Barometer of Investor Protection Rules

A survey of the expected impact on the Swiss finance centre

August 2013

Comprehensive insights on how market participants respond to the upcoming impacts of investor protection regulation.

pwc

Table of contents

Summary of key findings 4

Introduction and background 5

Description of the data 6

Methodology 6

Results of the survey 7
- Effects on the crossborder business 7
- Effects on investor profiles 9
- Effects on client segments and remuneration models 11
- Questions about investment products 14
- Operative challenges and impact on profitability 15

Conclusion 16

Contacts and authors 19

Summary of key findings

- ***MiFID II is already a front-burner topic in Switzerland.*** Every second participating financial services provider has commenced work and conducted analyses in connection with MiFID II – 14 per cent have already started to implement measures.
- ***The crossborder business model is not a dinosaur.*** Not only do banks specialised in the wealth management business want to grow via crossborder activities – this field continues to be of significance for cantonal and regional banks.
- ***The battle for discretionary mandates is escalating.*** 70 per cent of the wealth managers want to grow in terms of discretionary mandates, half of them even by more than 20 per cent. But also half of the cantonal and regional banks have their sights on 5 to 20 per cent growth in this client segment.
- ***Inducements are on the brink of extinction.*** Three-quarters of the respondents do not expect inducements to be a future source of revenue.
- ***Clients will have to help bear the costs.*** Clear majorities find it probable that prices both for standard offerings and higher-value services will increase.
- ***The distribution of complex investment products will wane.*** The fundamental complexity, sheer number of products, as well as the volume of complex investment products will be on the decline – especially in the advisory business.
- ***Profitability will be put to the test.*** More than half of the respondents predict that cost/income ratios will deteriorate by 1 to 3 percentage points. One-third expect the reading to worsen by even more than 3 percentage points.

Introduction and background

Those who itemise the challenges Switzerland will face as a financial centre in the years ahead cannot help but add the investor protection factor to their list. Ever since the global financial crisis unearthed weaknesses in various laws and the way they are enforced, there have been redoubled efforts to boost investor protection. One example at the European level is the publication of drafts for the revision of MiFID (Markets in Financial Instruments Directive). Switzerland also desires to keep pace with the move towards reformulating financial market laws and has started the legislative process for a Financial Services Act (FFSA).

More investor protection, new responsibilities, new demand for information

The planned regulations are aimed at achieving a vast improvement in the area of investor protection. They require extensive transparency with regard to financial products and services. Also, the advisory process should take into greater consideration the individual circumstances of the client. Here, the financial services providers must ensure that the products they propose are suitable and appropriate both in terms of their clients' risk tolerance and wealth situation as well as their knowledge and experience as investors.

But also the issuers of financial products will be taken to task. In recent years, they have tried to outdo each other through the increasing number and complexity of the investment vehicles they offer. All of this makes it extremely challenging not only for the distributor to have all necessary information ready in a timely manner, but also for the investor to digest the relevant information.

In addition, legislators want to improve advisory quality and client protection by ensuring the independence of the financial services provider. Conflicts of interest associated with inducements from product issuers are to be banned or at least transparently disclosed to the clients.

Prior to the introduction of these planned regulations, domestic financial institutions are faced with a number of challenges. They need to give serious thought to aspects such as client segmentation and the corresponding products and services they offer; but they also have to orient their compensation models more towards their clients and services. The requirements placed on advisory processes and quality will increase, and ultimately the financial services providers must promote an internal cultural change at all levels.

Status of the legislative processes

The MiFID II legislative process is moving ahead only slowly in the EU. At the heart of the matter are issues that do not relate directly to investor protection, but instead centre on access to trading platforms and clearing facilities. But now that the EU finance ministers have recently announced their position, the trialogue (negotiations between the EU Commission, EU Parliament and EU finance ministers) can get started. But due to the extensive legislative process in the EU, it is no longer presumed that MiFID II will enter into force at the national level in 2015 as originally planned.

In Switzerland, the Steering Committee[1] has published its hearing report on FFSA. Interested circles had the opportunity until 28 March 2013 to submit their comments. The goal of the project work remains one of drawing up a draft bill for Federal Council deliberations by the fall of this year.

Why this survey?

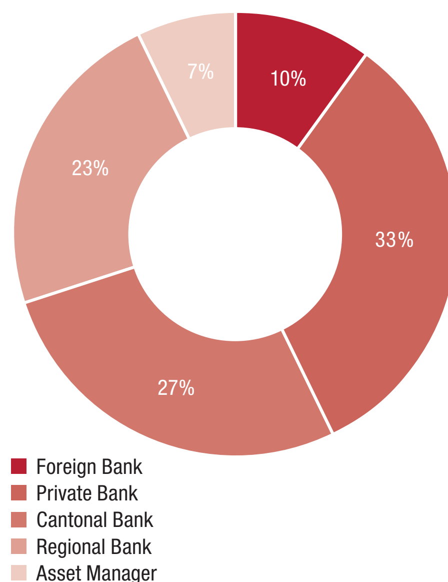
During the past several months, we met with many decision-makers in the Swiss financial services industry. In connection with the numerous presentations and dialogues, we determined that there is great interest in knowing how other market participants are responding to the matter. Uncertainties surrounding the legislative process, the many open details on regulation, as well as the question of just how serious the consequences will be, are all factors that make it difficult to analyse the need for action and gain a clearer picture of what could unfold in the future.

We therefore decided to address this need for clarity in a more systematic way by conducting the first Switzerland-wide survey on the topic of investor protection. On behalf of PwC as a whole, we would like to thank our discussion partners sincerely for their contribution to the formulation of the questionnaire, and of course our special thanks go to those respondents who actively participated in the survey.

1 Comprised of one representative each from the legal services units of the FDF, SIF, FINMA and FDJD

Description of the data

Participants



30 Swiss financial services companies participated in this study, amongst them two of the top five Swiss private banks[2], two of the top ten foreign banks[3], as well as six cantonal banks that together represent 44.3 per cent of the cumulative net assets of all Swiss cantonal banks. Private bankers are also represented, as are small- and medium-sized regional banks and asset managers.

