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Unleashing retail investors' potential - the key ingredient for enhancing the EU's investment funds and capital markets

Karel Lannoo and Apostolos Thomadakis*

The size of EU investment funds and capital markets lags well behind the US. Repeated calls for a better performing Capital Markets Union, to support investments in biotech, or the green transition, have so far not led to any change. Investment fund markets in Europe continue to grow in the number of funds, but not in size, while household savings are largely held as bank deposits. Unless we manage to address the supply side, capital markets in Europe will remain below par.

A grand plan is therefore needed to streamline Europe's fund markets.

Introduction

Well-designed and regulated fund markets are the prime vehicle for long-term savings for households. The EU has jumped early on this boat by adopting rules for investment funds in the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive back in 1985. UCITS has been updated several times and the most recent version (as amended by Directive 2014/91/EU, the so-called 'UCITS V') introduces rules on remuneration and strengthens the depositary regime. It is seen as a very successful form of EU product regulation and market integration, acclaimed by industry and used globally. UCITS can be sold with a single authorisation all over the EU and can take many different forms (e.g. classic securities funds mixed with a capital guarantee or an insurance element). The EU has followed this example with rules in more specific fields, such as for real estate with the European Long-Term Investment Funds (ELTIF), a pension product under the Personal European Pension Product (PEPP), and alternative funds under the Alternative Investment Fund Managers Directive (AIFMD).

**Karel Lannoo* is General Manager of ECMI and CEO of CEPS. *Apostolos Thomadakis*, Ph.D., is Research Fellow at ECMI and CEPS. *Comments by Jelmer Nagtegaal and ECMI members are gratefully acknowledged.*

Investment funds are products that require distribution networks to generate sales to customers (e.g. banks, brokers, investment managers, insurance companies). Rules apply according to these different professions on the commissions that may be applied. In some cases, distributors are provided retrocession fees or inducements by the fund provider for the successful sale of its funds to customers. These issues are covered by provisions on fiduciary duty and conflicts of interest in EU rules. Fees can only be claimed if the provider's actions are in the client's interest. If there is a conflict of interest, the provider must prove that the interests of the client take precedence.

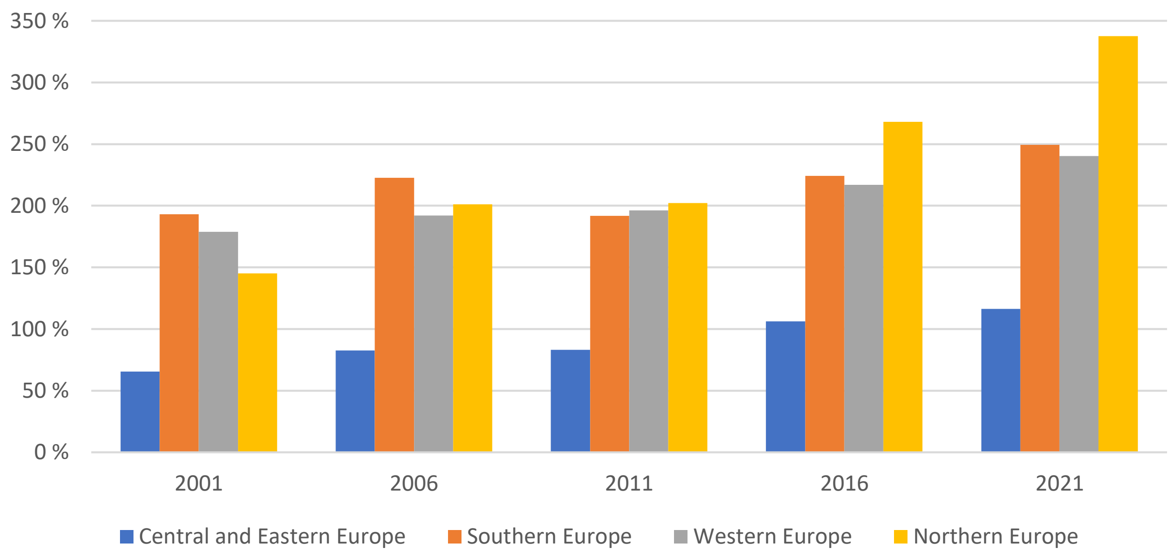
Market integrity is crucial for well-functioning securities markets. Up until the financial crisis, EU securities market rules, such as the Markets in Financial Instruments Directive (MiFID), had mostly focused on market efficiency and on opening up competition among securities markets in the EU. The crisis brought more emphasis on integrity, with MiFID II aiming to strengthening investor protection and improve market transparency, alongside the upgraded market abuse regulation.

