When the going gets tough, the tough gets going...

Level of readiness, strategic responses and major trends for 2018 in the wake of MiFID II

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Investment firms can no longer live off the fat
MiFID II entered into force on 3 January 2018. Affected entities in Luxembourg took very different approaches to the MiFID II regulation in 2017, and the regulatory, strategic, and operational conseque nces are likely to take up a lot of their time in 2018 as well.

With both of these technical challenges, as well as operational challenges, most investment firms have opted to work with external providers.

They have broken the back of the beast and are starting to see light at the end of the tunnel

Investment firms' level of readiness

In 2017, most firms dedicated significant time, resources, and (in most cases) IT manpower to being MiFID II ready by the start of 2018. As a result, significant progress has been made regarding the level of regulatory compliance and communication to clients and staff.

1) Level of regulatory compliance of MiFID firms

The level of coverage of the regulatory constraints seems to be very high in Luxembourg.

However, given the strict deadline and the fact that high-level guidelines are often issued late, investment firms have had to take some operational shortcuts to ensure compliance, but not always efficiency. Firms will need to upgrade these shortcuts in the course of 2018. In particular, due to very late guidelines, product governance, and the infamous "target market" concept, reporting obligations related to transactions and training programs have been the most difficult topics to tackle for most actors in Luxembourg.

As expected, given their greater financial, operational, and organizational resources, it seems that larger investment firms, especially those that are members of a group, have a higher overall level of readiness.

2) Client communication and staff

Most actors view ensuring that clients and staff understand all of the strategic and operational changes in the context of MiFID II as a key element of MiFID II implementation. However, given the very tight deadlines, and the fact that parts of the regulations were only finalized during the summer and some as late as December, not all investment firms have been able to properly communicate with clients in a timely and comprehensive manner.

In this context, investment firms have again taken different approaches in their client communications: some have provided concise, high-level information, while others have gone into (maybe too many?) details, and a third group of firms have not even communicated to their clients at all.

Regarding staff competencies and skills assessment, the degree of training delivered or to be delivered varies across the industry. Some have been organized and embarked on structured programs well in advance of any regulation being formally released. Meanwhile, others are still devising an implementation process so as to comply with CSSF Circulars 17/665 and 17/670, requiring, inter alia, at least 60 hours of training in the various areas of MiFID services or products if training sessions are to be delivered by external providers. For most investment firms, this means that training will have to continue in 2018 if they are to be able to certify their staff as MiFID II compliant.

A shared ordeal

Market impact is not to be underestimated

One area in which firms have been struggling to meet the deadlines is related to transparency and the reporting of transactions. With both of these technical challenges, as well as operational challenges, most investment firms have opted to work with external providers. Nevertheless, accurate and timely reporting have necessitated a painstaking trial and error approach to making improvements.

Additionally, in some instances, the aforementioned late communication and information requests to clients led to some client-related data, such as LEIs and national ID codes, not being available at the beginning of 2018. This created issues at least as regards regulatory transaction reporting, where the providers of LEI codes were simply unable to keep up with requests. In response to this development, ESMA provided some breathing room late in December 2017 to ensure the smooth introduction of the LEI requirements. This was achieved by allowing a six-month period during which transactions could be executed on behalf of clients, while waiting for the LEI providers to process the backlog of requests.

Regulators' level of readiness

In terms of MiFID II readiness, both investment firms and regulatory authorities are under a similar level of pressure. Indeed, MiFID II has not yet been enacted in the national legislation of all EU countries. In Luxembourg, implementation guidelines were published and drafted in the form of circulars very late in the game on topics such as staff competence and skills certification (13 October 2017) and transaction reporting (1 December 2017).

The reporting of daily transactions is an example of the Herculean tasks facing national competent authorities. Transaction reporting has been a huge challenge for national regulators, while many financial industry players doubt their capacity to efficiently and meaningfully process this immense flow of data. As a confirmation, ESMA, the EU Supervisory authority, published an instrument-level report on 9 January 2018, stating that only 2 percent of instruments that should have been subject to reporting had been adequately processed by the beginning of March.

