

The Future of UK Asset Management: Competitive Position and Location Choice



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Foreword

Michael Snyder
Chairman, Policy and Resources Committee
Corporation of London

I am very pleased to introduce this important piece of research exploring the competitive position of the UK asset management industry which the Corporation of London has commissioned in association with the Investment Management Association.

The researchers and authors of the report – Oxera – were asked to assess the competitive advantages of the UK asset management industry and measure the durability of the UK as location choice for such activity. The significance of this research lies in the methodological approach employed. For the first time, the constituent parts of the industry – its value chain – are analysed separately and in detail. The benefit of this approach is that it identifies both diverse and mutual pressures operating on different aspects of the fund management industry. By separating the industry into its three key components – core asset management, middle and back office, and marketing and distribution, we are able to identify the forces that determine location choice.

The results of this approach show that there is much to recommend the UK as a location of choice for asset management. Core asset management activities benefit from the excellent supply-side factors that the UK, and the City cluster in particular, has to offer. The availability of qualified labour and liquid capital markets ensure that the UK is particularly attractive for core operations. Likewise, the proximity to a large client base makes it advantageous to retain marketing and distribution functions in the UK. Policy-makers will, however, be concerned that the location of middle and back office functions is susceptible to cost pressures.

From the interviews with senior figures inside the industry, it is clear that legal, regulatory and tax factors will increasingly influence future location decisions. In the light of this, I hope the conclusions of the report will encourage policy-makers to consider what measures can be taken to protect the competitive advantages of a major industry in the UK.

*Michael Snyder
London
May 2005*

Foreword

Lindsay Tomlinson
Chairman
Investment Management Association

The Investment Management Association is delighted to co-sponsor this thought-provoking analysis into the dynamics of, and pressures on, the UK asset management industry.

This report argues that the industry is part of a cluster of financial services which depend one upon another, but that also the asset management industry is itself a cluster of component functions. The original reasons why this complex web of functions and relationships grew in the UK rather than elsewhere may have long since evaporated – what we have now is a ‘virtual’ cluster. Using the analogy of the children’s game of pick up sticks – a game in which participants try and remove individual sticks one by one without disturbing the rest of the pile – the key judgement now is about which sticks matter and which don’t in maintaining the structure of the industry. A number of important questions are raised. What is the glue that now holds the cluster together? What are the critical relationships? In sum, which sticks matter and which don’t?

This report presents a number of fascinating insights. The factors affecting the location of the constituent parts of the business differ appreciably, and the performance of the UK in relation to these also varies. While the overall message is positive, particularly for core asset management activities, we cannot afford to be complacent. As a virtual cluster, the potential for relocation is much greater. The IMA is committed to working with government and regulatory authorities to ensure that the potential threats identified in this report do not harm the industry in the future.

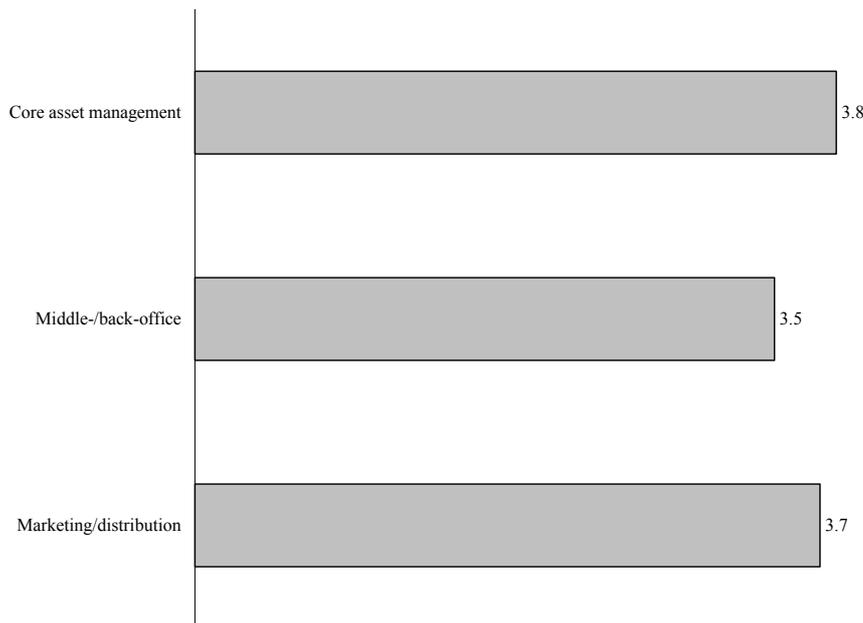
Lindsay Tomlinson
London
May 2005

Executive Summary

This study examines location choice in the asset management industry, the competitive position of the UK as a centre for asset management, and the major influences that may affect this position in the future. The analysis is based on a survey of 31 asset management firms, covering the majority of assets managed in the UK, and 27 in-depth interviews with asset managers, outsourcing service providers and experts on fund regulation and tax.

- There are three key parts of the asset management's value chain: core asset management, middle and back office, and marketing and distribution. The factors affecting the location of the three parts of the business differ appreciably, and the performance of the UK in relation to these also varies.
- The location of the core asset management function is primarily driven by supply-side factors, including availability of qualified labour, the performance and liquidity of capital markets, and the quality of the financial infrastructure. The UK performs well on these.
- The location of middle-/back-office functions is mainly influenced by cost considerations—in particular, the cost and availability of labour and property. This put the UK—in particular, London—at a disadvantage.
- The location of marketing and distribution functions is primarily driven by demand-side considerations. Proximity to clients is important, and the large pool of domestic savings means that the UK performs well in this respect.
- The chart overleaf compares the performance of the UK across the three parts of asset management. It shows a composite performance score for each part. Those surveyed were first asked to rank the importance of factors determining location choice and then asked to consider how well the UK scores on each factor, using a scale of 1 (very poor) to 5 (very good). The UK scores for each factor were then weighted according to the importance attached to the factor to derive the composite performance score.

Overall score of UK location



Source: Oxera questionnaire.

- The UK performs best in relation to core asset management and worst in relation to middle-/back-office functions, although the differences based on the overall score averages shown in the chart appear small.
- A substantial proportion of the middle/back office has already been outsourced or relocated within firms or groups, although much of this has been within the UK. Several asset management firms indicated their intention to continue relocating or outsourcing middle-/back-office functions in the next few years, and to consider the transfer of at least some functions to low-cost locations outside the UK. Given the high proportion of asset management employment in the middle/back office, this could have considerable consequences for UK employment.
- Core asset management and marketing/distribution activities currently appear to be quite securely located in the UK, and asset management firms generally expected no significant shifts of business outside of the UK at least in the next few years.
- Regulation and, to a lesser extent tax, rate highly as some of the most significant influences on the choice of where to locate core asset management and marketing/distribution activities. To date, regulation and tax have not led to

significant relocations of these activities outside the UK, and in some respects the UK regime is perceived as being supportive. Nevertheless, concerns have been expressed about the how regulation and tax in the UK may develop.

- Collective investment funds, including specialised vehicles such as hedge funds and money market funds, have increasingly been domiciled overseas, in particular in Dublin and Luxembourg. Although the management of the funds remains in the UK, associated administrative functions have been relocated as a consequence of overseas domicile, and further activities may move in the future.
- The separation of asset management into its component parts allows different locations to specialise in different parts of the value chain. This process of specialisation is likely to continue.

Core asset management

- The UK is secure as a centre for asset management in at least the short term (one to three years) and possibly longer.
- The main reason for this is the advantage that firms derive from clustering in one location and being in close proximity to a major international financial centre.
- The location of core asset management functions is primarily driven by supply-side factors. The main factors contributing to the success of the UK are the performance and liquidity of the UK's capital markets, the quality of its financial infrastructure and the size of its qualified labour pool.
- Regulatory considerations rate highly as some of the most significant influences on the choice of location of asset management. Tax is also important, although, in relation to asset management, is not cited as frequently as regulation.
- For the most part, the UK regulatory regime is regarded favourably. UK regulation is perceived to be more independent than most European systems and more principles-based than that in the USA.
- UK regulation is, however, also viewed as bureaucratic, prone to gold-plating, excessively rigid in the implementation of EU Directives, and more recently subject to excessive change.

- These concerns are more prevalent among firms servicing retail rather than institutional investors and were most often mentioned in relation to the regulation of collective investment schemes.
- Reliance on agglomeration factors for the preservation of the UK as a financial centre for asset management makes it fragile and potentially vulnerable to contraction. Regulatory, tax or other concerns, such as physical congestion and poor transport infrastructure, could prompt an exodus of firms in the longer term.

Middle and back office

- A substantial proportion of middle- and back-office activities have already been relocated within companies or outsourced.
- Outsourcing has been particularly significant in relation to custody, stock lending, transaction processing/settlement, and investment accounting.
- Most relocation to date has taken place within the UK (e.g. from London to regional centres). Some transaction processing, custodianship and investment accounting functions associated with collective investment vehicles have moved to Dublin and Luxembourg. A modest amount of relocation has occurred within Europe or to the USA for strategic reasons. To date, there is only limited evidence of outsourcing further afield (e.g. to India or South Africa).
- Neither regulation nor taxation is a primary motive for outsourcing.
- The location of middle- and back-office activities is essentially driven by cost-minimisation considerations. The most important influences on location decisions are the cost and availability of labour and property. The UK is ranked poorly in relation to these. Its high cost of labour and property make it an unattractive location for middle- and back-office activities.
- Looking forward, several firms indicated their intention to outsource middle- and back-office activities within the next five years. Most of these are the same activities that have been relocated in the past.
- While some firms saw advantages in being in close proximity to external providers of middle- and back-office functions, these providers are in turn

expected to source their inputs from the lowest-cost locations. Outsourcing to other firms is therefore likely to result in the transfer of at least some functions to low-cost locations.

- Given the high proportion of asset management employment in middle- and back-office functions, the consequences of this for UK employment are potentially considerable.

Marketing and distribution

- The location of marketing and distribution is primarily driven by demand-side considerations.
- The most important influences on the location of marketing and distribution are the pool of savings and proximity to clients. The UK scores well in relation to these, and asset management firms attached a low probability to the likelihood of this part of the business being relocated elsewhere.
- In the longer term, however, a declining savings pool or a worse regulatory and tax environment could undermine the UK's position.
- Funded pensions are particularly important in this regard, since they have made a major contribution to the growth of asset management in the UK in the past. In future, there is likely to be an expansion of funded pension schemes in Continental Europe.
- This presents significant opportunities and threats. On the one hand, it offers considerable scope for the expansion of asset management in the UK, particularly as the cross-border barriers to integration of European financial markets are removed. On the other hand, it poses a competitive threat to the UK by allowing other capital markets to grow in competition with London.
- While different factors drive the location decisions of core asset management and marketing/distribution, the relocation of marketing and distribution could have significant implications for where the actual management of the assets is undertaken.

Domicile of collective investment funds

- The effect of regulation and taxation has been most strongly felt in relation to the domicile decision of collective investment funds—including, in particular, specialised funds such as hedge funds and money market funds.
- The three most popular locations for domiciling such funds in Europe are Dublin, Luxembourg and the Channel Islands.
- Withholding taxes, corporation tax and VAT are all relevant to domicile decisions, but it is VAT that is most relevant to the decision by funds to locate offshore from the UK. Stamp duty and capital gains taxation were also cited as relevant, in particular to the location decisions of hedge funds.
- Domiciling funds offshore has been encouraged by a more responsive attitude of regulatory authorities in Ireland and Luxembourg towards the fund industry. The range of legal fund structures available and the comparative ease with which certain types of fund can be established and approved by the authorities make the legal and regulatory regimes of the offshore domiciles more attractive than the UK regime.
- While it may not be appropriate for the UK to adopt the regulatory arrangements of more liberal regimes in their entirety, the UK collective investment business was felt to have suffered from regulation that lacks flexibility.
- The development of offshore centres may have significant employment and revenue consequences. These are not confined to the administrative functions directly associated with offshore domicile of funds, but also include employment in broader tax, legal and other support services.
- Offshore domicile is a matter that deserves close attention by the UK authorities since the creation of these alternative centres shows the potential mobility of the industry.

1. Introduction

The Investment Management Association (IMA) and the Corporation of London commissioned Oxera to undertake a study of the UK asset management industry. The research was designed to identify the determinants of the competitive advantages of the UK asset management industry and the durability of the UK as a location for asset management activity, including the legal, regulatory and tax factors that may cause asset managers to relocate parts of their business going forward.

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

Asset management is a major industry in the UK. Although accurate estimates are difficult to obtain, industry-wide figures suggest that the UK asset management industry was responsible for assets of at least £2.8 trillion at the end of 2003 (Table 2.1).¹ Around 68% of assets were managed on behalf of UK institutional clients. Nearly a quarter of assets were managed on behalf of overseas clients, and UK private clients accounted for the remainder.

Table 2.1 Assets under management in the UK, 2003 (£ billion)

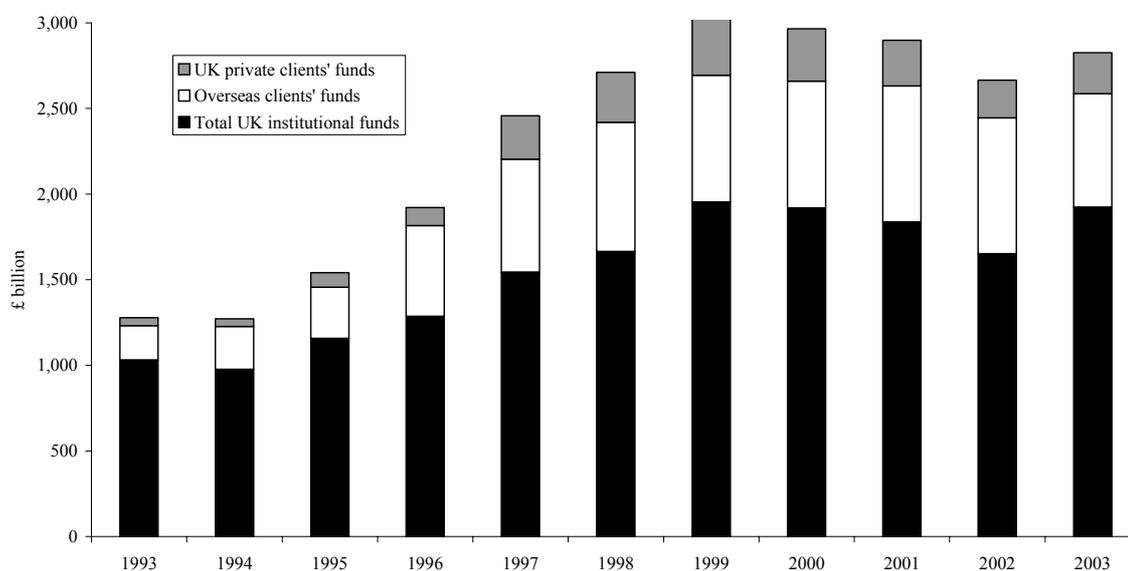
	UK clients	Overseas clients	Total
Institutional	1,923	608	2,532
Private	239	55	294
Total	2,163	663	2,826

Source: International Financial Services London (IFSL) (2004b).

¹ The reported figures may contain an element of double-counting.

