

# Enabling Sustainable Savings and Investment Channels in Europe



3rd Interim Report of the  
CEPS-ECMI Task Force on Asset Allocation in Europe

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# Enabling Sustainable Savings and Investment Channels in Europe Opportunities and Challenges

## *3rd Interim Report of the CEPS-ECMI Task Force on Asset Allocation in Europe*

**Cosmina Amariei\***

### 1. Introduction

At a first glance, it appears that European households have a very diverse set of financial products to choose from, such as listed bonds and equities, insurance and pension products, investment funds, structured products. However, policymakers continue to emphasise the need for capital markets to actually deliver on the financial promises made to retail investors. Many bottlenecks still persist, and retail investors do not benefit from the same safeguards as professional and institutional investors. Moreover, generating real positive returns for investment/saving products has proven to be increasingly difficult in recent years given the low yield environment, more competitive market dynamics and evolving regulatory landscape.

When it comes to the sustainability agenda, it is often argued that current asset prices do not accurately reflect environmental and social externalities because of the failure to put in place adequate market mechanisms, regulations, taxation or other policies. A growing body of academic and industry research illustrates that ESG integration can improve corporate financial performance as well as the risk-return characteristics of an investment portfolio. While institutional investors and asset managers cannot explicitly decide on sectoral policies, they can provide powerful incentives for corporates to take the necessary steps in transforming their operations and/or enable changes in their business models.

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This third Interim Report is based on the discussions among the experts present at the Task Force meeting held on 20 March 2018, additional secondary research and targeted bilateral consultations. The views expressed in this report are attributable solely to its author. The main ideas will be considered for the Final Task Force Report, which will put forward a series of policy recommendations supported by in-depth quantitative and qualitative analysis. More detailed and up-to-date information about the Task Force is available [here](#).

## 2. Retail investors

The European savers are and should remain at the core of the CMU project. To this end, a more balanced and diversified allocation of their financial assets is needed. Compared to the US, European households have more than double the amount of their savings in deposits, but only half as much in investment funds and shares. Moreover, due to a variety of reasons – savings rates/net financial wealth, investor preferences/behavioural aspects, market structure and access, regulatory/supervisory frameworks and tax regimes – the composition varies considerably across Europe. Retail capital markets services are also barely developed on a cross-border basis, and this translates into very limited cross-border holdings of financial assets. Against this background, the members of the Task Force explored the following questions:

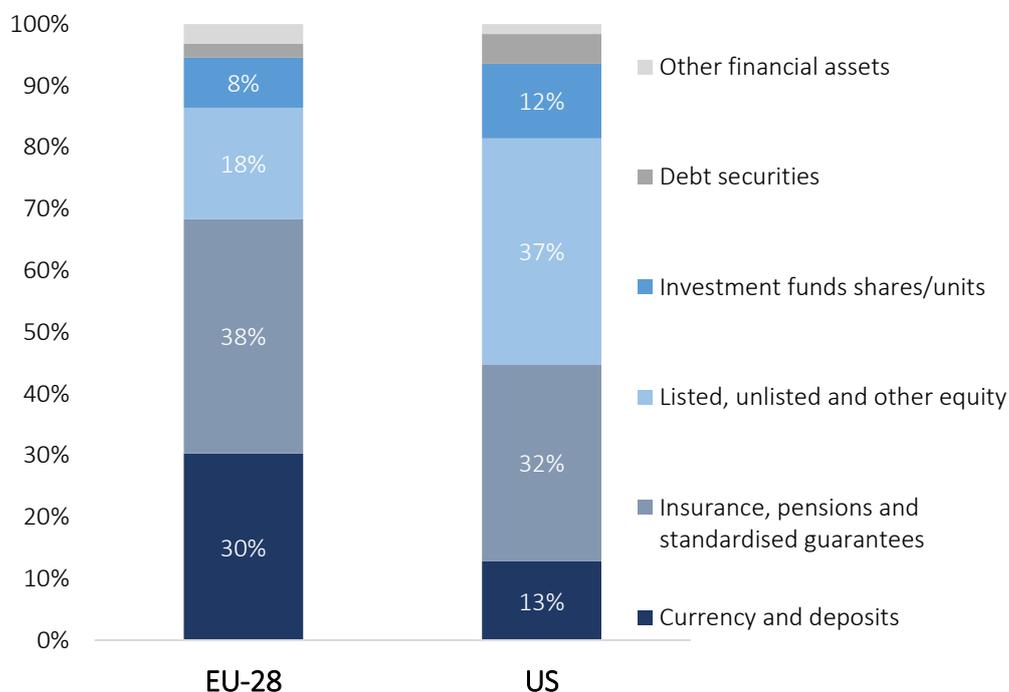
- What are the main factors influencing demand for savings/investment products across Europe? How to foster (in)direct retail participation in capital markets?
- Is the current supply fit for purpose, i.e. products with a rewarding risk-return profile, transparent pricing and cost/fee structures?
- Are the developments in manufacturing, marketing, distribution and financial advice moving into the right direction? How to tackle the lack of financial literacy?
- How effectively are the ESAs and NCAs overseeing the interaction among the different sectoral EU rules affecting retail investors?

### Asset allocation

The financial assets of European households amounted to €35tn in Q3 2017. On average, these savings were held in the form of insurance, pensions and standardised guarantees (38%), currency and deposits (30%), listed, unlisted and other equity (18%), investment funds shares/units (8%), debt securities (2%) and others (3%). The share of household savings locked in currency and deposits is above the EU average in 20 out of 28 member states. In Greece, Cyprus and Slovakia, this is considerably higher (over 60%). By contrast, this accounts for less than 18% in the Netherlands and Denmark, while the lowest share was recorded in Sweden (13.5%). Insurance, pensions and standardised guarantees are the principal financial assets in the Netherlands, United Kingdom, Denmark, Ireland and France. Estonia, Bulgaria, Finland, Sweden and Lithuania exhibit the largest proportional holdings of equity instruments (over 35%) while Luxembourg, Belgium, Spain and Italy in investment funds (over 10%). Malta and Hungary exhibit the largest proportional holdings of debt securities (over 10%) followed by Italy and Austria (over 5%). In Germany, currency and deposits, as well as insurance, pensions and standardised guarantees, are the main category of financial assets (over 35% each), followed by equity and investments funds (around 10% each).

