MASTER THESIS

The causes of the development of the mutual fund industry in France since the 1980s

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"What our generation has forgotten is that the system of private property is the most important guarantee of freedom, not only for those who own property, but scarcely less for those who do not. It is only because the control of the means of production is divided among many people acting independently that nobody has complete power over us, that we as individuals can decide what to do with ourselves."

Friedrich von Hayek, The Road to Serfdom (1944)

"Il n'y a de terrible en nous et sur la terre et dans le ciel peut-être que ce qui n'a pas encore été dit. On ne sera tranquille que lorsque tout aura été dit, une bonne fois pour toutes, alors enfin on fera silence et on aura plus peur de se taire. Ca y sera."

Céline, Voyage au bout de la nuit (1932)

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Introduction

In this paper, we study a combination of factors that help explain why the open-end fund industry has flourished in France. In this respect, our readers may wonder why the French case is particular and interesting. The development of the asset management industry worldwide has been documented in several academic papers (e.g. Otten and Sschweitze (2002), Klapper, Sullas and Vittas (2004), Khorana, Servaes, and Tufano (2005) and Ramos (2009). If we consider France as an interesting field of study, it is because it illustrates in a very relevant way the political and regulatory forces that shaped the development of the industry. Moreover, as we are going to see further, the French infrastructures and cultural habits are a very specific ground for the erection of a new financial paradigm. In this context, the data I deliver help us understand the particular historical context of the French case.
The analysis of the determinants of mutual fund growth in France is complicated by the large presence of non-households in mutual fund ownership. Indeed, non-household investors are likely to be influenced by different factors in their investment decisions than household investors. Another issue is the date of inception of the CAC40 index: the indicator of the Paris market was launched in 1988, therefore any measurement of performance or volatility of French stocks before this date is more complex.
At first sight, it may seem quite odd to start studying the mutual funds industry only from the beginning of the 1980s. But this decade appears to be a turning point for the industry. The start of the decade was also marked by an interesting and original political event: in 1981, a socialist President of France was elected with the support of communists. Therefore, this period was crucial for political and economic reasons.
Acting as a key intermediary for allocating the savings of French households, the third-party asset management business allocates financial resources to companies, to the French State, to local communities. Therefore, the asset management industry actively participates in financing the real economy[1]. About 1/6 of the financial resources of French households are invested in "OPCVM" (the French equivalent of US mutual funds and UK unit trusts), directly held or held via life insurance contracts. Moreover, companies invest an important part of their liquidities into mutual funds. As for institutional investors, they delegate about 70% of their regulatory reserve to asset management companies. As a consequence, mutual funds play an important role by helping economic actors (households, companies, public administrations, foundations …) to allocate their financial resources according to their risk profile. The contribution to the asset management industry to the French economy seems undeniable: nowadays, asset management companies hold about 20% of the free float of the market capitalisation of the CAC 40. They also participate in the liquidity of the banks through the holding of about 40% of the stock of securities issued on the French monetary market (such as deposit certificates or commercial papers).
The financial and economic environment experienced profound transformations since the 1980s. The major evolutions of the past thirty years conditioned the current financial mechanisms and behaviours we are observing nowadays, and the present asset management industry.

1: AFG, 2015

I: Since the 1980s, mutual funds have become unavoidable financial vehicles in the French financial landscape

A: Characterisation of mutual funds

A mutual fund is a financial vehicle which holds assets that are claims against other parties, such as companies, governments or supranational entities. Traditionally, mutual funds are divided into different categories, depending on their market segment (equities, fixed-income, money market, diversified), on their geographical exposure (France, Eurozone, Emerging markets, Frontier markets, etc.), on their risk profile (conservative, dynamic), on their management style (value, blend, growth). They can be either actively managed by portfolio managers or be passively managed (i.e. the goal is to replicate the performance of the benchmark index as closely as possible).

In France, the "Autorité des Marchés Financiers" (AMF) establishes a classification for general purpose funds[1.] They are characterised as follows: "French Equities" (must be invested and/or exposed 60% or more to the French equity market. Exchange rate risk and foreign market risk exposure must be minor.), "Euro Area Equities" (must be invested and/or exposed 60% or more to one or more markets for equities issued in one or more euro area countries, including France. Exchange rate risk and foreign market risk exposure outside the euro area must be minor.), "European Union Equities"(exposed 60% or more to one or more markets for equities issued in one or more European Union countries, including the euro area markets. Exposure to exchange rate risk for currencies other than the euro or a EU currency must be minor. Exposure to foreign market risk outside the EU must be minor.), "International Equities" (invested and/or exposed 60% or more to one or more foreign equities markets or to equities markets in several countries, including France.), "Euro Fixed Income" (invested and/or exposed to one or more fixed income markets in the euro area. Exposure to equity risk is limited to 10% of net assets. Exposure to exchange rate risk and foreign market risk outside the euro area must be minor.), "International Fixed Income" (invested and/or exposed to interest rate markets outside and inside the euro area. Exposure to equity risk is limited to 10% of net assets.), "Euro Money Market" (managed within a duration range of 0 to 0.5. Residents of France or other euro area countries are not exposed to exchange rate risk. Exposure to equity risk is banned.), "International Money Market" (managed within a duration range of 0 to 0.5. Exposure to equity risk is banned.), "Funds of Hedge Funds" (invested 10% or more in foreign investment funds, contractual funds or ARIA funds, shares or units in funds covered by Article L214-35 of the French Monetary and Financial Code and in futures funds.), "Structured" (managed to obtain a specific return at the end of a set period by applying a predefined calculation formula based on financial market indicators or financial instruments, and also to distribute income determined in the same way.), "Diversified Funds" (class for all the funds that do not fit into another class).

According to the "Code Monétaire et Financier", mutual funds are divided into three categories: OPCVM (which stands for "Organismes de Placements Collectifs en Valeurs Mobilières") must comply with the European UCITS IV Directive 2009/65/CE. UCITS stands for "Undertakings for Collective Investment in Transferable Securities". FIAs (Alternative Investment Funds) are regulated by the European AIFM Directive 2011/61/EU, transposed into French law in 2013[2]. Both UCITS and AIFM funds are granted a European passport allowing them to be sold throughout the EU. The funds which do not comply with the UCITS or the AIFM directives are named « Other mutual funds ».

1: http://www.afg.asso.fr

2: Order 2013-676 of 25 July 2013 and decree 2013-687 of 25 July 2013

The legal structure is another sorting criteria. FCPs (who stands for "Fonds Commun de Placement") and SICAVs ("Société d'Investissement à Capital Variable") are the two main legal structures. An FCP is a co-proprietorship which has no legal personality and is governed by a contractual arrangement, whereas a SICAV is a limited liability company whose capital is at any time equal to its net assets.
The concept of "nationality" of a mutual fund can be a misleading criteria, because a fund may be registered in one country, invest in securities of a second country, and be sold to citizens of a third country. If the first two geographical "identities" can be identified quite easily, the third one cannot.
The shares of a mutual fund (SICAV or FCP) are bought and sold on the basis of the value of the fund's assets, or net asset value (NAV).

B: Main features of the French mutual fund industry

French funds provide different actors of the economy with short, medium and long-term capitals. These funds hold about 20% of the float market capitalization of the CAC 40, 25% of the float market capitalization of the CAC Small 90. Mutual funds help business transfers via private equity structures, contribute to the liquidity of banking firms (funds hold 40% of the deposit certificates) and non-financial companies (they hold 35% of the corporate cash notes). They finance the medium and long-term financial needs of the country (by holding 22% of the capitalization of sovereign bonds).
According to the AFG[1], assets under management represented EUR 3200 bn at the end of October 2014 (as of 30/10.2014) in France, with about half of this amount being held by mutual funds, the rest in mandates and foreign funds.

