RETAIL INVESTMENT: OPPORTUNITIES, CHALLENGES AND EU POLICY PROPOSALS

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1. RETAIL INVESTMENT IN CAPITAL MARKETS REMAINS LIMITED IN THE EU

Developing long term retail investment in capital markets is one of the main objectives of the new Capital Markets Union (CMU) action plan published in September 2020, which aims to put capital markets "at the service of people". This was confirmed by the Ecofin of December 2020 which identified the development of investment by EU citizens as one of the short term priorities for the CMU.

Retail investment is indeed essential for the funding of the EU economy, with a significant part of the potential long-term funding of the EU economy coming directly or indirectly (i.e. via funds or pension products) from households. Retail investors also tend to have a longer term investment horizon than institutional investors, who are usually assessed and remunerated on a shorter-time horizon. In addition, favouring long-term investment is also essential for the future well-being of EU citizens, notably for the preparation of their retirement. At present, more than 18% of EU citizens are indeed at risk of poverty or social exclusion in older age and many others face potential revenue shortages during their retirement, making pension adequacy and coverage a priority for the Union and its governments[1].

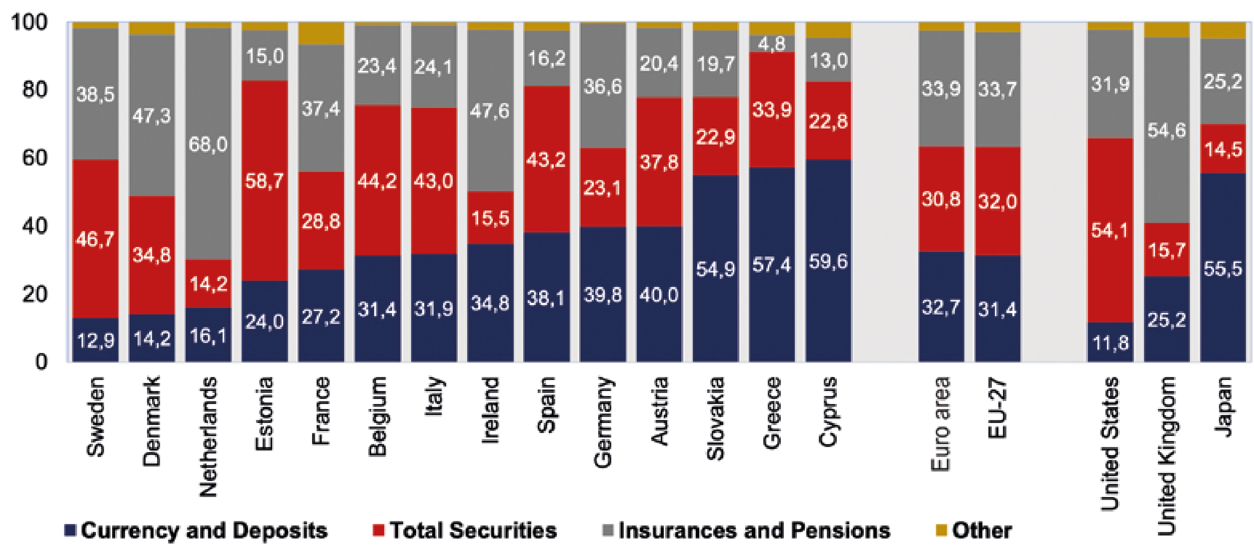
Europe has one of the highest individual savings rates[2] in the world, with households from Eurozone Member States[3] setting aside 12.4% of their gross disposable income every year on average between 2013 and 2019, against 7.2% in the United States[4].

