Retail investment strategy: what priorities?

1. Overview of retail investment trends in the EU

An investor representative gave an overview of retail financial investments in the EU. Firstly, financial savings in the EU are not only in bank accounts, which represent 33% of retail financial assets. They are also – and more - in life insurance and pension products, which comprise 38% of financial assets. This means that 71% of financial assets are mostly in fixed rate or fixed income related underlying assets. Third are listed stocks and bonds, representing 9% of assets. Lastly, investment funds represent about 9%. Retail investors only have a limited direct exposure to funds, but they are also exposed to them economically via unit linked products within life insurance and pension products. In terms of regulation, this means that retail investors are currently affected by a range of different rules; this is a consequence of the silo approach adopted by European law in which rules differ across product categories. The Retail Investment Strategy will hopefully mark an attempt to develop a consistent approach to investor protection rules throughout these different product categories.

A regulator highlighted the similar evolutions in every country since the beginning of the Covid pandemic. There has been a huge inflow of retail investors into the market. The fall in stock prices was seen as a buying opportunity. People also had more time on their hands, had saved money with restricted spending opportunities and had easier access to financial markets thanks to digital apps. Surveys conducted in the Netherlands have shown that these newcomers to the capital markets are younger than the average investors, are relatively confident about their capacity to make appropriate investment decisions and use execution only services, relying mostly on social media and 'finfluencers' for stock market advice. However, surveys have also concluded that roughly one third of these new investors had suboptimal investment strategies. They traded in and out too frequently and did not spread their investments sufficiently across assets and time, making them vulnerable to potential market fluctuations.

An industry speaker emphasised that saving rates hugely increased in 2020 and 2021 with the Covid crisis. There were some newcomers to the capital markets, but most European households saved in bank accounts and savings products. The normal rate of savings for a European family is around 12%. During the last two years, it was closer to 20%.

2. Opportunities and challenges associated with retail investment

2.1 Opportunities related to the development of retail investment

The Chair observed that the current macroeconomic environment of low interest rates provides an opportunity to encourage more household investment in capital market instruments, however also potentially generating new risks.

A regulator emphasised that the main policy objectives concerning retail saving should be to address the pension gap, build more pension adequacy in old age and enhance the long term funding capacity of the European economy. This long term perspective should underly the objective of developing retail investment. In Portugal and Spain, the average replacement ratio of pensions will be 40% of the salary in 40 years' time if nothing is done, compared to around 70 to 75% at present. When considering the macroeconomic environment and the risk of inflation, a push of the value for money offered to retail investors is also necessary. It is therefore necessary to propose simple, cost effective products for people to complete their savings for retirement. The regulator described digitalisation as a major opportunity in this regard, because it will facilitate the provision of simpler, more cost effective and more comparable products and services. Many of the costs supported by retail investors are due to the complexity of products. This should also lead to a simplification of regulatory requirements. Building a truly single market for capital is a further opportunity to support retail investment.

An industry speaker agreed that the objective of increasing retail participation in the capital markets should focus on achieving better outcomes for investors in terms of pension adequacy and long term saving. It is possible to generate much better value for investors by providing products corresponding to their long-term savings needs and adequate advice for facilitating their investment decisions.

An industry speaker emphasised that the development of retail investment also provides the opportunity to massively support a transition towards a more sustainable and digital economy. Asset managers in particular have a key role to play in channelling retail savings towards these investments.

2.2 Challenges faced by retail investors

Considering the challenges associated with the objective of developing retail investment, an investor representative stated that this is one of the worst times for retail investors because 'financial repression' is at an all time high. The current combination of monetary and prudential policies is resulting in investors obtaining a negative return in real terms on their investments and this will worsen with the upsurge of inflation since 2021. This is not a temporary issue and retail investors will be hit hard because 71% of their financial savings are in savings accounts and mostly fixed income related products. For example, in France, where capital guaranteed life insurance is the main saving product with €1.6 trillion of assets in 2021 alone, savers lost €43 billion in real terms in purchasing power in 2021 with an inflation of 3.4%. In addition, savers are taxed in most cases on nominal income, which is partly a fictitious income, and they are also being encouraged to move their assets to unit linked products, which are riskier, more expensive and more complex, at a time when stock markets are at an all time high. In the same way, the biggest saving pot in Belgium, which is bank saving accounts, lost €22 billion in purchasing power in 2021 alone.

