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ORTEC FINANCE

Pan-European Research: How is Investor Protection (MiFID II) implemented?

European practices around suitability

2021 | Tom Loonen & Ronald Janssen

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Preface

During the implementation of Markets in Financial Instruments Directive (MiFID) II in 2017, Ronald Janssen (Managing Director Goal Based Planning at Ortec Finance) together with Tom Loonen (Professor of Financial Law at VU University Amsterdam) and Arthur Killian (former Director of PwC) published a summary of the guidelines on Suitability and Appropriateness. This whitepaper is a follow up to that publication, discussing the implementation of MiFID II.

Despite the fact that MiFID requirements have resulted in more uniformity within the EU, we show that there is still heterogeneity in important areas when it comes to meeting the MiFID requirements.

As a result, the operation of these protective measures are also different, leading to effective harmonization not yet being achieved. More importantly, we argue that in some cases the measures have too limited an influence on investor protection and that it should be further harmonized across EU nations to meet the initial purpose of the regulations. We believe that the empirical evidence documented in this paper can be a tool to improve alignment with legislation, increase efficiency in processes, and deliver more added value to investors.

This whitepaper studies the way 'suitability' is implemented within 25 private banks in 10 countries, as a part of MiFID II. Numerous people with relevant knowledge of these private banks were willing to participate in this research. We thank them for sharing their knowledge.

We hope this whitepaper provides information that is helpful to improve the processes around suitability.

Introduction

MiFID is the cornerstone of the EU's regulation of financial markets. By creating a single market for investment services and activities, and ensuring a high degree of harmonized protection for investors using MiFID, the EU seeks to improve their competitiveness.

MiFID II requires private banks and wealth managers to demonstrate that the investment service, product or instrument they offer is suitable for their clients. These suitability requirements state that retail investors must have sufficient investment knowledge and experience to understand the functioning and the risks of the investment service, product(s) or instrument(s).

In 2021, we conduct a follow-up pan-European study. To this end, we interviewed policymakers at *25 private banks* across *10 European countries*. We focus on the quality of the 'Know-Your-Customer' (KYC) information that private banks obtained from their clients, and the extent to which it was digitized and translated into a risk profile; whether this process is client or product oriented; and how the client's risks are controlled and monitored.

Figure 1: Participating countries

Focus of the research:

- What kind of information do the private banks collect to meet the KYC-obligations under MiFID II?
- How do they use that information?
- In what manner and how often do they update this information?

The scope of this whitepaper is limited to MiFID II, and in particular, to 'suitability'. We undertook this research because we observe many different processes and approaches, some more efficient and effective than others. We also define different challenges within the risk profiling and suitability process. Different methodologies are used, but it is almost always based on a (paper) questionnaire. With a questionnaire approach it is challenging to interpret the answers to create a risk profile. Some of the questions we found to be challenging include:

- How to provide the retail investor with more understanding of the choice they need to make with respect to their risk profile?
- Do they understand the risks and rewards of the chosen risk profile, especially in relation to personal objectives?

- How to determine if the risk profile is in line with the investor's risk willingness and the ability to take risk?
- Is the approach focused on the product/instrument or do the private banks have a more holistic approach towards actual client needs?
- Is the KYC-information used to determine the suitability of the specific investment, and if yes, how? How do the private banks keep the obtained data up to date in an efficient way and how do they guide the retail investor during the life cycle of the product?

Thus, the research sought to answer the following questions:

- How do private banks match product characteristics with client characteristics, especially the willingness and ability to take risk?
- Do private banks have a product focused approach or a more holistic client focused approach?
- How do private banks manage suitability over time?
- How do private banks support clients to achieve their investment objectives?
- How can digitization help to determine suitability and keep this up to date?

Through our study, we provide insight into how MiFID II is implemented within private banks, the differences between the various private banks, and the best practices to be followed.

The target group of this whitepaper is any person involved, directly or indirectly, in servicing retail investors like investment advisors, compliance officers, heads of private banking and retail banking, product managers, etc.

1. Regulatory context of suitability

1.1. MiFID II and Investor Protection

The MiFID II directive attempts to create consistent requirements for investment services across the member states of the European Economic Area (EEA) with all participants subject to a similar regime. An important part of MiFID II is Investor Protection focussing on for example private banks that provide investment advice or manage assets. Specific provisions have been included that directly affect the relationship between private banks and clients, and provide relevant information regarding the suitability of the service and financial instruments to the clients. There are also requirements aimed at providing (post-transaction) information to the investor.

The requirements in MiFID II regarding Consumer Protection for private banks are:

a) align products and target markets (product approval and review process);
b) disclose all costs of the various investment services, financial products financial instruments, and provide the investor insight into costs, risks, and returns;
c) in relation to investment advice:
    - explain the basis on which investment advice is given, particularly on the range of financial instruments or a bundle of financial instruments they are considering (portfolio);
    - disclose whether they provide advice on an independent basis;
    - inform clients to assess suitability periodically; and
    - explain to clients the reasons behind the advice the investment firm provides.

The focus of this research is on the non-professional investor or retail investor; furthermore, the scope of this whitepaper is limited to the suitability assessment. The context of the whitepaper mainly refers to key articles of MiFID II (Art. 24 and Art. 25). Specifically, provisions that directly affect the relationship between private banks and clients.

1.2. Assessing suitability

The suitability provisions are investor protection requirements and guidelines on how to advice or manage the funds of clients in the best way possible. Aspects such as matching the willingness and ability to take risk, ability to bear losses, matching the investment solution with the financial situation of the client, and managing expectations are a part of this. The scope of the research is, if applicable, investment advice and portfolio management.

Table 1 shows an overview of relevant information to assess suitability. The main topics are investment knowledge and experience, the client’s financial situation, and the client’s investment objectives. Table 1 provides an overview of the relevant information needed to determine the investment knowledge and experience of clients. These definitions give direction to the Know Your Customer (KYC) information part of the suitability process.

Information to be obtained when assessing suitability	Requirements
Client's knowledge and experience[5]	• the types of services, transactions and the investments with which the client is familiar; • the nature, volume and frequency of the client's transactions with regulated investments; and • the level of education, profession or (if relevant) former profession of the client.
Client's personal financial situation*[6]	• the source and extent of the client's regular income; • the client's assets, including liquid assets, investments and real property; • the client's regular financial commitments; • the ability to bear losses.
Client's investment objectives	• the client's investment horizon; • the client's risk preferences, risk profile and risk tolerance; and • the purposes of the investment.

