PAN-EUROPEAN ASSET MANAGEMENT
ACHIEVEMENTS AND REGULATORY IMPEDIMENTS

REPORT OF THE CEPS TASK FORCE
ON
PAN-EUROPEAN ASSET MANAGEMENT

CHAIRMAN: PATRICK ZÜRSTRASSEN, SENIOR ADVISOR,
CRÉDIT AGRICOLE INDOSUEZ LUXEMBOURG

RAPPORTEURS: KAREL LANNOO, CHIEF EXECUTIVE, CEPS
MATTIAS LEVIN, RESEARCH FELLOW, CEPS

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This report is based on discussions in a CEPS Task Force on Pan-European Asset Management. The members of the Task Force participated in extensive debate in the course of several meetings and submitted comments on earlier drafts of this report. Its contents contain the general tone and direction of the discussion, but its recommendations do not necessarily reflect a full common position reached among all members of the Task Force, nor do they necessarily represent the views of the institutions to which the members belong. A list of participants and invited guests and speakers appears in Annex 4 at the end of this report.

The authors wish to thank the Chairman and the members of the Task Force for their input into the discussions and their contributions to this report, and Rym Ayadi for competent research assistance.
PAN-EUROPEAN ASSET MANAGEMENT

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EXECUTIVE SUMMARY

The asset management industry encompasses a broad range of businesses, in terms both of size as well as regulatory regimes. In terms of volume, the importance of the industry differs remarkably across jurisdictions, and is influenced by the wealth and savings behaviour of citizens, the existence and maturity of funded occupational pension schemes and the domestic regulatory environment. No less than five different legislative regimes govern asset management in the EU: banking, investment services, insurance, pension funds and investment funds. The purpose of this Task Force was to assess the adequacy of the current regulatory framework and the consistency of rules across sectors, most importantly from a capital adequacy and asset allocation perspective, to determine whether further regulatory action was necessary to advance market integration.

The findings of the Task Force are as follows:

• There is no need for a horizontal asset management directive to supersede the current directives. The recent agreement on two new investment fund directives – UCITS (undertakings for collective investment in transferable securities) II & III – and the pension funds directive (provisional) are important steps towards a more integrated European market for asset management, with a truly single passport. The choice of asset management regime has been extended to include discretionary asset management as an option for UCITS management companies (in the UCITS III) and for the application of the prudent man rule of the pension funds directive to the pension fund business of life insurance companies.

• The key issue, in the spirit of the Lamfalussy report, is to focus on level 2 and 3 issues to ensure adequate cooperation between European supervisory authorities so as to guarantee consistent implementation and a harmonised approach in secondary legislation and in supervisory practices. Both the UCITS and pension funds directives require a Lamfalussy-style approach for implementation of legislation at levels 2 and 3, which is not yet in place. The UCITS Committee has only limited implementing powers and is not formally part of the Securities Committee/Committee of European Securities Regulators structure, which should ensure harmonised implementation. The Insurance Committee will need to be upgraded to cover the secondary legislation of the pension funds directive, and will need a second level to review harmonised implementation.

• The amended investment services directive may become the most open of the asset management directives, with harmonised conduct-of-business rules. The new UCITS directive is probably the easiest one, with a low capital requirement, and the option of discretionary asset management. Much also depends, however, on the extent of the application of the operational risk charge in the context of the New Basel Capital Accord, which may apply to both regimes. Compared to other lines of business, losses resulting from operational risk in the asset management industry have been limited so far, and these can be covered by private insurance. It should also be remembered that US investment fund companies are not subject to capital requirements and that US broker-dealers will not be subject to the Basel Accord.
The key outstanding issue on which much work remains to be done is taxation. The current taxation system operates along national lines and cases of overt tax discrimination hamper pan-European asset management. It increases the cost of asset management and reduces returns to investors as national tax rules lead to the duplication of fund structures. In addition, the wide differences in taxation between countries makes cross-border investment more difficult. Moreover, there are wide variations between countries regarding compensation for taxes paid abroad, with some countries providing credit for such payments while others do not. Finally, little effective relief is in place at the investor level for taxes incurred at the fund level. The reason is that double-taxation treaties do not effectively work for investors, and funds are, in most cases, excluded from those treaties. This situation ought to be corrected.

The European Court of Justice (ECJ) should be supported in its efforts to eliminate restrictions to the freedoms of movement in the internal market. The Commission should initiate more infringement cases and industry should assist the Commission by bringing restrictive practices to its attention or by initiating cases themselves. As a complement to the case-by-case action of the ECJ, attempts should be made to further the convergence of tax systems, e.g. the taxation of pensions (having a single system for contributions to and pay-outs by funds) or in the field of corporate taxation (where the Commission is promoting convergence in the method of computing tax bases).

Member states are concerned to see their citizens’ savings placed abroad and hence beyond their tax powers. In response, member states often resort to tax and other measures that discourage citizens from placing savings with foreign service providers. If such measures discriminate between service providers on grounds of nationality, they violate EU law, as evidenced by several decisions of the ECJ. Court action takes time, however, and may not be sufficient to dismantle all such discriminatory measures. As a supplement to Court action, achieving further convergence in the way member states tax fund management and reaching a consensus on how to tax non-residents’ savings income may reduce the underlying reason why member states resort to such practices in the first place. The combination of convergence and consensus may therefore contribute to the reduction of discriminatory tax practices.
INTRODUCTION

Now that economic and monetary union (EMU) has been in place for some four years, it is a good time to make a first evaluation of its impact on European capital markets and to identify areas for future policy action. Before EMU, it was commonly assumed that the single currency would fundamentally alter the nature of several businesses, in particular the asset management industry. It was thought that the irrevocable fixing of currency rates and the expected reconfiguration in European capital markets would change the way in which the asset management industry acted in these markets.

The transformation of European capital markets has indeed happened, and the process is still going on. It has been the most rapid in the short-term end, i.e. in the money markets, followed by government bond markets, while the consolidation of European equity and derivatives markets is still in progress. The different markets are becoming truly European, compared to the nationally segmented markets that existed in the past.

The asset management industry on the other hand has probably not yet become as European as was originally anticipated. While structural factors play an important role, it is now widely assumed that the pace of convergence will be slower than expected. Regulatory, tax, language and cultural differences continue to provide a domestic focus and bias to investors. Not all of these issues can be solved by policy action, but some can. It is the latter on which this report focuses.

This report starts with a brief discussion of the fundamentals of the asset management industry, followed by an overview of developments in European capital markets and in the asset management industry in recent years. It then goes on to discuss the EU regulatory environment for asset management and the changes that have occurred in recent years. A final chapter addresses the barriers resulting from variations in taxation. A glossary of EU directives and acronyms referred to in this report can be found in Annex 3.
CHAPTER 1
SOME FUNDAMENTALS OF ASSET MANAGEMENT

Asset management is the generic term used to refer to the investment of funds of institutional investors in capital markets. Asset management can be executed by institutional investors themselves, or the function can be delegated to specialised intermediaries.

The process of asset management is composed of different elements that can be divided into front- and back-office tasks.¹

Front-office tasks include:
- marketing, and the development of new products; and
- fund management (asset allocation and risk management), research, trading and cash management (deposits and cash).

Back-office tasks include:
- transaction processing, settlement, custody, stock lending;
- systems support;
- accounting and administration (client support, performance analysis, etc.); and
- general administration and management (legal, human resources, etc.).

These descriptions already show that it is possible for different industrial organisations to operate in widely divergent manners in asset management. Firms may choose to be vertically integrated and execute the full chain of tasks in-house; others may specialise in parts of the process, both front as well as back-office tasks. The degree of integration differs across regions and sectors, with continental Europe traditionally being more vertically integrated than the UK and the US, for example, or the insurance industry more than mutual and pension funds.

The growing tendency to outsource parts of the process to other firms is related to the rapid development and globalisation of financial markets, technological change, increasing competition and the changing views on the organisation of the sector. Economies of scope and scale were seen as key factors in a vertically integrated model, with high degrees of concentration and oligopolies, and thus barriers to entry. Today, there is no single dominant model in the industry. While there has been a further increase in the size of the asset management industry, specialised players have emerged such as fund advisers and technology consultants, while big players have started to specialise in one aspect of the process, such as fund marketing, asset management or custody. Overall, the contestability of markets has increased.

The asset management industry can also be divided into wholesale and retail sectors. The former can be further subdivided into generic, specialised and balanced asset management, in the order of increasing degrees of discretion on the side of the manager. Retail comprises private banking, private fund management and the like. It can best be seen as a set of contracts between various parties providing a set of services. Increased costs, notably for medium-sized firms, and increased competition due to cross-border entry and the shift from active to passive management are a few of the factors creating pressure for change in wholesale management. On the retail side, similar pressure is exerted by increased competition from direct investor holdings and exchange-traded funds, as well as the cost of gathering assets. Industry

¹ The following is based upon Davis and Steil (2001).
concentration has resulted as a response to these developments. At EU level, the adoption of
the EU passport directives, the increasing professionalisation in asset management, and a
strong drive towards international investment have also contributed to change.

The key competitive factors in the asset management industry are performance and reputation,
according to a survey of firms discussed in the Task Force (see Davis and Steil, 2001, p. 205 ff.). Within a sample of 72 mainly Anglo-Saxon firms, which collectively managed almost $2 trillion in assets, the following factors were flagged:

- Performance of asset managers relative to other institutions, as well as reputation with
  consultants and advisors, are considered as the key elements in the competitive process.
- Existing firms’ reputation and relationships with clients, distribution channels and selling
  networks were considered as the main entry barriers in domestic and foreign markets.
- Greater name recognition and lower average operational costs were identified as the main
  benefits of large size for asset managers.
- Market impact of large transactions were seen as the main cost to large-size asset
  managers.
- Domestic and cross-border integration of the fund management industry was expected to
  continue, reshaping the current industry structure. Greater participation by banking
  institutions in asset management was also foreseen.

A large body of academic literature exists on the theory of optimal asset allocation and the
difference with empirical evidence. Modern portfolio theory suggests that investors should
have internationally diversified portfolios to improve the reward-to-risk ratio of their asset
holdings. The attractiveness of international diversification is mostly due to low levels of
correlation among national markets. Studies point out however that portfolios are not optimally
diversified and that the cost in terms of lower returns and higher risk is large.

Two examples of recent studies should be sufficient to illustrate the divergence between
optimal and effective allocation. Comparing risk and return of various equity portfolios for
European investors for the period January 1978 to June 2001, Schröder (2002) found that, for a
British investor, holding an optimal portfolio of 80% non-domestic assets instead of a portfolio
of 20% non-domestic assets would yield an excess return of 2.2% per year. For a German
investor, holding this optimal portfolio (which is 100% of the global allocation) instead of
about 20% would, in foreign assets, yield an excess return of 3% per year. For a French
investor, on the other hand, the optimal portfolio is near to the current portfolio allocation of
70% domestic French equities, so the gain from additional diversification is small. Lewis
(1999) shows that, following the minimum variance portfolio strategy for the US, investors
should allocate about 40% to non-US assets, rather than the 10% that is actually invested in
non-US equity. By not following this strategy, the US investor gives up about 50 basis points
per year in return (while also decreasing risk), or 80 basis points per year with no change in
risk.²

Scholars have tried to find reasons for this home bias in asset allocation, and have come up
with different possible explanations. Transaction costs partially explain the bias, but not fully
(Mann and Meade, 2002). Other factors come into play, such as market risk, agency costs,
political uncertainty, regulatory differences and impediments (such as accounting standards
and taxation, which favour local as compared to foreign investments) and, probably most
importantly, exchange rate volatility. The latter is most commonly used to explain investors’
resistance to international diversification. In the European context, exchange rate risk has been

² Examples taken from Mann and Meade (2002).
eliminated within EMU, and should largely ease EMU-wide diversification. At the same time, however, monetary union has reduced the benefits of diversification at the European level, since risk correlation between the different EMU members has increased.

Initial results from examining the effects of EMU on portfolio diversification in equity markets found that the correlation between countries has indeed increased as has, but to a more limited extent, the correlation between sectors. These findings support the view that a sectoral investment strategy prevails in EMU. Since country risk has a higher correlation than sectoral risk, investments are best spread along sectoral lines in EMU. Overall, the impact of EMU on optimal portfolio allocation was seen to be less important than its contribution to reducing the effective and psychological obstacles to diversification within the euro area. Some barriers disappeared the day the euro was introduced and others are decreasing as a result of dynamic effects that have been set into motion. Currency risk may thus be more important because of its role in strengthening the home bias than because of its impact on optimal investment strategies (Danthine et al., 1999, p. 83). The future should indicate to what extent currency is a more important factor in explaining home bias than other elements, which, in EMU, continue to differ along national lines.
CHAPTER 2
THE EUROPEAN ASSET MANAGEMENT INDUSTRY

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. The group is difficult to define by size as it encompasses far more than simply institutional investors (i.e. insurance companies, investment and pension funds). European banks also provide asset management services. The extent to which these activities are separately licensed will be reflected in the statistics. But individual asset management, such as private banking, is not considered as a separate legal entity from other, more traditional banking activities. This makes it difficult, if not impossible, to arrive at an overall size estimation of the industry. It should furthermore be kept in mind that there may be double counting in institutional investor data, as investment funds may be held by pension funds and insurance companies.

The relative importance of the asset management industry from one country to another depends on broader regulatory frameworks. The ways in which retirement plans are financed are crucial in explaining the large differences in pension fund size, as well as in the role of investment funds. Most European countries still have no pension funds of any significance, since pensions are financed on a pay-as-you-go basis, and the high level of replacement ratios in the official pension discourages the formation of additional privately-sponsored funded pension plans (2nd pillar or occupational pensions). The absence of a well developed 2nd pillar pension also explains the importance in some countries of other forms of organised savings, such as investment funds. These can be categorised as individual retirement savings (3rd pillar). As discussions on the EU savings tax have indicated, bank secrecy and the taxation of savings income also play a role as explanatory factors.

In volume terms, insurance companies are the most important group of institutional investors. They hold a total asset value, in percentage of GDP, of 54.4% in the EU (2000, see Table 5), compared to investment funds of 40.6% and pension funds of 29.2%. In the US, the order of importance is the reverse, with pension funds and investment funds being the largest (90.6% and 69.7% of GDP respectively), and insurance companies the least substantial (34.9% of GDP in 2000).