An industry speaker agreed that inflation is a game changer that is due to last and increase. There could even be a stagflation situation because the price of energy is going to rise quite dramatically, especially due to events in Ukraine. The consequences of inflation for retail savers are quite significant. Statistics show that €10,000 left in a bank account over the last 10 years has lost at least 10% in value in real terms. The same amount invested in an average diversified portfolio fund would have generated around 60% in real terms and net performance during the same period. This shows that savers need to invest in more diversified assets, which is an objective that investment funds can contribute to achieving. However, only 10% of retail savings are invested in funds at present, which needs improving.

A regulator stated that, while many savers are showing a new interest in investing in capital markets, it is important not to lose them as investors in the future due to foreseeable disappointments. Cost and trust are important in this respect. 'Cost' means that people should be offered products at fair prices. These products should make sense for retail investors and work under various economic circumstances. There should also be no inherent conflicts of interest that work to the detriment of investors in the system. Retail investors should also be protected from fraudulent or excessively risky propositions. In this new world of digitalisation, it is still very difficult for supervisors to go after foreign firms. Therefore, it is necessary to address investor protection from a cross border perspective. A further issue is that the strong interest in meaningful environmental, social and governance (ESG) investments means that way too much money is currently chasing too few ESG assets, leading to risks of greenwashing and a green asset price bubble.

The Chair stressed that ensuring investor protection for cross border investment is a significant challenge. A specific area of concern raised notably by the International Monetary Fund (IMF) concerns the way supervision is organised in the cross border context with the growing digitalisation of financial services.

A regulator added that the current geopolitical challenges will induce more volatility in a system that was already heated due to liquidity and risks that were probably inadequately measured. This will also impact retail investors.

3. Objectives of the Retail Investment Strategy

A policy maker explained that the Commission is considering putting forward a Retail Investment Strategy centred on the retail investor. This is the first time that the objective has been presented in this way at the EU level. Moving in this direction is a significant priority for the Commission.

The Commission's key objective is to develop retail investors' access to capital markets to better cater for their long term saving needs. The Commission's assessment of the present situation is in line with the comments made by the panellists. Capital markets represent opportunities and risks for retail investors. Changes in the profile of investors have been observed since the Covid crisis. Challenges include the limited level of financial literacy and the way the regulatory framework is currently structured, which may need some streamlining.

No decision has been taken yet, and consultations are ongoing. A first area that the Commission is considering is enhancing financial literacy. There is no legal basis in the treaty for interventions at the EU level in the field of education, but support can be provided by the Commission to member states. A second area is the streamlining of disclosure rules on which a study has been commissioned. Advice has also been asked from the three European Supervisory Authorities (ESAs) on possible improvements to these rules. Inducements are being assessed to determine whether they contribute to creating a conflict of interest that may hinder the provision of unbiased advice. This is a very divisive subject on which there are different views.

More generally, the Commission is assessing whether a more investor centred perspective can be developed in the regulatory framework, the policy-maker explained, because rules are mostly product based at present. The intention is to evolve towards a perspective of individual portfolio creation in the advice provided; this involves reconsidering whether the current product suitability and appropriateness regimes are still fit for purpose and how information that is currently provided for each product in great quantities should be presented to better suit the needs of investors. All these issues also need to be considered together with the opportunities and risks stemming from digitalisation. Finding the right balance between innovation and investor protection is not easy, but this is the objective that the Commission is endeavouring to achieve with the input to the ongoing consultation.

An investor representative stated that the Retail Investment Strategy is a once in a lifetime opportunity to improve the issues affecting individual investors in Europe that should not be missed.

The Chair emphasised that encouraging the participation of retail investors in EU capital markets is a priority in the context of the Capital Markets Union (CMU). The Retail Investment Strategy is a welcome initiative, as it should allow for breaking barriers to cross border investment, providing long term investment options to European households and ensuring that they have access to strong investor protection. This objective is particularly relevant in a context where households have accumulated significant savings during the pandemic and are facing low returns on their savings account due to the low interest rates.