Table 1: Requirements for assessing suitability

1.3. Collecting KYC-information

Know Your Customer information (article 54(2) Delegated Regulation (EU) 2017/565)

When providing investment advice or portfolio management, the investment firm (like a private bank) shall obtain the necessary information regarding the (potential) client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including assets and liabilities, his ability to bear losses and his investment objectives including his risk tolerance so as to enable the investment firm to recommend to the (potential) client, the investment services and financial instruments that are suitable for him and, in particular, are in accordance with his risk tolerance and ability to bear losses. When we speak of risk-taking preferences—in practice, the willingness to take risks, the investment objective and related investment horizon should be considered by the investment firm when assessing the client's risk tolerance (ESMA, 2018, p. 10).

As described above, a variety of client information needs to be obtained to assess the suitability of the service and/or the recommended transactions. Private banks shall obtain information about the client, giving due consideration to the nature and extent of the service provided, and the nature of the specific transaction to be recommended or entered into while providing a portfolio management service, satisfying the following criteria:

a) it meets the investment objectives of the client in question, including the client's risk tolerance;
b) it is such that the client is able financially to bear any related investment risks consistent with their investment objectives;
c) it is such that the client has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of their portfolio.

Gathering KYC-information (article 54 (7) Delegated Regulation (EU) 2017/565)

Private banks should take reasonable steps to ensure that the information collected about their (potential) clients is reliable. This shall include, but not be limited to, the following:

a) ensuring that clients are aware of the importance of providing accurate and up-to-date information;
b) ensuring all tools, such as risk assessment profiling tools or tools to assess a client's knowledge and experience, employed in the suitability assessment process are fit-for-purpose and are appropriately designed for use with their clients, with any limitations identified and actively mitigated through the suitability assessment process;
c) ensuring that the questions used in the process are likely to be understood by clients, capture an accurate reflection of the client's objectives and needs, and provide the information necessary to undertake the suitability assessment; and
d) taking steps, as appropriate, to ensure the consistency of client information, such as by considering whether there are obvious inaccuracies in the information provided by clients.

1.4. Requirements regarding financial information

Regarding the financial position of the clients, ESMA provides further guidance (see supporting guideline ESMA 43, p. 13): "*Information about a client's financial situation includes information regarding his investments. This implies that firms are expected to possess information about the financial investments the clients holds with the firm on an instrument-by-instrument basis. Depending on the scope of advice provided, firms should also encourage clients to disclose details on financial investments they hold with other firms, if possible, also on an instrument-by-instrument basis*."

Updating obtained information (article 54 (7) Delegated Regulation (EU) 2017/565)

An investment firm is entitled to rely on the information provided by its (potential) clients unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate, or incomplete. The issue is in determining when information is out of date. Neither MiFID nor ESMA provides an explicit answer about this (Article 55(3) Delegated Regulation). Article 54(7) of the MiFID Delegated Regulation states: "*7. Investment firms shall take reasonable steps to ensure that the information collected about their clients or potential clients is reliable".* Article 54(7) sub d.) states: "*taking steps, as appropriate, to ensure the consistency of client information, such as by considering whether there are obvious inaccuracies in the information provided by clients".* Furthermore, as stated in the Delegated Regulation: "*Investment firms having an on-going relationship with the client, such as by providing an ongoing advice or portfolio management service, shall have, and be able to demonstrate, appropriate policies and procedures to maintain adequate and up-to-date information about clients to the extent necessary to fulfil the requirements under paragraph 2".*

On page 45 of the Suitability Guidelines of ESMA, the definition of 'ongoing relationship' is further explained. The term 'ongoing' should apply to a client relationship that is continuing, or has been so during the preceding year. The existence of an ongoing relationship (or not) with a client should be assessed on a case-by-case basis, taking into consideration the nature of the service provided. Firms should be able to explain how, why, and when they have assessed a particular client relationship as ongoing (or not). "Firms should regularly review client information to ensure that it does not become manifestly out of date, inaccurate or incomplete. To this end, firms should implement procedures to encourage clients to update the information originally provided, where significant changes occur"

(Guidelines on Suitability, ESMA, page 45). According to ESMA, the frequency of updating information depends on the client's risk profiles and the type of financial instruments that are recommended.

When both parties have concluded a contract for the provision of an investment or ancillary service that is not a one-off service, the on-going relationship status would apply for as long as the parties agreed to such a contract and would include situations where there is an agreement for the firm to provide the client with a periodic assessment of suitability (see also chapter 15 of Q&A on MiFID II and MiFIR Investor protection and Intermediaries topics, ESMA 35-43-349).

In MiFID II article 25, it is stated that where an investment firm provides portfolio management or has informed the client that it will carry out a periodic assessment of suitability, the periodic report shall contain an updated statement of how the investment meets the client's preferences, objectives, and other characteristics of the retail investor.

2. Implementation of suitability provisions

2.1. Introduction

In this chapter, the results of our research are described. It provides a high-level overview of the results, connected to the trends described in the introduction.

Private banks should take the suitability framework as an opportunity to enter into a closer relationship with their clients. They will have to ensure that they obtain a clear picture about the knowledge, experience, financial situation, risk profile, and investment objectives so that they can provide advice or manage the portfolio in the most client-centric way.

In general, we observe large differences between the private banks, which are described later. One point that merits discussion is that the number of questions per risk questionnaire differs from 15 to 49. Although in the end, the most important point is what you do with the information collected, the differences are remarkable and indicate differences in their approaches. It is therefore important to assess how the information is used to comply with legislation and to support the clients in their investment decision making.

All the private banks are in a digitization process and many of them have already started with the digitization of different processes, like onboarding, collecting KYC-information. Starting from a digital perspective could give new insights and possibly another process. The following results and insights can help structure new processes.

2.2. Data collected by banks to ensure suitability

In the context of gathering relevant KYC-information, most of the private banks use an advisor-led approach and 52% use a paper questionnaire. Approximately 50% of these private banks make a scan of the intake form to store the answers in a digital way. In this case, it is challenging to learn from the data, for example, to define the characteristics of different client segments, to get information about all clients, and to use the data to improve processes, bring more added value, or make processes more efficient. None of the private banks use a fully-digital KYC-process. Some private banks use a combination of a digital and personal approach, but most of them rely on the input of the advisor.

In the MiFID regulation we do not see an obligation on the frequency of updating certain information. Thus, we see differences in the approach taken by the different banks. Almost half of the private banks update the information on an annual basis, 40% update the information every 3 or 5 years, and 16% of the private banks determine the frequency based on the risk profile of the client and/or the complexity of the client.

