Investment product frameworks: trends and further issues

1. Current market trends and related opportunities and challenges

An industry representative stated that the UCITS and AIF (Alternative Investment Funds) investment fund segments have both experienced significant growth over the last few years. Assets under management grew by more than 25% from 2018 to 2022. In 2022 there was significant growth in funds investing in alternative assets such as private equity, real estate and infrastructure both at the EU and global levels. These positive trends in the EU concerning retail and non-retail investors are the result of a combination of factors including investor demand, the wide range of funds provided by the industry and the regulatory framework, which allows for a comprehensive range of funds to be offered. A further trend in the EU is the increase of the proportion of funds marketed cross-border and bought by non-domestic investors from 27% in 2017 to 33% in 2021.

A second industry representative explained that initially the insurance-based investment products (IBIPs) marketed by insurers focused on unit-linked products with capital and income guarantees. Following the 2008 financial crisis, insurers moved away from guaranteed products towards unit-linked products without guarantees. Guaranteed products were indeed difficult to sustain, because of the high cost of the reinsurance and collateral arrangements needed to provide guarantees long term, in a context of higher volatility and uncertainty. The evolution of IBIPs towards unit-linked products raises the question of their added-value compared to other investment products such as investment funds. Insurance companies are trying to package products differently than asset managers, with products either mainly unit-linked with some protections or that offer protection with some unit-linked diversification, and therefore offer long-term investors more potential value. Solutions are also proposed within IBIPs to follow a person's lifecycle in terms of how investments should evolve across the asset categories over time.

The industry speaker noted that providing adequate pension products remains an important objective in the EU. The Pan-European Personal Pension product (PEPP) was designed to facilitate the provision of pension products across Europe and includes a guarantee meant to be beneficial for investors. Unfortunately, providing that guarantee has proven to be too expensive, so very few PEPPs have been launched so far. The challenge with the PEPP is meeting public policy objectives of encouraging long term retail investment while achieving a commercial viability, allowing firms to offer this product on a wide scale.

An industry representative suggested that the success of a product can be measured by the volume of assets managed and whether it is part of customers' investment choices. Exchange-traded funds (ETFs) are one of the most significant new product developments of the last few decades at the global level based on those criteria. From their launch in the early 1990s, about €9 trillion have been invested in ETFs globally. In Europe, that amount is about €1.4 trillion, which remains a small percentage of total outstanding assets, so ETFs have much room to grow. That success and growth has been possible thanks to the very broad range of investor types that have chosen ETFs as an investment vehicle. In the EU ETFs are structured as UCITS funds, so they are designed to be relevant for a wide range of investors from retail to high net worth individuals, and also pension funds, endowments, institutions and sovereign wealth funds. ETFs are a telling a story about the democratisation of investment, because all investors share in the same share class and the same vehicle is used across all investor types. There are not multiple share class structures, different tiers of fees or different transparency requirements with ETFs. All investors follow the same rules and are served by the same portfolio managers, which also means that with ETFs retail investors get access to the same efficient products as institutional investors.

2. Expected impacts of the AIFMD and ELTIF reviews

The Chair reminded the audience that the European Long-term Investment Fund (ELTIF) regulation seeks to foster investment with a long-term horizon in unlisted companies such as infrastructures and certain listed SMEs. ELTIF 1.0 was very narrow in its scope and disappointing in its take-up and has been reviewed in the context of the Capital Markets Union (CMU) action plan.

The AIFMD and UCITS directives have been very successful and are now global brands. The review of that legislation is currently in the trialogue stage and aims to update it to reflect recent market developments, while remaining a trusted brand.

2.1 AIFMD review

A regulator considered that the success of the UCITS and AIFMD frameworks has been impressive and has led to providing a coherent approach regarding investment funds in the EU. There is room for improvement in some areas however, which is to be provided by the ongoing review. The ESMA peer review conducted following Brexit showed that there is work remaining to be done on the harmonisation of delegation structures and substance requirements across the EU. The AIFMD needs to be reinforced in that regard. The other aspect is the need to widen access to liquidity management tools (LMTs) across the EU. It is important that there is adequate and sufficient availability of these tools for AIF funds across the EU.

An investor representative stated that the AIFMD and UCITS directives have become gold standards and globally recognised brands, appreciated both by retail and professional investors, as they allow the pooling of investments and provide an effective diversification at relatively low cost. Improvements have been proposed in terms of harmonisation, delegation structures and LMTs available.

2.2 ELTIF review

An industry representative agreed that the first version of the ELTIF regulation was not a success at the EU level. It has been possible to structure domestic AIFs in several member states including France that resemble ELTIFs in the composition of their portfolios, investing in private assets, real estate, infrastructure or private equity with an evergreen structure. 80% of the subscriptions in some of those funds come from investors who put in less than €10,000, which shows interest in these products from retail customers. One-third of the assets under management for such customers are private asset funds. This shows opportunities for such funds at EU level. It is hoped that the Level 2 measures of the ELTIF reviewed legislation will allow competitive ELTIFs to be launched, providing for an actual development for such funds through the European passport.

