An innovative Retail Investment Strategy that benefits retail investors

A position paper

Dutch Banking Association

Content

Introduction

In Europe there is a relatively low level of participation of retail investors in capital markets. In the upcoming Retail Investment Strategy (RIS), European policy makers will try to improve the current regulatory framework in order to protect investors, but also to make capital markets more attractive for retail investors. We ask policy makers who propose 'horizontal' requirements for investment service providers, to facilitate innovative services that benefit retail investors, like guided execution-only and online portfolio management. The experience in the Netherlands is that these services offer cost-efficient investment solutions with a high degree of investor protection. Making the current regulatory framework 'fit-for-purpose' for these services would help to further encourage retail investors to participate in capital markets. In this paper we provide some recommendations that we believe can help to determine the way forward for an effective RIS.

Recommendations

1 In order to facilitate innovative investment services, it is important to clearly differentiate in policy proposals between different categories of investment services, such as:
   - portfolio management services,
   - investment advice and
   - execution-only.

   Furthermore, it is important to differentiate within these categories. For example, we should differentiate between brokerage- and guided-execution only services and other types such as online portfolio management and traditional, private banking services;

2 Suitability requirements should be recalibrated based on the type of service and level of investor protection. More attention should be paid to proportionality. Specific proportionality principles could be included in legislation for online portfolio management services or portfolio management services that are provided to customers with relatively few assets ('light approach'). As an alternative, firms offering these services could collect suitability information over time (instead of before entering into an agreement and therefore, form a barrier to start investing).

3 Avoid introducing new intake and disclosure requirements for already cost-efficient propositions with a relatively high degree of investor protection. This could hamper the accessibility of these innovative concepts and will discourage citizens from investing.

1 Background

Capital Markets Union & Retail Investment Strategy

The Capital Markets Union (CMU) is the EU's initiative to create a single market for capital across the EU. It aims to get investments and savings flowing across all member states for the benefit of citizens, businesses and investors. The RIS is part of the CMU, which aims to ensure that consumers who invest in capital markets can do so with confidence and trust. It also aims to increase consumer participation in these markets. High savings rates and a preference for deposits are the dominant consumer preference in many European countries. While savings are important for citizens in times of need, the current high saving rates far exceed what is necessary as an economic household buffer [1]. With low interest rates and high inflation, that means that citizens are missing out on long term opportunities that they could have achieved more effectively by investing in capital markets.

What is the issue?

Current EU legislation in the area of retail investor protection aims to address challenges stemming from the information asymmetry and a lack of product transparency. There is a tension between disclosures that aim for transparency and comparability on the one hand and the ambition for the information disclosed to engage and encourage savers to start investing, on the other hand. Policy makers have tried to achieve more transparency and comparability of financial instruments with legislative changes over the past years, like MiFID II (suitability reports, cost transparency) and PRIIPs (key information documents). These changes arguably have increased the level of investor protection, but at the same time they have had a negative effect on retail investor participation. Research by the European Commission shows that the complex information indeed has created a barrier for people to start investing [2].

1 Comparing Wealth Effects of Saving and Index Investment, Netherlands Authority for Financial Markets (AFM), Alexandra van Geen, Johan Bonekamp, Loan van Hoeven, Mark Wielstra, March 2022. In the Netherlands for example, 3.1 million of the over 5 million non-investing households had sufficient buffers to cope with setbacks in 2019.

2 European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union, Uličná, D., Vincze, M., Mosoreanu, M., et al., Disclosure, inducements, and suitability rules for retail investors study: final report, Publications Office of the European Union, 2022, page 14.

What is the Commission proposing?

The RIS aims to ensure a more coherent regulatory framework, changing the current legislative framework (e.g., MiFID II), to make investing more attractive without giving in on investor protection. The Commission has recently consulted the idea of a transferable and standardized client intake/assessment accompanied by a Personal Asset Allocation Strategy ('PAAS') for every European investor [3]. This form of 'financial planning' is costly and firms will price these plans accordingly, making currently attractive investment services less accessible [4]. Currently the Commission is working to present more concrete policy proposals [5].

