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How MIFID II is changing the landscape of financial advisory in the European Union

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Abstract

This paper analyses some of the most relevant changes in the investor protection area that will be introduced at European Union level by the new MIFID II Directive. It also goes deeper into the potential consequences these rules will bring to the financial instruments distribution markets and in particular taking the example of the Spanish case. Distribution models will have to be transformed in order to reduce potential conflicts of interest in the market and recover investor confidence.

Keywords:

Investor protection, Asymmetries in information, Conflicts of interest, Unbundling process, Products Banking vs. Clients Banking.

JEL classification:

G11, G15, G21.

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Cómo está cambiando el asesoramiento financiero **en la Unión Europea con la llegada de MIFID II**

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Resumen

Este trabajo pretende analizar algunos de los cambios más significativos que se producirán en relación con el tema de la "protección del inversor" en la Unión Europea a raíz de la entrada en vigor de la nueva Directiva europea MIFID II. También se busca profundizar en las consecuencias previsibles que tendrá esta nueva normativa en los mercados de la distribución de productos financieros, y en particular mediante el análisis del caso español. Los modelos de distribución deberán adaptarse a la norma para reducir posibles conflictos de interés y recuperar con ello, de nuevo, la confianza de los inversores.

Palabras clave:

Protección del inversor, asimetrías en la información, conflictos de interés, proceso de unbundling (segregación de servicios), Banca de Productos frente a Banca de Clientes.

1. Introduction

During the last edition of the ASEPELT Congress that took place on July 6th 2017 in Lisbon (Portugal) there was a presentation by EFPA (European Financial Planning Association) and IEB (Instituto de Estudios Bursátiles) under the title *"MIFID II - Markets in Financial Instruments Directive: Consequences for Financial Advisory"*. Speakers for this panel session were Mr. Sergio Reyes, Specialized Programs Director at IEB, and Mr. Sergio Miguez, Institutional Relationships Manager at EFPA Spain. The panel focused on relevant aspects of the new European MIFID II Directive, and mainly on its "Investor protection" topics.

As it is widely known, financial advisory is considered to be a regulated (or reserved) activity and the previous European Directive (or MIFID I) has left certain shortcomings in relation to its main objective which is to effectively provide protection to retail investors. Significant asymmetries of information appear in a typical Client - Advisory Firm relationship. Therefore new requirements will come into force in January 2018 (now being called MIFID II) in order to overcome potential failures in the European Financial Instruments distribution markets. Multiple changes will have a material impact on topics like the following: Investment advice models; Inducements and conflicts of interest; Transparency; Employee remuneration; Product governance; and Knowledge and Competence requirements for advisors, a.o. Further in this briefing paper we analyze some of those changes and potential consequences in more detail.

This analysis is based on a Study that was published last January 2017 by the IEB Financial Advisory Observatory in collaboration with EFPA Spain under the title: *"Nuevos Modelos de Negocio en Asesoramiento Financiero tras MIFID-II"* (http://www.ieb.es/wp-content/uploads/2017/01/InformMIFID.pdf)

I would also like to point out that at the time of writing MIFID II still has to be taken to national European legislations and so some variations could potentially change direction depending on the way those rules are finally adapted to each market particularities. Our analyses focused mainly on the Spanish distribution market effects.

2. Main regulatory changes and impacts

2.1. Models for investment advice

First we should point out that the financial products distribution ecosystem is rather concentrated in many Continental European markets. And that means there is a deficit of independent financial advisory models. (A clear counterpoint to that is the

UK where distribution is extensively based on IFA-models). Apart from that there is not always a properly recognized and documented "advisory" process in many cases. An example of that is in the Spanish financial products distribution market where only less than 6% of all retail investors are formally classified by firms as clients "under advisory". That means there is no clear recognition by the client of an advisory service (or specific personal recommendation) either.

