MiFID II and savings

PhD. student **Adrian SIMION**[1]

Abstract

The markets in financial instruments directive (MiFID) is a regulation that appeared in 2008 across European Union, as an effect of the crisis, that increases the transparency across the financial markets and standardizes the regulatory disclosures for particular markets. In 2014 MiFID II appeared on Directive 65/EU and will be applied on the markets starting January 2018 all over European Union. It offers increased transparency especially for derivatives and other over-the counter markets. This paper aims to analyze the new directive and savings/investments in the new context as a part of MiFID II strategy for individuals. Higher regulations and higher understanding of the risk could lead to a higher exposure to the saving part in a portfolio.

Keywords: *saving, globalization, investments, directive.*

JEL Classification: K22, K33.

1. Introduction

Saving behaviors vary by country. Demographic and financial factors affect the saving behavior of each individual, and saving rates are generally different in each country.

As a result of the way in which investment products were promoted to customers in the pre-crisis period, the EU Markets in Financial Instruments Directive (MiFID) emerged in the EU to provide a direction for the financial markets with regard to risks and how to diversify the portfolio. The magnitude of the fall in capital markets, and in particular Lehman Brothers's bond market failure, has led to significant falls in customers' portfolio, since they are not properly and consistently informed about the associated risk and the maximum decline in portfolio products at the time of sale. Amounts of individual placements were formed either from income-saving (Savings = Income-Consumption) or from other sources such as inheritance, other previously saved amounts. They have suffered, in this case have been adjusted in line with declines in financial assets.

According to Barro and Sala-i-Martin[2] (2004), focusing on the predictions of neoclassical and endogenous theory to assess the relationship between saving and real economic growth, the long-term growth rates of the Solow-Swan model are entirely determined by exogenous factors. The main long-term substantive

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[1] Adrian Simion - Bucharest University of Economic Studies, adriansimiont@yahoo.com.

[2] Barro, R.J., Sala-i-Martin, X. (2004). *Economic Growth*, second edition, The MITT Press, Massachusetts Institute of Technology, London, England, pp. 34-50.

conclusions are that a steady increase in rates is independent of the saving rate or the level of technology. A steady increase in saving rates leads to rapid economic growth in the short term, and in most endogenous patterns, balanced countries tend to grow rapidly depending on their savings rate. The higher the saving rate, the higher the economic growth. Interestingly, the long-term effects of saving on economic growth are stronger for rich economies and less for poor economies.

The MiFID II legislative package updates and extends the regulatory framework in place as a result of the development of trading markets and the trading environment. It will help not only improve the transparency of the risk on each product and the aggregate risk on the portfolio, but also the way in which the financial institution providing the advisory process will communicate complex details of the transactions involved. Thus, the decision to invest / save will be more fully realized at an informed, individual level with a limited perspective to be affected in financial market corrections.

2. Theoretical fundamentals

Savings play an important role in the Keynesian theoretical framework, which is the key to new investments in an economy. In addition, neoclassical theory uses the hypothesis that investments are financed from households' savings.

According to Romer[3] (1986), countries with positive saving rates are expected to invest their resources to achieve a stable and sufficient economic growth rate and thus the relationship between the saving-investment gap and economic growth is positive and significant.

Savings are an important indicator at the aggregate level and at the individual level. The decision to save has many endogenous and exogenous variables.

After a review of the literature, authors such as Ewing and Payne[4] (1998) support a negative correlation between household saving behavior and Consumer Sentiment.

Matsusaka and Sbordone[5] (1995) explain why Consumer Sentiment reflects future expectations of growth and prosperity. One of the main reasons could be that households reflect their expectations of future in their consumption and saving behavior.

Milton Friedman also explains why at a time when uncertainty arises in the economy, the population will be tempted to save more, calling one of the most powerful features of money-liquidity. Also, the population, with positive economic climate expectations, will think it has enough time to save money along this road.

