esma European Securities and Markets Authority

Date: 16 November 2016
ESMA/2016/1579

# How can we improve outcomes for investors in investment funds?

## EFAMA Investment Management Forum, 16 November 2016, Brussels

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Ladies and gentlemen,

It is very good to be back at the annual Investment Management Forum and I want to thank EFAMA for inviting me to speak today.

The severity of the financial crisis of 2008 and its repercussions created a loss of confidence in the financial markets among many people across our society. The crisis has cast a long shadow over prosperity and living standards. Subsequent shocks, such as sovereign debt crises, have forced some Member States to review longstanding commitments to public funding of, for example, health care and retirement support. Market distrust only further serves to impede the saving and investing that households must undertake to meet their educational, housing, healthcare and especially retirement goals. The damage done to trust in our financial markets reinforces the need for ESMA to play a significant role in improving outcomes for retail investors.

In my view, the asset management sector can play a key role for households to meet their saving and investment goals. As we all know, the returns on bank deposits are extremely low, and households can only achieve a reasonable return on their investments in the long term if they invest in the capital market. Of course, the efficiency of the asset management sector will have a great impact on the potential impact it can achieve for investors.

A cursory review of the European fund market versus that of the US provides insight into ways in which the current structure of the European market could be made more efficient. Before I

give you some figures on the fund sectors in both regions, let me emphasise that the message will not be that we should emulate the model of the US fund industry in the EU. Not at all. As we all know, our fund industry inevitably reflects the very specific characteristics of the European Union. Rather, the figures indicate the opportunities for the EU fund industry to play an even bigger role in our financial system, to the benefit of both retail consumers and the fund industry.

Despite an EU population of 510 million, almost 60% greater than that of the US, total assets under management (AUM) in UCITS stand at 8 trillion euros, compared to around twice that amount in US 1940 Act funds, the American equivalent to UCITS. This structural difference has two important consequences. First, at an aggregate level, a greater value of total assets in the investment fund sector means more investments for firms, supporting economic growth and thereby improving our standard of living. Second, the greater the size of an investment fund, the more it can benefit from economies of scale, improving returns for investors who look to save for their important life goals. So an important question to ask is: why is the European fund sector, despite its strong growth in the past decade, still relatively small?

First, participation rates in Europe are significantly lower. Only 11% of EU households own funds. The proportion in the US is almost four times higher, at 43%. This stark difference is despite the fact that *median* household wealth in the Euro area – as opposed to mean household wealth – at 110,000 euros is almost twice the level of the US. This median figure gives the net worth of households at the middle of the wealth distribution. In other words, many European citizens have the means to invest in investment funds, but choose not to. This observation should give us pause for thought.

Second, expenses of European funds are much higher than their US counterparts. One reason is that more funds in the US are passive, rather than active: some 30% of investor assets are passively managed in the US compared to around 7% of AUM for the UCITS sector. The cost of passive investing is a fraction of that for active funds.

But even allowing for that difference, American funds are significantly cheaper. Recent figures based on a sample of actively managed funds put average charges to investors in active UCITS at 145 basis points, compared to 84 basis points in the US. Charges are of course lower among passive equity funds, but the marked difference between the EU and US persists: an average of 35 basis points in the EU compared to 11 basis points in the US.

What drives the higher costs across both active and passive funds in Europe? The more modest scale economies in the EU fund sector is one reason. American active funds are around 5 times the size of their European counterparts, while the average US passive fund is 10 to 12 times larger. It is largely the same amount of work to manage a 1 billion euro fund as it is to manage a 100 million euro fund, but the costs can be distributed over a larger pool of assets, allowing fees to be lower. Another reason for higher costs is how funds are distributed in Europe, where the distribution network is largely bank driven and the costs of that network increase fund costs. In contrast, the majority of funds in the US are sold outside the banking sector.