The questionnaire covered 25 issues, 14 of which are described and discussed in detail below. The other questions have been integrated as additional information in the analysis.

To simplify the evaluation, respondents were divided into two categories:

- ***wealth managers*** (foreign and private banks, asset managers); and
- ***cantonal and regional banks***

Methodology

The survey was conducted by means of an online questionnaire. 90 institutions were contacted and asked to participate in the survey. All respondents are Swiss-licensed financial services entities (banks or securities dealers).

The questionnaires were filled out between 25 April and 31 May 2013.

2 Based on assets under management
3 Based on assets under management

Results of the survey

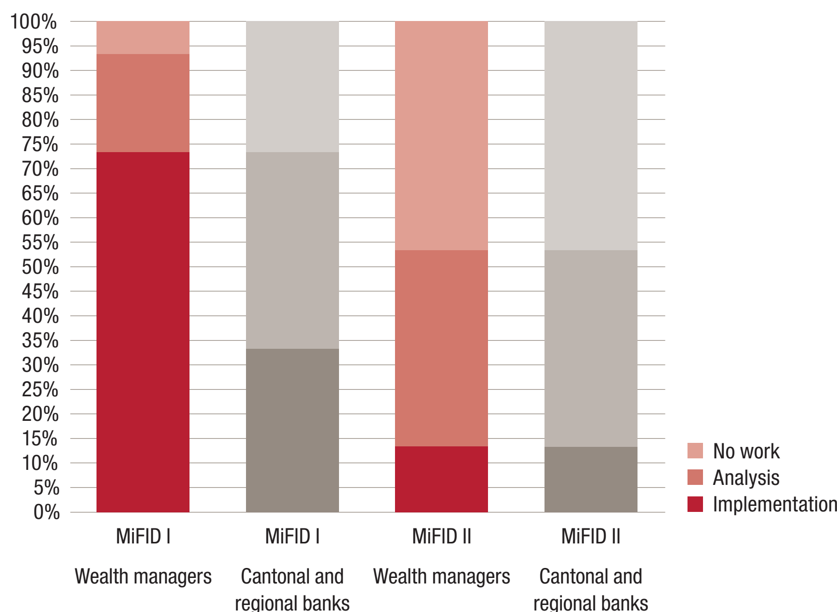
Effects on the crossborder business

The European MiFID directive is nothing new to the Swiss financial centre. The "MiFID II" provisions currently under discussion are supplemental to those of the original directive ("MiFID I") which has been in effect in the EU (applies also to the EEA) since November 2007. Although Switzerland is not part of these economic regions, many Swiss financial services providers have taken various approaches to implementing this directive.

In light of MiFID II, access to the EU market could be restricted. A number of affected parties in Switzerland interpret the EU Commission's current draft of the directive as meaning that a branch office within the EU will be required in order to offer basic financial services to clients domiciled there. PwC does not share this strict interpretation of the draft directive, but there nevertheless remains the question as to how Swiss financial services providers will position themselves in terms of crossborder business dealings.

The strategy of the Swiss legislature with regard to EU market access and the crossborder business in general is to key on the overriding objective of achieving a "level playing field" in the EU: domestic laws should be enacted that are accepted by the EU as "equivalent". Bern is going on the assumption that, with this approach, market access for Swiss companies will still be assured.

Degree of implementation of MiFID I and MiFID II



MiFID I – already today of relevance in Switzerland

More than 70 per cent of the participating wealth managers have already adopted MiFID I either wholly or partially. A further 20 per cent have at least conducted an impact analysis, and fewer than 10 per cent of them have taken no action at all. But in recent years also the cantonal and regional banks have been deeply occupied with this issue. More than 70 per cent have at least analysed the potential effect of the directive and roughly half of those institutions have implemented its provisions either wholly or partially. Only 25 per cent of the cantonal and regional banks have taken no action whatsoever with regard to MiFID I.

These findings clearly show that Swiss financial services providers pay great heed to the regulatory circumstances in Europe. That applies not only to the wealth managers that have traditionally conducted crossborder business, but also to the cantonal and regional banks, which as is well known are also involved in crossborder dealings due to their proximity to Switzerland's borders. But

these survey results can also be interpreted as meaning that Swiss financial services providers have realised for quite some time now that, in order to provide non-Swiss clients with proper advice, not only domestic but also foreign rules and regulations should be carefully examined and complied with. Moreover, it can be assumed that most of those providers have learned from the past and determined that they no longer can simply rely on the impenetrability of national borders when it comes down to the intervention of foreign regulators.

More than one out of two financial services providers have already come to grips with MiFID II

It therefore hardly comes as a surprise that Swiss financial firms have delved into the MiFID II issue. More than half of the respondents indicated that they have at least conducted impact analyses, and between 15 and 20 per cent of those institutions are even in the process of implementing the new European provisions – this despite the fact that the law has yet to be formulated conclusively.

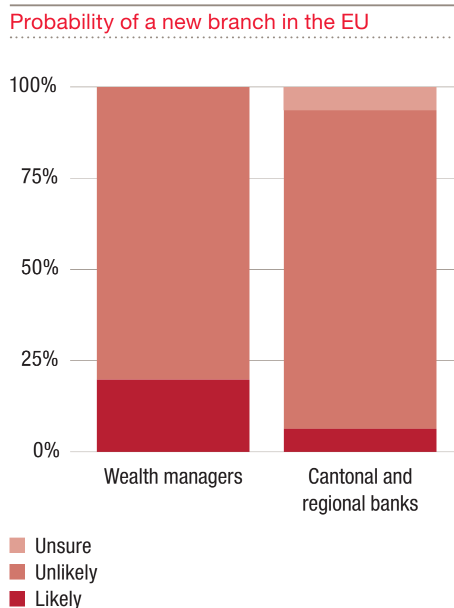
The reason behind this head start on the part of Swiss financial services providers is the likelihood that the planned Swiss FFSA will adopt major elements of MiFID II, thus the conclusion can be drawn that those elements ultimately become legally effective also in Switzerland.

