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Agenda

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Risky business: do European investors need protection?

Retail investors are exposed to a range of risks when engaging an investment firm to carry out services on their behalf. What are the main risks, and how adequate are current arrangements to protect investors? These questions are addressed in a report published this month, prepared by Oxera for the European Commission, which focuses on the statutory investor compensation schemes established in the EU Member States

There are a number of mechanisms in place to mitigate risks faced by investors. Statutory investor compensation schemes established in the EU Member States have provided important protection in the past, particularly against the risk of theft, fraud and embezzlement of assets held by firms on investors' behalf. However, they do not generally protect against other important risks, such as investor losses arising from poor financial advice.

This article draws on an Oxera report prepared for the European Commission (DG Internal Market), published in September 2005. In addition to assessing investor risk exposures, the report evaluates the operational performance of the schemes in handling claims and awarding compensation to investors, and the adequacy of scheme funding. The Commission has now launched a debate and invited Member States to comment on the report and its conclusions prior to deciding on the need for policy action.[1]

What are the main types of risk for retail investors?

Retail investors rely on investment intermediaries to advise them on the investment of their savings, execute financial transactions on their behalf, and manage their portfolios. This exposes them to a range of potential financial and operational risks.

- *Financial risks*—when passing funds to an intermediary for investment purposes, investors are exposed to the risk of the firm defaulting. If the investors' monies or securities held by the firm are not clearly segregated from the firm's own assets, all creditors of the firm may have a claim against investor assets in the event of insolvency. Investors run the risk that their assets cannot be returned to them. Where investor assets are clearly segregated and not available to creditors, there can still be losses in the form of disruption and inconvenience. Disruption arises from the freezing of investor assets during insolvency proceedings, leading to a loss of liquidity and associated opportunity costs in terms of forgone returns; once assets are unfrozen, investors incur costs in the form of inconvenience from transferring their investment business to a new firm.

- *Operational risks*—these encompass a broad range of risks, as summarised in Table 1. The potential loss to investors from operational failures depends on the type of failure, whether it is detected, and whether it is associated with the default of the firm. For example, if fraud or theft is revealed and the firm remains solvent, investors are likely to be fully compensated by the firm for any losses of assets. However, fraudulent behaviour may be difficult to detect, in which case misappropriation may continue for a period of time. Where a firm default occurs, the concern does not relate to detection; rather, the risk to the investors is that full compensation for fraud and theft cannot be paid by the firm.

Risks differ as regards probability of occurrence and impact in terms of amount of potential loss, and attempts have been made in a number of studies to measure and quantify risks in the EU.[2] Overall, the picture that emerges is that high-impact failures have a low frequency of occurrence, and the more frequent failures

Oxera's report, 'Description and Assessment of the National Investor Compensation Schemes Established in Accordance with Directive 97/9/EC', prepared for the European Commission (DG Internal Market), September 2005, is available at www.oxera.com.

Table 1 Operational risks in retail investment services

Main types of risk	Description
Theft and embezzlement	The risk of investor assets being stolen or otherwise misappropriated by employees or managers of the firm
Fraud	The risk of an unauthorised transfer or fraudulent use of investor assets (eg, to cover own-account trading losses, or other dishonest behaviour conducted by employees or managers of the firm)
Segregation error	The risk that investor assets are incorrectly identified as firm assets, or vice versa
Settlement error	The risk that there is a mismatch between delivery of securities and payment of investor funds
Reconciliation error	The risk that the firm is unable to reconcile investor balances in its own internal records with those in the reports of third parties
Accounting or record-keeping error	The risk that, due to recording problems, the firm is unable to allocate investor assets to individual clients
Failure to execute (or other breaches of) client instructions	The risk of losses arising from a firm's failure to execute a client's transaction on time or in the correct manner, or other breaches of instructions
Other poor investment management	The risk of, for example, mispricing, churning, corporate action failures and stocklending failures
Poor investment advice	The risk of receiving negligent financial advice (eg, advice without a reasonable basis)

Source: Oxera (2005), op. cit.

tend to be of limited impact in terms of the amount of the loss. Nevertheless, even a small loss may have severe consequences for a retail investor with limited financial resources.

What is the role of regulation?

Risks per se are not a problem. If investors can correctly anticipate their funds being threatened by financial or operational failures, they will incorporate this risk into their decision-making. Similarly, market forces will produce an efficient outcome if operational risks can be priced in terms of the anticipated returns and the charges that investors are willing to pay for services provided by firms.

In retail investment services, the most commonly cited source of market failure is imperfect, or asymmetric, information. Retail investors with limited information and little financial expertise cannot evaluate the quality of the investment advice provided, the financial risks taken by investment firms for their own account, the care taken by firms segregating investor funds or executing transactions, or the likelihood of fraud or theft being perpetrated. Regulation is therefore targeted at investor protection and maintaining confidence in the market for investment services at large.

