Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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Unit B2 – Economic analysis and evaluation
DG FISMA
European Commission
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Dear Sir, Madam,

Call for evidence: EU regulatory framework for financial services

This is the submission of the Financial Services Consumer Panel to the European Commission call for evidence on the EU regulatory framework for financial services. The Panel is an independent statutory body, which represents the consumer interest by advising and challenging the UK's Financial Conduct Authority (FCA) on how its policy and rules affect consumers. The Panel represents the interests of all groups of financial services consumers.

The emphasis of the Panel's work is on activities that are regulated by the FCA, although it may also look at the impact on consumers of activities that are not regulated but are related to the FCA's general duties (including the work of the European institutions).

In its response, the Panel has focused on areas where the EU regulatory framework has delivered benefits for consumers, and areas where we believe further action is needed to ensure that consumers' needs are met and that they can trust the industry to act in their best interests.

We welcome the Commission's commitment to its review of the EU financial regulatory framework, which is important to determine whether the current legislation is fit for purpose. Given the remit of the Panel, we have focused our submission on the conduct provisions of relevant EU legislation, in particular the Markets in Financial Instruments Directive II (MiFID II), the Insurance Distribution Directive (IDD), the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation and Undertakings for Collective Investment Transferable Securities (UCITS).

Quantifying the costs and benefits of regulation

The Panel is concerned that this call for evidence focuses unduly on quantifiable and empirical evidence as this is likely to benefit claims made by the industry about the costs of regulation. It is relatively straightforward for firms to estimate the costs of compliance. However, by definition, whether regulatory burdens are "unnecessary" or compliance costs "excessive" can be determined only by reference to their objectives and benefits. Firms will not want to highlight these.

The aggregate benefits to consumers of regulation, in particular the deterrent and preventative effect, are notoriously difficult to quantify. However, the estimation of counterfactuals is a problem regularly confronted by economists and evaluation professionals. It is common practice for modelling and simulation to provide indicators of potential effects if the policy were not in place so we believe the Commission should also do this. There are many examples of recent EU interventions which may have carried a cost to the industry but which are likely to serve European consumers and the market well, for example: the transparency measures in MiFID II and the PRIIPs Key Information Document (KID), the legal right to a basic bank account under the Payment Accounts Directive (PAD), and increased depositor protection for temporary high balances under the Deposit Guarantee Schemes Directive (DGSD).

Costs versus benefits

Repeated episodes of mis-selling across EU Member States show the importance of regulation. Firm misconduct has resulted in compensation claims already running to many tens of billions of euros. In the UK alone, recent compensation to consumers for mis-selling includes €30 billion for payment protection insurance, €16.5 billion for personal pension products and €3 billion for interest-rate hedging products. There is thus a strong prudential interest in effective conduct regulation, as effective conduct regulation reduces future penalties and compensation and improves system resilience.

Better Regulation: restoring consumer trust and unlocking investment

The Panel supports the Commission's "Better Regulation" agenda, designed to ensure that EU laws achieve their objectives in an effective but proportionate way. However, we are concerned that the consultation paper is excessively focused on "unnecessary regulatory burdens" and "excessive compliance costs".

We should remember that it was necessary to regulate the financial services sector in the wake of the financial crisis. Even now, there is still widespread misconduct, often driven by conflicts of interest between the needs of

firms and the needs of the customer. Ordinary households need to know that they can trust firms: that is also in the interests of financial services providers and the wider economy. Better regulation does not equal less regulation but bolder, clearer, regulation may weaken the need for constant renegotiation of the regulatory boundaries.

Crucially, rooting out misconduct is a precondition to unlocking household savings to finance growth. The Commission's Consumer Markets Scoreboard shows that financial services are among the least-trusted sectors in the Single Market, with over a fifth of consumers showing little to no trust in firms providing asset management, credit and mortgages. Capital Markets Union will not succeed unless this changes. Deregulatory measures that would simply make it easier for firms to provide consumers with unsuitable financial products would reduce trust further, and decrease retail investment in the long run.

Rather than an exercise in cutting red tape, the Panel believes the Commission should consider more effective alternatives to current regulatory measures where these are not delivering the right outcomes for consumers and the wider market. For example, there should be less reliance on the disclosure of conflicts of interest and a greater focus on eliminating such conflicts before they can cause consumer detriment. This will require a combination of measures that increase transparency, including surfacing hidden fees and charges, as well as tackling commission bias across the spectrum of financial services. There may also be a need for more creative approaches to deterrence and product intervention, such as temporarily prohibiting a misbehaving firm from marketing a particularly profitable product line.

Without an appropriate regulatory framework that leads to good conduct by financial firms, consumers will remain hesitant to invest. Giving European and national supervisory authorities the levers which they need to get the markets to behave would allow consumers them to be confident that the financial services sector puts the interests of its customers first.

Yours sincerely,

Sue Lewis

Chair

Financial Services Consumer Panel

Rules affecting the ability of the economy to finance itself and grow

No response to questions 1, 2 and 4

3. Investor and consumer protection

1. Access to basic bank accounts

Directive(s) and/or Regulation(s)

Directive 2014/92/EU, article 16

Executive summary

The PAD is a good example of a piece of EU legislation that increases consumers' access to a crucial financial product in the absence of a market solution. Article 16 creates a legal right to a basic bank account for all EU residents.

Supporting relevant and verifiable empirical evidence

Prior to the adoption of the Directive, the Commission found (*http://ec.europa.eu/finance/finservices-retail/docs/inclusion/20130508-impact-assessment_en.pdf*) that 11 EU Member States had not taken action to facilitate access to basic bank accounts for consumers. Where a right did exist, consumers were unaware of it (for example in Belgium, where 63% of unbanked consumers did not think a bank would accept their application to open a bank account).