In relative terms, there are remarkable cross-country differences, with southern EU countries having a much smaller insurance sector than found in the north. Pension funds are only of real importance in a few EU countries: the Netherlands, the UK and, to a lesser extent, Sweden and Ireland. Over time, the investment funds sector showed the strongest growth, expanding from €1,171 billion in 1995 to €3,448.8 billion in 2000. Pension funds grew from €1,188 billion in 1995 to €2,484.4 billion in 2000 (see Annex 2). Investment funds have thus become much more important in asset terms than pension funds.

Over the following pages, an overview is given of the total asset size and allocation of traditional institutional investors, insurance companies, pension funds and investment funds. By way of comparison, reference is also made to total asset size of banks, although no aggregated breakdown exists of their asset management activities.

2.1 Insurance companies and pension funds

Both insurance companies and pension funds have witnessed mitigated growth within the EU. Insurance companies recorded an average annual growth of 13% between 1995 and 1999, decreasing to 7% in 2000. Likewise, pension assets were estimated at €2,400.8 million in 1999 compared to €1,189 million in 1995. This corresponds to an average annual growth of 14%, but it went down to only 3% in 2000 (see Table 4). 

5
The development of the global insurance industry over the past five years was largely attributable to a steady average annual growth of 15% in the life insurance business (slowing down however to 6.6% in 2000). The non-life insurance business experienced an average growth of 12% over the same period, decreasing to 0.4% in 2000 (see Table A2 in Annex 2).

The investment behaviour of pension funds and insurance companies shows more similarities across countries than across sectors. Pension funds and insurance companies in English-speaking countries traditionally invested the major part of their assets in equity while those in continental European countries invested the largest part in fixed income. These differences have become less pronounced recently, but they remain clearly noticeable. In Germany, France, Portugal and Italy, data on the distribution of insurance company assets, including life and non-life businesses, indicate an average investment of 60% in domestic fixed income and almost 35% in equity (see Table 1). This compares with 28% for domestic fixed income and 56% for equity in the UK and Ireland. The difference is even more pronounced for pension funds (see Table 2).

**Table 1. Asset allocation of insurance companies¹ (%, 2000)**

<table>
<thead>
<tr>
<th></th>
<th>Equity²</th>
<th>Fixed income³</th>
<th>Real estate⁴</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>35.3</td>
<td>59.1</td>
<td>3.0</td>
<td>2.7</td>
</tr>
<tr>
<td>DK</td>
<td>42.4</td>
<td>49.8</td>
<td>2.8</td>
<td>5.0</td>
</tr>
<tr>
<td>D</td>
<td>36.0</td>
<td>60.5</td>
<td>3.1</td>
<td>0.4</td>
</tr>
<tr>
<td>EL</td>
<td>24.5</td>
<td>70.4</td>
<td>5.1</td>
<td>0.0</td>
</tr>
<tr>
<td>E</td>
<td>6.7</td>
<td>71.5</td>
<td>4.9</td>
<td>17.0</td>
</tr>
<tr>
<td>F</td>
<td>30.3</td>
<td>63.9</td>
<td>4.7</td>
<td>1.1</td>
</tr>
<tr>
<td>IRL</td>
<td>56.5</td>
<td>26.1</td>
<td>8.2</td>
<td>9.2</td>
</tr>
<tr>
<td>I</td>
<td>19.4</td>
<td>50.1</td>
<td>3.4</td>
<td>27.1</td>
</tr>
<tr>
<td>L</td>
<td>44.1</td>
<td>54.3</td>
<td>0.3</td>
<td>1.3</td>
</tr>
<tr>
<td>NL</td>
<td>33.4</td>
<td>54.6</td>
<td>5.2</td>
<td>6.8</td>
</tr>
<tr>
<td>A</td>
<td>34.0</td>
<td>55.0</td>
<td>7.0</td>
<td>4.0</td>
</tr>
<tr>
<td>P</td>
<td>20.4</td>
<td>63.3</td>
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<td>11.0</td>
</tr>
<tr>
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<td>52.9</td>
<td>11.0</td>
<td>0.1</td>
</tr>
<tr>
<td>S</td>
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<td>43.0</td>
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<td>0.5</td>
</tr>
<tr>
<td>UK</td>
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<td>28.8</td>
<td>5.6</td>
<td>8.9</td>
</tr>
<tr>
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<td>47.5</td>
<td>4.7</td>
<td>5.9</td>
</tr>
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<td>CH</td>
<td>27.8</td>
<td>57.4</td>
<td>8.8</td>
<td>6.1</td>
</tr>
</tbody>
</table>

¹Total assets include non-life investments.
²Variable yield securities and units in investment funds and investments in affiliated undertakings.
³Including debt securities and other fixed income securities and loans including loans guaranteed and deposits with credit institutions.
⁴Land, buildings and participating interests.

Source: CEA (2002).

Asset allocation is often determined more by country-specific patterns than by investment restrictions. German pension funds (*pensionskasse*), for example, used to invest far less in equity than allowed by law (less than 10%). This phenomenon could also be observed in the
past in the Netherlands, which had no quantitative restrictions on pension fund investments. This situation changed considerably, however, over the second half of the 1990s.

Table 2. Asset structure of pension funds (% 2000)

<table>
<thead>
<tr>
<th>Countries</th>
<th>Equity</th>
<th>Fixed income</th>
<th>Real estate</th>
<th>Cash &amp; short term invest.</th>
<th>Other</th>
<th>Unallocated assets</th>
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</thead>
<tbody>
<tr>
<td>B</td>
<td>49.9</td>
<td>40.4</td>
<td>3.9</td>
<td>4.3</td>
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<td>0.0</td>
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<td>D</td>
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<td>0.3</td>
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<td>79.3</td>
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<td>25.5</td>
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<td>0.0</td>
</tr>
<tr>
<td>E</td>
<td>12.5</td>
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<td>11.1</td>
<td>7.2</td>
<td>30.4</td>
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<tr>
<td>F</td>
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<td>4.0</td>
<td>1.3</td>
<td>1.1</td>
<td>44.0</td>
</tr>
<tr>
<td>IRL</td>
<td>64.4</td>
<td>22.1</td>
<td>6.6</td>
<td>4.5</td>
<td>2.4</td>
<td>0.0</td>
</tr>
<tr>
<td>I</td>
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<td>10.9</td>
<td>1.0</td>
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<td>22.8</td>
</tr>
<tr>
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<td>NL</td>
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<td>A</td>
<td>9.7</td>
<td>19.4</td>
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<tr>
<td>P</td>
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<td>S</td>
<td>34.0</td>
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<td>UK</td>
<td>71.0</td>
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<td>EU-15</td>
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<td>9.2</td>
<td>4.5</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Source: Data from the website of EFRP (www.efrp.org).

Differences in pension fund asset structure may also be determined by country differences in pension schemes. In Ireland, the Netherlands, the UK and, to a lesser extent, the US, defined benefit schemes for pension plans were in operation, whereby the employee’s pension was based on a percentage of his or her final salary. Other continental European countries relied more heavily on defined contribution schemes, whereby accumulated contributions constitute the final pension. Defined benefit schemes promise a pension based upon the last years of salary. This can result in an actuarial deficit since the value of the pension is not directly related to the contributions of the employee. Such schemes, however, induced fund managers to take higher risks to cover future liabilities and thus invest a higher proportion in shares, which gave better returns over the long term. Most defined benefit schemes have been trimmed down gradually in the private sector, although they continue to be in use in the public sector.

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It is too early to say whether the sharp downturn in the equity markets of the past two years will change this assessment. The longer term here refers to 30 years. In the US, the equity market has generated an annual return of 7.1% since World War II, compared to 1.3% for bonds and 0.6% for short-term paper. Research on the French market has shown that a gain of 100% can be realised with stocks if they are held for 30 years (Jean-Paul Betbéze, *Le Monde*, 1 October 2002). More recent research has indicated that bonds have outperformed stocks since 1987 (*Financial Times*, 17 February 2003).
sector. Several of these are said to be under-funded today, and huge problems may emerge if the slump in equity markets continues.

Over the last decade, pension fund and insurance sector margins have gradually decreased, with several firms becoming under-funded. Compared to the mid-1990s, when life insurers worked with average gross investment returns of 8.4%, returns have come down to 4.9% in 2001. The overall pay-out to policyholders however has stayed at a minimum of 3.5%, implying that net returns have decreased from 4.9% to 1.4%. The reason for this is the continuing decline of interest rates in Europe, the recent fall in equity markets and high levels of default on corporate bonds. As indicated above, insurers and pension funds have gradually increased their investment in stock over the course of the 1990s, but the combination of low government bond rates and a continuous slump in equity markets have left many in poor shape. Moreover, guaranteed yields to policyholders are often set by law and do not change as rapidly as market circumstances deteriorate. Insurers have traditionally focused on the liability risk rather than the asset risk, which is also embedded in regulation.

2.2 Investment funds

The UCITS directive, adopted in 1985, has been successful in contributing to the growth of investment funds within the EU. UCITS (undertakings for collective investment in transferable securities) are established in all member states and their total asset value totalled almost 41% of EU GDP by the end of 2000. Between 1995 and 2000, the sector recorded an annual asset growth rate of more than 20%. Geographically, investment funds are most important in France, Italy and Spain, with the highest incidence occurring in Luxembourg. In Italy, Luxembourg and Spain, investment funds are more important in asset terms than insurance companies, while they are of comparable importance in France.

The most significant element of UCITS growth within the EU were equity funds which grew considerably to reach 45.1% of total asset spread in the sector by the end of 2000, compared to 25% in 1995 (see Figure A2 in Annex 2). This remarkable growth in equity funds began to slow down considerably in 2001 to reach 40.4%, substituted by a slight growth in bond and money market funds. The growth of equity funds over the second half of the 1990s is related not only to new net cash flow in funds, but also to the strong growth of major equity price indices pushing up the value of equity investments. This trend is accompanied by a rise in the supply of both pan-European and global equity funds. Indeed, data from FEFSI (Federation of European Securities Exchanges) have demonstrated an internationalisation process of equity fund portfolios in Europe since 1999. European equity funds invested mainly in domestic shares have dropped from 66% in 1992 to 38% in 2001. As such, equity funds have been important contributors to the integration of European capital markets (see Delbecque, 2002).

Growth in mixed asset funds has also been remarkable, suggesting that fund investors seemed to find a suitable risk-return balance in these types of funds. As far as bond funds are concerned, a slow growth was noted against a backdrop of declining interest rates. This affected to an even greater extent the share of assets invested in money market funds, which stagnated in volume terms but more than halved proportionally compared to other funds.

---

Table 3. Investment funds asset spread in the EU (in billions of euro and as % of total, 2001)

<table>
<thead>
<tr>
<th>Country</th>
<th>Total</th>
<th>Equity funds</th>
<th>%</th>
<th>Bond funds</th>
<th>%</th>
<th>Mixed funds</th>
<th>%</th>
<th>Money market</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>B†</td>
<td>77.0</td>
<td>46.3</td>
<td>60.1</td>
<td>10.6</td>
<td>13.7</td>
<td>18.9</td>
<td>24.6</td>
<td>1.3</td>
<td>1.7</td>
</tr>
<tr>
<td>DK</td>
<td>38.0</td>
<td>17.1</td>
<td>45.1</td>
<td>19.0</td>
<td>49.9</td>
<td>1.9</td>
<td>4.9</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>D</td>
<td>239.7</td>
<td>124.6</td>
<td>52.0</td>
<td>60.1</td>
<td>25.1</td>
<td>20.6</td>
<td>8.6</td>
<td>34.4</td>
<td>14.3</td>
</tr>
<tr>
<td>EL</td>
<td>26.8</td>
<td>5.5</td>
<td>20.4</td>
<td>5.6</td>
<td>20.9</td>
<td>6.0</td>
<td>22.6</td>
<td>9.7</td>
<td>36.2</td>
</tr>
<tr>
<td>E</td>
<td>177.9</td>
<td>49.2</td>
<td>27.6</td>
<td>53.2</td>
<td>29.9</td>
<td>31.7</td>
<td>17.8</td>
<td>43.8</td>
<td>24.7</td>
</tr>
<tr>
<td>F</td>
<td>800.2</td>
<td>206.8</td>
<td>25.8</td>
<td>138.7</td>
<td>17.3</td>
<td>197.0</td>
<td>24.6</td>
<td>257.7</td>
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</tr>
<tr>
<td>IRL†</td>
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<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a</td>
<td>n.a.</td>
<td>n.a</td>
<td>n.a.</td>
</tr>
<tr>
<td>I</td>
<td>403.7</td>
<td>110.6</td>
<td>27.4</td>
<td>158.9</td>
<td>39.4</td>
<td>87.5</td>
<td>21.7</td>
<td>46.7</td>
<td>11.6</td>
</tr>
<tr>
<td>L</td>
<td>851.1</td>
<td>318.2</td>
<td>37.4</td>
<td>328.2</td>
<td>38.6</td>
<td>113.5</td>
<td>13.3</td>
<td>91.2</td>
<td>10.7</td>
</tr>
<tr>
<td>NL</td>
<td>88.8</td>
<td>48.2</td>
<td>54.3</td>
<td>23.1</td>
<td>26.0</td>
<td>17.5</td>
<td>19.7</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>A</td>
<td>61.9</td>
<td>12.6</td>
<td>20.4</td>
<td>39.3</td>
<td>63.5</td>
<td>9.1</td>
<td>14.6</td>
<td>0.9</td>
<td>1.4</td>
</tr>
<tr>
<td>P</td>
<td>18.6</td>
<td>2.2</td>
<td>12.0</td>
<td>7.0</td>
<td>37.7</td>
<td>1.8</td>
<td>9.4</td>
<td>7.6</td>
<td>40.9</td>
</tr>
<tr>
<td>FIN</td>
<td>14.5</td>
<td>6.2</td>
<td>42.7</td>
<td>2.2</td>
<td>14.9</td>
<td>3.1</td>
<td>21.5</td>
<td>3.0</td>
<td>20.9</td>
</tr>
<tr>
<td>S</td>
<td>73.6</td>
<td>52.4</td>
<td>71.3</td>
<td>3.7</td>
<td>5.1</td>
<td>13.5</td>
<td>18.3</td>
<td>3.9</td>
<td>5.3</td>
</tr>
<tr>
<td>UK</td>
<td>389.4</td>
<td>309.3</td>
<td>79.4</td>
<td>42.1</td>
<td>10.8</td>
<td>36.4</td>
<td>9.3</td>
<td>1.7</td>
<td>0.4</td>
</tr>
<tr>
<td>EU-12</td>
<td>2760.2</td>
<td>930.4</td>
<td>33.7</td>
<td>826.8</td>
<td>30.0</td>
<td>506.7</td>
<td>18.4</td>
<td>496.3</td>
<td>18.0</td>
</tr>
<tr>
<td>EU-15</td>
<td>3476.3</td>
<td>1309.2</td>
<td>40.1</td>
<td>891.5</td>
<td>27.3</td>
<td>558.4</td>
<td>17.1</td>
<td>502.0</td>
<td>15.4</td>
</tr>
<tr>
<td>CH</td>
<td>84.9</td>
<td>39.2</td>
<td>46.2</td>
<td>16.7</td>
<td>19.7</td>
<td>23.5</td>
<td>27.6</td>
<td>5.5</td>
<td>6.5</td>
</tr>
<tr>
<td>US</td>
<td>7914.4</td>
<td>3878.6</td>
<td>49.0</td>
<td>1049.7</td>
<td>13.3</td>
<td>393.0</td>
<td>5.0</td>
<td>2593.2</td>
<td>32.8</td>
</tr>
<tr>
<td>JP†</td>
<td>390.2</td>
<td>128.5</td>
<td>32.9</td>
<td>195.2</td>
<td>50.0</td>
<td>0.0</td>
<td>0.0</td>
<td>66.6</td>
<td>17.1</td>
</tr>
</tbody>
</table>

† Mixed funds include 10 pension-saving funds with total net assets of €7.4 billion.
‡ Total of sectoral funds exclude Ireland, for which no breakdown by type of funds is available.
§ Japanese equity funds include mixed funds.

