European Securities and Markets Authority

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ESMA35-43-3328

PUBLIC STATEMENT

To investment firms on the impact of inflation in the context of investment services to retail clients

Background

1. Over the past months inflation rates have risen in the EU, as in many other countries, due to a number of factors, including the Russian invasion of Ukraine that is leading to higher energy and commodity prices. This growth in inflation has impacted households, not only in their daily lives but also in their investments and investment decisions.

2. The European Securities and Markets Authority (ESMA) notes that from an investor protection perspective, this trend poses a risk for retail investors, as some of them will not fully appreciate the link between inflation and financial markets and may not fully understand how considerations on inflation should be factored in their saving and investment decisions[1].

3. ESMA is therefore issuing this Statement to remind firms of relevant MiFID II[2] requirements as it believes that investment firms may play a role in considering inflation and inflation risk, as appropriate, when manufacturing and distributing investment products and when providing investment services to retail clients, also in order to help raising clients' awareness of this risk.

MIFID II requirements

Fair, clear and not misleading information

4. Article 24(3) of MiFID II states "*All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading*".

5. This general principle is then further expanded in the requirements on the topic of the provision of information to clients included in Chapter III of the MiFID II Delegated Regulation.[3] In particular, Article 44(2) of the MiFID II Delegated Regulation that states *"Investment firm shall ensure that the information referred to in paragraph 1 complies with*

[1] On the topic of inflation and the impact of investor protection, ESMA has also received in April 2022 an own-initiative advice [Ref: ESMA22-106-4024] from its Securities and Markets Stakeholder Group (SMSG).
[2] Markets in Financial Instruments Directive – Directive 2014/65/EU of the European Parliament and of the Council
[3] Commission Delegated Regulation 2017/565.

the following conditions: […] b) the information is accurate and always gives a fair and prominent indication of any relevant risks when referencing any potential benefits of an investment service or financial instrument, …" "(e) the information does not disguise, diminish or obscure important items, statements or warnings".

6. In light of the above, ESMA believes that firms should ensure that the information they address to retail clients, or disseminate in such a way that it is likely to be received by them, reflect, in comprehensible form, inflation risks and the possible effect this may have on the value and return of the investment.

7. For example, when offering a financial instrument with any guarantee or capital protection it should be clearly explained that such guarantee or capital protection would not protect investors from the effect of inflation over time and that the return adjusted for inflation might be negative.

Suitability

8. The assessment of suitability is one of the most important requirements for investor protection in the MiFID II framework. It applies to the provision of any type of investment advice (whether independent or not) and portfolio management. The assessment of suitability is set out in Article 25(2) of MiFID II and Articles 54 and 55 of the MiFID II Delegated Regulation.

9. The ESMA guidelines on certain aspects of the MiFID suitability requirements (currently under review)[4], already clarify that *"Firms should adopt robust and objective procedures, methodologies and tools that allow them to appropriately consider the different characteristics and relevant risk factors (such as credit risk, market risk, liquidity risk, …) of each investment product they may recommend or invest in on behalf of clients."*

10. ESMA would expect firms, as part of the suitability assessment, to carefully consider, as part of the assessment of market risk and credit risk, the risk that inflation will undermine the performance and/or the value of an investment. In this respect it is particularly important that firms carefully assess and understand clients' investment horizons.

11. ESMA would also expect firms[5] to ensure that their policies and procedures enable them to ensure, inter alia:

    - that the investment advice and portfolio management services provided to their clients take account of an appropriate degree of risk diversification (including differentiation with regard to inflation risk as different investments are impacted in different way by inflation); and

[4] ESMA35-43-869
[5] See paragraph 78 of the ESMA guidelines on suitability.

- the client has an adequate understanding of the relationship between risk and return (including, where relevant, the impact inflation might have on nominal returns, the necessarily low remuneration of risk free assets and the incidence of time horizon on this relationship, and of the impact of overall costs and charges on his investments).

Product governance requirements

12. MiFID II sets out product governance requirements to ensure that firms which manufacture and distribute financial instruments act in the clients' best interests during all the stages of the life-cycle of products or services. ESMA considers that sound product governance arrangements are fundamental for investor protection purposes and can reduce the need for stricter actions by competent authorities.

13. MiFID II product governance requirements, as laid down mainly in Articles 16(3) and 24(2) of MiFID II and Articles 9 and 10 of the MiFID II Delegated Directive[6], cover a broad range of topics, including on mandatory 'product reviews' and 'scenario analyses'.

14. In light of the above requirements, ESMA expects that manufacturers and distributors consider the effect of the expected inflation in their product governance processes.

Next steps

15. ESMA and national competent authorities will continue to closely monitor the situation and remind market participants that they should ensure compliance with all relevant MiFID II regulatory requirements at all times.

16. ESMA notes that, beyond this Statement it will also:

    - Continue to monitor and assess the evolution of inflation and the potential impact on the market to identify and assess risks to investors, orderly markets and financial stability in the EU. ESMA's risk assessments and risk monitoring are published in a series of reports such as ESMA's Trends, Risks and Vulnerabilities report, the Risk Dashboard and the ESMA Statistical Report series.

    - Continue in 2023 its cross-sectoral work with the EBA and EIOPA on financial education[7]. The work, conducted through the Joint Committee, will assess – amongst other things – the impact these rate rises will have on the three financial sectors in general and, more specifically, on consumers and will aim at coordinating national initiative to raise awareness and facilitate consumers' education.

[6] Commission Delegated Directive 2017/593.
[7] See 2023 ESA Joint Committee Annual Work Programme.