In this ECMI policy brief, we analyse the crucial importance of well-functioning long-term savings plans for providing a decent income for old age and the opportunities and challenges European fund markets represent. Compared to a few years ago, a lot of information is now available on the performance of fund markets as provided by the European Securities and Markets Authority (ESMA), but also through studies conducted for the European Commission (EC). Policymakers are increasingly aware that some issues must be tackled to allow these markets to function better in the interest of their users.

The challenge: providing a decent income for retirement

Europe presents a very diverse picture regarding household wealth, as assets across Member States can be grouped into four distinct categories (see *Figure 1*). In relative terms, households' financial assets in 2021 ranged from 79 % and 105 % of GDP in Romania and Latvia respectively, to 426 % in Denmark and 368 % in Sweden. Some countries, particularly in northern Europe, have very well organised systems of collective savings, whereas most Member States (21 of the 27) hover below the EU average (236 % of GDP).

Figure 1. Households' financial assets across European regions (% of GDP, 2001-2021)



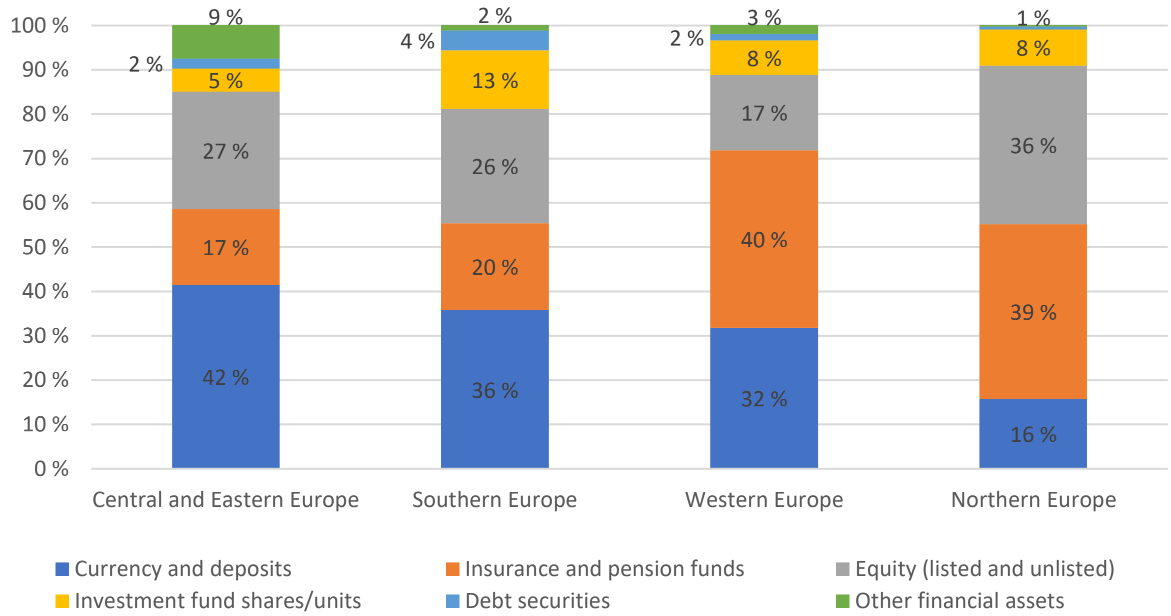
Source: Authors' calculations based on data from Eurostat.

