SESSION SUMMARY - BERLIN SEPTEMBER 2020

How to develop retail investment in the capital markets in the EU

1. Recent market trends since the Covid outbreak show increased retail participation

An industry representative emphasized the positive trend observed this year in the development of retail investment in equities. At one of the main French e-brokers, turnover increased by almost 49%, and the number of new clients by 232%, many of whom were investing in the markets for the first time. A vast majority of retail orders were purchases, showing that retail investors played a vital role in the liquidity of the market during the high volatility period of March and April 2020.

Another industry representative confirmed that overall in France there had been three times the number of stock subscriptions and newcomers in the market during the first months of 2020, compared to previous years. A significant amount of savings was also accumulated by retail savers during lockdown (€ 100 billion in France, which is the equivalent of about 10% of the annual GDP and approximately the size of the recovery plan recently announced by the French government). Similar trends were observed across Europe, although there were some differences, for instance, Germany saw massive cash withdrawals. Caution however prevailed, because most savings were in cash deposits, rather than equities.

A regulator confirmed this positive trend, highlighting some conclusions from a quantitative study recently published on the impact of Covid on retail investment behaviour. The study examines whether individuals bought or sold more shares of the domestic index during the crisis and analyses whether behaviour differs by age group and investment frequency using a comprehensive set of more than 3 million transactions. The results show that during the peak of the crisis, between 24 February and the end of April, investors traded five times more index shares than in the period just before. Younger investors between 18 and 35 years of age were the most active during the crisis period. 'Infrequent investors', meaning those who made a maximum of five transactions in the two years before the crisis, bought 10 times more index shares in March compared to the previous year. Generally, the study confirms the tendency of retail investors to take a contrarian strategy and go against market trends.

2. Main objectives and reasons for developing retail investment in capital markets

The speakers on the panel agreed that developing retail participation in the capital markets, both direct and indirect, is essential for ensuring pension adequacy and funding the real economy and also for achieving the Capital Markets Union (CMU). The role played by retail investors in market liquidity and maintaining an equilibrium in the market, especially in volatile periods such as the beginning of 2020, was also emphasized. The 'contrarianism' of retail investors means that they are likely to provide more liquidity than institutional investors and financial intermediaries when markets are under stress, an investor representative emphasized.

2.1 Ensuring pension adequacy and increasing returns for investors

A major reason advanced by a policy maker for developing retail investment is for them to obtain better returns and prepare more appropriately their retirement, especially in view of the current strains on public finances.

An investor representative added that more retail investment in capital markets is necessary for ensuring pension adequacy. Studies show that current long term pension savings are not likely to provide savers with sufficient real return. In the EU, 35% of financial savings are in bank accounts and 38% in very packaged products, such as life insurance, with a dominant share of the investments in fixed income. This is due in part to the fact that some regulators and providers have wrongly assessed investment risks by failing to take the time horizon and long term impact of product costs into account. One example is money market funds, which are still one of the main asset classes in which corporate defined contribution (DC) pensions invest in France. These funds may be less volatile in the short term but lead to quite high losses in the long term, compared to other instruments. With the Covid crisis, financial repression[1] has reached an all time high, and EU citizens and pension savers have been losing a great deal of money after fees and inflation with bank saving products. The situation is the same for all life insurance capital guaranteed and long term packaged products, which are mostly invested in fixed income.

A regulator agreed that in a low interest rate environment, relying heavily on bank deposits and fixed income is counterproductive. The figures show that net performance of equity, for example, annualises to around 7% between 2008 and 2018. It would have been nearly zero for banking savings. The situation however varies across the EU with higher levels of investment in capital markets in certain countries, from which lessons can potentially be drawn.

Another regulator added that investments that offer better returns and prospects are an opportunity for retail investors, who are faced with low interest rates for a prolonged period. The development of ESG-compliant products could provide

[1] Policies that result in savers earning returns below the rate of inflation in order to provide cheap loans to banks and governments, reducing the burden of their debt.

another source of attraction for the younger retail investors in particular.