In the current low interest environment, where it is difficult to achieve good returns on investments, cost performance is probably one of the most important decision criteria for investors. The comparison with the US suggests there is much scope to make EU-based investment funds more efficient and less costly for the average investor. The comparison also suggests that this can go hand in hand with a bigger role for the asset management sector in the financial system.

So what should we do to achieve these goals? Before I respond to that question, I would like to emphasise that all involved need to make a contribution: manufacturers, distributers and regulators.

To start with, we can build on two key initiatives ESMA has led in recent years. These are:

- One, improving transparency and the information available to fund investors to help them choose funds that offer them value for money in meeting their goals;
- Two, removing barriers to cross-border distribution of UCITS and finding other economies of scale through the Capital Markets Union (CMU).

I will talk in more detail on each of these regulatory initiatives, before turning to how we believe financial innovation and technology can provide new tools to drive efficiencies to benefit investors.

## Regulatory initiatives

I first turn to the topic of transparency. MiFID I already requires the provision of information on costs and charges in connection with the financial instruments and services offered to clients.

It also regulates the provision of various types of benefits to investment firms, known as inducements, due to their likelihood to influence a firm's choice and conduct when providing services to clients. Disclosure of inducements is already a requirement under MiFID I.

Cost disclosure, together with the disclosure about inducements, is an important element to improve the ability of investors to assess the products and services that are offered to them. The development of the regulatory framework in the EU, especially in the areas of MiFID and PRIIPs, underlines the relevance of costs for investors, and the difficulties experienced by investors in understanding the overall costs of their investments and the actual impact on returns.

The legal framework set by MiFID II on inducements and costs and charges has been extensively discussed so I will not go into too much detail, but will focus instead on the key achievements:

- First, the EU legislation has strengthened the requirements on inducements, with a particular emphasis on portfolio management and independent advice where the entirely discretionary nature of portfolio management services and the independent elements of some types of advice has warranted, in the MiFID II approach, a ban on the possibility to receive and retain monetary and non-monetary benefits from third parties. For all the other services, inducements must be justified by the enhancement of the quality of services provided to each client whereby the inducement received needs to be proportionate to the quality enhancement achieved;

- Second, all costs and associated charges related to investment and ancillary services and financial instruments will be disclosed to clients; moreover, all costs and charges will be aggregated in order to allow the client to understand the overall cost as well as the cumulative effect on return of the investment. This information will be provided on an ex-ante and, where applicable, ex-post basis.

More importantly, MiFID II took into account the different business models, whereby investment firms do not always directly and/or fully charge the client for their services but receive instead payments, or inducements, from third parties. Indeed, MiFID II acknowledges that, in such cases, the client indirectly pays the investment firm for the services rendered through higher commissions included in the charges and/or in the price of the financial instruments, which are subsequently partially passed on to the investment firm. Accordingly,

in addition to the requirement for firms to disclose the existence and amount of inducements, MiFID II requires that information about third-party payments be provided to clients in the context of information on costs and charges. This would inform clients about how they indirectly pay for the services they receive, and allow clients to understand the total costs of the service provided and to compare between different services and different financial instruments. This stronger focus on cost disclosure and inducements should lead to more competition amongst service providers and bring some positive outcomes for investors.

On the subject of MiFID, I would like to mention one point that ESMA has repeatedly made in relation to the importance of achieving further consistency between rules applicable to similar activities and substitutable products. In particular, ESMA has invited the Commission to assess possible inconsistencies between the UCITS/AIFMD and MiFID II frameworks with a view to achieving further consistency in the area of, among other points, cost disclosure and inducements.

In addition to our important ongoing work on MiFID II, we are looking at other ways to improve outcomes for investors in the asset management sector. Reforming the rules on the distribution of financial instruments is one way; another way would be to take advantage of the opportunities afforded by new technology. I will come back to the latter issue in due course. But first, I would like to focus on some of the legal and regulatory obstacles that might be acting as a brake on the optimal functioning of certain asset management activities.

