# INVESTMENT PRODUCT: TRENDS AND POLICY NEEDS

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## Balancing investor needs and protection

The publication of the Retail Investment Strategy paper (RIS) by the European Commission is an important initiative under the Capital Markets Union Action Plan. But does this mean that existing regulations such as UCITS, AIFMD, ELTIF and PEPP have failed to respond to investor needs? This mix of product and investment fund manager (IFM) regulations is being continued by current initiatives: the AIFMD2 proposal extending its scope to a specific product, loan funds, in addition to being predominantly an IFM regulation. These regulations generally pursue the shared ultimate objective to ensure investor protection, but their scope and focus are different, with product regulations having a direct impact on investment strategies and risk management frameworks and IFM regulations defining the IFM's options, obligations and minimum governance requirements.

But do these rules also consider investor needs, in addition to investor protection? The EU framework distinguishes between UCITS and alternative investment funds (AIF). UCITS are generally relying on cross-border distribution channels to reach retail investors, whereas AIF passporting is restricted to professional clients. The European Long-Term Investment Fund (ELTIF) regulation is kind of a hybrid between the two and allows marketing with a passport to retail clients under pre-defined conditions. Pan-European Personal Pension Products (PEPP) represent another example of product for retail clients.

The commendable objectives of the RIS to "build retail investor's trust in capital markets" and to "make the EU an even safer place for individuals to save and invest long-term" are twofold:

- further improve, where needed, investor protection mechanisms,
- widen the investment universe for retail investors by providing access to more diverse products.

The first objective is fundamental and fully anchored in existing regulations, whereas the access for retail clients to alternative products, also referred to as "retailisation of AIF", aims at providing additional long-term investment and savings options in addition to investments in transferable securities, alike UCITS products.

The principle of commingling private money within an investment fund structure and of having that money managed in line with a pre-agreed investment strategy and risk criteria, including risk diversification and liquidity management, is common to and accepted by all types of investors. But investors' financial capability and appetite of having less frequent access to their invested money – considering the generally longer-term and less liquid assets held by AIF – or, in a worst case, of losing money, may not be the same for all. This is where the adequate structuring of investment funds is crucial in order to reduce inherent liquidity mismatches between the funds' assets and liabilities and/or to introduce liquidity management tools that become effective in case of liquidity squeezes.

Retail investors who have been used to buy UCITS products with frequent, often daily, asset pricing and redemption options, will have the possibilities to invest in alternative assets. Investment fund managers will need to be very transparent when disclosing the nature of alternative assets, the associated valuation processes and risks as well as the applicable redemption frequencies/restrictions.

ELTIF2 alleviates constraints on the asset side of funds notably by enlarging the range of eligible investments and by reconsidering all current thresholds, including investment and borrowing limits. The flexibility offered by ELTIF2, both on the asset side and on the level of the structuring of an ELTIF allowing for redemptions during their life, will make it possible to reconcile the objective of channelling private money into long-term finance projects with the need to guarantee an acceptable level of liquidity, particularly for an ELTIF marketed to retail investors.

**Regulatory changes cannot exist in isolation and will need to take into account investor needs.**

Even though the RIS will hopefully assist in making investment products even better and more accessible to retail investors, most proposed changes focus on enhanced investor protection, and not on creating new investment opportunities and investment fund products at EU level. Whilst these changes relating to – for example – inducement rules, cost disclosures, cost benchmarks, 'value for money' and marketing communications are eminently important to foster investor confidence, they cannot exist in isolation and will need to take into account investor needs for two main reasons:

- investors look for investment fund performance, and they are most probably bearing the cost of compliance incurred by the investment funds respectively their actors which risks to negatively impact the performance,
- investors are interested in having access to a variety of investment strategies and in having a full choice in terms of UCITS and alternative products and in terms of traditional versus digital channels and facilities enabling them to buy, monitor and sell these products.


# ANNEMIE ROMBOUTS

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## Fostering retail investments: the product range is wide - how to help investors find their way?

To increase retail investors' participation in capital markets, the availability of suitable and competitive investment products is key. The investment product range within the EU is wide. The pan-European investment products par excellence to direct savings towards the real (green) economy are collective investment funds. As early as 1985, the UCITS regulatory framework introduced a product passport that was -and still is- a unique recipe for market integration. UCITS funds have kept growing despite the economic and financial crises and count as a global standard. The framework was refined and revised over the years towards greater investor security. More specific product rules in the fields of real estate (ELTIF), pensions (PEPP) and alternative investments have further completed it. Today, the collective investment frameworks allow for a great variety of products. Funds are moreover the easiest and fastest way to invest, while direct investment remains inaccessible to most retail investors.

