Retail Investment Strategy: key priorities

1. Ongoing changes in the European retail investment market

The Chair introduced the session by stating that many changes have happened in the retail space in terms of investor profile and behaviour, types of investments offered and macro-economic conditions impacting savings. Investors need help to navigate these complexities. Addressing these issues is one of the objectives of the upcoming Retail Investment Strategy (RIS) that the European Commission is preparing as part of the Capital Markets Union (CMU) initiative.

An industry representative explained that the global economic environment has changed over the last year with increased geopolitical risks and the return of inflation, which is a significant game changer for retail investors. The sustainability agenda is also offering new opportunities and challenges for retail investors. Financial planning and defining the right savings strategy for their short-term projects and longer term pension objectives is essential in this environment. Diversification is increasingly important, with traditional savings no longer providing sufficient interest, as well as investing in real assets in order to obtain more return over the long term.

An investor representative emphasised that the key market development that retail clients are facing at present is 'financial repression'. This is materialized by the difference between the inflation rate and the nominal interest rate. Interest rates remain low although they are slowly increasing and at the same time inflation in the eurozone is above 9%. The result for retail savers is a historical level of financial repression. In 2022 it is anticipated that individual financial savers in the eurozone area will be losing more than €1 trillion on their financial savings in real terms i.e. taking inflation into account, because the majority of these savings are in interest rate related products such as bank savings, capital guaranteed life insurance and pension products that invest mainly in fixed income and money market instruments. This is not a new phenomenon, but it has considerably amplified. Even with 2% inflation, savers lose half of their savings value over 34 years, when keeping them on their bank account.

A regulator noted that positive trends in terms of retail investment are being observed in several EU member states, particularly following the Covid crisis. 85% of people in the Netherlands are indirectly exposed to the capital markets through the pension system. There has been an increase in participation in the capital markets of +11% in 2019 and +12% in 2020, mainly in the execution only channel. There is however still significant room for improvement. A recent AFM study showed that almost half of Dutch households could benefit from increased exposure to the capital markets. Retail customers could also invest in a more effective way. Only 25% of them have a specific investment goal in mind and one-third display sub optimal investment behaviour trading too frequently, which increases costs. There is also insufficient diversification in their investments on average and too many risky products in their portfolios. In addition, the majority of the increase in retail investment is through execution-only orders and 50% of new investors invest less than €25,000, which is insufficient for them to benefit from a financial advisor.

The regulator added that crypto buying is another trend in the Netherlands, with 14% of people owning cryptoassets, although half of those have invested €500 or less. 63% of people surveyed by the AFM said that investing in crypto had more to do with gambling than investing. The Markets in Crypto Assets (MiCA) regulation is welcome, although there are caveats. The current growth in cryptoassets and the global dimension of this market would require a common supervisory approach at the EU level. More generally problems that are common to member states should be handled at a European level also in the retail space.

A regulator noted that market data in Belgium shows that most of the growth observed in terms of equity investment has come from the younger generation, who are showing an interest in real economy investments. Since the beginning of the Covid crisis, there has been a fivefold increase in the number of people trading on the BEL20, the Brussels stock exchange index, compared to the pre crisis period. Young and infrequent investors were more active during the lockdown period, but they are still present and did not engage significantly in cryptoassets. The number of unique investors in the BEL20 has doubled. The volume traded on the stock exchange index also rose during the Covid crisis, with investments focusing on biotech, pharmaceutical and real estate firms. ETFs have also gained in popularity among retail investors.

2. Objectives and priorities of the Retail Investment Strategy initiative

A regulator emphasised the importance of the RIS proposal being worked on by the European Commission. It is essential to send a balanced message with this initiative and to approach the issues of retail investment and investor protection in a pragmatic way. Actions are needed to ensure that investment products and new concepts such as ESG can be understood by ordinary citizens and supervision needs to be enhanced at the EU level for cross-border investments.

A public representative observed that the issues surrounding retail investment are complex and require an effective dialogue between all stakeholders concerned to achieve a practical and usable legislation. Defining the end goal of the RIS is crucial. The RIS is part of the broader CMU project, aiming to develop and further integrate capital markets in the EU. This requires in particular a diversification of investments, with more capital market investment, and attracting a broader range of active investors to the market. It is necessary for policy makers to take the consumer perspective into account and explain why it is important for retail investors to actively participate in the market. A usual point of consensus is that capital market investment is the most effective way to enhance long term returns and guarantee an additional income for the future, notably for pension years. This is a question of long term investment and not of speculation, which should be appealing for the European market, which is more conservative than other regions in terms of savings. Pension funds can support this objective; such vehicles should be made available in all member states.

