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NOT EVERYONE'S CUP OF TEA...

Catherine McBride

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About the author

Catherine McBride

Catherine McBride is a Senior Economist in the IEA's Financial Services Unit. She has 19 years' experience working in financial services in London predominantly in the international equity and commodity derivative markets. Before joining the IEA, she worked for the Special Trade Commission at the Legatum Institute and for the Financial Services Negotiation Forum, developing policy and governance recommendations to encourage continued growth of the UK's financial services industry after the UK leaves the EU.

Introduction

This paper is part of a review of the current state of financial services in the UK. It looks at how the financial services industry could be improved, especially in its primary credit raising function. It examines the results of the regulatory regimes of MiFID II, CRR/CRD IV and Solvency II, and assesses whether they could be refined after Brexit to better suit the UK market.

Much of the information in this paper comes from a series of roundtable discussions held in early 2019 with market practitioners from the investment management, insurance, broking and investment banking industries. A similar series of discussions took place in 2017, before the introduction of MiFID II. As part of the analysis, the earlier predictions are compared with the outcomes so far.

MiFID II, together with MiFIR (Regulation (EU) No 600/2014), was intended to create a more transparent, competitive and integrated financial market in the EU by reducing trading outside regulated markets, increasing protection for investors and consumers, and improving financial stability. The Directive harmonises the EU regulatory regime with respect to organisational requirements for investment firms, regulated markets, data reporting services and conduct of business rules for investment services, including inducements, disclosure requirements and product governance rules.

However, one year on, many practitioners' initial fears about MiFID II appear to have been realised, especially with regard to unbundled research causing a reduction in the amount of research available on smaller companies. Fears that new firms would be discouraged from starting in the UK due to excessive EU regulation and their 'gold plating' by the UK government

have also proved to be well founded.[1] Gold plating was cited as a particular problem for new market entrants in the insurance industry.

Although a lot of the present regulation comes from the G20 Financial Stability Board (FSB) and the Basel Committee on Banking Supervision's third Basel accord[2] (Basel III), the European Union has been responsible for a raft of financial services regulations that have increased both compliance costs and the complexity of international regulations. While EU Directives set a minimum standard that must be achieved by each member state, the member state is free to decide how to transpose the directives into national laws. However, it could be argued that imposing the same minimum regulations on all EU markets is a flawed approach due to the massive differences between the large, securities based, internationally focused UK financial markets and the much smaller, less sophisticated and locally oriented markets of many smaller EU member states.

1 An EU Directive such as MiFID II only sets a minimum standard that must be achieved by each member state, but the member state is free to decide how to transpose the directives into national laws and may add to them.

2 Basel III (or the Third Basel Accord or Basel Standards) is a global, voluntary regulatory framework on bank capital adequacy, stress testing, and market liquidity risk.

The economic impact of regulation

While regulation of financial services is generally seen as necessary to protect investors from unscrupulous agents, it may in fact have the opposite effect. The truly criminal tend to operate outside the law, while the economies of scale associated with complying with the regulation encourage the development of oligopolies which can then push up the cost of investment products as consumers are left with few viable alternatives. This may sound far-fetched, but oligopolies have formed in many UK markets from house builders, to supermarkets, to car manufacturers and high street banks. While these oligopolies may not have been initially formed by regulation, they have all had their positions further entrenched by regulation.

Excessive granular regulations increase the cost of doing business and so deter new firms from entering the market or force smaller firms to merge, thereby reducing consumer choice, increasing prices, entrenching established providers and eventually leading to the formation of oligopolies. EU financial regulation has also tended to increase salary expenses and capital requirements, making UK investment firms less competitive with their international rivals as well as reducing investment in small and medium sized companies.

In order for the UK financial sector to remain relevant as well as vibrant, competitive and innovative in the future, it is important that regulations do not hinder new market entrants, innovators and scale-up companies. And yet, the most consistent problem raised with MiFID II, as with most EU regulations and directives, is that it disproportionately affects small and medium sized companies that must employ more compliance staff and increase their computing capacity just to cope with the regulatory requirements.

MiFID II has added an extra layer of regulation and has been described as ‘the greatest job creation mechanism in the world’. Certainly, it is responsible for much of the recent growth in employment in financial service providers. While increased employment may sound positive, if the regulation is not solving a problem it is not. Compliance is purely a cost centre and makes EU based banks less competitive in international markets.

The roundtable discussions identified many areas that would benefit from reform, such as refining, reducing or even removing some of the current regulation. The views expressed in this paper represent those of the

participants, but warrant further discussion. While some regulation of financial markets may be necessary, there is an opportunity for the UK's financial market authorities to review and amend current regulations when the UK leaves the EU. In particular, it is important to consider the effect on competition in the marketplace when evaluating the economic impact of regulation, as well as whether the regulation is achieving its intended result. If regulation is left unchecked, the provision of financial services in the UK may eventually be controlled by large oligopolies, to the detriment of both consumers and market stability. Some of the most important regulations to review are: MIFID II, the capital raising process for new businesses, bank capital ratios and Solvency II.

Recommendations of the roundtable and potential action points

MiFID II

- UK firms that do not trade into the EU market should not be required to comply with EU regulation. In an international market place, MiFID II is disadvantageous to UK companies competing with non-EU firms, dealing in US dollar denominated instruments and servicing non-EU persons who do not need to comply with EU regulations.
- Regulations should be proportionate to the size and the age of the firm to actively encourage new market entrants.
- Unbundling research payments from dealing fees has allowed multinational investment banks to devastate independent research providers. While this will be hard to reverse, allowing firms to give away research if they like should not be an offence and could help smaller firms remain on investment managers' brokerage lists.
- Unbundled research payments are reducing the amount of analyst coverage available on SME companies and thus reducing the amount of interest in the AIM market and in start-up companies.
- The PRIIPs, KIIDs and trading data collection must be streamlined so that it is actually protecting and guiding consumer choices without increasing the cost of investing.
- The Regtech industry has essentially been created by excessive regulation rather than addressing a real economic need.
- Providing easily accessible financial education is probably the only effective way for the authorities to truly protect retail clients. There are

now several programmes being run in schools and a similar programme should also be provided to adults, who are obviously more likely to be investing in funds, insurance and pensions.

