

FUND MANAGEMENT

City Business Series



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The past year has seen a recovery in the value of global assets under management of the fund management industry. It follows a decline in assets between 1999 and 2002 caused by falls in equity markets and declining investment returns. The UK is one of the largest markets in the world for fund management along with the US and Japan. It has a strong international orientation and attracts significant overseas funds.

This Brief is an update of IFSL's City Business Series report on Fund Management, published in May 2003. The next full edition of the report will be published in 2005.

FUNDS UNDER MANAGEMENT IN THE UK

UK fund management overview According to IFSL estimates, the UK fund management industry was responsible for over £2,800bn of funds at the end of 2003 (Table 1). This was up 6% on the previous year but still 7% lower than at the peak in 1999. The recovery in 2003 was primarily due to rising stock markets and a flow of new investments. Between 2000 and 2002 the declines in the equity markets reduced commission income and fee levels, and made it more difficult to attract new funds. This followed a period of high growth in the 1990s during which funds more than doubled.

The international orientation of the UK's fund management industry is reflected in the presence of a broad range of UK and foreign-owned firms, in the significant investment in overseas securities, and in the management of overseas clients' assets. Around a third of funds under management in the UK are domiciled overseas (Chart 1). London is central to the UK's strong international position and is one of the two leading global centres for fund management along with New York. Edinburgh and Glasgow are also important international centres for fund management.

Types of funds Institutional funds account for the bulk of funds under management in the UK. The UK's strong international position as a fund management location means that significant funds from overseas are managed there. UK private clients account for the remaining funds.

Institutional funds have become increasingly prominent in the UK over the past decade. They accounted for 90% of funds under management at the end of 2003, up 6% on the previous year and four times the 1990 total. Institutional funds consist of insurance funds, pension funds, unit and investment trusts.

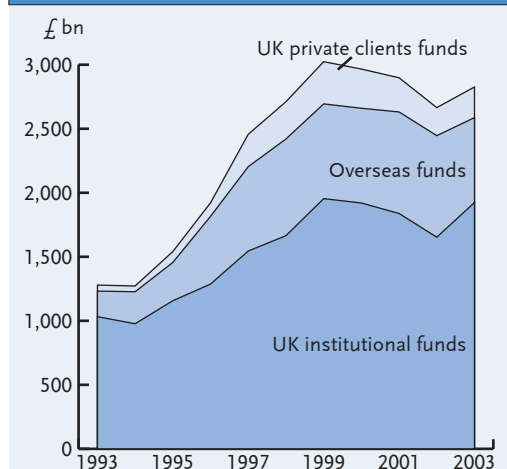
- Insurance funds account for the majority of institutional funds in the UK. Between 1994 and 2003, insurance funds more than doubled to £1,100bn. Around 90% of insurance investment funds are from long-term insurance policies as long-term premiums paid to insurance institutions are invested in order to meet the liability at maturity. The remainder was from general insurance policies which have a shorter timescale with claims less easy to plan for;

Table 1 Funds under management in the UK

| £bn, 2003 | UK clients | Overseas clients ¹ | Total |
|---|--------------|-------------------------------|--------------|
| <i>Institutional funds</i> | | | |
| - pension funds | 709 | 272 | 981 |
| - insurance companies | 1,103 | 50 | 1,153 |
| - unit trusts | 247 | 119 | 410 |
| - investment trusts | 44 | - | 44 |
| - other | - | 167 | 167 |
| less unit and investment trusts held by other funds | -179 | - | -179 |
| <i>Institutional total</i> | <i>1,923</i> | <i>608</i> | <i>2,532</i> |
| <i>Private clients</i> | <i>239</i> | <i>55</i> | <i>294</i> |
| All clients | 2,163 | 663 | 2,826 |

¹ estimates for overseas clients' funds are for June 2003
Source: IFSL estimates based on ONS, ComPeer, WM Company, UBS and IMA data

Chart 1 Growth of funds under management in the UK



Source: IFSL estimates based on ONS, ComPeer, WM Company, and IMA data

- Pension funds totalled £709bn at the end of 2003. This was up 16% on the previous year, largely due to the recovery in equity markets, but down 13% on the record level in 1999. The UK pension fund industry has been affected in recent years by various factors such as changes in regulation and accounting standards, the introduction of Stakeholder Pensions and a continuation of the movement away from defined benefit to defined contribution schemes;
- Unit trusts and Open Ended Investment Companies held £203bn at the end of 2002, down 6% from the previous year. IFSL estimates indicate that the stock of invested funds recovered in 2003 to £247bn. In December 2003, there were around 130 unit and investment trust groups which had combined funds under management of over £240bn;
- Investment trusts held £41bn of funds at the end of 2002, down 30% from the previous year. According to IFSL estimates, funds managed by investment trusts increased in 2003 to around £44bn. Investment trusts' share of institutional funds have declined from 6% to 2% over the past two decades.