Accordingly, intensive discussions are underway as to whether early implementation of parts or even all aspects of the new regulations could be of advantage or disadvantage to those firms.

Active pursuit of the crossborder business?

Although much is being said about the potential future obligation of banks to have physical presence in the EU region, the opening of a local office there is not an option at present for the vast majority of market participants in Switzerland. Nonetheless, for 23 per cent of the participating wealth managers and 6 per cent of the cantonal and regional banks, it is more or less likely that they will open a branch in the EU at some point in the future.

Probability of a new branch in the EU



The strategic options relating to this fundamental question will undoubtedly be discussed in depth over the course of the coming months, namely once there is greater clarity about the third-country ruling under MiFID II.

The key elements of this ruling pertain to the extent and provisos of any future passive freedom to render services. If Swiss financial services providers are substantially limited in the way they can contact and advise their EU-domiciled clients, then a number of market participants will need to ask themselves how this client segment can be serviced profitably and to clients' satisfaction.

The passive crossborder business – also in future, a mainstay of Swiss financial services providers

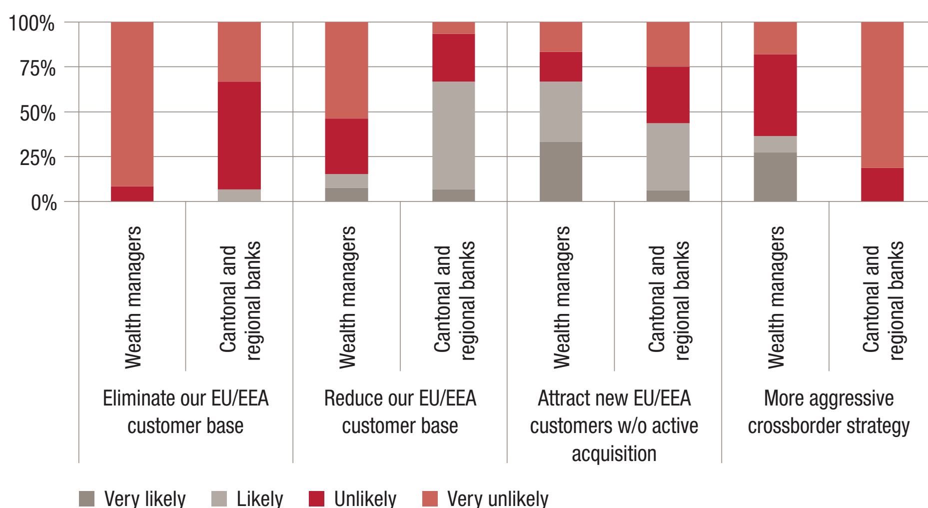
Although the regulatory demands attendant to the conduct of crossborder business with European clients will increase, almost none of the survey respondents desire to retreat entirely from this field of activity.

To the contrary, also in the years ahead Swiss financial services providers want to remain interesting for European clients and continue to attract new ones from this economic region. The two-thirds agreement rate from the wealth managers comes hardly as a surprise, but the 44 per cent nod from the cantonal and regional banks was not necessarily to be expected.

Moreover, 37 per cent of the wealth managers are going on the assumption that they will redouble their crossborder efforts. This stance is perhaps attributable to expectations on the part of several of those firms that they will gain competitive advantages over their European peers in the more costly and time-intensive advisory business of the future.

It is also interesting that the frequently cited need to focus on specific core markets and client segments appears to be only a topic at cantonal and regional banks. More than 65 per cent of them assert that, going forward, they want to concentrate on just a few core markets and are prepared to reduce their current European client base. This stands in sharp contrast to the wealth managers,

Assessment of strategic options in the cross-border business



where only a mere 15 per cent are of that mind – but there, too, the topic should be good for a number of discussions as time goes by.

These debates will be held against the backdrop of the previously mentioned third-country ruling under MiFID II. If Swiss financial services providers are substantially hindered in conducting crossborder business, the question also arises as to the future growth potential of business dealings with clients from the EU region.

Effects on investor profiles

As noted at the outset, the new regulations are aimed at boosting investor protection. One of the key elements in this regard is the assessment of an investment decision in terms of its appropriateness and suitability for the given client.

The "appropriateness test": The financial services advisor must at minimum be familiar with the client's knowledge of and previous experiences with the type of transaction under consideration. Based on that insight, the advisor then needs to judge whether the product type or service to be rendered is appropriate for that client.

The "suitability test": For advisory and discretionary mandates, determining the client's investment objectives as well as her willingness and capability to bear risk is the key task. And before any investment recommendation is made, the advisor must also judge whether the transaction is suitable for the client in terms of its consistency with the rest of the portfolio.

The financial advisor's comprehensive understanding of the client's circumstances forms the basis for these appropriateness and suitability tests. ESMA (European Securities and Markets Authority) has issued directives[4] in this regard. They attach greater importance to the personal situation of the investor than to his net worth when it comes to defining a risk profile. They also require that changes in the client's personal circumstances (e.g. her family situation) be reflected continuously in the investment profile and hence in the portfolio structure.

