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Article

Competition and structure of the mutual fund industry in Spain: The role of credit institutions☆

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ABSTRACT

In industries where consumers prefer to make all their purchases from a single company (for example, a supermarket), companies tend to offer a greater variety of products. By using that strategy, they succeed in growing their market share in the industry and gaining market power. This behaviour is also typical of the financial industry, where consumers usually prefer to concentrate all their financial operations in a single entity. In Spain, the big growth of mutual funds since 1995 and the model of universal banking, suggest the existence of these cross-effects on demand (spillovers). In this paper, we provide empirical evidence of the presence of these effects in the Spanish mutual fund market. Moreover these effects are stronger than in the US market. The intensity of the effects appears to be greater in the retail mutual fund segment than in the wholesale segment. This result would be consistent with the relative increase in the number of funds offered by management companies, the higher fees charged, and the stronger degree of concentration of fund families found in the retail segment.

1. Introduction

In some industries, the fact that the cost of making acquisitions from several suppliers may be too high (switching costs) or that it is too difficult for buyers to find the best suppliers of the products that they want (search costs) means that they prefer to concentrate their acquisitions at one single seller.[1] Examples of this behaviour can be found in non-financial industries related to commercial distribution, particularly supermarkets, but also in the financial industry as many users of financial services prefer to centralise their financial operations in one single entity.

In this type of industry, the type and diversity of products offered by companies may become important strategic variables which end up having an impact on the structure and conditions of market competition. Accordingly, in an industry in which the demanders prefer to buy from companies which offer a wide variety of products, the companies compete with each other by increasing said range of products. If these demand spillover effects are strong, companies have more incentive to offer a wide variety of products and thus achieve greater market power.

According to Gavazza (2011), the mutual fund industry may be considered as a natural terrain to study the presence of demand spillovers and the role played by the variety of products offered. It is reasonable to think that in this industry most buyers of mutual funds prefer to make their investments through one single financial institution or one single intermediary. This preference towards concentrating financial transactions at one single entity takes on special relevance in the case of Spain, where universal banking with close customer relations is the predominant model. This banking model, as opposed to specialised banking (or the Anglo-Saxon model), in which credit institutions are of two types, commercial banks and investment banks, is characterised both by the provision of all types of typical banking and investment services, and by business promotion and participation in the capital of companies through an extensive branch network.

The economies of Europe have ratios to GDP of banking deposits and credit which are appreciably higher than those of the United States. This fact suggests that European banks play a greater role in channelling the financial flows of the economy. Among European economies, Spain is clearly in the upper range of this indicator. In particular, ratios to GDP of banking deposits and credit in Spain (170 per cent and 187 per cent, respectively) are significantly higher than in Germany, France or Italy. Only the United Kingdom has higher percentages in both cases, while in the Netherlands and Ireland the

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[1] Most of time, when consumers of credit institutions decide to close their account and cancel the products which they have taken out with that entity to move them to another credit institution, they suffer costs, which include both time costs and money costs. See for example, Klemperer, P., Padilla, J., 1997. Do firm's product lines include too many varieties? RAND J. Econ. 28, 557–582.

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balance of bank deposits in terms of GDP is similar to Spain, but the credit balance is higher.[2]

During the decade prior to the crisis, Spanish banking followed a strategy of growth based on the physical proximity of its commercial branches to the clients. So, there was a considerable increase in the number of branches throughout Spain. The increase in the number of branches was of such a magnitude that the number of inhabitants per branch in September 2010 was 1000. This ratio contrasts with the considerably higher ratios observed in other advanced economies (for example, in the EU, USA and UK, the ratio is around 2000, 3000 and 5000 inhabitants per branch, respectively). The high density of Spain's commercial banking network can also be seen in the number of ATMs.

The existing Spanish model of retail banking in the years prior to the crisis was therefore characterised by a strong presence of domestic credit institutions with many branches of two or three employees.[3] These branches offered a full range of financial operations to their clients, whether in the form of financing (home and consumption) or investment products. Among the investment products, not only traditional bank deposits, but also other more sophisticated financial products, including mutual funds were included. The great importance of banking branches in the provision of financial services has been documented by Datamonitor (2001). This study shows how the distribution channel most used by users of banking services in Spain was the branch (nearly 90 per cent, compared with a European average of 80 per cent), in contrast to the marginal use of other channels such as telephone banking or the Internet.