More than half of UK institutional funds are invested in equity. As a result, institutional investors account for a larger proportion of shares in the UK than in most industrialised countries, 53% at the end of 2003.

Private clients remain a significant niche in the UK market and generated 10% of total funds or £294bn at the end of 2003. Individual ownership of UK shares accounted for around 15% of total share ownership or £204bn in 2003, down from over 50% in the 1960s. Although the proportion of equity held by individuals is lower than in some other countries, the greater UK market capitalisation implies a more significant penetration of individual share ownership. Within Europe the value of private client funds handled in the UK is probably exceeded only by funds managed in Switzerland.

Overseas clients In recent years, the UK has consolidated its position as one of the most important centres for the management of funds on behalf of foreign clients. According to IFSL estimates based on IMA data, funds in the UK managed on behalf of overseas clients totalled £663bn in 2003, £608bn from institutional clients and the remainder from private clients. This is more than twice the 1995 figure due not only to growth in the client base, but also due to consolidation which has been reflected in some significant acquisitions.

Chart 2 UK institutional funds

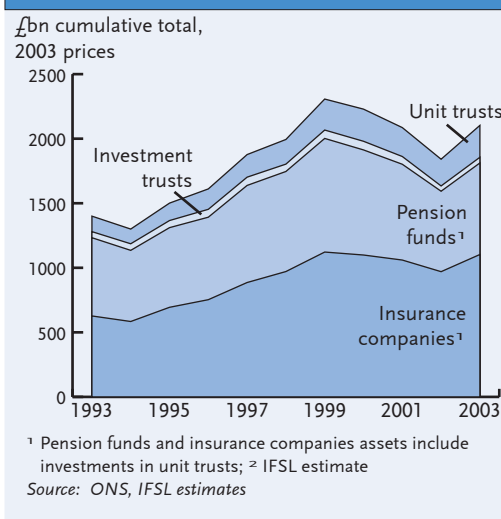
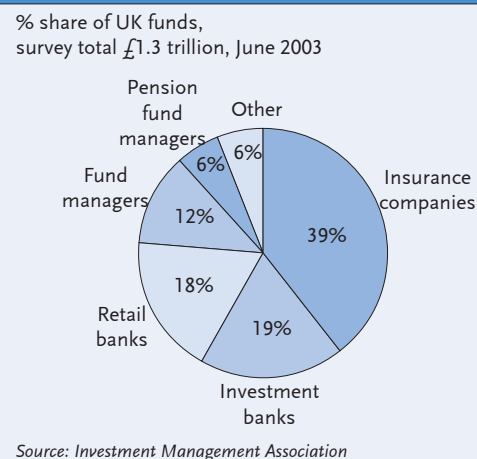


Chart 3 Assets managed in the UK by manager type



Advantages of the UK as a centre for fund management

- Highly sophisticated and innovative management styles, techniques and strategies;
- Skilled labour force and high quality professional and support services;
- Wide ranging client base: private and institutional, UK and overseas;
- Highly liquid market with the opportunity to trade in large blocks of shares;
- History of openness with relatively easy access to markets;
- Liberalised operating environment combined with protection against abuses;
- Competitive infrastructure in telecommunications services and airline links.

UK fund management organisations can be classified by ownership into (Chart 3):

- *Insurance companies* The fund management activities of insurance companies are either managed from their internal investment department or from a separate subsidiary which might manage funds of external clients as well as those of its parent company. Insurance companies accounted for 39% of assets managed in the UK in 2003;
- *Investment and retail banks* represent integrated banking and securities groups that combine securities firms, and fund management firms within the same group. Investment and retail banks accounted for 19% and 18% respectively of UK funds under management in 2003;
- *Independent investment managers* include independent investment managers that are not linked to any UK-based banking, securities or insurance groups. Their share of funds increased in recent years to reach 12% in 2003;
- *Pension fund managers* represent separate legal entities set up to manage a company's pension fund assets. Their share has fallen in recent years as companies' pension funds are increasingly managed externally. In 2003, self-managed pension funds in the UK held around 6% of funds under management.