- Private clients are the group most likely to invest in smaller companies and AIM listed companies. However, the regulatory squeeze is pushing smaller companies towards other non-listed forms of capital raising and pushing private clients into collective investment products.
- The UK should establish its own retail investment product, improving on the UCITS standard and appropriate for US mutual fund investors and other non-EU investors.
- The government should do more to encourage new and existing funds to set up their management companies in the UK rather than in Luxembourg or Dublin. This could be done by creating an enterprise-zone-style scheme and potentially be based outside of London.
- Double volume caps hurt UK companies with large trading volumes and hurt UK markets more than any other EU market and so should be abandoned after Brexit. The UK authorities should be encouraging large funds to be based in the UK, but to do so requires markets that enable large funds to trade without disturbing the market if required.
- Falling liquidity in both the bond and equity markets increases price volatility and investment risk. Returning to or introducing a new market making system, a specialist system or encouraging arbitrage trading could improve liquidity for investors.

Capital raising, CRR and CRD IV

- The UK needs a new prudential regime for capital rules in order to simplify the Capital Requirement Regulations.
- Once the UK leaves the EU, domestically focused UK financial services firms, who do not cater for clients outside of the UK and no longer have the potential to passport into the EU27, should no longer need to comply with the international capital requirements set by Basel III but imposed by the EU under CRD IV.
- Lowering capital ratios for domestically focused banks will increase the amount of capital that is available for local customers and businesses.
- The restrictions on employee bonuses should be removed and financial services firms should be allowed to remunerate employees as they see fit. This will lower a firm's fixed costs in a downturn as well as motivating employees.
- Although the UK is the leading country in the EU for creating 'unicorn' companies, it could improve its record by subsidising business administration courses for adults as well as improving STEM subject education in schools, imitating the achievement of Chicago, now a US hub for 'unicorn' companies.
- The Treasury should try to encourage endowment venture capitalists by introducing a taxation regime that encourages longer term investments in innovative companies.
- The SEIS, EIS and VCT schemes[3] have been essential to many UK entrepreneurs raising capital but they could be improved by removing the cap on investment schemes, increasing tax incentives to encourage investment in new companies and allowing investment in family businesses: one of the main sources of capital for entrepreneurs. The Treasury could also consider changing the tax rules on investments so that limits are applied to individuals rather than to companies.

3 See, for example: https://www.gov.uk/guidance/venture-capital-schemes-apply-to-use-the-seed-enterprise-investment-scheme; https://www.gov.uk/guidance/venture-capital-schemes-apply-for-the-enterprise-investment-scheme#when-you-issue-shares; https://www.gov.uk/guidance/venture-capital-schemes-tax-relief-for-investors

Solvency II

- UK insurers should be allowed to use the US insurance Generally Accepted Accounting Principles (GAAP) basis if they wish, especially if they do not provide insurance in the EU27.
- The UK should return to the Financial Conduct Authority's (FCA) Individual Capital Adequacy Standards (ICAS) regime which measured risk to ultimate (i.e. once all of the risks have run off) on a GAAP basis.
- Alternatively, if the UK continues to use the EU's Solvency II regime then make adherence to the EU's Internal Model calculations more cost efficient and streamline the PRA approval process, enabling more firms to use the more efficient risk measurement.
- Allow gender to be considered in the calculation of risk premiums in pensions, life insurance and car insurance. This would ensure that insurance premiums are correlated with the underlying risk and that low-risk genders are not subsidising high-risk genders.

MiFID II

MiFID II, the EU's second directive on Markets in Financial Instruments, was intended to create a more transparent, competitive and integrated financial market in the EU. In practice, MiFID II is having the counterproductive result of reducing rather than improving access to financial instruments.

In an international market place, MiFID II gives EU based firms an unnecessary compliance burden and is disadvantageous to financial service firms that are competing with non-EU firms, trading in US dollar denominated instruments and servicing non-EU persons who do not need to comply.

SME financial services firms

At both this year's roundtable discussions, as well in 2017, the most consistently mentioned problem is that the current regulations disproportionately affect small and medium sized (SME) financial services firms. SME financial services companies have had to employ more compliance staff and increase their computing capacity to cope with the extra regulatory requirements of MiFID II. The additional cost is having a significant effect on their profitability. Surprisingly some small firms have been able to remain competitive by offering a more bespoke service that differentiates their products from the mass-produced financial products of larger firms. Generally, larger financial services firms have found the additional cost of MiFID II compliance to be less problematic.

Unbundled research

Under MiFID II, investment research must be paid for separately by the end user and can no longer be included as part of the dealing fee. This was intended to ensure that research was not used by brokers as an inducement to trade, to ensure that investors were aware of the charges and to discourage investment managers from paying for research that they were not using.

However, many investment managers still dispute the very premise of this regulation. As they were not paying for ‘free’ research before if they didn’t trade on the advice, they were also not passing any cost on to the client for the research. If there was an ‘unnecessary cost’, it was at the broker’s expense not the investment manager or their clients’ expense. In contrast, under MiFID II many research providers are charging an annual subscription for all of their worldwide research, so UK asset managers may well be subsidising a lot of research that may be of no interest to them. In a larger investment management firm, the cost of research may be borne by many parts of the firm so has a less significant effect on their profitability.

Research reports, rather than an inducement to trade, give investment managers valuable information. Multiple ‘free’ reports mean more information and enable comparison of reports on a company or industry sector from many brokers. It is the investment manager’s decisions whether to follow this information or not, hopefully using the broker whose research the investment manager has found to be the most convincing. The more research available to the manager, generally the better their investment decisions are likely to be.

In February 2019, the FCA estimated that the new regulations had reduced the costs of equity investors by £180 million as a result of changing the way asset managers paid for research. But in an industry with Assets Under Management (AUM) of £7.7 trillion, 40% of which are held in equities, it is hard to imagine that a £180 million saving is significant when divided across all investors, or that it would alter an investor’s choice of manager. Investors generally choose an investment firm by the success of its investment decisions rather than its low fee structure.

Another prediction made by the pre-MiFID II roundtable was that unbundled research would reduce the number of independent research firms because multinational investment firms would be able to undercut them by offering access to all of their worldwide research for a relatively small annual

subscription. In order to compete, local independent researchers would need to convince their clients that they were providing much higher quality research, or a unique insight or an independent perspective.

