is of importance to understand the culture, the business structure and how business is done in the respective target market. However, investment firms stated that differences in consumer culture do not constitute a barrier to cross-border business per se.

Figure 25: Barriers due to different consumer culture

Source: IMA and ZEW Company Questionnaire 2003

C.8 Consumer protection

There are two different aspects of consumer protection:

First, from a producer perspective, divergence in national consumer protection standards constitutes market entry costs as providers need to comply with different regulations.

Second, from a consumer/investor perspective, consumer protection rules have to build up confidence and trust in the reliability of cross-border business. This includes complaint procedures, compensation schemes, and the like. All these measures aim at building up trust between investors and providers of financial services and strengthen confidence of investors. Strengthening consumer confidence is a key issue in cross-border marketing of investment funds. Confidence in trading between the different member states is a prerequisite for a well functioning internal market. Only then will the consumers benefit from wider choice and better prices and in turn the firms from easier market access.

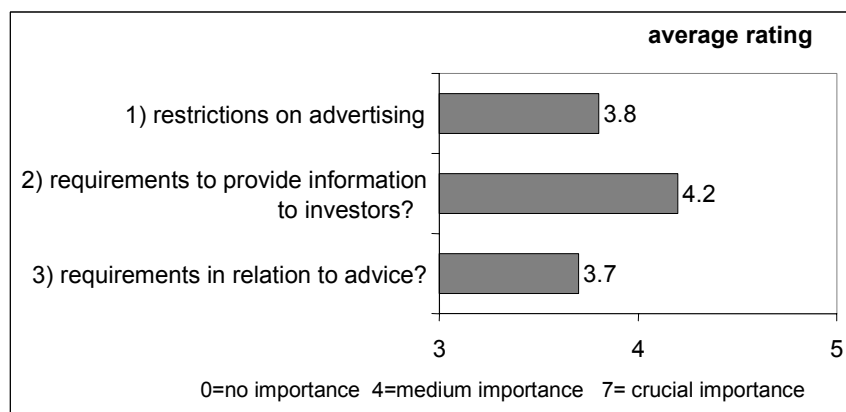
C.8.1 The producer side

In terms of the marketing of investment funds, the regulations on consumer protection vary significantly across EU member states. Examples include advertisement rules and information duties. Fund providers targeting different European markets have to comply with this diversity of rules, and these can constitute a barrier to market entry.

However, overall the companies that responded to the questionnaire only gave this issue a medium weighting – with a mean of 3.8. Restrictions on advertising, requirements to provide

information to investors, as well as requirements in relation to advice, were all valued (on average) to be of only medium importance (see Figure 26).

Figure 26: How important are national differences in consumer protecting concerning...



Source: IMA and ZEW Company Questionnaire 2003

Certainly, the diversity in consumer protection rules gives some trouble to companies operating at the pan-European level. However, it does not stop firms from entering a market. Thus, different consumer protection regulations do not hinder asset management companies from doing cross-border business if they do not want to do it anyway.

C.8.2 The consumer side

For the consumer it is important to have confidence in trading between the different member states. In this context issues such as improving investor information, enhancing transparency, as well as strengthening consumer education, play a decisive role. These issues are discussed in section C.9. Additionally, consumers investing in foreign financial products might fear difficulties in the event of needing to raise a complaint with suppliers. In this context a cross-border complaint network and investor compensation schemes may be of importance.

Cross-border complaint network

For the investment firms questioned, the lack of consumer confidence with respect to cross-border complaints procedures is of little importance in terms of hindering cross-border business (mean rating 2.5). Companies gave a straightforward explanation: the fund industry is not an industry with history of high volumes of complaints between customers and producers.

However, from a consumer protection point of view there should be some form of dispute resolution procedures in order to enhance investor confidence. FIN-NET, an EU-wide net-

work of financial services complaints bodies, has existed since February 2001.³⁷ FIN-NET links 41 different national complaint bodies into a single EU-wide complaint network. Thus the existing national infrastructure is used. The objective is to make out-of-court settlement of cross-border disputes accessible to the consumer when the consumer and the provider of the financial service do not come from the same member state. This is achieved by mutual recognition of the national redress bodies and exchange of information. In the event of a dispute the consumer will be able to complain to a third party even if the supplier does not adhere to the complaint scheme in the consumer's country of residence. The complainant is put in touch with the redress body in the supplier's country of operation through the redress body in his own country of residence.

While FIN-NET might be a good idea in theory, the interviewees have highlighted its major weakness: it is not well known. Most of the surveyed investment companies had never heard about it.

