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## **BANKING SYSTEM COMPLIANCE WITH MIFID II REGULATION: CONSEQUENCES AND CHALLENGES**

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### **ABSTRACT**

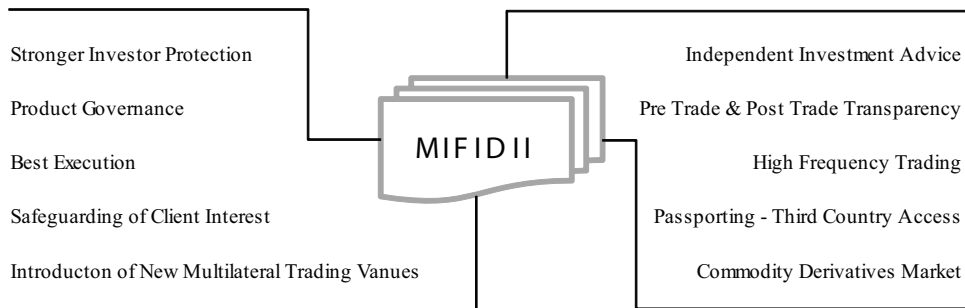
MIFID II represents overall financial market reforms in trading and processing of financial instruments. Major influence of new regulatory framework in banking industry is related with pricing, trading, reporting of banking products and financial institutions classifications. New financial markets infrastructure roles is providing more protection for banking clients including the significantly increasing a market transparency. Banks are obliged to demonstrate to the client the best execution price at related trading venues, transaction costs and market behaviour. Regulation is adjusted with other financial market regulation of over the counter markets and market abused protection to avoid regulatory overlap. New regulation is asking full compliance process of banking industry on the European Union banking system. Banks are faced with significant costs in internal processes reorganization, new technological support and opportunity costs of absence of extra profit in competitive and transparency markets. Major benefit of the MIFID II regulation will be traded by non qualified counterparts which will be fully reported in ex ante and ex post trading activities. Banks and other financial institutions which can not exploit the economy of scale will reduced activities and product offer to the clients in the period on regulatory framework adoption. MIFID II is significant challenge to management in positioning banking firm on demanding global financial market.

***Key words:*** *MIFID II, bank regulation, trading activities, financial markets.*

## 1. INTRODUCTION

Markets in Financial Instruments Directive (MiFID II) is one of the major centrepieces of financial market reform in post crisis period.<sup>1</sup> The result will be in revolutionary changes of the marketplace in trading and processing of financial instruments. The ongoing financial crisis has revealed weaknesses in the transparency of financial markets what can contribute to adverse socio and economic impacts. In order to strengthen the functioning of the financial market financial authorities established a new legal and organizational framework and participant obligations for transactions with financial instruments. Legal framework is supported by Directive (EU) 2014/65 of the European Parliament and of the Council together with Regulation (EU) 600/2014 (Markets in Financial Instruments Regulation – MiFIR) which is directly applicable to legislation implementation between market participants.<sup>2</sup> The major objective of the MiFID II is to improve the efficiency, resilience and integrity of financial markets on the European Union level, shown in figure is following.

**Figure 1** Key changes in MiFID II/MiFIR regulation



Source: Capgemini (2016) *MiFID II: Demystifying the Challenges*, p. 3.

MiFID II is strengthening the protection of investors through the enhancement of the rules on inducements a independent advice and new product governance, increasing the transparency through pre and post trade information regime, information to the clients about the product and position investment risk, and harmonising sanctions and ensuring effective cooperation between the relevant regulatory authorities. Tendency of the new regulatory framework is to introduce high technological trading development, extend

<sup>1</sup> MiFID II is continuity of Markets in Financial Instruments Directive 2004/39 (MiFID) which had been partially oriented to the ordering services of financial agents to clients.

<sup>2</sup> Based on the Article 249 of European Union Association Agreement each member state is in obligation to implement EU Directives and Regulations of the European Parliament and of the Council.

the scope of trading venues through developing the new trading platforms, and introduction of position limits and reporting requirements for commodity derivatives, broadening the definition of investment firm to capture firms trading commodity derivatives as a financial activity. The MiFID II/MiFIR applies to investment firms, market operators, data supply providers and third country companies, and partly to credit institutions to providing one or more investment services or performing investment activities. Market participants meet the regulatory requirements based on the regulation timeline, shown in the figure is following.

**Figure 2** MiFID II / MiFIR regulation timeline<sup>3</sup>



Source: *European Securities and Markets Authority – ESMA (www.esma.europa.eu)*.

