REGULATION

The meaning of MiFID II

Michael Hufton **explains just what MiFID II means and why it matters**

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MiFID II is the most maligned and misunderstood piece of legislation to come out of the European Union since the ban on curved bananas. Much of the financial establishment would have us believe that MiFID is a bank-bashing measure that crimps competitiveness and will cost jobs. It is nothing of the sort. MiFID II is all about consumer protection and it should result in substantially better retirement outcomes for millions of people across the EU28 by reducing cost. Grandiose claims. Let me explain.

Work by Towers Watson has shown that, for the average pension fund, transaction costs borne by the fund can amount to more than all other costs combined. Compression in average investment management fees, largely the result of growth of passive funds, exacerbates the problem – it means transaction costs account for an increasing proportion of the total cost burden. Point being if fund trustees want to improve returns to end clients, a laser focus on cost pass-through can be at least as important as attention to management fees.

Payment for 'service'

What is striking is that whilst trustees understand this, few put formal policies in place to manage dealing commissions incurred on their behalf by the fund managers they employ. Managing dealing commissions downwards can have a significant impact on fund costs and performance.

A typical institutional execution only commission rate would be of the order of 5-6 bps, with some funds still paying rates in the region of 8-10 bps. Yet via direct market access (DMA) and other efficient execution technologies the real cost of best execution is more like 1-3bps. It's a significant difference – with the gap often described as payment for 'service'. But what exactly is this service?

The cost of research is already stripped out from these numbers. The UK's Financial Conduct Authority (FCA) estimated that in 2012, of a total £3 billion of client money spent on dealing commissions in the UK market, £500 million of that went on corporate access – arranging meetings between investment managers and the executive management teams of quoted companies.

Meeting with the management teams of investee companies is a key part of the investment process for many managers, but using client funded commissions to pay for that corporate access was banned by the FCA in June 2014. Fund management houses have removed corporate access from their broker voting criteria – but there is precious little evidence of change to market practice in this area.

Over 90 per cent of corporate access remains intermediated by an investment bank, but it is now provided to clients 'for free'. Yet at a system level, there is little evidence of commissions paid falling. Companies are not paying for these meetings either - corporate broking in the UK market is a free service for all but the smallest companies. So if neither institutions nor corporates are paying, who is? It would seem likely that corporate access is the 'service' being paid for within fatter than necessary execution rates – or alternatively it's embedded within research spend. This UK analysis is equally applicable to other jurisdictions and has formed a core part of the European Securities and Markets Authority (ESMA)'s MiFID II proposals.

Research is another matter entirely – and is typically commission funded, either bundled or via a commission sharing agreement (CSA). In the UK, corporate access explicitly does not qualify as research, so cannot be bundled with and paid for along with research service – precisely what happens in much of the rest of the world. The language the FCA uses to describe this is "an overpayment for eligible service in order to remunerate an ineligible service".

Changing behaviour

Regulation could change behaviour in two ways. Final, detailed rules for MiFID II are not yet out – but under ESMA's final technical proposal to the commission, corporate access would be treated as an inducement. Europe would be going further than the UK rules. It would mean access is not commission eligible and has to be separately priced on a standalone basis. It could not be provided or accepted 'for free' - or bundled within execution or research spend. Secondly, the FCA's Wholesale Competition Review is investigating bundling and price transparency in corporate and investment banking. This report, due to be released at the turn of the year, could influence the provision of 'free' service on the other side of the same coin – to the corporate.

A forced unbundling of corporate access from both research and execution could prove material in helping investment managers reduce what they pay in dealing commission. But whatever the final outcome from MiFID, pension fund trustees should have policies in place regarding dealing commissions incurred to their funds by third party investment managers. What rates are being paid? Are those rates as low as they could be? How is the manager paying for research and corporate access and how are those payments being determined?

Provision of 'free' corporate broking services to corporates is a similar distortion, remunerated via transaction fees, which in many cases appear to be inflated. Ultimately all these costs are borne by the end investor. Being aware of them and managing them downwards has to be a good thing.

Underlying issues

It is worth stepping back a bit to consider the underlying problems. Low interest rates mean we are in a low return environment. Simply put, in a 7 per cent interest rate environment, losing 0.5 per cent in frictional costs along the way doesn't seem too bad. But in a 0.5 per cent world it's a major problem.

Work by the London Business School has shown that over the lifetime of a pension, reducing charges by 1 per cent would result in a 38 per cent higher income in retirement for the individual. So costs matter a lot in ensuring adequate retirement provision. View this in the context of chronic, systemic pension underfunding - and the urgent need for new, efficient, low-cost solutions comes clearly into focus.

MIFID II IS ALL ABOUT CONSUMER PROTECTION AND IT SHOULD RESULT IN SUBSTANTIALLY BETTER RETIREMENT OUTCOMES FOR MILLIONS OF PEOPLE ACROSS THE EU28

In his September 2015 report to the Treasury, Edi Truell, chairman of the London Pension Funds Authority, highlighted an unfunded pension deficit at the UK's National Health Service (NHS) of £500 billion, equivalent to a third of the entire UK national debt, and recommended the NHS increase its annual contributions to the scheme from £5.7 billion pa, 14 per cent of total annual payroll cost, to £32 billion pa, equivalent to 75 per cent of the annual wage bill. The Bank of England increased the cash contribution to its pension scheme in 2014/15 to 50.4 per cent of payroll. Again on Towers Watson numbers, average contributions to pension funds are around 10 per cent of wages.

Since the crisis we have seen a systemic transfer of risk in retirement provision the world over from institutions to individuals as sponsored, defined benefit schemes have closed and defined contribution has become the norm. Furthermore, one of the most important results of changes to pension legislation is that people are likely to hold their funds for much longer periods.

Removal of the requirement to purchase an annuity can extend the lifespan of the average person's pension fund to 50 years or more. This means an even greater need to focus on cost - as small amounts compounded over such long time periods have a huge impact. Putting this in context, for the UK as a whole, the FCA estimates that over a 30 year period, every 1 basis point improvement in trading costs could represent an additional £37.5 billion in client returns.

This is why it is a matter for regulators, because this is an issue where the impact will be felt by millions of individuals in retirement. It should be a focus of attention for us all. Pension underfunding is an acute problem and drives an immediate need for change to drive cost out of the system. Modern technology enables that change by providing new, efficient, low cost solutions – and new regulation will overcome inertia and vested interest to mandate that change.

This is how we will avoid the banana skins which, left unchecked, have the potential to become the next financial crisis. ■