INCREASING RETAIL ENGAGEMENT IN CAPITAL MARKETS

1. Current situation of retail capital markets in the EU

1.1. Limited level of engagement of EU households in capital markets

Increasing retail access to capital markets is a long-standing objective in the EU. Households, who are the main funders of the EU economy, should be at the heart of the Capital Markets Union (CMU), an investor representative believed, but there is some bad news. Statistics from the ECB comparing 2015 to the present show that the share of bank deposits, life insurance and pension schemes in total financial savings has slightly increased[1], whereas holdings in investment funds, listed equities and bonds have fallen despite the positive trend of markets over the last few years[2]. The audience was also reminded that 60% of households' assets are currently held in real estate or property, therefore the trends above only relate to 40% of overall assets.

A policymaker calculated that based on these figures, 12% of overall wealth is held in bank accounts in the EU. This may not seem excessive, because households are usually advised to keep around 20% of their savings in liquid or easily accessible assets, but in absolute terms this represents about 70% of EU GDP, which is quite significant and raises questions about possible lost investment opportunities. An industry representative tried to see this situation more as an opportunity than a problem. Involving retail more in capital markets is a necessity and must be the main objective of the CMU for the next five years as, ultimately, pooling retail investors' money into saving plans is fundamental, if not a prerequisite, to creating vibrant capital markets.

1.2. Obstacles to the further development of retail capital markets

Risk aversion and limited financial literacy: A policymaker saw numerous obstacles to moving savings out of bank accounts and into financial instruments. Foremost among them is risk aversion. Households prefer a little gain with certainty than the possibility of gaining a higher amount with more risk. This might however change somewhat if negative rates are generalized in bank and savings accounts. An industry representative felt that another reason why people tend to keep their money in bank deposits is insufficient financial literacy. A study by the Banque de France shows that only 40% of Europeans can answer basic questions about financial investments. An investor representative believed that one of the main reasons behind this loss of interest in capital markets is that listed shares and bonds are no longer sold directly to retail investors. Only packaged products are proposed in most cases, partly because they generate more commissions. As a result, distributors no longer know about securities. The speaker mentioned that retail savers nevertheless invest a higher proportion of their assets for the long term than institutional investors, when considering the total held in real estate, investment funds, life insurance, pensions, equities and bonds. These assets also bear some risk. The speaker also noted that it would help if the truth about how much could be lost from bank savings was disclosed to retail clients.

Complexity and lack of transparency of products: A policymaker noted that some retail products are quite discouraging, charging very high entrance fees for example that may take more than 10 years to recover. An industry representative believed that part of the problem is that complex and costly strategies have been added within the UCITS framework. UCITS is a success in many markets, but this complexity has reduced their appeal for retail investors. There is an interest of retail investors in finding appropriate investment solutions, when considering the pool of retail money invested in alternative investment funds (AIFs) for example. The question is how to deliver the appropriate products corresponding to retail investor needs.

Macroeconomic context: The investor representative referred to the current very low or negative interest-rate environment, which could be an incentive for moving money from bank deposits into more capital-market oriented products. An issue however, an industry speaker felt, is that the political and macroeconomic environment e.g. with Brexit, trade wars and other geopolitical events is quite frightening and might deter investors from taking more risks. In this context, households often prefer to limit losses before seeking gains.

2. Initiatives underway: progress made, unintended consequences and shortcomings

2.1. Capital Markets Union (CMU) and the PEPP

It could be said that the CMU has not worked for retail given the statistics mentioned previously, but in fact its actions for developing retail investment have not yet kicked in, an investor representative observed. The CMU needs to be completed on the retail side. Regarding pan European pension products (PEPPs), a 1% cap on fees was proposed. Some industry players disapprove of this. The investor representative felt that this proposal could be dropped if a ban on inducements can be obtained. An audience member was not sure that PEPPs will eventually take off despite the considerable amount of time that has been devoted to finalizing the text and it is still uncertain whether this product will foster a further integration of EU capital markets. The 1% fee cap seems appropriate but there are many other issues such as 'regretful' limitations put on EIOPA's role regarding PEPPs. An industry representative nonetheless believed that PEPPs might help to develop passports for pension funds.

A policy-maker acknowledged that in a liberal economy, fee capping should be anathema, as the market should do it itself, but this is not guaranteed on a cross-border level and excessive fees would hamper a product such as the PEPP. Relative fee capping mechanisms stating that cross-border prices should not be higher than domestic ones have successfully been used in the SEPA context for payments and for roaming mobile phone charges, which makes this an example to follow, although care is needed.