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Figure 1. Asset allocation by retail investors (EU-28 vs US)



Source: Eurostat (Q3 2017) and US Fed (Q4 2017)

Over the last 25 years, there has also been a dramatic decrease in the weight of individuals in the share ownership of European-listed companies. While high risk aversion but also misconceptions about the long-term performance of equity stand out as main drivers for the unbalanced allocation of savings, the lack of direct access or via financial intermediaries (as revealed in mystery shopping exercises) but also dissuasive taxation of dividends and capital gains have significantly contributed to these shifts. Retail private investments should be channelled into real assets by establishing stronger links with the needs in the real economy, such as the increasing funding gap for SMEs. To this end, the extent to which retail investors can easily gain access to illiquid asset classes (e.g. private equity and debt) should also be carefully analysed, i.e. identifying market and regulatory hurdles and what can be done to facilitate this path. Solutions at national level to foster a more 'equity-oriented' investment culture include investment savings accounts and employee share ownership/savings schemes. Some particularities can be observed in France, UK and Sweden where certain products are wrapped in a tax-efficient manner. More recently, equivalent individual savings plans – known as PIRs – have been launched in Italy, carrying a full exemption from 26% income tax if retail investors stay invested for at least 5 years. Asset managers have amassed over €10bn since February 2017. The funds are structured so that at least 70% is invested domestically, in either debt and/or equity. Of this, at least 30% (or 21% of total investable assets) must be in Italian

small and mid-caps not included in the main index (FTSE MIB). PIR funds have also sparked criticism for being high-risk investments and more suitable for institutional investors. At EU level, it was also argued that the PEPP (Pan-European Personal Pension Product) should provide the ideal wrapper for investments in equity and ETFs on a cross-border basis.

### **Retail savings/investment products**

The market structure for retail financial services remains highly fragmented in Europe given the concentration of product manufacturers and distribution channels at national level, less harmonised supervisory approaches and taxation constraints (e.g. burdensome withholding tax procedures). While some national markets already exhibit reasonable levels of competition, this does not hold true throughout the EU. The cross-border supply of retail savings/investment remains limited. But there is also a lack of demand for cross-border services. For example, even though investment funds are likely to be the most integrated segment to be tapped by retail investors, only 7% of total financial assets is allocated to direct holdings of mutual funds. Households also hold such instruments indirectly through investments by pension funds and insurance companies. Currently 70% of total assets under management are held by investment funds authorised or registered for distribution only in their domestic market. Only 37% of UCITS and about 3% of AIFs are registered for distribution in more than 3 member states. In March 2018, the Commission published a package of measures aimed at reducing regulatory barriers to cross-border distribution of investment funds in Europe.

Recent EU-wide desk research shows that investment funds (excluding ETFs) are by far the most widely-available product category on the websites of the distributors analysed – over 75% of all identified products, namely equity funds (32%) followed by bond funds (20%) and mixed funds (18%). ETFs represented about 12%, pension products around 9% and life insurance products up to 4% of all products identified on distributor websites. Generally, availability varies greatly across member states, but it is much more country-specific in the case of ETFs, pension products and life insurance policies. Nonetheless, the mystery shopping exercises revealed that seeking advice from non-independent advisors via banks and insurers remains the norm for the average retail investor in most member states. The products offered are mainly in-house investment funds, with the exception of France where life insurance policies dominate. Independent Financial Advisors (IFAs) in the UK usually propose investing in ETFs on top of investment funds and pension products. To a large extent, financial intermediaries have been constructing *ex ante* portfolio of products (in-house and third-party) to cover the needs of different retail investors. It is widely accepted that MiFID2 will drive rationalisation of product catalogues and distributor lists as a result of the trade-off between coverage, quality and complexity.

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The mass retail investor should be provided with easier access to financial products with stable returns in the long run. For example, the investment savings account (ISK) has reached over 20% penetration among Swedish households over a 5-year period. As a result of cooperation among relevant stakeholders, a comparison website has been launched where multiple providers list their products. Taxation is easy to understand and the management fees are reasonably low. In terms of asset allocation, an analysis of a top-5 bank (used as a market proxy) shows that around 68% is invested in equity (direct holdings and investment funds). It remains to be seen whether this model could be exported to other member states or established at EU level. As regards specific financial instruments, policy makers and consumer associations have been advocating for increasing the participation of retail investors in the ETF market (currently estimated at 10% to 15% of total assets). Equity funds represent the bulk of the ETF industry with 70% of assets under management, followed by bond funds (25%). In the US, retail and institutional investors played an equally important role in the growth of ETFs. On average, European ETFs are approximately 25% more expensive than their US counterparts, and 60% cheaper than actively managed European investment funds. In terms of availability, ETFs are easily accessible to retail investors through on-line investment platforms or robo-advisors, but this is not the case with mainstream distributors/advisors such as banks or insurance companies.