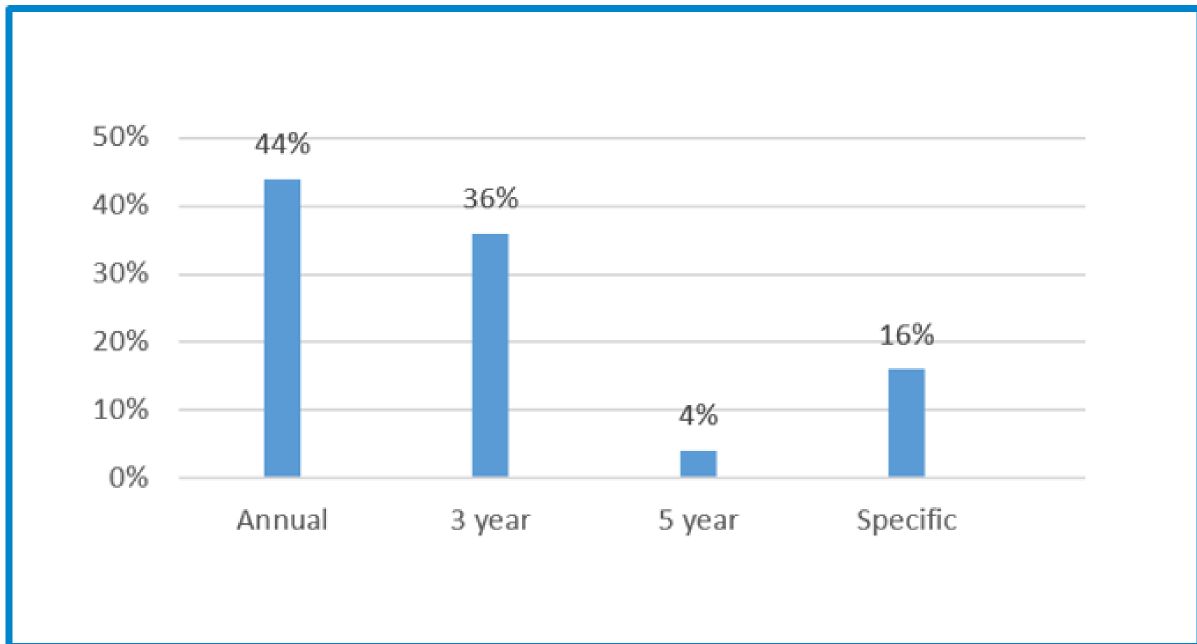

Figure 2: Update frequency KYC-information

Investment knowledge and experience

The private banks determine the investment knowledge of a client in different ways. Around 50% of the private banks use a questionnaire with only multiple-choice questions as a stand-alone tool. Around 40% of the private banks have a combined approach, using both multiple-choice questions and open questions. The open questions are often a starting point for a conversation, where the advisor can obtain an idea about the level of investment knowledge of the client. Although it is a more subjective process, the advisor is able to give more background on the questions and answers.

Both the MiFID directive and guidelines, as well as the ESMA Q&A provide no concrete guidance on the procedure to be followed when the clients have insufficient experience. Here we see different approaches. Around 30% of the private banks do not allow the client to invest at all. The other respondents put a restriction on the investment universe or put extra effort into education and/or providing extra information. Others are guiding the client towards other services.

When it comes to keeping the client data up to date, we see two approaches. On the one hand, there are private banks that retest investment knowledge through (periodic) conversations with the clients, or with the help of a questionnaire that is sent out (60% of the respondents). On the other hand, remarkably, approximately 30% indicate that they do not update the investment knowledge during the relationship, and only obtain investment knowledge during the onboarding process (5% state that it depends on how the client invests). According to them discretionary portfolio management requires no retesting and 5% do not gather information about investment knowledge at all. However, in MiFID II, this is a requirement. In those cases where the investment knowledge of the client was updated, this was almost always done with the help of the advisor via face-to-face or telephone conversations. In only 10% of the cases does this happens digitally. What is the added value of the advisor in this process?

Another question is whether it is possible that the knowledge and experience of the client can change over time. If not, a different approach for clients with sufficient knowledge and experience, and clients with limited to no knowledge and experience, ought to be developed.

Determining financial position

In general, the research shows that the banks collect information on the financial situation of the client quite extensively. The income specified to sources, the total value of accumulated assets, and the total value of accumulated liabilities is documented in most cases. A smaller part of the private banks also document the level of expenses, and differences are visible in the level of detail collected on assets and liabilities.

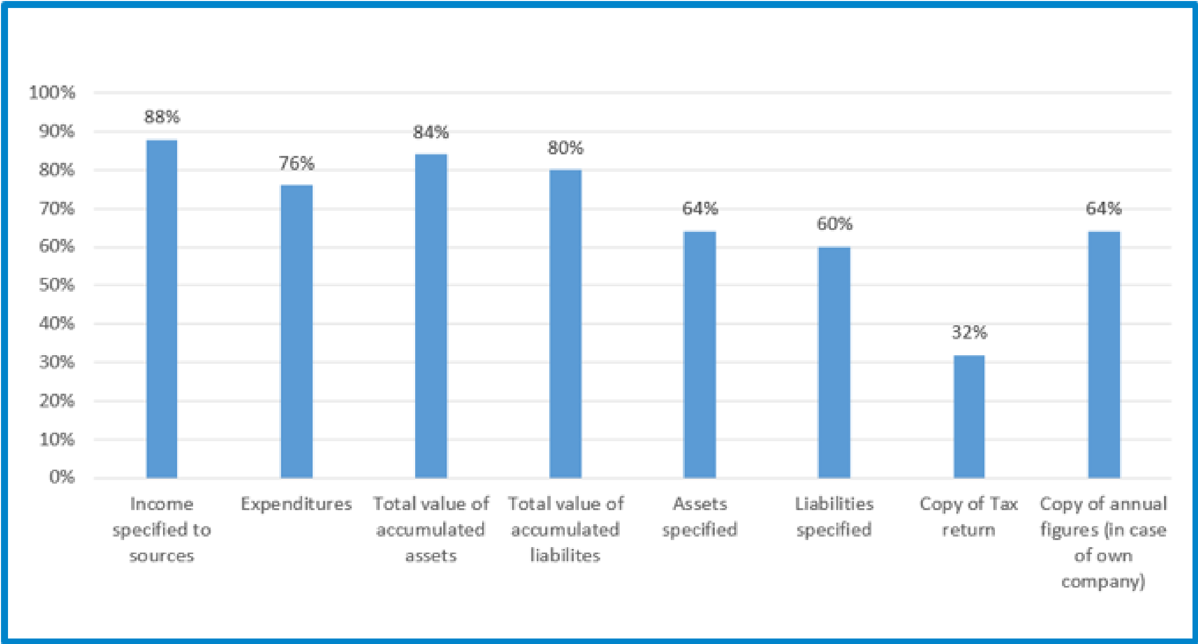

Figure 3: Type of information collected on the financial position of the retail investor

The level of detail also determines how the information is used to deliver added value or comply with regulations further in the process. When we closely examine the information on the current assets of the client collected as part of the KYC-process, we observe the following:

- Around 60% entails collecting detailed information, only 12% collects information on the level of securities.
- Around 40% collects information on an aggregated level.