Similarly, research cited by the Commission in its 2013 impact assessment (*http://ec.europa.eu/finance/finservices-retail/docs/inclusion/20130508-impact-assessment_en.pdf*) for the Directive estimated the number of EU citizens with no payment account numbered between 30 and 68 million.

Even though the existence of basic bank accounts have been a feature of the UK market for several years, major retail banks only announced a voluntary agreement to begin offering basic bank accounts to more customers in need of them in December 2014, after the PAD had been agreed in principle. We consider it unlikely this would have happened without the upcoming EU legal requirement.

Suggested remedies

The legislation does not need to be amended, but it will be crucial to ensure that the right to a basic bank account is not merely a right on paper but can be relied upon by consumers in practice. The Commission should monitor transposition and implementation closely to ensure that unbanked consumers can and do make use of their new legal right.

2. Increased depositor protection

Directive(s) and/or Regulation(s)

Directive 2014/49/EU on deposit guarantee schemes

Executive summary

Compensation arrangements for depositors are crucial to consumer confidence. We therefore welcomed the inclusion of article 6(2) in the new DGSD, which requires Member States to protect certain types of temporary high balances which exceed the normal deposit guarantee threshold of €100,000. However, the Panel believes the system of depositor protection could be enhanced further to provide clarity to consumers about coverage, and to make the compensation limit more consistent for countries outside the single currency area.

Supporting relevant and verifiable empirical evidence

The Panel believes that the application of the deposit protection limit based on a banking licence is confusing to consumers, for whom it would be much easier to understand if depositor protection was available on a per-brand basis, as they are unlikely to be aware of which brands are operating under a single authorisation. Moreover, deposit accounts are also marketed to the general public using brands, not the overarching group name.

Separately, the Directive creates significant problems for the consistency of protection limits in Member States outside the Eurozone. For example, as a result of fluctuating currency exchange rates, the UK has recently had to reduce its depositor protection limit from £85,000 to £75,000. A significant minority of EU Member States thus faces having to make similar re-adjustments every five years, which becomes a costly exercise in reviewing and reprinting the information. Pegging the limit of protection to a variable as volatile as exchange rates does not benefit consumer confidence in the system, and a more sustainable solution should be found in a review of the Directive.

Suggested remedies

Amend article Directive 2014/49/EU to apply the maximum protection to all accounts held with a single brand, rather than all accounts held by credit institutions operating under the same authorisation. Separately, a solution must be found to guarantee a stable and consistent maximum level of compensation for Member States that do not use the single currency.

3. Improving investment fund governance

Directive(s) and/or Regulation(s)

Directive 2009/65/EC on undertakings for collective investment in transferable securities, in particular Chapter IV on the obligations regarding the depositary.

Executive summary

Millions of individuals in the EU depend on the services of the fund management industry for their long-term financial needs. By investing, individuals are reliant, directly or indirectly, on fund managers to act as stewards of their savings. Retail investment also provides the real economy with a valuable source of funds, stimulating jobs and growth.

However, the Commission's own Consumer Markets Scoreboard (*http://ec.europa.eu/consumers/consumer_evidence/consumer_scoreboards/10_edition/docs/consumer_market_brochure_141027_en.pdf*) shows that EU consumers consistently rank asset management at the bottom of the scale for trust out of all consumer markets. Research (*https://fs-cp.org.uk/sites/default/files/investment_report_executive_summary_for_the_fscp.pdf#page=6*) has shown that independent governance is often lacking or defective, and can be marred by conflicts of interest.

Restoring consumer trust requires better governance in asset management. Independent oversight of asset managers could be improved if the UCITS Directive were to mandate separation of Management Company and depositary, and give the depositary greater powers to dismiss underperforming asset managers.

Supporting relevant and verifiable empirical evidence

According to EFAMA (*http://www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf*), total assets under management in Europe increased 9% in 2013 and 15% in 2014, to reach an estimated €19 trillion at end 2014.Poor fund governance is a persistent problem. In 2002, the Sandler Report on the retail investment market found "the reporting of product charges is typically neither clear nor consistent". In November 2014, Panel research (*https://fs-cp.org.uk/sites/default/files/investment_report_executive_summary_for_the_fscp.pdf*) found persistent weak governance in the asset management industry across Europe. Governance is frequently contracted out to commercial organisations, which are unlikely to criticise the investment manager who appointed them. Governance can also be provided by an associated group company, which shares the same ultimate owner, creating similar conflicts of interest.

In addition, it is questionable whether individuals exercising governance functions are in practice able to dedicate the necessary time to the tasks required of them. For example, a Central Bank of Ireland review (*https://www.centralbank.ie/regulation/industry-sectors/fund-service-provider/administrators/Documents/Industry%20Letter%20-%20Thematic%20Review%20of%20Directorships%20Final.pdf*) in 2015 found that there are 13 individuals who collectively hold 652 directorships in the Irish funds industry, an average of 50 per person. The Central Bank concluded that it would "deem [such directors] to be at a high risk of not being able to fulfil their board roles to an appropriate standard and, by implication, that there is a high risk to the quality of performance of those boards where the individual is a director."

