8 February 2018

BANKS. The impact on businesses of the new MiFID II rules on investment

More transparency or more bureaucracy?

What's changing in the management of corporate treasuries and issuance to raise funds on the market? Three opinions, pending indications from Consob and the Banca d'Italia

by **Giovanni Medioli**

At the beginning of January, the EU Directive "Markets in Financial Instruments (MiFID II)" entered into force. The new directive introduced a new, consistent set of rules for financial intermediaries in order to protect investors and in so doing effectively retired MiFID I, which dates back to 2004. With the hope, as a user of banking and financial services, that the new plethora of European rules on financial instruments will work at least a little better than the old ones, given that for now the first set of legislation seems to have provoked an exponential growth in the bureaucratic requirements for bank customers. Without, however, any real protection from the mis-selling of "dangerous" products even to small savers – something that can be confirmed by all the current-account holders of the Veneto cooperative banks and of other banks that have defaulted. They were sold subordinated bonds which then basically became worthless, without having had the risks explained to them (risks that needless to say became a reality).

More paperwork for investors…

The new set of regulations is so dense and complex that, according to the headlines run in the newspaper *Il Sole 24 Ore* on 17 December 2017, the banks used to joke amongst themselves, "Don't let the customers know!" [what's coming]. These are the customers who, up to now, seem to have understood only that they had been invited to go their branch to "review their risk profile".

This basically means that they have to sign more papers, only to find that they cannot declare a level of knowledge of financial matters that is too low, therefore qualifying for the minimum-risk profile, even if they want to mainly buy government bonds. Until a few years ago, this was considered the typical choice of the most cautious investors but today (after the sovereign debt crisis of 2011), it's viewed by the regulations as being typical of hardened speculators.

…and higher costs and more red tape for banks

Generally speaking, the new legislation does not come at a good time for Italian banks. Only last year, weakened by years of crisis, they began to emerge from the trap of increased bad debts and non-performing loans.

These irrecoverable loans, according to data from S & P Global Ratings, accounted for about 20% of bank lending between 2015 and 2016 but have now fallen below 15%. And there's a political storm raging over the (in)effectiveness of the supervision systems.

MiFID 2, beyond the official statements, means an increase in costs for the system and an unknown quantity of new procedures to implement at a difficult time. Even if market conditions were to make it possible to lend more to businesses, at the moment the production system does not seem to be asking for additional credit from banks and lending is struggling to pick up again.

In addition, MiFID 2 comes at the same time as other major regulatory and technological changes. The latter are a result of the increasing importance of online banking and mobile-phone payments that no longer need to go through banks but are made possible by fintech (the new financial transfer systems).

Uncertain impact on businesses

In this situation, the upcoming regulatory innovations are not only MiFID 2. International Financial Reporting Standards 9 (IFRS 9), with its new criteria for accounting reporting that should make it impossible "not to notice" loans at risk until it is too late, is also on the way. And then there's Payment Services Directive 2 (PSD 2), the new European directive issued in 2016 to regulate payment services offered through traditional channels (transfers and credit cards) as well as through the new digital channels.

One Italian daily newspaper recently ran the headline "(bank) branches know no peace", to indicate that MiFID 2 does not strictly apply only to commercial banks but also to investment banks, asset management companies, investment firms, financial brokers and dealers, regulated market management companies, wealth managers (including insurance companies) and financial advisers, and energy and commodity distributors.

The regulations therefore govern the production and the distribution and management of financial products. Even though they are chiefly addressed to physical persons (retail markets), in reality they embrace all users of financial products, including businesses, in at least two ways. First, through treasury management, i.e. investment of cash generated by the business; and second through issuance, the bonds or shares issued by a firm to raise funds on the market.

Three points of view

The bank's view

On the eve of the entry into force of MiFID 2, we ask a senior manager at Intesa Sanpaolo what the effects are likely to be

Obviously, it's too early to estimate what effect the main investor safeguards of MiFID 2 will have but, initially, we don't think that increased transparency as to costs will, of itself, change investors' decisions regarding their level of risk. Actually, nothing will change in this respect compared with MiFID 1: banks and other financial intermediaries offering financial advice are required to recommend investments that match customers' characteristics and requirements as set out in the customer profile. As far as business customers are concerned, early information we've obtained seems to confirm this assumption, as treasurers have not made any particular changes to the types of products in which they invest. Although the figures are incomplete, they do confirm that only a residual share of investment is in equity funds and this hasn't changed with the introduction of MiFID 2 (about l% of the total amount invested in funds). Around 75% of liquid assets are invested in bond funds (dropping slightly in 2018 to 65%). Investment in flexible funds is unchanged at around 22%.

This behaviour is consistent with the specific needs of this type of customer, whose choices are aligned with the need have access to their financial resources over a fairly short time horizon.

Looking at firms as issuers, on the other hand, what effects are you expecting to see? Isn't there a danger that end-investors might avoid buying, say, issues by small and medium-sized enterprises (SMEs), such as mini-bonds, because they're judged to be risker than issues by bigger corporations, even when combined in complex investment instruments such as individual saving plans [in Italian, *piani individuali di risparmio*, or PIRs]?

What I said earlier applies here too: in other words it's impossible to predict what impact MiFID 2 will have on end-investors. However, at first sight we don't feel that greater cost transparency will itself be something that encourages more cautious decisions or that MiFID 2 in itself will make "riskier financial products" less "sellable". According to our data for the first days of this year and to the impressions and feelings of our sales network, customers continue to show a preference for individual saving plans, partly because of the tax advantages. I'd like to point out that Eurizon's individual saving plans consist of 3 investment funds, each with a highly diversified portfolio, designed to include different asset classes, and with 3 different risk levels. In this way we hope to meet the needs of customers with different profiles.