Investor compensation schemes

In addition to a cross-border complaint network, investor compensation schemes may be of importance with regard to strengthening investor confidence in cross border business. According to the directive 97/9/EEC on investor-compensation schemes each member state is required to ensure that one or more national schemes are established and officially recognised to compensate investors in the event of an investment firm's inability to repay money or return assets held on their behalf (CEPS, 2002: 27). The directive applies to all firms licensed under the Investment Services Directive (ISD). The ISD covers individual portfolio management, securities brokerage and order execution activities. However, it is left to the member states to apply the directive to UCITS. Thus, in general UCITS managers are not covered by EU obligations to have a compensation scheme.

The surveyed investment firms do not regard progress towards uniform rules concerning the compensation of investors as being important (average rating 3.1).

In conclusion, there is no doubt that in case of consumers having difficulties with suppliers they should have a well functioning cross-border complaint network at hand. FIN-NET is certainly a step in the right direction, although is not well known - either consumers or by producers. A lot more has to be done concerning the marketing of this network. However, compared with other issues, progress towards a pan-European complaint and compensation schemes seems to be of minor importance.

Code of conduct

³⁷ For more information concerning FIN-NET see <http://finnet.jrc.it/en/>.

In addition to complaint and compensation schemes, measures of industry self-regulation (such as codes of conducts) may help to strengthen investor confidence. In some European countries there are already codes of conduct for the national fund industry. Recently, the BVI in Germany adopted a code of conduct for the German fund industry (BVI, 2002). Such rules of professional ethics are also put into practice in, for example, the UK and Switzerland.³⁸ As a consequence, there exists a diversity of conduct of business regimes that may restrict the freedom for investment firms to provide services throughout the EU. Furthermore, this diversity hinders the provision of an adequate level of investor protection in cross-border business.

At the European level self-regulation is still missing. In April 2002 the Committee of European Securities Regulators (CESR) made a proposal for a European regime of investor protection by harmonising the conduct of business rules (CESR, 2002). However, respondents to the questionnaire are split on the importance of a harmonised code of conduct for the completion of the single market. Four of the respondents think that a harmonised code of conduct is of no importance; whereas five think that it is of almost crucial importance (mean value of 3.6). The critics of a harmonised code of conduct argue that the reason for consumer mistrust is often poor consumer education, rather than the misbehaviour of suppliers. In these cases, codes of conducts cannot help. Supporters regard codes of conduct as particularly important in regard to common standards for the activities of IFAs.

Firms, however, agree on the question of who should define a standardised code of conduct. With few exceptions they are in favour of industry self-regulation. The companies' argument here is that the industry has the practical day-to-day experience to be better placed to implement best practice.

However, one potential problem with self-regulatory measures (such as a code of conduct) is that there may remain uncertainty over the status of commitments made in the codes and their enforcement (European Commission, 2001). Against this reservation stands the fact that codes of conduct work well at a national level. In addition, the fund industry may be particularly suitable for self-regulation. Investment firms must have a strong interest in retaining consumer's confidence. Free riders, or rogue traders, can substantially harm this confidence. As a consequence, self-regulation can contain clear voluntarily binding commitments towards consumers. Nevertheless, there may be the need for some forms of enforcement, perhaps through the introduction of a legal consequence for not honouring commitments contained within the codes.

³⁸ Concerning the Swiss code of conduct see Swiss Funds Association Annual report (2002), p. 17.

Qualification of financial advisors

Closely related to the discussion on codes of conduct are the issues over the qualifications of financial advisers. From the perspective of UK companies, continental markets are often characterised by lax requirements concerning the training and education of financial advisers. This is illustrated in the following quote: “In Germany in the morning he is a butcher, in the evening he is a financial adviser.” This problem is mainly relevant with regard to independent financial advisers and smaller financial service providers (since with big providers in the end the company stands for the competence and the integrity of the financial analysts it employs). However, in the big financial institutions with good reputations, it can be the case that there is a lack of objective advice. The absence of any certification requirements, as well as the dominance of existing providers, impedes the development of this channel of independent advisers on the continent. This also has a negative effect on the development of the open architecture concept (see section C.4). Thus, the development of EU-wide standards for financial advisers, or the introduction of requirements concerning their training and education, seems to be a possible step in order to enhance investor trust.

Overall, it should not be forgotten that measures to strengthen consumer confidence are only one part of consumer protection. Means of improving investor information, enhancing transparency, as well as strengthening consumer education also play a decisive role. Often the reason for consumer distrust is not misbehaviour of suppliers but simply poor knowledge resulting from information deficits and/or the lack of sufficient education on the side of investors.