The next question pertains to what the private banks do with the information. In the risk profiling process, 15% do nothing with the information, 50% consider other assets within the firm (not from other banks), and 35% consider other assets such as private and illiquid assets as well.

Investment objectives

Our research shows many differences in collecting information around investment objectives, both qualitative and quantitative. Objectives can be defined in three steps:

1) Select them from a list, high level;
2) Make objectives concrete with a (periodic) amount and horizon;
3) Prioritize objectives in case of multiple objectives.

From the respondents, 40% of the private banks select an investment objective from a list, as part of the questionnaire; therefore, they do not make the investment objective concrete. In this case it is not possible to test if it is realistic to achieve this investment objective. The other 60% define one or multiple objectives with a specific amount and a specific horizon. About 48% of the private banks split expense objectives and capital objectives. We see differences between countries, the regulator in the Netherlands (the AFM), for example, asks for concrete investment objectives and a periodical update. Therefore, the question is not 'Extra income during retirement', rather, 'how much capital does someone need to supplement their pension in 10 years' time?' In other countries, this is not always required.

It is remarkable that every respondent states that all clients have one or multiple investment objectives. More than 80% of the participants state that their clients have, on average, between 2 and 5 investment objectives. In 48% of the cases, it is not possible to define more than one investment objective per account during the suitability process. Thus, within these private banks, it is only possible to define one investment objective per account.

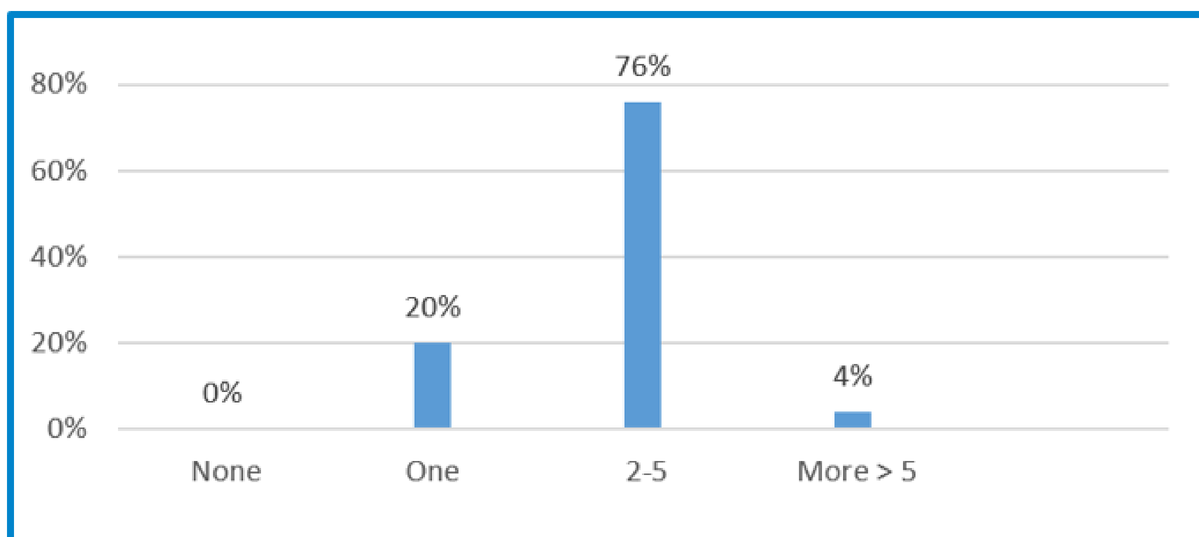

Figure 4: Insight into the expected number of objectives of an investor

The question is how do these private banks manage multiple investment objectives? For 32% of the private banks, it is possible to define multiple objectives and link these to multiple accounts.

Around 65% of the private banks update the objectives of an investor on a manual basis once in the 1st, 3rd, and 5th years, together with the update of the KYC-information. Approximately 15% is updating the probability to reach the objectives automatically.

Risk willingness and risk attitude

There is a difference between the risk willingness and the risk attitude of an investor. Where risk willingness indicates how much risk the client is willing to take with a specific amount invested, related to the investment objective and risk attitude, the risk attitude is independent of a specific amount invested and their objectives.

Figure 5: Difference between risk attitude and risk willingness

This difference is also made clear in Art. 25(2) MiFID II and in the ESMA guidance. Of the respondents, 64% indicate that they do not make this difference, while 36% does. All private banks focus on the risk willingness and a limited number of banks also focus on the risk attitude of the client.

The risk willingness is surveyed by a majority of the respondents using a risk questionnaire with a limited number of answers, while 44% of the respondents indicate that this was done using numerical insight into risk and return.

It is also important that investment firms appraise the client of basic financial notions such as investment risk and risk-return trade off. To this end, firms should consider using indicative, comprehensible examples of the levels of loss/return that may arise depending on the level of risk taken, and should assess the client's response to such scenarios. The question then arises whether insight on the risk/return trade-off should be provided at the product level or client level. We see differences between the approaches of the various private banks. Most of them provide insight on risk at the product level, as a percentage loss of the portfolio. We think the insights also depend on the objectives defined. In case of a retirement objective, it is necessary to give insight on risk at the client level. Is the client able to bear investment losses with respect to their retirement income? In case of children's study or capital preservation objective it could be possible to give insight in levels of loss/return on portfolio level. MiFID II is not clear on how to approach this.

Ability to bear losses

The private bank needs all relevant information to determine the suitability of an investment service. It must ensure that the (bundle of financial) instruments in the portfolio are in line with the objective,

and is in accordance with the risk willingness and ability to bear losses of the client, as stated in MiFID II article 25. It is important to decide whether the ability to bear losses needs to be determined at the product level or the client level. The banks practice both qualitative and quantitative approaches in determining the client's ability to bear losses. For example, the client may have a savings account with a large amount of money with another bank, whether this ought to be taken into account when determining the suitability of an investment portfolio and how the client can determine if they are able to bear the losses are determined using different approaches by the various banks. We see a difference in the focus of the banks between the product level and client level.

