Retail Investment Strategy: key issues

1. The upcoming Retail Investment Strategy proposal

The Chair stated that the upcoming Retail Investment Strategy (RIS) proposal due to be published by the end of May 2023 will be a key element of the Capital Markets Union (CMU) action plan. Retail investment is a key driver of the development and growth of EU capital markets, and beyond this, the RIS is also about increasing the interest of savers in investing for their future, matching investor needs with the funding needs of the economy and improving the effectiveness of the investment process.

An industry representative noted that the RIS should help to fund the transition to a green economy. It should also contribute to diversifying retail investments and boosting their return in a context where purchasing power and savings are eroded by the current high inflation rates.

An investor representative stressed that the CMU should not only work for the economy but also for people. Increasing citizens' participation in capital markets is essential.

2. Inducement rules: possible approaches and related implications

2.1 Potential benefits of a further restriction or ban on inducements

The Chair noted that the Netherlands (NL) banned inducements 10 years ago and is the only country in the EU that has chosen that approach so far.

A regulator stated that the ban was introduced after the NL had had a mis-selling scandal on top of the banking crisis in 2008. There was a realisation that the culture in the financial sector had to change and also a broad consensus within the financial sector that investors' interests needed to be better taken into account. This led to a ban on inducements which took 2 years to implement, as industry players had to alter business models in order to accommodate this new rule.

Suppliers now compete on the price and quality of products and focus more on investor outcomes, which has led to much lower costs for investors. The NL has among the lowest investor costs in the world, which is very beneficial for consumers. A reduction in costs of about 50-basis points makes a significant difference in the overall outcome for investors when compounded over many years. Advisors have also started advising simpler products, such as Exchange Traded Funds (ETFs) instead of more costly structured products, because there is no longer an incentive to sell complex products if these do not correspond to investor needs. Advice is also provided through digital channels in quite an innovative way. It is a misconception that inducements allow the provision of free advice, the regulator stated. It is not free because the costs are paid elsewhere and it is often more a sales pitch than advice.

In terms of enforcement, the ban on inducements has required supervisors to step in to make sure that rules are not circumvented through other forms of payments. There is also a risk of supervisory arbitrage and unlevel playing field if companies based in countries that have a different system target Dutch customers. However, despite these challenges, the experience in the NL after 10 years is satisfactory, with lower costs, simpler products, and a lively advisory sector and it is hoped that the EU can move towards more consistency in this area.

2.2 Issues raised by a potential ban on inducements

An investor representative agreed that inducements can create undue costs for consumers and also conflicts of interest, but more generally the main problem in the EU is the scarcity of independent or bias-free advice, which is a major obstacle to the development of retail investment in capital markets. The non-independent advice currently provided, that is paid for by inducements, results in limiting the exposure that customers get to lower cost products such as ETFs and listed securities and reduces investment returns over time. Statistics show that over the last five years, the funds sold with advice returned half as much as the non-advice ones, which is a huge detriment.

Differences in the structure of retail investment markets and distribution channels across the EU however need considering, a regulator stressed, because this may lead to different effects from an inducement ban. In some markets, such as France, where bank branches account for most of the distribution of investment products and also hold major investment management and insurance activities, the impact may be quite detrimental. Those banks are already under some pressure in terms of profitability and it can be expected that a ban on inducements would lead to a reduced availability of advice for low to median income households who cannot afford upfront advice fees. In addition, bank networks would have a strong incentive to limit distribution to in-house products, which would not encourage competition and probably not be beneficial for consumers either.

An industry representative emphasised that the different levels of maturity, financial knowledge, purchasing power, regulation, and access to capital markets that exist across the EU need to be taken into account in the implementation of the measures proposed. A common need across the EU is empowering people to take the right financial decisions for themselves, and to understand the opportunities and risks of different investment options. This requires a continued effort to develop a mature decision-making process among citizens regarding investments. That effort needs funding, and part of that funding comes from inducements. Inducements are used to offer free financial advice, which enables people with different levels of wealth to participate in the markets and have information to take the right investment decisions. A majority of people are indeed not ready to pay for advice upfront in most EU countries.

