OWN INITIATIVE ADVICE TO ESMA

Recommendations in regard of the impact of inflation on investor protection

I. Background

1. In the last decade the inflation rate was on average equal to 1.2% in euro area countries and to 1.6% in European Union countries[1]. Since the start of the pandemic there has been significant volatility in the path of inflation. Measures to contain the spread of the coronavirus (COVID-19) initially depressed inflation by curtailing economic activity: in 2020 the inflation rate was 0.3% in euro area countries and 0.7% in EU countries. The situation changed dramatically in 2021: the euro area annual inflation rate rose to 5.0% in December 2021, the highest on record, while the annual inflation rate was minus 0.3% in December 2020. Analogously, EU annual inflation increased to 5.3% in December 2021, while the rate was 0.3% in December 2020.

2. The recent surge in inflation is primarily driven by higher energy costs and supply chain disruptions that are pushing up prices across many sectors, as well as higher food prices. More fundamentally, monetary policy plays a role as well, at least as an enabler. The recent monetary policies of the ECB and other European central banks have resulted in a massive increase in money supply: the ECB's balance sheet has quadrupled between the end of 2015 and the end of 2021 to € 8.6 trillion[2].

3. In February 2022 the ECB noted that "Inflation is likely to remain elevated for longer than previously expected, but to decline in the course of this year. That is the ECB's central case, but there are upside risks to that outlook. Inflation could turn out to be higher if price pressures feed through into higher-than-anticipated wage rises, or if the economy returns to full capacity more quickly than foreseen."[3] Additionally, the dramatic conflict in Ukraine is weighing negatively on both supply and demand conditions, making uncertainty more acute and exacerbating risks to the medium-term inflation outlook[4].

4. Inflation obviously has a big impact on the real return on savings and investments. This may be especially problematic for retail clients, who are often not fully aware of the consequences of

[1] The source of euro area and EU inflation rates is Eurostat, the statistical office of the European Union. Data are available at: https://ec.europa.eu/eurostat/databrowser/view/tec00118/default/table?lang=en.
[2] Source: https://www.ecb.europa.eu/pub/annual/balance/html/all_balance_sheets.en.html.
[3] Luis de Guindos, Vice-President of the ECB, "Managing Europe's economic recovery after the pandemic", speech at the London School of Economics German Symposium, Frankfurt am Main, 10 February 2022. Available at https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220210~2923b1c6d4.en.html.
[4] Fabio Panetta, Member of the Executive Board of the ECB, "Small steps in a dark room: guiding policy on the path out of the pandemic", speech at an online seminar organized by the European University Institute, 28 February 2022. Available at https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220228~2ce9f09429.en.html.

a relatively high inflation on their savings. The SMSG decided to put this problem on the agenda of its meeting of February 4th 2022, which resulted in an animated discussion. Since many members agreed on the importance of this item, the group decided to draft an own initiative advice to ESMA on this matter.

5. The goals of this report are to (i) clearly set out the consequences of the high inflation rate on savings and investments, both on the primary and secondary markets, of savers and investors; (ii) point out how certain regulatory requirements, or the current interpretation and application thereof aggravate the situation; (iii) advise ESMA on measures ESMA could take to deal with this situation, taking into account the need to balance inflation risks with other risk considerations; and (iv) to indicate what change to the Level 1 and Level 2 framework would be useful to deal with the current regulatory shortcomings.

II. Impact of high inflation rate on savings and investments

6. A high inflation rate reduces the purchasing power of cash. The act of investing postpones current consumption opportunities to a later stage (e.g., during retirement). Investments are consequently also intended to protect the purchasing power of the cash invested. This implies that the impact of inflation should be considered in the evaluation of investment options. Real interest rates are adjusted for inflation by subtracting the inflation rate from the nominal interest rate. On an ex ante basis, the real interest rate is adjusted for the *expected* change in prices (i.e., the expected inflation rate). The ex ante real rate matters for investment decisions[5]. On an ex post basis, the real interest rate takes into account the *actual* change in prices (i.e., the actual inflation rate). The ex post real rate matters to assess the actual purchasing power generated by an investment. A high inflation rate results in an implicit wealth 'tax' (i.e., a wealth reduction) on all savers and investors, if nominal interest rates remain low and are not proportionally increased[6].