The public representative added that identifying the best way to interact with retail savers is another important issue. Digital tools can facilitate this. However, retail clients must be provided with sufficient protection and proper explanations when they use these tools, and they must have the same level of protection as when they go through an advisor. Investments going through advisory services are currently more regulated than direct investment, and digital channels rely on disclosures that are not always read or understood. An adequate balance needs to be found between the different investment channels in the level of protection provided. In some cases having personal advice is important as well, which must be kept available.

The public representative concluded that the RIS must take a holistic approach in covering the different drivers needed for fostering retail investment, including market regulations, information campaigns, financial literacy initiatives, and measures to reinforce trust such as cybersecurity. This approach must also be harmonised across all member states. In addition, a balance must be maintained in the measures proposed between the interests of financial advisors, service providers and retail investors in order to align incentives as much as possible and avoid principal-agent conflicts.

An industry representative highlighted the need to put investors at the centre of the strategy. No boost in retail investment in Europe will occur unless investors are confident and have trust in the markets they invest in. This is a common goal between the financial industry and the public authorities.

3. Key potential areas of focus for the Retail Investment Strategy

The panellists highlighted five key areas on which the RIS should focus: digitalisation; advice and inducements; disclosures; financial literacy; and product complexity and value for money.

3.1 Digitalisation

Several panellists stressed the importance of digital tools for supporting retail investment and the need for the RIS to be fit for the digital age.

An industry representative stated that digital tools provide many opportunities for interacting directly with customers on a regular basis and reinforcing their level of understanding of and confidence in financial investments. The regulatory framework must facilitate the on-going digital transformation led by financial firms with a 'digital by default' approach. This does not mean 'only digital'. Paper based information should be accessible, but only if requested by the customer.

The industry representative added that many investment products are sold through intermediaries. It is therefore important to consider how digital innovation may help intermediaries in their interactions with product providers and customers, notably for the provision of information and advice. The ability for advisors to get an immediate quote during a customer advice session thanks to digital tools is extremely valuable, because it facilitates the customer's decision making process and contributes to building trust. Digital tools may also help product providers to develop ongoing relationships with customers buying long term investment products, allowing them to easily access their accounts, track the evolution of their investments in real time and check the details of their products through their phone. This will contribute to engaging investors in a more active way than traditional annual statements and to enhancing financial literacy with a 'learning by doing' approach. These evolutions should be taken into account as a general trend in the framing of the RIS.

A regulator agreed that investor disclosure is an area where digitalisation can have a major impact. This requires eliminating the obligations to provide paper-based documents that are still embedded in some of the legislations regulating investment products. The European supervisory authorities (ESAs) are aware of this and are willing to contribute to changing the approach to customer disclosure and the way of engaging with customers. Behavioural research and consumer testing will also be helpful in this context.

More generally, technology is a potential game changer for retail investment, the regulator stated, facilitating access to different types of information, supporting transactions and allowing the industry to offer more tailored products. Digital tools can also play a role in terms of automating advice, but this can be challenging to use for long-term products such as life insurance. Open finance and its adaptation to insurance products also offers many opportunities. Digital tools may also support cross border retail investment, but this requires enhancing supervisory convergence in order to increase the trust of savers when investing cross-border. The ESAs are working on this, but the speed of convergence is sometimes slower than the speed of digitalisation and the increase in cross border business.

A second regulator concurred that there is a cross border element to digital distribution. The French AMF and the Dutch AFM published a position paper focused on execution-only transactions setting out the case for an improvement of cross border supervision in order to tackle possible cross-border issues. Digital tools may also play a significant role in steering clients in a potential direction. This steering can be positive and facilitate investment decisions for example showing pre-determined allocations or lists of stocks or funds corresponding to an amount the investor is intending to invest, but it can also have negative consequences if it is not appropriately implemented.

A third regulator noted that the RIS has to be fit for the digital age. Technology fosters more retail participation in stock markets particularly among the younger population, due to the ubiquitous and permanent use of mobile phones in particular. Investing through a digital device is different from the traditional dialogue with an advisor, and investors do not get the same information. This needs to be taken into account in the regulatory approach. Technology is also changing the way supervision is conducted, facilitating reporting, fact finding and the extraction of granular information from databases coming e.g. from MiFID II and MiFIR reporting. Finally data supported by digital tools can also provide regulators with better market insight, allowing them to better understand and regulate the market.