However, the rate of retail investor participation in capital markets remains low in the EU on average compared to other major economies such as the US and the UK (*see Chart 1 below*). In 2019, about 32% of EU27 household financial assets were held in securities either directly or via mutual funds[5]. In comparison in

CHART 1. Composition of Households' Financial Savings in Selected EU and non-EU Countries in 2019, %

Source: OECD

Note: "Total securities" include all existing market-based instruments held directly or indirectly, in the form of bonds, equity, mutual funds and money market funds; "Other" includes loans and other accounts receivable/payable in the sense of Eurostat definition

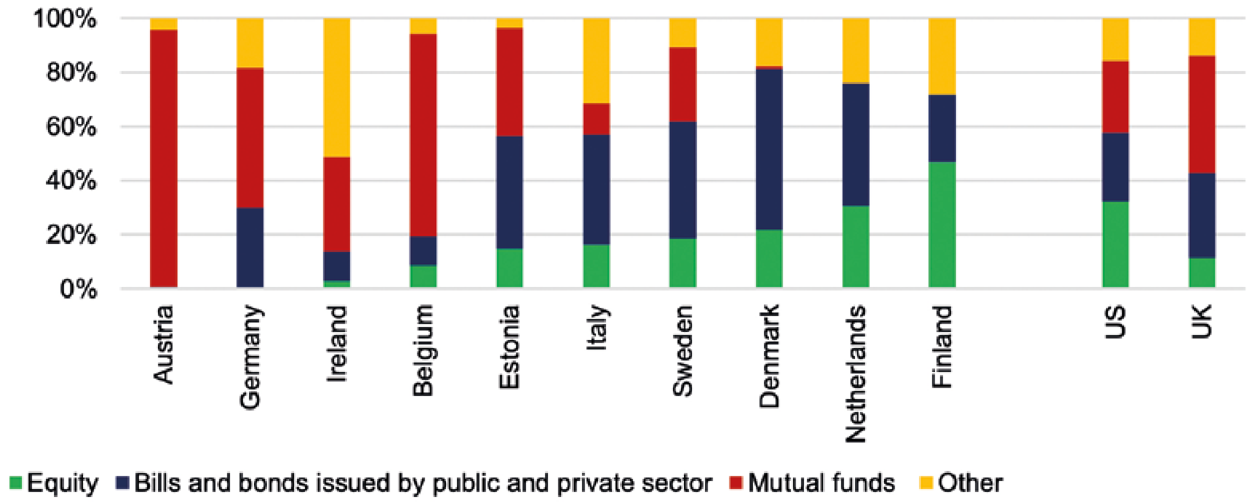


1. Source CMU High Level Forum report June 2020.
2. Defined by gross saving divided by gross disposable income, with the latter being adjusted for the change in the net equity of households in pension funds reserves. Gross saving is the part of the gross disposable income which is not spent as final consumption expenditure.
3. Eurostat, "Quarterly sector accounts – households", October 2021 (https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Quarterly_sector_accounts__households#Household_saving_rate_down_in_both_the_euro_area_and_the_EU).
4. Federal Reserve (https://fred.stlouisfed.org/series/A072RC1Q156SBEA).
5. Eurostat figures show that 29% of EU27 household financial assets were held in equity and investment fund shares in 2019, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Households_-_statistics_on_financial_assets_and_liabilities#Value_of_assets_and_liabilities
Some estimates however also show that the percentage of assets held by households in securities is closer to 15% (12% of household assets held in listed equity and investment funds, 2% in debt securities) when taking out securities held by family offices, holding companies, etc.. See Eurofi Regulatory Update September 2021.

CHART 2. Pension Funds Breakdown by assets (2019)

Source: OECD Global Pensions Statistics, Bank of Ireland

Note: Other = Loans, Unallocated Insurance Contracts, Land and Buildings, Hedge Funds, Private Equity Funds, Structured Products



the US approximately 54% of retail financial assets are held in securities. In addition in the US about 20% of retail financial assets are held in direct corporate equity ownership compared to 4% in the EU.

