Increasing retail investment in capital markets

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Retail investors are key to relaunch the CMU after the Covid-19 crisis

European capital markets development urgently needs a significantly wider engagement by retail investors, to equip the European Union (EU) with a financial system that can cope with the huge challenges we will be facing in the coming years. This is even more true given the deep, temporary, and hopefully short economic and financial contraction imposed by Covid-19. The flexibility and diversification of savings and credit alternatives offered by financial instruments to families and SMEs, but also to institutional investors, constitutes a significant advantage in supporting the recovery after the crisis, particularly in the context of a banking system under strain.

From a regulator's perspective, it is clear that, moving forward, financial supervisory and regulatory policies cannot focus mainly on market instruments and its infrastructure, as it has been the case in the first years of the EU's Capital Markets Union (CMU). More emphasis is needed on policies aimed at improving investor confidence in the capital markets, as there is no sound market without a wide investor base.

We should therefore focus on three dimensions: stronger financial literacy and investor protection, as retail investors are less prepared against bad market practices and have less capacity to recover from losses; fierce adherence to the highest quality and ethical standards among managers, especially in the financial sector; and on adopting a horizontal and cross-sectoral policy approach to markets, products and supervision that promotes a real single European financial market.

Regarding financial literacy, European initiatives have not been very expressive or effective. In what concerns investor protection, more has been done, and while trying to avoid overregulation, one should keep improving the legal framework and its application, as it being done regarding MiFID directive and legislation. Having said that, measures taken by ESMA, CMVM and other regulators to restrict CFD trading and binary options, or the use of its powers of product intervention, are part of the contribution we have given in this field.

When it comes to strengthening culture and professionalism of supervised entities and executives, the powers enshrined in MiFID, UCITS, AIFMD, EMIR, BMR and the Shareholders Directive allow regulators to assess and act on boards' culture, effectiveness and integrity and they should be strictly enforced. We should not refrain from acting.

Finally, to ensure a thriving European market for banking, investment, insurance and pension products, one should also level regulation and supervision accordingly, namely by aiming at a strong harmonization of the regulation across Member-states, including rules on ownership, insolvency and taxation of financial products.

The relaunch of the CMU after the Covid-19 crisis must be a priority, if we aim to regain our economies to full potential as soon as possible. For this to happen, the financial community as a whole needs to strengthen investor confidence in the capital markets by being more transparent and clearer regarding instruments, fees, rules and procedures; by being more focused on investors' needs; and by improving professional and ethical standards.

Niels Lemmers

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Never waste a good crisis to improve investor protection

The first few months of 2020 have been unique in the recent history of financial markets because of the speed of the correction. Almost all markets saw widespread sell-offs: equities, corporate bonds, commodities, gold and structured products. In the midst of promoting equity investments, the market turned south and had its worst performance in decades. And what years of legislative measures have tried to achieve happened in prompt reaction to the turmoil. In several countries more households started investing in equity. The WhatsApp indicator has arrived. Family and friends ask in WhatsApp groups how to start investing, because now you can get in relatively cheaply. And FinTech initiatives have made it even easier to start. If even the big drop do not keep households to invest for the longer term, then the tide may have turned. A proper, healthy equity culture is emerging. But at these junctures of market turmoil, unsuitable financial products are still being offered to households. Consequently, European Investors urge the reinforcement of investor protection rules.

▶ Regulation has been implemented to ensure investors are advised on the benefits of equity investing with a long-time horizon. Unfortunately, investors are also buying complex structured products because they have been told that this would be a safeguard. Such advice is also based on regulations. Before the drop, the market was quiet and the delta was low so structured products were als quiet and reassuring. Then markets plunged precipitously, structured products fell even harder and their delta increased. The markets became more volatile and structured products were carried along with them. As soon as the barrier in the structured product is crossed, it is transformed from a capital-protected product into a unconditional loss. When unwinding the structured product, the issuer also needs to unwind the derivative hedges that were necessary initially. As derivatives markets became particularly illiquid, the cost of unwinding hedges increased, resulting in lower unwind prices for the structured product. Was this potential risk and painful scenario also properly explained to the end investor?