7. The biggest impact will be on investors and savers whose holdings are concentrated in assets the return of which is not linked to the inflation rate. This group includes depositors who keep their money on savings accounts as well as investors who are confined to fixed income investments because of regulatory requirements, or have a preference for fixed-income investments for personal reasons. This is, therefore, a cross-sectoral problem, since it involves banking products (deposits), investment products, insurance-based investment products and pension products.[7] The French federation of investor and life insurance policy holder associations

[5] Not all investors might be familiar with the concept of ex ante real rate. This is especially the case for investors (e.g., retail investors) who are subject to monetary illusion. We discuss monetary illusion §11 of this advice.

[6] Inflation risk is different from interest rate risk. The former applies to all assets and relates to the impact on the real (i.e., after inflation) asset value resulting from an unexpected change in the inflation rate. The latter applies more specifically, at least in the common practice, to bonds and relates to the impact on the bond value resulting from an unexpected change in the market interest rate. The inflation risk of a bond is mitigated, or even neutralized, when the nominal interest rate is adjusted to take into account the actually observed inflation rate.

[7] A large fraction of the overall portfolio held by EU retail investors is made by currency and deposits (30%). The share of household savings locked in currency and deposits is above the EU average in 21 out of 28 member states. In Greece, Cyprus and Slovakia, this is considerably higher (around 60%). By contrast, this accounts for less than 16% in the Netherlands and Denmark, while the lowest share was recorded in Sweden (13.7%). In the US, the fraction of the portfolio represented by currency and deposits is 12%. Data refers to 2019 and the source is ECMI, 'Asset Allocation

(FAIDER) found, for instance, that French retail investors in capital guaranteed life insurance contracts have lost an estimated €40 billion in purchasing power (real return) in 2021 alone. This is before tax; the study mentions a loss after tax amounting to €43 billion.[8]

Similarly, the Belgian business journal, L'Echo, found that in Belgium, savers in bank savings accounts have lost an estimated €22 billion in 2021 alone in purchasing power.[9]

It is a source of concern in this respect that pension funds are heavily invested in Money Market Funds. Already in 2020, before the 2021 surge in inflation, the French Asset Management Association (AFG) found that the overall real returns before tax of French pension funds are negatively influenced predominantly by the heavy weight and negative return of money market funds (23% of assets; -4.8%).[10] However, a learning curve is observed as the weight of money market funds continues to decrease since 10 years and represents 18% of French pension funds in 2021 (vs 40% in 2012). In 2021, money market funds account for 13% of French employee savings schemes (down from 21% in 2013). Net inflows towards equity and balanced funds increase, whereas towards money market funds decrease.

8. For nominal (i.e., non inflation-linked) bonds, which is a fairly large asset class, inflation is an important source of risk. Inflation developments also influence stock markets, but the relation between inflation and stock prices is more complex and the reasons why a conceptually real asset, such as equities, is empirically inflation sensitive are debated. A few asset classes such as inflation-linked bonds, commodities (especially energy-related products), and real estate, have historically correlated better with inflation, or at least were less sensitive to it.

9. The previous paragraph highlights two dimensions to consider. First, the impact of inflation on the current value of the assets held by savers and investors depends on the composition of their portfolios. Second, the investment decision framework should take into account the current mix of identified risks and, where appropriate, incorporate the sensitivity of the future value of portfolios to changes in inflation rate (either upward or downward). In other words, whenever relevant, the exposure to inflation risk should play a role in the asset allocation decisions, especially for investment and saving products that are held with a long-term horizon.

III. Regulatory requirements do not take into account inflation risk and may thereby aggravate the situation

10. While the EU financial rulebook has established a well-developed investor protection framework, the SMSG is of the opinion that it does not fit well to the current circumstances and may even hamper an adequate response to this situation by market participants. The SMSG sees important shortcomings in the current rulebook in the field of information requirements, the

in Europe. Reality vs. Expectations' (Task Force report, April 2020). Available at https://www.ceps.eu/wp-content/uploads/2020/04/TFAA_Final-Report_ECMI.pdf.

[8] FAIDER press release, 17 February 2022.Available at https://www.faider.org/communiques

[9] https://www.lecho.be/monargent/epargne-et-placements/epargne/les-epargnants-belges-perdent-22-milliards-d-euros-de-pouvoir-d-achat/10356967.html.

[10] BETTERFINANCE, 'Long-Term and Pension Savings. The Real Return' (2021 Edition, p. 247). https://betterfinance.eu/wp-content/uploads/France-The-Real-Return-Long-Term-Pension-Savings-Report-2021-Edition.pdf.

MiFID and IDD suitability and appropriateness tests and product governance framework, and in certain investment fund requirements.