Consequently, the proportion of assets held in bank deposits and traditional savings accounts is much higher in the EU (31.4% of household financial assets) than in the US (approximately 12%[6]). This high amount of savings held in bank deposits and traditional savings reduces long-term financing options for enterprises and potential long-term returns for EU savers. As for the third main component of household assets (insurance-based products and pensions), the share in total savings is similar in the EU (33.7%) and in the US (31.9%). However, when considering the breakdown of assets held in these pension products (*see Chart 2*), it appears that in the US the proportion of pension fund assets held in equity and mutual funds is higher than in most EU countries: nearly 60% of assets in the US compared to an average of 20 to 40% in the EU, the remaining part being held in bonds, short term debt and real estate.

The composition of household financial savings is also very heterogeneous across EU member states, as shown by the statistics above, particularly with regard to the share of currency and deposits. While the savers of Nordic countries and the NL have less than 20% of their assets in deposits, this proportion is higher than 50% in several Eastern and Southern Europe countries. The split of the remaining savings between securities and insurance / pension products is also variable, depending in particular on the presence of pension funds. Among the countries where the proportion of assets held by households in deposits is lower than the EU average, those which have significant pension funds, such as in the NL, Ireland and the UK, have a stronger proportion of household assets in insurance / pension savings compared to securities. But, as shown in Chart 2, 50 to 80% of the assets held in pension funds are invested in securities (equities, bonds and mutual funds).

2. MAIN DRIVERS OF RETAIL INVESTMENT IN THE EU

In terms of drivers, the pension system, the maturity of capital markets and the financial literacy of citizens appear to be the three main factors that explain the structure of retail assets.

Starting with the pension system, countries with a pension system where capitalisation plays a strong role (with pension funds or mandatory or auto-enrolment defined contribution pension schemes[7]) tend to have a greater retail participation rate in capital markets, either directly or indirectly, than those where pay-as-you-go systems[8] are the main source of retirement revenue. This is apparent in Charts 1 and 2 above. OECD figures moreover show that in several Northern European countries (namely Denmark, Estonia, Finland, Netherlands, Latvia and Sweden), nearly all the working-age population participates in a mandatory retirement savings plan (invested in fixed income and equity instruments mainly) and in these countries, savings remaining in deposit accounts are relatively limited (less than 25% of total assets). Since a significant share of pension fund assets is held in securities in these countries (between 50 and 80%), the total proportion of assets held

6. Source BIS Household wealth in the main advanced countries - 2019.

7. A defined contribution (DC) pension plan uses contributions (from the employee, employer and/or government) to buy assets with the purpose of financing future retirement benefits. The benefits received depend on the value of contributions paid and the value of the assets upon retirement. The beneficiary bears the investment risk in the case of DC plans, (though in some cases the plan may provide a minimum return guarantee).

8. Pension schemes where current contributions and/or tax revenue finance current pension expenditure.

in securities is as high as 70 to 80% when considering securities held directly and those held indirectly in pension funds (with a proportion held in equities reaching 30 to 40%).

The second factor that influences retail participation rates in capital markets is the maturity of capital market development. For example Sweden, Finland and Belgium, where savers have a significantly higher proportion of their assets in securities also have more developed capital markets. The market capitalisation of domestic listed shares in these countries compared to GDP amounted to respectively 114%, 98% and 61% in 2019 compared to an EU average of 58%, whereas in countries where the participation of retail savers in capital markets is low, such as many Central and Eastern Europe countries, the ratio of market capitalisation to GDP is significantly lower (below 20%).

The third main factor is the level of financial literacy of citizens. Most of the countries where the proportion of assets invested is securities is above the EU average are also characterized by a relatively high level of financial education. In Sweden and Finland, respectively 71% and 63% of adults are financially literate according to evaluations made by Standards & Poor's[9], corresponding to the highest levels in the EU. This is also the case of 54% of the population in Estonia and Hungary, and 55% in Belgium. Some countries such as Spain and Italy with relatively developed capital markets escape this rule, with less than 40% of their population obtaining appropriate scores in terms of financial education, possibly related to a higher concentration of securities holding in these countries in the hands of the most financially literate.

