Increasing retail engagement in capital markets

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The recipe for a successful CMU project

The CMU Action Plan has progressed significantly since it was launched in 2015. Indeed, a large number of legislative changes has been proposed by the European Commission, and a majority of them has been subsequently agreed in the political process.

Despite this progress, however, some further steps will be needed to make the CMU project a complete success. One important point of attention of policy-makers should be on developing a larger European retail investor base.

As a matter of fact, the participation of European households in capital markets activities is overall quite low. This is problematic not only for the development of the CMU as such, but also in a wider economic context, in particular to increase returns of capital for an ageing population and improve diversification of funding channels and risk sharing.

In order for retail investors to place their savings in capital markets, one key challenge is finding the right balance between offering attractive investment opportunities and ensuring that investors can be sufficiently aware of risks, thereby increasing trust and market confidence.

> *"Attention of policy-makers should be on developing a larger European retail investor base."*
>
> \- VERENA ROSS

In order to overcome this challenge, we should firstly work on improving standardisation of products and provide clear, comprehensible and comparable information. In this context recent regulatory interventions, such as PRIIPs, have improved standardisation of disclosure for retail financial products at the EU level. However, there is a further need for more standardised, simple, cost efficient and safe investment products to facilitate retail investors. In addition, more could be done to reduce intra-EU market fragmentation especially when it comes to addressing tax disparities for common retail products. Finally, the data on actual distribution costs should be easily available. Looking at the particular area of investments in mutual funds, ESMA established that charges on UCITS funds impact their gross returns by one quarter on average, thus representing a significant drain on fund performance.

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>>> Furthermore, we should address concerns around product distribution, by further reducing conflicts of interests across the distribution chain. With MiFID II, measures have been taken to try and tackle these conflicts of interest through the introduction of independent advice and the tightening of requirements around inducements. Another MiFID II provision worth mentioning is the unbundling of research and execution costs when managing clients' portfolios. Despite the entry into force of MiFID II in January 2018, there is still more to do to ensure a wider and clearer choice for retail investors across the Union.

In addition, it would be worth considering certain pension reforms, and so increase retirement savings. We observed in a number of EU Member States that pension systems that rely on the second and third pillar stimulate retail investor appetite for capital market participation. Therefore, in countries where the pension system's second and third pillar are still underdeveloped, steps could be taken in this direction. At the same time, we should acknowledge that the recent adopted PEPP should create a large scale, portable long-term pension product, which is likely to be helpful in removing cross-border barriers to the creation of an integrated market for personal pension products and drive further participation in the EU capital markets.

Finally, we should be mindful that investors cannot be truly confident in financial markets if they do not understand at least their very basics. Hence, efforts to promote financial education may also contribute to a successful CMU. ●

Paul-Willem van Gerwen

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Investor protection is key to enhance retail engagement within capital markets

The need for retail investors to generate adequate returns from their investments has never been more urgent / pressing due to demographic, social and economic developments. Consumers increasingly need to provide for future financial and social provisions such as pensions, health care, and (educational) costs for children. Due to the low interest rate environment, consumers need to search for alternatives to bank deposits. As a result, the AFM has seen a significant growth of the Dutch asset management market. The EU has one of the highest saving rates in the world and EU households hold financial assets of almost 220% of gross domestic product (almost twice as much as in the US)[1]. However, 35% of those savings are placed in low-yield instruments such as cash and deposits. In the US these instruments account for only 15% of consumer assets, whereas investments in financial instruments (for example equity) is much more common. In other words, the EU market for retail investment seems underdeveloped.

The relative vulnerability of retail investors and the potential impact of investments on their financial wellbeing makes investor protection of key importance. The financial literacy of an average consumer is not comparable to that of a professional or institutional investor. Bounded rationality[2] makes complicated long-term investment products particularly hard to understand. Therefore, retail investors are generally best served by simple, safe, low cost products as well as services that are relatively easy to understand.