Asset allocation Fund managers have an array of investment choices available to them at home and overseas including equities, bonds, property and cash. The past year has seen a recovery in investment returns, following three consecutive years of negative returns. In the UK, the proportion invested in equities has generally been higher than in most other countries. Between 1999 and 2002 however, the average proportion of UK pension funds' portfolios allocated to equity declined from 75% to 64%. This increased to 67% in the following year as equity markets recovered. UK government and overseas bonds accounted for around a quarter of UK pension funds' investments in 2003. The remainder was held in cash and property funds. UK markets are also an important destination for international funds. Overseas share ownership of UK equities more than doubled during the past decade, increasing from 16% in 1993 to 32% in 2003. Most of these investments are in FTSE-100 companies.

Chart 4 Asset allocation of UK pension funds

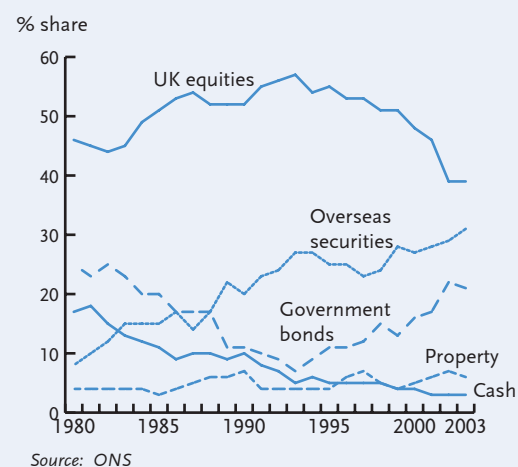


Table 2 Largest UK fund management organisations

| assets under management, as at 31 Dec 2002, \$bn | | |
|--|---------------------------|-----|
| 1 | Barclays Global Investors | 746 |
| 2 | Aviva | 334 |
| 3 | AMVESCAP ¹ | 333 |
| 4 | HSBC Group | 306 |
| 5 | Prudential | 250 |
| 6 | Legal & General Group | 187 |
| 7 | Schroders | 140 |
| 8 | Standard Life | 117 |
| 9 | Lloyds TSB Group | 112 |
| 10 | HBOS | 101 |
| 11 | Eureko (F&C) ² | 97 |
| 12 | Friends Provident | 96 |
| 13 | Royal & SunAlliance | 60 |
| 14 | Hermes Pension Management | 60 |
| 15 | Abbey National | 43 |

¹ UK/US; ² UK/Netherlands
Source: Watson Wyatt World 500, Pensions & Investments

Funds under management in Scotland

Finance has been an important industry in Scotland for the past three centuries. Employment in Scottish finance and business services has expanded by over 30% since 1986 to a current total in excess of 280,000 people. The sector contributes around 20% of Scotland's GDP.

According to Scottish Financial Enterprise, the Scottish investment management industry grew by over 50% between 1998 and 2003 to reach £327bn. A third of the funds invested by Scottish managers are long term life assurance funds with a further third in pension assets. Mutual funds and private and charitable funds make up most of the remainder. Scotland has a traditional strength in pensions and the management of long-term savings, including open and closed-end mutual funds.

Largest UK fund management organisations The UK market is relatively concentrated with the top five fund managers accounting for around 60% of the pool of assets of the top thirty fund managers. According to the Watson Wyatt World 500, Barclays Global Investment Managers was by far the largest UK registered investment manager in 2002 with \$746bn under management. It was followed by Aviva (\$334bn) and AMVESCAP (\$333bn). Substantial restructuring in the UK industry in recent years has reflected global developments. Some of the mergers have not only been between asset management firms but have also included related industries such as banking and insurance as firms seek to diversify. Recent more significant consolidation activity in the UK includes: the mergers between Hill Samuel and Scottish Widows and between Norwich Union and CGU. Major acquisitions include Stein Roe by AMVESCAP and Aberdeen Asset Management's FI unit trust business by New Star Asset Management.

