

Wealth Management and Compliance by Ian Murray

Ian Murray investigates the impact of MiFID on wealth management and asks if the M word is a blessing or a curse.

'Other people's money,' muttered an extremely senior industry figure caustically. He was reacting to the statement: 'Investment banks' ... trading books have tended to do much better than their asset management business, and I think that's a big problem for them going forward'. The statement was made by Anthony Bolton, director of investments at Fidelity Investments, at a forum hosted by Reuters in September. Whether the responding *sotto voce* comment is a fair comment is debatable, but its sentiment certainly lies at the heart of regulations like MiFID (the Markets in Financial Instruments Directive). With obvious relevance for wealth management, MiFID aims to ensure that your clients' money gets treated like your own.

Complying with MiFID may not seem so wonderful to the clients themselves. Everybody with a bank account already knows the irritation of having to comply with AML (anti-money laundering) KYC (know your client) regulations: you've been a client for yonks and you still have to march in with your passport and gas bill.

MiFID has similar impacts on the wealthy, forcing their brokers, advisors and portfolio managers to deluge them with revised paperwork and hundreds of not-always-new questions about their circumstances and goals. They are also forced by MiFID into a new category. Not being either 'eligible counterparty' or 'professional' investors, they are now classed as 'retail', which affords them the most protection under the directive.

'Client classification is becoming quite a difficult issue for us all,' says Tony Conway, director marketing and business development at Singer & Friedlander Investment Management. 'At the wealthier end of the scale, people don't like being pigeon-holed. If you classify them as retail, they throw their hands up and say 'No I'm not, I'm worth 2 million quid'.' Many of us, clutching our passports and gas bills, would of course be delighted to have this particular problem.

This kind of reaction, which is often shared by the relationship managers themselves, who have to sell to their clients, has led private banks and wealth managers to do their best to sell MiFID to their own staff, who otherwise might see compliance not merely as a necessary evil, but just plain bad for business.

'The commercial benefits of MiFID have been drivers for the programme from the beginning,' says David Pocock, head of global programmes and processes (and programme manager for MiFID) at ABN AMRO Private Clients. 'It's clear that the buy-in of the relationship managers is very important during times when new regulation is raining down in many different areas in the financial sector. So trying to deliver regulatory projects to them through business-driven and business-enhancing projects, we've found, is very useful.'

Some wealth managers have also, on top of all their other MiFID burdens, taken on selling MiFID to their clients, who, despite MiFID existing almost entirely for their benefit, know little about it, and see little of it apart from its inconvenience.

MiFID is not only good news for clients. It has given many private bankers and wealth managers the opportunity to renew outdated customer agreements and improve their processes in many areas of their businesses.

'The focus and the starting point for most organisations has been client categorisation, because that drives the application of other parts of MiFID,' comments Liz Purdy, head of private bank compliance at Investec Bank UK. 'Client categorisation is the key. But we've also taken the opportunity to update a lot of our internal business processes, and we're using MiFID as an opportunity to roll out other business changes that were in the pipeline.'

Although some may not say as much to their clients, all the repapering and heightened client contact is also giving practitioners the opportunity to market new products and sell their services, in addition to improving their advice.

'As for KYC, any additional information that the customers can give us obviously improves the ability for targeted and appropriate marketing,' says Pocock. 'The better we know our clients, the better we can identify the most suitable and appropriate investment advice for them. Private banking is very much about personal relationship management. It's not supermarket banking.'

Reclassifying clients is obviously only the start of this process. Although MiFID allows clients to request reclassification, even on a trade by trade basis, the exercise is essentially an up-front, one-off exercise. More important, going forward, are MiFID's rules on suitability and appropriateness.

These derive ultimately from Article 19 of the directive's first incarnation in 2004. Only masochists who like legalese, apparently badly translated from some European language where quadruple negatives may be the norm, will enjoy reading this. In essence, however, it says that discretionary portfolio managers (who take your money and do with it what they will), and financial advisors (who need you to agree with each suggestion first), must ensure that what they do and advise is suitable specifically for you.

Everybody else - in essence execution-only (XO) brokers (who respond to your requests without offering advice) - must consider, when you ask to trade a complex instrument, whether your request is appropriate for you. If not appropriate, they should warn you, or even, in principle, refuse to execute your trade, however unlikely that sounds in the real world. Some observe that these warnings are tantamount to negatively giving advice, an activity forbidden to XO brokers by MiFID. How appropriate, they ask, is that?

Although the words 'suitable' and 'appropriate' have similar meanings in English, MiFID is adamant that these are quite different things, and you confuse them at your peril. Both, however, require that you know a lot about your client, certainly more than the fact that his passport photo matches his face and his gas bill matches his address. KYC for AML is a seven stone weakling compared to MiFID, which is KYC on steroids.

