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“Retail investors and asset management are the pillars of a successful Capital Markets Union”

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Good afternoon Ladies and Gentlemen,

I am very pleased to be with you today – even if virtually – and to have the opportunity to deliver a key-note speech, which I will dedicate to the Capital Markets Union (CMU). I would like to thank the Irish Funds Industry Association for inviting me to this important event, which provides a unique opportunity to discuss EU financial markets policy with key Irish stakeholders.

Introduction

The general concept of the CMU has been with us now for the past six years. However, both the importance and urgency of putting in place all necessary elements have never been more burning. History has showed us countless times that extraordinary circumstances can be the catalyst for decisive changes, and so the COVID-19 pandemic may – quite unexpectedly – allow EU capital markets to begin to realise their potential.

In that context I should mention that the market turmoil in response to the pandemic – combined with lockdowns and quarantine arrangements – actually brought in some cases large numbers of first-time retail investors to the stock markets. Our neighbours in Paris, the Autorité des Marchés Financiers, found that in the early phase of the crisis, 150,000 retail clients bought French blue chip stocks for the first time in at least two years. Purchases by retail investors increased fourfold.

Similarly, to the healing process of a lasting condition, a successful CMU policy-making process should start first with an as-accurate-as-possible diagnosis. When it comes to the EU's capital markets, given all its complexities, the diagnosis is everything but straight-forward. For many, the success of the CMU would be primarily dependent on further harmonisation of regulation and reducing barriers for provision of services across EU Member States. I do agree with this view. However, I believe that what is more important, is to acknowledge the too low level of capital market activity across Europe and what needs to drastically change. If we want to see EU capital markets flourish, we need to engage far more with retail and household participants, both directly and indirectly, in this project. In today's speech, I would like to highlight a few ideas on how this could be done and the role that the asset management sector can play.

The right diagnosis

The European Union and its Member States have been relying heavily on their banking systems for decades. The clients' proximity naturally ensured by the large number of providers – just to recall that for example over 600 banks are licenced in Austria[1], a country with under 9 million citizens – created a very narrow focus for both capital-seekers and savers. From the macro-economic perspective, such a heavy dependency on the banking sector limits the funding channels available to companies and hence the capital available for growth and for innovative economic activities. The resulting indebtedness may be a source of systemic risk[2]. This systemic risk is even increasing as a result of the COVID-19 crisis as companies pick up additional bank credit in response to reduced revenues.

[1] Source: https://www.oenb.at/Statistik/Standardisierte-Tabellen/Finanzinstitutionen/Kreditinstitute/Strukturdaten.html
[2] See e.g. Langfield, L. and M. Pagano, ECB Working Paper 1797, May 2015, "Bank bias in Europe: effects on systemic risk and growth"

At the same time, in recent years bank deposits have offered near-zero returns on household savings. In contrast, net performance of equity UCITS was around 9% for retail clients, on an annualised basis, in the ten years up to the end of 2019. However, only a small number of households have taken advantage of this development, with traditional products like savings books still being the consumers' favourite and effectively preventing capital market driven alternatives.

This picture of a dominating banking sector that limits capital markets activity is, however, not homogenous across individual EU Member States. While across the EU, the share of households' financial assets held in investment funds is around 10%, at national level recent figures range from under 1% in Ireland, together with Estonia and Latvia, to around 16% in Belgium, for example. The proportion of households that own listed shares goes from around 1% in Estonia, Hungary and Portugal to 20% in Cyprus. Ireland is around the EU average, with households' holdings of listed shares at around 4%[3]. At the same time, patterns of participation may also vary in relation to indirect holding of financial assets by households, through pensions and insurance policies. For example, the rate of the indirect participation in investment funds varies from under 1% in Greece to over 30% in the Netherlands, Sweden and Denmark. In Ireland and Germany this rate is above 20%[4].

Another way to look at the question of citizens' involvement in capital markets is to consider the average portfolio across households. Around 65% of households' savings are held in currency and deposits in Greece, with the remainder in financial investments. There is a reversal of this position in countries such as Denmark and Sweden, where around 80% of savings are invested, either directly or indirectly. In several countries, including Ireland and Luxembourg, the share of households' saving held in currency and deposits is around 50%[5].

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[3] Source: ESMA, Performance and Costs of Retail Investment Products in the EU, 2020. See Chart ASR.PC.4 page 8. https://www.esma.europa.eu/sites/default/files/library/esma50-165-1106-asr-performance_and_costs.pdf

[4] Source: EFAMA, Ownership of Investment Funds in Europe 2019 edition. See Charts 2.12 and 2.13, pages 8-9. https://www.efama.org/Publications/EFAMA_Ownership_Investment_Funds.pdf

[5] Source: ESMA, Performance and Costs of Retail Investment Products in the EU, 2020. See Chart ASR.PC.4 page 8. https://www.esma.europa.eu/sites/default/files/library/esma50-165-1106-asr-performance_and_costs.pdf

A quick look outside the Union's borders and across the Atlantic to the United States provides further insight into the role of retail investors in the financial ecosystem. The US, where around 45% of households own mutual funds and which hosts vast, deep capital markets, provides a strong contrast with the EU[6]. In the US, a long-term trend has been for households to own fund shares rather than single stocks, providing them with diversification benefits[7]. There is a strong link between deep, liquid capital markets and household participation, as both markets and investors can thrive when we have the right regulatory frameworks in place. Economic studies show that strong legal protections for investors are associated with high levels of participation and with broader, deeper markets[8].

