Retail Investment Strategy: objectives and on-going assessments

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1. Improving the EU framework for retail investment is a key objective of the CMU

Retail investment is regulated at present by a significant policy framework[1] in the EU including product and disclosure rules[2] (UCITS, ELTIF, PEPP, PRIIPs…), distribution rules[3] (MiFID, IDD…) and securities regulations[4] (MiFIR, MAR…), but its effectiveness in terms of investor protection and capacity to foster increased retail investment is called into question in several areas.

A first issue is the fragmentation of investor protection rules across different legislations, which makes investment decisions across comparable products more difficult for consumers and leads to regulatory differences and overlaps, increasing the complexity for financial players to manage and distribute products across the EU. Secondly, the effectiveness of certain rules, notably the PRIIPs KID (Key Investor Document) and MiFID suitability and inducement requirements has been questioned (insufficient user-friendliness of the KID, suitability assessments considered to be too cumbersome for the more sophisticated investors and of limited use for average retail investors due to their product focus, insufficient capacity of MiFID inducement rules to eliminate biased advice[5]). The need to adapt investor protection rules and disclosure requirements to the increasing digitalisation of retail investment activities and also to new investment options in cryptoassets is moreover emphasized by many stakeholders. Thirdly, many observers consider that a stronger emphasis should be put on empowering customers and supporting them in their investment journey in order to foster more retail investment, rather than focusing mainly on investor protection.

In the new Capital Markets Union (CMU) action plan published in September 2020[6], the European Commission announced its intention to propose a Retail Investment Strategy in 2022, taking a more holistic and investor-centered perspective. Developing long term retail investment in capital markets is indeed one of the main objectives of this new CMU action plan[7]. According to the Commission's assessments, 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, particularly for preparing their retirement, with a significant proportion of savings still held in bank and savings accounts in many Member States[8].

The aim of the proposed Retail Investment Strategy is to ensure that retail investors can take full advantage of capital markets and that rules are coherent across financial instruments. More specifically, the objectives put forward by the Commission at the outset of this initiative were 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. Further objectives were that EU legislation is this area should be forward-looking and should reflect on-going developments in digitalisation and sustainability, as well as the increasing need for retirement savings. These priorities are currently being assessed by the Commission, as well as the policy actions that should be considered in the areas of financial literacy, disclosures, inducements and suitability and appropriateness regimes.

Other on-going CMU and MiFIR related actions that may have implications for retail investors include the European Single Access Point (ESAP) project[9], the review of the ELTIF

1. These EU frameworks are completed by domestic product frameworks and general consumer protection frameworks. Their implementation is supported by supervision that remains largely domestic in this field, although actions are being undertaken at ESMA level to enhance supervisory convergence. Educational aspects concerning the improvement of financial literacy are also managed at national level
2. EU product frameworks targeting retail savers such as the UCITS directive, the ELTIF and PEPP (Pan-European Pension Product) regulations cover notably eligible asset, liquidity and investor disclosure rules. The EU PRIIPs (Packaged Retail and Insurance-based Investment Products) regulation moreover aims to enhance the consistency of investor disclosure across comparable investment products such as investment funds, insurance based products or structured products
3. The MiFID and IDD (markets in financial instruments and insurance distribution) directives 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 inducements
4. MiFIR and other securities market regulations (MAR, EMIR, CSDR) also regulate the execution of securities transactions and the venues and market infrastructures that execute these transactions
5. The general MiFID II inducement 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 suggesting that they should be further curbed or banned (as is the case in the NL and UK), 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, particularly with the current distribution structure in the EU which is mostly integrated
6. Communication – A CMU for people and businesses – new action plan 24 September 2020
7. See note published by Eurofi in February 2022 for further information about retail investment trends, opportunities and challenges in Europe https://www.eurofi.net/wp-content/uploads/2022/05/eurofi_retail-investment_opportunities-challenges-and-eu-policy-proposals_paris_february-2022.pdf
8. See Eurofi note on retail investment (February 2022) for more detailed statistics https://www.eurofi.net/wp-content/uploads/2022/05/eurofi_retail-investment_opportunities-challenges-and-eu-policy-proposals_paris_february-2022.pdf
9. The ESAP project aims to provide all investors, including retail investors, with an easier access to financial and sustainability information on EU companies.

framework[10] and the MiFIR review proposals to improve the transparency on securities transactions[11]. On-going actions to improve pension adequacy (*e.g.* report on pension auto-enrolment best practice[12], pension dashboard[13]), financial literacy (publication of a financial competence framework that may support the development of national financial literacy strategies[14]) and sustainable finance disclosures and reporting also aim to contribute to increasing retail engagement in capital markets.

A further area of assessment is supervision and notably the supervision of cross-border activities in a context of increasing digitalisation and with the development of investments in cryptoassets which are often made on a cross-border basis.

Looking at the international level, initiatives are also being conducted in the US on similar topics, for example in the US with the work conducted by the SEC on digital engagement practices and the UK FCA's initiative on a new consumer duty that aims to set higher and clearer standards of consumer protection across financial services, requiring firms to put their customers' needs first.

2. A number of assessments have been conducted by the EU authorities since 2020 in preparation for the Retail Investment Strategy proposal

2.1 Assessments conducted on different aspects relating to retail investment: disclosures, inducements, digitalisation

To support the preparation of a proposal for a European Retail Investment Strategy, the Commission has conducted assessments to gather evidence on key issues potentially hampering retail investment.