Assets managed in the UK in 2003 were up 6% on the previous year, but still 7% lower than at the peak in 1999. This followed a period of high growth in the 1990s during which funds more than doubled (Figure 2.1).

Figure 2.1 Growth of assets under management, 1993–2003 (£ billion)



Source: IFSL (2004b).

The UK is one of the largest centres for asset management in the world and by far the largest in Europe. Ranked on the basis of the major classes of assets under management (AUM), the USA is the largest, with nearly half of the world total in 2003. As reported in Table 2.2, the USA was followed by Japan, with 12%, and the UK, with 8%.

Table 2.2 Sources of global assets under management, 2003 (\$ billion)

	Pension funds	Insurance companies	Mutual funds	Total
USA	7,492	4,633	7,414	19,539
Japan	2,867	1,919	349	5,135
UK	1,406	1,676	397	3,479
France	143	918	1,148	2,209
Germany	229	984	276	1,489
Netherlands	615	271	97	983
Switzerland	388	241	91	720
Other	1,827	2,857	4,186	8,870
Total	14,967	13,500	13,958	42,425

Note: Not included in this comparison are funds from private wealth and funds from alternative sources such as hedge funds.

Source: IFSL (2004b).

However, rankings based on source of assets understate the UK's position due to the substantial value of assets managed in the UK on behalf of overseas clients, as shown in Table 2.1 and Figure 2.1. The total amount of assets managed in the UK is larger than that managed in France and Germany combined. London is central to the UK's strong international position, and London is the leading centre internationally for asset management along with New York (IFSL, 2004b).

Asset management makes a significant direct contribution to the UK economy. The value-added of the industry has been estimated at 0.5% of GDP or £4.9 billion in 2003 (compared with the financial sector's total share of 5.3%) (IFSL, 2004b). The UK asset management industry also makes a significant contribution to the trade balance, with net exports estimated at £1.2 billion in 2003 (or just under 7% of total net exports of the UK financial services sector) (IFSL, 2004a). In terms of employment, data gathered by the IMA shows that, for a sample of 51 asset managers (representing 82% of UK AUM), total staff numbers of the firms amounted to 23,290 in 2003 (IMA, 2004). Industry-wide employment numbers are significantly greater.

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

Given the significance of asset management to the UK economy, the competitive advantages and deficiencies of the UK as a location of asset management are clearly of considerable importance. In evaluating the UK's competitive position, Oxera has had to take account of the diverse nature of the asset management business - the activities of which include segregated asset management for both institutional and retail investors, and the management of different types of collective investment funds, including specialised products such as hedge funds or money market funds, for these investors. Moreover, asset management covers a broad range of functions, comprising marketing/distribution, management, and middle-/back-office activities.

The remainder of this study is structured as follows:

- Section 2 summarises the research approach used by Oxera to carry out the study;
- Section 3 provides a review of existing research studies relevant to the determination of location decisions of asset management firms;
- Section 4 presents the main findings of the research, based on empirical evidence obtained from a survey carried out among a large sample of UK asset managers which are members of the IMA, and from in-depth interviews;
- Appendix 1 reproduces the questionnaire sent to IMA members. The lists of survey participants and interviewees are provided in Appendices 2 and 3.

2. Research Approach

A three-pronged approach was undertaken to determine the location decisions of asset management firms. The first step was a review of the existing literature on location decisions and the competitive position of different financial centres, including those in the UK. Many reports have been written on the City of London as a financial centre and on the future of the asset management industry. In addition, there is academic literature on how firms make location decisions and on the influences on location choice. This research was important in allowing the identification of key influences on location choice and the main areas of controversy that this research should address. Elsewhere, Oxera has written about the asset management business and its regulation, and in this report has drawn on the results reported there.²

Second, an in-depth survey of different types of firm was carried out to provide more precise and quantitative indicators of the determinants of location. The questionnaire was developed on the basis of a series of meetings with the IMA and four pilot interviews with representatives from the UK asset management industry. These meetings were often at, or close to, the most senior levels of the business.

The questionnaire began by addressing a set of ‘high-level’ questions. Has your firm relocated all or parts of its business recently? Has your firm withdrawn any significant parts of its business? Have you started new lines of business outside of the UK? Are you contemplating relocating any parts of your business in the near future? The focus of the high-level analysis was therefore on location and relocation decisions that have actually taken place or are being contemplated. The questionnaire then considered the nature of the businesses, why their activities are located in different areas of the world, the breakdown between activities (core asset management, marketing/distribution, and middle-/back-office functions) and their contributions to employment and value-added. It examined outsourcing decisions and the factors influencing outsourcing, including regulation and tax.

² See Oxera (2002), prepared for European Asset Management Association (EAMA); Oxera (2003), prepared for the Financial Services Authority (FSA); Franks, Mayer and Correia da Silva (2003), based on a report by Oxera (2001) also for EAMA; and Franks and Mayer (1991), a report prepared by members of the Oxera team for the Investment Management Regulatory Organization.

The questionnaire asked respondents to identify the significance of a number of factors to their location decisions, and the performance of the UK in relation to these factors. It did this separately for core asset management, marketing/distribution, and middle/back office. Questionnaire respondents were also asked to rank the UK in relation to other financial centres in terms of regulatory environment and the degree to which firms believe that other firms in the industry are likely to locate elsewhere, and which types of firm are most likely to do so.

In total, 31 responses were received, representing a response rate of 43%. These provide good coverage of the asset management industry by ownership, size of company, and type of asset managed. 26 of the 31 respondents reported total assets under management (AUM) in the UK amounting to £1.25 trillion. This represents 44% of the comparable figure estimated by the IFSL as at the end of 2003, and 63% of the figure estimated in the IMA's most recent annual survey (IMA 2004). The average (mean) value of AUM of the respondents was £47.9 billion, with a median value of £21.9 billion.

Sufficient information on AUM was given by 22 respondents to allow a split to be made between institutional and retail client types. Of the AUM that could be categorised along these lines, 76% were managed on behalf of institutional clients and 24% on behalf of retail clients. Of the assets that could be categorised, 72% were managed in segregated funds and 28% in collective vehicles. In terms of firm ownership, 33% of respondents were part of insurance groups, 29% were a fund management group (or part thereof), 21% were owned by investment banks, 13% by retail banks and 4% were custodians.

During the third step of the research, follow-up interviews were undertaken with 16 of the respondents to provide further clarification of the answers. This established whether there were any omissions from the questionnaire and whether respondents wanted to highlight policy issues that the questionnaire might have missed. In addition to interviewing traditional asset management firms, the research questions were discussed with representatives from hedge funds, money market funds, outsourcing providers, and experts on the legal and regulatory aspects of fund domicile decisions. A further seven such interviews were undertaken, resulting in a total of 27 interviews, including the four pilot interviews.

3. Literature Review

This section reviews the theoretical analysis of the location choice of firms, before examining the empirical evidence on what influences choice in practice, focusing on financial services firms and asset managers.

3.1 Theoretical considerations

Traditionally, economic theory has sought to explain the location choice of firms by reference to the presence in a particular location of an abundance of factors of production (labour, raw materials, land or capital), leading to one factor of production being inexpensive to acquire in one location relative to the other. This results in firms that use that factor of production intensively locating in countries where it is abundant. For example, in the context of asset management firms, access to skilled and trained labour is particularly important. Asset management firms may therefore be expected to locate in countries in which there is an abundance of skilled labour. Over time, the definition of factors of production has been extended to include intangible assets such as culture and institutional frameworks. So, for example, in addition to labour and capital, quality of life, regulatory environment and political stability are emphasised.

This traditional ‘factor of production’ approach has been supplemented in recent years by an ‘economic geography’ approach. Nachum (2000) describes this as follows:

This approach has emphasised the advantages accruing to firms located in geographic proximity as the major factor explaining location pattern. This research has shown that links among firms, institutions and infrastructures within a geographic area give rise to various forms of localised externalities that are external to individual firms but internal to the cluster, and are vital for the competitive success of the individual firms taking part in them ... the search for geographic proximity to such clusters is a major factor affecting the location choices of firms concerned.

In essence, it is argued that there are ‘agglomeration economies’ associated with locating in close proximity to other companies of a similar nature, leading to the creation of a cluster. A significant amount of research has attempted to identify the

precise benefits associated with clustering.³ On the demand side, this research has suggested factors including the following:

- locating in a cluster will make it more likely that the firm will be found by its (potential) customers;
- locating in a cluster signals that the firm is of a high quality—i.e. the firm receives a reputational benefit;
- when deciding whether and where to locate, the success of other firms already located in the cluster suggests to a potential entrant that it is likely to benefit from considerable demand if it locates in that cluster;

and the following on the supply side:

- firms benefit from information spillover within a cluster through labour market turnover, social interaction and diffusion of information via clients and suppliers. It has been stressed that it is not only the volume of information but also its quality and timeliness that are important;
- within a cluster, there is easy access to specialised inputs—in particular, vacancies may be filled faster and staff may be of a higher quality;
- proximity to other companies provides a powerful spur for performance and makes it easier to measure performance across rivals;
- within a cluster, there is more likely to be good access to supporting institutions (e.g. legal, actuarial, accounting advice, as well as trade associations).

Researchers have also sought to explain why, over time, some clusters dissipate. Factors considered include congestion effects in input markets, such that the cost of certain factors of production increases to a level that firms find prohibitive, or that the product market competition within the cluster becomes too intense. In essence, the positive feedback mechanisms that are present when a cluster is growing are replaced by negative feedback mechanisms, as ‘too many’ firms locate in an area. On this basis, some theorists have suggested a life-cycle theory of clusters.

³ Pandit, Cook and Swann (2002); Taylor *et al* (2003); and Porteous (1999).

Finally, although emphasis has tended to be placed on the differences between the two approaches outlined above, researchers have increasingly been seeking to combine the two. One such framework is described by Pandit, Cook and Swann (2002). Under this approach, it is the ‘fixed effects’ emphasised by the traditional location models (i.e. abundance of factors of production which are used intensively by particular types of firms) that initially make a location attractive for firms, and which are conducive for those firms to grow. In turn, however, the growth of these firms makes the area more attractive to other new entrants, for the reasons outlined above. Over time, this leads to the development of a cluster. As the cluster grows, and/or possibly contracts, the fixed factors that explained the initial development remain in place, but are not altered by the growth or contraction of the cluster.

3.2 Empirical research: financial services

3.2.1 Academic work

Considerable attention has been devoted to the location choice of financial services firms, not least because they provide good tests of the cluster theories. As Raikes and Newton (1994) argue:

financial centres can reach a ‘critical mass’ which allows them to grow in a self-sustaining way and attract newcomers to the markets. At the same time, the range of business and financial participants begin to develop synergies which allow further economies of scale and scope.

A study by Nachum (2000) attempted to examine whether the ‘traditional’ factors or the ‘economic geography/agglomeration economies’ arguments are more important in determining the location choice of transnational corporations (TNCs) in the financial and professional services industries across the different states of the USA. The conclusions drawn from this econometric analysis are as follows.

- Both location and agglomeration factors seem to be important in determining the location of foreign direct investment (FDI) in the financial and professional services industries (in that the model containing both sets of factors provides a better fit than that using one set of factors).

- The location advantages of states are more important than the agglomeration effects in determining the location choice of FDI, and these are more important in the financial services industry than in the professional services industry.
- The value of location advantages in explaining location decisions has fallen over time, and the value of those related to agglomeration economies has risen.

A different research question examined by Pandit, Cook and Swann (2002) was whether the advantages purported to be associated with clusters—specifically, above-average firm growth, as measured by firm employment, and new entry—are observed in the UK financial services (and broadcasting) industries. As well as examining the financial services industry as a whole, the study considered sub-sectors, such as banks, life insurance firms, and, importantly in this context, trusts.⁴ The study found that:

- cluster strength within a particular sub-sector (e.g. trusts) significantly promotes above-average firm growth within this sub-sector, but the strength of other sub-sectors within the overall industry significantly inhibits the growth of individual firms;
- the presence of trusts appears to attract entry into ‘non-bank activities’ and stock market activity, but that there are no other sub-sectors which encourage entry into the trusts sub-sector.

In other words, there are cluster benefits in trusts, and these spill over into some other financial services.

As well as questions regarding factors leading to cluster formation and the consequent benefits, academic studies have considered the relative strength of different financial service clusters. For example, Abraham *et al* (1994) asked ten academics and people from the banking world to rank six European financial centres on their performance against 47 criteria. They were also asked to rank the importance of each of the factors identified. The rankings were then weighted by the average importance attached to

⁴ Defined as ‘activities of investment trusts, activities of unit trusts and property unit trusts, security dealing on own account, pension funding, other financial intermediation not elsewhere classified’.

each of the factors. After some further aggregation, the overall results were, in descending order:

- 1) London
- 2) Paris
- 3) Frankfurt
- 4) Luxembourg
- 5) Zurich
- 6) Brussels

Although not directly concerned with the financial services industry, and also slightly dated, Molle *et al* (1989) present the results of a further survey that considered seven European cities as location options for headquarter functions, and ranked them according to six criteria: infrastructure and accessibility; agglomeration benefits; the presence of a highly qualified workforce; the quality of accommodation; the fiscal and legal environment; and the quality of the environment. These weighted rankings were:

- 1) London
- 2) Paris
- 3) Brussels and Randstad
- 4) Frankfurt and Munich
- 5) Hamburg

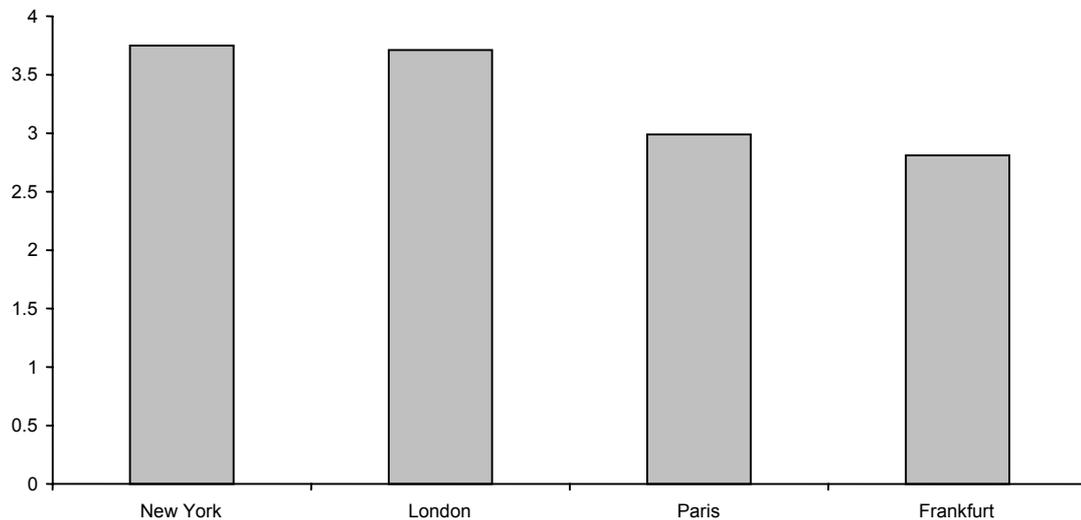
3.2.2 Survey analysis/consultants' reports

The academic work comparing clusters has been supplemented, and to a large extent corroborated, by a series of surveys undertaken by consultants. For instance, in 2003 the Corporation of London published the results of a survey, undertaken by the Centre for the Study of Financial Innovation, of City-based firms on the competitiveness of London as a financial centre, and the factors affecting its competitiveness. 274 responses were received, identifying six key factors driving competitiveness (in descending order of importance):

- 1) Pool of skilled labour
- 2) Competent regulator
- 3) Favourable personal/corporate tax regime
- 4) Responsive government
- 5) Light regulatory touch
- 6) Attractive living and working environment.

