ESMA's priorities for the asset management community
ALFI European Asset management Conference
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Keynote by Steven Maijoor, Chair

Good morning Ladies and Gentlemen,

It's a great pleasure for me to return here at the European Asset Management Conference and I want to thank the Association of Luxembourg Fund Industry for inviting me today.

This conference, during these two days, focuses on four "Ps" - Products, People, Progress and Prediction. ESMA, in its role of regulator and supervisor and in ensuring financial stability and investor protection, certainly has these four concepts at the forefront of its work.

In the spirit of the conference, I therefore decided to focus my remarks on how People's investments in financial Products Progress over time, and the role of costs. Firstly, I will talk you through ESMA's first annual costs and performance report on retail investment products. In particular, I will highlight how costs affect the value of an investment over time.

Secondly, I will focus on the relevance of costs of investment services and products in the EU legislative framework that relates to the provision of investment services.

Finally, given the importance of the role of costs on the value of an investment as mentioned above, I would like to emphasise the importance of cost disclosure in the context of the PRIIPs Regulation, and its upcoming review this year.

ESMA's first Annual Report on Performance and Costs of Retail Investment Products

ESMA published its first annual statistical report on costs and performance of retail investment products in January. Our report covers UCITS, retail alternative investment funds (retail AIFs) and structured retail products (SRPs). For UCITS, our analysis provides details on past performance and costs over a multi-year period in the EU as a whole and for individual Member States, and distinguishes different time horizons, asset classes, retail and institutional investors, actively and passively managed funds, and the impact of inflation.

The report is at the centre of ESMA's investor protection mandate: the objective of investors is to increase the value of their investments and costs are a key factor affecting the achievement of that objective. Past performance and costs of investment products have a major impact on the outcome of individuals' investment decisions. For investors to have trust in EU capital markets and to make informed choices about where to put their money, consistent EU-wide information on cost and performance of investment products is key. This is the main reason why the Commission has asked ESMA, and the other two ESAs, to produce these reports as a building block of the Capital Markets Union (CMU).

A key element to achieve the goal of a stronger participation of retail investors in capital markets is to provide them with clear, comprehensive and comparable information on retail investment products. Increased participation of retail investors in capital markets serves several purposes in a wider economic context. Capital market-based products tend to provide higher returns than deposits and thus can help meet the challenges posed by population ageing and low interest rates. Moreover, the last financial and sovereign crises highlighted the need for more diversified funding channels in the EU which can lead to a more balanced and improved allocation of capital.

Data on EU household financial assets continue to show that there is significant potential for increased participation of retail investors in EU capital markets, including in the fund sector. In the past years, while household assets have increased substantially, the various shares of asset classes remained relatively constant, with currency and deposits staying, on average at around 30% of total financial assets against 8%, 17% and 16% respectively for investment fund shares, equity and life insurance.

Costs and performance: the importance of costs of investment products

Focusing now on UCITS, we found that the total costs of a fund present a significant drain on fund performance, impacting retail investors to a much higher extent than institutional investors. On-going costs such as management fees constitute over 80% of the total cost paid by customers, whilst entry and exit fees have a much lower impact. I think it is important to highlight that, while the report is unprecedented in detail, we were not able to capture all distribution costs. The report clarifies such data limitations in more detail.

Let me provide you with an example on the value of an investment, following the results of the ESMA annual statistical report on costs and performance. Let's assume a retail investor makes an investment of 10,000 EUR over 10Y in an equity fund. Based on the report we assume a gross return of around 7.3%. The impact of costs relative to gross return for retail investors stands around 27% on average. What we observe is that, we will get well above 20,000 EUR at a gross level. Accounting for total costs or, in other words, having net returns of 5.4%, we will obtain just below 17,000 EUR. This means about 3,500 EUR less than before.

Our report found that institutional investors had on average a slightly higher gross return of 7.6% and incur much lower costs. The impact in the case of equity funds is around 14% on average. Thus, their pay-out after costs is just below 19,000 EUR, around 1,900 EUR less than in gross terms. In sum, these figures confirm that costs are a significant drain for retail investors on fund performance, and significantly higher compared to institutional investors.

