# Serving the interest of retail investors: towards a complete ban on inducements

*Statement by Theodor Kockelkoren, Board Member of the AFM, at an informal Q&A session hosted by members of the Europarliament and organized by Finance Watch and CEPS on 18$^{th}$ of September 2012 in Brussels.*

The topic of investor protection is a vital element both for investors as the industry. Investors may shy away from markets and the industry will have a hard time regaining trust if investor protection is not adequately embedded within the financial sector. The AFM welcomes the discussion of today and expresses its gratitude for the invitation to today's hosts and organizers.

Although the range of topics that can be addressed is broad, I have chosen to focus on two central topics: inducements as well as the cost levels in the industry.

**Inducements**

A total ban on inducements is said to decrease to offered product range and limit competition, to decrease the quality of advice and to increase cost of asset accumulation for the investor. At least, that is what we can hear from the industry groups. The AFM thinks this picture is not correct and actually the opposite will be closer to the truth. That is why we strongly support a complete ban on inducements, which will serve the long term interest of both the industry and its customers.

Let me start by discussing the claims made by the industry. Subsequently I will summarize the benefits of a complete ban on inducements.

***First of all, a ban will reduce the offered product range and limit competition. We think the contrary will be true: a ban will open up the market for all those, often low cost funds, now not paying inducements. We think the current trend of simplification in the offering for the convenience seeking investor will continue, irrespective of a ban on inducements. We also think that for investors valuing choice, banks cannot afford to maintain or go back to expensive house funds, because of increased competition.***

There are actually two trends going on: one of simplification and one of offering choice, i.e. a wider range of products. Let me elaborate first on the trend towards simplification. Banks typically have different offerings for the mass market retail customers and the affluent private banking customers. In their mass market operations, increasingly banks are simplifying matters both for customers seeking convenience. For these customers a number of banks offer a limited number of life cycle funds. Each of these funds is tailored to a specific range of risk appetite and investment horizon of customers. Customers who wish to limit their risk are put in a different fund than customers willing and able to take bigger risks. Depending on the investment horizon of the customer a fund is advised that automatically rebalances the asset classes as the investment horizon draws closer.

Banks operating in this way have reduced the number of funds for those customers that value convenience. Market research shows that the customer segment in the market favoring convenience is over half the market. In the eyes of these customers the reduction in the amount of products on offer is seen as a benefit. And let it be noted: this development has not been the result of regulation banning or limiting inducements.

There is a second trend showing financial institutions targeting a different customer segment with a wider choice of products. This is a customer segment that is growing increasingly critical on the quality of the product offering as well the advice provided by the industry. The crisis has catalyzed this development tremendously, one of the positive effects of this crisis. This customer segment typically does favor choice. Banks have responded ensuring to offer a wider range of products for these customers. Also, they have scaled down their marketing machines that previously launched new investment funds on every hot investment trend. They are increasingly tending the quality of their portfolio, realizing they cannot sell on an investment trend, yet they have to show performance.

Indeed, the crisis has exposed many funds and quite some portfolio managers as underperforming the market by a wide margin. This not only has enhanced the critical voice of investors, but has also increased the demand for passive investment products. Unfortunately, many investors have no easy access to these type of products. Why? Because these products typically do not pay inducements. For this reason they are cheaper and for this reason they tend not to be (or not prominently) on the shelves of banks.

Currently there are several bigger fund houses who privately indicate they are thinking about the merits of starting their own distribution. Customer behavior as well as technology is increasingly enabling distribution through platforms using either third party advise or self-assisted advise applications. Potential innovations in this direction are hampered by the inducement system, which gives the advantage to the large distributing banks, who in the rather concentrated European banking landscape determine the terms of distribution. Any fund house now musing a direct distribution strategy runs the risk of being pushed to the least attractive shelf space. Innovative new players have a difficult time entering the market as they are not able to negotiate an advantageous rebate.

A ban on inducements would therefore increase the competitive forces, effectively limiting the risk that banks would retrench to expensive house funds.

