BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

BETTER FINANCE's answers to DG FISMA's Discussion Note on Value for Money

Would you agree with the assessment that certain products that are offered to consumers do not offer Value for Money? If yes: a) how significant a problem would you consider this to be? b) for which products/market segments is this problem particularly relevant?

To begin with, BETTER FINANCE firmly suggests providing clear definitions for key concepts, as is the present case for *value for money*. On it hinges the qualification of "evidence", i.e. whether products deliver or not *value for money* to the customer.

In our view, value for money incorporates *suitability* or *appropriateness* of a product with a client's profile (knowledge, needs, investment horizon, risk tolerance), but it goes much further. As explained in our earlier exchanges, Value for Money (VfM) should be designed as a fundamental safeguard for consumer protection[1] building on the already existing safeguards, i.e. the alignment of the product with its target market (*suitability/appropriateness*) and the general duty of care (*act in the best interests of clients*). With this in mind, VfM must bring the standard of consumer protection higher, which is ultimately a goal that must be pursued through all Union policies by virtue of Art. 38 of the EU Charter of Fundamental Rights.

To illustrate through an example, a product whose annual expense ratio exceeds the average return and inflation of its peers is highly unlikely to deliver positive real net returns, thus it may be suitable for the client, but not in its best interest and certainly will not deliver value for money.

There is extensive research available, including BETTER FINANCE's,[1] proving that there are many savings and investment products offered to individual investors that do not deliver VfM. A clear example is the quantified case of the French market for unit-linked life insurance contracts highlighting the difference in cost and returns between products distributed under the commission-based model and those under execution-only services (no "inducements").

From the available data and research it seems that most of retail investment products do not offer VfM. The study[2] commissioned by the European Commission drew a grim picture detailing the obstacles retail investors face when seeking financial advice or wanting to buy an investment product. For instance, in the debate between passive, index-linked exchange traded funds, which closely track the performance of markets that most active funds consistently underperform, the findings of the "mystery shopping" analysis provided in the abovementioned report evidenced that these low-cost options were rarely proposed by "human" advisors but almost exclusively by robo-advisors. To the latter finding, BETTER FINANCE adds that, most probably, this is due to the lack of "commissions" paid by ETF manufacturers: given that all "inducements" need to be "clawed back" through the form of ongoing charges, and the price competition in the ETF market is fierce, this type of investment is rarely proposed by "non-independent" advisors.

However, this 2018 study was limited in its findings by the very restricted availability and comparability of costs and charges of the retail investment products (therefore mostly focusing on investment funds which represent only 8% of EU households' financial savings).

The problem is particularly relevant for the biggest segment of retail products by far: IBIPs, then funds (both UCITS and AIFs) and structured products.

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[1] Real Return of Long-Term and Pension Savings report 2013-2021 editions, available on BETTER FINANCE's website under Research Papers – https://betterfinance.eu/publications/research-papers/?tx_category=pensions; see also BETTER FINANCE's Study on the Correlation Between Cost and Performance in EU Equity Retail Funds (May 2019), available at: https://betterfinance.eu/publication/study-on-the-correlation-between-cost-and-performances-in-eu-equity-retail-funds/; See also BETTER FINANCE's Evidence Paper on the Detrimental Effects of "Inducements" https://betterfinance.eu/publication/better-finance-evidence-paper-on-the-detrimental-effects-of-inducements/,

[2] 2018 Study on the distribution systems of retail investment products https://ec.europa.eu/info/publications/180425-retail-investmentproducts-distribution-systems_en

The continuous lack of Value for Monday as regards the long-term savings and pension products is particularly concerning, please see the BETTER FINANCE's research on the real return of long-term and pension savings. As inflation continues to hit new records, timid increases in interest don't constitute effective measures, only slightly deviating policymakers from their overarching policy of 'debt relief through inflation'. Financial Repression exploits the cognitive bias of "money illusion" - the tendency of people to think of money in nominal, rather than real, terms.