An industry speaker considered that the Retail Investment Strategy, is a great opportunity to reflect on what is needed to strengthen the current pension environment and foster longer term saving in Europe. The objective to assess every step of the investor journey is the right approach as there is no silver bullet for achieving better outcomes for investors. Investment funds can provide an instrumental contribution to this objective, supporting wealth creation rather than just wealth management.

Another industry speaker was looking forward to the recommendations of the Retail Investment Strategy. Targeted changes to existing rules are needed rather than an overhaul of current frameworks and additional requirements and a more holistic and streamlined approach should be favoured rather than the current work in product silos.

A regulator added that simpler products and investor information would probably necessitate less regulation but more effective supervision. It is necessary to have stronger conduct supervision in Europe, and this needs to be much more centralised in European institutions.

4. Key areas of the Retail Investment Strategy

4.1 Financial education

An industry speaker believed that improving investor education is essential, which requires developing access to qualified advice. Retail investors should not rely on tips from social media or YouTube and should be able to make their own investment decisions. The level of financial literacy is very variable across EU Member States at present. Not much can be done at the European level in the area of education, which is under the remit of domestic authorities. The strong presence of pension funds in certain countries such as the NL has contributed to a higher level of financial literacy, but this is not widespread across the EU.

An industry speaker stressed that while financial education and literacy are very important pillars for the development of retail investment, they are also a long term goal. There is a role for mechanisms that can help individuals to think about financial planning and how to plan for retirement at different periods of their life, creating the right incentives along their wealth creation journey.

A regulator agreed that nudging people towards a periodic financial health check, as suggested by the previous speaker, that would examine whether their financial situation is still fit for purpose, given possible changes in their lives or projects or evolutions of the economy would be a good idea. There are questions about how recommendations can be made, the form that they may take, whether some may be compulsory, who is going to do the health check and who is going to take the necessary follow up actions, but this is worth thinking about in the context of the preparation of the Retail Investment Strategy.

The regulator added that empowering retail investors to be able to make their investment decisions should be the objective rather than educating them about finance. This does not mean them receiving more information, but rather better information. Indeed, it is not certain that better trained investors would make better financial decisions, because there are many behavioural factors at play: individuals are prone to biases, can be over-confident, excessively short-term oriented... Therefore, individuals will still need to be provided with an appropriate level of protection.

An investor representative stated that improving financial literacy is at best a quite long term solution that is often mentioned but cannot realistically be implemented at the EU level because there is no legal basis for the EU to intervene in the area of education. In addition, adults are not interested in being trained in this area, therefore a first critical step is should be to better inform them and advise them at the point of sale. The second objective should be to facilitate the engagement of investors. Developing responsible investment, especially for environmental reasons is a way to involve the younger generation. Facilitating the exercise of shareholder rights, particularly cross-border within the EU should be another objective. The new Shareholder Rights Directive (SRD II) was introduced in 2021 but it is not working and it is still extremely difficult and costly for small shareholders to exercise their voting rights within the EU. This would nevertheless be the best way to encourage companies to apply ESG criteria and invest in a responsible way, as shown by many studies including assessments conducted by Better Finance.

4.2 Product distribution and advice provision

An industry speaker welcomed the reassessment of the inducements regime in the context of the Retail Investment Strategy and suggested that this should be done from the perspective of improving the advice provided to retail investors in terms of quality and access. There is already significant evidence from the Netherlands and the UK showing that the suppression of inducements has not led to a shortfall in the provision of advice; in fact, it has led to more competition and higher levels of quality in the services and products provided. The objective to enhance the level playing field between investment funds or insurance products is also relevant.