### **Financial advice**

Different types of investment advice exist today under the European and national regulatory framework. Under MiFID2 rules, firms have to decide whether to offer advice on an independent basis, a non-independent basis, or both. Firms that choose to provide advice on an independent basis have to ensure that they can meet conduct of business and product governance rules. In the UK and the Netherlands, the ban on inducements has led to a shift from obtaining advice through banks and insurers to execution-only platforms or IFAs. While many consider this the way forward, there are also voices expressing concerns about the unintended consequences of an emerging 'advice gap' for those clients with modest portfolios, a segment that will become too costly for distributors to serve with proper advice. At present, the average retail investor does not fully understand the incentives schemes of the non-independent advisors, and the associated benefits or risks. All in all, advisers should remain faithful to the client and present risk-return considerations fairly. Nonetheless, for various economic reasons advisers have been incentivised to place products rather than offer services. In recent years, many robo-advisors have entered the market with the promise of positively impacting retail investors, though reduced costs, improved access to advice and better product choices. The UK and Germany lead in terms of current user adoption. Investments are generally limited to ETFs, followed by mixed funds (Spain, UK, Germany) and life insurance products (France). Nonetheless, flaws in algorithms, mis-selling risks and privacy and data protection concerns could negatively impact their take-up. Once a robo-advice tool qualifies as investment

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advice or portfolio management, the provider has to comply with the provisions of MiFID2, in particular the suitability assessments.

### **Distribution channels**

Investment funds are distributed through captive and third-party channels; the proportion strongly depends on the member state. More broadly, continental Europe is dominated by banks and insurers in contrast with the UK where IFAs and online platforms are prevalent. The EU-wide analysis of retail distribution channels has estimated that captive channels are dominant in Spain (representing almost 75%), equally represented in Italy, Germany and the Netherlands (50%) and substantially lower for France (30%), the UK (25%) and Sweden (15%). This will be further altered by MiFID2: fund selectors are expected to reduce the number of distribution partners as a result of them placing more business in-house. Insurance products are sold either directly by insurers or through a number of different channels (brokers, agents and bancassurance) depending on the specificities of the market and the type of insurance product. In Europe, fund managers retain 42% of the total recurring fees while distributors are paid 41% through retrocessions. The balance of 17% is used to cover operating services such as custody, administration and transfer agency. In the case of insurance products, distributors receive around 46% of fund management charges. In fact, this type of sales-driven distribution regimes reduces the attractiveness for distributors to propose ETFs to retail investors. The development of online channels and fintech companies is changing the way retail investment products are distributed. In particular, the ban on inducements in the Netherlands and the UK has triggered the development of more fund supermarkets, on-line brokers and on-line investment platforms of incumbents. While online brokers are present in almost all countries, fund supermarkets are only available in the UK, France, Germany and the Netherlands, followed to a lesser degree by Italy and Spain. Generally, fund supermarkets and online brokers display lower investment costs and focus on non-complex products, with rather basic suitability and appropriateness checks. In general, the distribution of life insurance and pension products through on-line channels remains marginal across Europe.

### **Returns, costs and charges**

In the semi-annual report on TRV by ESMA, retail investor portfolio returns stood at a monthly average rate of 0.3% for the year to December 2017, oscillating around the 5-year average of 0.4%, largely driven by the performance of direct and indirect equity investments. Nonetheless, investors associations argue that the mixed benchmark (47% Eurostoxx 600 Index, 12% Eurobonds market, 41% Euribor 6M) does not accurately reflect average retail investor portfolios (i.e. directly investing in equity and bond markets) and are not a valid proxy for retail investment performance because fees and commissions charged directly or indirectly are not taken into account.

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ESMA undertook a first study on fund performance in 2017. Over a 3-year horizon, from 2013 to 2015, on-going fees, one-off charges and inflation reduced gross returns by 29% on average in the EU. The reductions in fund returns vary across countries, asset classes, type of clients, management style. Gross annual returns range from around 6% (France, Spain, Austria, Italy) to 14% (United Kingdom)- given a typical higher equity exposure. In the Netherlands and Sweden, cost-related reductions were less than 10%. The most pronounced reductions have materialised in Austria, Spain, Italy, Luxembourg (more than 25%) and Belgium (31%). Equity funds have generally experienced lower return reductions than bond and mixed funds. Most importantly, the reductions for actively managed and retail funds tend to exceed those of passively managed and institutional funds. More recent analysis by ESMA in 2018 shows that at EU level the average relative reduction in the return of a UCITS retail fund share varies from 32% over a 10-year horizon to 25% for a 3-year horizon and 19% for a 1-year horizon. Compared to retail clients, institutional clients experienced lower reductions in returns at both the 10-year horizon (17%) and the 3-year and 1-year horizons (13% each). In Q4 2017, with an average annual level of real cost-adjusted returns of 2.3% (total expense ratio, load fees, trading spreads and inflation), the UCITS fund industry performed at levels broadly comparable to Q4 2016.

In the UK, the FCA found that there is weak price competition in a number of areas of the asset management industry, considerable price clustering for funds and limited evidence of prices falling as fund size increases. Their evidence suggests that on average actively managed funds underperform their benchmark after costs and that there is no clear relationship between price and performance – the most expensive funds do not appear to perform better than other funds before or after costs. When examining the 3-year record of 2,500 equity, bond and money market funds in continental Europe, with combined assets of €1.8tn, Prometeia found that less than one in five of the funds sold to retail investors in continental Europe outperformed their benchmark after fees were taken into account.

The EU-wide analysis showed that there are not only strong disparities in the level of costs and fees on retail investment products across the EU, but also within the same member state. For the average European retail investor, the availability of information on costs and charges was found to be quite opaque and inconsistent. Information on fees for investment funds (money market, bond, equity and mixed funds) was considered relatively easy to gather on the webpages of distributors. Distributors in the Netherlands and the UK offered the lowest on-going charges for all types of funds. On the other hand, in some member states, information on fees for life insurance and pension products could not be found on the webpage of any distributor. Even when displayed, it was difficult to discern whether the indicated fees include the costs related to underlying assets.