Following a year of unbundled research this prediction has been proved to be accurate. The discussion participants, backed up by the CFA Institute survey,[4] and the QCA/Peel Hunt survey,[5] found that research budgets have been cut by 20-30%, that the number of research analysts has decreased and that the surviving independent research providers have lost market share to large institutions which are now obliged to charge for research that they once provided for free.

The roundtable participants also feared that financial analysts would move their coverage to companies with greater trading volumes as these provide analysts with the greatest return from their research. They feared that this would push investment away from SME and start-up companies towards these more traded companies. The QCA/Peel Hunt survey has found this to be the result: 62% of investors report that there is less research being produced on small and mid-capitalised companies since MiFID II came into effect. This year's roundtable participants also confirmed that there was less competition amongst researchers, that companies with market capitalisations below £1billion had fewer research reports written about them and that it was both more difficult and more expensive for individual investors to access company research. One investment banker gave an example of a company with a market capital of £750 million that had previously been covered by 15 analysts that was now only covered by three.

Although it was agreed that analysts' coverage of small and medium sized companies had previously been subsidised by total broking firm revenues, this had been helpful in bringing new companies to market or raising capital for growing companies which in turn kept the UK economy dynamic. Although it had been suggested prior to the introduction of MiFID II that small companies could commission their own research reports, there was general agreement by the roundtable participants that investors did not trust research that had been paid for by the company that was the focus of the research or by that company's bank or broker. Companies are instead resorting to increased website visibility and live marketing days,

4 www.cfainstitute.org/-/media/documents/survey/cfa-mifid-II-survey-report.ashx
5 www.theqca.com/membership/pdf.php?path=/article_assets/articledir_286/143286/QCA_Peel_Hunt_Mid_and_Small-Cap_Investor_Survey_2018

which may well be against the spirit of MiFID II's objective of providing greater symmetry of information even if it is within the regulation.

The lower amount of research available on small or new companies, coupled with the demise of retail investors and SME funds which are able to invest in small companies, is making it more difficult for new or small-cap companies to raise capital in the markets. This will eventually have a knock-on effect on the whole economy. New market entrants challenge established companies and tend to enhance consumer choice.

Fragmented markets and trading platforms

Unbundled research payments are causing the additional problem that many SME broking firms which were providing independent research, have found themselves dropped from asset managers' lists, as the managers do not want to pay for the firm's research even though they may have been happy to trade with the firm as a broker. A Liquidnet survey[6] claims that of the asset managers they surveyed, all had reduced the number of brokers they used by between 20% and 70%, making it even more difficult for SME broking firms to compete with the larger investment banks which can divide their fixed costs between multiple revenue streams.

The fall in brokers' total commission revenue has encouraged more investment transactions to move onto electronic platforms and other execution options with lower trading costs. However, the increased number of trading platforms has fragmented the market, lowering liquidity in the process, as well as reducing the transparency that MiFID II was intended to increase. Low liquidity in the markets increases volatility and makes buying and selling more expensive as there is a wider spread between the bid and offer prices.

Excessive account opening, PRIIPS and trading data requirements

The brokers and investment managers at both this year's and at the pre-MiFID II roundtables complained about the excessive and often counterproductive data collection requirements demanded by MiFID II. One commodity broker stated that they needed to gather and complete

6 https://www.liquidnet.com/press-releases

up to 187 forms and identification documents in order to open a new account. All participants agreed that compliance was absorbing a bigger proportion of overall employees, expenses and capital, especially in smaller firms. As compliance costs are to some extent a fixed cost, they become a relatively greater problem for SME financial service firms than for larger firms and are becoming a prohibitive cost for new market entrants, which will eventually reduce competition in the market.

PRIIPs (Packaged Retail and Insurance-based Investment Products) were intended to help retail investors to understand and compare the key features, risk, rewards and costs of different investment products, through access to a short and consumer-friendly Key Information Document (KID). However, investment managers generally complain that PRIIPs are too complicated and often do not protect or benefit the client as was intended by the legislation. There have been many complaints and the FCA is reviewing the PRIIP requirements. There is a belief that the risk assessment calculations are inconsistent with conventionally expected market risks and sometimes give absurd results when a short-term investment is annualised. However, other reports suggest that the FCA review is primarily investigating whether firms are correctly including costs and charges in their marketing material rather than re-assessing the usefulness of the documentation in informing and protecting investors.

MiFID II also requires the collection of 65 pieces of data for every transaction on Regulated Markets (RM), Multilateral Trading Facilities (MTF) and Organised Trading Facilities (OTF). This was a 270% increase on the amount of data required per transaction under the original MiFID, which many market participants already thought was excessive. The amount of data being collected under MiFID II is now beyond the ability of the UK regulators to assess in any meaningful way - even the authorities' computing systems have had trouble coping with the daily volume of data. The amount of data required disproportionally affects an investment firm with a large number of small clients or a large number of clients who trade frequently as opposed to a firm with fewer but larger clients or clients who 'buy and hold' their investments.

While several multinational investment banks, with large compliance teams, were fined for reporting mistakes under the much simpler MiFID I where only 24 data fields were required, it has been difficult to access information on how many firms have been fined under the more extensive

MiFID II regime. The FCA website[7] lists 15 fines in 2018, totalling £60 million, but the largest ones were for 'unfair treatment of customers' for the seven fines imposed on firms and 'lack of fitness' in the eight fines imposed on individuals. However, it is likely that it could take several years before any misreporting is discovered, as the FCA has only just imposed fines on the Swiss bank UBS: £27.6 million for failings relating to 135.8 million transactions reported under the original MiFID regulations from 2007 to 2017.

FCA executive director of enforcement and market oversight, Mark Steward, was reported to have said that: 'If firms cannot report their transactions accurately, fundamental risks arise, including the risk that market abuse may be hidden.'[8]

But if there is a real chance of market abuse, surely it would be helpful to investors if it were detected in a more timely manner. Fining a company ten years after the fact increases the record keeping and regulatory compliance burden even more. And if, under the relatively simple first MiFID regulations, one of the largest banks in the world was unable to meet its compliance obligations, it does not bode well for SME companies under the new MiFID II regime which requires over two and a half times as much data to be collected. Even worse, they may not know that they have a huge fine to pay until ten years later.