3. SOME POSITIVE TRENDS HAVE BEEN OBSERVED SINCE THE BEGINNING OF THE COVID-19 CRISIS

Two positive trends for the development of retail investment in capital markets have been observed since the beginning of the Covid crisis: first, an accumulation of excess savings that can potentially be re-invested in financial markets and secondly an increasing participation in capital markets, particularly of the younger population.

The first factor observed since the outset of the Covid crisis is an increase of the savings of households due to restrained consumption in time of lockdowns and the preservation in many European countries of a stable income thanks to government support. The saving rate grew to 19% in the EU in 2020, up from 12% at the end of 2019[10], and to approximately 14% in the US[11] compared to 7% on average in previous years. Since then, it has declined to 9.5% in the US as of 2021-Q3 but remains markedly high compared to the pre-crisis trend and the average has remained high in the Eurozone also at 18.9%. This has led to the accumulation of significant excess savings, corresponding to the amount of saving households would have normally spent in the absence of the pandemic, but that is held in cash or assets instead. Some reports estimate that the "excess savings" accumulated since the beginning of the Covid crisis exceeded € 450bn in the euro area as of April 2021, corresponding to more than 4% of GDP[12]. Two thirds of these household excess savings ended up in bank accounts, while the remaining third was invested in capital markets, mainly in equity, indicating a new interest in risky financial assets among households during the pandemic.

A second positive trend observed since the beginning of the Covid crisis is a significant increase in the number of new openings of securities accounts, particularly among the younger population (18-35)[13], an increase in stock buying and volumes traded by retail investors[14] and a move from guaranteed products to unit-linked products within life insurance contacts. Evidence of greater household participation in capital markets since the beginning of the Covid crisis has been found[15] in several major European Member states including France[16], Italy[17], Germany[18] and Belgium[19]. These changes were triggered in particular by the opportunities for gains created by the market downfall at the outset of the Covid crisis and the search for higher yields in a context of very low interest rates and was also supported by the greater availability of online brokers and the spare time freed up by lockdowns. Still, there is no strong evidence yet that this increase in retail investor participation, particularly in equity markets, is driven by long-term investment motives and that it will last in the post-pandemic world.

9. Financial literacy is measured using questions assessing basic knowledge of four fundamental concepts in financial decision-making: knowledge of interest rates, interest compounding, inflation, and risk diversification. The survey was conducted in 2014 by the S&P – for further details, see 3313-Finlit_Report_FINAL-5.11.16.pdf (gflec.org).

10. Source Eurostat.

11. Source FRED – St Louis Fed December 2020.

12. Source European households: the double dividend of excess savings (eulerhermes.com).

13. For example, statistics from a major French e-broker indicate that new client accounts increased by +120% in 2020 and that 39% of all new clients are between 28 and 35 years old – Source Eurofi April 2021 seminar "Developing equity funding".

14. Source ESMA Report on Trends, Risks and Vulnerabilities, March 2021.

15. "Individual investor behaviour during the COVID-19 crisis in selected jurisdictions", https://betterfinance.eu/wp-content/uploads/BETTER-FINANCE-Response-EC-Strategy-for-Retail-Investors-03082021-Annex-2.pdf

16. In France, the share of 18-35 investing in capital markets increased by 7 ppts to 18%, bringing the median age of French individuals investing in capital markets from 58 years-old to 46, according to a study from the AMF (AMF France, *La Lettre de l'Observatoire de l'Epargne de l'AMF* (43) July 2021). Although 79% of the additional savings are held in the form of liquid assets (currency, current account and term deposits), 6.3% have been allocated to equity, according to the Banque de France according to figures from the Banque de France, *Présentation Trimestrielle de l'Epargne des Ménages* (2020 Q4), June 2021.

17. In Italy, the retail participation rate increased by 4ppts, from 30% in 2019 to 34% in 2020.

18. In Germany, the number of non-professional investors owning individual stocks or equity-based investments funds (including ETFs) grew by 27% in 2019, to 12.3m. Looking at age groups, the 14-29 population registered the strongest rise (+67% in 2020 compared to 2019), followed by the 30-39 group (+34%).

