

Is the German financial industry ready for MiFID?

EUROPEAN REGULATION IN SECURITIES TRADING WILL UNDERGO MASSIVE CHANGES WITH THE IMPLEMENTATION OF MIFID. THIS STUDY INVESTIGATES INTO THE READINESS FOR MIFID AND THE EXPECTATIONS OF THE GERMAN FINANCIAL INDUSTRY 21 MONTHS BEFORE THESE CHANGES TAKE EFFECT IN NOVEMBER 2007.

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Introduction

The Markets in Financial Instruments Directive (MiFID), representing the centerpiece of the EU Financial Service Action Plan, is intended to foster investor protection as well as market efficiency. For these purposes MiFID addresses the following key issues:

- a new classification of trading venues into Regulated Markets, Multilateral Trading Facilities (MTFs) – the EU pendant of Electronic Communication Networks (ECNs) in the US – and Systematic Internalizers
- requirements for Best Execution on a European level, and
- the introduction of extensive transparency regulations for OTC trading which is new e.g. for Germany.

The venue classification of MiFID is intended to establish a level playing field between execution mechanisms, to foster service and price competition as well as to assure that investors have a choice on execution venues. On the

basis of setting up an individual “Best Execution Policy” investment firms are supposed to realize the best possible result for customer orders. Off-exchange transactions have to be published as close to real-time as possible. In response to these major regulatory changes the financial industry in Europe is supposed to establish adequate processes and systems to comply with the new standards. This study is intended to investigate the preparation status of the German financial industry in February 2006, i.e. 21 months before MiFID takes effect. Furthermore it shall provide an overview of the attitude of investment firms towards the central topics of MiFID and provide a basis for firms to benchmark their own preparation status relative to other investment firms.

Data Sample

The survey „Die Umsetzung der MiFID in der deutschen Finanzindustrie“ (Implementation of MiFID in the German financial industry) was carried out in February 2006, including

193 investment firms consisting of the 100 largest financial institutions as well as the market participants of the three major German exchanges. For sound results five pretests were undertaken before investment firms were identified by phone that agreed to pass the survey. Finally a 28.5% rate of return (55 firms) was achieved.

Preparation levels and project status

Inhomogeneity of preparation levels – The analysis of the responses reveals a high variance in preparation levels among the German investment firms. About 42% of the companies are currently involved in collecting further information about MiFID, whereas 44% of the respondents are already aware of its core contents. Further 14% assess their familiarity with the new regulation to be very well. More than half of the investment firms have already started to prepare their activities for a MiFID implementation. Among the already

undertaken preparations, the analysis of the implications on internal business processes as well as on IT systems dominates for 48% of the firms. At the same time merely 29% of the responding investment firms are investigating the implications of MiFID on their business strategies.

Cost estimates surprisingly low – The majority (80%) of the surveyed investment firms estimate total one-off implementation costs for MiFID readiness to be lower than 1mn € (see figure 1.a). These estimates are clearly below the already publicly available and discussed cost estimates. Another 15.6% of German investment firms estimate the costs to lie between 1 and 5mn €. Only 4.4% expect costs above 20mn €. Among these results it is striking that the estimates of large investment firms do not show consistent patterns. Instead they are distributed among the different cost classes. The main cost driver is

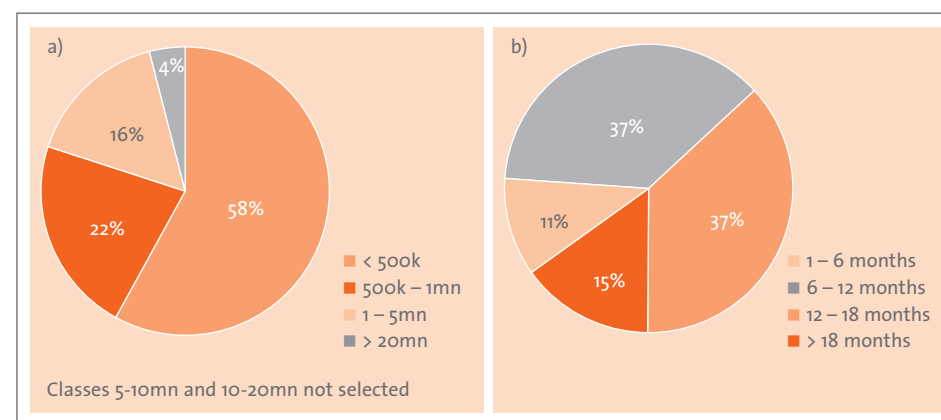


Figure 1: The left chart presents the estimations of overall one-off MiFID implementation costs, on the right the expected lead times for the implementation are shown.

