The market for long-term saving

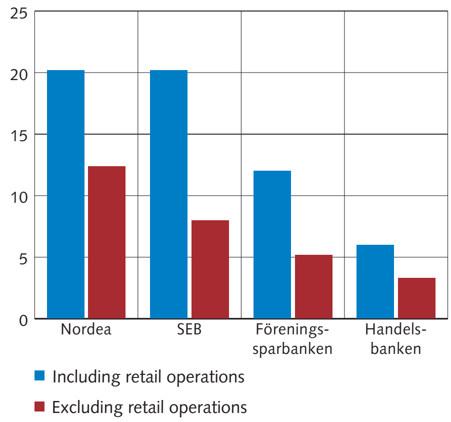
The savings market is changing. Against the background of a rising equity market the Swedish savings market was long characterised by substantial saving in mutual funds and life insurance, with stable inflows of new savings. The major banks were quick to secure a dominant position in the savings market through their fund management and life insurance companies. However, increased competition from both small domestic participants and bigger foreign players, coupled with more demanding savers, may lead to a change in these conditions. This entails a strategic challenge for the major banks' activities in the savings market.

A precondition for an efficient and stable banking system in the long run is that the banks are able to cope with structural change and adapt to new market conditions. When the external conditions for their business models change, the banks face strategic choices. The decisions that the banks make in response to these changes can in the long term have great significance for the risk in the banking system.

At the end of the 1970s the conditions governing households' saving changed when a personal savings market for the general public began to take shape. The banks proved to be the big winners on that occasion by quickly providing the fund and insurance products demanded by this new market. It now seems that the savings market is in the process of changing again, albeit not as radically as the first time, and the question is who is going to gain from it this time. The high margins in the market are attracting a constant stream of new players, while the recent years' weakness in the equity market may have made savers more demanding. The role of savers is also strengthening through a number of regulatory changes. This article discusses the banks' future role in the savings market.

Since the 1990s, asset management[86] has been an important component of the major banks' earnings. However, it is not that easy to quantify its significance in terms of profit. In the banks' operational accounts, the proportion of profits generated in asset management, pensions and insurance stands somewhere between a few per cent and, at most, just over 10 per cent (see Figure 1). This underestimates the significance of asset management though since a large fraction of the asset management earnings goes to the banks' branch operations, which distribute and sell fund and insurance products. Excluding the group internal fees asset management pays to retail banking, the estimated profit share is markedly higher, somewhere between around 6 per cent and 20 per cent.

Figure 1. Asset management's significance for the major banks' profits, 2003. Percentage share



Sources: The banks' reports and the Riksbank.

86 Asset management here means the management of savings on behalf of customers, for example through funds, insurance and pension products, and discretionary wealth management.

The personal savings market

AN INCREASED NEED FOR PERSONAL SAVING…

The collective social insurance systems are currently developing in a way that increases the need for additional personal saving.[87] The centralisation of the responsibility for saving from the individual to various public systems, which was a common feature of the post-war period, has stopped. The past decades have instead seen a gradual return of the responsibility for economic security back to the individual, which has boosted the incentives for personal saving.

This trend can be said to have begun in 1978 with the introduction of a savings scheme that offered tax incentives to individuals who saved in mutual funds or a special bank account (skattesparkonton). The saving in these mutual funds was carried out via monthly deposits, which were invested in Swedish exchange-listed equities. This savings scheme was later replaced by a similar public savings programme known as *allemansfonder*. As a result of these initiatives, regular monthly saving in equities and mutual funds became a part of many Swedes' personal finances, and the schemes can be said to have had a lasting impact on saving behaviour in the country. Conditions had been created to generate stable streams of savings that were invested chiefly through the banks, at the same time as the proportion of saving in bank accounts declined.

This development has continued in recent years, notably in some parts of the pension system. For instance, individual choices have been introduced that make individuals responsible for choosing how their savings are to be invested. This applies to both occupational pensions and the state pension system. These changes stimulate the demand for savings and also channel some of the earlier collective savings into the personal savings market.

…HAS HAD AN IMPACT ON THE BANKS' BUSINESS…

The development of a personal savings market has expanded the banks' range of savings services, which today comprises a large number of products in addition to traditional deposits. In 1975 more than 70 per cent of the banks' balance sheet total was composed of traditional deposits. Today the proportion is slightly less than 40 per cent.

Households' needs for other forms of saving than deposits have changed the banks' role. Even though deposits have traditionally been the banks' most important source of funding, there are from a bank's perspective several advantages to be gained from savers choosing to invest in funds and life insurance schemes instead of in deposit accounts. Above all the bank gains, via the management fee, from the growth in stock market value, which was considerable throughout

87 The public sector is still the main provider of many services, but fees have now begun to be used and above all to be discussed to a greater extent.

the 1990s. Furthermore taxation rules make it costly for a saver to transfer fund and insurance savings from one bank to another, which provides a stronger lock-in effect compared with deposits.