Research carried out (*https://fs-cp.org.uk/sites/default/files/investment_report_executive_summary_for_the_fscp.pdf*) on behalf of the Panel in 2014 showed that as a direct result of poor governance practices, that costs in funds such as UCITS are poorly controlled and disclosed. This is also borne out by research carried out by Better Finance, which concluded in its 2015 pensions report that "Fees and commissions substantially reduce performances of pension products, especially for personal "packaged" pension products. Charges are often complex, opaque and far from being harmonised between different pension providers and products." (*http://betterfinance.eu/fileadmin/user_upload/documents/Research_Reports/en/Pension_Report_2015_Edition_For_Web.pdf*)

Even though costs have a significant impact on investment returns, retail customers – and often institutional investors such as pension funds - do not know what costs they will face when they invest. Headline charges may be as little as a quarter of the true costs, as many of the charges are deducted directly from the fund and remain hidden.

The sheer size of the UCITS fund sector means that the majority of governance problems in funds will be concentrated there. According to Eurostat, in 2010 more than 85% of EU mutual fund investments were directed towards UCITS vehicles (€5.9 out of €6.9 billion), with households accounting for 28% of EU investment in mutual funds.

The Panel research concluded that well-governed funds are more likely to provide consumers with value for money by reviewing the quality of investment management and costs on a continuing basis. Poor governance can lead to investor detriment due to the use of inadequate or excessively risky investment strategies, or unnecessarily high costs.

As a result of the frequently ineffective governance of UCITS funds, consumer trust in the asset management industry has been eroded and has remained consistently low. All financial services markets are consistently towards the bottom of the table in the Commission's Consumer Markets Scoreboard, with asset management trailing by a long way.

Lack of trust could be a driver behind the relatively low rate of retail investor participation in the EU investment market: the Commission's own impact assessment for the UCITS V Directive found that only 10% of EU households are directly invested in mutual funds.

Suggested remedies

With 90% of mutual fund investments in the EU directly or indirectly (through pension funds or insurers) held by retail investors, improving fund governance for UCITS should be a priority.

At a minimum, the Panel considers that there should be a full and effective separation of the UCITS management company and the depositary. The 'independence' requirement under article 25 of the UCITS Directive is insufficient, as it does not prohibit the management company and the depositary being part of the same group, enabling conflicts of interest to thrive.

However, we believe that more far-reaching changes should also be considered. In particular, the Panel would like to see the depositary subject to more stringent transparency requirements and also acquire greater responsibilities, for example an obligation to make public statements on fund performance and value for money, and – crucially - the ability to replace investment managers, where necessary. This would be similar to the arrangements for Independent Governance Committees (IGCs), which have been recently introduced in the UK for pensions.

UCITS should be brought within the scope of the PRIIPs Regulation to ensure that managers are required to disclose all costs and charges, including transaction costs.

4. Alignment of the Consumer Credit Directive (CCD) and Mortgage Credit Directive

Directive(s) and/or Regulation(s)

Directive 2008/48/EC on credit agreements for consumers and Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property.

Executive summary

The Consumer Credit Directive (CCD), adopted in 2008, covers personal loans, credit card, overdraft facilities, and revolving credit or credit sale agreements. Under the Directive, lenders must provide the consumer with standardised pre-contractual information, comparable interest rates (APRC), a right of withdrawal and of early repayment. Besides several positive provisions, the CCD contains some loopholes.

Supporting relevant and verifiable empirical evidence

The CCD does not address the issue of irresponsible lending. In the UK alone estimates are that 8.8 million people are over-indebted (ref: *https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/personalising-the-debt-sector-a-segmentation-of-the-over-indebted-population_november2013.pdf*). The issue concerns the obligation for lenders to assess the creditworthiness of consumers prior to offering credit. There is a basic obligation to assess creditworthiness but the means by which this is done is largely left to the creditor and the directive still does not oblige lenders to grant credit only to those borrowers who are likely to repay it. Responsible lending principles are provided only in recital 26 of the directive, which is inconsistent with the recently adopted Mortgage Credit Directive (MCD). The latter obliges creditors to make the credit available to the consumer only where the result of the creditworthiness assessment indicates that the obligations resulting from credit agreement are likely to be met.

Another concern relates to small loans, for amounts under EUR 200. These are out of scope of the CCD, yet are widespread in many Member States under different forms (payday loans, for instance). Short-term loans, which can be very expensive, are often targeted at vulnerable groups and can cause significant financial detriment. When transposing the CCD at national level, many Member States have included small loans and short-term loans in the scope. Some other Member States have adopted specific measures. In an attempt to prevent irresponsible and abusive behaviour by payday lenders, for example, the UK regulator introduced an interest rate cap.

Suggested remedies

It is important to align the CCD with the responsible lending principles that apply to mortgage credit. This is particularly important as irresponsible lending is one of the causes of the last financial crisis as well as a cause of consumer over-indebtedness and should be prioritised by the Commission.

As part of the expected measures to fight against over-indebtedness, the Commission should also widen the scope of the CCD to bring in smaller loan amounts.

5. Revision of Prospectus Directive

Directive(s) and/or Regulation(s)

Directive 2003/01/EC on the prospectus to be published when securities are offered to the public or admitted to trading

Executive summary

The Commission's legislative proposal for the Prospectus Regulation to replace the existing Directive has been adopted. We support the underlying intention of the legislation as prospectuses can be overly long documents that are neither read nor understood by retail investors.

However, the Regulation will introduce a Universal Registration Document for frequent issuers, as well as raise the threshold at which issuance of a prospectus becomes mandatory. This creates some difficulties.

Supporting relevant and verifiable empirical evidence

Fewer issuances of shares will be subject to a prospectus requirement, potentially exposing retail investors to inappropriately risky investments. Most crowd-funding will be exempt altogether if any member states opt for the €10m de minimis threshold. The Panel's response to the review of the Prospectus Directive (*https://www.fs-cp.org.uk/sites/default/files/fscp_response_prospectus_directive_may_2015.pdf*) makes clear the Panel's concerns in this regard. The Panel does not see how more exemptions from the need to produce prospectuses helps consumers. The emphasis should be on the right kind of prospectuses – where there is evidence about what consumers need and are more likely to use and benefit from in a prospectus - , which is another way of addressing the same problem.