***I am now coming to the second claim of the industry: a ban will lead to a reduction in the quality of advice. On this point too, we think the opposite will be true. The introduction of a mandatory product approval process to ensure the quality of the products on offer, will be important to stimulate this development.***

Currently, advisors are working in a framework that favors house funds and values sufficient sales levels. Investigations we have conducted over the years show that even in a full open architecture model the amount of house funds in portfolios is large. Also, in portfolios often times products in which the bank itself has large stakes can be found in significant proportions. Mystery shopping has revealed that in the mass market segments customers tend to be advised certain fund categories irrespective of their stated risk appetite or investment objective. In the more affluent segments, reveal that the same customer is sold portfolios with very different risk and return profiles at different institutions. Regularly we receive informal signals from advisors complaining about the environment within their institutions which is not conducive to putting the interest of their client first.

The above makes clear the quality of advice currently requires serious attention. In this respect, it is important to note that in the current regulatory framework some of the above practices are allowed within limits. Beyond these limits regulators can and should enforce the duty of care stipulations in Mifid.

A ban will free the bank advisor to fulfill the implicit promise and put the interest of their customers first: the pressure to advise the high rebate funds will disappear and well performing, low cost funds will prevail to the detriment of the low performing , high cost house funds. New lower cost house funds will be introduced. Naturally, this will not change overnight. Institutions will have to adapt.

Therefore, the introduction of a mandatory product approval process will stimulate banks and product providers to critically assess their product offering and stay away from retrenching into high cost, often time lower performing house funds. Again, the regulator has an important role to play here as well.

***The third claim the industry makes, is that the cost of serving customers will go up after introducing a ban. We think a ban will facilitate the mass market segment to be served not by expensive bespoke advise, but by simple yet effective confection. This development will neither reduce quality nor increase price.***

It is said that a ban will imply that customers with small portfolios will have to start paying more than they currently do, i.e. the cost of portfolio management will go up. And yes, currently the system implies large cross subsidization between customers of which they are not aware. This subsidization will be ended by a ban. Whether this means cost levels will increase can be doubted.

Currently, most customers receive bespoke advice. This can't be right. Customers with smaller portfolios just want solid confection for a fair price. They do not want the private banking approach translated into the mass market. Banks currently have only a limited incentive to improve the service offering. And new, smaller players with new service models have difficulty gaining market share. So yes, if small customers are made to pay the bespoke price for advice, the price would go up. However, if an appropriate service concept is implemented the price actually will go down. Naturally, the implication of this is the large distributors will generate less income than they currently do with the rebates. And indeed, current rebates levels across the EU are well over 20 billion euros annually. So there is something at stake.

**<u>Cost levels</u>**

***Finally, there is something else at stake, far more important, both to the industry and its customers. If the industry is to regain trust they have to increase their focus on their customers and to reduce cost levels. The cost levels from the perspective from the investor are high and very damaging to the future capitals intended for pension, mortgage down payment or other objectives.***

It is striking how little discussion is spent on costs. This topic is the most pernicious in the investment industry, because it is a sleeping topic and because the cost levels do their damage slowly and in stealth.

Costs are typically not seen by investors, whether disclose is soft or hard. Research the AFM conducted in the Netherlands shows that 50% of customers have no idea of the cost level associated with their investments. The customers that do have an idea, most of the time do not have the full picture. To add insult to injury, when hearing cost levels, such as 2,5% annually, they shrug, as they think it a very small number. This is consistent with the fact that most people are not able to understand and apply the concept of interest on interest.

The mistake made by customers of not seeing the large impact of costs, is a very costly one. Retail investors in Europe have 4200 billion euro under management. Banning inducements will mean that investors end up with roughly 840 billion more after twenty years (in other words: they will have 9240 billion instead of 8400 billion). Accessing cheaper investment alternatives, as a result of the inducement ban, would increase the capital again with a similar amount. The price of not banning inducement can therefore conservatively put at least 1700 billion euros. A price paid by retail investors.

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Concluding, a complete ban on inducements will enable retail investors to access low cost funds such as ETFs. The ban will remove the root cause for biased investment advice. The ban will also increase competition and innovation between advise and service models. By implementing a product approval process requirement for product originators as well as distributors, the risk of banks retrenching into high cost, low performing funds or structured products can be mitigated sufficiently.