We can try to determine the main shareholders of the French mutual funds. The following chart is very illustrative:

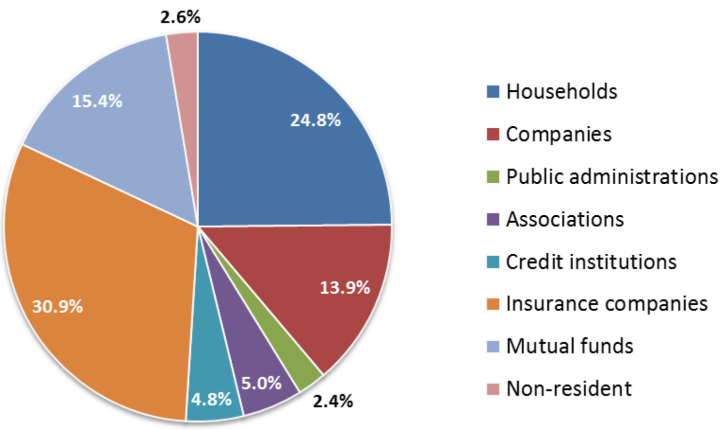

Figure 1: Distribution of the shareholders of funds marketed in France in 2001.
Source : *Les placements en valeurs mobilières des agents économiques*, AFG-ASFFI and Banque de France, 2002

1: AFG, 2015

The first important element that comes out of the study conducted by AFG-ASFFI and the Banque de France[1] is that the majority of the shares of mutual fund are held by insurance companies (30.9%), households (24.8%), funds (15.4%) and non-financial companies (13.9%).
The preponderant weight of households and insurance companies is found in several asset classes: for instance, they account for 70.1% of the shares of equity funds (households represent 46.2% of the shares, insurance companies represent 24.3%); and if we take into account the fact the indirect holdings of equity funds by households through life insurance contracts, households may hold around 60% of the shares of these funds.
Conversely, the shares of money-market fund are mostly held by institutional investors, who can invest their cash on short time periods. As a consequence, non-financial firms (32.4%), asset managers (17.5%) and insurance companies (17.4%) are the main shareholders for this asset class.

The structure of the portfolios of French registered funds is another aspect to mention, since it reflects the investment needs and the risk appetite of the French investors.

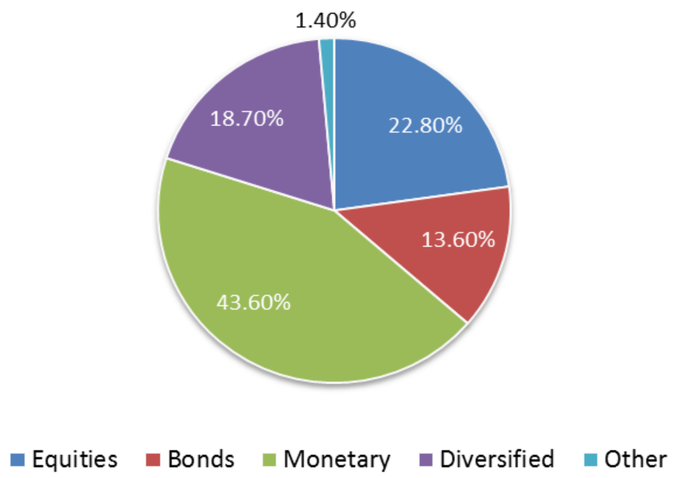

Figure 2: Structure of the portfolios of French registered mutual funds marketed in France in 2009. Source: EFAMA data, Q2 2009.

As we can notice, the majority of the assets held by French mutual funds are monetary instruments. The predominance of these short-term, liquid and secure financial securities breaks with the “aggressive” image of mutual funds.

The strong development of this industry dates back to the beginning of the 1980s. The figures speak for themselves. The AUM of mutual funds amounted to about FF 100 bn in 1982, and they grew steadily to reach about FF 1500 bn in 1988 and FF 3000 bn in 1993. The increasing amount of AUM went hand in hand with the expansion of funds and asset management companies. In 1977, about 100 asset management companies were present on the Parisian market, and their total AUM did not excess 5% of the market capitalization of the Parisian Stock Exchange. Their number increased to 350 in 1999, and in 2014 634 companies were present on the French market.

1: AFG-ASFFI and Banque de France, *Les placements en valeurs mobilières des agents économiques*, 2002

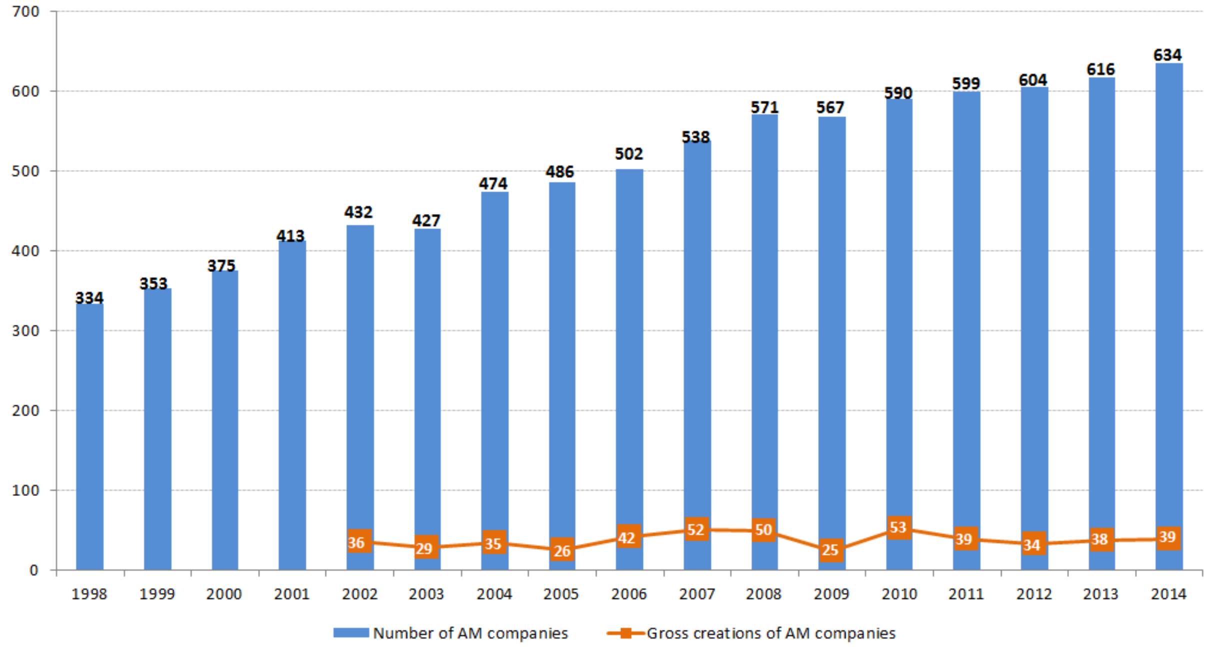

Figure 3: Number of French Asset Management (AM) firms in France and annual creation of AM companies. Source: AMF, 2015

One of the reasons for the dynamism of this industry is maybe its entrepreneurial spirit: 64% of asset management companies were held by private shareholders in 2013. However, these structures held only 6% of the AUM. Credit institutions and insurance companies accounted for 68% of the AUM (respectively 57% and 31%).

