Europe Economics

FCA's Market Study and Brexit: Next Challenges for the UK Asset Management Industry

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Europe Economics
Chancery House
53-64 Chancery Lane
London WC2A 1QU

Tel: (+44) (0) 20 7831 4717
Fax: (+44) (0) 20 7831 4515

www.europe-economics.com

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Introduction

Asset management is a major industry in the UK. It provides services to institutions such as insurance companies, pension funds, charities and government as well as individuals. It has emerged from the financial crisis to face a changing and complex regulatory and tax environment and a rapidly changing client base that is older and more risk-averse, yet more sophisticated and demanding. The industry has grown significantly over the past decade, remaining positioned as the largest in Europe by far and second only to the US globally. However, additional challenges and sources of uncertainty are forthcoming: the impact of the UK's decision to leave the European Union and the publication of the interim findings of the Financial Conduct Authority's (FCA) asset management market study.

The UK's decision to leave the European Union is a source of major regulatory and political uncertainty for the asset management industry, which is highly international but simultaneously highly integrated within the EU. The future role of the UK in the global asset management industry will depend on its ability to respond positively to the challenges of the next few years such as ensuring a commercial and regulatory environment which allows firms to continue deliver value for clients in the UK, in the rest of Europe and around the world.

The findings of the FCA's market study cause a shorter-term source of turmoil. It provides evidence of high profitability relative to market benchmarks and weak price competition in a number of areas, especially in actively managed retail investment funds. As a result, a number of remedies are proposed. They primarily aim at improving the transparency of fund charges and fund performance and increase scrutiny of the unregulated investment consultancy market.[1]

Both elements currently cause uncertainty for asset managers. In this briefing note, we will describe their potential effects after having provided an overview of the main facts and figures characterizing the UK asset management industry.

Overview of the UK asset management industry

The UK asset management industry is the largest in Europe.[2] Assets under management reached £5.7 trillion by the end of 2015, representing a growth of 8 per cent per annum over the last decade and bringing the size of the industry to over 320 per cent of UK GDP, compared to an European average of 114 per cent.[3] The UK asset management industry has a global reach: £2.2 trillion is managed in the UK for overseas clients, £1.2 trillion of which is managed for European clients.

The number of asset management firms currently authorized in the UK stands at 1,840, a 2 per cent increase since 2014. Between 2011 and 2015, at least 750 new asset management firms were authorised that currently remain authorised and active. Overall, the industry does not appear particularly

[1] FCA (2016), Asset Management Market Study, Interim Report.

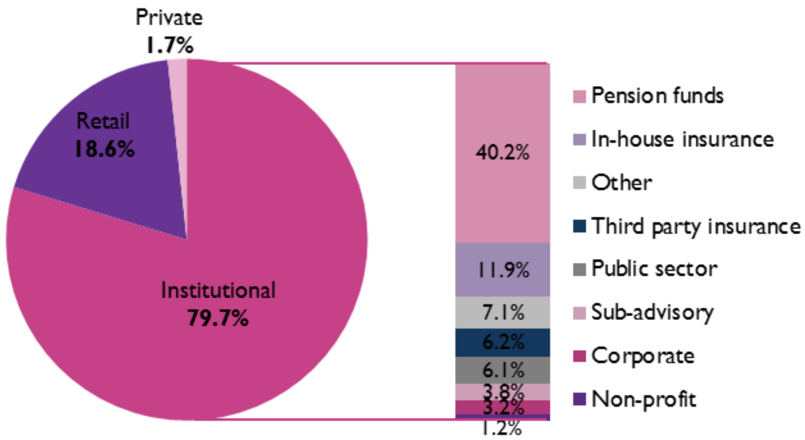
[2] The Investment Association (2016), Asset Management in the UK 2015-2016, The Investment Association Annual Survey.

[3] According to the Investment Association, total assets under management in the wider industry reached around £7 trillion including assets managed by firms that are non-IA members (e.g. hedge funds, private equity funds, commercial property management, and discretionary private client management).

concentrated, with the top ten asset management firms accounting for about 55 per cent of assets under management.[4] Asset management firms can range from small companies with fewer than ten employees to huge international companies employing thousands. Some of them only offer asset management services, while others are part of groups that offer related services such as investment consulting/ platforms and may offer access to other asset managers (e.g. through a multi-manager fund).

The vast majority of assets managed in the UK are managed for institutional clients (80 per cent) compared to retail investors that account for less than 20 per cent. Pension funds are the largest single institutional client type with about £2.1 trillion of assets under management (Figure 1).[5] The distinction of client types is particularly important because behaviours, relationships, governance and investment vehicles are expected to differ significantly. In particular, institutional and wealthy investors are likely to set up 'segregated mandates' which means their money will be managed independently of other investors, whereas retail investors generally invest in funds that combine their money with other investors' to increase scale and reduce costs.

