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PRESERVING THE COMMISSION-BASED MODEL OF DISTRIBUTION OF FINANCIAL PRODUCTS IS KEY FOR BOOSTING ACCESS TO CAPITAL MARKETS IN EUROPE

PARIS EUROPLACE POSITION PAPER

Paris EUROPLACE welcomes the forthcoming publication by the European Commission (EC) of its Retail Investment Strategy aimed at removing barriers for retail investors to access capital markets. However, despite the consensus around the objectives, which seem to inspire the publication of such strategy and the following initiatives of the EC, **we cannot avoid to voice our concerns around a potential ban on inducements** to improve access to independent investment advice [1] across the EU.

Currently, two models are available in Europe for the distribution of financial products to retail investors. One known as the **"commission-based model"** (where rebates aimed at covering, *inter alia*, cost of advice are paid by the manufacturer of the product to distributors), and the other known as the **"fee-based model"**. The former is present in countries such as Germany, France, Spain and Italy, while the latter is found only in the Netherlands and the United Kingdom.

Paris EUROPLACE considers essential to preserve the existence of both models within the European Union (EU). Setting a regulatory preference on one of the two models would have major disruptive consequences that would go against one of the key objectives of the Capital Markets Union (CMU), i.e. to foster retail participation to capital markets, essential for the financing of the economic recovery and the green transition.

Against this background, the aim of this paper is to set out first, how much the current regulatory framework already provides solid guarantees for retail investor protection. Second, to stress the importance of preserving retail investors' access to quality investment advice and, finally, to show that the commission-based model ensures access to quality investment advice for all.

[1] See European Commission, Public consultation on the Retail Investment Strategy, Question 8; Public consultation on the review of the MiFID II/MiFIR, Question 50.

1/ Both MiFID II and IDD already provides solid guarantees for retail investor protection

In spite of the concern that payment of inducements may be conducive to the development of conflicts of interest, **the current regulatory frameworks under the markets in financial instruments directive (MiFID II)[2] and the insurance distribution directive (IDD)[3] provide robust oversight to ensure effective protection for retail investors**.

These guarantees can be summarized as follows:

- The **receipt of inducements must be justified by a service improvement or not have a detrimental impact on the quality of the relevant service to the customer**. In other words, the quality of the service is key in both regulations[4].

- Obligation to provide to the customers appropriate information including the cost of advice and the retrocession amount received by the distributor[5].

- The **adviser is obliged to carry out a suitability test** (knowledge, experience, assets, investment objectives) on the client to ensure the suitability of the products available[6] and, the insurance intermediary or insurance undertaking shall also obtain the necessary information regarding the customer's or potential customer's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including that person's ability to bear losses, and that person's investment objectives, including that person's risk tolerance[7].

- Conflicts of interest may not even exist at the point of sale, as the **advisors do not even know the amount of the inducement paid by the producer to its network**[8] and **an insurance intermediary or an insurance undertaking** carrying on the distribution of insurance-based investment products **shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest**[9].

- In addition, we recall that current regulations **prohibit favoring a product** comparable to another **belonging to the same range or offer**, exclusively for reasons of remuneration. In practice, this means prohibiting differentiated remunerations for the

[2] DIRECTIVE 2014/65/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
[3] DIRECTIVE (EU) 2016/97 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 20 January 2016 on insurance distribution
[4] MiFID II, art. 24, 9. A and IDD Art. 29.2
[5] MiFID II, art. 24, 4. C and IDD Art. 29 1 (c)
[6] MiFID II, art. 25, 2.
[7] IDD, Art. 30, 1
[8] MiFID II, art. 24, 10.
[9] IDD, Art. 27

distributor or the employee. It also appears that some authorities are beginning to demand the same level of remuneration for all the products in their range.

2/ <u>Retail investors' access to quality investment advice must be preserved in order to achieve the objectives of the CMU and to avoid capital erosion</u>

Two factual examples could help to appreciate the importance for a retail investor to access to quality investment advice.

First, the **level of household savings remains particularly high compared to the pre-Covid-19 crisis level**, as evidenced by the European Central Bank, which has seen euro area household savings rising to extraordinary levels since the beginning of 2020[10]. **In the Eurozone, the household savings rate was** more than **2ppts higher** at the end of September 2021 than at the end of 2019.

Second, **the level of inflation is estimated to have risen sharply in the Eurozone, to 5.8% in February 2022**, driven by an increase in energy costs[11].

The combination of the above elements clearly shows how a concrete risk of erosion of the value of household savings exist and, hence the importance of good allocation of funds.

In this context, retail investors would need to consider **accessing capital markets** in order to **achieve more diversification** and the possibility to **gain higher returns**. Investors, in order to make the right choice in such investment journey, shall be **properly accompanied and advised**, since as the EC has already pointed out ***"financial literacy is an essential skill*** *for making good decisions about personal finances,* ***but many people have not yet mastered it"***[12].

