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Integration And Segmentation In European Investment Services Markets: Assessing The Implications For International Real Estate Investment.

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Abstract

This paper analyses developments in the growth and configuration of the institutional savings markets within the European Union. The paper discusses the changing socio-economic context in which investment services within the EU are being delivered. The is followed by an examination of drivers of market integration such as the growth and consolidation of the fund management industry, the demographic and fiscal pressures for reform of pensions markets and the process and effects of the deregulation of investment services markets. There is a review of outstanding sources of market segmentation. The projections for future growth in pensions are outlined and implications for real estate investment assessed. It is concluded that, although numerous imponderables render reliable quantitative projections problematic, growth and restructuring of the institutional savings market is likely to increase cross-border capital flows to real estate markets.

INTRODUCTION

Among European economies there are striking disparities in the level and destination of institutional private savings. Furthermore, despite ongoing economic integration, there remains considerable divergence between national states in terms of maturity of capital markets, 'institutionalisation' of savings, regulation of investment, typical portfolio structures and taxation and legal provisions. Consequently, the investment services sector within the EU remains relatively fragmented by national borders and comparatively undeveloped in some countries. It could be argued that such relative 'immaturity' reduces demand for real estate as an asset class whilst market segmentation along national lines impedes cross-border real estate investment flows. However, there are several indications that this position is being transformed and that this transformation will continue. Recent survey evidence from European investing institutions has found a consensus that pension funds and pension related life assurance will be a major future growth market within the EU (European Commission, 1998). In addition, the European fund management industry has been experiencing dramatic change in terms of consolidation and internationalisation. This paper seeks to explore the causes and potential consequences of anticipated growth, the barriers to integration in investment services markets, the forces driving the expansion, deregulation and internationalisation of this sector and to assess the implications for levels and patterns of commercial real estate investment.

When analysing the significance of potential changes in the structure of long-term savings markets and the consequences for real estate markets, we need distinguish between the effects of adjustments on the *destination* and *level* of real estate investment. Moreover, since the paper concentrates on growth and regulation of investment markets, a number of assumptions about causal relationships and feedback mechanisms are implied.

- *Ceteris paribus*, absolute increases in private savings will tend to produce absolute increases in direct real estate investment.

- *Ceteris paribus,* absolute increases in real estate investment will tend to produce absolute increases in cross-border real estate investment.

- *Ceteris paribus,* relative increases in cross-border selling of financial services and products will tend to produce relative increases in cross-border (real estate) investment.

- *Ceteris paribus,* decreased regulation of investment allocation will tend to produce absolute increases in cross-border real estate investment.

Although seemingly reasonable, it will become apparent below that the validity of these assumptions is not self-evident.

The scope of this paper is exploratory. It aims to address the potential evolution in terms of size and configuration of the institutional savings market within the EU and to consider the implication for real estate markets. The remainder of the paper is organised as follows. The first part of paper defines integration in terms of economies and markets. The second part discusses the changing context in which investment services within the EU are being provided focussing, in particular, the effects of globalization and regionalisation, trends in the real estate sector and the 'institutionalisation' of savings. The is followed by a examination of the drivers of market integration such as the growth and consolidation of the fund management industry, the demographic and fiscal pressures for reform of pensions markets and the process and effects of the deregulation of investment services markets. There is then a review of outstanding sources of market segmentation. Finally the paper concludes by assessing the key factors influencing the consequences for real estate investment.

ECONOMIC AND MARKET INTEGRATION

Since the concept of integration is multi-faceted, a range of approaches has been taken to defining and delimiting it producing an, often pedantic, debate concerning emphases and perspectives. Most relevantly in this case, Pelkmans (1997, p. 2) defines economic integration as the "elimination of economic frontiers between two or more economies" so that the price, quality and production costs of goods and services is not influenced by flows over the frontier. Most definitions concentrate on aspects related to the freedom of movement of goods and factors of production and identify factor-price equalisation as an ideal where the prices of factors and goods are even across political or administrative areas so that they become a single economic entity (Jovanovic, 1992; Robson, 1987). More specifically, market integration is defined as a "behavourial notion indicating that activities of market participants in different regions or Member States are geared to supply and demand conditions in the entire Union." (Pelkmans, 1997, p.6). Hence, in practical terms, market participants should be able to operate throughout an economic area without impediment by localised variations in regulation, restrictions, technical standards, fiscal policy or the existence of border controls.

To capture the differences between 'planned' government-led integration and market-led integration, a distinction can be drawn between intentional and incidental integration. Intentional integration is conceptualised as a deliberate, policy driven process pursued by governments and international institutions. Incidental integration refers to the reduction in the economic significance of national borders that occurs as a result of the effects of globalization that are outside the direct control of nation-states and driven by activities of market participants. This type of integration can be either a result of or response to economic change. The two types of integration are not dichotomous since intentional integration may force businesses to react in ways that deepen integration and incidental integration may compel or encourage governments to intervene in order to regulate or harmonise.

In terms of analysis or measurement, integration can be examined as both a dynamic process and a static concept. Since it involves evolving economic relationships between economic areas, relative progress towards complete integration can be measured at fixed points in time. Complete integration should, therefore, be regarded as a theoretical ideal. Consequently, theories or models of integration implicitly view it as an evolutionary, dynamic process and assess it as a relative state. Indeed much of the research on integration in economics and finance is focused on measuring the degree of or testing integration between markets and economies. In the remaining sections, the intentional and incidental drivers of integration in the European investment services markets are assessed and the changing balance between segmentation and integration is considered.