Figure 1: Assets managed in the UK by client type



Source: Investment Association.

A wide range of products can offer investors different combinations of risk and potential rewards. These include: actively managed products; products that can offer small positions either side of the market benchmark; products that can passively track an index by holding securities in proportion to the market; funds that aim at delivering a higher return than conventional passive funds by using alternative weightings ('smart beta'). Since 2005, passive funds have experienced nearly fivefold growth and now represent around 23 per cent of the assets under management in the UK.

FCA's key findings and proposed remedies

The FCA's market study generally found weak price competition and low consumer awareness in the asset management market. In particular, charges of actively managed funds appear to have stayed broadly the same for the last 10 years whereas charges for passive funds have fallen significantly. The finding that "actively managed investments do not outperform their benchmark after costs" also raises some concerns with respect to the relationship between fund charges and investment performance.

4 FCA (2016), Asset Management Market Study, Interim Report.

5 Even though they are labelled as institutional, the end-beneficiaries of many institutional investments are individual investors. Specifically, 75 per cent of UK households have occupational or personal pension wealth and defined benefit (DB) schemes still make up the greatest share of pension scheme assets (FCA, 2016).

The FCA also found that asset managers' operating margin is significant, averaging between 34-39 per cent over the period 2010-2015. These margins are considered to be particularly high compared for instance to the average margins of the firms in the FTSE All share index of about 16 per cent.

Another crucial finding of the market study relates to the role played by investment consultants. The FCA found that investment consultants helped institutional investors choose asset managers which met minimum quality and operational standards, but did not appear to help investors identify better performing managers or drive down costs. In contrast with the asset managers market, the investment consultancy market is relatively concentrated, with the top three firms accounting for around 60 per cent of the market with very low levels of switching.

For these reasons, the FCA study proposes to refer the investment consultancy market to the Competition and Markets Authority as it found limited scrutiny of asset allocation advice provided to institutional investors and potential conflicts of interest. It also proposes to recommend to HM Treasury that this market is brought within the scope of FCA regulation. A summary of the other remedies that have been proposed is provided below.

Strengthened governance

The FCA is considering the option of placing a duty on the boards of managers of authorised funds (AFMs) to demonstrate how their funds deliver value for money to investors, and reforming governance standards. Examples of proposed options to reform fund governance include: reforming the existing AFM board structure to have a majority of independent members and an independent chair; creating additional governance bodies modelled on independent bodies committees; and imposing greater duties on trustees and depositaries.

"All-in" fund fees

Different options are considered to introduce a unique charge that includes all transaction costs and require asset managers to bear any additional transaction costs incurred. Although there are potential benefits to investors for a single charge, the FCA recognises that this proposal transfers elements of risk to the fund manager that might respond by increasing the single charge to cover the risk of higher costs as well as by trading less than is in investors' best interests. Against this background, the regulator is also considering allowing asset managers to charge for "overspend" in exceptional circumstances.

Clear disclosure of fund charges and performance

The FCA proposes fund charges to be disclosed in pound amount by fund managers, advisors and platforms. It is also considering requiring asset managers to explain more clearly the impact charges have on returns on an on-going basis, and to disclose the total cost of investment (including distribution) pre-sale and on an on-going basis. For investors who want to scrutinise more closely the performance of their asset manager, there is the proposal to require asset managers to set specific fund objectives and provide investors with information on whether performance objectives are met, including disclosing managers' benchmarks and performance of funds that have merged or closed.

If the FCA's further work finds a pattern of persistent underperformance in the UK market, it may "shine a light" on funds with long-term underperformance or require asset managers to tell investors when their funds are underperforming relative to the fund's objectives. It also proposes to carry out further research on how asset management services and products are distributed to retail investors. The regulator is seeking feedback on its proposed remedies by 20 February 2017.

Brexit and passporting rights

Following the UK's vote to leave the European Union, asset managers and the financial sector as a whole are also facing another challenge: assessing the impact that the exit will have on their assets under management, the existing financial services regulatory regime, and the ease of conducting their business and marketing their products in the EU. The impact of Brexit on asset and fund managers would depend on the extent to which they are UK, EU or non-EU focused, their range of investment products and the services they offer to investors.