A regulator explained that funds contribute to the development of capital markets, which is an important objective for achieving a more balanced funding of the economy. In Portugal for example, bank deposits still represent 61% of financial instruments. Encouraging more investment in funds could allow the achievement of two key objectives: allowing more investment to be channelled for real economy projects and offering better returns to investors. Better connecting savings to the real economy through investment in funds may also have a positive impact on the way the public opinion perceives financial markets, showing that they are not speculation and not disconnected from reality. Progress is being made with the ongoing reviews of the EU fund frameworks. The ELTIF review is important as it can favour a more balanced funding of key components of the real economy - SMEs and infrastructure projects – and help retail investors to get better returns on their savings in the long term in a context of high inflation.

An investor representative regretted that ELTIFs have not been a success so far, with only 84 products introduced in the EU market. These funds were not opened to retail investors because of the risk that they may not understand the features and risks of ELTIFs sufficiently, particularly the illiquidity of the underlying assets which meant that they may be stuck with the product for 20 or 30 years. A question with ELTIFs is the importance that investors attach to liquidity in their investment decisions. From a retail investor perspective, there needs to be a balance between adequate information and investor protection, and removing some of the burdens in the product that have prevented its development so far. The changes proposed in the reviewed ELTIF regulation are a solution for adapting the consumer protection requirements in this perspective. Improving this legislation is important also to attract retail and institutional investors wanting to invest in the companies and projects aiming to contribute to the green transition, which is an essential objective for the future.

A second regulator noted that no ELTIFs have been launched in certain EU countries, including the Netherlands (NL), despite a flourishing fund market. This is a missed opportunity, because of the potential for portfolio diversification of ELTIFs, particularly with a long-term investment perspective. One of the main solutions proposed in the ELTIF review for relaunching the product is to move to open-ended structures. This raises questions in terms of liquidity mismatch risks however. Gates are a solution, but care is needed not to create a mismatch between the expectations of retail investors and the reality of a product that may not function as intended. The Chair agreed that there is a risk of mismatch of expectations on top of the more traditional liquidity mismatch risk that needs to be addressed in the reviewed framework in order to ensure a successful relaunch of this product category.

3. Further issues to be considered in the ongoing policy initiatives

3.1 Better taking into account the specificities of ETFs in EU legislations

An industry representative suggested that ETFs have contributed significantly to the promotion of the UCITS brand, although ETFs were created in the US and have a more significant market share there. A question is whether more should be done in the review of the UCITS legislation to take into account their specific nature. By and large, they are passive benchmark trackers. European fund regulation consistently takes the perspective of a 'traditional portfolio manager' - i.e. a portfolio manager doing stock picking based on an in-depth assessment of the fundamental value of stocks. That perspective does not translate well for ETFs, where portfolio managers run a fund that aims to replicate a benchmark comprising a wide range of securities that are chosen based on a standardised index methodology with very low turnover. The language in EU fund regulation makes it very difficult to apply to ETFs. This may have negative implications for investors, who have to balance two different languages which can impact their perception of different vehicle structures.

An example of these negative implications can be found with the Sustainable Financial Disclosure Regulation (SFDR) and fund tracking benchmarks that have a decarbonisation trajectory aligned to the Paris Climate Accord, the industry speaker explained. There was initial guidance, which required interpretation for passive funds. The initial consensus was that, subject to certain other criteria, passive funds passing a Paris-aligned benchmark were eligible for Article 9 classification. There was then subsequent guidance, which was written in a different language from a different lens and created ambiguity. The result was that a number of product providers reclassified Article 9 ETFs to Article 8, which is not good for end investors. This issue was raised with the European Commission and it was made clear that the original interpretation of a Paris-aligned benchmark meets the key criteria for Article 9 classification. A number of products are now expected to be reclassified to Article 9. This succession of interpretations linked to the fact that the rules were not initially drafted considering the ETF market seems counterproductive, especially given SFDR's prominence as one of the most significant pieces of ESG legislation globally and the potential for ETFs to support these objectives effectively.

Another specificity of ETFs is that they are both funds and exchange-traded products on the secondary market. Therefore the specificities of ETFs need to be considered in securities trading and post-trading legislation, such as MiFIR and the CSDR regulations. For an effective functioning of the market it is necessary to provide liquidity, ensuring that investors can enter and exit their positions easily. In this respect the two-layer structure of ETFs must be considered because liquidity in an ETF may be derived from the trading of the underlying constituents. Investors also need appropriate market data. The fact the EU legislative proposal on the consolidated tape takes into account ETFs is positive, because one of the reasons the US ETF industry has grown so rapidly is because of the transparency provided by the consolidation of trading information by the US ETF tape. Such a tape would allow investors to make better-informed investment decisions and support best execution, and allow the EU ETF sector to compete with other large jurisdictions by showcasing the true liquidity available in EU-listed products. It would also give regulators a more comprehensive overview of the market during periods of broader market stress.