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Table 1. Retail investment products (one-off and recurring costs)

	Entry fee	Exit fee	On-going charges
Money market funds	1.37	1.25	0.39
Bond funds	2.87	1.69	1.01
Equity funds	3.65	2.01	1.89
Mixed funds	3.77	2.73	1.51
Real estate funds	3.76	3.2	1.28
Life insurance			
with CG	2.88	1.83	0.88
without CG	2.22	1.03	1.38
Pension products			
with CG	3.4	2.62	0.87
without CG	2.19	0.97	1.45

	Execution fee	On-going charges
ETF	0.73	0.36
Listed bonds	0.5	0.32
Listed equity	0.64	0.32

Note: Average 15 EU MS (%), Deloitte analysis (2017).

*\* before the entry into application of MiFID2, PRIIPS, IDD.*

In October 2017, the ESAs have been mandated by the Commission to issue recurrent reports on the costs and past performance of the main categories of retail investment, insurance and pension products. All fees impacting the net performance of retail investment products should be reported, and notably investment costs (asset management fees, custodian fees) and possibly transaction costs, performance fees, administration costs, fees and commissions charged by financial intermediaries, initial charges (subscription fees) and exit charges (redemption fees). Moreover, differences in fees between distribution channels – direct sale by product manufacturers /intermediated distribution through financial institutions/advised versus execution-only sales/new distribution channels such as fund supermarkets – should also be considered subject to data availability. The main objective is not only to enhance competition pressure and drive pricing discipline, but also identify market segments and regions where investors are in a sub-optimal situation. The first reports are expected by the end of 2018. One step further would be to build publicly available comparative databases with comprehensive information on retail investment products to be run by independent bodies. To this end, there is also the need for enhanced coordination among ESAs and NCAs to align the requirements for disclosing the costs, charges and risk metrics across all retail financial

products. This is linked to a harmonized regime for remuneration rules across financial sectors for the distribution and sale of retail financial products.

As part of the reforms in costs and charges disclosure, PRIIPs requires financial intermediaries to provide a Key Information Document (KID) to retail investors. Some firms questioned the predictive accuracy of future performance based on historical data in certain circumstances, e.g. the strong past performance of certain markets, the way the calculations must be carried out, or calculation errors. For example, the UK FCA recommended that when firms selling or advising on PRIIPs have concerns that the performance scenarios in a particular KID may mislead their clients, they should consider how to address this, for example by providing additional explanation as part of their communications with clients. Another area regards the disclosure of transaction costs. According to industry estimates, around 8% of equity funds and 13% of bond funds sold across Europe are reporting zero or negative transaction costs, which makes some funds look artificially cheap. ESMA argues that these are just individual cases and that the calculation method is fundamentally sound. Fund turnover is a key input to transaction cost, and the negative results may be due to calculating turnover in different ways. The Dutch AFM guided managers to use an alternative simplified calculation methodology if they lacked the historic 36-month detailed record of trades needed to complete the transaction cost estimates. This guidance is not intended as a general exemption from the so-called 'slippage' calculation methodology.

The costs and returns for private pension products have also come under increasing scrutiny in recent years. Most national personal pension products have reported a net return just above the inflation rate or even negative net returns. In the case of DB (defined benefit) and DC (defined contribution) schemes, it was argued that market mechanisms might not be strong enough due to several inhibiting factors, such as the lack of engagement by plan participants given the long intermediary chain, complex and opaque charging structures, weak governance, barriers to entry/switching, or failure to exploit potential economies of scale. Transparency measures have been successful in encouraging pension fund providers to monitor, compare and control their costs and charges but insufficient to achieve real optimisation, i.e. lower costs for the same product or better products for the same costs. Investment expenses, which can absorb as much as 90% of total costs, are very sensitive to a scheme's asset allocation. OECD research highlights that in several jurisdictions policy makers have introduced direct measures to restrict fee options, to influence the structure of the pension market or the products offered by pension providers. Regulators might also consider benchmarking DB funds against relevant peer groups, and DC funds against a low-cost lifecycle strategy. Such exercises could translate into justifying any deviation from the performance of the proxy fund and highlight the need for cutting costs or modifying administration/investment activity. These efforts could be complemented by data on the 'value for money' offered by different funds to members and sponsors.

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## Regulatory/supervisory developments

ESAs, NCAs and consumer associations report that most complaints from retail investors usually cover three areas: mis-selling of products, the level of costs/returns and biased advice. MiFID2, PRIIPs, IDD have been designed to increase transparency on costs and performance and help investors take more informed investment decisions while also creating a more level playing field among different providers. A recent study on the marketing, sale and distribution of retail financial products requested by the ECON Committee (European Parliament) shows that significant weaknesses remain in the EU regulatory regime due to gaps in implementation, supervision and enforcement, which result not only in different levels of investor protection across the EU but also market segmentation risks and regulatory arbitrage opportunities.

Financial products that have similar economic characteristics and risk-return profiles should be treated in the same way when it comes to disclosure requirements, conflict of interest rules in their promotion and sale, and the product intervention powers of the supervisor. The assessment of suitability is one of the most important requirements for investor protection, and so is the enforcement of the rules. The institutional structures and mandates for consumer financial protection (also prudential and financial stability, and competition) vary across Europe. It is paramount that ESAs and NCAs effectively oversee the interaction among the different sectoral EU rules (banking, asset management, insurance, pension funds) and assess the medium to long-term impact on retail investors.

