Regulation is changing the distribution landscape

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The distribution of asset management products in Europe has been at the centre of debate since the launch of the Single European Act. Besides ensuring a common framework for financial products across Europe, the concept of sound advice on asset management products has been, and is, a core concern. The key question is: how can regulators ensure that clients receive quality advice when taking investment decisions?

Recent regulatory developments relating to asset management products, in particular the notion of advice, are further aimed at changing the European distribution landscape for the benefit of the consumer; but seem to be accompanied by some far-reaching unintended consequences.

Regulation for the better

Before analysing current and upcoming changes, it is worth reflecting on the key developments that have occurred since the freedom of services act was applied to financial services (insurance, banks and mutual funds) in the European Union.

At the outset, the European Union chose to regulate products rather than distribution itself, as the landscape was deemed too diverse to find real convergence. As an illustration, the distribution of financial products in the United Kingdom has always relied on traditional independent financial advisors, while banks and mortgage institutions have played a very limited role; this is very similar to the United States model inherited from the Glass-Steagall Act[1].

On the other side of the spectrum, banks have always played a central role in continental Europe. In France, for example, consumers traditionally seek advice from their banks when saving. Such practice is common across continental Europe, even if it varies across countries, e.g. in Sweden the insurance sector has historically played a much larger role. As a consequence, the European Union did not regulate the distribution model but instead focused on products, leaving the oversight of distribution to local regulators and governments. What altered the European landscape was the impact of the UCITS product directive, which proved to be an important catalyst in changing the distribution of asset management products. Indeed, with the exception of the UK where the importance of the independent financial advisor community allowed open architecture and supported multiple asset management boutiques, the rest of Europe was characterised by the distribution of in-house products manufactured within internal asset management units.

The UCITS product directive was fundamental as it created, for the first time, a single framework for a European product and opened the door to cross-border distribution. Suddenly, distribution to 350 million citizens became possible, creating potential economies of scale for non-bank owned asset managers whether of European, U.S. or any other origin. Although banks or insurance companies remained reluctant to propose such external solutions, the existence of financial advisory networks in Germany and Italy, and later in France and Belgium, allowed competition to flourish. Eventually this pressure became so strong that banks had to start offering third-party products, increasing the quality of the solutions offered to consumers and improving the impartiality of their advice.

It was in the middle of this wave of open architecture that the triad (Council, Commission, and Parliament) decided to expand their policies and build a common framework for advice. The MiFID directive introduced new regulations, notably covering advice across Europe. The measures encompassed establishing a risk profile for each investor, rating products according to their level of complexity and risks, developing a suitability test approach and defining key transparency requirements on products and incentives. The directive applies to all players, whether banks or investment firms, with the noticeable exception of the insurance sector.

Regulators were clearly aiming to unify advice practices across Europe. The result was greater competence of financial advisors and improved protection of retail investors by setting some important new standards. It encouraged independent advisors to join forces to create larger investment firms capable of challenging the major banking institutions.

1 The Glass-Steagall Act separated commercial banking and investment banking. As a result, the distribution of mutual funds and securities came to be performed by independent brokers. The strict separation was lifted under the Clinton administration.

As a consequence, the landscape today is quite different from that at the time the freedom of services act was established, but it has been a slow evolutionary process:

- The Nordic and German banks as well as insurance companies are still leading distributors. However, the IFA and wealth management sectors have developed strongly. This is largely thanks to consolidation, which was necessary to accommodate the growing burden of compliance and regulatory costs
- The French market retains a bank distribution model, where concentration has reduced the number of players to five large institutions. Despite this, the financial advisor community has been growing. One positive consequence is the support that has been provided to the creation of boutique asset managers, which did not exist a decade ago
- Southern Europe has experienced a shift in distribution from the traditional banks to networks of financial advisors. This is largely due to the recent crisis, and has favoured foreign asset managers providing non-domestic products
- The United Kingdom has only been minimally affected by European regulation; the launch of the Retail Distribution Review (RDR) has had a greater impact

Without a doubt, regulatory development has favoured further competition and fostered the development of better advice for the end consumer. This is despite the fact that distributors continue to receive commissions from the product manufacturer for their activities, a business model similar to insurance distribution.

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More regulation—for the better?

With the financial crisis bringing the global economy to the verge of collapse, European governments took charge of the necessary strengthening of the financial regulatory framework. It almost goes without saying that excesses needed to be addressed with structural reforms.

The Commission has undertaken many different initiatives, including the European supervision framework (EBA, ESMA, etc.), MiFID review, EMIR, CRD III and IV, AIFMD, UCITS V and ECB banking supervision. Not all of these measures have been ratified, let alone implemented, but it is undeniable that major structural reforms have been or are being introduced. It is also noticeable that the asset management industry and in particular its mutual fund business, already subject to one of the most stringent regulatory regimes in Europe[2], has been further subject to increased scrutiny.