Long-term savings vehicles are very fragmented in the EU and attempts to come up with a European-wide plan have not yielded much success thus far. Almost eight years since the ELTIF regulation entered into force, only [84 ELTIFs](#) had been launched and domiciled in just four Member States, according to

ESMA data. As for the PEPP regulation, which has been in place since 2019 – but is still being implemented[1] and thus it's too early to state whether it will become a truly European plan – there is only one provider that has been registered according to the European Insurance and Occupational Pensions Authority (EIOPA).

At the national level, a variety of systems are in place, from well-capitalised pension systems in a few Member States, to other forms of collective savings, to very tiny pension plans, and more abundant forms of third-pillar savings plans (with or without tax incentives). In some countries, mostly in northern Europe, a large amount of household savings is invested in securities markets or funds. In others, mostly in south-eastern Europe, they are kept as bank deposits (see *Figure 2*).

Figure 2. Households' financial assets across European regions (% of total financial assets, average 2015-2021)



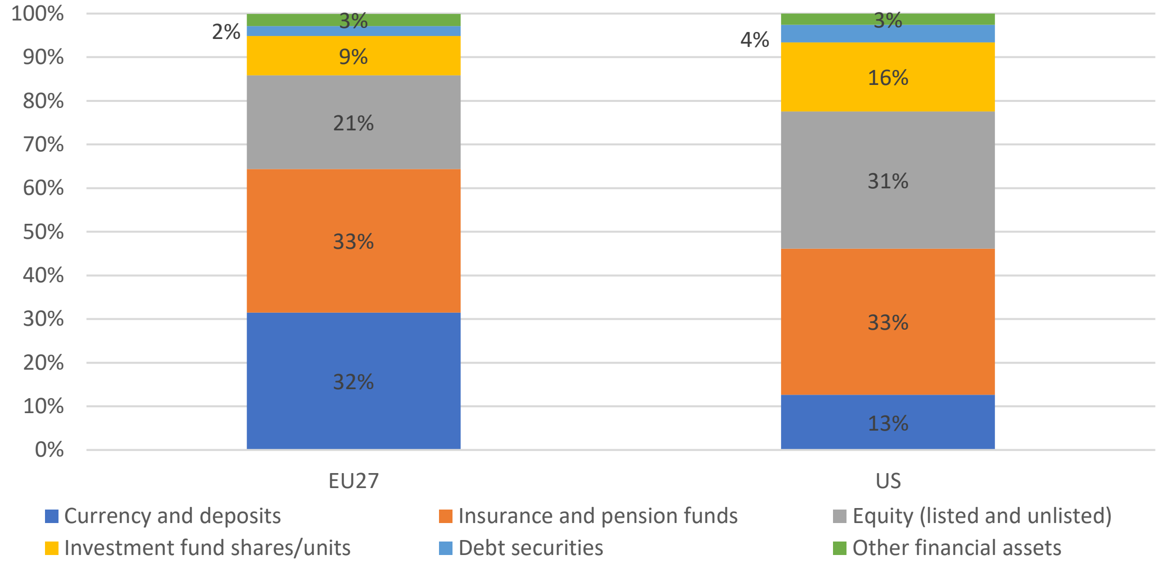
Note: The category 'Other financial assets' includes other accounts receivable, financial derivatives, and loans.
Source: Authors' calculations based on data from Eurostat.

The existence of well-developed collective savings plans usually goes together with the existence of well-developed capital markets. Market capitalisation levels are much higher in northwest Europe than in the southeast, which is also related to the size of local long-term savings schemes. Moreover, these countries have on average lower costs for investing in such products. The maturity of capital markets, the pension system, as well as citizens' financial literacy, are among the drivers of households' high levels of participation in capital markets (e.g. through equities and investment funds) observed in northern Europe (Thomadakis, Lannoo and Moloney, 2022).

Overall, and compared to the US, European households' savings are kept much more in bank accounts, rather than being invested in the markets (see *Figure 3*). Assets held under cash and deposits account for 32 % of households' financial assets in Europe and just 13 % in the US. Assets held in securities (either directly or via mutual funds) are half as much in Europe as in the US. This means that long-term returns for EU savers are poor, and so are the long-term financing options for businesses.