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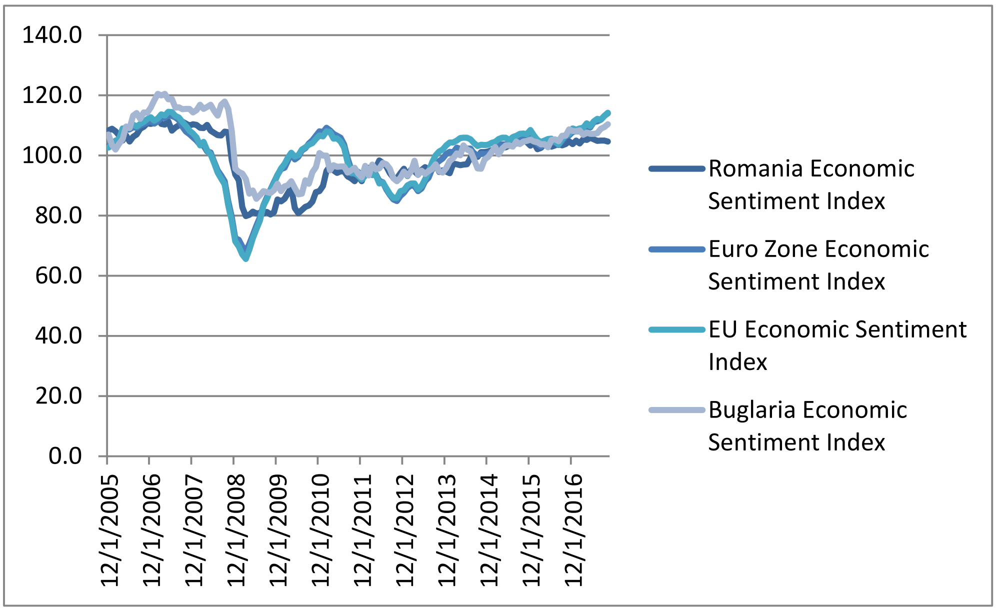
[3] Romer, P.M., 1986. *Increasing Returns and Long-run Growth*, The Journal of Political Economy, 94(5), pp. 1002-1037.

[4] Ewing, B.T., Payne, J. (1998). *The Long-Run Relationship between the Personal Savings Rate and Consumer Sentiment*, Financial Counselling and Planning, Vol. 9, No. 2.

[5] Matsusaka, J.G., Sbordane, A.M. (1995). *Consumer confidence and economic fluctuation*, Economic Inquiry, Vol. 33, No. 2.

According to the definition provided by Eurostat, the ESI (Economis Sentiment Index) is a composite indicator composed of five sectors, trust indicators with different weights: industrial confidence, service confidence, consumer confidence, construction confidence. Trusted indicators are arithmetic means of answering questions closely related to the seasonally adjusted balance variable (eg this indicator is calculated as an index with a mean value of 100 and a standard deviation of 10 per standardized standard sampling period.

Chart 1. Evolution of confidence in the economy.



Source: Eurostat

During the crisis, the sentiment / confidence indicator fell sharply in all Member States and the recovery was sluggish, with confidence in the economy being further affected by the sovereign debt crisis in the European Union. Thus, the impact of a market shock is immediately felt at the level of confidence, but the positive trajectory is much more difficult.

According to Simion[6] (2015), the change with one percentage point of ESI will result in a negative change of 0.4242% in the household savings rate. These results are consistent with other studies in our research field. The economic climate, disturbed by the crisis, has boosted the saving process. This is not considered good news, as the transition to a savings trap can be imminent. Taking into account the new legislation that applies from January 3, 2018 at Community level, which corresponds to the Keynesian theoretical framework, the individual

[6] Simion, A., 2015. *The evolution of the savings rate in Europe – empirical evidences*. ECTAP. Vol.22, No.3.

impact should be favorable to strengthening the confidence they have in the financial institution they are receiving advice from.

