Study on the Costs and Benefits of Potential Changes to Distribution Rules for Insurance Investment Products and other Non-MIFID Packaged Retail Investment Products

Final Report

Europe Economics
Chancery House
53-64 Chancery Lane
London WC2A 1QU
Tel: (+44) (0) 20 7831 4717
Fax: (+44) (0) 20 7831 4515
www.europe-economics.com

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EXECUTIVE SUMMARY

Introduction

1 This report was commissioned by DG Internal Market and Services to investigate the costs and benefits to industry of potential changes to the distribution rules for insurance investment products and other non-MIFID packaged retail investment products (PRIPs).

2 The aim of the study is to support evidence-based policy making in this area, feeding into wider cost-benefit and impact analysis work, which crucially includes work on the impact of options for other stakeholders, notably retail customers. Since this is an *ex ante* study to gather information to feed into the policy-making process, it has been conducted in the context of various ongoing discussions, principally (and critically) regarding the scope of application of any changes to regulation. The PRIPs initiative is seeking to apply similar distribution rules to all sales of retail investments; defining the scope of the initiative (i.e. what is and is not a 'retail investment') is likely therefore to be a key determinant of both the effectiveness but also the efficiency and attractiveness of the initiative.

3 Given this, and so as to shed light on a wide range of options on scope, this study has segmented insurance investment products for the assessment of costs. The study covers four groups of life investment insurance products, as defined below:

(a) Type 1 Life Insurance Investment Product — life insurance where the policyholder purchases “units” in a fund. The value of the policy at maturity is dependent upon the growth of the fund in which the policy is invested and there is generally no guarantee to the value of the policy when it matures, i.e. investment risk is borne by the policyholder and market values directly determine outcomes for the policyholder. In general this is referred to as a unit-linked life insurance policy and can be issued with or without a guarantee. One common example would be a eurofund.

(b) Type 2 Life Insurance Investment Product — life insurance where the policy’s cash value is tied to the performance of a financial index, e.g. FTSE 100. Most policies offer guarantees that if the index is negative, the crediting rate will not go below zero. In general this is referred to as an index-linked life insurance policy and can be issued with or without a guarantee.

(c) Type 3 Life Insurance Investment Product — these offer benefits that are partly guaranteed and partly dependent on the evolution of assets chosen by the policyholder (mostly UCITS). Correspondingly the insurance firm partially invests the premiums in guaranteed assets (in order to safeguard the guaranteed benefit) and partly in assets on the account and risk of policyholder.

(d) Type 4 Life Insurance Investment Product — the policyholder has some rights to participate in the profits of the insurance firm in addition to some guaranteed minimum return. The profits to the investor can result from:

- The investments' income exceeding some pre-defined guaranteed minimum return
- The mortality profit (i.e. actual death benefits lower than those calculated in advance)
- The general expenses profit (i.e. actual expenses lower than those charged to the policyholder)

The profits are in most cases added to the insurance policy as an annual bonus.

4 We also include within the scope of the study deposit-based retail structured products. These offer a combination of a term deposit with a return linked to the performance of some defined index or financial asset. They are designed to achieve a specific payoff profile, which they achieve through transactions in derivatives such as interest rate and currency options. Whilst the terminology varies across Member States these products are commonly referred to as retail structured deposits.

5 For the substance of proposed rules that would apply MiFID has been already identified as the benchmark for the PRIPs initiative. Though work is still ongoing on the precise detail of the requirements that should apply, it was agreed for the purposes of this study to assess possible costs based on MiFID as it currently is. It is also crucial to note however that the MiFID rules that are relevant to the PRIPs initiative are only a small part of MiFID. To be more specific, for the purposes of this study we are assessing the potential impact of introducing new MiFID-style regulations in the following areas only:

(a) Suitability and appropriateness tests — Articles 19 (4) and (5) of MiFID and Articles 35-39 of Directive 2006/73/EC (MiFID Implementing Directive).

(b) Conflicts of interest — Article 18 of MiFID and Articles 21-23 of the MiFID Implementing Directive.

(c) Inducements — Article 26 of the MiFID Implementing Directive.

Approach to the Study

6 The aim of this study is to analyse the costs and benefits of potential changes to the distribution rules for insurance investment products and other non-MIFID packaged retail investment products. The analysis of the costs will focus as far as possible on a quantitative analysis, while the benefits will be considered as part of a wider analysis of the qualitative impacts.

7 Since the purpose of this study is to develop a robust evidence base for formulating, fine-tuning and assessing policy options (e.g. on scope), primary data collection represents the core of our approach. The main elements of our methodology were as follows:

(a) Literature review and collection of existing public data — to develop a clear picture of the relevant markets across the EU and the way in which the relevant products are sold, and to provide some initial insights on the potential costs and benefits of change to feed into the design of a questionnaire for companies.

(b) Initial interviews with representatives of trade organisations — to improve our understanding of the issues surrounding regulation of life insurance products and other non-MiFID PRIPs, identify any complex additional issues, any divergence amongst Member States and assess data availability.

(c) Company questionnaire — to gather cost estimates for individual companies to comply with the possible regulatory provisions and identify any benefits that might also accrue within a sample of 12 Member States.

(d) Structured interviews with companies — to help us to process and to understand responses, and to elaborate on the responses received from specific respondents to the survey, as well as deepen our understanding of market trends.

(e) Supervisor questionnaire — to collect information on national markets and existing regulatory frameworks, and to explore the potential costs to the supervisors of implementing and administrating the proposed regulation.

(f) Estimation of the costs to industry for the EU27 — we use EU-wide data to extrapolate the cost estimates for the 12 sample Member States to the EU as a whole.

8 It is important to note that the necessarily heavy reliance on companies to estimate *ex ante* the potential costs of (as yet not fully defined) regulation inevitably introduces the potential for a large degree of error. Given this, and the relatively small sample size, the results must be treated with some caution; however the sample size and focus on estimates provided by firms is sufficient to establish the likely order of magnitude of costs and benefits of change for the *industry*, so as to provide greater clarity when assessing the impacts of different options.

Data

9 Overall, we compiled 81 usable responses from the interviews and the written responses received. Of these five came from companies that do not currently sell the products covered by the scope of this study but nonetheless offered interesting insights and feedback on the potential impacts of any regulation on the industry. Another of the responses was provided by a trade body, which offered some qualitative feedback on what the proposed rules would mean for their members. In total, therefore we compiled 75 responses from individual companies that sell the relevant products, 58 of which provided full quantitative estimates of the potential one-off and ongoing costs of compliance.

10 The table below illustrates the breakdown of the 81 responses compiled, across different types of companies and according to the level of alignment of the existing regulatory regime with the relevant MiFID provisions. The types of firm shown reflect the key classes of firm likely to be impacted by proposed changes (see Annex I for more detail). Based on other regulatory compliance work, a starting hypothesis would be that firm size and type are likely to be key dimensions for assessing the nature and distribution of variations in costs of compliance; naturally the degree of regulatory change, taking into account variance in national requirements, will also be of key importance.

Table 1: Number of Respondents by Firm Type and Regulatory Group

Regulatory group	Intermediaries	Life insurance companies	Banks	Total
Low	15	15	15	**45**
Medium	7	6	1	**14**
High	6	3	13	**22**
Total	**28**	**24**	**29**	**81**

Note: The regulatory groupings have been constructed based on feedback from national supervisors.

11 The distribution of the 58 companies that provided quantitative estimates of the potential costs is illustrated in the table below.

Table 2: Number of Respondents that Provided Quantitative Estimates of Costs by Firm Type and Regulatory Group

Regulatory group	Intermediaries	Life insurance companies	Banks	Total
Low	8	12	14	**34**
Med	5	6	1	**12**
High	5	2	5	**12**
Total	**18**	**20**	**20**	**58**

Key Findings: One-Off Costs

12 The median estimate for the one-off costs of compliance for our sample was 0.14 per cent of operating costs. The main drivers of these costs were estimated to be costs of introducing new IT systems, one-off staff training costs and costs associated with the project management of changes to business processes.

13 There is, however, a high degree of variation across companies of different types and sizes. Not only do intermediaries expect to bear a higher proportion of their operating costs in one-off costs, the dispersion of estimates is also markedly higher for intermediaries than for life insurance companies and banks.

14 The scale of operating costs (used here as a proxy for the size of the company) have a significant positive effect on the size of the one-off costs; generally, the larger the

company the greater the one-off costs in absolute terms. However, by examining SMEs and large companies separately, it is clear that this effect is stronger when focusing on smaller companies, such as intermediaries, than for larger companies.

15 The relationship between the one-off costs of compliance and the degree of current regulatory alignment with the likely content of possible new rules is less straightforward. The correlation between the two is generally low, though SMEs in general and banks operating in the life insurance sector appear to experience stronger relationships, the former driven largely by the conflict of interest provisions, the latter driven by the suitability and appropriateness provisions. However, while the explicit correlation is low, a consistent pattern does still emerge across all company types: companies operating in countries with a low level of regulatory alignment tend to record on average higher one-off costs than companies operating in countries with a high level of alignment.

16 There are various possible explanations for the relative weakness of this relationship. In particular, a measure of regulatory alignment focused (as the assessment in this study) on binding national requirements may understate alignment in practice on a voluntary basis, e.g. given the existence of informal industry-led codes of conduct that focus on similar areas as the relevant MiFID provisions being considered here. Evidence from Sweden would indicate that the effect of voluntary codes may not be consistent across companies (due to the voluntary nature of such codes) and even where it exists may have only a limited impact on the cost estimates. Apart from industry codes, some companies may also already have chosen on a voluntary basis to apply MiFID rules to life insurance investment products and structured deposits. Companies already subject to MFID in other areas of their business, for example, may apply such policies to the relevant non-MiFID products to earn reputational benefits or in order to streamline their business in some way. To the extent this factor is relevant, the actual costs of change are likely to be lower for these firms than for those who have not taken such voluntary steps; it is not possible to assess the scale of such an effect from the data returned by this study.

17 In addition, the development of the regulatory scoring was discrete from the collection of cost estimates and applies the same weight to different aspects of regulation, although the cost implications of each aspect are likely to vary. Whilst this would not significantly affect the comparison between firms based in countries with low and high regulatory scores — because such scores indicate that intervention, or the absence of it, is across the piece — it is likely to make comparisons with those with a medium score less clear cut and this will influence the overall degree of correlation witnessed. Finally, the sample size may also make it more difficult to gain a clear picture.

18 While larger companies in general would be likely to experience lower one-off costs as a proportion of their operating costs, there is a clear distinction between banks and life insurance companies. Since banks are more likely to already be subject to MiFID in other areas of their business, and non-MiFID PRIPs represent a smaller proportion of their business than for life insurance companies, this result supports the idea that the higher the proportion of the business that non-MiFID PRIPs represent, the higher the one-off costs are likely to be. Intuitively, businesses that already apply MiFID in other areas will

be more familiar with the processes involved and will already have the necessary systems in place (some may even have already applied MiFID provisions to sales of non-MiFID PRIPs voluntarily as discussed above). As such transition would be likely to involve smaller initial investment costs.

19 We employed two distinct approaches to construct an estimate of the one-off costs of compliance with the possible changes to rules for the EU as a whole:

(a) the first distinguishing between different types of company; and

(b) the second also incorporating analysis of the current regulatory alignment.

20 In most cases, the medians of the cost estimates from the sample were higher than the weighted means. We consider that this pattern of the results was consistent with the proportional cost impact being higher for smaller firms. Given the lack of strong relationships between the cost estimates and our measure of regulatory alignment (and the small sample) we have focused more upon the former approach in considering our final estimates.

21 We consider that central estimates of the likely one-off impact can be made as follows:

- for intermediaries of €50–€125 million;
- for insurers of €175–250 million (about 1.1–1.6 per cent of attributable expenditure[1]); and
- for banks of €125–€175 million.

This would mean total one-off costs of €350–€550 million.

22 The costs however are likely to be affected by a number of factors. For example if new EC regulation deviates other than trivially from the existing national approaches, costs are likely to be substantially higher than those presented above for those firms that already apply MiFID in some part of their business (i.e. primarily the banks). The estimates of cost impacts provided were on the basis of mapping across existing experience and systems to a new area — the cost impact of developing *new* systems in the new area would clearly be significantly greater. This will also be true for those companies that already apply MiFID voluntarily to a broader range of products than currently covered by local regulation, for example because a large part of their business is already covered by MiFID.

[1] The operating costs of life insurers attributable to linked life insurance investment products (as opposed to life insurance as a whole, including term products) are in the order of €16 billion across the EU.

23 The costs involved would also be affected by the scope of the eventual regulation, both in terms of product scope and the contracts it would apply to, i.e. whether it applies to all existing contracts or only new contracts going forwards. The working assumption for this study is that the regulatory changes, if and when implemented, would apply only to new contracts, since the changes in question are focused on sales (however, it is possible that individual companies assumed otherwise).

Key Findings: Incremental Ongoing Costs

24 Consistent with previous work in this area, the estimates of incremental ongoing costs of compliance are smaller than one-off costs, although the differential is somewhat less here than, for instance, was seen with regards to MiFID as a whole.

25 The median ongoing cost estimate for our sample represents 0.04 per cent of operating costs. These costs are largely driven by the costs of additional staffing requirements and ongoing staff training needs.

26 Once again, however, this figure hides a high degree of variation across different types of firms. Intermediaries bear the highest costs as a percentage of operating costs and demonstrate the highest degree of variation in the estimates across companies.

27 As in the case of one-off costs, operating costs have a significant positive effect on ongoing costs, indicating that the larger the company the higher the absolute value of the incremental ongoing costs. Once again, SMEs experience a stronger proportional effect than large companies.

28 The relationship between the level of alignment of the current regulatory framework with the proposed rules and the ongoing costs is weaker than for the one-off costs. This likely reflects companies' tendency to front-load the costs of change and/or the greater difficulty companies have in estimating ongoing costs *ex ante*.

29 As before, the proportion of non-MiFID PRIPS in the company's business seems likely to have an impact on the size of any incremental ongoing costs, with banks again recording smaller costs as a proportion of operating costs than life insurance companies. This distinction, however, appears to be weaker than for one-off costs, potentially reflecting a more general tendency by larger companies to structure the one-off expenditure in order to minimise the additional ongoing cost burden.

30 The same two approaches as were used to extrapolate one-off costs have been used to construct the ongoing cost estimates for the EU as a whole.

31 As we have noted previously, the ongoing cost estimates generated by firms are more dispersed than the one-off estimates, making the extrapolation of these more difficult and subject to judgement.

32 Informed by the above, we make our central estimate of the ongoing cost as follows:

- for intermediaries an ongoing annual impact of €25–€80 million;
- for insurers, €50–€80 million (i.e. up to 0.5 per cent of expenditure attributed by life insurers to the development and distribution of linked products); and
- for banks, an impact of €35–€60 million.

This gives a total of €110–€220 million in ongoing costs.

33 Once again, it is important to note that these estimates will be sensitive to the way in which any regulation is eventually designed and implemented. The estimates must also be considered within the context of this study and the relatively small sample used here.

Key Findings: Wider Impacts and Benefits

34 There are a number of potential wider impacts arising from the introduction of MiFID-style regulation to the selling practices of PRIPs and we took the opportunity to seek input as part of our surveys on these possible impacts. We focus on the impacts on firms and discuss those accruing to customers only to the extent to which they have a bearing on firms' expectations of the development of the relevant markets. Our work suggests that the wider impacts of the new regulation will vary notably across firm type.

35 Banks were most likely to indicate that a harmonised regulatory regime across product types could facilitate business synergies by comparison to the other firm types. Drivers of this effect include the streamlining of selling practices and staff training, opportunities to increase sales of other products, and centralised compliance functions. This is to be expected given the generally wider range of PRIPs sold by banks (specifically including ones already subject to MiFID) than intermediaries and insurance firms.

36 Impacts on product mix were the most important for intermediaries, reflecting a relatively greater impact of the new regulations on their selling processes and costs, and a corresponding willingness to consider a shift in their sales focus to simpler products. Where banks and insurance companies mentioned an impact on their product mix this was largely due to changes in customer preferences (e.g. the desire to avoid products with more stringent sales requirements or information requirements) as opposed to supply-side factors, though impacts on product costs on the supply-side could lead to changes on the demand-side, which links also to impacts on sales volumes.

37 The potential impact of the new regulations on sales volumes was noted by many respondents across all firm types, but was of most relevance among insurance firms and banks. A key reason given across respondents, in particular by insurance firms, was the foreseen impact on customer demand, both positive (in terms of increased investor confidence and improved sales advice) and negative (in terms of an information and paperwork overload reducing the demand for these products), with the latter being more common. Impacts are likely to be more wide-reaching in markets where insurance investment products are sold as part of a more common product package, such as a pensions wrapper. As with the impact on product mix, intermediaries more often reported

cost-related reasons for an anticipated decrease in sales volumes than insurance companies and, to a lesser extent, banks.

38 Anticipated change in distribution strategies as a result of the new rules was limited. The main reason for this cited by insurers was their reliance on intermediaries for the sale of their products, which the insurers would not wish to change despite the possible increase in regulatory burden on intermediaries. Banks that used multi-channel distribution strategies for different types of products noted that any shift in product mix towards a certain type of product would have a corresponding impact on the distribution strategy, but none cited a specific strategy change.

39 The impact on cross-border sales strategies is also likely to be limited across all firms, although this may just reflect the largely domestic focus of the firms in our sample. A potential harmonisation in selling regulation was clearly not considered sufficient to justify expansion in this area (even among those firm engaged in cross-border trade) given the other legal and logistical barriers.

40 Three main other impacts of the new regulations were cited by survey respondents. The creation of a level playing field between companies selling various types of investment products, and between investment products themselves, was far more important for banks than insurance firms or intermediaries. This is understandable given that banks are more likely to sell a range of investment products that are currently subject to different regulation. Increased harmonisation would create business synergies within banks and increase their competitiveness *vis à vis* insurance companies selling largely non-MiFID regulated products.

41 Insurance companies anticipated benefits in terms of increased legal protection arising from improved selling practices and greater awareness on the part of the client about the risks involved with investment products. Banks and intermediaries also anticipated that this effect might reduce their after-sales costs in terms of addressing the concerns of dissatisfied clients.

42 The results from our survey suggest that the nature and extent of the impacts of the new regulations on firms will depend largely on firm type, i.e. on factors such as relative size, range of products sold, ability to change sales focus, and reliance on certain distribution channels. This tends to outweigh location as a factor, although there are exceptions as we describe here. Focussing on the impacts on sales volumes, wider impacts of the new regulations appear to be limited across all firm types in Italy, Sweden and the UK. Italy and the UK both have a high level of existing regulation similar to MiFID and thus the introduction of MiFID-like selling rules on certain PRIPs would not be expected to signify a major change (depending, of course, to how similar the new regulations are to MiFID). Whilst Sweden has a relatively low level of national regulation, many of the banks and insurance companies (and some intermediaries) within our sample cited industry-wide codes of practice that are similar in many respects to the envisaged MiFID-style selling rules and so should again act to mediate the extent of the change.

43 On the other hand, the majority of firms in France and Estonia cited largely negative wider impacts on sales volumes of the introduction of new selling rules. The main concern among firms in France was that the new regulations, despite often being similar to existing rules, would significantly increase the regulatory burden without adding materially to consumer protection. There was no country from which firms consistently cited an anticipated increase in sales volume.

Costs to Supervisors

44 The costs to supervisors of monitoring and implementing the new regulations will differ according to the existing level of regulation within each sector. All of the supervisors that responded from Member States where regulation is already quite closely aligned with the proposed rules indicated that there would either be no additional costs or any costs would be minimal. Potential benefits are even likely: the use of the same regulatory and monitoring procedures for all financial products may help to facilitate a more streamlined supervisory activity and reduce costs. An important issue affecting the potential costs of all supervisors is the extent to which the new regulations compare in terms of depth and scope to MiFID regulations.

45 Supervisors within sectors where current levels of regulation are lower than the proposed rules cited potential increases in costs, driven by factors such as increased consumer complaints, or an increase in the number of on-site or off-site visits of firms. Survey results did not yield enough information for the robust estimation of potential costs; however, it is clear that these will not be significant compared with the costs to industry.

1 INTRODUCTION

Background

1.1 This report was commissioned by DG Internal Market and Services to investigate the costs and benefits to industry of potential changes to the distribution rules for insurance investment products and other non-MIFID packaged retail investment products. As will be outlined in this introduction, the study has been designed to provide additional information about the impact of possible changes in the key area of selling rules, addressing in particular those sectors and entities in the industry who would be most impacted by change.

1.2 The definition of Packaged Retail Investment Products (PRIPs) remains open to debate and further work. However, a working definition is that these are:

(a) products that offer exposure to underlying financial assets, but in packaged forms which modify that exposure compared with direct holdings;

(b) products that have capital accumulation as their primary function, although some may provide capital protection;

(c) products that are generally designed with the mid- to long-term retail market in mind; and

(d) products that are marketed directly to retail investors, although may also be sold to sophisticated investors.[2]

1.3 Examples of PRIPs include investment funds such as UCITS, unit-linked life insurance products and other insurance investment products, structured securities and structured deposits.

1.4 The economic objective of PRIPs is to facilitate *retail* investors' access to *investment* assets; the mechanism for achieving this is through a *packaged product*. A classic example is an investment fund or unit trust where the investor acquires indirect ownership of a bundle of shares in various quoted companies.

1.5 There are well-established arguments for packaging investments in this way: (a) the investor achieves greater diversification at a lower cost or overall investment level than would otherwise be feasible, and (b) the investor overcomes some of the informational disadvantages faced in making his or her investment decisions by transferring a significant part of the decision-making to someone else (i.e. you choose a fund manager, who then chooses stocks, bonds, etc). However, an immediate issue here is that the

[2] See the European Commission's Communication on Packaged Retail Investment Products (PRIPs) adopted on 30 April 2009.

investor may simply replace one asymmetric information problem with another (i.e. the principal-agent problem, whereby the incentives faced by the agent may not be aligned with those of the principal potentially giving rise to conflicts of interest and moral hazard).[3]

1.6 The regulation of PRIPs with regard to selling practices and disclosure varies across products and across the EU. For the purposes of this study we are addressing only sales rules.

1.7 The main EU-wide legislative tools dealing with sales and advice — MiFID (Markets in Financial Instruments Directive), UCITS IV (to a minor degree) and the IMD (Insurance Mediation Directive) — do not cover all PRIPs, and in any case differ from each other in their approach. Sales of some PRIPs, such as structured term deposits,[4] largely escape regulation under EU legislation (though there are some limited exceptions, such as the Distance Marketing Directive where relevant) and are subject only to national regulation (where this exists). Table 1.1 provides a high level overview of the current regulatory framework at the EU level.

Table 1.1: Overview of the Current Regulatory Framework

<table>
<tr><th></th><th>UCITS</th><th>Non-harmonised investment funds</th><th>Unit-linked life insurance policies</th><th>Structured securities and closed-end funds</th><th>Structured term deposits</th></tr>
<tr><td rowspan="3">Rules on product information applying to manufacturers, issuers or intermediaries</td><td>Simplified Prospectus of UCITS Directive</td><td rowspan="2">MiFID
(high-level product disclosure requirements apply to MiFID intermediaries when selling financial instruments)</td><td>Consolidated Life Directive</td><td>Prospectus Directive</td><td rowspan="2">No rules at EU level[1]</td></tr>
<tr><td>MiFID
(high-level product disclosure requirements apply to MiFID intermediaries when selling financial instruments)</td><td>IMD for some product disclosure requirements</td><td>MiFID
(high-level product disclosure requirements apply to MiFID intermediaries when selling financial instruments)</td></tr>
<tr><td colspan="5">E-commerce Directive or Distance Marketing of Financial Services Directive</td></tr>
<tr><td rowspan="3">Selling rules</td><td>MiFID
UCITS Directive</td><td>MiFID</td><td>IMD</td><td>MiFID</td><td>No rules at EU level</td></tr>
<tr><td colspan="5">E-commerce Directive or Distance Marketing of Financial Services Directive</td></tr>
</table>

Source: European Commission April 2009 Communication

1.8 The European Commission is exploring options for a horizontal approach to the regulation of sales of PRIPs, and MiFID-style selling rules have been identified as a benchmark to

[3] Clearly the asymmetric information problem facing the investor would still exist, though can be mitigated, for example by employing a financial advisor. This again, however, would create a principal-agent problem.

achieve this objective.[5] The choice of this benchmark is motivated as follows: firstly, the principles-based MiFID framework should allow different products and services to be accommodated. Secondly, MiFID already provides a sophisticated framework that addresses the major issues identified earlier in the PRIPs initiative with respect to selling practices, covering such crucial areas as rules on conflicts of interest and on the conduct of business more generally.

Scope of the Study

1.9 The aim of this study is to support evidence-based policy making in this area. Since this is an *ex ante* study to gather information to feed into an ongoing policy-making process, it has been conducted in the context of various ongoing discussions, principally (and critically) regarding the scope of any regulation.

1.10 Simplifying assumptions have had to be made to enable practical data gathering. The study has therefore been designed to focus on those PRIPs which are not currently covered by MiFID (broadly, insurance based PRIPs and certain deposit-based PRIPs), and to examine the possible impact of applying a MiFID-style regime on sales to these classes of product.

1.11 In order to illuminate the debate on the precise scope of the PRIPs work, a key element that had to be addressed in this study was the identification of the products that might qualify as PRIPs and thereby be subject to any new regulation. Part of the debate on product scope arises from the fact that life insurance investment products can be understood differently in different markets; the same products can have different labels in different Member States and different products can have the same labels across different Member States. For example what is termed a "with-profits" product might not so naturally be seen to fit within the description of a PRIP in some Member States but clearly would in other Member States. To address this challenge we have focused here on the relevant *features* of life insurance products rather than national labels.

1.12 Given this, and so as to shed light on a wide range of options on scope, this study has segmented insurance investment products for the assessment of costs. The study covers four groups of life investment insurance products, as defined:

(a) Type 1 Life Insurance Investment Product — life insurance where the policyholder purchases "units" in a fund. The value of the policy at maturity is dependent upon the growth of the fund in which the policy is invested and there is generally no guarantee to the value of the policy when it matures, i.e. investment risk is borne by the policyholder and market values directly determine outcomes for the policyholder. In

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[4] These are fixed-term deposits generally ranging from a month to a few years designed to achieve a specific payoff profile.

[5] European Commission, "Communication from the Commission to the European Parliament and the council on packaged retails investment products", April 2009.

general this is referred to as a unit-linked life insurance policy and can be issued with or without a guarantee. One common example would be a eurofund.

(b) Type 2 Life Insurance Investment Product — life insurance where the policy's cash value is tied to the performance of a financial index, e.g. FTSE 100. Most policies offer guarantees that if the index is negative, the crediting rate will not go below zero. In general this is referred to as an index-linked life insurance policy and can be issued with or without a guarantee.

(c) Type 3 Life Insurance Investment Product — these offer benefits that are partly guaranteed and partly dependent on the evolution of assets chosen by the policyholder (mostly UCITS). Correspondingly the insurance firm partially invests the premiums in guaranteed assets (in order to safeguard the guaranteed benefit) and partly in assets on the account and risk of policyholder.

(d) Type 4 Life Insurance Investment Product — the policyholder has some rights to participate in the profits of the insurance firm in addition to some guaranteed minimum return. The profits can result from:

- The investments' income exceeding the guaranteed minimum return
- The mortality profit (i.e. actual death benefits lower than those calculated in advance)
- The general expenses profit (i.e. actual expenses lower than those charged to the policyholder)

The profits are in most cases added to the insurance policy as an annual bonus.

1.13 It is important to note that the above descriptions of these products do not represent any legal or formal definition, they are purely to distinguish between different types of insurance products available in different markets and are therefore only approximate, but are appropriate for the needs of identifying any possible variations in cost levels between broad classes of product

1.14 The fifth type of PRIP we consider are deposit-based retail structured products. These offer a combination of a term deposit with a return linked to the performance of some defined index or financial asset. They are designed to achieve a specific payoff profile, which they achieve through transactions in derivatives such as interest rate and currency options. Whilst the terminology varies across Member States these products are commonly referred to as retail structured deposits.

1.15 The rationale for defining the scope in this way is discussed in more detail in Appendix 1.

Objectives of the Study

1.16 The aim of this study is to analyse the costs and benefits of potential changes to the distribution rules for insurance investment products and other non-MIFID packaged retail investment products. The analysis of the costs will focus as far as possible on a quantitative analysis, while the benefits will be considered as part of a wider qualitative analysis of impacts (which will of necessity be more suggestive in nature).

1.17 The focus in this study is on gathering evidence on the costs and any possible benefits (e.g. efficiency gains, market impacts) for the industry affected. The types of company that we have addressed in this study fall into three groups: insurance providers, banks and intermediaries. As we describe in Section 2, these are the essential distribution channels through which the products described above are sold.

1.18 We also consider the impact upon the competent authorities of additional supervisory burdens implied by the potential changes. A global analysis of the overall costs and benefits of the policy options will require further analysis of the impact of the options upon all stakeholders, and notably consumers (i.e. retail investors). This is being considered separately by the Commission. This wider work will consider the specific effectiveness and efficiency of different options in the light of the objectives (consumer protection, level playing field and single market) being sought, and this study will form part of the evidence-basis in this wider work. Though we do not directly consider the impacts on consumers here, we do provide some insights in passing where appropriate and relevant.

1.19 Since the purpose of this study is to develop a robust evidence base for formulating policy, primary data collection represents the core of our approach. The main elements of our methodology were as follows:

(a) Literature review and collection of existing public data — to develop a clear picture of the relevant markets across the EU and the way in which the relevant products are sold, and to provide some initial insights to the potential costs and benefits to feed into the design of the company questionnaire.

(b) Initial interviews with representatives of trade organisations — to improve our understanding of the issues surrounding regulation of life insurance products and other non-MiFID PRIPs, identify any complex additional issues, any divergence amongst Member States and assess data availability.

(c) Company questionnaire — to gather cost estimates for individual companies to comply with the relevant regulatory provisions and identify any benefits that might also accrue.

(d) Structured interviews with companies — to help us to process and to understand responses, and to elaborate on the responses received from specific respondents to the survey, as well as deepen our understanding of market trends.

(e) Supervisor questionnaire — to collect information on national markets and existing regulatory frameworks, and to explore the potential costs to the supervisors of implementing and administrating the proposed regulation.

(f) Estimation of the costs to industry for the EU27 — we use the EU wide data to extrapolate the cost estimates for the 12 sample Member States to the EU as a whole.

1.20 A more detailed description of the approach to stakeholder engagement, and in particular the surveys and company structured interviews, is provided in Appendix 1. It is important to note, however, that the heavy reliance on companies to estimate *ex ante* the potential costs of (as yet not fully defined) regulation inevitably introduces the potential for a large degree of error. Given this, and the relatively small sample size, the results must be treated with some caution. However, it was necessary to adopt this approach to obtain useful evidence at the stage of policy development; more concrete data will only be available once it is possible to assess costs on an *ex post* basis. A full description of the number of respondents and the types of respondents is also provided in Appendix 1.

The Relevant MiFID Provisions

1.21 The financial services sector has long been subject to regulation or control. The economic basis for this oversight stems not just out of concerns about market power (after all banks are not a natural monopoly in the sense of an electricity or water network operator) but also from a cluster of issues (information asymmetries principal-agent problems, the need for robust management of systemic risk and maintenance of economic stability, the need to mitigate the impact of skewed incentives, and the presence of externalities so that market prices may not be reflective of the true marginal social benefits, and distributional concerns). Of course, any intervention may itself give rise to costs which in some cases might outweigh the benefits gained from attempting to correct the perceived market failure; for this reason it is crucial to assess all interventions in the light of their likely impact across all stakeholders.

1.22 The conduct of business aspects of MiFID address a number of the problems encapsulated above. In particular, it enhances consumer protection and promotes investor confidence as well as facilitating the single market.

1.23 Information asymmetries, and the principal-agent problem in particular, are key drivers of the regulation of investment products aimed at the retail customer. The retail customer of such products is generally not as sophisticated or knowledgeable as the seller. Investors who end up purchasing unsuitable products because of a lack of understanding about the true risks or return on the product or lack of awareness about products better suited to their needs, or indeed due to inappropriate advice from those selling them, would be less well off in utility (or indeed monetary) terms. This can also give rise to lack of investor confidence which may lead to suppressed demand for investment products and the misallocation of resources.

1.24 MiFID is focused (amongst other things) on addressing issues in sales of investments (other separate legislation addresses product disclosure or transparency issues). To this end, MiFID includes informational, organisational and conduct of business requirements. A two-way information exchange and requirements on the sellers' conduct of business when making recommendations or a sale, such as under the MiFID suitability and appropriateness tests, are targeted at mitigating information asymmetries and principle-agent problems. The other two MiFID elements relevant to this study (on conflicts of interest and inducements) similarly work to manage skewed incentives on part of the seller and aim to enhance transparency.

1.25 It is worth bearing in mind the potential unintended consequence of 'information overload'. Presented with swathes of information on a host of different investment products (or even on a single product), an investor may resort to some rudimentary or even arbitrary selection method to save time or even refuse to make a decision at all. As noted, the Commission is addressing options in relation to product information separately to options for sales rules; the focus of this study is on the sales requirements.

1.26 It is crucial to note that the MiFID rules that are relevant to the PRIPs initiative are only a small part of MiFID, and the aim of the PRIPs work is not to replicate the entirety of MiFID across all investment sectors. To be more specific, and to appropriately simplify the preparation of *ex ante* cost estimates for the purposes this report, the specific rules in MiFID being considered as a basis for a wider MiFID-style sales regime are as follows:

(a) Suitability and appropriateness tests — Articles 19 (4) and (5) of MiFID and Articles 35-39 of Directive 2006/73/EC (MiFID Implementing Directive).[6]

(b) Conflicts of interest — Article 18 of MiFID and Articles 21-23 of the MiFID Implementing Directive.

(c) Inducements — Article 26 of the MiFID Implementing Directive.

1.27 By extending these rules (or rules with the same effect) to other products, the main aim is to level the playing field and in particular ease the comparison of products with the same economic function and aimed at the same class of investors. In addition, extending the rules and ensuring that the same high regulatory standards apply to all sales processes for PRIPs would remove 'regulatory arbitrage' as a driver of particular product sales.

1.28 Other requirements may in practice be necessary to ensure these requirements function in a consistent way across different sectors, but are not being considered directly in this study, since the PRIPs initiative is focused on achieving consistency in these areas alone.

[6] As outlined in Directive 2004/39/EC (MiFID) and Directive 2006/73/EC (MiFID Implementing Directive).

Suitability and appropriateness tests[7]

1.29 When providing investment advice (or portfolio management functions) firms must obtain sufficient information from the client in order to be able to recommend the most suitable product or service. The suitability test requires the gathering of information that reflects the client's financial situation, his investment objectives and his knowledge and experience in the relevant investment field. A recommendation of a suitable product or products can then be made. Where a recommendation is not being made, an appropriateness test (which assesses the appropriateness of the product or investment service in question) will often be necessary, which will require the gathering of information about the client's knowledge and experience in the relevant investment field.

1.30 The relevant information will relate to:

(a) The client's investment objectives, to ensure that the recommended transaction meets these objectives. Information may include the length of time for which the client wishes to hold the investment; his preferences regarding risk taking; his risk profile; and the purpose for his investment.

(b) The client's financial situation, to ensure the client is able to financially bear any related investment risks consistent with his investment objectives. Information may include the source and extent of his regular income; his assets (including liquid assets, investments and real property); and his regular financial commitments.

(c) The client's knowledge and experience in the investment field relevant to the specific type of product or service, to ensure that the client is sufficiently able to understand the risks involved in the transaction or in the management of his portfolio. Information may include:

- The types of services, transactions and financial instruments with which the client is familiar;
- The nature, volume and frequency of the client's transactions in financial instruments and the period over which they have been carried out;
- The level of education and profession of the client.

1.31 When providing investment services other than investment advice or portfolio management, firms must elicit information regarding the client's knowledge and experience in the relevant investment field to assess whether the investment service or product envisaged is appropriate for the client. The application of the appropriateness

[7] MiFID Article 19 (4) and (5) and Implementing Directive Article 35 – 38.

test depends on whether the client is retail or professional and the complexity of the product.

1.32 Firms will be entitled to assume that professional clients have the required knowledge and experience and are able to financially bear any related risks.

1.33 The firm shall rely on the information provided by the client unless it is aware that the information is manifestly inaccurate or out of date.

Retail client agreement[8]

1.34 Investment firms that provide an investment service other than investment advice to a new retail client must enter into a written basic agreement with the client (in paper or another durable medium) setting out the essential rights and obligations of the firm and the client.

1.35 The rights and duties of the parties to the agreement may be incorporated by reference to other documents or legal texts.

Conflict of interest[9]

1.36 MiFID Articles 13(3) and 18 specify that all firms must identify any conflicts of interest between themselves (including employees and tied agents) or any person directly or indirectly linked to them, and their clients, or between one client and another.

1.37 Systems should be put in place to avoid or manage such conflicts; where such systems are not sufficient to ensure that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.

1.38 The Implementing Directive defines conflicts of interest as situations in which:[10]

(a) The firm or a relevant person is likely to make a financial gain, or avoid a financial loss, at the expense of the client;

(b) The firm or person has an interest in the outcome of a service provided to the client which is distinct from the client's interest in that outcome;

(c) The firm or person has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client; and

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8 Implementing Directive Article 39.
9 MiFID Article 18 and Implementing Directive Article 21 – 23.
10 Implementing Directive 2006/73/EC Article 21.

(d) The firm or person will receive from someone other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service.

1.39 Firms will be required to establish and implement an effective conflicts of interest policy set out in writing and appropriate to the size and organisation of the firm and the nature, scale and complexity of its business. This must also include any firms belonging to groups.

1.40 The policy must include:[11]

(a) Identification of the circumstances which constitute or may give rise to a conflict of interest entailing a material risk or damage to the interests of one or more clients

(b) Specification of procedures to be followed and measures to be adopted in order to manage conflicts.

1.41 The procedures to be followed must include such of the following in order to ensure that the firm retains the requisite degree of independence:[12]

(a) Procedures to prevent or control the exchange of information between relevant persons engaged on activities involving a risk of conflict of interest where the exchange of this information may harm the interests of one or more clients;

(b) The separate supervision of persons whose principal functions involve carrying out activities on behalf of, or providing service to, clients whose interests may conflict, or who otherwise reflect interests that may conflict;

(c) The removal of any direct link between the remuneration of relevant persons engaged in one activity with the remuneration of or revenues collected by persons engaged in another activity, where a conflict of interest may arise in relation to these activities;

(d) Measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out investment services or activities;

(e) Measures to prevent or control the simultaneous or subsequent involvement of a person in a separate investment service where such involvement may impair the proper management of conflicts.

1.42 Firms will be required to keep an up to date record of all the services undertaken in which a conflict of interest has arisen or may arise.

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[11] MiFID Article 18(3) and Implementing Directive Article 22(2).
[12] These procedures are specified in Implementing Directive Article 22(3).

Inducements[13]

1.43 Inducement rules set out the acceptable forms of remuneration that investment firms are able to receive. The payment or receipt of any fee, commission or non-monetary benefit is only permitted if it is:

(a) Paid by the client or a person acting on behalf of the client.

(b) Paid by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:

i. full details regarding any payments (nature and amount, or methods of calculating amounts) are fully and clearly disclosed to the client prior to the provision of any investment service;

ii. the provision of the fee, commission or non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firms' duty to act in the best interests of the client.

(c) Proper fees which enable or are necessary for the provision of investment services (such as custody costs, settlement and exchange fees, regulatory levies or legal fees) and cannot give rise to conflicts of interest with the firm's duties to act fairly and honestly. Disclosure of such payments referred to in (b)(i) can be presented in summary form, provided further details are disclosed on request.

1.44 It is worth noting that under the current MiFID framework, while it is in general a 'maximum harmonisation' framework, there is nonetheless some scope in some areas for the authorities in individual jurisdictions to interpret provisions in different ways. As such, the rules may be applied differently in different jurisdictions, both in terms of the scope of products and services they are applied to (in addition to those defined in the MiFID framework), and in terms of the detailed content of specific requirements. This raises some potential methodological issues for this study. For example it may affect the way in which companies interpret these provisions when answering the questionnaire on potential costs, as well as potentially creating difficulties in assessing the exact level of alignment that currently exists with relation to the products that are the focus of this study and the MiFID provisions. The methodological risks associated with the study are discussed in more detail in Appendix 1 where we provide a detailed description of our approach. Our working assumption for the purposes of this study has been that these provisions are applied as described above and in a consistent way across all Member States, unless otherwise identified to us.

[13] MiFID Article 19 and Implementing Directive Article 26.

The Approach to Analysing the Impacts

The direct costs of compliance

1.45 In implementing MiFID-style rules on selling practices for the distribution of PRIPS not currently within the scope of MiFID, firms are likely to incur two forms of direct costs: one-off and ongoing. As only the incremental costs of any regulatory change should be considered, the nature and magnitude of these costs will depend on the existing regulation that the firm complies with and the approach that the firm would adopt in adapting to that regulatory change. These costs are defined as follows:

(a) One-off costs are those that are only incurred once (i.e. in making the transition), for example changes to IT systems required for compliance under the new regulation.

(b) Ongoing costs are those that are continuous as a result of the new regulation (i.e. that will be incurred on a recurring basis) such as reporting or administrative costs.

1.46 There may be some required changes that will incur both a one-off and an ongoing cost, such as the training of staff. In this case, designing updated training programmes and bringing all existing staff up to speed would represent a one-off cost, while the training of new staff brought in to ensure compliance with the new rules would be an additional ongoing cost.

One-off costs

1.47 In a previous study on the costs of complying with certain FSAP directives, Europe Economics identified a number of cost areas experienced by financial institutions when complying with MiFID.[14] Cost areas relevant to the proposed rules are summarised below:

(a) Familiarising the firm with the legal requirements of the new rules. This may take the form of training programmes or information packs, or engagement with legal advisors and/or consultants.

(b) The development of revised policies on conflicts of interest, sometimes accompanied by investment in improved systems architecture. In some cases, consultants were employed to map the potential for conflicts of interest to arise.

(c) The development and validation of new training packages and one-off activities (both e-learning and classroom based).

[14] Europe Economics (2009) 'Study on the Cost of Compliance with Selected FSAP Measures'.

(d) Legal and operational gap analysis aimed at the identification of processes (for instance in relation to customer communication) that required amendment and/or documentation.

(e) The making (and storage) of suitability assessments for existing customers.

(f) IT costs. A key practical issue here is to ensure that only those costs caused by the implementation of a particular regulation are recognised (often, the IT project implementing of a regulatory change will act as a "magnet" for IT development supporting other business changes, not directly related to the regulation itself, or in a number of cases, the firm may have implemented MiFID-compliant IT already in respect of other investment products).

(g) The project management of the whole process.

Ongoing costs

1.48 Certain *ex post* cost assessment studies have found recurring costs of implementing regulatory changes to be approximately 10 per cent of the one-off costs.[15] In our 2009 study on the costs of complying with the FSAP we found that this ratio is likely to depend on the recentness of the regulatory change, as the objective in most firms is to absorb recurring costs into the cost of "business as usual" as rapidly as possible.[16] This means that separating (and reporting) ongoing costs arising from the regulation from the "noise" of the firm's other running costs is more difficult the longer the regulation has been in place; implicitly also, the ongoing incremental cost impact will tend to reduce over time (to the extent that firms are successful in their attempts to absorb such costs into their "business as usual" processes). In the case of an *ex ante* cost assessment where firms are asked to estimate future ongoing costs (as opposed to disentangling them from other running costs), the ratio of ongoing costs to one-off costs is likely to be reported as being higher than found in previous *ex post* studies.[17]

1.49 The level of ongoing costs identified will also be related to the firm's ability to anticipate or foresee regulatory changes. If a firm begins to implement changes in accordance with expected regulatory requirements, the incremental costs of meeting the requirements when the regulation is eventually implemented will be lower.

1.50 In addition, our previous study on FSAP showed that in general, where a high degree of automation has been achieved in adapting to regulatory changes, the ongoing costs in respect of MiFID are much less significant than the original implementation.

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[15] See, for instance, the study conducted by Deloitte on behalf of the ABBL 'Impact of Compliance on Financial Institutions in Luxembourg' (2006).

[16] Europe Economics (2009) 'Study on the Cost of Compliance with Selected FSAP Measures'.

[17] For example, in our 2009 Cost of Compliance study we found a ratio of on-going to one-off costs of between 15 and 20 per cent, most likely due to the recentness of the particular Directives we examined. However, it is possible that for these the nature of the regulations imposed greater relative ongoing costs than one-of costs compared with the previous studies.

1.51 The following drivers of ongoing costs of complying with MiFID have been identified:[18]

(a) Communication with clients, particularly if achieved through mail-outs to customers. This has been found to be particularly expensive in respect of those clients where confirmation from the client was required. This may be most relevant in terms of the suitability and appropriateness rules if clients are required to send information to the firm in response to an initial communication, or sign and return the retail client agreement.

(b) Increase in transaction times (i.e. time spent with client and arranging the advice/service).

(c) Data storage costs, which would be particularly relevant to the client information requirements and to the monitoring of conflicts of interest and inducements.

(d) Practical application. For example, respondents to our previous study indicated that the practical application of the "inducements" clause in MiFID differs as to what is taken to constitute gifts and entertainment between the UK and Germany. Issues such as these consume the time of both compliance and operational workers.

1.52 The level of ongoing costs will be influenced by the investment in one-off costs, or costs incurred in the beginning of a compliance programme. Our previous study also identified that firms experiencing significant ongoing costs in respect of MiFID generally have relatively low one-off costs. This appears to be primarily because by spending less on upfront, automated solutions, compliance requires greater ongoing effort, e.g. in additional staffing.

Incremental Compliance Costs

1.53 For the purposes of this study, we are interested in what are known as "incremental compliance costs". As such any estimates must exclude costs already sunk by the firm or that the firm would incur regardless of the regulatory changes being assessed. In order to assess the incremental cost it is important, therefore, to define a baseline (known as the "counterfactual") against which to make comparisons. This counterfactual is normally the situation that would be expected to pertain had the regulation not been implemented. The Tender Specifications for the study specify that the baseline in terms of the regulatory environment are as follows:

[18] Europe Economics (2009) 'Study on the Cost of Compliance with Selected FSAP Measures'.

