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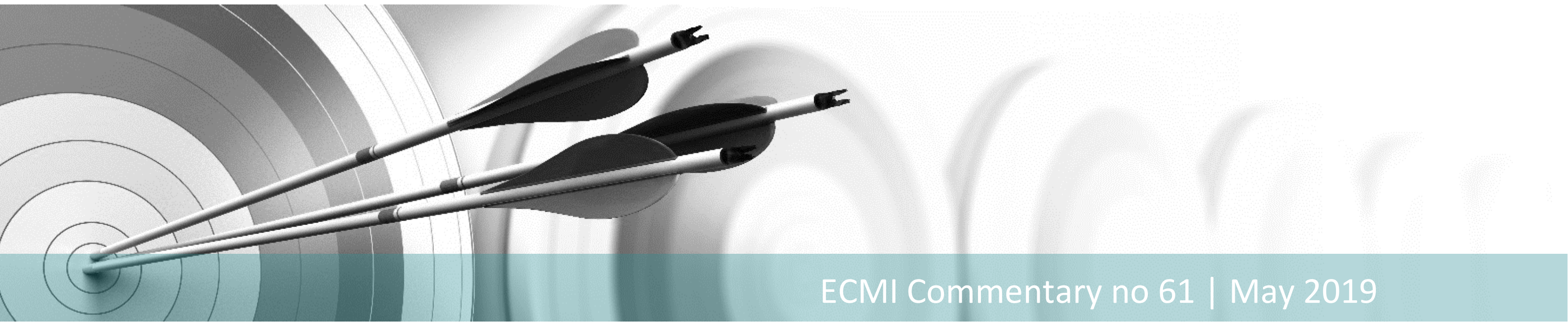

MiFID II critics are not seeing the big picture

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The MiFID II rules are leading to broader participation in capital markets by Europe's savers. This will far outweigh the costs, such as the more reduced investment research on small stocks. Recent criticism appears to overlook the broader picture, where the advantages of this revision are starting to become visible.

Earlier versions were fundamental in opening up EU securities markets, and have seen the City of London become the centre of securities trading, with the provisions allowing remote access for traders all over the EU. But some elements had to be further strengthened, above all the rules dealing with the protection of investors.

Early data on the effects of MiFID 2 indicate that market opening and integration is continuing apace, with further electronification or platform trading in products that had not been within the scope, such as government and corporate bonds, derivatives and exchange traded funds.[1] Banks are also confronted with many more requests for information from clients, as a result of the demand for more transparency on fees and charges, which is where MiFID II matters for individuals.

MiFID II had to go into much detail to achieve what earlier measures did not, and as such facilitates the access of households to capital markets. Investment funds are the main vehicle today, but they are too expensive for households because of their limited size and the deep conflicts of interest in the advice from banks — the main distribution channel. A recent study for the European Commission found that the average first-year cost (entry and management

[1] See ECMI Commentary no 59, February 2019.

fee) for an investment product in the EU is 4%. The lowest charges of about 1% apply for ETFs, thanks to on-exchange trading; the highest, of 5.5%, is for equity funds.[2]

The new rules have now taken a first step in the direction of reducing these costs, by increasing transparency. For the first time in many EU countries, households have received detailed overviews of the costs of investment products. In the case of my bank, this runs to more than 20 pages covering transaction charges, distribution (or retrocession) fees and taxes. All these fees and charges vary according to the size of the transaction, the product and the venue of execution. But banks continue to have room for manoeuvre in the broad definition of the "best execution" requirement and in the choice of the execution venue. In addition, the transparency requirements for bonds continues to be limited, meaning that price transparency applies only to liquid bonds, which number only 987 across the EU, according to the European Securities and Markets Authority (ESMA).

To ensure clarity in fees and to tackle conflicts of interest, MiFID II obliges operators to unbundle investment advice from execution. This measure was inspired by the UK's 2009 retail distribution review and has led to lower charges, an experience duplicated in the Netherlands. An ESMA overview revealed that charges on funds reduce returns by up to one-third, and that countries with unbundling requirements, (i.e. the Netherlands and the UK), see costs of only up to a third of those in the costliest country, Belgium.

If MiFID 2had to go that far to impose unbundling, it was because of the persistent conflicts of interest in investment advice. The EU's 1994 investment services directive, the predecessor of MiFID 2, already had provisions in this direction, which were further detailed in the 2004 MiFID I with the requirement on banks to tackle conflicts of interest — to no avail apparently. Unbundling will lower fees and encourage European savers to participate in capital markets, which is desperately needed given their overexposure to deposits. This benefit far outweighs the costs about which we have read so much in recent weeks. To put it the other way around, if more Europeans invest in the markets there will be enough money for research, including on small stocks.

The amounts in question are peanuts. For example, in France it involves a drop in investment research from €38m in 2016 to €34m in 2018, according to Amundi, or a decline of 6.3% in Europe according to the CFA Institute of investment professionals. [3]

The alternative is for charges on funds to be capped. This is under serious consideration at the European Commission. And the recently adopted proposal for a pan-European pension product sets charges at a maximum of 1%. Now that would put today's complaints in a different perspective.

[2] See for data references ECMI Commentary no 57, July 2018.
[3] See Special Report in IPE by Rhodri Preece, (CFA Institute) April 2019.

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