Unique investment landscape in the Netherlands

This paper aims to provide policy makers with some insights into innovative investment services that offer accessible, cost efficient and relatively safe means of investing to retail clients [6]. Some of these products have come into existence due to the specific features of the Dutch market. Based on these features and these new types of services, we provide our recommendations and considerations for the Retail Investment Strategy.

The Dutch Market

Most Dutch retail investors, invest through the following services:

1 Execution-only

Over 60% of the retail investors, representing especially those with a relatively modest starting capital, invest through an execution only channel. This service has been growing in market share for several years in a row. The Netherlands has a higher participation in execution only compared to neighboring countries where (personal) investment advice by banks is more common.

2 Investment advice

Investment advice in the Netherlands is only provided to very few consumers due to strict requirements and the need for personal customization. Therefore, advice can no longer be offered in a scalable and efficient way by Dutch banks.

3 Portfolio management services

However (online) portfolio management services are showing a positive trend in market size, especially due to the fully digitalized nature of these services.

3 European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union, Consultation Document Targeted consultation on options to enhance the suitability and appropriateness assessments.

4 Dutch Banking Association response to EC consultation on options to enhance the suitability and appropriateness assessments.

5 At the date of publication of this position paper, it is expected that these will be adopted in the second half of 2022 or the first half of 2023. However, this timing can be subject to change.

6 With relatively safe, we mean i) well diversified, ii) low cost and iii) acceptable risks. Most UCITS and AIF's in the Netherlands, align with these principles.

The three categories each have their own characteristics and their own degree of investor protection rules. The attractiveness of these investment services is determined, among other things, by the degree of accessibility and investor protection. Accessibility can, amongst others, be looked at from a cost level (both from the customer's perspective and the perspective of the service provider), the degree of digitalization and the starting capital to be invested. Moreover, the various levels of investor protection measures/frameworks differ in terms of appropriateness and suitability of the product, behavioral risks, the risk of underperformance and the degree of duty of care of the service provider (first of all related to the service provided to the investor).

Cost-efficient investment services

Key take away

The ban on inducements in the Netherlands has incentivized fully digitalized innovative services that significantly drove down costs for retail investors. Although 'investment advice' has become inaccessible in the Netherlands for investors with a modest starting capital ('advice gap'), Dutch investors have retained access to financial markets through fair value-for-money alternatives.

A distribution fee, also known as a commission, kickback or retrocession is a fee that an investment fund pays out to a third party (such as a broker or distributor) when this party decides to distribute the investment fund through its distribution channels. The Netherlands is the only country in the European Union with a full ban on distribution fees (inducements). Distribution fees are not prohibited according to EU legislation but are subject to strict (European) transparency rules.

In countries with distribution fees, 'in-house' investment funds are offered that often have a higher cost for the consumer than products that are largely based on cost efficient index-products, which form the basis of many of the Dutch investment services. The products for which inducements are paid are – on average – about 35% more expensive than investment products for which no inducements are paid [7]. A 2017 evaluation by the Dutch Ministry of Finance showed that, after the ban on inducements, Dutch execution only customers saved (as a conservative estimation) at least € 300 million due to a three-fold reduction in costs in the execution only channel [8]. According to figures from the European Securities and Markets Authority (ESMA), the Netherlands reported consistently the lowest level of fees across asset classes, averaging a 36% lower management fee compared to the EU average over the years 2010-2019 [9].

7 European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union, Uličná, D., Vincze, M., Mosoreanu, M., et al., Disclosure, inducements, and suitability rules for retail investors study : final report, Publications Office of the European Union, 2022, page 24-25.

8 The Netherlands Authority for Financial Markets (AFM).

9 ESMA 50-165-1710, page 25.

2 Innovation in the Dutch market

In the following section we describe some of the new, innovative services that have emerged over the past years in the Netherlands.

Guided-execution only services

Key take-away

Alternatives for 'investment advice', most notably 'guided execution only' services have proven to be good value-for-money products. Guided execution-only clients are well-protected. There is a significant difference between 'brokers' and 'guided-execution only'-providers regarding their choice environment for customers, as 'guided-execution only' services typically offer a smaller and more tailored selection of investment products. However, both services fit in the same legal category of execution-only investment services and are subjected to the same requirements.