[1] The PEPP regulation's legal basis became applicable in March 2022.

Figure 3. Households' financial assets in the EU and the US (% of total financial assets, average 2015-2021)

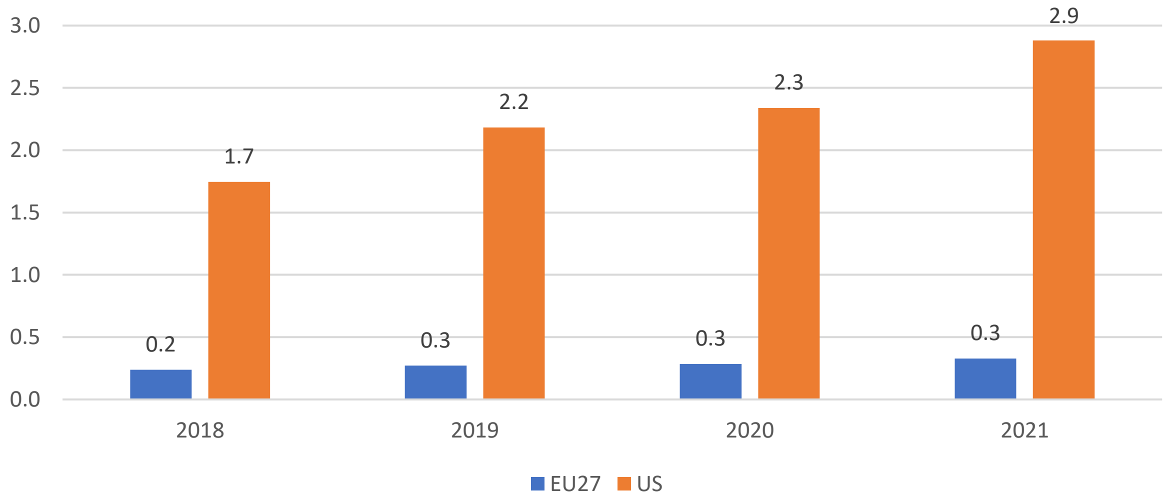


Notes: The category 'Other financial assets', for the EU27 includes other accounts receivable, financial derivatives, and loans. For the US it includes other miscellaneous assets, and loans.
Sources: Authors' calculations based on data from Eurostat and FRED.

European fund markets today

Since the adoption of the UCITS regulation, fund markets have developed enormously in the EU. Although the number of funds has grown exponentially, and probably too much, the average size per fund has remained low, certainly when compared to the US (see *Figure 4*). The contradiction in UCITS' success is that it allowed for a pan-European collective savings product but also demonstrated the huge diversity in national markets, as UCITS were adapted to the preferences of consumers and the local distribution networks.

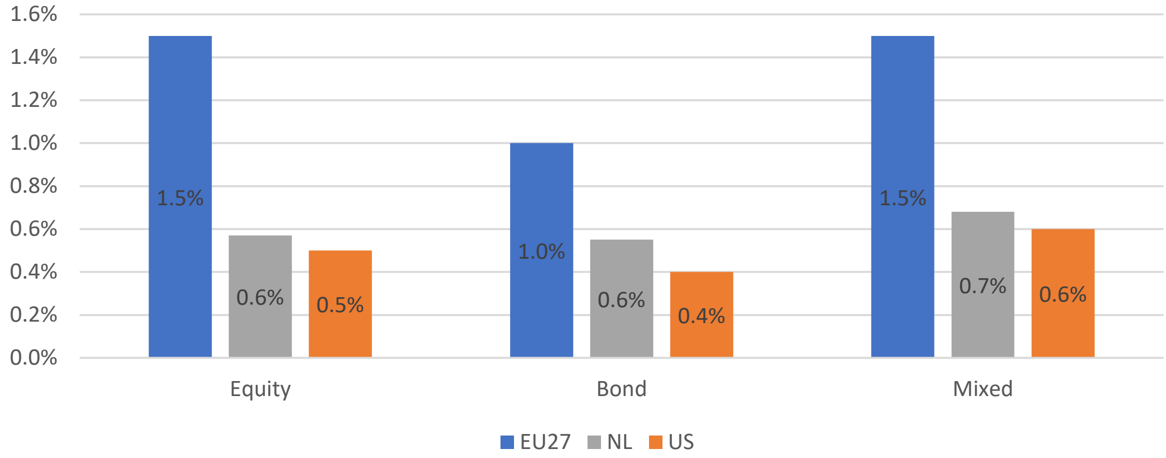
Figure 4. Average size of investment funds in the EU and the US(EUR billion)