> *"Retail investors will only invest in capital markets if their interests are well served."*
>
> \- PAUL-WILLEM VAN GERWEN

In light of the above, it is important that efforts to encourage retail engagement in the capital markets are enhanced and investor protection is strengthened along the way. Recent developed EU legislation like MiFID II, UCITS, PRIIPs and MAR provide a sound policy framework that support these efforts. MiFID II strengthens investor protection by requiring investment firms to provide more information about the costs of an investment service and about the independence of their investment >>>

>>> advice. With introduction of PRIIPs, uniform transparency requirements were introduced to a broad spectrum of competing investment products. By standardizing the information, comparison of different types of products is facilitated for retail investors. In addition, the introduction of POG (product oversight and governance) rules require producers to assess whether their offering is suitable for the targeted consumer groups. This can help to avoid products with an unsuitable risk profile being offered to consumers who do not understand the product.

Issues that require attention are the current passporting systems and Free Movement of Services. Technology has made cross border distribution much easier and so has the ease by which malignant parties could shop around for light-touch supervision. Support for the current system may erode when harmful products or services are offered (or pushed) to EU consumers. These issues will become more important with the ongoing digitalisation of financial services.

Another critical issue that Europe needs to tackle is the existence of sectoral production and distribution silos. Today, the consumer experience vary widely and is partially dependent on through which 'shop' the consumer enters the financial services sector. Investments may be sold in securities-, funds-, insurance- or banking-wrappers and/or packages, depending on the type of provider or advisor. These are often substitute products and the flexibility, cost loading and investment performance may be widely divergent. The level playing field and competition across the financial services sector must be improved, so that the start of the customer journey does not dictate the quality of the financial services and products. The AFM sees CMU initiatives – including an enhanced role for the ESAs – to play a key role in this. ●

1. Source: 'Capital Markets Union, measuring progress and planning for success, September 2018, AFME'.
2. The rationality of the investors is limited by the information they have, the cognitive limitations of their minds, and the finite amount of time they have to make a decision.

Guillaume Prache

Managing Director, Better Finance

Restoring trust: individual investors must be able to get redress when abused

Households' direct participation in capital markets has decreased significantly over the past 50 years and continues to do so. Currently, the largest share of the EU citizens' financial savings is held in complex, highly packaged life insurance and pension products. Investment funds make up only 8 % of their financial savings, low cost and simple index ETF being only a tiny portion of those. And listed stocks and bonds make up less than a fifth of their financial savings. Funding channels for SMEs come either from internal funds (68%) or from banks (13%), and less than 1.5% from equity or bond issuance. Most recently, corporate bonds have "disappeared" from the retail sector in many jurisdictions due to the PRIIPs Regulation's legal uncertainty.

As targeted by the CMU Initiative, unlocking a part of retail savings from banking and other packaged products to direct investments in capital markets would have a significantly positive impact for economic growth and jobs, not mentioning on pensions. However, individual investors are mostly sold fee-laden, highly packaged products, most of which underperform direct investments and fail to provide adequate long-term returns. The current surge of "dark" markets for equity trading does not make it easier: now less than half of European stocks are traded on individual investor friendly "lit" markets. Moreover, EU citizens are also demotivated to invest directly due to the persistent double-taxation of investment income and other obstacles to cross-border shareholder rights.

To achieve a higher participation rate in capital markets, BETTER FINANCE identified three priority issues that need to be tackled: trust, complexity, and private enforcement. Potential solutions are to better align distributors' incentives with clients' returns by minimizing conflicts of interests in distribution, ensure better access to simple investment products and provide a proper collective enforcement mechanism for investors, which is the "lion share" of investor rights.

Currently, European individual investors lack the necessary mechanisms to collectively defend their rights in court, except in the Netherlands and in Portugal. The latest example is the "Diesel Gate" scandal (VW), where US investors have already obtained compensation, while compensation for EU investors is nowhere in sight.

"A proper collective enforcement mechanism is the "lion share" for investor protection."