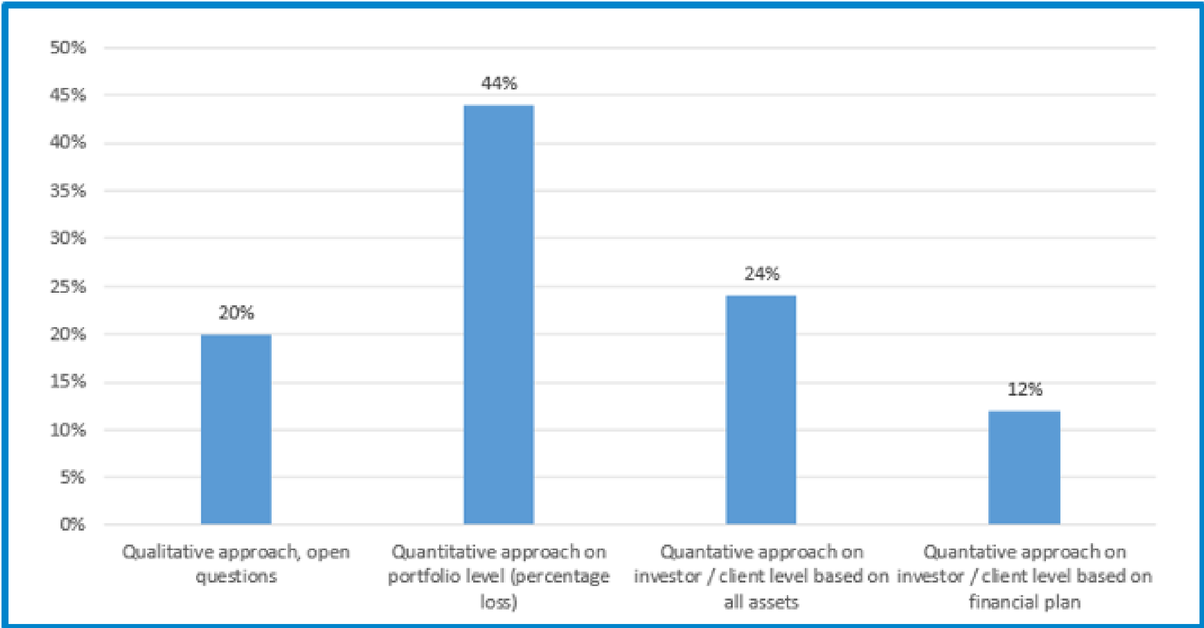

Figure 6: Different approaches to determine ability to bear losses

Of the respondents, 20% use a qualitative approach (open questions) to determine the ability to bear losses, and the decision depends on the knowledge and insights of the advisor combined with conversations with the client.

Many private banks (44%) take a product-oriented approach and define the loss by a percentage of the portfolio invested. Other (liquid) assets are not considered.

The rest, 36%, has implemented a more holistic approach on the client level, taking all assets into account, and in part of the cases also made a financial plan to determine the losses in a quantitative way.

Decision of the client to deviate from the advice

In case a client wants to choose another portfolio than that is based on the result of the questionnaire and/or advice, we see different processes to manage this situation. Around 30% do not accept a higher risk than the risk attitude. Most private banks accept a higher risk and manage the process. The clients must provide their signature because they are deviating from the proposed plan, and must provide the reason for the change. The bank will, in most cases, follow up with an annual check.

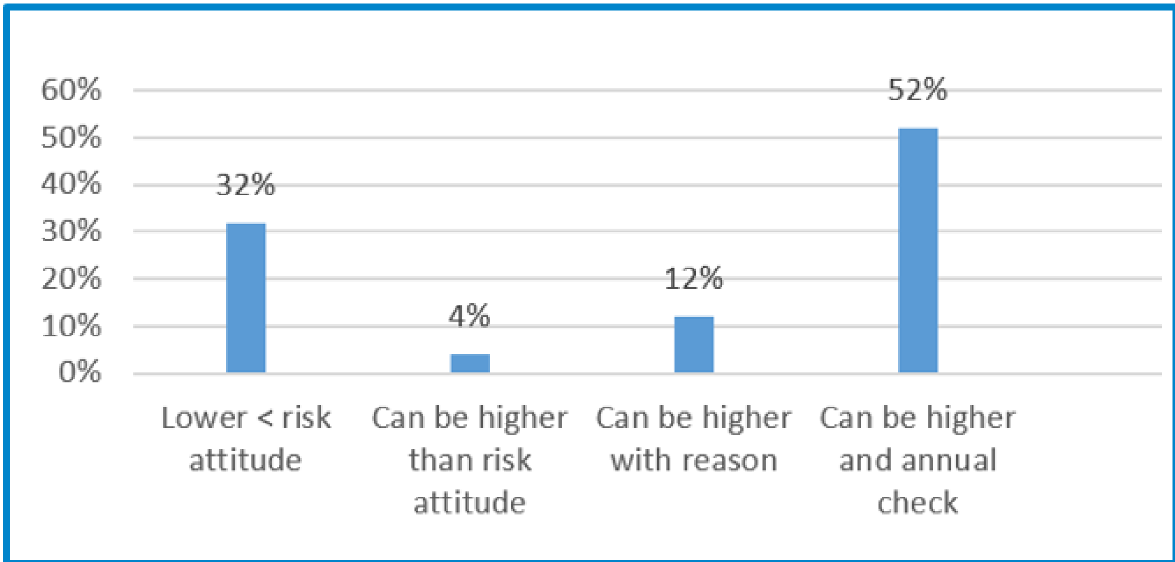

Figure 7: Flexibility to deviate for the investor

Managing client expectations

What is the best approach to determine the risk profile of a client? The majority of the private banks use a questionnaire to determine the risk profile. Around half of them also use other ways to support a client in determining a suitable risk profile. Around 45% provides insight into risk and return and around 50% provides insight into the probability to reach an objective. The latter two types of insight provide more understanding and background on the choice the client has to make and helps to manage client expectations.

3. Best practices around suitability

3.1. Introduction

The implementation of regulations is challenging for everybody. It is expensive and complex to implement and maintain over time. The findings of this research will be related to market trends. We distinguish three important market trends:

- developments towards a more digital world to increase efficiency, save costs, and bring more added value (digitization),
- guide clients with a more holistic approach, development from product focus to client focus (holistic approach), and
- pay more attention on risk management, monitoring of products and objectives, and client related risks (risk management).

What are the possibilities to improve on these three topics?

3.2. Results with respect to digitization

The different private banks are digitizing at different speeds. In general, we see a relatively poor state of digitization, with a lot of scope for improvement. For example, the process to update information on knowledge and experience takes a lot of time. Only 4% does a digital update via the client and in 96% of the cases an advisor is involved. In 40% of the cases, open questions are also part of the process. This process is expensive, error-prone, and subjective, but maybe important in terms of the personal approach.