From MIFID II onwards financial institutions and intermediaries will have to clearly declare themselves as "Independent" or "Non-independent" when providing any advisory to their clients. The difference between those two models has to do mainly with the following factors: (1) A variety of instruments (including 3rd party ones) to be considered when drafting an investment proposal for a client. That is equivalent to say that an Independent advisor will have to take into account a large number of products and also manufacturers. (2) No "implicit" payment (incentive or rebate) will be allowed to be received by those who claim to be Independent advisors. And that means the client will have to pay periodically invoices/charges for that service.

In the IEB Study mentioned above we predicted that **a majority of entities will go for a "Non-independent" route,** as incentives still play a significant role in their P&L accounts. Besides there is no clear advantage in the market for an advisor to choose an independent model, unless we take into account a potentially better positioning from a Marketing perspective. The question for many advisors could end up being as follows: a) Am I "independent" and so make personal recommendations that lead my clients to the best available products in the market (without any bias); b) Or will I formally declare myself as "Independent" from a regulatory standpoint? I argue that an advisor is not necessarily biased or unbiased because of the fact that he/she chooses from one or the other model. Many clients still today prefer not to pay invoices at all. And so we concluded that the Non-independent choice will be prevalent in the Spanish market, and probably in many other European countries as well. (Besides in the case of Spain an invoice for an advisory service still has to add a 21% VAT tax as well).

It should not be ruled out that some banks or firms (with enough critical mass) could potentially go for a "Mixed" model, in which they will only provide independent advisory to some clients belonging to their top segments (i.e. UHNWs or some HNWIs). For that they will have to completely separate teams, systems and controls, etc. Probably the most transparent way to implement that will be through a separation into two different corporate structures each of them giving support to one of both service types. It is not very likely that the mixed route will become very popular either, as clients (willing to accept an invoice for the service) could potentially be led to a Non-independent model but with "explicit" advisory fees anyway.

On the other hand a clear consequence of these business model discussions has already been the "intense" promotion by firms of the "Discretionary Portfolios Management" service even to some affluent segments. In a centralized portfolio system rebalancing is executed in a standard manner to all portfolios under the same risk profile. This implementation has significant advantages for firms in terms of efficiency, better control and monitoring, reduction in "outlier" portfolios, etc. We anticipate this process will continue in the future with MIFID II.

2.2. Inducements

This matter is directly linked to the Business Model discussion above. It is in the Directive spirit to avoid potential conflict of interest in the relationship between advisor and client. In this regard other legislative precedents like the *"Retail Distribution Review"* (RDR) from the UK are even stricter as a complete ban on incentives was imposed in that case.

Also known as inducements, incentives refer to any type of rebate, trailer fee, compensation or indirect remuneration received by distributors, service providers, or asset management firms when distributing products (i.e. mutual funds) to their clients.

In contrast to the RDR, MIFID II foresees a more gradual process as a ban on incentives is only foreseen in the case of "Discretionary Portfolios Management" and "Independent" advisory services. Nonetheless certain conditions to incentives are imposed in the other cases: "Non independent" advice and pure Distribution. And so a "concrete" benefit to clients must exist if an advisor receives any rebate on a continuous basis. It is termed *"quality enhancement"* requirement. And so in the provision of a "Non-independent" advisory service the delegated Directive gives basically two options to prove there is value addition: 1) Either to provide the advice on an ample choice of financial instruments (including a proportion of 3rd party providers products), or 2) to combine the service with some "value-added" tools that may be of the interest of clients. Examples of "Value-added" tools given are a *periodic assessment* of the products in a portfolio to validate their "appropriateness" according to client's current circumstances, or the provision of some type of an asset allocation to clients. And finally in the case of pure distribution incentives are still possible, but only when there is an ample offer of investment choices (including some 3rd party products too).

In conclusion all these questions will have a material impact in the way the service will be provided to clients in the future and how banks and other intermediaries try to adapt to this new reality in a very competitive market.