3.2 Advice and inducements

An industry representative considered that savers need to be properly advised to navigate the new environment with rising inflation, geopolitical risk and sustainability objectives, but the advice gap is quite significant in some member states. It is impossible for example with execution only services or robo advisors to explain to investors, in accordance with MiFID II rules, what is to be considered as sustainable investment under the complex taxonomy of the Sustainable Finance Disclosures Regulation (SFDR).

An investor representative emphasized that fostering bias-free advice was initially put forward by the European Commission as one of the top priorities of the RIS. However, the objective has now been given a lower priority. Statistics from the French market show that classic active retail equity funds represent 93% of the market share in unit-linked life insurance contracts, whereas ETFs only represent 2% of the market, which is in line with the statistics for direct investment in funds. This is due to a selection bias by financial intermediaries, which also has an impact on performance. Over the last five years the performance of French equity funds that are included in wrappers managed by insurance companies is half that of French equity ETFs, which cost 10 times less. But since these latter products are part of the non advised universe, only a small number of literate people invest in them through online brokers. A first step would be to ban inducements on execution only transactions, because by definition there is no advice and no cost related to advice in this case.

A regulator agreed on the relevance of banning inducements. In the Netherlands the payment and receipt of inducements on advice is banned, which has been very successful. All advice that is provided is directly paid for by the clients and not by inducements remunerating the sale of products by distributors. That reduces conflicts of interest. There has been a decline in advice, however this trend already started before the ban was introduced in the NL. The main result of this ban is that the cost of financial products for investors has dropped significantly. An increase in investor trust has also been observed. It is crucial to build trust in this environment, where there is a structural information asymmetry with a better understanding of financial products among financial advisors than their customers in most cases. This requires ensuring that client interests are protected to the greatest extent possible, as well as adequate product oversight and governance requirements.

An industry representative stated that customers who want advice should be able to access it. A report published by the Commission in August 2022 on costs, disclosures, inducements and suitability shows that in the Netherlands 58% of respondents said that they would not pay for advice even if it was at an affordable price. This means that the majority of people are potentially excluded from access to advice. Some people are happy buying on an execution only basis and do not want advice. This is the case of those investing in ETFs for example, which have been a growing segment in the French market since the Covid crisis, and also of the younger population. It is important to remember what happened to research on SMEs after the implementation of MiFID II rules mandating an unbundling of research and order execution costs, which resulted in a quasi-disappearance of research on these companies. A diversity of models is needed in the market. While execution-only investment in ETFs works well for certain customers, it is important to provide investors with a varied range of options in terms of products and order execution, and also for them to have access to advice which is essential for certain types of products, for example those that offer a guarantee in terms of capital or that have a long term perspective. Cost is not the main factor in investment decisions. The first consideration is risk, the second is return, and cost is the third.

The industry speaker suggested that a preferable option would be to streamline and simplify disclosures requirements or improve suitability tests for instance. The enhanced suitability test as proposed by the Commission, is an interesting way to explore, with the replacement of the current product suitability approach by an approach at the portfolio level. Under the current MiFID product-focused suitability test regime, as soon as investors are considered to be averse to risk, then firms cannot sell financial products with a SRRI (Synthetic Risk and Reward Indicator) ranked above 5 or 6 for example, so they cannot sell equity based products to them. Evaluating suitability at portfolio level would be a better way to ensure that, even if they are risk averse, people can still have a limited percentage of their investments e.g. 10% or 15% in equity, which would provide them with a better level for diversification. The practical implications however need considering. In addition, the Personalised Asset Allocation Strategy (PAAs) along with the idea that these allocations could be portable from one provider to another are more concerning options as they raise a number of questions, notably with respect to both the financing of this process by firms and the responsibility to keep the assessment always up to date.

3.3 Disclosures

A regulator considered that addressing information overload should be a key priority of the RIS because it does not improve investor protection. Lengthy prospectuses are unhelpful from an investor perspective because they dilute the useful information. There is a need to streamline the different disclosure requirements and adapt them to investor needs. Product information and communication, including publicity should also be appropriately supervised. For example, in the case of cryptoassets, advertising is the main source of information for investors. The Spanish National Securities Market Commission (CNMV) has extended supervision to publicity relating to cryptoassets, an approach which is now being implemented in other member states. Another proposal that has been made by ESMA is to use 'layering' techniques to provide relevant information step by step to investors in a more user-friendly way.

