



## Funds, fees and performance

Karel Lannoo

*Despite recent advances made in eliminating fragmentation and in standardising fees and performance across the European market for retail investment products, these efforts have produced limited or no effect so far. Further policy initiatives can thus be expected, as investors are the victim and market efficiency is at stake.*

The European market for retail investment products is extremely diverse in distribution networks, user preferences, regulatory treatment and supervisory attitudes, resulting in a high degree of fragmentation and a wide variety of customer fees and performance. Cross-border comparability is very difficult, as cost elements are not standardised, and price competition is hampered. As a result, retail investors refrain from investing in investment products and prefer to keep savings in deposits. The EU has attempted to address these shortcomings, as reflected most recently in the revamped version of the Markets in financial instruments Directive (MiFID II), and other measures are being implemented. So far, however, these have produced limited or no effect, as a recent study carried out for the European Commission concludes (European Commission, 2018a). Further policy initiatives can thus be expected, as investors are the victim and market efficiency is at stake.

Karel Lannoo is General Manager of ECMI and Chief Executive of CEPS.

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European Capital Markets Institute, Place du Congrès 1, 1000 Brussels, Belgium  
[www.eurocapitalmarkets.org](http://www.eurocapitalmarkets.org), [ecmi@ceps.eu](mailto:ecmi@ceps.eu)

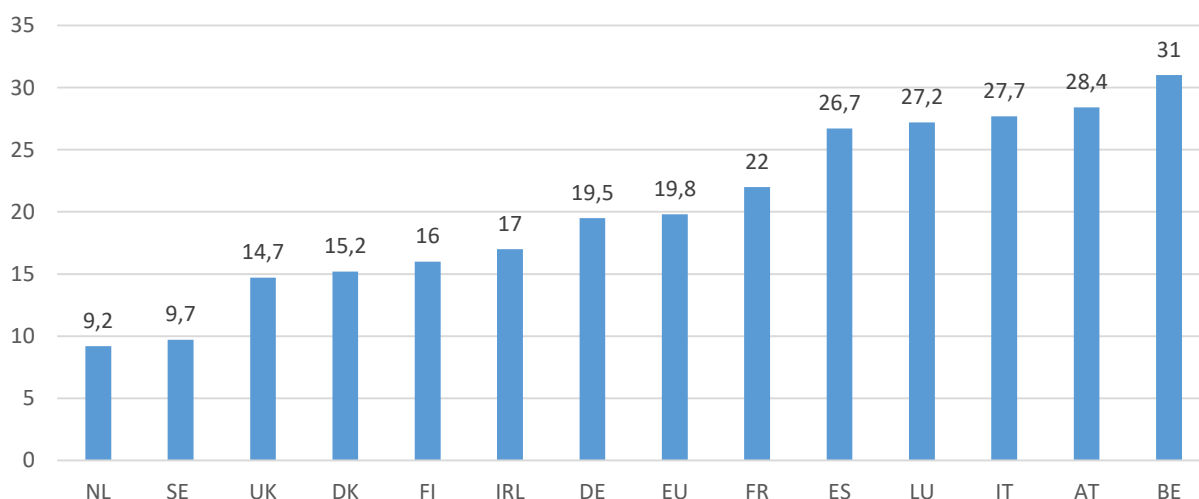
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Thinking ahead  
for Europe

Two recent studies stand as hallmarks in the debate over retail investment product charges and performance. In a study on fund performance, ESMA (2017) found that over the three-year horizon (2013-15), ongoing fees, one-off charges and inflation reduced the returns available to investors on average by 29% of gross returns or, in absolute terms, by 252bps. Fees charged to retail investors reduce their returns more than those charged to institutional investors. As shown in Figure 1, Denmark, the Netherlands and Sweden – countries that have implemented unbundling rules or more centrally organised long-term saving plans – have significantly lower charges, which are about half that of the most-costly country – Belgium – where total charges reduce returns by 31% (before inflation). By asset type, the highest reductions apply to the money market (34.8%) and bond funds (31.9%) for retail clients (before inflation) and for actively managed funds compared to passively managed funds.

Figure 1. Reduction in fund returns (expenses, sales and redemption fees) before inflation (%)



Source: ESMA (2018).