An investment firm's view

Angelo Meda, *equity market manager at Banor SIM*

Angelo Meda, equity market manager at Banor SIM, explains that, in his opinion, MiFID 2 is impacting on financial intermediaries on three levels. The first concerns IT and the need to fulfil certain technical requirements. The second concerns research and is related to the increased complexities facing operators, although it does not involve investment funds. The third, probably the level provoking the most discussion, concerns governance. There is a requirement to sell products suited to the customer's risk profile: the novelty is that the financial intermediary is wholly responsible if the product sold does not match that profile. But can we be sure that this rule (which in theory already existed under MiFID 1) will be applied more stringently? "It all depends on Consob and the Banca d'Italia," explains

Meda. "I wouldn't assume that we are really heading towards a more complicated restrictive policy regarding sales of financial products".

One of the doubts that many business owners have raised in recent weeks is that the introduction of stricter rules on sales of investment products will thwart the (so far hesitant) attempts to channel part of the savings of Italian investors towards issuances by SMEs, which seemed to be taking off with the introduction PIRs…

I can't see any problems with PIRs. In 2017 we gathered around €10 billion worth, with an average value of about €12,000, roughly 20% of the average financial wealth of each customer. I think the figure will be much the same this year. However, if you ask, "Have PIRs invested in SMEs?" then the answer is no. They should, of course, but in reality PIRs only invested in listed companies last year. The tax advantages of listing should be extended to issues of mini-bonds or direct lending to SMEs as well, partly in order to offer SMEs an alternative to bank loans. Clearly, the situation is unbalanced: in the US, SMEs raise over 90% of their financing on the market and less than 10% from banks, whereas in Italy banks are the source of almost 100% of funds for businesses. The costs of small issuance are still too high. In order to raise €3 million on the market you have to pay about €500,000 in fees. Bank managers need to understand this better and, most important, the tax incentives need to be restructured…

Does MiFID 2 also change things for corporate treasurers? Could it affect their investment decisions?

Aside from a slight increase in red tape, in theory the answer is no, as treasurers are regarded anyway as professional intermediaries and so face no risk of requests for compensation. I don't believe the rules place tight restrictions on where to invest; I think there's been a sort of psychological terrorism in this respect. If anything the rules are too permissive: for example, cryptocurrencies don't come under MiFID 2 and in theory anyone can buy as much as they like from their local bank. This is also the only country in Europe where funds are excluded from MiFID 2. All told, though, everything will depend on the decisions taken by the Banca d'Italia and Consob over the next six months.

An asset manager's view

Roberto Citarella, *managing director of HSBC Global Asset Management Italy*

Roberto Citarella, managing director di HSBC Global Asset Management Italy, says, "I think that MiFID 2 brings benefits for those managing corporate liquidity, in terms of transparency and lower production costs in asset management. For those entrusting treasury management to a bank or management company it will probably lead to more targeted products and lower management costs. That said, I think that the problem for treasurers is managing not only surpluses but also unused credit lines. Normally, treasurers always keep an eye on the possibility of disinvesting rapidly, without realising that cash is often a structural component of the business. It's no longer possible to combine quick liquidity and yields which, on the financial markets, don't exist any more".

So, the money to finance growth shouldn't necessarily come from cash flow …

No, as I said, that's a structural component. With the euro interest rate curve negative or close to zero, CFOs need to change their attitude: they can't expect investments to yield 2% per annum, be risk free and liquid, because such things simply don't exist on the market any more. MiFID 2 will probably help to make services clearer, and stop treasurers, perhaps pushed by their Board, from going for investments that are not transparent and entail high risk. Anyway, the MiFID rule "I only pay for advice if the quality of the service is right" is an encouragement to use experts.

Will the new limits on selling risky financial instruments to the public eventually make it impossible to provide venture capital for Italian SMEs, which it was hoped the introduction of the law on PIRs would achieve?

In reality, the system that was supposed to finance small firms without having them go through the banks has not materialised in Italy. Vehicles such as Italian and Luxembourg-based funds, whose net asset value (NAV, a method used by investment companies to assess what equity yield they need in their portfolios to sell new units or liquidate existing ones) is computed daily, can't do anything for SME units or issues. If I were CEO of a small company I'd stay well away from listing to avoid all the pressure from financial analysts.

It's better to stay in the segment of companies rated using the price/earning method, which is more advantageous despite carrying a relatively greater risk. In my opinion, PIRs are not the way to channel investment to SMEs; there are other ways that are better, such as Special Purpose Acquisition Companies (SPACs), which are valued over longer periods and cannot be liquidated before a given date. A daily NAV is a problem and in the end the banks invest, through funds, only in large listed companies from a very small circle of names. Small companies are left out in the cold.

So, are other instruments needed?

No, I don't think they're necessary. Low cap issues could take advantage of PIRs if units were liquidated not daily but at least weekly or monthly. On the other hand, I don't think they can prosper in a system where there's too much liquidity and too much anxiety. If market fluctuations are the result of algorithms that operate in a matter of seconds, then SMEs are at a great disadvantage. I'm convinced that MiFID 2 will reduce management costs because of greater transparency and competition, which should lead to increased disintermediation, hopefully at least. Of course, we need to know how Consob and the Banca d'Italia will manage the new rules to "take the edge off".

BANOR SIM