Baseline for insurance products	Baseline for deposit-based retail structured products
• IMD chapter III, particularly Article 12 • National requirements	• National requirements

1.54 The challenge, however, is understanding the path that financial services markets would take in the absence of regulation, as this is inherently unobservable. An overview of the baseline is set out in Section 2.

Benefits and wider impacts

1.55 In addition to the direct costs of compliance discussed above, the study also considers in a qualitative way any potential benefits and wider impacts that the application of the proposed rules might generate for companies. The benefits and wider impacts (such as any indirect costs) of the proposed regulation on firms or the industry as a whole may also be important.

1.56 Benefits could take the form of reduced costs from internal synergies across business streams, as well as any reputational benefits they might experience. Meanwhile wider impacts would include any impacts additional regulation would create in the market, such as the impact on sales volumes, on the mix of products that companies sell or the way in which they market affected products. New regulation may also have impacts on the costs for supervisors.

1.57 Though the costs and benefits to consumers are beyond the scope of this piece of work, where relevant we also touch on any consequences these may have for consumers too. The Commission is working separately on assessing potential consumer detriment under current requirements and the capacity of different options to reduce such potential for consumer detriment.

The Structure of the Report

1.58 In the main body of the report focuses on the analysis of the data collected in the study, with more detailed descriptions of the processes involved and methodology provided in the supporting appendices.

1.59 The main body of the report is structured as follows:

(a) Section 2: Overview of the current environment — this section provides an overview of the relevant markets. As part of this chapter we present information relating to the size and nature of the relevant markets across the EU, the structure of the distribution channels of the relevant products in different Member States and a discussion of the current and future regulatory environment in individual Member States. As such this section provides the context for the report and the counterfactual for our cost of compliance estimates.

(b) Section 3: The one-off cost of compliance — this section uses the feedback from the company survey and interviews to examine the potential one-off cost of complying with changes that applied the relevant MiFID-style provisions (or equivalent regulatory requirements) to sales in the five product areas forming the scope of this study. In this section we examine the dispersion of the cost estimates provided by companies, the impact of the size of the company on the cost estimates, the relationship between one-off costs and the existing regulatory context, and any variations in the one-off cost impacts across different types of companies. In our view these are the key likely dimensions for analysing any dispersal in the cost estimates. We use this information to construct estimates of the potential one-off costs for the EU as a whole and offer some insights into the potential for such costs to vary if the regulation were in fact adopted.

(c) Section 4: The ongoing cost of compliance — this section focuses on the ongoing costs of compliance. Again the analysis draws on the results of the company survey to analyse the relationship between additional ongoing costs and the existing regulatory context and any variations in additional ongoing costs across different types of companies, before once again providing an estimate for the potential additional ongoing cost for industry as a whole that would result from the relevant provisions being applied to the four life insurance investment products and structured term deposits. We also discuss how such costs may vary depending on the final form of any regulation and the nature of the implementation.

(d) Section 5: The potential benefits and wider impacts of regulation — the final section of the main report discusses the potential benefits of compliance and any wider impacts that may arise as a result of introducing the relevant provisions. The focus of this section is on qualitative information provided by companies as part of the survey and interview process and offers a broader perspective of the potential impacts beyond the direct one-off and ongoing costs of compliance. In particular, this section examines any similarities and differences in the responses across Member States and between different types of companies, in order to identify any patterns in the impacts of introducing the relevant provisions to the four life insurance investment products and structured term deposits.

1.60 Throughout, this report segments results by type and size of firm to assess dispersion in the estimates and possible disproportionalities in impacts, notably for smaller over larger firms, given the hypothesis that costs will vary accordingly.

1.61 Additional information to support the study is provided in the Appendices. These are as follows:

(a) Appendix 1: Approach to stakeholder engagement — this describes in detail the methodology adopted to conduct the study, in particular our approach to conducting the interviews with trade organisations and the surveys of companies and the relevant national supervisors, and provides an overview of the sampling approach and

distribution of the respondents, including by Member State, company type and product type;

(b) Appendix 2: Methodology for extrapolation — this section provides a detailed explanation of the approach used to calculate the aggregate cost estimates for the EU as a whole presented in the conclusions to Sections 3 and 4 of the main report; and

(c) Appendix 3: Standard cost model estimates — this section offers a detailed description of the approach adopted in calculating the Standard Cost Model (SCM) estimates, and presents the estimated costs associated with the relevant MiFID provisions under the SCM framework.

2 OVERVIEW OF THE CURRENT ENVIRONMENT

Introduction

2.1 This section sets out an overview of the current environment, examining market patterns and trends as well as regulatory frameworks in individual Member States across the EU. This is important to provide the context for any analysis of the potential impacts of introducing MiFID style regulations to life insurance investment products and deposit-based structured products, and provides a baseline for our assessment of the incremental costs later in the report. The analysis addresses life insurance based investments first, followed by those which are deposit-based.

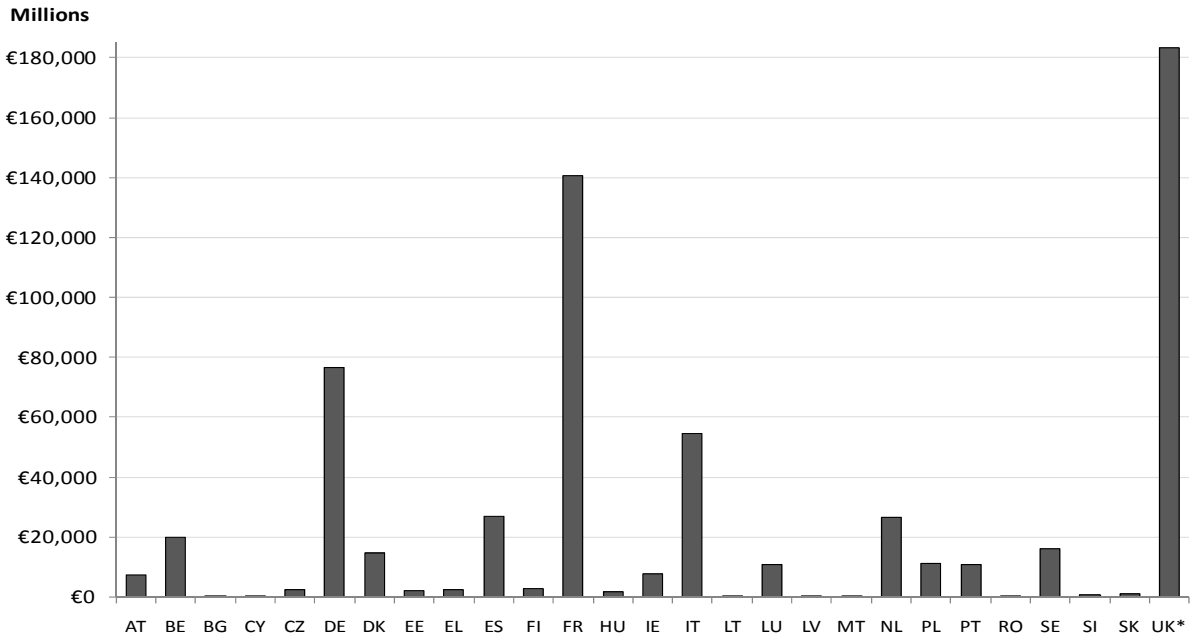
Life Insurance Investment Products

Size of the life insurance market

2.2 We begin by examining the life insurance market as a whole (i.e. including "classical" term life insurance as well as those normally described as life insurance investment products). The EU life insurance market was worth €621 billion in 2008.[19] The UK was by far the largest market, with gross premiums in 2008 of €183 billion, followed by France (€141 billion in 2008) and Germany (€76 billion in 2008). The smallest market was Latvia, with gross premiums in 2008 of €27 million.

[19] Eleven countries have yet to publish 2009 data so the 2008 data are the most up to date, comprehensive source available.

Figure 2.1: Gross Life Insurance Premiums across the EU27, 2008



Source: Questionnaire responses from national supervisors or their websites, CEIOPS Statistics 2008 (*).

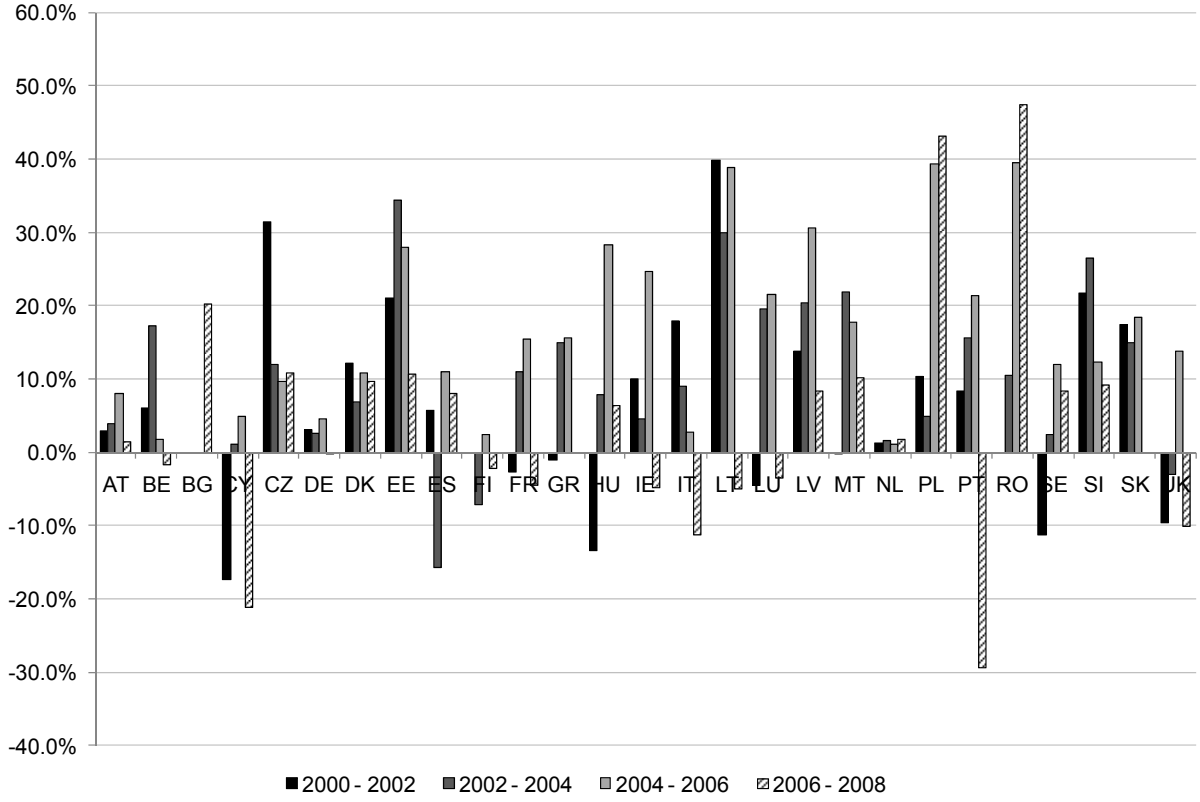
2.3 While Germany appears as the third largest market here we understand that life insurance products overlap significantly with pension-type products in that market, which may have lowered the size of the premiums in aggregate.

2.4 Evidence of the financial crisis can be found in the growth rates of the insurance markets across the EU. Figure 2.2 shows the growth in life insurance premiums in two-yearly groups for the EU27. Despite some volatility shown in Figure 2.2, the cumulative average growth rate from 2000 to 2006, representing the longer term trend in the markets, was positive in all but three Member States (Cyprus, Slovenia and, marginally negative, the UK).[20] However, growth from 2006 to 2008 was slower in the majority of Member States, with many experiencing negative growth. Significant examples include the UK, where gross premiums fell by 40 per cent in 2008 from 2007; Ireland (a 36 per cent fall in this time period); Lithuania and Estonia (around 30 per cent decline respectively).

2.5 It is interesting to note that some countries maintained relatively high growth rates in the latter period (i.e. 2006–08). However, these appear to be predominantly Member States (Bulgaria, Poland and Romania) where the development of the financial services sector as such is, generally speaking, more rapid.

[20] The cumulative average growth rate is a smoothed growth rate, describing the rate at which the market would have grown between 2000 and 2006 if it grew at a steady rate.

Figure 2.2: Growth in Life Insurance Premiums EU27

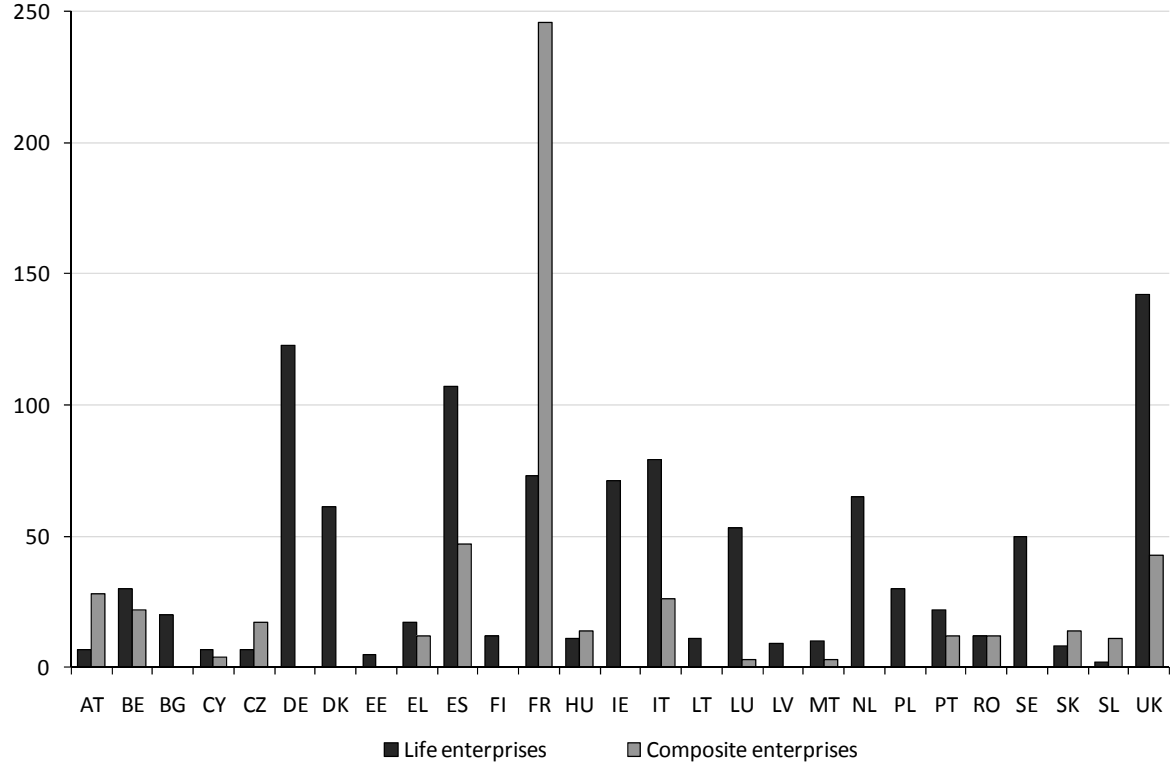


Source: Data for 2000 – 2005 from CEA (2009) 'European insurance in figures', and data for 2006 – 2008 from CEIOPS Statistics

2.6 The number of active life insurance and composite insurance companies varies across the EU27.[21] Figure 2.3 below shows the number of firms (both national and foreign) active in the Member State and subject to national regulation. The number of firms tends to mirror the size of the market. The lower numbers of composite entities implies that many life insurers are specialist in that segment and do not to sell non-life insurance. The most obvious exception is France, where composite entities predominate.

[21] Composite insurance companies are companies that sell both life and non-life products.

Figure 2.3: Number of Active Life and Composite Insurance Firms, 2008



Source: CEIOPS Statistics 2008

Life insurance investment products

2.7 The most common life insurance investment products in the EU tend to be unit-linked products.[22] Unit-linked life insurance can be used as a proxy for our "Type 1" product, though Type 1 under our definition is broader than just unit-linked products as products in some Member States which we include as Type 1 (for example the eurofund in France) may not be considered to be unit-linked by the national supervisors and thus may not be uniformly included in the data provided to us.

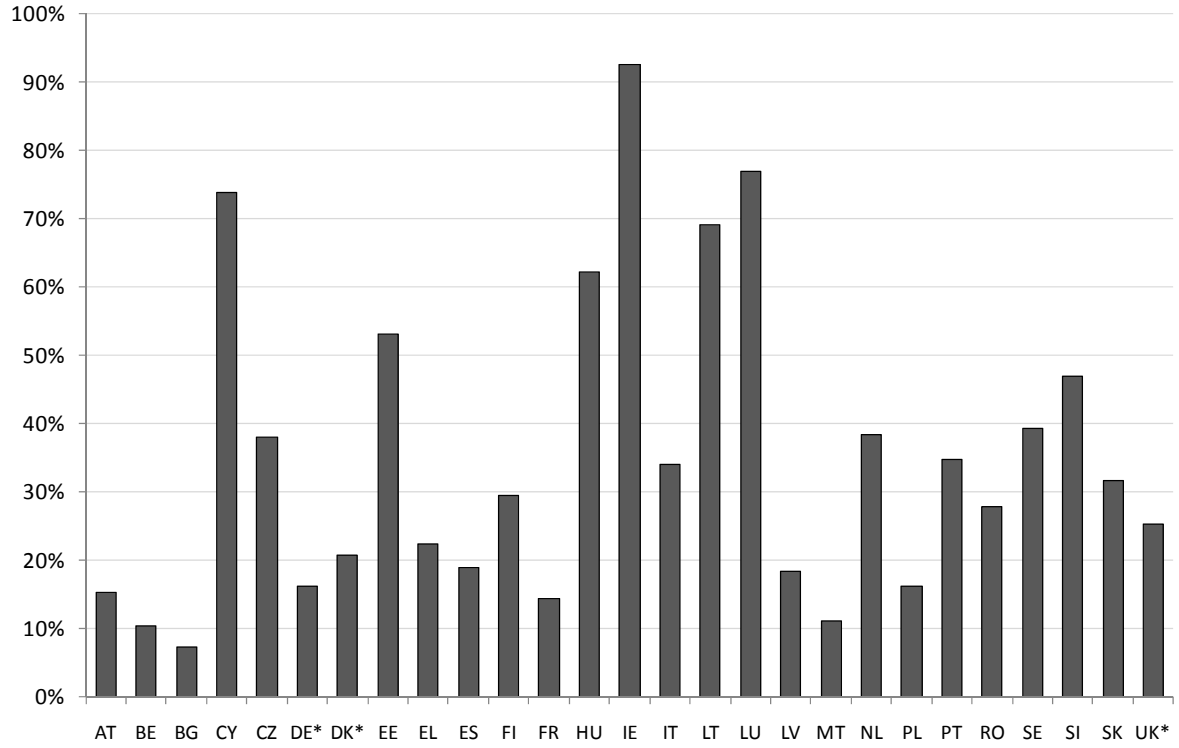
2.8 While data are available for the volume of unit-linked products, information is scarcer in terms of the incidence of the other forms in our typology — however, looking across the EU as a whole, these forms are individually notably less common than unit-linked products, though their prevalence varies across Member States; for example, according to feedback from the industry, in Italy and Spain Type 4 products are the most widely marketed.[23]

[22] Unit–linked products correspond to Class III life insurance as set out in Annex 1 of the Life Insurance Directive 2002/83/EC.
[23] This is based on feedback from national trade organisations.

2.9 Figure 2.4 shows the percentage of unit-linked life insurance (our proxy for Type 1) as a proportion of the total life insurance market. Due to a lack of data availability we are not able to show unit-linked products as a share of the four types of life insurance investment products we cover within the scope of this study. Therefore, although Type 1 products in most Member States seem to account for the largest proportion of PRIPs, it may be that in some Member States the proportion of the total life insurance market represented by PRIPs is greater than might be assumed by examining data relating to unit-linked life insurance alone.

2.10 The importance of this point is difficult to interpret. The percentage of the total life insurance market that unit-linked life products represent varies significantly across Member States. As seen in Figure 2.4 below, in Ireland, Luxembourg and Cyprus this class of investment product accounted for over 70 per cent of all life insurance premiums. In contrast, such products made up a far smaller proportion of the markets in Belgium, Bulgaria, Italy, Malta and Austria. With the exception of Italy and Spain, in which Type 4 products are the most widely marketed, it is not clear in these markets (as, indeed, is the case in those where we understand Type 1 products to be the dominant local form of life insurance investment product) what proportion of the remainder might be allocated to Type [2,] 3 or 4 products or to non-investment types of life insurance product. When looking at our selected sample of twelve Member States, it can however be noted that unit-linked life insurance investment products have the most significant share of the life insurance markets in Luxembourg and Estonia.

Figure 2.4: Percentage of Unit-Linked Life Insurance Investment Products as Share of Total Life Insurance Premiums, 2008



Source: Questionnaire response and websites of national supervisor and CEIOPS Statistics 2008 (*).

Note: Chart data refer to unit-linked life insurance as a proportion of all life insurance premiums, not just premiums related to the four PRIPs types used in our study. Such a breakdown is not possible given the data available to us.

2.11 In general, Type 3 and Type 4 products appear to have a marginal presence in most Member States.[24] Stakeholder engagement indicated that France, Germany, Italy and Spain are exceptions, though there may be others, for example in Member States outside our sample where we did not engage directly with stakeholders. While Type 3 products have a near negligible presence in Spain and Italy, Type 4 or 'with profits' products are fairly common in both Member States.[25] Type 4 products also have some presence in France, with a trade body suggesting that 17 per cent of the market consisted of these products in 2008. Type 2 products also do not appear to be common among many Member States. Feedback from stakeholders, including our company questionnaire, suggests that these products, where they do exist, are often considered similar to Type 1 and are seldom discussed distinctly.

[24] According to our feedback from stakeholders and judging from the dearth of available data or information on these types.

[25] According to industry sources in Spain 88 per cent of the life insurance market is traditional life insurance products with a guaranteed rate of interest. Of this, 20 per cent are 'with profits'.

2.12 It is notable that unit-linked investment products have a relatively small presence in some of the largest life insurance markets, such as France, Germany and the UK. Part of the reason may be due to the definitions used by authorities and industry in drawing together data. In Germany, life insurance products can often overlap with pensions products, and thus may not meet the definition of unit-linked in the Life Insurance Directive. Unit-linked products are also less dominant in Germany relative to Types 3 and 4 (however, index-linked products are marginal, seemingly only offered by a small number of operators). A similar situation appears in the UK, where the majority of the linked life insurance business is made up of linked pensions, which again would not be captured within the definition of unit-linked.[26]

2.13 In France, according to feedback from stakeholders including both national trade associations and individual insurance firms, eurofunds are among the most commonly sold life insurance investment product. According to a French trade body, eurofunds can meet the requirements of our Type 1 (100 per cent of the contract is linked to the fund) or our Type 3 (only a part of the contract is linked to the fund) products. However, no eurofunds (even those meeting our Type 1 requirements) are termed 'unit-linked' by the French regulatory authorities and this is likely to explain the relatively low proportion of unit-linked products in France shown in Figure 2.4 above.

2.14 Information from a trade body indicates that of the entire French life insurance market in 2008, 17 per cent was made up of Type 4 products and the rest (83 per cent) made up of Type 1 and Type 3 (which include both eurofunds and the French-definition of unit-linked). Data from the national supervisor indicates that unit-linked products account for 14 per cent of the whole market (as shown in Figure 2.4).

2.15 Given the difficulties that we thereby face in assessing the size and distribution of the markets for type 1 to 4 products, it may be worth trying to grasp the relative significance of the various product types from a different angle, by looking at the product offerings of individual firms. Among all the companies responding to our questionnaire that sell life insurance, 87 per cent sell Type 1 insurance products. Just over a third sells Type 2 and a similar proportion sell Type 3. A greater proportion — 55 per cent — reported that they sell Type 4, while sales of "other" life insurance products were reported by 39 per cent. However, the availability of products for sale speaks to diversity of choice only, not the volume of sales.

2.16 The above discussion provides a high-level overview of the significance of the four product types across Member States. As noted, the available data are not sufficient to enable us to provide a comprehensive breakdown of the relative market shares of each product type in each Member State.

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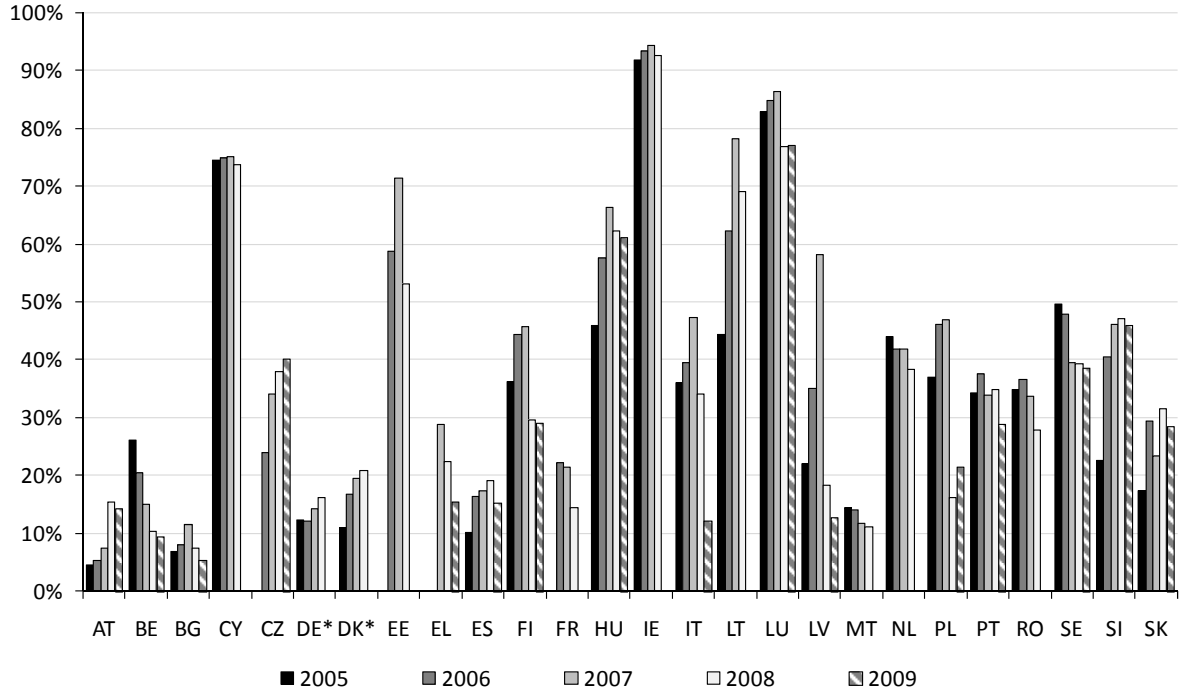
[26] A study from the Centre for Risk and Insurance Studies shows in 2008 new business APE in the insurance industry (annual premium equivalent a combined measure which is new annual premium plus 10 per cent of single premiums) was made up of approximately 25 per cent linked life insurance and 55 per cent linked pensions: Centre for Risk and Insurance Studies (2009) 'The UK with-profits life insurance industry: a market review', Nottingham University Business School.

2.17 However, we do not feel this necessarily detracts from our analysis. Indeed, as discussed below, current regulation does not differ substantially across product types, and in most cases both firms and supervisors in our sample could make no meaningful distinction between product types when discussing the costs and wider impacts of the new regulations.

Figure 2.5: Annual Unit-Linked Life Insurance as a Percentage of Total Life Insurance Premiums, 2005-2009



Source: Questionnaire responses from national supervisors or their websites.

2.18 Overall, most Member States experienced an increase in the proportion of unit-linked life insurance policies up until 2008. Exceptions here include Belgium and Sweden where the proportion of unit-linked life insurance policies has declined quite significantly since 2005. The fall in Sweden is most likely due to the performance of endowment insurance (which is included in the unit-linked definition), which declined in 2006 due to low interest rates and, more significantly, in 2007 due to a change in the tax rules.[27]

2.19 As with all life insurance, many markets declined in 2008, with Estonia, Finland, France, Latvia and Poland being the most noticeable (where unit-linked life insurance as a proportion of all life insurance fell by between 25 per cent and 60 per cent). In some Member States the share of unit-linked policies continued to fall after a substantial recovery of the whole life insurance market after 2008. This corresponds to information

[27] Swedish Insurance Federation Annual Reports 2006 – 2009.

given by a number of survey participants who note that demand for these products has been negatively affected by the financial crisis and an associated increased risk aversion of customers.

Distribution channels

2.20 Information about distribution channels is available only for the life insurance market as a whole and it is not possible to break this down across individual product types or to distinguish between life insurance as an investment and life insurance generally. That said we do not believe that the distribution channels of our four product types will differ significantly from each other. This is supported by the fact that in our discussions with trade bodies, firms and other stakeholders on distribution channels, a distinction was only occasionally made by respondents between our different product types or in comparing life insurance as an investment and life insurance generally.

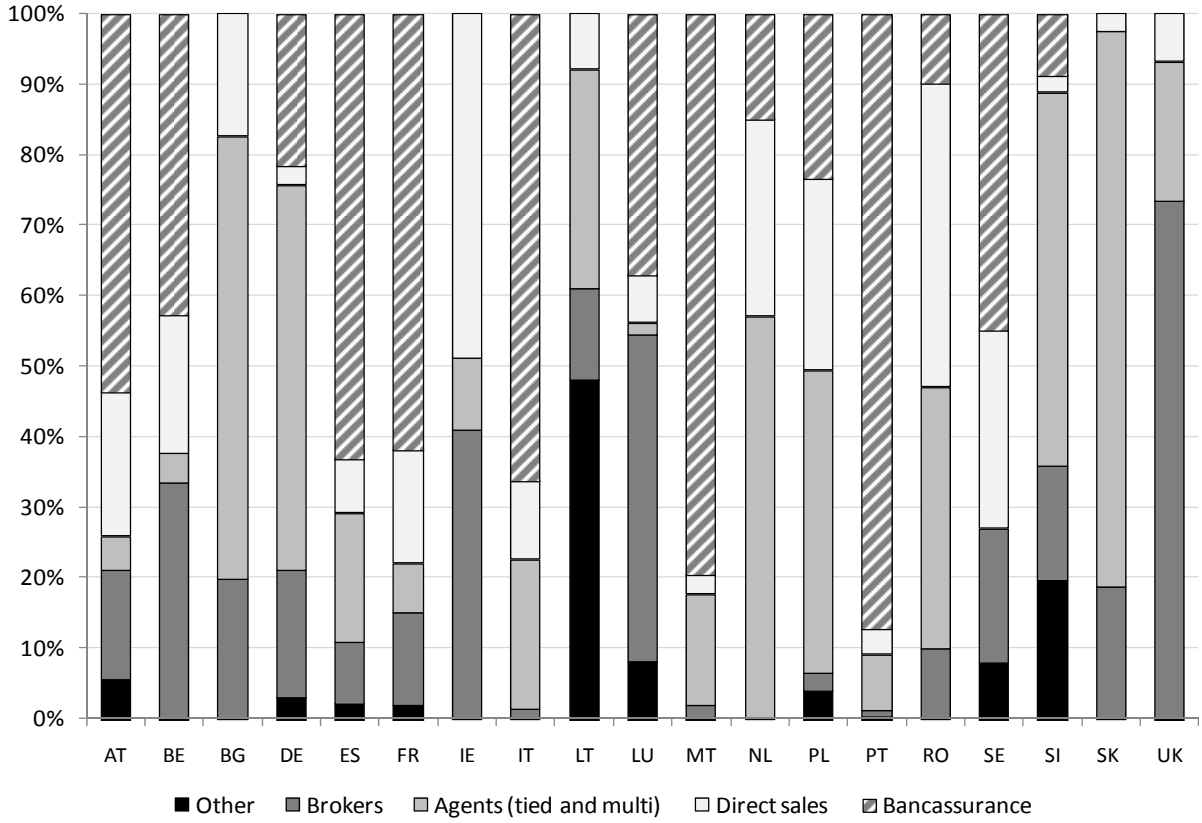
2.21 Life insurance is distributed via a number of channels in the EU. Bancassurance is one of the more common channels, along with the use of tied agents.[28] The bancassurance channel accounts for over 50 percent of the distribution in Austria, France, Italy, Malta, Portugal and Spain (see Figure 2.6 below). According to feedback from industry representatives bancassurance also plays a major role in Estonia, accounting for 80 per cent of distribution.[29] Meanwhile tied agents represent over 50 per cent of distribution in Bulgaria, Germany, the Netherlands and Slovakia.

2.22 By contrast, in the UK independent brokers are responsible for over 70 per cent of distribution (only Luxembourg and Ireland come close to this, at a little over 40 per cent being distributed through this channel).

[28] A tied agent is an intermediary that only offers products from specific insurance undertakings or banks with which they have agreements. They can either be sole or multi-firm agents. In contrast, brokers or independent financial advisors have no contractual agreements with any specific insurance carriers or banks. They offer independent advice on financial matters to their clients and recommend suitable financial products from a wider range of the market.

[29] According to interview with industry representatives.

Figure 2.6: Distribution Channels for all Life Insurance, 2007



Source: CEA (2010) 'CEA Statistics No. 39 Insurance Distribution Channels in Europe, Data from 2007. Data on distribution channels is only available for the presented selection of Member States.

2.23 As we have noted above, a distinction in distribution channels between product types has not generally been made. However, we are aware that that in Italy and Belgium bancassurance plays a more significant role in the distribution of unit-linked products (which we have taken above as a proxy for Type 1 products) than for life insurance in general. The share of bancassurance in the distribution of unit-linked in Italy was 91 per cent in 2006 (against about 70 per cent for all life insurance) and 76 per cent in Belgium (against just over 40 per cent for all life insurance).[30]

2.24 The distribution channel is likely to have an impact on the relative costs of adapting to the proposed new selling rules. An institution that is already familiar with MiFID, such as a bancassurer, will most likely experience lower costs of adaption than those channels dealing with a narrower range of products. This could be driven by a number of factors:

[30] CEA (2010) 'CEA Statistics No. 39 Insurance Distribution Channels in Europe.

(a) The bank arm would have already implemented MiFID, and so IT and other systems already exist to be extended to the extent that is required (it is implicit in this thought that any "MiFID-style" rules very closely follow MiFID).

(b) If the sales team is located within the bank, it is likely (but of course not inevitable) that those individuals would be advising on and/or selling a range of investment products, including some that are covered by MiFID itself. Indeed, according to the feedback we received from individual companies, some firms have voluntarily extended MiFID to cover life insurance investment products.

2.25 In similar fashion, an independent financial adviser would normally cover a range of investment products.

2.26 The types of products companies sell could affect both the actual costs they would face and their ability to accurately estimate these costs in advance.

2.27 As discussed above, the costs to each Member State of adapting to the new regulations may be influenced in part by the relative weight of distribution channels, with (for example) markets in which a large proportion of insurance products are distributed by bancassurers likely to face lower costs than those where direct sales are more common.

2.28 Table 2.1 below groups the countries for which data are available into those with main distribution channels of bancassurance, intermediaries and direct sales, as well as a fourth category of mixed where no distribution channel has a clear majority share (i.e. over 50 per cent). As noted, it is likely that those Member States where bancassurance is the main distribution channel will incur lower costs than other Member States; likewise for brokers that cover a wide range of investment products (i.e. not those agents tied to one or a few life insurance products).

2.29 Clearly there may be some overlap, since bancassurers can either sell their products via intermediaries or via direct sales. The primary aim here, however, is to capture any broad differences there might be in the company's familiarity with MiFID and the types of firms that are likely to be most affected in individual Member States.

2.30 Information on the distribution channels used within a Member State has contributed to our aggregation of the costs of the new regulations from our sample Member States to the EU level. However, other factors, such as the extent to which MiFID is already applied at the firm and national level, are likely to have a significant influence on the costs also. This is discussed in more detail in Sections 3 and 4 and Appendix 2.

Table 2.1: Member States by Main Distribution Channel

Direct sales	Intermediaries	Bancassurance	Mixed
Ireland	Bulgaria	Austria	Belgium*
	Germany	France	Lithuania
	Netherlands	Italy	Luxembourg
	Slovakia	Malta	Poland
	Slovenia	Portugal	
	UK	Spain	
		Sweden	

*Source: CEA (2010) 'CEA Statistics No. 39 Insurance Distribution Channels in Europe, Data from 2007. Note that data for nine Member States are not available. * To the extent that "unit-linked" products are representative of Types 1–4 in the Belgian market, then Belgium could be re-classified as "Bancassurance" as described at 2.23 above).*

Regulatory framework

2.31 A potentially significant influence on the incremental costs of complying with any new provisions would be the existing regulatory framework in each Member State. The existing framework's level of alignment with the proposed content of any new provisions would determine the scale and nature of any changes that would need to be made in order to comply with the proposed provisions. Figure 2.7 below summarises the national regulatory frameworks in terms of how closely they are aligned to MiFID in terms of suitability and appropriateness tests, disclosure of conflicts of interest, and disclosure of inducements for the four types of insurance investment products that form the focus of this study.

2.32 In order to calculate the scores for each Member State values were attached based on national supervisors' responses to the questionnaire regarding their current regulatory framework. In each case responses were scored to reflect how closely they complied with various aspects of the three types of provisions of MiFID of interest to this study. The scores allocated for each of the individual elements of the three overarching provisions were as follows: a maximum possible score of two for signalling that such a provision was in place and that it was modelled on the provisions of MiFID. If it was something similar but not modelled so closely on MiFID, then a value of one was allocated, and if it was not anything like MiFID a zero was allocated. As such, the regulatory score does not reflect whether or not a product is regulated at all but simply the alignment of the existing regulation with MiFID — and hence the regulatory gap in order to align with MiFID.

2.33 Since each of the three provisions contains multiple elements we have broken them down further. We sub-divided "suitability and appropriateness" into four discrete aspects and so this is scored out of eight,[31] conflicts of interest have been broken down into three

[31] As noted earlier the application of the appropriateness test depends on the experience of the investor as well as the complexity of the product. Though we do not here make any assumptions as to the classification of PRIPs in terms of being labelled as complex or non-complex products, for ease and consistency we have assumed that the appropriateness test

separate actions allowing a maximum of six points, and inducements into two actions allowing a maximum of four points. As such the maximum score any Member State can achieve is 18. A score of 18 would therefore indicate that the Member State already applies MiFID style regulation in all three areas.

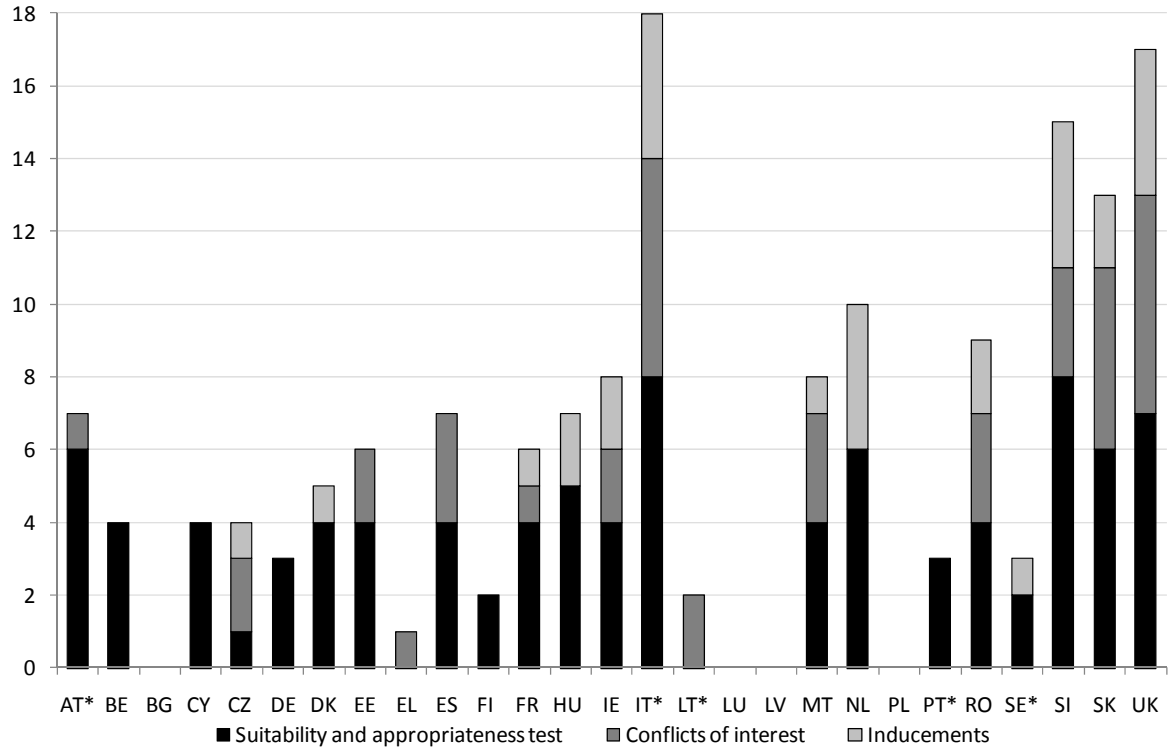
2.34 It is important to note that while this approach can be useful to create an overall picture of the level of alignment and the scale of the regulatory changes that would need to occur, this is a very rough tool based on subjective information (one person's interpretation of "similar" may vary dramatically from someone else's). Furthermore, the scores only include national regulation and do not take into account more informal industry codes of practice or voluntary adherence to MiFID that may result in some firms implementing MiFID-type selling rules. This ensures that the comparison is on a like-for-like basis only. The existence of these industry codes might somewhat distort the regulatory picture for some Member States, and we discuss wherever relevant in the sections that follow.

2.35 Figure 2.7 below presents the regulatory frameworks across EU27 Member States for life insurance products. In a few Member States regulation differs according to whether products are sold by a life insurance company or a life insurance intermediary. This issue is discussed in more detail in section 2.43 below, and where it occurs here we have used the overarching regulatory score across both firm types. This overarching score is calculated by taking the higher of the two firm type scores for each provision, where these differ. In subsequent sections, when we consider individual firm types in isolation, the relevant regulatory scores for each firm type are used.

2.36 The regulatory score also differs in certain Member States across different types of products. Where this is the case we have applied the score for Type 1 products, since these tend to be the most commonly sold of the four Types.

would be applied across the board when attaching the regulatory alignment scores.Furthermore, in line with the MiFID regulation described in 1.26, we assume that the Appropriateness test only requires the gathering of information relating to the client's knowledge and experience.

Figure 2.7: Summary of Regulatory Frameworks for Life Insurance Products across Member States, relative to MiFID, 2010



*Note: * indicates regulation differs across products. The score for Type One is shown where this is the case. Differences in the regulatory score between intermediaries and life insurance companies exist in Austria, the Czech Republic, Finland, France, Malta, Slovakia, Slovenia, Spain and Sweden. The distinction is only marked, in the sense that the different types of companies fall into different regulatory groupings, in Malta, Slovakia and Slovenia.*

Source: Questionnaire responses from national supervisors

2.37 As shown in Figure 2.7, regulation in the majority of Member States already requires some form of suitability and appropriateness test that is at least broadly in line with the requirements of MiFID. MiFID-like rules regarding conflicts of interest and inducements are somewhat less widespread.

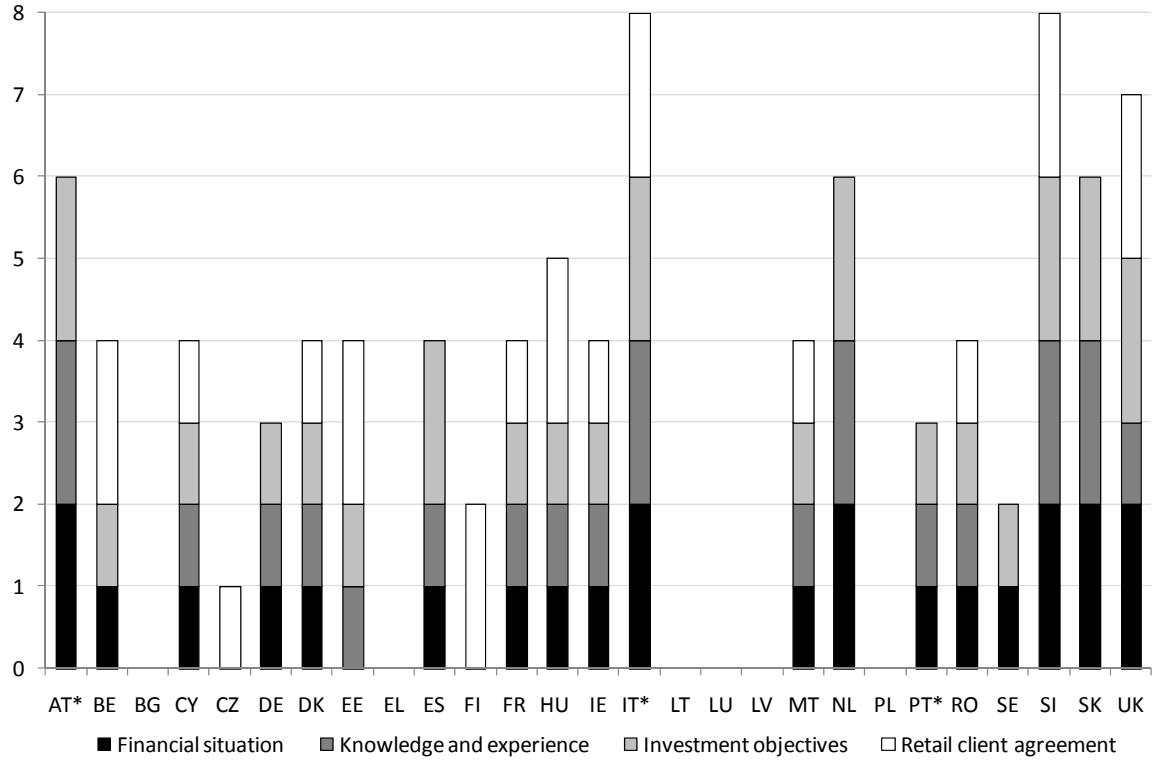
2.38 The UK and Italy's regulatory regimes mirror MiFID in terms of all aspects of the three conduct of business provisions of interest here.[32] It is likely, therefore, that the introduction of MiFID-like selling rules to the four types of life insurance investment products will not result in large changes in these countries. One exception is with Type 3 in Italy — no regulatory score was given for this product as, according to the Istituto per la

[32] In Italy, there is some ambiguity regarding the application of these regulations to Type 3 and 4 life insurance products. Information obtained from CONSOB indicated that these two types are covered by provisions consistent with MiFID, however responsibility for these products appears to officially lie with ISVAP. ISVAP was unable to provide a response for our Type 4 that could be readily interpreted in relation to the assumptions in this section, and did not provide information on Type 3. We understand that some regulations apply to all life insurance products, but a market participant indicated that, in practice, standards in line with MiFID requirements are not always achieved for Types 3 and 4.