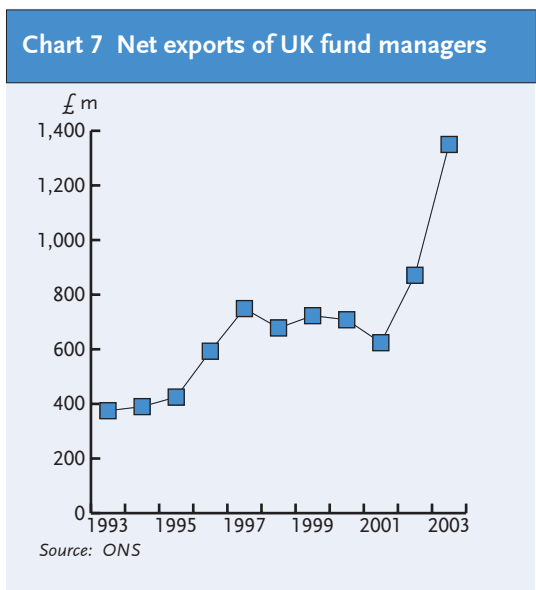
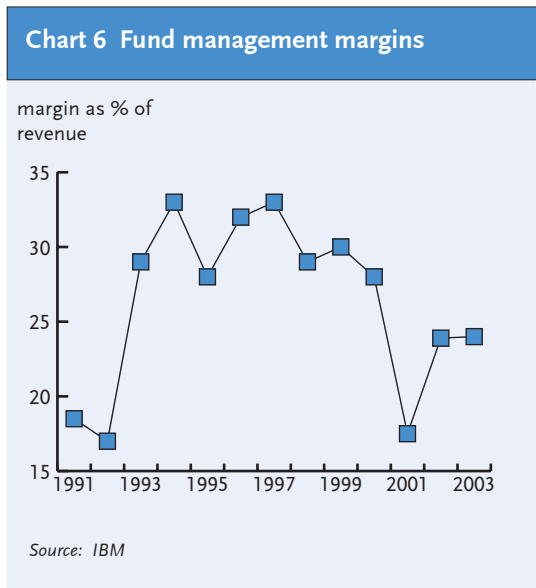
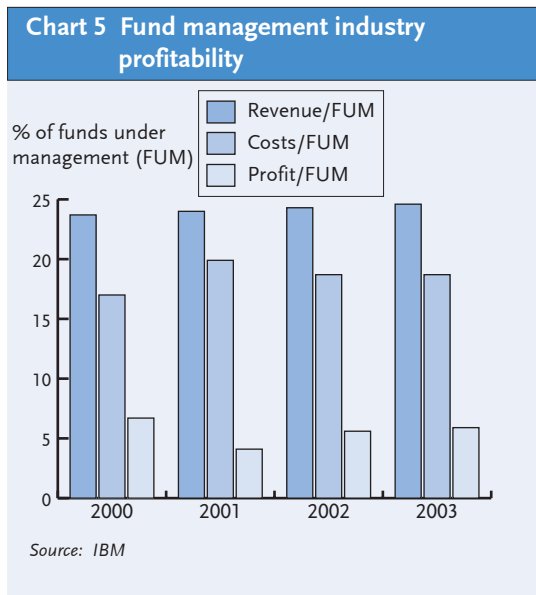
CONTRIBUTION TO THE UK ECONOMY

Value added While there is no official figure for the contribution of fund management to the UK's GDP, IFSL has made an estimate by applying IBM Consulting's cost margins indicators (Chart 5) to IFSL's estimate for funds under management in the UK. According to this measure, fund management generated around 0.5% of GDP or £4.9bn in 2003. It was therefore an important component of the financial sector's overall contribution of 5.3% in that year. Fund management's wider contribution to the economy stems from its promotion of the UK's capital market and from the many links fund managers have with other financial services providers, particularly banks, securities dealers and information providers.

Revenue Combining IBM Consulting data on revenue margins for institutional funds with data on revenue for private clients separately estimated by ComPeer, we calculate that the total revenue of fund management activities totalled £7.5bn in 2003.

Profits Fund management margins (profit / revenue) remained largely unchanged in 2003 at around 24%, consolidating the recovery of 2002. The increase in margins over the past two years was largely due to a reduction in costs, inflow of new money and an increase in prices. The recovery was more evident in the retail sector and followed two years of falling margins. Prior to this, for most of the 1990s profit margins were relatively stable, fluctuating between 29% and 33% (Chart 6).

Employment According to the latest Investment Management Association (IMA) survey, fund management firms in the UK (managing 82% of assets under management in the survey) employed 23,290 people in June 2003. Overall employment in the fund management industry, including the large number of small firms, probably exceeded 40,000. These figures do not include retail stockbrokers, who are thought to employ an additional 12,700 people. Fund management was one of the sectors particularly affected by the decline in financial services employment in 2001 and 2002 in London and other large financial centres. Employment is expected to grow again as the equity markets and global economy recover from the recent downturn.



Net exports generated by fund managers' services rose by more than a half from £871m in 2002 to a record £1.35bn in 2003, primarily as a result of a more comprehensive survey (Chart 7). Net exports from portfolio investment by financial institutions, which will have owed much to the activities of UK fund managers, totalled £12.7bn in 2002.