Another industry speaker emphasized that in the continental Europe distribution model, banks play a key role in terms of advice and distribution of investment products and that suppressing inducements would accomplish exactly the reverse of the objective in this context. A range of advice from face to face to simple digital advice can be provided, but it has to be paid for. In addition there is a huge challenge in terms of advising customers about sustainable investments and assessing their preferences in terms of ESG. If people are asked to pay for something that is currently free, most of them will choose the cheapest option with very limited or no advice as is the case for low-cost flights. Assessments conducted in the UK show that the average customer benefitting from advice has investments amounting to around £150,000, but the median amount held in securities in Europe is around €10,000. With the current bank centric distribution model in Europe, a full inducements ban would really risk excluding most investors from suitability tests and advice. There could be further unintended consequences from the suppression of inducements such as limitations to the development of open architecture distribution, as mentioned in an ESMA technical advice in 2021.

A regulator acknowledged the wide range of views that exist on the impacts of inducements. In the Netherlands, there has been a full ban on inducements since 2014 because of a major mis selling scandal. Eight years later, the authorities are satisfied because the costs for investors are the lowest in the EU. The advice industry was forced to become more innovative developing a range of advisory packages with different price tags, because there was no longer easy money to be made with inducements. Those who were not able to react left the industry and the others managed to innovate. It is true this change raises some challenges, but these are more of a short term nature and can be overcome, the regulator believed.

An investor representative emphasized that advice must be 'bias-free' (a main objective of the EC's retail investor strategy), because there is massive evidence of the damage caused by biased advice. Taking the example of France, two-thirds of the retail equity fund market is constituted by unit linked products promoted by insurance companies and banks, that returned on average 4% per year over the last five years, whereas cheaper exchange traded funds (ETFs) on the French stock market returned close to 8% over the same period. This is wealth destruction that shows the damage caused by the advice provided by biased financial advisors. An industry speaker agreed, stressing however that the number of retail investors finding their way to lower cost products that are easier for them to access, such as ETFs, is increasing.

The regulator stated that cost and trust are essential for retail investors. In particular, this requires rigorous product governance on the part of the financial industry and appropriate supervision. Products that are sold to retail customers should be cost effective and should work not only in good times, but also in bad ones. They should be marketed to the right people, and firms should be encouraged to guide customers towards products that make sense for them instead of the seller. This is part of product governance.

4.3 Digitalisation

An industry speaker emphasised that cost and value-for-money are a critical element for the growth of retail investment. One trend that should support this objective is an increased use of digital tools for executing transactions and also accessing different types of advice and guidance services. Providing a sliding scale of advice that includes digital options such as digital enabled advice or simpler digital guidance models is an effective way to attract a wider range of customers to financial advice. This reduces the barriers to entry and people of all ages may prefer digital interaction. Technology and its use in an open finance environment can also create efficiency and add value in other related areas such as the onboarding of clients, product comparison or the analysis of market data. All of that potentially paves the way for a far more scalable investment industry that reaches more people of all ages, incomes and stages.

A regulator stated that a huge part of the initial cost of advice lies with the product suitability and appropriateness tests. New technologies and open finance mechanisms can be used to streamline and standardise these tests, potentially reducing their cost significantly. This could work for a vast majority of customers.

4.4 Product disclosure and labelling

An industry speaker stressed that further standardising and streamlining investor disclosures should be a key objective, starting with an assessment of the present degree of divergence of disclosure across financial products. The amount of available information is overwhelming for retail investors and current key investor documents (KIDs) or prospectuses do not help much, as they are not easy to use and do not allow an easy comparison.

A regulator confirmed that KIDs are not often used by retail investors and that a new paradigm should be proposed for disclosures. This is a long-standing issue that needs to be tackled rather than repeating the same mistakes. The principles stated in the EU directives are correct, requiring to provide easy to read, comparable and understandable information. The problem is that this objective is then translated into a long list of items that need to be part of a KID, contradicting the initial objective. A way of providing radically simpler information needs to be found. The starting point should be the client to whom the product is going to be sold and the client's objectives and not the product itself. A way of doing this is layering the information. If some people want more detail they should be able to access it, but the first level of information should remain simple.

The regulator added that in some areas, labelling should also be part of the solution. This is the case for example of ESG investment. This is an area where a great deal of information is going to be provided to customers to inform them and understand their preferences. Retail investors should also get an upside from ESG investments, which means fighting against greenwashing and favouring the emergence of long term, ESG compatible investments, that may also be adequate for preparing retirement. Labelling could be of great help in this perspective.