An industry representative observed that while inducements currently raise certain concerns, a ban would be disproportionate because of the various unintended consequences. It would reduce choice for customers leading to a stronger focus on domestic and in-house investment products. In addition, it may lead to a reduction of the availability of advice. The ban on inducements in the UK following the Retail Distribution Review (RDR) led to an advice gap with many customers no longer having access to advice. With about 7% of fees charged for advice on average, only the wealthiest and more financially literate people now use financial advice in the UK.

2.3 Alternative approaches regarding inducements

The Chair noted that the debate on inducements was often binary, but there are some intermediary solutions worth considering.

An investor representative suggested that alternative solutions to a ban have also to be looked at. One key measure would be to ban inducements on transactions where there is no advice and where it is obvious that no payment should be due. Other areas for consideration include the improvement of transparency on inducements and ensuring that investors get value for money and are dealt with fairly. A third area is to assess how competition can be encouraged in the market to tackle high costs in the provision of retail investment products. Finally, the conflict-of-interest rules across different product categories should be harmonised and MiFID rules that cover conflicts of interest in particular and that only apply to 15% of savings and investment products at present, should be extended to other categories of retail investment products, such as insurance-based products and cryptoassets.

A regulator commented that the prevailing distribution model in Europe is non-independent advisors recommending inducement-paying products. The implementation of MiFID rules has not led to a significant change in that regard. Consumers do not wholly understand what they are paying for, which means that disclosures are ineffective in this area and that increasing disclosure on inducements would not be very helpful. There need to be more radical proposals and significant changes to the current market structure to deal with the issues and encourage investors to engage properly in the financial markets.

An industry representative noted that the insurance product market is not in the same situation as the NL market was 10 years ago. There is a strong EU regulation in place, the Insurance Distribution Directive (IDD), that has resulted in a decrease of customer complaints in a number of key EU markets. The aim of life insurance and asset management products providers is not to maximise commissions but to be able to leverage the use of different distribution channels in the best way to serve their customers. At present major insurance firms sell their products through different channels, some, where commissions are paid and other that use fee-based advisory models. What is needed is to move towards a real open architecture where product providers can provide products through different distribution channels, and savers can use different types of channels in a transparent way, with or without advice and with an understanding of the implications e.g. in terms of costs. Referring to a previous remark about the possibility of enhancing consistency across the rules applying to different categories of investment products, the industry speaker acknowledged the importance of this issue, e.g. for insurers that operate both in the asset management and insurance sectors, but it is easier said than done.

A second industry representative stated that there is room for improvement on the inducement and the advice mechanisms in the EU without actually banning inducements. There are examples of best practices across the EU that need considering. Increasing the adoption of digital advice is an area of improvement, as well as enhancing disclosures to allow for digital engagement. It is essential that citizens are better informed about savings and what they can do to obtain better outcomes.

A third industry representative had a neutral position on the question of inducements. What is important is to ensure that clients' long term goals are taken into account and that recommended products and solutions are aligned with these goals and provide appropriate outcomes.

A regulator mentioned that, in certain countries, financial guidance is provided through public bodies, which could be a cheaper and impartial option worth considering, particularly during a cost of living crisis, as a stage prior to the provision of regulated advice, to help consumers identify their options and narrow down their choices, but not telling them what to do or which product to buy.

3. Main priorities and areas of focus to be considered in the upcoming Retail Investment Strategy

The panellists highlighted a number of areas on which the Retail Investment Strategy should focus, beyond the questions of inducements and advice. These include product governance, value for money, the need to adapt rules to the digital age and to enhance cross-border supervision.

3.1 Product governance and value for money

The Chair observed that suggestions have been made that the design and governance of products upstream in the value chain should be addressed in the RIS in addition to tackling point-of-sale issues such as inducements.