Vigilanza sulle Assicurazioni Private e di Interesse Collettivo (ISVAP), this product type is not sold in Italy.

2.39 We have also broken down the responses into the three different areas of MiFID in Figure 2.8 to Figure 2.10 below. It must be noted that feedback from market participants has indicated that in Sweden an industry code of practice means that adherents to the code currently follow practices very similar to the MiFID conduct of business rules of interest to this study. This is not reflected in the charts below as these relate only to formal regulation.

Figure 2.8: Summary of Regulatory Frameworks for Life Insurance Products across Member States, relative to the Suitability and Appropriateness Test under MiFID, 2010



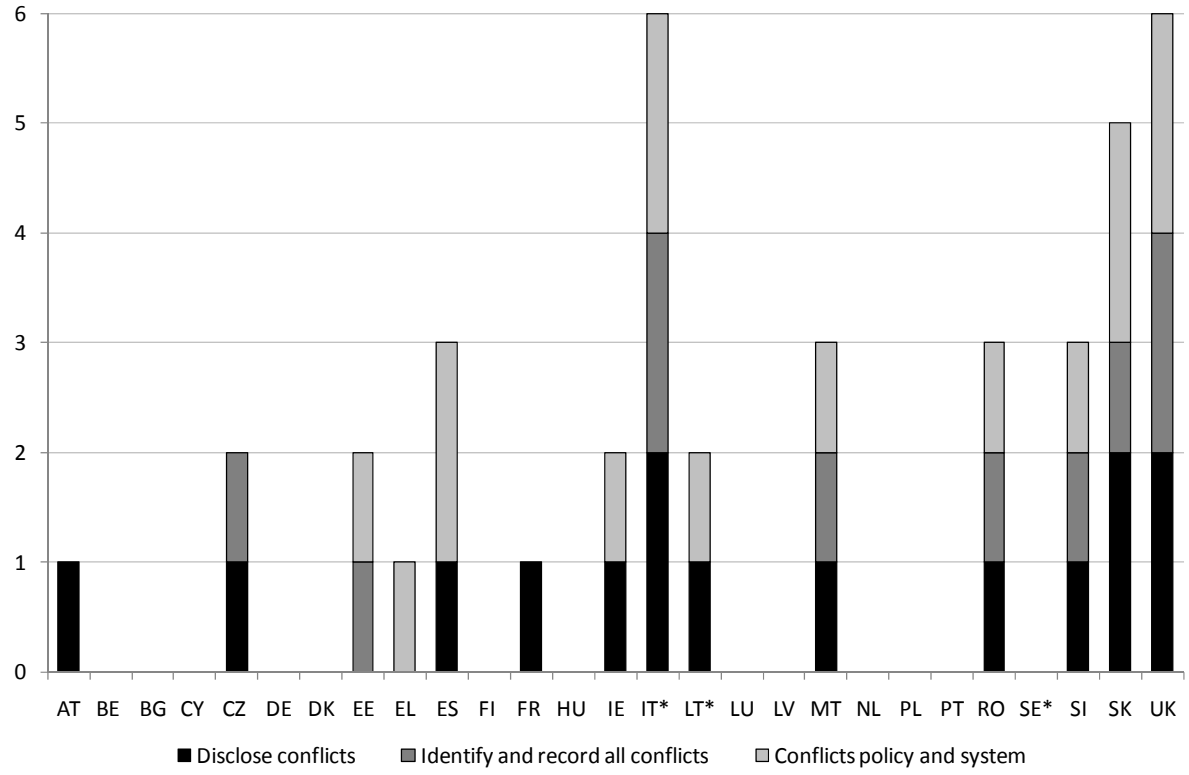
*Note: * indicates regulation differs across products. The score for Type One is shown where this is the case*

Source: Questionnaire responses from national supervisors

2.40 As in Figure 2.8, Italy and Slovenia have been assigned full scores in all four components of the suitability and appropriateness test and retail client agreement that we identified, with the UK meeting all components save the appropriateness test. Austria, Netherlands and Slovakia have in place provisions for all the requirements save a written retail client agreement. Countries such as France, Denmark and Romania reflect partially all four components of the test, while the current regulation in countries including Bulgaria, Greece, Luxembourg and Poland do not embody any of the MiFID suitability and appropriateness principles.

2.41 Fewer countries have regulations which mirror the MiFID conflict of interest provisions (see Figure 2.9). The regulation in Italy, UK and Slovakia are the most reflective of this provision overall. Disclosing any relevant conflicts of interest to clients is the most common component in this area and is present in the majority of states which had some similar conflict of interest rules in place, with the exception of Estonia, Greece and Lithuania.

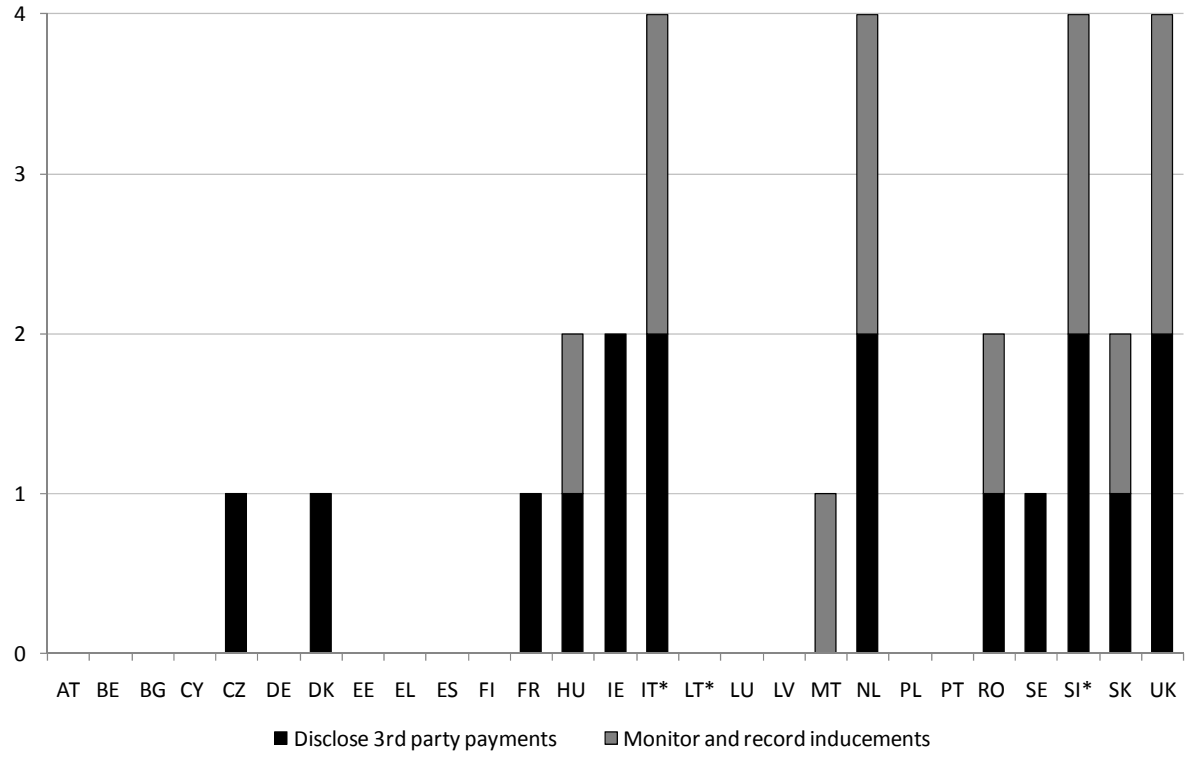
Figure 2.9: Summary of Regulatory Frameworks for Life Insurance Products across Member States, relative to the Conflicts of Interest provisions under MiFID, 2010



*Note: * indicates regulation differs across products. The score for Type One is shown where this is the case*

Source: Questionnaire responses from national supervisors

Figure 2.10: Summary of Regulatory Frameworks for Life Insurance Products across Member States, relative to the Inducements provisions under MiFID, 2010



Note: indicates regulation differs across products. The score for Type One is shown where this is the case*
Source: Questionnaire responses from national supervisors

2.42 Provisions relating to inducements, including notably their disclosure, are also less common than suitability and appropriateness checks across Member States. Where a regime is in place in relation to this, the monitoring and recording of inducements is often not a complementary requirement.

Differences across product and company type

2.43 According to the responses to the survey sent to supervisors, regulation differs very little across the four life insurance investment products defined for this study, and only in Austria, Portugal and Italy is the regulation not largely consistent across all products. These differences in regulation across products are very minor, however, and only ever apply to part of the three provisions.

2.44 In Austria, whilst Type 1 and Type 2 products (unit- and index-linked) carry the requirement for the seller to gather information about the customer's financial position, knowledge and experience, this does not apply to Type 3 and Type 4 products.

2.45 Portuguese regulation for all four types of life insurance product does not reflect MiFID for the large part. The exception is that Type 1 products are subject to suitability and

appropriateness provisions which are broadly similar to MiFID. As mentioned previously, no specific regulations are in place in Italy for Type 3 products due to their scarcity.

2.46 There does not appear be a pattern in the differences in the regulatory requirements across company types or distribution channel, and as such we have not included charts for this.[33] In general regulators apply similar requirements to direct sales as to intermediated sales. Examples of differences include Malta and Slovakia where intermediaries must satisfy MiFID type suitability and appropriateness tests and conflicts of interest rules while insurance companies are not required to do so. In Slovenia intermediaries are subject to regulations similar to all the MiFID style provisions, whilst insurance companies are not. Conflict of interest rules appear to apply to intermediaries and insurance companies alike in most Member States which apply them. Somewhat unsurprisingly, the disclosure of inducements rule is more widespread for intermediaries. And again, in some Member States — such as Denmark — commissions are indeed prohibited for independent insurance brokers (but not for tied agents).

Upcoming changes at the national level

2.47 As part of the counterfactual, it is important to examine the types of regulatory changes on the horizon at a national level as this will influence the costs of adjusting to any EU level action in the future. For instance, if a country has plans to align their national regulation with MiFID, the eventual cost for them would be lower if similar plans are introduced at the EU level.

2.48 As part of our survey, we asked supervisors whether they had any plans to reform the regulatory framework for any of the products which are the focus of this study. Five Member State supervisors informed us there was some upcoming regulatory change in the absence of any action at the EU level that would result in greater alignment with MiFID. The rest either told us of upcoming changes that did not signify great alignment to MiFID (three supervisors), or that they had no plans to alter the regulatory framework in the near future (seventeen supervisors). Of the latter group some Member States already have a high degree of alignment to MiFID for either life insurance-based investments or deposit-based structured products, such as Italy, Slovenia, Slovakia and the UK.

2.49 Most of the proposed changes (as outlined in the Table 2.2 below) would bring national regulations closer to MiFID or extend the scope of products covered by MiFID style requirements. While some of these plans may be independent of future EU-level regulatory action or about to be passed into law before any change at EU level, others depend on the outcomes which play out on the EU stage in relation to the ongoing MiFID discussions.

[33] Here, company types refer to our three groupings used throughout the report: insurance providers, banks and intermediaries, and thus any comments on company type will also refer, to a certain extent, to distribution channels.

2.50 Four member states (Belgium, Estonia, Finland, and Slovenia) already have established plans, which are common knowledge in the industry, to bring the distribution of life insurance investment products closer to MiFID. The Czech Republic also has plans to reform the regulatory framework in this way; however the timetable for these changes is dependent on the timetable of EU level discussions.

2.51 These proposed changes, by signifying a greater alignment to MiFID and to the proposed new provisions, would work to reduce the eventual costs experienced by these countries should MiFID-style provisions be developed formally at the EU level. On the other hand, confusion and additional bureaucracy stemming for reconciling new national changes with any new EU requirements would tend to increase the burden in the short term.

2.52 As an additional remark, if changes to align on a MiFID-style regime at national level would occur in the absence of steps at the EU level, then it may be argued that such changes should be assumed to be part of the counterfactual for such jurisdictions; however, given uncertainty in this regard, this factor has not been included in the analysis in this study.

Table 2.2: Summary of Upcoming Potential Regulatory Changes

Country	Description of upcoming change	Expected date of change
Belgium	Plans to extend the MiFID conduct of business rules to some types of life insurance investment products (yet to be determined) are under discussion. This would apply regardless of whether they are sold directly by insurance companies or indirectly through insurance intermediaries.	2011 initially but the deadline is uncertain due to parliamentary elections
Czech Republic	The disclosure and selling practice issues of similar investment product could be regulated in the same way regardless of the sector of origin. The scope in the insurance area would be based on profit-sharing (not only on unit/index-linked features of products).	It depends on the timetable at EU level
Estonia	Large-scale amendments concerning both the Estonian Credit Institutions Act and the Estonian Insurance Activities Act will be sent to the Parliament in the near future. If the amendment package is adopted, MiFID's suitability and appropriateness test will be applied to unit-linked life insurance and deposit-based retail structured products.	Near future
Finland	Change in the Insurance Contracts Act and Insurance Mediation Act that will require insurance companies and their agents and insurance brokers to take into consideration the experience in investing and the investment objectives of the potential policyholder choosing an investment product linked to an insurance policy. This regulation will apply to all kinds of life insurance policies. This has been required of the insurance companies, their agents and insurance brokers so far but now this requirement will be written into the law.	1 November 2010
Slovenia	Government has started procedure to amend existing Insurance Act where, among others, provisions regarding all costs charged to policyholder must be disclosed for all type of unit-linked or index-linked contracts.	2010
UK	The Retail Distribution Review (RDR) will primarily look to unbundle charges between product manufacturers and distributors of retail investment products by requiring distributors to disclose how much they charge for their services. The aim is to remove commission bias from advice on retail investment products and for consumers to know upfront how much advice is costing them and how they will pay for it. Firms will not be able to accept commission in return for recommending specific products. Firms offering independent advice will have to demonstrate that their recommendations are based on a comprehensive and unbiased analysis of the market, and that any product selection is made in their clients' best interests. However, if a firm chooses to limit its product range to certain investments or strategies, then the services it offers are restricted, and this should be clearly set out for customers.	2013

Source: Questionnaire responses from National Supervisors

Deposit-based Retail Structured Products

2.53 The information in this section has been drawn from Arete Consulting and the European Commission (based in turn on Arete's dataset). Arete Consulting offer the most comprehensive information on the structured product market, which it assembles through extensive contact with market participants. Those markets where Arete does not provide information are judged by it to be, as yet, of insufficient scale to justify the research effort. We have not found any evidence in the markets that we have examined to contradict this view.

Size of the structured product market

2.54 There are a number of forms that structured products can take (these forms are called wrappers) such as funds, notes, bonds, certificates and deposits. Whilst the focus of this study is on deposit-based structured products (as these currently do not fall within the scope of MiFID), much of the market information relates to the structured retail product industry as a whole.

2.55 The total outstanding amount invested across the EU at the end of 2008 was €678 billion, with total sales for 2008 reaching €179 billion.[34] Germany is the largest market in the EU in terms of annual sales (at €50.2 billion), followed by Italy, Spain and France.[35] In terms of outstanding amounts invested at the end of 2008 Italy has the lead (at €167.7 billion) followed by Germany, Spain, Belgium and France.

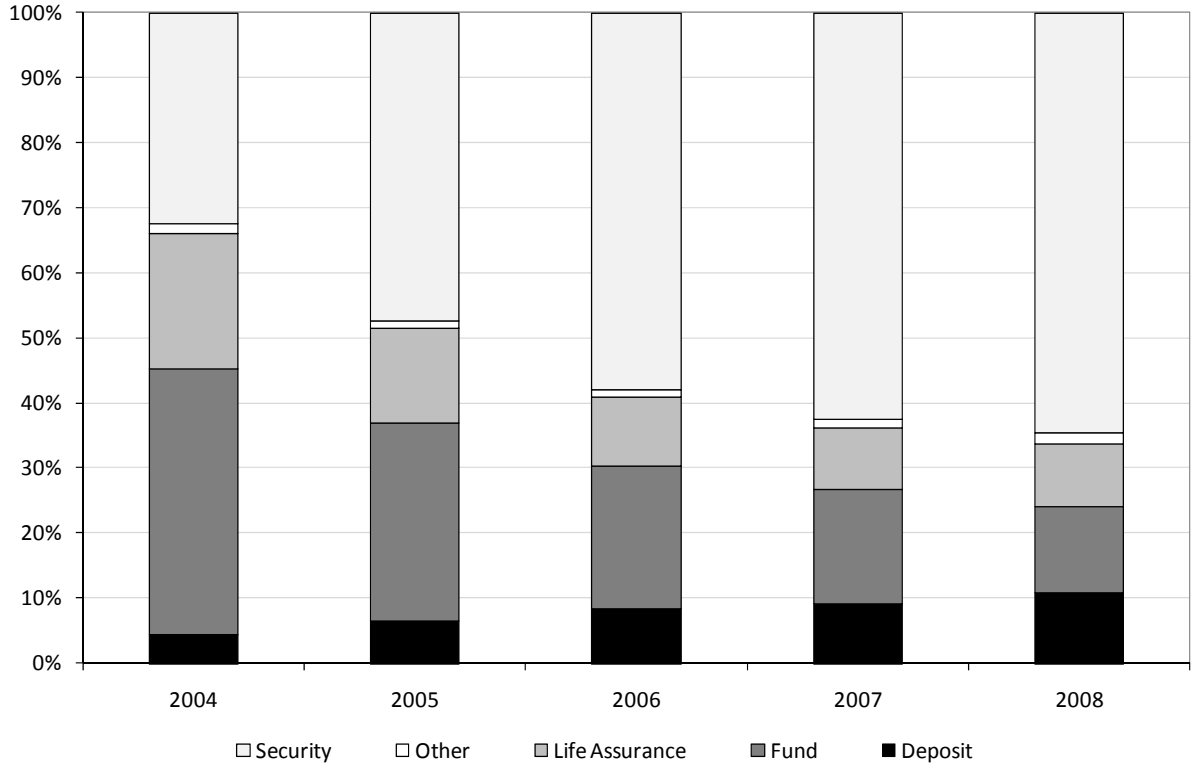
2.56 The dominant wrapper in Europe is the security,[36] which accounted for 59 per cent of total sales in 2008 (€106 billion). Deposit-based products — the focus of our work — hold only a small share of the market, although this has been increasing since 2004 along with the decline in securitised (in 2008) and fund-wrapped products, as shown in Figure 2.11 below.

[34] Data for the structured product markets comes from the European Commission (2008), representing 16 Member States. Member States not represented are Bulgaria, Cyprus, Estonia, Greece, Hungary, Lithuania, Luxembourg, Latvia, Malta, Romania and Slovenia. Arete does not publish data on these on the grounds of lack of market development. We judge it unlikely that these uncovered markets are significant, either individually or in aggregate.

[35] Spain and France have only recently overtaken Belgium, which suffered a 43 per cent drop in sales in 2008.

[36] This can be either in the form of a certificate, note or local bond.

Figure 2.11: Percentage of Gross Sales by Wrapper in the EU (2004 – 2008)



Source: Arete Consulting (2009) 'The European Structured Retail Product Market 2009 review management summary volume 1' These data only cover the 15 countries for which Arete collects data, these are: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Poland, Slovakia, Spain, Sweden, Switzerland and the UK

2.57 The relevant data on structured deposits provided by both Arete and the European Commission refer to structured products within a deposit wrapper. Arete describes structured products as "an investment product that provides a pre-defined return linked to one or more underlying financial prices, rates or indices. The product can usually be broken down into a number of separate financial instruments, one of which is a derivative product. In other cases it uses a derivative-based investment strategy to provide the return." Arete's deposit wrapper represents "bank deposits and savings accounts" to which a derivative is then attached.

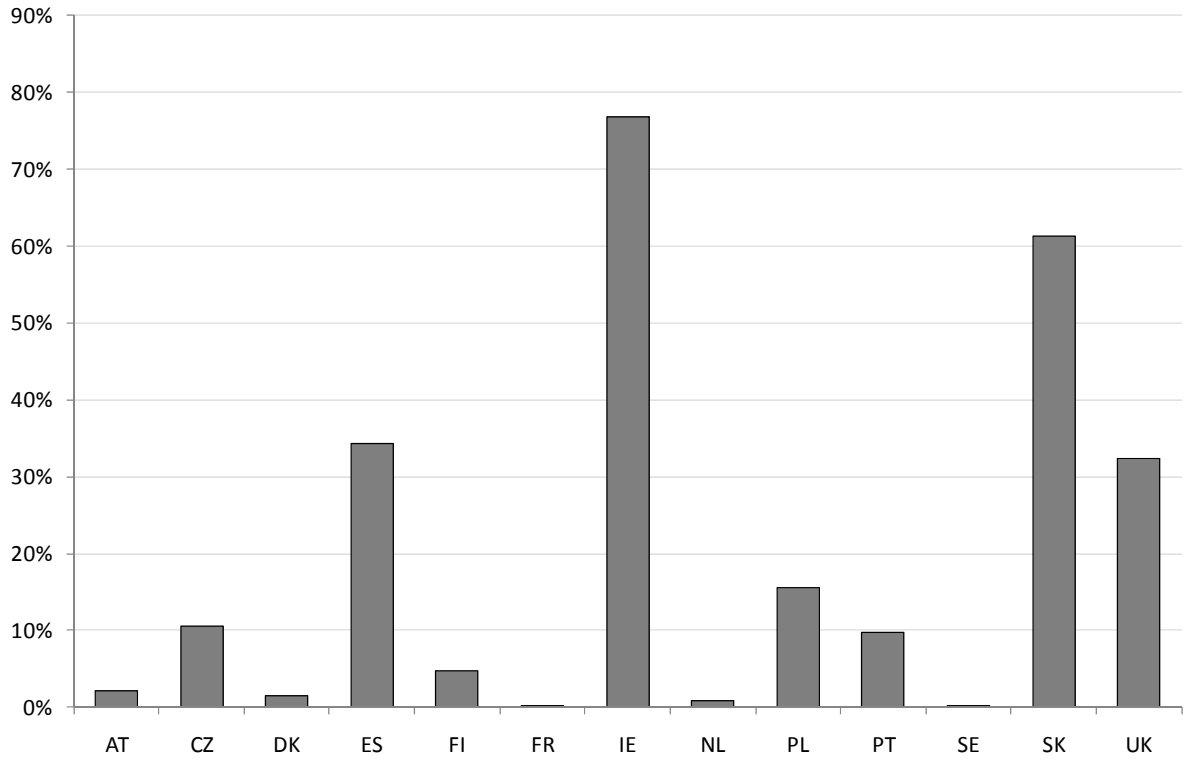
2.58 Deposit-based products accounted for approximately 12 per cent (€22 billion) of total sales of structured products in 2008. This is higher than the share in the outstanding amount invested, out of which deposit-based products formed just under eight per cent in 2008. Between 2004 and 2006, the compound annual growth rate (CAGR) of deposit-based wrappers was nearly 90 per cent.[37] This rate declined to just over 17 per cent in the period 2006-2008 though the growth remained positive. Securities experienced a

[37] Deposit based products increased from €4.12 billion in 2004 to €14.84 billion in 2006.

similar trend — a CAGR of 83 per cent between 2004-2006, slowing to 9 per cent between 2006 and 2008.

2.59 The importance of such deposit-based structured products within the structured product segment varies widely across the EU. Countries with a very significant share include Ireland, Slovakia, Spain and the UK, as shown in Figure 2.12 below. The Czech Republic, Portugal and Poland also have a higher share than many other Member States.

Figure 2.12: Deposit-Based Products as a Percentage of all Structured Products, 2008



Source: European Commission data, 2008. These data have been derived from Arete Consulting. Arete only gathers information on markets where it considers it commercially worth its while. The strong implication is that those markets not covered by Arete are relatively small or immature.

2.60 In Ireland, for example, 88 of the 119 products offered in 2008 were offered as deposit-based products either solely or in combination with another wrapper. In Slovakia deposit-based products have continued to attract the highest sales volumes, reaching a 69 per cent share in 2008 (up from 52 per cent in 2007).[38] In Spain, deposit-based products have long been a feature of the market, with the Cajas[39] using this wrapper for many years. Market reports suggest that, at least in large part, these are preferred by sellers as

[38] Information for this section taken from Arete Consulting (2009) 'The European Structured Retail Product Market: 2009 review'. Member State information may differ slightly to European Commission data due to collection methods.

they do not need to be registered with the local regulator, the CNMV, and there is also no need to file any documentation so they are a quick way to take a product to market.[40]

2.61 Per capita investments and sales give an indication of the penetration of structured products (in total) across Member States. The average invested in structured products per capita across Europe was €1,656 at the end of 2008, with on average €453 of sales per head in 2008. Of the EU Member States, Belgium had the highest average per capita investment with €9,167 per head of population, as well as the highest average per capita sales, at €1,181. The smaller Eastern European countries have the lowest per capita investments and sales (for example Czech Republic, Poland and Slovakia).

2.62 Specific to deposit-based products, Ireland had the highest amount outstanding per head of population at €696, with Spain responsible for highest sales per capita in 2008 at €353. Belgium, Germany and Italy did not sell any deposit-based products in 2008 based upon Arete's data; nor did they have any amounts outstanding.

Evolution of the structured product market

2.63 The European market for structured retail products has been significantly impacted by the financial crisis, with the total holdings of retail investors in all forms of structured products increasing by just under two per cent in 2009, compared to a five per cent increase in 2008.

2.64 The recent financial turmoil may help to explain the greater reduction in the growth rate of securities-based compared to deposit-based structured products between 2006 and 2008 (see Figure 2.11 above). The increased awareness and availability of deposit-protection since 2008, particularly in the wake of the collapse of the Icelandic banks, could further enhance the attractiveness of deposit-based products for retail customers, to the extent that these fall within the scope of such protection.

2.65 In the first half of 2008, as the first effects of the "credit crunch" were felt and stock markets began to decline, the markets for retail structured products continued to grow. According to Arete Consulting, the combination of rising volatility and declining interest rates saw demand for capital protected products such as deposit based structured products (which potentially may be able to offer both less risk than stock markets and better returns than cash deposits) expand across the region.

2.66 However, annual gross sales of retail structured products declined by an average of 21 per cent in 2009.[41] This masks the wide differences in growth in individual Member

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[39] Regional savings banks.

[40] New tax regulations have also played their part in the move to deposits. As of 1 January 2007, Spain introduced a flat 18% p.a. tax on investments regardless of term. This led to an increase in short term products that lend themselves to the structured deposit wrapper more than the fund wrapper.

[41] Arete Consultancy (2010), "An Overview of the Global Retail Structured Product Market and Outlook for 2010", 7th annual SRP Conference. Figures refer to tranche products only.

States. The UK for example experienced a 47 per cent growth while France saw a decline of 37 per cent. A rise in volatility in financial markets and a significant increase in investor risk aversion have been cited as the main drivers of the contraction.[42] Arete predict a modest recovery in 2010 with 8 per cent growth in the European market (against 9 per cent globally). It is noted, however, that Arete predicted (in 2008) a recovery in 2009 — in other words, such forecasts need to considered with due caution.

2.67 According to Arete Consulting, structured products are already well established across all the European retail markets that it covers and as such have the potential to grow in the future. Growth is also likely to be positively influenced by the ageing European population, as investors seek to preserve their investments in relatively less risky instruments (such as offered by many — but not all — structured products), whilst also looking for higher yielding investments once they retire. The perceived complexity of structured products may however operate as a countervailing force in regards to the overall expansion of the market.

Distribution channels

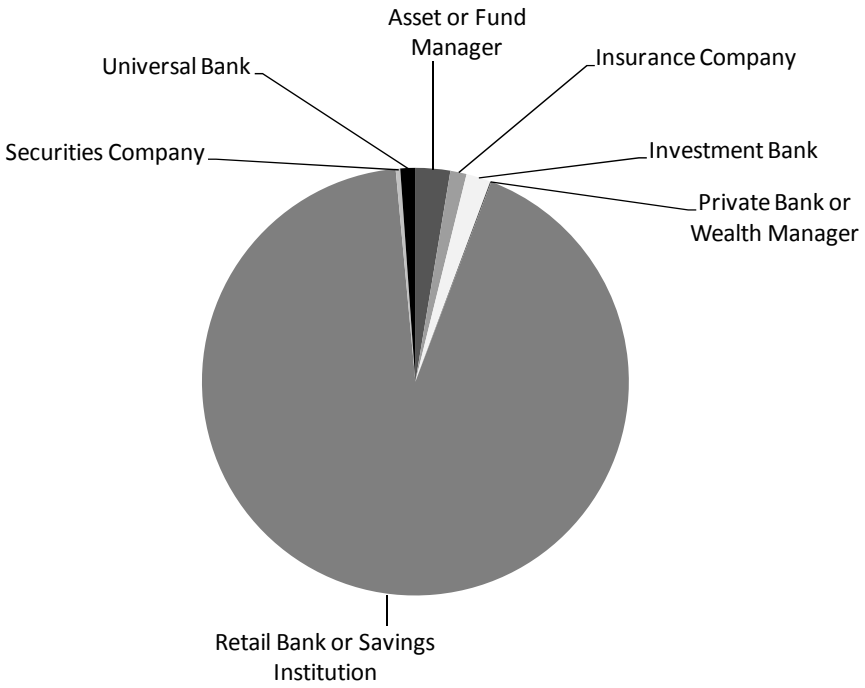
2.68 Major retail financial services companies across Europe typically offer some form of structured investment product. Product providers include retail banks, insurance companies, fund managers, post offices and other government or public owned entities (especially in Italy, France and the UK), investment banks and specialist structured products boutiques.

2.69 In the vast majority of cases, European investors buy their structured investment products from banks or the sales forces of insurance companies (including tied agent networks), much as with the distribution of insurance-based investments. Independent financial advisers (or brokers) hold a very small (two per cent), albeit increasing, share of the distribution. However, in some countries, like the UK, financial advisers hold a much larger proportion of the market and can even be the largest single distribution channel.

2.70 With regards to deposit-based investment products, however, the picture is simpler: the overwhelming majority (fully 92 per cent of sales in 2008) are provided by retail banks or savings institutions, as shown below in Figure 2.13.

[42] Arete Consulting (2009) 'The European Structured Retail Product Market, 2009 Review'.

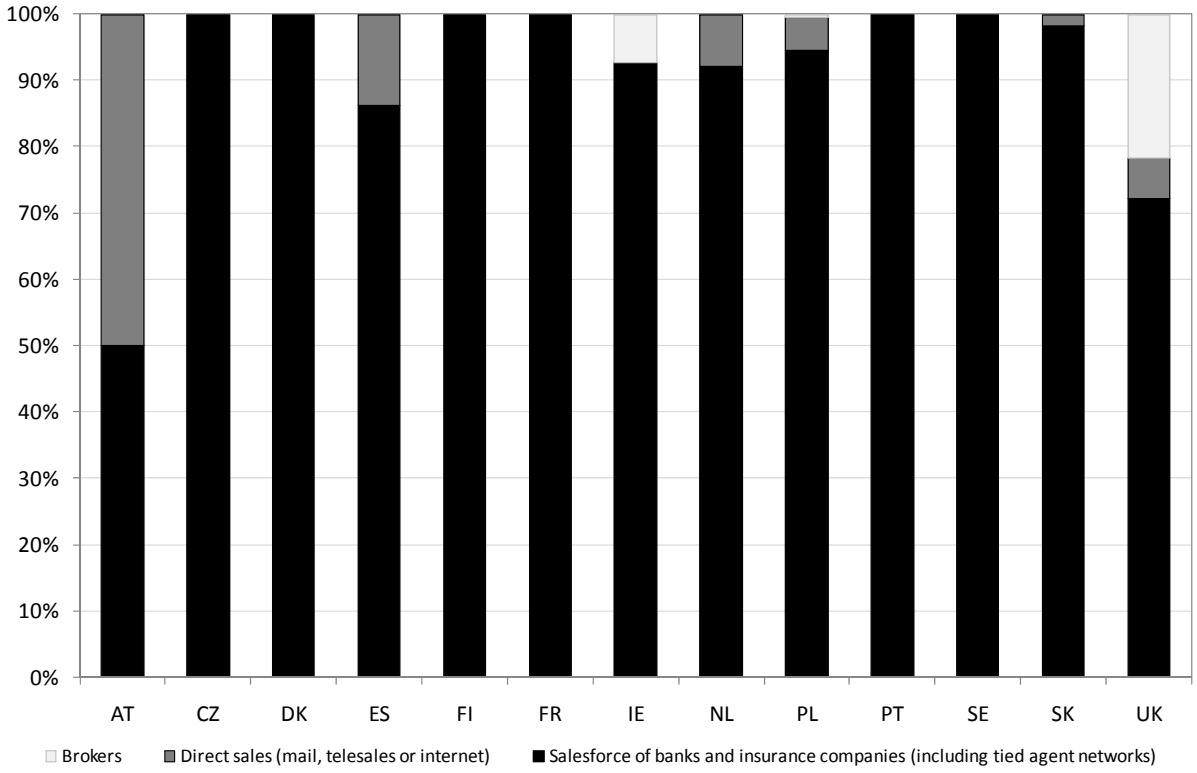
Figure 2.13: Sale of Structured Deposit-Based Products by Institution in the EU, 2008



Source: European Commission data, 2009

2.71 The European Commission data's decomposition of distribution is on a different basis to that available for life insurance investment products — in particular, it does not distinguish between tied agents and a firm's own sales staff. Deposit-based products are largely distributed by sales forces (via the retail banking network, in-house or through other tied network) as opposed to directly (i.e. via mail shots, telesales or the internet) or through a broker, (or independent financial advisor) as seen in Figure 2.14 below. However, some variations at the national level can be seen: the relative importance of financial advisors (just over 20 per cent) can be seen in the UK. The UK is again different in that while the majority of deposit-based products are provided by retail banks, asset and fund managers and insurance companies also play a role in the provision. Austria and Spain have more "direct" sales than other Member States, but sales forces still dominate overall.

Figure 2.14: Total Assets by Distribution Channel across Member States, 2008

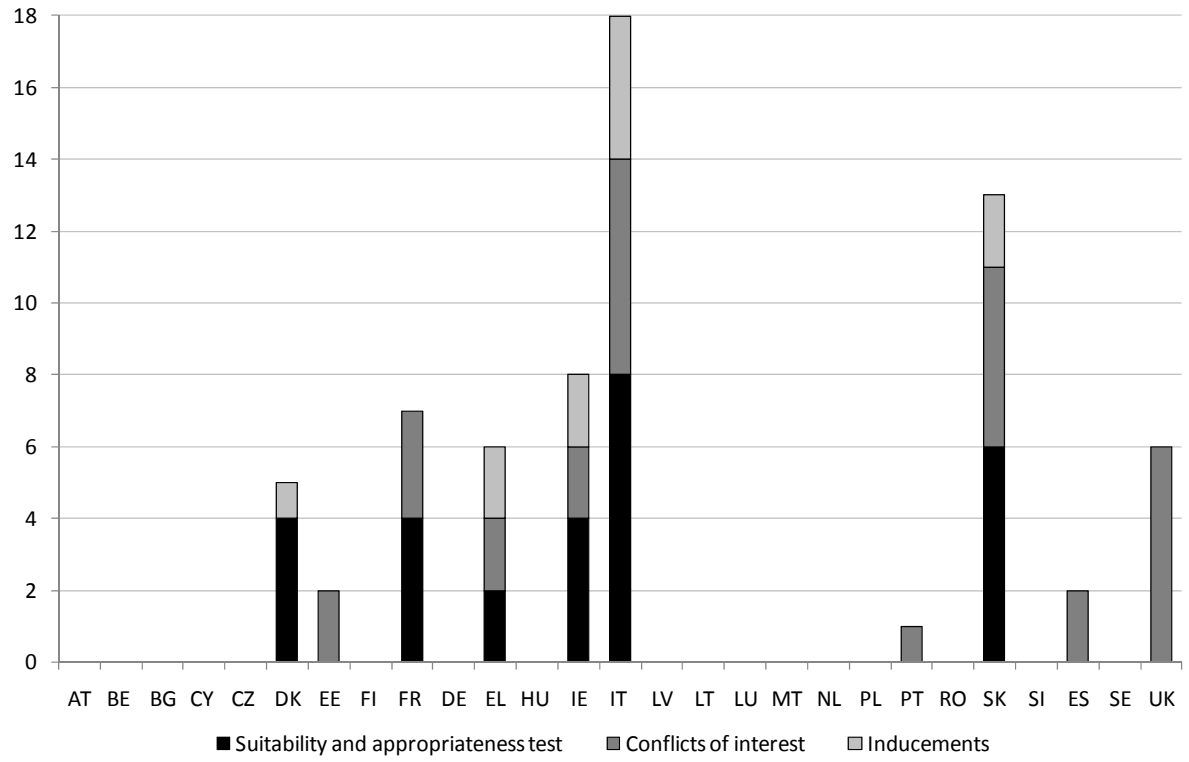


Source: European Commission data, 2009. Data on total assets as opposed to total sales is used to present a fuller data set.

Regulatory framework

2.72 The regulation of structured deposit-based products is much less widespread than that of life insurance investment products. We have found seventeen Member States which do not apply any regulation similar to the three areas of MiFID selling rules. On the other hand, Italy and Slovakia's regimes are most similar to MiFID, but only Italy's meets all of the provisions relevant to this study.

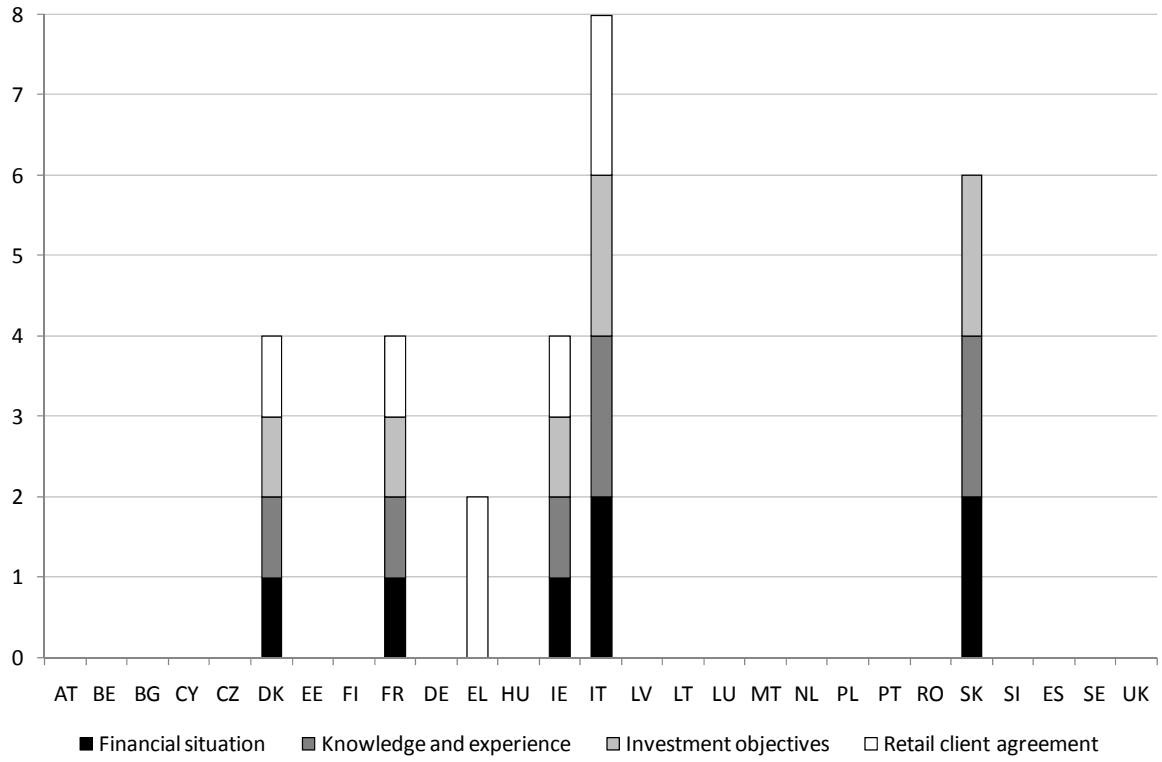
Figure 2.15: Summary of Regulatory Frameworks for Structured Deposits across Member States, relative to MiFID, 2010



Source: Questionnaire responses from national supervisors

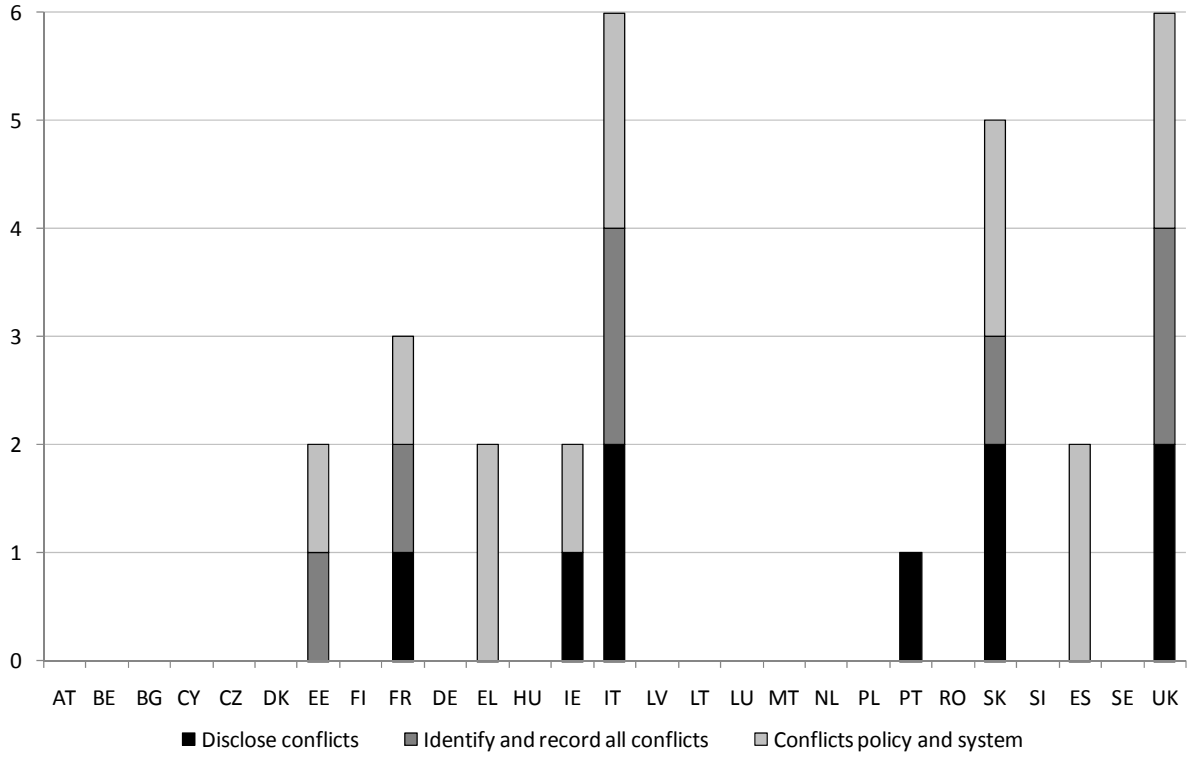
2.73 As illustrated in Figure 2.16 to Figure 2.18 below, regulations concerning the disclosure of conflicts of interest are the most common across the Member States.

Figure 2.16: Summary of Regulatory Frameworks for Deposit-Based Products across Member States, relative to the Suitability and Appropriateness Test under MiFID, 2010



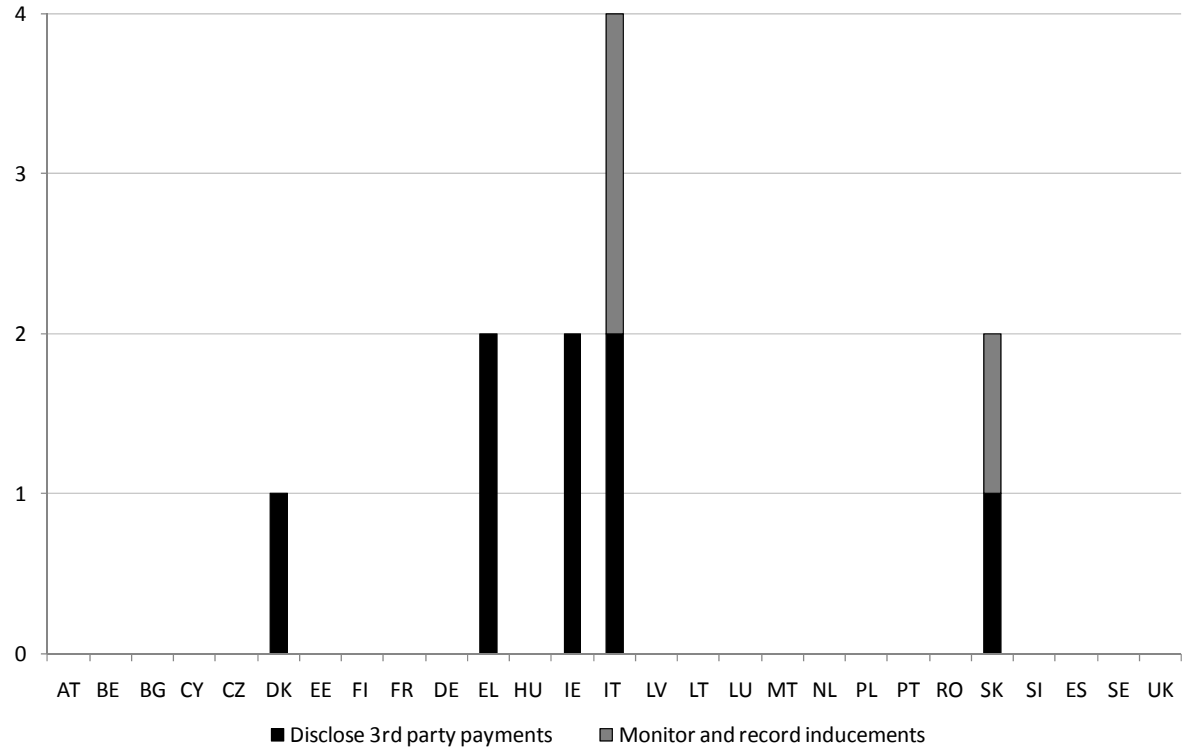
Source: Questionnaire responses from national supervisors

Figure 2.17: Summary of Regulatory Frameworks for Deposit-Based Products across Member States, relative to the Conflicts of Interest provisions under MiFID, 2010



Source: Questionnaire responses from national supervisors

Figure 2.18: Summary of Regulatory Frameworks for Deposit-Based Products across Member States, relative to the Inducements provisions under MiFID, 2010



Source: Questionnaire responses from national supervisors

2.74 The official regulation may mask the actual situation facing institutions selling these products in a number of Member States. As seen in Figure 2.13 and Figure 2.14, structured deposit-based products are predominantly sold through the in-house sales forces of retail and savings banks. As these institutions will be subject to MiFID in a number of other areas it is highly likely that the sale of structured deposit-based products will follow, at least in part, the same selling rules (applied by the firm under its own initiative) as those governing other investment product. In addition, evidence from certain stakeholders suggests that sales people selling structured deposit-based products may also sell a range of investment products and thus would be familiar with the provisions of MiFID.[43]

Upcoming changes at the national level

2.75 As set out earlier in Table 2.2, Estonia plans to extend aspects similar to MiFID to deposit-based structured products by applying suitability and appropriateness tests.