INTERNATIONAL COMPARISONS

The value of assets of the global fund management industry recovered in 2003 following a decline between 1999 and 2002. According to IFSL estimates, global fund management of conventional assets reached a record \$42.4 trillion at the end of 2003, up nearly 30% on the previous year (Chart 8). Pension assets alone totalled \$15.0 trillion, with a further \$14.0 trillion invested in mutual funds and \$13.5 trillion in insurance funds. Merrill Lynch also estimates the value of private wealth at \$28.8 trillion of which about a third was incorporated in other forms of conventional investment management. The increase in funds under management in 2003 was largely due to the recovery in the equity markets. Part of the increase in dollar terms however was due to a 15% fall in the value of the dollar during 2003.

The US is by far the largest source of funds under management with nearly half the world total in 2003 (Table 3). It was followed by Japan with 12% and the UK with 8%. Rankings based on sources of assets however, understate the UK's position due to the substantial value of funds managed there on behalf of overseas clients as shown in Table 1. Funds managed in the UK are larger than those managed in France and Germany combined. London is the leading global centre for fund management along with New York.

Sources of funds Pension funds, insurance companies and mutual funds, each accounted for around a third of conventional assets under management of the global fund management industry. Other funds were from private wealth and alternative sources such as hedge funds and private equity. Institutional clients generated the majority of global funds under management in 2002 as shown in Chart 9. There are substantial variations, however, between countries in the institutional to retail ratio. In countries with more developed private banking or mutual fund sectors, such as the UK, Germany, Italy and Switzerland, the retail sector was the source of most funds. On the other hand in the US, France and Japan where these sectors were not as large or where the pensions market was more developed, the majority of funds was from institutional clients.

Pension fund assets Global pension assets totalled \$15.0 trillion at the end of 2003, up nearly a third in dollar terms on the previous year. Measured in local currencies growth was around 12%, the strongest performance since 1999 largely due to the recovery in the global equity markets. The US remains the largest single market with \$7.5 trillion in pension assets or a half of the world total. Japan was the second largest centre (with 19% of the world total) followed by the UK (9%). The large volume of pension assets in the US and Japan is mainly a

Chart 8 Global fund management of conventional assets

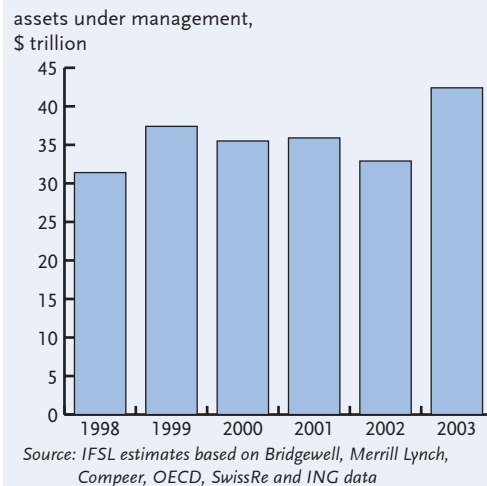


Chart 9 Funds by investor type

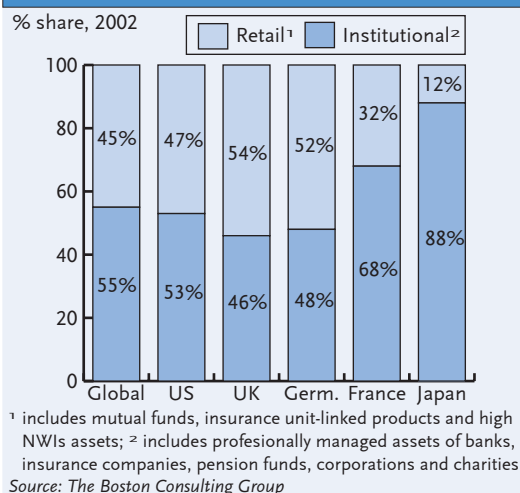


Table 3 Sources of global assets under management

| \$bn, end-2003 | Conventional investment management | | | | | |
|----------------|------------------------------------|-----------------|--------------|--------------------|-----------------------------|--------------------------------|
| | Pension funds | Insurance comp. | Mutual funds | Total conventional | Private wealth ¹ | Alternative funds ² |
| US | 7,492 | 4,633 | 7,414 | 19,539 | 8,500 | - |
| 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 | 28,800 | 1,220 |

¹ around one-third of private wealth is incorporated in conventional investment management

² alternative funds consist of hedge funds and private equity

Source: IFSL estimates based on Bridgewater, Merrill Lynch, Compeer, OECD and SwissRe data

reflection of their substantial domestic markets. The UK system, with assets amounting to 79% of GDP in 2003, is better funded than other major European economies. Switzerland (124%) had the most well funded pension system followed by The Netherlands (121%).