3. MiFID II

Directive 65/2014 / EU introduced MiFID II MiFID II Markets. After more than two years of debate, it was approved by the European Parliament and the European Council and officially published on 12 June 2014. Initially, the directive had to be implemented at Community level since 2017 but the decision was postponed to give the institutions time financial resources to train staff and modify IT systems.

The primary objective is to harmonize investor protection across the European Union to a high level of pre- and post-trade transparency regardless of where it occurs - OTC-Over The Counter. In this respect, part of the OTC trading on regulated platforms moves and a rigorous framework, including commodity derivatives markets, is put in place.

MiFID II redefines the structure of financial markets by setting up a new trading venue called OTF (Organized Trading Facility) and comes with specific requirements for independent operators by monitoring their classification in that category.

The aims of the directive are to:

- Increases transparency and streamlines financial markets
- Consolidate investor protection
- Creates the correctness of intermediaries
- Creates transaction efficiency

The new legislation approach starts from the level of the financial instrument and extends the capital market specific requirements and to the treasuries of credit institutions when they operate with specific financial instruments to which the MiFID II regime applies. Thus, by reference to individual clients, the transparency of purchase or sales prices will increase. Financial institutions will be required to execute client orders either by discussing orders resulting from the consultancy process or without advice at best (best execution price), and will be required to inform clients of the income earned from each transaction at the level of financial institution.

In addition, for some of the proceeds received directly or indirectly, the investment institution must justify their use for the purpose of training the staff and improving the way they serve their clients. If the revenue assigned to it is not warranted for training, it must be credited to clients' accounts and considered ineligible income for the credit institution. We are talking about an increase in the level of knowledge of training for employees of credit institutions.

According to Florea[7] (2014), given that modern teaching-learning-assessment strategies focus on interactivity, allowing trained people to show what

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[7] Ortansa Florea (Moise), 2014. *The development of Human Capital in the global crisis context.* ECTAP Vol.21, No. 8.

they can do, while traditional methods provide information, traditional methods should not be replaced, but rather to be used together with modern ones. Modern methods are viable to traditional ones, being complementary to them.

Additional customer protection will be enhanced with stringent portfolio management requirements and corporate governance rules and accountability for managers for investment firms. Each individual will be profiled in terms of risk by associating a grade between 1 and 7 where 1 means the lowest and the 7 highest.

Any transaction resulting from the financial advisory process will be tested to not increase the risk associated with the portfolio more than the risk profile. Thus, the risk portfolios are made more effective not only for the purchase of banking or financial products but also for sale.

Buying a risk-at-risk instrument to overcome the client's risk level will not be endorsed by the financial consultant, and the sale of a less risky instrument in the portfolio, which, by leaving the portfolio, will raise the aggregate risk of the pro-portfolio, as well will be positively endorsed by the financial institution. The risk, and thus the protection of the portfolio, should be managed actively to provide a security framework in situations where portfolio declines may occur as a result of corrections that will occur in the financial markets.

The studies conducted by Vasilescu and Vatui[8] (2004) based on a questionnaire in 2003, on a sample of 74 Romanian and foreign physical investors, of different professions and different age categories, in order to form a picture of the market investor typology capital at that date shows that: (i) individual investors had on average limited experience on the capital market: half started to invest a year ago, and only 32% more than six years ago. (ii) In adopting the investment decision, the bulk of investors watched gains from favorable stock price movements over a period of less than one year (49.52% of those questioned were seeking to increase the share price for a short period, and 27.63% of dividends). (iii) Sources of information about companies for fundamental analysis were the balance sheet, the articles in the specialized newspapers and the evolution of the daily quotations of the shares, as well as the recommendations of the financial analysts. (iv) the most important indicator on the basis of which the purchasing decisions were taken was the liquidity of the financial assets, followed by their volatility.