Weighting the scores of each factor according to the importance attached to it by the respondents, the overall scores (1 = least competitive, 5 = most competitive) achieved by London compared with three other major financial centres are shown in Figure 3.1.

Figure 3.1 Ranking of financial centre competitiveness



Source: Centre for the Study of Financial Innovation (2003).

This research is also broadly consistent with the work carried out by Lombard Street Research (2003), which came to the conclusion that:

if London has a competitiveness problem it is relative to the other big centre (that is, New York) and aspiring smaller centres in Switzerland and outside the EU.

The study noted that the main advantage that the smaller, peripheral centres were likely to have over London was a less punitive tax and regulatory regime. The study quoted a Forbes survey from May 2003 which stated that the tax burden in the UK was close to the median of the 47 countries investigated.

A further study undertaken in 2004 on behalf of the Corporation of London by the centre for economics and business research (cebr) examined, in general terms, the strengths and weaknesses of London as a financial centre. The study noted that London's main advantages are:

- the presence of a large and highly skilled labour force;
- a very flexible labour market, especially compared with other European centres;

- a home language that is also the international language of business;
- liberalised, efficient and relatively low-cost telecommunications;
- low levels of corporate and personal taxation by European standards, combined with tax arrangements that are particularly favourable to UK residents of foreign nationality;
- an efficient financial infrastructure, combined with fair and flexible regulation;
- the benefits associated with clustering with greater economies of scale than other financial centres and second only to New York in economies of scope.

This is countered by four identified weaknesses:

- an inadequate transport infrastructure;
- high labour and property costs;
- a perceived lack of policy coordination; and
- a dominance of foreign-owned institutions.

A similar type of survey undertaken by Taylor *et al* (2003) on behalf of the Corporation of London examined the advantages and disadvantages of London, specifically related to the fact that the City of London (including Canary Wharf) is a well-defined financial services cluster, and so should allow its members to take advantage of the benefits discussed above. Based on survey evidence, the report found that the main advantages derived from the cluster were:

- the reputational benefit (i.e. information externality) associated with a City of London address;
- proximity to customers that will stimulate innovation;
- proximity to customers leading to lower consumer search costs;
- knowledge spillovers through labour market turnover, social interaction and diffusion via clients and suppliers;
- face-to-face contact, and ease of arranging meetings;
- access to specialised inputs, especially specialised labour (flexibility, size, ease of recruiting good quality senior managers);
- access to supporting institutions (e.g. accounting, legal, actuarial);
- institutions that coordinate activities across companies to maximise collective productivity (i.e. trade associations);

- local rivalry provides powerful spur for performance;
- ease of measuring performance across local rivals;
- social environment, including ease of walking between clients.

However, the report also noted that the development of the cluster had led to some disadvantages for its members. The survey identified the most important of these to be:

- more intense competition, leading to falling profits;
- congestion and competition in input markets, leading to higher prices in these markets;
- transport difficulties (across London and between London and other cities).

3.3 Empirical research: asset management

Considerably less attention has been given in the literature to the specifics of the asset management industry, despite it having been recognised as an important area of study.

As Lewis (1995) notes:

It is ... an operation which encapsulates the complexity of locational decisions in financial services. Fund managers have to balance physical proximity to customers, closeness to the markets in which they deal and relations to other fund managers. Portfolio management can be separated from administration and other 'back office' activities and the type of fund is also a conditioning factor.

Bodenman (2000) is an exception to the paucity of analysis. Using econometric techniques, his paper examines how the nature of an asset management company is likely to determine where the company is located. Specifically, Bodenman examines how the nature of the asset management business makes it more or less likely that the company will locate in the financial core or periphery.⁵ Using data on US asset management firms, his main findings are that firms with:

⁵ A number of different definitions of 'core' are used: one definition is anywhere within New York, Boston, Chicago, Los Angeles or San Francisco; a second definition considers core as locating in a central county of a metropolitan area with 1 million or more people; and the third definition is located in the central city of a metropolitan area with 1 million or more people.

- parent companies are more likely to locate in the core than independent firms;
- ‘street-oriented’ styles are more likely to locate in the core, while firms that use quantitative or passive trading styles are more likely to be located outside the core.

A number of other factors are found to have little or no impact on location choice, including the size of the firm (measured by AUM, number of clients or number of employees), whether a firm is a single- or multi-site company, its age, and whether the firm outsources its research activities.

As part of a wider-ranging international survey, Walter (1999) also briefly discusses the location choice of asset management firms. He predicted, in 1999, that the asset management industry in Europe might come to resemble that in the USA, and specifically that:

- there may be a single market for transaction executions, separate from the seat of monetary policy and financial regulation;
- asset management centres would be dispersed, and on occasion there might be no centres as such, given that ‘the necessary information, interpretation and transactions services can all be delivered electronically and in real time’; and
- specialist centres are likely to emerge, focusing on particular financial instruments or industries.

Walter predicts that London and Switzerland will continue to share the top spot as locations for undertaking asset management, and anticipates, if anything, greater polarisation between these two centres and other locations in Europe.

Finally, as part of a recent project, Lombard Street Research (2003) has examined the prospects of the asset management industry in the City of London. Overall, the report considers that the prospects for further growth in the industry remain excellent, noting that two main drivers for further growth remain in place: the expansion of the quoted sector of the economy relative to the unquoted; and the increased institutionalisation of savings. However, the study also identifies some regulatory threats, particularly to the retail side of the industry. Specifically, it argues that:

- a reduction in the tax advantages of savings and regulatory concerns about traditional saving forms (particularly with-profits life insurance policies) may inhibit the growth of the industry;
- the proposed EU rules on capital adequacy may increase the number of funds that will register outside of the UK (although not necessarily the management of those funds);
- the unbundling of brokers' services, as proposed by the Financial Services Authority (FSA), will interfere with fund managers' operational freedom and could drive business to other centres.

3.4 Main findings and research agenda

This review of the literature has identified several key considerations that have formed the basis of our subsequent research, and feature prominently in the remainder of this report.

- It has highlighted the importance of two determinants of firms' location choice: the supply of factors such as skilled labour and infrastructure; and the cluster effects resulting from the agglomeration of firms in a single location and the diseconomies caused by congestion.
- The existing literature has identified traditional factors—in particular, the supply of skilled labour—as important in firms' location decisions in practice. It also finds that the factors that the new geography literature identifies as relevant to the formation of clusters have a critical bearing on location.
- The literature points to the strength of London as a financial centre in general and for asset management in particular. However, it also highlights several weaknesses, especially in regard to high labour costs and poor transport infrastructure. Questions have also been raised about certain aspects of regulation and taxation.

4. Main Findings from the Questionnaire and Interviews

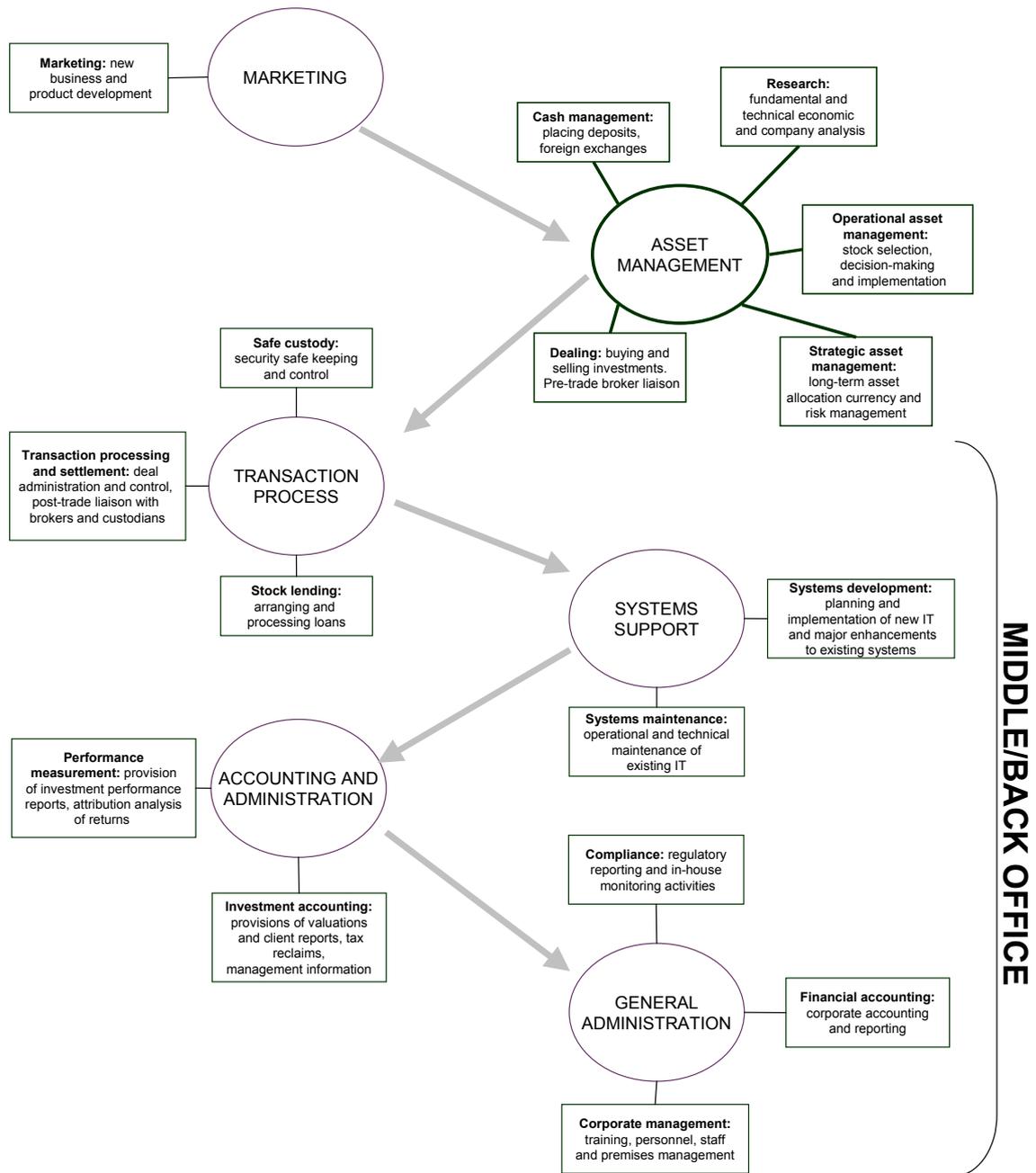
4.1 Overview

Asset management covers a broad range of functions. For the purpose of this research, we have broken this down into three main parts of an asset management business, and systematically consider location choices for each category.

- *Core asset management*—this constitutes the core function and includes investment research, management of investment portfolios, buying and selling investments, and pre- and post-trade broker liaison.
- *Marketing and distribution*—this encompasses activities related to marketing, sales, and business development.
- *Middle- and back-office functions*—this includes all trade support functions, such as transaction processing, settlement, custody and stock lending, IT support, performance measurement, investment accounting, compliance, financial accounting, and corporate management.

A diagrammatic presentation of the functions that make up the asset management value chain is provided in Figure 4.1 overleaf.

Figure 4.1 Asset management functions



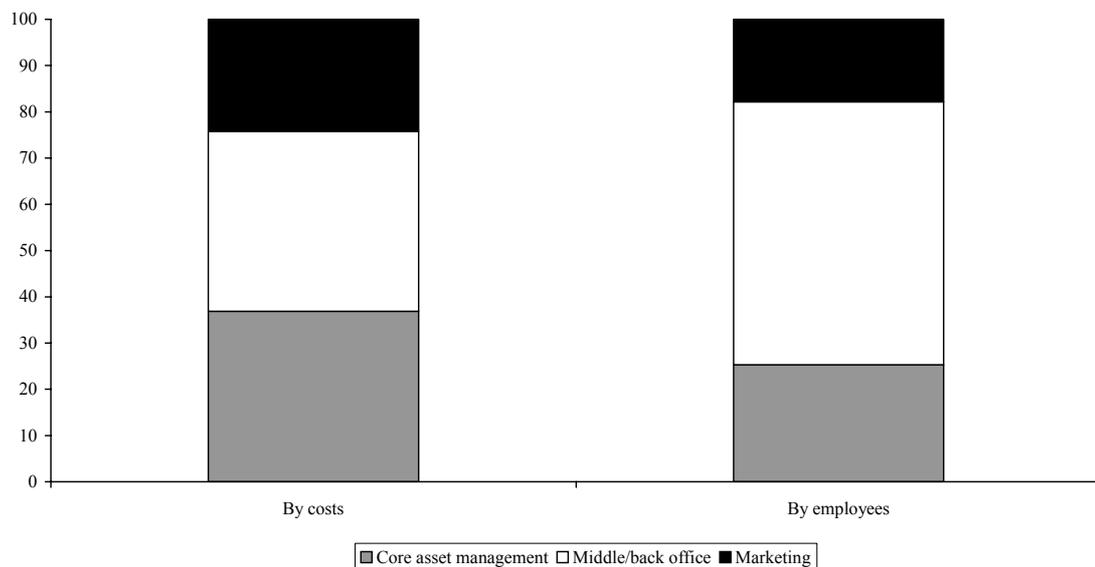
Source: Adapted from IFSL (2003).

The questionnaire asked respondents to break down their asset management business into the three parts, in terms of:

- total operating costs per function (either in relation to UK-managed assets, or, where not available, for global activities);⁶
- the number of staff employed in the firm’s UK offices (this could include employees working in distribution/marketing or the middle/back office, even if the assets are not physically managed in the UK).

All respondents provided details on the number of employees; 19 provided a breakdown of costs. The results are shown in Figure 4.2.

Figure 4.2 Breakdown of asset management functions by cost and employees (%)



Source: Oxera questionnaire.

The key observations from this figure are as follows.

- On average, 37% of reported costs and 25% of employees are associated with core asset management. The higher proportion of costs reflects the higher wage rates of employees and the higher value-added of the core function of an asset management business.

⁶ The reported cost figures need to be interpreted with some caution as respondents may have excluded some costs, such as those directly charged to funds.

- Middle- and back-office activities represent a substantial proportion of both employment (57%) and the cost structure (39%) of asset management firms.
- Measured both by employment (18%) and costs (24%), marketing and distribution is the smallest element of the asset management value chain.

These observations are important when considering the trends in the industry described below. The factors affecting the location of the three parts of the business differ markedly, and the performance of the UK in relation to the three areas varies. As a consequence, their likely prospects over the short and medium term differ, and the UK can be expected to concentrate on some aspects of asset management at the expense of others. The relative size of the three parts of asset management is therefore important in understanding the ramifications for employment and value-added in the UK.