BACKGROUND

Globalization[1] and Regionalisation

In order to weigh up the implications of deregulation and potential expansion of investment services markets, we need to consider the broader context of evolving macro-economic, financial and real estate market change. In the last two decades particularly, the collective and mutually reinforcing influences of globalization, technological innovation and trade liberalisation are creating intense competitive pressures in many economic sectors and

[1] Although a precise definition of globalization is elusive, it can be argued that the concepts of globalization and integration have some overlap. Grant (1992, p.1) defines globalization as

> "a process in which transactions across the borders of nation-states increase in importance relative to those within nation-states; and whereby national boundaries cease to be a significant impediment to the movement of goods and services"

generating, *inter alia*, increases in cross-border merger and acquisitions, foreign direct and portfolio investment and international trade. The integrating activities of the European Union have supported this structural economic transformation through legislative, administrative and monetary reform and harmonisation. Progress in economic convergence is evident by the expansion of intra-EU trade, increasingly symmetrical economic shocks and reductions in regional disparities (see Chisholm, 1995, Bayoumi and Prasad, 1997, Fagerberg and Verspagen, 1996, Sala-i-Martin 1995 and Fatas 1997). In particular, it is commonly accepted that deepening monetary integration has had and will continue to have major implications for institutional investment strategies within Euroland (see Beltratti, 1999 and Freimann, 1998). The introduction of the single currency has expanded the investment universe available to European investors with the *de facto* redefinition of the domestic market. The result is that institutional investors are beginning to analyse portfolio allocations by sector within Euroland rather than geographically by country. Subsequently, pan-European equity benchmarks and international stock exchange alliances have emerged.

Real Estate Trends

Over a similar time-scale, in terms of real estate investment, there have been a number of significant general trends. Firstly, it is clear that the allocation of investors to direct real estate has generally been decreasing. This has been linked with an upsurge in interest in indirect real estate as an alternative rather than a complement to direct investment (see Europroperty, 1998). Secondly, although all investment classes are affected by home country bias to some extent, real estate asset allocators have remained comparatively immune from globalization. For instance, although UK investors have been amongst the most active in terms of international direct and portfolio investment, in the 1990's the allocation of UK and US investing institutions to overseas property has remained negligible[2] (see Institutional Real Estate, Inc, 1999 and McAllister, 1999). The empirical evidence suggests that high costs of diversification and (actual and perceived) information asymmetries inhibit institutional cross-border real estate investment relative to bonds and equities (McAllister, 1999). Conversely, there are several symptoms of internationalisation within the real estate sector. Driven by the internationalisation of major clients, the real estate services sector has consolidated in the 1990's in a flurry of cross-border merger and acquisition. In the indirect sector, international strategic alliances have taken place between major real estate development companies (Europroperty, 1999)

The 'Institutionalisation' of Savings

Analyses of capital market development tend to stress the link between the relative significance of investing institutions and the presence of desirable capital market qualities such as liquidity, transparency, depth, efficiency and general sophistication. Similar analogies can be drawn in the property sector. In the OECD countries where the relative role of the investing institutions is more highly developed (US, Canada, UK, Netherlands and Australia), commercial property investment markets tend to display greater maturity in terms of trading levels, specialist professionals and market monitoring in turn creating greater liquidity and, more arguably, pricing efficiency. Amongst the most significant structural changes in global financial markets over the last two decades has been the rising concentration of private savings in the control of investing institutions. The last two decades have seen dramatic growth in the assets of pension funds, life assurance companies and, particularly, investment companies (OECD, 1997). All can be categorised as fund management services providers (FMSP). Explanations of the growth of the fund management sector have focussed on the consequences of four main often interrelated socio-economic

[2] Discussions with fund managers suggest that UK government data may be underestimating actual holdings. For instance, at the end of 1999 one long term insurance company had overseas property valued in excess of £400 million.

trends; demographic change, financial deregulation and liberalisation, technological innovation and disintermediation in the banking sector. The latter three developments have been significant drivers of the increasing blurring (where permitted) of functional boundaries in the financial services sector as banks move into fund management, life assurance companies provide banking services (and vice versa) and pension funds and banks and life assurance companies enter the independent fund management services sector. The result is a hotchpotch of independent FMSP, 'in-house' FMSP, bank owned (but separately capitalised) FMSP and life assurance company owned (but separately capitalised) FMSP. This complex blend of consolidation and fragmentation within the sector is further intensified by the fact that there are further relationships of cross-investment and service provision. For instance, life assurance companies often immunise pension funds against liability risk or may manage an element of pension funds' 'satellite' portfolios. Consequently, the diversity of the fund management sector should be acknowledged. Even with a single national market the activities and policies of fund management organisations are constrained by their liability structures, regulatory regimes, fiduciary mandates and tax situation. Variations in these factors enhance diversity in risk tolerances and asset allocation strategies.

Current Asset Allocation Patterns

There are notable variations in institutional portfolio structures within the EU. The relative lack of an equity culture is in many EU markets is well-documented. This is generally confirmed by the OECD data on allocations to bonds and equities are presented in Figures 3 and 4[3]. It is clear that most European institutional portfolios are dominated by bond investment. Although no figures are available (from OECD sources) for German life assurance and pension funds, mutual funds are heavily weighted towards bond investments in Germany[4]. Potential explanations for this bond bias relate to restrictive quantitative allocation regulations, anticipated inflation, risk preferences, lack of expertise in equity investment and underdeveloped capital markets. Whatever the reasons, it has been identified as producing low returns to savings, restricted development of capital markets affecting economic growth and job creation and a lack of investment diversification. As a result, the European Commission strongly favours the introduction of the 'prudent man' model of regulation. This is currently the regulatory framework found in the UK and Netherlands. It is unlikely to be coincidental that it is in these countries that long term savings are more likely to be invested in equities.