To extract more value from client information, it is necessary to digitize data. Digitizing is not just about storing data in a database. It is important to think, beforehand, how to get a client to fill in a questionnaire, make sure the client understands what he is doing, how to simplify and minimize the work of a financial advisor, and how to maximize the added value. In short, not only: what questions I am going to ask and how I am going to weigh the answers, but also, how am I going to ask the questions. It is difficult to digitize answers to open questions. When you ask closed questions, you can ask follow-up questions and automate the whole process. By collecting the information from different client groups, new clients can be helped by giving them better and faster advice, using information from the peer group.

This is also the case with information around the financial position. By structuring the information and collecting information in more detail, it is possible to deliver more added value to the client and improve the process to determine a suitable solution by taking a more holistic approach.

From this research, it can be concluded that most of the private banks can make steps in the digitization of processes. A conclusion that McKinsey (2020) also draws, as they state: “The pandemic has further exposed the limitations of private banks’ omni-channel capabilities. As the client demand for digitally enabled remote interactions from their banks grows, banks must urgently rethink their client service model and proposition.” The pre-transactional suitability is tested by a large number of private banks only against the risk appetite of the clients, while a minority does this against all KYC-information available (e.g. financial position, investment horizon, investment knowledge, and experience).

3.3. Holistic versus product focused approach

There are large differences between private banks when it comes to a product-oriented or client-oriented approach. Between private banks it differs from complete focus on the product, where no other client information is considered, to a holistic approach whereby the financial plan is updated on an ongoing basis.

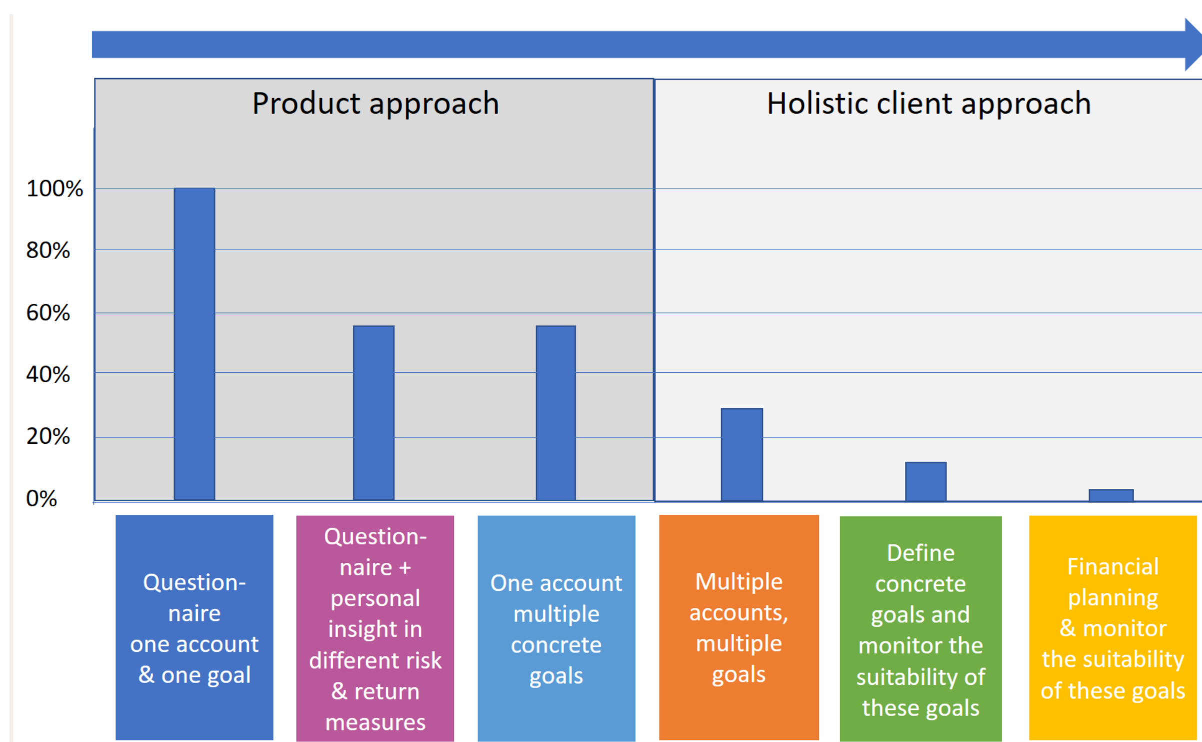

Figure 8: Overview of different stages in the services provided by different firms

We see different stages in the suitability process, as shown in figure 8.

1. All private banks use a questionnaire, most of them as part of the process. Most of them have a list with a limited number of investment objectives;
2. Part of the private banks show the impact of a possible choice by giving insight into the short-term risk, the long-term risk and return, and the probability to reach an investment objective;
3. Around half of the private banks support a process to manage multiple objectives of a client in case of one investment account;
4. A small percentage of the banks support a holistic approach with multiple objectives and multiple accounts;
5. Part of the private banks are further ahead in their digitization process and are thus able to monitor objectives automatically over time;
6. Only one bank is able to monitor the financial plan over time.

Although all private banks collect information on the financial position of the client, we see that there is a limitation in the implementation of this holistic approach. The suitability process is structured around the product and in limited cases around the client.

Suitability tested on product level or client level

Most private banks define risk profiles at the account level, so it is possible to have different accounts with different risk profiles. These private banks do not look at the aggregated risk of all accounts to determine the average risk on client level. Around 20% of the respondents compare the aggregated risk with the risk attitude of the client, but most of them only look at the accounts being held within the private bank. Most of the respondents agree that the best approach for the future is to look at the aggregated risk of different accounts, by considering the portfolios from other banks as well.

Financial planning as a service

The differences after the implementation of MiFID II regarding the initial collection of client information appear to be large—both between countries and within countries themselves.

A considerable amount of information collected during client onboarding can be used as input for financial planning, such as information concerning financial position. Preparing a financial plan is a way to use the collected information to improve the quality of the suitability determination process.

Financial planning is offered by 68% of the private banks. The fact that this is not universally done despite all the respondents being private banks is remarkable, as these banks pursue an in-depth relationship with clients and have insight and overview of all client assets and debts. Having this information is crucial in being able to provide good financial planning. The offering is still limited, as it is generally considered a costly service.

Of those banks that do offer financial planning, 24% stated that no additional criteria are set for this purpose. About 32% of the respondents stated that the amount held with the private bank determines whether the client qualifies for financial planning. A minimum amount of € 750,000 to € 1 million is often mentioned. Next to that 24% of the respondents mentioned the degree of financial complexity as a criterion for determining whether to offer a financial planning service.