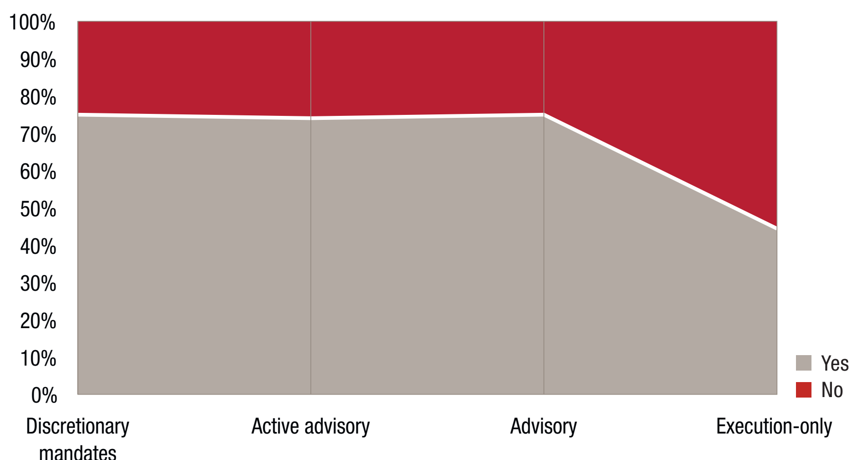
When compiling a risk profile, the financial services advisor must also ascertain that the client's statements are materially correct and – based on illustrative examples – have confidence that the client has understood the questions. The simple question-and-answer game in which the advisor merely ticks boxes on a standardised questionnaire without delving more deeply to determine the facts has seen its days, given the greater burden of proof that will now be placed on banks. And this especially because ESMA has stated explicitly that the financial services advisor should not unduly rely on the client's self-assessment.

New requirements regarding client information are of little concern

A large proportion of respondents indicate that already today their company requires structured and well-documented information on clients' knowledge and experiences in the investment field.

With an eye towards MiFID I and in anticipation of the new regulation, it appears that many financial services providers have already adapted their client profiling processes and documentation as well as supplemented them with questions concerning clients' know-how and experiences with various classes of financial instrument. In this regard, there are no significant differences between the both types of bank queried in this survey. A gap between the two as well as

Documentation of client profiles



4 See "Guidelines on certain aspects of the MiFID suitability requirements", ESMA, 25 June 2012

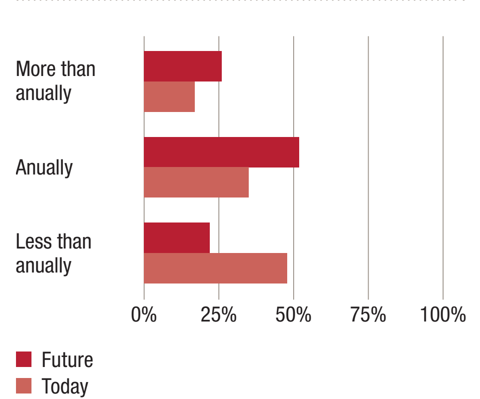
a greater need to catch up merely exists in the area of execution-only clients: here, there is room for improvement at more than 40 per cent of the wealth managers and almost 70 per cent of the cantonal and regional banks.

But in future it will be important that this information is applied in a structured manner during the advisory process: our observations have shown that this is not yet the case at all financial services providers. Especially when investors desire to purchase an investment product on their own volition, the information about their knowledge and experiences is rather rarely considered.

Cantonal and regional banks are better prepared

Already today, more than 70 per cent of the surveyed financial services providers fulfil the requirement that the investor profile be drawn up together with the client. Surprising however is the fact that, of all places, at the wealth managers a mere 50 per cent of the investor profiles are completed together with the client and 36 per cent by the client advisor alone. Consequently, roughly half of the participating wealth managers will presumably need to review the situation again with clients and determine their degree of risk tolerance.

Frequency of updating client profiles

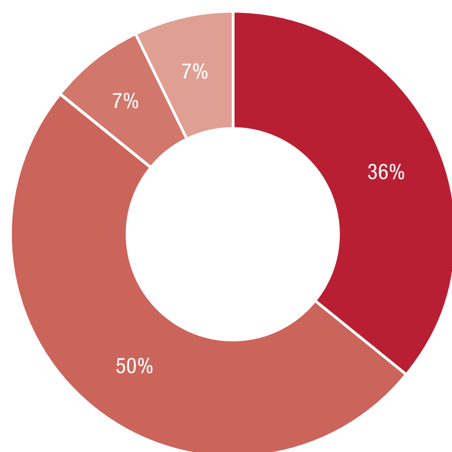


The precise content of the client profile was not addressed in our survey, for one reason because – in contrast to ESMA – the Swiss legislature has yet to state its position on the envisioned scope and content of investor profiles.

But if Bern were ultimately to take the same tack as ESMA at the ordinance level, the vast majority of Swiss financial services providers will in all likelihood have to rework their client profiles. This is also confirmed by the findings of the recently published PwC Global Private Banking and Wealth Management Survey 2013[5]. In that poll, more than two-thirds of the 200 participating wealth managers indicated that they lack sufficient information on the personal circumstances of their clients.

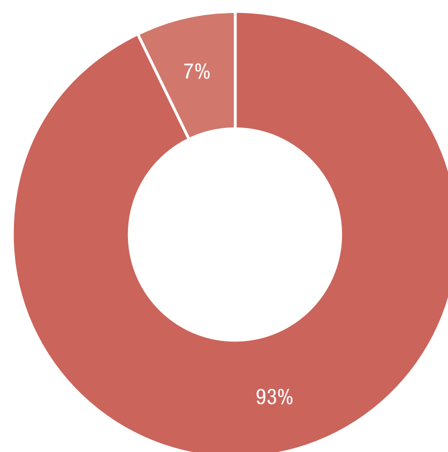
Methods for compiling client profiles

Wealth managers



- Questionnaire completed by the client advisor
- Questionnaire completed together with the client
- Questionnaire completed by the client
- Other

Cantonal and regional banks



- Questionnaire completed together with the client
- Questionnaire completed by the client

Going forward, client profiles will be updated more frequently

The importance of a financial institution's "knowing its clients" will increase even more as a result of these new regulations. That circumstance is also reflected in the anticipated frequency with which client profiles will be updated. Fewer than half of the respondents who wait more than a year to conduct those updates expect that pace to remain unchanged in the future. All others will be doing it annually or even periodically throughout the year.

It remains to be seen whether a financial services provider's insight into the personal circumstances of its clients will actually increase. If so, one challenge will then of course be to incorporate that knowledge systematically into the services it renders.

5 See "Navigation to tomorrow: serving clients and creating value", Global Private Banking and Wealth Management Survey 2013, June 2013

Effects on client segments and remuneration models

The aim of the new regulations is to achieve an improved level of investor protection by means of more comprehensive, client-specific advice as well as heightened transparency.