Figures 1 and 2 display the allocations of pension funds and life assurance companies to what the OECD categorise as 'non-financial assets'. In this context, this is assumed to represent direct real estate investment. This assumption is based on the reasoning that, although no separate classification for real estate is provided by OECD data, other studies have indicated a significant allocation to this asset class (see European Commission, 1997 and 1998c). Furthermore, for the UK, the OECD data on non-financial assets corresponds very closely to ONS figures in institutional holdings of real estate[5]. Apart from the major outlier of Italy, there is little dispersion concerning relative investment in real estate and that allocations are generally low. In addition, in common with UK and US experience, available evidence suggests that the allocation to real estate by life insurance companies has been declining in relative terms in the 1990s (see European Commission, 1998c). In terms of geographical

[3] The OECD Institutional Investors Statistical Yearbook is the source of the data. However, it contains a number of notable omissions. Although it is possible to find comparable figures in industry sources, their origin is rarely made clear.

[4] Figures of 75% and 70% allocation to bonds by German and French life insurance companies respectively are quoted by the European Commission (1997) – although no source is provided. Recent figures from WM Mercer quote allocations to bonds for French and German pension funds of 68% and 45% (33% in cash). No source or date is quoted.

[5] Differences are relatively small and may be explained by relatively minor investment in other non-financial assets such as fine art and antiques.

diversification, very little data is available. However, the evidence suggests that in common with the UK, there has been substantial investment in non-domestic equity and bond markets. Consequently, for the life insurance sector, the bond bias remains the major distinction between the 'Anglo-Saxon prudent man' model and the 'European quantitative restriction' model.

INTEGRATION DRIVERS

Demographic and Fiscal Pressures

There is a broad consensus amongst commentators that the current system of financing pension provision within many EU countries is unsustainable and that demographic change and associated fiscal consequences will lead to a restructuring of the funding of retirement. Although the relative merits of different approaches to funding retirement provision are politically contentious, it is widely envisaged that the solution to the 'burden' of unfunded, public pension models will be a prefunded, private pension approach. Within the EU, the central 'problem' is that currently the majority of national pension systems are unfunded. At present over 80% of total pension payouts within the EU are from unfunded schemes (European Commission, 1999). As reduced fertility and increased life expectancy reduce the dependency ratio if current trends continue, there will be a dramatic increase in the relative fiscal cost of pension provision. Recent forecasts within the EU are that the dependency ratio will reduce from 4:1 currently to 2:1 in 2040 (European Commission, 1997).

However, the implications are variable between countries. It has been estimated that by 2030, without structural reform, pension expenditure will account for 15-20% of GDP in Belgium, Finland, France, Germany and Italy. The comparable figures for UK, Portugal and Ireland are under 10% (European Commission, 1997). The size of national pension fund assets relative to GDP provides a useful proxy for the relative size of the problem in individual economies. It is generally envisaged that the reform of the funding of pension provision is inevitable and that the reform will follow the 'Anglo-Saxon' model of the growth of funded Second and Third Pillar schemes.

Table 1

EU Pension Fund and Life Assurance Company Assets

	Financial assets of institutional investors % of GDP 1996	Financial assets of pension funds % of GDP 1996	Financial assets of insurance cos. % of GDP 1996
Austria	39.4	1.2	21.0
Belgium	63.0	4.1	30.9
Denmark	67.1	16.9	45.1
Finland	57.0	-	14.0
France (1)	90.6	5.6 (1996)	52.6
Germany (1)	57.5	5.8 (1996)	31.9
Greece	28.5	11.9	28.5
Italy (1)	53.2	2.9	53.2
Netherlands (1)	183.8	102.0	60.3
Portugal (1)	31.7	10.1	9.4
Spain (1)	56.1	2.0	20.4
Sweden	120.3	2.4	56.9
United Kingdom	193.1	77.5	88.6

Source OECD 1999; BIS, 1998.

(1) 1997 figures

Financial Services Markets Liberalisation

Although the Treaty of Rome envisaged freedom of movement in goods and services, the policy emphasis in the decades that followed was on the product market (possibly reflecting the dominance of manufacturing in western economies). However, in the 1980's attention began to turn to services reflecting the increasing relative economic importance of this sector. The rationale was similar to that of the liberalisation of trade in goods with the emphasis on gains in efficiency and competitiveness. The focus of the 1985 White Paper (a precursor to the Single European Act) identified a number of major areas hindering the integration process including:-

- The role of national governments in public procurement and subsidies.
- The diversity of regulatory environments and technical standards producing non-tariff barriers to trade.
- The continuing existence of frontier controls.
- The existence of varying fiscal systems.
- The effective exclusion of major service industries from operating throughout the European Union.

Consequently, the 1990s have seen determined attempts by the European Commission to reduce the obstacles to cross-border trade in investment services. Figure 5 outlines the three key Directives introduced by the European Commission in order to liberalise markets in financial services.

Figure 5 Key Financial Market Liberalisation Directives

1989 Second Banking Directive

Introduced a 'single banking licence' allowing any credit institution authorised in a member state to set up branches or supply cross border services in all other states. Services included were portfolio management and advice.

1994 Third Life Assurance Directive
1994 Third Non-life Insurance Directive

Introduced a single system for the authorisation and financial supervision of insurance undertakings within the Single Market. Essentially authorisation in any EU country enabled an insurance undertaking to carry out its insurance business anywhere in the EU.

1996 Investment Services Directive

Introduced a "European passport" for non-bank investment firms wishing to carry out in all member states a wide range of investment business.

The next major objective of the Internal Market Directorate General is to introduce a Pension Services Directive. Preparation for and consultation on such a Directive are well advanced. The Commission have a relatively clear vision for the reform and integration of pension service provision with the Union. The Green Paper on supplementary pensions within the EU and the analysis of responses to this Green Paper suggest that they advocate a broad strategy

of growth in funded Second Pillar Schemes and the introduction of *qualitative* guidance on investment allocations. The main aims and objectives are that there should be freedom of investment, an "essential" increase in investment in equities for the longer term and that such freedom should be restricted by qualitative prudential principles rather than quantitative restrictions (see European Commission, 1999).

Growth and Consolidation within EU Investment Services Market.