[43] For example 55 per cent of the companies we received information from as part of our stakeholder engagement process that sell structured deposits, also sell other structured retail products.

2.76 This would work to reduce the eventual costs experienced by these countries should MiFID be extended formally at the EU level. On the other hand, possible confusion or additional administrative burdens stemming from reconciling new national changes with any new EU requirements may increase burdens over the short term.

2.77 In addition, while some of these plans may be independent of future EU-level regulatory action or about to be passed into law before any change at EU level, others depend on the outcomes which play out on the EU stage in relation to the ongoing MiFID discussions.

3 THE ONE-OFF COST OF COMPLIANCE

Introduction

3.1 In this section we examine the potential one-off costs of complying with the proposed rules. This is based on the estimates provided to us by the 58 respondents as part of our questionnaire and structured interview programme in our sample of 12 Member States. The breakdown of these 58 companies by both the type of company and the regulatory grouping of the country in which they operate is provided in Figure 3.1 below (a full description of the respondents is provided in Appendix 1).

Figure 3.1: Breakdown of Quantitative Responses by Company Type and Regulatory Score

Regulatory group	Intermediaries	Life insurance companies	Banks	**Total**
Low	8	12	14	**34**
Med	5	6	1	**12**
High	5	2	5	**12**
Total	**18**	**20**	**20**	**58**

3.2 There are a number of factors that we might expect to influence the size of potential one-off costs, for example:

(a) *The size of the company* — this could affect the size of one-off costs in a variety of ways, for example we may expect larger companies to face larger one-off costs in absolute terms, though smaller companies may face relatively higher one-off costs as a proportion of their size. That said, larger companies may be better able, and therefore more inclined, to incur higher one-off costs in an attempt to reduce any ongoing cost increases. In contrast smaller, less cash rich companies would be less well placed to operate in this way, and may therefore face smaller one-off costs given their size (but higher ongoing costs).

(b) *The degree of current regulatory alignment with MiFID* — the more aligned a country's current regulation of the relevant products is with MiFID provisions, the smaller the one-off costs are likely to be for individual company's and thus for the country as a whole.

(c) *The proportion of the company's existing business already regulated by MiFID* — companies that are already subject to MiFID in other parts of their business may already have the necessary systems in place and will have a better understanding of the provisions which could result in lower one-off costs of transition. (Along similar lines, where voluntary industry codes are applied by a firm, or a firm itself has chosen to apply compliance systems and controls aligned to a MiFID standard, this would

reduce the costs of regulatory alignment more widely along these lines, so long as that alignment remains consistent with the internal compliance systems).

(d) *The dominant method of distribution of the relevant products in the country* — given the above the structure of the distribution channel in a Member State is likely to affect the aggregate scale of any one-off costs in a country, for example whether smaller intermediaries dominate or whether banks and bancassurers play a greater role in the distribution of the relevant products.

3.3 Within this context, we begin by examining the one-off costs on an aggregate basis, i.e. across all company types and across all Member States. We then consider differences and similarities between companies of different types and sizes.

3.4 In each case we first provide an overview of the average and range of turnover, operating costs, and the cost estimates for the companies under consideration in that sub-section. Given the diversity of the companies and the small sample size (particularly when sub-divided) we consider both the mean and the median values.[44] A more detailed description of the companies that provided information for this study is set out in Appendix 1.

3.5 The overview is followed by analysis of the costs, including an examination of the relationships between a company's operating costs and the one-off cost estimates, the cost estimates and the current level of regulatory alignment with the proposed rules, and the main drivers of the costs.

3.6 We conclude the section with a discussion of the main points that have arisen out of the analysis and provide estimates of the total one-off costs for the EU based on an extrapolation of the data collected. A detailed description of the extrapolation methodology is provided in Appendix 2.

3.7 It is important to highlight at this stage that the data used in the following analysis is as robust as possible given the nature of the exercise and the relatively small sample size. Identifying potentially distortive results such as outliers, however, is inherently difficult with a sample of this size and given the uncertainties associated with an *ex ante* exercise of this sort. As such all results, especially those that rely on sub-groups within the sample, must be treated with caution and we have not considered it appropriate to exclude specific high or low estimates from our analysis. This means that in some cases cost estimates will necessarily cover wide ranges. For a full breakdown of the results and the methodology employed in collecting the data please refer to Appendix 1.

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[44] If one imagines all the data points arranged sequentially, the "median" is simply the middle value in this series. Meanwhile the "mean" of a set of values is obtained by dividing the sum of all values by the number of them. Individual values out of line with the mass of a data set can lead to the mean being very different from the median. The "range" offers an insight into the breadth of the data.

General Findings

3.8 The sample of businesses that provided us with information on the potential one-off costs ranges from very large companies to very small, micro firms with only one employee. This is reflected in the range of the companies' turnover and operating costs (see Table 3.1 below). The mean turnover is €2.6 billion, however, with a median of €116 million the implication is that most firms have turnover towards the lower end of the range, whilst a few have much greater turnovers, dragging up the mean. Such a sample is technically known as "skewed" towards the lower end.

3.9 The same also appears true of the estimated one-off costs. While the range, in absolute terms, is relatively broad, the mean and the median indicate that the distribution of responses is skewed towards the lower end of the one-off cost range.

3.10 Since the size of the company may be expected to affect the scale of the one-off costs incurred in absolute terms, it is important to control for firm size. There are two indicators of company size that we gathered information on; one is the company's annual turnover and the other is the company's operating costs for the last financial year. Controlling for differences in company size to allows us to create standardised estimates of the one-off costs.

3.11 The skewed pattern is also evident in these size controlled estimates of the one-off costs, though one-off costs as a percentage of operating costs are slightly higher than when considered as a percentage of turnover. On the basis that turnover can, in general, be expected to exceed a company's operating cost the disparity between the size controlled estimates is as we would expect; one-off costs as a percentage of turnover will on the whole be smaller than the one-off cost as a percentage of operating costs. (The bigger any difference the lower the company's operating costs compared to turnover and the smaller the difference between the percentages the smaller the difference between the company's turnover and operating costs.)

Table 3.1: Overview of Turnover, Operating Costs and One-Off Cost Estimates for all Respondents

	Turnover	Operating Costs	One-off Cost Estimate	One off costs as % of turnover	One off costs as % of operating costs
Mean	€ 2,626,052,708	€ 1,102,378,420	€ 786,050	1.45%	2.14%
Median	€ 116,350,000	€ 39,000,000	€ 100,000	0.04%	0.14%
Range	€75,448- €31,300,000,000	€28,293- €19,650,000,000	€0- €12,000,000	0%-23.8%	0%-25.4%

3.12 Throughout the rest of this section we use operating costs as a proxy for firm size in the analysis.[45] Whilst other choices are possible, given that operating costs offer a more relevant perspective when analysing ongoing costs (which will typically be expressed in the financial reporting by firms within their operating costs), for consistency we use operating costs as the size indicator when examining one-off costs too.[46] Furthermore, since past studies have typically expressed compliance costs relative to operating costs, this allows for more effective benchmarking of the results obtained. This choice should not bias the results in any way.

3.13 It is also important to highlight the existence of potential outliers in our sample. Throughout the analysis certain companies may appear to be outliers. However, given the limited sample size, we have been unable to discount these companies as outliers (in so far as they represent anomalies or deviations from the potential "true" outcome), and have therefore chosen not to discount them, to avoid inadvertently distorting the true picture. This inevitably means however that some of the results must be approached with caution, and show a rather wide range.

The relationship with firm size

3.14 Aside from the regulatory environment, it is possible that the size of the company itself may have an effect on the scale of any one-off costs incurred.

3.15 Employing a simple regression analysis we can determine that the size of the company (in this instance proxied by the company's operating costs), has a significant positive effect on the size of the one-off costs the company faces in order to comply with the relevant MiFID provisions set out in section 1.[47] As illustrated in Figure 3.2 below, simple regression analysis indicates that variance in operating costs explain 75 per cent of the variance in one-off costs. In this simplified case, for every euro that operating costs increase, the one-off cost of compliance would increase by €0.0005.[48]

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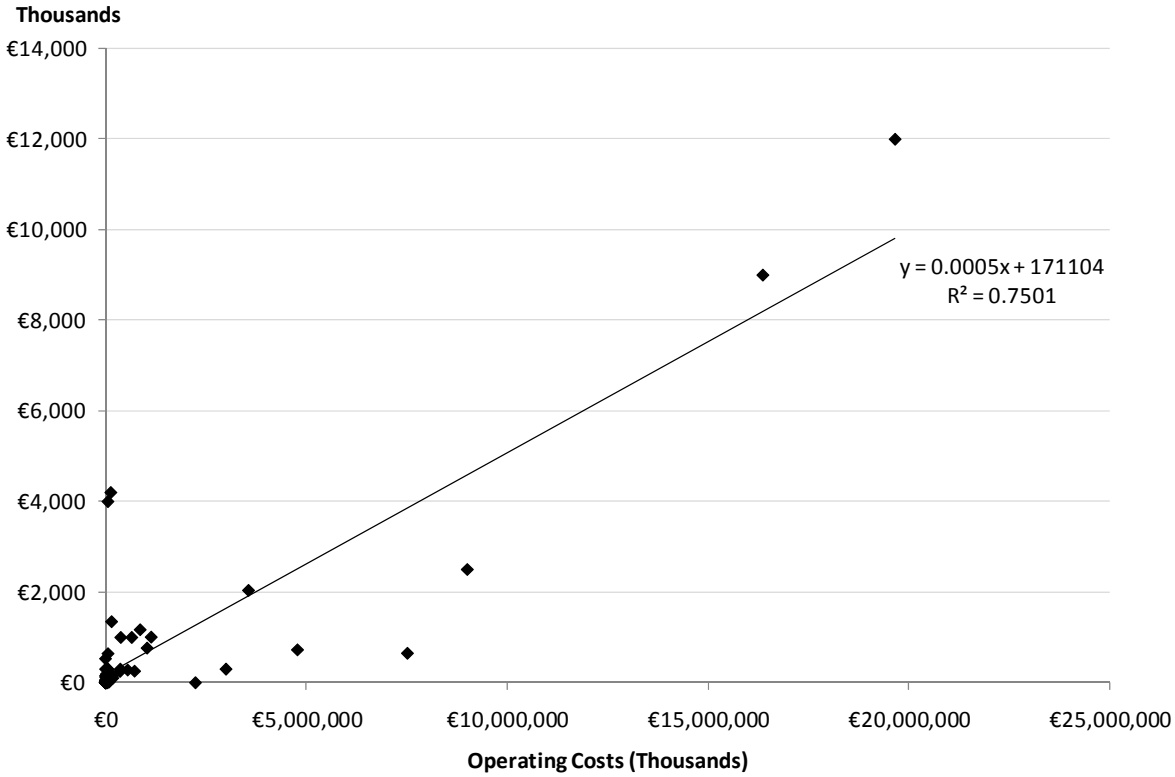
[45] Due to the quality of the data received on numbers of customers and the scale of companies' operations related specifically to the five products we focus on in this study we were in most cases unable to construct robust estimates of company turnover and operating costs related specifically to the five products for our respondents where this was not disclosed by the firm. As a result, throughout the study we use turnover and operating cost data for the company as a whole, unless otherwise specified.

[46] It could be argued that by using operating costs the analysis does not account for differences in the relative efficiency of individual companies. However, using the company's turnover would not address this, rather we would need to use some measure of profit. Whilst it would be interesting to explore this thought (i.e. that more efficient companies might incur lower additional costs than less efficient companies), unfortunately we do not have the data required for such an analysis for our respondents.

[47] The result is significant even at the 0.5% level.

[48] Given the limited data, we have used only a simple linear regression to model the relationship here. The relationship may in fact, however, be non-linear with the additional costs increasing less as firms increase in size. This would tally with evidence to indicate that smaller companies experience higher cost impacts as a proportion of their operating costs. Alternatively, it could be that there is a discontinuous relationship between firm size and the additional costs involved with complying with regulation; his would be represented by. This is explored further later when we consider large companies and SMEs separately.

Figure 3.2: Relationship between One-Off Cost Estimates and Operating Costs



3.16 Given the limited data, we have used only a simple linear regression to model the relationship here. The relationship may in fact, however, be non-linear with the one-off cost increasing less as firms increase in size. This would tally with evidence to indicate that smaller companies experience higher cost impacts as a proportion of their operating costs. Alternatively, it could be that there is a discontinuous relationship between firm size and the additional costs involved with complying with regulation; his would be represented by. This is explored further later when we consider large companies and SMEs separately.

3.17 As can be seen from the above diagram, there are one or two companies that appear to be outliers. We have, however, included these in the sample and analysis above. This is because, given the limited sample base, there is insufficient evidence to suggest that these companies do actually represent outliers in the true sense (i.e. anomalies that distort the "true" picture).

3.18 The relationship between operating costs related specifically to the relevant products and the size of the one-off costs is much weaker, though this is likely to be due to the quality of the segmental data available on the share of business activities that these products represent.

The relationship with regulation

3.19 In terms of the relationship between one-off costs and the regulatory context for life insurance investment products, the data generally follow the pattern one would expect, i.e. the less aligned with MiFID the regulatory framework is the higher the costs will be for companies to comply with the proposed rules. Estimates of the average one-off cost broken down by the level of regulatory alignment with the proposed rules demonstrate this relationship (see Table 3.2 below).

3.20 In the life insurance market the estimated one-off cost as a percentage of operating costs is on average much lower for companies in Member States with a high level of alignment than those with a low level of alignment. The relationship is less clear cut in Member States with a medium level of alignment, though both in terms of the mean and the median the average estimates of one-off costs as a percentage of operating costs is higher than for companies in Member States with a high level of alignment.

3.21 Estimates for companies selling structured deposits are less clearly aligned with the Member State's regulatory score. Not only is the average estimate lowest for companies in Member States with a medium level of alignment, but in terms of the median estimate for companies in Member States with a high level of alignment this is higher than the median estimate for companies in Member States with a low level of alignment. The reasons for this are, first, that nearly all of the vendors of such products also sell life insurance investment products (with the latter in greater volumes) and the difficulty found by participants in differentiating between the product groups in terms of cost. Second, some banks had voluntarily applied MiFID to such products because the salespeople involved were also actively selling MiFID products.

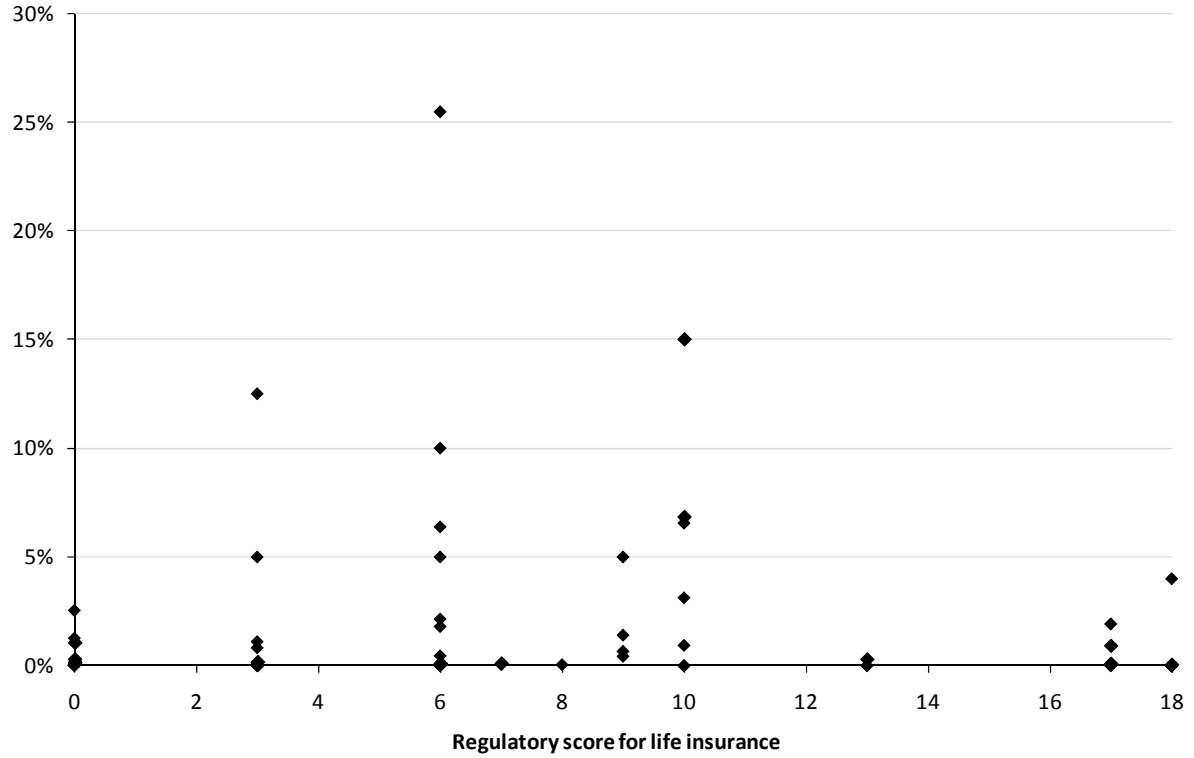
Table 3.2: Average One-Off Cost Estimates Broken Down by the Current Regulation's Level of Alignment with the Proposed Rules

	One-off cost estimate		One-off costs as a percentage of operating costs	
Life Insurance Market				
	Mean	Median	Mean	Median
Low	€ 1,040,604	€ 150,000	2.65%	0.26%
Medium	€ 718,833	€ 23,146	3.09%	0.94%
High	€ 428,341	€ 177,387	0.53%	0.05%
Structured Deposits				
	Mean	Median	Mean	Median
Low	€ 529,310	€ 180,037	1.76%	0.11%
Medium	€ 10,500,000	€ 10,500,000	0.06%	0.06%
High	€ 200,000	€ 200,000	0.13%	0.13%

Note: A low level of alignment would include any Member States with a regulatory score of between 0 and 6 inclusive, a medium level would be a score of between 7 and 12 inclusive, and a high level would be a score of 13 to 18 inclusive.

3.22 The correlation between one-off costs as a proportion of operating costs for companies selling life insurance investment products and the level of alignment in the regulation of distribution rules in that market with MiFID, however, is relatively low, with a correlation coefficient of -0.10. The relationship is stronger if we compare companies that *only* sell life insurance PRIPs, i.e. they do not sell structured deposits, the correlation increases to -0.21, though this is still relatively low.

Figure 3.3: One-off Cost Estimates as a Percentage of Operating Costs for Companies selling Life Insurance plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector



Note: Having not received information from the national supervisors on the existing regulatory framework in Luxembourg, Greece and Spain, data on companies from these Member States have been excluded from this chart.

3.23 The relatively low level of correlation could be the result of a number of companies reporting very low one-off costs even in highly unaligned regulatory contexts. This could be driven by the existence of informal industry-led regulation, for example as exists in Sweden, and/or companies applying MiFID-style regulation internally on a voluntary basis — this may be particularly true of large companies or conglomerates and/or companies that face MiFID-style regulation already in other areas of their business.

3.24 However, when we examine the results more closely it is apparent that estimates from Swedish companies do not appear to be consistently lower than for other companies in countries with a low level of alignment. As such, there is no evidence to suggest that this informal voluntary industry code in particular has consistently distorted the relationship between the existing regulation and the potential one-off costs.

3.25 The mix of companies may however help to explain the relatively weak relationship between the level of regulatory alignment and one-off costs. In those countries with a low level of regulatory alignment with MiFID (i.e. regulatory score between 0 and 6 inclusive) 40 per cent of the participants in our sample are banks. Since banks will be subject to MiFID in other areas of their business, it is quite possible that they may already have applied MiFID across the relevant products, resulting in a lower one-off cost estimate than we might expect.

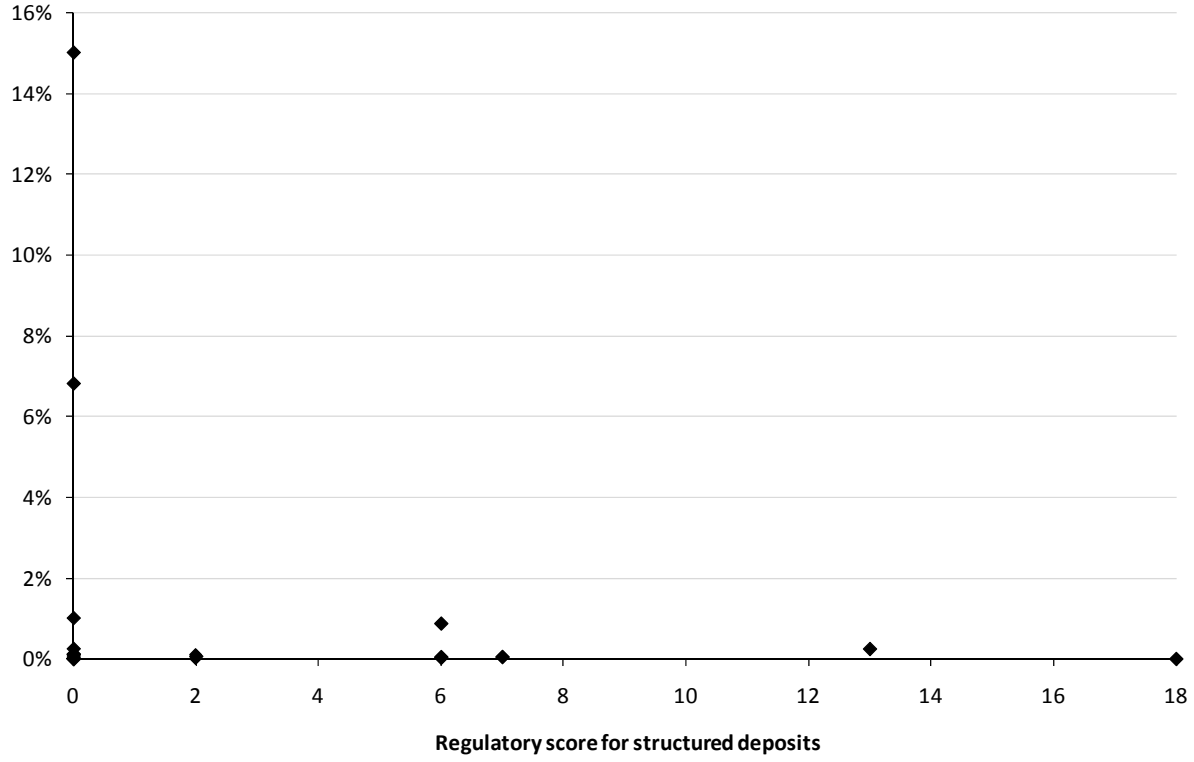
3.26 Even if the low level of correlation overall is due to voluntary implementation of the proposed rules by individual companies, it is also interesting to consider the way in which the regulatory context varies across the different elements of the proposed rules. While the relationship between one-off cost estimates and the regulatory score for the suitability and appropriateness (S&A) provisions and the provisions on inducements are considerably weaker than the overall correlation, the correlation between the one-off cost estimates as a proportion of operating costs and the regulatory score for conflicts of interest provisions is notably higher at -0.22.

3.27 This could reflect the fact many companies may already voluntarily undertake many of the measures implied by the S&A provisions, but that companies do not necessarily implement all of the provisions proposed under the new rules. Alternatively this could merely reflect the fact that certain provisions are less likely to be important drivers of the one-off costs that the companies would face if the proposed rules were introduced.

3.28 The relationship between one-off costs and the level of regulatory alignment is stronger for deposit-based structured products, with a correlation coefficient of -0.26 (though this is still relatively weak). This is quite surprising given that almost 60 per cent of the companies identified as selling deposit based structured products also sell other retail structured investment products which are already covered by MiFID, and as such we might expect the regulatory alignment to be less important than for life insurance investment PRIPs because of the potential overlap between different types of structured investment products.

3.29 However, the result may be influenced by the relatively small number of data points for deposit-based structured products and the fact that just under 90 per cent of those companies selling structured deposits also sell life insurance investment PRIPs, which may distort the connection between the level of regulatory alignment for structured deposits and the cost estimates (though we would normally expect this to result in a lower correlation coefficient rather than a higher one).

Figure 3.4: One-off Cost Estimates as a Percentage of Operating Costs for Companies selling Deposit-Based Structured Products plotted against the Current Regulatory Framework's alignment with MiFID for Structured Deposits

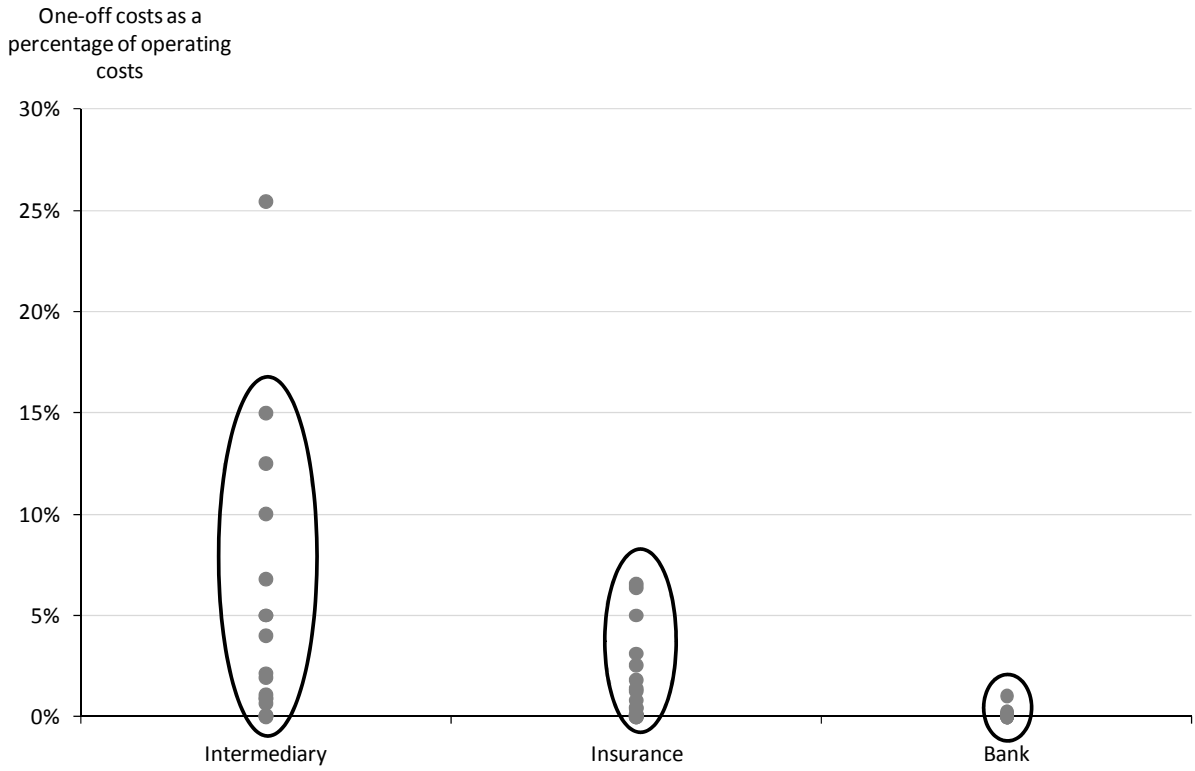


3.30 The strength of the relationships, once again vary across the different provisions. As before the strongest relationship between one-off costs and the regulatory score is apparent for the conflict of interest provisions (-0.31), and the weakest is for the inducements provisions (-0.12). Suitability and appropriateness seems to have a similarly weak relationship with the one-off cost estimates (-0.18), which again could reflect a tendency for companies to consider these provisions to be less important in terms of driving the additional costs, possibly because they already apply something similar.

The relationship with firm type

3.31 As we might expect given their greater familiarity with MiFID, the dispersion of one-off costs as a percentage of operating costs is much lower for banks than it is for insurance companies and intermediaries (see Figure 3.5 below). For intermediaries, in particular, there appears to be much greater variety in the size of the cost estimates, possibly a reflection of a greater degree of uncertainty in estimating such costs and/or the diversity in terms of the size of the intermediaries, or indeed in their nature (i.e. an IFA versus an intermediary focused primarily on non-life products but who sells life insurance and life insurance investment products on an occasional basis). However, it is clear that the anticipated cost impacts are greater amongst intermediaries than insurers and greater amongst insurers than banks.

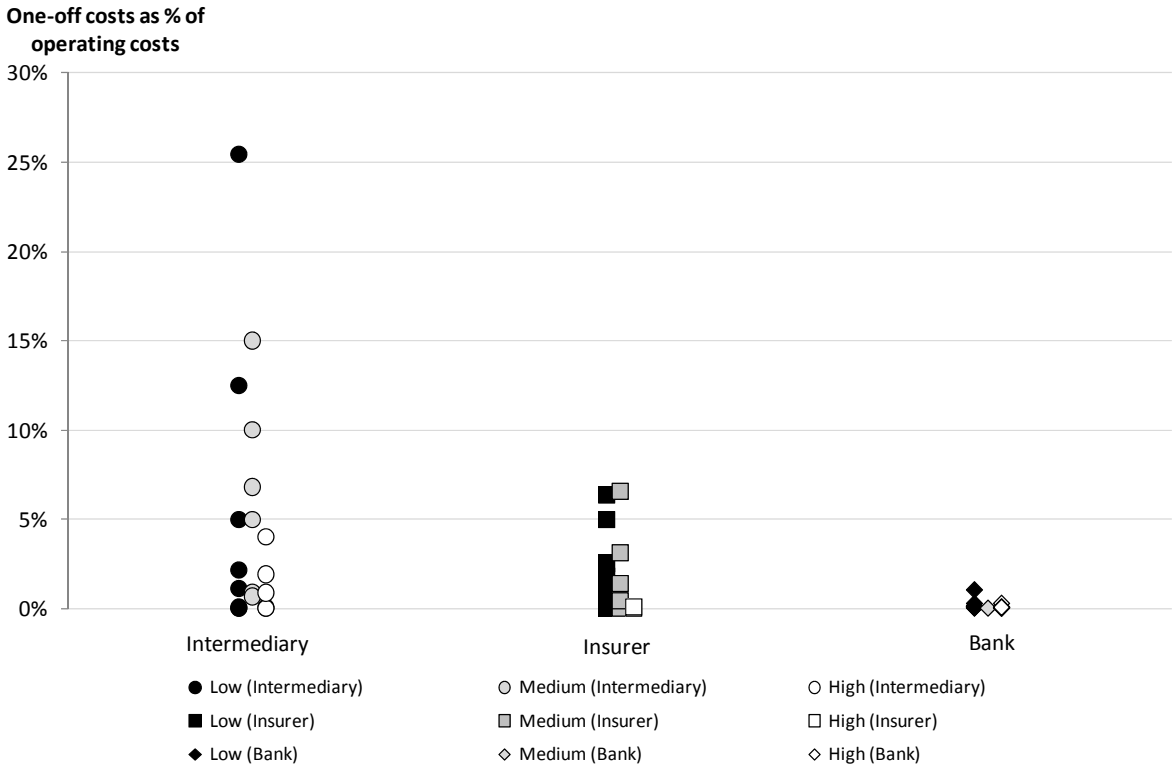
Figure 3.5: Dispersion of One-off Cost Estimates as a percentage of Operating Costs by Type of Company



3.32 There is no clear explanation for the one outlier in Figure 3.5 above and the estimate conflicts with estimates from other intermediaries of a similar size from that Member State. It is likely, therefore, that this merely reflects the difficulties SMEs in particular have in estimating the cost implications *ex ante*.

3.33 If we break the data down further to distinguish between the level of regulatory alignment in the countries in which the companies operate, a clear pattern emerges across all company types: the spread and values of estimates derived from firms in Member States with a high level of regulatory alignment is less than for companies operating in countries with low regulatory alignment (see figure below). This supports the idea that the level of regulatory alignment affects the scale of the potential costs and the ability of companies to estimate such costs *ex ante*.

Figure 3.6: Dispersion of One-off Cost Estimates as a percentage of Operating Costs by Type of Company and Level of Regulatory Alignment



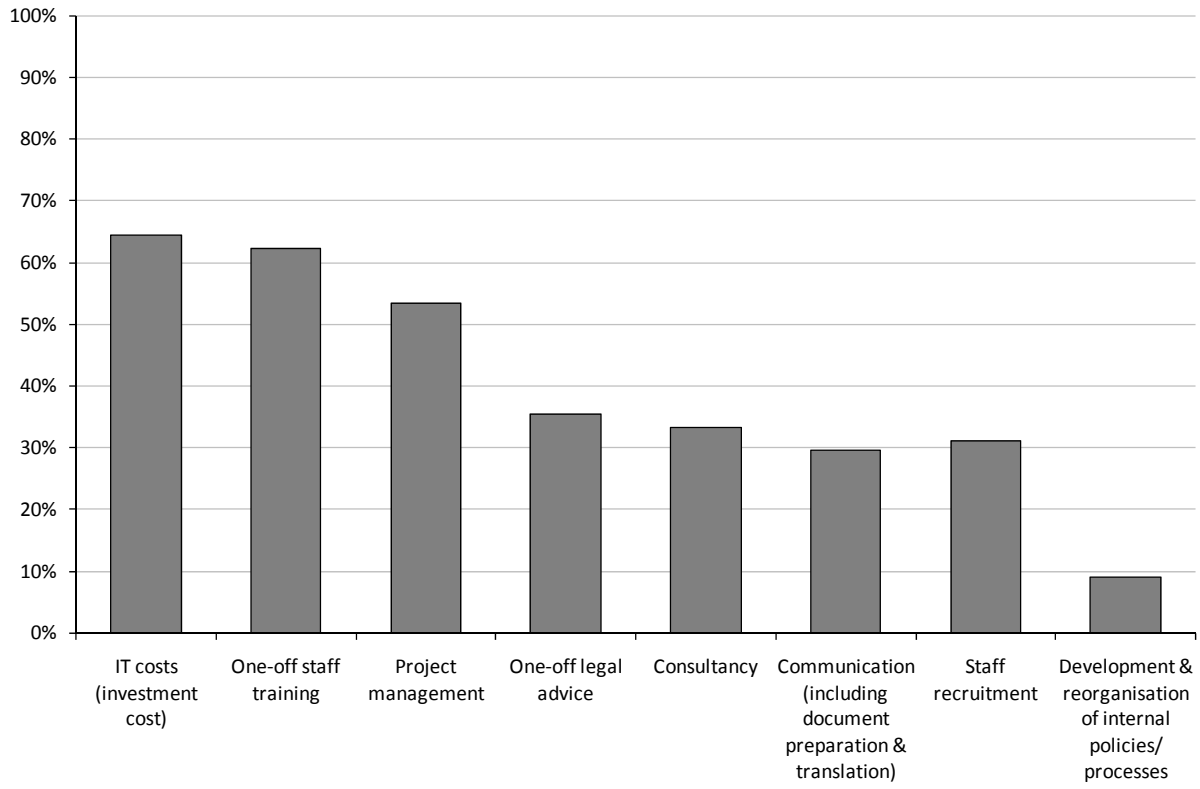
3.34 Where there is a medium-level of regulation at present, the situation is less clear cut.

3.35 The main drivers of the one-off costs cited by respondents were investment in IT systems, one-off staff training, and the project management required to implement the necessary changes. Figure 3.7 below illustrates the percentage of companies that cited the various drivers of one-off costs. It is important to note that whilst the data below provide an indication of the frequency with which certain factors were noted as driving the additional costs, they do not reflect the scale of these costs. As such, even though two factors may have been frequently recorded as driving one-off costs, the cost associated with the drivers could vary substantially.

3.36 Changes to IT systems were generally considered to be key in terms of driving the scale of any one-off costs. Not only would this involve a relatively large investment on part of the company but it could also take some time to implement. For some companies, however, such as banks that already sell MiFID regulated products (and thus already have necessary systems in place) and intermediaries that receive support from manufacturers (primarily tied agents), the costs associated with changes to the IT system are less significant.

3.37 The potential need to recruit additional staff in order to create sufficient segregation across the business and comply with the conflict of interest provisions was also highlighted as a possible source of one-off costs.

Figure 3.7: Main Drivers of One-Off Costs



SMEs versus Large Companies

3.38 We now consider the responses from SMEs and large companies separately. SMEs are defined here according to the EC definition of an SME, that is companies that have:

(a) turnover of less than or equal to €50 million; and

(b) a headcount of less than 250.

3.39 This definition includes micro size companies (that is companies with fewer than 10 employees and less than €2 million in turnover). SMEs represent just under 40 per cent of the companies in the sample, of which almost 60 per cent are micro companies, 25 over cent are SMEs and just over 15 per cent are medium-sized companies.

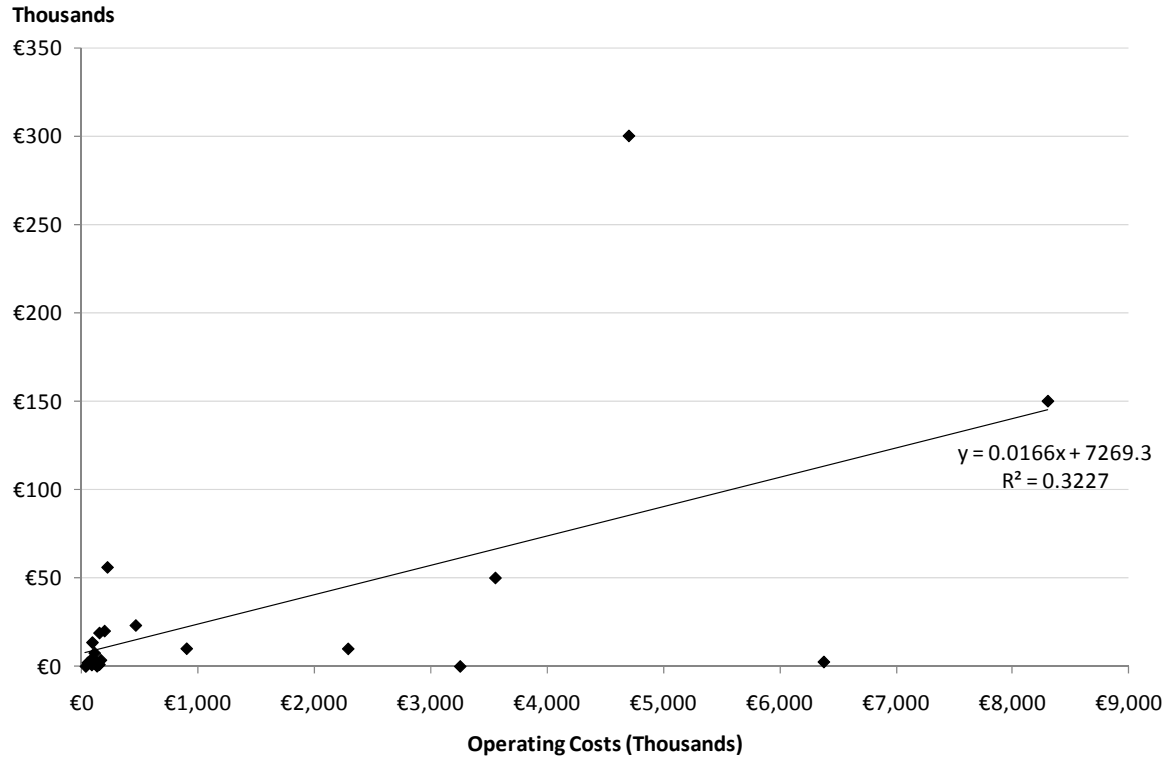
Table 3.3: Overview of Turnover, Operating Costs and One-Off Cost Estimates for all Respondents broken down by Size of Company

	Turnover		Operating Costs		One-off Cost Estimate (€)		One off costs as % of turnover		One off costs as % of operating costs	
	SMEs	Large	SMEs	Large	SMEs	Large	SMEs	Large	SMEs	Large
Mean	€ 5,205,789	€ 4,460,645,551	€ 2,311,878	€ 1,853,643,375	€ 32,176	€ 1,213,925	3.70%	0.14%	4.79%	0.64%
Median	€ 245,000	€ 801,564,035	€ 207,650	€ 182,000,000	€ 7,500	€ 280,743	0.98%	0.03%	1.92%	0.08%
Range	€75,448-€42,500,000	€68,189,046-€31,300,000,000	€28,293-€26,972,660	€1,059,560-€19,650,000,000	€0-€300,000	€0-€12,000,000	0%-23.8%	0%-1.13%	0%-25.4%	0%-6.56%

3.40 Consistent with our expectations, smaller companies do appear to face larger one-off costs both as a proportion of their operating costs and of turnover.

3.41 This is also reflected in Figure 3.8 and Figure 3.9 below, which illustrate that a rise in operating costs has a greater impact on one-off costs for SMEs; for each additional €1 of operating expenses the one-off cost rises by €0.02 compared to only €0.0005 for large companies.[49] It is important to note, however, that the relationship between the size of one-off costs and operating costs appears to be weaker for SMEs than for large companies, with only a third of the one-off costs being explained by operating costs for SMEs compared to almost three quarters for large companies.[50]

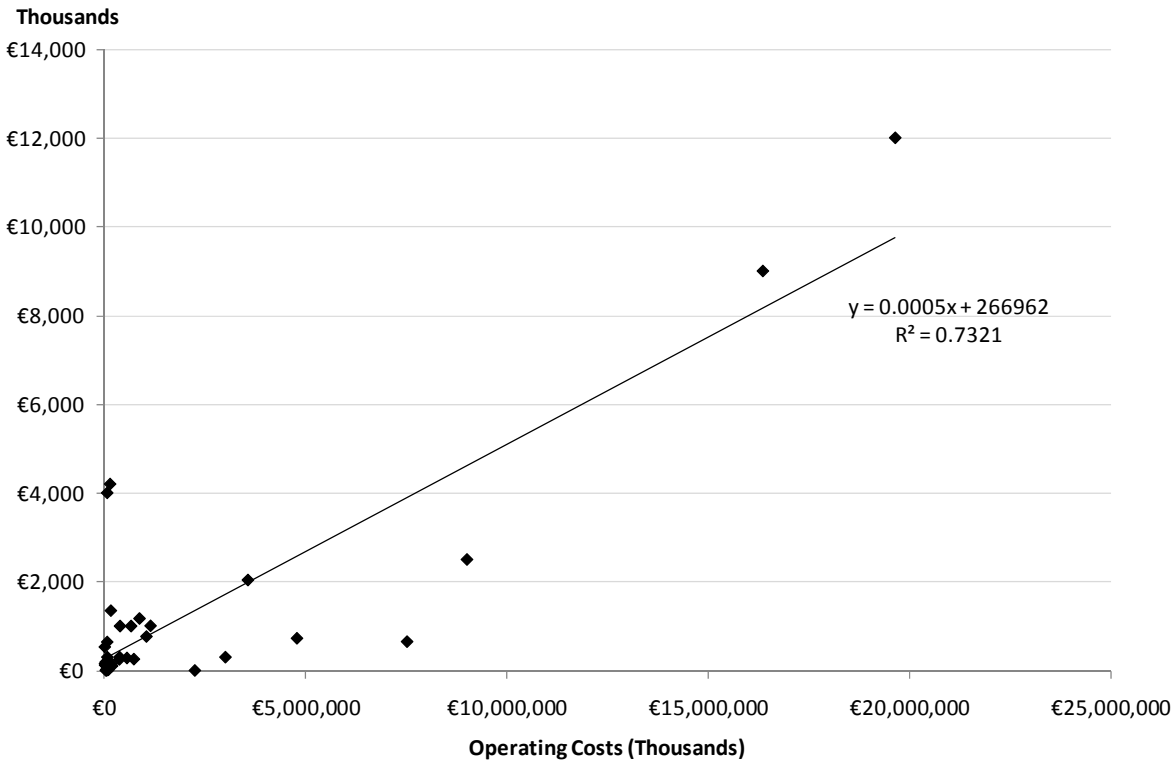
Figure 3.8: Relationship between One-Off Cost Estimates and Operating Costs for SMEs



[49] The result for small companies is significant at the 1% level, while the result for large companies is significant at the 0.5% level.

[50] To note the Adjusted R^2 for small companies is even lower at 0.29.

Figure 3.9: Relationship between One-Off Cost Estimates and Operating Costs for Large Companies



3.42 In both the case of SMEs and large companies, but more notably for SMEs, there are one or two companies that appear to represent outliers. The existence of such data points are likely to have affected the goodness of fit of the regression, however, in the absence of any evidence to suggest that these companies do truly represent outliers it would be inappropriate to exclude them from the analysis.

3.43 If we examine the relationship between one-off costs as a proportion of operating costs and the level of alignment with MiFID that currently exists, the inverse relationship that we would expect between the two appears to be more pronounced for SMEs than for large companies. This is reflected in Figure 3.10 and Figure 3.11 below, which present the one-off costs as a percentage of operating costs for companies that sell life insurance and the relevant regulatory score for the life insurance market in that Member State.