Insurance funds According to IFSL estimates, insurance companies held around \$13.5 trillion of funds under management at the end of 2003. This is calculated by applying the Watson Wyatt growth rate for global pension assets to the latest available SwissRe data on insurance companies funds under management for 2001. Approximately four-fifths of insurance funds are from long-term insurance policies and the remainder from general policies, such as health and property and casualty insurance. Over the past decade, insurance funds grew faster in Europe than in the US. Life companies funds also grew faster than non-life ones. UK insurance companies' investments totalled around \$1.7 trillion, almost double those of any other European country.

Mutual funds assets increased by a quarter in 2003 to reach \$14.0 trillion as equity markets recovered. This follows a 5% fall between 2000 and 2002, largely a result of the weakness in the global economy and equity markets. The US is by far the biggest source of mutual fund assets with more than half of the world total at the end of 2003. Most mutual funds are administered from only a few countries. UK mutual funds grew four-fold during the past decade to reach \$397bn or 2.3% of the global total. Other important centres include France, Luxembourg, Australia, Italy and Japan.

Managers of funds Most funds are managed by banks, insurance companies, service banks and independent players. There is a difference however, in their respective market shares in different countries. Banks and insurance companies managed the bulk of funds in Continental Europe in 2002. In the UK, US and Canada independent players, banks and insurance companies each accounted for around a third of funds (Chart 10).

US-owned companies held 41% of the \$35 trillion managed by the top 500 investment managers in 2002 (Chart 11). Japanese companies managed 11% of the total, Swiss 9%, UK 8% and German 8%. UK companies that appear in the top of this list include Barclays Global Investors (ranked 9th), AMVESCAP (19th), CGNU (24th) and Prudential M&G (37th). Concentration of the industry has grown in recent years. The top 20 fund managers' share of top 500 assets increased from 29% in 1996 to 38% in 2002. By contrast, the share of the 250 managers in the lower half of this list fell from 10% to 5% during this period.

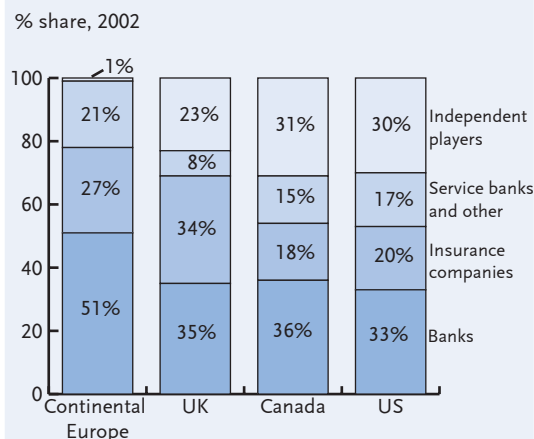
Asset allocation and capital markets Asset allocation around the world varies considerably. In the UK, US and Australia, the proportion invested in equities has generally been higher than in other centres, with commensurately less investment in government bonds and property. UK insurance companies and pension funds typically invest more than two-thirds of their portfolios in equities (Table 5) although this has fallen somewhat in recent years. In Continental Europe, around a third of portfolios are invested in equities with the remainder mainly in bonds and real estate.

Table 4 Largest global investment managers

| assets under management, as at 31 Dec 2002, \$bn | | | |
|--|---------------------------|-------------|-------|
| 1 | UBS | Switzerland | 1,468 |
| 2 | Allianz Group | Germany | 1,037 |
| 3 | Fidelity Investments | US | 911 |
| 4 | Credit Suisse | Switzerland | 861 |
| 5 | Deutsche Bank | Germany | 804 |
| 6 | Kampo | Japan | 803 |
| 7 | AXA Group | France | 773 |
| 8 | State Street Global | US | 763 |
| 9 | Barclays Global Investors | UK | 746 |
| 10 | Vanguard Group | US | 585 |
| 11 | Mellon Financial | US | 581 |
| 12 | Capital Group | US | 557 |
| 13 | Citigroup | US | 535 |
| 14 | JP Morgan Fleming | US | 516 |
| 15 | ING Group | Netherlands | 471 |

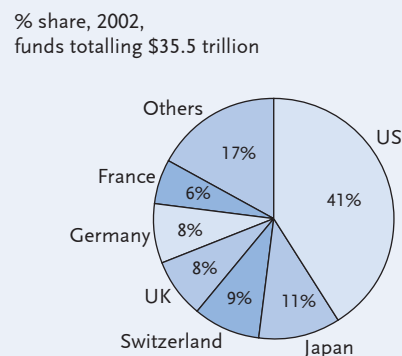
Source: Watson Wyatt World 500, Pensions & Investments

Chart 10 Funds by asset manager



Source: The Boston Consulting Group

Chart 11 Assets of 500 global managers



Source: P&I/Watson Wyatt World 500

Equity markets recovered strongly in 2003. In dollar terms, capitalisation increased by 36.6% during the year to reach \$31.2 trillion. Market capitalisation of US equity markets accounted for nearly a half of the global total. Japan's Nikkei followed with around 9% of the total. The London Stock Exchange was the largest equity market in Europe with market capitalisation of \$2,460bn, followed by Euronext Paris with \$2,076bn and Deutsche Börse with 1,079bn.