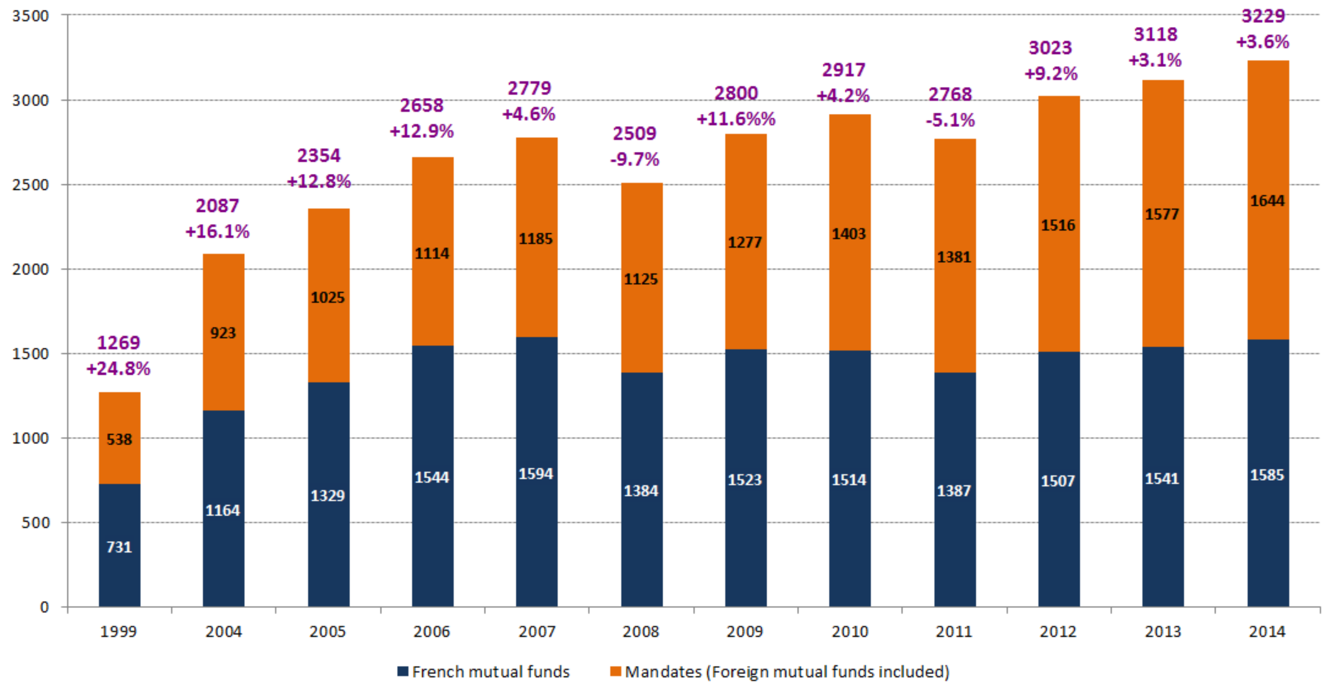

Figure 4: Third-party AUM in France. Source: AMF and 2014 AFG forecast.

We note that the asset management industry proved to be resilient, since it recovered well from the systemic shock created by the Lehman crisis[1]. The graph above illustrates this characteristic, but for more details, readers are referred to (Fourel and Bouloux, 2013).

C: Structure and evolution of household savings

The structure of French household[2] savings evolved to the advantage of investments in market securities, particularly equities and bonds. This shift took place to the detriment of traditional investments, which were mainly liquid: M1 (cash, unremunerated sight deposits), M2 (remunerated demand accounts: housing savings account, “livrets A”, etc...). These liquidities represented 65% at the beginning of the 1980s and less than 40% in 1985.

Savings accounts and other home savings plans were relatively attractive investment vehicles at the end of the 1970s, and the regulated rates offered were set by the monetary institutions. As a consequence, these vehicles were “safe” in comparison with stocks (which offer quite random yields). In this context, it is not surprising that the structure of savings was dominated by liquidities. The table infra compares the different interest rates:

1975-1978 (%, mean values)	**Return on liquidity**	**Bond rate**
Gross rate	6.00%	10.00%
Tax	Exemption	flat-tax rate of minimum 25%
Net rate	6.00%	7.50%
Transaction fees	N/A	Inversely proportional to the amount of the security
Rate after transaction fees	6.00%	6.60%
Opportunity costs	0.60%	0.60%
Level of risk	Very low	Low, medium or high

The strong preference French investors for liquidity of appears to be a logical behaviour, given the very small spread between the yield of bonds (6.6%) and the remuneration of liquidities. This type of spread does not compensate the risks associated to the holding of bonds (e.g. credit risk). This explains quite well the structure of household’s savings in the mid-1970s. But in a gradual way, the inflationary environment of the beginning of the 1980s altered the bond rates and the spread described supra increased in favour of fixed income products.

1: FOUREL Gisèle et BOULOUX Alain-Nicolas (2013), *Les opcvm français au travers de la* crise (2008-2012),
2: INSEE, *Épargne et patrimoine des ménages: données macroéconomiques et données d'enquêtes*, L'Economie Française (2006)

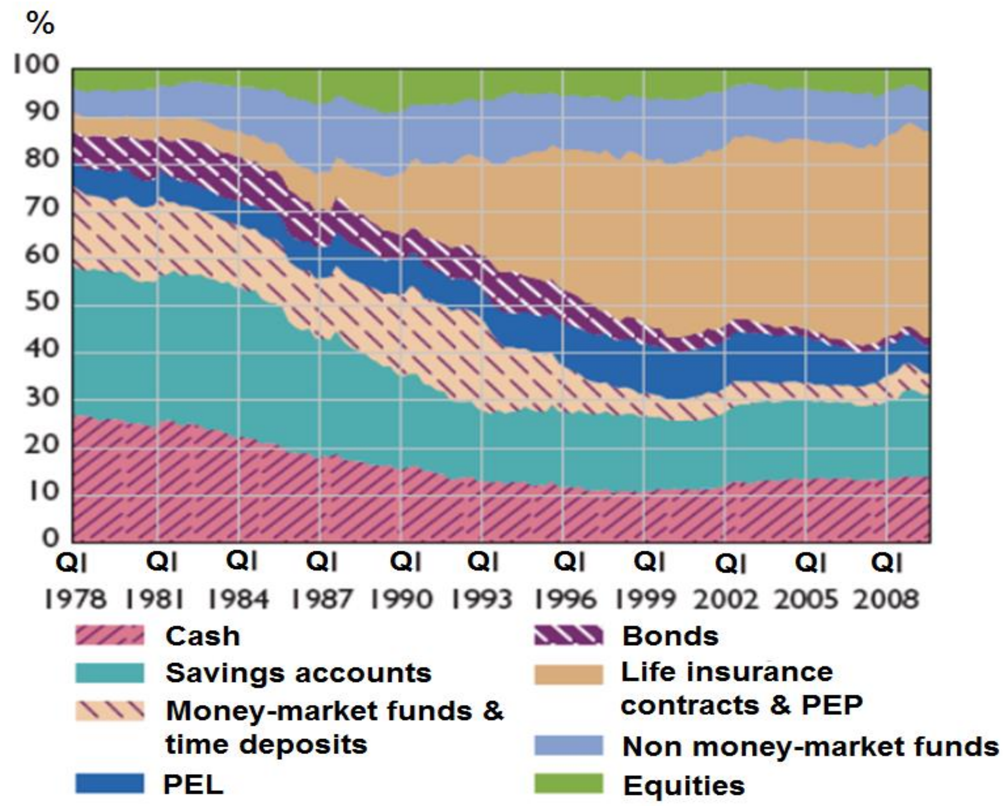

Figure 4: Evolution of the structure of financial portfolios of French household's (1978-2009). Source: Avouyi-Dovi, Borgy, Pfister and Sédillot (2011). PEL: "Plan d'Epargne Logement" (home ownership saving scheme). PEP: "Plan d'Epargne Populaire" (people's savings plan).

The graph above illustrates the rising popularity of life insurances as well as the decreasing share of savings accounts. Traditional financial investments (banking deposits, etc.) decreased sharply (53 % in 1990, 36 % in 2006), causing the share of securities directly held by households to follow a downside trend. The direct investments in mutual funds did not escape this long term rule. But the growing weight of life insurance contracts is inseparable from the development of funds. Indeed, the insurer's assets are invested in mutual funds.

Nowadays, life insurance policies are the favourite investment vehicle of French households. French life insurance policies can offer "Fonds en Euros" (euro-denominated funds) and/or "Supports en unités de compte" (unit-linked accounts). A "Fond en Euros" is secure and historically generated significantly more interest than most French savings accounts. Its assets are focused on government bonds - but can also include corporate bonds, shares and property. The united-linked accounts give access to a wide range of referenced mutual funds but, unlike the "Fonds en Euros", investing in these accounts may result in a capital loss.