3.44 The one-off cost estimates are more highly correlated with the existing regulatory framework for SMEs, with a correlation coefficient of -0.21 compared to -0.10 for large companies selling life insurance. The correlation for SMEs increases slightly to -0.26 if we focus on those companies that only sell life insurance PRIPs (and not structured deposits). The same pattern is not present for large companies (the relationship actually weakens very slightly instead).

3.45 The relatively low number of SMEs from whom we have had responses that sell structured products has made a similar comparison between small and large companies

for structured deposits infeasible. This is unsurprising — intermediaries are an important distribution channel in this market in only a small sub-set of countries across the EU (such as Ireland and the UK). Instead, distribution is largely through banks and, trivially, banks tend not to qualify as an SME under the EC definition (i.e. a bank may be relatively small but is still not an SME).

Figure 3.10: One-off Cost Estimates as a Percentage of Operating Costs for SMEs selling Life Insurance plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector

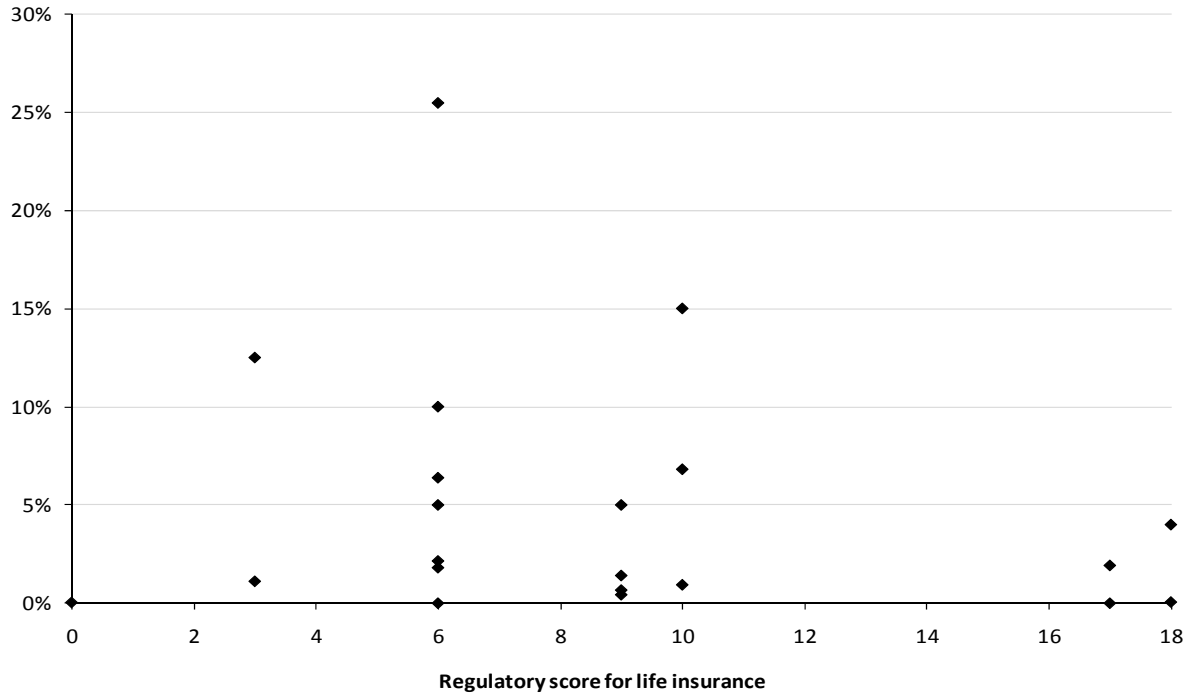
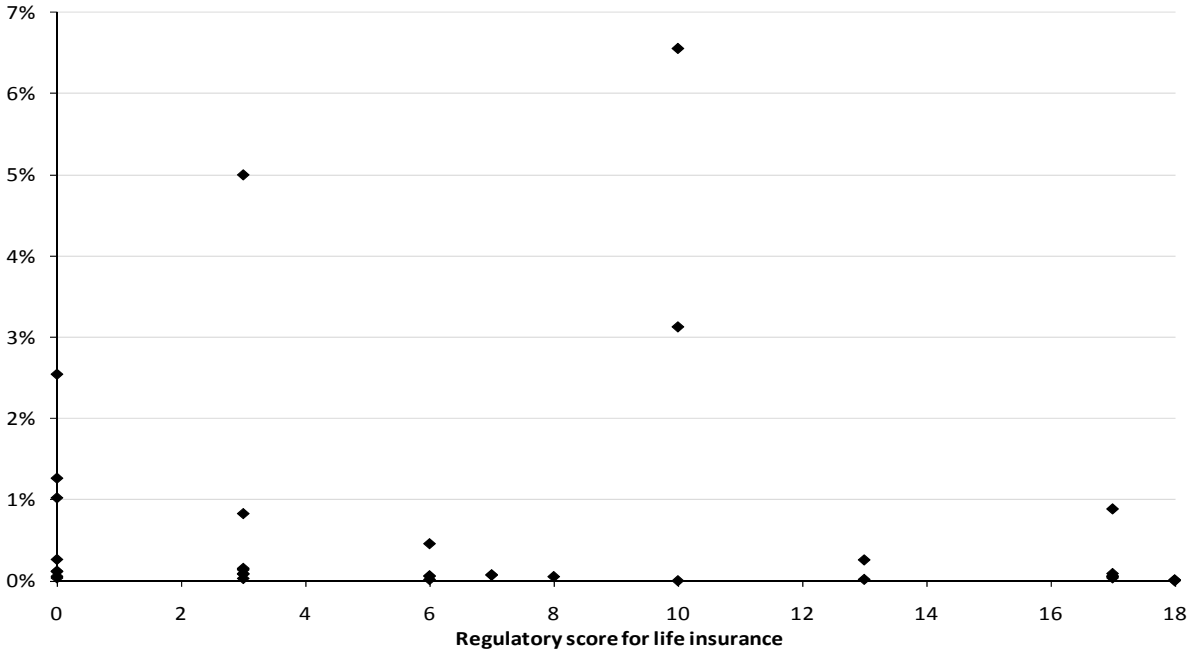


Figure 3.11: One-off Cost Estimates as a Percentage of Operating Costs for Large Companies selling Life Insurance plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector



3.46 Even though the strength of the relationship between one-off costs and the regulatory score differs between large companies and SMEs in the life insurance market, the two are consistent in terms of the relative importance of the individual provisions *vis-á-vis* the degree of correlation with one-off costs. The conflict of interest provisions are the most strongly correlated, followed by S&A provisions and the inducement provisions respectively. This again reinforces the idea that the conflict of interest provisions seem to represent a key driver of the one-off costs companies would be likely to incur.

3.47 The degree of correlation with conflict of interest provisions is particularly strong for SMEs, with a coefficient of -0.37, compared to the other provisions, which have coefficients of -0.09 and -0.05. The distinction between the various provisions is similar for large companies with correlation coefficients of -0.30, -0.02 and 0.06.

3.48 While there were no great differences in the main drivers of the costs identified by SMEs and large companies (IT, staff training and project management being the most frequently cited for both groups), for SMEs staff recruitment was considered relatively more important than for large companies, similarly legal advice and communication ranked higher large companies. This is not unsurprising given the small number of staff involved in SMEs (over 50 per cent of SMEs in our sample are micro size and therefore employ fewer than 10 staff), and the likely issues in ensuring effective information dissemination across large companies.

Figure 3.12: Main Drivers of One-Off Cost for SMEs

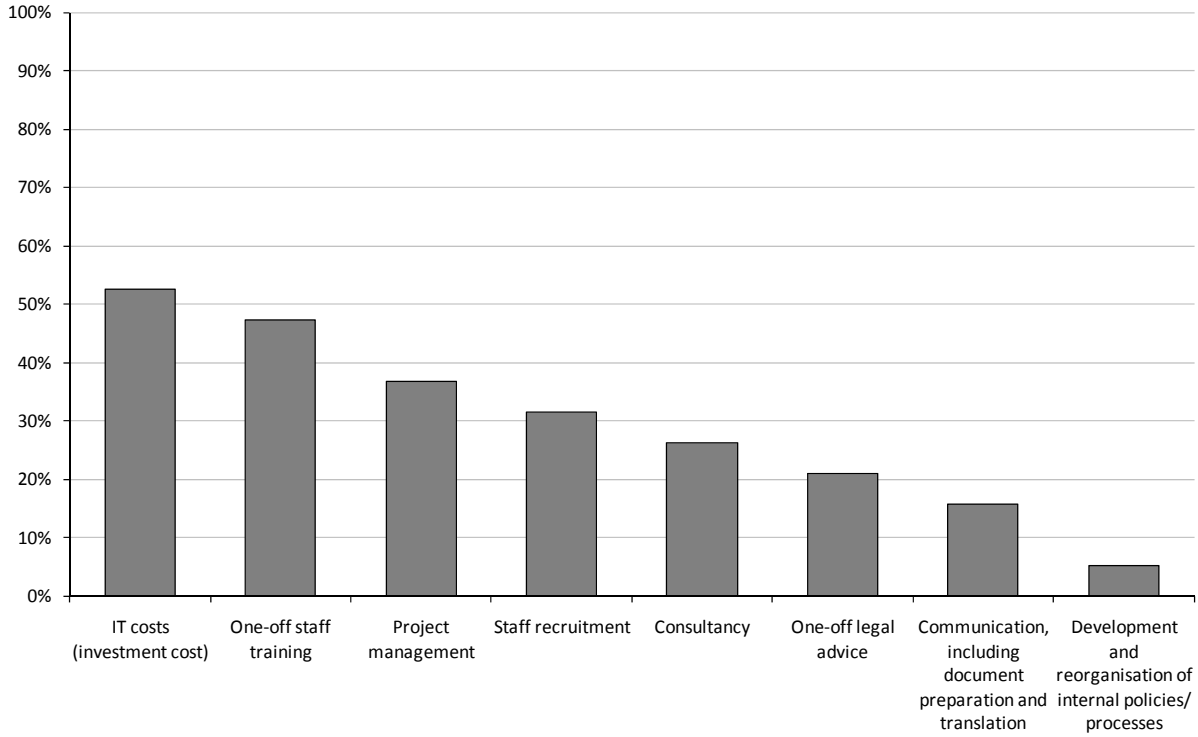
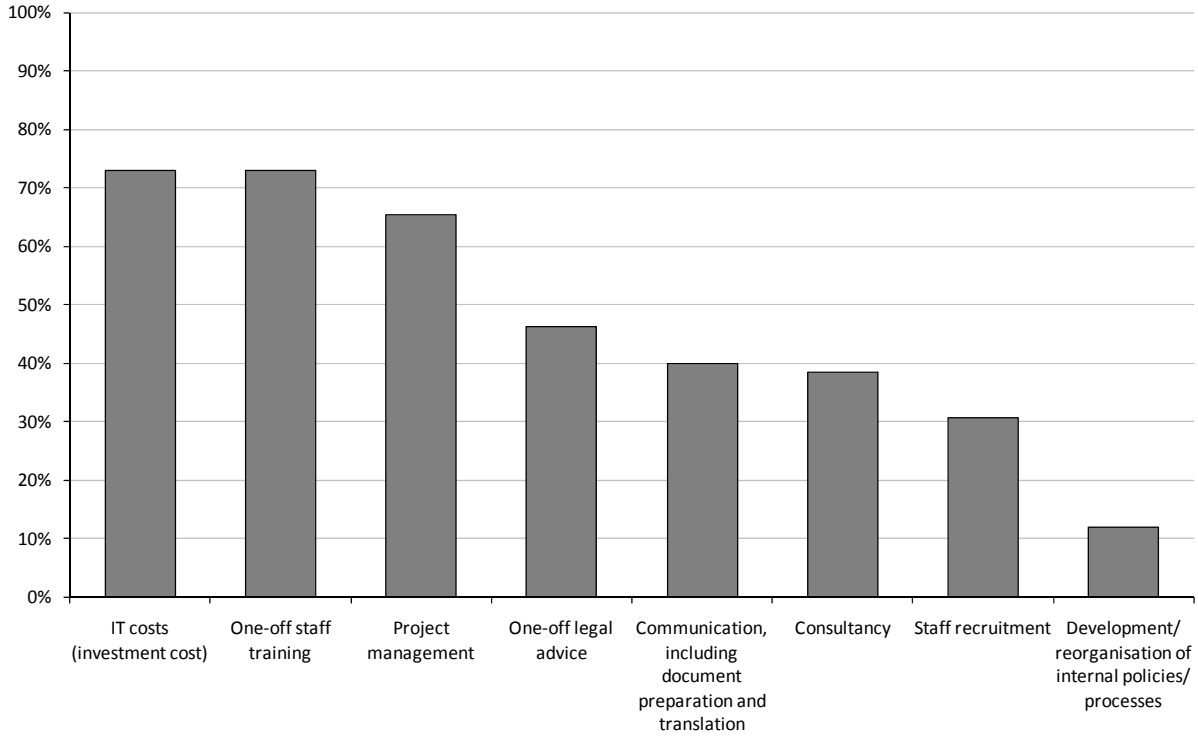


Figure 3.13: Main Drivers of One-Off Cost for Large Companies



Intermediaries

3.49 Given that smaller companies seem to face higher one-off costs, it is unsurprising that the estimates for intermediaries (the vast majority, almost 90 per cent, of which fall into this category) are relatively high compared to the average across all firms. The fact that the cost estimates are slightly higher, however, for intermediaries than SMEs in general, may suggest that intermediaries as a specific type of company may be more vulnerable to the one-off cost impacts of implementing the proposed rules.

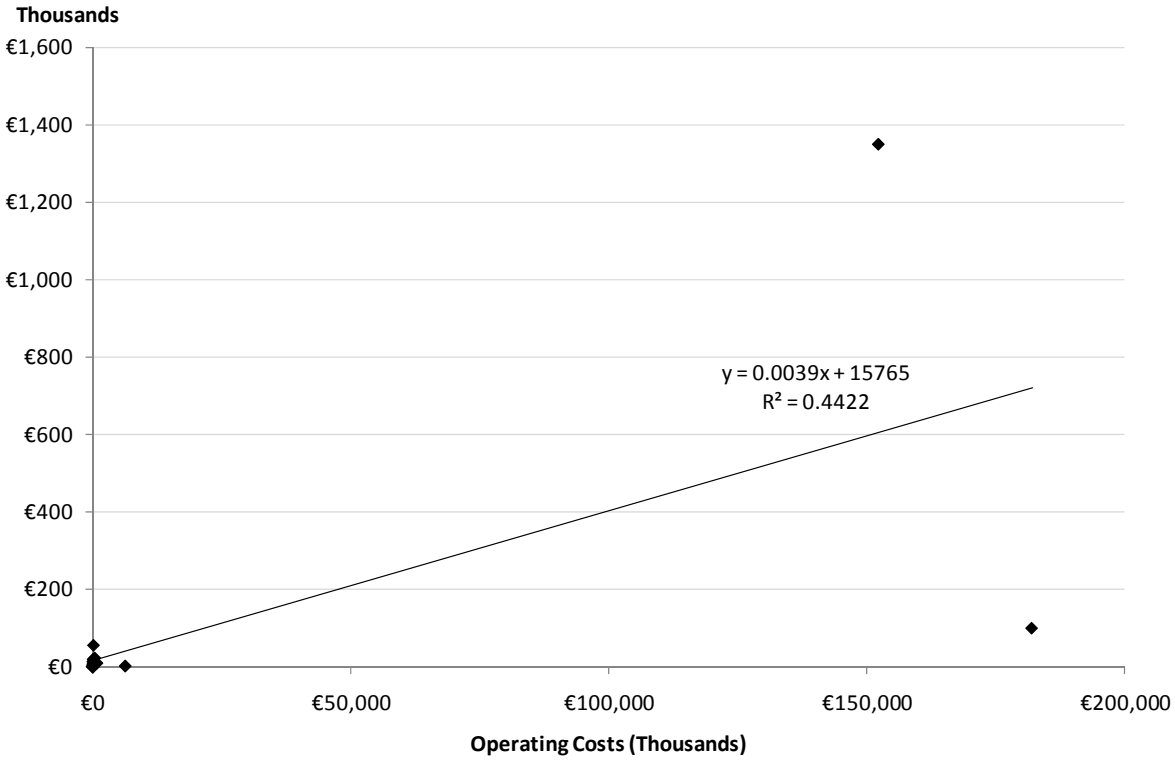
Table 3.4: Overview of Turnover, Operating Costs and One-Off Cost Estimates for Intermediaries

	Turnover	Operating Costs	One-off Cost Estimate	One off costs as a % of turnover	One off costs as a % of operating costs
Mean	€ 29,862,869	€ 21,393,497	€ 89,630	3.69%	5.09%
Median	€ 237,000	€ 163,000	€ 6,073	1.07%	2.04%
Range	€75,448-€350,000,000	€28,293-€184,870,000	€0-€1,347,564	0%-23.8%	0%-25.45%

3.50 This is also reflected in Figure 3.14 below. Although operating costs for intermediaries appear to have a smaller (though significant) impact on one-off costs than for SMEs more

generally, a €1 increase in operating costs creating only a €0.004 increase in one-off costs, the fixed one-off costs associated with intermediaries is over double that for small firms as a whole.[51] The goodness of fit, however, in this instance is likely to have been diminished by the existence of certain "extreme" results. However, as discussed earlier, it would be inappropriate to ignore these companies given the lack of any evidence to indicate that they are actually outliers rather than simply the result of a limited sample.

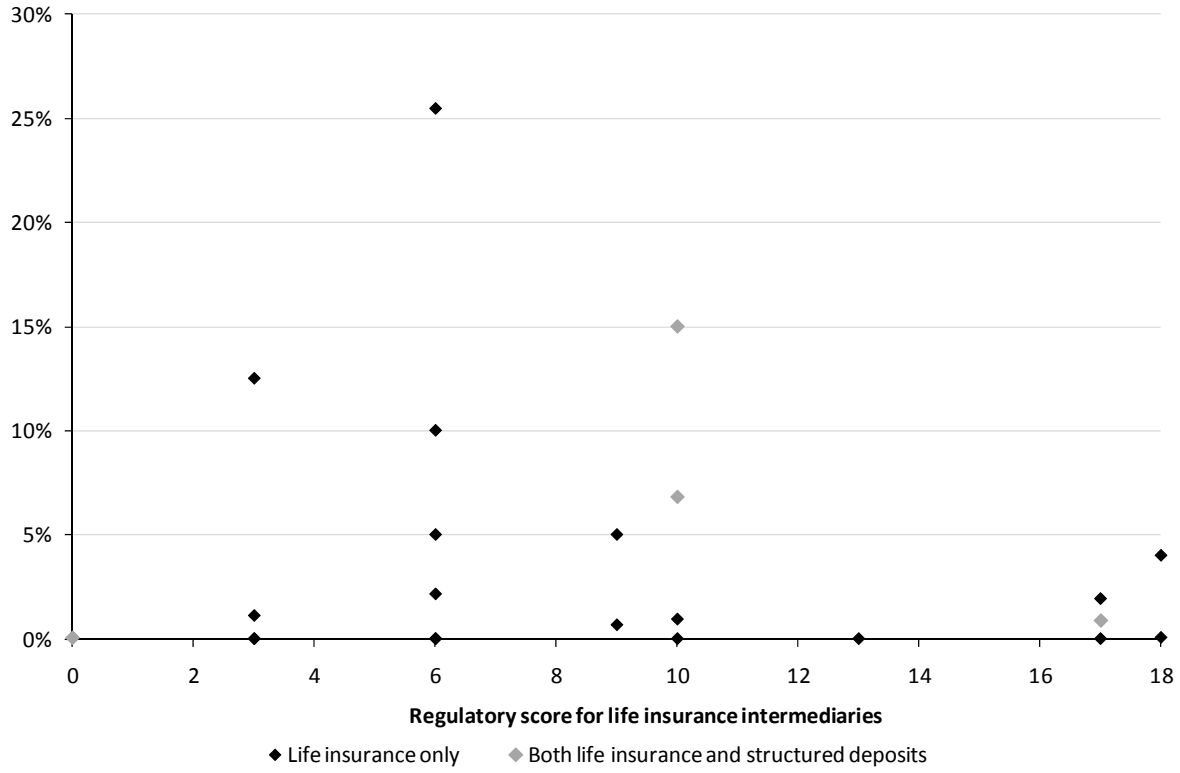
Figure 3.14: Relationship between One-Off Cost Estimates and Operating Costs for Intermediaries



3.51 Consistent with the relatively wide dispersion in the cost estimates across intermediaries the relationship between the existing regulatory environment and the one-off cost estimates appears to be relatively weak, with a correlation coefficient of -0.11. This represents a much weaker relationship to that for SMEs as a whole notwithstanding the fact that many intermediaries are SMEs. This could be simply because a small proportion of intermediaries are still large.

[51] It is important to note, however, that the average fixed cost estimate is not statistically significant. This is likely to reflect the large variety in the estimates and relatively small number of observations available.

Figure 3.15: One-off Cost Estimates as a Percentage of Operating Costs for Intermediaries selling Life Insurance Products plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector



3.52 While there are insufficient observations for companies selling structured deposits to create a meaningful chart of this sort on a standalone basis for that group, it is interesting to note that in Figure 3.15 above the companies that sell both life insurance and structured deposits that have recorded one-off costs as a proportion of operating expenses of 15 per cent and seven per cent, on the structured deposit side the regulatory score is zero. We do not have robust data on the product mix for these firms, but clearly a weighted average of the regulatory score would be lower than the score for life insurance investment products alone. The true position of these two data points would be (somewhere) to the left of the position illustrated above — as such they would fit nicely into the "wedge" shape that one would intuitively expect to observe.

3.53 In terms of the pattern of the relationship across individual provisions of the proposed rules, intermediaries more or less mirror those for small companies more generally, though the relationships are weaker.

3.54 In line with the general findings for all respondents, the top three drivers of one-off costs cited by intermediaries were IT costs, one-off staff training and project management. As in the case of SMEs more generally, intermediaries placed more emphasis on staff recruitment than legal advice or communications.

Insurance Undertakings

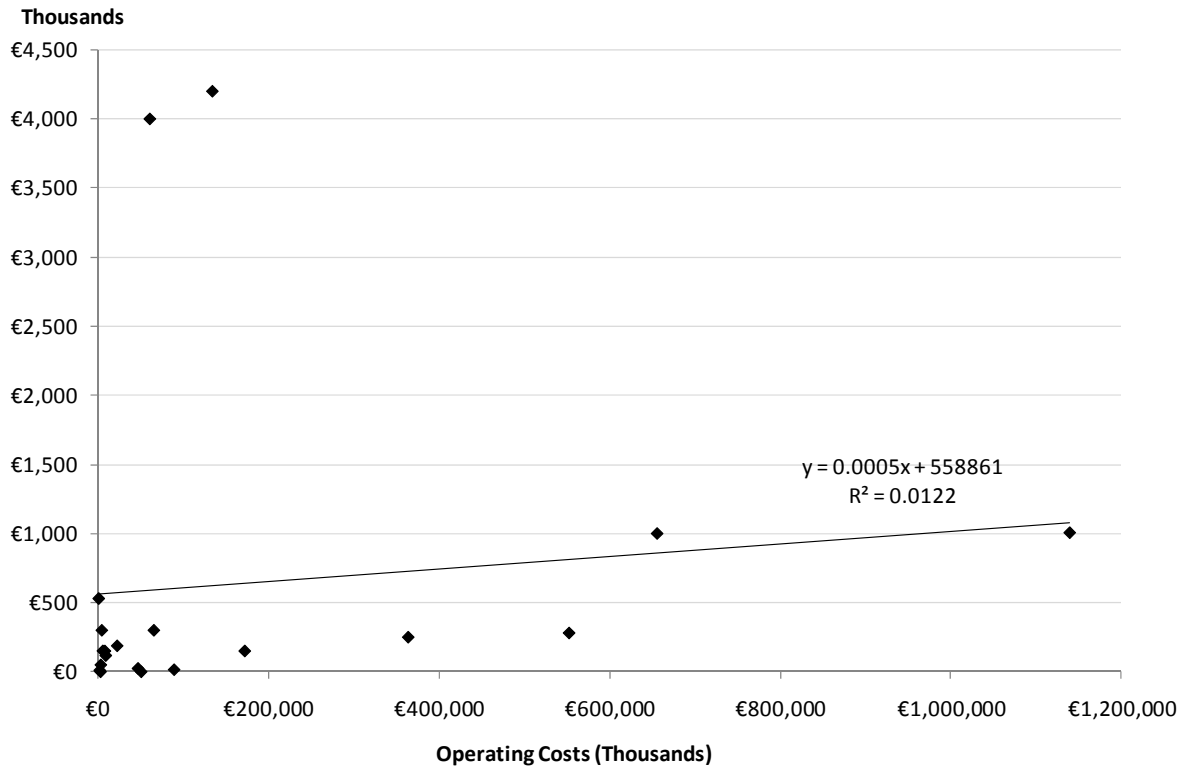
3.55 The one-off cost estimate, both as a proportion of operating costs and of turnover, is much lower for insurance companies than intermediaries. As mentioned earlier, this is consistent with the fact that insurance companies tend to be larger with an average turnover of over €2 billion compared to only €29 million for intermediaries.

Table 3.5: Overview of Turnover, Operating Costs and One-Off Cost Estimates for Insurance Undertakings

	Turnover	Operating Costs	One-off Cost Estimate	One off costs as % of turnover	One off costs as % of operating costs
Mean	€ 2,212,425,600	€ 215,012,764	€ 612,258	0.74%	1.52%
Median	€ 405,050,000	€ 49,032,370	€ 150,468	0.02%	0.45%
Range	€473,680-€12,656,400,000	€1,059,560-€1,328,900,000	€0-€4,200,000	0%-10.6%	0%-6.56%

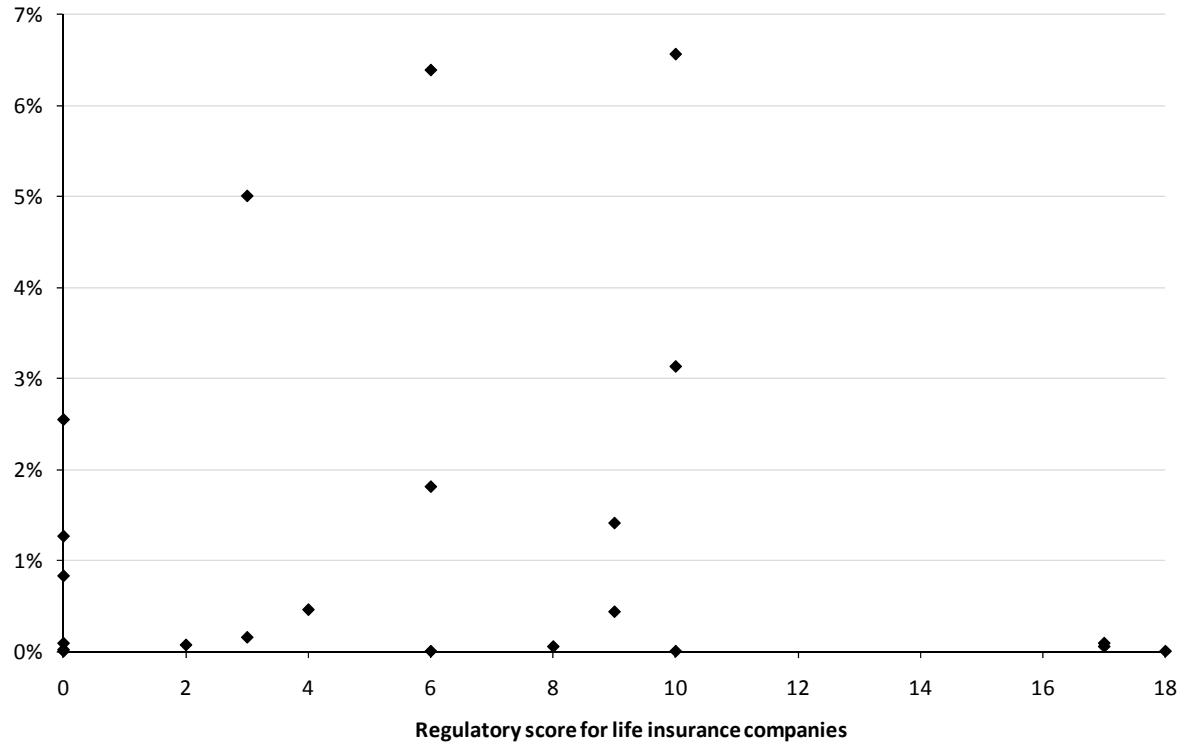
3.56 The relationship between operating costs and one-off cost estimates seems much less clear for life insurance companies. While the impact of operating costs on one-off costs is similar as for large companies more generally the regression has a much lower goodness of fit for the data, indicating that operating costs are likely to only explain one per cent of the one-off costs that life insurance companies would face when implementing the proposed rules (see Figure 3.16 below). In addition, not only is the impact of operating costs on one-off costs is not statistically significant here, nor is the regression itself. This result could be because of the low number of observations and the high degree of variation in the cost estimates, alternatively it could reflect the fact that the relationship in this case is non-linear. Unfortunately, given the limited size of the dataset it is impossible to determine whether any of the estimates are simply outliers distorting the true picture.

Figure 3.16: Relationship between One-Off Cost Estimates and Operating Costs for Life Insurance Companies



3.57 The degree of correlation between the one-off costs estimates and the regulatory score is relatively high compared to the relationship for respondents as a whole and closer to that for *small* companies, with life insurance companies also registering a weak negative relationship (with a correlation coefficient of -0.18). This result is particularly interesting since more than 80 per cent of life insurance companies in our sample are classified as *large*.

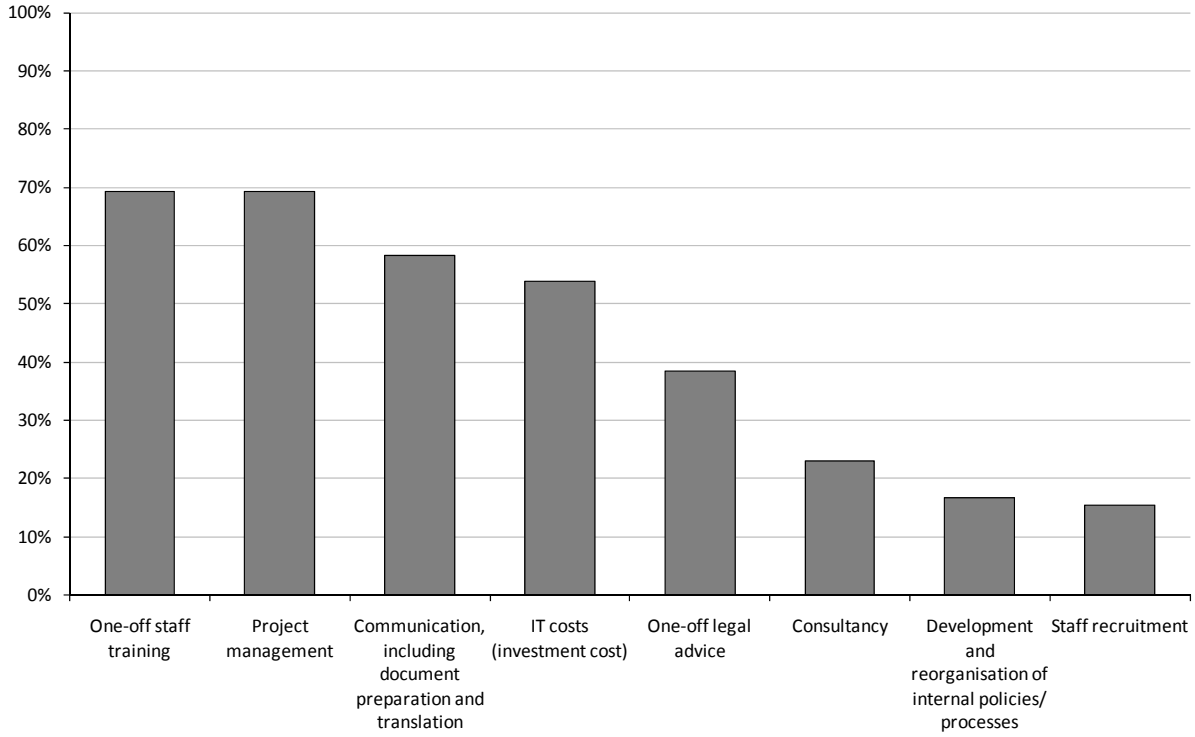
Figure 3.17: One-off Cost Estimates as a Percentage of Operating Costs for Life Insurance Companies plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector



3.58 In line with the general findings, the conflict of interest provisions have the strongest relationship with the one-off cost estimates as a proportion of operating costs with a correlation coefficient of -0.35.

3.59 In terms of the main drivers of one-off costs for insurance companies, interestingly for life insurance companies IT costs were cited less frequently than one-off staff training, project management and communications. Staff recruitment was the least frequently cited driver of one-off costs.

Figure 3.18: Main Drivers of One-off Costs for Insurance Companies



Banks

3.60 One-off costs for banks are substantially less than the average for all respondents as a proportion of operating costs and as a proportion of turnover, and even less than for life insurance companies. This may reflect the less important role that life insurance generally plays for these types of companies and/or their size (with an average turnover of over €6 billion banks are on the whole larger than other types of company).

Table 3.6: Overview of Turnover, Operating Costs and One-Off Cost Estimates for Banks

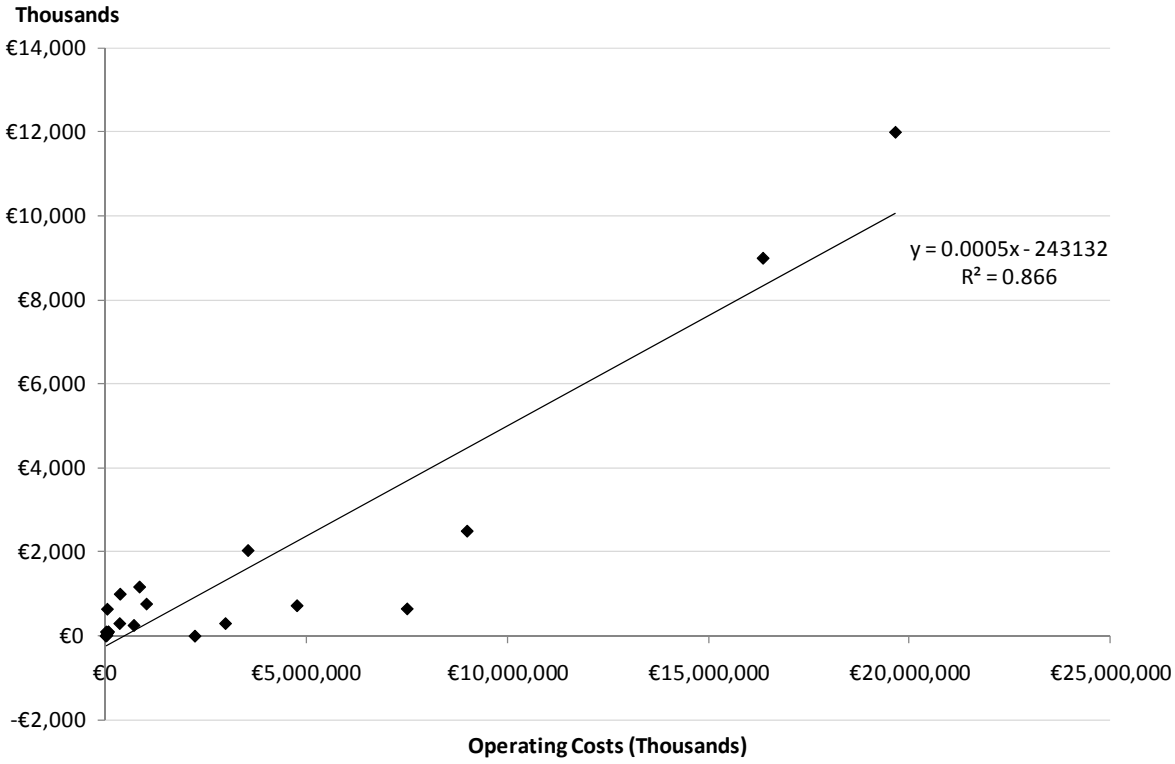
	Turnover	Operating Costs	One-off Cost Estimate (€)	One off costs as % of turnover	One off costs as % of operating costs
Mean	€ 6,150,078,534	€ 3,218,136,033	€ 1,586,621	0.08%	0.12%
Median	€ 1,580,000,000	€ 794,157,825	€ 471,000	0.03%	0.06%
Range	€24,331,980-€31,300,000,000	€26,972,660-€19,650,000,000	€0-€12,000,000	0%-0.94%	0%-1.02%

Note: Within this category of "banks" we include all banks, investment banks, bancassurers, and other credit institutions.

3.61 The variation in operating costs appears to explain a large amount of the variation in estimated one-off costs. The relationship between operating costs and one-off costs is statistically significant, as is the regression itself. However, an apparent discrepancy is

thrown up by the data, in that these imply a negative fixed component to the incremental cost. This result however is not statistically significant, and once again is likely to reflect the relatively small number of observations in the sample and the wide range in the size of the companies involved.

Figure 3.19: Relationship between One-Off Cost Estimates and Operating Costs for Banks



Note: Within this category we include all banks, investment banks, bancassurers, and other credit institutions.

3.62 The relationship between the one-off cost estimates and the current regulatory framework appears to be stronger for banks than for other types of company. On the life insurance side the data generate a correlation coefficient of -0.36 (rising to -0.66 for companies that only sell life insurance), while on the structured deposits side the correlation coefficient is -0.28. The higher level of correlation for banks compared to large companies more generally could also reflect the fact that banks, who are already exposed to MiFID through other products that they sell, may have a clearer understanding of what the proposed rules would involve and thereby allow them to make more accurate estimates given the current level of alignment in the regulatory framework.

3.63 Since the regulatory scores for the two groups (i.e. insurance companies and intermediaries) differ in only a few Member States, we have used the regulatory score that applies to intermediaries for banks and bancassurers. In all but one case the difference is minimal and does not alter the regulatory grouping that the country falls into (i.e. high, medium, or low). The exception is Slovakia, where the regulatory alignment for

intermediaries is high compared to a low level of regulatory alignment for life insurers. Only one of the banks that responded was from Slovakia, however, so we are confident that this potential scoring inaccuracy will bias the results in any substantive way.

3.64 As before, given the relative size of structured deposit markets and the fact that 86 per cent of all the banks that sell structured deposits also sell life insurance investment PRIPs, the difference between the correlation on the life insurance side and the structured deposit side could be due to the fact that companies' cost estimates are likely to be driven predominantly by the effects of introducing the proposed rules to life insurance products rather than any extension to structured deposits.

Figure 3.20: One-off Cost Estimates as a Percentage of Operating Costs for Banks selling Life Insurance Products plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector

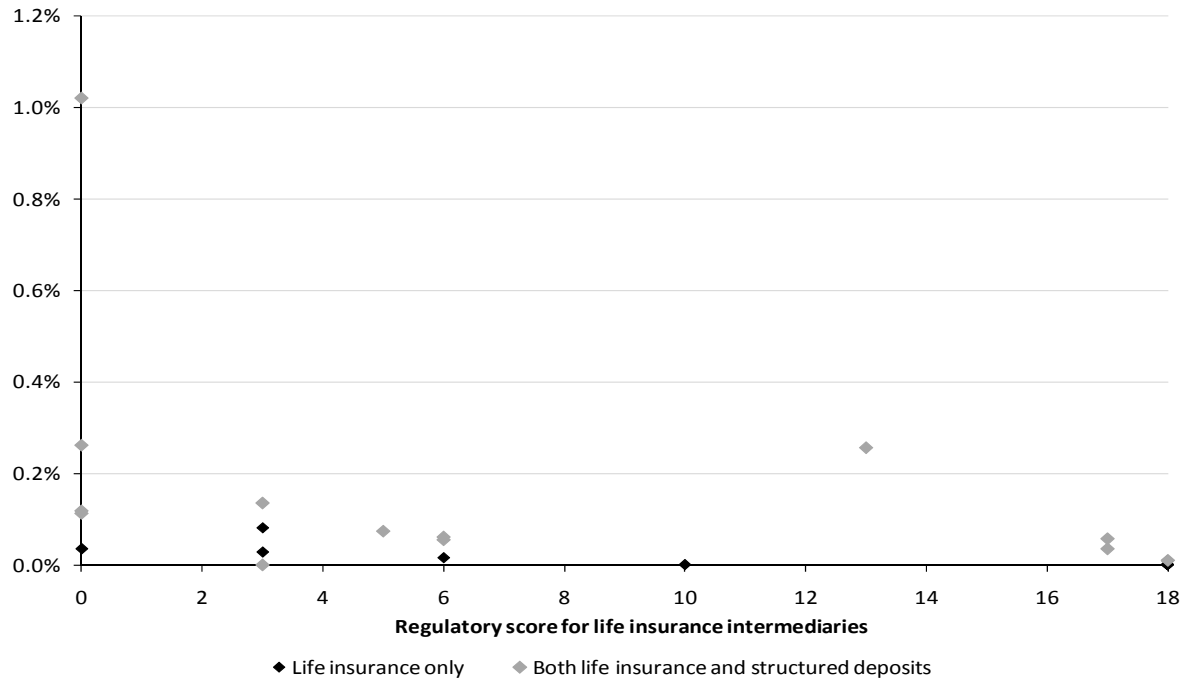
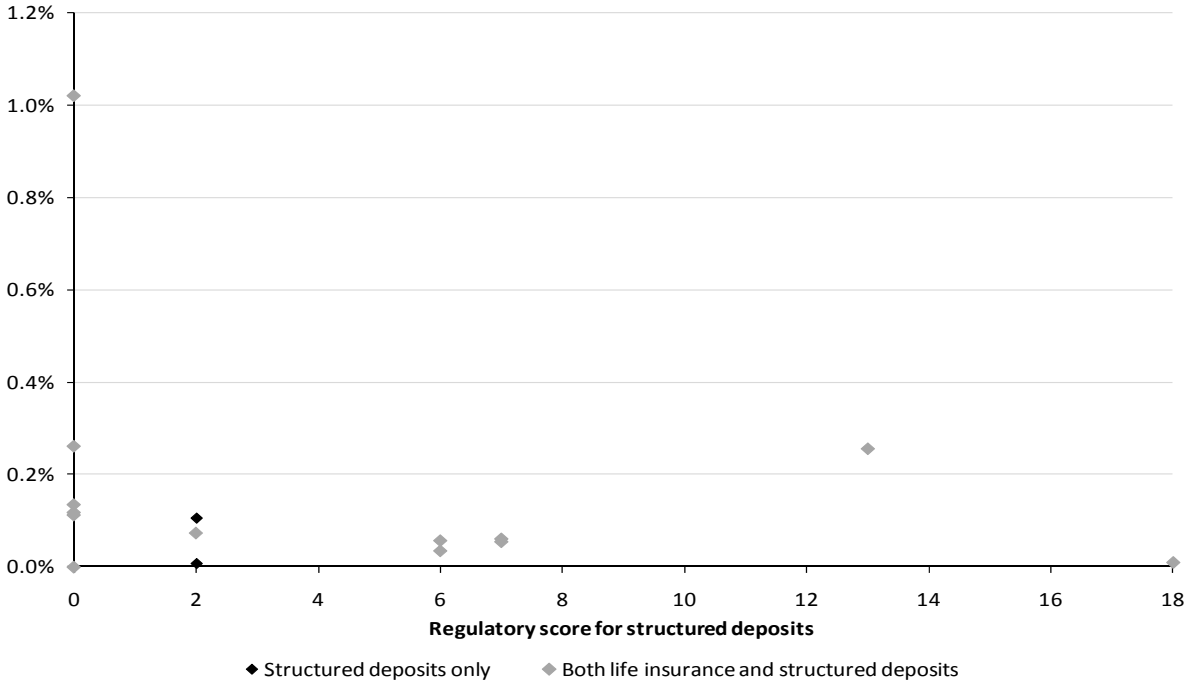


Figure 3.21: One-off Cost Estimates as a Percentage of Operating Costs for Banks selling Structured Deposits plotted against the Current Regulatory Framework's alignment with MiFID in the Structured Deposit Sector

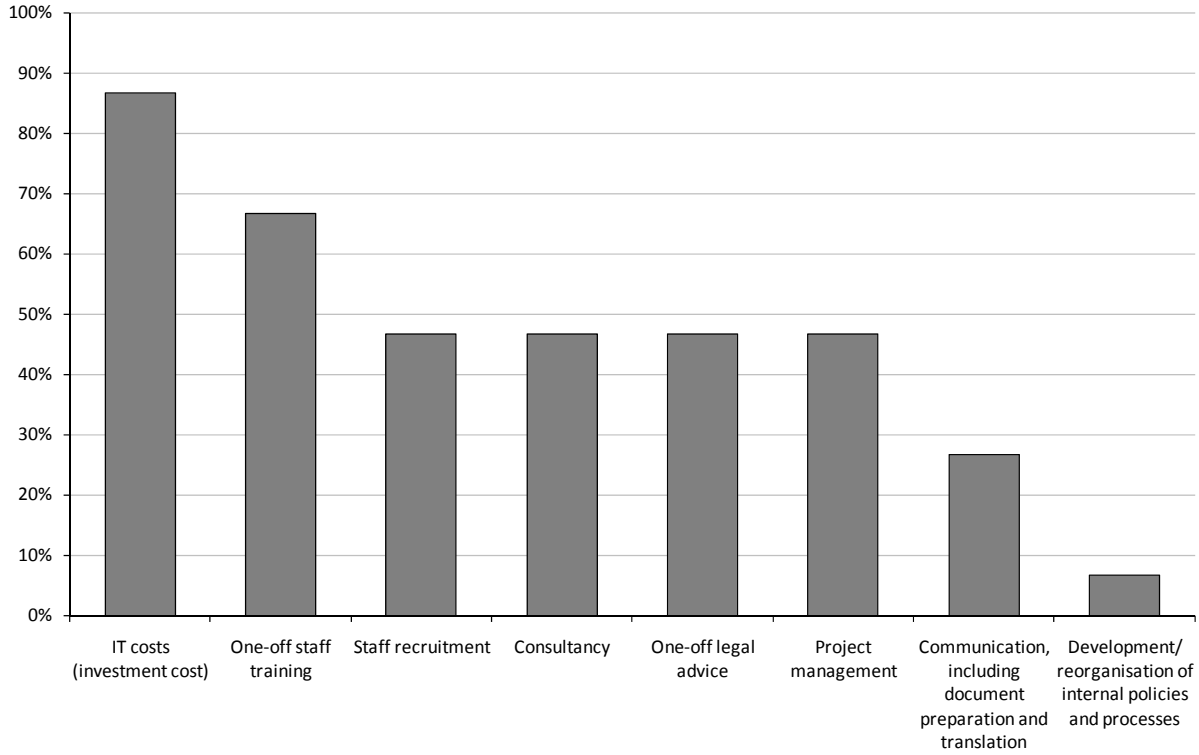


3.65 Once again the relationship between one-off costs and the current regulatory alignment with the various provisions of the proposed rules vary. In the life insurance market, the relationship is strongest for the S&A provisions with a correlation coefficient of -0.43, with the conflict of interest and inducement provisions creating coefficients of -0.29 and -0.34 respectively.