…AND CHANGED HOUSEHOLDS' FINANCIAL PORTFOLIO

From the households' perspective, saving in bank accounts has decreased considerably in importance. From having accounted for almost 60 per cent of households' financial wealth in 1980, bank deposits' share of savings has fallen to just over 20 per cent today (see Figure 2). The lion's share of households' savings has been transferred to the equity market, notably to mutual funds and life insurance, but also somewhat through direct ownership of equities. The proportion of Swedish adults who directly or indirectly own equities has more than doubled in 30 years, to around 84 per cent in 2003.

The trend towards a smaller share of deposits in households' financial saving is in no way unique to Sweden. But compared with many other countries, Swedish households invest a very small fraction of their savings in the bank, and a correspondingly large proportion of their savings in equities (including funds) and life insurance schemes (see Figure 3).

CONTINUED HIGH GROWTH…

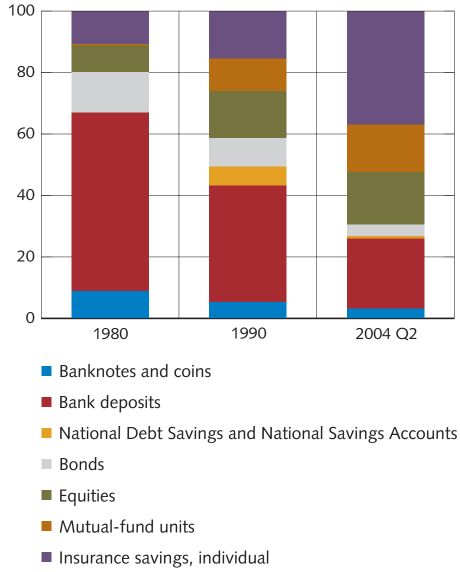
The personal savings market in Sweden comprises a host of different savings options (see Figure 4).[88] The single biggest one of these is traditional insurance, which accounts for around 30 per cent of the saving, followed by fund savings. The Premium Pension Authority's (PPM) pension scheme has so far only represented a small fraction, but this can be expected to grow as the contributions to the scheme increase. Following a temporary slowdown in connection with the equity market decline in 2001-2002 the savings market has begun to grow again in 2003-2004. The growth is not only attributable to the upturn in the stock market but also to a large inflow of new savings.

…BUT TOUGHER COMPETITION

The competition in the savings market has so far been fairly mixed, with many different kinds of institutions – for instance securities brokers, fund managers and insurance companies. These include both small domestic niche players and large global companies.

The four major banks were among the first to enter the savings market and therefore have a strong position. But as the competition in the savings market has gradually become tougher, the major banks' position has begun to weaken. Currently the four major banks have a share of just over half of the personal savings market, but the trend is in decline (see Figure 5). Between 1998 and 2004 the share decreased by more than four percentage points. In certain segments, such as

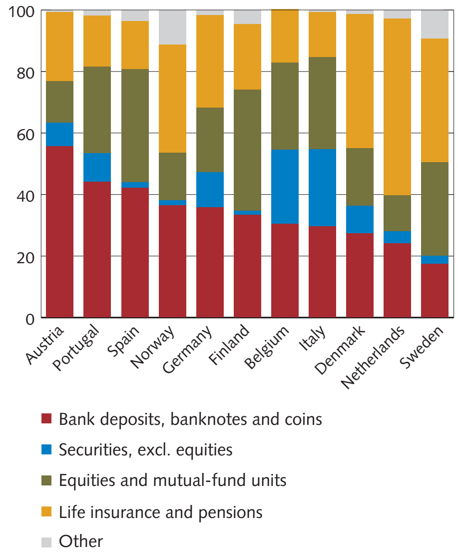
Figure 2. Households' financial saving. Percentage distribution



Note. The Figure does not include collective insurance schemes (via employers) or state insurance schemes (the National Pension Funds and premium pension fund).

Source: Statistics Sweden.

Figure 3. Households' financial saving in Europe in 2002. Percentage distribution

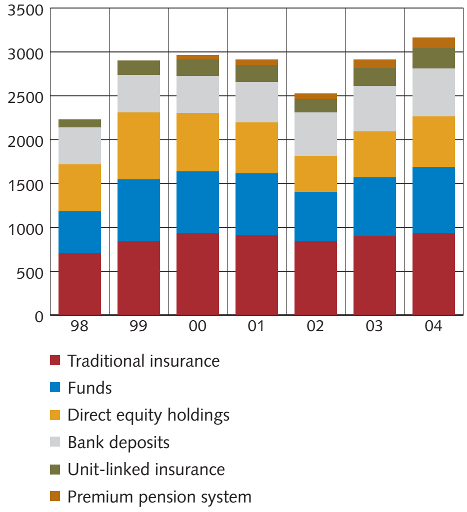


The Figure does not include collective insurance schemes (via employers) or state insurance schemes (the National Pension Funds and premium pension fund).