The expanding role of investing institutions and the emergence of a bancassurance sector have been already been acknowledged above. As in other sectors, it is considered that the more competitive environment produced by EMU will act as an additional catalyst to ongoing consolidation in the European financial services sectors (see EIU, 1999, White 1998). Indeed, there is evidence emerging which suggests that the way that services are being provided and funds managed is being transformed – particularly within the European Union. Consistent with globalized production, it has been argued that it is becoming increasingly difficult to allocate production of financial services to particular countries given the increasingly complex mature of the functional interrelationships that are developing (Fund Managers' Association, 1999). In the European pension fund sector, recent research has identified rapid expansion in the period 1997-9 in terms of funds managed, personnel employed and number of offices (W.M. Mercer, 1999). W.M Mercer estimated growth in assets to be from $6.1 trillion in 1997 to $8.2 trillion in 1998.

Although it is clear that portfolio investment is increasingly dispersed geographically, the evidence is not consistent as to whether this is leading to geographical dispersion or concentration of investment management functions. Reflecting the increased complexity of networks that distinguishes globalization from internationalisation, the W.M. Mercer research has found that over 20% of fund managers now operate in five or more countries with decentralisation of fund management and research functions being increasingly common. In addition, recent survey research has found that UK based fund managers are managing ssignificant amounts of overseas' clients funds (26% of total funds managed) whilst at the same time management of a comparable proportion of funds (22% of total funds managed) has been devolved to overseas' offices (Fund Managers' Association, 1999).

On the other hand, there is evidence to suggest that integration and consolidation is compelling pan-European organisations to centralise the management activities of geographically dispersed assets. In common with their equity and bond portfolios, recent market commentary suggests a consequence of the consolidation and internationalisation of the insurance sector is that major European insurance corporations such as Axa and Generali are in the process of combining the property portfolios of national subsidaries (see Frampton 1999). This process is also mirrored in the pension sector. Recently several pension funds of major multi-national enterprises have decided to aggregate their previously disparate European pension funds into "informally pooled" vehicles in order to benefit from economies of scale in fund management (EIU, 1999). A related trend is for individual or groups of institutional investors to 'spin off' their real estate management organisations and then to offer management services to other real estate investors with a view to achieving economies of scale and scope.

Interestingly the W.M. Mercer research found that 23% of European pension fund managers were involved in a merger or acquisition in the previous year (1998). This is consistent with consolidation in both the life assurance and banking sectors within the European Union. Research by Swiss Re (1999) found that on average the life insurance sector has experienced increased concentration within the EU accounting almost two thirds of global mergers and acquisitions in the 1990s. Perhaps more significantly, over half of the premium income acquired in the EU has been cross-border. An examination of UK insurance markets suggests that the pattern of expansion can vary significantly geographically and between the life and

non-life areas. Shears (1999) found that between 1985 and 1997 the life insurance premium income of UK insurers from EU countries increased by 230% in real terms [6]. Moreover, business growth varied geographically with most of the increase taking place in France. However, there is no evidence to suggest that this growth in international business is correlated with an increase in investment in international real estate.

OUTSTANDING SOURCES OF SEGMENTATION

Informal Barriers to Investment Services Market Integration

Most market participants recognise that there are limited formal barriers to market entry within the EU. Some do remain. For instance, at a general level, the Third Life Assurance Directive outlines minimum investment standards that must be met but allows member states to impose their own regulation in addition. Article 11 of the Investment Services Directive allow national regulatory authorities to retain substantial influence on local business conduct rules. However, the main obstacles to integration are informal and include international variation in

- Consumer protection legislation.
- Accounting practices.
- Bankruptcy law.
- Provision for legal redress.
- Interpretation of directives in particular the 'general good' principle.
- Access to necessary data (for insurance markets, notices of claims, medical data).
- Establishment requirements and compliance checks.

This has lead an increasingly frustrated European Commission to argue that

> "Differences between Member States legal provisions on the provisions on bankruptcy, security and applicable law mean that….difficulties will persist. Pan-European products such as mortgages, life assurance, pension funds cannot be developed until underlying differences in these national provisions are co-ordinated and/or mutually recognised….the necessary degree of convergence in national law is unlikely in the short term." (European Commission, 1998, p. 14-15)

However, it is relatively clear that, particularly in the life assurance sector, restrictions on operation have replaced restrictions on establishment as the main problem.

Investment Regulation

It is clear that there is a strong possibility of increases in private savings within the EU. However, there are significant obstacles to cross-border investment due to national regulations on portfolio structures. Many countries within the EU, still have quantitative restrictions on asset allocation. These are outlined in Table 3. Typically they tend to focus on the need for currency matching and place limits on investment in equities and foreign investments. It has been suggested that quantitative restrictions have very little impact on investment strategies and that most funds do not approach the permitted limits. However, it is notable that countries with qualitative regulation tend to invest a higher proportion of their assets in equity investments.

[6] Although this seems impressive, the comparable figure for the USA is 2000%.