Analyzing the behavior of investors, Vilag, Ionescu, Ungureanu and Toader[9] (2010) show that:

- Behavior of investors, whether individual or rational, influences the evolution of the capital market;
- Financial markets are "contagious" by financial crises that occur in other markets as a result of the integration and globalization of financial markets, with small markets suffering more. These places are transmitted only if they have a

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[8] Vasilescu, Camelia; Vătui, Mihaela; *Investitorii persoane fizice şi comportamentul lor investiţional pe piaţa de capital românească*, Finanţe, Bănci, Asigurări, No. 3 (75), year VII, March 2004, pp. 17-33.

[9] Toader, Vilag, Ionescu, Ungureanu; *Financial Crisis Propagation* . Vol.2, No.1.

negative (declining), indicating, for example, a decrease in the financial valuation of the shares. Investors are more tempted to mimic the behavior of other investors if they think they will otherwise lose;

- Investors can have both rational and irrational behavior; from the point of view of rational utility there are those who want to maximize their profits. Trying some investors to maximize their profits by imitating other investors, considered to be more informed, is proof of
rational behavior in terms of utility, but it can also be a proof of irrational behavior if through these actions they will cause losses.

Hence, rich portfolio diversification legislation is a key element at the individual level and a factor supporting decisions to diversify the portfolio in line with their knowledge.

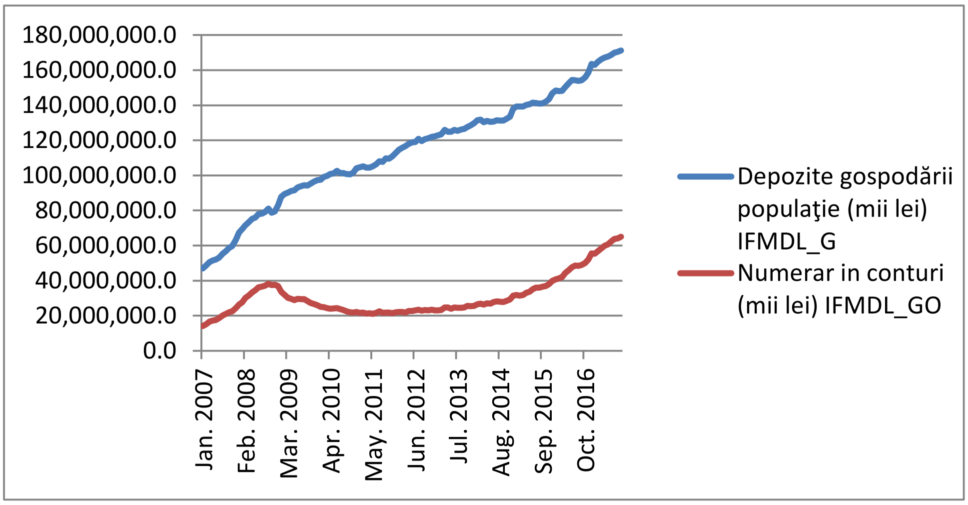
MiFID II norm provides for several customer tests. Both risk associated (scale 1-7) and investment / knowledge. These tools can direct or stop the decision to recommend portfolio diversification on products that they do not master / know well enough about.

4. The case of Romania

European legislation will, implicitly, be enforced in Romania with the same start date.

Compared to the more developed countries in the West where the degree of saving / diversification of the portfolio is higher, in Romania the share of bank deposits in total portfolio placements is high. Thus, in the context of MiFID II, the process of diversifying savings into higher risk instruments, eg government bonds, corporate bonds, absolute return funds, diversified funds, equity funds, shares and derivatives, will be slower and thus more calibrated at risk and shock waves.

Chart 2. Evolution of deposits and cash in the account for households



Source: National Bank of Romania

Invariably by the economic downturns recorded in Romania, the saving rate has increased, consumers limiting the consumption habit to the detriment of saving. The impact experienced at household level in the period 2008 - 2010, maintained an upward slope of income that is not consumed on a relatively steady trajectory.

In a process of diversification, natural risk should increase in stages. After the bank deposit, the following levels are given by government securities and investment funds. If community countries including Romania offer more avatars such as tax or higher returns for the population, new legislation will provide clear recommendations that the aggregate risk profile of the portfolio should not be exceeded, regardless of the form of diversification chosen by the consultants.