As can be deduced from the data in Table 3, it is difficult to draw general observations regarding the importance of different types of funds across the EU. A common European investment attitude or regional pattern is not in place. Rather, the ranking in importance of different forms of funds seems to be based on country-specific reasons. In 2001, equity funds were the most important fund vehicle in the UK, Sweden, Belgium and the Netherlands. Bond funds were most important in Austria, Denmark, Italy and Luxembourg and money market funds in Portugal, Greece and France. In general, the split may reflect differences in the investment behaviour of other institutional investors, as investment funds are also held by other institutional investors. To the extent that investment funds are held by individual citizens, it reflects the large differences in investment behaviour across countries.

Continuing pronounced differences in investment behaviour across countries reveal that a pan-European fund marketing strategy would be difficult. A closer look reveals that,
notwithstanding the existence of a single regulatory regime in the UCITS directive, the market is far from unified. This is obvious from the fact that the EU has three times as many registered funds as the US (by end 2000, the EU had 24,716 funds under management, as compared to 8,171 in the US). The average fund size in the EU is one-fifth of that found in the US (€176 million as compared to €910 million in March 2001). Although funds are sold on a cross-border basis in the EU, foreign entry is low in the large EU markets (Heinemann and Jopp, 2002). Funds are often developed in another jurisdiction, such as Luxembourg or Dublin, to be sold back on the home market (“round trip”). This is also done for regulatory reasons and is part of a trend towards specialisation among financial centres.

Knowing that scale matters in asset management, this pronounced market fragmentation impacts on average costs. In the US market, a negative correlation was found between fund size and fund costs – the average cost declining from 1.25% for a $51-200 million assets fund to 0.87% for a $1 billion fund. Applying the same methodology, a recent study estimated that the cost of fragmentation in the EU market was about €3 to €5 billion, whereby the latter figure refers to the cost saving that could be made if the average US fund size could be reached (Heinemann and Jopp, 2002). Fragmentation also limits the choice of investment products and reduces competition, the cost of which is difficult to quantify. While many of the differences between markets are rooted in structural factors such as consumer preferences and distribution networks, others are policy-induced and could be addressed by policy-makers. This is discussed in more detail in the next chapter.

The structure of the European banking sector also impacts on the competitiveness of the fund industry. Unlike the US, funds in Europe are mostly sold through banks, which have a strong bias towards their own funds. In Germany, 80% of funds are sold through bank branches, 70% in France and 61% in Spain. In the UK, independent advisers are the most important sales channel, while in Italy distribution is split equally among banks and independent advisers (both about 43%). In the US, only 8% are sold through bank branches, the most important channels being brokers and direct sales (Walter and Smith, 2000, p. 235). As European bank restructuring has mainly happened at the national level, this will not have had the effect of increasing competition or improving customer choice. On the contrary, it may have strengthened vertical integration in European financial markets.

<table>
<thead>
<tr>
<th></th>
<th>95-96</th>
<th>96-97</th>
<th>97-98</th>
<th>98-99</th>
<th>99-00</th>
<th>00-01</th>
<th>AAG 95-99</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment funds</td>
<td>21%</td>
<td>23%</td>
<td>30%</td>
<td>33%</td>
<td>15%</td>
<td>1%</td>
<td>27%</td>
</tr>
<tr>
<td>Pension funds</td>
<td>10%</td>
<td>19%</td>
<td>12%</td>
<td>15%</td>
<td>3%</td>
<td>n.a.</td>
<td>14%</td>
</tr>
<tr>
<td>Insurance</td>
<td>12%</td>
<td>19%</td>
<td>10%</td>
<td>10%</td>
<td>7%</td>
<td>n.a.</td>
<td>13%</td>
</tr>
</tbody>
</table>

1 Average nominal annual growth between 1995-99.

Sources: CEA, Eurostat, EFRP, FEFSI and OECD.
Table 5. Total assets of investment funds, pension funds, insurance companies and banks (2000, billions of euro and % of GDP)

<table>
<thead>
<tr>
<th></th>
<th>GDP</th>
<th>Investment funds % GDP</th>
<th>Pension funds % GDP</th>
<th>Insurance % GDP</th>
<th>Banks % GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
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<td>74.6</td>
<td>30.3</td>
<td>14.5</td>
<td>5.9</td>
</tr>
<tr>
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<td>19.7</td>
<td>42.0</td>
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</tr>
<tr>
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<td>12.4</td>
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</tr>
<tr>
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<td>4.2</td>
</tr>
<tr>
<td>E</td>
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<td>42.4</td>
<td>7.0</td>
</tr>
<tr>
<td>F</td>
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<td>765.9</td>
<td>54.9</td>
<td>92.2</td>
<td>6.6</td>
</tr>
<tr>
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<td>148.7</td>
<td>144.3</td>
<td>52.5</td>
<td>51.0</td>
</tr>
<tr>
<td>I</td>
<td>1165.7</td>
<td>449.9</td>
<td>38.6</td>
<td>30.0</td>
<td>2.6</td>
</tr>
<tr>
<td>L</td>
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<td>0.2</td>
</tr>
<tr>
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<td>101.8</td>
<td>25.3</td>
<td>445.0</td>
<td>110.8</td>
</tr>
<tr>
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<td>83.2</td>
<td>40.4</td>
<td>24.7</td>
<td>12.0</td>
</tr>
<tr>
<td>P</td>
<td>113.5</td>
<td>18.6</td>
<td>16.4</td>
<td>13.1</td>
<td>11.5</td>
</tr>
<tr>
<td>FIN</td>
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<td>13.5</td>
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<td>11.8</td>
<td>8.9</td>
</tr>
<tr>
<td>S</td>
<td>246.6</td>
<td>83.2</td>
<td>33.7</td>
<td>139.6</td>
<td>56.6</td>
</tr>
<tr>
<td>UK</td>
<td>1533.1</td>
<td>415.5</td>
<td>27.1</td>
<td>1240.2</td>
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</tr>
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<tr>
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<td>7485.5</td>
<td>69.7</td>
<td>9729.262</td>
<td>90.6</td>
</tr>
<tr>
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<td>464.3</td>
<td>9.0</td>
<td>2109.7</td>
<td>49.9</td>
</tr>
</tbody>
</table>

¹Provisional value of pension funds in 2000.

Sources: CEA, Eurostat, EFRP, FEFSI and OECD (2002).
CHAPTER 3
THE REGULATORY CONTEXT

In regulatory terms, the asset management industry as such does not exist. Rather, the regulatory regime depends upon the particular licence that the financial institution in question possesses. This may be as a bank, insurance company, pension fund, broker or investment fund, which immediately raises the question of possible inconsistencies across regulatory regimes, or arbitrage between regimes. For certain forms of the asset management business, which definitively belong to one of these groups, the choice will be non-existent; for others, however, it will present itself as an issue.

Diversity is one striking factor in the regulatory framework. This is a reflection of differences in the relative importance of various sectors from one country to another, as outlined in the previous chapter. Although sector regulation has been harmonised to a large extent at the European level, implementation of EU rules may vary, with supervisory structures and practices continuing to differ from country to country.

This chapter begins with a discussion of the rationale behind regulation in the asset management sector and the different approaches followed. Secondly, rules applicable to the asset management industry following sectoral subdivisions will be reviewed. The focus will essentially be on investment and asset allocation rules, followed by a brief reference to some horizontal directives affecting the sector, and an evaluation of the different regimes.

3.1 Rationale for the prudential regulation of asset management

Why should the asset management business be regulated? If asset management is about managing funds for third parties, would general regulation to prevent fraud and to ensure due diligence by managers not be sufficient? Following this line of reasoning, asset management regulation would, in essence, be composed of basic prudent person asset diversification rules, as well as comprehensive conduct-of-business rules to protect consumers. Unlike banking, where consumer deposits are invested in illiquid loans to enterprises and where a string of bad investments can give rise to systemic effects, a capital cushion would, in principle, not be needed. Asset managers’ funds are generally invested in liquid securities, which can be realised immediately. The task of the asset manager is to provide a good return for investors, or to ensure that his or her claims can be honoured in the case of accident or death. If the manager does not realise good returns, the investor can change shop. More regulation in the form of capital requirements would make asset management more costly or might create protective entry barriers. Too high a level of protection of investors, for example in investor compensation schemes, might reduce market discipline and create some form of moral hazard behaviour. Proper incentives should be in place for investors to monitor carefully in whose hands they leave their investments.

In practice, prudential capital regulation has developed in response to market failures as a safeguard against systemic risk and to protect consumers. Since taxpayers will incur much of the cost of the failure of an institution to adequately manage its business, minimum capital standards can be used to ensure that institutions do not abuse such protection. Minimum capital requirements for asset managers can also form a buffer against large shocks that affect the financial system. One firm’s decision to increase its capital base to face such circumstances would benefit other firms that do not maintain sufficient capital, hence the need to require all firms to maintain a minimum capital standard – the level playing field argument. Consumer protection is probably the most important argument for capital regulation in asset management. Since a consumer finds it difficult to evaluate the financial soundness of the firm, they may be vulnerable to adverse selection. They may select a firm that is not in a position to deliver the benefits that are promised in the future, for example. A capital requirement may be a form of...
threshold, although somewhat crude, to ensure a minimum protection for consumers. Allocation rules in asset management have developed on the basis of these arguments, albeit in different ways across countries. Well diversified portfolios should form a better buffer against systemic risk (e.g. internationally diversified) and provide better average returns to investors over time.

The fact that US securities law does not impose minimum capital requirements on mutual fund managers shows that there is no general consensus on this point. Crude capital requirements do not take into account the risk profile of the institution in question. They may level the playing field between different financial institutions whereby they equalise the threats they pose for the financial system, without providing an incentive for more prudently managed firms, or taking the different nature of firms into account. A more internal ratings-based approach, as is being proposed in the context of the Basel Capital Adequacy Review, is also gaining favour in the area of asset management. A recent report for the European Commission on the application of solvency ratios in the insurance industry proposed to apply the same three-pillar approach to insurance (European Commission, 2002).

The situation in the insurance sector is somewhat different from that in the fund management sector. Unlike fund management companies, insurance companies insure policyholders against risks, such as retirement, death, accident, fire, etc. To face potential claims from policyholders, insurers calculate the reserves needed on the basis of longevity, mortality and accident statistics. Without a minimum solvency regulation, insurers could rely on their premium income and investment returns to meet claims. In these circumstances, the risk of insolvency would be very high, and an insurer could easily declare bankruptcy if claims exceeded premium income and asset returns, leaving consumers disgruntled and the cost of an eventual bail-out to the state.

Risk to insurance companies increases with rapid and sudden change in certain patterns, such as natural disasters, rapid increases in longevity or, as noticed recently, variances in financial markets. Insurance managers may often not take such sudden changes into account and assume that certain trends of the past will continue. Moreover, certain insurance companies and pension funds promise their policyholders guaranteed annuities, providing a certain income to the point of death. In other cases, minimum returns on life insurance policies are set by the state. The important thing for supervisors is to closely monitor the reserves that are set aside for embedded options in the annuity contract. Declining mortality and long bond rates, for example, increase the risk of losses, threaten the annuity stream, and eventually lead to the insolvency of the insurer, as seen with Equitable Life in the UK. Further increases in reserves at an early stage are needed in such cases (Davis, 2002, p. 11).

According to Davis, the case for quantitative portfolio restrictions is strong for companies with guaranteed annuities. For such institutions, the matching of assets with similar duration is a desirable strategy. Strict portfolio regulations, however, could limit the opportunity to seek higher returns in order to develop new products. Prudent-person-based diversification and solvency rules, as well as comprehensive conduct-of-business rules to protect consumers, should be sufficient for a general insurer (Davis, 2002, p. 16).

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5 Also under the recently enacted Gramm-Leach-Bliley Act, investment management company affiliates of Financial Holding Companies are exempt from capital requirements. Gramm-Leach-Bliley prohibits the Federal Reserve Board from imposing capital adequacy rules on functionally regulated (this means regulated by the SEC) non-depository subsidiaries of Financial Holding Companies. Nevertheless, some state regulatory authorities in the US have imposed minimum capital requirements (see Calomiris and Herring, 2002, pp. 14-15).
3.2 The European regulatory framework

EU regulation covering the free provision of financial services in the asset management industry started with the UCITS (undertakings for collective investment in transferable securities) directive of 1985, which introduced the single licence for selling investment funds in the EU. It was followed in the early 1990s with the single licence directives covering banking, insurance and investment services sectors. The UCITS directive was amended and expanded in 2002 to become a more horizontal asset management directive. A provisional agreement was also reached in 2002 on the last outstanding piece of free provision of services regulation in the financial services sector, the pension funds directive.

Some horizontal elements of EU legislation are also of relevance to the asset management industry, the most important being the distance selling of financial services directive, on which a final agreement was reached in May 2002. The draft conglomerates directives will also be discussed briefly.

3.2.1 Investment funds

The 1985 UCITS directive opened the way for the cross-border sale of investment funds in the EU. Subject to some general criteria regarding authorisation, legal structure, investment policies and disclosure, units of open-ended funds that invest in transferable securities could be sold freely throughout the EU. Marketing and tax rules did not fall within the scope of this directive, which meant that they remained host-country issues. Prospectuses had to be translated into the official language of the host country, for example, and local consumer protection regulation had to be respected. Nor did the directive harmonise the prudential requirements of the companies managing investment funds. For example, it did not set a minimum capital standard or solvency requirements. This was modified by the 2002 amendments.