A regulator noted that the value for money of investments is an important element for savers on which progress is needed. 40% of them consider that the products that they are sold do not provide sufficient value for money, according to a recent Eurobarometer survey. The objective of improving product design and governance is taken into account in the Product Oversight and Governance (POG) requirements that require insurance firms to consider the best interest of customers during product design and throughout the lifecycle of a product. Proposals have been made about how to measure POG and implement it in a consistent way across EU supervisory authorities. The same should be done for value for money, so that it can be assessed in a consistent way by the national competent authorities (NCAs). Monitoring tools should be introduced, allowing the supervisory authorities to intervene, when the basic requirements in terms of value for money are not there, both at national and European levels. There should be a consistent approach to this issue across the Union because many investment products are sold across borders.

An investor representative suggested that a further objective should be to facilitate the access of retail investors to simple investment products such as ETFs, and listed securities. The retail bond market has mostly disappeared in recent years due in particular to inducement-based retail distribution and high investment thresholds. The focus of many intermediaries has instead been on more complex products such as structured retail products, e.g. based on complex indices, that have offered limited or negative returns over the last 5 years.

A regulator stated that the end outcome for investors and the value for money ultimately obtained are essential for investors. There has been a decrease over the last few years in the costs that investors face, but these remain significant and can represent up to 30% of the initial investment over a period of 10 years.

An industry representative stressed that value for money needs to be considered across the value chain, taking into consideration all intermediaries. A consistent framework is needed to achieve this because clients need to trust that value for money is assessed in the same way whatever distributor or product provider they select. This is important to build trust in the market and increase individual saver market participation. However, besides value for money, many other factors need to be taken into consideration such as performance, suitability and service levels. A European Long-Term Investment Fund (ELTIF) will always be more expensive than an ETF, so clients' preferences need to be looked at from a holistic portfolio perspective.

It is also important to build on best practices observed in the EU in terms of retail investor experience and tools used to facilitate investment, the industry speaker suggested. An example of best practice is the Investeringssparkonto (ISK) in Sweden, which is an investment savings account that is very efficient in terms of administration and how capital gains taxes are managed. More than 3 million Swedes use the ISK structure for their investments, more than one third of the population. A further example are the ETF savings plans that exist in Germany that are used by a growing number of retail investors. More than 3 million clients have signed up to plans which involve monthly investments into ETFs. These are two mechanisms that are replicable in other markets and can help to support savers in their investments.

A second industry representative stated that existing EU regulations such as the MiFID and UCITS directives already set high standards in terms of products, distribution and investor protection. The UCITS directive has been adopted by a large number of retail and institutional savers in the EU, Asia and Latin America. Concerning value for money, it is important to consider that value is not the same as cost and the two should be distinguished in regulatory discussions. An excessive focus on product costs may lead to unintended consequences. For example a charge cap imposed on defined contribution pension plans in the UK has led customers to choose the cheapest products that were not necessarily the most beneficial ones or those offering the highest value for money, which may have adverse consequences in future. It is necessary to adequately take industry and customer perceptions into account for achieving appropriate regulatory outcomes.

A regulator added that while the risks and costs associated with investment need to be taken into account, sufficient attention should also be paid by regulators and supervisors to the risk of not investing and losing money from leaving money on deposit accounts.

3.2 Adapting the retail investment framework and disclosures to the digital age

The Chair noted that digitalisation has significant implications for retail investment. ESMA recently published recommendations on so-called finfluencers who issue investment recommendations. How disclosure may be adapted to digital channels also needs considering.

A regulator suggested that there should be a clear emphasis in the Retail Investment Strategy on digital tools and digital disclosures which can play an important role in enhancing the interaction with retail investors and facilitating their access to capital markets. Digital tools can make disclosures more appealing and bespoke, with an effective layering of the information and, can facilitate a more seamless investment journey for investors. Information provided in digital form can also support the development of comparative tools for investors, for example a fund comparison tool that could be very useful for investors.