Do-it-yourself investing, for example through a broker, offers an accessible means of investing. Due to the ban on inducements and the highly digitalized nature of financial services in the Netherlands, the execution-only services offered to Dutch private investors have become simpler and the range of services has become more diversified and innovative [10]. Even though these services are subject to strict appropriateness and product governance requirements, they also bear some risk for retail investors. For pure execution-only services (brokers), suboptimal choices for example, can never be fully eradicated [11]. Some therefore argue that these investors are overall better protected when using advice or portfolio management services. These services, in which investment professionals guide investors, help to prevent suboptimal choices like too much trading, too little diversification or buying too risky or expensive products.

A good example of this are 'guided execution-only services' where a pre-determined, cost efficient and well-diversified range of only a few products is offered to clients. This is in contrast to investing through brokers who typically want to offer a wide array of financial instruments and markets) [12].

10 Dutch Ministry of Finance Dutch Authority for the Financial Markets July 2021 The Netherlands' position on effective consumer and investor protection to stimulate long-term retail investment, page 2.
11 Financial education can play a role in reducing retail investors' risk in a broker environment.
12 Most of the guided execution-only solutions have UCITS or AIF's as underlying. Since UCITS funds are designed to be suitable for retail investors, their rules incorporate certain levels of diversification with the aim of reducing their vulnerability to the performance of a small number of assets.

Through a relatively simple online-test, clients are able to determine their goals and appropriate risks, and are 'guided' to one of the aligned investment funds in an accessible way. This fully digitalized process of guided execution-only does not require costly (individual) advice from an advisor, because these investment products are an appropriate means of wealth accumulation for the vast majority of consumers.

Online portfolio management services

Key take-aways

The MiFID II rules on suitability should be made fit-for-purpose for online investment services by applying a lighter approach where it can be shown that retail investors would be better off. Current rules do not leave enough room for a proportionate approach by firms who want to offer these portfolio management services online to clients with a relatively small asset-base.

Due to the strict suitability requirements, we have observed reverse digitalization (i.e. firms who started their offering online, but moved back to physical/traditional methods). Retail investors who want to invest through online investment services are too often scared away by the intakes that are time consuming and have a too high level of detail. Subsequently they either refrain from investing, or move to brokerage services, where they are less well protected. Therefore, considering online-portfolio management services and (physical) private banking in the same way, leads to a situation in which consumers are being worse of both in terms of their investments and their protection.

In the Netherlands, online portfolio management services have been introduced. Online portfolio management means that clients mandate their bank in an online environment as their wealth manager. Offering these types of services to customers who want to invest 'care-free', provides them with an alternative to execution-only services with a higher degree of investor protection. Online portfolio management services allow clients to make use of the professional investment management knowledge of banks. Due to the digitalized nature of these services, they are scalable and can therefore be offered cost-efficiently.

The legal obligations of MiFID II (most notably Suitability) are – besides a proportionality aspect – 'one-size-fits all'. To conduct individual portfolio management services (for example a client who invests € 10.000) an investment firm is obliged to obtain very detailed information regarding the client's financial position, knowledge, experience, objective and risk appetite. This affects the cost efficiency of the service (i.e., it becomes expensive). The required information is identical for online and offline services. Also, no distinction is made for the type of client; the same information is required for clients with either few or large assets, or with either little, or much knowledge and experience.

In a 'traditional' private banking environment, complying with requirements regarding taking stock of clients' financial positions and updating these is challenging, but feasible. After all, in private banking, a great deal of attention can be paid to the client, often in an 'offline' environment (e.g., through conversations between clients and private bankers). It is far more difficult to get clients engaged in a scalable, online environment, for example to take stock of their financial position and to have them update their investment objectives periodically. As a consequence, we see clients refraining from online-portfolio management (and instead go to a broker where they are less protected) or banks move back to non-digitalized portfolio management services (i.e., in physical offices). As a consequence, accessibility of these innovative online services has been reduced [13].

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13 Anecdotal evidence even indicates that some clients experience the intake as a privacy breach.

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