3.1. Information obligations

3.1.1. Introduction

11. Need for fair, clear and not-misleading client information. A first pillar of investor protection is ensuring that retail clients receive clear and non-misleading information, to allow them to take informed investment decisions. This principle is established in many information documents (prospectus, UCITS KID, PRIIPs KID) and in the MiFID conduct of business rules (see below). Some information obligations require product providers and financial services providers to give information on past and/or expected performance and return on investment of the products offered to retail clients. Other provisions require to report to clients on the performance of the products they have invested in. However, providers, distributors and even public authorities very rarely disclose historical, or actual, returns of long-term savings or financial products in real terms (net of inflation).[11] This is hardly surprising, since none of the relevant rules require to provide ROI information "net of inflation". This was less of an issue in the recent past, in view of the low levels of inflation. In the current situation, however, this may lead to investors misunderstanding to what extent their savings / investments increase or decrease in real value (i.e., in terms of purchasing power, which is the 'real' value of money).

This is particularly problematic since behavioural finance studies have shown that retail investors suffer from cognitive biases such as "money illusion" and "exponential growth bias". Because of *money illusion* people have a tendency to view their wealth and income in nominal terms, rather than recognizing their real value, adjusted for inflation[12]. Additionally, *exponential–growth* bias describes people's tendency to undervalue the effects of compound interest. For investments, this means people tend to underestimate future values, while for inflation, it means an overestimate of the value of the purchasing power of savings[13].

The SMSG is of the opinion that merely providing information on nominal return can - in certain circumstances - be misleading for investors, even if that is not the intention of the financial institutions/advisors involved, in the sense that it omits material information that the average investor needs, according to the context, to take an informed transactional decision and thereby

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[11] There are some exceptions, such as the OECD (see for example pp. 28-29 of https://www.oecd.org/daf/fin/private-pensions/Pension-Markets-in-Focus-2021.pdf) and BETTERFINANCE (see for example https://betterfinance.eu/publication/real-return-of-long-term-and-pension-savings-report-2021-edition/).

[12] Darriet, E., Guille, M., Vergnaud, J. C., & Shimizu, M. (2020). "Money illusion, financial literacy and numeracy: Experimental evidence." *Journal of Economic Psychology 76*, 102211; Cohen, R. B., Polk, C., & Vuolteenaho, T. (2005). "Money illusion in the stock market: The Modigliani-Cohn hypothesis." *The Quarterly Journal of Economics*, 120 (2), 639-668; Shafir, E., Diamond, P., & Tversky, A. (1997). "Money illusion." *The Quarterly Journal of Economics* 112 (2), 341-374.

[13] Levy, M., and Tasoff, J. (2016) "Exponential-Growth Bias and Lifecycle Consumption", *Journal of the European Economic Association*, 14 (3), 545–583, https://doi.org/10.1111/jeea.12149; Stango, V. and Zinman, J. (2009), "Exponential Growth Bias and Household Finance",. *The Journal of Finance*, 64: 2807-2849. https://doi.org/10.1111/j.1540-6261.2009.01518.x; Almenberg, J., and Gerdes C. (2012), "Exponential growth bias and financial literacy", *Applied Economics Letters*, 19 (17), 1693-1696, DOI: 10.1080/13504851.2011.652772

causes or is likely to cause the average investor to take a transactional decision that he would not have taken otherwise.[14]

For example, “capital guaranteed” life insurance contracts, the most important financial saving product in France (with 1.7 trillion in assets as of 30/06/2021), in fact lost €43 billion in real terms in 2021 alone because of inflation. Stating that the capital of a product is guaranteed, without mentioning that only the “nominal” capital is guaranteed, while the real value can decrease because of inflation, can result in investors taking a transactional decision that they would not have taken if they would have been fully informed about what a “nominal” capital guarantee means, and warned about the potential negative impact of inflation over time. This consideration of monetary erosion is most pertinent for long-term investments with no fixed maturity and is without prejudice to the usefulness of capital guarantee in general. This is notably the case for assets with a fixed maturity whose value may be significantly impacted by volatility or market risk.

The SMSG therefore makes the following recommendations in regard of information obligations.