Suggested remedies

The legislation does need to be amended, but merely loosening prospectuses' requirements without a broader regulatory approach is not the best way forward. Any regulation needs to be calibrated in order to strengthen the industry on behalf of consumers. This review is needed to make sure that time and money are not being wasted under the current Directive, making markets inefficient without any corresponding value in terms of consumer protection. However, prospectuses, and in particular the prospectus summary, remain a crucial piece of information for consumers before deciding to invest their money. For this reason, the Panel opposes attempts to widen the exemptions from the prospectus requirement to more issuers by lowering the current thresholds.

Unnecessary regulatory burdens

No response to questions 5, 6, 7, 8 and 9

Interactions of individual rules, inconsistencies and gaps

No response to questions 10 and 11.

12. Overlaps, duplications and inconsistencies

1. Permissibility and disclosure of commission for investment intermediation

Directive(s) and/or Regulation(s)

Directive 2014/65/EU on markets in financial instruments, article 24

Insurance Distribution Directive (COM(2012)0360) as adopted by the Council and Parliament, article 24 (awaiting publication in the Official Journal)

Executive summary

The payment of commission triggers commission bias, resulting in a conflict of interest where intermediaries may seek to maximise their own remuneration rather than providing the customer with the most suitable product or service. This is a particular problem in markets where consumers rely heavily on intermediaries, notably the market for investment products.

Commission should in all cases be banned because it does not serve anyone well. It creates a conflict of interest between the customer and the agent; it creates incentives to mis-sell. And it also creates an uneven playing field between those products where commission is banned and where it is not. For instance, recently-agreed EU legislation governing investment intermediation is not consistent in its treatment of commission. Insurance-based investment products (IBIPs) are covered by the new IDD, while intermediation of other types of investment products is covered by MiFID II.

This creates the risk of regulatory arbitrage, and should be addressed urgently. In particular, the IDD has far more lenient provisions on commission paid for distribution of IBIPs than MiFID II does for other types of investment products.

Where commission is not banned, the Panel believes that the amount of commission the intermediary received should be disclosed to the customer. This allows them to make an informed judgement about whether the intermediary could be biased and whether they are receiving a suitable product.

The problem of commission is particularly pertinent with the advent of automated advice where consumers go online to look for 'advice'. It is most likely that most consumers are not familiar with what constitutes a protected form of regulated advice versus an unprotected sale (often called 'non-advice' in the UK). Where the line blurs online between 'execution only services' and 'fully automated services' it is increasingly difficult (ref *https://www.eba.europa.eu/documents/10180/1299866/JC+2015+080+Discussion+Paper+on+automation+in+financial+advice.pdf*). In member states where execution only services can still receive commission while advice services may not this creates an unlevel playing field for the advice sector. It also incentivises firms to invest in execution only platforms rather than advice platforms, putting consumers at a distinct disadvantage.

It also increases the risk in a cross-border market where there are different incentive structures. Banning commission on the sale of all financial products across Europe and providing clarity on the price consumers are paying for services would be a bold and effective move in regulating the market. Whilst this would not be popular, it would be more effective than the current regulatory approach which is piecemeal, costly to implement and ineffective for consumers.

Supporting relevant and verifiable empirical evidence

That bias that can be triggered by commission payments is well-established. This is of particular concern in investment intermediation, as the sheer number of overcomplicated products means that many consumers rely on intermediaries for their product choice.

For example, research from CRA International commissioned by the Association of British Insurers found evidence of bias to recommend a particular type of product and also bias to recommend particular providers depending on the commission paid. This eventually contributed to the Retail Distribution Review in the UK, which banned payment of commission for investment advice.

To prevent regulatory arbitrage, it is important that commission payments for investment intermediation are the same under both MiFID II and the Insurance Distribution Directive. Otherwise firms, driven by commercial incentives, will opt for the regulatory regime that presents the least barriers.

Unfortunately, this alignment between the two Directives has not yet been achieved. This misalignment manifests itself in three areas: 1) the banning of commission for intermediaries who market themselves as 'independent', 2) the requirement to disclose amount of commission received and 3) the need for commission to 'enhance the quality' of the service provided.

Article 24(7)(b) of MiFID II prohibits independent intermediaries from accepting commission payments, but this ban is missing from the IDD as agreed by the European Parliament and the Council. Alignment could be achieved by inserting into the IDD the Commission's original proposal for article 24(5)(b) of the recast IDD.

Article 24(9) of MiFID II requires intermediaries to disclose the 'existence, nature and amount' of commission received prior to sale. This enables the customer to make a judgement about whether the commission is of such a nature that it would impair the ability of the intermediary to act in the customer's best interest.

However, it is unclear at present whether the final IDD would require disclosure of the amount of commission received by the intermediary for insurance-based investment products.

While the draft IDD in article 24(7)(c) refers to 'any third-party payments' to be included in the costs and charges to be disclosed, by default the costs will be presented as an aggregate figure, meaning the customer would only see the amount of commission if they specifically requested an itemised breakdown.

In this regard we would also draw the Commission's attention to the judgement of the UK Supreme Court in *Plevin v Paragon Personal Finance Limited*, which found that non-disclosure of the amount of commission and the identity of the recipients made the customer's relationship with provider unfair under consumer protection law. There is clearly a strong case that the amount of commission should be clearly disclosed prior to sale.

