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MiFID: A Regulatory Doomsday?

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The EU financial services industry has experienced an enormous regulatory adaptation over the past decade. The dust that had been thrown up by the 1992 programme had barely settled when a new regulatory programme was announced covering 42 measures that had to be implemented by 2005. Exchange rates were fixed in 1998 to prepare the start of monetary union in 1999, followed by the introduction of euro notes and coins a few years later. Accounting standards were changed to IFRS in 2005, the new Basel norms on capital adequacy for banks have to be implemented by the end of 2006, and the MiFID directive regulating capital market activity will be applicable from late 2007 onwards. With almost ever year over the last 10 years having been marked by profound change, it is no wonder that financial markets suffer from regulatory fatigue. Brussels is widely seen as a source of trouble and complaints on the ever increasing cost of compliance are mounting.

The upcoming MiFID directive (Market in Financial Instruments Directive) is a case in point. A centrepiece of the EU's regulatory programme to create a single capital market, MiFID will radically increase competition between markets and banks. It replaces the 1992 Investment Services Directive, but has opted for a very high degree of harmonisation to achieve this integrated market. If a simple word count is any indication, MiFID is about five (!) times as burdensome as the directive it replaces. It contains very detailed provisions on best execution of trades, trade transparency, client suitability, conflicts of interest and internalisation of trades, which banks are preparing to implement. According to authoritative sources, the one-off cost for implementation ranges on average from €4 million to €20 million per bank, with smaller banks being hit more than proportionally. For very large banks, the cost of implementation could reach €106 million per institution, according to a recent study by JPMorgan.[1]

Looking at the European and global banking landscape, it does not seem however that the European banking sector and financial markets in general are suffering too much from these huge compliance costs. Banking profitability is rising and European banks' share prices are at all-time highs. Nor does the competitiveness of European capital markets seem to have suffered. Both the issuance of corporate debt and the number and total value of IPOs in Europe surpassed those in the US in 2005, which is an historic feat in itself and a trend that has continued into 2006. Is it possible then that, even if costs are high, the benefits for markets and the economy as a whole are even higher? It is probably too early to say, but the situation clearly reveals an old problem, namely, the difficulty Brussels institutions have traditionally had to clearly communicate their strategy to markets and citizens alike, the interaction with the markets in the elaboration of regulation, and the application of ex-ante cost-benefit analysis which tends to highlight costs while the benefits are more difficult to quantify.

In recent years, the EU Commission has stepped up its efforts to do a better job in reaching out in its various initiatives through broad consultations, and in the context of its 'better regulation' programme, also started to apply impact assessments to all proposals for rule-making. This should allow legislators and the public at large to know the full costs and benefits of future legislation. However, the EU's experience with this discipline is still in its infancy, and the way in which the procedure has been implemented has produced a sea of disappointment. Of the about 95 extended impact assessments produced to date, only a few clearly quantified the expected costs and benefits and only 2 concerned the financial sector, with questionable results.[2]

To return to MiFID, a decent *ex-ante* impact assessment would probably have produced a similar directive, but with a more limited degree of harmonisation and more focus on mutual recognition. But the effect of the ever-growing burden of regulation on business would be the same as could already be noticed: more detailed and complex regulation leads to further concentration and consolidation in the financial sector, and increases the barriers to entry, or reduces the contestability of markets. Smaller players are absorbed into larger entities or are doomed to disappear, and only the large or sharply-focused players survive. Future EU regulation should thus aim at ensuring the openness and contestability of markets.

Overall, it is an illusion to believe that there could be something like a regulatory pause in financial markets. Given that financial markets' capacity to innovate and develop is almost unlimited, there will always be excesses and distortions, hence a need for regulators to react and to try to accommodate regulations to these developments. Moreover, the EU's single market is a moving target, and as soon as certain barriers have been brought down, and market integration advanced, new problems are identified. The costs of these new rules will essentially fall on firms, which will of course complain, but the benefits should go to the users, and the economy as a whole – at least if the rule-making process has followed decent procedures. The challenge is thus to make sure that regulators apply these processes, but also that they do not refrain to take certain steps if they have to be taken.

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[1]Figures quoted by the author in *The MiFID Revolution*, available from http://www.ceps.be/

[2]Andrea Renda, Impact Assessment in the EU, CEPS 2006.