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Regulatory Department

European Commission Discussion note

on Value for Money

ESBG position

ESBG welcomes the intentions of the European Commission to seek views among stakeholders on how the retail investor protection framework might be enhanced through the development of a Value for Money (VfM) approach. Nevertheless, it should be made clear that this approach cannot work as a *one-size-fits-all* under the entire product governance requirements.

A Value for Money approach is already implemented but might be further improved. Therefore, we would like to answer the following questions with the aim of explaining why this approach should focus mainly on products distributed under investment advice, if at all.

In order to prevent a distortion of the competition between manufacturers, the concept will need to be fine-tuned, taking into account the potential regulatory increasing costs of bureaucracy, calculation and daily reporting obligations. The new regulatory regime should also contribute to diversify the supply. As it is well known, a broad range of manufacturers and products is essential to guarantee a competitive offer.

Questions for discussion

1) Would you agree with the assessment that certain products that are offered to consumers do not offer Value for Money?

We do not pretend to have a view on the whole market offer. However, the existing regulatory requirements should prevent this. Indeed, there are already current requirements under product governance to address the performance of products and their costs and charges. These are implemented through various measures taken by the manufacturers and distributors. Please find some examples below:

- During the product approval process the manufacturer is supposed to ensure that the products generate value for the investor. For instance, for structured products, PRIIPs performance scenario including costs is supposed to demonstrate the value for money for the investor and to compare similar products. Of course, the manufacturer cannot give a “guarantee” that a derivative investment product will perform positively – these are the immanent risks of capital market products, about which the investor is informed in detail during the investment advice process or when purchasing the product without investment advice as a self-decider.

- It is examined whether the cost structure is suitable for the target market. This is relevant, among other things, when determining the investment horizon, as part of the target market.

- The products are reviewed on an ongoing basis in accordance with the supervisory and regulatory requirements. If a product does not perform as planned, it is reviewed to determine whether it needs to be modified (e.g. the underlying asset in the case of certificates or the investment strategy in the case of funds) or even whether sales should be discontinued.

At the level of the distributors, a check is already carried out during the investment advice process as to whether the distributor also offers equivalent products to the product which is intended for recommendation. If this is the case, the product with lower costs must be recommended or a justification must be given as to why the product with higher costs is recommended. The provisions in this regard result from the requirement in Art. 54 (9) CDR (EU) 2017/565 (while ESMA`s guidelines on suitability assessment contain further details how to comply with the requirement):

“Investment firms shall have, and be able to demonstrate, adequate policies and procedures in place to ensure that they understand the nature, features, including costs and risks of investment services and financial instruments selected for their clients and that they assess, while taking into account cost and complexity, whether equivalent investment services or financial instruments can meet their client’s profile”

In addition, Art. 54 (11) requires for the distributors, when recommending switching investments, that advisors have to ensure that the benefits of the switch are higher than the connected costs (for which ESMA has foreseen further requirements in new guidelines on suitability assessment).

Value for money is also about all included services provided by the producers and the distributors, whether to ease execution, to give some context, to offer digital tools to clients, as well as receiving target advice by specialists along their life, for free.

Should the legislator conclude that the current regulations are not sufficient, the existing requirements should be clarified as part of the Retail Investment Strategy.

Any VFM, should it be introduced at all by way of new rules, must not lead to an additional layer of highly detailed and potentially inflexible methodology-based regulation that in practice replaces the manufacturer risk-based business decisions (on the product features) or the customer’s essential investment choice (on the underlying market risk).

If yes:

a) how significant a problem would you consider this to be?

Most capital market products are derivative products or investment vehicles (OPC,…), which may have higher risks than vanilla products, but also allow for higher returns. Some of them might have a lower performance when reviewed ex post due to several factors, such as unexpected events at the global level or markets move against the anticipated hypothesis. In these cases, the broadly presented risks of derivative products (i.e. in the PRIIPs KIDs) manifest themselves. However, the negative performance of a product does not mean that the product in question did not have an adequate risk-return profile when it was designed.