The banks have to be compliant with new regulatory framework like other professional market oriented financial institutions what can affect the bank business model behaviour in the scope of financial services to the clients, revenue and assets structure.

## 2. FINANCIAL MARKET ORGANIZATION UNDER MIFID II

The new legislation of financial markets has brought about significant changes in the operations of investment companies and organization of financial markets. Investment firms which execute transactions in financial instruments since January 2018, report complete and accurate details of such transactions to the competent authority as quickly as possible, and no later than the close of the following working day (Regulation (EU) No 600/2014, Article 26).<sup>4</sup> The new legislative focus on investment products that are traded on a traded venue (TOTV). Beside the regulatory market, MiFID II extended the meaning of

<sup>3</sup> Official date of MiFIR implementation is 3<sup>rd</sup> January 2018. During the 2018 other regulation tasks of MiFID should be implementing while the SI request form derivative product is postponed for 1<sup>st</sup> February 2018.

<sup>4</sup> Investment firm is any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis (Regulation (EU) No 600/2014, Article 4.1).

trading facilities to organized trading facility (OTF), multilateral trading facilities (MTF), and systematic internaliser (SI) to improve financial market transparency (Directive (EU) 2014/65, RTS 23). In the scope of obligatory transaction reporting are financial instruments which are admitted to trading or traded on a trading venue, or which are requested for admission for trading, or financial instruments where is underlying instrument traded on a trading venue, and financial instruments with underlying market index or a basket of financial instruments traded on a trading venue.<sup>5</sup> ESMA defines trading venues as those registered in the European Economic Area as Regulated Markets. To reduce over the counter trading, regulatory authorities introduced new form of institutional trading - systematic internaliser (SI). Systematic internaliser means an investment firm which on organized, frequent systematic, and substantial basis deals on own account when executing client orders outside of other forms of regulated market.<sup>6</sup> MiFIR obliges trading venues and systematic internaliser to submit identifying reference data for relevant financial instruments to competent authorities. ESMA publishes received information as a part of the Financial Instrument Reference Data System (FIRDS) available to investment firms and local regulators. Systematic internalisers for over the counter financial instruments traded on have to issue International Securities Identification Number (ISIN) as the global traded standard identifier of financial instruments.<sup>7</sup> Therefore, financial instruments registered at FIRDS<sup>8</sup> database are under the obligation for post trade transparency reporting to Approved Publication Arrangement – APA (list of the Approved Publication Arrangement see in Table 3 of the Appendix). The scope of post trade transparency reporting to APA are the transaction traded out of the trading venue (over the counter transactions). To improve the monitoring of the market participants ESMA requires from customers to be identified by means of a Legal Entity Identifier (LEI) or by unique national identification number for individual customers or customers out of European Economic Area.<sup>9</sup> A natural person shall be identified in a transaction report using the designation resulting from the concatenation of the ISO 3166-1 country code of the nationality of the person followed by the national client identifier (Regulation (EU) 2017/590).

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<sup>5</sup> Investment products traded on trading venue shall be traded on: regulated market, multilateral trading facilities, systematic internalisation, and equivalent third country trading venue out of European Economic Area (EEA).

<sup>6</sup> Based on ESMA register up to 30<sup>th</sup> June there are 103 SI financial firms ([www.esma.europa.eu/system](http://www.esma.europa.eu/system)).

<sup>7</sup> The ISIN are issued by a network of National Numbering Agencies (NNAs). ISIN for OTC derivatives are issued by Derivatives Service Bureau (DSB like a new infrastructure being built specifically for this purpose).

<sup>8</sup> FIRDS database also include other identifiers such as Classification of Financial Instruments (CFI) and Financial Instruments Short Name (FISIN) and other standardized instrument labels, as well as information about issuer and trading venue and the associated instrument attributes. See more on: [www.esma.europa.eu/system](http://www.esma.europa.eu/system).

<sup>9</sup> The list of LEI issuers is available on the Global Legal Entity Identifier Foundation – GLEIF.

Beside the reorganization of market structure MiFID II has significant impact on market stakeholders in trading risk identification and control through: risk governance implementation, organization governance, risk control and measurement, and on going compliance process. In algorithmic and high frequency trading Regulatory Technical Standard 6 of the Directive (EU) 2014/65 implement appropriate trading thresholds and limits in number of financial instruments being traded, price of the instrument, value of the orders, number of the orders, strategy position and number of markets. Only professional investment firms can comply to the new regulatory standards due to internal know how, technological and organization structure, and ability to take over significant implementation costs.