19. In Belgium the number of private investors has almost doubled as of the first quarter of 2021, compared to 2019 Source: Presentation of the President of the Belgian FSMA, Webinaire Investisseurs de détail sur la bourse (21 June 2021).

4. REVIEWING THE EU POLICY FRAMEWORK TO FOSTER MORE RETAIL INVESTMENT IS A KEY PRIORITY GOING FORWARD

4.1. A significant policy framework already exists in the EU for retail investment but its effectiveness has been questioned in several areas

Retail investor protection rules are set out in a number of sector-specific EU legislations addressing different aspects of investor protection at the product, distribution and order execution levels. These rules are completed by general consumer protection frameworks under domestic rules and also supervision that remains largely domestic in this field, although actions are being undertaken at ESMA level to enhance supervisory convergence. Educational aspects are also managed at national level.

Concerning EU frameworks, MiFID (Markets in Financial Instruments Directive) and IDD (Insurance Distribution Directive) provide rules for the distribution respectively of securities and insurance-based products covering issues such as investor classification, product suitability and appropriateness assessment, advice and information at the point of sale and also restrictions on the use of inducements. MiFIR and other securities market regulations[20] also regulate the execution of securities transactions.

These distribution and securities market rules are completed by the PRIIPs regulation (Packaged Retail and Insurance-based Investment Products) which aims to enhance the consistency of investor disclosure across comparable investment products and to make it easier for retail investors to understand and compare the key features, risks, rewards and costs of different investment products[21] through the provision of the pre-contractual Key Investor Document (KID) prior to the conclusion of any transaction. Product frameworks such as the UCITS Directive, the ELTIF regulation and PEPP moreover contain measures for ensuring the protection of retail customers investing in these products, and cover in part similar ground to the legislations previously mentioned. UCITS for example, includes eligible asset and liquidity rules and also investor disclosure rules designed for the protection of retail investors.

The effectiveness of these distribution and product frameworks in terms of investor protection and capacity to foster increased retail investment is called into question. Several of these frameworks are currently being reviewed, which will provide the opportunity to tackle these different issues. A first issue is that these EU frameworks, which all aim to enhance investor protection in different areas differ and overlap to a certain extent. This makes investment decisions across comparable products potentially more difficult for consumers and increases the complexity for producers and distributors of marketing investment products to the retail market. Secondly, the relevance or adequacy of certain rules has been questioned including: MiFID suitability assessments, which are considered to be too cumbersome particularly for the more sophisticated investors[22], PRIIPs disclosures regarding cost and performance, MiFID inducement rules regarding their capacity to eliminate biased advice[23]. The need to adapt investor protection rules and disclosure requirements to the increasing digitalisation of retail investment activities is moreover emphasized by many stakeholders[24].

4.2. Developing retail investment is a key objective of the new CMU action plan

According to the EU Commission's assessments[25], the current low level of retail investor participation in capital markets deprives EU companies and more generally the EU economy of long-term funding and it also means that retail investors do not benefit sufficiently from the investment opportunities offered by capital markets and cannot address adequately their retirement needs.

Developing retail investment was thus put forward as a key objective of the new CMU action plan published in September 2020 to relaunch the CMU. Three legislative proposals published in November 2021 to implement the September 2020 action plan should contribute to fostering more retail investment. The proposals made in the context of the ELTIF review should help to make these funds more accessible to retail investors, with a reduction of the investment thresholds applicable to these funds and the introduction of an additional liquidity window redemption mechanism, thus allowing more retail long-term investment in infrastructure projects and SMEs. The ESAP project (European Single Access Point) should also provide all investors, including retail investors, with an easier access to financial and

20. Other market regulations such as MiFIR, the Market Abuse Regulation (MAR) and post-trading regulations (EMIR, CSDR).

21. The following products are in the scope of PRIIPs: Investment funds (UCITS have exemption until June 2022); Life insurance-based investment products (such as unit-linked or with-profits policies); Retail structured securities (including instruments issued by securitisation institutions and corporate bonds); Structured term deposits; Derivatives; Convertible bonds and other structured securities with embedded derivatives; Pension products and annuities not recognised by the national law.