MiFID asks firms to obtain information on the 'client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives'. This is a short clause, but some practitioners have had to translate this into questionnaires or input screens with hundreds of fields, which is not just a deterrent for clients, but can also greatly delay the account opening process and thwart trading opportunities for both parties.

More luckily for firms, this gathering of detailed information is in tune with relationship banking in the first place, and in particular with the way the market is going. Wealth management has been booming, with frenetic acquisition activity and office openings reflecting the huge growth in wealthy individuals in countries like China, Russia and India, and in the Middle East and Asia in general. Enhancing your client knowledge and focus, in effect boosting the long-touted personal relationship aspect of the business, is increasingly viewed as a key differentiator in the drive for greater 'share of wallet'.

IT has a key role to play in this, as a key enabler of this key differentiator. Apart from giving relationship managers an apparently effortless (and caring) recall of your personal circumstances, IT also offers firms the prospect of targeting services at you that you will actually want to hear about. This will be wealth management's souped-up equivalent to the credit-card-busting temptations that book lovers already have to endure on sites like Amazon, where the software lures you with books like those you tend to buy, or that other people like you bought when they bought books like you buy.

To achieve this kind of responsiveness, IT systems are being asked to record far more 'soft' information than MiFID requires. Growth in compliance requirements and simultaneous business growth are compounding to make IT ever more important.

Market growth is driving the take-up or upgrading of IT in other ways as well. Expansion has led to a huge shortage of good relationship managers, so much so that recruitment problems are becoming a major business hindrance, driving up remuneration. Relationship managers have to be the kind of people you want to trust with your money, obviously, and must be well informed about the products and services they sell. However they also have to be extremely well versed in compliance issues such as suitability and appropriateness, and have to spend a lot of time recording their contacts and decisions, so that they can prove they and their firms are compliant.

Anything that automates or reduces the compliance burden on the front office presumably must be a good thing. 'Wealth managers are really struggling with the shortage of front office talent and providing efficient tools that enable them,' says Bill Rosensweig, senior VP private account services at Brown Brothers Harriman, a major supplier of custodian and wealth management outsourcing services. 'If a relationship manager can support 100 clients as opposed to 50, that's a real saving.'

It is not just in the front office that salaries are rising fast. According to figures from wealth management industry analysts Compeer, in the three years to Summer 2007 the salaries of compliance directors rose by 48%. Compliance in many ways is directly related to volumes – the more business you do, the more business you have to check is compliant. Plainly no firm wants increasing compliance and increasing transactions to combine together to drive up staff numbers at the very time when the cost of those staff is rising. Automating compliance is becoming ever less wish-list and ever more must-have.

However both that automation and the minimum costs of increased compliance may prove a threat to smaller firms. 'The cost of compliance is now phenomenal, and this cost is significant if you're running just a few hundred million under management,' says Conway. 'I think you'll see further consolidation in the industry. Not because of the management of money, but because of the cost of administering it and the compliance aspects.'

So what are MiFID's biggest impacts on wealth managers and their IT? There are many other regulations to comply with, but MiFID is the requirement of the moment, being huge, still unclear in many areas, incomplete across Europe, and having an extremely tight deadline. As such, MiFID as a whole has hogged the limelight for many months. Surprisingly, however, those parts of MiFID that have attracted the greatest attention, such as best execution, price transparency and transaction reporting, have comparatively little impact on wealth management.

This is primarily because in large banks these requirements mainly affect other departments, those who perform the actual execution of the wealth manager's orders. In private banking in particular, many clients contract directly with the parent in Switzerland, which is not covered by MiFID. For smaller firms, many sell-side brokers have taken on the reporting and best execution requirements of their buy-side customers.

At the retail end of the market (in the usual sense of 'retail', as opposed to MiFID's confusing use of the word), the wealth management arms of many traditional full-service stockbrokers in the UK have long been using services like Proquote's, which poll multiple RSPs (retail service providers) and so provide best execution.

All this has meant that some technically difficult, expensive and time-critical issues have affected other people's systems rather than wealth managers'. Apart from client classification and suitability and appropriateness, which have an impact on both the front-office CRM and archive retrieval aspects of IT, the other big systems issue has been client reporting. This affects confirmations and contract notes, which need to show additional information, including, sometimes, something new which MiFID may not have intended.

'Some firms are beginning to levy an additional compliance charge,' observes Conway. 'The contract will show the cost of your trade, the commission, the cost of the external brokerage, the cost of the currency, whatever it might be, and here's an additional cost for compliance. It's great in terms of openness and transparency, but it does beg the question, 'What is the cost of the compliance business?'

Statements and performance reports are another aspect of client reporting that MiFID has things to say about. Apart from limiting the kinds of performance figures and benchmarks that can be used, MiFID may simultaneously require more information. HNW (high net worth) and especially UHNW (ultra HNW) clients are notoriously demanding, often requiring that reports look not just smart, but just the way they personally want them to look, a technical challenge in itself. Perhaps even more than most consumers, however, they are impatient of confusing presentation, which implies the need for less information, not more.