## 3. Sustainable finance

In Europe, the capital markets ecosystem is expected to continue to develop in line with the overall objective of enhancing long-term value creation in the real economy. Institutional investors and asset managers have a fiduciary duty to act in the best interest of their end investors, and therefore should be equipped to seize the opportunities and tackle the risks arising from materially relevant ESG factors. Retail investors have also been increasing their direct presence in this segment. With respect to non-financial data and integrated reporting, there seems to be a huge learning curve for companies, investors, service providers, policymakers and other stakeholders. Transparency, proportionality, the right incentives, and ultimately financial performance will allow the market to develop in size and maturity. Against this background, the members of the Task Force explored the following questions:

- Are investors mainstreaming the integration of sustainability factors? What are their approaches to ESG assessments, preferred asset classes and investment strategies?
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- Is there a real ‘scarcity’ of sustainable assets/projects in Europe? Would fully-fledged taxonomies, labels and standards improve the conditions for investments?
- What drives the take-up of sustainability ratings/scoring, indices and benchmarks? How to ensure that SMEs are not underrepresented in investors’ portfolios?
- How will the Commission’s Action Plan translate into practice? Should prudential regulation encourage such investments?

### **Asset allocation**

In the context of the CMU, the Commission has committed to unlocking the full potential of public and private investment to support the transition towards low-carbon, circular and resource-efficient economy, as indicated in the Action Plan published in early March 2018. An extra €180bn a year is necessary to meet climate and energy targets by 2030. This amount rises to €270bn when including the goals for energy, transport, water and the waste sector as a whole, according to analysis by the EIB. Commission staff estimated that a shift of 0.5% in the asset allocation of asset managers and insurers would increase these investments by €115.5bn and €50bn, respectively. As of 2016, there are globally around \$23tn of assets professionally managed under SRI/ESG strategies, as reported by the GSIA (Global Sustainable Investment Alliance). Adopting a filtering process on the universe of funds, JP Morgan finds out that only around 2%, or \$650bn incorporate ESG factors in a more systematic and active manner. ESG factor incorporation increases with fund size and 71% of funds with AuM greater than \$20bn use ESG in some aspect of decision-making. Extrapolating the ¼ share of retail funds, it is estimated that the retail and institutional ESG/SRI AuM amount to around \$2.5tn (or 10%).

In Europe, Eurosif reports that the total amount of assets based on sustainable investment strategies has increased to approximately €11tn at the end of 2015. Exclusions remain the dominant strategy, covering 48% of the total of European professionally managed assets. ‘Norms-based screening’ and ‘Engagement & Voting’ are the 2nd and 3rd largest segments, covering approximately 20% each of total managed assets. 12% is captured by the more formalised process of ESG integration. And the remaining 3% of SRI assets are categorized as either ‘Best in Class’, ‘Sustainability themed’, or ‘Impact Investing’. However, it should be noted that there is an increasing overlap between SRI strategies in Europe, with investment vehicles frequently using more than one strategy. Traditionally, the ‘Norms-based screening’ has been very popular in the Nordic region, ‘Best in Class’ in France and ‘Stewardship’ in the UK. Although institutional investors continue to lead the market, there is increasing interest from retail investors. A study conducted by KPMG shows that the European responsible investing fund market amounted to €476bn (or 2,413 registered funds) at the end of 2016. Negative and positive screenings, together forming the ESG cross-sectoral category, represent 89% of the

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AuM. While 53% of the funds in the ESG Cross-sectoral category apply positive screenings, they represent 42% of AuM. The number of sustainable investment fund options (equity, bond, mixed allocation) is expected to increase in the coming years as well as existing funds adopting ESG by prospectus. However, most sustainable funds still lack the minimum 3-year track record that many investors require. According to Morningstar, which assigns 1 to 5 sustainability ratings to funds, 155 funds domiciled in Europe with around €40bn AuM have ratings above average (score higher and equal to 4). Among those, 13 fall under the category of low-carbon funds with a total AuM of €2.5bn. According to Pensions & Investments, assets of passive ESG funds and ETFs have reached \$108bn in 2017 compared to \$17bn in 2006.

A survey by Ernst & Young (2015) estimates that less than 25% of investment professionals consider extra-financial information frequently in their investment decision process. A survey by the CFA Institute (2017) found that portfolio managers and research analysts in the EMEA region – private and institutional investors – take ESG factors into account in their investment analysis/decisions as follows: Environmental – 66%, Social – 65%, Governance – 74%, or not at all (19%). Moreover, for the consideration of ESG issues going forward, respondents prioritised the demand from clients/investors (61%), a proven link between ESG and financial performance (44%) and regulatory/legal requirements (38%). The ESG analysis applies to all conventional asset classes (equities, bonds, money market, diversified solutions) as well as real and alternative assets (private equity, real estate, and infrastructure). Over 60% indicated that they integrated ESG factors in a systematic manner across listed equity (76%), fixed income (51%), private equity (22%), real estate (21%), infrastructure (15%), and hedge funds (7%). Despite the recent developments in the green and social bond market, these still constitute a very small share of the total EU bond market. These segments are particularly strong in the UK, France and Germany, but also in the Nordics and the Netherlands. As regards pension funds, a survey by Mercer (2017) reported that typically only around 20% integrate ESG risks in their investment process, driven by the financial materiality of these risks. In a global survey by BNP Paribas (2017) of asset owners and asset managers, 174 of which were European, 46% of asset owners indicated that they plan to have 50% or more of their investments in ESG funds while 54% of asset managers plan to market 50% or more of their funds as ESG funds. More recently, in the public consultation of the European Commission (2018), approximately 60% of pension providers, insurance companies and asset managers reported that the level of ESG integration is ‘low/no integration’. As to individual portfolio managers, 76% reported that the level of integration is ‘low/no integration’.