For this reason, we would like to warn against taking a retrospective view when assessing the aspect of value for money (ex post evaluation). The evaluation must always refer ex ante at the time of the product conception or the product approval (ex-ante evaluation) taking into account the current and expected market conditions.

One of the most valued services our members provide to their customers is the personalised investment advice that a human will offer and that currently no digital tools can replace. This service is particularly valuable for non-wealthy investors who need to be able to ask any open questions, that can't all be planned in advance. Usually, the discussion will go far beyond what the regulation is requesting. To do so, our members consider the circumstances of each client, analysing personal indicators such as the financial situation, discuss, provide with clarity and pedagogy for the client to understand its risk profile, experience in financial instruments, investment objectives and needs.

Our members analyse these and other elements to offer investment proposals tailored to the situation of each customer, acting in the clients' best interest. Thanks to this approach, clients can build or adapt their investment portfolio with the combination of products that meet their goals and risk-appetite. Digital tools cannot yet fully replace a discussion with a human being.

b) for which products/market segments is this problem particularly relevant?

We do not see any problems with any specific products or market segments where special problems occur. On the other hand, we really see the added value of all the tools we make available to support client's investment decisions.

However, we would like to point out that investors with a low-risk appetite may require products that involve higher manufacturer efforts and lower returns (by introducing safeguards). Examples include products with capital protection or the offering of mixed funds (consisting of shares and bonds), which are more difficult to manage than, for example, a pure equity fund.

2) How should the concept of "Value for Money" be framed? In particular:

a) Which criteria should be used for an assessment of VfM?

Today, manufacturers already carry out comprehensive inquiries of the costs of their products in order to inform investors (i.e. in the PRIIPs KIDs), so that meaningful data is available on costs and charges. But the client may have other considerations like the horizon of investment of a piece of their savings, the level of security…. so it is not possible to only take figures into account.

The investor is usually interested in the most attractive possible return. The future return of a product cannot be predicted when it is launched.

Therefore, the focus should be on product-immanent aspects that increase the probability of good performance or on precautions to reduce risks as far as possible. These include, for example, active fund management, capital protection, the careful selection of underlying in structured products, or an adjusted risk-return profile. Product designs that relate to the pursuit of non-financial objectives (such as the pursuit of sustainability aspects) also constitute added value for the investor.

If quantitative aspects are nevertheless deemed necessary, the EU legislator could leverage on the specifications of the PRIIPs Regulation for calculating the performance scenarios to be used as a basis in this regard (which, however, are themselves to be improved as part of the Retail Investment Strategy). No new or even different methodology for determining performance should be developed for the value for money test, but rather the improved specifications of the PRIIPs Regulation for determining the performance scenarios should be used.

b) How should costs and performance be measured and compared?

With regard to the costs' comparison, a relatively granular approach is required to compare the level of costs between relatively similar products and based on compliance within an acceptable range of products or an explanation. Otherwise, a costs comparison will lead to misallocations if certain positive features of one product are not taken into account and thus the supposedly cheaper product is recommended with priority ("comparison of apples with oranges"). This would run counter the interests of investors.

When calculating product costs, the focus should be on the costs calculated on the basis of statutory requirements (e.g. according to the PRIIPs Regulation or MiFID II).

When comparing the "value", the above-mentioned problem arises that no statement on future performance is possible for any financial products. Thus, what can be analysed is the possible level of revenue in a reasonable statistics scenario against the level of costs.

In view of the impossibility of forecasting future performance, the product features mentioned under a) (e.g. active fund management, any capital protection, careful selection of underlying in the case of structured products, an adjusted risk/return profile or the pursuit of sustainability aspects) should be used to measure the "value" of the product.

The guiding principle on the side of manufacturers thus essentially needs to be whether the level of cost of a product is still within a normal competitive range or is so excessive that it would amount to usury in civil law terms.

c) Which cost and performance benchmarks could be relevant as tools for comparison?