'Many wealth managers were fairly content that their reporting was appropriate for their clients, and part of their product offering, but now they're having to open up the hood and make changes,' comments Rosensweig. 'There's a case of more data being put into the reports, but whether that will lead to more information being conveyed, I guess is an open question.'

So how much work has all this involved for IT departments? If their systems are rules based or parameter driven, in other words highly configurable, then surprisingly little. Private bank EFG International, for example, is a long-time user of T24 from Temenos, and Ian Cookson, the member of EFG's executive committee responsible for IT, is a fan. 'You can add additional fields very easily and you can process them without programming, through parameters,' he says. He cautions: 'However you have to be very careful with powerful commands, because sometimes they have an impact that you don't expect, so it is better to use IT professionals rather than 'IT aware' end-users.'

The bulk of the work follows only after the new fields have been added: 'Products have to be coded up one by one,' he explains. 'We have senior people who've gone through the products and defined the rules for classifying them, and we've now got a team of people working on classifying them. It's a case of coding clients and products appropriately, and then parameterising the rules which will apply at the time of transaction execution, or which will produce exception listings post-trade that compliance and private banking management can look at.'

This approach allows, for example, for a fully automated, real-time, pre-trade suitability or appropriateness check, a prime objective for business managers, IT departments and software vendors alike. More prosaically, it can also automate reviews of a client's portfolio when his profile changes, or if the products in them change category.

Some observers note that automation may not be worth the effort for smaller firms or those concentrating on a few UHNW clients. This is because the volume of transactions does not justify the expense of coding the subtleties of clients' wishes (for certain shades of ethical investments only, for example), or the large number of products available (which, to continue the example, may become subtly unethical over time).

'The technology's there, but it's only as good as the stock identification process,' comments Daniel Carpenter, sales director at wealth management software provider Investmaster. 'You can have more data against that stock, but someone's got to maintain that data, so it becomes a balancing act of how much do you turn into an automated process, and how much do you turn round and say, 'Well we'll do so much in this area, but there will always be this manual check'.'

It might be possible for data vendors to supply feeds of MiFID product codings to alleviate this problem for products at least, if not for client profiles. However many products are in fact unique, such as the wonderfully named 'investments of passion'. 'Clients may have assets that could be art, property, cars, yachts etc., which can all be held in a portfolio within our system,' observes Nicola Price, marketing director for software vendor Financial Objects, of her firm's Activebank Wealth Manager package.

Nevertheless, front office automation is here to stay. Odyssey, a wealth management software vendor, has also identified this as a key area. 'We know that many financial institutions are convinced that these kinds of [compliance] controls cannot be done post-trade,' says Didier Pitton, Odyssey's product marketing manager. 'They realise they have to be done pre-trade.' Odyssey is investing heavily in developing a sophisticated engine for this purpose, although this will not be ready until Q2 next year. Meanwhile Odyssey has helped its clients configure its package to be compliant by MiFID's deadline of 1st November.

Most software vendors have found themselves caught in a trap by MiFID. Regulatory uncertainty up to the last minute, and interpretable principles-based regulations, have deprived them of the absolute clarity that IT developers typically need to do their work. Many vendors have spent months talking to clients and studying the regulations, only to make, in the end, a few small changes.

'I don't want to minimise that effort,' comments Nicholas Hacking, director of ERI, vendor of private banking package Olympic, 'but equally, I think we were quite fortunate in not having to do as much as some people, because what was needed was already there.'

Finantix develops wealth management and rules management components which can be used alone, or by banks and other software vendors to front or to integrate their own products. The components and rules are the key to this flexibility. Finantix have been working with a large Dutch bank to help them develop next-generation wealth management systems, particularly in the front office. 'It's one of the largest projects we have,' comments Alessandro Tonchia, founder of Finantix, 'and MiFID has been a very strong driver behind the bank's development [project].' It seems that the bank's legacy systems could not easily be adapted for MiFID to match an advisor's proposals with the client's risk profile, let alone prove later that this had been properly done.

Despite the huge effort, MiFID, combined with the boom in wealth management, has been good to many vendors, who report greatly increased interest and sales activity in recent months.

Other compliance issues, such as UCITS 3 or, in Islamic banking, Sharia law, have far less impact on wealth management (as opposed to, for example, in the case of UCITS, funds administration or manufacture). The effects of increasing pressure for disclosure to tax authorities, and the FSA's ongoing Retail Distribution Review, will probably fall into the same category. All can be mostly accommodated by configurable IT that can flexibly code and match products according to regulatory and customer requirements, and that can flexibly select and report to both clients and regulators, preferably globally and across all investments.

Whatever happens next, most firms' IT is significantly better poised, following 1st November, to help them serve both their clients and themselves. After a summer of acute pain for some from doing business where the money ain't, ie. subprime, MiFID is leaving firms well positioned to do business where the money definitely is, ie. wealth - other people's money.

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