3.1.2. Key Information Documents

12. Key Information Documents (PRIIPS / PEPP KID and UCITS KIID, IORP) should also include the inflation risks relative to the product, if relevant, and provide a general warning that inflation may have an impact on the real return of investments. The SMSG agrees, moreover, that it would be very useful for savers and investors if information on past performance would also provide a warning, if relevant, that the real return, corrected by the inflation rate, can be lower. For the PEPP KID and UCITS KIID information on (nominal) past performance is part of the KID.[15] For the PRIIPs KID, this is, however, to the regret of the SMSG,[16] not the case. The inflation risk warning could in this case be mentioned in the future performance scenarios’ section. The SMSG therefore recommends that the ESAs should look into this matter and, after a wider stakeholder consultation, assess whether and, if so how it would be feasible and desirable to insert, where relevant, inflation risk warnings in the past and or future performance information section in key information documents. Depending on the result of this assessment, the ESAs should then decide whether to recommend the Commission to take action on this point. Another concern is the necessity of a cross-sectoral level playing field. If the risk of inflation would only be mentioned in the information documents of certain investment products, but not be integrated in the information regarding other saving and investment products (for instance on simple saving accounts), investors could be put off from investing in the former and drawn to investing in the latter, even though the impact of inflation could be equally high or even higher. The SMSG therefore recommends ESMA to cooperate with the other ESAs in this field to ensure a level playing field across all saving and investment products. If the ESAs would come to the conclusion

[14] See the definition of a misleading omission in art. 7 of Unfair Commercial Practices Directive 2005/29/EC.

[15] By July 2022 all UCITS funds will have use the PRIIPs KID instead of the UCITS KIID, meaning that nominal actual (past) performance will not be provided any more for UCITS funds either. This will make it even more difficult, if not impossible for EU retail investors to assess the long-term negative impact of inflation on their long-term savings, as they will not even have easy access to the nominal returns to start with.

[16] The SMSG position supporting the inclusion of past performance dates back to 2015. See the SMSG Advice on the ESA’s joint Discussion Paper “Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPS)”, 17 February 2015 (ESMA/2015/SMSG/005).

that this would be feasible, the ESAs could bring this up during the Retail Investor Strategy on which the European Commission is working.

3.1.3. MiFID and IDD information obligations

13. The SMSG is of the opinion that investment firms should provide information on inflation risk, when selling / advising on long-term products that are sensitive to inflation. In the view of the SMSG, the MiFID rules can be interpreted in that manner, especially:

- art. 24 (3) Dir 2014/65/EU: "All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading."
- Art. 24 (4) Dir. 2014/65/EU: "Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges."

  "That information shall include the following: …

  (b) the information on financial instruments and proposed investment strategies must include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies and whether the financial instrument is intended for retail or professional clients, taking account of the identified target market in accordance with paragraph 2"

  "5. The information referred to in paragraphs 4 and 9 shall be provided in a comprehensible form in such a manner that clients or potential clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis. Member States may allow that information to be provided in a standardised format."
- Art. 44 of the MiFID delegated Regulation: "b) the information is accurate and always gives a fair and prominent indication of any relevant risks when referencing any potential benefits of an investment service or financial instrument, …"

  "(e) the information does not disguise, diminish or obscure important items, statements or warnings".

The SMSG advises ESMA to clarify – in a Q&A or in guidelines – that the above mentioned rules should be interpreted in such a way that investment firms have to inform/educate the client, where relevant, in a clear, non-misleading and comprehensible form of risks of rising inflation while interest rates remain low and the possible effect this may have on the real long term value and return of their proposed or envisaged investment.

3.2. MiFID and IDD conduct of business rules

3.2.1. The Suitability Test

14. Suitability test. MIFID /IDD require investment firms and insurance intermediaries who provide advice or portfolio management to assess the suitability of investments for investors, on the basis of an assessment of the client's (i) knowledge and experience; (ii) objectives; and (iii) financial capacity to bear the consequences of their objectives. In the current advice practice, however, there is a tendency for advisors to advise investors with a low 'ability to bear losses', to invest in low volatility / low risk products (often long-term fixed-income products). As a result, products that are most vulnerable to value erosion through inflation are proposed to those investors.

The SMSG is of the opinion that the suitability test and the suitability report should, where applicable, take into account the potential risk of inflation, also considering, for instance, the investment horizon of the client. In general, also risk-adverse clients with a very long-term investment horizon, should have access to a diversified set of proposals, namely also to products other than fixed-income products. Nevertheless, under the banner of inflation risk, risk-averse clients should not be lured into unsuitable high risk investment products. The SMSG advises ESMA to envisage to study the above issue in order to decide whether to clarify the above in the MiFID Suitability Guidelines.

3.2.2. The Appropriateness Test

15. Appropriateness test. MiFID requires investment firms to assess the appropriateness of services / transactions of clients in execution only services, by assessing their knowledge and experience. Today this is focused on knowledge of how different financial instruments function, and what the risks are. However, questionnaires typically do not ask questions about clients' understanding of the impact of inflation on real return in a context where interest rates are typically far below the inflation rate.