2.2. MiFID II, PRIIPs and UCITS

An industry representative warned that some features of MiFID II and PRIIPs, and also the KIID (key investor information document) and the financial transaction tax (FTT) may hinder the efforts made with the CMU and the PEPP to promote the development of retail capital markets. People need to have consistent incentives

across the different EU legislations, which is not the case at present.

An investor representative agreed that several elements of MiFID II need reviewing to restart the CMU. One suggestion is to ban non-independent advice, because advice is also needed for simple products such as ETFs, listed shares and bonds. Banks are reluctant to offer what is perceived as riskier portfolios including shares and bonds and prefer directing individual savers towards funds or life insurance wrappers. Dark venues that exploded after MiFID II and now represent more than half of equity markets, are another issue and should come into the light. Systematic internalisers (SIs), described by the speaker as 'free riders creaming off the top of regulated markets' are particularly problematic.

A regulator suggested that the growth of the asset management sector that has been experienced in certain member states such as the Netherlands, following the implementation of asset management legislation, could support further retail investment in the capital markets. A policymaker however emphasized that customers need to be able to choose the products what they want to invest in, which is not always possible at present. UCITS is a completely harmonised product across Europe, but all banks and distributors do not provide access to all UCITS funds. Some banks use MiFID as an excuse for not providing certain funds, but if it is the customer who asks for a particular fund, it should be available on an execution-only basis. A second issue is that domestic supervisors have different ways of approving investment products with different interpretations of MiFID. This creates additional costs and frictions when funds are sold on a cross-border basis, which are then passed on to investors. As a result, even the larger asset management firms distribute different products across the 28 member states and these artificial extra costs hinder retail investment across the EU. An industry speaker agreed that enabling investors to choose the products they want is essential.

3. Additional solutions for developing retail investment in the EU

3.1. Developing employee share ownership

An industry representative reported that although there is an increasing take-up of employee saving and share-ownership schemes, around 65% of EU firms are still not covered by such plans. A statistic of the Commission shows that 300,000 firms could be candidates for these schemes across the EU. At present, however, there is no harmonised vehicle that ensures the portability of these schemes between member states. Around 50% of the larger European companies offer broad-based plans covering all employees, but only 10% of these are offered on a cross-border basis.

The passporting potential of employee share-ownership schemes should be leveraged, the speaker stated, because there are many potential benefits from these schemes for EU citizens. Assessments show that they favour the commitment of employees to their company, but they are also often a first step into equity markets and are a way of developing financial literacy. Creating an EU employee share-ownership vehicle to complement PEPPs and existing fund categories could be a relatively quick fix provided tax issues, which are part of this, can be addressed.

An investor representative believed that employee share ownership could be the most powerful tool for reaching the CMU objectives. This has been advocated by investor associations such as Better Finance for many years with concrete proposals and pilot projects were conducted as early as 2014. The fact that the project is now being picked up by the Commission is a positive move. If the EU had the same level of employee share ownership that is currently enjoyed in the US, it would increase its listed equity market by €2 trillion and could multiply flows into non-listed small and medium-sized enterprises (SMEs) by 200. This could also be a solution to bypass financial intermediaries who no longer want to distribute equities and bonds; this latter issue could however change if inducements are banned. A policymaker agreed that the potential of employee share-ownership schemes should be further explored, noting that pension funds also play a significant role in the US retail capital market.

3.2. Improving product disclosures

Transparency and simplicity are key, in an industry speaker's view, when it comes to encouraging retail customers to invest into capital markets. There are opportunities in particular to simplify product disclosure, which is the first element the retail investor is in contact with and make it more consistent. Clients are increasingly seeking for solutions aiming to e.g. preserve capital, grow capital or generate revenues, rather than single products or a particular type of wrap. This is also related to the fact that the European investment market is very much bank intermediated. Investor protection rules will need to be adapted to these changes to move away from the current silo approach. A quick win could be to create a new rule that protects retail investors whatever the product they invest in and that may fit inside the broad framework that existing directives provide.

An investor representative agreed that more transparency and simplicity are needed because MiFID and PRIIPs, notably with the KIID, have not been successful in this regard. The most important action of the CMU in the retail area is to enhance transparency of performance and fees in order to increase trust in these products, which is very low at present. This is because it is not only impossible to know what will be the future performance, which seems normal, but it is also not possible to know precisely the past performance i.e. how much money was made, if the asset manager has met the objectives of the fund or how the product compares with other ones. First reports have been published on this by the ESAs with data notably on UCITS funds and to a lesser extent on AIFs, but further work is needed, as well as a review of PRIIPs.