Take the example of Belgium, an open economy with more than 5000 different authorised or registered UCITS investment (sub-) funds, 87% of them foreign. There is no doubt any Belgian retail investor could find suitable and competitive funds within this wide range that, incidentally, has the same tax regime. Belgian retail investors nonetheless tend to have a bias for Belgian funds: although the latter account for only 13% of the retail offer, they attract 60% of Belgian citizens' investments.

Evidence has also shown that, throughout Europe, commercial bank-affiliated funds underperform unaffiliated funds. Despite their inferior performance, bank-affiliated funds hold an important market share because they have a captive investor clientele.

For long-term wealth creation and not considering national tax measures, the challenge at product level does not lie so much in the available product range but rather in helping citizens find their way to the most suitable and competitive products and in continuing to ensure effective supervisory convergence.

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To boost citizens' awareness about active savings strategies, the RIS enshrines the importance of financial litteracy for the first time in European legislation. The objectives of financial education range from financial inclusion and combating excessive indebtedness through learning citizens about the characteristics of financial products and active savings strategies to informing retirees. It is also about teaching consumers to take a critical stance, notably with regard to marketing. Priorities will have to be set at local level. With its Wikifin financial education programme, the FSMA is a forerunner in the field of contributing to the financial literacy of citizens - in 2011 already, it received the legal mandate to that effect.

However, financial education is not a substitute for information and intrusive supervision. Understandability and comparability of product information, especially with regard to the costs of the investment products, remain a major concern for regulators. As regards the KID for example, consumers struggle to identify the product with the most unpredictable returns, the product with the highest expected return or the product that guarantees a positive return or guarantees them their money back. The revision of the PRIIPS regulation builds on the KID.

Here, the question arises whether there are not limits to simplification. In this respect, regulators will also have their role to play in providing guidance to investors. Publications of the NCA's, such as the FSMA on costs of Belgian funds or as ESMA on costs and performance of EU Retail Investment Products aim at helping investors by prompting producers to justify their level of costs against that of peers. Where the RIS introduces cost and performance benchmarks published by the ESAs, it builds on this kind of initiatives.

Finally yet importantly, passportable retail products need national supervisors who set the bar equally high in terms of passport access and quality of information. Even if collective investment schemes are now an old concept, regulators should continue to invest in convergence of supervisory practices, especially as the products are subject to new evolutions, such as the sustainable finance framework. Common supervisory actions and peer reviews conducted at the initiative of the ESA's should therefore receive the greatest support.

With the current regulatory framework allowing for a broad range of suitable investment products, the RIS will have reached its goal if clients of financial institutions contribute to mobilising bottom-up disciplinary forces in favour of an ever more client-centric attitude of manufacturers and distributors.

CHRISTOPH BERGWEILER
Chair of the Board - JPMorgan Asset Management (Europe)

## Prioritize helping citizens to become more confident investors

The ongoing economic uncertainty has significantly increased the need to improve the financial literacy of European citizens. Helping more Europeans make the jump from savers to investors can go a long way towards helping them achieve a more secure financial future. This will also have broader benefits e.g. by ensuring a more diversified source of funding for the EU economy. Asset managers have a key role to play, helping direct capital to where it is needed most and creating opportunities for everyday investors to achieve higher returns.

A vast majority of European households still do not invest and continue to have high levels of savings in deposits. In the current inflationary environment, and where the interest rates on deposits offered by banks do not necessarily match the headline rate, this may not be in their best interests. This inefficient allocation of capital may correlate with the low levels of financial literacy across the EU; the European Commission's own statistics indicate only 18% of EU citizens are considered to have a high level of financial literacy[1].

It is important that policy measures to address these issues focus on a positive vision which serves to empower citizens to invest for their financial future. Policy needs to promote investor choice and transparency, supported by sound financial advice, as a way to help citizens become more confident investors.

The EU benefits from a strong product framework for retail investors, offering an array of investment opportunities while maintaining very high standards of investor protection, achieved both through product-specific and cross-cutting rules. For example, the MiFID II investor protection and transparency rules. Also, the UCITS Directive, which has enabled the exponential growth of the UCITS fund into a widely-recognised gold-standard product globally. These rules are being continuously improved, reflecting market developments and changing investor appetite. For example, we welcome the revised ELTIF Regulation, which will allow for more efficient and effective access to alternative assets by retail investors.