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Some investment firms are going beyond "mere" regulatory readiness to review their strategic positioning

With the increase in regulatory constraints and the partial ban on inducements, MiFID II has forced investment firms to take action to mitigate the increased costs and compensate for lost revenue.

1) Investment value proposition reshuffle

MiFID II has introduced the notion of independent advice. While some investment firms were unsure how to position their advisory services a year ago, lack of interest from clients regarding independent positioning and the additional regulatory burden led the majority of firms to opt for non-independent positioning. For example, if we focus on banks, a benchmark shows that all 15 banks benchmarked in Luxembourg opted for non-independent positioning.

Alongside their non-independent positioning, banks also had to position themselves regarding the treatment of inducements.

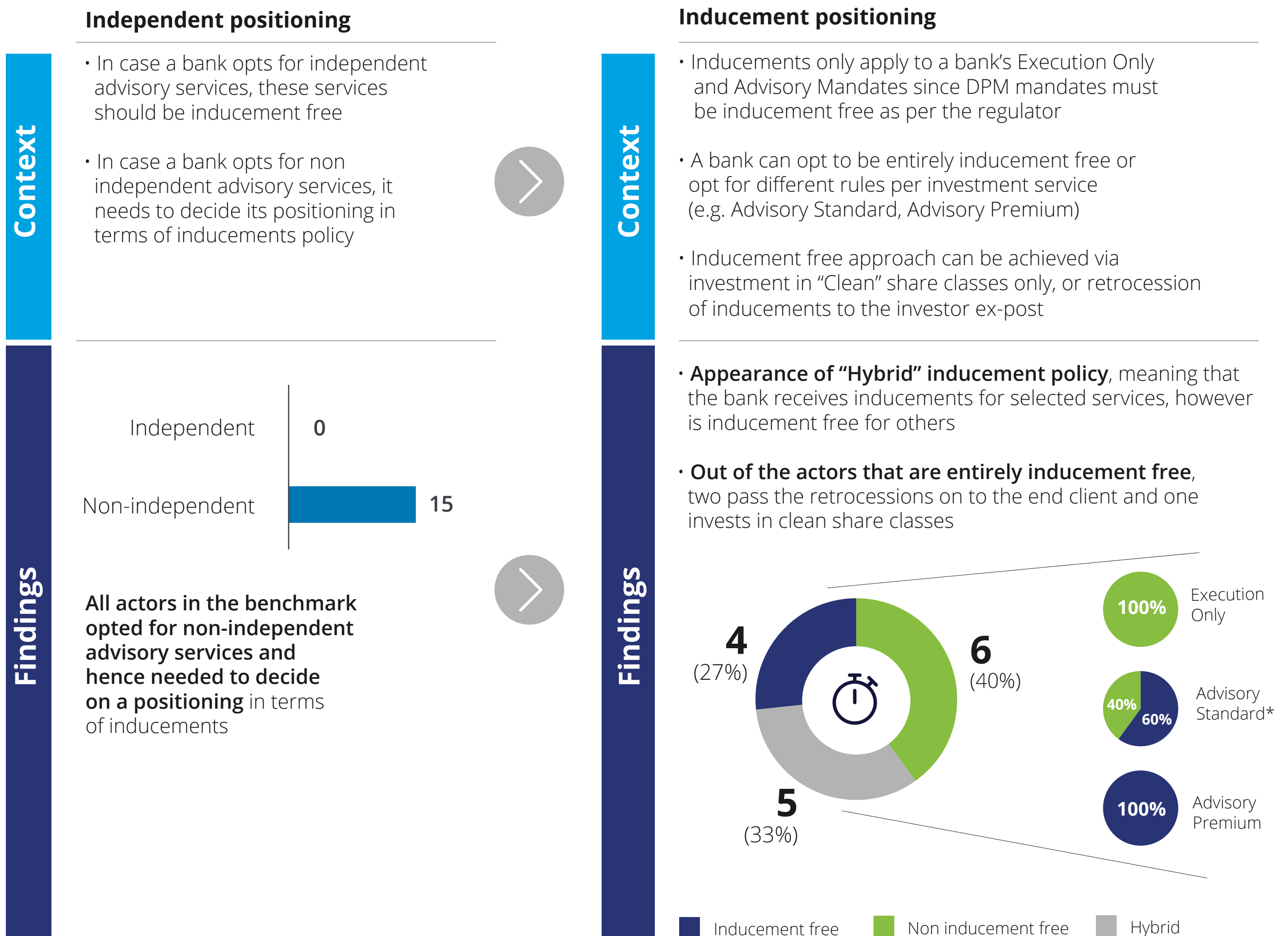
Banks had three options:

01. To be totally inducement-free (i.e., not receiving and/or not keeping received inducements related to any investment services offered). A minority (a quarter) of banks have chosen to be fully inducement-free. These banks clearly marketed this positioning to their clients.
02. To retain inducements related to their investment services (except for discretionary portfolio management services where doing so is forbidden by the regulation). Almost 40 percent of banks have chosen this option.

03. To be partially inducement-free. One third of banks have chosen a hybrid model. These banks all offer premium advisory services that are inducement-free, and all are keeping inducements on their execution-only offering while having different positioning on their standard advisory offering.

MiFID II also incentivized investment firms to position their execution-only offering as a real (packaged) offering to distinguish it clearly from advice and to launch a premium advisory offering to enable a distinct inducement positioning on advisory services.

MiFID II has forced Banks to position themselves regarding inducements
Benchmark performed in Luxembourg on 15 Private Banks



* One actor that keeps inducements on existing Advisory mandates, however follows an inducement free policy for new mandates is shown in graph as inducement free

2) Investment pricing: "each service has price, transparency has a cost"
On top of reviewing their value proposition, some banks have also worked on the pricing strategy of their investment offering.

To compensate for the partial loss of inducements as well as the increased costs related to client reporting and monitoring, most banks have amended their overall pricing. Not all banks have overhauled their prices entirely; some have just tweaked existing fees or added a new MiFID II related fee. Others have exhaustively reviewed their pricing list, and this might lead to some unwelcomed surprises by the end of 2018.

Two thirds of the banks from our benchmark published new price lists in the last quarter of 2017 to benefit from the pricing change as of the first quarter of 2018. Others are still working on it or have adopted a wait-and-see approach to see how the clients will react to the price change. It should be noted that the pricing review was carried out at the same time as a review of discount policies and procedures so as to have stricter rules to avoid losing the compensation benefits of the new pricing.

3) Launch of new products
In addition to reviewing their current value proposition and pricing, some banks have also looked at launching new products to compensate for the impacts of MiFID II.

In particular, banks mainly positioned as funds distributors, which have most to lose as a result of the partial ban on inducements, are aiming to improve their position as fund producer. This launch/increase of the share of in-house funds will, of course, take time to produce positive effects, but may have a long-term impact on the Luxembourg fund industry.

What's next?

Trends and outlook

1) Many "first times" in terms of readiness
Investment firms will have to manage their "first times" in 2018.

- Inter alia, the first round of quarterly client reporting, the first round of reporting on the top five execution venues, the launch of the systematic internalize role and the first round of yearly post-trade costs and charges reporting are on the agenda for 2018.
- Investment firms are also providing further training and official certification to their workforce.
- Processes will need to be reviewed to correct operational shortcuts taken in 2017 in the context of MiFID II but other processes will also have to be improved in order to save commercial time that has been taken up by MiFID II.
- Investment firms will also probably have to manage MiFID II on-site inspections from the regulator in 2018.

2) MiFID II is only a stepping-stone and strategic considerations should reflect this
A trade-off was found under MiFID II with a partial ban on inducements, but this situation will not last forever. What is not yet clear, however, is who (the client or the regulator) will demand a full ban on inducements and when it will happen. In any case, we can expect to see inducements disappear in the long term. This ban will force investment firms to look at other strategic mitigation actions. In parallel, it may also be in the fund industry's best interests to reconsider its pricing schemes.

Brexit implications will also have to be closely monitored as the United Kingdom represents a major share of the European banking industry. In particular, all "market" related measures will have to be amended and considered by investment firms once Brexit occurs.

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