The draft MiFID II provisions are also geared towards segmenting clients more distinctly according to the intensity of advice they require. Also, a line of demarcation must be drawn between portfolio management mandates, advisory mandates and the execution-only business. Coupled with that are clearly defined responsibilities per client segment in terms of the suitability and appropriateness tests as well as monitoring tasks.

So for the financial services provider, the question arises as to which service segments it wishes to focus on and, by logical extension, with which services and client segments its growth and profitability goals can be achieved. In addressing this question, it is crucial to bear in mind the future time, effort and added expense that will be involved in the advisory process, as well as the given company's strategic positioning in terms of its range of products and services.

Then there is also the fact that greater transparency will be required when it comes to remuneration. This applies not only to direct fees paid by clients but also to third-party inducements (e.g. trailer fees in connection with fund distribution agreements). What's more, under discussion in the legislative process are also constellations that could ultimately lead to the prohibition of such third-party inducements for specific services (e.g. a ban on receiving inducements in the case of an independent provision of services).

All of these factors will mean that the advisory and monitoring processes for Swiss financial services providers will become more time-/cost-intensive and certain revenue streams could ebb or even cease entirely.

So here the question arises as to how Swiss financial services providers wish to position themselves in this regard.

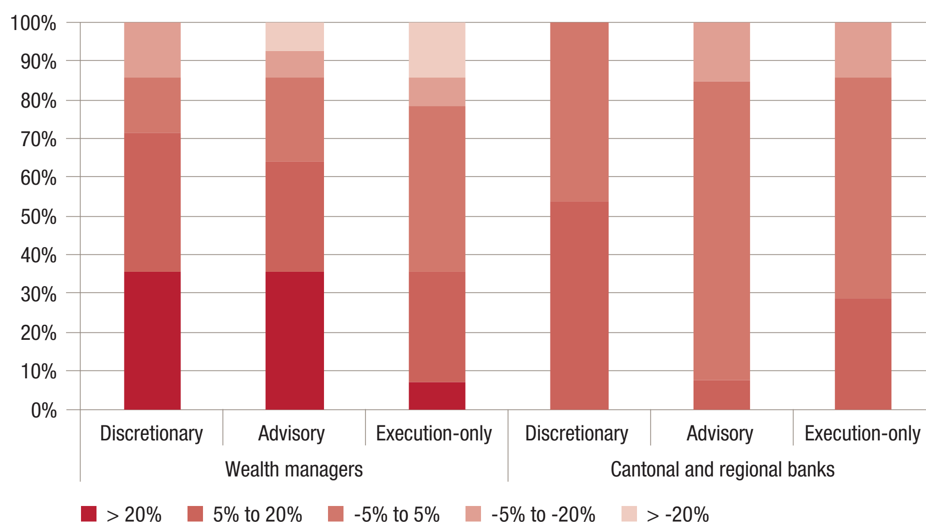
Are portfolio management mandates the model of the future?

The survey evaluation clearly points up one area of agreement: the wealth managers as well as the cantonal and regional banks want to grow in the discretionary portfolio management area. In view of the upcoming legislation, this strategy is quite understandable: already today, good margins are to be earned in this service segment. Moreover, the added time and effort involved in complying with the regulations is relatively modest and the possibility to achieve economies of scale is relatively great.

A more differentiated picture is to be seen when it comes to advisory mandates. While more than 60 per cent of the wealth managers want to grow also in this segment, close to 80 per cent of the cantonal and regional banks are assuming little or no change to the status quo.

This finding also shows where the strategic emphasis is being placed at the two different types of institution: while the wealth managers must come to grips with new regulatory requirements governing the way they service clients, and are therefore likely to focus on a premium segment, the cantonal and regional banks simply take a respectful view of the new rules. Mainly in terms of the latter it will have to be seen which services they wish to offer their clients in the years ahead (primarily in the retail and affluent segments) and how they will tailor and render those services profitably.

Growth expectations for individual client segments



But one trend can be readily inferred here: the banks will be encouraging clients with non-advisory, low-margin mandates to switch to discretionary portfolio management or at least advisory mandates. If the banks are successful at convincing clients to make this change, it is probable that increased revenues can also be achieved.

But that will not likely be an easy task. In the past, the banks have been hard put to convince their clients of the advantages of a portfolio management mandate. In the period between 2007 and 2011, the proportion of those mandates relative to total client assets declined from 24 to 20 per cent[6].

Paradigm change in remuneration models – expectations for the demise of inducements

Inducements have been a thorny issue for regulators as well as the courts for years now. The current regulatory initiatives want at least to enhance the transparency of inducements and some even aim to eliminate them entirely. Several countries have already prohibited these inducements for certain client segments or product groups. In Switzerland, the landmark Federal Supreme Court decision of 30 October 2012 has led a number of banks to focus on retro-free mandates in the portfolio management segment. So the global trend seems relatively clear.

A clear three-quarters majority of respondents predict the long-term demise of inducements also in Switzerland. Upon closer inspection, it becomes apparent that this opinion is generally shared by both surveyed banking models.

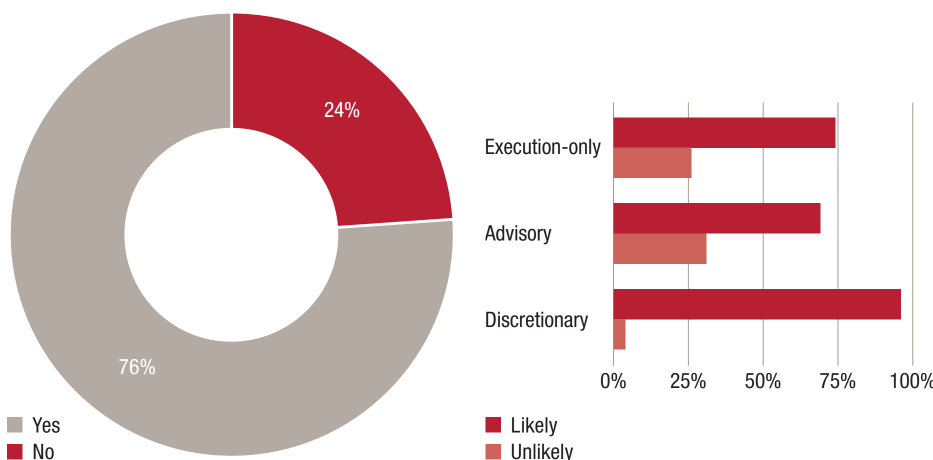
Moreover, a more detailed analysis by types of mandate reveals that 95 per cent of the respondents are going on the assumption that they will ultimately forego inducements on portfolio management mandates. For advisory and execution-only clients, the "likely" response is about 75 per cent in both cases.