In focusing on limited retail participation as one of the causes of the current condition of EU capital markets, I am echoing findings by other policymakers and experts. In particular, I would like to refer to the recently published European Commission Action Plan on Capital Markets Union[9] that considers that wider retail participation allowing individual investors to take full advantage of capital markets is a key pre-requisite for a successful CMU.

The right cure

With the *a priori* situation as just described, starting at too low levels in a number of European countries, there should be plenty of potential to engage retail and households in more extensive capital markets activity in the years come. In order to explore this potential, in my opinion we need to deploy several instruments simultaneously. Those instruments should range from investor protection, transparency and confidence, financial education and additionally – which lies outside ESMA's remit – reforming private pension systems.

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[6] Source: Investment Company Institute.

[7] Vanguard research note, 24 January 2020, Unexpected benefits: Measuring the advantages of diversified mutual funds . See figure 1 especially: https://www.vanguard.co.uk/adviser/adv/articles/research-commentary/topical-insights/measuring-the-advantages-of-diversified-mutual-fun.jsp

[8] The link between legal protections for investors and capital markets is established in La Porta, R., F. Lopez-De-Silanes, A. Shleifer and R. Vishny, 1997, "Legal Determinants of External Finance" *The Journal of Finance, 52*(3), 1131-1150. Another study by the authors shows that strong investor protections are linked with retail participation: La Porta, R., F. Lopez-De-Silanes, A. Shleifer and R. Vishny, 1998, "Law and Finance", *Journal of Political Economy, 106*(6), 1113-1155

[9] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2020:590:FIN

Increasing investor trust is a prerequisite to achieve more retail engagement in Europe's capital markets, and that brings me to the first key aspect: investor protection.

Investor protection

Studies show that retail investment products in the EU are characterised by high costs that have a significant negative effect on long-term returns. ESMA's Annual Statistical Reports on the cost and performance of retail investment products[10] have found that the charges have a significant impact on investors' final returns. For example, a ten-year investment in a UCITS fund – averaging across asset classes – can expect to see costs reduce gross returns by over a quarter. The prospect of increased returns on household savings – when compared with a traditional bank savings account – would be an even more powerful argument in the CMU debate when the charges for retail products are kept on a fair level.

Therefore, we decided, among other actions, to launch a specific supervisory initiative in the funds' costs area throughout next year. ESMA will coordinate a Common Supervisory Action (CSA) exercise on investment funds' costs and fees. NCAs will simultaneously investigate whether market participants in their jurisdictions adhere to the key regulatory requirements on costs and fees in their day-to-day business. I expect this to ultimately enhance the protection of investors across the EU by increasing supervisory scrutiny of costs and fees charged to fund investors.

Closely related is the issue of inducements due to the potential conflicts of interests they bring between the firm being paid by the product provider and its clients seeking suitable and low-cost products. Distribution of investment products in most Member States remains dominated by non-independent investment advisors that often recommend inducements-paying products[11]. As experiences of some European countries show, further restricting the acceptance of inducements can be an effective tool to ensure access to high-quality services and low-cost products. Therefore, in line with the objective to build retail investors' trust in capital markets in the recent CMU

[10] ESMA Annual Statistical Reports (2019 and 2020) on Performance and Costs of Retail Investment Products in the EU

[11] Commission's 2018 report on 'Distribution systems of retail investment products across the European Union'

Action Plan, I support a fundamental assessment of the role of inducements in the distribution of investment products in the EU, in which the experience of countries that have banned the use of inducements should be carefully considered. In doing so, the Commission will be well-advised to consider that distribution models whereby the incentives of distributors are better aligned with their clients could also be less onerous in terms of administration and disclosure requirements for the industry.

A similarly careful assessment should be devoted to a proposal to reform the MiFID client categories. MiFID II already provides for the possibility for the most experienced retail clients to opt-up to a professional client status and waive some of the protections from which retail investors benefit. In this context, ESMA has already proposed to reduce the information flow addressed to non-retail clients (including therefore professional clients on request) and to make the provision of information more flexible for telephone trading to avoid disclosure requirements becoming an obstacle to this type of trading. Nevertheless, some propose adding another category of clients, which in my view may increase the complexity of the framework and would risk undermining appropriate protection levels. If there is a wish to provide some relief for experienced retail clients, I would suggest analysing the very criteria defining the status of retail and professional clients on request and consider any potential enhancement there first.

To enable retail investors to make an informed investment decision, MiFID II and the PRIIPs frameworks ensure that all costs and charges, explicit and implicit, are disclosed to the client. Further alignment of these frameworks is of course essential to facilitating appropriate and understandable disclosures. I hope that the European Commission can find a way, together with the Council and Parliament, to move forward as soon as possible the technical proposals to improve the PRIIPS KID that the Boards of the three European Supervisory Authorities voted on earlier this year. I am convinced that the proposals would improve the document for all stakeholders involved, such as simpler future performance scenarios, the introduction of past performance information, and the alignment of costs and charges information between PRIIPS and MIFID.

