FINASTRA

MARKET COMMENTARY

MiFID II to Restore Trust in Banks?

How much is it worth paying to restore trust in banks and financial markets? First, let's start by establishing how much trust in those institutions was lost as a result of the 2008 financial crisis.

> "One of the biggest challenge banks have in meeting these higher standards is the cohesive and aggregated management of data, across asset classes and front-to-back through the organization from pre- to post-trade lifecycle."

Clearly regulators had to do something, given that such a liquidity and banking crisis happened on their watch, if only to restore trust in themselves as market oversight had also gone horribly wrong. But have they done the right things and will some of the regulatory incursions deliver unintended consequences that do more harm than good?

A Regulatory Deluge

The reactions were swift, at least by regulatory standards, as American and European lawmakers, along with the likes of the Bank for International Settlements (BIS) moved to plug the gaps, or market deficiencies, they had identified. At the heart of a blizzard of new rules to emerge over the next eight years were measures that fell into two groups. The first was to better protect investors and the others to make banks safer and avoid systemic risk. On the one hand, these were designed to improve market oversight and transparency and on the other to significantly raise the level of banks' capital buffers that would be available to offset unexpected losses from riskier transactions.

So, off the printing presses they rolled. First up was Dodd-Frank as American legislators were determined to take the lead in new global regulations. A monster of 24,000 pages encompassing 400 regulations, followed by its Volcker Rule amendment that sought to plug more gaps not identified in the first pass by effectively closing down American investment banks' ability to conduct proprietary trading. But so far only some 70% of those have actually been implemented, with 10% pending and around 20% yet to even be proposed. It is still going to be a long haul, despite talk about the new American administration trying to roll back some of the new laws.

The European Union (EU) had actually got the ball rolling with the first Markets in Financial Instruments Directive (MiFID I) just prior to the market crash in 2007. Following the crisis, it was quickly decided these went nowhere near far enough and the gestation of MiFID II was soon underway. MiFID II and its associated regulation, MIFIR, will become law on 3 January 2018. For good measure, the BIS Basel Committee on Banking Supervision (BCBS) weighed in with its own tougher capital rules to protect bank solvency that are being taken into the stratosphere with the introduction of the Fundamental Review of the |Trading Book (FRTB) in January 2020. And let's not forget the likes of other alphabet regulations such as FACTA, EMIR, AML, MAD II, and IFRS 9. It has been quite a deluge.

THE FUTURE OF FINANCE IS OPEN

One of the biggest challenge banks have in meeting these higher standards is the cohesive and aggregated management of data, across asset classes and front-to-back through the organization from pre- to post-trade lifecycle.”

Clearly the banks have not been happy at this turn of events. But recognizing the self-inflicted nature of much of the crisis and the widespread public opprobrium, they were not in a very strong position to offer much resistance. Nevertheless, lobbying has now intensified and many individual banks and industry associations are starting to rail against the regulatory impositions that are piling up.

A Far-Reaching and Costly Regulation

In the meantime, however, they have to get ready if they want to stay in business. Not only is this an expensive exercise, in the United States (US) alone some estimates put this as adding USD 10 billion a year to banks' costs. It is complex to implement and sustain. Part of that has to do with the creaking and unwieldy IT infrastructures at most banks and the need for new business models and working practices to manage the data flows and analysis that the regulators are now demanding.

The regulators themselves have to absorb part of the costs. Under MiFID II, they will have to be able to cope with collecting data on 15 million financial instruments from around 300 different trading venues. If it is not already covered by the billions so far raised in misconduct fines, the rest will be passed on. It is also worth remembering that, while the banks are bleating about implementation costs, these too will no doubt eventually be passed on to customers in some form or other.

MiFID II seeks to both impose greater transparency around trading and settlement to ensure best execution, while also removing potential conflicts of interest by separating the payment for research by asset managers from sell-side banks from the commissions they pay them. This is expected to deal a crushing blow to the vast research teams historically employed by banks to underpin their marketing of bonds and equities, with the money spent on it set to halve to $300-500 million a year.

