MiFID II
From a compliance to a business challenge

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Why MiFID II?

When the first Markets in Financial Instruments Directive (MiFID I) package entered into force in 2007, the European legislator did not expect the text to be applied as it is today. For instance, requirements on inducements and their full transparency for the customer have been interpreted and implemented differently by the industry.

Moreover, innovation, market and technological developments (e.g. high frequency trading), and growing complexity in financial instruments have outpaced current MiFID provisions.

As a response, Europe has proposed and recently voted on a recast of the package, comprising a directive (MiFID) and a regulation (MiFIR), collectively known as MiFID II. The new package runs to more than 700 pages, to which detailed standards based on the ESMA guidelines will be added.

What is new with MiFID II?

Unsurprisingly, most of the provisions contained in MiFID are strengthened in MiFID II, for example: an enlarged scope of products and activities, a revised marketing and targeting process, more comprehensive client profiling, a broader definition of complex instruments, more detailed client reports and new pre- and post-trade reporting. All of these changes will bring further transformation to the banking and asset management industries, which must be compliant by the end of 2016, the expected implementation date.

Out of the whole MiFID package, a single article has sent shockwaves throughout the industry: article 24, which prohibits the common practice of retrocessions (inducements) for discretionary asset management and 'independent' advice. Article 24 creates a huge difference between MiFID I and MiFID II: while the first generated compliance costs, the second puts significant revenue at risk. In other words, MiFID I was mainly a compliance matter for the financial industry, but MiFID II poses challenges for your revenue and thus your strategy and business model.

By end-2016, all 28 EU member states will be on a level playing field, unless certain countries go for more stringent rules (gold plating). In the meantime, national regulators throughout Europe have already taken tough measures to either ban retrocessions or strictly limit them. A number of countries, including the United Kingdom, Italy, Netherlands and Germany, already have requirements that go beyond MiFID II.

One of the most notorious changes to legislation is the United Kingdom's Retail Distribution Review (RDR), which came into effect on 31 December 2012. In particular, it bans commissions received by financial advisors from fund managers on all new products (including insurance products). After more than a year under the RDR regime, the effects are clearly visible: a number of institutions have withdrawn their advisory services from the mass market, believing that this offer would become unprofitable without retrocessions.

Insurance products scoped out
Despite the request of many stakeholders, including EFAMA, the MiFID rules on distribution (including inducements) will not apply to insurance products. Although insurance products will be covered by a different directive (IMD II), the latter has been considerably delayed. The asset management industry is of the opinion that this creates a clear risk for a non-level playing field, where insurance products will benefit from more flexible distribution rules until IMD II addresses the issue.

Consequences and challenges for distribution

The impact of MiFID II on distribution models in Europe will vary from one model to another and from one country to another. There will be losers, but also winners.

Discretionary asset management

Discretionary asset management (DAM), i.e. the management of client assets under a mandate allowing the manager to buy and sell securities on behalf of clients without explicit client consent for each transaction, will be directly impacted by MiFID II.

Banning inducements in DAM may remove a significant portion of the asset manager's revenue. In particular, retrocessions received from third-party funds will disappear. This may lead the asset manager to:

- Increase DAM fees transparently charged to clients, as far as the client agrees to pay them
- Increase the minimum portfolio size to make DAM services economically viable, thereby excluding many investors from accessing affordable advice
- Promote in-house funds, since buying third-party funds would not provide any advantage
- Encourage clients to shift to non-independent advisory, where inducements are not banned

Proprietary distribution

In principle, banks and asset managers with integrated distribution networks can be considered 'non-independent' because they tend to favour the sale of in-house products. However, such networks may also provide access to third-party funds, giving a veneer of independence.

Large banks and asset managers may, as far as possible, combine non-independent and independent advice inside their own distribution network, applying different remuneration models depending on the situation: (i) non-independent advice organised more or less as it is today, and (ii) independent advice with a strict ban on inducements and a revised remuneration model (developed later in this article).

This 'hybrid profile' scenario would have the advantage for banks of leaving the door open to retrocessions for all non-independent advice. However, banks would have to deal with increased operational complexity, since distribution models and the related remuneration of each service would depend on whether this particular service is provided on an independent basis or not.

Independent financial advisors

Independent Financial Advisors (IFA) are individuals or small- or medium-sized companies that do not belong to banking or insurance groups. Consequently, they do not have access to an internal distribution network.

IFA are generally remunerated by commissions received from third-party product providers. Their remuneration will therefore be directly impacted by MiFID II. The change will mean:

- IFAs will have to be paid by investors for the advice they provide, instead of receiving remuneration from product providers. They will need to demonstrate to their clients that their advice is of added value and worth the fee. Lessons can be learned from the recent experiences in the United Kingdom and the Netherlands, and by looking at models in the United States where similar rules exist

- Tough times for IFAs unable to revise their remuneration model and offset the loss of retrocessions.
- Assessing how legacy assets will be affected during the transposition period
- Simplification of the product offering, where standardised/straightforward products will be preferred by investors because they are easy to understand and have lower management fees

Private bankers
In a similar way to IFAs, private bankers will see their revenue decrease, since retrocessions often constitute a considerable portion of their remuneration.

The potential impacts may be comparable to those of IFAs. However, private bankers will generally be able to increase the advisory fees charged to clients, and so be less vulnerable than IFAs to the changes introduced by MiFID II.

Distribution platforms
Distribution platforms primarily offer a wide range of funds to buyers (e.g. sub-distributor, client advisor). Acting as an intermediary between the management company and the buyer, these platforms mainly receive remuneration in the form of retrocessions from management companies, which will be banned under MiFID II.