The investment policy rules of the UCITS I were fairly liberal. UCITS could invest in a diversified portfolio of listed equity and debt securities, respecting the 5/10/40% rule: limits apply of 5% for stock of a single body (which can be extended to 10% by the home country authorities), and an overall limit of 40% for the total of large single blocks of securities. A limit of 10% applied for non-listed securities. Exceptions applied for government or government guaranteed paper. The limit applicable for investment in other funds was 5% of the whole portfolio, meaning that funds of funds were not permitted. Real estate and commodity funds were excluded from the directive, as were money market instruments.

The 2002 UCITS amendments expand and detail the UCITS I directive. One directive (UCITS II or the “Product Directive”) widens the investment possibilities of funds to instruments such as derivatives and allows for new forms of funds, such as funds of funds, money market funds, cash funds or index tracker funds. A second directive (UCITS III or the “Promoter Directive”) details minimum standards, including the introduction of a minimum level of own funds, and broadens the permissible activities of the fund management company. It also introduces a simplified prospectus, which provides for easier and comparable information to investors. The amendments need to be implemented by the member states by August 2003, although existing UCITS may be “grandfathered” for a further five years from the date when the amended directive comes into force (at the latest in August 2003), meaning that they will be allowed to continue to function temporarily under the UCITS I framework.

The new UCITS directives did not come about easily, but the end-result is gaining broad acceptance in policy and industry circles. An earlier proposal for expanding the scope of the

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6 Olle Schmidt, Member of the European Parliament and rapporteur for the directive, said at the first meeting of the Task Force on 29 November 2001, that "the common position on the directive strikes a good balance between investor protection and investment freedom, between the demands of the
directive had to be withdrawn in 1995, and subsequent drafts took almost four years to be formally proposed by the EU Commission.\(^7\) These directives are not yet of the “framework” type, with broad implementing powers for a Securities Committee, as proposed by the Lamfalussy Group, since they were proposed before this new procedure was adopted. UCITS I provided for a “Contact Committee” with limited implementing powers, which are somewhat extended by UCITS II, but not comparable to what is being proposed in the post-Lamfalussy context.

Correct implementation of the directive by member states (and the Accession Countries) will be crucial. The European Commission and member state authorities will need to demonstrate that, even if the directives date from pre-Lamfalussy times, the new approach will be applied in practice, meaning that member states’ authorities will need to cooperate fully in order to ensure correct implementation, while the Commission will undertake enforcement procedures. It remains to be seen whether all parties are amenable to this aim. The Economic and Financial Committee (EFC) has, in the context of the extension of the Lamfalussy procedures, proposed to integrate the UCITS Committee within the Securities Committee-CESR structure (EFC, 2002), but this still gives rise to legal problems. Only through a formal change to the UCITS II directive can the existing UCITS Contact Committee be integrated into the Securities Committee structure,\(^8\) and even more so for the expansion of articles that can be revised by such a Committee.

The most important achievement of the updated UCITS is the single licence for fund management companies. The 1985 UCITS directive did not give the single passport to companies, but only to the cross-border marketing of its units. The minimum harmonisation at company-level in the 1985 directive was very limited and, in this respect, it could be considered surprising that the UCITS I directive has been so successful. The UCITS III directive grants the “single licence” to fund management companies in the broad sense of the word. It does not only comprise of the management of investment funds, the “core services”, but also other forms of portfolio management, such as pension funds for individuals, investment advice, safekeeping (custody) and administration of investment funds, which are seen as “non-core” or ancillary.\(^9\) A fund management company, which has been duly authorised in one member state, can thus also offer pension fund management services in another member state, provided the pension fund in the host country is allowed to do so under its local laws (i.e. awaiting the adoption of the draft pension funds directive, discussed below).

UCITS III introduces a minimum capital requirement of €125,000 for investment fund companies and an on-going own capital of 0.02% of total assets (with a maximum of €10 million when the assets exceed €250 million). Total own funds however can never be lower than the amount described under “other risks” in the capital adequacy directive (directive 93/6/EEC, henceforth CAD), which states that a company’s own funds shall never be less than 13 weeks of “fixed overheads”. This could also include, when the New Basel Capital Accord comes into force in the EU, an operational risks charge as foreseen for banks and investment

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\(^7\) The 1993 proposal to expand investment funds to money market funds stranded as a result of the turmoil on European currency markets. See Proposal for a Council directive amending 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), COM(93)37 of 9 February 1993, OJ C 59 of 2.3.93.

\(^8\) See Art. 53 of UCITS I and Art. 53a of UCITS II.

\(^9\) Other forms of portfolio management, i.e. management of pension fund portfolios or those of individuals, are presented as a form of “derogation” from the central objective of the directive, which is management of investment funds as authorised under the directive (Art. 5). The wording of this Art. 5 alone already indicates how important a close scrutiny of the implementation process will be.
firms. The directive also stipulates that up to 50% of ongoing capital requirement can be replaced by a guarantee from a bank or insurance company. The new capital requirement of the directive is not seen as problematic by the industry, as most companies hold a multiple of what is required by the directive.10

Minimum standards for the conduct of business by investment fund companies are harmonised and monitored by home country authorities. The company must act honestly and fairly, with due care and diligence, having the resources and procedures in place that are necessary for the proper performance of activities. It must try “to avoid conflicts of interest, and when they cannot be avoided, ensure that the UCITS it manages is fairly treated” (Art. 5h). Persons directing the management company must be of “good repute” and “sufficiently experienced”, and their names must be communicated to the competent authorities. The conduct of the company must be at least decided by two persons meeting these conditions.11 In case the investment company provides “non-core” or ancillary services, the conduct-of-business rules of the investment services directive (ISD) shall apply (see below).

UCITS III also introduces a simplified prospectus for the sale of harmonised investment funds, which, according to the industry federation FEFSI, is much more investor friendly. Prospectus documentation needs to be composed of a full and a simplified prospectus, which must be kept up to date, and an annual and half-yearly report. All these documents need to be published in the official language(s) of the host country but should allow for cross-border recognition without additional documents.12 The notification and translation requirements of UCITS continue to vary from one member state to another, however. Although the directive specifies which documents need to be provided to the authorities, many countries require additional information, a fund’s board minutes for example, which also need to be translated.13 Such requirements lengthen the registration period. This again underlines the need for tight scrutiny of the implementation process and a strong structure for cooperation among supervisory authorities.

UCITS II determines what kind of funds can be sold with a single licence and sets investment allocation rules. It now also covers funds invested in money market instruments, index funds (funds of funds), other funds and derivatives. The investment limits of the 1985 directive have been further detailed, depending on the instruments. Overall, the 5/10/40% rule continues to apply. Maximum levels of 10% apply for investments in money market instruments issued by the same body, and of 20% for investments in one single other fund (also applicable for index tracker funds) and for deposits with credit institutions.

The 2002 UCITS amendments are seen to be important contributors to the further growth of European capital markets in general, and the European investment fund markets in particular. It is expected that the euro commercial paper market should flourish as a result of the expansion

10 According to Patrick Zurstrassen at the ICBI Fund Forum in Rome of July 2002.
11 Requirements could have gone further, by requiring funds to have independent directors, as is the case in the US, and an audit committee, but this was regarded as expensive and too difficult to realise by the industry. For an overview of governance systems of UCITS, see Thompson and Choi (2001).
12 For comparison, the draft prospectus directive regarding initial offerings of securities (July 2001, updated August 2002), proposes that only the summary note will have to be translated for cross-border offerings in case the registration document and securities note are published in a language that is “customary in the field of finance”. But UCITS III does not follow the maximum harmonisation approach of the prospectus directive.
to money market funds.\textsuperscript{14} It is well known however that, in the area of index tracking funds, problems in respecting the 5/10/40\% rule may occur. Many European sector-based indexes cannot be tracked exactly without exceeding the 40\% rule, some even exceed the 10\% rule since there are not enough companies in a certain sector present in the index, or there are a few big firms dominating the sector, and thus the index (see Table 6 below). UCITS II tries to respond to these issues by Art. 22a, which gives the possibility of raising the single entity limit to 20\%, but it is unclear how this fits in with the general rule and thus with the consistency of the text. It should be added, however, that these index tracking funds are not necessarily registered as UCITS.

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|c|c|}
\hline
\textbf{Sector} & \textbf{Number of shares in index} & \textbf{Shares $>10\%$} & \textbf{Share of large blocks $>40\%$ rule} & \textbf{Weight of 5 largest shares} \\
\hline
Food (F&B) & 25 & 3 & 70.1\% & 70.1\% \\
Media & 37 & 1 & 37.4\% & 42.1\% \\
Techno & 37 & 3 & 65.2\% & 65.2\% \\
Telecom & 27 & 2 & 74.2\% & 56.9\% \\
Chemicals & 16 & 3 & 74.0\% & 63.7\% \\
Healthcare & 36 & 4 & 81.4\% & 74.1\% \\
Retail & 27 & 1 & 63.3\% & 47.1\% \\
Banks & 66 & 1 & 36.4\% & 36.4\% \\
\hline
\end{tabular}
\caption{Weighting of shares in European sector-based DJ Stoxx indexes (following the 5/10/40\% rule)}
\end{table}

\textit{Source:} DJ Eurostoxx (as of 27 May 2002).

### 3.2.2 Insurance companies

European insurance markets were liberalised in two steps. The “third-generation” insurance directives, which introduced the single passport in the insurance sector, came into force in July 1994, but was preceded in 1990 by a form of partial liberalisation for informed customers on the life insurance side and large risks on the non-life side. Harmonisation of asset allocation rules only occurred in the “third-generation” insurance directives, which introduced minimum rules for the qualitative and quantitative investment of assets. The minimum solvency margin (the capital adequacy of the insurance sector) has recently been updated.\textsuperscript{15}

In insurance, potential policyholder claims are backed by technical provisions that are set to cover anticipated claims and associated costs arising from the policies underwritten. The “third-generation” insurance directives set rules for admissible assets to cover technical provisions and their diversification. With regard to admissible assets, the directives only set some general principles that needed to be followed, leaving member states the choice of whether to establish more detailed quantitative rules. As for diversification, maximum percentages apply for single blocks of real estate investment ($<10\%$), cash ($<3\%$), non-listed securities ($<10\%$), single holdings ($<10\%$) and the total of single large holdings or loans. As with UCITS, the 5/10/40\% rule for investment in tradable securities also applies to insurance.


\textsuperscript{15} Issues related to the regulation and supervision of insurance companies in the EU are the subject of a new CEPS Task Force created in 2003.
companies. Member states can lay down more detailed rules – in this case lower maximum percentages on asset diversification for firms under their supervision following certain general criteria. The directives also contain rules on currency matching, which prohibit insurance firms from holding more than 20% of their assets denominated in currencies that do not match the currency denomination of liabilities.

In the implementation of the third insurance directives, most continental European countries have continued to apply detailed quantitative restrictions on admissible assets and have transposed asset diversification rules as prescribed in the directive. The UK, on the contrary, has relied more on the prudent-person rule, and likewise for the diversification rules. The end result is that asset allocation in the insurance sector has continued to differ, as exemplified above, depending on local traditions and different views on risk and admissible assets. Since restrictions come at a cost in average, real or nominal returns, competition should benefit more prudent-person-based rules, and thus lead to a further reduction or elimination of quantitative limits in national law.

Insurance companies are required to maintain a guarantee fund or a buffer that they need in order to cover unexpected losses and costs as minimum capital. Moreover, they must reinsure part of their risks with reinsurance companies. A recent directive increased the minimum guarantee fund to €3 million (or €2 million for certain classes of non-life insurance). The guarantee fund should be at least equal to one-third of the solvency margin, which is proportional to the total business underwritten. Supervisors have also been given increased powers to intervene in obliging insurance companies to maintain a higher solvency margin in case policyholders’ interests are threatened. An ongoing review (the Solvency II project) is seeking to establish a system that better matches the true risks of an insurance company. A recent study proposes to apply to the insurance sector the same three-pillar approach suggested in the context of the Basel Review (European Commission, 2002). It adds however that an approach to risk-modelling may not be achievable or necessarily desirable in leaving firms sufficient scope for innovation in risk management. Prudential supervision is indeed starting to become more and more comparable to what is being discussed in banking or what is applicable to it.

### 3.2.3 Pension funds

After an initial failure in the early 1990s, the European Commission succeeded with its new proposal for the liberalisation of pension fund management and investment in the EU, which is expected to be formally adopted in the first half of 2003. Although the draft is less far-reaching than the first and its scope more restrictive, it definitely introduces the single licence for pension funds with the “prudent man” as the basic investment rule. It inaugurates a Community legal framework for pension funds, the last area of the financial services sector where no Community legislation had previously existed. The directive does not harmonise vesting rules, nor does it affect the tax treatment of contributions to pension funds or the pay-out by pension funds, which will be the subject of another proposal.

Today, as a result of the absence of a Community legal framework, pension funds are regulated on a variety of bases in the member states, as either insurance companies, investment funds or pension funds. This implies a cost for employers and employees in the contributions to pension funds, in possible lower return on funds and in additional administrative expenses.

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Contributions to pension funds established in other member states are not tax-deductible, which obliges migrating employees to be members of funds in different member states, or imposes extra costs on firms when making pension contributions on behalf of their employees. Custodians of pension funds are often required to have a separate establishment in the member state in which the fund resides. Restrictions on pension fund investments have not been harmonised, implying possible lower returns from the perspective of optimal portfolio allocation. An overview of the most important quantitative restrictions on pension fund investments in Europe is given in Table 7.

Table 7. Most important quantitative restrictions on pension fund investments in Europe

<table>
<thead>
<tr>
<th>Country</th>
<th>Restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>&gt;15% in government bonds</td>
</tr>
<tr>
<td>DK</td>
<td>rules of the EU’s 3rd life insurance directive, 80% currency-matching</td>
</tr>
<tr>
<td>F</td>
<td>&gt;50% EU government bonds</td>
</tr>
<tr>
<td>D¹</td>
<td>&lt;35% EU equities, &lt;25% EU property, &lt;6% non-EU equities, &lt;6% non-EU bonds, &lt;20% overall foreign assets, &gt;70% currency-matching</td>
</tr>
<tr>
<td>I</td>
<td>&lt;20% liquid assets, &lt;50% non-listed OECD securities, &lt;5% non-OECD securities, &gt;30% currency-matching</td>
</tr>
<tr>
<td>P</td>
<td>&lt;40% in foreign equity</td>
</tr>
<tr>
<td>CH</td>
<td>&lt;50% real estate, &lt;30% Swiss equities, &lt;30% foreign loans, &lt;25% foreign equities</td>
</tr>
</tbody>
</table>

¹ Rules for Germany refer to insurance companies and pensionskasse; new legislation has recently introduced the prudent-man rule for a new type of pension funds.


