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Strengthening the EU policy framework for retail investors

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Context

The Covid-19 crisis has only exacerbated what for many individuals across the EU is already a challenging financial situation. Large-scale fiscal and monetary counter-programmes continue to be deployed, but the full extent of the economic fallout has yet to be understood. For this reason, it is paramount to build financial security and resilience by promoting personal responsibility, and by strengthening the social safety net. Undoubtedly, asset allocation will take on new relevance in the context of the lower-for-longer yield scenario (including negative real interest rates), or during other episodes of financial volatility.

In recent months, beneficiaries of pension funds in several countries were allowed emergency access to parts of their savings, or to have the payment of their contributions deferred. Some member states subsidised employers/employees' contributions or limited the materialisation of investment losses. The shift from defined benefit to defined contribution schemes is expected to accelerate, which creates uncertainty about income in retirement. This will depend more on market returns and decumulation type (lump sum, annuities, phased-in withdrawals).

Market developments

At first glance, it would appear that capital markets offer multiple options, such as stocks and bonds, investment funds, insurance contracts, pension products, etc. In terms of supply, some national markets are more open than others. But in practice, retail investors do not always find the way to cost-efficient options with a rewarding risk-return profile. These can be further supported by reducing unwarranted complexity, breaking down barriers between countries, as well as by tackling unhelpful fiscal signalling/biases.

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This commentary is part of a dedicated series, as a follow-up to the CEPS–ECMI Task Force Report on "Asset Allocation in Europe: Reality vs Expectations" released in April 2020.

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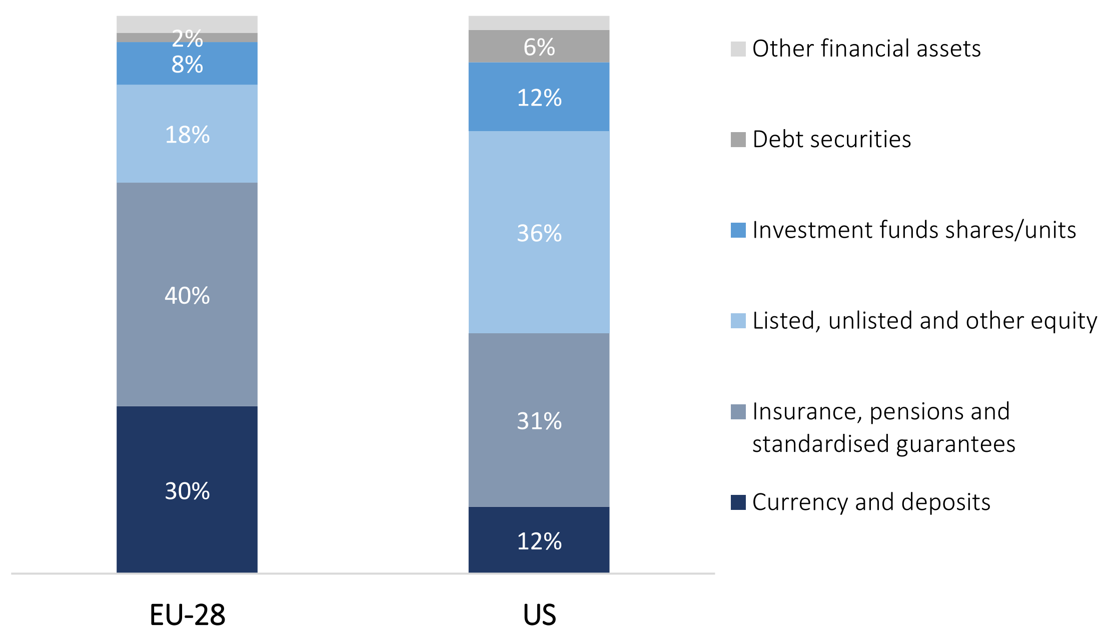
On an aggregate level, participation in capital markets varies substantially across the EU for many reasons, such as net financial wealth, market structure, investor knowledge/preferences, regulatory/supervisory aspects and tax regimes. More generally, savings in bank accounts (Figure 1) are simply denied the wealth-generative effect of long-term investments in equities or alternatives, which could establish stronger links with and contribute to recovery in the real economy. Nevertheless, conservative strategies (fixed-income dominated portfolios) remain adequate for certain categories of investors.

Figure 1. Asset allocation by households (EU-28[1] vs US)



Sources: Eurostat (Q3 2019) and US Fed (Q4 2019).

