Investment products: trends and policy needs

1. Current trends in the EU investment fund sector

The Chair asked the panellists for their views on current market trends in the EU investment fund sector, which market segments are the most dynamic at present and the main opportunities and challenges particularly from a retail perspective.

1.1 Overall market trends and flows

An industry representative noted that the implications for European savers of the current macro-economic environment first need to be taken into account. There are some positive trends. A great deal of the savings from the Covid period have now been used but the labour market is still extremely strong, so negotiation for wage increase is possible. Fiscal spending is relatively high globally also, led by the US. On the more negative side, further increases in energy, food prices and wages cannot be ruled out, despite action taken by the European Central Bank (ECB) to address inflation. The ongoing monetary tightening might also lead to the risk of economic recession. Increasing long-term participation in capital markets in order to achieve better returns remains a major objective for retail investors in the EU. Deposits indeed continue to be the dominant asset class for retail clients despite a negative return in real terms. There is still more than €16,000 billion in deposits in the EU, approximately half owned by retail investors and half by businesses.

Trends are positive in the EU asset management sector in 2023 in terms of net inflows, the industry representative added. Fixed income is attracting renewed interest from investors, with the increase of interest rates, creating a further element of diversification for their portfolios. Sustainability remains a strong investment objective in line with the objectives of the EU Green Deal, representing 60% of industry flows.

An investor representative regretted that the majority of EU citizens' excess liquidity remains in deposits and savings accounts. This will not provide the type of funding needed for growing businesses and investing in the green transition. There are some positive signals in the retail space, although retail investor participation must be increased further. Over the last seven years, the total size of their investment increased by 70% in UCITS and 80% in alternative investment funds (AIFs). UCITS remain the primary vehicle for retail investors in the fund market, accounting for 75% of the retail fund assets.

1.2 Increasing adoption of ETFs

An industry representative stated that a new trend since the 2020 Covid crisis in the EU is a significant increase in the adoption of exchange traded funds (ETFs). These funds are appealing to both retail and institutional investors in terms of diversification, transparency and liquidity, but also because they facilitate investments in a variety of asset classes including fixed income and investment on ESG criteria. A further feature is that with ETFs retail investors have access to the same investment vehicles as large institutional investors, which is a major driver of democratisation in the investment space. On the institutional side, ETFs were already used in 2020 as fully-funded proxy-futures for strategic and tactical asset allocation purposes. Now ETF wrappers are also increasingly popular with retail investors in Europe. There has been an increasing usage of ETF building blocks since 2020 as part of managed or advice products. Fixed income ETFs have grown in popularity with retail and the advisory channel, as well as ESG building blocks with the clarification provided by article 8 and 9 fund rules.

Until now, the absence of a consolidated tape in the EU has limited the adoption of ETFs and their liquidity, as the same instrument has to be listed in many different venues to attract investors, the industry speaker noted, but this is being addressed in the current MiFIR review proposal. A similar shift in retail investor appetite towards ETFs was observed in the US a few years ago, accelerated by the implementation of a consolidated tape and the fiscal alignment of ETFs and mutual funds. The development of ETFs is also supported by the growth of digital wealth platforms, which propose savings plans involving a regular investment in a portfolio of ETFs. This trend started in Germany and is expanding to southern Europe. These platforms target self-directed investors, the number of which may increase as a consequence.

Another industry representative highlighted that ETFs currently dominate inflows, representing 70% of net inflows into fund products, with a significant increase in active ETFs. Many areas of the economy, including the agenda of promoting decarbonisation in the EU, will however continue to require active asset management.

A regulator noted that some potential impacts on the wider economy from the rise of passive investment need to be monitored. Corporates will increasingly need to be part of an index to have access to liquidity. This may advantage the larger corporates, contrary to some of the objectives of the Capital Markets Union (CMU) aiming to diversify the funding of SMEs. In addition, the growth of ETFs can raise questions about the efficiency of the underlying market in terms of numbers of shareholders.

1.3 Fragmentation of the EU fund market

The Chair asked whether the current fragmentation of the EU fund market and the relatively small size of EU domiciled funds is an issue for retail investors, and whether there is an over or undersupply of investment products in certain areas of the EU retail market.