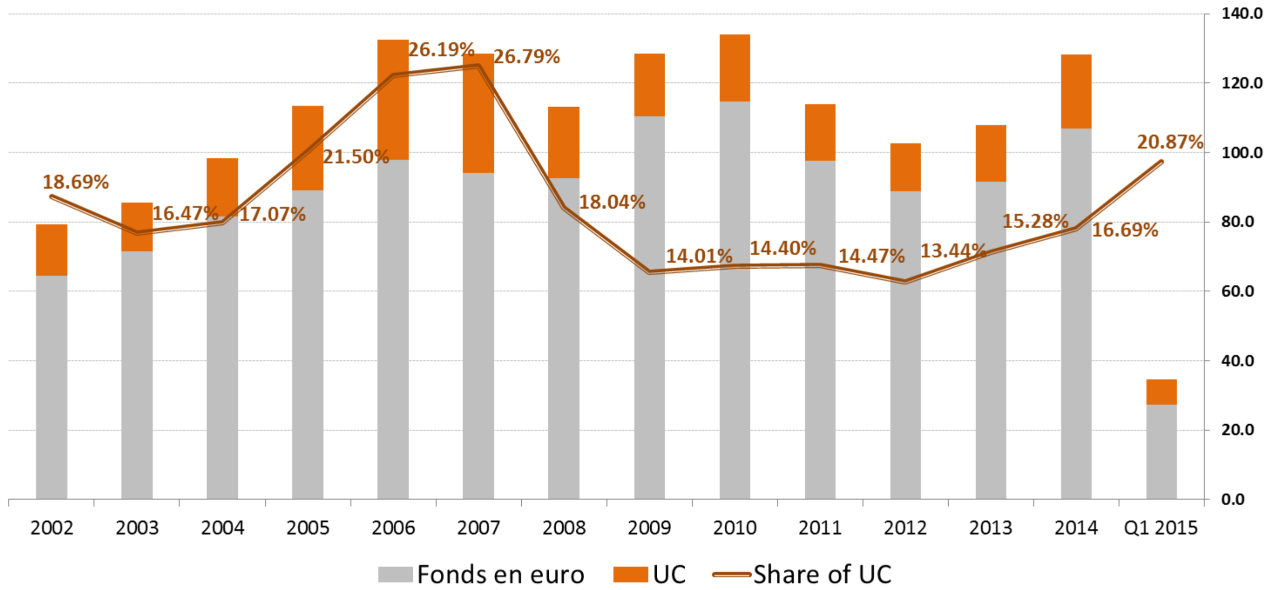

Figure 4: Net inflows (in Billions); life insurance policies and capitalisation policies. UC: "Support en unités de compte" (unit-linked accounts). Source: FFSA, 2015

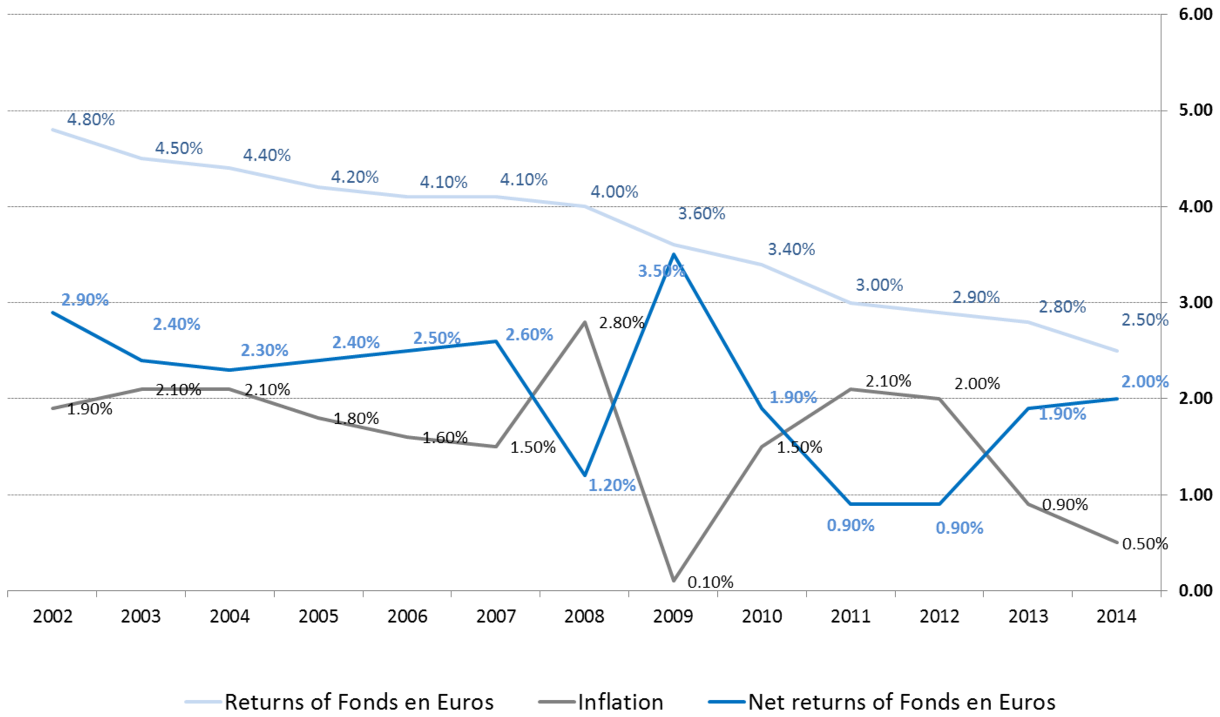

Figure 5: Net inflows (in Billions); returns of "Fond en Euros" and inflation rate. Source: FFSA and INSEE, 2015

Most insurance companies offer a "guaranteed" rate of return, which grants investors the security of their savings. Moreover, the ratchet effect allows an efficient interest capitalisation. In addition to its positive real returns on the long term, the "Fonds en Euros" offers significant tax advantages.

For instance, after 8 years, withdrawals are tax-free if their amount do not exceed EUR 9200 per annum (for a couple). In all cases, withdrawals are subject to social taxes (CSG, CRDS, etc.) at 15.5% (taking into account any Euro Fund interest already taxed at source).

II: The causes of the development of the industry in France: an original case

What factors could invert the structure of the French household savings at the beginning of the 1980s? Explaining such a structural transformation cannot be done properly if we rule out the financial and monetary environment of the period. This environment depends itself on multiple factors, such as the monetary policy carried out by the public authorities.

A: Financial deregulation: a critical turning point

Before the 1980s, the credit-based economy presented three main patterns: first, the predominance of financial intermediation: there was a low rate of corporate self-financing due to a distribution of sharing value unfavourable to firms. As a result, French companies had to call on outside finance, and bank loans were privileged because of the limited size of French capital markets. Second, an insufficient competition between financial institutions: the collection of savings and the financing were fragmented networks. Third, a strong control of lending by the monetary authorities. The disadvantages of this "administered financing system" became more and more problematic, with a permissive monitoring of inflation, an excessive cost of intermediation, and inefficiencies in the allocation of financial resources. At this time, the financial markets did not meet the growing financing needs of firms and of the State. Beginning a deregulation process and opening the financial markets became necessary. This context made possible and necessary the implementation of structural reforms aiming to increase the role of market mechanisms and to improve the efficiency of the financial system: the monetary policy was reoriented: the anchoring of the French Franc to its parity with the German mark led to an increase in nominal and real rates; the economy progressively adapted to this new situation: thanks to the productivity gains and to the relative de-indexation of salaries, the distribution of added value became more favourable to firms. It was the first step to the dismantling of several financing schemes with preferred rates. This dismantling was a prerequisite to the adoption of new techniques of monetary regulation via the interest rates and to the phasing out of credit control. The reorientation of the monetary policy gave incentives to the State to promote financial innovations in order to increase the financing of its budget deficit by the issuance of debt and to limit the cost of its debt-management strategy (the costs had increased with the rise in interest rates).

But the decline of "indirect finance" was not linear: the maximum intermediation rate was reached in 1983 (66%), the rate decreased until 1986 (34%) and it increased again during the economic recovery at the end of the decade. Simultaneously, the disintermediated increased in the 1980s because of the dual effect of the increasing self-financing rate (990% between 1986 and 1988 vs 60% at the beginning of the 1980s) and of the rising popularity of the financial markets. The issue of shares grew from FF 40 bn in 1981 to FF 213 bn in 1989, and the issue of bonds grew from FF 28 bn in 1981 to about FF 100 bn at the end of the decade.

The deregulation process and the openness to the French capital markets were part of a comprehensive approach aiming at increasing the competition between financial institutions and between the financial products. We can take as example the unification of the credit market: in 1982, the conditions for the collection of liquid savings were partly eased with the possibility for banks to offer tax-exempted products to their customers ("livret d'épargne populaire", "Codevi", etc.); in 1984, a new banking law unified the regulation of credit institutions; the credit control, which limited the volume of bank loans and the competition between credit institution, was relaxed in 1986 and definitely abolished in 1987. Another example is the greater openness to international markets: controls on exchange rates were gradually suppressed during the decade, and were abolished in January 1990.