### **3. COST OF IMPLEMENTATION NEW REGULATION**

Process of compliance of investment firms to the MiFID II regulatory framework will request significant costs. European Commission estimate to impose one off compliance costs of between €512 and €732 million and ongoing costs of between €312 and €586 million per year (European Commission, 2014). Therefore, the expectation of European Commission is that ongoing costs of European Union banking sector will not exceed 0,15% of total operating costs. The one off cost impact of introduction of MiFID II were estimated about 0,6% for retail and saving banks and 0,7% for investment banks of total operating spending. Recurring compliance costs were estimated up to 0,2% of total operating expenditure. Beside the direct costs banks are exposed to opportunity income lost because of decrease of the trading margin due to the obligatory best execution information to the client (Directive (EU) 2014/65, RTS 28). Significant one off costs of MiFID II implementation will caused of exit of the small and non professional investment firms which can not absorb the costs exploiting the economic of scale on investment activities. Decreasing the market participants will impact the effect on total trading turnover with final consequence of decreasing the trading profit, lower ratio of trading portfolio in balance sheet of financial institution, and increasing relative costs in total expenditure.

### **4. REGULATORY IMPACT TO BANKING FIRM PERFORMANCES**

Analyse of the impact of MiFID II on bank performances, out of direct costs and lost income opportunities, and bank business model has to be done together with the EMIR regulation (Regulation (EU), 648/2012), Capital Requirements Directive (Regulation (EU), 575/2013), and Market Abused Directive (Directive (EU), 2014/57). Global financial crisis, volatility of financial markets, new regulatory capital requests and new regulation of market infrastructure impact

the change of bank business model (Ercegovac, 2016). Because of overbanking in European Banking System most banks reduced interbank assets, ratio of trading assets in total bank assets what impacted lost in fee income from trading activities and financial services to customers. In compare of some market activities parameters of the system important banks in the European Union between pre crisis period (2002/2008) and post crisis period (2009/2017) it is clear that ratios of trading income in total bank revenue and the ratio of trading assets in total bank assets are strongly declining.

**Table 1** Selected bank performance indicators changes<sup>10</sup>

<b>Bank Name</b>	<b>Trading Income</b>	<b>Trading Assets Ratio</b>
BANCO BILBAO VIZCAYA ARGENTA	-0,0175	-0,0022
BANCO SANTANDER SA	-0,0246	-0,0033
BARCLAYS PLC	0,1044	-0,0167
BNP PARIBAS	-0,1029	-0,0133
COMMERZBANK AG	-0,0571	0,0544
CREDIT AGRICOLE SA	-0,0686	-0,0178
CREDIT SUISSE GROUP AGREG	-0,2052	-0,0489
DANSKE BANK A/S	-0,0227	0,0011
DEUTSCHE BANK AGREGISTERED	-0,2008	-0,0333
ERSTE GROUP BANK AG	-0,0214	-0,0156
HSBC HOLDINGS PLC	0,0671	-0,0522
INTESA SANPAOLO	0,0556	-0,0711
KBC GROUP NV	-0,1471	-0,0300
NORDEA BANK AB	0,0624	0,0000
ROYAL BANK OF SCOTLAND	-0,0248	0,0000
SOCIETE GENERALE SA	-0,1108	0,0178
SWEDBANK AB A SHARES	-0,0130	-0,0111
UBS GROUP AGREG	-0,1781	-0,0522
UNICREDIT SPA	-0,0346	-0,0200

Source: Author; Bloomberg.

Strong prudential constrains and significant compliance costs overtake risk trading transaction and prop trading of universal banks promoting the orientation to client related banking. The significance of the difference of trading assets ratio in post crisis period inside the new regulatory framework can be done with sample test of mean difference with level of significance of 5%. Base hypothesis is that there is no difference in trading income,  $(\text{Mean}_{2002/2008} - \text{Mean}_{2009/2017}) = 0$ . The test results are in table is following.

<sup>10</sup> Trading assets ratio is ratio of trading securities and other trading book position in total bank assets.

**Table 2** Mean differences of trading assets ratio 2002/2008 – 2009/2017 - test results

Parameters	Test Condition	Difference
n	19	19
Mean	0,0000	-0,0495
Std Dev	0,0000	0,0902
SE	0,0000	0,0207
Sp	0,0638	
t	2,3903	
One sided p-value	0,0111	
Two sided p-value	0,0222	

Source: Bloomberg. Author.