Admittedly there is now a growing industry in the UK of 'Regtech' companies, outsourced compliance fulfilment companies, who are benefitting from the ever-increasing data requirements and complexity of compliance regulation. However, as one of the intentions of the increased regulation was to reduce mis-selling, it is difficult to imagine how mis-selling will be reduced if the data compliance is being outsourced to a third party which may have less knowledge of the risks of an investment.

Onerous private client regulations

At both pre- and post-MiFID II roundtables the onerous regulations for private clients were one of the most complained about issues. The overly prescriptive, regulatory protection of retail investors requires that investment

7 https://www.fca.org.uk/news/news-stories/2018-fines
8 https://citywire.co.uk/wealth-manager/news/fca-fines-ubs-27-6m-for-136-million-mifid-reporting-

firms must be able to prove that they have assessed the 'suitability and appropriateness' of any investments recommended to retail clients. They must document their clients' level of financial knowledge, investment experience, financial situation, ability to bear losses, risk tolerance and investment objectives. While this is a laudable aim, the problem lies in the extremely prescriptive manner in which they have to be documented in detail. Firms must even be responsible for ascertaining whether another financial instrument could better suit the client's profile and firms must be able to prove that the benefits of switching investments outweigh the costs of the transaction. All of this information must be retained, and regularly updated, making it more expensive for investment managers to focus their business on retail investors.

The burden of proof to satisfy the regulator and the advisory industry has become excessive for many SME investment management firms, even though it has always been in the interests of an experienced manager to protect the interests of their investors because most SME managers rely very heavily on repeat business and personal recommendations. However, the present excessive compliance has resulted in a reduction in investors' choices, especially if they want to invest in a bespoke or higher risk portfolio. The cost of documentation for a non-standard investment is making such a choice prohibitive.

The additional costs and complications of servicing private clients is counterproductively reducing the number of companies willing to provide financial services to them. Ironically, although the additional regulatory costs could be covered by larger financial service providers, these firms don't want to expend the additional effort this requires as the returns from private investors are too small. Meanwhile, SME financial services firms which should be catering to the private client market, find the compliance costs and extra work this entails uneconomic.

Although the roundtable participants accept that MiFID II was intended to protect retail investors, they felt that it had also discouraged retail clients from investing in individual equities and bonds, channelling them instead into fund investments. Participants claimed that self-certifying as a capable and knowledgeable investor has become difficult and an investor with less than £100,000 to invest would now have difficulty finding a firm to advise them. The investment benchmarks have become the very large private client providers such as St James Place and Hargreaves Lansdowne, with

many investors moving to passive index tracker funds. However, the underlying market still benefits from the liquidity provided by small speculators.

Additionally, the onerous regulations on retail investors have implications for the ability of small and medium sized companies to raise funds in the equity markets. Smaller companies typically rely on private client share ownership as they are too small to appeal to large investment funds which must buy large tranches of shares to make any impact on the value of their portfolios. UK regulators should recognise the negative implications for competition of this potential loss of small cap investors. Small and innovative companies are the foundation of a vibrant economy.

Roundtable participants also objected to the '10% down rule', which requires clients to be notified immediately in writing if their portfolios have fallen in value by 10%. In 2019, it is easy for an investor who takes a very active interest in the value of their portfolios to see this online, second by second if desired. Moreover, long-term investors who are content to hand over day-to-day management to a discretionary manager should not be panicked by potentially alarming notifications, especially as such notifications must be sent immediately after a fall in valuation, even if it is caused by a temporary price fall due to a large order that may correct itself in a day or so. However, during a regular market downturn, the regulations do not allow a fund manager to take a few days to make a more considered review of their clients' portfolio. There is no scope, for example, to reassure an investor that their portfolio may be down 10% over one year but up a much greater amount since they started investing. Immediate 10% down communications distract smaller fund management firms from actually doing what they should be in a time of high market volatility – weighing up appropriate adjustments to avoid further losses in their clients' portfolios, and possibly reassuring those clients that their portfolio is being suitably managed. At times of high market volatility, complying with pointless regulations should not suddenly be an all-consuming problem for the asset manager, as happened at the end of 2018.

A better solution for retail client protection would be to encourage easily accessible financial education and more active investment. This would reduce the number of inexperienced investors. Encouraging people to actively manage their pension funds, as happens in the US with 401K plans, would in turn encourage more competition amongst brokers to supply this market and allow more small companies to raise money via the markets.

It is hard to believe that in the UK people are not taught about the financial system even though it will have a major influence on everything they do in their adult lives. Such education would also help the investment industry as it would reduce the need for onerous data collection, complex product rules, PRIIPs, separate simplistic 'retail' prospectuses, 10% down notices or additional written client investment advice. The cost of retail investor education would eventually be returned to the industry in the form of more active investment in the markets.

Some other recommendations from the roundtable discussions

- VAT should be applied evenly or preferably removed evenly. At present VAT is not charged on fund management fees but is charged at 20% on individual investment advice fees. This makes financial products produced by banks, pension companies and insurers less expensive relative to investment advisory services.
- Remove the requirement to issue separate 'retail' prospectuses in simplistic language. A new issue should only need one prospectus.
- MiFID requires every transaction to be reported regardless of the size of the transaction. The regulator needs to introduce a de minimis rule.
- Remove the requirement to send written advice to a client when all telephone calls are recorded. If the advice is to be followed, the order can be given verbally over the phone by the client, so sending them written advice after the fact is unnecessarily bureaucratic and time consuming.
- Regulations relating to retail clients should not be applied to discretionary fund managers who invest for retail clients.

UCITS or UKITS?

MiFID II openly favours the EU's retail investment product known as Undertakings for Collective Investment in Transferable Securities (UCITS) over other investments. For a fund to be classed as a UCITS it must be domiciled and managed in the EU. Under MiFID II regulations all investments must be classified as either 'complex' or 'non-complex', where complexity is intended to reflect the investment risk. MiFID II discourages retail investors from buying 'complex' investment products by loss of some investor protections. The list of investments that MiFID II classifies as

‘non-complex’ includes all UCITS funds but excludes shares in Non-UCITS Retail Schemes (NURS). While MiFID II classifies all UCITS funds as ‘non-complex’, any investment product that is not a UCITS is automatically considered to be ‘complex’ regardless of its risk and therefore not suitable for retail investment. Yet NURS funds and investment trusts often have no greater complexity or risk than UCITS funds. The UK’s regulator, the FCA, in its Consultation Paper CP16/29, agrees that NURS funds and investment trusts cannot be automatically considered to be ‘complex’ or ‘non-complex’. More importantly, after the UK leaves the EU, all UK managed UCITS will become NURS and will therefore suddenly be considered ‘complex’ investment products unless the UK re-defines complex investments and establishes its own retail investment product standard. The roundtable participants believed that the UK could improve on the UCITS investment vehicle and create a retail investment standard that would be appropriate for US mutual fund investors as well as EU and other non-EU investors.