The more recent study cited earlier (European Commission, 2018a) on the distribution of retail investment products concluded that there is a complete mismatch between supply and demand. Using mystery shopping – a tool used by market research companies to measure the quality of service, compliance with regulation or to gather specific information about products and services – the inquiry found that comparing and interpreting fees across providers and products is very difficult, even for a well-informed investor. Information provided to clients is not transparent and nor is it standardised across countries. Fees vary widely depending on the investment product and distributor, with the overall lowest fees (about 1%) charged for listed equities and bonds, and exchange traded funds (including execution and custody fees). The highest fees applied to equity, mixed and real estate funds, with the fees totaling 8% if an investor sells the product within one year (entry, exit and ongoing charges). The average first-year cost for an investment product in the sample was 4% (entry and ongoing charges, see Table 1). Hence, retail investors may abstain from investing at all in investment products.

Table 1. Average entry, exit and ongoing charges on investment products in the EU (% of assets)

	Real estate funds	Mixed funds	Equity funds	Bond funds	Money market funds	Guaranteed life insurance	Life insurance	Guaranteed pension products	Pension products	Pension mutual funds	Average
Entry	3.76%	3.77%	3.65%	2.87%	1.37%	2.88%	2.22%	3.40%	2.19%	2.30%	2.84%
Exit	3.20%	2.73%	2.01%	1.69%	1.25%	1.83%	1.03%	2.62%	0.97%	1.65%	1.90%
Ongoing charges	1.28%	1.51%	1.89%	1.01%	0.39%	0.88%	1.38%	0.87%	1.45%	1.15%	1.18%
<b>Total</b>	<b>8.24%</b>	<b>8.01%</b>	<b>7.55%</b>	<b>5.57%</b>	<b>3.01%</b>	<b>5.59%</b>	<b>4.63%</b>	<b>6.89%</b>	<b>4.61%</b>	<b>5.10%</b>	<b>5.92%</b>

Source: European Commission (2018a).

The most independent financial advice is available in countries that have actively implemented unbundling requirements and have banned inducements, such as the UK and the Netherlands, which also have the lowest fees, as shown in Figure 1. The study concludes that financial services for consumers are consistently ranked among “the poorest performing services market”. Digitalisation or robo-advice will not necessarily change this assessment. Even if it may make it easier to compare products, it will not reduce the sheer complexity of the supply. The study also indicates that fees for robo-advice are often either difficult to find on the webpage and/or are presented in a complicated way. In addition, to decipher the display of fees, a certain degree of financial literacy is required, which on average is quite low.

As a result of the unbundling requirement introduced in MiFID II, charges on investment products may decline, but the appetite to invest in such products may go down as well. To tackle conflicts of interest, MiFID II requires providers to inform clients whether their investment advice is provided on an independent basis, i.e. that it is paid for by the user. Payments from third parties to sell certain financial products to clients, apart from certain “minor non-monetary benefits”, are prohibited. The willingness to pay for advice is generally low, and even lower when an investor becomes aware of the possible conflicts of interest his advisor faces, according to the study. This was demonstrated by the experience of the Retail Distribution Review (RDR) in the UK, aimed at introducing more transparency in the investment industry, improving services through higher qualifications and ensuring that investors understand the true cost of advice. The future model for investment advice will be robo-advice, which has been widely adopted in countries that have implemented unbundling. But algorithms used by robo-advice should be closely controlled and tested, to ensure that the suitability criteria are properly applied and that consumers are not directed towards unsuitable products. Comparison tools should be certified.

A more far-reaching initiative may thus be required to shake-up the fragmented and costly fund markets and stimulate retail investors towards higher-performing investments. Policy-makers could strive to i) stimulate initiatives towards market consolidation, in different ways, and ii) make cost structures more comparable or eventually cap charges.

## Market consolidation initiatives

Several efforts have already been taken to facilitate market consolidation, but with limited results so far. The main problem is that product development is supply-driven, and not necessarily demand-driven, with some exceptions. The priority should therefore be to develop a simple, low-cost product that generates scale and is designed with users' interests in mind. An example is the Investment Savings Account (ISK) in Sweden, or possibly the proposed Pan-European Pension Products (PEPPs) from the Commission. Earlier EU initiatives, contained in the UCITS IV amendments, have facilitated mergers among funds, but regulatory barriers still remain.