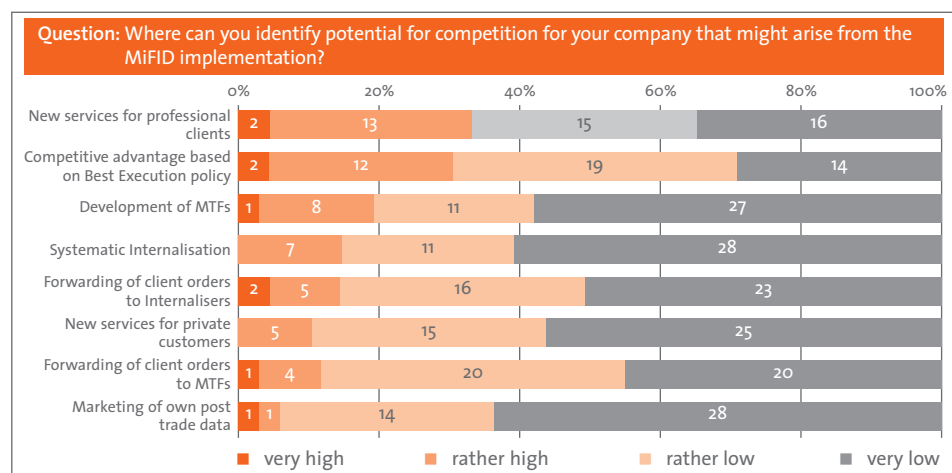


Figure 2: Potential for competition by MiFID implementation

expected to be the implementation of the requirements concerning Best Execution.

Timely implementation expected – In February 2006, the majority of surveyed investment firms assesses that the implementation of all MiFID requirements is achievable in less than 18 months (see figure 1.b). Only 16.7% of the companies expect the implementation to take longer. Among the respondents only 32% have already undergone a budget planning process for MiFID implementation. The companies that already have more concrete budget plans are allocating the budgets primarily for 2007.

Competitive potential and assessment of key MiFID topics

MiFID is seen as a regulatory obligation rather than as a strategic chance – Best Execution plays a key role in MiFID and offers investment

firms a chance for differentiation. Another area where firms see potential for new competitive moves is the provision of new services for professional clients (see figure 2). But overall, the industry does not see much potential for competition that can be derived from the implementation of MiFID. Especially, investment firms do not see a business opportunity in the marketing of their own post trade data although MiFID allows providing post trade data on a commercial basis and via self selected data distribution channels. Furthermore, most companies have not selected a distribution channel yet.

Self assessment of firms concerning the criteria for classification as Systematic Internalizers

In the draft Level 2 implementing measures, the EU Commission defines four criteria for a classification of investment firms as Systematic

Internalizers. Among the respondents of the study 55.1% possess rules as well as business processes supporting an execution of client orders against their own account (criterion 1). Furthermore, 40.8% provide personal or automated systems for executing customer orders against their own trading books (criterion 2). 26.5% of the investment firms assess themselves to provide this service to clients on a regular basis (criterion 3) and for 14% of responding firms, execution of customer orders against own account has a material commercial role (criterion 4).

Expansion of transparency rules is not desired

– The transparency requirements of MiFID will apply to equities only with the start in November 2007. Nevertheless, MiFID provides for an expansion to further financial instruments based on a review by the Commission. A majority of German investment firms (51.2%) rejects an expansion of the transparency rules to any further financial instruments.

Conclusion

Many investment firms still collect information concerning MiFID on which they will base their decision for concrete actions. One reason for their “wait-and-see” attitude may be due to the fact that the technical implementation details on the EU level are not finalized yet (target date: September 2006) and that MiFID has to be transformed into national legislation (target date: January 2007).

A survey performed by the MiFID Joint Working Group in autumn 2005 among UK

investment banks led to quite similar results. The uncertainty was even stronger: e.g. only 24% stated that their knowledge on MiFID is sufficient to take the necessary steps for developing a Best Execution Policy and 80% of the respondents had not developed a strategy for the requirements of the market transparency regulations yet. A BearingPoint survey in late 2005 also coincides with our results by stating that the main potential for competition is seen in Best Execution and that this issue is expected to generate high implementation costs.

Although MiFID constitutes completely new requirements e.g. on order executions that may provide new opportunities for firms, overall the industry currently sees MiFID as an obligation rather than a strategic chance. A follow-up study after the national implementation in early 2007 is planned to evaluate both the attitude of firms roughly 6 months before MiFID will go live and how the attitudes and cost estimates have changed given the full set of regulatory requirements and intensified internal investigations by investment firms.

References

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