The environment in which individuals make financial decisions is inherently 'noisy', regardless of whether they choose to engage directly or go through financial intermediaries. Ensuring that they are not trapped in the web of products or lose the ability to act in their best interests is crucial. Many relevant criteria for retail investment are hardcoded in legislation.[2] However, the socio-demographic characteristics, available capital, the purpose of the investment, the degree of expected liquidity, the acceptable level of volatility, risk appetite, the search for diversification, all these stand out.

Yet many individuals continue to face obstacles when seeking financial advice or analysing relevant information and comparing various investment options. In this regard, the experience with packaged retail investment and insurance products (PRIIPs) has been far from satisfactory, for consumers or for providers. The development of an EU-wide database for retail savings/investment products, ideally run by the ESAs (in coordination with NCAs), based on disclosures by regulated entities, would certainly be a significant step forward. A feasibility

[1] The differences would be even more pronounced without the UK.

[2] For example, MiFID2, IDD, PRIIPS, UCITS, AIFMD, ELTIF, Solvency2, IORP2, PEPP, SFDR, etc.

study is called for, namely to look into the usability for consumers, relevant search criteria, what products to prioritise, how to ensure consistency across sectors, meaningful data to be populated by providers, and whether to go for a public-private option, etc.

Retail investors generally also find it difficult to understand the remuneration schemes of financial intermediaries. In most cases, they cannot draw conclusions from the information provided and end up not taking any action based on the disclosed conflict of interest. Their choice of advisor is more influenced by personal trust and convenience, perceived quality and objectivity and the diversity of products (in-house or third-party). Distribution via banks and insurers is the norm, and is rarely handled directly by asset managers. Generally, fund supermarkets, platforms and online brokers focus on non-complex products.

Most importantly, less sophisticated individuals or those with modest portfolios often struggle to manage their financial affairs and need to be protected from mis-selling practices. The use of default options, mandatory auto-enrolment and execution-only (low-risk investments) versus discretionary mandates or advisory-based models could be more suitable for them. The trends towards fully bearing the investment risk should also be carefully analysed because it may deter certain types of potential savers. Financial education is also important, but it cannot replace affordable advice, open distribution channels, redress tools or tax incentives.

Regulatory conditions

Sectoral silos could be tackled with the horizontal review of the disclosure, inducements and suitability rules. Regulation should balance investor protection with inclusion/access, and be guided by the general principle that products with similar economic characteristics are treated in the same way. Levelling the playing field between packaged and non-packaged products is also necessary. Sustainable finance (integrating ESG preferences in client profiling and product selection, transparency on features and performance, or the eco-label for financial products) and digitalisation/technology (robo-advice, platforms, comparison tools) will remain important cross-cutting behavioural drivers.

Feeding evidence back into EU policies is not an easy task due to, for example, inconclusive findings or heterogenous conditions. Changes must be informed by normative/positive and behavioural finance based on micro-data, large-scale consumer testing, mystery shopping and benchmarking exercises, in addition to business model analysis across the value chain (manufacturing, distribution, investment). Isolating institutional determinants or incentives that are present only at national level might add another layer of difficulty for the cross-border dimension. Much work remains to be done to create a fully integrated retail market.

While necessary, driving pricing discipline may not be sufficient. Identifying market segments and/or investment strategies (active vs passive) where investors are in a suboptimal situation is however imperative, without necessarily favouring one product over another. In their reports on costs and performance, ESMA and EIOPA continue to highlight data challenges, in particular with regards to distribution and advice. The focus has been so far on disclosure, but any other tools (mandated fee levels) could gain traction if preceded by adequate impact assessment. The Pan-European Personal Pension Product (PEPP) was the first of its kind to introduce an 'all inclusive' cost cap; its economic viability will depend on both savers and providers.

Going forward

Retail investors need coherent and reliable narratives around capital markets. This requires moving away from reductive debates about products and providers. Rather, a comprehensive agenda for retail investors should focus on solutions (and underlying asset classes) to meet specific financial objectives (fully scalable and/or customised). And ultimately, the financial industry must deliver 'good value for money'. The CMU 2.0 Action Plan alone is not likely to solve long-standing structural problems. Ensuring that retail investors benefit in practice from the same safeguards as professional and institutional investors is essential. Weaknesses in supervision and enforcement could give rise to regulatory arbitrage or market fragmentation, which will be to the detriment of these investors.

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