The European Commission launched its CMU initiative last year. As we have said on many occasions, ESMA is very supportive of the aims of the CMU to foster deeper and more integrated capital markets across the EU. Asset management has been identified as a key activity in the CMU context. This is not surprising – after all, the UCITS Directive is an excellent example of how to establish a successful platform for cross-border capital market activity across the EU, including for products that are accessible by retail investors.

The UCITS framework has been a great success. The fact that the UCITS market has grown to €8 trillion of assets under management, although still less than the equivalent figure for US funds, is a welcome development. Importantly, around 80% of UCITS funds are marketed cross-border. However, if you dig deeper into the figures, it is clear that there is scope for improvement. One third of UCITS that are marketed cross-border are only sold in one Member State in addition to their home country. Another third are not sold in more than four Member States outside of their home country. As I mentioned in my earlier remarks, UCITS funds are

also significantly smaller than US investment funds. The average European investment fund is valued at approximately €200 million, while the average US fund is almost seven times as large.

Could the regulatory framework explain why the cross-border activity of UCITS has not developed even further? Stakeholders regularly draw our attention to the practical difficulties that they sometimes face when seeking to exercise their pass-porting rights. The Commission also recognised this issue and incorporated in its CMU Action Plan a specific work-stream on identifying – and subsequently removing – unjustified barriers to the cross-border distribution of investment funds. These barriers could include discriminatory tax treatment, varying national requirements on the marketing of funds and fees for cross-border notifications.

ESMA contributed to this work initially by gathering information on the practices of national competent authorities in this respect. We then provided that information to the Commission. The mapping that we did was very comprehensive in nature, covering not only AIFMD and UCITS but also EuSEF, EuVECA and ELTIF. The Commission used our input as a basis for the consultation that closed last month.

This is an important initiative as it recognises that the regulatory framework, and the way that national regulators apply it, can introduce additional costs. Regulatory fees are perhaps the most transparent of these costs but I would not be surprised if other obstacles and barriers, such as additional requirements on marketing imposed at national level, actually had a bigger cost impact. We know that such costs will at least partially end up being paid by the end investor, so we should look at these requirements closely to see whether they are fully justified. At the same time, national regulators are justifiably wary of any moves to diminish their important role in ensuring investor protection. Indeed, requirements imposed at national level must have been introduced for a reason and any decision to reduce or remove those requirements would have to take full account of the resulting impact on the ability of the national regulator to fulfil its tasks.

Another aspect of the CMU to which ESMA is contributing relates to the net returns and performance of long-term investment products. The Commission is keen to assess in a comprehensive manner the actual returns that retail investors get from some of the most common investment products, and has asked the European Supervisory Authorities (ESAs) to provide input. We are currently discussing the details of this work with the Commission but I can already say that the overall aims of the initiative are very much in line with the messages

I am seeking to get across today. As this work develops, it will be important to take into account recent and upcoming regulatory initiatives, such as MiFID II and PRIIPs, that should improve the transparency of information on costs and performance.

We should also be realistic and accept that it is not within our power as a regulatory authority to address some of the obstacles to cross-border activity. For example, some investors will inevitably prefer to invest their money with a provider that is established in their jurisdiction. There are also linguistic and cultural preferences that may influence investor behaviour. Looking beyond the regulatory sphere, we know that the tax framework plays an important role in the structure of the financial industry. I mentioned earlier the relative size of EU funds versus their US counterparts – the audience will remember that the UCITS IV Directive aimed, among other things, to facilitate and encourage cross-border mergers of funds by harmonising their regulatory treatment. Unfortunately, the evidence of the past few years suggests that this has not had the desired impact, notably because many Member States still impose tax on cross-border fund mergers while taking a tax neutral approach to domestic mergers. I would not wish to present myself as a specialist on tax issues or as an advocate for fiscal reform but I believe that it is important to take a broad view of the issues if we are to achieve the desired improvements.