Essentially, all pooled funds must now declare whether they are suitable for retail clients. However, many fund managers are claiming that they are not suitable for retail investors, if they have above average risk or invest in smaller companies, in order to avoid the additional regulatory burden that comes with retail clients. Meanwhile, discretionary private client fund managers, who look at a client’s portfolio more holistically, may want to invest some portion of the portfolio in a higher risk investment but must obey the same additional regulation as an individual retail investor. As private client fund managers are already required to assess the suitability of any decision they make, adding an additional burden of proof is both time consuming and pointless.

Several roundtable participants suggested that the UK Treasury should encourage UK managed investment funds to ‘on-shore’ their EU funds by moving their management companies (Mancos) back to the UK from Luxembourg and Ireland. This would have been necessary if there had been no agreement on financial services after Brexit. However, the European Securities and Markets Authority (ESMA) has agreed a Memorandum of Understanding, on behalf of the EU27 national regulators with the UK’s FCA, and so delegation of portfolio management of EU based funds to UK based portfolio managers can continue after the UK leaves the EU, with or without a withdrawal agreement.

However, the roundtable participants still believed that encouraging more Mancos to establish in the UK is a good idea. Besides the fact that any future divergence in regulation between the UK and the EU could make operating a business divided across different countries more difficult, the investment management industry is a major contributor to the UK economy and the UK government should do more to encourage new and existing funds to set up their management companies in the UK rather than in Luxembourg or Dublin. This could be done by creating an enterprise-zone-style scheme, possibly even based in the 'Northern Powerhouse' area.

Dark pool trading caps (double volume caps)

Regulators were concerned that the prices on public stock exchanges no longer reflected true investor demand and supply due to the popularity of off-exchange transactions. As such activity is more difficult to monitor, 'dark pool' operators could be misleading investors or manipulating the market price. By introducing dark pool trading caps, regulators hoped to move transactions back onto public 'lit' exchanges to re-establish them as the main trading venues for equities, thereby improving valuations and transparency.

MiFID II enforced limits on the amount of an equity that can be traded outside the regulated exchanges on trading venues known as dark pools where transactions are cheaper, anonymous and only disclosed after the trade has been completed. MiFID II caps trading with a rolling 12-month limit of 4% of annual traded volume on any single dark-pool and a maximum of 8% of the annual traded volume in a stock across all dark pools. When these limits, known as double volume caps (DVC), are breached, dark-pool trading in that stock is suspended for 6 months on the individual venue that breached the 4% cap and on all dark pools when the 8% cap is hit.

However off-exchange transactions serve a useful purpose by allowing large volume trades to be completed away from public scrutiny, to avoid affecting the market price before the deal was done or alerting other investors of their trading intentions. Since the introduction of DVCs, off-market transactions have continued but simply moved to different venues such as periodic auctions, large-in-scale waivers, OTC markets and systematic internalisers (SI). The SI operators saw trading volumes increase by 6% in the 1st quarter of 2018 as a result of DVCs. SI trading is generally run by large investment firms which offer exclusive quotations to their

clients and, like dark pools, SI trading has limited pre-trade transparency and quotations are only good for standard market volumes.

The plan to increase trade transparency appears to have failed so far. Although the DVCs forced some transactions back onto the traditional exchanges temporarily, once the rolling DVCs expired trading volumes returned to the dark pools. According to Rosenblatt Securities,[9] before DVCs were introduced dark pool MTFs accounted for 4.5% of turnover in Europe. After the first set of caps were in place this had dropped to just over 2%, but in the month after the DVCs had expired, dark pool trading jumped back up to over 5% of the market, while the traditional exchanges saw their market share fall by 3.5% to 33% and periodic auction market share fell to just over 1% of the market.

The DVCs have been particularly detrimental to the UK market as they restrict one of the most effective methods of trading for large investors, as well as hurting the largest and most actively traded companies unnecessarily, including most FTSE100 firms. It is ridiculous to arbitrarily impose uniform restrictions for all sizes of company, across all EU markets, especially as many of the smaller EU markets and less traded EU stocks have few off-exchange transactions and are unlikely to ever be affected by these regulations.

It is also believed that the levels at which ESMA set the caps were far too low and that the UK's FCA had wanted higher limits of 11% and 17% of annual market turnover, if any. This has been aggravated by ESMA's inability to calculate accurate trading volumes as several stocks were suspended from dark pool trading only to be reinstated the following month. Off-market transactions enable large funds to trade in large volumes without disturbing the market. This has become more important as funds are becoming larger and larger. The world's twenty largest fund managers now have over $1 trillion of assets under management. Retaining the trading caps after Brexit will undoubtedly have consequences on how and more importantly where large funds place their equity orders. Forcing large transactions on to the lit markets will simply increase price fluctuations and this will create valuation spikes for all investment and pension funds but especially smaller funds and individual shareowners.

9 www.rblt.com/news/old-habits-die-hard-european-equity-traders-still-prefer-the-dark-defy-mifid

Bond market illiquidity

EU bond market illiquidity is still one of the most frequent complaints of the roundtable participants. EU financial regulations strongly incentivise investors to hold their money in funds and structured products rather than directly investing in bonds and equities. It is likely that the banks and financial institutions that manufacture and distribute financial products have convinced the regulators that they are safer investments. However, bond funds have no transparency and no liquidity in a market downturn. The vast majority of their investments, European bond issues, are illiquid, so a bond fund does not provide the type of investor protection or flexibility envisioned by the MiFID II regulations.
The roundtable participants believed that MiFID II is too equity focused and does not work well for the bond markets, even though bonds and interest rate securities are the primary investment in continental Europe. MiFID II was meant to increase transparency, public reporting and regulatory reporting, but with no market convention on data publication it is impossible to compare bond investments or traded prices. It is difficult and expensive to compile fixed income trading data from multiple sources. There is no centralised database, while multiple markets/platforms and illiquid instruments have made compliance with the MiFID II policy of 'Best Execution' impossible. Although MiFID II requires transactions in liquid instruments to be reported within 50 minutes, most European fixed income issues are illiquid. There are 68,000 bond issues in the EU, 89% of which are illiquid, and 45,000 corporate bond issues in the EU, of which almost all of them, 99.6%, are deemed illiquid.