3.66 Not only are these generally higher than for the regulatory provisions for structured deposits, but the emphasis also differs. In the structured deposits market the relationship is strongest for the conflict of interest provisions (-0.35), followed by S&A (-0.17) and inducements (-0.11) respectively.

3.67 There is also a difference between the main drivers identified by banks and those identified by large companies more generally. In particular, as illustrated in Figure 3.22 below, staff recruitment and consultancy were cited more frequently than communications and with a similar frequency to project management and one off legal advice. IT costs and staff training were still, however, the most commonly cited drivers.

Figure 3.22: Main Drivers of One-Off Costs for Banks



Benchmarking against Previous Studies

3.68 Benchmarking against previous studies offers a potential sense-check for our findings. We also used benchmarks from previous studies as an input in our structured discussions with respondents, where this was necessary or appropriate, to help respondents consider their own costs for the purposes of this study.[52]

3.69 We begin by describing the evidence available from past studies, and then make a comparison to our own results.

3.70 There are several pre-existing *ex ante* and *ex post* studies of the implementation of MiFID, from a range of sources. We have considered the following:

(a) Europe Economics, 2009, "Cost of Compliance with Selected FSAP Measures" (for DG MARKT);

[52] Where we used figures from this benchmarking exercise as an input in some of the interviews (to seek reactions from respondents), this created a latent risk that those respondents would simply tend to confirm those estimates. Therefore we have always worked here with a wide range of absolute values, and when using these in interviews we varied them based upon our knowledge of the firm in question (i.e. we would suggest lower estimates to a very small intermediary).

(b) CRAI, 2010, "The Cost of Financial Advice" (for the UK's ABI);

(c) LECG, 2005, "MiFID Implementation, Cost Survey of the UK Investment Industry" (for the UK FSA);

(d) Vhayu, 2006, "Answering the technology challenges of MiFID";

(e) Gomber, P and Reininger, C, 2006, "Die Umstezung der MiFID in der deutschen finanzindustrie", Frankfurt University;

(f) JP Morgan, 2006, "MiFID II"; and

(g) Deloitte and ABBL, 2006, "Impact of Compliance on Financial Institutions in Luxembourg".

3.71 Of these, we have found (a) to (c) to be the most helpful to benchmarking the estimates described above. Our own study reviews companies from 18 Member States, including firms from eleven of the twelve Member States included here. The LECG's and CRAI's work has a limited geographic focus (only the UK is considered). However, the LECG work does provide a decomposition of the cost drivers of MiFID between its conduct of business and its other aspects. This decomposed analysis is extremely useful, despite its UK-focus, and is not otherwise available in this way. Similarly, CRAI's analysis describes, inter alia, the typical time spent by financial advisers in the UK in fact-finding, advising and administering (post sale) on a range of investment products and is useful for contextualisation but has not otherwise driven the benchmarking estimates used below.

3.72 Firstly, whilst the assessment of suitability and appropriateness, and properly dealing with conflicts of interest and inducements issues are non-trivial, these do not appear to have driven the majority of the cost of implementing MiFID. The aspects of MiFID outside of these (in particular, those dealing with, say, systematic internalization and best execution) had the greatest impact, albeit across a smaller population of firms, than the conduct of business rules. Using data derived from LECG's study, we set out below the relative positions (LECG set out both means and medians — we have preferred the latter due to the relatively small sample available to LECG):

Table 3.7: Median Incremental One-off Cost Impact of MiFID on UK Investment Firms

	Small (< 100 employees)	Medium	Large (> 500 employees)
	€000	€000	€000
Data gathering and classification (suitability, etc)	16.3	76.8	478.3
Data gathering (appropriateness)	3.9	36.6	14.6
Staff training	8.8	24.9	247.2
Additional record keeping (electronic storage only)	-	-	-
Conflicts of Interest	-	-	-
	29.0	138.2	740.1
Total costs of MiFID	131.6	3,144.8	6,947.9
Portion relating to relevant COB aspects	22%	4%	11%

Source: LECG, translated into euro at average 2005 rate (£1:€1.46271, www.oanda.com)

3.73 The firms surveyed by LECG mostly considered themselves to already have in place adequate systems to deal with conflicts of interest. On the other hand, the figure for staff training does not relate exclusively to Conduct of Business (COB) matters, however LECG's report (unsurprisingly, given that this was not its purpose) does not contain adequate detail to decompose this figure further.

3.74 We set out below the estimates from our own work. We have focused upon banks as the most relevant category of those that we studied. It must be noted that these estimates related to all of MiFID, without further decomposition and with different identification of large and small participants (a "small" bank was any with operating costs below €250 million — we have therefore also disaggregated those banks with annual operating costs above €50 million as a proxy to those with a headcount above 500).

Table 3.8: Median Incremental One-off Cost Impact of MiFID on Banks and Financial Conglomerates

	Sample	All €000	Small €000	Large €000
All banks	39	1,007	517	15,840
Retail only banks	28	682	471	15,635
Banks with operating costs above €50 million only				
All banks	30	3,228	1,004	15,840
Retail only banks	19	1,051	1,004	15,635

Source: Europe Economics, Cost of Compliance (2009)

3.75 Given that our 2009 estimates applies to all of MiFID, the results would need to be scaled back to make them comparable to those prepared by LECG. (This is assuming that the costs of applying the COB aspects of the MiFID are similar, regardless of the *type* of firm). If the scaling is about 10–20 per cent (implied by the above) then the results of both studies appear to be of approximately the same order of magnitude (at least).

3.76 Second, different implementation strategies are available to firms. For example, smaller firms may rely less upon IT to support changes in processes — this reduces the relative scale of implementation costs, all else being equal, but at the expense of an increased burden on ongoing costs. Similarly, firms in Central and Eastern Europe sometimes adopted an implementation approach that suited the circumstances of local development in financial services, but may not have worked in other more mature markets. (Both these points are made in our own 2009 study on the Costs of Compliance with the FSAP.)

3.77 Smaller firms tend to have proportionately higher costs, but not dramatically so. In other words, this is not simply a function of the effects of implementation having an unavoidable fixed cost element.[53] The observations made above have a countervailing effect, at least for most firms. In LECG's results, for instance, there is a clear step change between the cost experience for small firms (in absolute values) and that for medium and then again large-sized investment firms. LECG found that the median one-off costs of non-COB rules were particularly significant outside of the smaller firms.

3.78 The costs relevant to the study appear to be mostly payroll-related, with some IT spending. Naturally, there is scope for software vendors to have reduced prices. We expect that this would have been at least offset by wage inflation and our estimates have made a small allowance for this.

Table 3.9: Estimates of COB Impact based on Past Studies

	One-off cost €000	Ongoing cost €000
Intermediaries (other than very large intermediaries)	50 - 250	7.5 - 50
Large intermediaries, banks and insurers	500 - 1500	75 - 300

3.79 These estimates actually match up quite well against our findings as described above (e.g. by comparison to Table 3.1).

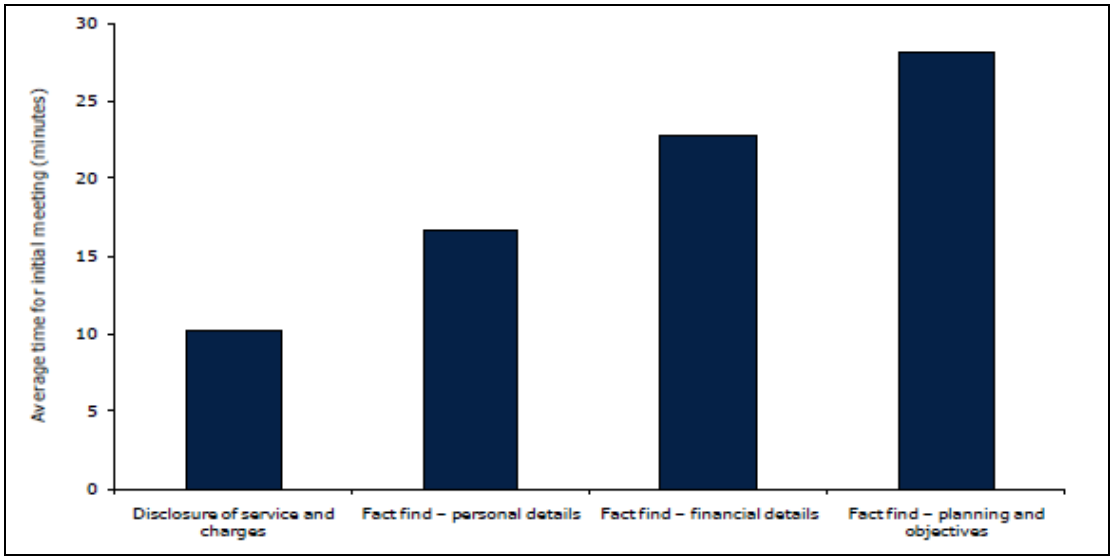
3.80 For completeness, we note that LECG analyse some of their cost estimates on a per customer basis also. The implied average implementation cost per customer for their UK-based sample of the aspects of MiFID relevant to this study would be about €150.

[53] However, we are not aware of any studies — including our own — that fully decompose the costs associated with MiFID into a fixed and a variable cost elements.

However, this looks high when compared to the analysis undertaken by CRAI includes estimates of the time taken by UK advisers in various parts of the sales/ advice process.

3.81 We show below the average time taken per customer for initial fact-finding, totalling just under one and a half hours of time with the client. This would include (but would not be limited to) the gathering of information to inform the assessment of suitability and appropriateness, as necessary (though time for assessing appropriateness would be normally shorter than that for assessing suitability).[54]

Table 3.10: Extract from CRAI, Average Time for Initial Meeting Across All Channels



Source: CRAI (2010)

3.82 Even if all of the time above were attributed solely to regulatory intervention (i.e. it would not happen otherwise), the *per client* cost would be about €50.

3.83 Furthermore, companies that have already implemented MiFID in respect of other products in their portfolios may have lower cost exposure than those without prior experience. However, if costs are largely variable in nature, the effect of this may be limited and therefore we have not made an *a priori* adjustment for this.

[54] This is consistent with the feedback from this study and from other previous work — such as the analysis prepared by CRAI on the "Cost of Providing Financial Advice" on behalf of the UK's ABI in 2010.

Conclusions

3.84 Overall on average, the one-off costs of compliance represent 0.14 per cent of operating costs.[55] The main drivers of these costs are the costs of introducing new IT systems, one off staff training and the costs associated with project management.

3.85 This, however, disguises a high degree of variation across companies of different types and sizes, both in terms of the actual estimates and the degree of variation of estimates within the groups. Not only do intermediaries bear a higher proportion of their operating costs in one-off costs, the dispersion of estimates is also markedly higher for intermediaries than for life insurance companies and banks. Table 3.11 below illustrates the average cost associated with each of the different types of firm.

Table 3.11: Median One-Off Costs as a Percentage of Operating Costs for Different Types of Firm

SMEs	Large	Intermediaries	Life Insurance Companies	Banks
1.92%	0.08%	2.04%	0.45%	0.06%

3.86 The scale of operating costs has a significant positive effect on the size of the one-off costs, indicating that the larger the company the greater the one-off costs in absolute terms. However, by examining SMEs and large companies separately, it is clear that this effect is stronger for small companies, such as intermediaries, than for larger companies (i.e. as the size of the company increases the implications for one-off costs are greater for SMEs than they would be for a similar increase in the size of a large company). These estimates are generally in line with the benchmarks described above.

3.87 The relationship between the one-off costs of compliance and the current regulatory alignment with the proposed rules is less clear. The correlation between the two is generally low, though SMEs and banks operating in the life insurance sector appear to experience stronger relationships, the former driven largely by the conflict of interest provisions, the latter driven by the suitability and appropriateness provisions. However, a consistent pattern does emerge across all company types, with companies operating in countries with a low level of regulatory alignment tending to record on average higher one-off costs than the companies operating in countries with a high level of alignment.

3.88 There are various possible explanations for the weakness of this relationship. In particular, the existence of informal industry-led codes of conduct that focus on similar areas as the relevant MiFID provisions being considered here may distort the picture

[55] The average referred to here is the median. Given that the estimates are skewed this offers a much more accurate indication of the actual costs.

somewhat, though evidence from Sweden would indicate that this effect is not consistent across companies (due to the voluntary nature of such regulation) and even where it exists may have only a limited impact on the cost estimates. Another possible explanation is that some companies may already apply MiFID rules to life insurance investment products and structured deposits voluntarily. Companies already subject to MFID in other areas of their business, for example, may apply such policies to the relevant non-MiFID products to earn reputational benefits or in order to streamline their business in some way. Finally, the sample size may also make it more difficult to gain a clear picture.

3.89 While larger companies in general would be likely to experience lower one-off costs as a proportion of their operating costs, there is a clear distinction between banks and life insurance companies. Since banks are more likely to already be subject to MiFID in other areas of their business, and non-MiFID PRIPs represent a smaller proportion of their business than for life insurance companies, this result supports the idea that the higher the proportion of the business that non-MiFID PRIPs represent, the higher the one-off costs are likely to be. Intuitively, businesses that already apply MiFID in other areas will be more familiar with the processes involved and will already have the necessary systems in place (some may even have already applied MiFID provisions to sales of non-MiFID PRIPs voluntarily as discussed above). As such transition would be likely to involve smaller initial investment costs.

3.90 We have used the above analysis to extrapolate the results from our sample to construct an estimate of the one-off cost of compliance with the proposed rules for the EU as a whole. We employed two distinct approaches to construct the estimate, the first distinguishing between different types of company, the second also incorporating analysis of the current regulatory alignment. Given the lack of strong relationships between cost estimates and the regulatory framework (and the small sample) we focus here on the former approach. Table 3.12 below illustrates these estimates (refer to Appendix 2 for a full description of the two approaches and the estimates calculated).

Table 3.12: One-Off Cost Estimates for the EU27

	Medians €m	Weighted mean €m	Medians, decomposed by regulatory score €m	Weighted means, decomposed by regulatory score €m
Intermediaries	106.2	24.8	187.3	56.8
Insurers	205.3	166.5	249.3	178.4
Banks	209.2	91.4	154.3	125.7
Total	520.7	282.6	590.9	360.8

3.91 In most cases, the medians generate higher estimates than the weighted means. This is consistent with the proportional cost impact being higher for smaller firms.

3.92 We consider that central estimates of the likely impact can be made as follows:

- on intermediaries of €50–€125 million;
- for insurers, a one-off impact of €175–250 million (about 1.1–1.6 per cent of attributable expenditure[56]); and
- on banks of €125–€175 million.

3.93 This would mean total one-off costs of €350–€550 million.

3.94 The costs however are likely to be affected by a number of factors. For example if new EC regulation deviates other than trivially from existing national approaches in terms of the requirements imposed and/or the client base the regulation would apply to, the costs are likely to be substantially higher as those companies currently subject to the rules under the original text will incur costs that they would otherwise avoid. This will also be true for those companies that already apply MiFID voluntarily to a broader range of products than currently covered by the regulation, for example because a large part of their business is already covered by MiFID.

3.95 The costs involved would also be affected by the scope of the eventual regulation, both in terms of product scope and the contracts it would apply to, i.e. whether it applies to all existing contracts or only new contracts going forwards. One Member State where the scope is likely to be particularly important is Germany. The interaction between pensions and life insurance investment products could mean that the costs of complying with the proposed rules would extend beyond simply those companies selling the relevant PRIPs.

3.96 Aside from these factors, the cost estimates above must be taken within the context of this study and the relatively small sample used.

[56] The operating costs of life insurers attributable to linked life insurance investment products (as opposed to life insurance as a whole, including classical term products) are in the order of €16 billion across the EU. This means that the one-off estimates represent non-trivial values.

4 THE ONGOING COST OF COMPLIANCE

Introduction

4.1 This section examines the potential incremental ongoing costs of complying with the proposed rules. The analysis is based on the same 58 responses as used in the previous Chapter (refer to Appendix 1 for a full description of the survey and interview respondents).

4.2 There are a number of factors that we might expect to influence the size of potential ongoing costs, for example:

(a) *The size of the company* — larger companies that incur higher one-off costs of investment up front would be likely to incur smaller additional ongoing costs.

(b) *The degree of current regulatory alignment with MiFID* — as with one-off costs, the more aligned a country's current regulation of the relevant products is with MiFID provisions, the smaller the incremental ongoing costs are likely to be.

(c) *The proportion of their existing business already regulated by MiFID* — the smaller the proportion of the business affected by the additional regulation the smaller the likely impact on the operating costs of the business. As with on-going costs, voluntary alignment of compliance systems and controls around MiFID-style requirements would also, in theory, have a similar impact.

(d) *The dominant method of distribution of the relevant products* — given the above the structure of the distribution channel in a Member State is likely to affect the aggregate scale of any incremental ongoing costs.

4.3 The section is structured in the same way as the previous section. Once again we start of by examining the ongoing costs on an aggregate basis, i.e. across all company types across all Member States. We then consider any differences (or similarities) across companies of different sizes and different types of companies.

4.4 In each case we first provide an overview of the average and range of turnover, operating costs, and, of course, cost estimates for the companies under consideration in that sub-section. Given the diversity of the companies we consider both the mean and the median values. A more detailed description of the companies that provided information for this study is set out in Appendix 1.

4.5 The overview is followed by a general analysis of the costs, including an examination of the relationships between a company's operating costs and the incremental ongoing cost estimates, the cost estimates and the current level of regulatory alignment with the proposed rules, and the main drivers of the costs. Throughout we draw comparisons where appropriate with the analysis of the one-off costs.

4.6 We conclude the section with a discussion of the main points that have arisen out of the analysis and provide estimates of the total ongoing costs for the EU27 based on an extrapolation of the data collected. A detailed description of the extrapolation methodology is provided in Appendix 2.

4.7 It is important to highlight again, as with the analysis of one-off costs, that the data used in the following analysis is as robust as possible given the nature of the exercise and the relatively small sample size. Identifying potentially distortive results such as outliers, however, is inherently difficult with a sample of this size and given the uncertainties associated with an *ex ante* exercise of this sort. As such all results, especially those that rely on sub-groups within the sample, must be treated with caution. For a full breakdown of the results and the methodology employed in collecting the data please refer to Appendix 1.

General Findings

4.8 As in the case of the estimates of potential one-off costs of compliance, the range of ongoing costs is relatively wide though the mean and median figures indicate that ongoing cost estimates are skewed towards the lower end of the distribution (i.e. most data points lie towards the lower end of the distribution with a few being much higher dragging up the mean), see Table 4.1 below.

4.9 As with one-off costs it is important to control for the size of the company to allow a more useful comparison of the potential ongoing costs. Since ongoing costs will directly impact on the company's operating costs, the more appropriate indicator in this context is the company's operating costs from the last financial year. As such, although we include the ongoing cost estimates as a percentage of turnover in the summary tables throughout this section we focus on ongoing costs as a percentage of operating costs.

4.10 Even though the general pattern in the ongoing cost estimates is similar to that for one-off costs, the ongoing cost estimates are smaller than the one-off cost estimates as a percentage of the company's operating costs. This is not surprising, as companies typically try to smooth any additional ongoing costs into their normal business, potentially incurring higher one-off costs in order to do this (for example by introducing a more sophisticated IT system that minimises the need for additional staff). This is supported to some extent by the data as, although one-off cost estimates and ongoing cost estimates do appear to be positively correlated, for all respondents the relation is less than one (i.e. for any given firm estimated annual, ongoing costs are below one-off costs).

Table 4.1: Overview of Turnover, Operating Costs and Ongoing Cost Estimates for all Respondents

	Turnover	Operating Costs	Ongoing Cost Estimate (€)	Ongoing costs as a % of turnover	Ongoing costs as % of operating costs
Mean	€ 2,626,052,708	€ 1,102,378,420	€ 206,201	0.92%	1.67%
Median	€ 116,350,000	€ 39,000,000	€ 30,000	0.02%	0.04%
Range	€75,448-€31,300,000,000	€28,293-€19,650,000,000	€0-€3,750,000	0%-19%	0%-20%

The relation with firm size

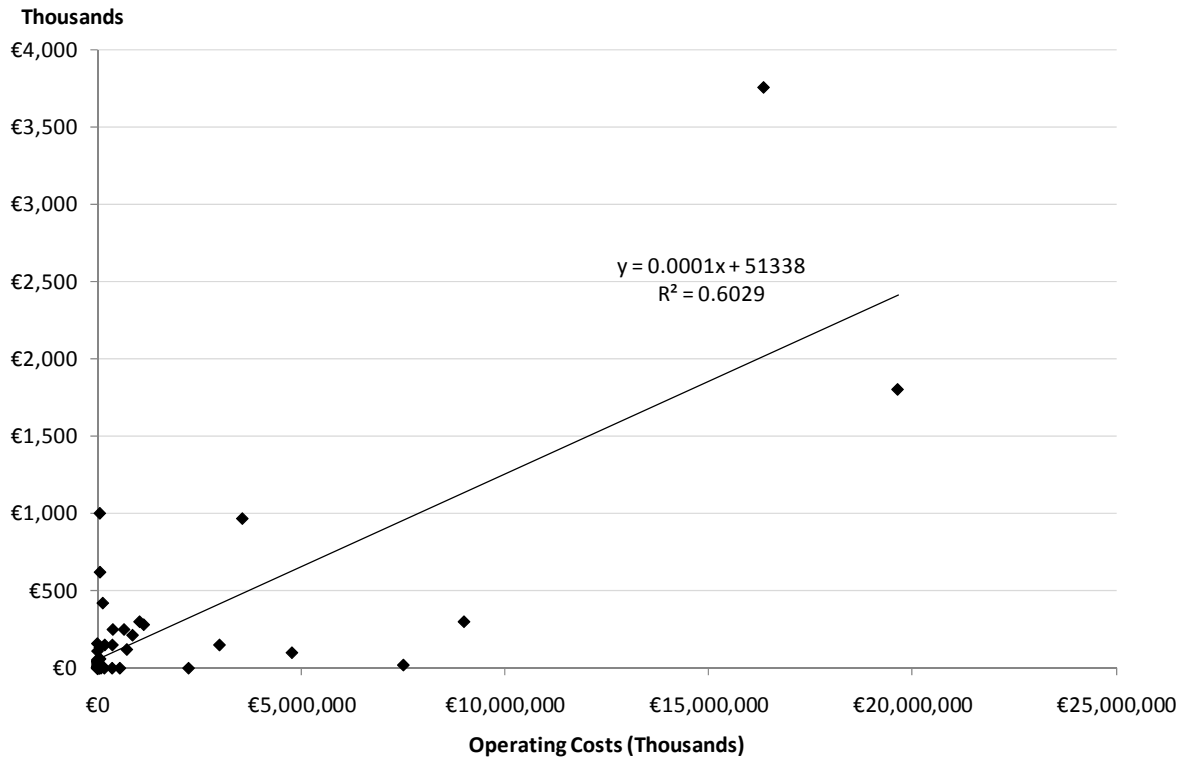
4.11 As in the case of the one-off cost estimates there appears to be a reasonably strong relationship between the size of a company's operating costs and the size of any additional ongoing compliance costs — variations in operating costs explain around 60 per cent of the variation in the incremental ongoing costs. So once again the larger the company the larger the costs they face (in absolute terms). This is, however, a weaker relationship than for one-off costs, which may reflect the smoothing effect mentioned above or simply the fact that ongoing costs may be more difficult for companies to estimate *ex ante*.[57]

4.12 The simple regression analysis indicates that, in addition to an average incremental cost of €51,338 that all companies would incur, for every extra €1 in operating costs, the company would expect to incur an extra €0.0001 in ongoing costs.[58] This is clearly lower than the one-off costs, where the average incremental cost was estimated to be €171,104 with operating costs increasing the total one-off cost by €0.0005.

[57] This is typical: one-off costs are more likely to be budgeted for discretely than ongoing costs and so participants have greater experience to draw upon in preparing their estimates. The ongoing impact of regulatory change (or indeed any change) is rarely itemised separately — instead the objective is to minimise it as quickly as possible by absorbing into the costs of conducting "business as usual" (even where the meaning of business as usual has itself changed).

[58] While the relationship between operating costs and ongoing costs is statistically significant (even at the 0.5% level) the estimate for average fixed costs is not.

Figure 4.1: Relationship between Ongoing Cost Estimates and Operating Costs for all Respondents



4.13 As in the case of one off costs, the dispersion of the results may be the result of a number of outliers. However, given the small sample size, and in the absence of any evidence to indicate that such companies do represent outliers, we have included them in the analysis.

The relation with regulation

4.14 Breaking the cost estimates down by the level of regulatory alignment with the proposed rules across individual Member States illustrates a clear pattern between the level of regulatory alignment and the size of the potential ongoing costs. Whilst (as before) estimates for Member States with a medium level of alignment are not always smaller than the estimates in low alignment environment relative to the companies' operating costs, the costs for those companies operating in highly aligned Member States demonstrate the lowest cost estimates.

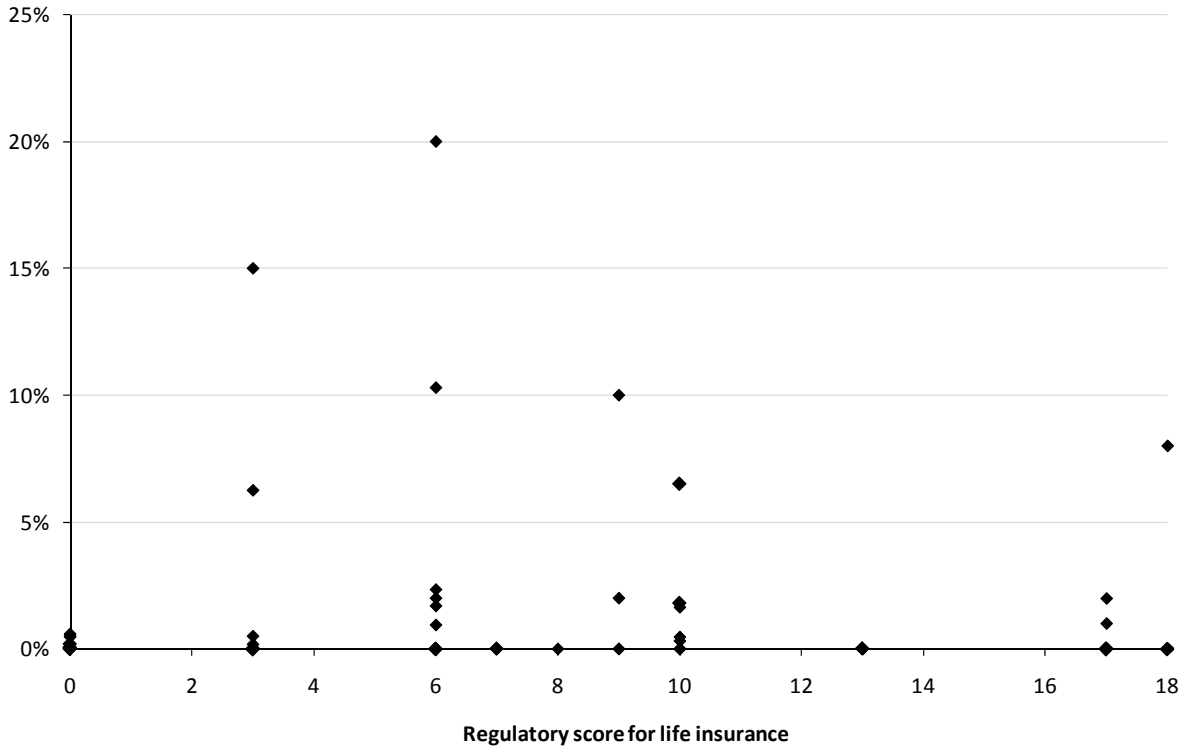
Table 4.2: Average Ongoing Cost Estimates Broken Down by the Current Regulation's Level of Alignment with the Proposed Rules

	One-off cost estimate		One-off costs as a percentage of operating costs	
Life Insurance Market				
	Mean	Median	Mean	Median
Low	€ 286,870	€ 47,500	2.11%	0.08%
Medium	€ 139,556	€ 2,000	1.75%	0.31%
High	€ 119,913	€ 4,000	0.85%	0.02%
Structured Deposits				
	Mean	Median	Mean	Median
Low	€ 169,393	€ 120,719	0.69%	0.03%
Medium	€ 2,775,000	€ 2,775,000	0.02%	0.02%
High	€ 82,500	€ 82,500	0.02%	0.02%

Note: A low level of alignment would include any Member States with a regulatory score of between 0 and 6 inclusive, a medium level would be a score of between 7 and 12 inclusive, and a high level would be a score of 13 to 18 inclusive.

4.15 In spite of this pattern, the correlation between additional ongoing costs as a proportion of operating costs and the level of regulatory alignment with MiFID in the life insurance market is generally very weak, with a coefficient of only -0.02. The fact that the correlation is even weaker for ongoing costs than for one-off costs is again unsurprising as, as discussed earlier, companies may front-load the costs of change by implementing more sophisticated technology or processes in order to reduce any ongoing incremental costs for the business. As such the incremental ongoing costs would be driven less by any differences between the existing regulatory environment and the proposed rules and more by what investment had been made during the transition phase. Moreover, it may be more difficult for companies to estimate ongoing costs than one-off costs undermining any evidence of the relationship between the ongoing cost estimates and the current regulatory environment.

Figure 4.2: Ongoing Cost Estimates as a Percentage of Operating Costs for Companies selling Life Insurance plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector

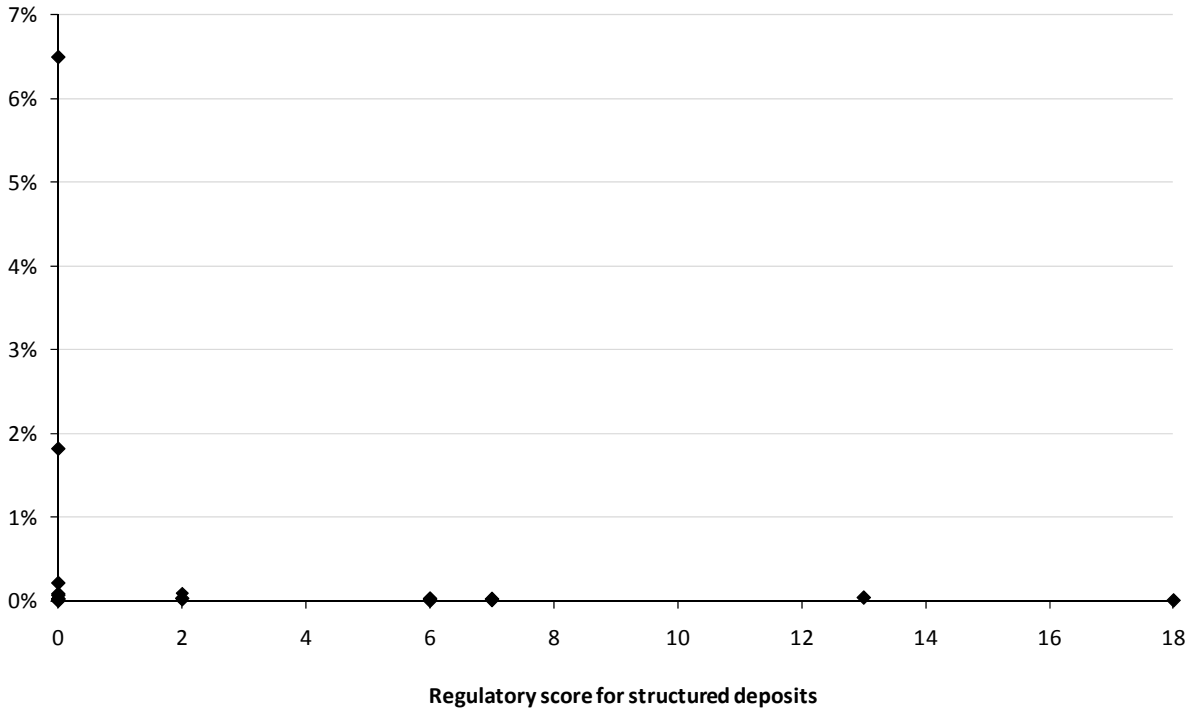


4.16 As before, those companies operating in Member States with a low level of alignment (i.e. a regulatory score of six or less) are either large banks or the insurance arm of a financial conglomerate. Another reason for the low level of correlation may, thus, derive from the fact that some of the larger companies, particularly banks and bancassurers that already sell products covered by MiFID, are either familiar with the regulation and would be able to extend it further without significant additional ongoing costs to their business, or they already have extended it to life insurance investment products.

4.17 In line with the findings for one-off costs, the relationship between the regulatory score and ongoing costs estimates is strongest for the conflict of interest provisions (-0.09). Meanwhile, the correlation between cost estimates and the regulatory score for S&A provisions and inducements is very weak.

4.18 As with one-off costs, the correlation between additional ongoing costs as a percentage of operating costs and the level of alignment with the proposed rules is stronger for deposit-based structured products (with a correlation coefficient of -0.23). Once again, this may reflect the limited data available for companies selling only structured deposits and not life insurance PRIPs.

Figure 4.3: Ongoing Cost Estimates as a Percentage of Operating Costs for Companies selling Deposit-Based Structured Products plotted against the Current Regulatory Framework's alignment with MiFID for Structured Deposits

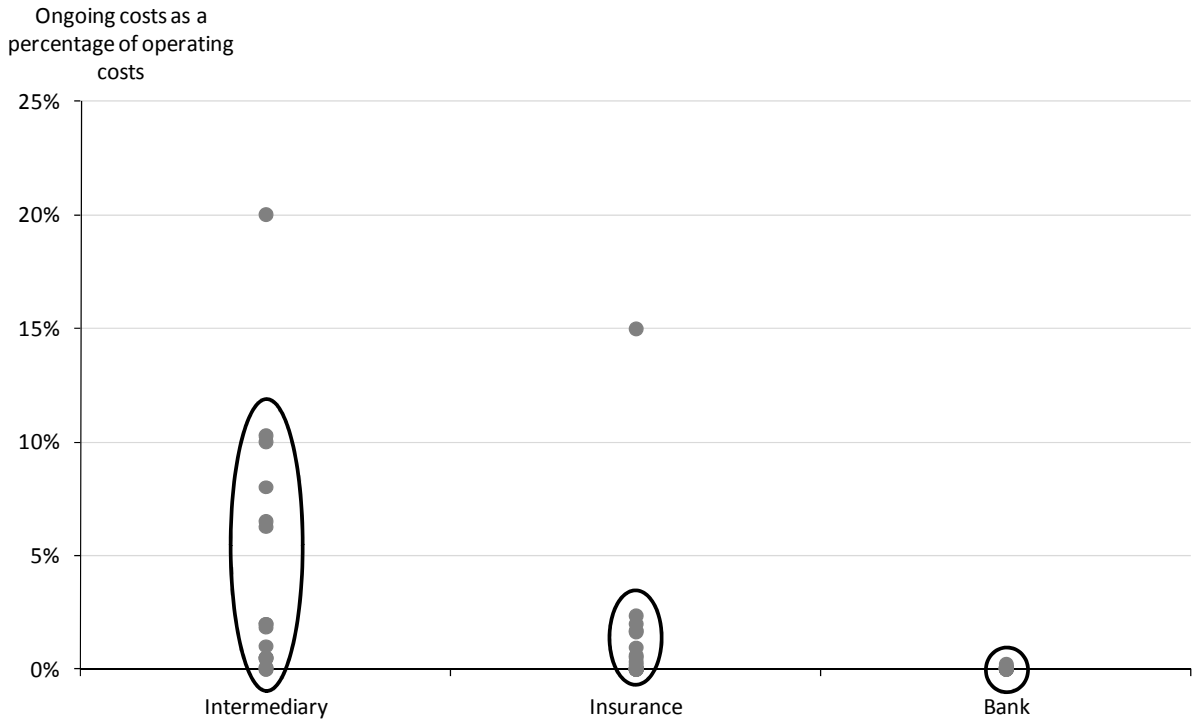


4.19 The relative importance of the current regulatory context of the individual provisions in terms of the ongoing cost estimates in the structured deposits market mirrors that for one-off costs, with very similar correlation coefficients. As before conflicts of interest provisions are most closely correlated with cost estimates (-0.29), followed by S&A provisions (-0.17) and finally inducement provisions (-0.11).

The relation with firm type

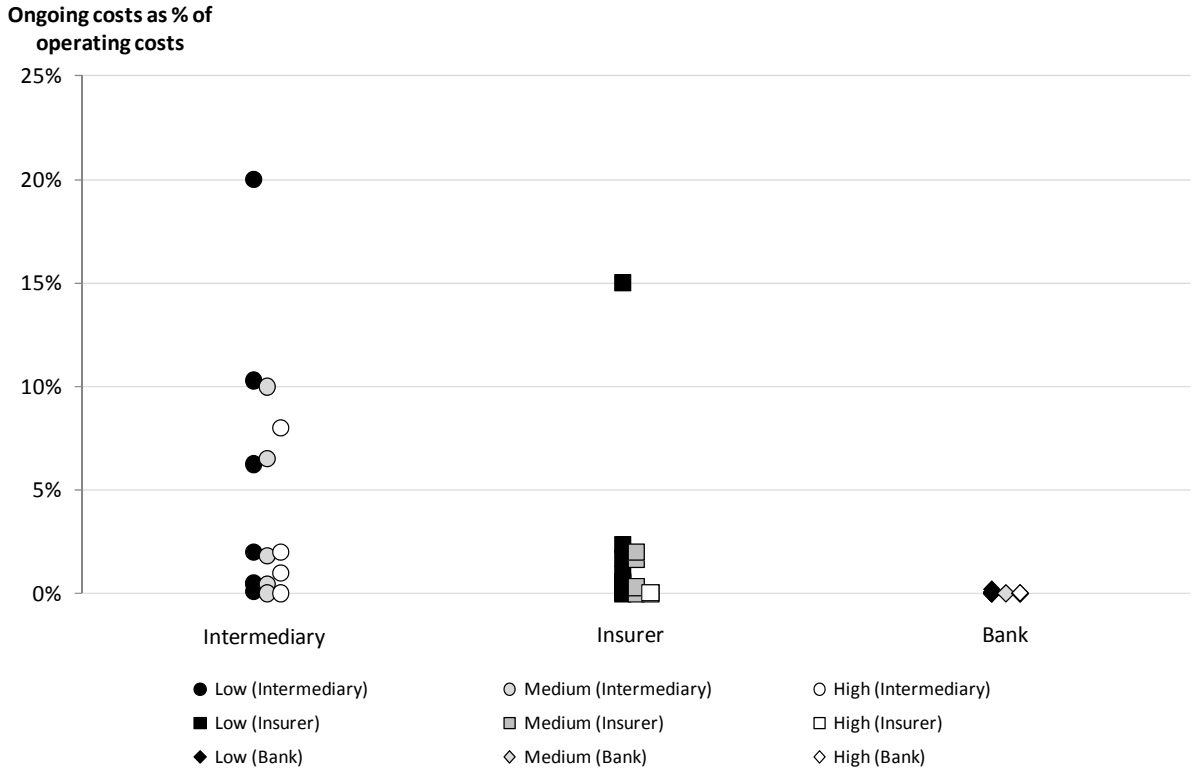
4.20 In terms of the dispersion of the estimates of potential additional ongoing costs, even if we leave aside the outliers, there is still a distinct pattern in terms of the dispersion of responses across the different types of company, as illustrated in Figure 4.4 below. While banks appear to be clustered around the zero per cent mark, the variation in ongoing cost estimates as a percentage of operating costs is much greater for life insurance companies and intermediaries, intermediaries demonstrating the greatest degree of variation overall. The dispersion also indicates that the estimates of ongoing costs as a proportion of operating costs are generally higher for intermediaries (in particular) and life insurance companies than banks. The differences between the types of companies are explored further below.

Figure 4.4: Dispersion of Ongoing Cost Estimates as a percentage of Operating Costs by Type of Company



4.21 As with one-off costs, if we break the data down further to distinguish between the level of regulatory alignment in the countries in which the companies operate, a clear pattern emerges across all company types: firms operating in Member States with a high level of regulatory alignment tend to be lower and less dispersed than for companies operating in countries with low regulatory alignment (see figure below). This again reinforces the idea that the level of regulatory alignment affects the scale of the potential costs and the ability of companies to estimate such costs *ex ante*.

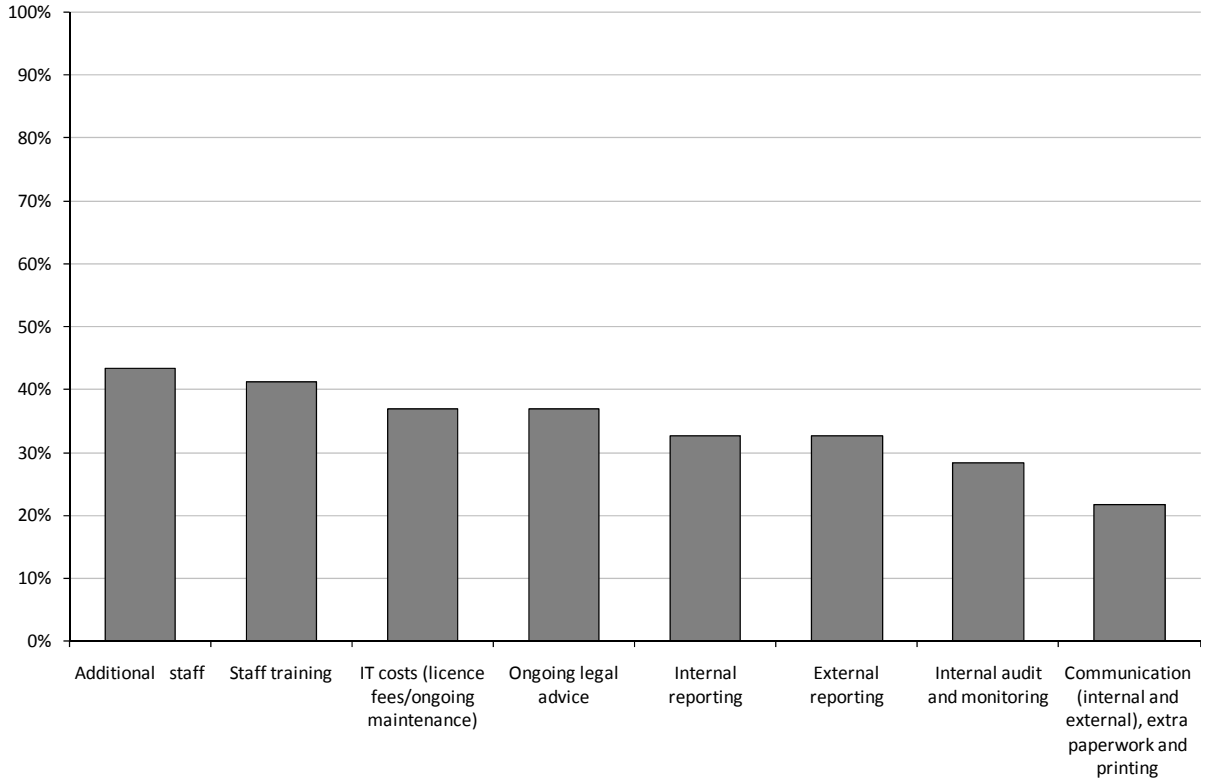
Figure 4.5: Dispersion of Ongoing Cost Estimates as a percentage of Operating Costs by Type of Company and Level of Regulatory Alignment



4.22 As we would expect, the most frequently cited drivers of any additional costs were additional staff and ongoing staff training (see Figure 4.6 below). After the initial one-off investment the costs arising from changes to the IT system become much less important, as does communication. Meanwhile, ongoing internal monitoring and reporting would be expected to create more significant additional ongoing costs (since the firm will continue to distribute).

4.23 A number of companies that engaged in the study highlighted the extra time that sales staff would have to spend with customers as being one of the key drivers of the additional ongoing costs. In addition to this any requirements that result in the need for more highly qualified staff would result in additional costs as these would be more expensive to recruit and retain.

Figure 4.6: Main Drivers of Incremental Ongoing Costs



SMEs versus Large Companies

4.24 As we would expect, and as with one-off costs, SMEs also face larger ongoing costs as a proportion of operating costs than large companies (see Table 4.3 below). This may also reflect the reduced ability of SMEs to front-load the costs and automate systems and processes as part of any one-off investment. Certainly, although the correlation between one-off costs and ongoing costs is positive for both small and large companies, the positive relationship is weaker for large companies (0.61 as opposed to 0.86 for SMEs).

Table 4.3: Overview of Turnover, Operating Costs and Ongoing Cost Estimates for all Respondents broken down by Size of Company

	Turnover		Operating Costs		Ongoing Cost Estimate (€)		Ongoing costs as % of turnover		Ongoing costs as % of operating costs	
	SMEs	**Large**	**SMEs**	**Large**	**SMEs**	**Large**	**SMEs**	**Large**	**SMEs**	**Large**
Mean	€ 5,205,789	€ 4,460,645,551	€ 2,311,878	€ 1,853,643,375	€ 18,764	€ 307,519	2.52%	0.03%	3.77%	0.54%
Median	€ 245,000	€ 801,564,035	€ 207,650	€ 182,000,000	€ 4,000	€ 100,000	0.47%	0.01%	1.90%	0.02%
Range	€75,448-€42,500,000	€68,189,046-€31,300,000,000	€28,293-€26,972,660	€1,059,560-€19,650,000,000	€0-€110,000	€0-€3,750,000	0%-19%	0%-0.28%	0%-20%	0%-15%

4.25 Similar to one-off costs, the relationship between a company's operating costs and the potential ongoing costs of complying with the proposed rules is statistically much stronger for large companies than for SMEs: operating costs explaining almost 60 per cent of the variation in ongoing costs across large companies, compared to only 11 per cent for SMEs. Figure 4.7 and Figure 4.8 below illustrate these relationships.