The overall perception is that access to more granular ESG data allows for a better assessment of the material impact as well as integration into absolute valuation models. The performance of ESG factors has been robust since the global financial crisis. However, there is no conclusive evidence as to whether ESG returns are significantly better or worse than the more established

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benchmark returns. For example, Brièrea et al. (2014) propose a new decomposition of the variability of mutual fund returns in order to measure the performance contributions of SRI screening compared with other traditional sources: market movement, asset allocation choices and active management. Their results show that SRI screening does explain the variability in mutual fund performance, alongside asset allocation and active management. However, the sum of these three components accounts for only 30% of total performance. SRI screening matters, but it has a limited impact on total equity fund performance, which remains heavily dominated by market movements. A recent MSCI study (2018) shows a statistically significant causal link between ESG and performance, namely that ESG affects the valuation and performance of companies both through their systematic risk profile (lower costs of capital and higher valuations) and their idiosyncratic risk profile (higher profitability and lower exposures to tail risk), and that changes in a company's ESG characteristics (ESG momentum) may be a useful financial indicator in its own right. Quantitative research by JP. Morgan (2018) shows that when ESGQ is added to traditional investment styles such as value, growth, momentum and quality (VGMQ) results in lower volatility, higher returns and subsequently improved Sharpe ratios.

### **Sustainability for corporates**

Promoting long-term value creation in corporate strategies, improving decision-making and risk management through an integrated approach (financial and non-financial factors) as well as enhancing transparency and accountability of companies with regard to ESG impact are key issues going forward. As the sustainable finance markets continue to grow in size and maturity, investors will demand better corporate sustainability data and third-party assessments will develop. Overall, ESG metrics at the corporate level have improved over time, both in terms of individual performance metrics as well as the broader metrics on disclosure of ESG data. Investors have developed internal rating tools complemented by external data and engagement with companies. Companies with good ratings on material ESG factors can significantly outperform and experience lower capital constraints. However, there are multiple challenges related to comparability, timeliness and reliability of non-financial information. When it comes to materiality of ESG issues, there is no one size fits all as it can vary depending on the company and their business models, within and across sectors, countries, regions. In practice, the willingness of corporates to disclose ESG factors is growing. However, non-listed companies face greater challenges as they do not report on a regular basis. There has been also increasing concern about not adding to the reporting burden for SMEs. A recent KPMG survey also reports that the increase in corporate reporting extends to smaller firms as well, although to a lesser degree. Among the smaller firms surveyed, 45% used third-party assurance versus 38% in 2011. Ensuring that SMEs are not underrepresented in investor portfolios should remain a priority. Gathering evidence on the impact of MiFID 2 rules on SME equity and fixed income research should be examined from both the demand side (asset managers, portfolio managers

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and institutional investors – referred to as the ‘buy-side’) and the supply side (as investment banks, brokers and financial analysts – referred to as the ‘sell-side’). Up until now, most concerns were raised by certain parts on the sell side arguing that unbundling requirements make it very difficult to spread the cost of research across large companies. However, the new rules could also open up the market to high quality, value-added research on small and midcaps by independent research providers.

Relevant EU legislation for public corporate reporting comprises a range of requirements applicable to listed and non-listed companies, sector specific requirements (banks and insurers), as well as additional disclosure requirements applicable to listed companies. In Q2 2019, the Commission will publish its fitness check and amend its non-binding guidelines on non-financial reporting adopted in June 2017. It will also adopt a delegated act on the content of the prospectus for green bond issuances and publish a comprehensive study on sustainability ratings and research. Sustainability accounting and disclosure standards, such as the Global Reporting Initiative (GRI Standards), Sustainability Accounting Standards Board (SASB) and Carbon Disclosure Project (CDP) are increasingly used by analysts to guide recommendations. As part of the requirements of the Accounting Directive, companies (including small issuers), have to report non-financial information as part of their management report to the extent necessary for an understanding of the company's development, position and impact of their activities. EU rules on non-financial reporting (the NFI Directive) only apply to large public-interest companies with more than 500 employees. This covers approximately 6,000 large companies and groups across the EU, including listed companies, banks, insurance companies and other companies designated by national authorities as public-interest entities. The first reports in line with NFI Directive have to be published by the end of 2018. Some stakeholders argue that it is too early to assess the impact of this Directive and that the guidelines on non-financial information should be reviewed only after several reporting seasons and broader consultations with the reporting entities. For issuers not covered by the reporting requirements of the Accounting Directive, Commission staff have estimated the additional cost to disclose a non-financial statement between €600 and €4,300 per issuer.

### **Retail and institutional investors**

In May 2018, the Commission proposed a series of measures targeting the investment and advisory processes of financial markets participants at large by introducing mandatory disclosures at the level of the firm/financial product (via a new regulation) as well as explicit integration of sustainability factors as part of duties towards end-investors/beneficiaries (to be further specified through delegated acts). The increased disclosure initiative is aimed at reducing the information asymmetry between end-investors and financial entities. The Commission's proposal requires the transparency of sustainability risk policies at the firm level, *ex ante* disclosure in pre-contractual and contractual documents and *ex post* disclosure in

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regular reporting. Financial market participants have to include detailed descriptions of procedures and conditions applied for integrating ESG risks and to describe how these risks are likely to influence the return on investment regardless of whether investment objectives are pursued. However, if asset managers and institutional investors are offering products or services marketed as sustainable, they will have to disclose how they achieve their sustainability target. Most stakeholders argue that while blanket disclosures at firm level should be manageable, they may not be able to fully comply for some or many products. In particular, the disclosures related to sustainable products might end up touching on some things that could be deemed commercially sensitive (e.g. portfolio construction).