Nevertheless, it is crucial we do not become complacent. The current macroeconomic environment presents an opportune moment to take a more holistic approach to the retail investment landscape and find meaningful ways to promote greater investor participation. It is crucial that the recently proposed Retail Investment Strategy, which seeks to address many of these challenges, focuses on policy solutions which improve the engagement with citizens, the accessibility to advice and the competitiveness of investment funds. At the same time, policymakers must be mindful of potential unintended consequences of ill-thought out or rushed rule-making.

**...focus on a positive vision which serves to empower citizens to invest for their financial future.**

In this context, we question the narrow focus on cost in the European Commission's legislative proposal. The average ongoing charges for funds, including UCITS, have been declining[2] over the past decade, both as a result of enhanced transparency requirements under EU legislation and competitive market dynamics. Also, while we agree with the principle of delivering value for investors, a value for money framework which is only informed by costs may not result in optimal investment outcomes. Cost as an almost exclusive measure of product quality might well be misleading in an environment where added value from active asset management can play a meaningful role. We strongly encourage policymakers to consider value more holistically and to recognize the different costs associated with different levels of service.

In addition, we support measures that ensure easy access to professional advice. Policymakers should be mindful of requirements, such as changes to distribution rules, which could ultimately act as an impediment to accessing advice and create an "advice gap". While we recognise there is scope for improvement, it is unclear whether blunt policy tools will improve investor outcomes. For example, given distribution in the EU remains heavily reliant on banks, a ban on the commission-based model may remove the incentives for distributors to offer third-party products, potentially significantly reducing access to, and choice for, investors.

Instead, we need to ensure more harmonised and consistent rules, so that all investors benefit from the broadest possible choice, while benefitting from the same level of investor protection. We also need to simplify and digitalise disclosures so that transparency serves to enable informed decision-making rather than confuse investors.

As the EU moves forward with its dedicated retail investing framework, policymakers should promote an investment culture which encourages responsibly-managed risk taking. The new rules must prioritise increasing investor confidence without impairing the choice and access for retail investors offered by the existing product framework.

1. *European Commission Monitoring the level of financial literacy in the EU July 2023*
2. *ICI Research Perspective October 2022*

MATTEO ANDREETTO

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# Retail Investment Strategy: an opportunity to turn Europe into an ETF powerhouse

ETFs have been one of the most significant new product innovations in asset management over the past three decades. Although ETFs have been available in Europe since 2000, they really saw significant growth post the Global Financial Crisis. While the European ETF industry started 2010 with just US$228Bn of assets[1], they swelled to over US$1.63Tn[2] as of June 2023. This growth is projected to continue, with AUM expected to grow at an annual rate of 12% over the next 5 years, reaching in excess of US$3.1Tn AUM by 2030[3].

This extraordinary growth has been propelled by several key attributes of ETFs:

- **Access:** ETFs can offer investors access to niche and difficult to trade exposures, such as emerging market equity and debt or high yield bonds, while investing in a single security on a local and regulated exchange.
- **Liquidity:** The ability to trade intra-day on-exchange at very low cost makes ETFs attractive for investors.
- **Low Fees:** As ETFs are traditionally being passive vehicles, fees are kept to a minimum. Also, due to the on-exchange nature, there is no minimum investment in an ETF share, meaning the management fee applied to all ETF shareholders is the same, irrespective of size.
- **Transparency:** Given ETFs are required to publish their full holdings on a daily basis, this means investors can know exactly what they are buying, and are less likely to get stung by managers holding exotic instruments that may not be appropriate for their portfolios.

All of these attributes make ETFs an appealing investment vehicle for retail investors, as the vehicle has democratized the way investors can access markets.

In this context, retail investors are becoming a distinct distribution channel in what was traditionally a market of wholesale and institutional clients. To date, we have seen Germany be the driving force behind the retail adoption of ETFs in Europe, which has largely been encouraged by the introduction of savings plans in the country. This has increased the ease by which retail investors can become self-directed investors through digital wealth platforms.

**The value of ETFs for end investors should remain at the centre of the EU legislative agenda.**

The value of ETFs for end investors should remain at the centre of the EU legislative agenda. In this sense, the Retail Investment Strategy could be a great opportunity to build up on these positive developments and replicate them in other markets across Europe, to further facilitate end investors access to simple and transparent products such as ETFs. Digital engagement and distribution is key in this new phase of the EU ETF market and should be adequately supported by regulation.

ETFs have also proven resilient during times of market stress. While many had predicted that in a market sell-off, ETFs could struggle due to the mismatch in liquidity between the ETF shares and the underlying securities in the fund (particularly for less liquid asset classes such as the corporate bond market), the COVID crisis showed this was not the case. ETF shares continued to trade in an orderly manner, and although shares traded at steep premiums and discounts to NAV, the common consensus was that the ETF prices likely better reflected the fair price of the underlying securities than the NAV or index price, due to prices being stale from a complete lack of trading in the underlying bonds.