And the previously referenced research by BETTER FINANCE over the last 10 years has shown that the real returns (after costs and inflation) from private pension funds have been negative in several EU Member States. If one adds a soaring inflation since 2021 into the equation, and the symbolic interest rate hikes will barely make a difference, with the purchasing power (real value) of EU citizens' savings further plummeting. European savers are now looking at a real loss of value of about €1 trillion or more for 2022 alone.

2) How should the concept of "Value for Money" be framed? In particular:
a) Which criteria should be used for an assessment of VfM?
b) How should costs and performance be measured and compared?
c) Which cost and performance benchmarks could be relevant as tools for comparison?
d) In particular for IBIPs, how would you apportion and assess the value of the insurance/guarantee component in the overall VfM assessment?
e) Should the above definition be further refined and/or be adapted to take into account the different PRIIPs?
f) How should manufacturers and distributors ensure that their products continuously meet VfM standards after having been sold to their clients?

BETTER FINANCE proposes to improve Value for Money rules as a **tentative proxy to "ensure bias-free advice"**, following four main objectives (or factors) to be considered.

A. Target market adequacy

The stated investment objective in the mandatory key disclosure documents must be aligned with narrower categories of "retail" investors. General approaches (e.g. "*fund aims to provide capital growth*[3]") should not be allowed. In this sense, the PRIIPs Regulatory framework (Levels 1 and 2) should be amended.

B. Cost legitimacy

EU rules must be much clearer and enforceable in relation to the prohibition to charge "undue costs" in UCITS. To begin with, this prohibition should be extended across the entire spectrum of "retail" investment products (PRIIPs scope), starting with alternative investment funds:

- the European Commission should establish that all costs must be correlated to a clearly identifiable service, which must directly amount to objective of the service/product;
- second, it should set-up a list of services that can be charged accompanied by a legal assumption that all other services fall out, except where duly justified.

The Level 2 implementing or delegated Commission Regulation, based on technical advice received from the European Supervisory Authorities, should specify the criteria that would help the latter, as well as national competent authorities, to enforce these rules:

[3] taken from the KIID of an actively managed fund (from BETTER FINANCE's research)

- for instance, the UK FCA (annual value review, 2021[4] and 2022[5]) states rightly that an "active" product must mean a product that aims at over performing its investment universe or benchmark;
  - for this it charges higher fees than for example passive funds who merely replicate the performance of their investment universe or benchmark;
  - however, if the active product is actually performing like the benchmark or worse below the benchmark for the RHP or more than its "active" fee level is not justified.
- The French securities markets supervisor (AMF) will recommend the same[6] but only the first case: for active funds that perform actually like their benchmark (closet indexing) but not below[7];

These rules should include the most problematic cases (such as unit linked IBIPs which are growing fast currently).

C. Cost competitiveness

Value for Money must make the existing rule consistent across retail investment products (apply to all PRIIPs, not only to MiFID products) at level 1 (amendment to PRIIPs (EU) Regulation).

Evaluate cost compared to equivalent products: Total costs must be reviewed against competitors and ensure that deviations are justified by additional services (already existing rule in MiFID L2 "*assess, while taking into account cost and complexity, whether equivalent investment services or financial instruments can meet their client's profile*" – Art. 54(9) MiFID II DA). The FR AMF is including in its "doctrine" (May 2022) for ISPs to do precisely that regarding index funds.

In relation to the EU Commission's proposals presented in the Discussion Note on the Value for Money, we wish to make the following particular comments:

- "*clearly identify and quantify all costs and charges*" - implies to thoroughly revamp PRIIPs rules: we need comparable ACTUAL costs and performances of product AND of its benchmark like we could with the UCITS KIID, but not with the PRIIPs KID: PRIIPs Levels 1 and 2;
- "*ensure that costs and charges are not undue and are proportionate to the expected risk adjusted return; this aspect might be measured against relevant benchmark*" – it should not be proportionate to the return (how to calculate? what does proportionate mean?) but instead to the investment objective and management style (e.g. as per the UK FCA: if active it means the objective is to over perform the product's investment universe/benchmark; If it does not achieve this over the recommended holding period and is close or below the benchmark, then it should lower its fee); see also AMF upcoming change of "doctrine " on this issue.
- we stress the rule specifying "*assess, while taking into account costs, whether equivalent financial instruments can meet their client's profile*" (EU 2017/565 art.54.9); also consider making it clearer and clearly mandatory for ISPs in level 1 (upcoming AMF position on passive funds will require ISPs to do exactly that); e.g.: ensure that there ar no equivalent retail investment products (in the sense of the PRIIPs Reg) that are less costly and can meet their client's profile;
- for IBIPs – there is a need of a prominent warning of the little value of long-term capital guarantee in nominal terms.
- Advisors, when recommending products, should be required beyond existing requirements to more explicitly consider the costs and expected performance (i.e. the cost efficiency).

[4] https://www.fca.org.uk/publications/multi-firm-reviews/authorised-fund-managers-assessments-their-funds-value
[5] https://www.thepensionsregulator.gov.uk/en/document-library/consultations/value-for-money-discussion-paper/feedback-statement-on-driving-value-for-money-in-defined-contribution-pensions
[6] https://www.amf-france.org/fr/actualites-publications/actualites/fonds-presentant-des-frais-importants-lamf-met-jour-sa-doctrine
[7] https://www.amf-france.org/fr/actualites-publications/communiques/communiques-de-lamf/lamf-publie-la-synthese-de-ses-constats-sur-les-couts-et-frais-des-opcvm-commercialises-aupres-des

D. Investment management and performance

Level 2: With rare exceptions, all products must be benchmarked against an objective indicator, not peer groups: see ESMA Q&A on the application of UCITS Directive (2019 updates on benchmark disclosures, Questions 8 et seq). The performance must be regularly assessed on that background (see BETTER FINANCE recommendations on performance fees, UK FCA and FR AMF abovementioned policies).

E. Disclosure and reporting

- Investment objectives, actual cost and past performance must be simple, clear, and comparable – issue with PRIIPs KID approach[8]. (PRIIPs Regulation, Levels 1 and 2);
- Review the undue cost rule compliance every year;
- Review pricing every year based on the recommended holding period the past performance versus benchmark (to prevent pricing closet index funds and active funds which have delivered consistent below target / benchmark performance like in the UK funds).

3) Scope: a) Should the VfM requirement apply to all investment products? b) Would you see any challenges and if so, which?

We definitely would like to see the VfM applied to all investment products. We would be quite concerned about the message the it would send to the investors and consumers if it was applied only to selected categories of investment products.

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)? b) at the product governance and oversight (POG) stage? c) at the distribution stage (notably requirements in relation to advised services)?

Differences and lag in implementation at national level will cause regulatory arbitrage, gold plating, and forum shopping. This hampers the development of the Single Market for Financial Services and creates uneven playing fields between jurisdictions.

The VfM requirement could be set out in the relevant legislation at level 1, while more granular technical specifications (possibly including benchmarks against which VfM would be measured) could be developed in level 2.

Nevertheless, **the key provisions should be set through a Level 1 regulation** (co-decision), and not through implementing acts (Level 2) or soft law (Levels 3/4). At least the current level 1 rules on undue costs and on comparing costs of equivalent products should be extended to all retail investment products (PRIIPs) and clarified in level 1. That is the prerequisite to help ESAs and NCAs to implement it as Value of Money should be enforceable.

Regulatory strategy: minimum vs maximum harmonisation EU law should be clear in its formulations or criteria to be further expanded by national supervisory authorities, the EU Commission should choose maximum harmonisation at Level 1 through an EU Regulation, with further implementing details to be set at Level 2 (COM DA) based on ESMA technical advice.

Some of the proposals form the Discussion Note should be avoided as they are not practical, too vague and very difficult to translate into clear criteria (e.g. "*make sure that the costs are proportionate compared to market standards (taking into account expected performance and risks of the product*").