A regulator noted that, despite observations that the active investment fund market is overcrowded in Europe, consolidation is ongoing in certain markets. In Belgium, there has been a decrease in the number of open-ended funds of 36% between 2017 and 2021 and an increase in the average net asset value of funds of 37% over the same period. The value-for-money proposals of the Retail Investment Strategy (RIS) that may put pressure on product costs, might accelerate this consolidation and help European funds move towards a more critical size, at national level at least.

Some challenges associated with a further consolidation of the fund market also need considering, the regulator underlined. Market consolidation and the optimisation of product supply at the EU level also face several obstacles related notably to tax differences and the current distribution architecture, with most retail capital being intermediated by banks which reinforces domestic bias. 86% of funds offered in the Belgian market are foreign, but 60% of savings are concentrated in the 14% of Belgian domiciled funds, so there is clear bias in favour of Belgian funds, in part due to the way they are distributed. In addition, while the further consolidation of funds may appear necessary from a cost efficiency perspective, it may have other consequences in the market, notably in terms of stability if risks are not appropriately managed.

An investor representative was favourable to more consolidation in the EU fund market. The UCITS and AIFMD directives have succeeded in creating a market for open-ended funds that reached 56,000 funds in 2018 in the EU, which is four times as many funds as in the US. But the total value of assets under management in EU funds is only 42% of that in the US. This demonstrates the fragmentation of the EU fund sector and is inconsistent with the objective of creating a single market for funds and generating economies of scale at the EU level. Funds have fixed costs, so those that are distributed among a smaller number of clients are more expensive and less competitive, hindering their ability to adequately fulfil the needs of investors. Fragmentation also creates a gap with other more competitive markets, in the first place the US.

The underlying issues in the European fund market are however more the sub-optimisation of the single market and the insufficient competitive pressure, rather than an excessive supply of products. Fragmentation is an issue for almost all areas of the European financial services market and is in part a legacy of the past. The national and home bias remains very strong in Europe, hence the inflow of funds from other member states remains suboptimal. In the Netherlands, for example, some of Europe's best performing funds are not available for retail clients because fund managers decide not to market certain funds in smaller markets due to the specificity or complexity of requirements and the related costs. Inducements also play a role as they preserve the current distribution structure and favour biased advice, undermining investor confidence and interest. This combination of legacy fragmentation and lack of investor trust creates many missed opportunities for the European fund sector. More direct retail investment is also needed in EU capital markets, in addition to pension funds and institutional investors, to provide liquidity to the markets and ensure appropriate price formation.

There are further drivers of fragmentation at the supervisory level that the Retail Investment Strategy proposal is attempting to address, the investor representative added. Home-host arrangements are not appropriately coordinated at the EU level. Consequently investor protection rules remain fragmented. Rules are also interpreted differently across member states for example concerning marketing requirements leading to fragmentation and regulatory arbitrage risk.

2. Enhancements expected from the reviews of the EU fund frameworks

The Chair asked whether the existing investment fund categories in the EU and the corresponding frameworks, address the main needs of retail investors and what enhancements are expected to result from the AIFMD, UCITS and ELTIF reviews.

2.1 AIFMD and UCITS reviews

A regulator stated that the existing fund regulatory frameworks allow for a broad range of products: actively and passively managed, long-term and short-term, traditional and alternative. They also meet the needs of the main investor categories: high net worth individuals to whom tailor-made products can be proposed within these frameworks, autonomous investors who may invest in UCITS and increasingly ETFs and mass retail customers for whom UCITS are also adequate. The ongoing reviews should also lead to a greater alignment of rules for substitutable products, which will benefit investors.

An investor representative highlighted that the AIFMD and UCITS directives have delivered successful brands that are recognised as the gold standards at the global level. They allow an effective pooling of investments and access to professional portfolio management. A further alignment and harmonisation of the requirements is however needed, which is one of the objectives of the ongoing reviews.

A regulator considered that UCITS has been successful in addressing investors' needs, offering a transparent and well-regulated product that provides access to a wide range of asset classes and strategies. Investors indeed want access to a wide choice of instruments and to information enabling them to make the right decisions. Like regulators, they also want products to be predictable, which UCITS funds are. The amendments made in the context of the UCITS and AIFMD reviews should ensure continued investor interest in the related products.