4.2 Core asset management

The UK, and London in particular, is the dominant location for core asset management activities in Europe. As noted above, total assets managed from within the UK have been estimated to exceed £2.8 trillion (IFSL, 2004b). This is higher than the volume of assets managed from France and Germany combined, ranking only behind the USA. Furthermore, as shown in Figure 4.2 above, core management is the part of the asset management business that generates proportionately the most value-added—although constituting on average not more than 25% of employment, asset management amounts to more than 37% of the industry’s cost base.

The main conclusion that emerges from this section is that, at least in the short term (i.e. over the next one to three years), this part of the asset management business is quite securely located in the UK (see section 4.2.1). This is mainly a consequence of agglomeration factors that are discussed in section 4.2.2. It is also partly a result of a favourable regulatory and tax environment relative to competitor locations (section 4.2.3). While secure in the short term, there are risks to the UK location in the longer term. Section 4.2.4 examines factors that could undermine the UK as a location for core asset management activities.

4.2.1 Is London/UK as a centre for core asset management under threat in the short to medium term?

The results of the survey strongly suggest that, for the physical management of assets, the position of the UK and London is unlikely to be threatened in the near future. The questionnaire results provide several pieces of evidence to support this claim.

- Only three respondents had moved the location of some asset management activities outside of the UK in the last five years. At the same time, two had moved part or all of these activities into the UK. Therefore, the evidence to date suggests that, at most, there is some degree of location ‘churn’ but no systematic decline in the number of asset managers locating their core activities in the UK/London.
- When asked to assess the likelihood that the company would relocate some or all of these activities outside of the UK in the next five years, with a scale of between 1 (very unlikely) to 5 (very likely), the average response was 1.23, with no respondent giving a likelihood greater than 2.
- When asked about the likely percentage of the industry that would move these activities outside of the UK in the next five years, over 30% of those who answered the question suggested 0%, with only one respondent suggesting a figure higher than 10%.
- Even when asked how, hypothetically, they would relocate their business if this could be done at zero cost, only four respondents suggested that they would consider removing core asset management functions from their current location in London/UK, and one of these emphasised that it would entail a move out of London, but not out of the UK.

What explains the strength of the UK/London location in relation to these activities? To help answer this, respondents were asked to rank the importance of a wide range of factors that might influence location choice, using a scale from 1 (not important) to 5 (very important). Respondents were also asked to score how well their current UK location features on each factor, from 1 (very poor) to 5 (very good).

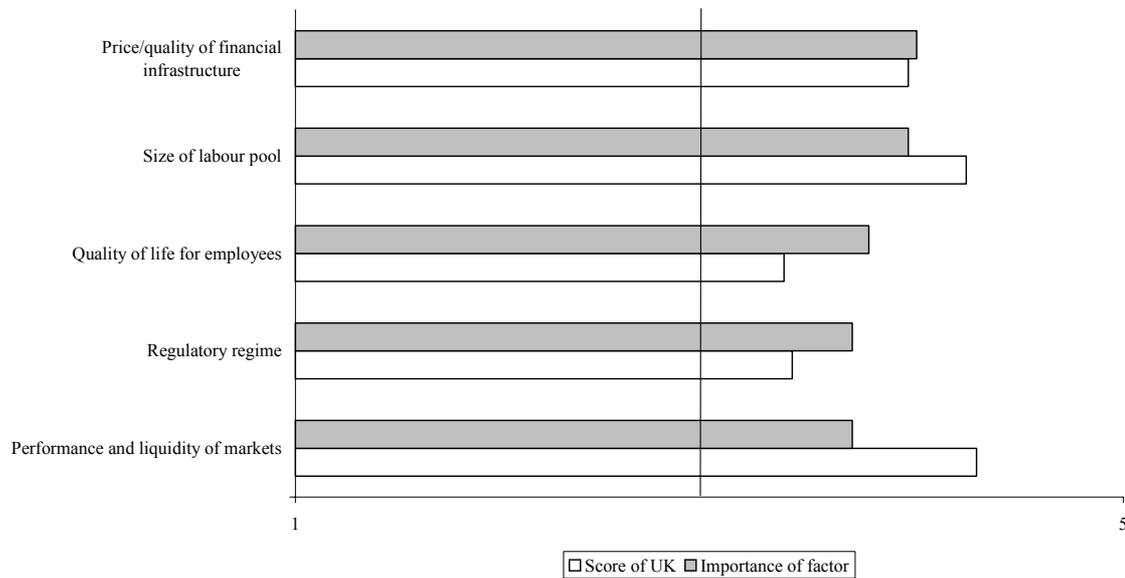
Table 4.1 Importance of factors and score of UK location in relation to core asset management

	Importance of factor	Score of UK
Pool of savings, proximity to clients	3.00	4.34
Performance and liquidity of markets	3.69	4.29
Flexibility of labour market	3.54	3.58
Total labour cost	3.42	2.77
Rental/property costs	2.96	2.12
Price/quality of financial infrastructure	4.00	3.96
Quality of life for employees	3.77	3.36
Regulatory regime	3.69	3.40
Tax regime	3.35	3.16
Reputation gained from address	2.80	4.08
Proximity to parent	1.70	2.90
Proximity to other asset managers	3.08	4.31
Proximity to trading platforms	3.32	4.40
Proximity to brokers	3.38	4.35
Proximity to support services	2.85	4.27
Size of labour pool	3.96	4.24

Source: Oxera questionnaire.

The top five factors ranked by importance have been put in bold format in Table 4.1 and are repeated in Figure 4.3. These relate to financial infrastructure, market performance and liquidity, labour availability and quality of life considerations for employees, as well as regulation (discussed separately below). As can be seen, for three of these five, including the first and second most important factors, the UK location has a score close to, or higher than, 4.

Figure 4.3 Five most important location factors and score of UK location in relation to core asset management



Source: Oxera questionnaire.

London scored well in relation to the price/quality of the financial infrastructure, which on average is ranked as the single most important location factor, and the liquidity and performance of markets. Survey respondents attached great importance to being close to well-performing and liquid markets in which the managed assets are traded, and the London markets are evaluated very favourably in this respect (average score above 4).

This is despite the fact that the literature review suggested that, in principle, there was no need for this proximity, as ‘the necessary information, interpretation and transactions services can all be delivered electronically and in real time’ (Walter 1999).

Two counterarguments to this view emerged from the interviews, and to some extent from the questionnaires. First, locating close to where the assets were actually traded was seen as being important in giving some informational benefits that could not be achieved if the assets were managed remotely. One interviewee discussed how they had alerted the US office of their company to reverse a recent investment decision in relation to a UK company, as the ‘information on the ground’ suggested it was a mistake, despite the underlying financial fundamentals appearing sound. He believed that subsequent events vindicated this decision.

The argument that there are perceived to be information benefits associated with being close to the market is further supported by the finding that the majority of respondents did not see that the factors affecting the location of research activities were any different from those affecting the location of asset management activities. Consequently, if there were information benefits from undertaking research in one location, this was equivalently a benefit from locating asset management activities in the same place. This was stated most explicitly by one respondent, who noted that:

We operate a business model whereby research is integrated with fund management and is regarded as one function.

However, although recognised as important, some interviewees argued that this actual benefit was only part of the explanation. The perception of clients was even more important in explaining the pre-eminence of this factor. A number of the interviewees noted that, in recent years increasing pressure had been attached by clients, particularly institutional clients, to the companies managing their assets being located close to the markets in which those assets were traded. In this regard, the importance attached to this factor can be considered as much a demand-side as a supply-side phenomenon.

The availability of a skilled labour force is also critical to location choice, with the size of the labour pool and related quality of life considerations being ranked second and third in the list of critical factors. In addition to asking managers to rank the different factors, the survey contained an open question asking managers to identify the single most important factor. The most frequent responses to this question were size and quality of the labour pool, constituting almost 42% of the factors named (some respondents gave multiple answers).

In relation to the labour factor, it is clear that London/UK is perceived to be doing well, scoring almost 4.25 in Table 4.1 above. This was confirmed in the interviews, where typical comments included that ‘London has a far better labour pool than any continental European country, both in terms of skills of individuals as well as mass.’ In this regard, typically, the USA was seen as the only competing location that rivals the UK in terms of labour market depth and skills, providing further evidence as to why the London/UK position as a centre for asset management, at least within Europe, is likely to remain intact.

Finally, the weaknesses of a London/UK location are not seen as being particularly important. For instance, property prices and rental costs are clearly viewed as a disadvantage of locating asset management activities in London/UK, but this is also a factor which is given comparatively low importance as a location factor (with a ranking of below 3 in Table 4.1).

4.2.2 How important are agglomeration economies?

As was seen in the literature review, one of the key research themes in the financial services industry in recent years has been to explain the importance of, and dynamics behind, clustering behaviour. The results from this questionnaire provide some useful information on these issues in relation to the asset management industry.

The first point is that, in relation to the core asset management function, the City of London in particular can be considered as almost a paradigmatic example of a cluster. On all but one of the factors that could be considered as agglomeration factors, respondents gave a score in excess of 4 to their present UK location choice, which is overwhelmingly London.⁷

Consistent with other studies in the financial service sectors, these results suggest not only that an asset management cluster has developed in London, but also that there are perceived to be some significant benefits to asset management companies from this cluster development. Respondents rated two important benefits from the cluster development to be the size (and hence depth) of the labour pool and the performance and liquidity of the markets. The first of these can clearly be categorised as a supply-side benefit, while, following the discussion above, proximity to the market can be thought of as yielding both demand- and supply-side benefits.

By contrast, those factors that could be thought of as explicitly demand-side benefits appear, from this survey, to be less important. For instance, it has been argued that companies seek to locate in clusters due to the reputation benefit that this brings and hence the stimulus to demand this will generate. The questionnaire results suggest

⁷ The factors which it is argued could be considered as 'agglomeration' factors are performance and liquidity of the markets, reputation gained from a particular location, proximity to parent company, proximity to other asset managers, proximity to trading platforms, proximity to brokers, proximity to support services and size of labour pool.

that this is relatively unimportant for asset management companies, with reputation benefits scored at only 2.80. Similarly, proximity to other asset managers, which might be thought of as important in allowing potential customers to find the company in question (reduced customer search costs), only receives an average importance ranking of just over 3.

In sum, a tentative conclusion that can be reached from this analysis is that the location of core asset management activities is driven more from a supply-side perspective—with the agglomeration benefits playing an important role in this behaviour—than it is through demand-side considerations, although it would be incorrect to argue that demand-side effects are of no consequence.

Finally, consistent with most of the other literature, the results suggest that agglomeration economies do not give the full picture in terms of factors affecting location choice of asset managers. In particular, price/quality of the financial infrastructure and the nature of the regulatory regime can be thought of as other ‘traditional’ factors determining location choice, and the survey has indicated that both of these are also important in location decisions. The potential implications of this will be returned to in section 4.2.4 below.

4.2.3 What effect does regulation/tax have on the decision to locate physical management of assets in the UK?

One of the important aims of this project was to understand what role regulation, tax and other legal factors may be playing in the present, and likely future, location of core asset management activities in the UK. The questionnaire results and interviews suggest that, although perhaps not the critical factor in determining the location choice of these activities, such factors are undoubtedly important.

However, the results also suggest that, on the whole, the UK regime is perceived as being reasonably supportive. For instance, as Table 4.1 and Figure 4.3 above show, regulation is perceived as being one of the top five factors influencing location choice, but the present UK location of respondents is awarded the above-average ranking of 3.40. Taxation is perceived as being less important.

Further corroboration that the UK is perceived as providing at least a relatively good regulatory and taxation system is provided by the response given to the question

regarding the likelihood of relocation due to tax or regulatory factors in the next five years. Respondents were asked to rank this on a scale from 1 (very unlikely) to 5 (very likely). Although the question was asked in relation to the business as a whole, rather than the core asset management activity only, an average score of 1.79 again suggests that respondents are unlikely to relocate due to these factors⁸ and hence view the UK regime as relatively supportive.

However, these aggregate results mask some interesting variety within the overall sample of respondents. When undertaking the interviews, a number of companies which predominately engaged in retail business argued that regulation was more likely to be a concern for companies such as themselves. It was also striking in the interviews that those companies that predominately offered services to institutional clients tended to be much more content with the regulatory regime. This suggests that regulation of asset management activities in the retail market is perceived as both more important as a determinant of location choice and more burdensome in the UK. As discussed below, part of the perceived stricter regime in the retail market may relate to the regulatory requirements that affect retail investment products and related marketing/distribution activities.

When investigating what features of the UK regulatory system are considered to be attractive or advantageous, some consistent themes emerged:

- Mentioned most commonly in contrast to regulation in Continental Europe, but on occasion also relative to the USA, the UK system of regulation was praised for its independence and generally apolitical approach.
- Particularly in relation to the USA, the UK regulatory system was praised for taking a ‘principles-based’ approach to regulation and, as a consequence, was seen as being less likely to be rigid or litigious than the US system. In the words of one asset manager: ‘the US regulator is generally more prescriptive and rules focussed than the UK regulator, who tends to better understand a firm’s culture, environment and the ability of the company to self-regulate.’ Corroborating this, a further response stated that the ‘USA has a very rigid approach, very rules

⁸ 86% of respondents considered relocation due to regulation/tax reasons ‘unlikely’ or ‘very unlikely’.

based. Fines and penalties can be harsh. There is very little room for dialogue between firms and regulators'. There were, however, some asset managers who perceived the US regulatory system as more favourable, with its emphasis on disclosure and enforcement rather than detailed regulatory guidance.

- More generally, the UK regulatory regime was frequently characterised, in a positive light, as being in between the US style and a 'typical' Continental European style of regulation. One respondent noted that the FSA had struck an appropriate balance and that, as a result, 'we wouldn't go to anywhere less regulated.'

None of the survey respondents had relocated core management activities due to regulation, although a few stated in the questionnaire that they had considered doing so. In relation to the UK tax regime, many survey respondents and interviewees noted that corporation and personal tax rates in the UK compared favourably with potential competitor locations in Continental Europe.

Despite this overall picture, it should be stressed that there was not unanimity that these features should be recognised as an advantage of the UK regime. A potentially significant minority of respondents, 23%, cited that the regulatory or tax regimes were the single greatest disadvantage of the UK location.

In particular in relation to regulation, some respondents suggested that the 'principles-based' approach of FSA regulation generated regulatory uncertainty, as it was not obvious how the principles would be applied in any one particular instance. Moreover, in the opinion of these respondents, the FSA's principles and interpretations had changed unpredictably over time.

In addition, some common criticisms were made about the UK regulatory regime.

- The main concern cited was the risk that the FSA becomes a cumbersome, bureaucratic body that is prone to gold-plate EU regulations. Some also thought that the FSA requested an excessive amount of information that merely left the regulator exposed if, despite this collection of information, it still made mistakes.

- There was a concern that EU Directives in some other jurisdictions were interpreted on a more pragmatic and flexible basis. For instance, one survey respondent stated that: ‘In Europe regulations are integrated with much greater latitude and applied less stringently.’ As discussed in more detail in section 4.6, one specific, and frequently cited, example was the flexible interpretation by other regulators of the Directive governing investment funds.
- Finally, a general point raised by a number of interviewees was that, although UK regulation used to be broadly at an appropriate level, over the last two or three years the direction and speed at which regulation was moving was raising concern. This was particularly important as companies had often invested considerable time and effort into a regime that was suspected of changing its priorities too frequently. Summing up this view, one interviewee claimed that ‘the rate of change of regulation is indigestible.’