Source: Eurostat.

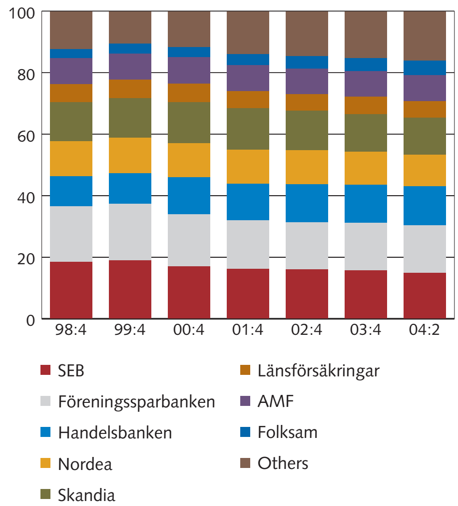
88 By far the largest share of households' total real and financial wealth is accounted for by housing, which comprises a little more than 40 per cent. Amortisation of home loans can indeed be seen as saving in non-financial assets and competes to some extent with the banks' range of savings products. But the focus in this article is on households' financial saving.

Figure 4. The personal savings market, broken down by type of saving.
SEK billion



Sources: SEB's Saving Barometer and the Riksbank.

Figure 5. The savings market.
Market shares in per cent



Source: SEB's Saving Barometer.

mutual funds, the development has been more pronounced. The major banks' market share of directly owned funds shrank between 1998 and 2004 by 16 percentage points, from 88 per cent to 72 per cent. Over the same period the major banks' share of new saving in funds dropped by 18 percentage points, from 77 to 59 per cent.

The total stock of savings includes different categories of products with different contractual terms and duration. A large portion of the stock is relatively stable, while other parts are more flexible. The rigidity of a large part of the stock means that there is a lag before changes in market shares of new saving have an impact on the savings stock. However, there is reason to expect increased flexibility in the future.

Changed saving behaviour

PREVIOUSLY LOYAL SAVERS...

The savings market is characterised by considerable rigidities and lock-ins, which are due to contractual and tax-related factors as well as behavioural reasons. Contractual lock-ins are most evident in life insurance, where the saver, due to the structure of insurance policy contracts, can only terminate the relationship at a high cost. Current tax legislation contributes further to the lock-in problem by providing incentives to savers to enter into long-term saving contracts with a regular transfer of new savings. As regards mutual funds the biggest rigidity stems from capital gains taxation, which makes it costly in tax terms to change from one fund to another. These lock-ins and rigidities make it difficult or costly for savers to terminate a contract or assignment with an underperforming provider. This is a favourable situation for the asset managers, of course, who can count on stable volumes and new inflows of savings even when their performance is relatively weak.

However, there are other factors that cause savings to be sluggish even in the absence of contractual and tax-related lock-ins. A typical saver often lacks both the time and knowledge to regularly assess and reconsider previous saving decisions to any great extent.[89] For individuals, saving is in practice often a 'durable good'. For instance, an individual might decide to save monthly in a fund or to have a standing transfer to an insurance scheme. This decision can easily be forgotten over time, with the saving continuing automatically. Furthermore, like all financial investments, saving involves a number of genuinely difficult considerations. Saving in funds and insurance schemes entails exposure to markets that the savers often have no in-depth knowledge about. It is far from easy for an individual saver

89 There are also psychological explanations for sluggish saving behaviour. A large number of studies have shown that financial decisions are often affected by emotions. For example, most people find it very hard to "accept" failure, which is manifested in an unwillingness to realise losses or a tendency to forget unsuccessful investments. Another common behavioural trait among savers is to take the blame for a failed strategy instead of questioning the asset manager or adviser. Consequently, many savers do not take action despite poor performance on the part of the provider.

to assess a previous saving decision and even more so to evaluate the provider's performance in relation to the general market performance, competitors and fees. For a saver that has evaluated an existing contract and wishes to reconsider it, the chief means available is to freeze the contract and instead enter into a new one with a different provider. The number of contracts that a saver enters into can therefore increase continuously, making the situation difficult to survey and reducing the incentives to try new forms of saving.

…MAY BECOME MORE DEMANDING

The robust performance of the securities markets during long periods of the 1980s and 1990s did not provide any great motivation for savers to evaluate and reconsider previous saving decisions. However, the more subdued and sometimes negative performance in the equity market in recent years has increased savers' awareness of the pros and cons of different savings options, and of different players' performance and fees.[90]

Furthermore, a number of regulatory changes have recently been implemented, and these are likely to lead to more assessments and reconsiderations on the part of savers as well as increase the opportunities to reallocate previously invested savings. Examples of such changes include the requirements for clear disclosure of fees and the new law to strengthen the protection of consumers receiving financial advice. Should the discussions regarding the right of consumers to move their life insurance and unit-linked insurance policies, and a scrapping of capital gains taxation when changing funds, lead to progress, the flexibility of savings may increase further.