2.2 ELTIF review

A regulator expected that the reviewed ELTIF regulation (ELTIF 2), which is now in development, will bring significant improvements over ELTIF 1 and should be more successful. The main enhancement of ELTIF 2 is to facilitate retail investment in these funds by removing some restrictions, such as investment limits, and adapting subscription thresholds. ELTIFs will also be able to invest in more assets classes, making the product more attractive. Thresholds on the investment and redemption sides must be carefully fixed however, to ensure investor protection without damaging the product.

An industry representative noted that there is currently a strong global trend of retail investment in non-listed assets, as will be highlighted in an upcoming World Economic Forum study. ELTIF 2 should help Europe to take advantage of this trend, with many fund manufacturers interested in launching ELTIFs with the new rules. ELTIF 1 did not work with only 100 ELTIF funds licensed in total across the EU 27 compared to a total of more than 30,000 UCITS funds. It is hoped that the review of ELTIF will allow the market to develop, particularly with the objective to facilitate retail investment in these funds, which are complementary to UCITS funds.

Care must be taken however not to impose too many constraints at Level 2, as this may jeopardise the success of ELTIF 2 funds. Two main issues need adjusting in the drafting of Level 2 requirements. First, ESMA proposed a minimum holding period for ELTIF fund units of three years in its advice, which is a long period of time. Recommending a minimum holding period is quite relevant, but imposing it by regulation seems difficult. Secondly, ESMA's consultation proposed a minimum redemption pace of 3 months, which is the pace at which ELTIF fund units may be redeemed. Fixing such a parameter in absolute terms is inappropriate. It should be adapted to the different investment strategies of ELTIFs which cover a wide range of underlying assets including real estate, infrastructure, private equity and private debt, and also to the investors targeted, who are quite diverse. These different aspects could more easily be taken into account by supervisors, when asset managers submit authorisations for ELTIF funds, rather than being fixed in absolute terms by Level 2 requirements.

The industry speaker added that domestic best practices in the area of long-term assets sold to retail investors should be capitalised on. In France, open-ended retail funds invested in infrastructures have been very successful, demonstrating how the real economy can be financed by domestic savers. The same approach should be pursued at the EU level, directing retail savings towards the EU economy, in line with CMU objectives.

Another industry representative observed that ELTIF 2 will provide a solid basis for the democratisation of alternative investment funds if the liquidity risk is managed carefully.

3. Expected impact of the Retail Investment Strategy and related issues

The Chair asked whether the Retail Investment Strategy (RIS) is expected to have a beneficial effect on the supply of retail investment products in the EU and whether further improvements to existing product frameworks and ranges are needed to foster retail investment in the EU.

3.1 Expected impacts of the Retail Investment Strategy

A regulator considered that the RIS should encourage more retail participation in capital markets and also contribute to enhancing the consistency of investor protection across the EU. Investor protection rules are currently provided in the main investment product regulations, including AIFMD, UCITS and ELTIF, but they tend to differ between different financial instruments and may be interpreted differently by member states. This inconsistency leads to cumulative or differing requirements, which may be confusing for retail investors.

Another regulator highlighted the importance of enhancing the financial education of the mass retail clients who can afford to put money aside but do not have the knowledge or time to inform themselves. They largely depend on financial intermediaries such as banks and insurance companies for their savings and investments. Their level of knowledge would need to be enhanced particularly around long-term saving strategies and being able to take a critical stance with regard to the marketing information they are provided with, especially via digital channels. These objectives are currently being addressed in the context of the RIS.

An investor representative stated that in order to develop retail investment in Europe, regulation must strengthen investor confidence, with adequate investor protection rules, and provide a framework that fosters fair and efficient capital markets. Progress can be made with the provision of adequate product information and financial education, but it is essential that on top of this EU policies, such as the CMU and the RIS, should incorporate a concept of client centricity, whereby the client's interests are placed at the top priority for all public and private institutions. Supervisors at the EU and domestic levels must also foster further convergence and should be further empowered to act against outliers. The measures proposed in the RIS to improve cross-border supervision and home-host cooperation are a step forward in this regard. The introduction of pan-European collective redress is also crucial to preserve shareholder rights. It should be possible to go to court not only in one jurisdiction, but also in a pan-European context. The impacts of technological innovation should also be considered from a retail investor perspective.

