MiFID II
To protect and to serve, but at what cost?

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While the primary objectives of the initial Markets in Financial Instruments Directive (MiFID) were to increase the competition, improve investor protection and allow EU passporting, the MiFID II package now introduces a range of measures aimed at addressing the consequences of MiFID I and issues raised by the financial crisis, such as making financial markets more efficient, resilient and transparent, improving investor protection, as well as addressing commitments made by the G20 in Pittsburgh (2009) on these topics.
There is a need for modernization, as technological advancements and the changing complexity of financial markets have outpaced the provisions of the original directive.

After intense discussions, the new MiFID II package was adopted by the European Parliament (EP) on 15 April 2014. By the end of 2016, all 28 EU Member States will be on the same playing field.

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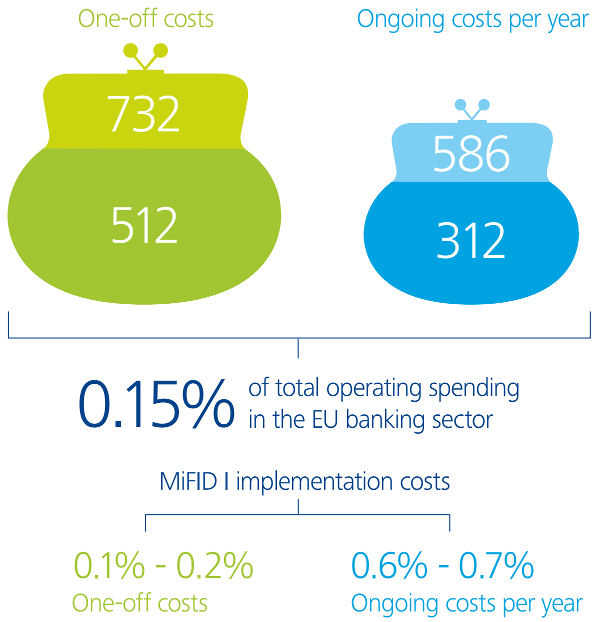
The revisions to MiFID I will have **a significant impact on both the business strategy and the operational processes** implemented by firms. The challenge will be to turn those effects into opportunities; however, this will come at a certain cost at first, even just to comply.

Although the European commission has estimated the initial costs of the MiFID II implementation between €512 million and €732 million for the whole European banking sector, these costs only include the compliance costs, which may obviously vary from one financial institution to the next, depending on the business model and strategic ambitions of each one. Although the directive only applies to MiFID firms, fund management companies will likely also incur costs to enable the banking distributors of their funds to fulfill their requirements.

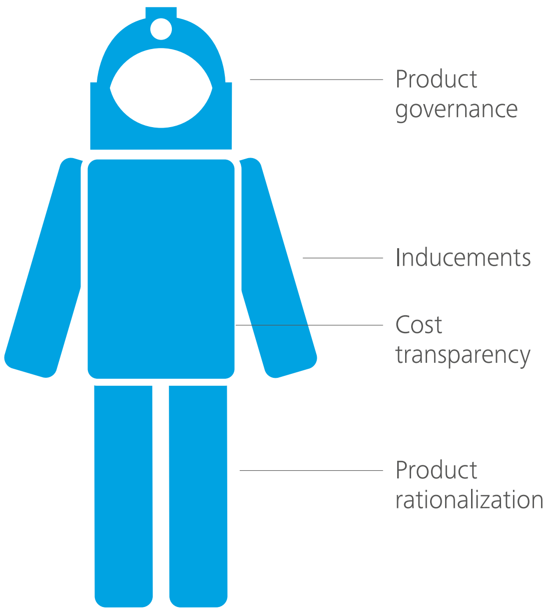
The cost and effort it will take to implement MiFID II features need to be carefully addressed and planned. Indeed, this compliance cost will create a heavier burden on smaller firms and could become a barrier to entering the market, or jeopardize their existing market position.

Key challenges for the fund industry

The impact of MiFID II will vary from one business model to the next. The fund industry may expect consequences in the following areas:



Source: European Commission



Product governance—New obligations for both manufacturers and distributors

MiFID II introduces extensive product governance obligations for both manufacturers and distributors of investment products. In short, manufacturers will need to take reasonable steps to ensure target market and end clients are identified and reached. In other words, they will need to put a strong product governance and product approval process in place and will have to perform ongoing reviews of those products.