Chart 3. Evolution of local underwriting of investment funds

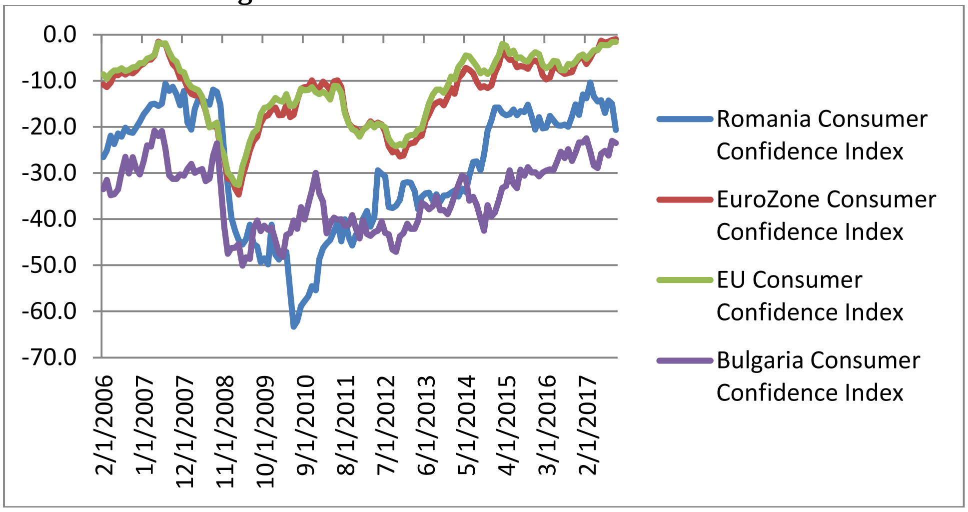
Source: AAF

As between bank deposits and funds is just one step at risk, we see how most of the structure is in money and low-risk bonds. MiFID II creates the basis for risk diversification at portfolio level by maintaining the agreed level (scale 1-7) and thus exposure to risk assets vs. bank deposits. Step-by-step education at the individual level will lead to greater portfolio diversity and increased potential return.

There are other issues that need to be considered when discussing portfolio diversification: confidence in the banking / financial system, inflation and confidence in the local / supra-state economic environment (European Union / International). Thus, households tend to choose those savings / investment instruments that generate real return (higher inflation) and do not present an irrational risk exposure. Milton Friedman said inflation is taxing without legislation and is dangerous because if the yield is below inflation, the level of saving will fall year on year.

Consumer confidence is a country-wide indicator and a union-level aggregate that can be used to verify the economy's economy on average.

Figure 4. Evolution of Consumer Confidence.

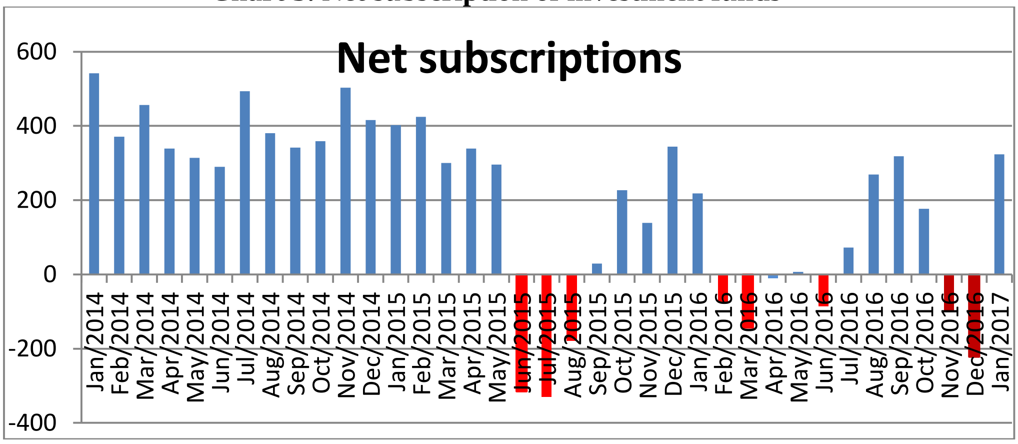


Source: Eurostat

In Romania vs neighbors (Bulgaria) and the countries to which they converge (the euro area) the level of consumer confidence has an average evolution almost similar to that of the euro zone. Differences in the chart appear largely due to fiscal and monetary gaps at local level.