While ETFs remain a compelling option for retail investors, changes in market structure and the evolving regulatory landscape can also have a detrimental impact on end investors, which regulators should remain vigilant on.

A good example of this is the planned US move to T+1 settlement in May 2024. This will pose significant challenges to EU ETFs that include US exposures, such as global equity ETFs. The mis-alignment between the ETF shares and the underlying securities will create problems for Authorized Participants, because it will make managing a creation or a redemption more challenging.

These operational difficulties are further exacerbated by the CSDR regulation, as the operational challenges will lead to an increase in failed trades, which will lead to an increase in fines. APs will be forced to embed these extra costs into the spreads that they charge to the market, ultimately increasing the costs of trading for retail investors.

On the flip side, the recent announcement of a pre and post trade Consolidated Tape is a positive regulatory development for EU investors, as this will help increase transparency on ETF order books and allow end investors to get a better and more precise picture of the way that ETFs are traded.

1. *Source: Morningstar Direct.*
2. *Source: ETFGI June European ETF Report: https://etfgi.com/news/press-releases/2023/07/etfgi-reports-assets-invested-etfs-industry-europe-reached-record-us163*
3. *Source: EY report on European ETF market growth https://www.ey.com/en_gl/news/2023/03/despite-european-etf-market-decline-in-2022-positive-inflows-and-sustained-investor-demand-mean-growth-forecast-from-this-year-onwards*


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## Are EU retail investors fully benefiting from active fund management strategies?

Up to now, the EU has been very successful regarding the investment fund regulatory framework, in making the UCITS a golden standard, more recently complemented by the AIFs. And the recent political success achieved on 20 July 2023 by the Spanish Presidency, the EP Rapporteur and the EC regarding the AIFM and UCITS Review is just the latest illustration that this EU fund framework can remain stable on its cornerstones while being regularly upgraded and adapted over time in a targeted manner.

**But does this EU fund regulatory success fully benefits EU retail investors in practice?**

From a CMU perspective, retail investors have been progressively able to get a wider cross-border access to traditional assets (equities, bonds) in collective portfolios represented by the UCITS funds, in particular thanks to the "retail passport" attached to it.

But this cross-border access at pan-EU level by retail investors is not yet possible in practice towards the rest of fund assets (such as infrastructure or real estate).

The interesting case today is that, at national level in many Member States, various local ranges of funds investing in so called private assets (infrastructure, real estate, private equity, private debt) have been successful for years towards retail investors, including mass retail investors. Many retail investors have invested in such domestic private asset funds and remained invested in them (including through open-ended funds).

Therefore, the most important challenge now is to replicate at EU level the success of such domestic private asset retail funds, to ensure that EU retail investors may in the near future benefit from the same Single Market product offer as for UCITS funds.

To that end, the practical modalities of the European Long-Term Investment Fund (ELTIF), through the technical advice of ESMA to be submitted to the EC by the end of this year, will be key for the success – or failure - of the reviewed ELTIF as a complement of UCITS funds for EU retail investors.

**Technical advice of ESMA to the EC will be key for the success – or failure - of the reviewed ELTIF.**

In addition to that reviewed ELTIF offer, the EC proposal for a Retail Investment Strategy (RIS) seems a way, if rightly calibrated, to facilitate such a wider access and more appropriate choice of investments by EU retail investors.

**Which aspects of the RIS should then be clarified to avoid adverse unintended consequences?**

First, regarding the Value for Money (VfM) approach and its related benchmarks (at both manufacturer and distributor levels), a race to the cheapest product in strictly absolute terms would have to be avoided. At fund manager's level, any benchmark related to fund peers should consist of a meaningful underlying sample, for instance not to put funds of different types in the same sample (e.g. mutual funds and ETFs; or actively-managed ETFs and passive ETFs). It is even more important at distributor's level, where the various MiFID tests to be applied vis-à-vis the investor should ensure that the product offered in practice to a given individual client is the most appropriate one, which does not necessarily lead to the cheapest product as such.

Second, regarding undue costs, as for the notion of VfM, everyone is of course in favor of avoiding them as being detrimental to the investor. Still, the final provisions will have to be carefully designed in setting the related requirements for fund manufacturers at fund launch and over time, to avoid disproportionate obligations and processes.

Third, regarding PRIIPs, in the same vein the intent to introduce a new section on sustainability is perfectly legitimate, but overloading the content and reading of the currently short document will have to be avoided too.

