

EPFSF Lunch Discussion

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“Protecting EU retail investors: More to be done?”

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I am pleased to represent Barclays Wealth, the private client business of Barclays Bank. Barclays Wealth is the UK's largest private wealth manager, and the world's ninth largest in terms of assets under management, and it has been one of the fastest-growing in this business in recent years. I am also pleased to be speaking as a member firm of APCIMS, the industry association representing private client stock brokers and investment managers in the UK.

1. Consequences of the Credit Crunch for retail investors

(a) Financial consequences on individual savings and need for regulatory action

The most significant financial crisis since the Great Depression has led to very severe disruptions in the functioning of global capital markets, a serious global recession, and destroyed confidence in financial markets.

Major market indices were down 30 - 40% in 2008, wiping out gains from the past decade and trillions of euros off the market capitalisation of listed companies; and leading to significant shortfalls in pensions and other individual savings.

As a result retail investors have become even more risk-averse, there is a true crisis of confidence in market mechanisms, and possible long-term loss of retail investor appetite for market risk. Confidence has fallen to levels not seen since the Great Depression and restoring it as soon as possible in markets, financial intermediation, asset management and regulation is a critical public policy objective.

(b) Resolving the crisis of confidence in the financial services industry

As an industry, we recognise that fundamental failings in self-regulation and internal governance contributed to this *état d'esprit*. But the depth and breadth of the current crisis cannot be attributed to industry's failings alone – there were clearly parallel drivers, such as shortfalls in existing regulatory and supervisory structures and approaches, excess liquidity in the monetary system as a result of lax monetary policy, and the build-up of massive macroeconomic imbalances in the global economy. All of this is easy to say with hindsight of course.

Some segments of financial markets will therefore have to be regulated for the first time, or in some cases, re-regulated. However, any regulatory drive to improve protection for retail investors must also be conducive to innovation and competition. Too often, these three objectives were seen as mutually exclusive. We at Barclays Wealth disagree with this notion. Indeed, so long as the regulatory framework is focused on the outcomes the regulation is trying to achieve rather than the drafting of rules, protection, innovation and competition can be seen as a harmonious trinity.

The restoration of retail investor confidence should be coordinated between careful and considered regulatory proposals on the one hand, and dynamic, ambitious attempts by the

industry to improve competition, transparency in intermediation, and incentive structures on the other.

(c) Revisiting accepted theories

The Credit Crunch of 2008 shook to the core widely accepted beliefs in the way markets function, in the way risk is modelled, and in portfolio construction. The efficient market hypothesis has been beating a retreat since the advent of behavioural finance but the 2008 was yet another nail in its coffin.

Risk models which assumed efficient markets, normal distributions of returns and a uni-dimensional definition of risk as volatility have proven inadequate and the excess reliance placed upon them by the industry was catastrophic. Volatility is not static over time and the normal distribution in which the risk of realising predefined returns is symmetric around the mean does not reflect retail investors' asymmetric aversion to downside risk.

2. Improving the existing European legislative framework

(a) Gold-plating and achieving convergent standards

Despite the urgency and magnitude of the task facing regulators it would be senseless to produce rafts of new legislation without assessing where existing law, regulation and rules are achieving policy objectives and where they are failing or even undermining them.

One aspect of this is to ensure convergent implementation of EU legislation. As is well known there are for example numerous cases where UCITS directives and the MiFID have been transposed in ways which impede the proper functioning of the Single Market. Convergent standards of retail investor protection thus remain to be achieved and there is no level regulatory playing field across the EEA. This increases the costs of business which are inevitably partly passed on to retail clients in the form of higher fees, charges and prices.

(b) Resolving existing inconsistencies

I would like to propose that retail investor protection is not guaranteed by an increasingly complex and detailed set of rules. These often lead to internal inconsistencies, open the door to regulatory arbitrage and a race to the bottom, and provide a route map to get around them. This is conducive neither to retail investor protection nor to a competitive market.

Resolving inconsistencies in the existing European legislative framework should therefore be a key priority before further legislative proposals are contemplated.

3. Core pillars of a holistic regime of investor protection

The 'need to act' demanded of politicians by the public can generate enormous pressure to legislate quickly, without proper reflection on the consequences. There are many historical examples, such as Regulation Q in the 1960s that caused the Eurobond market to leave New York for London, or more recently Sarbanes-Oxley.

To achieve a consistent and harmonised regulatory framework across all retail investment products and activities in the face of intense public scrutiny, it is very important for European regulators to **focus on the outcomes** of proposed legislative initiatives and to avoid thinking solely about drafting a rulebook.

This means that regulators across the EEA should come to a convergent understanding of core principles which will provide a holistic framework for retail investor protection across the entire product life-cycle. These principles can be thought of as three core pillars:

- (1) key product characteristics
- (2) key principles of product governance
- (3) key principles of sales and advisory process governance

(1) key product characteristics

All investment products which are designed for retail investors should fulfil basic yet essential requirements. These should crystallise in a regulatory regime as minimum agreed standards in relation to:

- **Liquidity**
- **Diversification**
- **Transparency**
- **Leverage limits**
- **(Conditional) capital protection (?) – this one is more controversial**

(2) key principles of product governance

Product regulation on its own is not a sufficient safeguard against conflicts of interest and poor governance standards which can have a detrimental impact on retail clients' interests across the product life-cycle. Indeed, without attendant product governance and sales, advisory, and portfolio management governance standards, product regulation alone is as likely to protect retail investors as a helmet is likely to protect a soldier without a weapon or a shield. The core principles which should form the bedrock of product governance standards should nevertheless evolve around:

- **Defining the target client market**
- **Independent, transparent robust product selection**
- **Managing operational risk**
- **Ensuring service continuity post-sales**

(3) Sales and advisory process governance

As is well recognised, the governance of the sales and advisory process, as well as around portfolio management, is so critical to the protection of retail investors that I would go so far as to suggest that product regulation is worthless without it. Core principles which should form the bedrock of such standards revolve around:

- **Training and Competence**
- **Suitability/appropriateness at point of sale**
- **Post-sales suitability monitoring**
- **Conflicts of interest**

In many respects, MiFID already captures these principles. The problem of course is that currently, MiFID is restricted in scope (for example, it does not extend to insurance products) and some MiFID investment products face pan-European standards of product regulation, while many do not. Hence the urgent need to define and agree – as outlined above – core minimum principles of product regulation and product governance across all retail investment products at European level.

I hope that these points have provided useful fodder for discussion. Thank you for your attention.