\- GUILLAUME PRACHE

A window of opportunity lies with the collective redress directive, but the lack of political will and protectionism of businesses remain the main obstacles for a robust and efficient cross-border enforcement mechanism. The EU must balance the scale in favour of consumers of financial services and ensure that all individual investors are covered (not discriminating direct investors by excluding them), that the mechanism includes all harmed consumers (opt-out system) and that representative organisations can actually defend consumers' rights. Of importance as well is the cross-border dimension: a Single Market for financial services cannot be achieved if individual non-professional investors are deterred or precluded from enforcing their rights.

Finally, in order to incentivise case-handling efficiency, the collective redress mechanism should be articulated with alternative dispute resolution mechanisms. ●

Simon Janin

Head of Public Affairs,
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Creating a virtuous circle to increase retail investment in capital markets

Asset management plays a fundamental role in the EU economy by channeling retail savings towards investment, notably in capital markets instruments, essential to foster growth and jobs. Yet, retail investment in capital instruments tends to decrease in number of European countries. Therefore, it is essential to promote measures that will improve the engagement of non-professional investors in capital markets.

In this respect, the creation of a pan-European Personal Pension Product (PEPP) represents undoubtedly a progress, as it will help to channel households' savings towards long-term investments and enhance incentives for retail investors to save in capital market instruments. In particular, the inclusion of life-cycle strategies as the default option marks a real improvement for retail investors. As shown by studies, life-cycle strategies offer superior returns and lower risks compared to bonds over a long investment horizon. The success of the PEPP will of course now notably depend on sound and workable level 2 measures.

However, more has to be done to foster retail engagement in capital markets.

The very first step is to restore confidence of retail investors in the proper functioning of capital markets, and this particularly in the context of global uncertainty of a changing world. This requires developing new ways to take consumers preferences into account through products that follow specific sustainable or responsible investment strategies as well as increasing the general level of financial education. This is a major challenge, as most people lack sufficient financial and investor education to be able to make informed decisions whilst being increasingly expected to be more responsible for their own financial wellbeing in a context of ageing population and the resulting pressure on public pensions.

Fostering retail engagement in capital markets implies also to develop more employee share ownership solutions at the European level. These schemes, that align the interests of companies and of their employees, are already a real success in some EU countries but with different levels of shared benefits. Then, common rules could favor more ambitious levels of employee savings and allow for cross-border shareholding plans in pan European companies.

This can be a key driver for EU capital markets, creating a truly virtuous circle. As experience tends to show, a majority of people exposed to employee share ownership will also open brokerage accounts and buy other shares. This would also be a major step to reinforce the local base of individual investors who traditionally play a bigger role in the small and midcap markets than in the overall markets.

Last but not least, work has to be done on existing EU legislations to make sure they do not have counterproductive effect on retail investors engagement in capital markets. In this regard, the forthcoming reviews of MiFID II and PRIIPs could be the occasion to address these issues. More generally, the relevance and understandability of information disclosed should be scrutinized with a view to reduce the volume of data mandatorily shown to non-professional investors. ●

Mario Nava

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The case for more retail investments in the EU

Fostering retail investment in capital markets has been on the agenda of the Capital Markets Union ('CMU') from its outset and featured prominently in the CMU Action Plan in 2015 and the CMU Midterm Review in 2017. European households continue to have one of the highest savings rates worldwide. However, according to the latest available figures from Eurostat, 29.7% of the total financial assets of EU-28 households (valued at EUR 35 318 billion in 2017), are held in currency and deposits, producing negative real returns. This means that roughly EUR 10.5 trillion – i.e. ~70% of the EU GDP – are unproductive and constitute an untapped potential. At the same time, many EU companies continue to rely exclusively on bank financing.

