23 February 2024

FSUG Opinion on Value for Money in Retail Investments

Background

The Financial Services User Group (FSUG) welcomes the ongoing legislative and supervisory works aiming to improve the 'Value for Money' that retail investors obtain from their packaged retail and insurance-based investment products (PRIIPs). The FSUG argues that ensuring retail investment products are effectively designed to increase the financial wealth of investors should be amongst the primary obligations of product manufacturers, and it should be amongst supervisors' core duties to ensure that investment products which consistently fail to fulfil this basic purpose are eliminated from the market. A truly consumer-centric approach to designing and supervising PRIIPs must start with acknowledging that their primary function is to increase the purchasing power of savings, that is, provide significantly positive real net returns to investors.

The FSUG wished to stress that the assessment of the value for money offered by PRIIPs to investors is much more than yet another regulatory innovation from the European Commission (EC). As the European Insurance and Occupational Pensions Authority (EIOPA) remarked in its Supervisory Statement on Value for Money, the requirement to assess whether an insurance-based investment product (IBIP) is aligned with the objective, needs and characteristics of its target market is enshrined in the Insurance Distribution Directive's (IDD, Directive [EU] 2016/97) Product Oversight and Governance (POG) requirements since 2016. The same requirement applies to packaged retail investment products distributed by investment firms under MiFID II (Directive 2014/65/EU).

The FSUG shares EIOPA's analysis that this requirement to align a product with the objective, needs and characteristics of its target market should logically lead to eradicate products that offer poor value to investors:

> *Considering that no target market has as its objective receiving poor value, it is clear that unit-linked products which offer poor value are not aligned with the objectives of any target market and should therefore not be marketed to consumers." (European Insurance and Occupational Pensions Authority, 2021, p.5)*

The FSUG, therefore, supports EIOPA's ongoing work on Value for Money assessment in unit-linked and hybrid life insurance market. However, the FSUG shares the EC's view that the regulatory and supervisory framework applicable to retail investment products must be consistent across the various types of products, regardless of their legal nature (life insurance, investment fund shares, etc.).

The requirement for product manufacturers to assess the Value for Money offer of their products should therefore be implemented in a horizontal, harmonised, retail investor-centric manner across all relevant pieces of EU legislation, including MiFID and IDD, as proposed by the European Commission. All firms that intend to market retail investment products to consumers should be held equally accountable for the quality of these products.

The concept of “Value for Money”

Ongoing policy debates at the EU-level as well as in Member States and other jurisdictions (see e.g., Financial Conduct Authority, 2023, p.16) reveal the varying, sometimes conflicting, views that stakeholders hold about the concept of “Value for Money”. The notion generally refers to the relation between the various costs and charges that investors have to pay (the “Money”) and the various benefits they obtain from their investment in a PRIIP (the “Value”). For the retail investment market to effectively serve the interests of retail investors, that relation should be balanced: the costs of the product must be proportionate to the benefits the investor derives from it. The FSUG, therefore, supports EIOPA’s view that:

> *unit-linked products offer value for money when costs and charges are proportionate to the benefits (i.e. investment performance, guarantees, coverage and services) to the identified target market as well as reasonable, taking into account the expenses born by the providers. (European Insurance and Occupational Pensions Authority, 2021, p.3)*

Beyond this general and rather consensual view that costs and benefits should be balanced, assessing whether retail investment products offer Value for Money requires further defining the two terms of the equation: What costs and charges ought to be included in the assessment? And how are the benefits to be measured?

As regards the costs, an investor-centric approach necessarily implies including *all* costs and charges borne by the investor, whatever their denomination, method of calculation or way in which the investor pays them. From the investor’s point of view, it is crucial to have a clear picture of what the total cost of their investment is.

Defining the “benefits” term of the equation is less straightforward. The range of products offered by investment firms and insurance companies across Europe presents a seemingly infinite number of combinations of investment options and features, offering retail investors a variety of financial and non-financial benefits. How a particular investor values a given combination of benefits depends on a combination of factors specific to that investor that define whether or not they belong to the product’s target market: Two investors with different personal and financial situations will not assign the same value to a same product. This is what makes the appropriate identification of a product’s target market a crucial step in the Value for Money assessment.

“Target market”: A key notion

The identification of an appropriate target market for the product is, then, a crucial step of the product development process, on which hinges the ability of the product to deliver value to the investors who buy it.