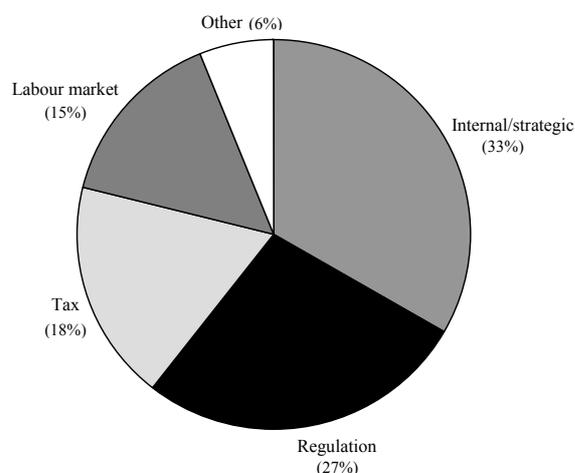
4.2.4 Is significant relocation possible in the longer term and what role might regulation play?

The analysis so far has illustrated that, on the whole, the core asset management activity appears relatively secure in its present location in the UK/London in the near future. Consistent with this, most asset managers perceive the advantages of the UK regulatory and tax systems to outweigh their disadvantages, or are at least no worse than, and in many cases better than, the systems in potential competitor locations.

What does emerge throughout, however, is that all asset managers—particularly those companies with a relatively high proportion of retail funds under management—do think that regulation is an important factor in determining location choice, as reflected by the overall importance score of 3.69, rising to 4.13 for companies with an above-average proportion of retail business.

Respondents were asked about the factor that would be most likely to cause relocation of core asset management activities in the future. As can be seen in Figure 4.4 below, regulation was an important driver, as was tax (with the exception of responses that could be classified as ‘internal’ or ‘strategic’, such as ‘group decision to consolidate activities globally’ or ‘internal group restructuring or acquisition’).

Figure 4.4 Factor most likely to lead to relocation of core asset management activity



Source: Oxera questionnaire.

For example, a significant proportion of respondents cited regulation as the driver most likely to lead to relocation of the core asset management activity. Consistent with earlier results, this proportion rose to 50% for companies with a high proportion of retail business and fell to 21% for those with a proportionately higher focus on institutional asset management. This has potentially worrying longer-term consequences. As discussed above, it appears that the key drivers of location choice of core asset management activities were a combination of ‘agglomeration’ and more ‘traditional’ factors. On the one hand, this has a reassuring public policy implication. It implies that there is more to the location benefits of UK/London than simply the fact that everyone else is there; instead, factors that can be influenced by public policy are also relevant. On the other hand, it makes the UK vulnerable to contraction.

In the case of core asset management, the survey results, particularly as shown in Figure 4.4, suggest that the regulatory regime is one of the key ‘traditional’ factors with a potentially pivotal role in determining location choice. In this regard, as the general thrust of results discussed above shows, it does not appear that there are immediate problems with the regulatory regime, and there is little evidence that it is leading companies to consider relocation. However, the fact that 23% of respondents stated that regulation or tax already represents the greatest disadvantage of doing business in the UK, as well as comments from interviewees such as ‘we struggle to find any area of endeavour where the FSA offers a more business-friendly regime

than other Member States', suggest that this has the potential to become a crucial issue in the longer term.

Apart from regulation and tax, many respondents noted factors that can be classified as 'internal or 'strategic' to be significant drivers for potential future relocations. These included 'parent company decision', 'group decision to consolidate activities globally', and 'internal restructuring or acquisition'. However, no evidence was provided to suggest that these internal/strategic decisions would lead to more business shifting out of the UK than coming in.

Finally, it is worth noting what falls within the 'other' category of factors in Figure 4.4 above that asset managers stated could result in moving their core asset management activity. One noted that it would have to be a 'big push' and gave the examples of either a dirty bomb in London or a massive growth in the German pensions industry. A deterioration in the lifestyle of employees was noted by one respondent, which is particularly interesting as a further interviewee noted that they had moved some activity to the Continent recently and that, while this would have been impossible five years ago, some employees were now very keen to move out of London. Finally, one respondent thought that UK entry into the euro, and the development of a pan-European market, could lead to them relocating these activities out of the UK.

4.3 Middle and back office

Figure 4.2 showed that, measured in terms of either number of employees or total operating costs, middle and back office is the largest part of asset management firms. It is also the most mobile. There have been significant changes in location involving outsourcing of functions, the transfer of existing activities within a firm or group, and the 'lift-out' of activities to other firms. The questionnaire and interviews record that this is an area of the asset management business that is susceptible to further shifts in location in the future. However, they also reveal that the asset management business is likely to embrace a diversity of business models, and that claims that the asset management industry is moving inexorably in the direction of a model in which companies focus on core management activities, alone with the remainder contracted out, are probably exaggerated.

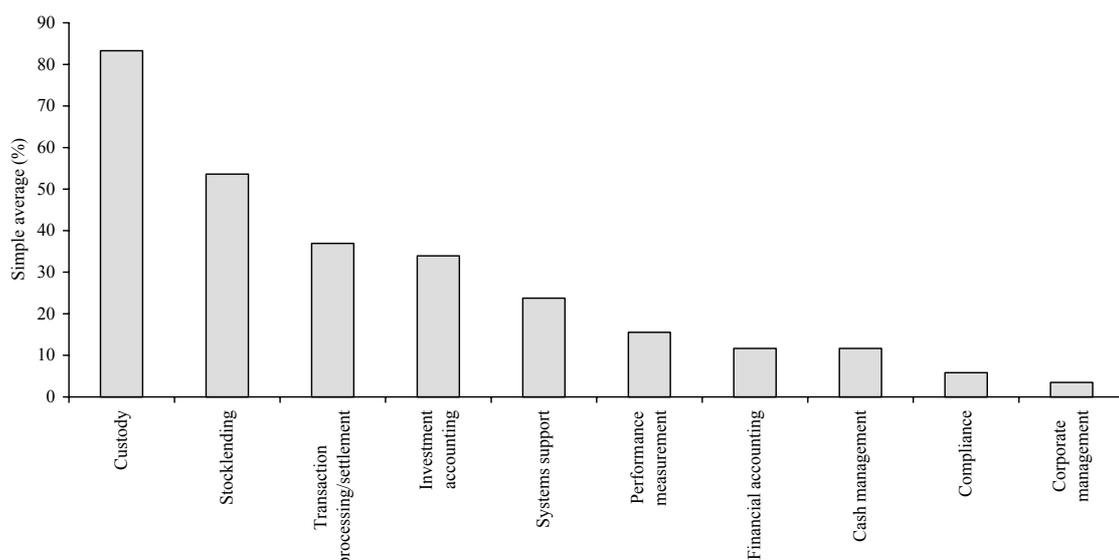
4.3.1 Has the location of the middle and back office changed? Which functions have been relocated, and how have these changes been realised?

Over 45% of respondents have relocated part or all of their middle- and back-office activities in the last five years. The prime reasons for this were: a desire to reduce the direct cost of undertaking these activities; to specialise in core areas of the business and outsource the remainder; and to make the cost base more variable (e.g. by avoiding the fixed costs associated with having to invest in appropriate systems to support middle-/back-office activities in-house).

A high proportion of relocation has not taken the form of outsourcing per se. Of companies that have changed the location of their activities in the last five years, 43% had done so by relocating them within their group and less than 50% had outsourced them. One respondent had undertaken a ‘lift-out’, whereby the physical location of the activities was unchanged but the activities and personnel were transferred to a new employer, which then contracted the services back to the asset management company in question.

Figure 4.5 shows the activities that firms have outsourced. It records the simple (unweighted) average of the percentage of functions that respondents have recorded as currently being outsourced.

Figure 4.5 Outsourcing / relocation of middle- and back-office activities



Source: Oxera questionnaire.

The main outsourced/relocated activities are custody and stock lending, with transaction processing and investment accounting following close behind. The diversity in the extent to which different functions have been outsourced suggests that, although it is sometimes useful to group middle-/back-office functions together, each of these functions is distinct. In particular, some functions are more prone to relocation/outsourcing than others.

From a public policy perspective, a fundamental question is to where these jobs have been outsourced or relocated. The responses to the survey suggest that most relocation has, to date, taken place within the UK. On occasion this has been to more peripheral regions such as Cardiff or Kent, but in many cases it has been to other locations/providers within London. Scotland, in particular Edinburgh, has also been cited as an important and growing centre for the provision of outsourced middle-/back-office activities, with a number of large external outsourcing providers having located at least part of their operations there. There are a number of cases where companies have moved activities for 'strategic' reasons to locations on the Continent or to the USA (often where the parent company is based in these alternative locations).

As will be discussed below, a significant proportion of transaction processing, custody and investment accounting in relation to collective investment vehicles has been outsourced to providers in Dublin or Luxembourg. Only two of the respondents, or 6%, had moved a substantial proportion of activities further afield (to India and South Africa respectively), with a combined loss of jobs in the UK of 215, or 2% of the total number of UK employees reported by all respondents. A third respondent had moved the base for undertaking some activities to Continental Europe, and, as a result, some activities had been outsourced to India. Nevertheless, the 'India effect' is being considered as important as an issue for the future, and several respondents noted the possibility of at least considering shifting some parts of their business to low-cost locations.

4.3.2 What are the likely future trends for middle- and back-office activities?

Although there has been considerable relocation of these activities already, the evidence collected from the questionnaire responses suggests that there is considerable scope for further outsourcing/relocation.

The potential for further shifts is illustrated by the results in Table 4.2 below. The table summarises the ranks attached by survey respondents to the importance of factors in determining where to locate the middle/back office. It contrasts this ranking with a score of how well the UK performs on these factors.

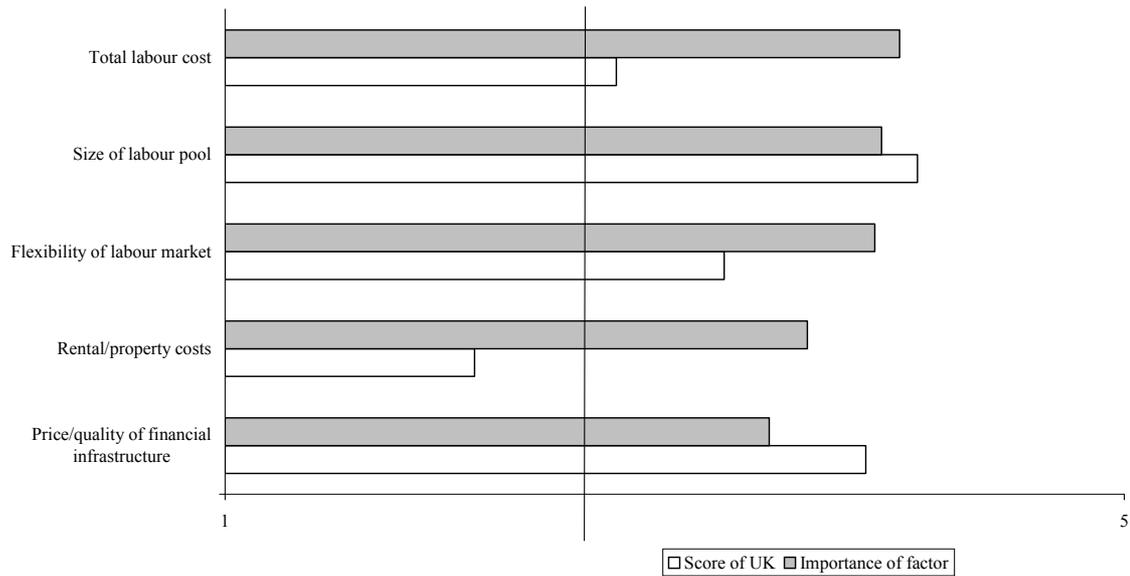
Table 4.2 Importance of factors and score of UK location in relation to middle-/back-office functions

	Importance of factor	Score of UK
Pool of savings, proximity to clients	1.93	4.13
Performance and liquidity of markets	1.74	3.98
Flexibility of labour market	3.89	3.22
Total labour cost	4.00	2.74
Rental/property costs	3.59	2.11
Price/quality of financial infrastructure	3.42	3.85
Quality of life for employees	3.26	3.15
Regulatory regime	3.22	3.42
Tax regime	3.00	3.15
Reputation gained from address	1.54	3.64
Proximity to parent	1.42	2.86
Proximity to other asset managers	1.81	3.96
Proximity to trading platforms	2.19	4.19
Proximity to brokers	2.16	4.16
Proximity to support services	2.93	4.26
Size of labour pool	3.92	4.08

Source: Oxera questionnaire.

The most important factors are the cost and availability of labour, rental and property costs, and financial infrastructure costs. These are highlighted in bold in the table above, and repeated in Figure 4.6 below. The location of middle- and back-office activities is therefore driven by cost considerations, and it is striking that the UK is rated poorly in particular on labour and rental/property costs. Its high cost of labour and property make it an unattractive location for middle- and back-office functions. Just under 50% of respondents cite direct costs as the most significant disadvantage of their current UK location of middle-/back-office functions.

Figure 4.6 Five most important location factors and score of UK location in relation to middle-/back-office functions



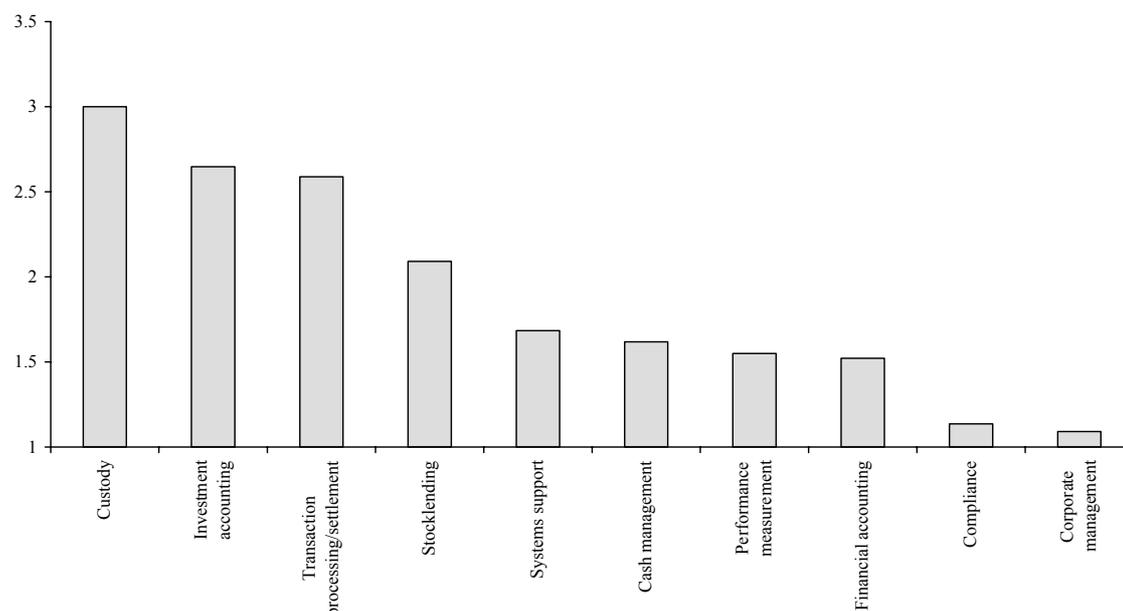
Source: Oxera questionnaire.