2.2 Funding the real economy

A policy maker also stressed that developing retail investment and facilitating the channelling of household wealth into businesses is an important element of the response to the Covid crisis. While bank lending is instrumental in mitigating the impact of the pandemic on firms in the short term, it is unlikely to cover the magnitude and duration of the EU's financing needs sufficiently. Funding sources have to be better balanced across the European economy because market financing is essential for sustaining recovery and growth in the longer term.

The investor representative explained that households are the major source of funding for the real economy, as they are by far the biggest net creditor among economic agents. Individual retail investors are indeed more long term oriented and relatively less risk averse than institutional investors. It is also documented that they are willing to invest more in SMEs, which is greatly needed for European job creation and innovation. A regulator added that encouraging more SMEs to go to the market would also provide investors with more diversified investment opportunities.

Another regulator agreed that retail savers are the largest holders of financial assets in Europe, but pointed out that only 18% of these assets are invested in financial instruments.

An industry representative also saw new opportunities associated with the investment of the huge amount of excess savings accumulated during the first months of 2020 into infrastructure projects, company equity and responsible investments for the longer term.

3. Conditions for developing retail investment

3.1 Ensuring investor protection and trust

Maintaining a high level of consumer protection and market integrity is necessary for fostering retail participation in capital markets, a regulator stated. Trust is key to this. This means that the easing of market abuse rules that has been proposed (e.g. regarding insider information), should be handled cautiously, because it may lead to a negative perception of the integrity of the market. Another regulator emphasized that investors need both appropriate products and an adequate level of protection. This is because equity investment involves participation in the capital structure of companies, which entails significant risks. Investment funds may provide retail investors with appropriate diversification and protection. However, in order to attract more retail investors, the financial community should endeavour to provide simpler products with an adequate level of fees and costs and that are compatible with a long term investment perspective, such as ESG-compliant products.

An industry player added that the involvement of retail investors is also conditioned to transparent and liquid markets that make the expectation of future gains possible.

3.2 Providing adequate access to capital markets for retail investors

An investor representative felt that the access of retail investors to capital markets is very limited at present and this is partly due to investor protection requirements imposed by the public authorities and financial intermediaries.

A regulator considered that allowing the access of retail investors to capital markets is a question of democracy and that creating inequalities should be avoided. It is however a controversial question, particularly in times of crisis and with the persistence of low financial literacy standards. An appropriate balance needs to be found and policy makers must act carefully both in terms of regulation and supervision to ensure investor protection and avoid the unintended consequences of hindering retail participation to capital markets. A precondition is for retail investors to understand that, in case of economic difficulties, investment losses may occur in capital markets.

Another regulator added that retail investor participation in the capital markets is both a demand and supply–side issue. For the time being European citizens have mainly relied on financial intermediaries such as banks for saving for their old age. One reason is that banks are close to their clients and there is a large number of branches that provide their customers with all the essential financial services including savings. It is also important therefore that distribution networks supply their clients with the right information on capital markets to enable them to make the right choices about their savings and investments.

The investor representative moreover questioned whether retail investment is really a priority for the EU public authorities, when considering the different recommendations made for achieving the CMU, including those from the CMU High Level Forum (HLF) published in June 2020. One example is the recommendation of the report not to discriminate individual direct investments by retail investors in equity and fixed income instruments, by including them in the scope of the Directive on representative actions for the protection of the collective interests of consumers. Later in June, the Wirecard scandal was further proof of the need to restore trust in individual investors. About €20 billion was wiped out, notably from pension savers, laying bare huge failures of corporate governance, public supervision and external auditing. Despite this and the HLF recommendation mentioned previously, the EU authorities did not include individual shareholders in the scope of the proposed directive on collective redress. Addressing this issue now should be a major priority, the investor representative believed.