At a minimum, the FSUG believes, product manufacturers should determine the following characteristics of any product’s target market: - Objectives, demands and needs, which should in particular take into account the time horizon of the investor in relation with the purpose of their investment (e.g., pension savings for an individual in the early years of their career); - Knowledge and competence, in particular the target investor’s ability to understand the risks related to the product; - Level of risk tolerance, which, again, should take into account the target investor’s time horizon, and their ability to accept short-term risk of financial loss in exchange for higher long-term returns; - Financial situation, including current income and incompressible expenses, savings and potential existing financial investments. From a retail investor perspective, product comparability is essential to ensure more competitive financial markets and therefore better products.

In its 2020 “Approach to the supervision of product oversight and governance”, EIOPA reminded manufacturers of the necessity to identify the target market with a level of detail corresponding the degree of complexity of their products:

> *While for simpler, more common products, the target market can be identified with less detail (which should reflect the characteristics of the target market), it is expected that the target market for more complex products or less common products is identified with more detail, taking into account the*

> *increased risk of consumer detriment associated with such products. (European Insurance and Occupational Pensions Authority, 2020, p.11)*

In short, the more complex a product, the more developed its features, the more detailed the sketch that the manufacturer should draw of the investor to whom they intend to sell the product, and the more detailed the justification of why these complex features answer the objective, needs and characteristics of this investor.

Value for Money risk

As EIOPA notes, "the main risk of a pension product is the risk of not reaching the individual's retirement objective" (European Insurance and Occupational Pensions Authority, 2020, p.2), an assertion that can be extended to all retail investment products. From this perspective, value for money risk should be understood as the risk that an investment product does not answer the needs and objectives of the individuals it is sold to. In other words, it is the risk of a mismatch between the product's features and what the investor asks and needs. It can arise from the product including features that are unnecessary and thereby increase the costs to the investor without bringing any added value, from the product's design *not* including specific features that would have been necessary to answer the investor's needs, or simply from the product and its features being over-priced for the value that investors can derive from them.

Value for money risk is, unfortunately, an all too actual risk that investors are facing. As EIOPA noted in its 2021 "Cost and Past Performance Report":

> *unit-linked products which are not designed in a customer-centric manner continue to be a prominent area of concern, with competent authorities reporting a number of issues, such as: high complexity, mis-selling, mismatches between actual returns and customers' expectations. (European Insurance and Occupational Pensions Authority, 2021, p.3)*

That is why the FSUG stresses the urgency to enhance regulatory and supervisory requirements regarding product oversight and governance for retail investments, and fully supports the remark made by EIOPA in its supervisory statement on value for money that:

> *[t]he pricing process should evidence that each product feature delivers value for money in line with the needs, objectives and characteristics of the target market. (European Insurance and Occupational Pensions Authority, 2021, p.7)*

Assessing the Value for Money in retail investments

Key objectives

The FSUG believes that any value for money regulation and supervision system should pursue three main objectives: 1) Ensuring that the features of each product match the characteristics of its identified target market and that each product is distributed exclusively to its target market. 2) Prevent product manufacturers from charging undue costs, which by definition constitute an illegitimate and unlawful transfer of wealth from investors to financial intermediaries. 3) Eliminating products involving unjustified or disproportionate costs for the investor, which by design reduce or even nullify the value that investors can expect to derive from their investments in terms of future purchasing power.

The FSUG believes that were the European market for retail investment products equipped with a regulatory and supervisory system enabling to achieve these three objectives, it would result in better investment returns for consumers, spurring a higher degree of retail participation in European capital markets, which is, in turn, sorely needed to improve European SME's access to funding and accelerate the transition towards an environmentally and socially sustainable economy.

There are multiple ways to concurrently pursue these three objectives. In the remainder of this paper, the FSUG will comment on two sets of concrete proposals, namely those that the EC has put forward as part of its Retail Investment Strategy, and those that are part of ESMA and EIOPA's parallel and independent workstream on value for money supervision.

Value for Money in the Retail Investment Strategy: A horizontal approach

Due vs. undue costs in fund management

The FSUG welcomes the Commission's proposals to introduce in EU legislation—in UCITS and AIFMD—clearer, more explicit criteria to determine whether costs are due or undue. Clear and precise rules are essential for implementation by fund managers, but also to enable effective supervision by competent authorities and private enforcement when fund holders seek redress for fund managers charging undue costs.