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Never waste a good crisis, they say. Retail engagement in capital market is important to build that proper, healthy equity culture in Europe.

Understanding the trade-offs in the market is just as important, however. If anything, the ongoing reviews of the MiFID II/MiFIR and PRIIPs regulatory frameworks need to address two issues. First, investors should always receive clear and unbiased investment advice, giving them a realistic picture of how financial markets and products function.

The financial education of households will take time, maybe decades, but it all depends on the information given before entering the capital markets. Second, some products are hardly suitable for investors. Certainly not in volatile markets like those we are currently seeing. Without wanting to diminish the investor's choice, we need to be cautious.

We can only have these products on the sales board if investors were told about the risks and returns of these products. Strong and enforceable regulation is needed in this area. Preferably steered by ESMA. European Investors calls upon the European Commission and Parliament to act swiftly.

Retail investors don't need a new 'CMU part 3'. They need reinforcement of the current regulatory framework and investor protection rules. ●

Javier Hernani Burzaco

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Boosting the flow of retail investment into capital markets

I head a financial group that has traditionally been proud of attracting high levels of retail investment.

Delving into my old papers while I was preparing this piece, I found that in 1998 a stunning 35,1% of our total market value of shares was in households' hands, ranking second after non-residents with a 35,9%, being the rest of holders banks, corporates, UCITS and public sector.

Unfortunately, the tune has changed since then, and in 2018 the figure had fallen to 17,2%, three points below ten years earlier. But there is always a silver lining: this figure shows a convergence with the rest of the continental exchanges –where direct retail investment has been lower– and almost 2,5 million Spanish households hold listed stocks within their portfolios.

There are several reasons that account for this trend. The most evident is the growth of investment funds. They provide fiscal benefits and are easily marketable by banks and, therefore, are a competitor difficult to beat. While 5% of the households' savings is directly invested in listed stocks, 14% is invested in funds. Market behaviour –particularly in sectors that whet retail investors' appetite, like banks–, also discouraged direct retail investment.

Finally, like the rest of Europe, Spanish financial sector is predominantly driven by bank products.

I mentioned above that there is a low level of retail investment across Europe. If we agree on the importance of retail participation in financial markets in order to release financial resources to fund companies' growth, we must admit that there is a European problem. ▶

If retail investors do not find easy ways to channel savings to productive investment, something is not working well in the Europe of the CMU.

In the CMU Green Paper, five years ago, the Commission stated that the development of capital markets in the EU required, among other measures, boosting the flow of retail investment into capital markets to diversify funding sources, which only could be achieved by enhancing the confidence of retail investors in capital markets and its intermediaries.

However, in the Midterm Review, four years later, the Commission acknowledges that engagement by retail investors with capital markets remains low, even though European households are amongst the highest savers in the world. The diagnose remains unchanged: most of the savings are held in bank deposits and accounts.

CMU must promote initiatives to increase levels of retail investor participation in public capital markets.

So, the measures have been insufficient and extra efforts are needed.

Maybe we should think carefully about the design underlying our European financial markets and particularly, financial regulation. Blue chips squeeze less liquid stocks out. Big issuers leave no room in the marketplace to small and medium companies.

Investment advice limitations also contribute to make SMEs invisible. Small intermediaries are disappearing, cutting the links with the local financial ecosystems. Costs and lack of transparency throw retail investors out...

Daniel Kapffer

Member of the Management Board, DekaBank Deutsche Girozentrale

CMU on the tipping point – retail investments are key for sound economic development of the EU

Participation of retail investors in capital markets is absolutely crucial for two reasons. On the one hand, households and other retail savers are the main source of long-term funding for the European economy. Without sufficient retail investor engagement, the high dependency on bank loans will persist. On the other hand, pension schemes will not provide enough retirement benefits to maintain living standards.

Retail investors need to build a significant component through capital markets investments. That's why the CMU aims to foster greater participation from retail customers.