The SMSG is of the opinion that the assessment of knowledge and experience, both in the appropriateness and the suitability test, should include where appropriate and relevant an assessment of the understanding of the impact of inflation on returns. The SMSG advises ESMA to clarify the above in the MiFID Appropriateness Guidelines and in the MiFID Suitability Guidelines.

3.2.3. Product Governance

16. Product governance. In certain Member States, many higher risk/higher return products are not available to certain categories of retail clients, because they are not included in the target market for such products. This may lead to a situation where product distributors simply do not offer products that are less vulnerable to inflation risk to certain retail clients.

The SMSG is of the opinion that investment firms should not be induced by regulation to be overly restrictive when defining the target market for products. Clients with a long term horizon and a low risk profile could, for instance, still be included in the target market of products that are more volatile in the short term. The SMSG advises ESMA to analyze this situation and to decide whether this should be clarified in its Product Governance Guidelines.

3.2.4. Reporting obligations.

17. Reporting obligations and inflation. Art. 25 (6) of MiFID II provides that investment firms should provide the client with adequate reports on the service provided. The SMSG is of the opinion that it would be useful (i) to reflect in the suitability reports on investment advice how inflation risk has been taken into account in the advice, if relevant; and (ii) to include in the periodic statements in regard of portfolio management, a warning that the real return of the portfolio over the reporting period could be lower, as a result of inflation.

18. Suitability report. The SMSG advises ESMA to examine whether it is feasible and desirable to reflect in the suitability reports on investment advice how inflation risk has been taken into account in the advice, and, if the case may be, to reflect this in the MiFID Suitability Guidelines.

19. Portfolio management. In regard of the periodic statements relating to portfolio management, the SMSG advises ESMA to consider, and if relevant, consult, on whether it is desirable and feasible for investment firms to include in the periodic statements on portfolio management either (i) information on the real performance of the client's portfolio, or (ii) a warning that the real performance of the client's portfolio may be lower, due to inflation, than the nominal performance of the portfolio, with a reference to the inflation rate over the reporting period. Subject to the result of this consideration and consultation, this could be clarified in guidelines on the application of art. 60 of the MiFID Delegated Regulation."

3.3. Regulation of investment funds

20. UCITS Directive. Article 50(2)(a) of the UCITS Directive provides that a UCITS fund shall not "invest more than 10 % of its assets in transferable securities or money market instruments other than those referred to in paragraph 1". This ratio, also called "trash ratio" or "other assets" ratio, is a build-in diversification ratio. It permits to invest in other instruments than the listed "UCITS eligible assets", up to 10% of the assets. In the current interpretation, however, other funds do not qualify as investments that can be made under this "other assets" ratio. It means that UCITS funds cannot, under the "other assets ratio" invest in real estate funds, commodity ETNs, funds of hedge funds, managed futures (which offer non-linear arbitrage strategies), etc. In a period of high inflation, however, these funds represent good tools to diversify, which are less risky than direct investments in the underlying assets. This should, however, not increase the overall proportion of non-UCITS funds in UCITS' portfolios.

The SMSG advises ESMA to examine whether it is useful or even necessary to explicitly re-interpret art. 50(2)(a) to allow investment in other funds under the "other assets ratio".

IV. Other issues

4.1. Financial Education

21. Need for financial education. As already mentioned above, many people fail to understand basic financial concepts such as inflation, and are, moreover subject to biases. In order to deal with the problems raised in this advice, it is therefore key to increase financial literacy and improve financial education. The SMSG advises ESMA to coordinate on this issue with the other ESAs.

4.2. Reports published by the ESAs

22. Finally, the SMSG is of the opinion that the ESAs, as standard-setters, should in their own reports, take into account the risk of inflation by increasing awareness and education, and provide, where relevant, both nominal return of long-term saving and investment products, as well as estimates of actual returns in real terms (net of inflation) where possible. The SMSG advises ESMA to do this, for instance, in its publications like the annual "TRV" reports.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Since inflation has a very similar impact on all fixed income products, irrespective of whether they qualify as banking, investment, insurance or pension products, the SMSG has not only sent this advice to ESMA, but also the other ESAs and their Stakeholder Groups. A coordinated approach across authorities on this matter would be preferable. The SMSG encourages ESMA to take up this point with the other ESAs when taking action in this respect.

Adopted on 27 April 2022.

[signed]

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