Nevertheless, the FSUG notes that the proposed criteria need to be further refined, through regulatory technical standards (RTS) as proposed by ESMA (European Securities and Markets Authority, 2023, pp.9–14), to become truly enforceable, and market participants—fund managers and holders—to be provided with supervisory guidance for the practical implementation of these criteria. For instance, the FSUG believes it necessary to further elaborate on the meaning of the requirement that costs are "in line with disclosures", to clarify the criteria that should be used to determine that a cost is "borne by investors in a way that ensures fair treatment of investors" as well as how far fund managers can stretch the notion that a cost is "necessary for the [fund] to operate".

Without further specification, not only are fund managers facing legal uncertainty in the management of their funds, but retail investors are left exposed to the risk that the manager adopts such a restrictive interpretation of the notion of "undue costs" that they are left without any possibility to obtain reimbursement for these costs. Furthermore, the substantial room for interpretation left with the EC's proposed criteria could hamper the uniform implementation of the UCITS and AIFMD legislation across the EU, potentially leading to regulatory arbitrage and, *in fine* consumer detriment on a large scale.

Product approval and pricing processes

The FSUG welcomes the proposals to strengthen the product approval processes already required for manufacturers of PRIIPs under the current versions of MiFID and IDD, and to introduce such a process for fund managers in UCITS and AIFMD. Requiring that product manufacturers conduct a sound product approval process is crucial to ensuring that those products are distributed to the right target market. In this regard the FSUG calls on the EC, as well as on ESMA and EIOPA, to further refine the requirements applicable to the identification of a product's target market by its manufacturer, to the regular review of the target market characteristics, as well as the requirements for distributors to ensure that the product is effectively distributed only to clients who belong to the target market. This step of the product approval process is essential to avoid consumer detriment since, as established earlier, the value of an investment product depends heavily on the characteristics of its target market.

The introduction of a formal requirement to identify, quantify and justify all the costs borne by the retail investor for the various parts of the retail investment product and related services —i.e., a pricing process— is the *conditio sine qua non* to establish fair competition across providers, enable retail investors to make informed investment decisions and eliminate products that, by design, fail to offer value to investors. In this sense, the establishment of a horizontal requirement to list, quantify and appropriately justify all costs is key to "building retail investors' trust in capital markets" (see European Commission, 2020, Action 8) and must ensure that all costs are accounted for, in particular inducements and other commissions transferred from product manufacturers to distributors.

The FSUG supports the view that the results of all the steps in the product approval and pricing processes—including comparisons to relevant benchmarks, see below—should be made available to competent authorities, but also to the general public. Making this documentation available to the public would constitute a guarantee of transparency and enable independent studies of the European market for retail investment products.

Benchmarking requirement

The FSUG equally welcomes the introduction of a requirement for product manufacturers and distributors to compare the products they offer or intend to offer to retail investors to a benchmark. We believe that systematically comparing a product's mix of costs and performance to an external benchmark can greatly contribute to identifying problematic cases, starting with products that are so poorly designed that they cannot bring any value to consumers.

Such a screening of the retail investment market is urgently needed, since, as EIOPA notes in relation to life insurance:

> *unit-linked products which are not designed in a customer-centric manner continue to be a prominent area of concern, with competent authorities reporting a number of issues, such as: high complexity, mis-selling, mismatches between actual returns and customers' expectations." (European Insurance and Occupational Pensions Authority, 2021, p.3)*

The EC's proposals to delegate to ESMA and EIOPA the task to develop benchmarks for products falling in their remit undoubtedly makes sense, considering the specificities of the various product categories that must be taken into account. The FSUG also considers appropriate the approach consisting of establishing a benchmark per category of products sharing similar characteristics, that is, comparing a product to its 'peers' on the market. The FSUG also supports the proposal to create benchmarks that will combine indicators on costs and on performance, considering that high costs are only an issue when they come with poor performance. Performance, in turn, should be measured primarily in terms of the financial benefits investors can expect to obtain from the product: while non-monetary benefits can add value to product, we shall remain conscious that the primary purpose of an investment product is to provide a positive return on investment.

The FSUG however notes that the timeline resulting from the EC's proposal to set up a functional benchmarking system is very long: before the requirement can be effectively applied, the Omnibus Directive must be adopted, giving ESMA and EIOPA to draft the delegated acts specifying their respective methodologies, which in turn must be adopted by the EC, giving ESMA and EIOPA a legal basis to collect the necessary data to calibrate the benchmarks.

The FSUG remarks that, at least for the unit-linked and hybrid life insurance market, EIOPA is already moving forward with its methodology to create Value for Money benchmarks (see European Insurance and Occupational Pensions Authority, 2023), on which the FSUG comments below.