4. Policy priorities for increasing retail participation in the capital markets

The panellists welcomed the focus in the recommendations of the CMU High Level Forum (HLF) on increasing the participation of retail investors. The development of retail investment should indeed be one of the key themes of the CMU 2.0 project. A policy maker stated that the relatively low level of retail investor participation in a large number of domestic EU markets is one of the main reasons why EU capital markets are not achieving their full potential. While household savings in the EU are high, retail investor participation is relatively low in a large number of domestic EU markets, though there are differences between member states. The speakers highlighted some priorities.

4.1 Ensuring the adequacy of costs and charges

A regulator considered costs and fees to be a key issue; at present they are sometimes too high in the EU and not always sufficiently transparent and comparable, undermining investors' confidence and significantly impacting investor return. Another regulator reported that ESMA had issued a supervisory briefing indicating how European supervisors should converge in their interpretation of undue costs. Given their impact on investors' returns and confidence, ESMA has to make sure that costs are transparent, comparable and supervised in the same way across Europe. The recommendation of the CMU HLF on disclosure and distribution should also be translated into concrete measures that allow for proper cost and return comparison tools. ESMA has undertaken work on performance fees and making sure they have an appropriate framework in order to ensure their transparency and fairness. The guarantee that the same products and risks are regulated and supervised in the same way across the EU would not only provide protection, but also foster cross border investment.

Another important issue concerns inducements and the potential conflict of interest between providers, distributors and clients they may create. The first regulator welcomed the recommendation of the HLF report to further assess this issue. Some EU countries, by restricting the acceptance of inducements, have indeed improved access to high quality services and low cost products. The second regulator considered that stricter inducement regimes would lead to more transparent cost and fee disclosures and would also help to enhance cross-border investment.

An industry representative stated that the costs of cross border retail trading should also be reviewed. These are too expensive in the EU, especially because of the post trade process. Clients consequently prefer to trade in the US market, on Nasdaq or NYSE, which are less costly. Further legal and fiscal harmonisation are needed in the EU to tackle this issue. A regulator added that creating the appropriate context for cross border retail investors would further enhance the attractiveness of EU's capital markets.

4.2 Improving transparency, disclosures and research

An industry representative noted that, although there is a complete set of legislation on product disclosure, the goal of providing investors with meaningful and comparable information between investment products that was pursued with PRIIPs has not been achieved. An investor is not looking for detailed information about each type of product, but for thematic information about the sectors or areas covered by different investment products and the related risks and performance. Different rules or interpretations across member states e.g. in the case of ESG investment add an extra layer of complexity. More harmonisation is needed in this respect for achieving a common CMU.

A regulator agreed that improving PRIIPs and further aligning the MiFID and PRIIPs frameworks is necessary. Comparability across all products is essential for providing investors with appropriate and comparable information. Improving equity research is another objective. However the regulator advised care in rolling back the unbundling rules of MiFID II[2], recalling that these were introduced to improve the overall distribution and clarity of the money being spent on research. Solutions need to be found for improving the availability of research on SMEs, but this does not necessarily mean suppressing the unbundling provisions which were an important improvement of MiFID II.

The recommendations of the CMU HLF on financial literacy, investment culture, disclosure and distribution 'fall a little short', in one regulator's view. These issues, which relate in part to governance, professionalism and ethics should be at the top of the European priorities given the behavioural problems that have been affecting the market in the last few years. Such issues are key to fostering investors' confidence. It is important in particular to launch a harmonised complaints regime in Europe, and ensure that ESG products and supervision are appropriate, provide investors with clear and credible information and meet investors' needs.

4.3 Developing private pension and employee shareholding schemes

An industry representative emphasized that employee shareholding schemes are a relevant and concrete solution mentioned in the HLF report for developing retail participation. However, such a solution should be based on investment funds in order to facilitate cross-border investment. This would help to provide liquidity for non listed companies as well as larger pan European groups. The CMU action plan is an opportunity to push for such a concrete solution. Investing in the equity of your own company is often the first step towards investing more in equity in the future. A regulator added that it is important to foster more retail and household participation in private pension systems. Some member states already offer good examples of this.