There is no doubt – investor protection rules are fundamental to a healthy development of retail investments in capital markets. However, if they result primarily in significant obstacles, they will only prevent investments.

European regulation seems to follow the idea that the client should be able to have a deep understanding of his potential investments similar to that of his investment advisor. This results in a significant complexity even for a simple investment in a plain-vanilla instrument. Consequently, it not only scares the retail investor but also denies a fundamental principle of modern economies – specialization.

Short and easy to understand information is fundamental for investor confidence

The recent EU regulations Packaged Retail and Insurance-based Investment Products PRIIPS and MiFID/MiFIR have aimed at reducing complexity and helping retail investors better understand the key features, risks, rewards and costs of different products through a short key information document. However, MiFID and PRIIPS have not been harmonized, particularly as costs are concerned.

Another issue that has already been taken on by regulators are the performance scenarios that might lead to very misleading information on returns. Also, the high degree of standardization (for example SRRI) has replaced qualitative descriptions of the key risks. In the end retail investors receive less information that might even be more confusing.

...investor protection rules are fundamental to a healthy development of retail investments in capital markets.

Convenience stimulates confidence and reduces obstacles

In order to achieve the two goals retail clients, need to invest on a regular basis into the capital markets. A one-time investment will not provide enough benefit. However, the rules set out especially in the MiFID/MiFIR for retail clients do not make a difference between different levels of retail investors. For each single transaction the whole set of requirements applies as it did for the last one even if this was in the same financial instrument.

▶ Product information documents, ex-ante and ex-post cost statements and other complex regulatory rules are difficult to digest for retail investors and so discourages them from investing in financial markets. The lack of convenience leads to a lack of confidence, which affects not only direct retail participation in capital markets, but also the indirect forms of investment available through the variety of collective investment vehicles, like investment funds and pension funds, because it lowers the general investors' demand for access to capital markets.

In addition, the requirements regarding a timely provision of ex-ante information are a significant obstacle for investments via distance communication channels – in the age of digitalization a major channel. To ensure that these clients can use a means of distance communication effectively, and to ensure the timely conclusion of transactions, more flexibility is required.

The need to record phone conversations should be deleted especially because of privacy concerns for customers and the potential to impair the confidentiality of communication between investment firm and client.

Overall the regulatory approach has increased obstacles for retail clients to invest in capital markets while generating extremely high implication cost and increased cost of service for investment firms. The CMU can only evolve with investors who feel convenient and comfortable with their choices. ●

Paul-Willem van Gerwen

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How a strong CMU could help reduce the fall-out of the Covid-19 crisis

In 2020 we saw global disturbance, as a result of the outbreak of Covid-19, resulting in markets being in turmoil. The current situation makes the case for a CMU even stronger – the need for highly integrated markets, with deep liquidity and available unlocked capital flowing freely. Facilitated by an appropriate set of rules this will offer companies various financing options by different types of market participants and financing providers.

A recurring key element to strengthen the CMU and increase funding options for companies across Europe is in achieving stronger participation among retail investors in capital markets and to provide them with more cost effective, simpler financial products and fair advice.

In relation hereto, building adequate and sustainable pension systems will help the retail investor to indirectly enter the capital markets by savings for his or her retirement. It would be worth exploring both public and private sector options to improve pension adequacy in member states with less developed pension systems.

Also, further improved investor protection on EU level is required to achieve retail participation suitable for cross-border activities and open, transparent capital markets. In light hereof, the current EU passporting system, while being a cornerstone of the internal financial market, still faces challenges with regards to its implementation in the respective EU countries, as NCAs might hold different views on how to operationalize different EU legislation. This in turn can lead to 'jurisdiction shopping' where financial services companies seek the jurisdiction that applies specific requirements less intrusively.

Another key prerequisite for the CMU to become successful is the availability of transparent, integrated, standardized and highly liquid secondary markets covering various types of financial instruments such as equities and bonds.