Beyond a comparison with similar products, however, the FSUG believes that the performance of investment products should also be measured by two external yardsticks: the performance of capital markets, and inflation:

- **Capital markets**: PRIIPs are, ultimately, vehicles for retail investors to invest their savings in capital markets; product manufacturers should therefore assess and report on the performance of their products *vis à vis* the average performance of the markets they invest in. For instance, the manufacturer of a unit-linked life insurance contract investing in European equity should compare the performance of their product to that of a pan-European stock market index.

- **Inflation**: Although it is beyond the control of fund managers and PRIIPs manufacturers, assessing the value offered by retail investment products cannot ignore "the substantial impact of inflation on consumers and their investment outcomes" (European Insurance and Occupational Pensions Authority, 2023, p.5). From an investor's perspective, a product that does not manage to at least preserve the value of their investments against the eroding effect of long-term inflation does not provide any value: preserving the purchasing power of one's savings should be the baseline requirement of any product design. That is why the FSUG believes that the performance of retail investment products should be regularly assessed against inflation (calculating the product's net returns in real terms) over their recommended holding periods.

EIOPA's and ESMA's work on Value for Money

In parallel to the ongoing legislative works on the Retail Investment Strategy, EIOPA and ESMA has been developing their own supervisory approach to Value for Money, on the basis of the existing MiFID and IDD product (oversight and) governance requirements, and the existing prohibition to charge undue costs under UCITS and AIFMD. The parallel though independent works arose from a common understanding, which the FSUG shares, that "aspects related to value for money are already embedded in the IDD [and MiFID] albeit implicitly" (European Insurance and Occupational Pensions Authority, 2021, p.3), and that their effective implementation requires the development of a harmonised approach to assessing the value for money offered by retail investment products.

On the issue of undue costs, the FSUG supports, as already mentioned, the proposals put forward by ESMA to further refine the criteria for considering that costs are due through RTS.

In the realm of insurance-based investment products, EIOPA has developed proposals for a methodology to assess the value for money of unit-linked and hybrid products (European Insurance and Occupational Pensions Authority, 2022) as well as a methodology for the creation of Value for Money benchmarks for these products (European Insurance and Occupational Pensions Authority, 2023).

The FSUG generally supports the three-layered approach that EIOPA suggests for NCAs to supervise the value-for-money offer of unit-linked and hybrid insurance products: 1) A high-level analysis of the market based on common indicators of costs and performance available in documents such as the KID, market data collected at the national level, or Solvency II retail risk indicators. This first step would enable NCAs to identify which products in their jurisdiction need to be urgently subject to enhanced supervision. 2) Enhanced supervision would imply the collection of more detailed qualitative and quantitative information about individual products, including a "profitability test", to determine whether a product presents a "value for money risk" for its target market. 3) A supervision of the manufacturer's implementation of product governance requirements, to identify the source of the mismatch between the product and its target markets' needs, objectives and characteristics.

The FSUG also generally supports EIOPA's proposed approach to define value for money benchmarks, albeit with some reservations. The FSUG agrees, as already mentioned, with the idea that products should be clustered based on their essential features, and with the proposal to use a set of indicators to assess both costs, performance and potential additional benefits. The FSUG, however, stress that the proposed methodology needs to be further refined, features and indicators further specified, before all market participants can reach a common understanding of the methodology.

Finally, while EIOPA judges that, at least in the initial phase of the benchmarking exercise, the benchmarks should not be disclosed to consumers, the FSUG believes that disclosure of this information is essential to empower consumers in their investment decisions: the benchmarks would provide them with a set of reference points to assess the costs and performance of the various products offered to them. While the FSUG understands EIOPA's warnings about the potential complexity of such benchmarks and its wish to stabilize the methodology before disclosing its results to consumers, the FSUG warns against a paternalistic attitude towards consumers that would postulate their incapacity to understand information and calls on EIOPA—and ESMA, when it starts developing its own benchmark—to work in parallel on the creation of the benchmarks themselves and on the best way to communicate these to consumers. This work should go hand-in-hand with works on an overhaul of the KID for more readability, intelligibility and comparability to which the two authorities, we expect, will contribute greatly.

About FSUG

The Financial Services User Group (FSUG) was set up by the Commission in order to involve users of financial services in policy-making. Composed of 20 members, the FSUG represents the interests of consumers, retail investors, and micro-enterprises on national and EU levels. More details you can find at: Financial Services User Group (FSUG) - European Commission (europa.eu)

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