Another industry representative emphasised that the ultimate objective of the RIS measures should not be forgotten. It should be to build a 'retail financing union' within the broader CMU, aiming to ensure that more retail savings are channelled towards the financing of the real EU economy, such as infrastructure investments or the green transition. The proposals of the RIS to enhance the consistency of retail investor protection rules or improve the value that investors get out of their investments should be considered in this perspective.

3.2 Value-for-money measures proposed in the RIS

An investor representative considered that the development of cost and performance product benchmarks by ESMA and EIOPA proposed in the context of the value-for-money (VFM) measures of the RIS should contribute to developing retail investor trust.

A regulator observed that while the objective of increasing VFM is relevant, some measures proposed in the RIS that over-emphasise costs need reconsidering. Other important elements also need to be taken into account as part of VFM, such as the expected performance of funds and the quality of the service. Lessons from similar approaches in other jurisdictions, such as the UK, can also be useful to take into account.

There are also many questions around how product benchmarks on costs and performance can be appropriately implemented, the regulator emphasised. Some funds contain different compartments pursuing different investment strategies within one vehicle. It is unclear how a benchmark will work in this case and whether it will be possible to group different strategies in one benchmark. There is also the risk of a race to the bottom with a benchmark approach. Funds with costs higher than the average will need to take action, whereas those with lower than average costs will not need to. The latter funds may however increase their costs gradually, for example when launching new products, which will need to be closely monitored. In addition, there may be discrepancies in the application of benchmarks between home and host member states. This could increase market share concentration in some countries. Rather than a narrow focus on product cost benchmarks, the VFM approach should ensure that all retail investors receive an adequate explanation of how financial instruments are offering value for the money invested and that this information is presented in a comparable way.

An industry representative agreed that while the principle of VFM and maximising value for investors are essential objectives for asset managers, such a framework should not excessively focus on cost, because retail investors consider a range of different values in their product choice, such as performance, service quality or sustainability. How the proposed cost and performance benchmarks will work in practice will also need to be understood. Peer groups will be created for comparing funds, but different tax regimes and local characteristics make it difficult to compare products at the EU level. Whether these benchmarks should be performed at the domestic or pan European level is an open question. In addition, the larger asset managers also have a share of their business outside the EU based on UCITS, which may be influenced by these measures.

The industry speaker added that the UCITS regime already offers a remarkable level of protection and transparency with regular reporting to supervisors on cost and performance information and transparency for clients in the key investor document (KID). While information can always be further improved, it seems more urgent to address as a priority in the RIS the current low level of financial literacy of many EU citizens.

A regulator stated that the RIS is not about price regulation or encouraging people to invest in cheaper products but instead about requiring producers and distributors to explain their added value and supervisors to check these explanations. The first step towards this is for regulators to develop and publish their own benchmarks. The approach must be sufficiently simple to implement in order to be usable and enforceable at the EU level, but not over simplistic, which is quite challenging.

Costs and yields must be compared in particular, the regulator noted, but with the current proliferation of funds which often seem very similar to one another, it is unsurprising that pricing is increasingly used as a differentiator, resulting in a persistent downward pressure on costs. The assessment of the costs that the RIS includes in the product governance rules is likely to enhance that. For traditional, actively-managed funds it can also be difficult to prove their added value compared to ETFs and straightforward saving products, particularly in a context where rising interest rates will improve the return provided. The VFM measures will hopefully make it easier to identify this added value. Finally, supervisory convergence around these requirements is vital so market stakeholders can trust that different supervisors have the same interpretations.

3.3 Inducement rules

A regulator suggested that further clarity is needed around the best interest of the client test proposed in the RIS for allowing the payment or receipt of inducements, how it may be implemented and its potential impacts for investors and on the market.

An industry representative noted that the proposal to ban inducements for execution-only transactions could potentially limit the usage of ETFs for direct investors using digital platforms to access the products. This must be considered in the ongoing development of the RIS proposal.