The first proposal for a directive had to be withdrawn by the European Commission in 1994, mainly as a result of broad disagreements regarding pension fund investment policies, but also as a result of the ignorance and ideological stances of some member states. The draft pension funds directive contained only qualitative, prudent-person-based rules for the spread of investments in the EU, and a lower currency-matching rule than the life insurance directives, which represented the main stumbling block of the proposal. This directive would thus have favoured retirement savings in the form of pension funds, as compared to group insurance schemes, which are subject to life insurance directive rules.¹⁹ Some member states with pension funds, such as Denmark, however, have made their pension funds subject to the rules of the life insurance directives, but most other member states with sizeable pension funds have kept them under a separate legal regime.

Under the new UCITS III directive, fund managers will be able to offer their services for the management of investment portfolios on a European basis, including those of pension funds. Pension funds from the different states however can still be required to follow specific rules for asset allocation, as in force within their territory. Moreover, UCITS III does not affect the right of member states to require pension funds to have a separate licence.

The proposal on which agreement was reached at the Ecofin Council on 4 June 2002 overcomes these barriers.²⁰ It introduces the single passport for pension fund management and investment in the EU, under the control of the home country. It lays down the prudent-man

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¹⁹ This was the reason why the insurance sector in some member states strongly opposed the first draft. See Lannoo (1996) for a detailed assessment of the failure of the first draft directive.

²⁰ The formal common position by the EU Council followed on 5 November 2002, after which it was sent to the European Parliament for a second reading. The EP reinstated the “biometric risk” amendment in the second reading.
principle for investments, meaning that assets need to be invested taking qualitative criteria into account (nature and duration, proper diversification). In this sense, the Council compromise follows the European Commission proposal. Remaining provisions are left to mutual recognition between member states, such as the calculation of technical provisions or the governance of pension funds.

Technical provisions and funding proved to be quite controversial subjects. With respect to the former, major concerns were expressed regarding the method of calculation, certifications by actuaries and the role of insurance advisors. Additional issues raised related to a lack of confidence in the proposed technical provisions and the fact that if a minimum nominal rate would have been set, more harmonisation would be envisaged than in life insurance proposals. The directive therefore left it to the member states to set more detailed rules. With regards to funding, there was some suspicion surrounding the possibility of derogating from full funding. Specific provisions were nevertheless accepted to depart from it. In the case of cross-border activity, technical provisions shall be fully funded at all times. For the calculation of the solvency margin, the rules of the life insurance directive shall apply.

Only one quantitative restriction on investment rules is general to the directive, i.e. the limit for investments in the sponsoring undertaking, which is set at 5% per individual undertaking (and 10% for the group). For the remainder, the key feature of the directive is the prudent-man principle as the main guiding mechanism for asset allocation. Member states may lay down more detailed quantitative rules for institutions established within their jurisdiction, provided that they do not lower the threshold for investments in shares or similar instruments below 70% and non-matching currencies below 30%. Member states can apply the same investment rules to the occupational pension business of life insurance companies (covered by directive 92/96/EEC), in which case the business is ring-fenced, managed and organised separately from the insurance company’s other activities, without any possibility of transfer.

In the event of cross-border activity, the competent authorities of each host state may impose additional quantitative restrictions, provided the same or stricter rules apply to institutions located in that state. In this case, the following rules may apply: a maximum of 5% with a single issuer (10% for a single group), a maximum of 30% of shares traded on non-regulated markets, and a maximum of 30% of assets in non-matching currency. This addition of the so-called “prudent-person-plus” rule (Art. 18.7) was necessary to reach a compromise in the Council, but it is expected that these restrictions will probably be limited to four member states. If these restrictions are applied, the home member state of a pension fund not applying these quantitative restrictions can ask the investments (assets and liabilities) of the pension fund in the country that applies these restrictions to be ring-fenced, without any possibility of transfer.

Pension fund members will need to be adequately informed regarding the investment policy’s level of benefits in case of termination of employment, accrued entitlements and investment risk. The directive will not apply to institutions managing social security schemes or to companies using book-reserve schemes. The application to civil servant pension funds is left to the discretion of member states.

With cross-border membership, the underlying principles ask for prudential requirements plus supervision by the home member state, while social and labour law requirements are left to the host member state. The host state may only intervene in a last resort should some sort of misconduct take place. It has, in principle, the duty to inform the home authority of the pension fund at which point the home regulator is expected to act. The above may only properly function under the cooperation and exchange of information among national authorities, which

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21 The draft directive says, “In particular, member states may apply investment provisions similar to those of Council directive 92/96/EEC” (the third life insurance directive).
requires an adaptation of the role of the EU Insurance Committee to also cover the pension funds directive. This has also been proposed by the Economic and Financial Committee (EFC) in the context of the extension of the Lamfalussy procedures to banking and insurance.

3.2.4 Banks

Banks are permitted to carry out the broadest range of activities among all financial institutions in an EU context as a result of the “universal banking” approach. The set of applicable rules, however, are also the most extensive. Moreover, as a result of ongoing Basel Committee discussions, capital adequacy rules will become even more complex.

Further to the second banking directive (1989), EU licensed banks are permitted to pursue a broad set of activities, ranging from traditional banking to more investment-related businesses, such as portfolio management and advice, safekeeping and administration of securities, trading in and underwriting of securities, and advice on M&As. Banks are subject to the capital adequacy rules of the solvency ratios directive (this is the translation in EU law of the 1988 Basel Accord) or, for their trading book, to the rules of the capital adequacy directive (CAD). This was introduced to guarantee the level playing field with separately authorised investment firms in the EU. Banks are furthermore subject to rules limiting large holdings and limitations on large credit exposures.

With the New Basel Accord approaching, capital adequacy will increasingly be based upon internal models, available for all banking activities and for investment firms. A step in this direction was already taken in 1995 in the Amendment to the Basel Capital Accord to Incorporate Market Risk. It became operational for the EU from 1998 onwards with the adoption of value-at-risk models in CAD II. It is expected that Basel II will increase the cost of credit, certainly in an initial phase, albeit only as a result of high implementing costs. In the longer term, it may lead to lower capital charges for highly-rated borrowers, but higher capital charges for low-rated borrowers (Meier-Ewert, 2001). It is expected to lead to a further consolidation and specialisation in banking, since smaller banks may be disadvantaged compared to large ones, and specialised players may find it easier to apply the more sophisticated approach.

A specific charge has also been proposed for operational risk in the context of the review of the Basel Accord. This will, in a European context, be applied on a consolidated basis for asset management arms of banks and investment firms, whereas this will not be the case for investment firms or independent asset management firms based in the US. It is, however, too early to say whether or not this will increase the capital charge for banks overall, since the Basel Committee announced that it will calibrate its capital charge for operational risk so that regulatory capital does not increase (Calomiris and Herring, 2002, p. 15).

3.2.5 Investment firms

Provisions on market risk of Basel II will also be applicable as the capital standard for all EU-licensed investment firms, which are covered by the investment services directive. The ISD covers individual portfolio management, securities brokerage and order execution activities. The directive is currently being revised as the degree of harmonisation was lower than in other single licence financial services directives, and more reliance was made on mutual recognition such as in conduct-of-business rules, which has hampered market integration.

The ISD, which came into force in 1996, introduced the single licence for non-bank investment firms and organised markets, i.e. exchanges. Although the directive was initially criticised as being full of “red tape”, especially in the City, the ISD has been widely used for cross-border provision of investment services, if one considers only the number of firms that have made use of the single passport. In Italy, Sweden and Belgium, for example, there have been over 800 notifications of cross-border provision of services under the ISD (European Commission,
The main problem has been the application of conduct-of-business rules (Art. 11) in cross-border business, where investment firms may be subject to home and host country rules. The directive states that compliance with conduct-of-business rules is the responsibility of the member state “in which a service is provided”, which could be either the home or the host country. This has also been applied to cross-border business with professional investors, although a special provision for the latter group is foreseen in Art. 11.3, allowing for the “professional nature” of the client to be taken into account.

The new proposal suggests a harmonisation of conditions applicable to different order execution venues with the abolition of the “concentration” provision – this is the requirement to channel all trades through the exchange – but with tighter regulation of “internalisation” of trades by banks and investment firms to increase transparency, monitor conflict of interests and guarantee “best execution” towards investors. The draft directive would also explicitly extend cross-border membership to clearing and settlement facilities, which should increase competition between back-office facilities and reduce the cost of cross-border settlement for asset management.22

The Committee of European Securities Regulators (CESR) has issued standardised conduct-of-business rules for retail and professional investors, which should eliminate the scope for host country intervention in cross-border provision of services. The retail regime is fully harmonised, whereas standards for the wholesale regime are much less elaborate. In the retail regime, a hand-holding relationship is the “base-case” of its provisions. With regards to standards and rules of general application, provisions are made for outsourcing, conflicts of interest and inducements, compliance and code of conduct. Concerning information to customers, issues covered relate to marketing and information regarding the investment fund, i.e. its products and services, risk warnings and reporting arrangements to the customer. Additionally, reference is made to information from the customer to the fund manager (“know your customer” principle on the duty of care and suitability) and on dealing requirements (“best execution”). Management requirements specify a strict separation of functions (covering independence and conflicts of interest), definition of investment strategies and that transactions should be motivated only by the interest of the customer. The wholesale regime, by contrast, is much less elaborate on issues related to the information that is to be provided to customers or the duty of care for example. It applies to financial institutions, large corporations and others who can ask for an opt-out under the retail regime.

3.3 Horizontal measures

The EU has enacted several other measures that impact investment business across the board, or affect cross-border provision of financial services. They generally concern investor protection or conduct-of-business regulation. The most problematic is the distance marketing of financial services directive. Other relevant directives concern the supervision of financial conglomerates, investor compensation schemes or the prevention of money laundering.

3.3.1 The distance marketing directive

The distance marketing of financial services directive defines in detail the information to be supplied to consumers before the conclusion of a contract negotiated at a distance. It is a maximum harmonisation directive, in the sense that member states must not adopt provisions other than those laid down in the directive of the fields it harmonises. The directive defines the contract form, the financial services covered, the information to be provided, the right of

22 The draft directive does not harmonise the operating conditions for CSDs (central securities depositories), which may come up in another draft directive. On the EU clearing and settlement industry, see Lannoo and Levin (2001).
withdrawal (with a cooling-off period of 14 to 30 days, which does not apply however for a whole series of financial services, such as UCITS) and the settlement of disputes.

Three provisions of the directive are problematic. On unsolicited communications (Art. 10), the provision for consumers to expressly opt-in or opt-out is left to the discretion of the member states. This means that in some member states the general rule will be that consumers must specifically opt-in for providers to be allowed to make unsolicited communications, whereas in other member states it will be up to consumers to manifestly opt-out of it. This certainly does not ease pan-European marketing campaigns with e-mail, for example, as providers will need to know which rules apply in the different member states. Another provision of the directive to cause concern is Art. 16, which states that member states can impose additional rules on providers from countries where the distance-selling directive has not been properly implemented. In practice, this provision opens the way to arbitrariness and overrules the country-of-origin rules of the e-commerce directive (2000). A related doubtful provision is Art. 4, which states that member states may introduce more stringent requirements on prior information when the provisions are in conformity with Community law.

3.3.2 Investor compensation schemes

Directive 97/9/EEC requires that each member state ensures that one or more national schemes are established and officially recognised to compensate retail investors in the event of an investment firm’s inability to repay money or return assets held on their behalf. It applies to firms licensed under the ISD, but leaves it to the member states to apply it to UCITS. The directive broadly follows the principles as laid down in the deposit guarantee directive and introduces a minimum guaranteed coverage of €20,000. As many operational aspects are left to the member states, however, the way in which different national compensation schemes work varies considerably from one member state to another. Moreover, most member states did not have investor compensation schemes in operation before this directive came into force. It is thus too soon to make any judgements about their viability, or whether a further degree of harmonisation is required. Furthermore, failures of investment firms may only start to occur more frequently now that the investment boom of the second half of the 1990s has come to a close.

3.3.3 Money laundering

In the wake of the September 11th attacks, EU institutions managed to reach an agreement on an update of the money laundering directive. The 1991 money laundering directive required financial institutions to keep identification files on clients involved in transfers exceeding €15,000. The directive was however fairly narrow in scope, and gave rise to some important differences in implementation across member states. Before the September 11 events, the draft amendments to the directive had been stuck in co-decision due to disagreement between the Commission, the European Parliament and the Council. The disagreement related to two issues. First, the definition of what constituted a money laundering offence. Second, the extent to which non-financial professions should be obliged to report suspected money laundering to authorities.

The agreement reached by the Conciliation Committee in mid-October and voted through in the European Parliament’s third reading on 13 November 2001, was a compromise whereby the directive was extended to cover all crimes. Reporting requirements were also extended under certain conditions to some non-financial professions vulnerable to money-laundering attempts, such as notaries and lawyers.
3.3.4 Financial conglomerates

In a late amendment to the draft financial conglomerates directive, member states have also explicitly proposed to make this new measure applicable to asset management companies. The intention of this proposal was to adapt the European legal framework for the supervision of financial institutions to heterogeneous groups. The intention of the proposal is to:

- make sure that financial conglomerates are adequately capitalised,
- introduce methods for calculating a financial conglomerate’s overall solvency position,
- deal with the issues of intra-group transactions and group-exposure to risks,
- make sure that a final supervisor is in place for such groups, and
- ensure equivalence in the treatment of such groups.

The inclusion of asset management groups follows the adoption of the UCITS II and III directives, which allow asset management companies to compete directly with investment firms, which are already submitted to group-wide supervision. The directive provides that member states will decide according to which sectoral rules these asset management companies will have to be included in group-wide supervision (consolidated supervision of credit institutions and investment firms and/or insurance undertakings in an insurance group), and the scope of supplementary supervision within the meaning of this directive. The Commission is to make a report on member states’ practices by 2007 and propose further harmonisation of EU legislation if necessary.

3.4 Which regime to follow?

For the European Commission, asset management can be subdivided into a “collective” and an “individual” component whereby insurance, investment funds and pension funds are considered to be collective, and banking and brokerage are individual. The distinction is certainly not clear-cut and for less well defined aspects of asset management, choosing the right regulatory environment matters. This will be the case to an even greater extent with the entry into force of UCITS III.

