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Client Alert

News Flash

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Commission Publishes Study of EU Market in Retail Investment Products

The Commission shares the results of a 2017 study into the current functioning of European markets for retail investment products.

Key Points:

- The European Commission's Final Report is the result of examining a broad spectrum of retail investment products across 15 Member States, with a particular focus on how retail investors prefer to access those products and the issues affecting the products' distribution.
- The Commission's findings are the result of desk-based market research, as well as extensive mystery shopping. The Final Report therefore includes a broad overview of the entry and exit fees and on-going charges (where relevant) of each category of retail investment product in the scope of the study.
- The Final Report will be used by policymakers to develop future regulatory change.

Introduction

On 24 April 2018, the Commission published its Final Report with the aim of providing empirical data which demonstrates the current features and functioning of EU markets for retail investment products. The Commission engaged Deloitte to perform the study, the purpose of which is to assist the Commission in future policymaking decisions by analysing, specifically the:

- Supply through various distribution channels of certain retail investment products (namely, investment funds — including ETFs, listed bonds and equities, life insurance products with investment components, and pension products)

- Access to financial advice (that is, independent advice, non-independent advice (primarily via an advisor of a bank or insurer), and robo-advice (*i.e.,* through an automated web-based platform)) by retail investors and related risks and benefits

- Impact of online distribution on the retail investment offering (particularly the breadth and terms of the offer) and investor protection (including the transparency of costs and charges)

- Risks and benefits of new distribution models developed by FinTech providers

The study covers 15 Member States chosen based on market size, date of integration into the EU, and the variety of specific policy frameworks in place: (i) Belgium; (ii) Czech Republic; (iii) Denmark; (iv) Estonia; (v) France; (vi) Germany; (vii) Italy (viii) Luxembourg; (ix) the Netherlands; (x) Poland; (xi) Portugal; (xii) Romania; (xiii) Spain (xiv) Sweden; and (xv) the UK. Annex 1 of the Final Report sets out the detailed methodology and scope of the study.

Whilst currency and deposits generally remain the most common form of financial asset owned by households across the Member States, the remainder is typically invested in various types of investment products. Equity funds, bond funds, and mixed funds represent the greatest number of products typically presented to retail investors across the Member States in the study. However, the representation of other asset categories such as pension entitlements, ETFs, and life insurance products varied significantly between Member States. In order to observe these differences, the study used two investor profiles to test and map the investment products and services offered to each of those profiles (by way of desk research and mystery shopping).

- Profile A is a risk-averse young professional with €10,000 to investment on a long-term basis
- Profile B is a more risk-inclined professional who is nearing retirement age with €100,000 to invest

The data collection for the study notably took place throughout 2017, before the entry into force of MiFID II or the PRIIPs KID Regulation, both of which will continue to have a significant impact on the market. The Final Report does, however, highlight nuances between national rules in different Member States in the study, which EU policymakers may use to benchmark Member States' implementation of the new rules. For example, prior to MiFID II, the UK and the Netherlands had both implemented a ban on product provider commission being paid to advisors ahead of similar changes brought about by MiFID II. This has led, in the Commission's view, to a demonstrable shift in investor behaviour away from obtaining non-independent advice through banks and insurers. Retail investors are now either taking investment decisions on their own or via online investment platforms, or obtaining advice from IFAs. However, in the majority of the other Member States in the study, investors will typically obtain non-independent advice via their bank or insurance provider.

Given the stated purpose of the study, the Final Report stops short of setting out specific policy aims or indicating future regulatory developments. However, manufacturers and distributors of retail investment products may find the Final Report helpful as a way of assessing their practices as against their peers in other Member States.

Challenges for investors

The Final Report found that the average retail investor has little confidence in their own financial decision-making, as well as in financial institutions in general. In turn, the Report identified that the majority of households in the Member States in the study do not invest on capital markets or do so infrequently.