2.3. Transparency requirements

The search for a better transparency in a way that really gives the client the opportunity to understand and evaluate the service provided in a clear, concise, brief and unbiased manner is key to investor protection. As mentioned before significant information asymmetries still exist in this type of client-firm relationship. The previous MIFID Directive was instrumental to improve transparency, but MIFID II will impose even stricter rules on that.

Among all requirements it is probably key to point out that a new full information pre and post trade on the whole service will have to be provided. And so clients will open their eyes to total costs. Those figures will have to be informed not only in percentage terms but also in Euros. This is an information "unbundling" process, or transparency on the whole production and distribution chain

(An Example of a typical advisory service calculation of a portfolio based on Mutual Funds): Fund Management Fees (& Total Expense Ratio) + Platform trading Fees + Custody Fess + Advisory Fees and/or other potential Incentives to distributors, etc. and that addition must be shown disaggregated in both percentage % and € terms.

It is not difficult to imagine that all this thorough information will have an impact on clients in current environment of low interest rates and low expected portfolio returns. Some players in the industry will probably have to lower costs and or improve quality service in order to be able to compete further.

Particularly in the case of the "retail" segment a transition from an implicit to an "explicit" cost structure will probably lead to a cultural change coming from all these new transparency requirements. Clients will be informed better and consequently have more factors to consider in terms of a balance between net returns achieved and overall costs.

2.4. Employee remuneration

Banks and other intermediaries will also have to adjust their compensation schemes to employees. The industry is very much used to link variable packages to the achievement of certain sales targets. The idea now is that the industry should always satisfy clients' needs first and not pursue sales targets. And so a new set of rules aim to give clients an opportunity to reach their objectives. Pure quantitative metrics will not be allowed any more. In this regard various many "qualitative" factors will have to be taken into consideration, i.e. number and type of claims from clients, quality of service metrics, client retention, continuous education completion, etc. These factors will af-

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fect professionals working both as bankers or tied agents. All in all it seems new rules aim to gradually transform the marketing culture from the ancient model of "Products Banking" into a new one of "Clients Banking".

2.5. Product governance

A completely new product governance will be introduced too. Again product offer will have to satisfy clients' needs. A "Target Market" will have to be defined during the design process for each product by manufacturers/asset managers. But even more important than that distribution will have to control that each product will only reach clients belonging to that previously defined target. So a completely new set of criteria will have to be defined before launching a new product/service:

- Client type
- Previous knowledge and experience
- Previous financial wealth (in order to withstand potential losses)
- Risk tolerance
- Targets and needs

2.6. New requirements for knowledge and competence

It may sound very surprising but until MIFID II rules come into force at EU level there was no previous specific requirement in many countries for professionals to prove they have enough knowledge and/or experience in order to provide such a service to their clients. If you allow a crude comparison, this would be like driving a car without having a requirement to own and maintain a valid driving license. New MIFID II rules will change this situation dramatically as can be seen in the following article:

> "*Article 25, MiFID II:*
> Member States shall **require investment firms** to ensure and demonstrate to competent authorities on request that **natural persons giving investment advice or information** about financial instruments, investment services or ancillary services to clients on behalf of the investment firm **possess the necessary knowledge and competence to fulfil their obligations** under Article 24 and this Article. Member States shall publish the criteria to be used for assessing such knowledge and competence."

So this will be the first requirement to possess and maintain knowledge and competence at EU level. Until now only some "self-regulation" initiatives existed in Europe. Those initiatives aimed to create professional and ethical standards and certificate that knowledge after a proper training and successful examination process. To mention here the example of EFPA Europe (*European Financial Planning Association*) that has been granting independent certifications to more than 30,000 professionals throughout Europe since the year 2000. (For more information please see following link: http://www.efpa-eu.org/)

- Generally speaking "competence" should be interpreted as "experience".

- Investment firms are now made responsible for the knowledge and experience of their staff (natural persons). So it is not anymore just in the interest of individual advisors, but a new rule for firms too.

