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The ESAs role in financial consumer protection

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Ladies and gentlemen,

A journalist asked me recently how I think the economy is doing. My answer needed to be brief, to the point and last no longer than a few seconds. I told her that if I would have to respond with one word it would be “good”. If it could be two words it would be “not good”.

I think there is no better way to describe the European and Spanish economy at this point in time. Yes, we are no longer in the stormy waters we were a few years ago. European governments and citizens have been severely challenged over the past few years by difficult decisions on how national budgets are spent, how taxes are levied and on the future of the welfare state. The EU responded with, amongst other measures, enhanced co-ordination of national budgets, a European Stability Mechanism, and a new supervisory architecture including three EU supervisory authorities and a single supervisor for banks in the Eurozone. Today, modest and fragile, the growth forecast for the European economy looks marginally positive. The Spanish economy has turned the corner and has been gaining strength since the second half of 2013. The fact that BME, the Spanish stock market, expects to have 17 Initial Public Offerings (IPOs) by the end of the year is a good sign of that.

However, Europeans are still suffering from the crisis and we are not heading for a walk in the park. Unemployment, especially among young people, remains high – a fact I do not need to remind anyone of in this country. Companies still face far too much debt and although funding conditions for banks have improved, many are still heavily reliant on central bank funding.

While the banking sector is gradually getting stronger and lending conditions are starting to ease, credit is still contracting faster than desirable, which hampers economic recovery. Despite recent progress, a significant part is due to banks raising their capital ratios more by shrinking lending than by raising capital. Altogether since its peak in 2008, gross new bank lending to companies has declined by more than 40% according to the European Central Bank.

Today EU companies rely for roughly 80% of their financing on bank lending. The expected, and needed,[1] bank deleveraging will downsize the banking sector further over the coming years and should accelerate the development of alternative, capital market-based sources of finance. EU securities lending already rose in the first half of 2014. The value of EU securities issued on loan averaged 528 billion EUR compared to 485 billion EUR in the first half of 2013. However, this was mainly due to a significant increase following seasonal effects (lending for cross-country tax arbitrage) in both the quantity and value of EU equities loans, the highest in three years.

The development of alternative ways of financing is of utmost importance to secure our future. Stricter prudential rules are needed for safer banks, but doing so, and at the same time sticking to Europe's tradition of relying heavily on bank funding, will not be sufficient to face the challenges ahead.

Europe needs to invest more than ever in its infrastructure. According to the European Commission, two trillion EUR of investment is needed in telecoms, energy and transportation infrastructure by 2020[2]. The only way we will be able to find money for those investments, and to have safer banks, will be through strengthening the role of capital markets in the EU. Increasing the role of the non-banking sector will not only help in accessing the much needed money for investments, it will also help in making a shift from debt to equity funding. Bank funding is by far and away debt-based, while the financial markets provide a range of equity-based funding sources, like private equity, venture capital, and of course the classic equity IPO. This shift is very much welcome considering the high indebtedness level of the private sectors mentioned earlier.

President-elect of the European Commission Jean-Claude Juncker has, rightly in my opinion, launched a debate on developing a Capital Markets Union to improve the financing of the economy by further integrating European capital markets, primarily to help small and medium- sized companies.

What can we do to make sure our companies find the funding they need to flourish, to develop the real economy and to create jobs? There are still too many artificial boundaries within the EU Single Market hampering the flow of capital. We need to address them, which should primarily benefit investors and small and medium sized companies. This obviously does not mean that bank financing will disappear. Banks understand the business of their clients and understand the risks entailed in investments. I would not even exclude that banks will continue to be the better funding option for the smaller entities in the broad range of SME companies.

By now I see some people thinking what all this has to do with investor protection? I see two important elements, which I would like to discuss further:

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1 E. Feyen and I. Gonzalez del Mazo (2013) *European Bank Deleveraging and Global Credit Conditions*. The World Bank.

2 http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/investment_needs_en.htm

- how can we ensure that investors are and feel sufficiently protected that they are willing to enter the capital markets; and

- the need to ensure convergence in national investor protection practices within a European integrated market.