Table 2 provides an overview of the main mechanisms in place to protect retail investors. In addition to regulatory investor protection, there are some market-based solutions to reduce retail investors' exposure to risk and to improve the operations of the market. These mechanisms may already be in place to reduce the likelihood of a risk occurring, or may mitigate the loss to investors in the event of failure.

Market-based protection mechanisms include reputation, capital and insurance. For example, firms that value their reputation will be careful to ensure that they are consistently delivering high-quality work and acting in the best interest of their clients. This aims to prevent risks occurring, and, where problems do arise, firms may compensate investors for any losses incurred. Economic capital provides ex ante protection against the risk of default. In relation to operational risks, capital protects ex post if firms use their 'deep pockets' to cover losses where failures do occur. Similarly, firms can, in principle, buy insurance to cover loss events that may put investors at risk. In addition, investment firms may enter external custody agreements to ensure that investor assets are safeguarded and properly serviced by a third-party custodian.

Table 2 Classification of main investor protection mechanisms

	Regulatory protection	Market-based protection
Prevention (reducing the risk of failure)	Segregation of client assets Other conduct-of-business rules (eg, disclosure) Authorisation, supervision and enforcement Regulatory capital	Reputation Economic capital External custody
Mitigation (mitigating the impact of failure)	Regulatory capital Investor compensation scheme	Private insurance Reputation Economic capital

The question is whether these market-based forms of protection are adequate. Past cases of fraud, misappropriation, or other failures suggest that reputational concerns are not always strong enough to align a firm's interest with those of its clients. Serious concerns have also been raised about the functioning of the insurance market and insurability of certain risks.

Regulatory protection has a role where market-based protection fails. For example, minimum capital requirements reduce the risk of default if they induce firms to hold more capital than they otherwise would. If default does occur, the impact on investors can be minimised by having in place strict asset segregation requirements to ensure that investor assets are separate from those of the firm and can be returned to investors following default. Regulatory frameworks in Member States provide investor protection by imposing other conduct-of-business rules, which seek to ensure that investment firms operate efficiently, honestly, and in the best interest of their clients.

As a last resort, when all other protection mechanisms fail, Member States have implemented statutory schemes, which grant retail investors compensation for losses they incur.

Investor compensation in the EU

All EU Member States have established schemes that, in accordance with a 1997 Directive, provide investors with compensation for any losses they incur, up to €20,000.[3] Although there are considerable variations across the EU in scheme organisation, operation and funding, all national schemes protect against the risk that, in the event of default, an investment firm is not able to return to investors the monies or investment instruments belonging to them.

Table 3 reports the frequency of compensation cases in 11 Member States, the highest number of claims for each country, and the largest amount of compensation awarded for a single case of firm failure. In those Member States not listed in the table, there has not been a single compensation event since the establishment of the compensation scheme. Furthermore, where schemes have been activated, cases of firm failure have been relatively infrequent (the exception is the UK, as explained below). This would suggest that, overall, loss exposures of retail investors are small, and that the combination of the other regulatory and market-based protection mechanisms in place works effectively to reduce the risk of default and loss of investor assets.

Nevertheless, the table also shows that, no matter how infrequent, there have been instances where the alternative protection mechanisms have failed and where individual investors would have incurred significant losses had a statutory compensation scheme not been in place. As such, compensation schemes have played an important role in complementing the other mechanisms and providing last-resort protection in the event of failure

Moreover, it is important to appreciate that investor compensation schemes offer protection against only a

Table 3 Overview of compensation cases, 1999–2003

		Number of cases since 1999	Highest number of claims for a case	Highest total payout for a case
Belgium		1	400 (approx.)	€2.6m
Czech Republic		6	n/a	n/a
Denmark		1	204	DKr11.6m (€1.6m)
Germany		15	723	Approx. €7m[3]
Greece		5	n/a	n/a
Hungary		13	n/a	n/a
Ireland		3	2,601	Approx. €10m[3]
Italy		10	394	€5.7m
Netherlands		2	n/a	n/a
Spain		5[1]	6,852	€31.8m[3]
UK[2]	1999	661	2,633	£15.5m (€23m)
	2000	360		
	2001	284		
	2002	139		
	2003	164		

Notes: No compensation cases are reported for the other Member States. [1] Failures occurred before 1999, but were handled by the scheme after 1999. [2] Most cases relate to bad advice. Figures for each year may include cases handled that occurred before 1999. [3] Case ongoing at the time the information was gathered.
Source: Oxera (2005), op. cit.

very specific risk—ie, firm default combined with an operational failure that results in a loss of assets (in most cases, some form of fraudulent misappropriation of assets). Many sources of potential loss incurred by investors do not qualify for compensation—for example, losses arising from bad investment advice. The UK is currently the only country that requires investment advisers to participate in the compensation scheme and extends compensation cover to losses arising from poor advice.[4] This broader scope of scheme coverage explains the significantly larger number of compensation events recorded for the UK in Table 3. If bad advice cases were excluded, the case volume in the UK would look more similar to that observed in the other countries.