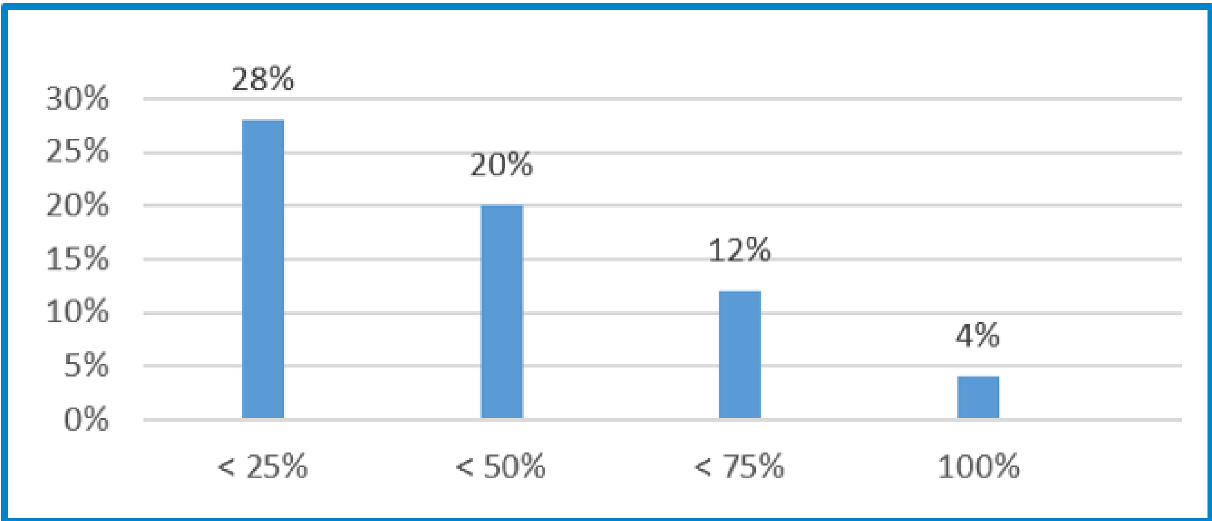

Figure 9: Percentage of clients who get a financial plan

Only 4% of the private banks deliver a financial planning service to all clients, in 28% of the cases, less than 25% of the clients are offered a financial plan. Although a majority of the private banks state that they offer financial planning as a service, it has not become clear if the information obtained from this plan is also used for KYC and suitability purposes. Using it in this way? would be beneficial to both the clients and the banks.

3.4. Risk management

Different risk management approaches are used by the different banks. This is becoming more important as more investors are taking higher risks because the returns on the savings accounts and other assets are very low.

Monitor the portfolio in relation to risk profile and objectives

Different approaches are used to monitor investment risks: monitoring the weight related to the bandwidth of asset categories, monitoring Value at Risk (VaR), and monitoring of the standard deviation. The first approach is implemented by monitoring of the securities. Private banks have defined strategic asset-allocation (SAA)s per risk profile. Each asset-category has a bandwidth, for example the SAA of Balanced is 50% Fixed Income and 50% Equity. The bandwidth of Equity is then for example 40%-60%. All securities are mapped towards an asset category, and they calculate if the total amount invested in the asset-category is within the bandwidth of this asset category. Of all private banks 76% uses this approach and in some cases along with other approaches. As part of this approach, in many cases they have rules to manage diversification risk.

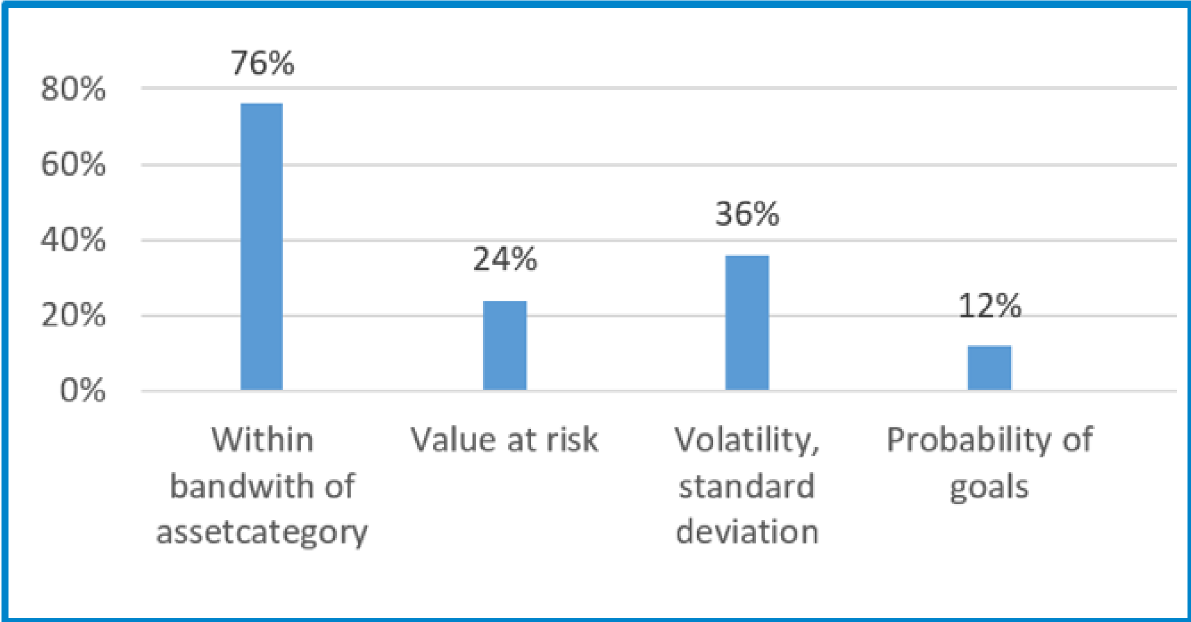

Figure 10: Approaches to monitor risk of portfolios and objectives[1]

[1] Multiple private banks use more than one approach to monitor the risk, that is why the percentages total more than 100%.

Other approaches are focused on measuring the downside risk of portfolios. A few of the respondents do this via the 'value at risk' approach; others, by measuring the standard deviation of portfolios. This is a more accurate methodology because diversification risk can also be captured. The last defined approach is not focused on monitoring the risk of portfolios but on monitoring the suitability. Is it still realistic to achieve the investment objective or is it necessary for the client to take action? Only a minority of the private banks (12%), uses this approach. Big improvements are possible when it comes to efficiency and better management of client expectations.