The extent to which access to EU financial markets and financial services will be preserved for asset management firms is directly linked to the discussion about passporting rights. 'Passporting' is the exercise of the right for a firm registered in the European Economic Area (EEA) to do business in any other EEA state without needing further authorization in each country. Often companies based outside of the EEA will get authorized in one EEA state and use its passporting rights to either open an establishment elsewhere in the EEA or providing cross-border services.[6]

Thanks to passporting, asset managers incorporated and authorised in one Member State are able to conduct regulated activities throughout the EU under the freedom to provide financial services provisions of applicable EU directives.[7] In particular, they can set up pooled funds using a variety of forms and manage them within a number of regulatory structures, depending on the directive of reference. For instance, they might be set up as UCITS funds (i.e. funds intended to for the retail market which comply with the requirements of the UCITS Directive).[8] Some pooled funds are also subject to the Alternative Investment Fund Manager Directive (AIFMD) which regulates the fund manager rather than the fund itself, while many operators will delegate the fund management to a MiFID investment manager.[9]

At the moment, 244 asset management firms out of the 1,840 authorised in the UK have passport under an EU directive. Additionally, 139 firms have inbound passports, meaning that they can sell their financial services from other EEA jurisdictions into the UK. It is important to notice that funds can be managed in a jurisdiction that is different from the domicile. While the UK is the largest centre in terms of assets under management in Europe, it is only the fifth largest domicile centre (11 per cent of European investment funds are domiciled in the UK).[10] Fund domicile determines the tax treatment of the fund whereas fund domicile in combination with other factors dictate the regulatory treatment.[11]

Passporting has been used extensively to shape the way many asset managers conduct their businesses; for instance, by allowing funds concentrating in centres such as Dublin or Luxemburg, as well as by enabling non-EU managers (e.g. from the US and Switzerland) to establish their presence in the UK, from which they can passport into other EU Member States.

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6 According to FCA figures, 5,476 UK-registered firms hold at least one passport to do business in another EU or EEA Member State, while over 8,000 companies authorised in other EU states use these rules to do business in the UK – a sign that the passporting rules are also important to non-UK firms.

7 The most relevant directives for asset managers are the following: AIFM, UCITS and MIFID directives.

8 The Undertakings for the Collective Investment of Transferable Securities (UCITS) is a regulatory framework of the European Commission that creates a harmonized regime throughout Europe for the management and sale of mutual funds. UCITS funds can be registered in Europe and sold to investors worldwide using unified regulatory and investor protection requirements. UCITS fund providers who meet the standards are exempt from national regulation in individual European countries.

9 An investment management firm subject to the Markets in Financial Instruments Directive.

10 The largest fund centre in Europe is Luxemburg (26 per cent), followed by Ireland (14 per cent), France (13 per cent) and Germany (13 per cent). http://rapport.alfi.lu/en/statistics-luxembourg-global-player.

11 EFAMA, Asset management in Europe, 8th Annual Review. http://www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf.

Depending on whether EU or UK focused asset management firms are operating uniquely within their own geographic market or not, the impact of Brexit will be different, as described below.

- UK focused asset and fund managers:
  - UK entities and their UK subsidiaries as well as UK branches of non-EU entities will not face any material impacts unless they rely on passports to market their funds into the EU or provide advisory services to EU clients. Brexit would likely mean UK firms would no longer qualify for a passport under existing EU legislation and, therefore, it would be necessary for them to consider obtaining separate licences in the relevant EU jurisdictions to the extent available and revisiting subsidiary group structures.
  - EU branches of UK focused asset and fund managers will likely lose passporting rights and may be forced to comply with local licensing requirements in the relevant EU jurisdictions or close conversely, on the basis that they would then be branches of a non-EU entity.
- EU focused asset and fund managers:
  - EU asset managers operating in the UK who do not wish to limit their UK activities would need to consider establishing a UK subsidiary, or obtaining UK authorisation if operating on a cross border basis.[12]

Conclusions

The UK asset management industry is now facing multiple challenges. They range from political and regulatory turmoil at the national level to worldwide weak economic growth and growing political instability, especially in Europe.

On the political side, there is still high uncertainty about the possible post-Brexit models. Asset and fund managers can achieve meaningful mitigation of the risks posed by the decision to leave the EU by actively monitoring the post-Brexit arrangement negotiations and planning their business models and group structures accordingly.

On the regulatory side, the publication of the FCA's interim report is arguably an important moment for the UK fund management industry and may challenge the fundamentals of the investment management model. The proposed remedies are likely to increase awareness and hence scrutiny of fund charges and investment performance. Asset managers will need to review the competitiveness of their offerings, with a particular focus on higher margin and underperforming products. For investment consultants, the prospect of a market investigation reference to the CMA will require careful consideration and positive engagement with the FCA during the consultation period.

[12] Allen & Overy (2016), Impact of Brexit on asset and fund managers.