It will be interesting to see how Swiss financial services providers deal with the issue of inducements in the near future. Will individual banks and asset managers dare to take the step into a retro-free era even without regulatory pressure, and will they do so only for specific service segments; or will they do it for all clients? And what will the competitive environment be like if all other financial services providers follow suit?

Apart from this purely strategic question, these institutions will also need to assess from an operative standpoint whether out of profitability considerations it makes more sense to simply opt out of inducements rather than making the investments necessary to meet the transparency requirements.

The coming months will show how the players line up on the field in this regard.

General expectation for the demise of inducements



Fees will increase for investors

If in fact third-party remunerations are partially or wholly eliminated, the question arises as to how Swiss financial services providers can make up for the income shortfall.

The clear majority of respondents expect that their transaction charges as well as safe custody fees will increase for investment funds and structured products.

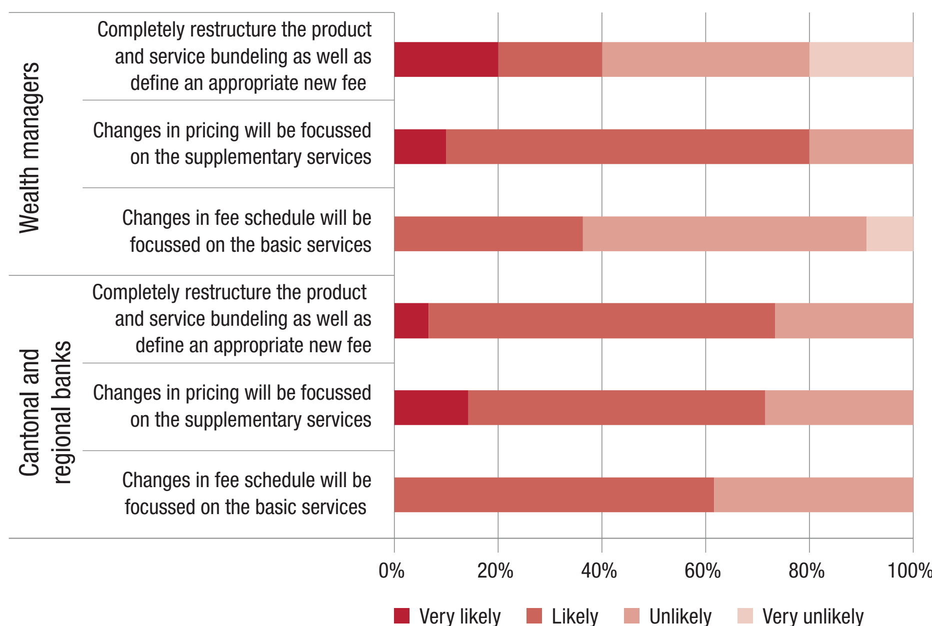
6 See "The End of a Golden Age", PwC Private Banking Study, PwC, January 2013

Each provider on its own will have to figure out what the effect of this inducement elimination will have on its bottom line, while taking into account the rising costs for maintaining a distribution network and the related physical infrastructure.

The core question here is how transparently the financial services providers will disclose these price increases and as of which point in time the announcement is made and the new rates take effect. From our discussions with several institutions, we came away with the impression that there is still great hesitancy in this regard.

Compensation for a possible elimination of inducements

Impact on scope of services and pricing models



Initial tendencies as to how the income shortfall can be offset are already identifiable

An additional differentiation between advisory and execution-only clients is likely to be seen also in the range of services offered to a given segment. And with that, the question arises as to how much the existing price models have to be adjusted.

In this regard, it appears that wealth managers are contemplating a different approach than cantonal and regional banks. While only 40 per cent of the former are assuming that they will need to totally rework their current catalogue of services and prices, 73 per cent of the cantonal and regional banks are of that opinion. This divergence can be attributed to the fact that, when future profitability is taken into consideration, the upcoming regulations will have a major impact especially on the retail and affluent segments. Here, Swiss financial services providers will be compelled to think long and hard about where the cost-drivers lie and how the remuneration models can be aligned with their future service models. In our opinion, it can be expected that the introduction of the new laws and ordinances will also lead to substantial cutbacks in those service models.

When it comes to the question of which services are likely to experience price changes, the wealth managers and cantonal/regional banks are essentially of the same mind: 80 per cent of the former and 71 of the latter assume that price adjustments will be made in the higher-value services. This is also in line with current observations in the Swiss marketplace, where the first several participants have already introduced corre-

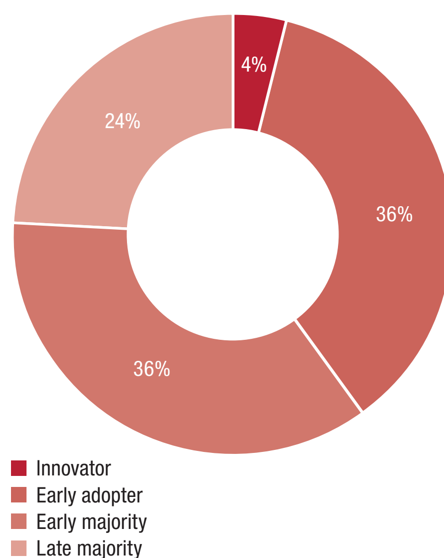
sponding price increases for portfolio management mandates.