When so many new regulations come into force, the risk of implementing overlapping and contradictory rules cannot be ignored. To all intent and purposes it is almost impossible to perform the necessary impact analysis, thus increasing the risk of unintended consequences. Some of the measures will alter the European distribution landscape for financial products, and in addition, individual countries have launched local initiatives, making the regulatory environment even more complex.

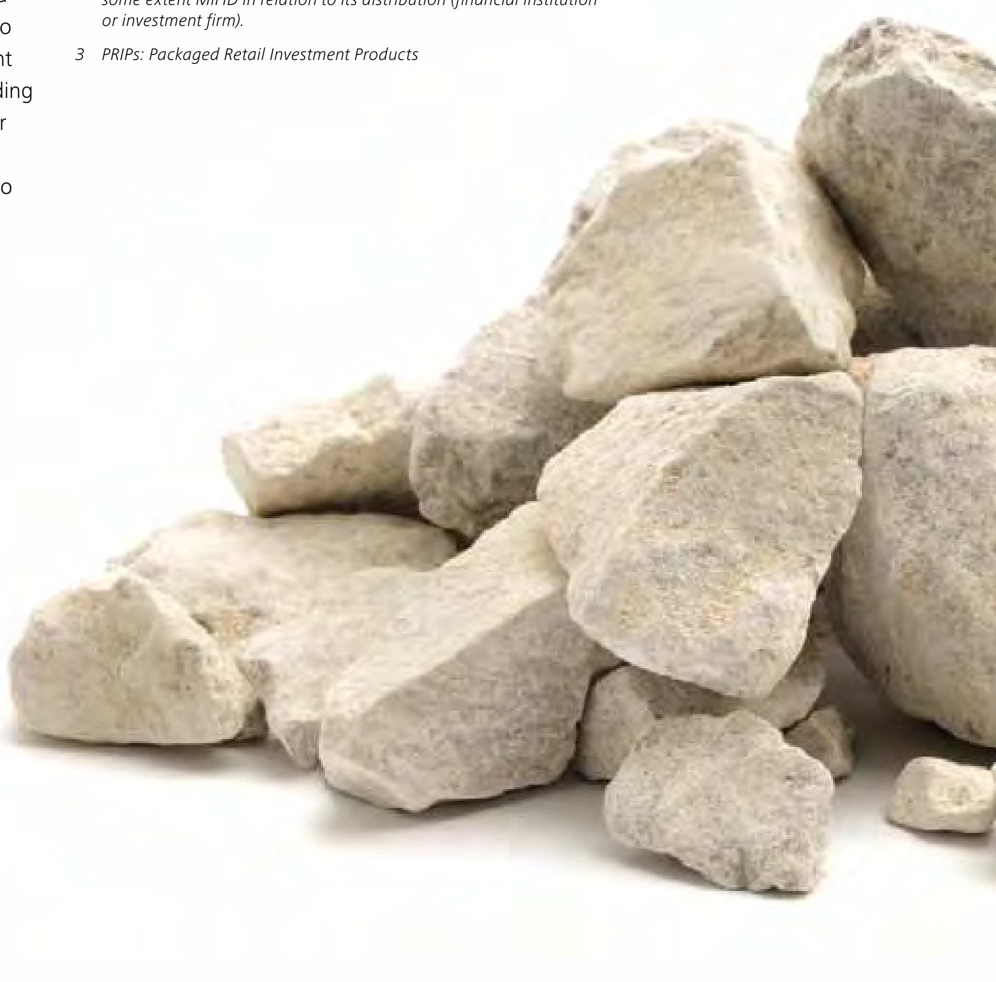
In particular, the distribution of mutual funds, and its related incentives structure, has been the target of the FSA in the UK, with the RDR, or the AFM in the Netherlands, with the imminent ban on retrocessions.

When it comes to the financial crisis and the regulation of asset management products in particular, the initial reaction of distributors has been to become extremely risk averse. The first indication is that large banks have been focused on counterparty risk, not within asset management products but in relation to promoters. As a consequence, financial institutions have stopped working with asset management boutiques, instead favouring relationships with large players demonstrating a solid financial base. The aim is to limit the reputational risk and costs associated with the selection of asset management products, by privileging large brands. As a result, some of the more innovative asset management boutiques have had to cope with a lower asset base meanwhile absorbing the costs associated with new regulations. The result is that they are therefore either withdrawing from the market or merging with other firms. On the other hand, banks have prioritised their discretionary business to minimise risks related to advice. This has taken the form of awarding significant assets to well-known asset management brands, leading to very large funds becoming even bigger. Their sheer size and liquidity then becomes a source of potential market risk. There can be no doubt that the barriers to entry have been raised dramatically in the industry. As an unintended consequence, end clients have less choice and could lose out on quality and innovation. Worse still, the potential for market risk/volatility could be set to increase.