Finally, the draft IDD stipulates in article 24(10) that any commission paid for IBIPs must not have a 'detrimental effect' on the quality of the service. However, this is clearly a lower standard than which applies to commission for distribution of other types of investment products under article 24(9)(a) of MiFID II, where it must actively 'enhance the quality of the service'.

Suggested remedies

Commission for independent intermediaries selling IBIPs under the IDD should be banned. This will require an amendment to article 24 to align it with article 24(9) of MiFID II.

Article 24(7)(c) of the IDD should be amended to ensure that the amount of commission paid should be disclosed prior to sale of an IBIP, aligning it with article 24(9) of MiFID II.

The requirement for the permissibility of commission for IBIPs under article 24(10) of the IDD should be aligned with article 24(9)(a) of MiFID II, meaning that such third-party payments must enhance the quality of the service provide rather than lack a 'detrimental effect'.

2. Transaction costs reporting

Directive(s) and/or Regulation(s)

Directive 2014/65/EU on markets in financial instruments, article 24

Directive 2009/65/EC on undertakings for collective investment in transferable securities

Regulation 1286/2014 on key information documents for packaged retail and insurance-based investment products, article 32

Executive summary

There are inconsistencies between the pre-sale disclosure requirements relating to costs and charges, particularly transaction costs, under the UCITS Directive, the PRIIPs Regulation and MiFID II.

MiFID II requires regulated investment intermediaries to disclose transaction costs for the investment products they sell. This information must be obtained from the manufacturer of the product, which in the case of UCITS funds is the management company. However, UCITS funds will not be under a legal obligation to report their transaction costs, jeopardising the effectiveness of the new investor disclosure requirement.

UCITS should be brought within the scope of the PRIIPs Regulation no later than the expiry of the current exemption in 2019, as this would oblige them to report their transaction costs.

Supporting relevant and verifiable empirical evidence

The new PRIIPs Regulation will mandate improved disclosure requirements for retail investment products. This is a welcome intervention in a market characterised by cost opacity, and will be a significant step forward in helping retail investors and their advisers to assess value for money. It should also lead to improved cost control by making it clearer to investors what they are paying, enabling them to compare different products.

However, the Panel is concerned about the inconsistencies between the pre-sale disclosure requirements under the UCITS Directive, the PRIIPs Regulation and MiFID II. In particular, under article 24 of MiFID II, regulated investment intermediaries will be required to disclose transaction costs for the investment products they sell. This information must be obtained from the manufacturer of the product, which in the case of UCITS funds is the management company.

However, as manufacturers rather than distributors of investment products, UCITS funds will not be subject to MiFID II. Nor is there a legal obligation on collective funds to report their transaction costs as part of the 'Key Investor Information Document' required under the UCITS Directive.

While the new 'Key Information Document' under the PRIIPs Regulation will require manufacturers to report transaction costs, UCITS are exempt from this legislation until the end of 2019 (and possibly indefinitely thereafter) under article 32 of the Regulation.

This has created a situation where investment intermediaries will be obliged provide information to their customers on transaction costs related to collective funds, while these funds are not required to provide this information to the intermediaries.

This is a significant shortcoming, as transaction costs are often significant. Undisclosed transaction costs could, for example, add almost 1.5% per annum to the disclosed costs of a collective investment scheme (*https://www.fs-cp.org.uk/sites/default/files/investment_jaitly_final_report_full_report.pdf*).

To address this inconsistency on a provisional basis, ESMA has recommended that, where a UCITS management company has not already provided transaction costs up front, investment firms should liaise with management companies to obtain the relevant information.

This situation is clearly not ideal, as UCITS funds could refuse to cooperate with investment intermediaries, jeopardising the implementation of MiFID II and reducing the effectiveness of the new cost disclosure regime.

Suggested remedies

UCITS should be brought within the scope of the PRIIPs Regulation before the expiry of the current exemption in 2019, as this would oblige them to report their transaction costs.

13. Gaps

1. Eliminating conflicts of interest in asset management to control costs borne by investors

Directive(s) and/or Regulation(s)

Directive 2014/65/EU on markets in financial instruments

Regulation 1286/2014 on key information documents for packaged retail and insurance-based investment products

Insurance Distribution Directive (COM(2012)0360) as adopted by the Council and Parliament, article 24 (awaiting publication in the Official Journal)

Executive summary

Overall, the complexities of retail fund structures, combined with weak fund governance and asymmetries of information and power between the retail investor and the investment manager, have resulted in an extremely unbalanced principal-agent relationship. Profit maximisation combined with incomplete disclosure and poor management of conflicts of interest has skewed the basis on which healthy competition depends.

MiFID II will be a significant improvement by mandating full disclosure of all costs and charges. However, the history of regulatory action in surfacing full costs has not been effective. Moreover, the full costs borne by savers are simply not known, as costs are often deducted from the fund directly by the provider.

One long-term solution might be a single investment management charge; all intermediation costs, charges and expenses incurred by the investment manager, including transaction costs, should be borne directly by the firm and not deducted from the fund. A single charge would require firms to price their services in such a way that they remain profitable yet competitive.

Supporting relevant and verifiable empirical evidence

Overall, the complexities of retail fund structures, combined with weak fund governance and asymmetries of information and power between the retail investor and the investment manager, have resulted in an extremely unbalanced principal-agent relationship. Profit maximisation combined with incomplete disclosure and poor management of conflicts of interest has skewed the basis on which healthy competition depends.