We can focus on the reforms in the capital market in favour of equities and bonds. Indeed, some famous financial innovations and regulatory evolutions contributed to the importance of the development of capital markets.
In 1983, a bill liberalised the conditions for the issuance of securities and allowed new type of financial instrument, both in the equity market (investment certificates, participative stocks) and in the fixed income market (bonds with share warrants attached (OBSA), bonds redeemable for shares (obligations remboursables en actions), undated subordinated notes (titres subordonnés à durée indéterminée) …).
From 1985 and ahead, France reformed its methods for issuing debt in order to make the government debt instruments more attractive and to lower their cost: for instance, issuances were completed according to a pre-established agenda, and the "technique de l'assimilation" (fungibility technique) was introduced to constitute a large number of securities for the different maturities. The conditions of access to capital markets were also improved several times: the international openness of the primary bond market was decided in 1984, and the Commission des Opérations de Bourse (the French Securities and stock exchange Commission) of the "Second Marché" of the Paris stock exchange was created in 1983.
The markets themselves were reformed: the establishment of a continuous market, the creation of the monthly account system (marché unique à règlement mensuel) and implementation of the Relit system in 1991 are notable technological advances. In this respect, technology allowed a large reduction in the cost of operating a large number of accounts and a larger volume of transactions. This has made mutual funds, especially money market funds, more competitive vis-à-vis banks (cf Fernando, Klapper, Sulla, and Vittas (2004).

In 1988, the organisation of the Paris stock exchange was reformed. Previously, it was characterized by the monopoly of the certified members duly authorized for the trading of securities. As of that date, the capital of the "sociétés de bourse" (stockbroking firms) – the former "agents de change" - was opened to financial and banking companies (French or not), and their security trading monopoly was eliminated; the "Société des bourses françaises" was responsible for the listing of securities and for the clearing); the "Conseil des bourses de valeurs" was established to define the rule of access to the listing and the conditions of trading; in 1989, a bill (loi sur la sécurité et la transparence du marché financier) extended the regulatory and control powers of the "Commission des opérations de bourse" (COB).

The abandonment of credit control has to be highlighted. If the period 1967-1975 was characterised by a succession of periods of monetary easing and monetary tightening, the monetary policy became clearer and coherent with Barre governments (Barre 1: August 25th 1976 – March 29th 1977, Barre 2: March 29th 1977- March 31st 1978, Barre 3: April 3rd 1978 – May 13th 1981). From 1976, the limitation of the growth of liquidities – with some variations under the circumstances – became a priority. Until 1984, the French "credit-based- economy was characterised by the lack of flexibility of the administered interest rates which illustrates the issue of exchange rate management. Indeed, during this period, the monetary market was

disconnected from other capital markets and reserved to financial intermediaries and to some non-financial institutions. On this monetary market, central bank money (i.e. the credit balances with the Banque de France) and interbank money were traded against Treasury bills or private instruments. The French banks were certain to find the necessary liquidity. However, to provide the economic system with liquidity at a time when inflation was running high, the monetary authorities chose to control lending to regulate monetary creation. Each bank was granted a margin of increase in its outstanding loans that it must not exceed. In case the bank went beyond this administered limit, it had to constitute compulsory reserves based on the total of loans given by the Banque de France. The advantage of this procedure was to control strictly the first source of monetary creation. But this procedure had two main disadvantages: it limited banking competition, and small and medium-sized enterprise had difficulties in being properly financed due to their credit risk profile. In this perspective, the tight restrictions on the interest rates that banks could pay on retail deposits has stimulated the growth of money market mutual funds has been stimulated by the imposition of tight restrictions on the interest rate that banks could pay on retail deposits.
The French banks tried to circumvent this administered regime by creating a specific market: the banks with credit demands superior to the imposed limit used to ask other banks to “buy” their unused margin...with the blessing of the Banque de France, which even granted carryover of credit quotas from one period to the next (see Patat and Bozzi, 1993). This policy inflected from 1976 onwards, in favour of a strategy of monetary norms. But the real change occurred in 1986 when credit control was abandoned thanks to Minister for Economic Affairs Pierre Bérégovoy, who permitted the adoption of a law in 1984 which dramatically changed the monetary policy. This Act stated that (i) all economic actors would have access to the monetary market, (ii) the capital market would be enlarged and decompartmentalized, (3) the economic actors would be encouraged to finance their activities via the capital markets and (iii) the subsidies on loans would be systematically abandoned in order to maximise the efficiency of interest rate variations.

The abandonment of exchange controls should also be detailed. From 1945 to 1986, France intended to limit the capital outflows thanks to exchange controls. They were particularly severe from 1981 to 1983, when Minister for Economic Affairs Jacques Delors fought against speculations on the FF in the context of the beginning of a socialist political era (1981-1995). Two arguments were raised to explain the weakness of the French Franc: the first was a cyclical one: in the 1980s, the inflation differential with the FRG (Federal Republic of Germany) caused a lack a competitiveness for the French production. The second is more structural: the lack of specialisation of French exported products generated a deficit of the trade balance. Moreover, there was a vicious circle of devaluations: devaluations caused imported inflation and forced the government to devaluate again. The recovery economic policy launched by the socialist government proved to be a complete failure and mainly benefited our economic partners. The deficit of the balance of payments was amounting FF 17.6 bn in 1980, and it reached a record FF 79.3 bn in 1982.Worse than that, the trade balance moves from the equilibrium in 1978 to a deficit of more than FF 100 bn in 1982. As a consequence of this policy, three devaluations were carried out: 3% on October 4th 1981, 5.75% on June 12th 1982 and 2.45% on March 21st 1983. Moreover, the government had to apply a policy of budgetary rigour in order to return to economic stability. This policy, led by Minister Pierre Bérégovoy, succeeded in reducing the inflation rate (from 9.8% in 1983 to 2.1% in 1986) and in restoring growth (1.4% in 1984 vs 0.7% in 1983). From 1986, exchange controls gradually disappeared in order to confront the French companies to the international competition and to participate in the development of an integrated European capital market which would prepare the economy for the European Monetary Union. From then on the

1: TADJEDDINE Yamina and COTTA Jean-Christophe (2011), *La gestion collective en France: l’utopie d’une finance pour tous*, Revue d'économie industrielle interest rates were fixed to maintain the parity of the FF with the other currencies of the European Monetary System (EMS), the forerunner of the single currency. The freedom of capital movements coupled with almost fixed interest rates imposed by the participation in the EMS was the starting point of a loss of independence of the French monetary policy.

B: A socialist government in the continuity of the ideal of a "democratized finance"

On May 10th 1981, the socialist politician François Mitterrand was elected President of the French Republic. Mitterrand was certainly not the candidate of the financial sphere. Among the elderly and a large part of the population, this political turning point sounds like a tragedy. It was rumoured that hundreds of investors were already ruined. A large-cale capital fligth towards Switzerland was evidenced by the French Customs. On May 26th, some underground Parisian clearing houses which used to organise a parallel exchange-rate system were very surprised: the informal value of the Swiss Franc reached a record FF 3.10. On the eve of the second round of the presidential election, an intense speculation against the Franc occurred: in one week, the interventions of the Banque de France to stabilise the value of the Franc cost FF 10 bn. In this context, financial commentators predict a tightening of exchange controls. The years that followed showed that this political upheaval proved to be a good ally of the liberalisation process.
The political impetus was given at the end of the Second World War. High ranking officials considered at that time that the path of national recovery could not avoid the development of a democratized finance able to contribute to modernize the country. The American track record deeply inspired French officials, as demonstrated by the number of reports published during this period[1.]
Mutual funds were very soon designed by Finance Officers. The 2nd Economic Plan ("IIème plan français de modernisation et d'équipement", published on April 1st 1956, also known as the "Hirsch Plan", 1954-1957), at the end of the IVth French Republic, clearly described the need of a strong mutual funds industry. The following excerpt is particularly enlightening: "The acquisition of securities in the market by individuals is, in most developed country, on a declining trend. Indeed, more and more collecting bodies monitor the investment for individual investors and ensure them secure and more liquid investments. This move towards collecting entities shall be considered as a subject of particular importance and as an irreversible phenomenon". In the view of French politicians, the asset management industry contributes to the regulation of the financial markets and stimulates them. The collected assets, focused on the long term, foster market elasticity and the numerous trades make exchanges more fluid. Developing a more resilient financial system was a strategic that matched both political and economic interests.
Historical facts tend to prove the continuity of this vision: the ordinance of 2 November 1945 (creating private asset managing companies). was promulgated by the "Conseil National de la Résistance", the law "Monory" (granting the non-taxation of capital gains on the stock markets) of 13 July 1979 was voted during the mandate of President Valérie Giscard d'Estaing, and the "Plan d'Epargne en Actions" (saving plan in shares) was created during the presidency of Mitterrand. As we see, French politicians, from Général de Gaulle to Mitterrand, made the bet to financialise the savings through the development of mutual funds. Proving the vast majority of the population with profitable financial vehicles that would meet their expectations was a strong political desire. Moreover, mutual fund were seen by French politician as a way of strengthening the French financial industry and the French companies.