This is not to say that compensation cover in other countries should be extended to include bad advice losses. However, it supports the view that bad advice is the most significant source of risk for retail investors. It also raises the question about what are appropriate means of protecting investors against this risk. This question is likely to become increasingly important going forward, for a number of reasons.

– *Changing market structures*—in many European markets, the majority of retail investment services are carried out by banks or firms belonging to larger banking and insurance groups. In France, Germany and Italy, approximately 60% of investments in mutual funds are undertaken through a bank—in Spain, the figure is above 90%.[5] This contrasts with the UK market, which has a considerable number of small and independent players and where independent financial advisers (IFAs) and retail brokers control more than 60% of UK retail mutual fund sales.[6] Current market structures are expected to change; in relation to retail investment funds, the market is expected to move towards a third-party fund-distribution system. There is also an expectation of significant growth in the general market for independent financial advice. To the extent that retail investors may increasingly use IFAs or smaller retail brokers instead of the large credit institutions, as they already do in the UK, this is likely to have implications for their risk exposure.

– *Greater reliance on financial advice*—while the UK has traditionally represented a more market-based investment culture, investors in many other EU countries have tended to place their funds in bank deposits or opted for other forms of saving, and only recently increased their equity holdings. However, the financial landscape is changing, and retail investment is expected to increase in all EU countries. One reason for this is the shift towards private pension provision, which is likely to result in increased use of investment instruments, and may therefore induce a further change in the profile of households' saving and investment patterns. Another reason relates to greater cross-border competition, along with increasing integration of the EU financial markets, which is expected to widen the range of savings and investment products available to retail investors. Increased (and potentially more complex) retail investment means that investors will place greater reliance on the financial advice of intermediaries. This increases their exposure to losses arising from poor-quality advice.

– *Investment advice to become a core investment service*—in many Member States, investment advice is not currently an investment service that is subject to initial authorisation and ongoing supervision by the national regulatory authority. However, this will change following Member States' transposition of the Markets in Financial Instruments Directive (MFID) into national law by October 2006.[7] As investment advice becomes a core investment service under European requirements, and hence a regulated activity (which is already the case in the UK, for example), more emphasis is likely to be placed on the risk of bad advice and there may be increased calls for protecting investors against this particular risk.

Concluding remarks

Retail investor protection is high on the regulatory agenda in the EU. Regulatory mechanisms are available to minimise the various types of risk exposure. Where losses do occur, procedures have been established to compensate investors for certain risks. Regulatory intervention by regulators should be targeted at those areas where risks are significant and where the market would fail to deliver an appropriate outcome if left unregulated.

Going forward, regulators will need to pay increasing attention to the risk of loss arising from poor investment advice. This is perhaps the most significant risk to retail investors, and a risk that is, at present, largely unregulated in many EU countries. The implementation of the MFID is likely to increase calls for regulatory protection against this risk.

[1] European Commission (2005), 'Evaluation of the Investment Compensation Scheme Directive: Executive Report and Recommendations'.
[2] For example, Oxera (2001), 'Risks and Regulation in European Asset Management: Is there a Role for Capital Requirements?', report prepared for the European Asset Management Association; and Biais, B., Casamatta, C. and Rochet, J.C. (2003), 'Operational Risk and Capital Requirements in the European Investment Fund Industry', report prepared for the Fédération Européenne des Fonds et Sociétés d'Investissement.
[3] Directive 97/9/EC of the European Parliament and of the Council of March 3rd 1997 on investor compensation schemes. A number of EU Member States have adopted compensation levels beyond the required €20,000 prescribed in the Directive.
[4] The compensation scheme pays only if the firm providing the advice is not able to compensate the investor itself, usually because it is insolvent. Most bad advice cases in the UK relate to mis-selling of pension and endowment insurance products, as well as advice to invest in investment instruments that are 'inappropriate' (eg, given the investor's risk profile), or where investors were insufficiently informed about the risk implications.
[5] See Datamonitor (2002), 'European Financial Advisers 2003', December.
[6] Ibid.
[7] Directive 2004/39/EC of the European Parliament and of the Council of April 21st 2004 on markets in financial instruments.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.co.uk

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