In practice, most ESG-related disclosures happen at entity level and in annual/periodic reports. There are also firms that have client-specific disclosure, which is not public, and others that have already amended their disclosures at product level, which is public. Some stakeholders estimate that the most significant costs would come from reviewing the pre-contractual and contractual documents (e.g. a one-off cost of about €40,000 per prospectus). However, these costs are expected to be limited if there is a transitional period. Some firms have established separate ESG policies and reporting processes to an ESG committee and to their board, and aligned ESG integration with remuneration policies. For example, the signatories to the Principles for Responsible Investment (PRI) have an annual reporting duty to the PRI. Signatories report on their responsible investment activities by responding to asset-specific modules in the reporting framework. The overall assessment outlines how implementation by signatories of responsible investment compares year-on-year, across asset classes, and with peers at the local and global level. Most signatories also disclose their policies and practices in a more user-friendly format on their firm webpages. The disclosure requirements should be proportionate in particular for non-signatories as well as for responsible investment 'beginners'. At EU level, the Long-term shareholder engagement Directive increased the transparency obligations for institutional investors and asset managers by requiring them to develop and disclose an engagement strategy including a description of how they monitor investee companies on non-financial performance, social and environmental impact and corporate governance, and to disclose on an annual basis how their engagement policy has been implemented.

With respect to the explicit integration of ESG factors as part of duties towards end-investors/beneficiaries, the chosen policy option relies on the fact that the existing sectoral EU frameworks (AIFMD, UCITS, MiFID 2, the Solvency 2, IDD Directive), with the only exception of the IORPs 2 Directive, already foresee empowerments to specify the details of the duties of relevant entities in the areas of governance, asset allocation, investment strategy, risk management, suitability assessment and product selection. These requirements will be further specified through Delegated Acts (to be adopted in 2019) based on advice from the ESAs and will entail amendments to secondary rules on general organisational and operating procedures

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or, where such measures do not yet exist as is the case under IORPs 2, introduce them in a consistent way. Asset managers and institutional investors will have to assess the sustainability risks of their portfolios as a whole against financial materiality considerations. The criteria specifying how and where material ESG risks are to be integrated within the existing procedures will be developed taking into account the size, nature, scale and complexity of the activities of the relevant entity. At present, most ESG-related costs are part of the overall internal and organisational costs related to the risk management and monitoring of certain exposures. The ESG risk mapping should be aiming at identifying areas, industries, or companies at risk. The focus should always be on acting in the best interest of the end-investors/beneficiaries. The ESG analysis should not be confused with restricting the investable universe and, as such, the addition of the ESG factor should not be a hindrance to delivering the best financial outcome. In the public consultation on investor duties, over 70% of respondents saw social factors as the most difficult to integrate, followed by climate and other environmental factors (over 55%), while governance factors did not pose significant problems. However, Social and Environmental criteria currently dominate the metrics used to define ESG methodology, partly due to the availability of data sources. Governance factors are usually harder to incorporate into scoring systems because of the low frequency of the data, which is usually reported annually, and often with lags longer than one year.

In the accompanying impact assessment, the most common areas of ESG integration identified by the interviewed entities were investment strategy, risk management, governance measures, engagement with investees and voting policy. Asset managers focused on the positive impact on financial performance (particularly over the long term), improved risk/return characteristics of the managed portfolio, reputational benefits, and ability to attract new clients. Insurers and pension providers mentioned an increased demand from beneficiaries/policy holders. Institutional investors also cited a number of difficulties related to identifying and valuing ESG risks and opportunities, in particular data availability, valuation techniques and modelling constraints. The majority of the entities interviewed combine external and internal sustainability ratings and measure the impact through quantitative and qualitative analysis. The costs of acquiring ESG data from external providers was estimated on average between €80,000 and €150,000 per year. According to a small/medium asset manager, the total costs of assessment, integration and disclosure of ESG factors is about 1-1.5% of the total cost of the product/service, i.e. collecting ESG data from external providers, and the additional internal/organisational costs linked to setting up documentation, preparing a prospectus, drafting contracts (legal), and monitoring the exposure (risk management). ESG-related costs are part of the overall internal and organisational costs related to the risk management and monitoring of certain exposures. In fact, the additional tasks covered by this initiative would be incorporated within the existing organisational and operating procedures.

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Financial intermediaries have to act in the best interests and according to the expectations of the end investors/beneficiaries, within the received mandate. Whether the way institutional investors, asset managers, insurance distributors and investment advisors are exercising the duties of care, loyalty and diligence is compatible with ESG integration continues to be subject to considerable debate. At present, these principles are embedded in fiduciary duty obligations (mostly in common law jurisdictions) and various pieces of EU legislation (investor/beneficiary/policy holder protection). A recent study by OECD (2017) finds that regulatory frameworks do not present obstacles to ESG integration. However, institutional investors may benefit from greater clarity about the role of ESG integration in prudent investment governance. At the same time, regulators must be confident that institutional investors meet the required standards when they include ESG considerations in their portfolio decisions. Further analysis of the ESG investment models being used by institutional investors might therefore be beneficial. Insurance and pension providers should consult their beneficiaries on an annual/periodic basis with respect to their sustainability preferences. As to using a broader interpretation of fiduciary duty, some stakeholders argue that the concept should not be confined to a static legal/contractual interpretation. The question remains of whether there is a need to reframe or redefine fiduciary duty in order to prevent the failure to consider long-term investment value drivers, such as material ESG factors, in investment practice. In the overall debate about ESG integration, industry representatives also warned against conflating the roles of asset owners and asset managers, respectively. Asset managers act as agents on behalf of asset owners – retail or institutional investors, operating within the defined investment objectives and guidelines, as embedded in EU fund regulation, mandate letters and investment agreements. Large, passive, index-based fund managers are also committing to active stewardship and putting into question the so called ‘cross-ownership’ phenomenon.