Qualified advice not only helps an individual in achieving a sound financial position, but through employing such surplus of savings it also **contributes to the financing of the economic recovery post-Covid-19** (by improving access to financing for SMEs, building vital infrastructure etc.), and **to finance the green transition**. Specifically, with respect to the latter, the commission-based model seems more adapted to the important development of the increasingly complex regulatory framework in the field of sustainable finance insofar as it will better ensure access to information and its comprehension by retail investors.

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[10] See ECB Economic Bulletin (05/2021): https://www.ecb.europa.eu/pub/economic-bulletin/focus/2021/html/ecb.ebbox202105_04~d8787003f8.en.html

See Stat Banque de France (11/2021) : https://www.banque-france.fr/statistiques/epargne-des-menages-2021t2
14083883/2-07012022-AP-FR.pdf/633e6191-cc43-7fce-3016-83a427bc8ace

[12] See CMU Action Plan Action 7

3/ <u>The commission-based model is more likely to ensure access to quality investment advice for all</u>

Along with providing access to quality advice, the **commission-based model is also well suited to grant such access to all retail investors, regardless of their level of wealth**, whereas in the fee-based model such qualified advice is often reserved only to the wealthiest investors.

Through **a mutualisation of costs amongst wealthier and less wealthy individuals**, the commission-based model has the benefit of providing investment advice to all the individuals wishing to enter capital markets. Such mutualisation is made possible by the fact that manufacturers – in exchange of an enhancement of the quality of services provided to a client (including advice) – would pay a portion of their management fees to distributors.

Mutualisation is not only between rich and poor customers. It also happens **over time**. An advisor can work on a file losing money for years because he bets that he will win over time or past a certain income threshold. It therefore pools the same client but over time. However, this moment of changeover is almost definable and almost certain because the retrocessions arrive regularly, without unpaid bills. This is not seen in a full-fee model, which involves ensuring settlement and moreover, settlement "at the right price" because the client is in no way bound to his adviser for a specific period.

On the contrary, in both the UK and the Netherlands, where a ban on inducements has been adopted, **there is objective evidence of a lack of qualified advice for non-wealthy investors**. To this end, in December 2020, the UK Financial Conduct Authority (FCA) noted that *"target* [*to advice*] *customers remain largely wealthier consumers [and that] the average advised customer has over £150,000 of assets under advice"* [13]. The FCA is also clear that many UK investors should invest more and be properly advised to do so [14]. With regard to the Netherlands, the Commission itself pointed out that banks and independent financial advisors only propose discretionary portfolio management (DPM) services for investors with limited financial resources; however, **these services are not considered as an advice**[15].

[13] See Financial Conduct Authority, Evaluation of the Impact of the Retail Distribution Review and the Financial Advice Market Review, December 2020

[14] "Many consumers are holding their money in cash rather than investing it, so are missing out on the potential opportunity to make their money work better for them in the longer term. Many consumers do not seek, or receive, the sort of help with their finances that would equip them to make better investment decisions." ; "Many consumers would benefit from receiving support to help them make investment decisions"

[15] See European Commission study on "Distribution systems of retail investment products across the European Union – Final Report" : banks "propose discretionary portfolio management services, even for investors with limited financial resources, however these services are not considered advice. […] Dutch independent financial advisors (IFAs) do not replace banks and insurance companies as providers of financial advice. Like banks, IFAs only proposed discretionary portfolio management services. Those who did provide advice only would do so for investors with substantial capital to invest: depending on the IFA, qualifying for advice required minimum investment amounts ranging from 250,000 EUR to 500,000 EUR"

Finally, it is well established that savers and investors do not correctly quantify the volume and the real price of a service in fees. In Germany, for example, a recent study[16] shows that consumers are only willing to pay a fee of around €40 for advice (while the average price of one hour of advice in Western Europe is around €200).

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In conclusion, **the commission-based model**, which is currently predominant in Europe, **has many advantages for retail investors without impairing their protection, given that MiFID II and IDD already provide a strong framework for dealing with potential conflicts of interest.**

On the other hand, when exploring any amendment to the commission-based regime, **it also essential to thoroughly consider the potential detrimental effects that a ban could cause.** Detrimental effects could include, for example, reluctance by retail individuals to invest, choice of products not necessarily in line with the retail investor's need or risk profile, as well as the risk of unwillingly push for a close architecture. As clearly affirmed by ESMA: *"in the case of Member States with bank-centric distribution models, there is a risk that, because of the loss of incentives to sell third party products, banks could react by increasing closed-architecture models."*[17]

For all these reasons, Paris EUROPLACE urges European policy makers to preserve both types of models in order to take into account the differences in investor profiles as well as the specificities of national markets.

[16] See KPMG Whitepaper, The Future of Advice, November 2021.
[17] ESMA's Technical Advice (March 2020)