22. The current client categorisation in MiFID is criticized as it may lead to unnecessary precautions and burdensome suitability verification processes particularly for the more sophisticated retail investors.

23. The general inducements MiFID II rule prohibits firms from paying benefits to or receiving benefits from third parties, unless the benefits are designed to enhance the quality of the relevant service to the client, and do not impair compliance with the firm's duty to act honestly, fairly, and professionally in accordance with the best interests of its clients. These rules give rise to heated debates. While some stakeholders consider that the current restrictions on inducements are not sufficient for eliminating biased advice, others argue that a stricter ban of inducements would be detrimental for investors, potentially increasing the price of advice and reducing its availability for non-high net worth clients.

24. Digitalisation, which is becoming an increasingly important feature for retail investment with the development of investment apps, robo-advice platforms and social media needs to be appropriately taken into account in legislation. Investor protection rules need to be adapted to the new digital environment in order to allow investors to benefit from the new opportunities offered by digitalisation (e.g. in terms of easier access to investment products and information, improved comparability, lower costs) and also to mitigate related risks (e.g. related to an easier access to risky products or to possible gamification).

25. Communication – A CMU for people and businesses – new action plan 24 September 2020.

sustainability information on EU companies. Finally the measures proposed in the MiFIR review to enhance transparency, in particular the implementation of an EU consolidated tape, should contribute to improving the information available to retail investors among others.

Actions initiated by the Commission in the area of pensions and financial literacy should also support greater retail engagement in capital markets. A first step in this regard was the publication in November 2021 of a report on pension auto-enrolment best practices, which is a mechanism that automatically enrols individuals into a supplementary retirement savings scheme unless they explicitly opt-out, in order to ensure more adequate retirement income. The Commission is also working on the development of pension dashboards[26] aiming to support Member States in the improvement of their pension systems and of best practices for the implementation of individual pension tracking systems at domestic level[27] for providing citizens with an overview of their future retirement income. Concerning financial literacy, the Commission published in January 2022 a financial competence framework for adults developed with the OECD, which is due to be completed by a framework for children and youths. The objective of this framework, which defines the competences that individuals need for making sensible decisions about their personal finances including savings, investment and preparing for retirement, is to support actions at the domestic level (such as the development of national financial literacy strategies, the design of financial education programmes and tools and the assessment of financial literacy levels).

Additional actions proposed in the CMU action plan and due to be implemented at a later stage (notably in the context of the MiFID II review) may have further implications for retail investors. First, measures proposed to improve the level of professional qualifications of financial advisors in the EU possibly with the setting up of a pan-EU competence certificate. And secondly, measures to improve applicable rules concerning inducements in order to foster unbiased advice and to reduce information overload for experienced retail investors with an improved investor categorisation[28].

The work on inducements builds on the advice published in April 2020 by ESMA on inducements and costs and charges disclosures under MiFID II. ESMA did not recommend a ban of inducements for retail products, but encouraged the European Commission to conduct further analysis on their impact and on the possible implications of a ban and proposed some changes to the regime (notably in terms of client information about inducements). In terms of disclosure, ESMA advised the Commission to scale back certain disclosure obligations on costs and charges for eligible counterparties and professional investors. The Commission subsequently launched at the end of 2020 an extensive study[29] of the different disclosure regimes in the EU, of current practices in terms of advice provision and of the impact of inducements and related rules in order to investigate how far the current legal framework empowers customers to participate in the market and make informed investment decisions, while providing adequate investor protection.