1: TADJEDDINE Yamina and COTTA Jean-Christophe (2011), *La gestion collective en France: l'utopie d'une finance pour tous*, Revue d'économie industrielle

C: Tax policies and regulations cemented the position of the industry

The finance literature is replete with examples of how tax policy can affect investment decisions (see, e.g., Poterba and Samwick, 2003). We expect funds to grow stronger when tax rules make these investments more attractive relative to others. In this respect, the Monory Law of July 13th 1978 was a starting point: it exempted from taxation SICAV which held mainly French assets. First, this law transformed mutual funds into a popular financial vehicle. Second, it emphasized the need of new regulations for mutual funds. This law was followed by the law of January 3rd 1983 which created open-end mutual funds and the law of July 8th 1984 which determined the requirements for tax exemption. Several decrees rounded off this set of legal measures: one of them allowed investors to deduct a portion of their income taxes for the interests of the loans subscribed for the buying of equities. The capitalisation of interests is also a major issue: the law of December 29th 1989 granted SICAV and FCP the right to "freely" recapitalise interests without taxation. The law of July 16th 1992 created the "Plan d'Epargne en Action" (PEA), a tax exempted (as long as it is held for a minimum of five years) financial vehicle for the holding of European equities. Thanks to the PEA, the public authorities tried to deter French households to invest in monetary funds to channel savings towards long-term investments (e.g. equities). At the end of the 20th century, only dividends received from directly-held equities are subject to income taxes. These fiscal measures led T. Piketty (2001) to assess the secular fiscal evolution in these terms: "dividends have moved from a triple taxation scheme to a single taxation scheme".

Laws and regulations are also a key factor explaining differences in the pace of financial development. La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998) showed that the quality of the legal system could contribute to the development of mutual funds by boosting investor's confidence in financial markets. According to their research, the transparency of reporting, the prevention of conflicts of interests between funds and funds investors and the general protection of the investors were determining criteria.

Regulatory improvements in France were numerous well before the 1980s. In 1957 a legislative decree defined the legal framework of SICAV and FCP in France. Four years later, the "Association des sociétés françaises d'investissement" (ASFI) was created with the decree of March 23rd 1967 to define the regulatory process relative to the first SICAV.

We can note The European Union became a supranational regulator with the UCITS directives. These directives aim to establish investor protection through strict investment limits, capital and disclosure requirements and independent oversight. They gradually unified and harmonized the distribution of mutual funds in the Member States of the Union. In1985, the first mutual fund directive 85/611/CEE gave birth to "coordinated" mutual funds. This legislation was the first step of the UCITS regime (Undertakings for collective investments in transferable securities). This directive set up a single passport system for mutual funds in the space of the European Union. In 2009, the mutual fund directive 2009/65/CE (also known as "UCITS IV"), published on November 17th 2009, provided significant improvements, dealing for example with cross-border mergers of mutual funds. It created a single European regime for master/feeder funds and replaced the "simplified prospectus" by the KIID. The implementing laws were adopted on July 1st 2010 and they were transposed into the national laws of the Member States on July 1st 2011. More recently, in 2011, the directive AIFM (Alternative Investment Fund Managers) 2011/61/CE, published on July 8th 2011, aimed to set up a legal framework for all non-UCITS mutual funds (hedge funds, FCPR, OPCI, etc.). The forthcoming regulations are UCITS V, which will define new rules on fund manager remuneration, reinforce the accountability of custodians and harmonize the sanctions regime throughout the EU (this directive will be transposed into the national laws of member states from March 2016). UCITS IV will be followed by a general review of the UCITS legal framework (consultations have already begun) which will give birth to UCITS V.

The « Lamfalussy » process, named after the former President of the European Monetary Institute (EMI), is an approach used by the European Union to enact legislation (directives or rules) in the sector of financial services. This approach is based on four levels: the first level is the preparation of legislation: the European Commission puts forward a text which is adopted within the principle of co-decision (between the European Parliament and the European Council). At this stage, the text describes the framework principles and defines implementing measures. The second level is the preparation of implementing measures: the Committee of European Securities Regulators (CESR) is responsible for the technical implementation of the legislation. For this purpose, it initiates consultations and collaborates with the national legislative bodies, then makes a proposal to the European Commission. The third level is the cooperation of regulators: the CESR draw up common interpretative recommendations and ensures a uniform implementation of the legislation. The Member States of the European Union transpose into their national laws this legislation. The final level is the monitoring to ensure compliance with Community law: the European Commission track the effective implementation of the legislation in the Member States. This process enables the European Union to adapt quickly and efficiently to the latest financial innovations.
A brief descriptions of some basic UCITS rules may help us understand how this regulation can improve investor's confidence in mutual funds. First, UCITS funds must comply with concentration ratios: in this respect, the "5/10/40" rule is fundamental: a UCITS funds cannot invest more than 5% of its assets in securities issued. This limit can be increased up to 10% provided that where the 5% limit is exceeded, the exposure to these issuers, when added together, does not exceed 40% of the fund's assets. Second, UCITS rules require readily accessible, comprehensible and up-to-date information. According to the UCITS rules, the fund must publish a prospectus, annual and semi-annual reports, and a Key Investor Information Document (KIID). Another example is the requirement of a high level of liquidity: as a general rule, investors may buy or sell UCITS shares or units at least twice a month. In reality, the vast majority of UCITS funds offer daily liquidity. Moreover, some financial instruments are limited or prohibited in order to ensure investors invest in transparent and highly liquid products.

Financial instruments	Eligible	Maximum limit
Approved securities (e.g. equities, bonds, deposits, deposit certificates)	yes	none
Sovereign bonds	yes	none
Warrants	yes	none
Derivatives	yes	none
Real Estate	**no**	**N/A**
Commodities	**no**	**N/A**
Unlisted securities	**no**	**N/A**
Hedging instruments	yes	none
Securities lending	yes	none
Borrowing	**yes**	**10%[1]**
Cash & equivalents	yes	none

1: Only on a temporary basis in order to meet redemptions.

Non eligible instrument   Limited instrument

Figure 6: Eligibility of financial instruments for UCITS funds. Source: European Commission.

To finish, it may be necessary nuancing our point: in our view, there is no legal determinism. Indeed, the legal framework can have unexpected results. Khorana, Servaes, and Tufano (2005) mention one possible paradox concerning investor protection: while protecting mutual fund investors helps the industry, protecting individual equity investors may have opposite effects. They suggest that failing to enforce insider trading laws can have a positive consequences on the size of the equity fund industry because individual investors feel they cannot compete with better informed insiders (i.e. the professional investors).

D: Supply and demand dynamics

The marketability of mutual funds must not be overlooked, because the intrinsic advantages of mutual funds are numerous. First, they are an efficient tool of diversification. Diversification can be defined as the mixing of investments within a financial portfolio. To hold a well-diversified portfolio, an investor may have to buy bonds from multiple issuers and different maturities, and equities with different capitalisations and from various industries. We easily understand that achieving such a diversification can be very costly. Mutual funds allow investors to have the benefit of diversification and asset allocation without the large amounts of cash needed to create individual portfolios. Funds also generate economies of scale because they reduce the relative cost of transaction fees by taking advantage of their buying and selling size. Liquidity is another appreciated characteristic of this vehicle: being able to sell a mutual fund in a short period of time without there being much difference between the sale price and the most current market value is determining criteria. Mutual funds generally transact once per day after the fund's net asset value (NAV) is calculated. The liquidity of Exchange-traded funds (ETFs) is even higher since they trade any time during market hours. Professional management is also highly valuable. When they buy mutual funds, investors delegate the management of their assets. Therefore, investors do not need to thoroughly research every investment before they decide to conduct arbitrages.

In terms of demand, we expect that the degree of wealth and education of the population is correlated with its desire to adopt innovations in place of the older methods of investing.
For instance, the use of the internet can illustrate the ability of the population to access various sources of information and adapt to new technologies.