Making abstraction of specificities of national implementing legislation and other non-harmonised aspects such as taxation, the most open regimes for asset management are those falling under the second banking directive, the ISD and UCITS III. The bank licence will remain expensive because of the high initial capital requirement, although the impact of the Basel Review should be observed. UCITS III, which allows for investment management in the broad sense, should certainly become an interesting regime. The advantages are low initial capital requirements (€125,000), with an absolute cap of €10 million, and a low additional charge for other risks. The rules on asset allocation are nevertheless strict, but exceptions are possible.

The big question for UCITS III is the application of operational risk provisions, as is being discussed in the context of Basel II. Through the reference in the UCITS III directive (Art. 5a) to the CAD provisions on “other risks”, the operational risk charge may also apply to investment firms, but it is too early to affirm this. If this were to be the case, investment management companies would be even further disadvantaged vis-à-vis their US counterparts, which have no initial capital requirement. This should, on the other hand, not be overplayed, as the initial capital requirement is low and annual losses resulting from operational risks in the fund industry amount to less than 1 basis point of assets under management.  

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23 According to Patrick Zurstrassen on the basis of independently obtained data on the subject, ICBI Fund Forum, Rome, July 2002.
The ISD allows for the broadest possibilities, with lower initial capital requirements than banking, and no asset allocation rules. The directive has not been equally implemented in the member states, however, and the basic text has left room for interpretation. The ongoing review will ease cross-border business with the harmonisation of conduct-of-business rules for professional investors, but the final outcome of the regulatory regime for “internalisation” of order flow may still create problems. Requirements on best execution and client order handling may increase the administrative burden and thus the cost for firms, and may lead to a further consolidation in the sector. The application of an operational risk charge in the context of the Basel Review will need to be followed, but again, it is too early to make any statements on this.

It has been argued that a capital charge for operational risk is not appropriate, since it is anti-competitive and not risk-sensitive. It is discriminatory for smaller firms which do not have the resources in place to rely upon more sophisticated approaches. A better approach would be to rely upon process regulation and private insurance – both of which are proposed in the draft ISD. Process regulation requires firms to have the appropriate processes and procedures in place to identify, measure, and control operational risk. Private insurance, such as indemnity, employee fidelity and fraud insurance are seen to be more appropriate and are already widely used. Moreover, the application of operational risk charge may again be discriminatory for EU investment firms as compared to their US counterparts, which will not be covered by it.

With regards to conduct-of-business rules, the harmonisation undertaken by the Committee of European Securities Regulators (CESR) for investment services is a big step forward. The new CESR conduct-of-business rules (CBR) however are burdensome, and purely voluntary as a “level 3” issue under the Lamfalussy approach. CESR will need to show that this approach can work, and that its members will live up to it; otherwise, more statutory harmonisation from higher up will follow. Nevertheless, this still goes further than what is in place for UCITS management companies, which will still need to follow host country advertising and marketing rules.

The consistency of secondary legislation across sectors is of crucial importance for the asset management industry. The procedures agreed to in the context of the Lamfalussy report are of little comfort to the asset management industry, since asset management crosses the three basic sectors of financial services. The consistency of procedures in banking, securities markets and insurance is of crucial importance therefore. This is an issue that is on the agenda of the EU Council of Finance Ministers, but it is not certain that the application of Lamfalussy-style procedures in the banking and insurance sectors will be acceptable to the European Parliament. One solution is to expand the Securities Committee’s tasks to become a Finance Committee; another is to upgrade the Banking Advisory Committee and the Insurance Committee. Our preference would be the latter solution, as was proposed by the Economic and Financial Committee (EFC, 2002), and to ensure consistency of approach and settle problems of conflicting rules across sectors in an upgraded Financial Services Policy Group.

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24 Article 11 of the draft ISD II specifies that firms that are exempted from the CAD shall hold professional indemnity insurance.
26 “CESR members will seek to implement the Standards and Rules set out in this paper in their regulatory objectives and, when possible, in their respective rules. If a CESR member does not have the authority to implement a certain Standard or Rule, it will commend the Standard or Rule to its government and to the responsible regulatory authority. CESR is committed to undertake reviews of regulatory practices within the single market, on the basis of Article 4.3 of its Charter.” See CESR (2002a, p. 4) and CESR (2002b, p. 10).
Tax is the main obstacle remaining in the integration of European fund management. Large differences in the way member states tax fund management and outright discriminatory tax barriers hamper funds from freely providing the full range of services across borders. National taxation rules, by leading often to duplication of fund structures and hence preventing funds from reaching optimal scale, also increase the cost of asset management and reduce investor returns. This chapter of the report takes a closer look at these obstacles. A first part looks at current national tax regimes and concludes that there are significant differences in the way funds and their policyholders are taxed. A second part examines the cross-border effect of such natural tax differences, but also at tax rules whose purpose appears to be discriminatory, i.e. favouring domestic service providers at the expense of foreign companies. One conclusion reached here is that measures could be taken at EU and member state level that would significantly reduce such discriminatory barriers. The kind of action that can be taken to reduce such tensions is the subject of the third and final part. It will look at both ad hoc actions by the European Court of Justice and outline potential parallel actions, e.g. increasing the effectiveness of double tax conventions.

4.1 Overview of current national tax regimes

The way in which funds and the fund policyholders are taxed varies considerably between member states. While presenting business opportunities for fund managers, these differences may also make cross-border fund management more difficult.

4.1.1 Tax treatment of funds

Tax treatment of funds depends on the nature of the fund. Most countries tax investment funds, as they are regarded as separate entities subject to tax (Belgium being the only exception in the EU). Nevertheless, investment funds often receive a more lenient tax treatment in order to circumvent the problem of double taxation (i.e. taxing both fund and investor). This is normally motivated by funds being regarded as fulfilling an important societal role in providing a convenient savings vehicle. The tax treatment of funds can therefore take many special forms:

- **Not subject to tax**: for example a non-taxable person (e.g. Belgium) or exempted individual (e.g. Finland). In some countries an investment fund normally subject to tax may be exempt if it fulfils certain conditions (e.g. on basis of activity as in Luxembourg).

- **Special tax base**: in some countries investment funds are subject to tax but the taxable income (base) is much lower than for other companies (e.g. investment companies in Belgium) or reduced (e.g. paid distributions to investors subtracted from taxable income as in Sweden or the UK).

- **Special tax rate**: in some countries, investment funds are subject to tax but at special (low) rates (e.g. the Netherlands where the rate can sometimes reach 0%).

- **Fully subject to tax but compensation at investor level**: in some countries the investment fund is fully subject to tax, but investors are normally compensated for the tax paid at fund level via a reduction or an exemption of tax at investor level, as is the UK imputation system, for example (IFA, 1997).

The impression that fund taxation is heterogeneous is further amplified when looking at pension and life insurance funds. These funds are often granted favourable taxation by policymakers eager to encourage citizens to take charge of their retirement or to assume the risks they
are facing. These numerous tax breaks result in complex and opaque tax rules, as exemplified in Table 8.

**Table 8. Taxation of pension and life insurance funds**

<table>
<thead>
<tr>
<th>Country</th>
<th>Income tax, %</th>
<th>VAT</th>
<th>Premium taxes, %</th>
<th>Other taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>39</td>
<td>Exempt</td>
<td>3-9.25</td>
<td>0.17% on value of goods held by non profit pension funds</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(Compensatory funds: 0.25-10%)</td>
<td>9.25% tax on profits policies</td>
</tr>
<tr>
<td>DK</td>
<td>30</td>
<td>Exempt</td>
<td>1-50</td>
<td>4.5% on 190% of payroll</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.6-4% on deeds</td>
</tr>
<tr>
<td>D</td>
<td>25</td>
<td>Exempt</td>
<td>2-15</td>
<td>1% tax on capital formation</td>
</tr>
<tr>
<td>E</td>
<td>35</td>
<td>Exempt</td>
<td>6</td>
<td>1% financial institution overhead tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(comp. funds 1.9-8.5%)</td>
<td>4.25-13.6% social contribution tax</td>
</tr>
<tr>
<td>F</td>
<td>33.33</td>
<td>Exempt</td>
<td>7-30</td>
<td>0.1% turnover tax on value of shares, stocks, real estate etc.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Stamp duties</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Profit-sharing plan</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Professional tax</td>
</tr>
<tr>
<td>IRL</td>
<td>10</td>
<td>Exempt</td>
<td>2</td>
<td>1% on share capital</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Special tax on securities</td>
</tr>
<tr>
<td>I</td>
<td>36</td>
<td>Exempt</td>
<td>2.5-21.25</td>
<td>Municipal business tax (varies, 10% Lux.)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(comp. funds 1-6.5)</td>
<td>0.5% wealth tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.2% net wealth tax on capital</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1% capital investment tax</td>
</tr>
<tr>
<td>L</td>
<td>30</td>
<td>Exempt</td>
<td>4-6</td>
<td>1% of share capital</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1% of capital contributions</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.04-0.15% stock turnover tax (bonds, shares)</td>
</tr>
<tr>
<td>NL</td>
<td>35</td>
<td>Exempt</td>
<td>7</td>
<td>License fees</td>
</tr>
<tr>
<td>A</td>
<td>34</td>
<td>Exempt</td>
<td>1-10</td>
<td></td>
</tr>
<tr>
<td>P</td>
<td>32</td>
<td>Yes, but recovered on pro rata basis</td>
<td>0.45-12</td>
<td>License fees</td>
</tr>
<tr>
<td>FIN</td>
<td>29</td>
<td>Exempt</td>
<td>22</td>
<td></td>
</tr>
<tr>
<td>S</td>
<td>28</td>
<td>Exempt</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>30</td>
<td>Exempt</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>35</td>
<td>Exempt</td>
<td>3-4</td>
<td>State capital and franchise taxes</td>
</tr>
<tr>
<td>CH</td>
<td>35</td>
<td>Exempt</td>
<td>2.5-5</td>
<td>0.5% on shareholder equity</td>
</tr>
</tbody>
</table>

*Source: Lee (2002).*

Premium taxes vary widely within the EU (0.25%-50%). All countries, with the exception of Portugal, exempt these funds from VAT, while all countries, as in the case of investment funds, impose a corporate income tax on funds. The last column is of particular interest, as it shows the variety of additional taxes that financial institutions in general and funds in particular may carry. These range from explicit taxes on financial institutions (France) to various taxes on the financial assets and activities of a typical financial intermediary (e.g. capital formation taxes, stamp duties, stock turnover taxes, etc.). In sum, there is thus considerable diversity in the way member states tax funds.
4.1.2 Taxation of policyholders

Not only are funds taxed, but so too are their policyholders. Taxation can take many forms – taxation on distributions from the fund, taxation on the interest generated from the holding in the fund and taxation on the attribution of income or gains (IFA, 1997).

Faced with an ageing population, which implies that individuals will increasingly have to provide for their own pensions, industrialised countries have tried to decrease taxes on interest income for life insurance and pension funds in order to stimulate savings for retirement. As with the taxation of funds, these tax breaks make it difficult to acquire an overall view of the taxation of fund policyholders. While all the differences between member states in taxing policyholders are beyond the scope of this report, the area of pensions illustrates well the form and effect that such differences can take.

<table>
<thead>
<tr>
<th>Country</th>
<th>EET¹</th>
<th>ETT²</th>
<th>TEE³</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DK</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>D</td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>EL</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>E</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>F</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>IRL</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>L</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NL</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>P</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>FIN</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>S</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>UK</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

¹ Exempt contributions, Exempt investment income and capital gains of the pension institution, Taxed benefits.
² Exempt contributions, Taxed investment income and capital gains of the pension institution, Taxed Benefits.
³ Taxed contributions, Exempt income and capital gains of the pension institution, Exempt benefits.


The most common treatment is to grant tax allowances for pension contributions and exempt returns on fund assets while benefits remain taxed (van den Noord and Heady, 2001). Of the current 15 EU member states, 11 practice such an EET system (Exempt contributions, Exempt return on fund assets, Taxed benefits). Three member states also tax investment income (ETT). Luxembourg and Germany are the only countries that take the opposite approach, by taxing contributions but exempting investment income and benefits from taxation (TEE) (European Commission, 2001b).

These differences lead to considerable cross-border difficulties. Few individuals are likely to engage in “forum-shopping” (e.g. working in a country where contributions are exempt and residing in a country where premiums are exempt). Nevertheless, differences in pension taxation do effectively impinge upon the free movement of labour, as workers remain tied to pension arrangements in the country where they have been working. Accordingly, the divergence of pension tax rules hampers the development of truly European pension schemes.
4.2 Cross-border effects of current national tax regimes

There is no reason why the taxation of funds should be harmonised between countries, as the tax differences outlined above are natural reflections of systems tailored along competing national lines. Such differences may, nevertheless, unintentionally act as barriers in an integrated economic area such as the EU’s internal market. In some cases, national tax rules may be specifically shaped to penalise foreign funds and/or to favour domestic funds and thus keep asset management markets segmented.

4.2.1 Natural cross-border tensions

Income moving across borders with increasing ease has strained national tax systems. In an economically integrated area, national tax rules developed without assessing their cross-border effect may unintentionally act as discriminatory barriers. The EU has developed no systematic and coherent way of allocating capital jurisdiction for tax purposes. Instead, “principles” have developed on an ad-hoc basis. For example, member states aim to tax equity income where the income is generated (source principle), but on the other hand try to tax debt income according to the residence of the investor (residence principle) (Cnossen, 2000).

Currently, there are a number of ways in which countries try to mitigate the effects of foreign taxes on residents. The two main approaches are:

- **Credit system**: Some countries operate direct credit systems, i.e. they tax a tax subject’s foreign-source income but credit the withholding taxes that the subject has paid abroad (thus decreasing the domestic tax bill). Other countries operate an indirect credit system, with the same benefits as direct systems, but also crediting corporate taxes paid abroad.

- **Exemption method**: In some countries, all foreign source capital income is exempt from domestic taxation.

Concerning the taxation of non-residents’ income, two means dominate:

- **Withholding taxes**: This is the traditional way of taxing cross-border flows. Statutory withholding tax rates of EU member states vary widely. On interest income, six EU members did not impose withholding taxes on interest income in 2001. The remaining members imposed standard rates varying between 15 and 27%. This is lower than both the US and Switzerland, which have standard rates of 30 and 35% respectively (IBFD, 2001). While the average level of withholding taxes on dividends is higher than on interest (20.6% compared to 11.8%), the same disparity between member states can be observed. Double taxation treaties often reduce statutory rates, however. For example, withholding taxes on interest on bank deposits are rarely levied between EU member states (Portugal being the only exception in the EU). Moreover, some interest income is more favourably treated than others, e.g. interest on bank deposits (Huizinga and Nicodème, 2001). The real withholding tax rates are therefore significantly lower.