This would indeed pave the way to bring UCITS in the scope of the PRIIPs Regulation, which is one of the objectives we have been trying to achieve for years in order to end the current framework under which both the UCITS KIID and the PRIIPs KID coexist at the same time. However, let me be clear on one point: if the past performance information will not become part of a revised PRIIPs KID, I would not support any more bringing UCITS in the scope of the PRIIPs Regulation, because this would be detrimental to retail investors.

I would also like to take the opportunity to mention the MiFID II “research unbundling” rules, and how they impact the availability of research for the SME sector. These rules have received a lot of attention since 2018, and are the subject of negotiations for some proposed exemptions to improve research provision for SMEs. ESMA recently conducted an impact assessment of these rules on more than 8,000 EU companies. This rich dataset has shown us that the research unbundling provisions are associated with less research only for the largest companies, whereas research availability per SME is quite stable. And our research shows, in line with a number of parallel and independent academic studies, that the increasing number of firms losing research coverage is nothing new: this is a trend that already began in 2012, when we still had bundling of research and execution[12]. Therefore, I fail to see how undoing the research unbundling provisions, which began in 2018, can improve research availability for SMEs. And let me add that the recent proposal to introduce a market capitalisation-based exemption from the research unbundling provisions is supposed to be “narrowly-defined”. However, our analysis of EU companies suggests that exempting companies according to the proposed 1 billion EUR figure would effectively mean 75% of companies being exempted. Finally, we should not ignore the significant investor protection benefits brought by the MiFID II unbundling rules, such as more transparency and accountability over firms’ research spending and the pricing of execution services. Is it worth throwing these benefits away?

Finally, when talking about investor protection, we should of course also be honest and admit that investors can be confronted with severe downturns in financial markets. The

[12] ESMA TRV 2/2020 - https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1287_report_on_trends_risks_and_vulnerabilities_no.2_2020.pdf

COVID-related events were a source of severe stress in capital markets, and in particular for investment funds. This is an issue that securities markets regulators took very seriously because of the consequences not only for financial stability, but also for investor protection. ESMA has reinforced its ongoing coordination role and it has been organising frequent exchanges with National Competent Authorities (NCAs) to discuss market developments and supervisory risks linked to the COVID-19 crisis focusing particularly on liquidity issues. Overall, there was an increased use of exceptional Liquidity Management Tools (LMTs) by investment funds but still modest in absolute value. For instance, only 0.2% of asset under management within the EU were temporarily suspended by the end of the last week of March 2020. Moreover, we understand that the great majority of suspensions were activated to protect investors best interests in a context of valuation uncertainty.

In this context, ESMA also welcomed the ESRB recommendation published last May to coordinate a supervisory engagement with investment funds that have significant exposures to corporate debt and real estate, in order to assess their preparedness to potential future redemption and valuation shocks. We are currently finalising our work in relation to this recommendation. Supervisory engagements of this type aim at addressing not only financial stability concerns but enhanced supervisory scrutiny of liquidity management is also key in ensuring investor protection and ultimately trust in investment funds.

Non-regulatory framework

Ladies and gentlemen,

Let me finally speak briefly about measures which are important for a successful CMU but not governed by securities markets legislation.

Let us be frank: capital market investing is not self-explanatory for anyone who is not a finance professional, especially in a bank-dominated world. Therefore, a powerful impact on households' capital markets participation could be achieved by comprehensive financial education programmes, which could be developed and led jointly by public institutions and the private sector. With a wider educational outreach, a decisive cultural change could be achieved.

It is finally important to note that private pension systems are a key determinant of retail and household participation in capital markets. Certain pension systems, such as those in Sweden or Netherlands, provide for a significant deepening of local capital markets, and at the same time indirect participation of households. Asset managers and investment funds can play a very important role in the development of such private pension systems and facilitating such indirect participation of the households in the capital markets. Together with tackling the issue of retirement funding following many years of fiscal pressure on state pensions and annuity rates at all-time lows, auto-enrolment schemes can help us drive the growth of household participation in capital markets and an adequate long-term return on savings.

Conclusion

A successful Capital Markets Union requires a comprehensive diagnosis and a complex set of remedial actions. Regarding the diagnosis, a lot of time and effort have been spent to come forward with the right answers, and at this juncture many will agree with me that retail participation is among the most important factors for the overall success of the project.

Regarding the remedial actions, we still have a long way ahead of us. The appropriate regulatory framework will ensure investor protection and raise the confidence of the market. However, the regulatory framework will also need to be aided by re-focused pension systems and enhanced efforts of public and private sectors in relation to financial education. While a perspective of increased returns on household savings through capital markets activities may be a strong argument to many, a good understanding for a wide part of the society will be indispensable for a long-term success.

ESMA will continue to be committed to all these efforts towards moving to the decisive phase of building the Capital Markets Union.

Thank you.