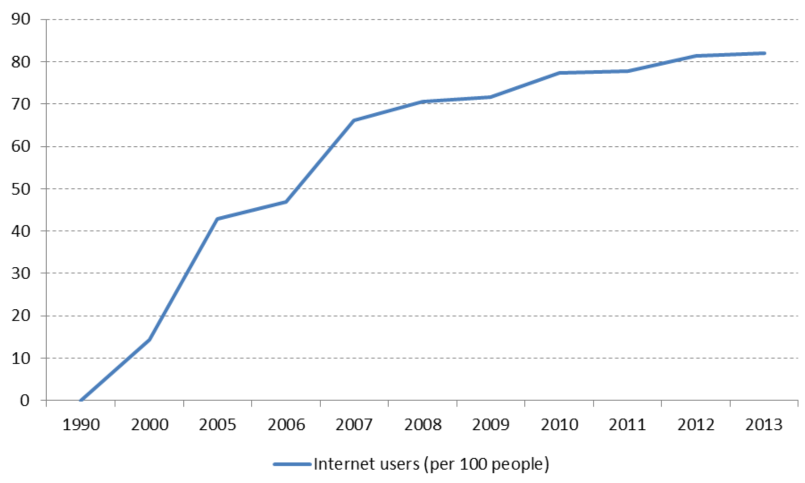

Figure 6: Internet users[1] per 100 people in France. Source: International Telecommunication Union, World Telecommunication/ICT Development Report and database, and World Bank estimates.

1: Internet users are individuals who have used the Internet (from any location) in the last 12 months. Internet can be used via a computer, mobile phone, personal digital assistant, games machine, digital TV, etc.

Demographic trends are also at stake. Thanks to the post-war economic recovery, the generations of the 1950s, 1960s and 1970s benefited from a strong growth of the GDP, from an increasing purchasing power and from the increasing value of their moveable and immoveable assets. The ageing of the population who was born during the “baby boom” period generated a strong growth of the amount of savings (11 % per annum between 1995 and 1999), whereas the income increased by 4 % per annum over the period (Babeau, 2003). The household wealth represented 229,6 % of the GDP in 2000 versus 137.3 % in 1990 (Byrne and Davis, 2002). This increase in French household's financial assets concerned all social groups, and especially middle-class people. Given this demographic evolution, there was undeniably a strong and massive need for efficient and affordable financial vehicles.
One of the French particularities is its social welfare system, and in particular its public pensions system. As a consequence of the predominance of this public scheme, pension funds are little developed in France. However, it is quite unlikely that the expansion of pension funds would increase significantly the amount of household savings, given the fact that the presence of the national pension system did not prevent the strong growth of other institutional investors.
Cultural factors may also play a role. The pooling of resources and the sharing of profits (or losses) which characterize mutual funds may meet a national aspiration. Lazarus (2009) thinks that the “ethical precepts” of common investors, built on the double cultural heritage of Christian charity and “republican benevolence”, could explain the French appetite for democratic financial vehicles represented by mutual funds. We should keep in mind that the French revolution (1789-1799) introduced strong democratic ideals in the French society and was inspired by a liberal conception of the individual. “Liberté, Egalité, Fraternité” (liberty, equality, fraternity) is not a vain maxim. It is one of the pillars of the French Constitution of 1958, directly inspired by the “Déclaration des droits de l'homme et du citoyen” (Declaration of the Rights of Man and of the Citizen), passed by France's National Constituent Assembly in August 1789, where the imprescriptible rights of man are defined as “Liberty, property, security and resistance to oppression” (Article 2). It would not be an exaggeration to state that the structure of mutual (losses, profits are pooled) meets the philosophical spirit of these values, and that it can partly explain the popularity of this financial product.

On the supply side, competitive dynamics can help us understand the adoption rate of mutual funds. For instance, a concentrated banking sector could plausibly encourage or discourage the formation of a strong fund industry, depending on whether banks saw the fund business as a complement or substitute to their traditional deposit-taking activities.

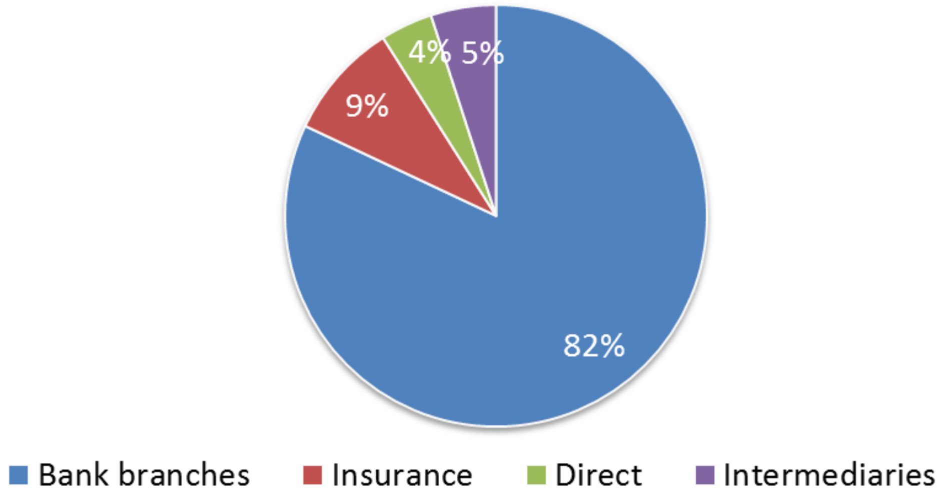

Figure 7: Distributors of mutual funds in 2003 (in % of the market share). Source: BCG 2003, on the basis of the following sources: Investment Company Institute, Datamonitor, EFID, Association of Insurances, Association of Unit Trusts and Investment funds, business press, BCG analysis

The central position occupied by banks in the distribution channel of mutual funds suggest that these institutions adapted to the financialisation of the savings and had a strong economic interest in assisting their clients when they moved to non-traditional financial vehicles.

E: A particularly favourable stock-market environment

The highly favourable financial environment during the 1980s cannot be separated from the "take-off" stage of the fund industry. It is impossible to determine *a posteriori* whether the asset management industry could develop at the same pace or not without a favourable external environment. Our goal is not to explain the factors of development of the financial markets from the 1980s. Readers are referred to Porta et Al, and Rajan & Zingales for more details on this subject. Our point is to note that the conditions of the French financial markets could have a lever effect to promote mutual funds and encourage the population to face market risks.

The exceptional returns on financial markets undeniably contributed to the popularity of mutual funds. Between 1980 and 2008, the real yearly return of monetary assets, stocks and bonds was 2.4 %, 7.8 % and 7.8 % respectively, which is more 2.6 %, 5.8 % et 4.7 % respectively than during the 1950-1980 period (Garnier et Thesmar, 2009). The CAC 40, the most widely-used indicator of the Paris markets, reflects the performance of the 40 largest equities in France, measured by free-float market-capitalization and liquidity. The index was developed with a basis level of 1000 as of December 31st 1987, but there were listed companies well before this date. David Le Bris built a posteriori the Parisian index, the "HCAC 40", which allows us to consider the evolution of the stock-exchange market in a longer-term perspective.

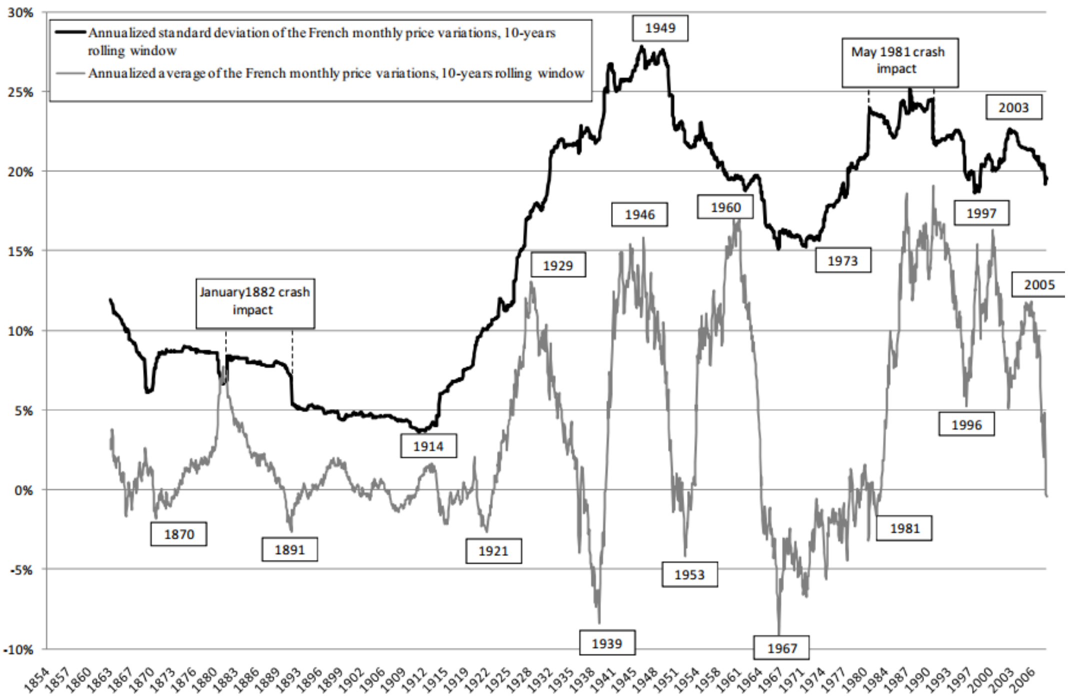

Figure 9: Average and standard deviation of monthly price variations of the HCAC. January 1854-December 2008. These statistics are measured over a ten year rolling window and annualized. The standard deviation of the HCAC 40 measures the market risk. Sources: Source: Le Bris (2009) with INSEE, Bourguignon and Lévy-Leboyer (1985)