- Main objective here is that investors/clients really understand the risks embedded in their products. For that to happen it is a "must" that advisors are knowledgeable (properly trained) and act in good faith in the best benefit of clients.

- Regarding the final sentence in which member states will publish the criteria for assessing such knowledge and competence we would like to point out that the ESMA (European Securities and Markets Authority) published its guidelines on this matter last December 2015. Main ideas in the guidelines were:

    - Qualifications are differentiated between services (advisory and information) and proportionate to the type/complexity of service being provided to clients.

    - No "grandfathering" was allowed, and so knowledge cannot be substituted by experience or vice versa.

    - New education requirements also include "Continuous" education.

    - Independent Certificates, whereby Certifying bodies and Education centers are not the same firm, were considered as best practice, i.e. EFPA certificates are granted after passing an EFPA exam, but education/training is provided by a completely separated university or business school.

In adapting these European rules to the market the Spanish regulator CNMV recently published its technical guide on knowledge and competence (Guía Técnica 4/2017) with the following main points to mention:

- Compliance with all these new educational requirements affects corporate governances issues in the sense that a new process on this matter must be inserted in the firm's governance rules and must be approved by the board.

- Specific requirements for education, (i.e. the course for candidates to provide advisory services will last at least 150 hours of training hours); or for ongoing education, (i.e. for advisors at least 30 evaluated hours will be required per year to prove re-certification), etc.

- An official list of Certificates will be published by the CNMV. This will be considered as a safe haven for candidates and firms. In this regard a first list has just been published (with 6 institutions and 20 certificates included).

- Though the roles of educator and examiner are not always fully distinguished the regulator will assess the proper separation between both of them.

- In line with ESMA guidelines business ethics standards are implemented as well.

3. Conclusions

Even many experts are not completely sure how the vast set of the above mentioned rules governing European financial services will work. Everyone accepts it will mean a significant overhaul in the way financial advisers do business going forward. Rules are intended to increase transparency, competition and shore up investor confidence, which was severely impacted by the 2008 financial crisis. But it is probably once we see the behaviour in practice that we will see interpreted decisions become more visible as there are many areas where interpretation is unclear. On the other hand rules were intended for a complete ban on incentives but a "compromise" solution had to be reached and as a result some exceptions will still exist. It was probably not very realistic to go from 0 to 100 in just one shot and as it happened with the previous MIFID Directive, we can be sure a future Directive will come to complete the job done. It will probably come under the name of MIFID III or MIFID IV. Only time will tell...

The main conclusions of our Study were the following:

- **Clients will be placed at the "center" of the service model**
  To my opinion this is probably one of the main ideas behind MIFID II and aims to serve as a catalyst for the market to change its ways of doing business. In fact clients will be in the future much more demanding in the quality of service. Following factors were mentioned in our Study:

  1. A description of an average Spanish saver will show a somewhat "bipolar" risk profile in many cases. On one side investors still make a choice for real estate investments, but on the other side they tend to invest their financial investments in a very conservative manner (low relative weights in Equities and short Investment Horizons). So there is a long way to go in mainstream financial education and culture.

2. An investing world of low expected long term real returns will make this learning curve process even harder for advisors.

3. Spanish investors are also lagging others in the EU when asked about their planning for pension/retirement. They still rely on public pensions to support their future needs with high doses of optimism.

4. So the role of advisors will be essential in order to inform, educate and guide clients through all the challenges mentioned before. Only those advisors who really add value to clients will finally survive.

- **A majority of firms will choose to provide their service on a "Non-independent" basis**

  For the reasons already mention only a few players will try to differentiate through an "Independent" positioning, and/or alternatively though a "Mixed" model. Conflicts of interest will be reduced but it is now very important for regulators to monitor and assess how restrictions and value-addition tools are implemented in practice. A somewhat flexible and realistic but also very clear approach will be welcomed.