4.26 In this instance, however, the impact of operating costs on ongoing costs is not statistically significant for SMEs (nor is the regression as a whole), while it is for larger companies; a €1 increase in operating costs increasing the ongoing costs of a large company by €0.0001. This could be because the relationship is non-linear or the existence of outliers that distort the picture but which we have been unable to identify. Alternatively, this could simply reflect the fact that small companies may have greater difficulty in estimating the ongoing costs, for example because of a lack of familiarity with the proposed rules, and/or a greater degree of variability in their approach to complying with the proposed rules. As illustrated in Figure 4.4 above the dispersion across intermediaries is much greater than for the other types of companies.

4.27 The fixed cost underpinning the incremental ongoing cost for large companies is less than half that for the one-off cost, and the variable cost is also lower.

Figure 4.7: Relationship between Ongoing Cost Estimates and Operating Costs for SMEs

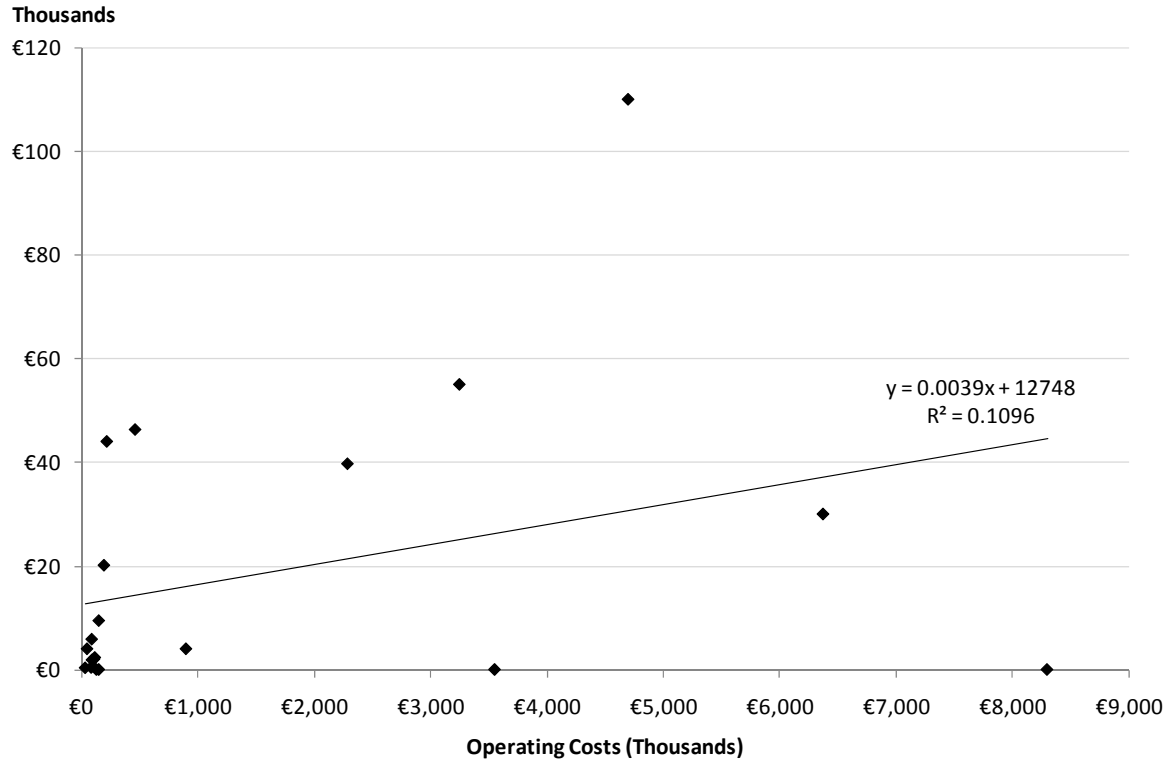
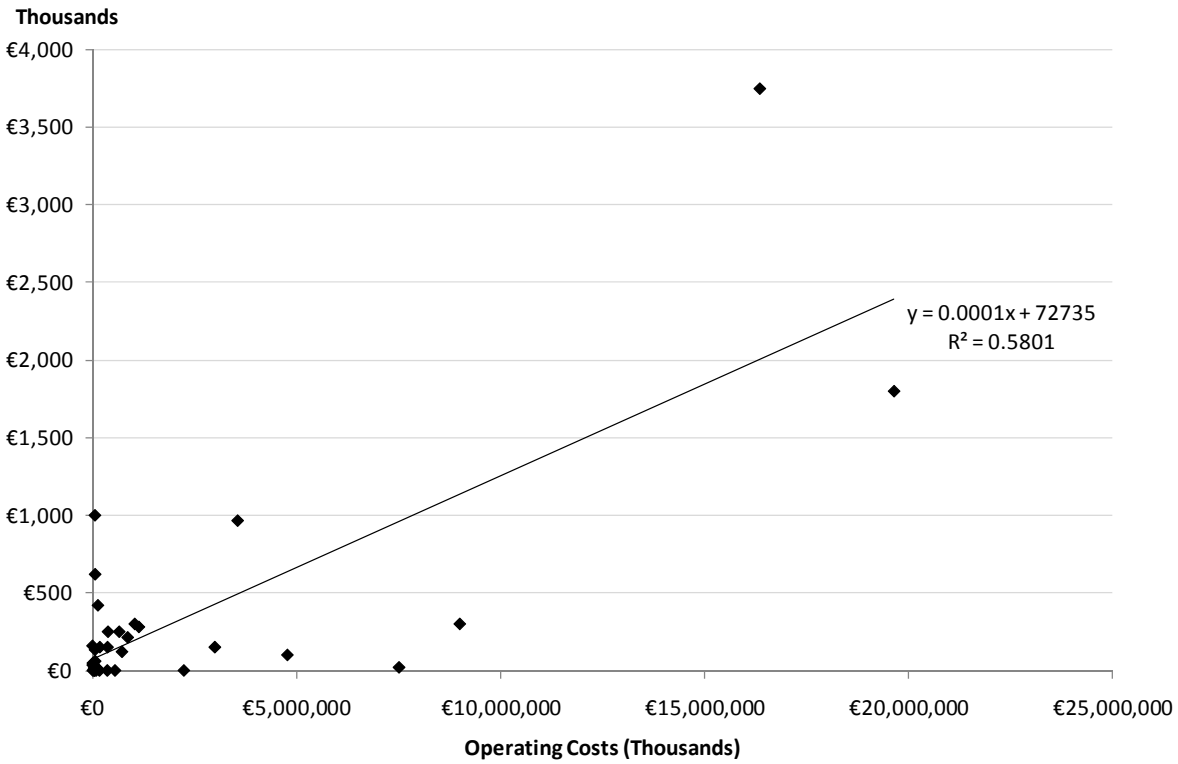


Figure 4.8: Relationship between Ongoing Cost Estimates and Operating Costs for Large Companies



4.28 In terms of the relationship between the ongoing costs as a percentage of operating costs and the level of regulatory alignment with the proposed rules, unlike one-off costs, there appears to be little difference due to company size. However if we use data only from those companies that do not sell structured deposits but do sell life insurance PRIPs the correlation increases from -0.08 to -0.16 for SMEs, whilst remaining largely unchanged for large companies.

4.29 Although there are insufficient data to construct a correlation coefficient for SMEs, the correlation for large firms between the ongoing cost as a percentage of operating costs and the level of regulatory alignment in the structured deposits market, at -0.37, is relatively strong.

Figure 4.9: Ongoing Cost Estimates as a Percentage of Operating Costs for SMEs selling Life Insurance plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector

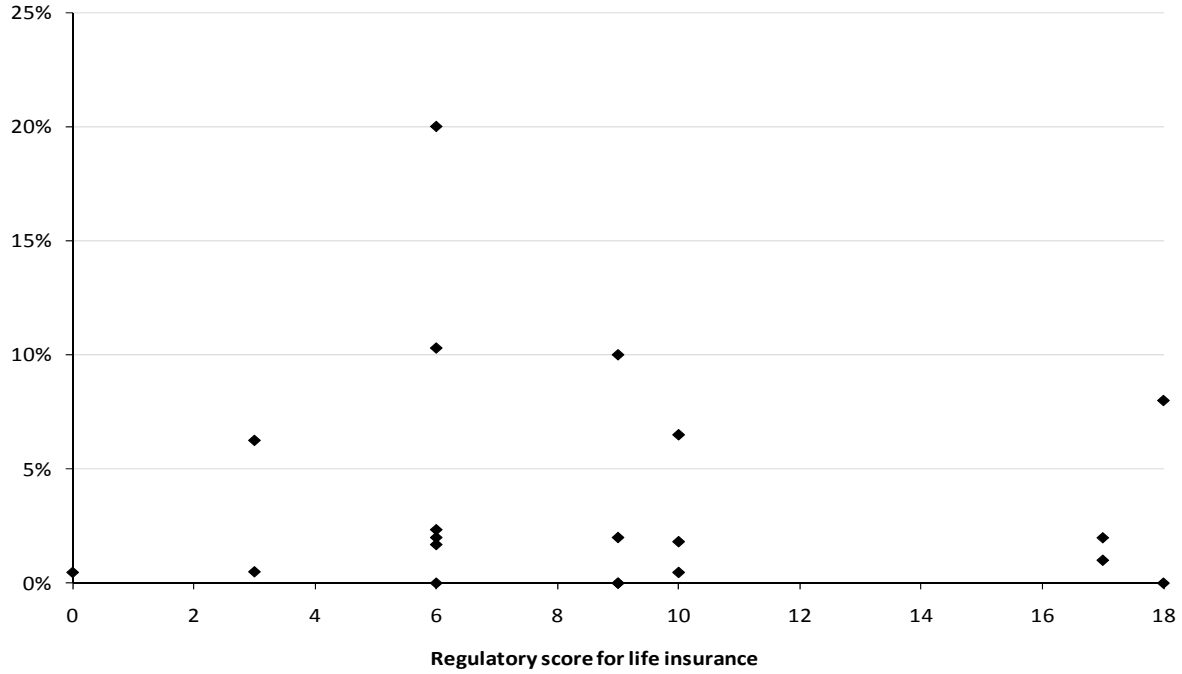
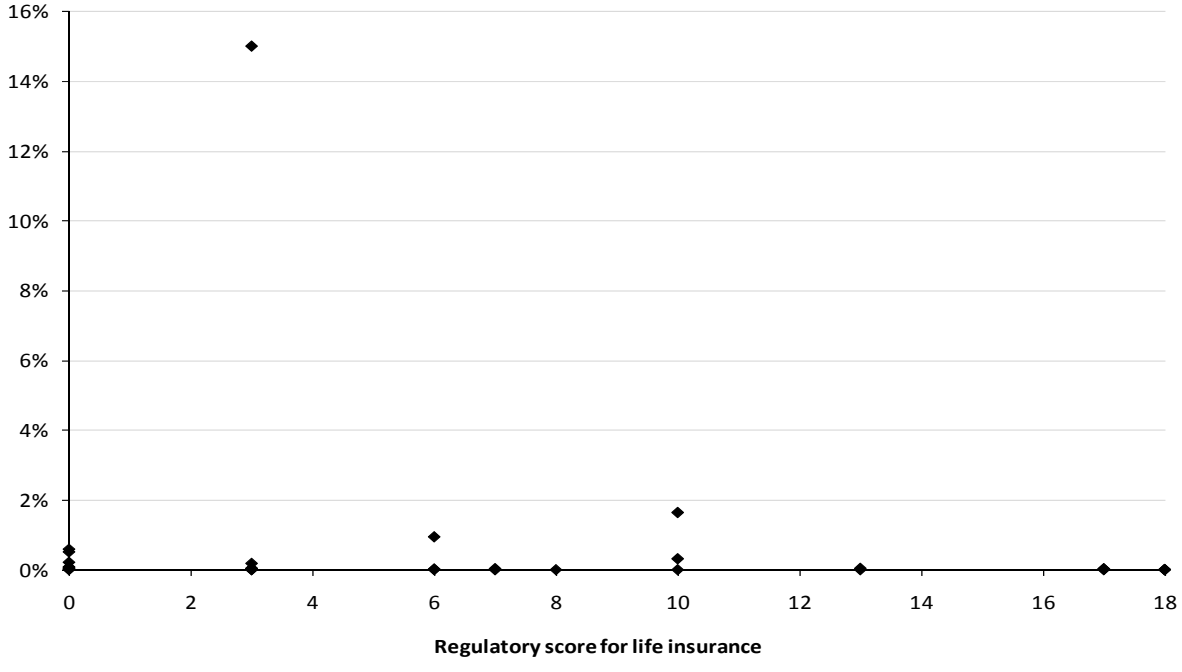


Figure 4.10: Ongoing Cost Estimates as a Percentage of Operating Costs for Large Companies selling Life Insurance plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector



4.30 While for small companies the relative importance of the various provisions remains the same as for one-off costs, the correlation coefficient for large companies between the inducements provisions and the ongoing costs as a proportion of operating costs is markedly higher than it was for one-off costs. Moreover, the strength of the relationship for large companies (-0.15) is much greater than for small companies (-0.09) for the inducements provisions, while the relationship between ongoing cost estimates and the S&A provisions are much weaker for large companies (-0.04) than SMEs (-0.14).

4.31 Consistent with the general findings, the SMEs cited additional staff, staff training, IT costs and ongoing legal advice as the main drivers of ongoing costs. While these were also frequently cited by large companies, the most commonly identified driver was the costs associated with internal reporting. For SMEs internal reporting was the least commonly identified source of costs. This could be explained by their small size (and thus less need for formal internal reporting), or possibly by their potentially more limited experience with the requirements associated with the proposed rules.

4.32 Conversely, communication, a key driver of one-off costs for large companies, was the least frequently cited driver of ongoing cost for large companies but one of the more commonly cited drivers for SMEs. This is likely to reflect a difference in the choices made by the different sizes of firm — a larger firm may be able to develop a major communications campaign (covering both internal and external communications, and also documentation changes) as a one-off event whereas an SME may choose a programme of continuing communication.

Figure 4.11: Main Drivers of Ongoing Costs for SMEs

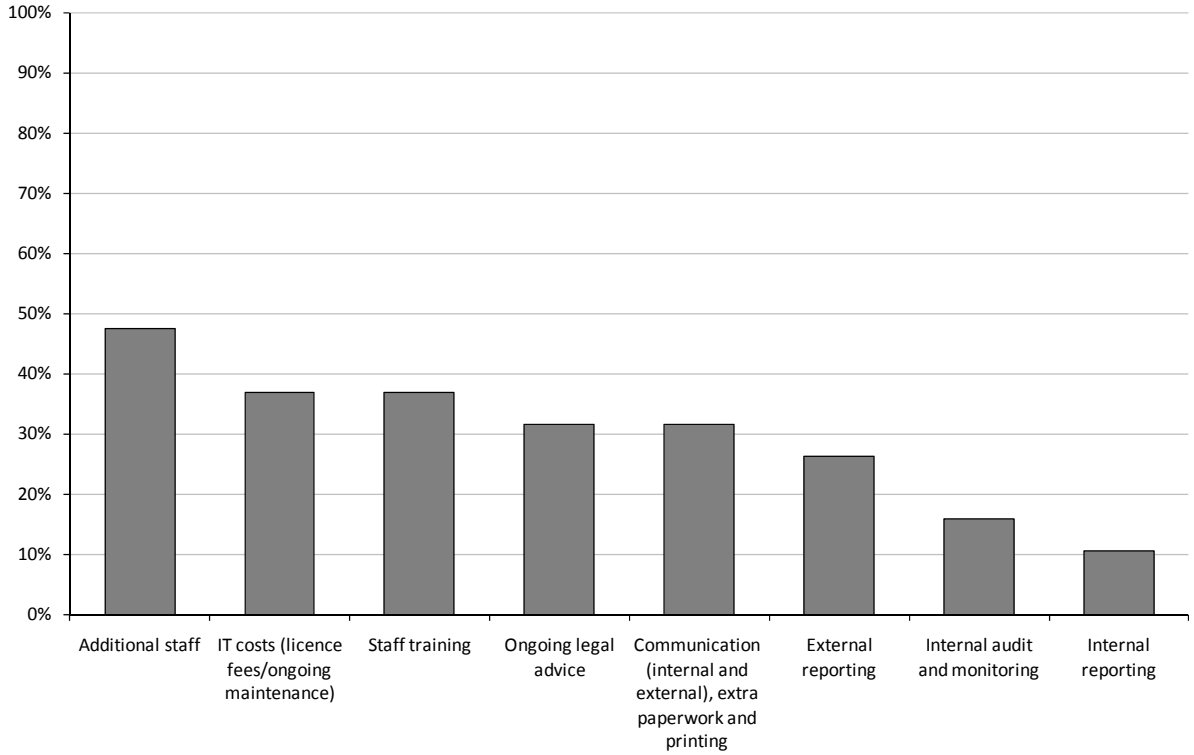
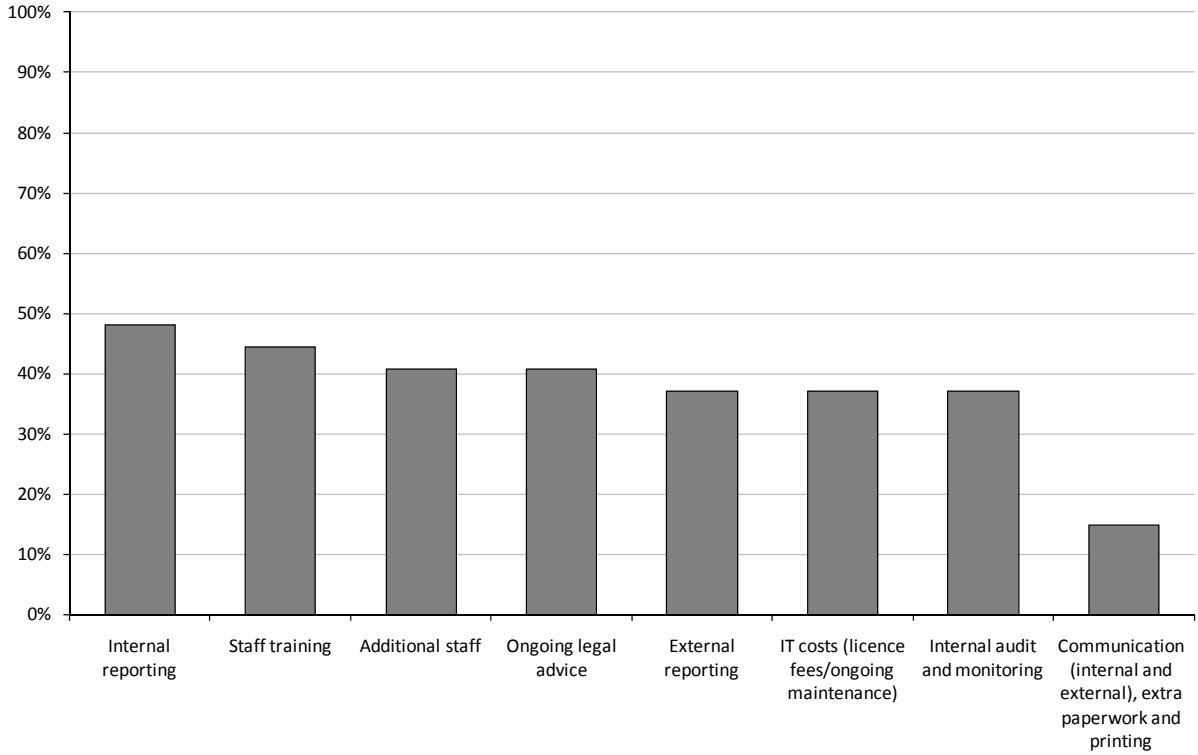


Figure 4.12: Main Drivers of Ongoing Costs for Large Companies



Intermediaries

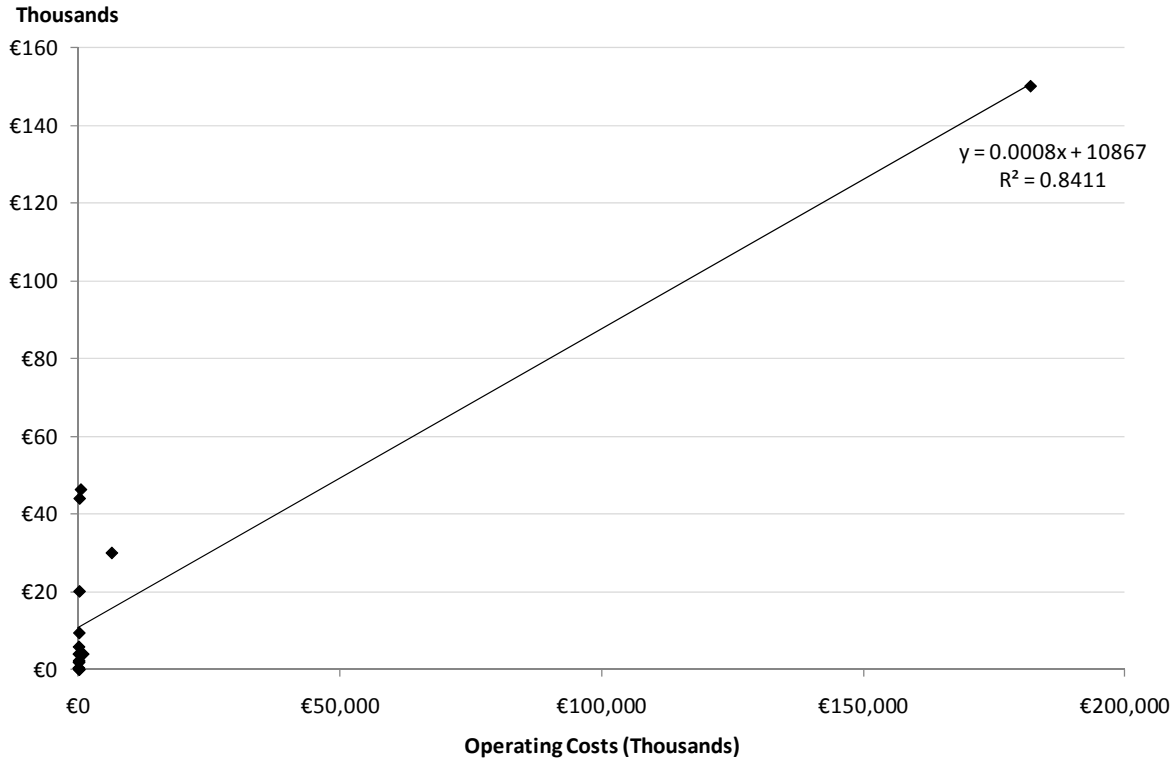
4.33 A small number of intermediaries are large companies. As a result, the mean estimate of the ongoing cost, in absolute terms, is greater than that for SMEs. The median estimate of ongoing costs, however, is unchanged, suggesting that the general trend for intermediaries is skewed towards the lower end of the range of the estimates of cost as a proportion of ongoing costs.

Table 4.4: Overview of Turnover, Operating Costs and Ongoing Cost Estimates for Intermediaries

	Turnover	Operating Costs	Ongoing Cost Estimate (€)	Ongoing costs as % of turnover	Ongoing costs as % of operating costs
Mean	€ 29,862,869	€ 21,393,497	€ 20,037	2.98%	4.34%
Median	€ 237,000	€ 163,000	€ 4,000	0.74%	1.90%
Range	€75,448-€350,000,000	€28,293-€184,870,000	€0-€150,000	0%-19%	0%-20%

4.34 As illustrated in Figure 4.13 below, operating costs explain almost 85 per cent of the variation in ongoing costs for intermediaries. In line with the general findings, the size of the effect from operating costs, while statistically significant, is smaller than for one-off costs, a €1 increase in operating costs translating into only €0.0001 increase in ongoing costs. Similarly, the average fixed cost for intermediaries is also lower than for one-off costs (€10,867 compared to €15,765 for one-off costs).[59]

Figure 4.13: Relationship between Ongoing Cost Estimates and Operating Costs for Intermediaries



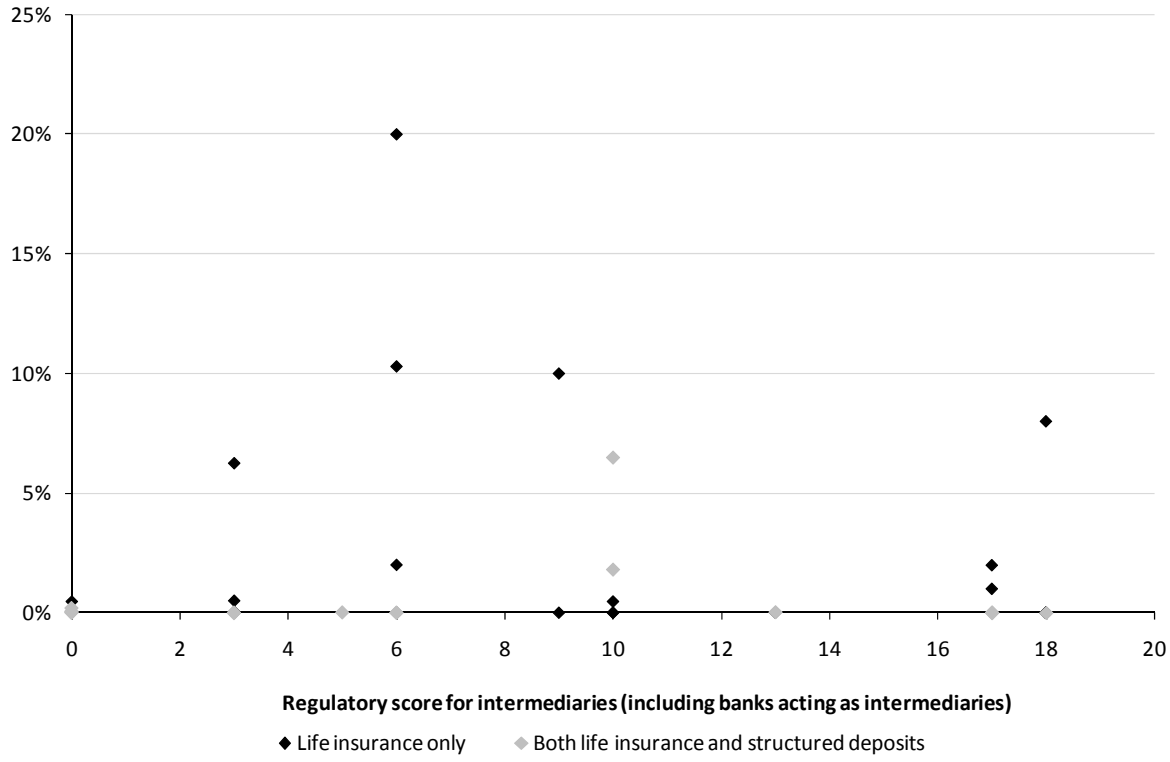
4.35 Even though the goodness of fit and significance of this regression would suggest that this is a strong result, it is important to remember that given the small sample size it is very difficult to identify outliers with sufficient accuracy so as to be able to discount them. As such the results of this analysis must be treated with caution.

4.36 The degree of correlation for intermediaries between the regulatory score of the Member State and the company's ongoing cost estimates is lower than the estimate for all companies (-0.01), and one tenth of the strength of the correlation for one-off costs for intermediaries. This could be due to difficulties in estimating ongoing costs, or indeed

[59] It is worth noting, however, that while the average fixed cost estimate for intermediaries is not significant for one-off costs, it is for ongoing costs and at the 5% level.

could reflect less certainty about what would exactly be involved on an ongoing basis in order to comply with the proposed rules.

Figure 4.14: Ongoing Cost Estimates as a Percentage of Operating Costs for Intermediaries selling Life Insurance plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector



4.37 Examining the correlation across the individual provisions, the most significant change is in the relative importance and strength of the relationship between costs and the conflict of interest provisions. The relationship for intermediaries with ongoing costs is much weaker (-0.03) than for ongoing costs.

4.38 Unsurprisingly, given that the majority are SMEs, the main drivers identified by intermediaries as underpinning the additional ongoing costs follow a similar pattern as the drivers for SMEs. The one distinction compared to SMEs was a greater emphasis on communication and less emphasis on IT costs as sources of ongoing costs.

Insurance Undertakings

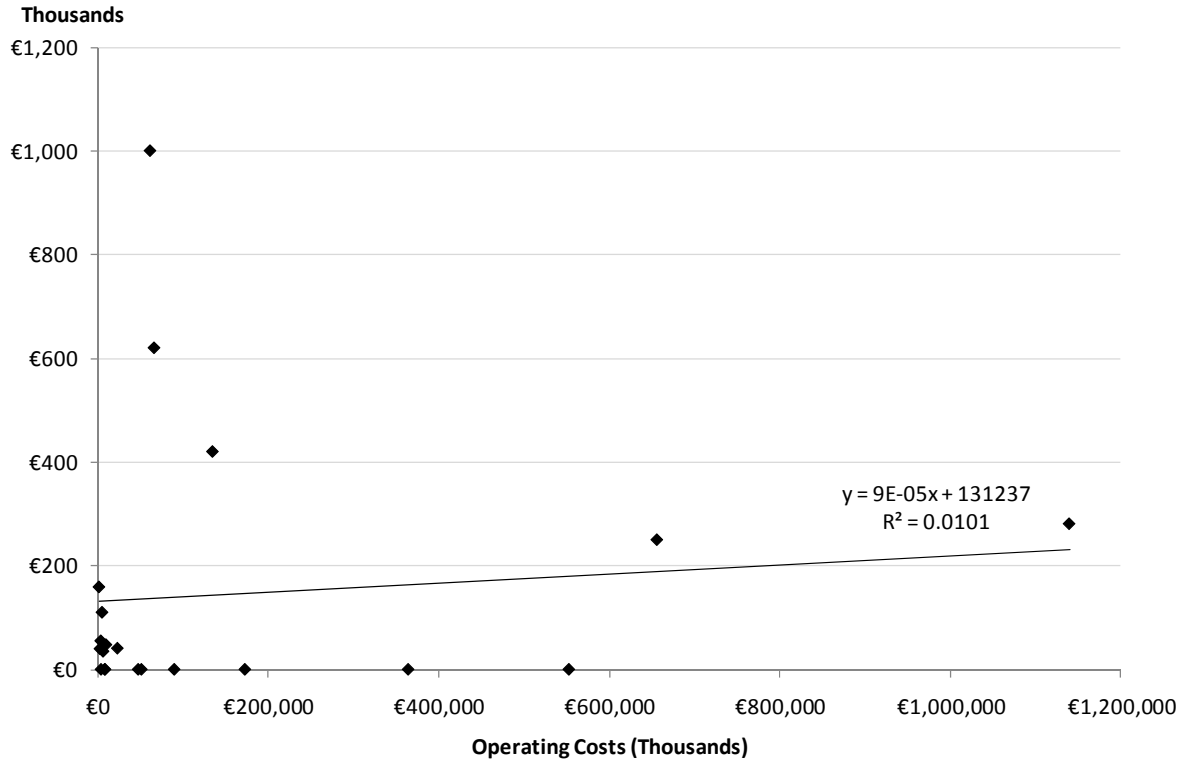
4.39 Again average cost estimates for insurance companies are lower than for one-off costs. The range of cost estimates has, however, increased. This may reflect greater uncertainty in estimating the ongoing costs.

Table 4.5: Overview of Turnover, Operating Costs and Ongoing Cost Estimates for Insurance Companies

	Turnover	Operating Costs	Ongoing Cost Estimate (€)	Ongoing costs as % of turnover	Ongoing costs as % of operating costs
Mean	€ 2,212,425,600	€ 215,012,764	€ 145,591	0.16%	1.20%
Median	€ 405,050,000	€ 49,032,370	€ 39,692	0.01%	0.04%
Range	€473,680-€12,656,400,000	€1,059,560-€1,328,900,000	€0-€1,000,000	0%-2%	0%-15%

4.40 As with one-off costs, the relationship between operating costs and ongoing cost estimates is statistically very weak. Based on simple regression analysis operating costs explain only one per cent of the variation in ongoing costs.[60]

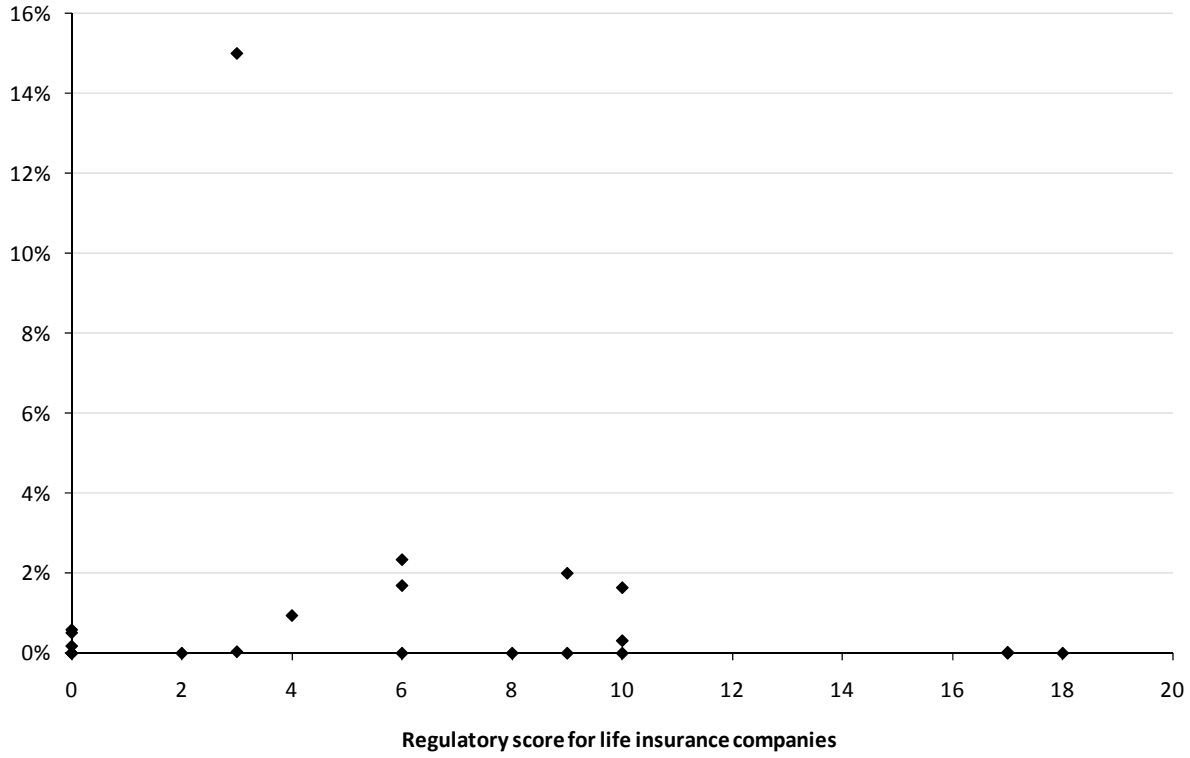
Figure 4.15: Relationship between Ongoing Cost Estimates and Operating Costs for Life Insurance Companies



[60] Neither the relationship between operating costs and ongoing costs nor the regression itself are statistically significant.

4.41 The relationship between the regulatory context and ongoing costs as a proportion of operating costs is stronger for life insurance companies than for intermediaries (-0.19 compared to -0.01). This may in part reflect the fact that the range of products sold by insurance companies is potentially more limited than for intermediaries, making the degree of alignment of the life insurance market with MiFID (or lack of it) more relevant for life insurance companies.

Figure 4.16: Ongoing Cost Estimates as a Percentage of Operating Costs for Life Insurance Companies plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector

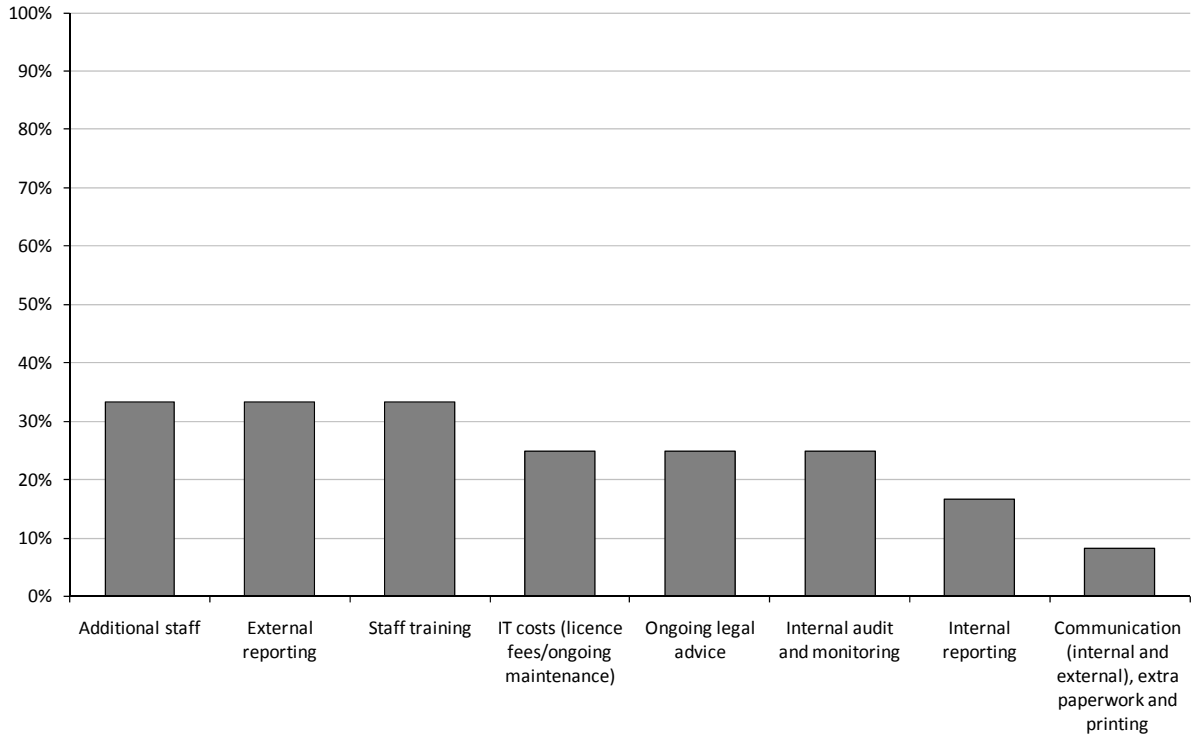


4.42 In terms of the relationship between the individual provisions and the ongoing cost estimates, life insurance companies mirror the general trend for large companies, with the relationship between the regulatory alignment with the provisions on inducements and ongoing costs as a proportion of operating costs becoming much stronger than it appears for one-off costs. The correlation coefficient rises to -0.23, compared to -0.20 and -0.07 for conflicts of interest and S&A provisions respectively.

4.43 While the main drivers of ongoing costs for life insurance companies generally follow a similar pattern as that for large companies more generally, there is a key distinction in terms of the importance placed on internal reporting. Internal reporting was the most commonly cited source of ongoing costs for large companies, however, for life insurance companies this represents the second to least most frequently recorded source of ongoing costs. As with intermediaries and SMEs more generally, this could be due to a

lower level of familiarity on the part of insurance companies with the proposed rules since they are unlikely to sell many (if any) products that are currently regulated by MiFID.

Figure 4.17: Main Drivers for Cost for Life Insurance Companies



Banks

4.44 The estimated ongoing costs for banks as a proportion of their operating costs are extremely small, particularly by comparison to the other two categories. As we have not before, the investment products under consideration tend to be less prominent in the business of banks than of life insurers. In addition, banks have prior knowledge of MiFID and this should facilitate maintaining a tighter grip upon costs. Moreover the range of estimates is very narrow. This suggests that bank estimates of ongoing costs have been reasonably consistent (this is reinforced by the earlier discussion of dispersion rates illustrated in Figure 4.4 above).

Table 4.6: Overview of Turnover, Operating Costs and Ongoing Cost Estimates for Banks

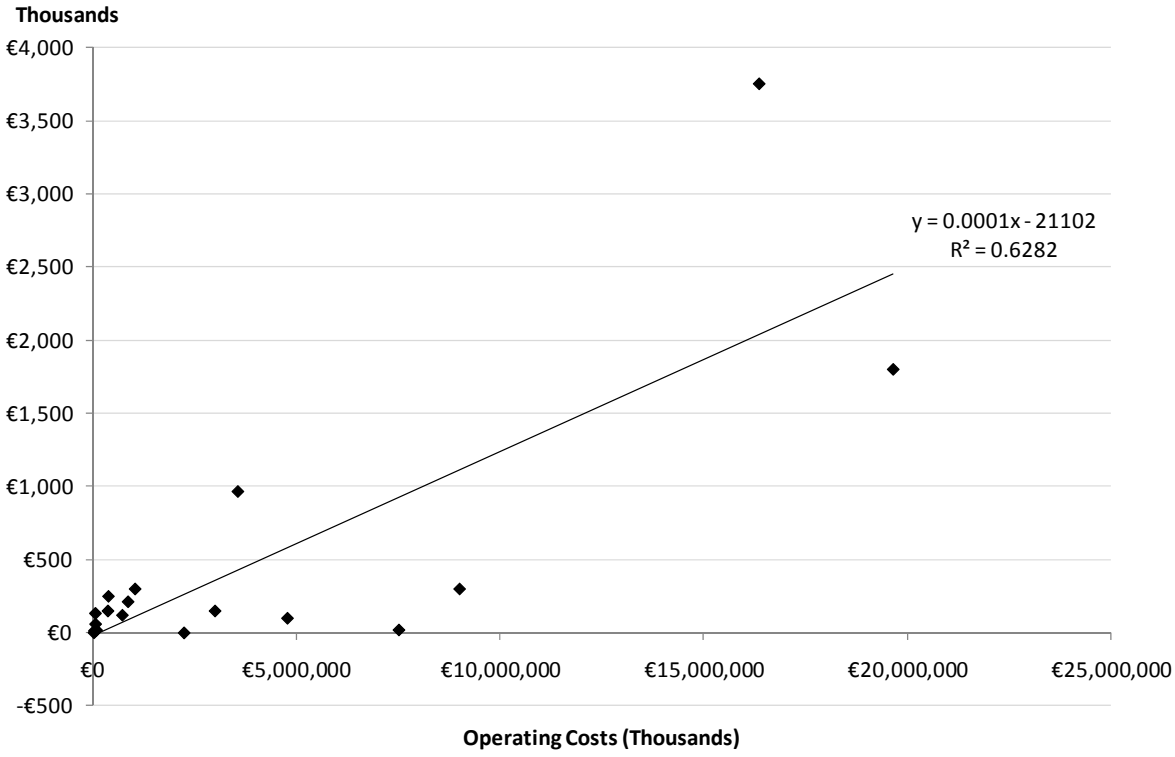
	Turnover	Operating Costs	Ongoing Cost Estimate (€)	Ongoing costs as % of turnover	Ongoing costs as % of operating costs
Mean	€ 6,150,078,534	€ 3,218,136,033	€ 418,773	0.02%	0.03%
Median	€ 1,580,000,000	€ 794,157,825	€ 127,185	0.01%	0.02%
Range	€24,331,980-€31,300,000,000	€26,972,660-€19,650,000,000	€0-€3,750,000	0.20%	0%-0.21%

Note: when we refer to banks we include within that definition bancassurers, investment banks and retail banks.

4.45 The explanatory power of operating costs in terms of the ongoing costs for banks is greater than for large companies more generally; a €1 increase in a bank's operating costs creating a €0.001 increase in ongoing costs. The relationship between operating costs and one-off costs is statistically significant, as is the regression itself.

4.46 However, once again, an apparent discrepancy is thrown up by the data, in that these imply a negative fixed component to the incremental cost. As before, this result is not statistically significant, and is likely to reflect the relatively small number of observations in the sample and the wide range in the size of the companies involved. There is a strong implication that the underlying relationship is non-linear.

Figure 4.18: Relationship between Ongoing Cost Estimates and Operating Costs for Banks



4.47 Once again the correlation between the cost estimates and the degree of alignment in the existing regulatory framework and the proposed rules is relatively strong for banks. If all companies selling life insurance are considered a correlation coefficient of -0.39 is achieved. If the sample is split further to include only those companies that sell life insurance PRIPs but not structured deposits this correlation increases to -0.59.

4.48 The relationship is also relatively strong for structured deposits (-0.34). As before these relatively high correlations may reflect a deeper understanding of the proposed rules by banks, as many will already be subject to MiFID in other areas of their business.