As far as costs are concerned, it makes sense to focus on the costs calculated in accordance with the statutory requirements. We are not aware of any benchmarks in this respect and the challenge is to capture similar products to allow a relevant comparison. In relation with performance, a benchmark could help to demonstrate the alpha value of a product compared with passive investment but not in itself determine stand-alone the value for money.

With regard to the determination of the "value", we refer to the problems mentioned above under paragraph 2 (a).

d) In particular for IBIPs, how would you apportion and assess the value of the insurance/guarantee component in the overall VfM assessment?

This insurance risk component coverage is based on mortality references backed by the public sector level to which a technical margin is incorporated. It cannot be compared as such with other capital guarantees. It is per se a feature embedded in the product which can be compared to, the same feature in similar product, a piece of the global value for money.

e) Should the above definition be further refined and/or be adapted to take into account the different PRIIPs?

The proposed definition is in itself well suited for a high-level description of the approach. Nevertheless, we would like to suggest the following clarifications:

- it is important to realize that the clarification envisaged at level 2 is paramount. Here, the specific requirements are set, so that the relevant specifications must be carefully determined and comprehensively consulted (public consultation) in order to avoid regulatory missteering that would be detrimental to investors.

- The focus should be added that manufacturers should base their calculations on the product costs calculated in accordance with the legal requirements under MiFID II and the PRIIPs Regulation.

- The expected return (risk adjusted net potential/possible return or loss) cannot be forecasted. Instead, the focus should be on product-immanent aspects that create added value for the customer.

- It should be made clear that manufacturers can refer to their preparations for implementing the requirements for reviewing their products in accordance with the Product Governance.

f) How should manufacturers and distributors ensure that their products continuously meet VfM standards after having been sold to their clients?

As part of product governance, there is already an obligation to review products as long as they are offered to investors. In this course the manufacturer examines how the product has developed and what conclusions are drawn from this for the future launch and distribution of the product (change in the product concept or even discontinuation of the product, change in the target market or distribution strategy, etc.).

For example, in the case of a fund that is not performing as anticipated and is also performing poorly in a market comparison, one would examine whether the investment strategy should be adjusted or even whether distribution should be discontinued.

In addition, increased complaints to the manufacturer or related feedback from distributors (e.g., as part of reporting on target market deviations according to product governance) will also be included in the decision on whether to continue the product.

Research evaluations are also often taken into account in the review process.

3) Scope

a) Should the VfM requirement apply to all investment products?

This requirement needs to be carefully assessed as it might not be relevant for some asset classes, like cash equity.

b) Would you see any challenges and if so, which?

The main challenges are:

- How to cluster similar products in terms of potential net remuneration versus costs, how to assess and recognize globally the value for money for very diversified clients' investments at a portfolio level and not only at a product level?

  In the case of truly comparable products (equivalent products), a cost comparison based on the costs calculated in accordance with the statutory requirements makes sense. But as mentioned it is complicated to have truly comparable products as usually different features are embedded in them: level of guaranteed capital, liquidity…; the risk is to not value these features enough when just focusing on the comparison of the level of costs, and to be detrimental to the diversity of the offer.

- With regard to another aspect of the value, there is the problem, mentioned several times, that future performance cannot be predicted. In this respect, performance cannot be a meaningful criterion for measuring the value of an investment product. In this respect, the focus should be on the features of the products that can create added value for customers and remain as simple as possible.

4) What would be the advantages/disadvantages to further develop/clarify the VfM concept in level 1 and level 2:

a) at a general level (duty to act in the best interest of the client)?

Further clarifications at Level 2 could help to ensure consistent practices across producers and distributors in the EU.

b) at the product governance and oversight (POG) stage?

It seems appropriate to locate some of the requirements in the product governance.

c) at the distribution stage (notably requirements in relation to advised services)?