Notes: Data include funds of funds, exchange-traded funds (ETFs) and institutional funds. For the EU27, only UCITS and AIFs have been included.
Source: Authors' calculations based on data from the European Fund and Asset Management Association (EFAMA).

This enormous diversity has had a negative impact on market efficiency, particularly on costs, which have only recently – and marginally – started to decline (ESMA, 2023). Costs, as expressed by the Total Expense Ratio (TER), are also considerably higher in Europe than in the US (see *Figure 5*)[2], and markedly higher for retail as compared to institutional investors[3]. This poses a problem for EU policymakers, who must ensure that markets function efficiently, as a single market, with price competition bringing the best deal for consumers. Market integrity rules need to ensure that consumers get the products that are in their best interest.

Figure 5. Ongoing costs of retail funds in the EU, the Netherlands and the US (%, per annum, 2017-2021)



Notes: For the EU, average costs refer to ongoing costs of retail UCITS or mutual funds for a five-year investment horizon between 2017-2021. Ongoing costs are proxied by the total expense ratio (TER). For the US, average expense ratios refer to long-term mutual funds.
Sources: Authors' calculations based on data from ESMA and the International Company Institute (ICI).

Overall, the problem is an oversupply of funds, which is not necessarily in the interest of users. An institutional investor can certainly find what fits into its portfolio but not a retail client. This is where the role of advice comes in, and the question of whether financial advice can be bundled with the price of the fund product. These questions are the subject of EU rules, most importantly MiFID, but also the Insurance Distribution directive (IDD), which governs insurance companies and brokers.

Given the lack of long-term savings in Europe, the existing EU framework, and the role of investment advice**, the European Commission commissioned a study on the market for retail investment products and the role of advice**. The study, entitled 'Disclosure, inducements, and suitability rules for retail investors' (EC, 2022) found that:

- Disclosure is not applied consistently. Consumers are not able to find their way through the complex terminology of investment products and costs but there is no evidence that more disclosure would lead to more investments.

[2] A recent study shows that while UCITS costs are indeed higher, this is due to distribution and advice costs being included in their price (EFAMA, 2022). When distribution and advice costs are excluded, the costs of UCITS funds are just as expensive or cheaper than the cost of US mutual funds. However, this finding highlights the need to unbundle costs and fees for investors to know exactly what they are paying for distribution and/or advice. Notwithstanding the importance of distribution costs, the relevant information is limited (ESMA, 2023).
[3] According to ESMA (2023), in a hypothetical five-year investment of EUR 10 000 in a UCITS portfolio, a retail investor would pay 78 % more on ongoing costs, compared to an institutional investor.

- The availability of product information scores highly. However, comparability across products is more difficult, and its quality is lower for more complex products.
- Coherence of contractual information across different investment products is in place, although there may be problems with comparing costs across products.
- Consumers are mostly not aware of inducements, and information documents rarely refer explicitly to inducements. Consumers assume advice is free and are not aware of conflicts of interest in advice.
- The need for advice differs. Some groups do not want advice, others do not need advice and buy execution-only products.
- Sources of advice differ. Apart from professional advice, there is informal and independent advice, which is what most respondents prefer, and there is a growing number of digital tools for investment decisions.
- MiFID's inducement regime is overall badly implemented. While it is in principle prohibited, inducements are applied in 40 % of cases, to the extent that information is disclosed. The inducement is on average 0.7 % per annum, or 45 % of the ongoing costs charged to the retail investor, making such products 25% more expensive. There is no evidence on the possible decline of inducements.
- The costs are inconsistently disclosed, which hampers comparability, hence price competition for funds only marginally works.