Three respondents explicitly stated that they had plans to relocate, or will seriously consider relocating, much of their middle and back office within the next five years, with a further two stating that, although existing staff may not be affected, middle- and back-office activities associated with new business initiatives are likely to be located outside the UK.

Furthermore, when asked about the likelihood of relocating some of these activities overseas in the next five years, the overall average score was 2.29, higher than the score for any of the other parts of the asset management industry. Moreover, a small but significant proportion of the sample, 16%, scored the likelihood of relocation as 4 or 5 (i.e. likely or very likely), pointing to a further movement of jobs out of the UK in the near future.

Respondents were asked to rank the likelihood of further outsourcing of different middle-/back-office activities. The average ranks are reported in Figure 4.7. A rank of 1 (5) indicates that further outsourcing is very unlikely (very likely).

Figure 4.7 Ranking of likelihood of further outsourcing of middle- and back-office activities



Source: Oxera questionnaire.

The activities that are most likely to be outsourced in the future are custody, investment accounting, transaction processing/settlement, and stock lending. These are activities that have already been subject to significant outsourcing or relocation in past years (see Figure 4.5).

These results suggest that there is likely to be further relocation/outsourcing of middle- and back-office functions, and that some of this will result in jobs moving out of the UK. However, what is perhaps surprising about the results is that, in terms of the likelihood of both moving middle- and back-office activities out of the UK and further outsourcing, the scores are on average comparatively low. Although the likelihood is high for some managers, many others do not foresee further significant shifts. The following reasons for this can be hypothesised.

- They have already relocated or outsourced their middle- and back-office functions.
- Further outsourcing is discouraged by VAT that introduces a wedge of 17.5% between the costs of undertaking activities externally and in-house. It is therefore commercially desirable to outsource only those activities that achieve a cost saving of at least 17.5% before VAT.

- Outsourcing may involve a trade-off between cost and quality. Some firms indicated that they were reluctant to shift activities outside the UK. Several reasons were cited for this. There may be monitoring advantages in having firms in close proximity. The FSA was regarded by some firms as providing quality assurance of service providers. Some firms saw an advantage in having service providers located in the same time zone as the asset manager. However, although these may encourage the service being in close proximity to the asset manager, they do not prevent the service provider from sourcing their inputs from lowest-cost locations overseas. One respondent to the questionnaire stated: ‘we fully expect our third party service provider to utilise low cost operating opportunities’. Another noted: ‘it must be a possibility that [x] will consider shifting some of their activities to other, lower cost, countries.’ Interviews with outsourcers and outsourcing providers confirmed that this was a likely development.

4.3.3 The influence of regulation and taxation on outsourcing

The primary motive for outsourcing is cost minimisation. Regulation and taxation play a limited, or no, role. Indeed, as noted above, VAT can make outsourcing tax-inefficient. Table 4.3 records the importance that the surveyed asset management firms attached to regulation in their outsourcing decisions. Firms were asked to rank the importance on a scale from 1 (not important) to 5 (very important), distinguishing between different types of asset management (i.e. management of segregated portfolios or collective funds for institutional or retail clients).

Table 4.3 Importance of regulation for outsourcing decision

Type of management	Effect of regulation on likelihood of outsourcing
Segregated institutional	2.14
Segregated retail	2.33
Collective institutional	2.40
Collective retail	2.55
Overall	2.39

Source: Oxera questionnaire.

The table shows that in no case was regulation regarded as a primary influence. However, the questionnaire and interviews with firms revealed two caveats to this conclusion:

- in some cases, regulatory compliance costs were contributing to the pressure to minimise costs by eroding margins;
- some administrative functions are associated with the domicile of collective investment funds, and, as will be described below, regulatory and tax considerations are driving some of these offshore.

4.4 Marketing and distribution

4.4.1 Are marketing and distribution activities in the UK secure?

The third part of the asset management value chain is marketing and distribution. The survey asked respondents to rank the importance of a range of influences on location choice and to rank the UK as a location in relation to each of them. The average results are reported in Table 4.4.

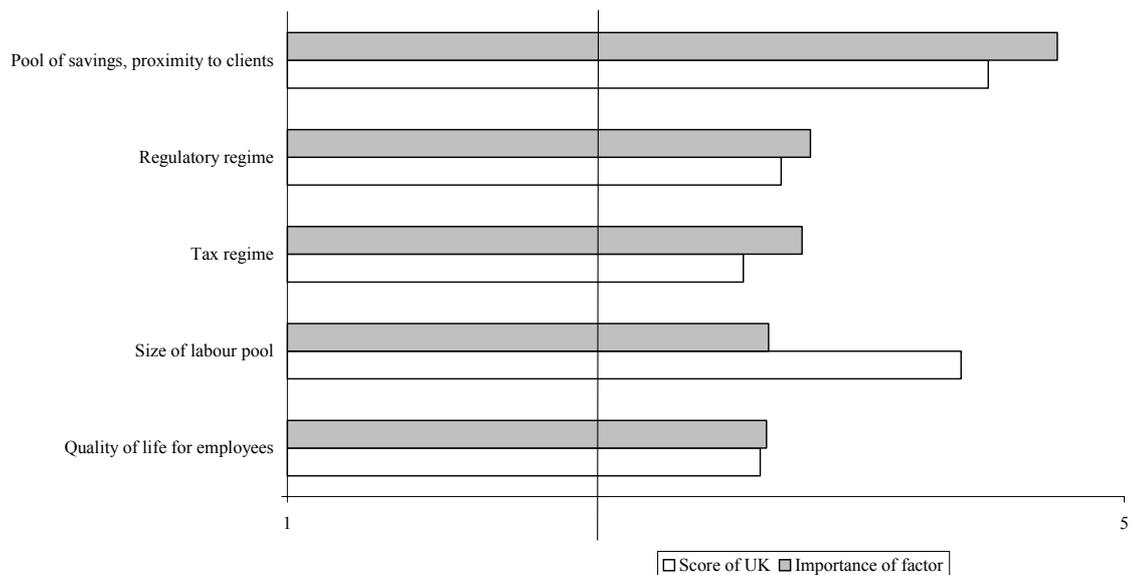
Table 4.4 Importance of factors and score of UK location in relation to marketing and distribution

	Importance of factor	Score of UK
Pool of savings, proximity to clients	4.68	4.35
Performance and liquidity of markets	2.93	4.05
Flexibility of labour market	3.21	3.36
Total labour cost	3.25	2.75
Rental/property costs	2.86	2.11
Price/quality of financial infrastructure	3.26	3.85
Quality of life for employees	3.29	3.26
Regulatory regime	3.50	3.36
Tax regime	3.46	3.18
Reputation gained from address	2.78	4.04
Proximity to parent	1.68	3.04
Proximity to other asset managers	2.50	4.32
Proximity to trading platforms	2.22	4.33
Proximity to brokers	1.89	4.36
Proximity to support services	2.93	4.32
Size of labour pool	3.30	4.22

Source: Oxera questionnaire.

By far the most important influence on the location of marketing and distribution is the pool of savings and proximity to clients (Figure 4.8). This factor was given an average importance rating one full mark higher than any other factor in the list quoted. Similarly, when asked to identify the single most important influence on location choice for marketing/distribution activities, 74% of respondents cited this factor.

Figure 4.8 Five most important location factors and score of UK location in relation to marketing/distribution



Source: Oxera questionnaire.

The UK scores highly on the most important location factor, with an average of 4.35 on its ‘pool of savings and proximity to clients’. This suggests that this part of the asset management industry is quite securely based in the UK. When asked about the likelihood of marketing and distribution being relocated outside of the UK in the next five years, the average response was 1.23. No respondent gave an answer of more than 2 in response to this question, indicating that relocation is unlikely in the near future.

However, several concerns were raised in the questionnaire and interviews. One survey respondent stated:

In the UK, the present government is apt to view financial services companies as a ‘cash cow’ to raid when required—and is doing little to encourage retail investors to invest via tax breaks. The UK Government also taxes and regulates pension funds in such a way as to render them less appealing investment vehicles to both companies and private individuals

A few respondents explicitly noted that the score they were giving the UK related to the present situation, and that they expected to award it a lower score in the future. In particular, the competitive advantage which the UK currently enjoys from its comparatively large pool of domestic savings is at risk if growth in the UK is inhibited (e.g. due to a reduction in tax advantages or changes in regulation) while the savings pools in other countries grow and catch up with UK levels. Expected growth in the Continental European pension markets in the longer term was mentioned in this respect.

It is also worth noting that tax and regulation are among the five most important influences on location choice. The UK scores lower on these than on some other factors, although the average scores (3.18 and 3.36, respectively) suggest that the UK is currently not faring too poorly. Companies with a high proportion of retail funds under management expressed particular concerns about regulation. For example, one respondent stated that:

The FSA's approach to past performance advertising is uniquely draconian. It handicaps our ability to develop pan-European campaigns and in our view systematically disadvantages investors. UK-regulated marketing is more complex to develop, more likely to result in regulatory squabbling, legal and adviser fees than any other jurisdiction.

Concerns about the UK regulatory regime have also been expressed in relation to the regulator's approach to recent cases of mis-selling of retail investment products.

The overall picture that emerges in relation to marketing and distribution is therefore similar in many respects to that for core asset management. London/UK generally scores well on the factors deemed most important in determining location, but there are concerns about longer-term decline and a belief that regulation and taxes may be contributing to this.

4.4.2 The impact of the location of marketing and distribution on other asset management activities

At one level, it might be thought that the location of marketing and distribution would have little influence on core asset management. As noted above, marketing and distribution are essentially driven by demand (pool of savings and proximity to

clients), while core asset management is driven by the supply side (pool of talent, proximity to markets and financial infrastructure). However, some links do exist, as outlined below.

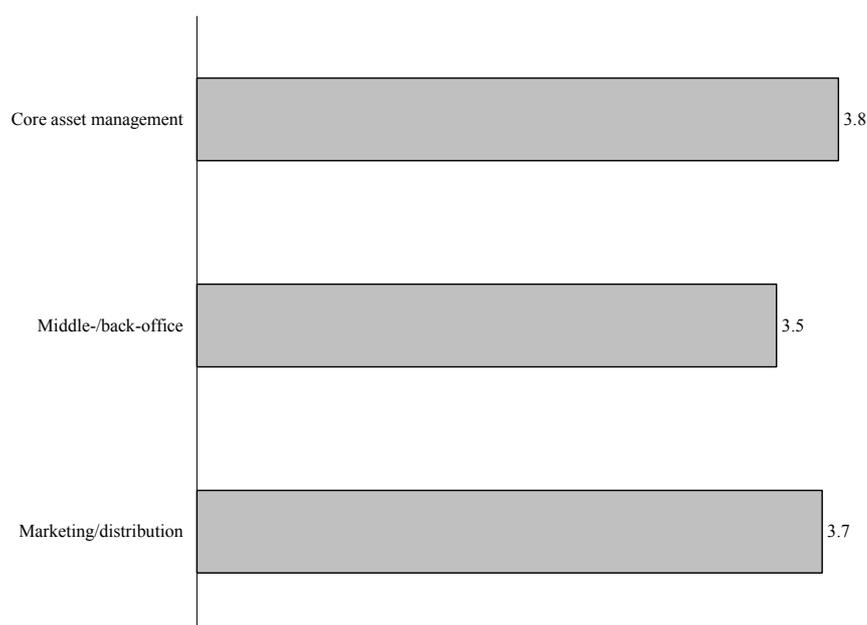
- A number of international management groups noted that their European business had developed in London on the back of a marketing and distribution office. A shift of marketing and distribution could therefore be associated with an outflow of core asset management as well.
- When asked what would drive core asset management away from its existing location, some respondents referred to the client base. One hypothesised that a ‘significant shift in client base’ could lead to a relocation of core asset management activity from its current UK location. One noted that a ‘massive growth in German pensions’ would induce the company to shift marketing focus and possibly its core asset management. However, not all respondents agreed with this, with one asset management company stating that, even if the French pensions market developed, portfolios would most likely continue to be managed from London.
- This suggests an opportunity for the UK asset management industry to capture some of the expanding French and German pension fund markets. On the other hand, the growing pools of savings outside the UK may allow other financial centres to develop at the expense of London.

Thus, there is some evidence that a shift in marketing and distribution could cause other activities to move too, although this is unlikely to occur in the immediate future.

4.5 Summary of UK competitive position along the value chain

The factors affecting location of the three parts of asset management differ appreciably, and the performance of the UK in relation to these also varies. Figure 4.9 compares the performance of the UK across the three parts. It shows a composite performance score for each part. This has been obtained by taking the scores given by survey respondents to each of the factors determining location (see Tables 4.1, 4.2 and 4.4), and weighting these according to the importance attached to each factor.

Figure 4.9 Overall score of UK location



Source: Oxera questionnaire.

The UK location scores highest in relation to core asset management and lowest in relation to middle-/back-office functions. Although the difference in the composite scores is less pronounced than that suggested by the more disaggregated analysis of individual location factors, the results support the general conclusion that middle/back-office functions are the most vulnerable to relocation. Core asset management and marketing/distribution, on the other hand, appear quite securely located in the UK at least in the short term and possibly longer.

4.6 Domicile of collective investment vehicles

The one area in the asset management industry where the role of regulation and taxation has been significant relates to collective investment funds. These funds are separate legal entities in which assets are pooled and collectively managed for investors. Taxation and/or regulation are critical to the choice of where to domicile funds. Collective investment funds managed from the UK have increasingly been established in, or shifted to, offshore locations for these reasons. Among the survey respondents:

- all but one company that offered funds had domiciled at least some of them offshore;

- the three most popular locations for such funds were, in order of importance, Dublin, Luxembourg and the Channel Islands;
- taxation and regulation have played an important part in the decision to domicile funds outside the UK. 50% of asset managers explicitly mentioned regulation or taxation as a primary reason to go offshore.⁹ Similarly, a majority of interviewees stated that tax was the prime reason for domiciling funds outside the UK, with regulation coming a close second.

One firm highlighted that the fund domicile decision is separate from the choice of where to carry out the actual asset management activity and is driven by different factors. In particular, it stated that:

Tax has had no influence on asset management location but has been a key driver in fund domicile decisions

A second firm suggested that tax factors encouraged funds to domicile offshore and, once that decision had been made, alternative offshore locations were selected on the basis of their regulatory regimes.

Sections 4.6.1 and 4.6.2 provide an overview of how tax and regulation, respectively, affect the decision to domicile a fund offshore. Section 4.6.3 discusses whether offshore fund domicile matters if the actual management of the funds is being carried out from the UK.

4.6.1 How does tax affect the domicile decision of firms?

There are several taxes involved in the decision to domicile funds abroad, the significance of which varies by the type of investor, investment and firm. There are, nevertheless, a number of common threads to the domicile decision.