As recent events have shown, market liquidity is essential in times of severe stress conditions as demonstrated during the current fall-out of the Covid-19 crisis, particularly for firms to retain access to funding. While the equity markets remained open and liquid (though highly volatile), the European bond markets came to a near-standstill with liquidity all but completely evaporating, particularly in the corporate bond market.

> *A fully integrated CMU is essential in avoiding future market collapses of any kind.*

In light of the strengthening of the CMU, it would be worthwhile to trigger a discussion on further improving the foundations of the EU-bond markets, particularly allowing for more open equity-like transparent market structures enabling cash-strapped companies with more direct access to retail savings. As the current primary and secondary bond markets are highly dominated by banks and the volumes of new issuances make bonds almost illiquid by nature, a necessary prerequisite would be further standardization of eligible instruments. This would enable access and liquidity provision by a more diverse landscape of market participants ranging from banks, professional trading groups, institutional and retail investors. Fundamentally, rather than central banks purchasing bonds of the balance sheet of banks to trigger the provision of credit, a more sensible approach could be offered by a strong CMU enabling firms to seek funding through a multitude of sources. ●

Judith Hardt

Senior Advisor, Better Finance

Retail investors are the key to the completion of the Capital Markets Union

There have been several attempts to build an integrated and resilient Capital Markets Union. From the perspective of Better Finance, the CMU project still lacks a solid individual retail investor base. 50 years ago, households were the primary owners of European stocks[1]. Today, foreign investors hold 32% of Eurozone listed equity, while households' ownership represents merely 11%. EU savers who have financial investments[2] gain exposure to the EU economy mostly indirectly, through packaged products (insurances, pensions, etc.), while listed shares account for only 4% of their financial balance sheets[3]. This is because investors are being "sold" packaged investments which are unfortunately often quite expensive and fee-laden products. They are very rarely offered 'plain vanilla' shares.

This development had a negative impact on Europe's capital markets. The market capitalisation of listed equities in the EU is almost three times smaller than in the US. SME fund themselves to a large extent through bank loans. In addition, dark trading increased despite the double volume cap introduced by MiFID II. About 60% of equity trading now takes place over the counter, versus 20% -40% before MiFID I.

To integrate capital markets, you need to integrate investor demand and retail user's perspective into the equation. Household savings are the foundation of any capital market. The first sentence of the Interim Report of the High-Level Forum on the capital markets union notes the following: Demographics clearly show that pay-as-you-go pensions will increasingly need to be supplemented by life-long intelligent saving and investing. If low interest rates persist in the long-term, savings accounts will no longer be a mechanism to increase the value of one's savings. This will only be achieved through a large-scale switch to equity investments.

It has become increasingly clear that the CMU must provide real investment opportunities for citizens to help them prepare their long-term needs, such as retirement, health and education.

To achieve this, investors firstly need easier access to specialised and truly independent expertise. The MiFID 2 and IDD reviews must eliminate inducements, at the very least for execution-only services, regardless if the investment products are insurance-based or not.

Secondly, Better Finance believes that it is paramount to develop and incentivize Employee Share Ownership. This could be the single most powerful driver to develop equity markets and culture.

Thirdly, the PRIIPs framework must be reviewed as popular "retail" bond markets decreased by 70%, due to the new KID requirements.

Finally, individual investors need free and easy access to pre and post trade information on the listed securities they buy. All "retail" trading, must be brought back to regulated markets. ●

This article has been co-writen by Stefan Voicu, Research & Policy Officer of Packaged Investments, Pensions & Insurances, Better Finance

1. Didier Davydoff, Daniele Fano, Li Qin, 'Who Owns the European Economy?' (August 2013) Observatoire de l'epargne Européene, Insead Oee Data Services, p. 86, Annex 5, Table 3.
2. A survey in 10 large Eurozone Member States shows that, on average, only 43% of citizens do have financial investments, which speaks a lot about both households' participation in capital markets and financial inclusion; see European Commission, 'Study on the Distribution
3. See BETTER FINANCE's CMU Assessment Report 2015-2019, https://betterfinance.eu/wp-content/uploads/CMU-Assessment-Report-2019.pdf.