Millions of individuals in the EU depend on the services of the fund management industry for their long-term financial needs. The importance of fund managers' stewardship continues to grow. According to EFAMA (*http://www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf*), total assets under management in Europe increased 9% in 2013 and 15% in 2014, to reach an estimated €19 trillion at end 2014.Poor fund governance is a persistent problem.

Individuals are therefore dependent on the asset management industry to deliver good outcomes at an acceptable cost. Independent research commissioned by the Panel in 2014 (*https://fs-cp.org.uk/sites/default/files/investment_report_executive_summary_for_the_fscp.pdf*) found that the full costs incurred by consumers when making long-term investments are not consistently and comprehensively defined, nor understood.

Moreover, fund managers too frequently exercise poor control of costs, which are not necessarily visible to investors and which managers can deduct directly from the value of funds, rather than treat as a business cost that they meet out of their own pockets. For example, Better Finance has stated repeatedly that fees and commissions substantially reduce performances of pension products, especially for personal "packaged" pension products: "Charges are often complex, opaque and far from being harmonised between different pension providers and products."
(*http://betterfinance.eu/fileadmin/user_upload/documents/Research_Reports/en/Pension_Report_2015_Edition_For_Web.pdf*)

These weaknesses matter greatly. Over extended periods, apparently small differences in the cost of investing can make a material difference to the value of individuals' long-term savings: over a working lifetime, a 1% annual charge could slice the value of a pension pot by a quarter. (Illustrative calculations by the UK's Department for Work and Pensions in November 2013 ("Pensions Bill 2013, Information Pack for Peers") show that an individual who saves throughout their working life into a scheme with a 0.5% annual charge could lose around 13% of their pension pot at retirement as a result of charges. A 1% annual charge could reduce that pot by 24%.)

Furthermore, without a clear idea of the comparative costs and charges of different investment vehicles, individuals and their representatives cannot make informed judgements about value for money. Price competition is thus impaired.

The problems of cost opacity and cost control are both widespread and long-standing. In 2002, the Sandler Report on the UK retail investment market found "the reporting of product charges is typically neither clear nor consistent" (*Sandler Report (July 2002), "Medium and Long-Term Retail Savings in the UK: A Review*".) In May 2014, following its thematic review of retail funds, the UK's Financial Conduct Authority castigated firms for too frequently providing information on fund charges that was unclear, insufficiently comprehensive and misleading. (*FCA (May 2014), "Clarity of fund charges", TR14/7*.) In its 2013 study, the British Office of Fair Trading (OFT) reported problems of cost opacity similar to those that it had uncovered in 1997. (*OFT (September 2013, revised February 2014), "Defined contribution workplace pension market study", OFT 1505*.)

Persistent problems also arise with the incentives of fund managers to control costs. In 2012, the FSA found that few firms exercised the same vigilance in their expenditure on research and execution services (the costs of which are deducted directly from the value of funds under management and therefore hidden from view to investors) as they exercised over payments made from the firms' own resources. (*FSA (November 2012), "Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks*".)

The widespread and persistent nature of the problems of cost opacity and cost control suggest underlying structural deficiencies in the fund management industry. These were forcefully identified in the 2012 Kay Review of UK equity markets, which described 'the decline of trust and the misalignment of incentives throughout the equity investment chain'. ("*The Kay Review of UK Equity Markets and Long-Term Decision Making", Final Report, July 2012*.)

After a review of a wide range of studies and methods of calculation in 2014, the Pitt-Watson team concluded that the full costs borne by savers are simply not known, and costs are deducted from the fund directly by the provider. The main reasons are simply that many costs are not properly measured or declared. In Jaitly's view, the result has been a "waterbed effect": cost suppression in one place has led to cost inflation in another place, with no net impact.

MiFID II will be a significant improvement by mandating full disclosure of all costs and charges. However, the history of regulatory action in surfacing full costs, as described above, has not been effective.

Moreover, as Jaitly argues, full disclosure should be seen as a complement to structural reform, not as a substitute. Without a fundamental alignment of incentives, the industry is always likely to find ways around even the most prescriptive forms of regulation.

Disclosure alone would not immediately change the incentives for fund managers to control those costs that can be charged against the value of funds and are consequently hidden from the investor. One solution might be a single investment management charge; all other intermediation costs, charges and expenses incurred by the investment manager, including transaction costs, would be borne directly by the firm and reflected in the single charge.

A single charge would require firms to price their services in such a way that they remain profitable yet competitive. The single charge regime would place investment managers at risk for the decisions they make and strengthen accountability – to the consumer and also to the firms that employ them. The reform could trigger a sea-change in industry practices and remuneration structures.

The Panel fully understands that such a radical proposal would require structural changes in the industry and would be likely to be challenged by investment firms. However we believe a single charge merits consideration

because other options are not working. And again it is an example of how bold regulation may be less costly for firms over the long term and regulate the market far more effectively for consumers, rather than the very complex, piecemeal approach required presently.

Suggested remedies

In addition to the inclusion of personal pension products within the scope of MiFID II and improvements to the legal requirements for the governance of funds, the EU should work towards the imposition of a 'single charge' which is transparent and clear. Charges should not be defrayed against the value of the fund but clearly billed to the client.

2. Investor Compensation Schemes Directive

Directive(s) and/or Regulation(s)

Directive 1997/9/EC on investor-compensation schemes

Executive summary

The Investor Compensation Schemes Directive (ICSD) has not been updated since 1997. It mandates a minimum compensation limit of €20,000. To give retail investors peace of mind when investing their money in another EU Member State, it is crucial that they trust the redress mechanisms in place and have confidence that appropriate compensation is available if things go wrong.