- Withholding taxes—these are taxes levied at source on the income of a fund’s underlying securities. Withholding tax rates on income from non-domestic sources depend on bilateral international tax treaties, and it is advantageous for a

⁹ This is a conservative estimate, as it only included respondents who explicitly mentioned regulation or tax in their answer. Statements such as ‘it suits our clients’ needs better’ were not included, even though tax may be a principal underlying cause in these cases.

fund to be domiciled in a jurisdiction that has negotiated favourable tax treaties with other countries. In this regard, it has been suggested that onshore domicile in the UK rather than offshore domicile may be beneficial since the UK has established one of the most extensive networks of double tax treaties in the world, and on terms that are more favourable than those in offshore locations. In this regard, it is noteworthy that one of the asset managers interviewed said that they were in the process of moving funds back from Dublin to the UK because of more favourable double taxation arrangements.

- Corporation tax—UK-domiciled funds are subject to tax, whereas no tax is levied in Luxembourg or Dublin. This allows reserves to be accumulated free of tax in the offshore location. However, some asset managers raised doubts about the significance of this since withholding taxes can be offset against UK corporation tax, whereas they cannot be offset in offshore locations where the fund does not pay tax. Coupled with the lower withholding tax rates in the UK, the combined tax burden may be lower in the UK than offshore. Furthermore, tax planning gives firms considerable latitude in the determination of their effective tax rate as against the statutory rate.
- VAT—in contrast to withholding and corporation taxes, VAT may be a real incentive for funds to be domiciled overseas. As investment services in the UK are generally VAT-exempt, if asset managers provide management services to a UK-domiciled fund, this is done without VAT being charged. As a result, fund managers incur a VAT write-off, as the VAT paid on inputs into the asset management company cannot be offset against the outputs provided. This does not apply if a UK-based asset manager provides the same services to an offshore fund in Dublin or Luxembourg. In this case, the UK tax authorities grant the asset manager a credit for VAT and allow the asset manager to offset its VAT charge for services provided to an offshore fund, on the assumption that taxes are levied overseas. At the same time, Dublin and Luxembourg do not actually charge VAT on the services provided. Thus, while the UK manager benefits from being able to offset VAT, the fund itself is not disadvantaged as it, too, does not pay VAT.

The choice between offshore and onshore domiciles is also determined by the tax status and location of investors in the fund. The effect varies between institutional and retail investors.

- Institutional investors seek the benefits of pooling funds without the pooling vehicle being tax-distorting. This requires a fund structure that is tax-transparent, in the sense of presenting investors in different tax jurisdictions with the same rates of taxation as if they had invested directly in the underlying securities. This was attempted in the UK through the creation of the Pension Fund Pooling Vehicle, but this measure ultimately failed because it was based on the legal structure of a trust that was unattractive to overseas investors. In contrast, Ireland has been able to attract investors through the recent creation of a Common Contractual Fund (CCF), which is a contractual agreement between investors that more closely resembles a partnership than a trust. CCFs may make Ireland the preferred jurisdiction of choice of pooling vehicles, especially those for pension funds. One interviewee noted that, following pressure from overseas pension fund investors, they were in the process of transferring a £6 billion fund that is currently domiciled onshore into a Dublin-domiciled CCF.
- Retail investors—to date, it has in general been tax-inefficient for UK retail investors to invest in offshore funds. However, this is changing, opening up the possibility of retail funds relocating offshore. Fund domicile may also be affected by implementation of the European Savings Tax Directive, although its precise effects are yet to be determined.

There are other respects in which the tax regime puts the UK at a disadvantage.

- Stamp duty—in the UK, stamp duty is levied on securities transactions. In Luxembourg, the *tax d'abonnement* is levied as a percentage of the net asset value of a fund. In contrast, there are no taxes on funds domiciled in Dublin, putting Ireland at a relative advantage to both the UK and Luxembourg.
- Capital gains tax on hedge funds—most European hedge funds are domiciled in Dublin, whereas the management activity of these funds takes place in the UK. One tax impediment to domiciling hedge funds in the UK is capital gains tax.

While the high volume of transactions by hedge funds subjects them to capital gains tax as a trading activity in the UK, they are tax-exempt in Ireland.

4.6.2 The impact of regulation on the domicile decision

A significant minority of firms viewed regulation above taxation as having a more important influence on domicile. Firms seek UCITS certification as a way of making their funds more marketable across Europe.¹⁰ Some consider a UCITS certification obtained in the UK as particularly beneficial in this regard. For example, one interviewee noted that the Spanish regulator had prevented the distribution of a Dublin-based UCITS on the grounds that the regulatory regime was perceived as being too lax. UK independent financial advisers also tend to favour UK retail funds over offshore vehicles. On the other hand, the UK form of collective investment schemes, the unit trust, has traditionally been difficult to market on the Continent because of its trust status. While this has changed with the introduction of open-ended investment companies, a unit trust culture was perceived as persisting in the UK.

The main advantage that other regulatory authorities, particularly Dublin and Luxembourg, were perceived to have over the UK is their more flexible interpretation of the UCITS Directive. One specific example refers to money market funds. In particular, the UK authorities have put impediments in the way of money market funds achieving UCITS status by asserting that the funds' underlying investments do not qualify as 'transferable securities' under the UCITS Directive. In contrast, the Dublin authorities have adopted a broader definition of qualifying securities that allow money market funds domiciled in Ireland to be marketed as UCITS across Europe. The UK approach to money market funds struck many asset managers as particularly questionable in light of the low-risk nature of the funds—which are almost exclusively AAA rated.

¹⁰ The term UCITS (Undertakings for Collective Investment in Transferable Securities) refers to pan-European investment funds. The objective of the UCITS Directive, adopted in 1985 and amended since, was to allow for investment funds investing in transferable securities to have a single regulatory regime across the EU. The idea behind the legislative uniformity was to allow funds authorised in one EU country to be available to be sold to the public elsewhere in the EU without further authorisation. Funds qualifying as UCITS must meet certain minimum requirements for funds and not invest in certain types of riskier assets, or more than a maximum amount in the paper of one issuer, for example.

The UK authorities were similarly criticised for failing to provide a regulatory environment suited to the requirements of hedge funds. Dublin takes a more innovative approach to hedge fund regulation than the UK, which was criticised for failing to distinguish adequately between hedge funds and other collective investment vehicles.

Overall, non-UK locations were seen as more desirable for fund domicile, for tax and regulatory reasons. Some asset managers questioned whether it was possible or appropriate for the FSA to adopt entirely the approach of other regulators. For example, given the size of the domestic market, UK regulation is probably more appropriately focused on domestic investor protection considerations than the export-oriented Irish regulation.

Nevertheless, it was generally believed that some reform was both possible and desirable. The UK was thought to have missed out on a considerable proportion of the market for investment funds, particularly in relation to specialised products such as hedge funds and money market funds. This is an area that deserves closer attention.

4.6.3 Does non-UK fund domicile matter?

The question to be addressed is whether the domicile of investment funds matters, particularly if the actual management of these funds remains located in the UK.

From the perspective of negotiating and shaping European Directives affecting the industry, it may be advantageous for the UK if other countries, such as Ireland and Luxembourg, have a similar interest in the competitiveness of the European fund management industry, as was noted by one of the asset managers interviewed.

However, offshore domicile is of concern for at least two reasons.

- First, it results in a loss of governance and scrutiny by the UK regulator of key areas of the asset management industry. Offshore fund domicile also has implications for onshore tax revenues.
- Second, and more importantly, the evidence collected in the survey and through the interviews suggests that there are ‘real’ economic consequences as a result of

the decision to domicile funds offshore. Domiciling funds offshore involves shifts of physical activities (and hence employment) to these locations. Similarly, in the case of new business, establishing new funds offshore creates jobs in these locations, which could otherwise have been created onshore in the UK. Several survey respondents and interviewees noted that they have relocated activities to offshore locations or use external service providers located offshore to administer their funds.

Offshore locations such as Luxembourg and in particular Dublin have seen substantial growth in employment in activities associated with the support and servicing of funds. This may be for regulatory reasons (e.g. the requirement to carry out fund administration or custody in the same location as the domicile of the fund), or simply due to cost and efficiency reasons, which make it advantageous to shift physical activities offshore. Thus, even if the core asset management activity remains located onshore in the UK (as discussed in section 4.1), offshore locations benefit from the creation of economic activities in related functions, including fund administration, custodianship, legal support, secretarial services, tax, accounting and auditing. This should not be thought surprising, as there would otherwise be little point in offshore jurisdictions taking a proactive approach to attract funds managed abroad to domicile within their countries.

Finally, it is interesting to note the presence of agglomeration effects in relation to offshore activities. Although it was possible to collect only anecdotal evidence, it appears that locations such as Dublin and Luxembourg have, over time, developed a reputation for efficient administration of funds and related activities. Several interviewees talked about the ‘core expertise’ or ‘centre of excellence’ of Dublin in these activities. Indeed, the expertise of Dublin in fund administration and related services has developed to a point that it is now servicing a large number of funds that are domiciled outside Ireland.¹¹

¹¹ See Global Investor (2004).

5. Summary and Conclusions

The UK is a leading centre for asset management in the world, and asset management is a major source of income and employment for the UK. In addition, asset managers make a wider indirect contribution through their links with banks, securities dealers and information providers. The scale of their operations means that asset managers promote market activity and liquidity.

Asset management is a diverse business, the activities of which include segregated asset management for both institutional and retail investors, and the management of different types of collective investment fund for these investors, including specialised products such as hedge funds or money market funds. Asset management also covers a broad range of functions that make up the value chain of a firm.

For the purpose of this research, it was important to break down the value chain into at least three main parts: core asset management, marketing/distribution, and middle-/back-office activities. Middle- and back-office functions are the most important in terms of costs and employment. Core asset management is the next most significant, particularly when measured by costs, reflecting that this is where most value is being added.

The factors affecting the location of the three parts of the business differ appreciably, and the performance of the UK in relation to these also varies:

- The location of the core asset management function is primarily driven by supply-side factors, including availability of qualified labour, the performance and liquidity of capital markets, and the quality of the financial infrastructure. The UK performs well on these.
- The location of middle-/back-office functions is mainly influenced by cost considerations—in particular, the cost and availability of labour and property costs. The high cost of labour and property put the UK (and London in particular) at a disadvantage.

- The location of marketing/distribution functions is primarily driven by demand-side considerations. Proximity to clients is important, and the large pool of domestic savings means that the UK performs well in this respect.

The UK performs best in relation to core asset management and worst in relation to middle-/back-office functions. A substantial proportion of the middle/back office has already been outsourced or relocated within firms or groups, although much of this has been within the UK. Several asset management firms indicated their intention to continue relocating or outsourcing middle-/back-office functions in the next few years, and to consider the transfer of at least some functions to low-cost locations outside the UK. Given the high proportion of asset management employment in the middle/back office, this could have considerable consequences for UK employment.

Core asset management and marketing/distribution activities currently appear to be quite securely located in the UK, and asset management firms generally expected no significant shifts of business outside of the UK at least in the next few years.

Regulation and, to a lesser extent, tax rate highly as some of the most significant influences on the choice of where to locate core asset management and marketing/distribution activities. To date, however, regulation and tax have not led to significant relocations of these activities outside the UK, and in some respects the UK regime is perceived as being supportive. Nevertheless, concerns have been expressed about how regulation and tax in the UK are developing, which may put the UK at a competitive disadvantage and could contribute to relocation in the longer term.

The UK's competitive position may also be affected in the longer term by developments in other countries, such as the expected growth in Continental European pension markets and the resulting increase in saving pools, which could shift marketing/distribution focus outside the UK and may allow asset management activities in other financial centres to expand at the expense of the UK/London. Also, while the presence of agglomeration or cluster effects contributes to the UK's current position as a centre for asset management, reliance on such effects makes the UK vulnerable to contraction. Regulatory, tax or other concerns, such as physical congestion and poor transport infrastructure, could prompt some firms to relocate and then trigger an exodus of other firms in the longer term.

The one area where a shift of activities has been most strongly felt to date is in relation to the domicile decision of collective investment funds. Although the actual fund management remains located in the UK, investment funds (including, in particular, specialised products such as hedge funds and money market funds) have increasingly been established in, or shifted to, offshore locations. In Europe, the three most popular offshore domiciles are Dublin, Luxembourg and the Channel Islands.

Taxation has played an important part in the decision to domicile funds outside the UK. Relevant taxes include withholding taxes, corporation tax, and, in particular, VAT, but stamp duty and capital gains taxes can also be important.

Domiciling funds offshore has also been encouraged by regulation. The survey respondents and interviewees consulted as part of this research generally praised the more responsive attitude of regulatory authorities in Ireland and Luxembourg towards the fund industry. The range of legal fund structures available, and the comparative ease with which certain types of fund can be established and approved by the authorities, make the legal and regulatory regimes of the offshore domiciles more attractive than the UK regime.

The UK has already missed out on a considerable proportion of the market for investment funds. Even if the management of the funds remains located onshore, the development of offshore centres has employment and revenue consequences for the UK. Luxembourg and, in particular, Dublin have seen substantial growth in activities associated with the support and servicing of funds, and have developed as ‘centres of excellence’ in these activities. Offshore fund domicile is therefore a matter that deserves close attention by the UK authorities. Moreover, it suggests that the industry is potentially mobile.

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Appendix 1 Questionnaire

Oxera has been commissioned by the IMA and the Corporation of London to undertake an analysis of the competitive position of the asset management industry in the UK, and the major legal, tax and regulatory influences that may affect performance in future. The research examines the reasons why asset managers locate their business in the UK, the value added in the asset management industry value chain, and the factors that may cause asset managers to outsource or relocate parts of their business in future.

An integral part of this analysis involves undertaking a survey of asset managers, to obtain their views on these issues. This is the objective of this questionnaire, which has been sent to a large number of IMA members. We hope that the questionnaire will be followed up with a telephone/face-to-face interview.

In designing the questionnaire, we have sought to minimise the burden, and focus only on the questions that are essential to carry out the research analysis. In many cases, we will use the information collected in the IMA's own annual survey (e.g. assets under management and client base). You can make your answers as long as you wish: for example, you may expand the space provided under each question or by attaching additional sheets.

A number of asset managers have provided comments on the content and design of the questionnaire. As such, we hope to have covered all of the important issues. However, if you wish to address additional issues that you believe are important, please feel free to attach extra sheets.

More generally, if you are unable to answer a question, please supply information that would provide at least a partial answer.

The questionnaire is structured as follows.

- *Part 1: High-level questions*—this part covers a small number of critical questions that our research is seeking to address. The other parts investigate the research issues through more detailed questions.
- *Part 2: Background Information*—this relates to current location arrangements and other background information about your company.
- *Part 3: Company activities and outsourcing*—this seeks information about your company’s asset management value chain and the activities that are outsourced to other entities in the group or external service providers.
- *Part 4: Revenues and costs*—this includes questions about your company’s revenues and the costs of different activities in the value chain. This part of the questionnaire should be directed to the Chief Financial Officer and his or her team for completion.
- *Part 5: Location decisions and sources of competitive advantage*—this aims to evaluate why your company locates in the UK, the sources of competitive advantage of the UK location, and the factors that could influence your location decisions going forward.

Thank you very much for your cooperation.