Another important finding of the report is that after costs, passive equity funds consistently outperform active equity funds. Costs are higher for actively managed equity funds compared to passively managed equity funds, which leads to lower performance net of costs for active compared to passive funds. In net terms, 10-year horizon returns are about 5.5% for active funds against 5.8% for passive.

The fact that active performs lower compared to passive raises important questions on the effectiveness of active strategies for retail investors. Hence, given these initial findings, ESMA is further looking into the performance of active versus passive funds and expects to report on this in more detail in the next version of the report. We will also look into the performance of the specific class of equity ETFs.

A final key finding of the report is the significant variation in costs and gross performance across Member States. There are a number of potential reasons for this, including differences in asset classes and strategies followed, as well as heterogeneity in the way ongoing costs are calculated. For example, differences might be related to the inclusion of distribution costs and performance fees in reported costs.

Whilst we are confident our results for UCITS are robust, we are aware that there are challenges associated with the availability, quality, and comparability of cost and past performance data, which can inhibit assessment of retail investment products. This is something we will work on in future editions of the annual report. However, for retail AIFs and SRPs there is a lack of available and usable cost and performance data. This is a significant issue from an investor protection perspective. ESMA is also considering the implications of the report findings for further policy work within our investor protection mandate.

The importance of costs of investment products in the EU framework regulating investment services.

Given the importance of costs to investors achieving their investment objectives, they should also play a central role in the regulatory framework for investment services. Indeed, strengthening requirements on costs and charges of financial products and services has been a key topic during the revision of the MiFID I framework and this led to important regulatory changes with the objective to enhance investor protection.

Under the MiFID II framework a new transparency regime has been established in relation to information on costs and charges that must be provided to investors before and after their investment activity.

Additionally, considerations on costs have also been taken into account to specify the firms' duty to act in accordance with the best interest of their clients. This is an overarching obligation that does not only apply in the MiFID II context but also in the context of the UCITS and the AIFMD regulatory frameworks. Indeed, the general duty to act honestly, fairly and in the best interests of the investors should also have an impact on the costs of investment products for investors and on avoiding charging undue costs to them.

On the first aspect that I mentioned, the new transparency regime for investors, the provision of better information on costs to clients is clearly one of the ways to pursue the goal of rebuilding investors' confidence. While I acknowledge that, from a legal point of view, it is typically not the task of securities supervisors to regulate the costs, or pricing, of financial services and financial products: we generally do not have a competition mandate. However, it is our mission to ensure that consumers are able to receive a clear picture and thus understand what are the costs associated with the investment option they choose. A clear picture will enable them to assess whether they are making a cost-effective choice and to compare it with other available options. Enhancing transparency on costs and performance is especially important taking into account the current low interest rate environment.

Therefore, I am convinced that, as a consequence of increased information on costs, investors will be better informed and able to make better choices and ultimately see their costs reduced.

The MiFID II rules on costs and charges, differ from the PRIIPs framework and are usually more high level. ESMA has already issued a number of Q&As on this topic and continues preparing further clarifications. The purpose is to achieve effective supervisory convergence and obtain a harmonised interpretation and standardisation of practices concerning the new rules. This is essential for enabling investors to effectively compare investments, also when they are supervised by different national regulators.

With regard to the second aspect that I mentioned before, the duty to act in the best interest of clients, I would like to recall two main new provisions provided under the new MiFID II framework that are very important to understanding the role that the costs of investments may play in ensuring firms' compliance with this duty. I will refer in particular to the requirements detailed by the implementing acts of MiFID II.

First of all, an important provision stems from the MiFID II Delegated Regulation on organisation requirements and operating conditions for investment firm[1]. The Regulation underlines the importance of costs and charges to meet the duties of conduct of firms providing advice or discretionary portfolio management. In accordance with the new provisions, firms must be able to understand the nature and the features of financial instruments selected for their clients and this understanding now explicitly includes costs and risks of those instruments. Firms must also take into account costs and complexity and assess whether equivalent, but simpler and/or less costly investment services or financial instruments can also meet their clients' profile.