Because the two side p-value is less with the critical test value (0,05) the hypothesis is rejected and conclusion is that decrease in average trading income of selected bank in post crisis period under the new regulatory framework is significant. The similar conclusion is for the ratio of trading assets of the selected sample (two side p-value = 0,016).

Direct impact of MiFID II will be in reducing trading spreads and increasing competition because of the higher transparency of trading activities. Regulatory limits implementation and trading organization change will force banks in changing current business models. The governance and processing of trading activities through front office tasks, middle office support and back office evidence will implicate new technology development and control functions with professional supporting tools and high educated staff.

## 5. CONCLUSION

MiFID/MiFIR are part of the most important regulatory changes inside the European Union regulatory agenda. New regulatory framework has significant impact on banks and other financial institutions from the perspective of their business strategy, operating business model, and client information and protection. In the core of MiFID/MiFIR regulation is investor protection, reduction of over the counter transaction, and market speculation control. Compliance process to regulatory framework is particularly demanding for banking firm whose core business is not investment bank activities. Costs in implementation and changes in organization structure will impact the correction in business model in the segments of front office behaviour and organization, middle office role and back office professional tools engagements. Increasing the transparency of financial markets, trading limit introduction and best execu-

tion reporting to clients will decrease trading margin in market competition improvement with final impact on reduction of trading activities and trading income. The challenges of compliance process to new regulatory requirements can be new opportunity for the banks are provided wealth management service, investment advisory and orders execution because of exploring the effects of improving market efficiency in business development. New regulation should support client oriented banking business and enforce banks to separate risk taking products and behaviour in promoting long term stability of banking system in European Union.

## 6. LITERATURE

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[www.bloomberg.com](http://www.bloomberg.com)

[www.esma.europa.eu](http://www.esma.europa.eu)

[www.gleif.org](http://www.gleif.org)



## 7. APPENDIX

**Table 3** Approved Publication Arrangement list as per 31.12.2017.

<b>Entity name</b>	<b>Home Member State</b>	<b>MIC/LEI</b>	<b>LEI</b>
<i>Abide Financial DRSP Limited</i>	<i>UNITED KINGDOM</i>	<i>AFDL</i>	<i>549300FVRWYPDFJTH118</i>
<i>BME REGULATORY SERVICES</i>	<i>SPAIN</i>	<i>BMEA</i>	<i>959800QN4DV2FYZS9Q98</i>
<i>Bloomberg Data Reporting Services Ltd</i>	<i>UNITED KINGDOM</i>	<i>BAPA</i>	<i>254900BF4G8VMW8GG471</i>
<i>Cboe Europe Limited</i>	<i>UNITED KINGDOM</i>	<i>BOTC</i>	<i>254900ERRPSKE7UZH711</i>
<i>Deutsche Börse Aktiengesellschaft</i>	<i>GERMANY</i>	<i>DAPA</i>	<i>529900G3SW56SHYNPR95</i>
<i>Euronext Paris SA</i>	<i>FRANCE</i>	<i>XAPA</i>	<i>969500HMVSZ0TCV65D58</i>
<i>KELER Központi Értéktár Zrt.</i>	<i>HUNGARY</i>	<i>KELR</i>	<i>529900MPT6BHOJRPB746</i>
<i>London Stock Exchange plc</i>	<i>UNITED KINGDOM</i>	<i>ECHO</i>	<i>213800D1EI4B9WTWWD28</i>
<i>Nasdaq Stockholm Aktiebolag</i>	<i>SWEDEN</i>	<i>NAPA</i>	<i>549300KBQIVNEJEZVL96</i>
<i>Oslo Børs APA</i>	<i>NORWAY</i>	<i>OAPA</i>	<i>5967007LIEEXZXHDL433</i>
<i>Tradeweb Europe Limited</i>	<i>UNITED KINGDOM</i>	<i>TREA</i>	<i>2138001WXZQOPMPA3D50</i>
<i>Wiener Börse AG</i>	<i>AUSTRIA</i>	<i>APAW</i>	<i>315700LCYNUH9SYC0I94</i>
<i>Xtrakter Limited</i>	<i>UNITED KINGDOM</i>	<i>TRAX</i>	<i>213800O7QMOIFJZ3K44</i>
<i>Zagrebačka burza d.d.</i>	<i>CROATIA</i>	<i>ZAPA</i>	<i>7478000050A040C0D041</i>

Source: ESMA ([www.esma.europa.eu/system](http://www.esma.europa.eu/system))