For the sake of improving the understanding of the investment products, manufacturers will have to ensure distributors have access to all necessary documentation and information so that they themselves can make sure those products reach the targeted markets and end clients.

Client segmentation is likely to be challenging for firms as it seems that ESMA will not provide any further guidance on how to identify those target markets. In addition, the notions of the target market may differ from one firm or country to another; e.g. firms may have varying definitions of "European clients". Manufacturers designing products that are distributed through other investment firms should identify the target market on a "theoretical basis". Distributors should use the manufacturers' target market assessment (unless it is unavailable i.e. in the event the manufacturer is not subject to MiFID) together with existing information on their clients to identify their own target market for a product. If the investment firm acts as both manufacturer and distributor there is no need to duplicate the target market assessment and distribution strategy exercise, although the firm should ensure it undertakes these activities in sufficient detail to meet both the manufacturer and distributor obligations.

A key challenge will be managing this dual responsibility between manufacturers and distributors, and ensuring that arrangements are in place to exchange the necessary information and documentation.

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Inducement will be allowed under strict conditions

In its Technical Advice, released in December 2014, the ESMA clarified that it will not opt for a full ban on inducements as was the case in the UK and the Netherlands. Nevertheless, the conditions under which they will be allowed will be strictly monitored and reported. Monetary and non-monetary benefits only being allowed for non-independent advice, independent advisers will have to start charging–and disclosing–an explicit fee for advisory as one possible way to compensate for the loss of inducement.

Needless to say, this shift will have to be carefully planned and well-communicated to avoid client dissatisfaction and change of advisers.

The trend we see now is that more and more advisers will likely decide to go for non-independent status offering a range of financial products from a limited number of product manufacturers. Many advisers are keen to explore this non-independent set-up, that will probably result in less impact on their models and potentially more focus on in-house products.

New charging structure may impact the customers' choice

Retail investors tend to prefer a commission model rather than a servicing fee model, which has complicated the move toward fee models in markets that have banned commissions (e.g. UK and NL) and may result in a large underserved population. This preference for a commission model often arises from a lack of understanding of the fees charged through inducements or commissions. Often, investors think financial advice paid through inducements is free. Investors also often fail to understand just how much they are paying advisers, whether they are operating under a commission or a flat-fee structure.

Communication of a new charging model will have to be carefully planned, well before the implementation in Q1 2017. This could be done, for example, through regular newsletters, distribution of reading material to clients, description of the benefits of advisory through a real case study, deconstruction of the advice into sub-services (meeting, call, online information tool, etc.), providing reports in hard copy, making it more tangible to the clients.

The care advisers give to their clients will be more important than ever in this new competitive environment, in which all adviser service offerings and related fees will be more visible to investors. Take the UK RDR impact on the IFAs as an example: there has been a decrease of 10,000 Independent Financial Advisers (IFAs) since 2010. Even if this skimmed off a good layer of the non-competent advisers, this phenomenon cannot be disregarded.

Rationalization and standardization of products can be expected

In this context, potential rationalization and standardization of products is likely to happen. Manufacturers will need to ensure that the products are distributed to the target market and that the products meet the target clients' needs. On top of that, regular performance reviews have to be performed on the products so that the distributors can assess whether they still fit with their clients' profiles.

We view this work as an opportunity for firms to rethink their model and boost their profitability through cost reduction, to continue to operate profitably.
The requirement to better manage the increased flow of information shared between the investment firms and distributors regarding details on the product will probably see a rise in document dissemination platform service offerings.

What's next?

It is now time for the industry (credit institutions, investment firms, asset management) to assess the first strategic and operational impacts, by estimating which of their revenue streams is at risk and how this loss of revenue can be compensated in their value chain.

What you can start doing:

- Organize training sessions to raise your teams' awareness of the MiFID II challenges
- Assess impacts of inducement ban on revenues
- Identify P&L optimization opportunities on services, products and client mix considering the impact of MIFID II
- Identify links and synergies with other upcoming regulations or market initiatives impacting the fund distribution models (e.g. AML IV, T2S, PRIIPS)