Finally, whichever piece of EU legislation to be considered and above regulations, the ultimate aim must be to satisfy the needs of retail investors – at pan-EU level - in the best way. Currently, EU retail fund investors have increasing requests and expectations towards fund managers: to be more active in their ESG approaches (either through their fund investments, or actual participations in issuers' AGMs), to offer longer-term and sustainable investments beyond the mere listed securities, as well as various fund vehicles depending on their needs.

As a long-standing active and ESG fund manager, dealing with the whole range of retail investment funds – UCITS, national Long-Term Investment Fund ranges as well as Active ETFs – and by being strongly involved in the life of our investments, we just want to answer such needs.

We are now expecting that the ELTIF Review will facilitate the Long-Term Investment fund offer to EU retail investors in the near future. And we deeply hope that the RIS will not unintendedly make the EU fund offer more complicated.

GERBEN EVERTS
Executive Director - European Investors' Association

# Value for money requires client centricity + effective pan-EU shareholder rights

In the CMU, retail investment strategy and subsequent regulatory proposals, a lot has been shared about investors and the investor perspective. The interest of investors is mainly voiced and protected by others. Consequently, investors hardly have any flexibility in choosing the most adequate distribution channels. Furthermore, protection against wrongdoing in the governance and pan-EU distribution of financial products is suboptimal.

As long as industry is in the position to convince policy makers that inducement models have added value, the value for money and equity culture will not develop. The ECMI-CEPS report as well as Prof. Dr. Steffen Sebastian's recent academic work on the effect of inducements has three clear take-aways: a ban on inducements has a positive effect on household returns on investments, no negative effect on savings and a ban is also positive for poorer households.

Many retail investors are not aware that incentive structures are not in their interest and eat away large parts of their future revenues. The most important advice retail investors deserve is the advice to save on unnecessary costs they have to pay every year for a one-off advice in a distant past.

To truly increase retail investor participation, we need fair and efficient capital markets, where diversification and returns are important. Investors want (qualitative) value for money, preferably with simple products. Pan-EU pension products should be allowed a second chance. Financial literacy and financial education are important, but one should caution for biases (education by intermediaries). The important concept of client centricity should be incorporated in the law and the role of supervisors enhanced. The introduction of pan-EU collective redress is crucial to attract cross-border retail investments and the essential rights of shareholders should be kept intact.

Against this background, the CMU and retail investment strategy are important stepping stones. The AIFM and UCITS directives have delivered successful brands, recognized as the golden standard. We all know that pooling investments is helpful as professional portfolio management is stimulated, standardization is delivered and investors' and consumers' interests are served. However, further clarification and harmonization of delegation structures and liquidity management tools in the AIFMD and UCITS are still required.

**Citizens of Europe, whether they invest directly or indirectly, need to be the true CMU champions.**

A preliminary observation on ELTIF is that less than 100 ELTIFs have been created altogether. We still have difficulty in accepting that to stimulate retail investment, the EU has resorted to lowering investor protection. For this reason, the intention to enable open-end ELTIFs can be criticized. Access to infrastructural products enables diversification and more optimal portfolio management. However, the characteristics of illiquid assets are significantly different. Investors need to be well informed to be able to make a careful decision.

We've entered an era where we see more pan-EU financial flexibility, comprehensive digitalization, demographics requiring self-discipline and a higher educated population. The main issue is not that investors don't understand financial products. Overly complex information creates barriers for people to start investing. Investors don't trust products, nor the 'independent' intermediaries. Consequently, huge amounts of consumers' savings are dead wood on a savings account washed away by inflation. A further review on existing regulation is important.

If you compare Europe with the US, the fragmentation in the fund sector is a key difference. We have too many funds. Also, all distributors have their own funds and an incentive to advise those. Consequently, funds are too small, liquidity is poor and costs are too high. We are stuck with a non-competitive situation.

In an ideal world, seamless cross-border distribution of investment products would be the default. However, we all know that the home/host supervisory arrangements are not interpreted from a European angle, but from a national perspective and an attempt to protect 'national champions' on the sell-side. The rigidity of supervision is different if you compare Member States with a large domestic market with those where a domestic market is essentially absent. The latter have no incentive to protect consumers and investors. The dodgier entrants from third countries decide on their registration accordingly. Consequently, marketing and investor protection rules will remain fragmented to protect local consumers and investors and to restore the level playing field with domestic players.

An effective CMU cannot be delivered without strengthening supervisory convergence. Flexibility to opt for the lowest hurdle needs to be curbed and the ESA's be given the right to decide where third-country issuers and intermediaries are to be regulated. As the silent majority, the citizens of Europe, whether they invest directly or indirectly, need to be the true champions of the CMU.