- **Information exchange**: Information exchange can take many forms, one example being the source country reporting the account information of non-residents to residence country tax administrators. For a significant period of time, problems were of a practical nature, although technological progress has somewhat decreased this complication. The major remaining problem is more of a political kind i.e. unwillingness to exchange information. This is linked to the strategic interests of some countries, where information exchange would impinge upon one foundation of their financial centres, i.e. bank secrecy. Following the OECD’s project on limiting harmful tax competition, information exchange has nevertheless come to the forefront as the solution proposed by (most) industrialised countries to tax capital income. The OECD has taken steps towards developing the
operational side of the exchange (standards, means, assets etc.) (OECD, 2000). Negotiations with tax havens have not yet been finalised however. It also remains to be seen whether OECD-members Luxembourg and Switzerland will consider themselves bound by such a system, as they abstained from adopting the original OECD report.

The lack of an accepted model may contribute to competition between countries, complex and potentially discriminatory tax systems and reduced tax revenues. Countries may find it too costly to individually impose taxes or exchange information, as this may lead to capital flight and an increase in the cost of capital due to the higher yields needed in order to compensate investors for tax loss (Haflauer, 1998; McLure, 2001). Accordingly, capital placed in low-tax jurisdictions abroad largely escape taxation at home. Faced with this tax risk, authorities have an incentive to discourage their tax subjects placing savings with foreign service providers (e.g. foreign fund managers). Although member states’ ability to do so in the EU is outlawed, as discriminatory tax measures are forbidden, such practices remain important.

4.2.2 Discriminatory tax barriers

Apart from the inherent difficulties in allocating cross-border income flows for tax purposes, in many cases countries deliberately penalise foreign service providers. As argued above, concerns of tax consequences of placing capital abroad may offer a benign interpretation of such behaviour. Other less altruistic reasons, e.g. outright protectionism, are most probably at least as important.

In the UCITS area, for example, PriceWaterhouseCoopers and FEFSI have carried out two studies on discriminatory tax barriers. One example of a country with such discriminatory barriers is France, where the favourable taxation of funds was, in 2001, only accorded to certain French funds (Plan d’Épargne en Action), which the then French Minister of Finance, Christian Sautter, defended on the grounds that while France was willing to subsidise its citizens’ investments in French funds, it was certainly not willing to extend that treatment to investments in foreign funds (Newton, 2001). Another example is Germany, where the benefits of the 2001 tax reform (only 50% of dividend income treated as taxable income) were accorded to investments in domestic funds only. A recent law would extend the same tax discrimination to capital gains. A similar example is the UK, where the imputation system does not apply to foreign equity. In other words, foreign equity dividends are not taxed at the same reduced rate as domestic equity, where an imputation system attempts to avoid taxing the same income stream twice. These barriers are costly, as they discourage cross-border selling of funds, thereby preventing funds reaching a more optimal scale. According to research, the lack of scale adds to the average cost in terms of fund charges.

27 As of April 2002, 31 jurisdictions have decided to cooperate with the OECD while seven jurisdictions have been classified as non-cooperative.
28 As illustrated by the Danner case (see below).
29 This section builds on the presentation by David Newton, partner of PriceWaterhouseCoopers, delivered to the Task Force on 11 June 2002, and a paper he wrote with FEFSI (Newton, 2001).
30 On 19 December 2002, the Commission sent an official request for information to Germany asking it to explain what appeared to be tax discrimination. The letter of formal notice is the first step in the infringement procedure, leaving Germany two months to reply. If the answer fails to satisfy the Commission, it may issue a reasoned opinion demanding Germany to alter the law. If Germany does not do so, the Commission may bring it to the Court of Justice (see Commission press release, IP/02/1924).
31 According to research by PwC and FEFSI, the lack of scale adds 40 basis points to the average cost in terms of fund charges, which considering the overall market size represents a cost of €14 billion (Newton, 2001). This is in line with the findings of the research of Schröder (2002), discussed above.
4.3 Addressing cross-border effects of current national tax regimes

In order to reduce the tax obstacles to pan-European asset management, the Commission should aim to eliminate discriminatory tax measures but also address some of the underlying causes as to why such measures arise in the first place. This could be achieved, for example, by reducing those differences in national tax systems that affect asset management and by reaching a consensus on the taxation of non-residents’ savings income.

4.3.1 Eliminating discriminatory tax barriers

The dismantling of discriminatory tax barriers that prevent foreign funds from effectively competing in certain national markets would have the most direct impact on asset management. So far, the European Court of Justice has been the main driver behind the dismantling of discriminatory tax barriers. Court action is only effective, however, if the cases are initiated and brought forward, and this is not always the case at the present time. The Commission claims to be overextended, and business seeks to avoid the wrath of local regulators. A first step should be to increase the efforts of bringing cases of discrimination to the Court. While this is primarily the responsibility of the Commission, those market participants who are experiencing tax discrimination must bring it to public attention. Ad hoc Court action is, nevertheless, unlikely to be sufficient to forge a coherent public policy response to the underlying reason why such tax discrimination arises in the first place.

4.3.2 Increasing effectiveness of double tax conventions

Although many countries have used tax instruments to attract funds, most countries continue to exercise their right to tax foreign funds at source. In addition, most countries do not give funds access to tax treaties, as most funds do not fulfil such treaty requirements as “persona residence” and beneficial ownership rules. In theory, this is not a problem, as individuals have access to double tax treaties and therefore could claim credit or compensation for taxes paid on their investment abroad. This does not work in practice however and, as a result, double-taxation at the level of the investment, the level of the fund, and the level of the investor, may arise. This problem will become accentuated as globalisation implies that cross-border investments will increase.

4.3.3 Parallel measures with indirect effects

Apart from outright protectionist reasons, discriminatory tax barriers may also originate as unintended effects of national tax measures that have been developed without considering potential cross-border effects, or because of member states’ fear of otherwise seeing capital placed abroad and thus less easily taxed. In order to address these underlying causes for discrimination, a number of measures supplementary to Court action may be considered.

a) Promoting convergence between member states’ tax systems

As some of the tax measures with discriminatory effects derive from tax measures developed without considering potential cross-border effects, a complement to Court action could be to promote further convergence of those parts of national tax systems that have cross-border effects. For example, the Commission is currently trying to achieve such limited convergence in the taxation of occupational pensions, where it is trying to persuade member states to move towards an EET-system (European Commission, 2001).32

A related area that may be of interest is the field of corporate taxation, where the Commission is trying to convince member states to move towards converging the way that the corporate tax

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32 For a critical analysis of the European Commission’s efforts to achieve pension portability, see Mortensen (2003).
base is calculated. The aim is to reduce the compliance costs of companies, which currently have to abide to 15 different company tax systems. According to Commission plans, this could be achieved either by allowing mutual recognition of other member states’ tax systems, thus allowing a company to choose one state as their “home state” for fiscal purposes, or by agreeing on an EU corporate tax base that companies could opt for. Regardless of which method is chosen, such convergence of tax bases would make it easier for credit institutions to operate on a pan-European basis. Similar tax base convergence in the field of personal direct income taxation could be desirable as well, but is unlikely to be politically feasible in the foreseeable future.

b) Achieving consensus on how to tax non-resident income

Discrimination is outlawed by EU law but, as illustrated above, many discriminatory tax measures remain. Protectionism is not the only reason why member states effectively penalise foreign service providers. Another reason is that they fear the tax consequences of their tax subjects placing their capital abroad.

This is illustrated by the Danner case before the European Court of Justice. Rolf-Dieter Danner, a German doctor working in Finland, claimed tax deductions for pension insurance savings placed in a German fund. Although such deductions were permitted for Finnish funds, the tax authorities denied Mr Danner full deductions. The reason why the Finnish law did not grant similar tax deductions to Mr Danner’s German savings was that the working party drafting the law found it “necessary to prohibit the deduction of contributions to foreign voluntary pension insurance because the pension to be received in due course would in practice often be excluded from taxation in Finland either because the recipient had moved abroad or because of a lack of information about the pension payments” (ECJ, 2002, para. 7).

The ECJ did not accept that reasoning, as it found that the intended goal (avoid tax evasion) could be achieved by less discriminatory means. In other words, fear of tax evasion does not legitimise discrimination. The case is interesting, however, as it provides one illustrative tale of the link between the increasing ability of citizens to place their savings abroad, member states’ fears for negative tax revenue consequences and the corresponding incentive for states to discourage citizens from placing savings abroad.

If member states felt more comfortable that revenue would not be entirely lost if savings went abroad, part of the incentive to discriminate against foreign service providers would disappear. As outlined above, there are currently two major approaches in taxing non-resident income – the levy of withholding taxes at source and exchanging information for tax purposes with other countries’ tax administrators. Although home country tax administrators are likely to favour information exchange, a system of withholding taxes with repatriation of part of the revenues may also assuage tax authorities’ concerns. Accordingly, a consensus on how to tax non-resident savings is important in order to reduce incentives for member states to reduce their citizens’ opportunity to use the services of foreign service providers via taxes.
Chapter 5
Conclusions

This report has focused essentially on two aspects of obstacles to pan-European asset management. First, those resulting from regulatory differences in EU rules affecting the asset management industry and, secondly, tax obstacles.

With regards to regulatory differences, we believe that there is no need for a horizontal asset management directive at this stage. The UCITS III directive as well as the draft pension funds directive allow for a broader use of the facilities provided for in the directive and reduce the opportunities for regulatory arbitrage. The main priority should thus be to focus on adequate and consistent implementation across member states, strong cooperation between supervisory authorities and swift adaptation in secondary legislation. The means to ensure that these steps can be taken are not fully available, not only because the Lamfalussy procedures do not apply to the UCITS directives, but also because asset management spans the whole sector of financial services and a consistency of rules will be needed across banking, insurance and securities markets. Although cooperation between EU banking and insurance supervisory authorities has been in place for a much longer time than in the securities market sector, the procedures need to be urgently upgraded to what is now in place for securities markets. This applies to the need for broad consultation, as well as to the scope for secondary legislation and the structure of cooperation between European and national regulatory and supervisory authorities. This should be done in close cooperation with the European Parliament, in view of discussions leading to the 2003 Intergovernmental Conference.

Tax obstacles to a more integrated market for asset management are, beyond doubt, the major remaining problem. Differences in taxation are a natural reflection of tax systems developed along national lines and in competition with other states. These differences are therefore not problematic per se, as they reflect a healthy competition. National tax rules however often lead to duplication of fund structures, preventing funds reaching optimal scale, resulting in higher management costs. Moreover, national tax systems have difficulty coping with cross-border flows of income. Sometimes these difficulties may have unintended effects that penalise foreign service providers. In other instances, tax rules may have been deliberately designed to deter foreign funds. So far, the EU has implemented no coherent or systematic way of addressing these divergences, although a tax package has been on the table since 1997. Instead, ad hoc actions towards reducing the most rampant restrictions to freedoms of the internal market have been initiated by the ECJ.

In the light of the above, some tentative conclusions can be drawn:

- Wide differences in tax rates and taxable bases exist between countries in the three fund categories surveyed. Generally, pension and insurance funds are more favoured than investment funds. While this reduces horizontal neutrality, it may be defensible from a societal point of view (providing for future pension and risk needs). The wide differences in taxation between countries, however, may make cross-border investment more difficult. Moreover, there is a wide difference between countries regarding the compensation for taxes paid abroad with some countries crediting and others not.

- Little effective relief at policyholder level is in place for taxes incurred at fund level. The reason is that double tax treaties do not effectively work for policyholders and funds are, in most cases, excluded from those treaties. This anomaly ought to be corrected.

- The ECJ should be supported in its efforts to eliminate restrictions to the freedoms of the internal market. The Commission should bring more infringement cases forward, while industry should assist the Commission by bringing forward restrictive practices encountered or by initiating cases themselves.
As a complement to the case-by-case action of the ECJ, attempts should be made at reducing the underlying reasons why discriminatory tax measures blocking pan-European asset management arise in the first place. One step would be to further the convergence of those aspects of national tax systems that may give rise to discriminatory tax treatment. Two such current initiatives by the Commission (the taxation of pensions where the Commission is pushing for EET, and corporate taxation, where the Commission promotes convergence in the way of computing tax bases) should be supported. Another step would be to reduce member states’ concern with the tax consequences of savings placed abroad, as evidenced by the Finnish authorities’ argument in the Danner case. Currently, such savings easily escape home taxation and member states have an incentive to discourage capital being placed abroad accordingly (although under EU law they are not allowed to do so). Consensus on how to tax non-residents’ savings income may reduce member states’ concerns and may be an important tool in the reduction of discriminatory treatment of foreign funds.
REFERENCES


Comité européen des assurances (CEA) (2002), *European Insurance in Figures*, CD ROM.


European Commission (2002a), Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision, May.

European Commission (2002b), Revision of the investment services directive, Second consultation, April.