Let me touch upon those two elements and on what ESMA is already doing in those areas and where we should be heading. Let me start with the role of investor protection within an integrated EU capital market.

Europeans are champions of accumulating money in a savings account, which in today's environment is almost the same as hiding it under your mattress. It is easy, has a relative low risk due to deposit protection but also a low return and its added value for the economy depends on how banks invest it further: it does not necessarily find its way to the real economy. For example, we know that banks have been increasing their exposures to government debt over the last few years. Over the last yer alone, the value of government debt held by euro area banks grew by 4,2%.

At the same time the European population is ageing which might endanger the long term sustainability of pension systems. Pension assets in Europe amount, according to some studies, to around 6,3 trillion EUR or about 43% of Europe's GDP. That is not even half the size of the pension market in the US, which has assets of around 16,5 trillion EUR or 125% of GDP[3]. If we want to build long-term European capital markets we will need to encourage the growth of long-term pools of capital and stimulate financial consumers to save and invest more. The only way we will be able to persuade investors to do so is by focusing initiatives around the investor and to find a balance between investor protection and capital market formation. No investment, no economic return can be risk-free. But for financial consumers to enter the capital markets we need to make sure they understand the process and have sufficient information on how it works. Further work is needed in that respect.

The three European Supervisory Authorities (ESAs) – the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) – work on improving consumer protection by contributing to a higher degree of regulatory and supervisory convergence across EU financial markets and securing cross-border coordination. We do this primarily by enhancing investor protection when creating the single rulebook for EU financial markets, but also by more direct measures such as issuing EU-wide investor warnings.

Indeed, ESMA plays a key role in the completion of EU financial markets legislation developed by the European Commission, the European Parliament and the Council of the European Union. Two legislative acts are currently high on our agenda in this respect – and I guess also high on the agenda of many people in the audience here today – that I must speak about them: PRIIPs and the MiFID review.

[3] W. Wright (2014) Driving Growth: Making the case bigger and better capital markets in Europe. New Financial

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PRIIPs

The work we are doing on Packaged Retail and Insurance-based Investment Products (PRIIPs) is clearly all about investor protection. PRIIPs provides a framework for establishing consistent and high quality disclosures for retail investors across the financial services sector. It will capture investment funds, structured products (including structured deposits) and insurance-based investments. The PRIIPS work is a big challenge for the ESAs: it is arguably the most extensive and complex workstream that has been tackled by the Joint Committee of the three ESAs so far.

The Key Information Document (KID) will be the most tangible output of the ESAs in the eyes of most financial consumers. The KID, which is limited to three pages in length, has to contain sufficient information to allow consumers to make an informed investment decision and to compare offerings. It will have to present information in an accessible consumer-friendly way and in the language of the retail consumer. Otherwise, they will simply not read it. This should include information on the product itself, the related costs and what happens if the issuer is unable to pay out. The three ESAs will next month publish a discussion paper outlining the format and content of the KID on which we will seek your input. This is by the way not the only opportunity we will give to stakeholders to comment. There will be at least two further consultation rounds between now and the end of 2015.

The feedback from that process will be complemented by the results of a consumer testing exercise that the European Commission, together with the ESAs, will launch very soon. A similar testing exercise was run in the context of the UCITS KID and it was probably the single most important element in arriving at the final policy choices. That is how things should be done given that the KID will be used by millions of consumers across the EU on a daily basis, so it is only right that consumer input will be a key driver of what the final document looks like.

MiFID II: inducements

The topic on capital market functioning and investors’ decisions ties-in closely with our recent MiFID II consultations. MiFID II introduced the biggest overhaul of EU financial markets in more than a decade. MiFID II will improve the functioning of EU capital markets and will expand the scope of its predecessor in various areas, such as the transparency required before and after products are traded, and the financial instruments covered. ESMA has an important role to play in its implementation and published a discussion and consultation paper in May 2014 setting out our initial thinking on a very wide range of issues. A crude indicator of the size of this project is the fact that the papers themselves came to a total of about 800 pages. Out of the many MiFID II issues, I would like to focus today on one specific item: the role of inducements when advising on financial instruments.

