Improving investment advice in the EU: From selling products to providing solutions

*We consider this paper particularly relevant in the context of **Q6, Q13 and Q42** of ESMA's Call for Evidence.*

It is helpful that in considering how to improve the retail investor journey, a closer look should be taken on advice and distribution. This contrasts with recent legislative, regulatory and supervisory focus on product and manufacturing of investment products. While the latter is important and easier to analyse and assess, it is essential to start with the investor, which involves looking at the entire value chain. The EU retail investment market is highly intermediated and while it may be tempting to reach for simple "quick fixes", it is imperative to have some understanding of the market and the potential consequences of any policy interventions. It is also important to have a clear view of the desired end result.

How do retail investment markets in Europe work?

One of the challenges in considering these issues is the **lack of data around the distribution** of retail investment products around Europe – including basic information, such as the proportion of the market which is "captive" (distribution of in-house products) and, on the other hand, which involves distribution by third parties.

It's estimated that roughly half of open-ended investment funds are distributed under "captive distribution", but there are probably very significant national differences. These differences between countries illustrate the difficulty of taking a policy solution that might work in one market and applying it to all markets across the EU.

There is a similar issue when looking at data on individuals holding capital market based instruments as opposed to bank deposits. On average, roughly a third of household financial assets are held in deposits accounts, but national variations seem to range from low two digits to almost two thirds.

This shows a need to work with the grain of existing structures rather than starting completely from scratch. While there are new channels developing, it's important not to leave existing market participants, in particular retail banks, out of sight as the ones who still have greatest access to the individuals policy makers are seeking to target.

How to start with the consumer?

Alongside understanding the structure of the existing markets, the other vital factor to understand is consumer, i.e. potential and actual investors. In particular, it is important to be clear as to who is the "target consumer" and what are his/her priorities. Investment clearly needs to be seen within the broader context of a consumer's financial position, with the priority generally accepted as being:

a. Paying off debts
b. "Rainy day" cash which may need to be accessed at short notice
c. Protection – i.e. insurance – whether of belongings or against illness or death
d. Provision aimed at achieving income in retirement – which, in itself, is then ranked, broadly as:
    - Pillar 1 – state provision
    - Pillar 2 – employer-based provision, which can then, in itself, be divided between
        - Defined benefit where the employer takes the risk
        - Defined contribution where the employee takes the risk
    - Pillar 3 – private provision
e. Discretionary saving which is more long-term and does not necessarily need to be accessed immediately

This description is simplified since the lines are somewhat blurred between pillars 2 and 3 where, for example, employee contributions may be encouraged by matching employer contributions. Similarly there may be an overlap between pillar 3 and discretionary saving. And c and d are ultimately backed by capital market investments.

To simplify, the main assumption is that in the EU there is too much money held in category (b) which could be made to work harder for the investor, and benefit the EU economies generally if it were moved to (d)/Pillar 2+3 and (e).

The other aspect needing attention is how to develop more of an **investment culture** going forward – i.e. how to avoid perpetuating the build-up of cash in banks. This could probably be done by considering how to encourage regular savings, which can be for relatively small amounts of money. However, it assumes that there is some "excess" income and that the other priorities have been covered, which is probably not right for the lowest income households.

It should be recognised that consumers have **different attitudes to different financial services** and there are reasons for this: Car, house, or contents insurance may be mandatory and/or often have to be renewed each year, meaning that consumers learn from experience and have quite a clear view of what they want and need. Generally, such products and services can be commoditised relatively easily and lend themselves to quite simple comparisons (e.g. on comparison websites).

Investment is much less familiar, the outcomes are often less clear and individual circumstances and attitudes play a much more determining part. Individual consumers do not think in terms of "product" and are unlikely to think "I want/need to buy an equity income fund today". Similarly, in a sphere where diversification is an important component in risk management, their needs are not necessarily going to be met by a single product (a single fund can be seen as a component in a broader approach). Individuals need prompts, and support, and a focus on benefits to them if they are to be encouraged to invest for the longer term. They are also likely to need on-going "hand-holding" to ride through the inevitable ups and downs involved in the investment process and often advice about "getting out" or drawing down is just as important as advice about investing in the first place. Rather than focusing on how we can make investment products accessible to consumers, we need to talk about how we can meet their needs and aspirations – **how can investment help them** to solve their problems, avert problems in the future, or meet those aspirations - and what are the possible trade-offs in seeking to achieve those aspirations. **Good, professional and trustworthy support and advice is likely to be central** to achieving this.

What does good advice consist of?