The graph above shows for each month the mean performance of the 10 previous years. It appears that, since 1983, investing in stocks offered an unprecedented real return, with 12% as an average (Le Bris, 2009).

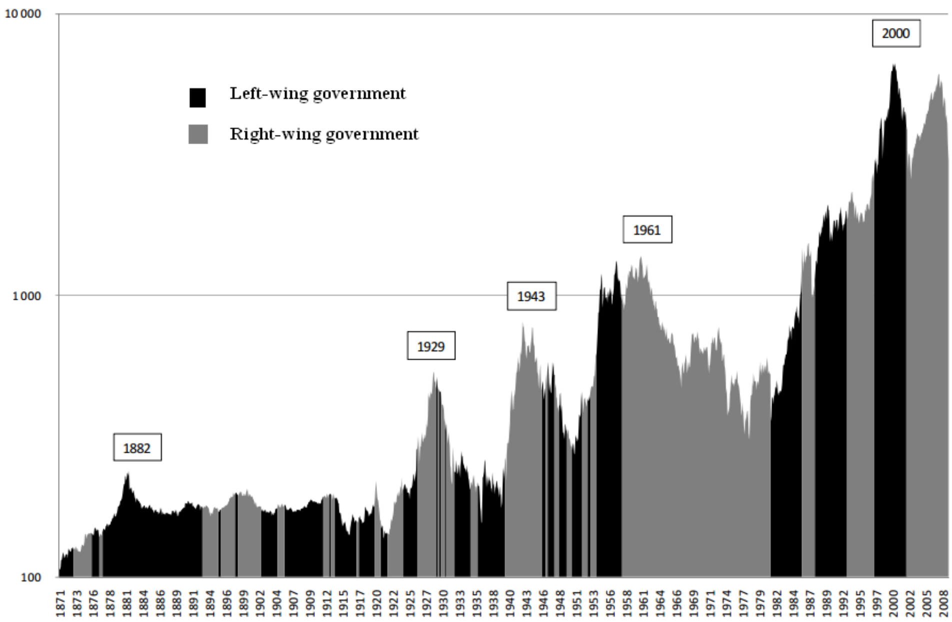

Figure 9: Evolution of HCAC 40 price under left-wing and right-wing governments. 1871-2008. Basis: 1000 points on January 1st 1988, as decided by Euronext. Source: Le Bris (2009) with INSEE, Bourguignon and Lévy-Leboyer (1985)

Political considerations seem marginal if we consider that six political alternation took place between 1980 and 2008.

Market liquidity has to be considered since it reflects the ability to operate financial transactions without impacting the prices of the involved assets. Market liquidity can be identified by the "depth" of the market (the ability to operate large financial transactions without impacting excessively the price), by its "narrowness" (the spread between the bid price and the offer price, or the speed in which transactions can be operated) and by the "resilience" of the market (the speed in which the prices return to their normal levels after a market event).

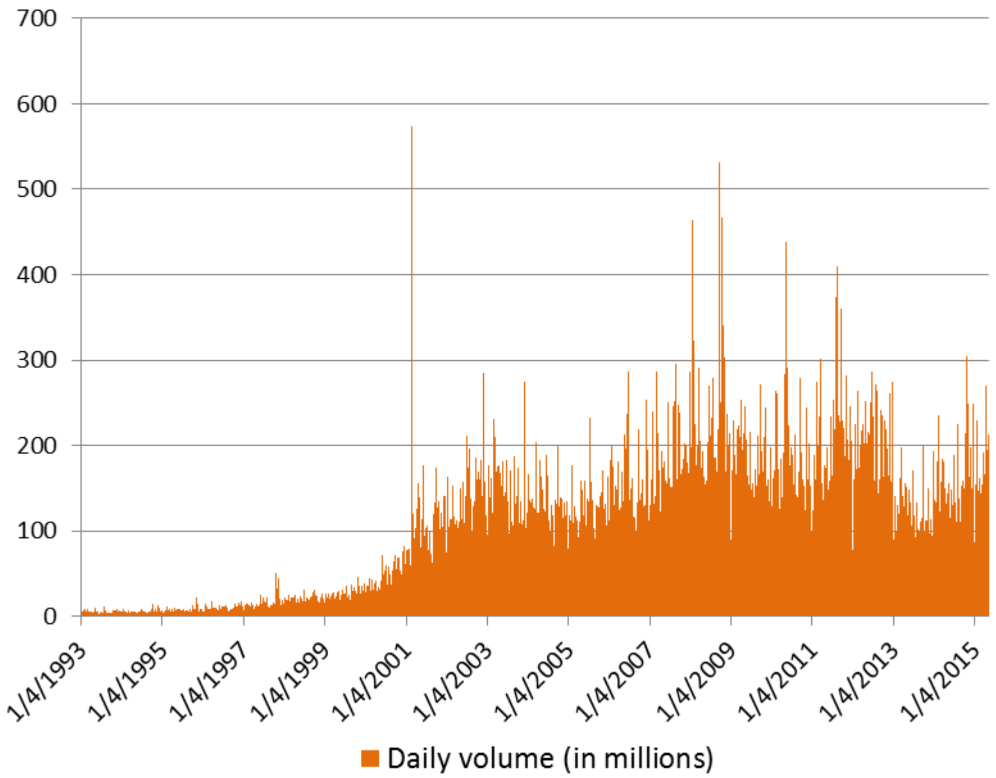

Figure 10: Daily volume of CAC 40. From 04/01/1993 to 07/05/2015. Source: Bloomberg

The determinants of market liquidity are numerous, but some of them can be identified, We can list some exogenous and objective criteria to analyse market liquidity, such as low transaction costs, narrow price ranges, high number of buyers and sellers, and transparency of the financial assets (in case the perception of the underlying value of the assets change, prices should result in price adjustments).

Conclusion

Our results corroborate the findings of Khorana, Servaes, and Tufano (2005) in the sense that the regulatory framework of a country deeply affects financial development. The French financial authorities, followed by the European regulators, accompanied financial changes and provided a strong and harmonised legal basis for the industry, particularly regarding the transparency of financial reporting. This vigilance with regard to the protection of shareholders' interests was a significant contributor to the increasing confidence in financial markets. Structural reforms and technological factors were, in another degrees, important levers for the development of funds. The "credit based system", which was characteristic of the French economy in the 1960s and 1970s, gradually disappeared in the 1980s to make way for a new financial intermediation and a new monetary regulation.

The development of the national fund industry followed a specific pattern: the strong relative development of money-market mutual funds is one of them, and is probably linked to the French "administered" banking structure which was imposed for a long period; the deregulation did not stop their development, probably because these financial products proved to outperform the banking competition.

However, in our view, there is no legal determinism nor *sense of History*: the development of the industry cannot be reduced to a package of rules and laws. History is made of individual's decisions, and can be unpredictable. In this respect, the election of President François Mitterrand is a textbook case. One could have predicted that his election would sign the end of business-friendly era. But less than three years after he was elected, his government, guided by the *principle of realism*, turned out to be an ally – perhaps one of the best - of the financial change towards modernity. Moreover, we suggest that mutual funds are consistent with the national values which have been inspiring the French people for centuries. The idea of a "collective" financial instrument, the concept of a freely negotiated contract between investors and asset managers may echo the French inspirations expressed in violent forms during the *French Revolution*.

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