Another complaint is that MiFID II has exacerbated bond illiquidity by the lack of comparable pricing information. As there are no standardised bond pricing formats it is difficult to know at what price a bond should trade relative to other issues. Moreover, complying with MiFID II's requirement to have three quotes could move the price, while bond market regulations in MiFID favour larger firms.

There is the additional problem of whether a Euro denominated bond issued by an EU member state can really be considered sovereign debt or whether EU government bonds should be discounted when used as collateral because the issuing government is not able to issue more currency if their country is in economic difficulty.

Capital ratios, venture capital and initial public offerings

Capital Requirements Directive and Capital Requirement Regulation

The Capital Requirement Directive (CRD IV) and Capital Requirement Regulation (CRR) are the EU's interpretation of the Basel III accord, the internationally agreed standards developed by the Basel Committee of Banking Supervision (BCBS) after the financial crisis of 2007/8. However, while the Basel III capital adequacy agreements only apply to 'internationally active banks', within the EU, CRR and CRD IV apply to all banks and investment firms regardless of whether they are internationally active or even large enough to pose a systemic threat to the market.

The underlying objectives of these internationally agreed standards are to avoid systemic risk, market fragmentation and regulatory arbitrage. They also aim to reduce the risk of a Systemically Important Bank (SIB) failure causing international financial contagion as happened in the financial crisis of 2007/2008.

Although this regulation was necessary for EU banks involved in cross-border EU trade, even the European Commission acknowledges that EU consumers largely purchase financial products in their domestic market and firms overwhelmingly serve markets in which they are physically established. Even within the Eurozone, cross-border loans account for less than 1% of the total household loans. Yet all financial service institutions, regardless of size or risk profile, must comply with CRR and CRD IV, which increases the amount of capital they are required to hold, and reduces the amount they can lend to, underwrite or invest in the wider economy.

The roundtable participants generally agreed that the UK needs a new prudential regime for capital rules and that the new Capital Requirement Regulations (CRR II) will simplify the rules. Certainly, once the UK leaves the EU, domestically focused UK financial services firms, which do not cater for clients outside of the UK and no longer have the potential to passport into the EU27, should no longer be required to comply with the international standards set by the CRR and CRD IV. This should increase the amount of capital that is available for local clients and businesses and help to strengthen the UK economy.

Venture capital and initial public offerings

At the most recent roundtable there was also much talk of the difficulties of capital raising for start-up and developing companies. Although changes to the domestic capital ratios mentioned above should improve this, there was a general feeling that regulation was making it difficult to start new companies and that the regulation has to be proportionate to the size and age of the company. This happens in Singapore with different tax regimes for companies that are less than 3 years old as well as companies that have income below $300,000.

During the last decade, the number of companies listed on the AIM market has fallen from just under 1700 at its peak in 2007 to only 925 in December 2018. The number of new issues on AIM has also fallen from 519 in 2005 to only 65 in 2018.[10] Although this may be for many reasons, it is still noticeable that while the number of AIM listed companies has fallen steadily, the total market valuation is still close to the levels reached in 2007 - that is, the AIM market now has fewer but larger companies. The roundtable participants believed that the loss of small cap listings has hurt the growth of entrepreneurial companies in the UK.

The UK needs to encourage successful entrepreneurs and high net worth individuals to be angel investors for new start-ups, so called heritage venture capital. Although the UK has more successful unicorn companies than any other EU country, it still has less than Chicago.

10 www.londonstockexchange.com/statistics/historic/aim/aim.htm

There are more than six times as many 'unicorn' companies in the US than there are in the EU.[11] While this could be partly blamed on regulatory burdens, there will be many other relevant factors. Chicago has become a start-up hub in the last 10 years, and this appears to have followed an emphasis on STEM education and business administration courses.[12] The EU's underlying principles appear to favour established companies over new enterprises, allowing regulatory barriers to further entrench established firms and discourage new market entrants. Of the 25 unicorn companies in the EU, 16 are in the UK and only 5 are in Germany, with one each in France, Spain, Luxembourg and Estonia.[13]

Roundtable participants claimed that it was difficult for small businesses in the UK to raise funding of between £1-3 million and estimated that it takes a minimum of 6 months to raise any finance and that an entrepreneurial CEO must spend half their time raising capital. Small and new businesses generally don't have enough staff for this to be the case. Because UK SMEs are on a constant fund-raising programme, they are less inclined to take market risks, so are slower to expand than a new company in the US where the ethos is less risk adverse. This could also be a reflection of the different bankruptcy laws in the US compared with the UK and the different cultural attitude to failure as well. But reduced entrepreneurship is surely holding back the whole UK economy, reducing the number of new market entrants and thereby competition.

The roundtable participants believed that UK private equity funds do not have enough risk capital. They claim that second round (Series B) financing is hardest to get, when a company needs to raise between $2 million to $5 million in capital. Private equity investors and peer-to-peer lending platforms have developed rapidly over the last 10 years to fill this funding gap. Although they can be useful sources of capital generally, they only provide third and fourth round financing. Entrepreneurs hoping to use peer-to-peer platforms need to have at least 60% of their financing already in place.

Regulation can also deter innovation in some sectors of the financial services industry. For example, Insuretech is rethinking existing insurance models

11 https://s3.amazonaws.com/cbi-research-portal-uploads/2019/01/15143206/us-tech-startups-map-01.15.2019.png

12 www.forbes.com/sites/peterandrewwilkins/2018/02/20/how-illinois-universities-power-the-chicago-startup-ecosystem/#21206ca162a4

13 www.cbinsights.com/research-unicorn-companies

but the insurance industry is very tightly regulated. Innovators believe that the regulation creates a circular trap when raising capital, as they need investment to be able to afford to comply with the regulation but need to be compliant with the regulations before they can attract any investment.