C.9 Information issues

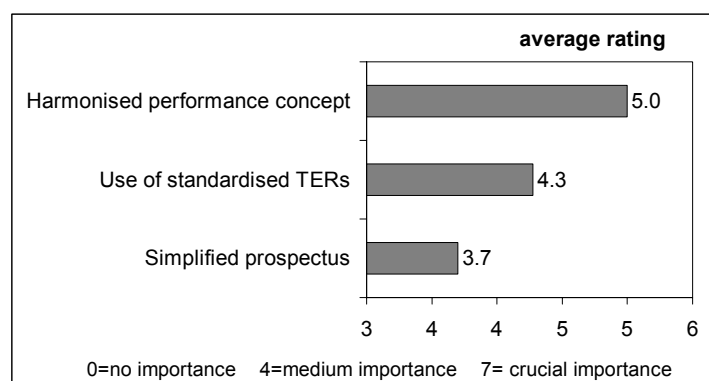
The fund industry, and more generally the financial services industry, is characterised by information asymmetry between the investor and the provider. Customers entrusting their money or assets to a financial services provider may have less information about whether their money will be secure than the provider does. Usually the investment firm knows a lot more about the nature of the product - including the costs. Improving investor information by enhancing transparency on indicators such as performance and costs of funds, may be a key issue allowing for meaningful cross-border comparisons.

Due to different regulation and traditions, information standards vary between EU countries in respect of fund costs and performance. This diversity may impede cross-border business from both the producer and the consumer side. From a producer perspective, the diversity may entail different and costly information obligations for each target market. From a consumer perspective, the diversity constitutes an important obstacle because consumers have no basis for consistent comparisons.

The surveyed investment companies assessed the diversity in information standards as being of medium importance. The producer perspective was valued slightly higher (average value 3.8) than the consumer perspective (average value 3.1). One explanation for the latter is that the vast majority of consumers do not attempt to carry out cross-border comparisons of fund products. This is partly a result of the fact that in almost all European countries there is little direct cross-border fund purchasing.

In the following sections we discuss several measures to enhance transparency, namely the simplified prospectus, the total expense ratio (TER), and performance reporting standards. Figure 27 displays the average assessment of the questioned firms on these measures in terms of their contribution to greater transparency across Europe.

Figure 27: Rating of different measures to enhance transparency



Source: IMA and ZEW Company Questionnaire 2003

Simplified prospectus

One of the measures to improve investor information, and at the same time to mitigate the burden for investment companies with regard to information requirements, is a short and simplified prospectus. One of the 2002 UCITS amendments, namely the so-called “Promoter Directive”, introduces a simplified prospectus for the sale of investment funds (CEPS, 2002: 19). A simplified prospectus aims at providing the potential investor with clear, relevant and intelligible information on key features: the aim of the fund, fees, how it is invested and how the full prospectus and latest annual report may be obtained (FEFSI, 1996: 2). Since investors are more likely to read a short simplified prospectus rather than the full prospectus (which can stretch to 30 or 40 pages), this should give them a better base for their investment decisions.

Surveyed investment firms think that the simplified prospectus as a contribution towards more pan-European transparency is of medium importance (mean value of 3.7). The fact that almost all surveyed companies are intending to issue a simplified prospectus, even if there is

no regulatory obligation, is encouraging. Some companies expect costs savings (for example in printing and mailing costs) because the shorter simplified prospectus can replace the full prospectus in marketing activities. For all companies it is highly desirable that the simplified prospectus constitutes a single fully harmonised pan-European document that can be used for the cross-border marketing of UCITS in all countries.

The proposal for a consistent simplified prospectus made by FEFSI (FEFSI, 2002b) appears very helpful in this context. FEFSI recommends a two page long standardised document comprising information on the investment objective, the investment policy, the fund's risk profile and performance and fund expenses among other things.

However, the simplified prospectus will not solve all excessive costs associated with specific requirements in individual countries referring to the full prospectus. The simplified prospectus cannot replace the full prospectus. The latter will have to be supplied to investors upon request. So far there are no developments under way that could also lead to a European harmonisation of the full prospectus.

As mentioned above, two important constituents of such a simplified prospectus are fund costs and performance reporting.

Fund costs

In order to make a considered investment decision, investors need to be able to compare the costs associated with a product. Total fees and charges are often opaque to the consumer and therefore not comparable between different investment funds, particularly between countries. The difficulties consumers have in understanding charges are not simply due to lack of financial knowledge. To a considerable extent the reason is that a significant element of the price is not disclosed (Sandler, 2002: 130). Furthermore, even where investors can identify elements of the price, they may not place sufficient weight on this information in taking investment decisions. Therefore improving disclosure and transparency with regard to fees and charges, as well as simplification, should encourage comparisons between funds – and also between countries. This in turn should help to stimulate cross-border marketing of funds.