A second regulator emphasised that information and disclosures need to be fundamentally reviewed to fit an increasingly digital world - e.g. with visual layering - and adapted to the online behaviours of customers who tend to read less and less information before validating choices. Actions undertaken in different countries to improve pre-contractual information, guide investment choices, and increase retail participation thanks to digital tools have been used as a source of inspiration, in particular when defining the precontractual information for the Pan-European Personal Pension Product (PEPP), with the aim to provide customers with information in a more user-friendly way.

An industry representative observed that the provision of adequate disclosures can be challenging. There are lessons to be learned from fintechs in terms of user-friendliness and of simplicity and accessibility of the information provided. Some fintechs have indeed succeeded in making complex information on products and services much more accessible and engaging for customers, presenting information in a more visual way.

An industry representative added that the objective should be to provide customers with useful information that they can understand, rather than piling it up. Layering can play an important role in making information more accessible. This applies both to the pre-contractual information that is provided during the sales process but also to after-sales reporting. A great deal of time and effort is spent by financial institutions in providing platforms that customers can use to follow the performance of their products, access market and product information, and adjust their investments. This is an important part of the investment value chain, as many products are long-term investments that customers hold for many years.

A second industry speaker observed that it is essential to provide investors with information, advice and decision-making tools both in a physical and digital form to increase their ability to participate in the capital markets. Order execution should also be possible on digital channels with a better adaptation of documents to the digital environment.

3.3 Enhancing supervision at the cross-border level within the EU

Answering a question from the Chair about the issues raised by the cross-border distribution of products to retail investors, a regulator stated that these issues are not sufficiently considered, particularly in discussions about digitalisation. The digitalisation of the distribution of financial products should be further encouraged, as it is a way to improve competition in the retail market, but the regulatory and supervisory framework needs to be adapted to this evolution. The current regulatory framework was built when a physical presence was required to serve a customer base in a given member state. This provided the host NCA with a number of powers notably in terms of investor protection, but digitalisation has facilitated the development of remote businesses with no physical presence. In such a case, the host authority has no power to intervene in case e.g. of mis-selling according to the current rules, and the home authority is not incentivized to act quickly because the problem is not happening in their jurisdiction. The business models that rely on freedom to provide services provisions often concentrate most of the problems that are raised by consumers regarding investment products at present. This is a structural weakness of the retail single market that should be addressed in the upcoming Retail Investment Strategy. The simplest way to address that problem would be to give the host authority the same power under the freedom to provide services model, as under the branch model. Other possibilities include enhanced cooperation mechanisms between home and host authorities.

A second regulator agreed that there is a gap in supervision to the detriment of the investor when it comes to the cross-border distribution of investment products within the EU. This problem could be solved by centralising the supervision of cross-border activities at the EU level, but that is not on the cards for now. The second-best way is to increase the powers and competencies of the host supervisors, as suggested by the previous speaker.

A third regulator echoed the comments made about the opportunities offered by digital tools for developing cross-border investment and the need to take this into account in the supervisory approach. ESMA has committed to enhancing supervisory convergence in order to build collective trust in the EU single market, by making sure that there is a proper understanding among supervisors of sales processes taking place at home and abroad, and ensuring that supervisors have the data and information to properly supervise that and intervene if needed.

3.4 Improving financial education

An industry representative suggested that more emphasis should also be put on improving financial literacy throughout the lifetime of savers, starting from school. This needs to be taken into account in the upcoming RIS. There are also many actors in the market that give financial advice or information in an unregulated way. Allowing customers to continue having access to financial coaching and information that is not classified as advice is important as this can contribute to improving their financial literacy.

An industry representative emphasised that empowering people to take the right financial decisions for themselves, based on an assessment of the opportunities and risks associated with investments, should be a common objective across the EU. This requires financial education to improve the average level of financial knowledge among the general population and also among financial advisors, as well as providing access to appropriate information and decision-making tools both in physical and digital form. It is very important that formal and informal education tracks include financial literacy and sustainable investment aspects so that savers can learn how to invest for their future in a coherent way with their values. The information provided and the level of protection offered should also be segmented according to the level of experience of investors. Moreover, fiscal incentives are needed to encourage people to build wealth in an effective way.