Entrepreneurs believe that it is very difficult to get funding in the UK without SEIS, EIS or VCT. It was generally agreed that the UK government should consider removing the cap on investment schemes, especially after the UK leaves the EU, when the UK will be able to increase tax incentives to encourage investment in new companies. The UK EIS scheme will not allow investment in family businesses even though this is well known to be one of the main sources of capital for entrepreneurs all over the world. The UK Treasury could consider changing the tax rules on investments so that they are applied to individuals rather than companies, set at possibly £50k per investor.

Additionally, the UK should follow Chicago's example and increase investment in financial education and business administration, as well as encouraging STEM subjects at school. Comparison was also made between the US and the UK regarding the existence of Endowment Venture Capitalists in the US, who are more likely to take longer term investments in an innovative company.

There was even a suggestion by the roundtable participants that the government could consider creating a new version of '3i', which started as the Industrial and Commercial Finance Corporation (ICFC), established to provide long-term investment funding for SMEs which were unable to raise long-term capital from banks or the stock market. ICFC later expanded to provide growth capital for unquoted companies and finance for management buyouts.

Remove EU financial service compensation policies

The CRR and CRD IV also cap bankers' bonuses at a maximum of 100% of their salaries. The roundtable participants agreed that this has simply caused bankers' salaries to increase, thereby increasing the banks' fixed costs.

The roundtable participants claimed that the cap on bonuses had increased salaries by a multiple of three. This obviously increases banks' fixed costs as well as their capital requirements. Most believe that the previous system of paying minimum wages and large variable bonuses from annual profits was a more successful business model for the industry where revenue can vary dramatically from year to year. It was also agreed that end-of-year variable bonuses incentivise a company's employees to work hard, pursue new customers and keep expenses/trading losses low. By contrast, high fixed salaries encourage a more bureaucratic, less entrepreneurial work ethic. High fixed salaries also make financial firms less stable in a downturn so that firms are more likely to cut staff whom they previously could have retained at a lower base salary.

In a global financial environment, higher fixed salaries make EU based employees, even of non-EU banks, more expensive than their colleagues at other non-EU branches. Increasing fixed costs in this way makes EU based banks less profitable than non-EU based banks. Additionally, employees of an EU bank who are posted to cities outside of the EU are at an advantage, as they can continue to receive large bonuses if they are successful.

Similarly, under both UCITS V and AIFMD, of asset managers' variable renumeration, 40-60% must be deferred for 3 to 5 years, and at least 50% must be paid in non-cash instruments such as units in the funds that they manage or in shares in the asset management company.

The participants agreed that while deferred renumeration paid in fund units or shares is fine for established fund managers, monitoring such a payment scheme requires additional administration and in a year with lower profits fund managers will receive much lower cash payments. As fund managers cannot eat or pay their rent with deferred UCITS fund units, this regulation, intended to discourage asset managers from investing their clients' money in high risk/high return instruments, could still tempt managers to take on more risk simply so that the cash proportion of their remuneration is higher.

The benefits that come from the bonus culture must not be underestimated. It has been an essential part of the growth in world leading financial services in the UK and one that would work well in any industry trying to improve its productivity. It could be one of the first EU regulations to be disposed of post Brexit. It is hard to believe that the general populous would resist changing a regulation that actually increases bankers' pay packets. Not only would the financial firm's shareholders be happy to see the company's costs lowered in less profitable years, the City's deal makers and successful asset managers would welcome a return to the low salary/ high bonus system, and a move away from bureaucratic encroachment.

Solvency II

Solvency II is an EU regulation that harmonises EU insurance regulation, replacing 14 EU insurance directives. Besides setting capital ratios and reserve requirements, Solvency II also covers the harmonisation of asset valuations, regulatory authorisation, corporate governance, supervisory reporting, public disclosure, risk assessment and risk management. Solvency II requires insurers to publish details of their risk portfolio, capital adequacy and risk management.

The fundamental goal of Solvency II was transparency of an insurer's financial position and its ability to absorb loss. It was hoped that Solvency II would improve consumer choice, ensure uniform consumer protection across the EU, and allow market forces to prevent insurers taking excessive risks. This harmonisation of EU directives on insurance was intended to help policy holders, make insurers more transparent and exposed to market forces, while shifting supervisory focus towards an insurer's risk profile, risk management and governance.

Solvency II was designed primarily for basic retail insurance such as pension, life and property insurance, as this is the predominant type of insurance sold throughout mainland Europe. Unfortunately, Solvency II also applies to UK companies which sell wholesale and commercial insurance and reinsurance covering less frequent events such as catastrophe insurance, aircraft insurance, cargo insurance or more complex insurance such as oil platforms, nuclear power plants, construction contract overruns and errors, and omissions insurance for consultancy contracts.

Solvency II's capital requirements are over reliant on data samples which are often small and of poor-quality for assessing the risk of rare or complex events. Solvency II is also over cautious in its capital requirements, allowable asset classes and durations. This also impacts on the

competitiveness of UK insurers compared to non-EU based insurance companies.

Post Brexit, UK regulators should review the appropriateness of Solvency II capital requirements, especially for insurance that is more complex than simple life, car or house insurance. Any divergence from Solvency II should be used to enhance the competitiveness and efficiency of the UK insurance market without eroding the fundamental goal of ensuring that an insurance provider is able to meet its obligations and absorb any losses.

One roundtable participant rejected the premise that 'harmonisation' of capital requirements had ever been necessary. Greater convergence of regulation around the management of risk could actually increase systemic risk. Synchronising the insurance market has the implication that if the prescribed risk and capital calculations are wrong, everyone could go bust at the same time.

Another complaint about Solvency II was that adherence to the regulation has led to a large increase in compliance costs, making it harder for smaller insurers to compete. Increased barriers to entry also deter new market entrants. This, as well as consolidation in the industry, is likely to reduce competition over time, which will in turn tend to lower welfare by increasing premiums for businesses and consumers.

It is also not clear whether Solvency II has actually achieved the objective of making insurance companies safer. Roundtable participants believed that the previous capital standards applied in the UK under the ICAS regime were arguably stronger than those under Solvency II, while management time is distracted by the box ticking exercise of complying with the regulation and the measurement of risk rather than actually managing the risk.