FEFSI has recommended the use of a total expense ratio (TER). The surveyed investment companies value the use of a TER as being quite important (mean value 4.3) for pan-European transparency. Almost all firms already report TERs, or plan to do so in the future. Some of those that do not plan to report TERs, do not do so because there is no standard definition.

In order to achieve comparability, and in turn stimulate cross-border marketing of funds, standardisation of TERs is required. But who should define standardised TERs? Almost all surveyed investment firms opt for industry self-regulation. One argument in support of the EU

legislator would be that a clear and uniform definition is needed that may be best supplied by one authority. However, experience with EU decision-making suggests that this process takes too much time. The same holds for the other extreme solution of leaving it to the market. There needs to be some guidance when defining standards. This should come from the industry itself. One shortcoming of this solution is of course the potential lack of enforcement.

Performance reporting

Closely related to the cost issue is the issue of reporting the performance of an investment fund (since performance depends partly on the costs). In the fund industry, past performance is a primary marketing tool and it has been alleged that investors choose to invest in a fund mainly based on the fund's past performance and without reviewing other information about the fund (Sandler, 2002: p. 128, FSA, 2001).

National performance presentation standards differ with respect to treatment of fees and expenses, the time period underlying the performance measurement, use of benchmarks, the period of performance presentation, volatility disclosure requirements etc. (see OICV-IOSCO, 2002). Certainly, standardised performance reporting would help investors to make meaningful comparisons between funds, and thus to make fully informed investment decisions. In addition, providers could distribute funds in all European countries with just one document thereby realising a reduction in costs.

Whereas two of the surveyed firms think that a harmonised performance concept has no importance with respect to pan-European transparency, nine firms assess this measure as being very important. This leads to a mean of 5.0 which, compared to other instruments of enhancing transparency, is the highest. This reflects the importance of performance reporting in the marketing of funds. Again, the majority of surveyed firms are in favour of self-regulation when it comes to defining a standardised performance concept.

Summing up, a standardised simplified prospectus seems to be a good way of improving investor information and enhancing transparency, thereby reducing information asymmetry between consumers and providers. Two important parts of a simplified prospectus that could, however, are the total expense ratio (TER) and a performance-reporting standard. Given consistency across countries, this would make (cross-border) comparisons between funds easy and, thus, in turn stimulate cross-border marketing of fund products.

Consumer education

In addition to improving investor information, investors have to be able to deal with the information they receive. In this respect, the education of investors becomes important. In general, the need for financial management skills is becoming increasingly important (Sandler, 2002: p. 59).

Of course, in practice improving financial literacy substantially is a difficult task. It would take a considerable level of resource applied for many years. Nevertheless, consumer education can make a meaningful contribution to enhancing investor information and strengthening confidence and so in turn stimulating cross-border business. In the long run, it is essential to question how financial education should be embedded in the school curriculum. Certainly, this task is beyond the scope of this report.

However, there are also means of addressing educational deficiencies in the short term. Such measures may embrace either print or electronic publications to provide general financial advice on different financial products and services. In this respect the UK may well serve as an example, where the FSA has developed a number of initiatives (see Sandler, 2002). Also in the UK, IMA undertakes some initiatives such as offering a selection of brochures to help promote investor understanding of investment funds (PriceWaterhouseCoopers, 2002a: p. 46). Moreover, governmental education programmes – such as those run in France, the UK and Germany – on pension savings are a step in the right direction (see also section C.4).

C.10 Legislative and regulatory issues

In section B.4 the UCITS III directive was introduced as one of the legislative measures aiming at the completion of a single market. The industry's assessment of the new UCITS amendments in the ZEW interviews reaches a mean weight of 4.1 pointing to an integration contribution of medium importance.

The UCITS amendments bring about a lot of helpful changes, in particular on the product side, such as funds of funds, index funds or the opportunity to invest in derivatives (FEFSI, 2001). In addition, the introduction of a harmonised simplified prospectus, as discussed in section C.9, is certainly a step forward with regard to the marketing of funds as well as to enhancing investor information and protection.

However, there are also shortcomings of the directives (see also FERI, 2002): industry representatives mentioned the potential difference in implementation across countries as one of the main drawbacks. Lack of a common interpretation as well as a missing single supervisory practice within the EU result in part from the fact that UCITS III is pre-Lamfalussy. Nevertheless, it will be implemented under the comitology procedure, meaning that the UCITS

Contact Committee³⁹ has limited regulatory powers in addition to its advisory function. This may be, at least to some extent, helpful in avoiding different interpretations of the new UCITS directive (FEFSI, 2002a: p. 10). Consistent implementation of the directive by the member states will be crucial.