Raising the minimum compensation limit would also take account of the effects of inflation in the EU and better align the level of compensation to the average value of investments held by retail clients. Measures should also be put in place to ensure that consumers are made aware of the applicable compensation scheme where they do business with a firm not registered in their Member State of residence.

Supporting relevant and verifiable empirical evidence

In absence of action at EU level, a number of Member States have increased the compensation available under their national investor compensation schemes since 1997. For example, the UK Financial Ombudsman Service (FOS) can offer redress up to £50,000 (€70,000), more than triple the minimum mandated by Directive 1997/9/EC. Similarly, France, Spain and Slovakia also offer significantly more than €20,000, while most other Member States offer a maximum of €20,000.

As a result, an increasingly uneven level of protection has emerged across the Single Market, which could deter retail investors from choosing providers in countries with lower compensation limits.

Suggested remedies

Provide for a higher minimum compensation limit under Directive 1997/9/EC, while retaining flexibility for individual Member States to set higher limits (i.e. there should be no maximum harmonisation like under the DGSD).

There should also be a legal requirement to provide retail investors with information about the applicable compensation scheme (and maximum compensation limit) when an investment product is bought cross-border.

3. Insurance Guarantee Schemes Directive

Directive(s) and/or Regulation(s)

There is no EU legislation on Insurance Guarantee Schemes at present, but the issue was explored in detail in Commission White Paper on Insurance Guarantee Schemes (COM(2010)370).

Recital 141 of the Solvency II Directive (Directive 2009/138/EC) calls for "harmonised and adequately funded insurance guarantee schemes".

Executive summary

Many Member States do not have an insurance guarantee scheme that indemnifies consumers if their insurer is unable to pay out for a valid insurance claim. As a result, cross-border shopping for insurance is risky, and consumers are likely to be put off by the lack of clarity about the applicable protection if they choose a provider in another Member State.

An EU-wide Insurance Guarantee Schemes Directive which mandates the establishment of such a scheme in every Member State would raise consumer protection standards in many parts of the EU, and bring the protection of insurance policyholders in line with similar standards under the DGSD and the ICSD.

Supporting relevant and verifiable empirical evidence

The European Commission's own White Paper noted in 2010 that only 12 out of the then 30 EU-EEA Member States operated an Insurance Guarantee Scheme.

Measured in terms of gross written premiums, one third of the entire EU-EEA insurance market is not covered by any IGS in the event of an insurance company going bankrupt. Some 26% of all life insurance policies and 56% of all non-life insurance policies are unprotected. This is particularly concerning in light of unpredictable weather patterns which could force many insurance companies to go bankrupt in a worst-case scenario.

Suggested remedies

The Commission should bring forward a legislative proposal for an Insurance Guarantee Schemes Directive, to ensure that consumers in every Member State can rely on redress being available if their insurer is unable to

pay out a valid claim. The Directive should provide Member States with the flexibility to set their own compensation limits above a minimum EU-wide threshold.

4. Extending EU disclosure requirements to pension products

Directive(s) and/or Regulation(s)

Directive 2014/65/EU on markets in financial instruments, recital 89

Regulation 1286/2014 on key information documents for packaged retail and insurance-based investment products, article 2(2) and article 33(2)

Draft Insurance Distribution Directive (COM(2012)0360), article 2(4)

Executive summary

Recent EU legislation has made significant improvements to the disclosure of investment costs to retail investors, enabling them to make a better judgement of the value for money they are receiving.

However, the exclusion of particular pension products from the scope of the relevant legislation - MiFID II, the IDD and the PRIIPs Regulation - limits the effectiveness of these new requirements, as pension products may be one of few long-term investment products purchased by a majority of EU citizens.

Costs have a significant impact on retirement income drawn from pension products, and greater transparency is needed to allow consumers and their representatives to ascertain whether they are receiving value for money. The disclosure requirements under MiFID II / IDD and the PRIIPs Regulation should be extended to pension products at the earliest opportunity.

Supporting relevant and verifiable empirical evidence

MiFID II does not apply to pension products as these are seen as IBIPs (recital 89). These are covered by the IDD, which in turn explicitly excludes them from its scope (article 2(4)).

Moreover, the PRIIPs Regulation in article 2(2)(e) states that the Regulation will not apply to personal pension products.

This is a significant exclusion from the new investor disclosure regime created by these laws. In the UK alone, the continued decline of company final salary schemes and the impact of automatic enrolment mean that many more people, possibly over 12 million by 2018, will be regularly contributing to “defined contribution” (DC) pension schemes, in which the final pension pot depends largely on the level of contributions and net investment returns achieved by asset managers. These schemes will not be covered by the new transparency requirements of MiFID II, the IDD or PRIIPs. In addition excluding the proposed pan-European personal pension scheme (ref: *https://eiopa.europa.eu/Publications/Consultations/EIOPA-CP-15-006-Consultation-paper-Standardised-Pan-European-Personal-Pension-product.pdf*) from the new investor disclosure regime will make it more difficult for consumers to make an informed choice in a very complex market as there will be different regulatory regimes for different types of personal pensions (PPPs) within individual Member States.

Cost opacity in relation to pension products matters greatly. Over extended periods, apparently small differences in the cost of investing can make a material difference to the value of individuals’ long-term savings. The UK Department for Work & Pensions found that, over a working lifetime, a 1% annual charge could slice the value of a pension pot by a quarter. Fees and commissions substantially reduce performances of pension products, especially for personal “packaged” pension products. Similarly, Better Finance concluded that charges defrayed against pension funds are often complex, opaque and far from being harmonised between different pension providers and products.
(*http://betterfinance.eu/fileadmin/user_upload/documents/Research_Reports/en/Pension_Report_2015_Edition_For_Web.pdf*)

Moreover, the exclusion creates an uneven playing field and opens up possibilities for regulatory arbitrage. It allows manufacturers to game the system as regulatory requirements for personal pension products are lower than for other retail investment products. As the Commission itself noted in its proposal for the PRIIPs Regulation, personal pension products “often compete with the other products under this Regulation and are distributed in a similar way to the retail investors”.