But the big question is how to deal with the advisory services aspect in the years ahead. Will they be considered basic services or will a certain price tag be attached to them as additional services?

36 per cent of the wealth managers want to adjust their price schedule for basic services, while 62 per cent of the cantonal and regional banks are prepared to do so. The reasons for this disparity are perhaps attributable again to the cost-driver dimension as well as the volume-dependent concept applied in current pricing models. Although the generally retail- and affluent-oriented cantonal and regional banks need to address in detail the issue of how they intend to compensate for the higher future costs of the advisory business, the wealth managers feel that they are in a somewhat more comfortable situation in this regard.

But hints about the remuneration trends of tomorrow are already discernible today. Regardless of the type of bank, Swiss financial services providers will attempt, more or less transparently, to pass through to their clients the higher costs of advisory services that result from the potential elimination or reduction of third-party incentives.

Strategy in respect to adapting pricing models



Adapt early on – but don't be the first

The issue as to whether Swiss financial services providers will adjust their pricing models was essentially answered with a "Yes" in the previous question. So now it becomes a matter of when that might occur.

Our actual-practice observations of the Swiss market are also confirmed by this survey. Although isolated instances of price hikes in specific service segments were to be seen in recent weeks, practically none of the Swiss financial services providers is prepared to take the first step as an innovator and substantially change its current pricing model. The majority of respondents fear the so-called "first mover disadvantage" and are waiting to see what their peers do.

Nonetheless, if one peer or a small number of competitors successfully introduces new pricing models, the vast majority of survey participants (72 per cent) want to respond to the changes at an early date. Only a quarter of the respondents intend to take a wait-and-see approach.

In connection with the foregoing questions, there appears to be a considerable amount of tension: practically all of the market participants are aware that their pricing models will have to be changed. Equally clear is that those changes are likely to be radical in comparison to the previously stable (pricing) world of investment advice and portfolio management. But what is not clear is when the overall situation in the market will change. Everyone is waiting for the first move.

Questions about investment products

The new regulations pertain not only to the obligations of advisors and distribution organisations; they are also targeted at re-regulating the use of financial products in a more specific manner. Front and centre in this regard is the transparency of risks and costs, which in turn should enable investors to make more well-informed decisions.

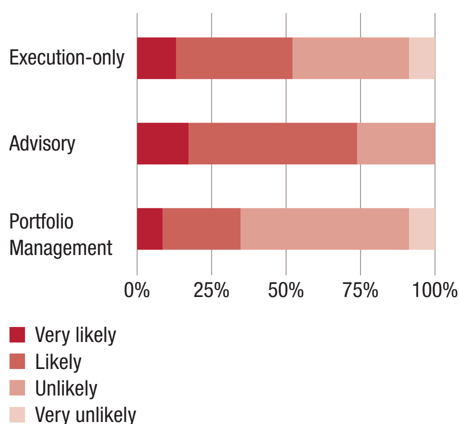
In the same vein, however, there are also plans for limitations on the use of com-

plex financial products in client portfolios. Going forward, products of this nature are to be recommended only to those investors or, within the framework of a portfolio management mandate, purchased only for those clients who also have the necessary knowledge and experiences with such financial instruments. What's more, the legal provisions governing the suitability test must also be observed.

But even if clients on their own volition wish to purchase a complex financial product, the financial services provider is still obliged to explain the risks associated with that product to the client.

Thus it is easy to conclude that the active and passive distribution of complex investment instruments will be restrained or, as it were, involve a greater amount of time and expense in the years ahead.

Limitation in the use of complex financial products



Distribution of complex investment products will wane

It follows that the distribution of these products will be made more difficult in the coming years. So not surprisingly, roughly 74 per cent of the survey participants intend to limit their current range of complex financial products for use by advisory clients. But also in the execution-only segment, more than half of the respondents consider it likely that they will reduce the number of complex instruments on offer.

In the discretionary area, where already today complex investment products are being used more selectively, only 35 per cent of the respondents assume that limitations will be put on their array of products.

In response to the specific question as to how the market for complex investment products will evolve, the most frequent answer was that the fundamental complexity and sheer number of those instruments will decrease, closely followed by expectations of a decline in their trading volume. As regards the latter, the survey participants are going on the assumption that the volume drop in structured products will be almost twice as large as that for collective investment schemes.

It will certainly be of interest to see how today's providers of complex investment products come to grips with the new situation faced by their distributors. Based on our survey findings, it is likely that a number of those providers will be hard put to make their business model sustainable and profitable in future years.

Operative challenges and impact on profitability

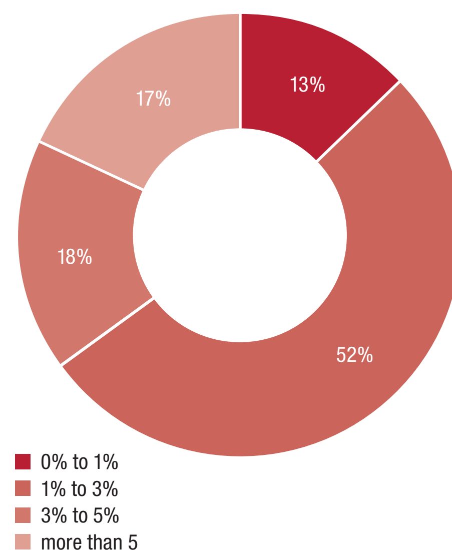
Many of the relevant operative changes are rather closely tied to the new or expanded compliance requirements under the investor protection legislation. As it is relatively easy to conclude from the foregoing evaluations and comments, Swiss financial services providers will have to endure increasing efforts and costs as a result of the new regulations.

Investor protection will clearly leave its mark on profitability

The survey participants are going on the assumption that the requirements of the impending investor protection regulations will also have a major impact on their company's profitability. The reason for this conviction can be found not just in the heightened demands placed on client advice, but also in terms of risk clarification and the continuous risk-monitoring of client assets.