In order to survive, distribution platforms will need to revise their contracts and means of remuneration. In fact, their commission for enabling distributors to select funds according to the risk profile of clients is justified, however it is received (e.g. fees paid by investors instead of retrocession from the management company), and should be reconsidered.

The diversification of revenue sources will be necessary. Asset platforms can provide other ancillary services that can be charged for separately, such as investment advice (e.g. fund screening and selection, provision of factsheets), transaction management, risk reporting and other types of reporting, and analytical services. Going beyond a pure model of operating as a logistical hub, platforms will broaden their revenue sources and re-establish their position on the market.

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Towards a revolution of business models?

To be independent or not—that is the first question

Since article 24 of MiFID II gives advisors the option to adopt independent status, there is a decision to be made.

Opting for the status of independent advisor will be a strong commitment to giving up all kinds of retrocessions and advising on a wide range of financial instruments.

An open question remains as to how much clients will value the independence of their advisor and how much they will be willing to pay at the *"point of advice"* to benefit from independent advice.

You would have thought that when it comes to advice, clients would always value independence. However, current practice shows that most of the advice we follow every day is free or cheap, but biased. When you search for 'best investment fund' on Google, your first hit will be a paid ad. Similarly, when you ask your travel agent to recommend the best hotels in Spain, for example, he may recommend his preferred partners, which will remunerate the agency for sending clients to their hotel. Even your insurance broker will probably start with the products he most wants to sell.

Does this mean that we do not value independent advice? One answer to this question may be that the greater the wealth of a client, the greater his ability and desire to pay for real independent advice. This would mean that, on one hand, pure private bankers serving the HNWI segment would claim independence and increase advisory fees, while on the other hand, the mass market would be served by non-independent advisors guiding them through in-house products or third-party products with generous retrocessions.

It should be noted that the definition of 'independent advisor' is to be clarified by ESMA, as part of the technical standards it will be working on over the next two years.

New fee structures

Various fees are paid by the client to its bank and/or financial advisor. Some fees are straightforward and very transparent (e.g. account opening/closing fees, account maintenance fees, transaction fees, custody fees, advisory fees), some are less so (trailer fees, performance fees, finder's fees, soft commissions and other types of inducements).

The objective of MiFID II is to shine a light on or ban most of the non-transparent fees listed above. The challenge for the sector will be to adequately re-evaluate its fee structure and find innovative and cost-effective solutions. As experience in the United Kingdom and the Netherlands has shown, new fee structures may include hourly rates, a percentage of funds invested and annual flat fees.

The main question sector players will have is: what additional costs will the customer be willing to pay, especially in times of economic crisis, low gross returns, mistrust in the financial sector and often an uncertain investment horizon? The task will be to measure the perceived value of advice and effectively market this service along with other ancillary services from which clients can benefit. Substantial investment in the revision of contracts and schedules, as well as staff training, will be needed before informing clients of the new arrangements.

Increased use of technology as a response to lower fees

One solution may be to provide an asset management service that is highly computerised, where the algorithm defines portfolio allocation on the basis of a profile completed online, in a similar way to 'wrap' programmes. This would, admittedly, be less attractive than a discussion in a cosy living room, but may be more attractive for wealthy European clients in the retail rather than the (U) HNWI category.

Platforms such as Skype, Paypal, Amazon, Booking.com and many others have already revolutionised their respective industries and captured millions of clients. They have quickly proven to be efficient and cost effective. Will financial advisory become the new development area for platforms? For sure, those that can implement innovative solutions to target the mass market will win.

It is clear that many retail clients are now choosing not to pay for financial advice, instead opting to either use online platforms or go direct. This is a concern, not only for the advisors losing clients and assets under management, but also for regulators if they see that the number of retail clients investing directly without prior advice is growing. Furthermore, this could create unintended consequences such as poor tax planning, inappropriate liquidity and uninformed purchasing of products with high cancellation fees.

Changes in the product offering

A review of the service offering, business models and pricing may also be accompanied by changes in the product offering. Since the level of retrocessions will no longer be a differentiating factor, the focus of advisors will, more than ever, be drawn to the brand, product performance and costs.

Passively managed investment products may receive more attention. While they were disregarded by certain advisors because the products did not generate sufficient income to pay retrocessions, such products may now appeal to customers who object to paying advisory fees.

New share classes have emerged, as investment managers have had to develop clean share classes that strip out commission and platform fees. Despite the increased complexity introduced by the existence of multiple share classes, each with its own remuneration scheme, this method has the advantage of offering MiFID-compliant solutions for each type of service and client.

Conclusion

The times of hefty commissions or inducements being charged—directly or indirectly—to clients have definitely gone. The whole industry needs to question its current model. We expect small advisors or portfolio managers serving the mass affluent and making a living from opaque retrocessions to be the most impacted.

High-margin and complex products may be penalised by increased transparency requirements (including when IMD II is implemented), whereas simple, low-load, passively managed funds might become more appealing to investors because of their low-cost structure. The emergence of clean share classes has come as a MiFID II-compliant response to the ban of inducements, leading to increased complexity in operations.

While MiFID I was mainly a compliance matter for private banking, MiFID II calls into question strategies and business models. Although MiFID II will not be implemented before the end of 2016, the major implications are known and require action. Since changing a business model may take years, investment firms need to address these implications now.

An effective response to MiFID II may create new opportunities for the smartest firms to enhance their market position.