An earlier study on the distribution of retail investment products concluded that there is a complete mismatch between supply and demand (EC, 2018). An average consumer is overwhelmed by the sheer complexity of investment products. Hence most households simply do not invest. Additionally, less literate and less wealthy investors rely more on advice to guide how they make their financial decisions, but they also pay more.

Information provided to clients is not transparent and nor is it standardised across countries. The study found that comparing and interpreting fees across providers and products is very difficult, even for a well-informed investor. The most independent financial advice is available in countries that have actively implemented unbundling requirements and have banned inducements. This is the case for the Netherlands and the UK, which also have the lowest fees.

The implications of the above are clear. The regime created by MiFID II (and IDD) on prohibiting conflicts of interest is not working as it should. At present, non-independent advice is more commonly used than independent advice to distribute retail investment products, also because there are few independent advisors (Better Finance, 2022)[4]. However, and in terms of suitability (another core element of MiFID), several studies have demonstrated the inadequacy of non-independent advice (BEUC, 2018; BEUC, 2019; EC, 2022). Advice driven by inducements results in a product being offered to a retail investor not because it provides value for money for the investor but because the sale of the product provides monetary benefits for the product's seller/distributor and manufacturer.

[4] For example, according to the German Federal Financial Supervisory Authority (BaFin), there are currently 18 independent advisors registered in Germany.

Moving forward

The European investment funds market is fraught with huge imperfections:

- Long-term savings are underdeveloped in Europe and costs to invest in collective savings vehicles are too high. These costs are higher for retail as compared to institutional investors. Over time, costs have only started to marginally decline but they decline more rapidly for new funds (ESMA, 2023).
- This underdevelopment of long-term savings has happened even with bundled advice in most markets, hence the argument to maintain bundling does not hold. Moreover, bundled advice is not the preferred mode and creates all kinds of problems.
- Inducement advice costs are charged for the entire time that the funds are kept, not once. This is clearly not in the consumer's interest but rather the product distributor's interest.
- It is not by rendering markets less transparent that we will have more competition. On the contrary, more transparency is needed on the different cost components to create trust and fair competition.

Hence one can only conclude that the regime on investment advice and conflicts of interest under MiFID II and IDD need to be properly implemented and its underlying logic needs to be pursued further. Steps undertaken by ESMA and the National Competent Authorities (NCAs) to further MiFID's implementation have started to have an effect and are becoming visible in the data. This concerns, among others, the identification of UCITS with high costs; the harmonisation of manager performance fees; Common Supervisory Action (CSA) on costs and fees for investment funds, highlighting the importance of supervisors in ensuring that investors are not charged with undue costs; and guidelines on suitability requirements (ESMA, 2023, p. 12). But more needs to be done to enforce cost unbundling and against inducements.

Collective savings vehicles lack economies of scale. While UCITS is a very successful example of European product market harmonisation, a way needs to be found to make it work more in the interest of consumers. ESMA (2023) confirms what can be expected, larger funds have much lower costs than smaller funds – the top 25 % are on average 40 % cheaper compared to the bottom 25 % funds.

NCAs need to take a more active role in calling for price transparency and price competition in fund markets, as ESMA has started to do. Moreover, NCAs need to be stricter in authorising funds in view of expected size and costs, and tackle complexity. A simple method could be applied, by checking the number of supervisors in charge of authorising and monitoring funds, and the number of authorised funds in a given country. ESMA has also started to look more carefully into supervisory practices in the Member States.

The status quo is not a solution. An innovative approach composed of more consolidation and cost transparency on the supply side should be developed, while fully applying the MiFID II and IDD rules prohibiting conflicts of interest. On the supervisory side, a more pro-active approach would not only ensure that investors are not charged with undue costs, but also enhance supervisors' scrutiny and monitoring efficiency. Streamlining Europe's fund markets will benefit retail investors and bring the EU a step close towards a true Capital Markets Union. If done properly, this could be a win-win situation.

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