Table 3 Regulation of Investment Allocation within the EU

Country	Restrictions
Austria	*Pensions:* 50% minimum in Austrian currency deposits or bonds. 35% ceiling in foreign assets.
Belgium	*Pensions:* 50% ceiling on foreign assets
Denmark	*Pensions:* Maximum of 40% in 'high risk assets' – these include domestic and foreign equities and unlisted securities. 80% currency matching requirement. Up to 50% of liabilities can be covered by assets denominated in ECU. *Life Assurance:* 40% combined limit on domestic and foreign equity, 10% limit on unlisted securities, 10% combined limit on mortgages and loans.
Finland	*Pensions:* 80% currency matching rule *Life Assurance:* 80% currency matching rule
Germany	*Pensions:* Maximum 30% EU equity, 25% EU property, 6% non-EU shares and bonds, 20% overall foreign assets. 80% currency matching rule. Foreign fund managers required to link with German unit trust fund manager. Life Assurance: *Similar to above.*
Spain	*Pensions*: 90% of assets must be registered in quoted securities, bank deposits, property or mortgages. *Life assurance:* No specific limits.
France	*Pensions*: At least 50% must be invested in EU government bonds. *Life assurance:* 65% combined limit on domestic equity, unlisted securities and foreign equity, 40% limit on property, 10% combined limit on loans and mortgages.
Italy	*Pensions*: No pension law specific for self administered schemes but investment policy. *Life assurance:* Maximum of 20% in domestic equity, unlisted securities and foreign equity, 50% in foreign bonds, 50% property, 50% mortgages.
Netherlands	*Pensions:* Prudent man rule *Life assurance:* 10% combined limit of unlisted securities and mortgages, 8% limit on loans.
Sweden	*Pensions:* Majority to be held in bonds, debentures and mortgages *Life assurance:* 25% combined limit on domestic equity, unlisted securities and foreign equity. 25% combined limit on property and mortgages. 10% limit on loans
UK	*Pensions:* Prudent man rule. *Life assurance:* 10% combined limit on unlisted securities, mortgages and loans

Source: European Commission, 1997, Bank of England, 1998.

The European insurance market provides interesting insights into the potential effects of deregulation on investment patterns. Since the Third Life Assurance Directive the European Commission still consider that direct supplier to consumer provision of insurance services remains largely immature on a cross-border basis with the result that insurance companies in most EU states register no cross border sales (European Commission, 1998). In the insurance sector the trend has been for international expansion to take place by merger, acquisition or

new venture in individual national markets. However, significant informal barriers remain due access to distribution, access to risk management data. Moreover, it is important to bear in mind that a 'European passport' for financial institutions is not a passport for financial products. With regard to the latter, companies may have to design tailored products in order to reflect national variations in advertising, marketing and contract law. Similar issues apply to pension funds, although for pension funds taxation differences seem to present the key obstacle to market integration.

Taxation

Differential tax structures within the EU remain a significant barrier to the internationalisation of investment services. The European Commission identify tax related issues as the main obstacles to pan-European investment strategies in the absence of exchange rate risk (European Commission, 1998). Particularly in the pensions sector, the EU lacks a coherent framework for cross-border transfers of contributions, benefits and transfer values. International disparities in tax laws are a major barrier to the creation of pan European pension funds. In order to benefit from favourable tax treatment multi-national companies are forced to set up individual funds within each country due to a lack of mutual recognition of non-domestic pension schemes and potential double taxation. The extract below from an industry response to the European Commission's Green Paper illustrates effectively the nature and implications of lack of tax harmonisation.

> "Discriminatory tax treatment of pension contributions is the single most important barrier to a Single Market for supplementary plans. National regulations still discriminate directly or indirectly against foreign pension funds. As a rule, tax deductions are available only for contributions to domestic schemes. This both distorts competition and limits labour mobility….Fragmentation of the pension product market due to discrimination based on nationality also increases transaction costs. Products must be designed for a specific Member State market and typically must have the unique characteristics required to benefit from tax relief in that Member State. In-country establishments are required – often only contributions made to domestic institutions will receive favourable tax treatment. As long as such discriminatory tax barriers exist, providers of supplementary pension plans are not able to benefit from economies of scale. They must create unique products and establish specific investment policies for what may be relatively small markets. The need to establish often duplicative country-specific infrastructure to manage products further drives up costs." (European Commission, 1998, p. 29)

The consultation exercise carried out by the European Commission on the Green Paper suggested that many investment managers did not foresee significant changes in this respect in the shot to medium term. This fragmentation has been recognised by the European Commission as an important barrier to labour mobility with the Single Market and there is increasing momentum for a Pension Services Directive to reduce with formal and informal regulatory and tax barriers to cross-border pension provision.

IMPLICATIONS FOR REAL ESTATE INVESTMENT

Forecasting Asset Growth and Destination

It is clear from the discussion so far that, as in many other sectors, investing institutions in the EU are being affected by pressures to consolidate and internationalise. Given that they are key investors in commercial real estate markets, changes in market size, concentration and organisation will influence the level and destination of investment flows. However, there are major methodological difficulties in quantifying the consequences of such changes for the private fund management sector. In terms of market growth, the EIU analysis below reflects the general expected repercussions of increased savings.

> "..the countries with the highest projected increases in savings will tend to be capital exporters to the rest of the euro zone because they will want to build up pan-European investment portfolios. Indeed the rate of growth of pension funds from currently low EU levels could be a significant driver of cross-border capital flows." (EIU, 1999, p. 27)

For pension reform, although it is clear that there will be significant fiscal pressures on many EU countries, policy responses are likely to be neither consistent nor comprehensive. Potential policy alternatives to private funded models are: the development of public pre-funded schemes; adjustments of present entitlements such as contributions levels, retirement age and indexation provisions; fiscal adjustments to expenditure or taxation levels; or macro-economic reform to influence demographic profiles, productivity and technological innovation. Manifestly, these are not mutually exclusive and a pragmatic blend of these policy alternatives is most likely and, indeed, can be observed in nascent form. Even if there is a shift towards a privately funded model, the consequences of the transition will be influenced by uncertain factors such as market returns, growth in demand for lifestyle and income protection and the speed of transition. As a result, forecasts of the growth of institutional savings markets have needed to make significant leaps of faith regarding future events and trends. Unfortunately, these assumptions are not always transparent when their results are reported.

Indeed, many analyses simply seek to measure the size of the 'savings' gap rather than forecast market growth. Starting from an assumption of an instantaneous switch to private savings, Swiss Re (1998) estimated that annual private savings would need to expand by in the region of $80 billion dollars in France, $130 billion in Germany and $40 billion in Italy in order to cover the financing gap in public provision[7].