Not even one respondent is of the opinion that the new rules can be implemented in a cost-neutral way. An absolute majority 52 per cent believe their company's cost/income ratio will increase by 1 to 3 percentage points. A further significant proportion of the survey participants (35 per cent) even think the ratio will rise by 3 percentage points or more.

Impact of the new investor protection rules on cost/income ratio



For just a single new regulation, this anticipated cost/income bump is substantial – especially when one considers that additional laws in the tax area (e.g. FATCA, "Rubik") or the upcoming OTC regulations will also leave skid marks on the profitability of Swiss financial services providers. The question here is whether they are prepared and in a position to counter the negative impact by means of enhanced efficiency and/or whether they can pass on those costs (at least partially) to clients via higher fees.

Conclusion

Intensification of investor protection is now underway

MiFID II and Switzerland's FFSA represent current challenges for the Swiss financial centre. Given the plethora of regulatory changes, the question of prioritisation is always the major issue – what is important and urgent enough to warrant the deployment of scarce resources right now? Investor protection has made its way onto the political agenda; but it is also an onerous bugbear that Swiss financial institutions need to deal with immediately. Despite the many yet unanswered questions, not merely a few but practically half of the Swiss banks have already started to analyse or war-game the associated trouble spots.

By means of detailed and well-documented client profiles, the foundation has already been laid at most of the Swiss financial services providers for coping with the imminent suitability and appropriateness tests. A need to catch up exists mainly with regard to today's less rigorously documented execution-only clients. For a number of institutions, there also remains the question as to whether their previously compiled client profiles suffice to meet the future requirements. But the greatest challenge will be in updating the client information on a regular basis and to the necessary extent, as well as integrating that information consistently into the advisory and risk-explanation process.

The participating banks have succumbed to no illusions when it comes to the demise of inducements. These payments are the subject of many investor protection initiatives throughout the world, and the pressure to ban them continues to rise. A clear majority of respondents foresees an end to third-party inducements in the form of trailer fees and the like. This will have sustained effects on the entire remuneration chain – from client, to distributor, to product issuer. And the distributors will undoubtedly attempt to offset the loss of this revenue stream.

Participants appear feisty

For Swiss financial services providers, the crossborder business will remain an important mainstay also in the years ahead. Here, a not ignorable minority of banks are even devising plans for expansion in the EU region. But also those institutions that merely want to maintain their current crossborder business model (mainly via the passive freedom to render services) are not throwing in the towel: an active, in certain instances even aggressive strategy is viewed by the majority as being the most likely scenario. An awareness of one's own strengths and the foreign demand for those qualities still appears to be intact.

But this focus on specific client segments will not take its course without friction. Achieving growth targets in excess of 20 per cent is a challenge under the best of circumstances. However, if those goals are to be reached in a business segment that has been marked by a decline over the past five years, a large measure of ingenuity will be needed. It is of course no coincidence that all survey participants want to gain ground primarily in the high-margin portfolio management segment. At the same time, the question arises for the cantonal and regional banks as to how they intend to operate profitably in the time-/cost-intensive advisory business or, as it were, the lower-margin "execution only" business. While the latter institutions are viewing the future advisory business with respect, it still represents a core

segment for the wealth managers and they want to grow there – this because of alluring margins that will ease some of the aforementioned pressure. Thus a highly competitive environment is on the horizon for the coming years, one in which the new regulations need to be implemented efficiently and the existing strategic orientations – i.e. core markets, core segments, etc. – adapted to reflect the changing circumstances.

Whether this pressure will, as so often predicted, lead to a consolidation in the industry remains to be seen. Be that as it may, the survey participants anticipate in any case a consolidation in the array of products on offer. What accentuates the problem for product issuers is the simultaneously expected reduction in the number and complexity their creations – in recent years, a noticeable characteristic of new product development. Fewer, less-complex products: that is the future world as perceived by our survey participants; and this in parallel with lower trading volumes. Which and how many product issuers manage to position themselves successfully under these conditions is a matter of conjecture.

Who can discover and leverage the potential benefits?

Apart from the previously discussed strategic challenges, the new regulations also need to be implemented operationally – and that involves risks and costs. Survey participants believe the related impact on productivity will be significant. The majority of them view a cost/income ratio increase of 1 to 3 percentage points as the most likely scenario (a hefty hit for just one regulation) – a further 34 per cent expect the profitability losses will be even greater, with close to half of those respondents predicting that their cost/income ratio will increase by a whopping 5 percentage points or more.

From the standpoint of these financial services providers, it is clear that investors will end up bearing at least a portion of the related costs in the form of higher fees. Whether regulations aimed at protecting investors while provoking added costs actually achieve their purpose is an issue to be discussed elsewhere. What does have to be taken into account, however, is that the ability to pass through costs to the end investor is limited to a certain extent due to ever-fiercer competition and strained margins.

Thus in order to be successful in the years ahead, banks must be clearly cognisant of the necessity to strive for efficiency enhancements via their cost structures. But interestingly enough, this investor protection move offers the one-time opportunity to address fundamental questions concerning one's own wealth management business and in particular the advisory process.
If it is ultimately possible to couple the foreboding yet necessary process adaptations with improvements in service quality and point-of-sale efficiency, then these new provisions can actually represent a springboard to a successful business model for the future.

Contacts and authors

Contacts

Christiana Suhr Brunner
Partner
Financial Services Consulting

+41 58 792 25 66
christiana.suhr.brunner@ch.pwc.com

Rolf Wietlisbach
Director
Financial Services Consulting

+41 58 792 24 87
rolf.wietlisbach@ch.pwc.com

Patric A. Huber
Senior Manager
Financial Services Consulting

+41 58 792 25 05
patric.a.huber@ch.pwc.com

Samy Amara
Senior Manager
Financial Services Consulting

+41 58 792 16 43
samy.amara@ch.pwc.com

Torsten Neuwirth
Senior Manager
Financial Services Consulting

+41 58 792 27 08
torsten.neuwirth@ch.pwc.com

Authors

Rolf Wietlisbach

Patric A. Huber

www.pwc.ch