Part 1: High-level questions

1. Has the location of any significant part of your asset management business (including distribution and middle/back-office functions) changed within the last five years? **YES/NO**

IF YES:

Which parts were relocated, and where from and to?

.....
.....

Did this involve relocation within the company or group, or outsourcing?

.....

What were the main reasons for this relocation/outsourcing decision?

.....
.....

If the relocation/outsourcing shifted activities away from the UK, please provide an estimate of the approximate reduction in UK staff (i.e. the decline in the number and percentage of employees compared with staff levels at the time the decision was reached).

.....

2. Has your company withdrawn (as opposed to relocated/outsourced) any significant parts of its activities from the UK within the last five years? If so, please give details and the reasons.

.....
.....

3. Has your company made any new investments/developed any new business lines within the last five years where it has been decided not to locate this activity in the UK? If so, please give details and the reasons for not locating in the UK.

.....
.....

4. Are there any important parts of your business (including new business) that you are presently considering, or are likely, to shift to or from the UK? If so, which parts of the business may shift, and how much (e.g. in terms of impact on staff numbers)? Please give details and the reasons.

.....
.....

Part 2: Background information

1. Name of company
2. Your name and position
3. Your contact details

4. Since when has your company been physically managing assets in the UK?

5. Although your company physically manages assets in the UK, it may be incorporated, regulated and/or taxed outside the UK. Please briefly explain whether the location of your legal, regulated and/or financial entity is outside the UK and, if so, why? (The remainder of this questionnaire focuses on the physical location of your activities.)

6. Is your company part of a larger group? **YES/NO**

If YES:

Please give the name and main activity of your ultimate parent company.

.....
 Location of your parent company's headquarters

If your company or group only carries out asset management activities in the UK, please go to Part 3. Otherwise, please continue and answer questions 6 to 9 of Part 2.

7. Considering the *global* asset management activities of your company or group, please provide an approximate percentage breakdown in terms of assets under management according to where the physical management of the assets takes place.

Geographical area	% managed in area	<u>Main</u> locations in area
UK		
France		
Germany		
Rest of Europe		
North America		
Asia Pacific		
Elsewhere		

Please indicate whether the above breakdown applies to your company or wider group.

.....

Please describe any major changes in the location of the core fund management activities within your company or wider group in the last five years.

.....

.....

8. For assets that are *physically managed by your company in the UK*, please provide an approximate percentage breakdown of related marketing/distribution activities and middle/back-office activities that are carried out by your company's (or group's) offices in the different locations.

Geographical area	% of marketing/ distribution activities in area	% of operations/back office activities in area
UK		
Rest of Europe		
North America		
Asia Pacific		
Elsewhere		

Please describe any major changes in the location of these activities within your company or wider group in the last five years.

.....

.....

9. For assets that are *physically managed by your company outside the UK*, please explain whether your UK offices carry out a significant part of marketing/distribution or middle/back-office functions in relation to those assets.

.....

.....

10. Please provide any additional information you consider necessary for us to understand the basic facts about your company's or group's location of asset management activities.

.....

.....

Part 3: Outsourcing of company activities

1. For assets that are *physically managed by your company from offices in the UK*, please indicate:
 - the approximate percentage of the other activities in the value chain which are outsourced;
 - for (partly or fully) outsourced activities, the name of the service provider and, if known, the location from which the outsourced service is carried out (ie, in the UK or elsewhere);
 - for activities not currently outsourced, the likelihood of outsourcing in the near future (within approximately five years), using a scale from 1 to 5 (*1 = very unlikely and 5 = very likely*).

Function	% of activity outsourced	Name of service provider and location	Rating of likelihood of future outsourcing
Research			
Dealing			
Cash management			
Transaction processing, settlement			
Safe custody			
Stock lending			
Performance measurement			
Investment accounting, client reporting			
Systems support			
Compliance			
Financial accounting			
Corporate management			
Other (Please specify)			

Please explain if current outsourcing arrangements differ depending on the type of asset management (e.g. segregated, collective, institutional, retail, active, passive).

.....

2. For each function that has been outsourced, what were the main factors that led to the outsourcing being undertaken?

.....

3. For functions that you consider likely to be outsourced in the near future, which factors are likely to determine whether you go ahead with the outsourcing?

.....

Please explain if you expect any future outsourcing to shift activities away from the UK.

.....

4. Which legal, regulatory or tax factors, if any, have influenced outsourcing decisions of your company in the past or are likely to lead to outsourcing in the future?

.....

5. Considering other UK asset managers, which legal, regulatory or tax factors, if any, do you think have influenced companies to outsource asset management functions? Which factors are likely to be important going forward?

.....

6. Overall, please rate the importance of legal, regulatory or tax factors for outsourcing decisions in general, using a scale from 1 to 5 (*1 = not important and 5 = very important*)?

Type of asset management	Rating
Segregated—Institutional	
Segregated—Retail	
Collective—Institutional	
Collective—Retail	
Overall rating	

7. Please briefly explain if collective investment vehicles managed by your company from the UK are registered in jurisdictions outside the UK? Where are they registered and why?

.....

.....

.....

Part 4: Revenues and costs

The revenue and cost data in questions 1 to 5 should refer to your company's UK management activities only—i.e. relating to assets where the physical management takes place in the UK—and for the accounting year-end 2003.

If you are unable to provide an answer with respect to UK activities only, please answer the question based on global management activities and state this explicitly. Please also state explicitly if your answers to any of the questions are approximations or based on strong assumptions (e.g. about cost allocations).

1. Please provide the total revenue of your company's UK management activities.

..... (£'000)

2. Please provide the total operating costs (including annual outsourcing costs) of your company's activities in relation to UK-managed assets, and approximate breakdown for different parts of the asset management value chain. If your company does not break down costs in the way suggested in the table below, please use a different breakdown.

	Amount in £'000 (or percentage of total)
Total operating costs	
Of which:	
Marketing, distribution	
Fund management, research, dealing	
Middle/back-office functions	

3. If your company has outsourced part of its activities, please provide the approximate total annual outsourcing costs (which you have included in the cost estimates in the above table).

..... (£'000)

Please use the space below if you wish to provide further information on the cost of your current outsourcing arrangements.

.....

4. Please provide total assets under management, revenues and costs for different types of assets that are physically managed in the UK (£'000). If your company does not break down products in the way suggested in the table below, please use a different breakdown.

	Assets under management	Revenues	Costs
Segregated—Institutional			
Segregated—Retail			
Collective—Institutional			
Collective—Retail			

5. What is the level of capital held by your UK company (in £'000)?

.....

Please provide an estimate of your annual capital costs for your UK business and explain how you have derived the estimate (eg, which costs you have included).

.....

.....

6. The last question relates to the number of staff working in your UK offices. (This could also include employees working in distribution/marketing or the back office although the assets are not physically managed in the UK.)

Please provide the approximate total number of UK-based employees, broken down by function. If you cannot provide data for the suggested breakdown, please use a different breakdown. Please indicate the date to which the staff numbers refer.

	Number of employees in UK offices
Total number of employees in UK offices	
Of which:	
Marketing, distribution	
Fund management, research, dealing	
Middle/back-office functions	

If your company has outsourced part of its activities, please compare pre-outsourcing UK staff levels with the current number of UK staff reported in the above table—i.e. what was the approximate decline in the number of staff in the UK due to the outsourcing? Over what period of time was this decline observed?

.....

Part 5: Location decisions and sources of competitive advantage

1. Provided below is a list of factors that may influence location choice for different activities in the asset management value chain. For each factor and each activity, please indicate, using a scale from 1 to 5:
 - how important the factor is in determining the location choice of asset managers (*1 = not important and 5 = very important*);
 - how well the UK location scores on this factor (*1 = very poor and 5 = very good*).

Factors	Marketing, distribution		Fund management, research, dealing		Middle/back office	
	Importance	Score of UK location	Importance	Score of UK location	Importance	Score of UK location
Demand-side factors						
Presence of a large pool of domestic savings and proximity to clients						
Long-term performance and liquidity of the markets in that country						
Supply-side factors						
Flexibility of labour market						
Total labour cost						
Rental/property costs						
Price and quality of financial infrastructure						
Quality of life for employees						
Regulation, tax						
Regulatory regime						
Tax regime						
Agglomeration effects and other factors						
Reputation gained from a particular address						
Proximity to parent company						
Proximity to other asset managers						
Proximity to trading platforms and markets						
Proximity to brokers						
Proximity to support services (eg, legal, accountancy services)						
Size of labour pool						

Of the factors listed in the above table, what is the single most important one for each asset management activity?

Marketing/distribution:

Fund management, research, dealing:

Middle/back office:

Since you may have aggregated your response for fund management and research and dealing activities, please explain if there are significant differences in the location factors between these functions.

.....

2. Are there any important factors that we have missed out in the above table? How does your UK location score on these factors?

.....

3. Please explain if your overall evaluation of factors would be different for different types of asset management (segregated, collective, passive, active, etc) or types of client (institutional, retail).

.....

4. What is the single most important relative advantage of being located in the UK?

.....

5. And the single most important relative disadvantage?

.....

6. When was the last time your company reviewed its location decision?

.....

In general, how often are location decisions reviewed?

.....

How important an issue is location choice at board level at present?

(1 = not important and 5 = very important)

7. How likely is it that your company will relocate its distribution/marketing activities from the UK within the next five years?

(1 = very unlikely and 5 = very likely)

How likely is it that your company will relocate its core fund management activities from the UK within the next five years?

(1 = very unlikely and 5 = very likely)

How likely is it that your company will relocate research and dealing desks and trading activities outside the UK within the next five years?

(1 = very unlikely and 5 = very likely)

How likely is it that your company will relocate middle/back-office functions outside the UK within the next five years?

(1 = very unlikely and 5 = very likely)

8. What factors would be most likely to make you alter the location of the core fund management activities of your company? (Rather than considering relocation of all activities, you may want to answer the question with respect to marginal (e.g. new) business.)

.....
.....
.....

9. If your company could start all over and set up its business again, please outline where you would choose to locate the various parts of the business, and how such a new 'ideal' location structure differs from current location arrangements.

.....
.....
.....
.....
.....

10. Looking at other asset managers located in (or outside) the UK, what types of companies, if any, do you think are most likely to relocate from (or to) the UK in the near future (five years)?

.....

Can you suggest examples of any major relocations to or from the UK in recent years that we should consider as part of the research?

.....

11. In your opinion, what approximate percentage of UK asset managers is likely to relocate their core fund management function to abroad in the near future (five years)?

Firms relocating core fund management function %

12. In general, what do you see as the main competitor locations to the UK and why? You may want to distinguish by type of management activity or product/service offered.

.....

.....

.....

13. Turning to regulation specifically, please rank the overall regulatory environments for asset managers located outside the UK relative to FSA regulation in the UK, using a scale from 1 to 5 (*1 = significantly worse than the UK, 3 = comparable with the UK, and 5 = significantly better than the UK*).

	Score relative to the UK regulatory environment
USA	
France	
Germany	
Ireland	
Switzerland	
Other (please expand list if you wish)	

What single aspect of regulation in one or more of the competitor locations do you consider *better* than in the UK?

.....

What single aspect of regulation in one or more of the competitor locations do you consider *worse* than in the UK?

.....

Has your company considered relocating parts or all of its business due to regulation? **YES/NO**

Has your company actually relocated parts or all of its business due to regulation?
YES/NO

If YES to either of the above, please explain.

.....
.....

14. Going forward, how likely is it that your company will relocate different parts or all of its business due to (changes in) FSA or overseas regulation?

(1 = very unlikely and 5 = very likely)

Looking at other asset managers located in (or outside) the UK, what types of companies, if any, do you think are most likely to relocate from (or to) the UK because of regulation in the near future and why?

.....

15. Please explain whether and how taxation in the UK or abroad has influenced the decision of where to locate the different parts of your asset management business in the past—which elements of the tax regime, if any, have been important?

.....

.....

Please list any specific tax changes that you consider likely to influence a decision to relocate parts of the business to or from the UK going forward.

.....

.....

.....

16. Please describe any elements of the legal framework, other than financial services regulation and taxation, that have influenced your location decision in the past. You may also want to list any expected legal changes and how these are likely to influence your decision to relocate parts of your business to or from the UK going forward.

.....

.....

Appendix 2 Respondents to Questionnaire

ABN AMRO Asset Management Ltd
AEGON Asset Management UK Ltd
Aerion Fund Management Ltd
Baillie Gifford & Co Ltd
Barclays Global Investors Ltd
BNP Paribas Asset Management UK Ltd
Britannic Asset Management
Cazenove Fund Management
Citigroup Asset Management Ltd
Fidelity Investments
Framlington Group
Franklin Templeton Investment Management Ltd
GAM
Gartmore Investment Management plc
Henderson Global Investors
Hermes Pensions Management Ltd
Insight Investment Management Ltd
Investec Asset Management Ltd
Jupiter Asset Management Ltd
Legal & General Investment Management Ltd
Legg Mason Investments Ltd
Liverpool Victoria Asset Management Ltd
Lombard Odier Darier Hentsch Asset Management Ltd
M&G Securities Ltd
Merrill Lynch Investment Managers Ltd
Morley Fund Management Ltd
PIMCO Europe Ltd
Schroders Investment Management Ltd
SG Asset Management UK Ltd
State Street Global Advisors UK Ltd
Threadneedle Asset Management Ltd

Appendix 3 Interviewees

AEGON Asset Management UK Ltd
AXA Investment Managers
Bank of New York
Banque Populaire
Barclays Global Investors Ltd
Deutsche Asset Management
Fidelity Investments
Franklin Templeton Investment Management Ltd
Goldman Sachs Asset Management International
IFDS Group
Insight Investment Management Ltd
Investec Asset Management Ltd
JP Morgan Fleming Asset Management
Legal & General Investment Management Ltd
Lombard Odier Darier Hentsch Asset Management Ltd
Merrill Lynch Investment Managers Ltd
M&G Securities Ltd
Morley Fund Management Ltd
Payden & Rygel
PIMCO Europe Ltd
Schroders Investment Management Ltd
Scottish Widows Investment Partnership
SG Asset Management UK Ltd
Threadneedle Asset Management Ltd
UBS Global Asset Management Funds Ltd
Winton Capital Management

The Corporation of London

The City of London is exceptional in many ways, not least in that it has a dedicated local authority committed to enhancing its status on the world stage. The smooth running of the City's business relies on the web of high quality services that the Corporation of London provides.

Older than Parliament itself, the Corporation has centuries of proven success in protecting the City's interests, whether it be policing and cleaning its streets or in identifying international opportunities for economic growth. It is also able to promote the City in a unique and powerful way through the Lord Mayor of London, a respected ambassador for financial services who takes the City's credentials to a remarkably wide and influential audience.

Alongside its promotion of the business community, the Corporation has a host of responsibilities which extend far beyond the City boundaries. It runs the internationally renowned Barbican Arts Centre; it is the port health authority for the whole of the Thames estuary; it manages a portfolio of property throughout the capital, and it owns and protects 10,000 acres of open space in and around it.

The Corporation, however, never loses sight of its primary role – the sustained and expert promotion of the 'City', a byword for strength and stability, innovation and flexibility – and it seeks to perpetuate the City's position as a global business leader into the new century.



CORPORATION
OF LONDON