Suggested remedies

Under article 33(2) of the PRIIPs Regulation, the European Commission must consider whether to include pension products in scope of the Regulation by 31 December 2018. Given that the issues with cost opacity within the asset management industry are well known - coupled with the clear potential for regulatory arbitrage and distortion of competition created by the exclusion of PPPs - the Panel would urge the Commission to act earlier and ensure a consistent legal approach to all retail investment products.

Similarly, we believe the IDD should cover personal pension products to avoid a discrepancy in the regulatory treatment of such products by manufacturers under PRIIPs and distributors under the IDD.

These legislative changes would ensure that the disclosure of all costs and charges related to pension products would have to be disclosed to retail investors, enabling them to judge value for money and compare products.

D. Rules giving rise to possible other unintended consequences

No response to question 15

14. Risk

1. Regulatory arbitrage due to lack of alignment between MiFID II and the IDD

Directive(s) and/or Regulation(s)

Directive 2014/65/EU on markets in financial instruments

Insurance Distribution Directive (COM(2012)0360) as adopted by the Council and Parliament, article 24 (awaiting publication in the Official Journal)

Executive summary

The types of investment products covered by MiFID II and the Insurance Distribution Directive are largely substitutable, but MiFID II has stricter provisions on investor protection. As a result, the Directives create an unintended risk of regulatory arbitrage that incentivises firms to add an insurance element to their investment products to be subject to the less strict regime under the IDD.

Supporting relevant and verifiable empirical evidence

There is a significant lack of alignment between the investor protection provisions of MiFID II and the IDD. Most investment products are covered by MiFID II, with the exception of insurance-based investment products, which are covered by the IDD.

The types of investment products covered by both Directives are largely substitutable, but MiFID II has stricter provisions on investor protection, such as cost disclosure and restrictions on inducements. As a result, the Directives create an unintended risk of regulatory arbitrage that incentivises firms to add an insurance element to their investment products to be subject to the less strict regime under the IDD.

To prevent regulatory arbitrage, it is important that requirements for investment intermediaries are the same under both MiFID II and the IDD. Otherwise firms, driven by commercial incentives, will opt for the regulatory regime that presents the least barriers.

Unfortunately, this alignment between the two Directives has not yet been achieved. This misalignment manifests itself most clearly in the treatment of commission and inducement for independent intermediaries. Article 24(7)(b) of MiFID II prohibits independent intermediaries from accepting commission payments, but this ban is missing from the IDD as agreed by the European Parliament and the Council.

Article 24(9) of MiFID II requires intermediaries to disclose the 'existence, nature and amount' of commission received prior to sale. This enables the customer to make a judgement about whether the commission is of such a nature that it would impair the ability of the intermediary to act in the customer's best interest. However, it is unclear at present whether the final IDD would require disclosure of the amount of commission received by the intermediary for insurance-based investment products.

While the draft IDD in article 24(7)(c) refers to 'any third-party payments' to be included in the costs and charges to be disclosed, by default the costs will be presented as an aggregate figure, meaning the customer would only see the amount of commission if they specifically requested an itemised breakdown.

Furthermore, the draft IDD stipulates in article 24(10) that any commission paid for investment-based insurance products must not have a 'detrimental effect' on the quality of the service. However, this is clearly a lower standard than which applies to commission for distribution of other types of investment products under article 24(9)(a) of MiFID II, where it must actively 'enhance the quality of the service'.

Lastly, there is no mandate for EIOPA to set clear legal standards for the disclosure of all costs and charges, unlike the mandate for ESMA to do so under MiFID II. This means that individual firms will be able to decide what costs should be included in this disclosure requirement: this is likely to lead to wildly divergent and incomparable disclosures. It also fails to recognise the incentive for firms to hide costs to make their products seem more attractive.

Suggested remedies

The IDD should be reviewed at the earliest opportunity to amend those provisions that apply to insurance-based investment products which diverge from the standards set for other types of investment products under MiFID II. This should include in particular the same test for the permissibility of inducements, a ban on commission for independent intermediaries and a mandate for EIOPA to develop with ESMA a delegated act on cost disclosure.

2. Regulatory arbitrage with enforcement of EU law

Directive(s) and/or Regulation(s)

Regulation (EC) No 2006/2004 on consumer protection cooperation.

Executive summary

Financial service providers may perform their activities throughout the EU, either through the establishment of a branch or the provision of services, based on a single authorisation (passport) issued by the competent

authorities of the home Member State. While we understand the idea behind is to facilitate the single market for companies, passporting in its current form presents serious challenges for consumers.

Supporting relevant and verifiable empirical evidence

Passporting may cause regulatory arbitrage, where companies obtain the passport in a country with lower consumer protection requirements, and then operate in all other Member States. And because those companies are being supervised by their home state competent authorities, consumers in other countries where companies operate may find themselves unprotected in case of incidents, such as mis-selling, low-quality advice, fraud, and company bankruptcy. And in case of a problem, out-of-court redress bodies of the consumer's country are not competent to address the consumer's complaint.

Suggested remedies

The Commission should to take steps to ensure EU legislation is appropriately enforced in each member state and that redress and compensation can be consistently applied, so that consumes can purchase products across borders with confidence.