4. Conclusions & recommendations

Based on the interviews, we provide the following conclusions and recommendations:

- It is noticeable that private banks interpret the concepts (and provisions) arising from the MiFID directive differently. There is still uncertainty about themes such as risk appetite, risk acceptance, and the ability to bear losses. Concepts are interpreted and implemented differently in different processes. For example, some banks regard the 'ability to bear losses' as the emotional risk awareness of a client, while other banks perceive this as a maximum drawdown of the portfolio and whether the client is (financially) able to bear this loss. Therefore, the regulators should make definitions for concepts like 'the ability to bear losses' more concrete and provide more guidance on how they should be implemented.
- Improvements can be made in providing information on 'investment objectives'. We suggest making objectives more concrete and monitoring them over time in a more frequent and structured way. This will lead to a more client-centred approach and will improve the investment decision making process. This will lead to clients having a higher probability of realizing their investment objectives.
- In terms of the process, to comply with MiFID II, we recommend redefining the tasks of the advisor and client with respect to information exchange. It is also important to determine which information must be collected, how this information can be used to meet the requirements for investor protection, and how the information can be used for investment decision making. This will lead to a new focus on added value and can improve efficiency of financial services.
- The number of open questions must be reduced during the collection of information to improve support efficiency and clarity. Open questions take more time to answer and it is difficult to process the answers in later stages. They are only valuable when they improve the quality of the results.
- Updating relevant information from the client has not been sufficiently worked out in the text of MiFID II and thus there are differences in its implementation between banks. For example, there are banks that perform an update of the information on an annual basis, but other banks request an update once every three years. Specific topics such as 'ability to bear losses' are periodically tested at many banks, but still only 16% does this pre-contractually. More efficiency can be attained by determining which information must be updated with what frequency.
- Owing to this pluralism, various information is requested from the client in multiple manners. This can lead to different conclusions being drawn by private banks about the same client, an undesirable situation that can have negative financial consequences. For example: the questionnaires that are used by the private banks differ strongly. The number of questions varies between 15 and 49, so the effort and quality to determine suitability can also differ substantially.
- Various private banks in the EU member states indicate that they do exactly what is in accordance with the MiFID directive. For example, insight into investments with third parties is not part of this, although they indicate that they consider this in the customer's interest, but simply cannot (technically) incorporate this information into their processes and/or systems.
- It is also striking that the subjects to which the private banks pay special attention show strong geographical differences. For example, the Italian banks seem to focus on good product governance, whereby a more product based approach prevails. While countries such as the

Netherlands and Germany seem to focus more on a holistic customer view in which the deep(er) acquisition of KYC-information is more important.

- When it comes to the contact with national regulators some issues were detected. In some cases, the national regulator does not approve questionnaires that were approved by regulators in another country.
- It can be concluded that most of the private banks can make steps in the digitization of processes. A conclusion that McKinsey (2020) also draws, as they state, “The pandemic has further exposed the limitations of private banks’ omnichannel capabilities. As client demand for digitally enabled remote interactions from their banks grow, banks must urgently rethink their client service model and proposition”.
- Many legal obligations (arising from MiFID) regularly lead to compliance with the letter of the law and focus primarily on the investment portfolio, but do not always lead to a broader inventory and a holistic advice to private banking clients. Last but not least: The sector is burdened by enormous regulatory pressure. Banks are busy complying with all the information and administrative obligations, thus there is a risk that the actual client interest (do the investments really suit the customer and their situation) will be overlooked.

Even though the MiFID obligations have resulted in more consistency within the EU, we provide empirical evidence that there is still heterogeneity in important areas when it comes to meeting the MiFID obligations. As a result, the operation of these protected measures is also different and there is no full harmonization yet. More importantly, we argue that in some cases this could have (negative) influence on investor protection and should further be harmonized in order to meet the initial purpose of the requirement(s). We believe that the empirical evidence documented in this paper can be a tool for regulatory authorities and bank managers.

Appendix I: List of participants

The following private banks (who gave permission to be named) participated in the research:

Company	Country
ABN AMRO Belgium	Belgium
ABN AMRO MeesPierson	Netherlands
Accuro	Belgium
Bâloise	Luxembourg
Bethmann Bank	Germany
Brown Shipley	United Kingdom
CA Indosuez Wealth Management	Luxembourg
CA Indosuez Wealth Management	Spain
Credem Banca	Italy
Danske Bank	Denmark
ING Bank	The Netherlands
InsingerGilissen	The Netherlands
Jyske Bank	Denmark
Merck Finck	Germany
Neufilze OBC	France
Puilaetco	Belgium
Quintet Private Bank	Luxembourg
Rabobank	The Netherlands
St. James's Place	United Kingdom
Triodos Bank	The Netherlands
Van Lanschot	The Netherlands

Appendix II: About the authors

Tom Loonen works as managing director Quality Assurance (KYC and AML) and is a member of the Country Management Committee at InsingerGilissen Bankiers. He is a part time professor at the School of Business and Economics, VU University, Amsterdam, where he teaches financial law and compliance. He also teaches corporate governance and financial ethics at the University of Amsterdam (Master International Finance). He is a part time expert judge (Raad) at the Enterprise Chamber of the Amsterdam Court of Justice and a member of the Disciplinary Committee on Banks (Tuchtrecht Banken).

Ronald Janssen is director of the Goal Based Planning solutions of Ortec Finance and is responsible for the development and global distribution of their goal-based planning and monitoring platform. He also lectures at the Erasmus University in Rotterdam and has written articles for professional journals like The Journal of Wealth Management.

Contact details

Ronald.Janssen@ortec-finance.nl

Tom.Loonen@vu.nl

Appendix III: Glossary

Several terms are used in this white paper. Although the explanation is given in the text, we have compiled a list of the most commonly used acronyms for your ease of reference.

AFM: Authority for the Financial Markets. The Dutch supervisory authority for the financial markets.

Client profile: Information regarding the financial position, the experience with investments, and the investment objectives. The point of departure when drawing up and establishing the client profile is that the investment firm must act in the interest of its client and, partly for that reason, must be conversant with the client profile.

ESMA: European Securities and Markets Authority. Independent EU Authority enhancing the protection of investors and promoting stable and orderly financial markets.

FCA: Financial Conduct Authority. The conduct and prudential regulator for financial services in the United Kingdom.

Investment or risk profile: Banks use a wide range of terms, with 'investment profile' and 'risk profile' being used interchangeably. These profile names indicate which investment risk a client is emotionally and financially able and willing to run. This profile shows what the relationship is between the risk that a client wants to take and the expected return. Such a profile can vary from very defensive to very offensive.

Risk Willingness: How much risk an investor is willing to take with the specific amount invested related to one or multiple objectives

Risk attitude: Behavior of an investor independent of a specific amount invested and objectives

Securities: A collective name for securities which represent a company. Examples are shares and bonds. Derived products are also referred to as derivatives.