When facing an investment decision, a retail investor will often rely on advice in a face-to-face setting through a non-independent advisor of a bank or insurance company. The Final Report cites research which also suggests that different socio-economic groups use advice in different ways. High net worth and informed investors tend to consult an advisor to complement their own knowledge and further support their own decision-making. However, financially less literate and less wealthy investors strongly rely on advice provided by their bank or insurance agent to guide them in their financial decision-making, and possess too little financial knowledge to challenge unsuitable recommendations.

Furthermore, retail investors frequently consider non-independent advice to be free of costs, as they do not realise the incentive scheme of the non-independent advisor and are therefore unable to identify potential conflicts of interest. In addition, the Final Report states that studies suggest that when investors do become aware of the conflict of interest of their advisor (due to the incentive scheme in the case of non-independent advice outside of the UK and the Netherlands pre-MiFID II) they are substantially less willing to pay for advice or follow the recommendation.

Finally, when surveyed, most retail investors remain unwilling to pay for independent advice. Despite growing in popularity, it also remains only a minority of retail investors who are willing to make investments via robo-advisor platforms. Given the combination of the above factors, the study suggests that investors will benefit from:

- Increased financial education
- Clarity on costs and charges (see below)
- Robo-advice that is complemented with human advice
- Other options, such as simpler products

Outcomes of different types of advice and suitability

The study also looked at how different types of advice take into account the profile and investment needs of a retail investor and match this with the features of the recommended investment products.

First, the study observed that generally, when advice was provided (be it independent or non-independent) investors were, on average, recommended three different product types in which to invest. Whereas, in the case of robo-advice, investors were advised to invest only in ETFs in 80% of cases. Equally, the Final Report notes that ETFs, whilst perceived as increasingly popular amongst retail investors and despite the significant growth in their manufacture, were otherwise more difficult for the average investor to access. This is because whilst robo-advisors will typically provide access to ETFs, the Final Report found they were “rarely” proposed by human advisors. The result being that a well-educated and self-directed retail investor is significantly more likely to invest in ETFs.

Second, the study looked at how different types of distributors establish the suitability of investment products for their clients. The Final Report found that the intended **investment duration** is generally discussed with the client irrespective of the type of advice. In contrast, substantial discrepancies appear across Member States and types of advice in relation to recording the **investment purpose**, as well as the **risk profile** of the investor (the Final Report found advisors were much more sporadic in recording each of these categories).

In relation to the client’s **knowledge and experience**, the client’s prior experience with investments is largely covered by all types of advisors and across all Member States. Conversely, the degree to which the client is asked about their **profession** varies significantly across Member States. The level of **education** of the investor was very rarely recorded.

With regard to the client's **ability to afford and hold the investment**, advisors frequently inquired about their current financial situation in terms of assets. On the other hand, advisors asked significantly less frequently about the client's **income and regular commitments**.

Granularity of suitability assessments: profile A and profile B

The Final Report found evidence that advisors tend to ask fewer questions regarding the financial situation (*e.g.*, resources, source of income, assets, and expenses) of clients wishing to invest larger amounts, such as profile B. The suggested rationale is that such clients are more valuable customers in the eyes of a financial institution compared to clients with less capital. As a result, distributors typically may choose to adopt a more commercial approach with clients with more capital, less centred on potentially intrusive questions and more focused on product marketing and investment objectives.

This is also reflected in the fact that clients with more capital are generally asked more questions on investment experience, horizon, objectives, and risk appetite than those with less capital, such as profile A. Notably, however, although they are asked fewer resource-related questions, clients looking to invest larger amounts are also asked much more often about their ability to bear potential losses than clients looking to invest less capital.

Notably, assessing the client's **ability to bear losses** was not a requirement under MiFID but was tested in anticipation of MiFID II. Though the rates varied widely for this criterion, advisors in some Member States do frequently inquire about this point. Despite the fact that the results between independent and non-independent advisors seem to be globally comparable across and within Member States, independent advisors appear to ask questions regarding the ability to bear losses more frequently than non-independent advisors.