3.2 Enhancing retail investor protection and value for money

An investor representative stated that the access of retail investors to well-managed investment products needs to be facilitated. There is a risk or cost of not investing because of high inflation and low returns provided by savings accounts, but investors are hesitant to invest in Europe. One obstacle is inducements, which are a barrier to the provision of low-cost investment solutions. Investors do not want to pay every year for services provided only once at the start of the investment and some do not want any advice. In addition, they do not understand how these commissions work and what they relate to. This creates distrust with regard to intermediaries, potentially hindering further investment in securities. The EU authorities should also aim to create a balance in the policies proposed between reducing regulatory burdens where this is relevant and preserving investor protection in order to prevent any tail risks of new crises. The recent banking crisis in the US and Switzerland shows that these risks exist, although this recent crisis only had limited repercussions in the EU. However, with higher interest rates and market vulnerability, the EU financial sector is not immune.

A regulator stated that properly functioning markets must allow retail investors to extract the benefits from the market. Policymakers and regulators should pursue this objective, because they have a general interest mandate and must ensure their decisions have the right impact for the general public. There are a number of improvements needed to ensure that the interests of retail investors are taken care of.

First, it should be ensured that retail investors suffer no undue cost, because the return obtained by the investor cannot be separated from the cost. Costs are mostly under the control of producers and distributors. ESMA has been very active in this area. A second area for improvement is on the quality of information. Investors, need clear, concise and comparable information on costs and expected returns in order to make the right investment decisions. Progress has been made but there are still pending issues. Thirdly, the production and provision of information needs to be adapted to the digital world. Making better use of tools such as natural language processing (NLP) could be an opportunity, although this is up to each firm to decide. The comparability of products is a fourth area of improvement. There is always a balance to be achieved between the comparability, the flexibility and the adequacy of products. Multinational companies also have tensions between centralising and adapting to local needs. That balance is a moving target that requires sufficient proportionality.

Value for money is a further topic that will deserve specific attention, the regulator emphasised. A financial product offers value for money to the investor when the costs and charges are appropriate in relation to the expenses incurred by producers and distributors, and in relation to the expected returns for the target investors. According to ESMA figures, the costs incurred by retail investors can represent up to 30% of the amount of the initial investment over a period of 10 years. This needs addressing to ensure that retail investors get sufficient return from their investments, otherwise they will not participate in the market. The Portuguese authorities in particular are very active in this area and have recently carried out a supervisory exercise that allowed the identification of products with low expected benefits for the target market and relatively high cost.

An industry representative agreed that the objectives of developing the equity culture of retail savers and the flow of savings to the real economy and to the digital and green transformations are essential. The public policy push in this direction is welcome. There is however a question around whether this lead to a balanced approach in terms of risks and who should be taking the related risks. With direct investment in securities, the risk is taken by investors. Sometimes the lines are more blurred when it comes to packaged investment products. For these products, regulatory requirements are imposed to make sure that the management companies are not taking too much risk and are putting capital aside to handle e.g. liquidity or leverage risks. Consumer protection requirements come on top of this. There is still work to do around the holistic risk assessment of this policy objective, the possible side effects and how to address them. One aspect concerns banks. An increase of investment in securities will likely reduce bank deposits, which may impact their resilience. This raises the question of the consequences in terms of risks and financing of the real economy of these measures, and whether the financial system is going to be reinforced by this evolution.

A regulator suggested that there is room for improvement in a number of areas related to investment products, including investor protection, the rules applying to fund distribution and the coordination of supervision in the case of cross-border distribution. Inducements are a first issue. In the NL they are banned, which means that the clients pay upfront for the advice they get. That ban led to a shift in the types of products that clients were advised on, with more focus put on simpler and lower cost products and on understanding retail investor needs. Transparency is a second important area of improvement, particularly with the need to enhance the layering of product information in digital environments and adapting it to online customer behaviour, because simply adding more information will not help investors make the right decisions. A third area of improvement concerns the product offering. The product oversight and governance requirements in the MiFID directive should help to ensure the adequacy of products offered to retail investors. MiFID completes some domestic approaches in this regard. In the NL, firms perform scenario analyses that test how products perform in different stress situations and assess whether this is consistent with the expectations of the target market defined.

An industry representative noted that in terms of value for money, the total costs incurred by asset managers along the value chain need to be taken into account, including the costs that asset managers have to bear vis-à-vis their own service providers. In particular in the context of ESG, especially with the growing concern about greenwashing, asset managers need to obtain value for money when buying ESG data from providers. The European Commission is going to make an official legislative proposal by the summer of 2023 on ESG rating providers, but at this stage it seems that they do not intend to follow the international recommendation made by IOSCO in 2021 to include ESG data providers too. This is a concern, not only because ESG data provision is a significant cost for asset managers, but also as the quality and reliability of ESG data marketed by providers is insufficient relative to the cost at present, despite the regular due diligence performed by asset managers.