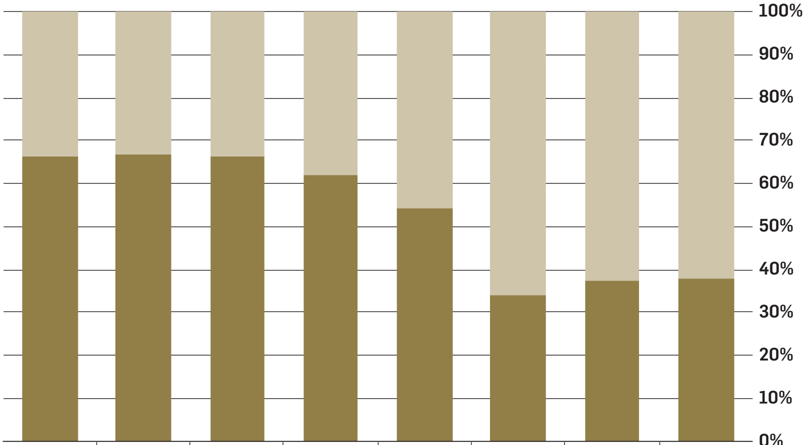
- **The investment in Technology will become a major issue for all firms**

  IT spending will be a key factor to navigate through this regulatory burden. A typical example could be the provision of advisory services. For this service to remain valid any proposal, interaction, input, client's decision and potential execution will have to leave a trace and be recorded in a monitoring system. So that means any interaction with clients has to be compliant and easy to reproduce and that can only be achieved with the help of a robust technology. Otherwise the provision of advisory could become too burdensome for firms. Besides harder competition in the market will make firms pay more attention to "client experience" (immediacy, information quality, digital integration, etc.). So apart from regulation costs firms will have to face new IT costs and tougher competition...

- **Client's financial wealth amount still to be decisive in order to have access to services**

  Due to an expected increase in firms spending (regulation + technology upgrades) clients will have to be segmented even in a more restrictive way, i.e. limited access to individual discretionary portfolio service or to "open architecture" in mutual funds, etc. Nonetheless it remains open if affluent or even lower segment clients are going to be excluded from the access to advisory services as it happened with the RDR in the UK. One of the outcomes of RDR rules was that a significant part of the population was left without financial advisory and consequently considered as “orphans”.

Figure 1. Advised and non-advised sales volumen in the UK (figure in thousand GBP)



2008	2009	2010	2011	2012	2013	2014	2015 H1	
1.000.196	878.245	941.642	995.628	1.072.323	2.064.131	2.135.229	819.513	Non-advised sale
1.963.165	1.762.583	1.859.813	1.612.716	1.271.440	1.054.625	1.272.001	501.950	Advised sale

SOURCE: THE FINANCIAL ADVISER MARKET. EDITION 3.0 - APFA 2015

Branch network Staff qualification will be a key differentiator in the market

Proper qualification is not a regulatory issue only. It has to do with specialization and capacity to give answers that satisfy client objectives in very challenging market conditions. We argue that although rules tend to classify investors into various different risk profiles, in fact those objectives (i.e. retirement, children education, 2nd. residence, new car) are the key points to plan for. Nowadays advisors should be in a high command on topics like Markets and financial instruments, Portfolio construction, Pension planning, Alternative investments, main Tax and Legal issues, among others. To facilitate advisors an access to higher than just regulatory-level education will make a difference and generate robust returns in the future. Qualified advisors plus technology and as a result of all that, good service will be an equation for success to navigate safely through these market waves.