Table 4

The Funding 'Gap' in EU Pensions

	Private pension fund assets 1996 $ bn	Adjustment required to reach US level $ bn
Austria	3	139
Belgium	11	148
Denmark	38	69
Finland	18	39
France	37	893
Germany	137	1341
Greece	4	74
Ireland	32	14
Italy	32	777
Netherlands	349	-103
Portugal	30	50
Spain	22	317
Sweden	38	34
UK	966	-168
Total (excluding UK and Netherlands)		3353

Source: Bank of England, 1998

Alternatively for the same countries they suggest that private savings need to expand at annual rates 3%, 4.5% and 5.5% respectively. Swiss Re point out that the figures are not

[7] The assumptions underlying the calculations are not clear. They *appear* to assume that there is no relative expansion of public expenditure on pension provision and that additional private savings fill the resultant shortfall.

forecasts of market growth but rather serve to illustrate the potential for growth in the market. The Bank of England (1998) published data on the required increase in pension fund assets necessary to provide European economies with pre-funding comparable to US levels. Although it is manifest that many European economies will not be able or feel it necessary to match a US bench mark, the figures are displayed in Table 4 give an indication of the scale of the sums involved. Even if we assume that a conservative proportion of the projected 'shortfalls' are met by private savings, this implies large capital flows of which a proportion will be invested in direct real estate. Research by Pragma Consulting (for the European Commission) has produced broad projections of the growth of assets of EU pension funds. Based on assumed returns on portfolios of 6.4% p.a. and 2.6% growth in net contributions, it is projected that by 2010 pension funds assets will grow nearly threefold within the EU (see Table 5).

Table 5 Projected Asset Growth of EU Pension Funds

End 2000	€2107.47
End 2005	€3242.60
End 2010	€4989.14
End 2015	€7676.41
End 2020	€11811.10

Source: European Commission, 1999

Analysis of the Pragma data suggests that they expect new fund flows in the region of €60 billion per annum. Although conservative compared to Swiss Re and Bank of England figures, they would seem more realistic given the political complexities of and potential alternatives to a swift switch to private pension schemes. Whatever the quantity, it seems reasonably evident that there will be a significant expansion of private pensions within the EU.

It has already been pointed out that two notably pervasive features of the institutional investment in real estate have been declining allocation and acute home country bias. It is uncertain whether these trends will persist. Survey evidence from the US suggests that most investors are seeking to increase their exposure to direct domestic and non-domestic real estate markets (Institutional Real Estate Inc, 1999). The key questions are

- To what extent will the introduction of the Euro lead to a geographical portfolio restructuring of current real estate portfolios?
- What proportion of new institutional funds will be allocated to real estate?
- What proportion of new institutional real estate funds will be allocated to cross-border real estate?

In order to arrive at estimates of net flows to direct real estate, the first stage is to separate new inflows from growth in value of existing assets. The Pragma projections are that nearly 27% of the growth in assets will be due to new contributions. In Table 6, an average growth of 2.6% per annum and reflect the implied annual growth in the Pragma data.. Next the amount of new funds allocated to real estate is estimated. In Table 6, a figure of 5% is used since this is broadly in line with current UK and US allocations. Hence the allocation to real estate column provides an estimate of the flows of 'new money' into real estate from pension

related savings within the Euro zone over the next 20 years. Assuming that 25%[8] of these funds are invested outside the domestic market, then the allocation to international real estate column provides an estimate of the flow of new international real estate funds from increased pension fund within the EU.

Table 6

Projected Growth of EU Pension Fund Assets 2000-2020
At current prices

Year	Projected Fund growth €bn	Net Increase €bn	Allocation to real estate €bn	Of which Cross-border €bn
2000	2107.47			
2001	2162.26	54.79	2.74	0.68
2002	2218.48	56.22	2.81	0.70
2003	2276.16	57.68	2.88	0.72
2004	2335.34	59.18	2.96	0.74
2005	2396.06	60.72	3.04	0.76
2006	2458.36	62.30	3.11	0.78
2007	2522.28	63.92	3.20	0.80
2008	2587.86	65.58	3.28	0.82
2009	2655.14	67.28	3.36	0.84
2010	2724.18	69.03	3.45	0.86
2011	2795.00	70.83	3.54	0.89
2012	2867.67	72.67	3.63	0.91
2013	2942.23	74.56	3.73	0.93
2014	3018.73	76.50	3.82	0.96
2015	3097.22	78.49	3.92	0.98
2016	3177.75	80.53	4.03	1.01
2017	3260.37	82.62	4.13	1.03
2018	3345.14	84.77	4.24	1.06
2019	3432.11	86.97	4.35	1.09
2020	3521.35	89.23	4.46	1.12

Assumptions:

Growth in contributions	2.60%
Allocation to real estate	5%
Cross-border	25%

Source: Adapted from European Commission 1997

This produces estimates of new pension related capital flows to direct real estate investment of €2.74 billion per annum in 2001 growing to €3.5 billion in 2010. Given assumptions about cross-border flows, this reflects an increase in cross-border flows of €0.7 billion in 2001. Manifestly, the reliability of such projections is dependent upon the reliability of the inputs and underlyng assumptions. Table 6 illustrates the sensitivity of the projections to relatively

[8] Obviously the figure of 25% is rather arbitrary. It is much higher than current allocations to international property for UK and US funds. It reflects the expected impact of the introduction of the Euro and the consequent elimination of currency matching issues for Eurozone pension funds.

small variations in assumptions about savings expansion and allocation to real estate. It is apparent that relatively minor adjustments to growth and allocation expectations can lead to large increases in the projection of new funds.