## ANNEX 1

**Basic Rules for Capital Adequacy & Asset Allocation under the EU’s Financial Services Directives**

<table>
<thead>
<tr>
<th></th>
<th>Second banking directive (2BD)</th>
<th>3rd insurance directives</th>
<th>Draft pension funds directive</th>
<th>Investment services directive (ISD)</th>
<th>Investment funds directives (UCITS)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial capital</strong></td>
<td>Min €5 million own funds</td>
<td>Min €3 million guarantee fund (€2 million for some classes of non-life insurance)</td>
<td>Where the institution itself underwrites the liability, the rules of the life insurance directive apply</td>
<td>Min €125,000 initial capital for small brokers (not trading for their own account), others €730,000 (this still applies under ISD II)</td>
<td>Min €125,000 initial capital plus 0.02% of total assets (as soon as assets exceed €250 million), with maximum of €10 million (UCITS III). Existing UCITS may be “grandfathered” for up to 5 years</td>
</tr>
<tr>
<td><strong>Additional capital requirements</strong></td>
<td>Min 8% of risk-weighted assets (Basel Accord) or VAR for trading book (rules of CAD I and CAD II)</td>
<td>Solvency margin must be three times the guarantee fund, and a proportion of technical provisions (in general 4%)</td>
<td>(idem)</td>
<td>CAD: different capital requirements for position risk, settlement and counterparty risk, foreign exchange risk and 1 quarter of “fixed overheads” for other risks, modified in CAD II to take Value-at-Risk models into account</td>
<td>Own funds shall never be less than 13 weeks of “fixed overheads” (rules on “other risks”, annex IV of the CAD)</td>
</tr>
<tr>
<td><strong>Permissible activities (non-exhaustive, only when related to asset management)</strong></td>
<td>Portfolio management, safekeeping and administration of securities, trading in and underwriting of securities</td>
<td>Life insurance (including group insurance) Non-life insurance (large and mass risk)</td>
<td>Management and investment of funded occupational pension schemes</td>
<td>Individual portfolio management, securities brokerage and order execution activities</td>
<td>Management of investment funds Non-core: - Individual asset management (including pension funds) - Investment advice - Safekeeping (custody) and administration of UCITS</td>
</tr>
<tr>
<td><strong>Asset allocation</strong></td>
<td>Holdings in non-financial institutions limited to 60% of own funds, and 15% for a single holding. Large credit exposures to single clients are limited to 800% of own funds and 25% for a single exposure.</td>
<td>Harmonised minimum rules: &lt; 10% single holding of real estate, &lt; 5% non-listed securities, &lt; 10% of assets in single security, except for public debt, and &lt; 40% for total large exposures of blocks of 5%, &lt; 20% in other currency than liabilities</td>
<td>Prudent man rule: Member states may set more stringent rules for institutions active on their territory, but within certain limits. Investment in sponsoring undertaking are limited to 5% of the technical provisions.</td>
<td>Rules on large exposures: &lt; 10% of assets in single security, except for public debt, and &lt; 40% for single investments of 5%, &lt; 10% non-listed securities, &lt; 10% of same body for money market instruments, and &lt; 20% for investments in single other funds and deposits with credit institutions.</td>
<td></td>
</tr>
<tr>
<td><strong>Conduct of business</strong></td>
<td>Host country “general good” provisions</td>
<td>Host country “general good” provisions</td>
<td>Host country social and labour rules</td>
<td>Harmonised CESR standards, extensive for retail investors, limited for professionals.</td>
<td></td>
</tr>
<tr>
<td><strong>Disclosure</strong></td>
<td>Limited Disclosure of investment policies, risk and accrued benefits to fund members</td>
<td>Disclosure of investment policies, risk and accrued benefits to fund members</td>
<td>Transparency rules for regulated markets, post-trade transparency for OTC and large blocks.</td>
<td>Simplified and full prospectus (to be updated frequently), half-yearly and annual report.</td>
<td></td>
</tr>
<tr>
<td><strong>Investor compensation</strong></td>
<td>Deposit guarantee directive</td>
<td></td>
<td>Investor compensation schemes directive</td>
<td>Investor compensation schemes (depending upon national implementation).</td>
<td></td>
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<tr>
<td><strong>Technical adaptations</strong></td>
<td>Banking Advisory Committee (BAC), limited</td>
<td>Insurance Advisory Committee (IAC), limited</td>
<td>[Insurance and Pensions Advisory Committee]</td>
<td>[Securities Committee under new draft ISD]</td>
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**PAN-EUROPEAN ASSET MANAGEMENT**
ANNEX 2

STATISTICS ON FUND MANAGEMENT

Figure A1. The asset management industry in the EU-15
Totl funds under management

Figure A2. Types of investment funds as % of total net funds assets in the EU

Sources: CEA, FEFSI, EFRP.

Source: FEFSI (2002).
Table A1. Evolution of life insurance investments in the EU (billions of euro)

<table>
<thead>
<tr>
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<td>DK</td>
<td>49.6</td>
<td>68.6</td>
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<td>D</td>
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<td>373.5</td>
<td>504.7</td>
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<td>n.a.</td>
<td>n.a.</td>
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<td>60.7</td>
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<td>743.0</td>
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<td>39.5</td>
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<td>15.5</td>
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<td>166.1</td>
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<td>1454.3</td>
<td>1509.6</td>
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<td>EU-15</td>
<td>1269.8</td>
<td>1810.0</td>
<td>3581.2</td>
<td>3816.1</td>
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<td>CH</td>
<td>83.7</td>
<td>122.9</td>
<td>182.2</td>
<td>183.8</td>
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</table>

1 Total life insurance investments in the EU.
2 Total non-life insurance investments in the EU.
3 Provisional data.

Source: CEA (2002).

Table A2. Growth of life insurance and non-life insurance businesses in the EU

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<thead>
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<td>Life insurance</td>
<td>4465.9</td>
<td>5400</td>
<td>8722.4</td>
<td>9083</td>
<td>9232.2</td>
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<td>Growth rate</td>
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<td>42.5%</td>
<td>97.9%</td>
<td>6.6%</td>
<td>2.4%</td>
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<tr>
<td>AAGR1</td>
<td>n.a.</td>
<td>7%</td>
<td>15%</td>
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<td>n.a.</td>
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<td>Non-life insurance</td>
<td>415</td>
<td>536</td>
<td>800.3</td>
<td>803.6</td>
<td>862.</td>
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<td>Growth rate</td>
<td>n.a.</td>
<td>29.2%</td>
<td>49.3%</td>
<td>0.4%</td>
<td>7.3%</td>
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<td>AAGR</td>
<td>n.a.</td>
<td>10%</td>
<td>12%</td>
<td>n.a.</td>
<td>n.a.</td>
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</table>

1 Average annual nominal growth rate.
Table A3. Asset allocation of life insurance companies (%, 2000)

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<thead>
<tr>
<th>Country</th>
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<th>Fixed Income</th>
<th>Real Estate</th>
<th>Others</th>
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<td>42.4</td>
<td>49.8</td>
<td>2.8</td>
<td>5.0</td>
</tr>
<tr>
<td>D</td>
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<td>60.5</td>
<td>3.1</td>
<td>0.4</td>
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<tr>
<td>E</td>
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<td>71.5</td>
<td>4.9</td>
<td>17.0</td>
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<tr>
<td>F</td>
<td>30.3</td>
<td>63.9</td>
<td>4.7</td>
<td>1.1</td>
</tr>
<tr>
<td>IRL</td>
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<td>26.1</td>
<td>8.2</td>
<td>9.2</td>
</tr>
<tr>
<td>I</td>
<td>19.4</td>
<td>50.1</td>
<td>3.4</td>
<td>27.1</td>
</tr>
<tr>
<td>L</td>
<td>44.1</td>
<td>54.3</td>
<td>0.3</td>
<td>1.3</td>
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<tr>
<td>NL</td>
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<td>54.6</td>
<td>5.2</td>
<td>6.8</td>
</tr>
<tr>
<td>A</td>
<td>34.0</td>
<td>55.0</td>
<td>7.0</td>
<td>4.0</td>
</tr>
<tr>
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<td>63.3</td>
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<td>11.0</td>
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<td>52.9</td>
<td>11.0</td>
<td>0.1</td>
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<tr>
<td>S</td>
<td>51.7</td>
<td>43.0</td>
<td>4.9</td>
<td>0.5</td>
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<td>UK</td>
<td>56.8</td>
<td>28.8</td>
<td>5.6</td>
<td>8.9</td>
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<td>41.9</td>
<td>47.5</td>
<td>4.7</td>
<td>5.9</td>
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<td>27.8</td>
<td>57.4</td>
<td>8.8</td>
<td>6.1</td>
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Source: CEA (2002).
ANNEX 3

GLOSSARY OF EU DIRECTIVES & ACRONYMS MENTIONED IN REPORT

EU Directives


**Financial conglomerates directive:** Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, Official Journal L 035 of 11/02/2003


collective investment in transferable securities (UCITS), with regard to investments of UCITS, OJ L41 of 13/02/02.


**Acronyms**

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
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<tr>
<td>CAD</td>
<td>Capital Adequacy Directive</td>
</tr>
<tr>
<td>CBR</td>
<td>Conduct-of-Business Rules</td>
</tr>
<tr>
<td>CEA</td>
<td>Comité Européen des Assurances</td>
</tr>
<tr>
<td>CESR</td>
<td>Committee of European Securities Regulators</td>
</tr>
<tr>
<td>CSD</td>
<td>Central Securities Depository</td>
</tr>
<tr>
<td>ECJ</td>
<td>European Court of Justice</td>
</tr>
<tr>
<td>EMU</td>
<td>Economic and Monetary Union</td>
</tr>
<tr>
<td>EET</td>
<td>Exempt contributions, Exempt investment income and capital gains of the pension institution, Taxed benefits</td>
</tr>
<tr>
<td>EFC</td>
<td>Economic and Financial Committee</td>
</tr>
<tr>
<td>EFRP</td>
<td>European Federation of Retirement Provision</td>
</tr>
<tr>
<td>ETT</td>
<td>Exempt contributions, Taxed investment income and capital gains of the pension institution, Taxed Benefits</td>
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<tr>
<td>FEFSI</td>
<td>Fédération Européenne des Fonds et Sociétés d’Investissement</td>
</tr>
<tr>
<td>IFA</td>
<td>International Fiscal Association</td>
</tr>
<tr>
<td>ISD</td>
<td>Investment Services Directive</td>
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<td>TEE</td>
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<td>UCITS</td>
<td>Undertakings for Collective Investment in Transferable Securities</td>
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ANNEX 4
LIST OF TASK FORCE PARTICIPANTS*

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<thead>
<tr>
<th>Chairman:</th>
<th>Patrick Zurstrassen</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Senior Adviser</td>
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<tr>
<td></td>
<td>Crédit Agricole Indosuez Luxembourg</td>
</tr>
<tr>
<td>Rapporteurs:</td>
<td>Karel Lannoo</td>
</tr>
<tr>
<td></td>
<td>Chief Executive</td>
</tr>
<tr>
<td></td>
<td>CEPS</td>
</tr>
<tr>
<td></td>
<td>Mattias Levin</td>
</tr>
<tr>
<td></td>
<td>Research Fellow</td>
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<td>CEPS</td>
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<thead>
<tr>
<th>Björn C. Andersson</th>
<th>Kerry Duffain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Vice President</td>
<td>Director</td>
</tr>
<tr>
<td>Handelsbanken</td>
<td>Citigroup</td>
</tr>
<tr>
<td>Arianna Arzeni</td>
<td>Joanna Elson</td>
</tr>
<tr>
<td>Marketing Manager</td>
<td>Director</td>
</tr>
<tr>
<td>Crédit Agricole Indosuez Luxembourg</td>
<td>British Bankers’ Association</td>
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<tr>
<td>Rym Ayadi</td>
<td>Soren Gade</td>
</tr>
<tr>
<td>Research Fellow</td>
<td>Head of Department</td>
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<td>CEPS</td>
<td>Danish Bankers Association</td>
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<td></td>
<td>(Finansradet)</td>
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<td>Alan Barry</td>
<td>Kyriakos Gialoglou</td>
</tr>
<tr>
<td>Senior Product Developer</td>
<td>Research Fellow</td>
</tr>
<tr>
<td>ABN Amro Bank N.V.</td>
<td>CEPS</td>
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<tr>
<td>Tim Blackwell</td>
<td>Charles Goldfinger</td>
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<tr>
<td>Executive Director</td>
<td>Managing Director</td>
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<tr>
<td>UBS Global Asset Management</td>
<td>Global Electronic Finance</td>
</tr>
<tr>
<td>Joanna Cound</td>
<td>Linda Gray</td>
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<tr>
<td>Merrill Lynch Investment Managers</td>
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</tr>
<tr>
<td>Marc Dassesse</td>
<td>Tim Herrington</td>
</tr>
<tr>
<td>Professor</td>
<td>Partner &amp; Head</td>
</tr>
<tr>
<td>ULB (Free University of Brussels)</td>
<td>Clifford Chance</td>
</tr>
<tr>
<td>Bernard Delbecque</td>
<td>Staffan Jerneck</td>
</tr>
<tr>
<td>Senior Economic Advisor</td>
<td>Deputy Director &amp; Director of</td>
</tr>
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<tr>
<td>Terry Donovan</td>
<td>Matthew Judd</td>
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<td>Deputy Head</td>
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<td>Central Bank of Ireland</td>
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* Each member of the Task Force does not necessarily subscribe to every assessment contained in this report, nor does it reflect the views of the respective institutions to which they belong.
Steffen Kern
Senior Economist
Deutsche Bank AG

Helmut Martin
Senior Vice President
Commerzbank EU-Liaison Office Brussels

Steffen Matthias
Secretary General
European Federation of Investment Funds & Companies (FEFSI)

José Navarro de Pablo
Economist
UBS

Richard Parlour
Partner
Richards Butler

Reinhard Petschnigg
Representative
National Bank of Austria

Jane C. Platt
Managing Director
Reuters

Dirk M. Popielas
Head Pension Services Group Germany
Goldman, Sachs & Co OHG

Christopher Preston
Associate-Conduct of Business Standards
The Financial Services Authority

James Ranaivoson
Head of Portfolio Management
European Investment Bank

Derek Reed
Administrator
European Parliament

Wendy Reed
Senior Manager
PriceWaterhouseCoopers

Jean-François Schock
Managing Director
State Street Global Advisors

Axel Schultz
White & Case

Sally Scutt
Deputy CEO
British Bankers’ Association

John J. Stewart
Senior Vice President
State Street Corporation

John K. Thompson
Financial Counsellor
OECD

Mireille Tissot
Member of Senior Management
Swiss Bankers’ Association

Stéphane Tourette
Deputy General Counsel
Credit Suisse Asset Management

Dominique Valschaerts
CCLux

Michael Von Kessel
ADIG – Allgemeine Deutsche Investment Gesellschaft mbH

Philip Warland
Senior Advisor
Regulatory Advisory Services
PriceWaterhouseCoopers

Miles Webber
Head of Public Affairs
Merrill Lynch Europe

Ian Williams
European Affairs Manager
Prudential PLC

Michael John Wilson
Executive Director
State Street Bank Europe Ltd.

Georges Zavvos
Member of the Legal Service
European Commission
INVITED SPEAKERS AND GUESTS

Niall Bohan
DG Market
European Commission

Steinar Bye
McKinsey

Carlo Comporti
DG Market
European Commission

Luis Correia
OXERA

Philip E. Davis
Brunel University

Jose Maria Fombellida
Head of Unit
European Commission

John E Ford
Director, ECP Product Manager
Deutsche Bank AG London

Michael Haag
Secretary General
European Asset Management Association

Friedrich Heinemann
Zentrum für Europäische Wirtschaftsforschung

Ashley Kovas
The Financial Services Authority

Lieve Lowet
McKinsey

Jean-Yves Muylle
DG Market
European Commission

Olle Schmidt
MEP
European Parliament