MiFID II aims to narrow these differences / gaps when discussing portfolio diversification. Legislation at Community level results from the varied and ambiguous legislation in some cases previously MiFID I. It is a perspective to offer with small differences a compact and mixed portfolio diversification portfolio with a relatively low impact on risk levels. A sense of confidence in European legislation and implicitly on changes made to financial advisory rules would be interesting.

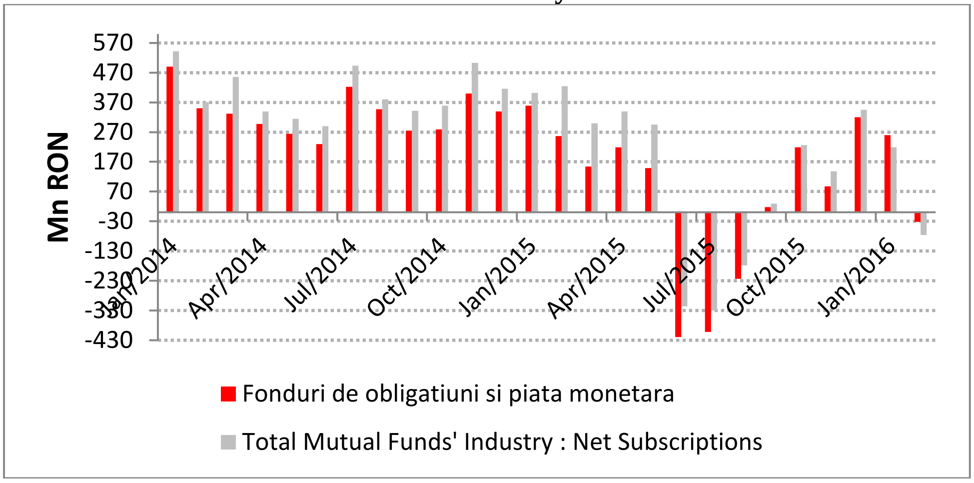
Chart 5. Net subscription of investment funds



Source: AAF

In recent years, a rescheduling of saving financial assets with a more active rise in investment funds (preponderated bond funds) has been observed. Bank deposits. We are talking about a wider growth in investment funds vs. other investment-generating instruments.

Chart 6. Breakdown of net underwritings in bond and money market versus total money



Source: AAF

Thus, in the case of Romania, MiFID II is a directive that will provide a conducive to diversifying the portfolio. Higher exposure to higher risk-priced instruments, while maintaining aggregate risk at portfolio level, will generate net underwritings on equity and diversified rather than conservative.

5. Conclusions

2018 will be an exciting year at the community level and especially at the local level as a result of the complex approach of the individual on the diversification of the portfolio. Financial institutions will provide innovative, person-level services with a high level of transparency, with a high level of risk and potential for increasing the level of savings. If, during and after the post-crisis period, saving has had a positive dynamics in the context of MiFID II in the context of a new stress scenario, saving should have additional dynamics targeted by a potential portfolio risk (and thus a low decrease) and an additional aversion to reduced risk.

The new regulations aim ultimately to streamline the allocation of savings resources and to limit the deviation from the average to the EU level.

It is to be pursued and deepened on the basis of an econometric model based on the saving movement in the context of the new MiFID II European

Directive, a dynamic of saving in the context of new regulations as a 2008 vs 2018 evolution, invariably if a new crisis or market correction importance.

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