Moreover, UCITS III does not solve the problems concerning taxation and registration, discussed in sections C.2 and C.5.

Finally, there are clear transition problems arising from the following issues (PriceWaterhouseCoopers, 2002b: p. 7): a member state that has not yet implemented the directive would have the right to refuse acceptance of foreign funds created under the new directive. Moreover, once a country has implemented the new directive it would not be possible for it to continue to create UCITS under the old directive. As a consequence, a country implementing the new Product Directive earlier than other member states can only create new UCITS products which “slower” states may be reluctant to accept. Clearly, this is a temporary problem. Besides, goodwill of national regulators who could choose to accept UCITS III funds could mitigate the impact of this.

Near final adoption is a new directive on the activities and supervision of institutions for occupational retirement provision with the objective of establishing an internal market for occupational pension schemes. The directive introduces the single licence for pension funds, with the “prudent man” as the main guiding mechanism for asset allocation. The prudent man principle means that assets need to be invested taking qualitative criteria into account (nature and duration, proper diversification), not quantitative. However, member states keep much power with regard to individual regulation, for example they can still impose certain qualitative restrictions to the asset allocation. Therefore, the directive on occupational pensions will certainly not be a major breakthrough with regard to the internal market for pension products. This view is clearly supported by the industry’s assessment: the interviewed companies assign small weights to the importance of the occupational pensions directive (mean weight 3.2).

³⁹ The UCITS Contact Committee chaired by the Commission brings together national fund supervisors and regulators. The role and responsibilities of the UCITS Contact Committee are set out in Article 53 of Council Directive 85/611/EEC (UCITS I).

Part D What needs to be done

D.1 General strategy

The analysis has shown that, for the most part, the reasons for imperfections in the single market are well known and are not controversial. What is less clear is who should bear the brunt of responsibility for overcoming these imperfections. The answer to this question highlights a remarkable difference in perception between European legislators and sections of the asset management industry. While law-makers are generally quite optimistic that their efforts are promoting further integration, the industry remains sceptical. This was evident in the industry's assessment of UCITS III as well as the draft directive on occupational pensions (section C.10). Industry representatives also complain that there is a lack of understanding of the asset management industry among legislators and that this leads to poor regulation and an unnecessary bureaucratic burden.

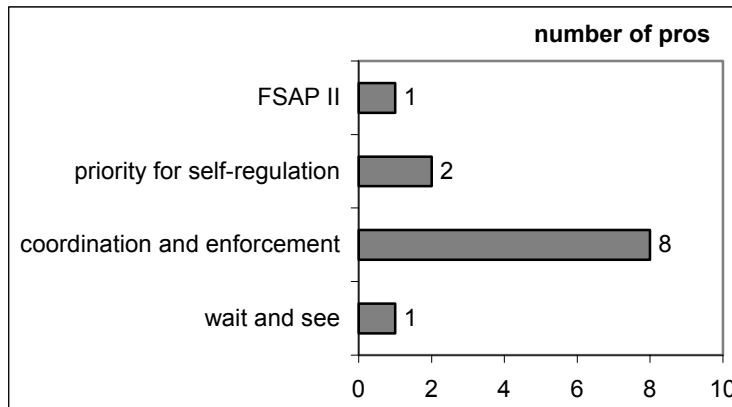
The industry's recommendations for the strategic focus of the post-FSAP integration policy stem directly from this experience.(Figure 28).

A substantial majority of companies interviewed for this study do not see a case for any new, far-reaching, legislative initiatives (such as a "FSAP II"). The preference is for a concentration of efforts on a coordinated implementation and enforcement of the existing legislation. First, existing rules should be put into practice before further legislation is considered. Any additional law threatens to be costly in terms of increased bureaucratic requirements, and as the following statement from one respondent illustrates: "new legislation would only benefit accountants and lawyers". This view is also consistent with the hierarchy of barriers to integration: so long as existing law is not applied seriously (for example with regard to tax discrimination), there is not much sense in new legislation which addresses integration needs that are of lesser importance.