An external study was published by the Commission in August 2022 on disclosure, inducements and suitability rules for retail investor[15] aiming to evaluate the impact of existing rules on the ability of retail investors to understand the risks, costs and potential returns of investment products, assess the effective implementation of requirements and identify potential inconsistencies across regimes. The study first describes the main trends in the supply and distribution of retail investment products in the EU and the main current drivers for the demand of retail investor products (low interest rates, supply of products with lower costs, supply of products labelled as sustainable and the booming demand for cryptoassets particularly among the younger and risk-seeking population). The study also evaluates the impact, cost-efficiency and EU added value of potential actions in the areas of (i) disclosure, (ii) inducements and advice and (iii) suitability tests.

This study follows the advice published in April 2020 by ESMA on inducements and costs and charges disclosures under MiFID II in which 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 also 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 in particular.

ESMA and EIOPA were also asked by the Commission to provide advice on a number of focused aspects of retail investor protection such as disclosures, digital channels, inducements and product complexity, which have led to recommendations to update MiFID II, IDD in these areas published in April 2022[16].

Concerning disclosures, ESMA emphasized the ergonomics of information provision proposing for example that minimum 'vital information' should be defined for investors to be able to make informed decisions and to use 'layering' to provide relevant information step by step to investors in a user-friendly way and address overload and complexity. New areas such as 'gamification' *i.e.* the use of game-like elements or functions in non-game contexts were also addressed in ESMA's recommendations with a balanced approach. While considering that practices related to gamification may be beneficial in some ways *e.g.* for conveying information in a simpler and more understandable way, ESMA recommended ensuring that certain online practices on social media encouraging investors to make investments do not wrongly influence them *e.g.* nudging them to take undue risks, with a view that such gaming tools should be authorised as long as they are in the best interest of customers.

EIOPA also set views in a number of areas. First, in the area of consumer disclosure, EIOPA recommended a shift towards truly consumer-focused disclosures built upon an enhanced framework that fits the digital age and built using behavioural research and consumer testing. EIOPA also proposed tackling conflicts of interest that arise throughout the product lifecycle, including in the product design phase when underlying funds are selected

10. One of the key objectives of the review of the ELTIF (European Long Term Investment Fund) regulation is to make those 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
11. 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
12. Pension auto-enrolment 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
13. The pension dashboard aims to support Member States in the improvement of their pension systems, in addition to collecting best practices for the implementation of individual pension tracking systems at domestic level
14. 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
15. Disclosure, inducements and suitability rules for retail investors study – Kantar in cooperation with milieu and CEPS - August 2022 https://op.europa.eu/en/publication-detail/-/publication/5d189b3c-120a-11ed-8fa0-01aa75ed71a1/language-en
16. See ESMA_final_report_on_technical_advice_on_ec_retail_investments_strategy_290422.pdf, EIOPA_Final Report - Technical advice on Retail Investor Protection_290422.pdf, ESA Joint, Com_advice_on_priips_regulation_Call for advice_290422.pdf

for unit-linked products and in the sales process notably concerning inducements. Thirdly EIOPA recommended addressing complexity and cost-efficiency in the retail investment market particularly at the product level, where clearer standards or criteria should be defined for evaluating product complexity.

The ESA Joint Committee moreover made recommendations concerning PRIIPs and notably the KID, to make it more consumer-friendly and to enhance the clarity and consistency of product descriptions.

2.2 Consultations led by the Commission highlighted the importance of improving suitability and appropriateness regimes

A consultation was conducted by the Commission between May and August 2021 aiming to identify the main issues to tackle in the Retail Investment Strategy and the MiFID II, IDD and PRIIPs reviews with regard to retail investment[17]. In the answers received, financial literacy was considered to be the area with most scope for improvement, followed by disclosure requirements and digital innovation. Many stakeholders also called for an improvement of the suitability and appropriateness regimes of MiFID II and IDD to simplify the way investor profiles are assessed, develop a more holistic approach focusing more on investor portfolio composition than individual product investment and adjust requirements to online environments.

The Commission subsequently launched a targeted consultation at the beginning of 2022 on ways to improve suitability and appropriateness assessments with a proposal to replace the current product suitability approach by the establishment of a personalised asset allocation strategy that would set out an investment plan and an optimal allocation of asset classes considered fit for the goals of a given retail investor. The aim is to allow an evolution towards a perspective of individual portfolio creation in the advice provided, rather than the current focus on individual products and to enhance the portability of suitability assessments. The investor would remain free to choose the products she/he wants to invest in within this personalised asset allocation, which could be transferable across financial intermediaries.

ESMA has also proposed some specific improvements to MiFID II suitability requirements at the beginning of 2022 notably to clarify how the assessment of clients' sustainability preferences should be conducted in the context of suitability assessments.

2.3 Assessment of the value-for-money of retail investment products

The value for money of retail investment products is a further area of investigation of ESMA and EIOPA, based on an annual monitoring of product performance and costs.

In its third annual report on this topic (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[18]. In addition it was estimated that 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 with lower risk profiles. EIOPA subsequently launched a consultation[19] on a framework to assess whether unit-linked products offer sufficient 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, it was recommended that 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 that efforts should be made to make products easier to understand by retail customers.

17. Main areas covered: 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
18. Source: Performance and costs of retail investment products in the EU – ESMA – 14 April 2021
19. Consultation on a framework to address value for money risk in the EU unit-linked market – EIOPA – April 2021