Creating conditions that are favourable for capital market investments from European households and savers can contribute to the development of funding sources alternative to bank financing, thus funnelling additional money into the real economy. This can help improve access to financing also for SMEs and benefit the economy in general by enabling companies

to invest and create jobs. At the same time, retail investments in the capital markets can help meet the challenges posed by population ageing and other future >>>

>>> liabilities by allowing investors to build or protect their wealth and to meet their needs related to health, education and retirement as such investments typically target higher rates of return. It is, however, important to ensure that retail investors are able to understand and compare different products and the corresponding risks, so they can decide for the most suitable products that fit their risk profile and offer the most adequate risk/return balance.

"Retail investments in the capital markets can help meet the challenges posed by population ageing."

- MARIO NAVA

The CMU can bring together more companies and investors and help them match their respective financing and investment needs, domestically and cross-border, providing for deeper, more liquid markets and diversified sources of funding. Obviously, special attention has to be given to retail investors. Consumer advocates have voiced concern that often times overly complex and fee-laden products are sold to retail investors and that investment advice may be biased due to conflicts of interest of advisors. The CMU aims at creating a well-functioning market for retail investments that is transparent, competitive, and cost-effective for consumers while at the same time ensuring a high standard of investor protection. A number of previous initiatives (e.g. the regulatory frameworks applicable to Undertakings for the Collective Investment in Transferable Securities (UCITS), Packaged Retail and Insurance-based Investment Products (PRIIPS) or the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD)) have improved investor protection, introduced better safeguards against mis-selling and provided for greater transparency of the features, risk/return profile and costs of investment products. Some of these initiatives have only entered into effect rather recently and may therefore not yet have produced their full effect in the market. Going forward, the Commission may need to review the interplay of the different pieces of legislation as well as consider if the comparison of the features and costs of different retail investment products can be made easier for the benefit of retail investors. ●

Sergio Trezzi

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Breaking down the silos to simplify retail investing for consumers

Improving retail participation in the capital markets is arguably the most important objective of the CMU for the next 5 years. Research shows that the presence of deep and liquid pools of capital in the form of long-term savings are a prerequisite for the development of vibrant capital markets. While there is no shortage of savings in Europe, most of these savings remain in low-interest rate bank accounts and other low-yielding products. Some of the reasons for this are down to culture, market inefficiency and tax treatment but the regulatory framework should be used to simplify the investment process for retail investors.

Today, retail investors face a patchwork of regimes when investing, depending on whether their financial advisor is subject to MiFID or IDD, or whether they will receive a UCITS KIID, a PRIIPs KID, a MiFID disclosure or, at worst, all three. Breaking down the artificial silos created by regulation can help re-focus attention on what investors really need, which is to access investment opportunities that can meet their long-term savings goals.

First, we must simplify the product landscape. UCITS is a European success story and the gold standard around the world. However, the bias towards UCITS in the regulatory regime may have contributed to more complex strategies being included in UCITS, diluting its image as a simple product. We believe that retail investors should be able to access a broader range of investment opportunities than those that are available in the UCITS wrapper if we are to help them achieve their long-term savings goals.

There is clearly an appetite for other retail options when we consider that 60% of AIFs are classed as "other", a significant proportion of which are retail products that don't fit within the UCITS framework. Developing a long-term European investment vehicle to sit alongside UCITS would allow access to more long-term investment options to retail investors while maintain the integrity of UCITS as simple investment vehicle.

"Breaking down the artificial silos created by regulation can help re-focus attention on what investors really need."

- SERGIO TREZZI

Second, we need to reform investor disclosure in Europe. Disclosure is not an end in and of itself but a means to help investors make more informed choices. As we move to greater institutionalization of the retail market, where the focus is increasingly on providing investment solutions rather than individual products, we believe that the disclosure regime should evolve to reflect this market change.

This means moving towards a single client disclosure aggregating the risks, performance and costs of the products and services provided, as is currently the case for costs and charges under MiFID 2, and doing away with UCITS KIIDs and PRIIPs KIDs. Furthermore, regulation should be less prescriptive about the presentation of this information to allow advisors to develop their own solutions to help retail investors navigate this information, leveraging new technological innovations to do so. ●