Internal model (IM) or standard formula (SF)?

Under the Solvency II regime, capital can either be measured using a prescribed calculation known as the 'standard formula', or by using the insurers' own bespoke model based on Solvency II principles, known as an internal model. The default capital calculation is the standard formula while a bespoke internal model has to be approved by the regulator before it can be used. This approval process is expensive and time consuming, so smaller firms will tend to use the standard formula while a larger firm is able to afford to get approval to create a bespoke internal model that better fits its business.

The standard formula tends to overestimate the levels of capital that insurers must hold for many types of complex insurance as it was designed for more general insurance products. An internal model calculates a more precise capital requirement level as it is calibrated internally to fit an individual firm's business. This gives the advantage of lower capital requirements to firms which are able to afford the additional regulatory approval costs of an internal model. Generally, it is mainly larger firms which can afford to use an internal model, giving them an advantage over smaller firms which cannot.

However, both the standard formula and internal model calculations require that insurers' balance sheets are calculated on a Solvency II basis rather than a US insurance Generally Accepted Accounting Principles (GAAP) basis. As many UK insurance companies calculate their balance sheets using UK/US GAAP this means that insurers have to calculate their balance sheets on two different bases to comply, which again adds to their costs.

The internal model calculates risk as the movement in the Solvency II balance sheet over a spurious one-year time horizon. This is arguably a weaker capital regime than the previous UK FCA's Individual Capital Adequacy Standards (ICAS) regime which measured risk to ultimatum (i.e. once all of the risks have run off) on a GAAP basis.

Changes to internal model calculations must be approved by committees, boards and the regulator if they are over the firm's model change policy threshold (which must also be approved by the PRA). Although this stops firms from changing the capital calculations on an ad hoc basis, the way the PRA is applying this rule is absurdly onerous and discourages firms from making changes even if it would lead to a better measurement of risk. Meanwhile the regulation requires that all internal models are subject

to an external validation every three years, which has become a very lucrative income stream for external consultancies.

There are other issues with the Solvency II economic basis: it is not a very good basis for measuring risk as it abolishes the concept of earnings and focuses instead on cashflows - even though some parts of the Solvency II balance sheet system are not actually measurable, having been created by the use of the models. The balance sheet is calculated on an economic basis where liabilities are held at a ‘market price’ even though this is completely unknown.

Roundtable participants generally welcomed Solvency II’s greater transparency in terms of having to publish publicly details on capital and risk management regimes, and also its requirement to complete an annual internal risk assessment. They agreed that Solvency II had been an improvement on the original Solvency calculations but felt that the UK had already largely addressed these problems with the ICAS regime.

Solvency II introduces some economic concepts which are useful when measuring risk, such as discounting. However, the PRA has gold-plated the model change regime beyond comprehension so that too much time is wasted questioning market practitioners on their models rather than monitoring systemic market-wide issues.

Gender as a risk factor

Post Brexit, UK authorities should also review the illegality under EU regulation of using gender as a risk factor in driving insurance and life insurance. This defies logic. Denying that gender can alter the risk factor in an insurance contract seems to be based on virtue signalling rather than actuarial statistics, and could also be considered discriminatory depending on which types of policies are being purchased by the individual. More importantly, it goes against the fundamental principle of insurance, that individuals’ premiums are based on the likelihood of a claim being required against the policy.

It is well known that gender is quite an important risk factor in pensions, life insurance and car insurance. For life insurance and pensions, it should be obvious that it cannot be legislated that men must live as long as women on average. But by assuming that they have the same longevity Solvency II has led to women overpaying for life insurance and men overpaying for

annuities. The results mean that insurance premiums are no long correlated with the underlying risk even though, when considering car insurance for example, it seems entirely sensible to most people that young men should be charged a higher premium than young women given that young men are far more likely to have an accident.

It was also suggested that the UK Treasury could remove the taxation of loss equalisation reserves and catastrophe reserves.

Conclusion

Costly and time-consuming regulation is causing consolidation among smaller brokerage and advisory firms; research payments are reducing the amount of research available on small and startup companies; MiFID II costs and VAT charges are forcing more retail investors away from direct share investment and into funds. But funds are now becoming too large to invest in SME companies and in some cases they are too large to trade on public exchanges without moving the market against them and causing a price spike - yet the MiFID II regulations restrict the amount of trading that funds can do in dark pools. Similarly, small insurance companies cannot afford the more efficient internal model and often need to keep two accounting standards.

It is important that regulators take competition into account in assessing the effectiveness of the current regulations and do not allow this negative spiral to undermine the listing of new companies which help to keep the whole economy competitive and vibrant.

The UK has a huge opportunity to streamline its regulatory environment when it leaves the EU, as well as reorient its taxation policies to encourage long-term investment in innovative companies. Although the roundtable participants had voted in various ways in the referendum, they were generally focusing on the opportunities of leaving the EU rather than worrying about possible losses. The financial services industry has always been quick to adapt to change and has either set up small offices in the EU27 or found other ways to continue doing business with EU clients.

The UK has many advantages over the rest of the EU27 and is a leader in new technology, financial technology and entrepreneurial businesses. The roundtable participants saw it as important that the finance industry returned

to its primary function of pooling capital for business investment and welcomed any taxation or regulatory changes that would encourage this.

It is important that the UK authorities do not kill the goose that has been laying golden eggs for the UK economy for the last 50 years. This is especially important now, as platform-based systems can move easily to another country, as happened in the early 1990s at the OM exchange, to the UK's advantage, but also with some ICE traded oil contracts last year, to the UK's detriment.

Finally, many other issues were raised that are beyond the scope of this paper:

- Roundtable participants pointed out that other parts of the financial sector, most notably auditing, required much more regulator attention, as together with the ratings agencies, auditing should be providing the bedrock on which all investment valuations are built.
- The UK's more general loss of a middle class - through the stagnation of wages and ever-increasing stealth taxation on the populace - has resulted in people having less money to invest beyond their pensions. Together with increased regulations for retail investors, this has reduced the amount of capital available to the underlying economy.
- UK based banks, paying the 8% taxation surcharge, are expected to remain competitive with non-UK banks internationally, while domestically they were competing with less regulated peer-to-peer lenders for both customers and clients.

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