4.4 Improving investor education and information and assessing the role of inducements

Several speakers mentioned the importance of investor education in supporting more retail investment. A regulator stressed that this ambition put forward by the CMU HLF must be encouraged. Ensuring that retail investors and SMEs make wise financial decisions is however a complex task. Initiatives have been put in place by some domestic supervisors, such as the Wikifin Lab in Belgium. This is an interactive experience centre for financial education designed for secondary-school students, with a fully digital trajectory, located at the premises of the FSMA. It provides them with tools allowing them for example to balance their budget by analysing their own consumption, their saving capacity and related risks and the consequences of these choices for society.

Some limitations to action at the EU level in this area were also discussed. An investor representative pointed out that the EU has no competency for young people's education. A regulator agreed that financial literacy is mostly the responsibility of member states, but felt that this action could be better coordinated at EU level with a combination of top down and bottom up approaches. Another regulator suggested that ESMA could play a concrete role in coordinating domestic financial education actions. This would be relevant because educational programmes in different member states could learn from one another.

The investor representative believed that much can also be done at EU level to improve the level of information and education of adult consumers on capital markets, starting with actions at the point of sale. The way to favour better information at the point of sale is to put an end to kickbacks or inducements for packaged products. This would put them on an equal footing with direct investments such as exchange traded funds or ordinary stocks, for which there are no inducements. This has also been picked up by the CMU HLF, which suggested that the Commission should study the role of inducements in the adequacy of advice and sales processes, including the role and impact of inducements in execution-only services, and that it should examine how the inducement rules under IDD (Insurance Distribution Directive) can ensure a sufficient level of consumer protection consistent

[2] Through which sell-side brokers are now obliged to unbundle their research from other services provided to clients and on the buy-side, asset managers now explicitly need to pay for research themselves.

with the investor protection standards applicable under MiFID II for insurance-based investment products (IBIPs). The Commission was also invited by the HLF to put forward the appropriate legislative proposals, including a prohibition to accept and retain inducement paid for the distribution of IBIPs where distributors provide independent advice or portfolio management services to clients.

4.5 Reviewing retail investor categorisation

A regulator considered that the uniform application of investor protection rules may unnecessarily hinder the access of more experienced retail investors to certain products. Introducing a new category of qualified investors in MiFID, as suggested by the CMU HLF, could solve this problem. Another positive proposal of the HLF report is to introduce a definition of 'shareholder', which is a challenging issue however because it is linked to civil law in certain member states. Developing ELTIFs would also help to improve the participation of retail investors in more long term sustainable investments that may be too illiquid for direct participation. But there are currently differences between the target investors identified by ELTIF producers and distributors, hindering the access of retail investors to these products.

4.6 Ensuring effective and convergent supervision

Several speakers emphasized the importance of appropriate supervision and supervisory convergence for developing retail investment.

A regulator considered that supervision has a critical role to play in providing investors with appropriate levels of protection and that enhancing supervision is preferable to additional regulations, which may create extra burdens. This is the objective pursued by ESMA's Investment Management Standing Committee, which has been working on measures aiming to provide investors with the appropriate conditions for investment and increasing their level of trust and comfort. Actions are also being undertaken by ESMA for improving supervisory convergence, which may help to unify supervisory and management practices and tools pertaining to retail investment products such as liquidity management tools for investment funds.

Another regulator agreed that adequate and more consistent supervision is necessary for achieving appropriate disclosure and risk/reward for investors. Supervisors can for example put in place actions to ban products that are excessively complex. A voluntary ban on complex products, which was proposed in Belgium 9 years ago, has been very successful and is now widely supported by the financial industry. Supervision can also ensure that information is appropriately communicated to retail investors, particularly with on-going evolutions such as digitalisation. It is also important to define who is best placed to supervise parts of the capital market, the regulator stated. For wholesale and third country aspects, this is ESMA. But for specific national financial markets, the National Competent Authority (NCA) is usually better placed, provided there is sufficient supervisory convergence.

Another regulator added that proactive and effective supervision can help to ensure market transparency and integrity, which are important for investor confidence. For that the European institutions need to work closely with the NCAs. ■