The value of the world's bond markets reached \$42.4 trillion at the end of 2003. The US has historically been the largest market with a half of the total, followed by Japan. The amount outstanding on the UK bond market amounted to \$1,275bn or around 3% of the global total in 2003. The bulk of the global market is in domestic bonds where bonds are issued by companies in their own country and local currency, although the share of international bonds has increased in recent years.

Alternative investments such as those in hedge funds and private equity have gained in importance in recent years. The hedge fund industry in particular has become an important part of the fund management industry. The number of hedge funds increased from less than 2,000 in 1990 to over 8,100 in 2003. During this period assets under management grew from \$50bn to \$820bn. In the first quarter of 2004 they increased further to \$860bn (Chart 13). Although the US is still by far the most important location for hedge fund managers with around three-quarters of hedge fund assets under management, over the past few years Europe has gained in importance. European-based hedge funds' assets more than doubled between 2002 and 2003 to reach \$170bn.

London is Europe's leading centre for managers of hedge funds. In 2003, 70% of European-based hedge funds' assets were managed from London. Assets managed there nearly doubled between 2002 and 2003 from \$61bn to \$119bn. The number of European-based hedge funds located in the UK totalled 513 in 2003, up a quarter on the previous year.

PRIVATE WEALTH

The annual World Wealth Report published by Merrill Lynch and Cap Gemini estimates that there were 7.7 million people with financial assets in excess of \$1m in 2003. Their combined wealth totalled \$28.8 trillion, up 7.7% on the previous year (Chart 14). This means that the private wealth industry is larger than the global insurance industry, pensions industry or mutual fund industry. However, these categories overlap since the private wealth industry is also an investor in conventional asset management.

The recovery in the global economy and a 36% average increase in equity markets capitalisation were major factors behind the growth in private wealth assets in 2003. The share of HNWIs' portfolio allocation to equities increased from 20% to 35% during the year. A half of this increase can be attributed to rising equity markets and half to increased exposure.

Table 5 Asset allocation in major pension markets

| % share, 2003 | | | | | | |
|---------------|-------------------|--------------------|----------------|-----------------|------|-------|
| | Domestic equities | Internat. equities | Domestic bonds | Internat. bonds | Cash | Other |
| Australia | 31 | 22 | 17 | 5 | 6 | 19 |
| Japan | 27 | 17 | 32 | 13 | 5 | 6 |
| Netherlands | 7 | 36 | 8 | 32 | 4 | 13 |
| Sweden | 21 | 16 | 29 | 26 | 2 | 6 |
| Switzerland | 12 | 13 | 30 | 16 | 10 | 19 |
| UK | 39 | 28 | 12 | 3 | 3 | 15 |
| US | 48 | 14 | 33 | 1 | 1 | 3 |

Source: UBS Global AM, WM, Callan Associates

Chart 12 Size of the global equity and bond markets

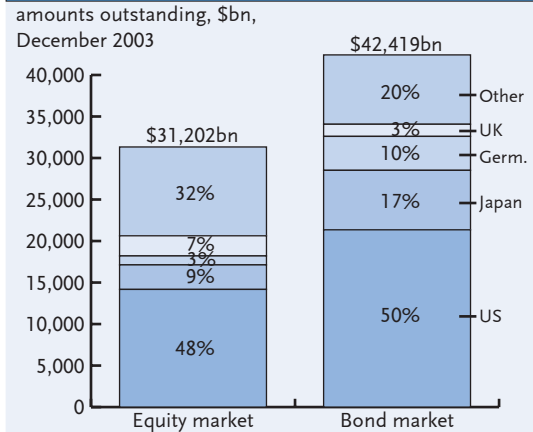
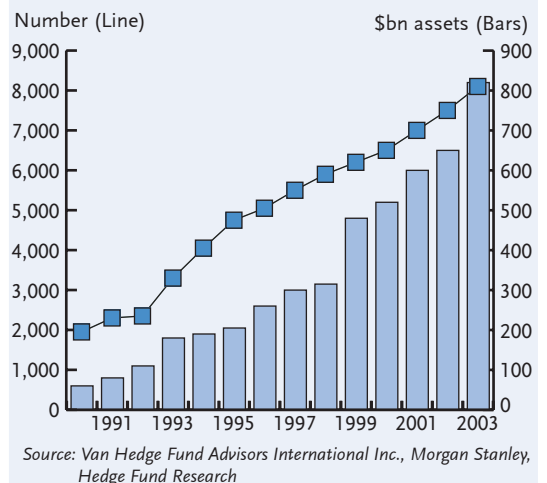