In addition to the work being done at European level, our Competent Authorities are undertaking important initiatives at national level that will improve the investment fund sector from the investor's perspective. A good example is that several Competent Authorities are working to address 'closet indexing', whereby funds that are essentially passive in their investment strategy charge fees typically associated with active management. This work builds on the initial efforts of ESMA in this area, which led to a public statement at the beginning of this year.

## The role of technology

The final topic I will talk about today, under the theme of addressing issues in the investment fund sector, is that of financial innovation relating to technology. Of course, many improvements in outcomes for investors will come not from regulation but from innovation in the private sector. The proper role of regulators in this setting is to enable innovation to flourish where it promises benefits to investors and other market participants. At the same time, we must be alert to the risks that new technologies might pose. ESMA believes this balanced

approach – both protective and supportive – is the right way to ensure new technologies and innovations deliver better outcomes for investors.

One area of financial innovation that may bring radical change across the financial sector is that of financial technology, or "FinTech". We are seeing a number of developments pioneered by FinTech firms that are already having an impact on the way investment funds are distributed to clients. A prominent example is automated advice. More and more consumers now use automated tools when seeking recommendations or advice prior to purchasing or selling financial products and services. Several studies forecast the market share of automated advice to expand rapidly over the next few years. However, it is a recent phenomenon and so it starts from a low base. Well under 1% of AUM was invested via automated advice in the US in 2015, and an even smaller fraction invested via automated advice in the EU. We see much potential for automated advice to bring a number of benefits to consumers as it becomes increasingly adopted.

One major benefit of automated advice is to financial inclusion in the investment fund sector. Automated advice may be provided alongside other automated tools customers can use to plan their finances – such as to monitor and manage their savings or debts – and inform themselves about financial products. The development of these new options can help widen access to investment funds and provide comparatively low cost professional advice at lower entry minimums to EU households. For EU households in particular it may help raise the participation rate from that very low 11% level that I mentioned earlier.

Financial inclusion is, of course, a worthy objective in its own right, as it helps households meet their savings goals. In addition, it encourages new investment channels, contributing to the economies of scale that drive down the costs of running a fund.

Alongside financial inclusion, another key potential benefit stemming from automated advice is a direct reduction in the costs involved in providing advice. These cost savings appear to be at least in part passed on to consumers, with automated advice tools offered by most providers as a low cost alternative to human advice.

Earlier I mentioned that in taking a balanced approach to innovation, we need to support firms but also to protect consumers. Automated advice does bring some risks, as it is clearly not a perfect substitute for advice provided by a human expert. Our challenge is to manage the risks

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as we facilitate greater efficiency among EU-based investment funds. On one side it is true that a well-developed algorithm may be more consistently accurate than the human brain at complex repeatable regular processes, and in making predictions, and therefore provide consumers with higher-quality advice. However, the respondents to the Joint Committee's Discussion Paper on this topic correctly pointed out that the accuracy of automated advice depends on both the underlying logic of the algorithm and the quality and completeness of the information fed into the system. Respondents also emphasised the importance of the human element and human interaction with clients.

We also need to think about how different areas of regulation, both European and national, can interact to shape the evolution of technologies such as automated advice. For example, restrictions on inducements may have stimulated the growth of the automated advice market. We continue to monitor and assess FinTech developments taking such factors into account.

## Conclusion

To recap, the European asset management industry and the regulatory frameworks of MIFID and UCITS have clearly brought economic and social benefits to the EU investor. But we believe that more can be done to improve the efficiency and transparency of the investment fund sector. This belief underpins our work to improve transparency and information available to investors, and our contributions to the CMU Action Plan on facilitating cross-border distribution. In addition, we are always alive to innovation in the financial sector, and our balanced approach seeks to support technologies – such as automated advice – where we see significant potential benefits, while guarding against risks.

Through our work in all these areas we will promote participation by European households in the investment fund sector, helping citizens meet their financial goals. In doing so, we support the development of a competitive investment sector, critical for both the accumulation and retirement phase of European citizens, and one with strong growth prospects.

Thank you for your attention.