To help capital markets play a more central role in the financing of the economy, we need a well-functioning intermediation process so that financial instruments, like bonds and equity, find their way properly into the portfolios of asset managers and end-investors. MIFID II very

much recognises that this process is still distorted and that further improvements are needed in the way investment advice on financial instruments is provided.

Supervisory experience and market research demonstrate that important factors can lead to poor advice regarding financial instruments, or more broadly financial products, including conflicts of interest arising due to payments provided to investment firms in relation to the service they provide to clients (so called inducements).

These problems cannot be solved just with more transparency. This holds true even when the information is “fair, clear and not misleading”. We know now that too much information can confuse investors, especially unsophisticated retail investors, and can lead to them making poor choices or wrong decisions. The combination of rational decision-making by consumers, full transparency and competition among suppliers solves many problems in markets. However, experience has shown that this market mechanism does not always work effectively in financial markets and regulation and supervision is needed to achieve the right outcomes and to protect investors.

In this respect, MiFID II has made important progress in the area of inducements and the draft ESMA advice for the Commission, included in the consultation paper I mentioned earlier, proposes further strengthening the framework. In short, disclosure of inducements is simply not sufficient. At a minimum, we need to ban inducements in certain cases and we need to ensure that inducements are effectively used to serve clients appropriately.

MiFID II strengthens the investor protection framework regarding inducements in a number of areas:

- It introduces a ban on inducements for portfolio management and investment advice provided on an independent basis (with the limited exception of inducements that are minor non-monetary benefits). Independent advisors might still receive monetary inducements but they should pass them to investors as soon as possible after receipt;
- It confirms, for the other services, the requirement that inducements:
  i.) should be disclosed to clients;
  ii.) should not impair compliance with the firm’s duty to act honestly, fairly and professionally in accordance with the best interest of the client; and
  iii.) should be designed to enhance the quality of the relevant service to the client.

The European Commission will have to adopt delegated acts in these areas and has requested ESMA to provide advice in relation to the future delegated acts. ESMA’s advice on inducements will focus on the following main aspects:

- **Minor non-monetary benefits** (portfolio management and independent advice). Non-monetary benefits received by the portfolio manager and the advisor should not

be allowed when they are likely to inappropriately influence their behaviour. A specific type of non-monetary benefit is research when the portfolio manager receives it from a broker out of dealing commissions.

The ESMA consultation paper in this area is based on the principle that portfolio managers should not choose their brokers on the basis of the research received from them. In its consultation paper, ESMA has proposed that in order to be considered as a minor non-monetary benefit, research should be intended for distribution so that it is accessible by a large number of persons (or by the public) at the same time.

- **Quality enhancement**. In its consultation paper, ESMA consulted on introducing a non-exhaustive list of circumstances and situations in which quality enhancement is not met and a fee, commission or non-monetary benefit may not be regarded as designed to enhance the quality of the service to the client.

  In line with the obligation to enhance the service to the client, ESMA further proposes that inducements could be considered acceptable if high quality investment advice is provided to the client, i.e. advice going beyond the basic requirements for advice.

As I said before, we have consulted market participants on our proposals and are currently assessing the more than 700 responses received to the consultation and discussion paper. I would like to use the opportunity to emphasise the importance of those responses. They are extremely valuable for ESMA in better understanding the impact of our proposals when finalising policy proposals. I would strongly encourage you to participate in ESMA's consultations. From the responses we received and from interactions we had earlier with stakeholders it is clear that the work on inducements is sensitive. We are currently reading all responses carefully and we will take them into account when taking a final decision on the technical advice in December 2014. Without prejudice to this final decision, I would like to make three remarks.

Firstly, I would like to reassure you that ESMA did not – and does not – have any intention to extend the ban on inducements beyond the situations in which this is foreseen in the Level 1 text. That is to say: when portfolio management and investment advice on an independent basis are provided. At the same time we have to respect the will of the legislators and I would like to recall that the level one is clear in requiring that, in all the other circumstances, the inducement "is designed to enhance the quality of the relevant service to the client".