It is interesting to note that overall the industry is neither enthusiastic about a strategy based on "wait and see" nor an approach based solely on self-regulation. This is remarkable as, at first sight, these options come with a high degree of freedom and should be appealing. What might lie behind the rejection of "wait and see" is the experience that market trends, like open architecture or the development of a standard infrastructure, are perceived to be too slow to make "*laissez faire*" an acceptable strategy. An additional problem with the option of self-regulation is that many companies cannot envisage which organisations would be responsible for enforcement. There is widespread scepticism as to whether an association such as FEFSI could undertake this responsibility, since it is characterised as an "association of associations" that lacks the insights of market practitioners. It must be stressed, however, that the self-

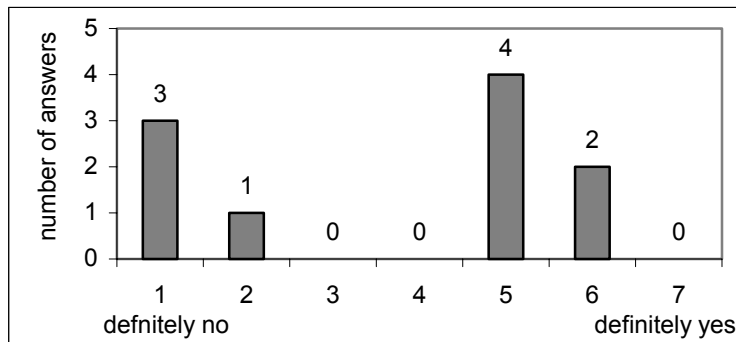
regulation option is preferred for certain and well-defined areas - such as harmonisation of performance reporting or cost transparency (see section C.9).

Figure 28: Policy priorities for the years after the implementation of the FSAP



Source: IMA and ZEW Company Questionnaire 2003

Therefore, from the industry's perspective, better coordination among national authorities, stricter enforcement and a more coherent implementation of European regulation should be the priority for the immediate future. The issue of varying national implementation makes it tempting to opt for an easy answer: the establishment of a single European regulator that would, through its unified regulatory implications, guarantee a level playing field across Europe. At the moment this does not appear to be a realistic option, but it is interesting to note the industry response on this issue: no other topic so divided opinion among the companies that were questioned (Figure 29). While the supporters of this solution see the opportunity for unified rules, the opponents fear a slow and distant bureaucracy. So while there is an agreement that a more uniform implementation of the legal framework for a single market is highly desirable, there is no agreement, at present, that this should be achieved through the creation of a unified single regulator.

Figure 29: Desirability of a single European regulator

Source: IMA and ZEW Company Questionnaire 2003

The sceptical view at the legislative approach in general does not preclude that there may well be a case for further legislative action in certain fields. Nevertheless, the industry's legitimate scepticism towards "regulated integration" points to an important bottleneck for ambitious legislative initiatives: as national authority remains far reaching, if the important actors in national legislation and administration do not support integration it is easy for them to block progress. This potential barrier should be kept in mind when considering the recommendations for future legislative priorities that are suggested in the next section.

D.2 Measures addressing specific particularly relevant problems

The preceding comments have been of a very general nature. This section will now look at more specific policy conclusions for the various barriers that have been identified as holding up progress towards an internal market.

D.2.1 Taxes

If the objective of a single market in financial services is a serious goal, then the issue of tax discrimination must be regarded as a top priority. Progress towards fiscal neutrality in the treatment of foreign funds vis-à-vis domestic funds would produce a noticeable stimulus on cross-border business. This barrier highlights the conclusion that further European legislative acts should not be the current priority. Tax discrimination of asset management products does not result from a lack of European legislation but from a lack of enforcement of existing obligations. More specifically, the problem is that too few cases of tax discrimination are challenged at the European Court of Justice.

This is for several different reasons, and it concerns the behaviour of the industry itself. Although cross-border companies complain a lot about tax discrimination, they rarely bring cases to the European Court of Justice. There are different explanations. First, there is a clas-

sical “free rider” problem: for a single company a lawsuit is very costly in terms of staff resources and expensive legal assistance, and yet the benefit would be largely external and would also accrue to all their competitors. Second, there is a problem with time horizons: given the restricted time-horizon of the industry’s management the long duration of a legal case (with its unpredictable results) is seldom an attractive option. A more fundamental reason, however, appears to be that financial companies are keen to develop good relations with the authorities in promising markets. Companies fear that a lawsuit could provoke the national authority into retaliation.

A further explanation relates to the Commission. Sometimes it seems that the priorities in the Commission’s work programme do not correspond to the relative size of barriers that prevent further integration. Here, a better allocation of Commission resources could help. Compared to the impact of tax discrimination, much of the FSAP will probably have only a negligible impact. Given the relative importance between the two, the activities of the Commission and EU legislation appear unbalanced: while considerable resources are devoted to the legislative package defined by the FSAP, the more fundamental issue of tax discrimination is hardly addressed. Thus, it appears to be a sensible move that, with the infringement case against German foreign fund discrimination, the Commission shows signs of taking a more aggressive stance against tax discrimination in financial products.

Without a more active role from the Commission, no progress to overcome the tax discrimination problem can be expected. Recent experience in the development of national tax and pension policy has shown that aspects relating to European integration receive very low attention in domestic political decision-making.