Table 7

Sensitivity of 2001 Projection
Allocation to Real Estate €bn

Pension growth	Allocation 6%	7%	8%	9%	10%
3.00%	3.79	4.43	5.06	5.69	6.32
3.50%	4.43	5.16	5.90	6.64	7.38
4.00%	5.06	5.90	6.74	7.59	8.43
4.50%	5.67	6.64	7.59	8.54	9.48
5.00%	6.32	7.38	8.43	9.48	10.54

This analysis also raises questions about the route of investment flows to the property market, probable destinations and implications for returns. Although speculative, it is possible to make a number of points. It is likely that a significant alternative channel of institutional funds to the property sector will be through pooled vehicles. A proportion of the new funds will flow indirectly to real estate with the expansion of equity markets and widely acknowledged institutional preferences for indirect vehicles. It is instructive that the US institutional approach to investment in EU real estate markets has mainly been through opportunist funds and REITS. Indeed, Eichholtz and Lie (2000) identify significant variations in the level of securitisation among the real estate markets of the EU, estimate that only 1-2% of the total property stock of the EU is securitised and suggest that there is considerable scope for expansion of this sector particularly in the Mediterranean economies. On a more topical note, there has been recent conjecture that the high level of business owner-occupation in the EU will start to reduce as EU corporations start to liquidate their property assets in order to raise capital (Carpenter, 2000). This is closely linked to an assessment of the implications for returns. Given the complexities involved in trying to identify the determinants of property returns, it is inappropriate in this context to try to make specific projections. However, key questions that need to be considered concern:-

- The extent to which increased capital flows to European equity and (corporate) bond markets will impact upon property returns.

- What proportion of additional investment will come from changes in ownership of existing stock relative to new construction?

- For new construction, to what extent will the growth in investment demand exceed, match or fall below growth in GDP?

- To what extent will there be significant geographical variations in the allocation of new investment funds?

Conclusion

Contemplating the questions above and the numerous other imponderables associated with this discussion highlights the difficulties of making any confident judgements about the potential repercussions of pension reform for EU markets. However, this does not mean that the topic can be ignored. It is clear that there is a strong possibility the next decade will

witness dramatic developments in the size and configuration of the fund management sector within the European Union. Whilst there is uncertainty about magnitude and extent, the whole thrust of current developments is for continuing growth and integration of the investment services market. The former implies increased demand for real estate as an asset class, whilst the latter implies increased cross-border flows of real estate investment. There is a broad consensus that the current and latent fiscal pressures produced by ageing populations will produce an increase in private savings within the EU, in particular, in France, Italy and Germany. Although the main destination of these savings will be in the equity and corporate bond markets of the euro zone, a proportion will go to real estate. The deregulation of the life assurance, banking and investment services has removed most of the formal barriers to market entry in other European Union countries. Although cross-border provision of financial services is still undeveloped, deregulation and technological innovation are lowering the costs of market entry in European markets. The implementation of EMU has changed the parameters of investment allocation. As funds expand, portfolios will become increasingly 'euroised'. The fund management sector itself is undergoing profound change in terms of consolidation, internationalisation and liberalisation. Within the banking and insurance sectors, there has been notable convergence and consolidation. This is expected to continue and increase on cross-border basis. Furthermore, powerful consumers of pan-European investment management services are seeking to benefit from perceived economies of scale of pan-European management services provision.

Nevertheless it needs to be acknowledged that there remain barriers to integration due to international variations in legal, regulatory, market and, in particular, taxation regimes which effectively hinder cross-border trading. However, it is noticeable that such barriers are widely recognised and are the 'targets' of continued deregulation. Additionally, there are substantial barriers distinct to real estate which seem to inhibit cross-border real estate investment. Real estate is much more prone to home country bias than equity or bonds. The underlying structural trends seem to be towards lower allocations to direct real estate investment generally and relative to indirect real estate investment. Expansion and integration of investment services markets may simply act as a brake on these long-term trends. Given that recorded cross-border activity for office investment in 1998 in Europe was approximately €6.5 billion, it seems reasonable to conclude that pension reform and associated deregulation will not have dramatic direct effects upon domestic and cross-border real estate investment within the EU (Europroperty, 1999). Possibly more important, but more difficult to quantify, is the impact of the fundamental restructuring occurring in the European fund management, banking and insurance sectors.

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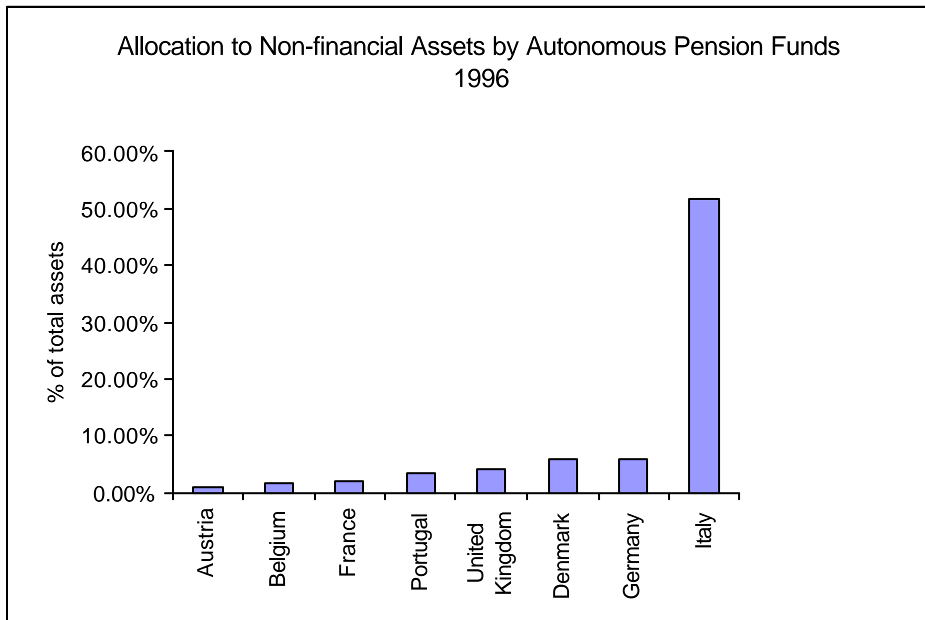
Appendix One – Figures