“Robo-Advisors” will probably not have significant traction in the Private Banking segment

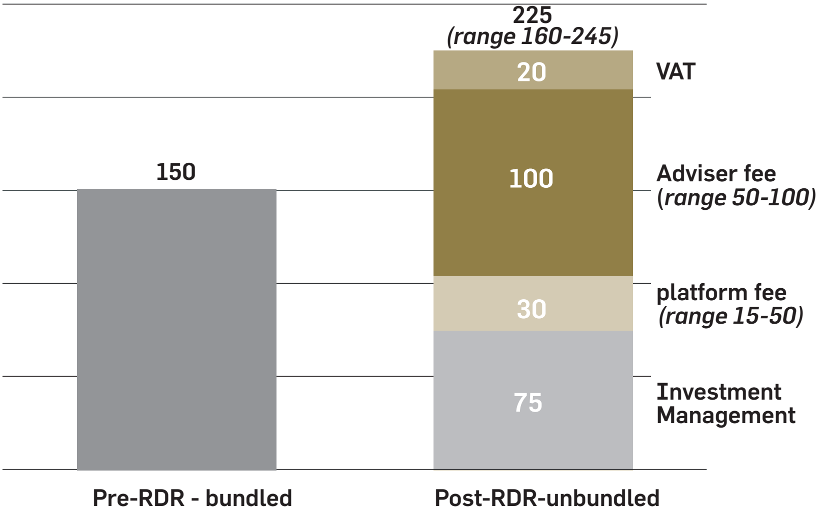
According to a definition by Paul Sironi, “Robo-Advisors are automated investment solutions which engage individuals with digital tools to guide them through a self-assessment process and shape their investment behaviour towards rudimentary goal-based decision-making, conveniently supported by portfolio rebalancing techniques using trading algorithms based on passive investments and diversification strategies".

We argue that these systems based on very simple risk profiling, portfolio construction and rebalancing algorithms and main allocations to passive investing probably are not good enough to satisfy Private Banking clients whose wealth structures and needs are in most cases rather complex. I assume these automated tools will be more helpful to Personal advisors (in a B2B model type), than to end investors (in a B2C model), especially when "C" stands for a Private Banking - Client.

- **Due to the overall increase in costs for firms final price paid by clients could potentially be higher too**

We assume that market competition and model transition process will have a direct impact on firms' accounts. A margin contraction of even 20-25% could be realistic at first and firms will have to do their best to compete without further margin jeopardy. It should not be ruled out that once impacts from new rules crystallize they try to transmit some costs onto clients. Anyway it is hard to anticipate at this point of time if and how this will happen (i.e. new custody and platform charges?). On the other hand a generalization in the use of "clean share" classes (in mutual funds) for services with "explicit" charges to clients will probably reinforce that process. Nevertheless it is not clear at all if in the Continental EU countries final price impact to clients will mirror the outcome of higher fees in the Post-RDR era in the UK (please see graph below).

Figure 2. **Mutual funds fees split – Situation pre and post RDR in the UK**



SOURCE: PETER GRIMMETT, M&G INVESTMENTS.

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- **Trading and execution will be significantly challenged**

  Service unbundling will lead to a separation between the provision of analysis and execution/trading services. Analysis is currently being subsidized and payed in most cases by means of Execution costs. From now on asset managers will have to create a separated budget account for external analysis and decide whether to assume those costs internally or charge them to the funds/vehicles they manage on behalf of clients. A new environment where Research expenses are clearly segregated will potentially leave Execution as a commodity under significant cost pressure in the market.

- **Private Banking landscape (in countries like Spain) will change significantly**

  We anticipate market and regulatory dynamics will cause significant variations in the PB landscape going forward. Incumbent firms (PB-franchises linked to a big Commercial bank name) will have to adapt to new models, new specialized entrants (in the form of IFAs, etc.) will play a key role, and impact on "*Millennials*" and other *tech-savvy* investors by new digital and automated proposals will lead to new client experience demands. A Market-Share competition (with potentially new players) in a deteriorating situation for P&L accounts/margins.

- **Willingness to comply by the firms will be critical again**

  As it happens in all major regulation overhauls the level of requirement by the regulator and the willingness by the firms to comply will be critical. Regarding the former, as there are so many aspects to be transferred in practice to national regulations/markets most firms still today expect a "learning by doing" supervision approach.

  On the other hand the will to comply and act in the best interest of clients by firms and advisors will be essential for a gradual recovery of the reputation that the industry lost in the past years.