- What does proportionate mean ?
- What are "market standards"

[8] BETTER FINANCE's response to the ESA's Call for Evidence on the PRIIPs Regulation https://betterfinance.eu/publication/better-finances-response-to-the-esas-call-for-evidence-on-the-priips-regulation/

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?

In our view, the information received from the product manufacturer as part of the product oversight and governance (POG) process is already mandatory but not enough to assess value for money. We reiterate that there is already a key requirement in the distribution architecture that the distributor does its own assessment, in addition to that provided by the product manufacturer, to determine to whom in particular a product is *suitable* or *appropriate* for. In this light, **VfM must go further than the mere *suitability* or *appropriateness* assessments**, essentially boiling down to the target market identification. In our view, two situations should be distinguished: first, if the product is new (launched), then the distributor must also assess against its peers to evaluate how it is intended to perform, particularly from an asset allocation, investment strategy, and costs point of view (already required by Articles 9 and 10 of the Commission Delegated Directive (EU) 2017/5932 - MiFID II Delegated Directive); second, if the product is not new, the key requirement is to evaluate whether the asset manager has met its stated investment objectives in the past.

The second will be, unfortunately, impossible after the retreat of the UCITS Key Investor Information Document (KIID), the last pre-contractual disclosure that will show actual cost and past performance versus the povider's benchmark.

In addition to the above, we draw to our recommendations under Question 2 above: those factors must be taken into consideration by the distributor in order to assess, pre-contractually, if the product is cost-efficient vs; equivalent product.

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?

Yes, the advisor should be required to 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. However, in order to not increase the administrative (compliance) burden, it would be useful to prepare standardised *Value for Money* report templates, having also the benefit of being easier to read and engage with by clients and to supervisor by competent authorities.

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

To begin with, the advisor is already obliged to propose only products that are suitable for the client. Thus, if it narrows down to a range of products that are suitable or appropriate, but only some can deliver value for money (or have the vocation to do it more than others), then we believe it follows from the already existing obligation (Art. 24 MiFID II, Art. 17 IDD) to recommend only the "best" products out of the available range.

However, we should not confuse with the hypothesis that the client exercises a different choice or preference to what was recommended, case which is already present today. In that sense, we believe ESMA's Level 3 guidelines should be: (i) changed and (ii) given legal enforceability. The investment firm should not be allowed to refuse to distribute a different product than that recommended, but the client should expressly consent that it understands the risks of choosing a different product than the actual investment recommendation and that the said product is not the best suitable or appropriate option for the client according to the evaluation done by the distributor.

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?

First, as explained above, the very essence of the VfM assessment and report would be based on a comparison with a broader range of products available on the market. Second, in line with our recommendations under Question 2 and point a) of Question 5 above, the analysis of *Value for Money* must take into account both the peer group of the product and other similar/equivalent products, including those of a different nature.

To illustrate through an example: if a client wishes to make an investment, the peer analysis would not be confined between investment funds only, but should also extend to investments options that are similar to investment funds in terms of holding horizon, volatility, e.g. an ETF.

It is essential that EU law incentivises distributors to exit the "product" paradigm to which the commission-based model has shifted thinking and practices in the market: there is more to investments than packaged products, and non-professional clients should be able to subscribe with any advisor or seller to other investments than funds or life insurances.

6) What would be the key impacts (including costs and benefits – one-off and recurring) of the above suggested changes on: a) Manufacturers? b) Distributors/advisors? c) Retail investors?

For retail investors, the key impact would be a significant improvement in the allocation of financial savings, investment returns, and ultimately in the trust placed in financial intermediaries. Our explanations span over the concept of *mis-selling* and poor Value for Money, which create a wide range of detrimental effects.

In reality, forcing distributors to assess and report Value for Money will, inevitably, broaden the range of potential investment options for retail clients, diversify, and generate better outcomes for the investment journey.