This retail distribution model is in contrast to what we see in the USA, where the presence of financial advisers, not necessarily associated with any banking entity, plays a much more important role. In the specific case of the marketing of mutual funds, the Investment Company Institute (2012) revealed that in 2011, 44 per cent of US households had some kind of participation in mutual funds, and that half of those households had made use of the financial services of a professional, usually in the form of brokers or independent financial advisers.[4] In Spain, the Household Financial Survey (EFF) for 2008 reported that 31.3 per cent of all households had shares in some form of collective investment scheme (5.6 per cent in investment funds), most of which were likely to have been acquired through a bank branch. This difference in the percentage of households having an investment fund is due to the fact that, in the United States, investment funds are the main financial instrument used by citizens to invest the money they will use for their retirement (Cohen and Schmidt, 2009).

In addition to the signs which suggest that consumers of financial services, particularly in Spain, have a strong preference towards concentrating their financial operations in one single entity, there is a second reason why the mutual fund industry is appropriate for investigating the existence and intensity of demand spillovers. This industry may be segmented into two groups, depending on the type of investor, retail or wholesale, for which said demand spillovers are likely to be different. In general, it is reasonable to suppose that wholesale investors are more sophisticated in financial terms and, therefore, their costs for changing investment between funds of different management companies would be lower and their ability to find funds with a higher expected return, or lower costs, would be greater. Therefore, the variety in the range of funds offered by management company should, a priori, be greater in the retail mutual fund segment, as these investors incur greater costs in order to find satisfactory investments with other management companies.

If this is the case, management companies which market mutual funds in the retail segment would have incentives to increase the range of funds which they offer (in number and/or category). With this strategy, their market share in the industry would increase and they could charge higher prices (fees in this context) to their consumers. Finally, given this strategy, this fund segment should show a high level of concentration.

The preliminary data on the Spanish mutual fund industry for the period 1995–2010, which is described in the following section, suggest that demand spillovers may play a significant role in this industry and that, in addition, they seem to be more intense in the retail segment of the mutual fund industry. In particular, the data shows that (1) the average number of funds offered by management companies in the retail sector is much higher than in the wholesale sector, (2) the fees applied to retail funds are higher than those applied to wholesale funds and (3) the concentration of management companies is higher in the retail segment.

This paper, which follows the approach set by Gavazza (2011) for the fund industry in the USA between 1999 and 2007, aims to contribute towards the literature on mutual funds from two points of view. Firstly, it attempts to explain the competition conditions in the Spanish investment industry by using certain patterns of demand which, in this case, incorporate the preference of consumers for variety and/or depth in the offering of products. Secondly, it offers a comparison with the patterns identified in the US industry with regard to the presence of demand spillovers for mutual funds and the differences in their intensity between the wholesale and retail segment.

The document is structured in the following manner. In Section 2 we describe the main characteristics of the supply of investment funds in Spain between 1995 and 2010, placing special emphasis on the conditions of competition in the industry. In Section 3 we present an empirical analysis, in which we attempt to identify the presence of demand spillovers in the Spanish fund industry and the differences between the wholesale and retail segments. Finally, in the last section we draw our principal conclusions.

2. Competition in the mutual fund industry

The number of mutual funds in Spain, as well as their assets, grew significantly in the period between 1995 and 2010, although we can divide this period into four sub-periods. Firstly, between 1995 and 2000, the industry expanded significantly, both in the number of funds and in the assets under management. This increase was due to the popularisation of this type of financial instrument among investors, especially among retail investors. In the years 2001 and 2002, the industry contracted as a consequence of the bursting of the technological bubble, which was reflected in a significant fall in the assets managed by mutual funds, although the number of funds remained stable. Coinciding with the sharp economic growth of the Spanish economy between 2003 and 2007, there was a new expansion, both in the number of funds and the volume of assets under management. In the final stage of the period under study, 2008–2010, both the number of funds and the assets under management fell significantly as a consequence of the financial crisis, which began in 2007.

[2] The case of the United Kingdom is special. Due to the fact that it is an international centre of finance, a large percentage of investment banking in Europe is concentrated in London. This means that the UK deals with a significantly greater volume of both deposits and credit than other European countries.

[3] In 2009, domestic credit institutions in Spain accounted for around 90 per cent of all baking assets, a higher percentage than the 73 per cent reported as the EU average. For a more detailed study of the strategic trends in baking management, see Fernandez de Lis and Garcia Mora (2008) or Delgado et al. (2003).

[4] The rest of the households had invested in investment funds, either directly or through the management company, through a fund supermarket or through their pension plan.