Within the wave of regulation, governing bodies have started to put into question the remuneration model for distribution across Europe. A new model has become effective in the United Kingdom and will be introduced in the Netherlands at the beginning of 2014. The rebate discussion has moved on at a European level and now concerns only mutual funds. It is unclear if PRIPs[3] will apply to other financial products, and it seems certain that the insurance sector will not be included (i.e. the insurance sectors will continue to pursue their bundled business model).

2 *To illustrate, the distribution of UCITS is almost subject to dual regulation: the UCITS directives, when it comes to the product, its management company and its passporting rules; but also to some extent MiFID in relation to its distribution (financial institution or investment firm).*

3 *PRIPs: Packaged Retail Investment Products*



While the aim of unbundling pricing for distribution is very welcome as it leads to greater transparency, it has far-reaching side effects:

- For the mutual fund industry it would create an uneven playing field with insurance or structured products; moreover it is difficult to see the justification for the difference in treatment between competing savings products
- It has now become apparent that prices are actually increasing in the United Kingdom rather than decreasing after the first year of the implementation of RDR, as all parties in the value chain are reassessing their fee models and costs
- It leads to the creation of an advisory fee, which might push advisors to churn client portfolios simply to prove that they are pursuing active advice, i.e. core investments run the risk of appearing to be ‘lazy asset allocation solutions’
- It might also strengthen the relative position of the banking sector, which benefits from a holistic relationship with clients, where charging for advice is only one component. For independent financial advisors or wealth managers, it is the only source of revenue and their ability to charge such a direct fee is not yet established. This situation might have important consequences:
    - Retail consumers may choose to no longer receive advice and become self-directed investors; experience tells us this leads to asset misallocation
    - Independent wealth managers, still at the infancy stage in continental Europe, could end up withdrawing from the market, which would further strengthen the power of banks
    - Without a healthy independent wealth management sector, asset management boutiques will not survive. It would be impossible for these players to source their first assets from the banks who favour established brands, three-year track records and funds with large volumes of assets under management

Better for the consumer?

The regulatory agenda is fundamentally changing the distribution landscape in Europe, but this is not a new phenomenon. It is worth remembering that the freedom of services act is at the source of the cross-border asset management industry in Europe. It has allowed the creation of a single market and opened up alternative solutions to the self-manufactured products of banks. The MiFID directive further enhanced the framework with requirements for sound advice when it comes to financial products. The main caveat is that it unfortunately did not encompass the insurance sector.

Post-crisis developments have led to several regulatory initiatives to address excesses in the financial sector. Any financial professional should welcome such action. However, some of the initiatives may lead to unintended consequences when it comes to the distribution of asset management products. The risks are quite significant: privileging remunerative insurance products over investment funds, the disappearance of small asset management boutiques, the concentration of distribution in the hands of large banking institutions, the reduction of choice for consumers, the resurgence of sub-standard self-manufactured products and potentially rising costs for end investors. It is crucial that these risks are mitigated, as some of them may outweigh the benefits of new regulation and could lead to a world where the quality of advice is not improved.

Regulators, and the financial industry itself, must not lose sight of the end client. It is critical that reform is not rushed but considered, to ensure end investors benefit from choice, transparency and simplicity; e.g. alternative measures could require distributors to propose to clients to choose between the bundled and the unbundled pricing approach, thereby empowering end consumers.

Finally, regulation is only one of a number of possible levers available: stakeholders could focus more on education as a way of empowering end consumers to help them make more informed decisions. It is remarkable that children are taught physics and literature but very few European school curricula integrate financial literacy into their syllabus. This is not only true for savings, but also for lending products. Consumers are all too often confronted with making difficult decisions that will have a direct impact on their lifestyle and retirement, without having the necessary education. Financial literacy should start at school, but it is also the duty of the financial and asset management industry to become more active. Sometimes it is down to small innovative entrepreneurs to set a good example. In Spain, independent financial adviser Maria Jesus Soto has written an educational book[4] on investing, with children in mind. The rest of the industry should follow suit, and embrace the challenge that lies ahead.

4 *Mi primer libro de economia, ahorro e inversion*

To the **point**:

- Historically, the European regulatory framework (UCITS and MiFID) has favoured further product competition and fostered the development of better advice for the end consumer
- Recent regulatory developments are however numerous and complex, making it almost impossible to perform thorough impact analysis, thereby increasing the risk of unintended consequences
- Unbundling mutual fund pricing structures to increase transparency, but not doing the same for alternative saving solutions increases the risk of regulatory arbitrage to the detriment of mutual funds
- The resulting fee-based advice might favour banks at the expense of wealth managers and independent financial advisors, which could result in concentration of distribution and lead to less competition, lower quality products, reduced choice and rising costs
- Mitigating these risks goes hand in hand with empowering end consumers in their ability to make informed decisions