Sweden's Investment Savings Account (ISK) is a simple and transparent product, designed for households, with comparability parameters between all product providers on a webpage. It has a low level of taxation, and its assets are mostly in equity and balanced funds, with very low levels of cash. About 1.8 million residents have an ISK, or almost 20% of the population. The PEPPs proposal aims to introduce something similar at European level, but its design is still under discussion. A big advantage of the PEPPs should be the single authorisation by EIOPA, the EU insurance authority, which should allow for scale and exclude regulatory arbitrage, as is the case for investment funds today.

## Cost structures

On the cost structures, the impact of MiFID II and the rules governing PRIIPs (packaged retail and insurance-based investment products) should allow for more standardised transaction cost data, but it is still too early to judge their utility, according to industry participants, as the data are not yet aligned and are only available for a limited period. In addition, PRIIPs will apply to UCITS only from 2020 onwards. The European Commission (2018b), from its side, recently proposed to standardise national marketing requirements and regulatory fees for funds, to facilitate cross-border distribution of funds through better comparison of costs. Additional national marketing requirements by supervisory authorities and diverse fee structures are a hindrance to market integration. The European Securities and Markets Authority (ESMA) has been given the competence to propose technical guidelines in this respect and also to manage a centralised database with the fees or charges applied by the competent authorities. It is difficult to see, however, how this initiative will interact with the transparency of industry charges, which are contained in MiFID II and PRIIPs, or whether it will make it even more complex.

The advent of Brexit makes the picture even more blurred. With about 40% of the EU's assets under management concentrated in the UK, it seems that Brexit may paradoxically lead to higher costs, certainly in the short term, as businesses will have to re-think their operational models across the entire value chain. Asset management – but also clearing, settlement and custody – may end up even more fragmented as a result, in an area that was already not remarkably highly concentrated in the first place, certainly as compared to the US. Hence, fragmentation may grow, and the industry's performance will be negatively affected as a result, the cost of which will be passed on to the consumer.

## The way forward

EU regulation has contributed to reducing cost for the directly investing in equity and bonds by increasing the competition among market operators. Direct exposure of households to these products has declined in most European countries, however, while they are mostly exposed indirectly through investment funds or other forms of institutional investment, where costs remain prohibitively high.

The asset management sector is the least harmonised across the EU. The rules depend on the type of licence that the financial institution in question possesses – which may be as a bank, an asset management company, an insurance company, a pension fund, a broker – and the product the company distributes. Progress has been achieved with MiFID II, PRIIPs and the Insurance Distribution Directive (IDD), but huge differences remain concerning the appreciation and respect of rules and in the diversity of investor protection rules. Much remains to be done to achieve more *supervisory convergence*, but this is very difficult since many different actors are involved: the three European Supervisory Authorities (ESAs), the ECB and the National Competent Authorities (NCAs). This structure is too complex, and there is too much regulatory competition. Moreover, the role of supervisors in capital markets differs markedly from that in banking.

Hence, a reduction in the fees for funds in the EU is not imminent, because of the multiplicity of providers and supervisors involved. The implementation of MiFID II, and the unbundling requirement, will certainly have an effect, but it will take another two years before its impact on fees becomes apparent. An attractive PEPPs or alternatively, a pan-European long-term savings scheme is the best solution forward in the longer term. Another priority is strengthening the powers of the ESAs, and ESMA in particular, over NCAs in the authorisation of products and the control of cost structures. Article 9 of the ESA regulations requires the authorities to “...take a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products” and allows them to prohibit or limit certain financial activities. This requirement is repeated in MiFIR’s Article 40, which was invoked for the first time in an ESMA decision of 1 June 2018, to ban binary options and to restrict contracts for differences (CFDs), but it is only temporarily in effect, i.e. it has to be renewed every three months.

Would it be possible for the European Commission to cap charges? The abundance and complexity of the fund markets provide a clear reason for the European Commission to argue that competition nor the single market functions in this sector, for which retail investors end up paying the price. To address this failure and to allow for a more balanced financial system, one option could be to impose a limit on charges, but this would require a sufficient level of standardisation across the cost structures. And to start with, transparency would have to be significantly improved and careful scrutiny given to the impact of the unbundling requirement.

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