Even within the process of encouraging individuals to invest, there are likely to be a number of components in the process. Starting from the perspective of the investor these are likely to be:

- **Financial planning**. The most effective form of initial interaction with the investment process is likely not to be one that just focuses on investment products, but one that is part of a process of establishing the needs and aspirations of individuals. The financial planning process not only covers investment but also takes a broad perspective of the individual's overall financial position and, for example, the priorities noted above. One important point to consider is how to "nudge" people into recognising the need for a financial plan, the value of seeking advice (and for paying for it, by whatever means). Experience suggests that individuals are most receptive at important life stages (buying a house, getting married, having a baby, educating children[1]).
- **Risk assessment**. As and when it becomes clear that investment is the right approach for an individual, it is important for them to be supported in understanding the value of taking managed risk, the relevance of timescales, etc (to understand the "risk of not taking risk"). This then enables them to determine which investment strategy they should be taking.
- **Asset allocation**. Even at this third stage, the question of "product" may still not be relevant since initial discussions about asset allocation are likely to be around broad asset classes, in light of the risk assessment.
- **Product choice.** Again, depending on the assessments above, the conclusion may be that a single product may meet the needs of the investor, but equally a broader portfolio with a range of components or "products", might be appropriate. This might take a range of forms, whether it is an individually

[1] When the Financial Services Authority in the UK had a financial education team, one of their most successful initiatives was to provide materials about financial planning for doctors and midwives to give to expectant women.

tailored portfolio, a "model portfolio" which is based on the customer's risk profile or a "multi-asset" or "multi-manager" fund which offers a range of investments in a single fund.

- **Product production/management.** It is really only at this stage in the process that individual products or funds become the focus of attention and are the components or building blocks on which the investor's portfolio are based.

These aspects do not need to be offered by only one **provider**. Typically in the UK, for example, the first two steps will be undertaken by the financial planner who will then rely on the services of a wealth manager or platform to put together the components of the portfolio, which are then provided by a range of portfolio managers.

The extent to which it may be desirable for these services to be offered by a range of different "experts" or for them to be offered as a single package is one for debate, but anecdotal evidence is that, generally regulation such as MiFID 2 across Europe and RDR in the UK is leading to greater use of discretionary/model portfolios. This typically leads to greater volatility as the discretionary managers switch ever larger portfolios overnight, seeking to justify their existence, and are subject to regular reporting requirements to clients and need to justify performance on a quarterly basis. This should not, however, detract from the importance of developing the availability of professional, strong financial planning (as opposed to investment advice) to potential investors.

There are additional questions around the **use of technology**. While it may seem attractive to reach for comparison websites, more important would be a focus on technology which can support the financial planning process, including e.g. providing "educational" materials which are easily found when looking for information about other aspects of life; or tools which help potential investors to understand both the risk and rewards of investing (and developing their own risk profile). At this stage, where we are targeting individuals who are relatively unfamiliar with capital market investment, this is likely to complement rather than replace face-to-face support.

What does this mean in relation to policy interventions?

This consideration of the existing investment market suggests a number of conclusions:

- Rather than talking about "how to make products available to retail consumers" we should be talking in terms of "how to **support retail consumers** to meet their financial needs and aspirations".
- Individuals are unlikely spontaneously, or independently, to seek out investment opportunities or products and need to be **nudged and guided** in this process. In 2022, *New Financial* issued an interesting note in this context: An introduction to financial health checks.
- Rather than focusing on the quality of investment and/or product advice, we need to take a broader view and focus on more holistic **financial planning**.
- If we are to draw in more individuals to investment, in Europe, the **retail banks** are likely to be important in the process (a) because they hold the deposits which are the initial target in terms of where such investment is going to come from and (b) because they are an important part of the existing value chain.
- We also need to focus on the **role of employers**, not just in terms of engagement with pensions (the group will presumably be looking further at this). Employers cannot be expected to offer personalised advice, but can offer signposts and an environment which will encourage investment. (This is not just about employee share ownership, but more broad).
- **Technology** can provide support, and potentially bring down costs and offer better compliance and audit trails but is unlikely to be a substitute for some element of human interaction, especially in encouraging individuals to take the first step towards investment.
- The distribution/advice/financial planning **landscape** throughout Europe is **not well documented or understood** but any policy interventions could have a significant impact on "real people". There are significant dangers in "experimenting on a live patient", particularly when the understanding of that patient is rudimentary at best. One known factor is that markets around Europe are heterogeneous so it may not be possible to take a "one size fits all approach". We certainly need to be careful in ensuring

that we have some understanding of all aspects of the value chain and so can judge the potential consequences of any policy interventions that may be taken and ensure that any intervention is clearly evidence based.

- **Financial education** does not offer a "silver bullet" but can be focused on making individuals more comfortable with discussing financial matters, and more confident in knowing what questions to ask of their professional advisers/intermediaries. We also need to catch individuals when they are most receptive.
- The focus needs to be on ensuring that **professional financial planning services** are available to individuals.