Greater flexibility should mean that savers' regular assessments and reconsiderations will have a more direct impact on the stock of savings, which in all likelihood should lead to a tightening of demands on management performance. Managers that cannot justify their fees through sufficiently high performance will presumably see their margins shrink. The Swedish savings market has been characterised up to now by stable streams of savings that in large part have been channelled to the banks. The combination of a more demanding saver with greater power and tougher competition from new players may very well change the foundation of this system.

The savings market in the future – opportunities and threats for the major banks

The savings market will continue to grow. At the same time, higher demands and tougher competition may entail shrinking market shares and in the long run lower margins. This tougher future is by no means a foregone conclusion, however. The conditions for

90 The daily press, business press and other media as well as organisations such as Aktiefrämjandet and the Swedish Shareholders' Association have helped arouse many people's interest in finance and investments.

asset management involve factors that, depending on the choice of strategy, could just as well work in the banks' favour. Successful asset management is usually based on one or more of the following basic elements: (1) economies of scale (2) respected management expertise (3) efficient distribution (4) solid reputation thanks to a strong brand.

There are potentially large economies of scale to be realised in asset management. The earnings in asset management consist of the fees that the savers pay for the management services. These fees are mostly charged as a fixed fraction of the value of the savings. In exceptional cases, such as in the case of many hedge funds, the fee is performance-based and is charged, for example, as a fraction of any positive return. Also in dividend-paying life insurance companies the fee can be said to be partly performance-based since the manager can only charge a percentage of any excess return. The costs incurred in asset management comprise primarily the costs for staff, distribution and marketing, systems and broker commissions. A large part of these costs, such as those for staff and systems, are fairly fixed in relation to the size of the managed capital. This means that an asset manager's earnings can rise as a result of an increasing stock of managed capital but without necessarily incurring any equivalent rise in costs. The larger the managed capital, the lower the fees that can be charged to the savers. Compared with smaller domestic competitors the major banks have a distinct advantage owing to their appreciably larger volumes. However, in comparison with the big global asset managers that have started to enter the Swedish market the major banks' managed volumes are rather modest.

However, asset management has up to now not competed to any great extent on the basis of price, but rather on the basis of reputation, which in the long run is mainly determined by management performance. As mentioned previously, savers have no major incentive to assess a manager's performance as long as they receive a high return, as was the norm before the protracted equity market decline from 2000-2002. Since then, however, it has become more clear to savers that some managers are good and some less good, and that a manager that is good one year might be less successful the next. Managers that are considered capable of generating a higher, more stable return than their competitors will presumably be able to continue to charge high fees. On the other hand, managers that only outperform a market portfolio now and again are likely to find it increasingly difficult to justify current fee levels. The major Swedish banks' management performance in recent years leaves much to be desired, but it hasn't been any worse than that of their competitors.

The efficiency of distribution to customers is critical for profitability in asset management. The bank-owned asset managers have always enjoyed an advantage over their independent competitors in this regard thanks to the well-established distribution channels they have through their branch networks and internet banks.

The independent asset managers must instead reach their customers through their own distribution efforts – advertisements, campaigns and telesales – or in exchange for a fee via other players, such as banks and insurance companies, which have established customer relationships. An indication of the value of the bank branches' customer relationships is given by the intra-group payments that the major banks' asset managers make to the branches. The value of the branch network and customer relationships is also something that the major banks could take advantage of when foreign managers seek out channels to Swedish savers.

A solid reputation among the general public is crucial for being able to attract customers' capital. The public's confidence has been a contributory factor in the banks' success and is also an asset in their current competitive position. The major Swedish banks have a solid reputation, as different surveys have shown. However, some surveys indicate that this reputation has been tarnished in recent years.[91]

Conclusions

- As it becomes easier for savers to move their capital, management performance and fees will become an increasingly important means of competition.

- In the short run, strong brands may well delay this process, but in the longer term managers that cannot produce a higher-than-average return will face shrinking margins.

- With lower margins the significance of scale economies and access to efficient distribution channels will increase. An efficient distribution channel does not have to include a physical branch network, but can instead involve less tangible aspects such as strong customer relationships.

91 A report by Förtroendekommissionen (the Commission on Business Confidence) presents the results of different academic measurements of confidence in the business community, which also includes the banks. See SOU 2004:47. Näringslivet och förtroendet (The business community and its reputation), Appendix 4, Förtroendet för näringslivet (Confidence in the business community).