An industry representative agreed that investors should be provided with more meaningful information built with an investor-centric perspective. There is currently too much information which is too complex. A new layer is being added with the MiFID sustainability requirements, which might discourage investors from investing in this area.

Another industry representative also emphasised that customer information must be tailored to customer needs in order to empower them to make informed financial decisions. Ex-ante consumer testing, to ensure that customer information is meaningful and fit for purpose, is key. No new retail disclosure requirements in EU financial markets should be enacted without it. The work done by EIOPA to outline duplicative disclosure requirements between Solvency II and the Insurance Distribution Directive (IDD) is an important first step also. There are different formats for the same information, which not only adds unnecessary costs, but may also lead to confusion. This issue should be addressed in the RIS proposals. Regarding the Key Information Document (KID), customers could be further empowered by giving more prominence to essential information such as the existence or lack of insurance cover, payment flexibility and other benefits concerning insurance-based products.

An investor representative stated that digitalising key disclosures is an important priority because the younger generations particularly, conduct most of their financial activities on smartphones and need to be able to easily access information on products on their phones and compare them. In Norway there is an independent public finance portal which compiles the data of all available financial products, which in turn are used by commercial web comparing apps. A second important aspect concerns the data that needs to be provided. In order for retail investors to be able to compare products easily, information on the actual cost and performance of products should be included alongside the provider's benchmarks in the key information document (KID). This must be factual and comparable information based on historical performance, and not putative future projections such as those that can be found in the current packaged retail investment and insurance products (PRIIPS) KID, which is a significant regression from the original KIID[1].

3.4 Financial literacy and education

A public representative stressed that enhancing financial literacy is a key objective for ensuring a widespread participation of retail customers in the capital markets and is an important driver for the RIS. It should be everyone's responsibility - i.e. regulators, member states, national education systems, advisors or the financial sector - that a basic level of financial literacy should be guaranteed in Europe. Educating and informing customers cannot be the sole responsibility of the financial advisors, because this may lead to quite a selective and biased approach. It does not seem appropriate either to leave it to regulators alone because they do not have direct interactions with consumers.

An industry representative agreed that increasing financial literacy is essential. One approach to this is 'learning by doing'. Employee share ownership schemes and workplace schemes, which allow employees to invest a part of their revenue in the shares of the company in which they work or in products proposed by their employer can contribute to this objective.

A regulator observed that enhancing the financial literacy of retail investors is particularly important with regard to climate change and ESG objectives in order to help customers make better decisions concerning how to finance the climate transition and avoid greenwashing. There is much demand for this on the investor side but it is quite a technical area. A challenging aspect with regard to financial literacy is that the legal capacity of the Commission relating to financial education is very limited, so there is a need to enshrine the task of consumer education in the mission statements of the National Competent Authorities (NCAs) and the ESAs. This has been done in Belgium where a fully digital financial education centre was set up by the FSMA and opened during the Covid crisis. This centre is very successful with over 10,000 students having visited it, which shows that there is a need and a demand for such initiatives.

3.5 Product complexity and value for money

A regulator noted that providing products that can be understood by ordinary citizens is essential. This also applies to ESG products which must be easy to understand and have a clear objective of avoiding greenwashing.

1. KIID: key investor information document previously required for UCITS funds.

A regulator stated that for many small retail savers life insurance or pension products where they invest for 20 or 30 years is the only contact they get with capital markets. However, these products often do not offer much guarantee, because there is a possibility to escape from the capital guarantee in most cases. Adequate conduct of business is therefore essential for retail investors, including conduct supervision.

An investor representative noted that a report published in August 2022 by the Commission on costs, disclosures, inducements and suitability shows that products with inducements cost 35% more on average than products without inducements. This is not only a question of cost, but also of performance. The Commission has recently been considering the possibility of enhancing value for money rules, which seems relevant, but is only a proxy measure to the tackling of biased advice, which should remain the priority. There are already value for money rules in EU regulations such as the UCITS and AIFMD directives for investment funds, whereby providers are prohibited from charging undue costs, but they do not yet apply to other product categories. In addition, these rules are not properly enforced by the NCAs, as indicated by ESMA in its recent Common Supervisory Action report. A first step proposed by the Commission is to make sure these existing rules are enforced.