With regard to robo-advice, the Final Report does advise that all robo-advice platforms should be complemented with the availability of human advice (*i.e.*, as differentiated from technical assistance), especially when the client is completing the suitability self-assessment when being on-boarded and when receiving a recommendation (*i.e.*, before execution takes place). This recommendation follows observations of both overconfidence in investors when answering the automated questions or the provision of unreliable information (including investors who are rejected by the platform who will attempt to circumvent the suitability process by starting the self-assessment again and altering their answers).

Transparency of fees

The Final Report makes broad observations on the accessibility of easy-to-understand information on the initial and on-going costs and charges of retail investment products. The study was always able to find information on fees for listed bonds and equities, and was typically able to find fee information for investment funds of all types with relative ease (presumably because of the presence of a KIID). For ETFs and REITs, locating information on fees was, on average, more difficult (often because no consolidated figure was provided to investors, instead requiring clients to find and combine the figures correctly). The most variation in accessibility to fee information was for life insurance and pension products. The Final Report found this was because it was difficult for investors to know whether the indicated fees include the cost of any underlying asset (this was particularly true in relation to insurance products without a capital guarantee).

As a result, the Final Report found that, in its view, it is "*very difficult for retail investors to collect comprehensive information on fees and correctly interpret the information provided. This impedes their ability to compare fees across different products and distributors*". However, presumably this concern is mitigated since the entry into force of the PRIIPs KID Regulation (and, to a certain extent, MiFID II).

National Consumer Protection Agencies and Alternative Dispute Resolution Agencies report that retail investors most frequently complain about mis-selling of products due to the provision of insufficient or unclear information about the product, its associated risks or the product being not adapted to their risk appetite. Retail investors also frequently complain about the fees associated with the investment products they purchased, claiming that fees actually charged are higher than those explained during the advice process.

Manufacturers and Distributors may find Annex 2 of the Final Report of particular interest given it provides an overview of the entry and exit fees and the on-going charges associated with each category of retail investment product, and across each Member State, selected for the study.

The impact of online platforms and other FinTech solutions

The study looked at fund supermarkets and online brokers, robo-advisors, and social (*i.e.*, copy or mirror) trading platforms as innovative distribution channels for retail investment products.

The study found that fund supermarkets and online brokers are rapidly increasing their market share, generally because they offer lower costs for investing. However, the level of development of fund supermarkets varies strongly across the EU, with the UK, France, Germany, and the Netherlands leading — followed to a lesser degree by Italy and Spain. The ban on inducements in the Netherlands and the UK has been a strong driver for fund supermarkets, online brokers, and online investment platforms of incumbents.

In relation to robo-advice, while certain retail clients are early adopters, the robo-advisory client spectrum is expected to widen. Although the market share of robo-advice has rapidly increased recently, only a "*tiny fraction of retail investors do rely on such platforms*", with the UK and Germany leading in terms of current user adoption.

Social trading platforms (namely copy and mirror trading systems which allow retail investors to mimic the trading strategies of more experienced investors) are also gaining popularity, but are flagged as being "*less adapted to the average retail investor with little knowledge of financial product*s" and, consequently, expose investors to a greater degree of risk.

Consistent themes arise in relation to each innovative method of investing that does not involve face-to-face advice. The Final Report expresses concerns over unclear fee structures and the risk of mis-selling due to clients not having access to a human advisor. Whilst the Report acknowledges the barriers to retail investors accessing reliable advice, which would mandate innovation, the Report is concerned that FinTech solutions should be subject to the same regulatory requirements as existing retail advisors. It is also clear that the Commission wishes to stimulate innovation, and raise standards, in existing market participants and is not therefore looking to automatically favour "disruptor" FinTech providers to stimulate the market.

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