D.2.2 Fund mergers

With regard to ability of firms to merge funds, the study has revealed two main problems that need to be addressed: first, the treatment of a merger as a taxable event and second, the protectionist regulation of outward cross-border mergers by some countries.

The responsibilities for addressing both problems have to be assigned to different policy makers. The tax problem can only adequately be addressed by member state legislation. Treating fund mergers as taxable events is not compatible with a sensible tax system. However, this issue cannot be adequately addressed by the Commission (for example through infringement proceedings), as these policies are not *per se* of a discriminatory nature. So the only chance is that the industry can persuade governments in the Members States that a more neutral approach to fund mergers is in the interest of the domestic industry.

With regard to national restrictions on the emigration of funds, the European legislator (the Commission) is the appropriate actor, as these policies present barriers towards relocating funds and, as such, have clear common market implications. A major breakthrough can be achieved if the redomiciling rules are liberalised on a EU-wide basis. If moving funds between EU jurisdictions can become a standard operation with no discrimination, no further EU wide harmonisation or standard setting for the merger of domestic funds would be required. Competition between fund locations would be a sufficient counterweight against illiberal domestic merger regimes. A fund company preparing a merger would be able to concentrate funds in a location with efficient merger rules, and competition would then force illiberal countries to correct their rules.

From this debate, there is an obvious recommendation for future amendments to UCITS: it would be desirable to harmonise the rules for relocating investment funds within the single market. There is no justification to formulate particularly strict common rules for these relocations, since for a consumer within the single market the location of a fund is hardly relevant. This innovation would have an important medium-term impact on the development of the single market for funds working like a catalyst for consolidation and economies of scale.

D.2.3 Distribution bias

The main obstacles to open architecture in Europe, which is a principle goal for the cross border fund business, are the barriers that originate in distribution systems that have traditionally been dominated by banks. Lack of commitment to third party distribution reflects the strong market positions of incumbent suppliers. Lack of incentives for the sales staff and insufficient knowledge are a secondary issue, but the problem stems from a lack of willingness to really practice open architecture. However, even if progress is slow it is to be expected that competition will succeed in forcing suppliers to open their distribution networks to third party products. Improving consumers' literacy (for example through government education programmes in pension savings planning) is likely to mildly accelerate this process. A stronger impact, however, could be exerted by tightening national regulation of advice in order to secure for the consumer unbiased and objective guidance. This process, which has already started on a EU level, should be reinforced on a national level. Leaving an extremely high proportion of the management fees to distributors does reflect the market power of distributors, which is also likely to be eroded in more competitive market.

The costs of technology, and the costs incurred by technological heterogeneity, are another concern. Progress towards a more balanced distribution is closely linked to progress towards a more uniform European infrastructure. Setting uniform standards for messaging, as well as electronic platforms, would reduce costs drastically. Further technical standardisation would

also reduce operational risk. Compliance risks are a further obstacle to OA, and reinforce the case for the harmonisation of national regulations. Finally, the treatment of reputation risk should be left to market, so long as proper regulation of distributors concerning their financial standing and required skills is warranted.

D.2.4 Infrastructure

Infrastructure fragmentation is today posing a burden that is particularly heavy for cross-border trade in investment funds (see section C.5). Currently, even the most basic rules (such as settlement time and fund valuation) are not standardised. Thus, the situation is far from the ideal model of “straight-through-processing”. The basic economic problem behind the slow development results from the inherent characteristics of a network: big initial investments are necessary to develop pan-European systems, and investors face uncertainty over which systems and standards will finally prevail. Nevertheless, experience with other markets with high fixed and low marginal costs, shows that market processes can succeed in creating working networks. In principle there is no reason not to expect this success also in regard to clearing and settlement in Europe – which is the main part of current infrastructure problems.

Although it is debatable whether a market-led process will be fast enough, there are no real or viable alternatives. Setting up a kind of European NSCC (following the successful US example) is not realistic given the differences between markets in Europe today and the American experience of the mid-1970s. Industry self-regulation is not likely to achieve any progress without the support of leading market players. Therefore, the recommendation is to leave the development to market forces and the competition among leading infrastructure service providers. However, there is also a clear role for the European Commission to speed up the process: it has the task of removing any legal and regulatory barriers (such as different national tax reporting requirements) that pose problems for unified systems. If (and only if) competition results in a natural monopoly of one successful standard setter, this monopoly will have to be regulated in order to avoid market abuse.

D.2.5 Registration

The current differences in the UCITS registration practice (as described in C.5) does not yet satisfy the needs of a true single market. In addition, it is hard to justify this divergence with respect to consumer protection. The more realistic driving forces appear to be a mixture of bureaucratic self-interest and protectionism.