ESMA has recently reviewed the guidelines on certain aspects of MiFID II suitability requirements in order to update the previous version, issued under MiFID I. In our review, we have included a specific guideline that provides firms with details for the compliance with this requirement. In order to ensure that firms recommend suitable investments, or make suitable investments on behalf of their clients, they have to undertake a thorough assessment of the

[1] Regulation No 2017/565

possible investment alternatives, taking into account products' costs. Hence, they need to fully understand all the different aspects of the products that they select and be able to clearly justify situations where a more costly product is recommended to a client.

The second main provision which I would like to mention concerns the new product governance regime detailed by the MiFID II Delegated Directive[2]. The Directive requires that investment firms consider the charging structure proposed for the relevant financial instrument when manufacturing financial instruments. In particular, manufacturers under MiFID II must examine:

- That financial instrument's costs are compatible with clients' objectives;
- That charges do not undermine the financial instrument's return expectations; and
- That the charging structure is transparent and is not too complex to understand.

Such provisions must be read in conjunction with the product governance obligations that the aforementioned delegated directive provides for distributors. Distributors indeed need to obtain from manufactures all the information to gain the necessary understanding and knowledge of the products they intend to recommend or sell. Even when manufacturers are not subject to MiFID II, distributors have to undertake all reasonable steps to obtain adequate and reliable information from these manufacturers in order to ensure that products are distributed in accordance with the characteristics, objectives and needs of the target market.

Overall, these MiFID II provisions on suitability and product governance confirm and emphasise the importance of analysing product costs, and their impact, when providing investment services to investors.

The importance of cost disclosure in the legislative context of PRIIPs

As mentioned earlier, ESMA's first annual costs and performance report on retail investment products clearly confirms that, in the case of UCITS, the total costs of a fund present a significant drain on fund performance. I believe that what is true for UCITS is also true for other types of investment funds, and more generally for most types of investment products marketed

[2] Directive 2017/593

to the retail investor, whether these products are funds, structured products or insurance contracts: costs are a key factor determining performance.

The new PRIIPs disclosure framework has of course an important role to play in this respect. This is because it should help the retail investor to be aware of the costs embedded in the investment product he or she is about to buy. This is not to neglect that some improvements to this framework will be warranted in light of first application experiences. However, we believe that, thanks to the PRIIPs KID, investors should now have a better picture of the costs of the investment product they are buying in a comparable format. I am convinced that this will lead to healthier financial planning choices and also in all likelihood to a reduction in costs for the end-investor in the medium to long run.

But we need to ensure that this new disclosure framework is equally appropriate for all types of PRIIPs, allowing retail investors to compare the features of the products they will buy before they take their investment decision, but also allowing retail investors to understand as clearly as possible the costs they will pay. This is not a simple task, given the heterogeneity of the products, and their cost structures, in the scope of the PRIIPs Regulation.

This leads me to mention our recently published report on targeted amendments to the PRIIPs Level 2 which you may have already seen. In this report, we have reviewed the feedback provided to the earlier consultation, and we have also taken into account the latest information regarding discussions between the European co-legislators on the application of the KID by UCITS and the timing of a review of PRIIPs.

Based on this feedback and these developments, we have decided that it is not appropriate to propose substantive amendments to the PRIIPs Level 2 at this time. Instead, we have initiated work to conduct a broad review of the PRIIPs Delegated Regulation during 2019. We expect to hold a public consultation in Q3 this year, and we will be looking forward to receiving your input.

This review will first of all include proposals to review the performance scenarios section of the PRIIPs KID, which proved to show over-optimistic results in certain cases. But this review will also cover cost related issues, such as the presentation and calculation of costs.

While conducting this review, we will also have in mind that the cost figures included in the PRIIPs KID are not only of immediate use for investors, but they also enable the future analysis of costs and performance of retail investment products. ESMA will continue running this exercise annually in the future in order to provide this aggregated and comparative information to investors.

Conclusion

Ladies and Gentlemen, ESMA will continue paying great attention to costs, as an important factor to improve services and products addressed to investors, especially retail. This is needed in order to contribute to strengthening, or regaining, investors' trust in the financial sector, and to increase their participation in the capital markets, including in the fund sector. I'm convinced that industry should actively participate in the efforts in this direction, and I'm confident it will.