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Sustainable Architecture for Finance in Europe (<https://safe-frankfurt.de/>)

SAFE Finance Blog

The Regulatory Dilemma of MiFID II

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Interview with Günter Franke: New rules impair service to retail investors



On 3 January 2018, the EU Directive MiFID II becomes effective. It aims to increase market transparency and to enhance the protection of bank clients with stricter rules for the sale of financial products. The complexity and the scope of the new legislation – the legal texts comprise about 20,000 pages – raise doubts whether MiFID II can achieve the objectives of the European Commission. Günter Franke (<https://safe-frankfurt.de/de/forschung/wissenschaftler/details/showauthor/210-franke.html>), Professor of International Finance at the University of Konstanz and Associated Research Professor at the SAFE Policy Center, proposes in a SAFE White Paper a mixture of rules and principles that would allow for a more effective protection of retail clients without increasing compliance costs for banks.

Mr. Franke, MiFID II aims at increasing transparency and improving protection for retail clients. Why do you criticize the new rules?

MiFID II, by using strict rules, follows a legally inspired approach. It threatens misconduct with civil sanctions and criminal penalties. Strict rules are attractive because they allow to clearly define violations so that sanctions can be imposed. However, MiFID II in the current form sets wrong incentives. Given the new, strict rules in consumer protection and the wide-ranging ban on commissions, it hardly pays off any more for financial institutions to provide bank advice for retail clients. The new rules increase costs and reduce margins of the banks so that they will curtail bank advisory services and offer robo-advice instead, which is difficult to understand for customers with little financial knowledge.

What are the advantages of an approach based not only on rules but also on behavioral principles?

Rules provide clarity, security and transparency regardless of the client's profile. However, they do not live up to the great heterogeneity on both sides – clients and banks. We therefore propose a three-pillar framework: In addition to rules, we advocate principles that guide the advisory process. Principles phrase norms which are put forward in the bank's guidelines for consultancy. They take different needs of each bank-client relationship into account – in particular the level of financial literacy of the client. Rules of conduct offer more freedom for the investment advisor. However, as a consequence, both the bank consultant and the client have to accept more responsibility. The better the financial literacy of the client, the more responsibility he or she should accept in this process.

Even if one assumes a certain level of financial literacy, there is usually an asymmetry of information between the bank and its clients. How could such a system be supervised so that the bank does not take advantage of its clients?

Our approach needs supervision. Banking advice should be monitored by regulatory authorities. Are the rules followed? Is the outcome of the advisory process satisfactory for the client, evaluated by his or her needs (risk appetite, income, etc.)? According to MiFID II banks are obliged to learn about their clients' risk tolerance. This is essential. In order to respect the principle of proportionality we propose to monitor the advisory process by random sampling. A breach of the rules by a bank should be sanctioned. In case of unsatisfactory implementation of the principles, the financial supervisory authority and the bank should jointly seek to improve the advisory process. In addition, market discipline could motivate careful advice for retail clients. This is where the third pillar of our approach comes into play: The advisory process could be evaluated by external experts and customers. The publication of the findings including the banks' names would provide an additional incentive for high quality banking advice.

Your approach promises more retail client protection, lower costs and higher returns for banks. However, fewer rules and more principles do not per se guarantee better margins in investment advice.

Banks only offer banking advice of high quality if they can earn the cost of capital in retail banking. Therefore, we oppose the limitation of commissions as well as the complete abolition of the commission-based retail banking.

MiFID II places narrow limits on the commission-based business. Commissions may only be paid if they are used to improve the quality of the advisory process. However, proving that is not easy. If commission in retail banking is limited or even eliminated, banks will only provide a minimum of advice. This may be acceptable for clients who buy simple financial products. In principle, every client should be able to choose among financial products of a certain product group which fits his or her financial literacy and needs. Transaction commissions should rise according to the complexity of the product group. Thereby, moral

hazard problems in client advice would be reduced.

A direct fee-based compensation instead of a commission paid by the client to the bank advisor could provide a solution to the moral hazard problem.

In recent years, fee-based advisory service as an alternative to commission-based advisory service has been observed for more affluent clients only. Small investors often feel that fee-based banking advisory service is too expensive.

How will retail banking develop under MiFID II?

We are already witnessing a trend towards robo-advice, i.e. algorithm-based systems that provide investment recommendations without human involvement. For the banks, the marginal costs are very low. However, especially for clients without any financial knowledge this does not provide a sensible form of banking advice, because they do not understand it. For such clients investment advice provided by robots is as helpful as no advice. Therefore – under the current conditions of MiFID II – I recommend a combination of robo-advice and personal advice. Some banks have already started testing this approach.

More on this topic: Günter Franke, Thomas Mosk, Eberhard Schnebel: Fair Retail Banking: How to Prevent Mis-selling by Banks, White Paper Nr. 39. (<https://safe-frankfurt.de/de/policy-center/publikationen/detailsview/publicationname/fair-retail-banking-how-to-prevent-mis-selling-by-banks.html>)

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