Through the amendments to MiFID 2 and IDD, the Commission is seeking to create mandatory requirements to take into account ESG preferences in the advisory process, both in customer profiling and product selection. Some of the reasons for this would be increasing the transparency on ESG products/portfolios, reducing the risk of ‘greenwashing’, or providing adequate information on the impact of sustainability factors. In the accompanying impact assessment, a sampling of 19 questionnaires of mainstream retailers in five EU countries (France, Germany, Italy, Spain, and the United Kingdom) revealed that none of them contained questions on non-financial objectives and preferences. Nonetheless, the increasing demand from retail investors is often cited as a driving force for the sustainability agenda and re-allocating savings into more equity investments. However, the question is whether risk-appropriate, cost-efficient investment products will actually be available if the sustainability preferences of retail investors become more bespoke. This could in turn enhance the segmentation between mass retail investors (passive investment strategies) and high net worth

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individuals (private wealth management). Retail investor associations and industry representatives are currently seeking for more clarity with respect to the different timings between the amendments to MiFID 2 and IDD and the expected entry into force of delegated acts on taxonomy (the transitional period), the possible structure of a questionnaire (level of granularity, separation of the different components of ESG), the treatment of sustainability preferences in the selection of products (integrated with financial considerations of the same relevance/weight, prevailing over financial considerations), the scope (existing clients and the process to follow for new clients with or without any ESG preferences), and the marketing of 'sustainable' products – standards and labels. In the Final Report on Guidelines on certain aspects of the MiFID 2 suitability requirements (May 2018), ESMA has included, pending changes to the legal framework, a good practice for firms and supervisors addressing the topic of sustainability preferences. Similar work is expected to be undertaken by EIOPA for the insurance-based investment products. Insurance intermediaries argues that any transitional period should only commence once the overall taxonomy, or ESG classification system, has been finalised. Alternatively, such changes could be introduced within the context of the IDD review, by which time the relevant taxonomy will have been established.

The initiatives on duties and disclosures have been complemented with a proposal for defining key minimum standards in the case of low-carbon and positive-carbon impact benchmarks, such as the criteria for the choice of the eligible underlying assets; the criteria and method for weighting of assets in a benchmark; and the method for the calculation of carbon emissions and carbon savings associated with the underlying assets. The underlying idea is that the benchmarks used by asset managers and retail/institutional investors to track/measure the performance of a product/portfolio should be appropriate for the pursued investment strategy – sustainable or not, reliable and comparable. If no index has been designated as reference benchmark, it will be up to the providers themselves to explain how their sustainability targets are reached. In the past decade, the supply of ESG and low-carbon benchmarks by mainstream asset managers and 'pure play' index providers has increased substantially. However, many of the low-carbon/climate funds are still being assessed against a conventional benchmark. At present, the data on company specific carbon footprints, the foundation for many low carbon indices, is being challenged on account of inconsistency due to limited company disclosure and differences in the carbon estimation models used by data vendors. Moreover, current indices may not be able to map consistently whether or not an individual company is compliant with a 2°C scenario. Most investors would prefer investing in companies with viable transition solutions rather than simply overweighting in their portfolio those operating in low carbon industries.

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## Financial regulation

The cornerstone of the Commission's action plan on financing sustainable growth is designing a fully-fledged taxonomy on sustainability at EU level by 2022 (finalising the environmental part by 2019). The European Parliament called for a 'Green Finance Mark' to be granted to investment/savings products achieving the highest standards in the sustainability taxonomy. This is in line with the Commission's objective for the taxonomy to act as a guidebook for national labelling schemes but also form the basis for the future use of the EU ecolabel framework for certain financial products. Under-pricing risks in 'brown finance' should be carefully monitored. Financial institutions will have to re-assess their lending/investment portfolio against long-term material risks under various transition scenarios. The introduction of European carbon stress tests for banks and other financial intermediaries, as proposed by the European Parliament, is needed to address the risks to such stranded assets. Lowering bank capital requirements and recalibrating the risk weights for insurers' investments in line with the EU taxonomy on sustainable activities as well as exploring potential alternative accounting treatments to fair value measurement for long-term investment portfolios should have a sound prudential basis, beyond the economic and political considerations of CMU.

## 4. Conclusions

Notwithstanding the significant differences between member states, the overexposure to bank deposits as well as the equity underweight in the portfolios of European households represent structural issues in Europe. Both market and regulatory developments should head in the direction of increasing access to suitable retail savings/investment products with comparable cost structures and stable returns in the long run. The onus of financial education should not only be on retail investors, but also on advisers and distributors, i.e. strictly monitored, properly trained professionals, regardless of captive or open distribution models.

Multiple stakeholders need to be on board in working towards building and implementing the business-financial-societal case for sustainability. The use of financial regulation as a tool to provide incentives or disincentives for retail/institutional investors should be exercised with great caution and be complemented by other appropriate sectoral policies. This is essential in order to avoid a build-up in asset bubbles and further misallocation of resources. Moving sustainability from a niche segment will require a larger pool of sustainable assets and restoring confidence in the capacity of capital markets to generate long-term value in the real economy.

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## 5. Next steps

This Task Force was based on an independent research agenda and consisted of 3 dedicated meetings ([14 June 2017](#), [24 October 2017](#), [20 March 2018](#)) covering asset allocation issues relevant for households, asset managers, insurance companies and pension funds under the overarching theme of unlocking long-term savings and investment channels in Europe. The post-meeting reports were intended to bring more discipline and transparency into the general proceedings. The final workshop on policy recommendations will be organised on [31 October 2018](#) and focus on the draft version of the final report. The content of the final report (to be finalised in Q4 2018) will be attributed solely to the rapporteurs and not to ECMI, CEPS or any individual member of the Task Force. The external experts joined the Task Force in their personal capacity and do not necessarily endorse the policy recommendations and/or overall conclusions.

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## ANNEX

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ECMI conducts in-depth research aimed at informing the public debate and policy-making process on a broad range of issues related to capital markets. Through its various activities, ECMI facilitates the interaction among market participants, policy-makers and academics. These exchanges are fuelled by the various outputs ECMI produces, such as commentaries, policy briefs, working papers, statistics, task forces, conferences, workshops and seminars. In addition, ECMI undertakes studies commissioned by the EU institutions and other organisations, and publishes contributions from high-profile external researchers.



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