Chart 13 Number and assets under management of hedge funds



A report by The Boston Consulting Group, estimates that the wealth of 33 million wealthy households (each with over \$250,000 assets under management), totalled \$38 trillion in 2002, down 14% on the 1999 total. This decline caused a 25% fall in the revenue of fund managers during this period (Chart 15). The reduction in fee income was concentrated in the more mature markets of North America and Europe, while fund managers and investors prospered in the small but faster growing markets in Asia.

Based on MLCG's report, Europe and North America were the major sources of private wealth with 63% of the total wealth at the end of 2003 and 67% of the number of HNWI (High Net Worth Individuals). HNWI from Asia held 23% of wealth and those from Latin America 13%. The Middle East and Africa together accounted for the remainder.

Private wealth can be held in onshore or offshore accounts. A major trend in recent years has been the increasing attraction of the large onshore centres, notably London, New York, Tokyo, Singapore and Hong Kong. The Channel Islands and Isle of Man, offshore to the UK, are key offshore centres.

LINKS TO OTHER SOURCES OF INFORMATION:

ComPeer Limited: Private Client Stockbroking & Fund Management Survey
www.compeer.co.uk

Boston Consulting Group: Global Wealth Report, Global Asset Management
www.bcg.com

Bridgewell: Themes in Global Fund Management
www.bridgewell.co.uk

IBM Consulting: Investment Management Survey
www.ibm.com

Institutional Investor/Watson Wyatt: Worlds top 500 fund managers
www.institutionalinvestor.com

Investment Management Association: Funds Under Management, Fund Management Survey
www.investmentuk.org

Merrill Lynch/Cap Gemini: World Wealth Report
www.ml.com

Office for National Statistics: Insur. Companies', Pension Funds' and Trusts' Investment, Q4
www.nationalstatistics.gov.uk

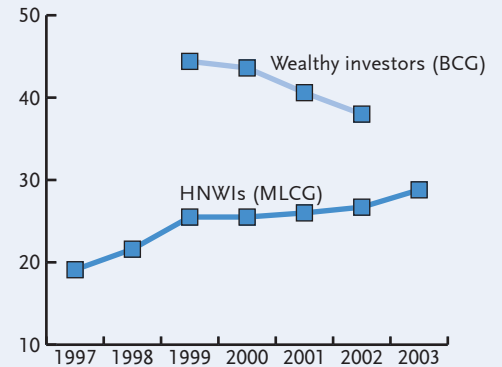
UBS Asset Management: Pension Fund Indicators, International Pension Fund Indicators
www.ubs.com

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Chart 14 Private wealth

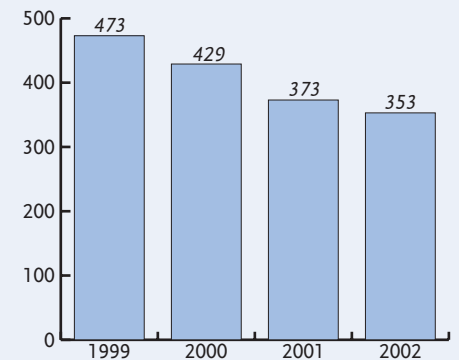
value of assets, \$ trillion



Sources: Boston Consulting Group (BCG),
Merrill Lynch Cap Gemini (MLCG)

Chart 15 Fund managers' revenue from wealthy investors

Revenue, \$bn



Source: The Boston Consulting Group

IFSL: International Financial Services, London (IFSL) is a private sector organisation, with over 30 years experience of successfully promoting the UK-based financial services industry throughout the world.

Research: informs by raising awareness of the UK's role in international financial markets and by highlighting the major contribution of financial services to the UK economy. Financial sector reports in the City Business Series remain the centrepiece of research. IFSL is also producing a separate series of reports on UK product expertise. Other major publications include International Financial Markets in the UK, Financial Sector Net Exports and World Invisible Trade.

This Brief was compiled by IFSL's Economist Marko Maslakovic.

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