Figure One



Source OECD 1999

Figure Two

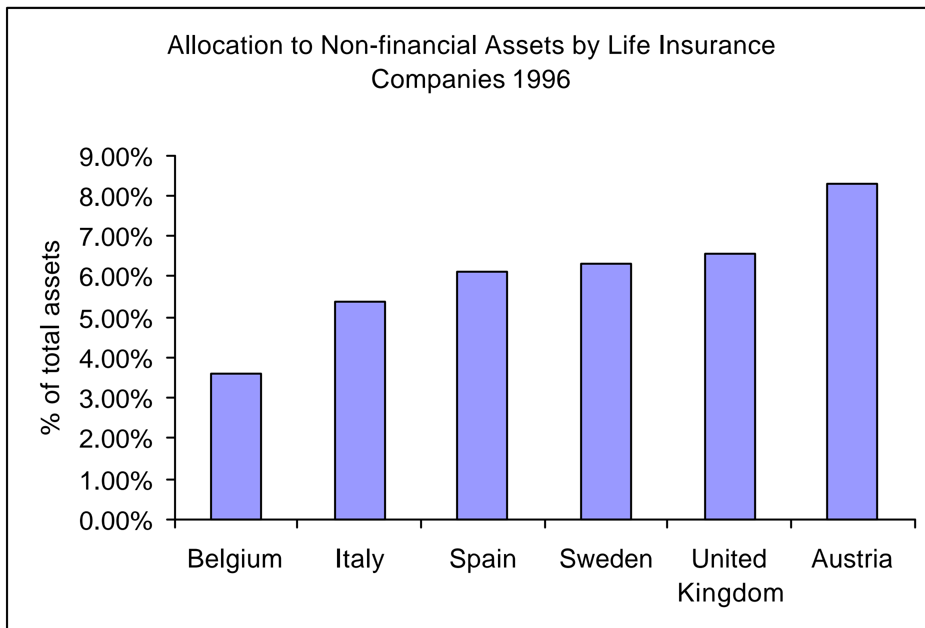


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Figure Three

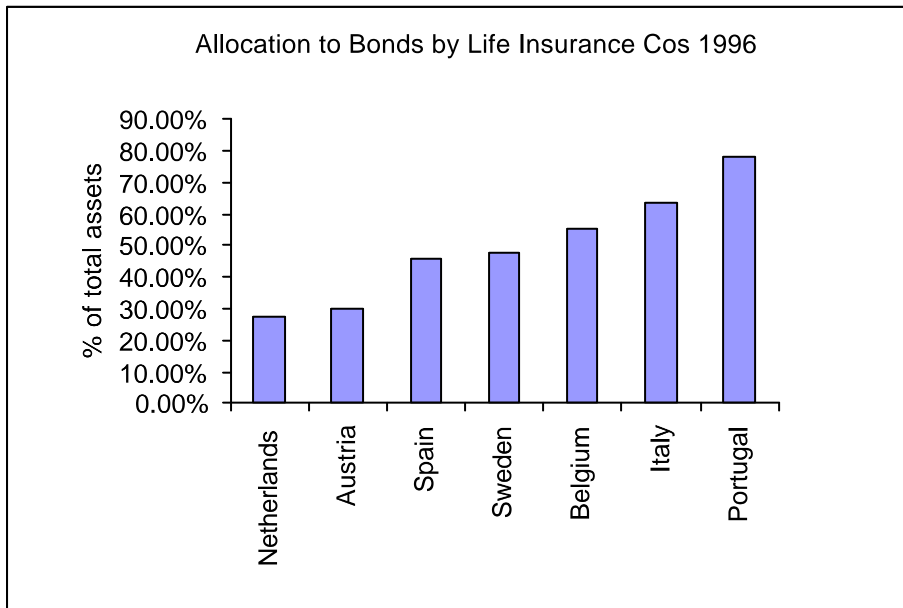

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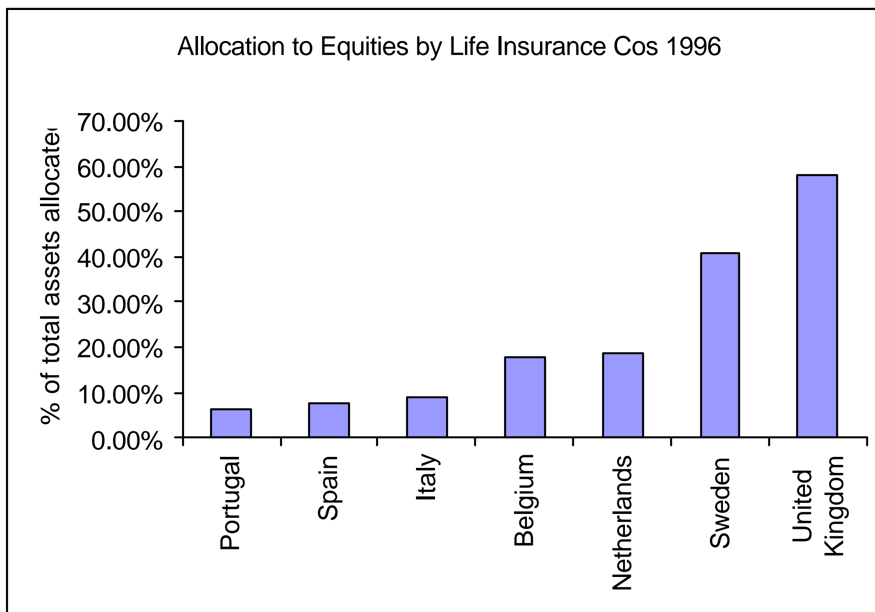
Figure Four



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