Asset Management Revolution May Be Looming in Europe

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Originally published in French in *La Tribune*, 2 June 2008

The financial crisis is probably far from over, in spite of reassuring words from various quarters since the Bear Stearns rescue by JPMorgan Chase and the US authorities in March.

Even without knowing what the next steps will be, it is already clear that the market turmoil since last summer has triggered lasting change in banking economic models, risk information processing, or financial regulatory and supervisory frameworks. Some collateral effects are clear, such as the evaporation of entire categories of complex structured products.

Other effects are more indirect and hypothetical. One may be that the crisis might precipitate structural change in the asset management industry, a relatively inconspicuous but increasingly key segment of the financial services industry.

To understand why this might happen, one must recall the development of this segment since a decade or so. The French Asset Management Association (AFG) estimates that total assets under management in Europe have gone from less than €3,500 billion in 1995 to more than €8,000 billion in 2000 and €14,000 billion in 2007. By way of comparison, the much talked-about sovereign wealth funds amount to little more than €2,000 billion globally.

Asset management requires increasingly specific and diversified skills depending on individual investment profiles. This parallel trend of growth and talent specialisation is bound to continue, especially as population ages and third-pillar pensions grow in importance, and institutional investors correspondingly assert themselves with ever higher demands in terms of financial performance.

But meanwhile, the structure of the sector has changed relatively little in continental Europe. The major asset management firms essentially remain fully-owned subsidiaries of large banking and insurance institutions, such as Crédit Agricole Asset Management or AXA Investment Managers.

The likely reason is the large financial advantage of vertical integration which yields significant margins to such financial groups. Unfortunately, available information to assess this effect is scarce and difficult to interpret.

A recent study by Lipper, the specialised unit of Thomson Reuters, contends that the distribution costs of mutual funds are twice as high in Europe than in the US, partly due to the fragmentation of European markets and legal systems. Others put the gap at less.

What remains is that, despite the potential economies of scale which consultancies such as BCG and McKinsey have underlined for years, and notwithstanding Brussels' efforts to push European integration, cross-border consolidation of asset management firms does not happen quicker than at parent company level. As a consequence, the market remains fragmented.

According to a November 2007 speech by Mario Draghi, the governor of the Bank of Italy, no less than 90% of Continental European asset management activity is carried out under the vertically integrated model, compared with less than two thirds in the US and the UK.

The financial crisis may topple this balance. Many banks across Europe are feeling the pressure on their shareholders' equity. Some could conclude that selling off activities is needed in order to restore capital strength.

In spite of being so profitable, asset management subsidiaries are more autonomous, and thus easier to sell off than core business such as retail branches and investment banking units.

A few deals have emerged over the last few weeks. Fortis announced in March the transfer to its Chinese partner Ping An of a 50 percent stake in its asset management subsidiary. This reflects a strategic rationale of development in Asia, but also the need for new capital as a consequence of the acquisition of part of ABN Amro.

More recently, Italy's Monte dei Paschi di Siena announced the auctioning off of a majority of the capital of its asset management arm.

Both of these cases can be considered specific, but others may follow.

The vertically integrated model has obvious advantages for big financial services groups, and will certainly remain dominant in any case.

But even limited development of horizontal competition over the full range of asset management products might hasten the emergence of innovative players, and simultaneously sharpen up the performance of those already in the market for savers' money.

This may prove parallel to the transformation of Europe's telecoms sector since the early 1990s. 'New champions' such as France's Iliad have emerged, and at the same time there has been an appreciable improvement in service offered by incumbents.

The US, where the asset management market is more mature and diversified, offers interesting points of comparison.

The market leader, Barclays Global Investors, stimulated by the US context of fierce product competition driven by institutional investors, has met international success while remaining part of a UK banking group.

Meanwhile, Blackrock, created as recently as 1995, is now one of the Wall Street's most respected firms. In March the Federal Reserve chose Blackrock rather than an older asset manager to take care of the $29 billion of assets it took over from Bear Stearns.

The crisis is seeping into every corner of the financial sector. It is too early to reach conclusions, but its impact on the asset management industry could turn out to be especially profound.

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