Secondly, a main concern that has been expressed is that our proposed advice might reduce the access to advice for retail consumers. Of course, as a regulator with investor protection as one of its main objectives, I very much support the need for good advice for retail consumers. However, we should also acknowledge that not all advice is good advice. We do not serve investor protection when advice is distorted by inducements, instead of enhanced by inducements.

Thirdly, in the area of research, a main concern expressed is that our proposal would reduce the amount and scope of research conducted. Again, as a regulator I fully see the

importance of high quality research for well-functioning financial markets. Hence, we need to have a solution ensuring compliance with the legal requirements while avoiding affecting availability and coverage of research.

Warnings

However, developing technical standards and providing the European Commission with advice is not the only work we do on investor protection. As already indicated ESMA has warned investors at different occasions over the last few years and asked national authorities to intervene accordingly. For example, we have issued warnings on topics like the sale of complex products, on contracts for differences and investing on the internet. More recently, and I definitely wanted to touch upon this today after being made aware of some practices in Spain, we have warned about the so called self-placement practices where financial institutions sell their own clients the financial instruments they have issued to comply with stricter prudential requirements. The *loss bearing* features of many of these products mean that consumers are exposed to significant risks that do not exist for other financial instruments. For example, investors are more likely to be subject to bail-in and the absence of harmonised structures, trigger points and loss absorption makes it difficult for investors to understand and compare the products. Each product needs to be assessed as a unique offering, which may be particularly challenging for retail investors.

Let me now turn to the second element: the importance of supervisory convergence. Developing a single rulebook is important for the success of and in order that all can benefit from the Single Market. However, we cannot rest on our laurels after developing a single set of financial regulation across the EU. Regulation should also be applied and supervised consistently within a Single Market. National regulatory authorities play an important role in the European System of Financial Supervision (ESFS) where supervision and – the subsequent potential enforcement – is done at the national level except for credit rating agencies and for trade repositories where ESMA acts as the direct European supervisor.

Indeed, differences in supervision, and regulatory competition, undermine the achievement of the objectives of investor protection and financial stability. To have a truly single EU financial market, supervisory convergence between the 28 EU Member States is needed to ensure that the single rulebook also results in a truly single EU financial market. We are therefore stepping up our activities in this area and will invest more resources in it in the next few years. No, this is not about Europe taking power or limiting the activities of national supervisors and this is not about policing Member States. This is about preserving the Single Market.

We have employed a range of instruments to achieve this objective over the last few years including guidelines, questions and answers, opinions and peer reviews. These are tools that help us in setting out how *EU legislation should be applied* in practice but also to better understand *how EU legislation is applied* in practice by market participants and national supervisors and whether additional efforts are needed in some Member States.

Peer reviews are an important tool in that respect and we continue to strengthen our methodology, including the more frequent use of on-site visits. Indeed, where our previous reviews were mainly desk-based we now go on the spot and visit national supervisors to collect information by discussing with the supervisory teams how they assess certain cases and by looking into supervisory files.

I am pleased to inform you today that following that new methodology we have already stepped up our activities and organised on-site visits by an independent technical assessment team examining, in addition to the desk-based collected information, further information from a selected group of national authorities by looking into their day-to-day supervisory practices. The peer review in this new style looked at the supervisory practices on the MiFID conduct of business rules, including the application of agreed good practices. This touches upon areas like marketing communication and that information addressed to clients or potential clients should be fair, clear and not misleading. Also, marketing communication should be clearly identifiable as such. ESMA's peer review identifies potential difficulties that may need to be addressed, such as the reliance on external auditors for supervision, the need for a clear definition on information and marketing material to be supervised, and the distribution channels used by firms.

As I said before we will increase our activities in this area further as supervisory convergence and investor protection stand at the heart of ESMA's role. I believe that this is the only way we will be able to convince financial consumers to become active in capital markets in order to provide young people with creative ideas, our entrepreneurs, our companies, – and SMEs in particular – with an alternative to bank financing.

Ladies and gentleman, Europe faces enormous challenges. We will need every cent for the much needed investments. Our best response is a real, strong and safe EU capital market to make the economy flourish. Let us work on that together.

Thank you.