Other on-going areas of assessment include the value for money of retail investment products, based on an annual monitoring of the performance and costs of retail investment products conducted by ESMA and EIOPA. In its third annual report (2021) ESMA emphasized the high impact of costs on the final returns of retail investors: over the period of 2009-18, a hypothetical 10 year retail investment has generated a net return of +61% with costs amounting to 17%, according to ESMA's calculations and costs tend to be significantly higher for retail investors than for institutional ones[30]. In addition the gross outperformance of active funds compared to passive ones such as ETFs was not high enough to compensate for the higher costs. Concerning life insurance products, EIOPA also underlined the need to put consumer outcomes at the heart of product design and distribution, following observations that unit-linked products provide on average higher returns despite the higher costs, but also expose policyholders to market shocks and volatility, which may generate a lower return in some periods than profit participation products which lower risk profiles. EIOPA subsequently launched a consultation[31] on a framework to assess whether unit-linked products offer value for money, taking into account the needs, objectives and characteristics of the target market. The principles put forward include that the value offered by these products should be assessed by considering the product as a whole, as well as each of its components. In addition, product features and characteristics including costs and the reward profile of the products should be tested to ensure that no undue costs are charged to consumers and efforts should be made to make products easier to understand by retail customers.

4.3. A Retail Investment Strategy has been announced for 2022

In the new CMU action plan proposed in September 2020, the Commission announced its intention to publish a comprehensive strategy for retail investment in Europe in the first half of 2022, aiming to ensure that retail investors can take full advantage of capital markets and improve the coherence of rules across

26. Complementing the existing monitoring tools with more detailed information on occupational pension schemes, pension dashboards will provide Member States with a more comprehensive view of the adequacy of their pension systems, encouraging them to address shortcomings and share best practices.
27. Individual pension tracking systems will provide citizens with an overview of their future retirement income, based on their entitlements in all the pension schemes they participate in or the expected return of long-term products they invest in.
28. See actions proposed in the CMU September 2020 action plan: Amendments to applicable rules in the area of inducements in order to ensure that retail investors receive fair and adequate advice (Q1 2022). Introduction of a new category of qualified investors in MiFID II and reduction of the current information and administrative overload for these investors (Q1 2022).
29. Disclosure, inducements and suitability rules for retail investors study.
30. Source: Performance and costs of retail investment products in the EU – ESMA – 14 April 2021.
31. Consultation on a framework to address value for money risk in the EU unit-linked market – EIOPA – April 2021.

different investment products. The objective of the upcoming Retail Investment Strategy is to ensure that retail investors benefit from (i) adequate protection, (ii) bias-free advice and fair treatment, (iii) open markets with a variety of competitive and cost-efficient financial services and products and (iv) transparent, comparable and understandable product information. In addition, EU legislation is this area should be forward-looking and should reflect on-going developments in digitalisation and sustainability, according to the Commission, as well as the increasing need for retirement savings.

A consultation for preparing a proposal for an EU Retail Investment Strategy and reviewing MiFID II rules was conducted by the Commission between May and August 2021. This consultation covered the main topics that have been identified as potential areas of improvement for encouraging more retail investment in the context of the CMU initiative and also of the reviews of existing regulations such as MiFID II, IDD or PRIIPs. These include: financial literacy, digital innovation, disclosure requirements, suitability and appropriateness assessment, investor categorisation, inducements and quality of advice, product complexity, redress and complaints, intervention powers and sustainable investing.

ESMA moreover conducted a call for evidence at the end of 2021 to provide the Commission by April 2022 with input on three key aspects of investor protection: (i) investor disclosures, assessing whether current rules allow consumers to make informed choices and whether the information provided is adequate; (ii) digital disclosures, in order to define how regulatory disclosures can work best for consumers in the digital age; and (iii) digital tools and channels to assess the risks and opportunities associated with the use of digital tools and the increasing levels of direct investor participation via online trading platforms and robo-advisors[32]. In addition, this call for evidence also explored the topic of open finance (i.e. how far value chains should be opened up by sharing specific investor data among investment firms and third-party providers) and the potential effects in terms of innovation, competition and improvements for retail investors.

32. Call for evidence on certain aspects relating to retail investor protection – ESMA – 1 October 2021.