PriceWaterhouseCoopers/FEFSI (2001a) recommend a strategy targeted at harmonising the implementation and administrative practice of the UCITS regime. For that purpose, a first step would be an agreement on a standardised form to apply for registration.

While this first step of harmonisation would be beneficial the question remains, whether the progress would really be substantial so long as host authorities keep their basic responsibilities for registration. The more straightforward solution would be to take the European passport literally: in this model, a fund accepted as UCITS in its domicile would be immediately marketable all over the EU. This would be a far-reaching breakthrough. This logical recommendation for improving the single market warrants serious attention in the coming debates on reform of the UCITS framework.

D.2.6 Transparency/information requirements

With regard to improving investor information the simplified prospectus introduced by the UCITS III directive is a helpful movement in the right direction (by enhancing transparency and at the same time standardising the information requirements for producers). However, its full potential can only be realised if this prospectus is harmonised throughout the EU, so that fund providers can distribute funds with only one document and investors get truly comparable information across countries. The FEFSI model prospectus seems to be a quite reasonable basis for this harmonisation.

In spite of its advantages the simplified prospectus has to be regarded as only a first step on the way towards a standardisation of the information requirement. It does not solve the problem of various national requirements concerning the full prospectus. The need to adjust the full prospectus to specific legal obligations in every European market raises the entry costs and hinders integration. Therefore, the direction of further reforms should be clear in this respect: the definition of a harmonised European prospectus that would be sufficient for each registration procedure. This harmonisation would also fit well with the previous suggestion of abolishing the registration requirement in the host country.

A precondition for the harmonisation of European information requirements is the agreement of the industry itself. The European legislator is not able to solve the difficult tasks of defining harmonised standards (for example performance and cost reporting). Therefore, it is the industry - and not the legislator - who has the main responsibility for harmonising information standards. The earlier the European fund management industry succeeds in agreeing common standards on information and on cost and performance reporting, the better are the chances in getting an end to host country registration requirements.

In addition to improving investor information, the education of consumers is of crucial importance. Achievable short-term measures could be things such as consumer helplines, websites and publications that provide general financial advice. The initiatives in the UK by the FSA and IMA may serve as a role model.

Conclusions

Compared to the pre-UCITS-1985 situation, substantial progress in integration has been achieved in the European market for investment funds. However, the situation is far from satisfactory if one evaluates today's circumstances with the more ambitious yardstick of a single market. National borders still have a significance that appears anachronistic. This fragmentation is costly, and the opportunity costs have many dimensions including investment returns and product choice, but also growth and employment. These statements are not controversial among the market participants nor among the political and administrative actors. More controversial is the question concerning the best way to achieve further integration. Different perceptions should not come as a surprise as they are related to different roles: political actors stress the contribution of legislation towards more integration, while the industry is more sceptical about an integration strategy based largely on directives and regulations.

This report has shown that the dispute between legislated and market based integration cannot be reconciled in the abstract. What is needed is a thorough analysis of each single barrier to integration to determine which strategy is more promising.

The most pressing problem that must be addressed is tax discrimination. Even if this conclusion is not new it needs to be stressed again and again. A level playing field in taxation would give market forces a powerful boost to overcome other barriers to a truly single market. The ways to achieve progress in taxation are not related to legislation, but to enforcement of the existing common market rules. Strong incentives exist for competitive companies to cross national borders. Once market turbulence recedes these incentives will drive integration. Thus, it is highly likely that the momentum from ending tax discrimination would (in the medium-term) be strong enough to induce substantial progress in relation to the problems related to distribution and infrastructure.

A second conclusion is that legislators will continue to play a role in promoting further integration, though this role has to be undertaken in a cautious way. UCITS III, for example, is definitely not the last act in developing the single market regime for investment funds. Issues that should be addressed in coming adjustments are the registration problem, heterogeneous information requirement and fund relocations: the single passport for funds should be taken seriously so that national registration procedures become obsolete. An equally liberal regime

is needed in regard to the cross-border movements of funds: the barriers that exist today effectively prevent funds being moved between countries and are not in line with the spirit of a single market. Finally, there is clearly a case for a stricter regulation on quality of advice since this could strengthen the trend towards unbiased distribution.

In regard to overcoming the fragmentation of infrastructure the European legislator has only a minor role to play - since there is no realistic alternative to the market driven creation of unified standards and networks.

However, what is needed before any hasty new legislative moves is a more critical evaluation of past legislative steps. This recommendation is particularly valid with respect to the FSAP. Once this project is finished a thorough monitoring of its is necessary before considering any further, far-reaching, legislative packages.

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