It seems appropriate to locate some of the requirements at the distribution stage for products eligible for investment advice to retail clients.

5) If applied at the advice stage, how extensive should the obligation of the advisor be in relation to the VfM assessment:

a) should the advisor be able to base their assessment on the information provided by the product manufacturer?

Yes, the product related aspects must come from the manufacturers who know their products best (that would be in line with current legislation, see recital 12 of the PRIIPs Regulation: "*PRIIPs manufacturers — such as fund managers, insurance undertakings, credit institutions or investment firms — should draw up the key information document for the PRIIPs that they manufacture, as they are in the best position to know the product.*"). In addition, as part of the assessment of VfM, all services provided to clients and embedded in the cost of the products, need to be considered.

b) should the advisor provide a justification to the client as to how the range of suitable products or the recommended product can be expected to offer value for money?

No, as product comparisons are based on very technical aspects, investors will hardly be able to understand statements in this regard. In our view, this piece of the value for money test should comprise internal arrangements of distributors that are not communicated to customers. This would be in line with the current concept of product governance, which also concerns specifications for the internal processes of manufacturers and distributors that are not communicated to customers. With regard to the embedded services, the features and the costs of the products are already communicated to clients. There is room for improvement to get a clearer and more simple information for the clients to be revised during the RIS.

c) should the advisor be under obligation to propose only the product that offers best value for money from their range of products?

There is no product offering the best VfM per se, as it needs to take into account the objectives and needs of client. We would like to point out that in order to provide the best Value for Money, the adviser would need to assess the global portfolio as well as the personal circumstances of each client including indicators such as the financial situation, risk profile, experience in financial instruments and investment objectives.

d) should the advisor compare the outcome of the VfM assessment for a recommended product with a broad range of investment products available on the market?

No, this would not really be possible in practice.

- There are too many products (in Germany 1.8 million) and the product comparison would therefore be endless.
- The distributor is dependent on very detailed manufacturer information in order to make a meaningful product comparison.
- The value for money is a combination of characteristics of comparable products at reasonable costs given its potential performance, and the embedded services delivered to the clients, which matches as best as possible its needs, this, at the time of the investment.
- The comparison could only be possible between similar products.
- The distributor needs information and other support services from the manufacturers that are tailored to the respective advisory processes (such as additional product information, explanation on sustainability features, internal risk indicators or similar aspects). These tailored support services will only be available for actively offered products from manufacturers with which the distributor has a close relationship. It will therefore not be possible for the sales office to advise on any product on the market if it wants to ensure a high quality of advice. Urging the distributor to offer products from manufacturers that do not provide tailored information on their products would lead to worse quality of the advice as several aspects cannot be discussed with the investor.
- In addition, the distributor might have additional selection criteria to take into account when choosing a manufacturer e.g. ESG criteria (exclusion policy), reputation, etc.

Therefore, for all the points we stated above, the distributors cannot offer all the available and similar products on the market.

6) What would be the key impacts (including costs and benefits – one-off and recurring) of the above suggested changes on:

The real outcome is ensuring the quality and the competitiveness of the offer and the service delivered to the client more systematically. But the VfM process needs to remain reasonable as this is adding a cost for the end-clients that needs to remain proportionate to the delivered value.

a) Manufacturers?

In theory manufacturers are already supposed to kill products with undue cost and build a competitive offer. This regulation should allow a more systematic approach throughout EU.

Depending on how VfM is implemented it could entail very high and ongoing costs for manufacturers. The high expenses could lead to a smaller product range (abandonment of certain product types), which would not be in the customer's interest.

b) Distributors/advisors?

Depending on how VfM is implemented it could entail very high and ongoing costs for distributors/advisors.

c) Retail investors?

For investors, the increased focus on VfM can lead to (slightly) more favourable products being recommended to them when they are available.
However, a careful determination of the legal criteria as well as a detailed consultation of the market participants is therefore indispensable to avoid misguided decisions and preserve the clients' interests.