While some will argue this is long overdue given the anemic nature of many of the analysts' conclusions, which appear loath to upset corporate clients with negative or "sell" recommendations, others will agree that the "unbundling" of research that is proposed will promote competition, weed out the weaker providers and, in the end, provide greater value for money.

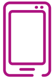
Other new rules in MiFID II require a whole range of previously Over-the-Counter (OTC) traded products - mainly derivatives and certain commodity assets - to now be settled through regulated platforms. And in order to protect against surprises from automated trading banks will have to register algorithms and include "circuit breakers" that can be used to shut down their operations when they are deemed to have caused disruption. The list goes on.

One of the biggest challenge banks have in meeting these higher standards is the cohesive and aggregated management of data, across asset classes and front-to-back through the organization from pre- to post-trade lifecycle. The historic evolution of bank trading operations around data siloes aligned to asset classes and business lines makes this transition extremely difficult, if not impossible when trying to also meet regulator expectations of delivering these answers in close to real time.

In addition, the amount of manual interventions through the trade lifecycle and the reliance on spreadsheets means most banks are a long way from being able to achieve MiFID II compliance. A great deal of automation of trade process will have to be high on the agenda. The grumbles and complaints are certainly increasing, but still cannot counter regulators' contentions that these new rules are essential to re-establish investor and wider public trust in financial institutions and better protect customers. They might be right. But we might never know.

For More Information Visit
finastra.com

Contact Us At
capitalmarkets@finastra.com



Telephone
+44 (0) 203 320 5000

More Questions than Answers?

The new rules have certainly made banks safer by doubling—or more—reserve capital requirements. But in the process many banks contend that the new rules have also made them unprofitable.

So how will we actually measure the benefits of best execution on an individual trade and how that is passed on to an individual investor? Even the large institutions struggle to analyze this, noting that in certain markets—particularly large parts of fixed income - large transactions in less liquid bonds are better when dealt directly with one buyer, rather than subject to transparent bid-offer spreads MiFID II requires. In fact, there are already examples of liquidity challenges in less frequently traded bonds due to capital penalties being imposed on banks for holding large bond inventories.

But the demand for higher standards is relentless and, while some of the specific proposals might well be altered when experience demonstrates deficiencies, there is no real turning back. Banks therefore need to accelerate the modernization of their technology infrastructure to cope. And in order to offset the initial impact of the sharply higher operating costs these might entail, they will need to embrace capabilities that place digitalization at its core and leverage resources like cloud computing and Platform-as-a-Service (PaaS) as its modus operandi.

So, will it be worth it to restore trust? It is unlikely anyone will be able to say. Some believe there is a new banking crisis lurking just beneath the surface and with the all the regulatory pressure being piled on it might just be the last straw that brings another bank down.

The bigger American banks believe that they have done all the hard work to both clean up their balance sheets and to be competitive in the new regulatory environment. They might not all be right. But in Europe it is a much more uncertain picture, where it seems clear that many banks shied away from overhauling their capital structures, facing up to bad debts and other problems when they had the opportunity. Is it a ticking time bomb? Will the new regulations expose that? If it does and investors again lose out, then who will take the blame this time: the banks or the regulators? As stated before, this means more questions than answers. At least so far. But banks will need to be ready either way if they want to keep their licenses—and their customers.

About Finastra

Finastra unlocks the potential of people and businesses in finance, creating a platform for open innovation. Formed in 2017 by the combination of Misys and D+H, we provide the broadest portfolio of financial services software in the world today – spanning retail banking, transaction banking, lending, and treasury and capital markets. Our solutions enable customers to deploy mission critical technology on premises or in the cloud. Our scale and geographical reach means that we can serve customers effectively, regardless of their size or geographic location – from global financial institutions, to community banks and credit unions. Through our open, secure and reliable solutions, customers are empowered to accelerate growth, optimize cost, mitigate risk and continually evolve to meet the changing needs of their customers. 48 of the world's top 50 banks use Finastra technology. Please visit **finastra.com**

Corporate Headquarters
One Kingdom Street
Paddington
London W2 6BL
United Kingdom
T +44 20 3320 5000

Finastra and the Finastra 'ribbon' mark are trademarks of the Finastra group companies.
© 2017 Finastra. All rights reserved.

GB 318 / 0917