A policymaker agreed that transparency of performance and fees is probably the biggest obstacle to date to retail investment.

3.3. Enhancing guidelines for product fees

Another issue is the level of fees applied to retail investors.

An industry representative stressed the importance of defining clear guidelines on entry fees and also on management and performance fees. ESMA is currently working on these issues. Some suggest that in today's very low or negative interest rate environment, perhaps fees should be limited to cases where there are positive absolute-returns. However IOSCO has produced some clear guidelines that do not prohibit performance fees when there are no positive absolute-returns. It should indeed be possible for asset managers to have an incentive to provide better returns than the market, even if interest rates are negative. In addition if fees are limited to positive absolute-return situations there would no longer be a common interest with the investor to promote products that are giving very low returns.

A policy-maker disagreed, suggesting that positive-return fees make sense if there is full transparency and the investors understand all the implications. In that case the investor needs to know that the savings will be losing a certain percentage every year for the duration of the investment. An investor representative also endorsed the idea of imposing

fees on positive returns only, as a percentage of the return, suggesting that it should be included in ESMA's consultation on performance fees. This mechanism is already used by some robo-advisers.

Another industry representative believed that attempting to control the level of fees is difficult in a market where participants are for-profit. Great capabilities are also needed to manage assets and manage the risks that need to be remunerated. In addition regulation means compliance which has a cost. Fee levels will ultimately be defined by the market, by demand and competition and may also lead to an evolution of the products offered, hence the development of passive vs active products. Also the level of fees can be misleading. For example, many people believed that ETFs at zero management fee and zero total expense were free, but this is not the case, because there are costs that need to be covered. Instead, there is a need to work on fee clarity, transparency and communication and also on the way fees are structured, in order to ensure that they relate to results achieved and that this can be presented in a simple way.

Following a question from an audience member about the relative importance of costs at the product and distribution levels, an industry representative stressed the importance of understanding who does what in the value chain and the related costs in order for end-clients to have an appropriate perception of the fees. This is challenging in the case of wrappers for example, which is why transparent disclosure is essential, as previously mentioned. The experience in the UK is interesting to consider in this regard. In the past asset managers used to take all the fees and return a rebate but the RDR (retail distribution review legislation) has put an end to this and now each element of the value chain is priced individually. Prices are still pretty high but the objective of the RDR was not to force a reduction of fees but rather to clarify them, which should help to reduce them over time. This is a journey but it is moving in the right direction, the industry speaker felt.

A regulator concluded that transparency is key, but is not just about more information; it is about the comparability and simplicity of that information, making sure that the distribution and production chains that lead to the product also create the right incentives and that the retail investor regains trust in, and understanding of, what they are getting.

3.4. Strengthening EU supervision

Supervisory convergence: A regulator raised the issue that European directives may get implemented in national legislation with different interpretations, potentially hindering cross-border markets. The Commission has said that it may move to a systematic use of regulations, which do not have to be implemented in national legislation, but interpretation issues could still arise, as has been evidenced in the case of MiFIR, MAR or PRIIPs. In this regulator's view, this justifies reconsidering the role that the European supervisory authorities (ESAs) may play, their activities and responsibilities and whether direct supervision that is used for credit rating agencies and trade repositories could be extended to other activities. An industry representative agreed that there are issues with national barriers and gold-plating by some member states that need to be addressed.

Reconsidering the licence application rules of the EU passporting regime: The regulator moreover suggested that the rules of the European passporting regime regarding the location of licence applications should be reconsidered and limited to the countries where the company is performing its activities. Indeed the present rules do not prevent applications for licences from being made in the country with the lowest regulatory regime in the EU, even if the company applying has no real activity in this country. This means that in such a case home-country control and supervision are limited, and the host country has to rely on the supervision of the home-country. Such a system needs to be reconsidered.

Pan-European collective redress scheme: Also on the EU authorities' table is a pan-European collective redress scheme for retail investors, including direct investors, an investor representative mentioned. The proposal is to model the scheme after the excellent Dutch collective redress system so that, unlike the US system, the money goes to the abused investors and not to the class action lawyers.

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[1] Bank deposits represented 34.4% of total financial savings at the end of 2015, and 35.3% today, so are up. Life insurance and pension schemes were 31.6% at the end of 2015 and 33% today, again up.

[2] Investment funds represented 9.1% of total financial savings at the end of 2015 and are slightly lower now. Listed equities were 4.5% four years ago and are 4.2% now. Listed bonds is the biggest drop, from 3.7% down to 2.4% today.