Figure 4.19: Ongoing Cost Estimates as a Percentage of Operating Costs for Banks selling Life Insurance Investment Products plotted against the Current Regulatory Framework's alignment with MiFID in the Life Insurance Sector

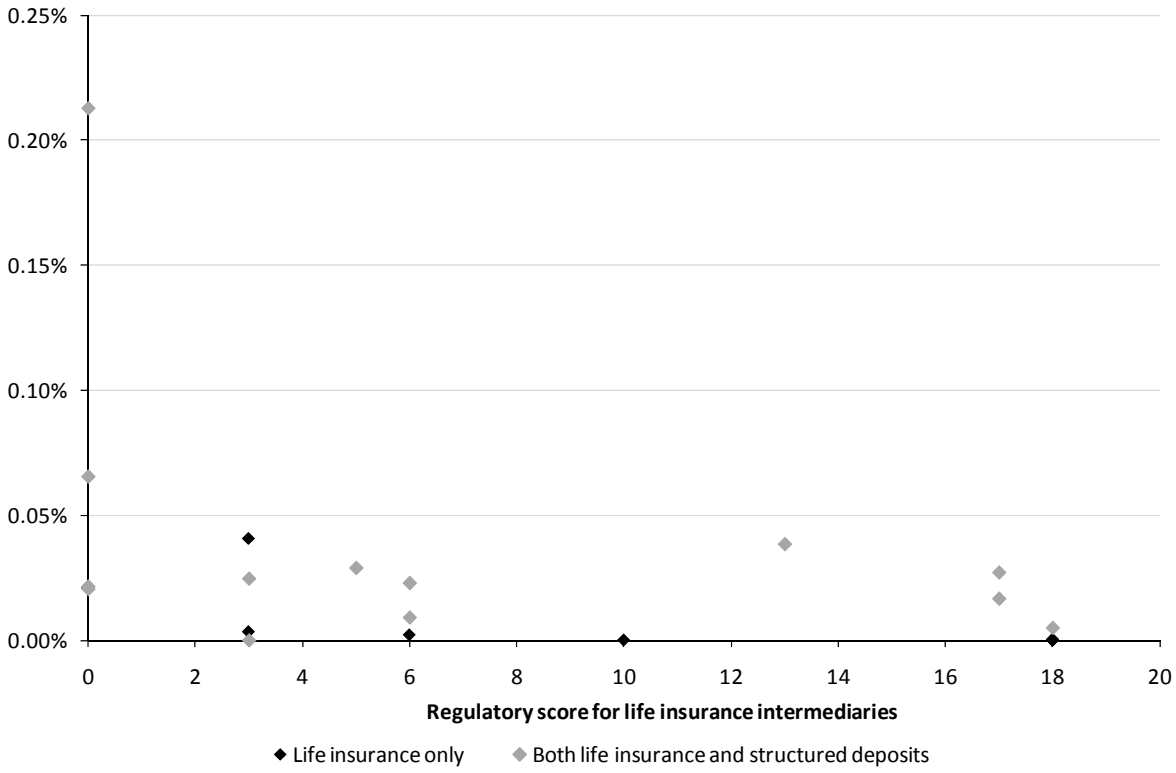
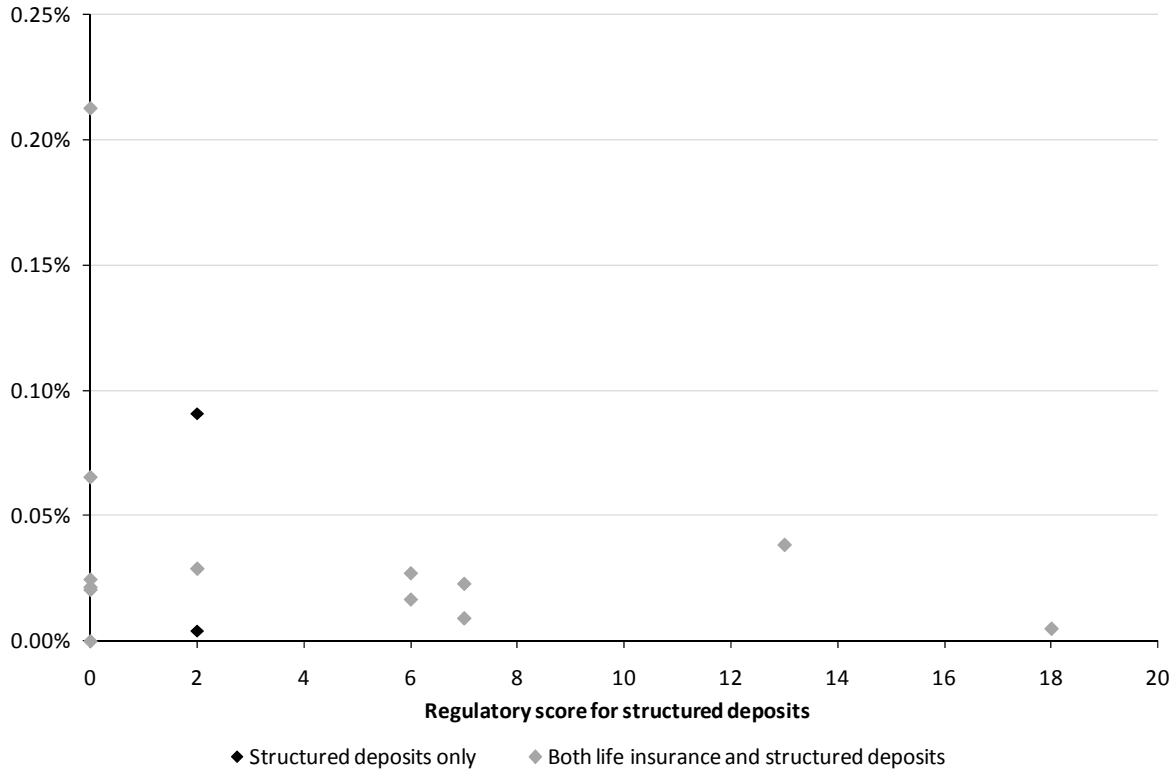


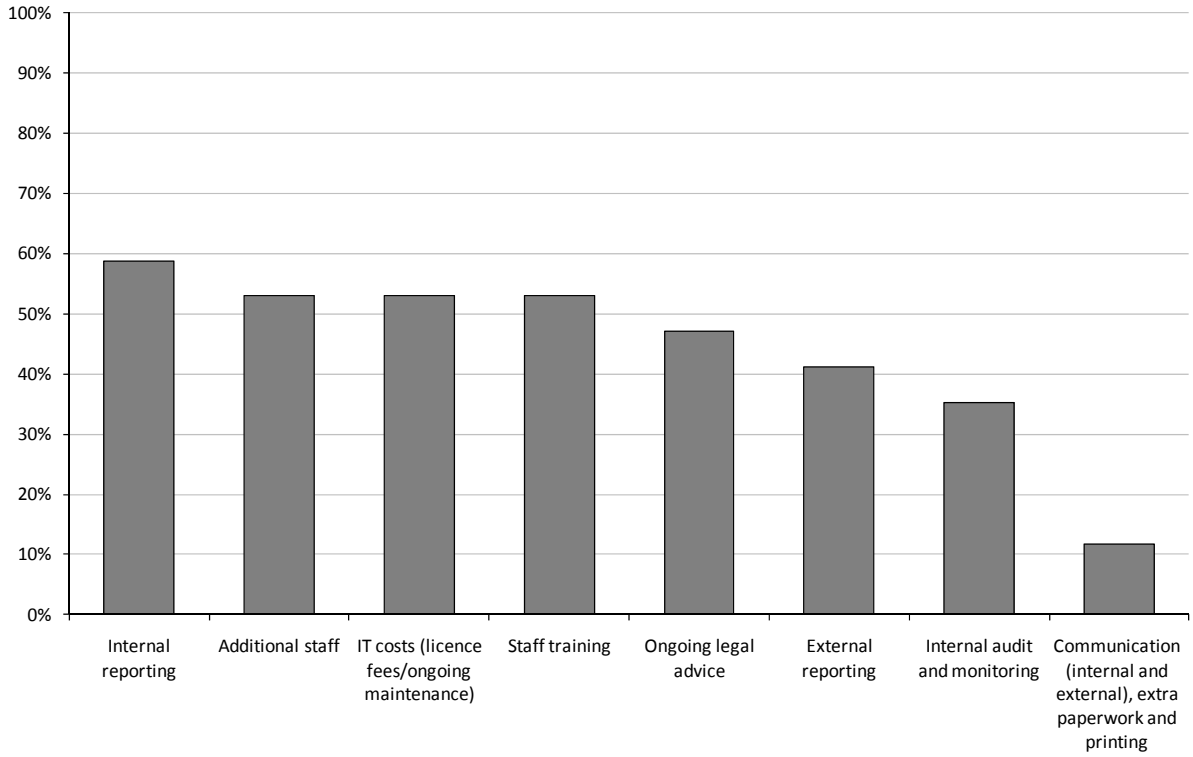
Figure 4.20: Ongoing Cost Estimates as a Percentage of Operating Costs for Banks selling Structured Deposits plotted against the Current Regulatory Framework's alignment with MiFID in the Structured Deposit Sector



4.49 The relative importance of the various provisions and the distinctions between the life insurance market and structured products mirror those for the one-off cost estimates for banks.

4.50 The changes identified as sources of the incremental ongoing costs mirror those for large companies more generally.

Figure 4.21: Main Drivers of Ongoing Costs for Banks



Benchmarking

4.51 Past work on MiFID (as identified in the previous section) indicates that estimates of ongoing incremental costs tend to be significantly lower than the costs of the initial implementation of regulatory change. A range of these recurring costs set at 15–20 per cent of one-off costs would be fairly typical.

4.52 Our work indicates that ongoing costs are somewhat higher than this relative to one-off costs in this case. This effect is likely to be a function of the nature of the rule changes under consideration here: simply put, some aspects of the propose changes can be expected to have a notable effect on the time spent by sales people with customers every time a sale is made.

Conclusions

4.53 Consistent with previous work in this area the estimates of incremental ongoing costs of compliance are smaller than one-off costs, although the differential is somewhat less here than with regards to other aspects of MiFID. On average ongoing costs for our sample

represent 0.04 per cent of operating costs.[61] These costs are largely driven by the costs of additional staffing requirements and ongoing staff training needs.

4.54 Once again, however, this figure hides a high degree of variation across different types of firms. Intermediaries bear the highest costs as a percentage of operating costs and demonstrate the highest degree of variation in the estimates across companies. Table 4.7 below illustrates the average cost associated with each of the different types of firm.

Table 4.7: Median Ongoing Cost as a Percentage of the Operating Costs for Different Types of Firm

SMEs	Large	Intermediaries	Life Insurance Companies	Banks
1.90%	0.02%	1.90%	0.04%	0.02%

4.55 As in the case of one-off costs, operating costs have a significant positive effect on ongoing costs, indicating that the larger the company the higher the absolute value of the incremental ongoing costs. Once again, SMEs experience a stronger proportional effect than large companies.

4.56 The relationship between the level of alignment of the current regulatory framework with the proposed rules and the ongoing costs is weaker than for the one-off costs. This likely reflects companies' tendency to front-load the costs of change and/or the greater difficulty companies have in estimating ongoing costs *ex ante*.

4.57 As before, the proportion of non-MiFID PRIPS in the company's business seems likely to have an impact on the size of any incremental ongoing costs, with banks again recording smaller costs as a proportion of operating costs than life insurance companies. This distinction, however, appears to be weaker than for one-off costs, potentially reflecting a more general tendency by larger companies to structure the one-off expenditure in order to minimise the additional ongoing cost burden.

4.58 The same two approaches as were used to extrapolate one-off costs have been used to construct the ongoing cost estimates for the EU as a whole. Given the particularly weak relationship between ongoing costs and the degree of regulatory alignment, as in Section 3, we focus here on the estimates constructed using the approach focussing purely on the type of company (refer to Appendix 2 for estimates constructed using the second approach). These are illustrated in Table 4.8 below.

[61] The average referred to here is the median. Given that the estimates are skewed this offers a much more accurate indication of the actual costs.

Table 4.8: Ongoing Cost Estimates for the EU27

	Medians €m	Weighted mean €m	Medians, decomposed by regulatory score €m	Weighted means, decomposed by regulatory score €m
Intermediaries	99.2	4.9	100.2	18.8
Insurers	17.6	41.6	118.1	51.1
Banks	73.2	24.1	45.4	36.3
Total	190.0	70.5	263.7	106.1

4.59 As we have noted previously, the ongoing cost estimates generated by firms are more dispersed than the one-off estimates, making the extrapolation of these more difficult and subject to judgement.

4.60 Informed by the above, we make our central estimate of the ongoing cost as follows:

- for intermediaries an ongoing annual impact of €25–€80 million;
- for insurers, €50–€80 million (i.e. up to 0.5 per cent of expenditure attributed by life insurers to the development and distribution of linked products); and
- for banks, an impact of €35–€60 million.

4.61 This gives a total of €110–€220 million in ongoing costs.

4.62 Once again, it is important to note that these estimates will be sensitive to the way in which any regulation is eventually designed and implemented. The estimates must also be considered within the context of this study and the relatively small sample used here.

5 THE POTENTIAL BENEFITS AND WIDER IMPACTS OF REGULATION

Introduction

5.1 There are a number of potential benefits to and wider impacts on both firms and consumers of introducing MiFID-style regulation on selling practices. In line with the scope of the study we focus on the impacts of the proposed rules on firms. The reader is reminded that this study represents only one part of the Commission's analysis and that the Commission is working separately on the vital work of assessing the consumer impacts. This will form part of an analysis of the effectiveness of different regulatory options for achieving consumer protection, market efficiency and single market outcomes. That said, we discuss certain impacts relating to consumers that arose from the firms' standpoint where this is relevant below. It should be underlined however that in this study we do not undertake an independent value chain analysis or market analysis to assess the scale of likely impacts; the aim is more to gather evidence from firms themselves on likely factors that can be considered separately to assess their likely scale and significance.

5.2 Without prejudice to the Commission's work, potential consumer benefits include enhanced consumer protection; ease of comparison of products with the same economic function and aimed at the same class of investors; reduction of 'regulatory arbitrage' as a driver of particular product sales, facilitating improvement in portfolio diversification; reduction of 'mis-sales' by ensuring effective avoidance or management of conflicts of interest; (re)building investor confidence; and facilitating the single market. Given the narrower focus of this study (on gathering evidence on impacts of change for firms themselves), we address these wider benefits and outcomes only to the extent that they have a bearing upon firms' expectations of the development of the relevant markets.

5.3 We have considered the potential benefits that impact upon firms as a direct result of the regulatory change — such as reduced training costs from aligning training needs or streamlining the compliance function.

5.4 We also discuss indirect benefits and wider impacts arising not out of the direct actions of the new regulations but through their knock-on and possibly unintended effects on companies and the wider market.

5.5 In discussing the benefits and wider impacts of the new regulations, we focus on the qualitative responses provided by companies as part of our questionnaire. These are paraphrased below:

(a) Whether, and how, the introduction of the proposed regulations would reduce the firm's costs (referred to collectively as "Cost Reductions" in the following sections).

(b) Whether, and how, the introduction of the proposed regulations would impact upon the firm's existing portfolio of products or product mix (referred to as "Product mix").

(c) Whether, and how, the introduction of the proposed regulations would impact upon the firm's sales volumes (referred to as "Sales volumes").

(d) Whether, and how, the introduction of the proposed regulations would impact upon the firm's distribution strategy (referred to as "Distribution strategy").

(e) Whether, and how, the introduction of the proposed regulations would impact upon the firm's cross-border sales (referred to as "Cross-border sales").

5.6 In addition to these specific questions, respondents were also given the opportunity to cite any additional impacts of the new regulations they felt could be relevant. One distinct issue raised was the potential for the proposed regulations to level the playing field between different firm types, or between different products (referred to as "Level playing field" in the following sections).

5.7 We present the general findings from the survey across all respondents, and then consider each type of company in turn, bringing out key differences and similarities. These considerations are essentially qualitative views as expressed from those surveyed for this study (that is, industry participants), and do not represent the outcomes of our own independent analysis of market trends, value chains or possible developments. In addition, the survey only was addressed to those firms active in the distribution of non-MiFID PRIPs; the views of firms already subject to MiFID (that is, those that distribute MiFID PRIPs) may well be divergent across the questions addressed here. Given these points, the results in this section should therefore be interpreted in an appropriate fashion: they neither represent an independent view on market developments, nor a representative sample across the whole of the PRIPs market.

General Findings

5.8 A greater number of companies responded to the qualitative questions about the wider impacts of the new regulations than provided costs estimates presented in Chapters 3 and 4 above. Thus the total number of respondents for this section is 81 as opposed to 58. Table 5.1 below breaks down the respondents by company type and regulatory group.

5.9 As explained earlier, the regulatory group represents the degree of alignment of existing national regulations with the relevant MiFID provisions on selling rules. Member States with a regulatory score of six or less are considered to have only a low level of alignment and are, therefore, labelled as being 'Low'; Member States with scores greater than six but less than 13 are considered 'Medium'; and Member States with scores of 13 or higher are 'High'.

5.10 The level of alignment, however, varies across different types of companies and products. As such we have a specific regulatory score for insurance companies, one for intermediaries selling life insurance and one for intermediaries selling structured deposits, as well as one for banks selling life insurance products and another for banks selling structured deposits. For the purposes of Table 5.1 below we have used the life insurance

sector scores for intermediaries and banks. The vast majority of intermediaries and banks in our sample sell either life insurance products only or both life insurance and structured deposits, very few sell only structured deposits. It is also important to note that in constructing the regulatory score for banks selling life insurance we have treated them as intermediaries. Since our definition of banks also includes bancassurers, it is possible that some banks are subject to regulation pertaining to life insurance companies, rather than life insurance intermediation. However, given that the regulatory scores for these two firm types does not differ across the majority of Member States, we do not consider this to be an issue.

Table 5.1: Number of Respondents by Firm Type and Regulatory Group

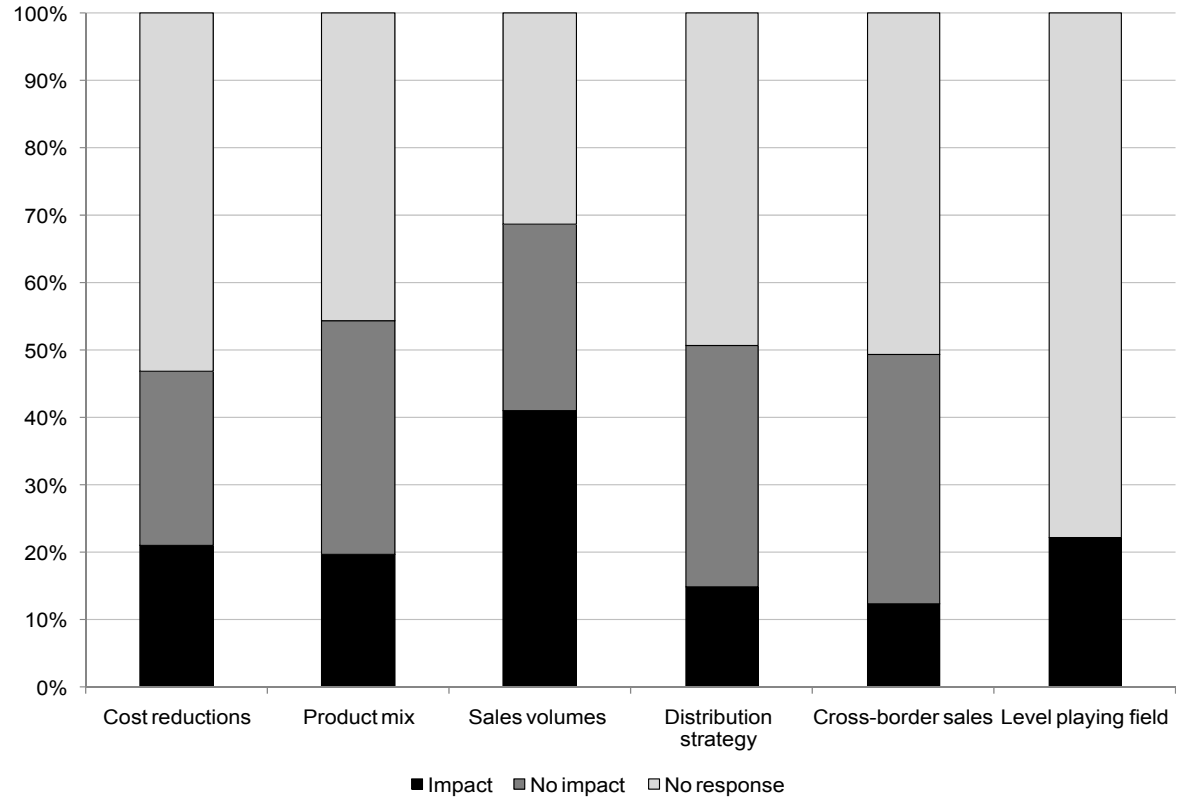
Regulatory group	Intermediaries	Life insurance companies	Banks	**Total**
Low	15	15	15	**45**
Medium	7	6	1	**14**
High	6	3	13	**22**
Total	**28**	**24**	**29**	**81**

Source: Europe Economics Survey of companies in Estonia, France, Germany, Italy, Luxembourg, the Netherlands, Poland, Romania, Slovakia, Spain, Sweden and UK

5.11 Figure 5.1 summarises the responses from all 81 survey participants to the questions set out in paragraphs 5.5 and 5.6. The chart not only indicates what proportion of respondents did envisage an impact and those who did not, but also the proportion that did not respond to the questions at all.

5.12 The most frequently cited impact of the new rules was that on sales volumes, cited by almost 42 per cent of respondents (34 out of the total of 81). After sales volumes, the most frequently cited impacts were reductions in business costs (17 out of the total of 81), and the levelling of the playing field between firms and product types (18 out of 81). It is important to recognise that across most categories a greater proportion of respondents indicate no impact that those that indicated an impact (with the exception of sales volumes and level playing field).

Figure 5.1: Frequency of Responses, as a Proportion of all Survey Participants



Source: Europe Economics Survey of companies in Estonia, France, Germany, Italy, Luxembourg, the Netherlands, Poland, Romania, Slovakia, Spain, Sweden and UK

5.13 In the following section, we have focused upon general findings, leaving analysis by firm type to the sub-sections which follow. Given the size of the sample, particularly when broken down by individual types of companies, it is important to emphasise that any feedback and conclusions drawn must be treated with care.

Cost reductions

5.14 One of the more frequently cited benefits of the new regulations (21 per cent of all respondents) is the reduction in business costs. One of the main drivers of this as highlighted by respondents is that the greater harmonisation of selling rules across all PRIPS may have the potential to decrease overall costs of complying with regulation and create business synergies among firms. Such synergies could stem from streamlining documentation and staff training across products, and economies of scale from more centralised legal and compliance functions. In some cases, depending on the nature of the firm and products sold, the additional information gathered on clients buying PRIPs may enhance other areas of firms' business by enabling or simplifying the sale of other products.

5.15 One company from Luxembourg that operates predominantly on the international market acknowledged that greater regulatory harmonisation across the EU could be theoretically

beneficial, as it would reduce the need for the firm to train its staff about the different legislation in each Member State, and reduce the time spent checking the legislation in each market when marketing products. Such synergies could be relevant for other international companies and/or financial conglomerates operating in a number of Member States. Cost savings could also potentially arise out of streamlining documentation and training across the various Member States in which they operate. However, it was also noted that to achieve such synergies the degree of harmonisation would need to be extremely high, and would not be achieved if Member States were allowed to vary greatly the way in which he provisions are implemented as is currently the situation under MiFID.

5.16 Other potential sources of reduced costs identified stem from an improvement in the quality of the advice provided to customers as a result of the new selling regulations, leading to a reduction in mis-selling. This would imply a reduction in the time spent with dissatisfied clients and thus in the costs associated with complaints. In addition, reduced levels of mis-selling could lead to greater levels of confidence in the retail market, reduced levels of brand damage in that market, and reduced payouts related to valid compensation claims.

5.17 An additional impact raised by number of respondents (10 per cent of the total sample) was that more formal client agreements may enhance the legal protection of the firm if the new rules ensure that clients are both fully aware of, and accept, potential risks related to their investments. This could also have a positive effect on cost savings.

5.18 No clear pattern across Member States emerged in terms of the potential for cost reductions. Within each Member State respondents held a range of opinions, and very often those that said there would be an impact cited different drivers for this.

Product mix

5.19 Twenty per cent of all respondents felt that the new rules would impact on their product mix. The main reason given for this was a potential increase in selling costs from complying with the regulations. This could result in a shift away from selling products within the scope of the new regulations, towards simpler products subject to lighter regulation. (The extent to which this could be possible would of course depend on the scope of application of any proposed regulatory changes).

5.20 However, in many cases (35 per cent of all respondents) firms indicated that they would not change their product mix in response to new regulations, even if this increases their costs, as product mix is often a function of customer demand rather than selling costs. The impact of customer demand on product mix acts in two directions. On the one hand, it is likely that the new regulations will bring about improved selling practices among at least some firms and so increase investor confidence, thus boosting demand for these products. On the other hand, the extent to which increased selling costs are passed onto consumers (either in direct costs or in increased time and paperwork) may reduce the (relative) volume of demand for the regulated PRIPs.

5.21 Again, there was little noticeable difference across respondents from different Member States. Only in Sweden and Luxembourg did all or the vast majority of respondents indicate that the proposed rules would have no impact on product mix. Rather, the responses related to firm-specific factors (such as the firms having a specific client profile, or always offering as wide a range of products as possible) and did not suggest any underlying country- or market-specific factors.

Sales volumes

5.22 The effect on sales volumes was the most widely cited possible impact of new regulations (42 per cent of all respondents). Respondents reporting a possible reduction in volumes (32 per cent) indicated that this could result both from a general contraction in business due to increased costs of selling the non-MiFID PRIPs, or from a fall in customer demand for these products if any additional costs and administrative burden were directly passed on to consumers. As with product mix, the effects of consumer demand appeared to be more relevant to firms than increased selling costs, though demand was being linked to costs.

5.23 Some respondents (10 per cent of the total) were of the opinion that the new regulations would bring about an increase in the volumes of non-MiFID products sold. Increased investor confidence and client satisfaction as a result of the new rules were cited as a reason for possible increased sales volumes by attracting customers who ordinarily would not have considered these products, particularly where investor confidence had suffered as a result of the financial crisis. It was also felt that improved quality of advice could have a positive reputational effect on firms and thus boost customer demand for their products.

5.24 There were some differences across Member States, however. Wider impacts of the new regulations on sales volumes appear to be limited across all firm types in Italy, Sweden and the UK. Italy and the UK both have a high level of existing regulation similar to MiFID and firms indicated that the introduction of MiFID-like selling rules on certain PRIPs would not be expected to signify a major change (depending, of course, to how similar the new regulations are to MiFID). Whilst Sweden has a relatively low level of national regulation, many of the banks and insurance companies (and some intermediaries) within our sample cited industry-wide codes of practice that are similar in many respects to the envisaged MiFID-style selling rules and so should again act to mediate the extent of the change.

5.25 On the other hand, the majority of firms in France and Estonia cited the possibility of largely negative wider impacts on sales volumes of the introduction of new selling rules. This could be related in part to the levels of existing regulation compared to a more stringent new regime, although this was not explicitly indicated by the respondents. The main concern among firms in France was that the new regulations, despite in their opinion being similar in some cases to existing rules, would significantly increase the regulatory burden without adding materially to consumer protection.

5.26 It is interesting to note, however, that some firms within Member States with high regulatory scores (such as Italy and the UK) also indicated that new regulations would have a non-negligible impact. For example, in Italy two firms suggested new rules would have a negative impact on sales. The reason for this, given by both, was demand-orientated (e.g. a fall in demand due to assumed information overload) rather than cost-related. This is in line with the thought that firms in Member States that have a regulatory framework closely aligned to MiFID are not likely to incur significant costs of complying with the new provisions, but illustrates that the companies may be affected indirectly from the wider impacts of any regulation. This point is difficult to interpret, however, should new requirements be in fact very close to those already applying in a particular Member State.

5.27 Two firms from the UK also indicated that their sales volumes could decrease. In this case, however, factors related to a reduction in profitability of providing non-MiFID PRIPs were cited, as opposed to demand-side issues. That said, it is important to note that in both UK cases the decline in sales volumes related to their specific form of distribution, and are unlikely to offer an accurate representation for the UK as a whole.

5.28 There was no country from which firms consistently cited an anticipated increase in sales volume. It should be noted that without conducting detailed value chain analysis it is difficult to independently assess firms' views.

Distribution Strategy

5.29 Respondents suggested a number of ways in which the new regulations could impact on the distribution strategies of firms. Twelve firms across a range of Member States highlighted that intermediaries would be disproportionately impacted by the possible new regulations, both in terms of increased costs of doing business and for the need to undergo further training or qualifications. This is, of course, in line with our quantitative findings.

5.30 Some firms in the Netherlands, Poland and the UK responding to this question highlighted the importance of intermediaries (both independent brokers and tied agents) as a distribution channel. This in line with the information we have received from trade associations and publically available sources that indicate that intermediaries are indeed an important distribution channel in these Member States. The more personal and long-term client base of intermediaries — depending of course on the kind of intermediary and the type of services offered — is an important factor in the sales of PRIPs and there does not appear to be much appetite on the side of providers to move away from this distribution channel.

5.31 Respondents indicated that what is likely to happen, however, is a more careful selection of agents and brokers and possible reduction in the pool of agents and brokers used by providers, to ensure that the intermediaries used are capable of selling the more heavily regulated products. Some companies in the UK and the Netherlands, for example, indicated that they may increase their use of independent brokers over agents given the generally higher levels of skills and qualifications of the former. This may have

implications for the structure of the intermediary market, with independent brokers increasing in importance.

Cross border impacts

5.32 Very few respondents (12 per cent of the total sample) indicated that the new regulations would impact on their cross-border selling strategies. This is largely due to the predominantly domestic focus of the firms within our sample, who did not feel that the changes brought about by the regulations would be significant enough to change this focus. Harmonised regulations may be beneficial, but respondents identified a number of other factors (such as tax and other legal differences, the nature of the products, consumer culture etc) that influence cross-border sales decisions that would not be affected by the new rules. Even the few companies that do operate outside of domestic markets offered no indication that such regulatory harmonisation would lead them to expand their cross border business strategy.

5.33 Of the firms that did cite cross-border impacts, the majority were based in Italy. This appears to stem largely from the fact that the current level of MiFID-like regulation in Italy is high and Italian firms feel that this puts them at a competitive disadvantage *vis-á-vis* firms from other Member States. However, even among these firms the impacts cited are of a more general nature, and none have indicated a specific strategy change that might result.

Level playing field

5.34 A number of firms (22 per cent in total) indicated that new MiFID-like rules would level the regulatory playing field between firm types and across products. A level playing field across products is likely to create business synergies. A level playing field across firm types is likely to increase competition between firms currently applying a relatively high level of regulation and those with a lower burden. This would apply particularly to competition between banks and life insurance companies selling life insurance investment products, and it is likely that the former will already be subject to some degree of MiFID-type regulation. This impact was cited across all firm types in the Netherlands and Germany.

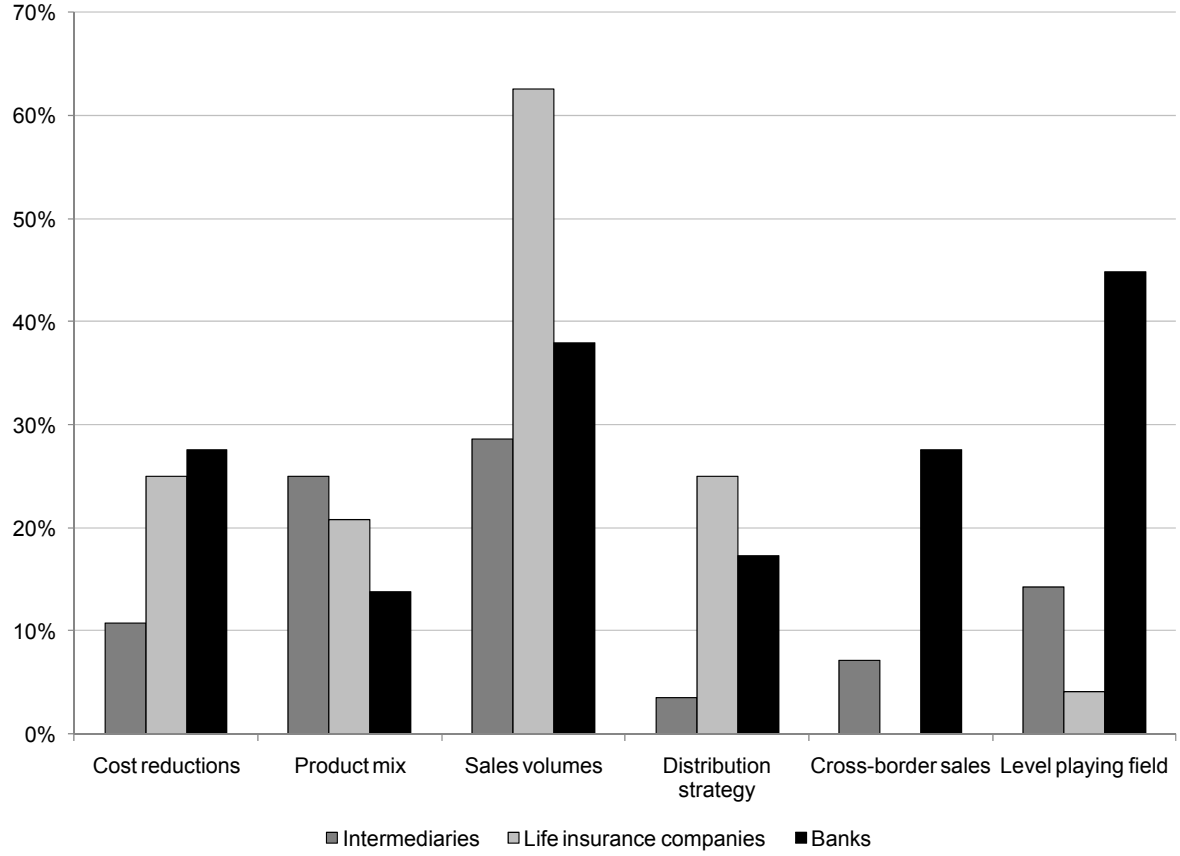
5.35 There is an interaction between level playing field impacts and other kinds of possible impact. For instance, any levelling of the playing field and increase in competition could however be reduced in impact if, as indicated by some respondents, the intermediary channel was restricted by the new regulations due to increased regulatory burdens and the associated costs.

Similarities across Member States

5.36 As discussed above, there emerged very few similarities across all firms within individual Member States regarding the wider benefits and impacts of the proposed regulations. This could be related to our small sample of firms in each Member State, however, in general, the impacts vary much more across firm type.

5.37 In Figure 5.2 below we present the breakdown of responses by firm type. To enhance the clarity of the chart, we have only looked at whether respondents said the proposed rules would have an impact, and have not included the 'no impact' or 'no response' responses.[62] Note that, in order to account for different sample sizes across firm types, the proportions below relate to the sample sizes for each firm type. For example, 63 per cent of insurance companies (15 companies out of the sample of 24 insurance companies) indicated that the proposed rules would have an impact on sales volumes, compared to 29 per cent of intermediaries (eight companies out of 28 intermediaries).

Figure 5.2: Frequency of Reported Impacts as a Proportion of Respondents in Each Firm Type



Source: Europe Economics Survey of companies in Estonia, France, Germany, Italy, Luxembourg, the Netherlands, Poland, Romania, Slovakia, Spain, Sweden and UK

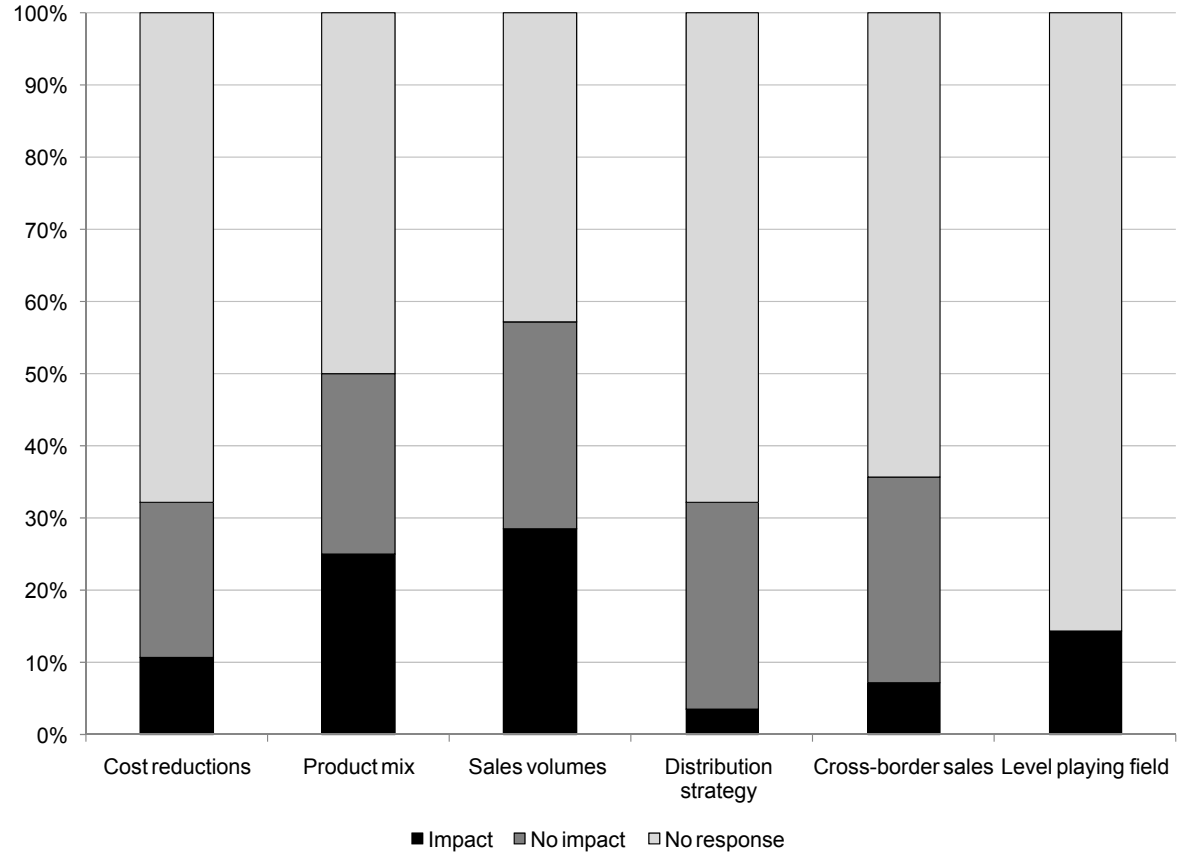
5.38 We now consider the impacts of the proposed rules on each firm type in turn.

[62] The bars in Figure 5.2 correspond with the 'Impact' bars in Figure 5.3, Figure 5.4 and Figure 5.5.

Intermediaries

5.39 Figure 5.3 below presents the views of intermediaries regarding the wider impacts of the new regulations. As with the general findings, the most frequently cited impact among intermediaries is that on sales volumes. Again, generally more respondents considered there would be 'no impact' than an impact.

Figure 5.3: Frequency of Reported Impacts as a Proportion of all Intermediaries



Source: Europe Economics Survey of companies in Estonia, France, Germany, Italy, Luxembourg, the Netherlands, Poland, Romania, Slovakia, Spain, Sweden and UK.

Cost reductions

5.40 A small proportion of intermediaries (11 per cent) indicated that the new regulations would result in cost reductions, with 21 per cent of respondents saying that they would experience no change in this regard, and 68 per cent not responding. This is less than the general findings for the whole sample, in which over 20 per cent of respondents indicated that they would experience cost reductions. This is perhaps not surprising as the majority of intermediaries in our sample provided information indicating that they are small firms, largely selling products not currently subject to MiFID-like regulations, such as life and retail insurance (although a small number do currently sell other structured products, but are not clear as to the nature or the regulation of the products). Benefits of

a harmonised regulatory regime across products in terms of reducing staff confusion about different types of regulation or streamlining compliance functions and product documentation, as identified in the general findings, are therefore not likely to be relevant. In fact, in the opinion of some intermediaries, the opposite is likely to be true, with the new regulations creating regulatory imbalances between products (to the extent of course that some products may remain outside of its scope, highlighting the importance of scope).

5.41 Only one intermediary (representing four per cent of the sample of intermediaries) thought that more formal client agreements could provide enhanced legal protection in the case of any dissatisfied clients, although they did not associate this with any reduction in costs.

Product mix

5.42 The respondents felt that the proposed rules were likely to have more of an impact on the product mix of intermediaries than on business costs. A quarter of intermediaries indicated that the shares of the different products that they sell might change. For some this was in a positive sense, such as offering a wider range of PRIPs that are currently regulated differently (e.g. adding life insurance products to the sale of structured deposits). However, most foresaw a shift away from offering PRIPs (those currently not covered by MiFID) on a large scale, or even at all, due to the increased costs in complying with the proposed selling rules. In response to this partial or total market exit, the relevant firms anticipated either a compensating increase in focus on simpler products that would not fall under the new regulation (such as non-life products) or else forecast an overall decline in sales.

5.43 However, an equal proportion of intermediaries (25 per cent) suggested that they would not change their product mix in response to new regulations, even if this increased their costs. (In addition, 50 per cent did not respond to the question which is likely to imply that they too did not foresee any impact on their product mix.) This is somewhat lower than the general findings across all companies, in which 35 per cent of firms said that there would be no change in their product mix. For many intermediaries (as with all firm types), product mix is a function of customer demand rather than their unit selling costs. Product mix may be indirectly affected through an increase in demand (e.g. from increased customer confidence) but respondents here implied that it would not be driven from the supply side.

5.44 Furthermore, it seems that some intermediaries are relatively constrained in their product offerings by the supply of these products by banks and insurance companies. Tied agents in particular indicated that they have a limited choice of product mix, and thus the costs associated with providing certain products would not be easily avoidable by "choosing" a different product mix (as insurers and banks wish to see their tied agents selling across as much of their product range as is possible). This reduction in flexibility is more likely to result in costs being passed on to consumers, or, where this is not possible due to competitive pressure, a decline in profitability for the intermediaries.

Sales volumes

5.45 A similar level of expectation was reported for sales volumes, with 29 per cent of intermediaries anticipating an impact from the new regulations. Of these, the majority (22 per cent of intermediaries) reported a likely decrease in sales volume, with only seven per cent indicating a positive impact.

5.46 In line with our general findings, intermediaries indicated that a decline in sales would result from either supply-side pressures from increased selling costs (where it is not possible to pass these costs on or substitute other, less regulated products), or from a reduction in consumer demand (either resulting from an increased cost of advice, or from increased administrative burden and confusion).

5.47 In some cases, intermediaries suggested that a supply-side reduction in the selling of non-MiFID PRIPs would be likely to disproportionately affect those customers investing smaller amounts, as the relative costs of providing the products would make it uneconomic to service these clients. This may have unintended consequences on consumers (switching to less regulated products or even going unadvised).

5.48 Of the firms that suggested that the new regulation may have a positive impact on their sales volumes, the majority cited demand-side effects of increased consumer confidence in better regulated products.

5.49 Of the firms that indicated no expectation of change (20 per cent of respondents), many highlighted their small share in the products or their existing high compliance standards as reasons.

Distribution strategy

5.50 As mentioned under product mix, and consistent with the general findings, the impact of the new regulations on sales volumes and profitability appears to be particularly pronounced among intermediaries, especially tied agents. The thought expressed to us was that this might result in some tied agents switching to being independent brokers, in order to access the increased opportunities for flexibility and relative market power. However, such a switch may be non-trivial, potentially involving higher standards of professional education and the building of additional business relationships, for example.

Cross-border sales

5.51 As with most firms in our sample, very few intermediaries currently sell non-MiFID PRIPs, or indeed any products, cross-border and this is not expected to change even with the possible harmonisation of regulation across the EU. Most respondents indicated that they only sold the products of domestic firms as these were more tailored to the needs and expectations of the local client base. Only seven per cent of intermediaries said that the new regulations would have any cross-border impacts.

5.52 There was some perception among intermediaries that increased harmonisation may increase international competition amongst insurance providers. If this had the effect of reducing product prices then intermediaries who sell products from international providers could stand to gain through increased revenue or consumer demand.

Level playing fields

5.53 A small proportion of intermediaries (14 per cent) indicated that the proposed regulations could serve to level the playing field between firms selling non-MiFID PRIPs and those selling other investment products already regulated by MiFID. This is smaller than the impact presented in our general findings, which was cited by 22 per cent of the total sample.

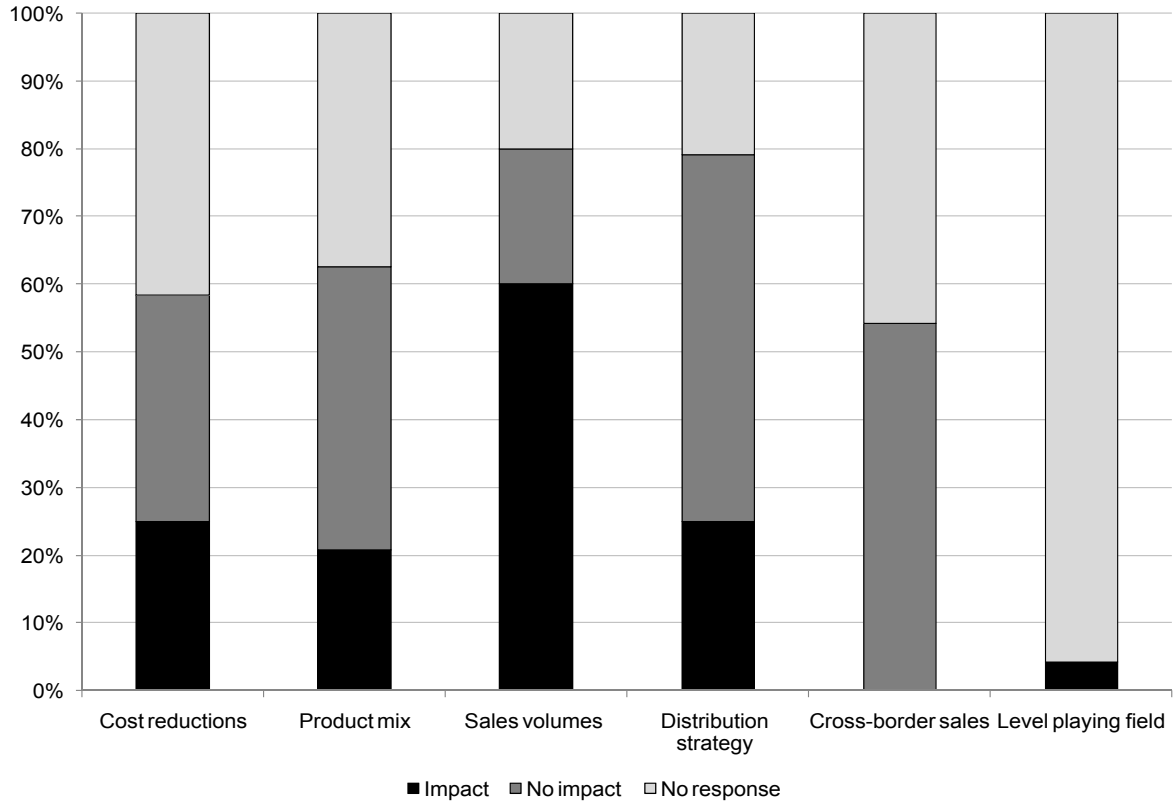
5.54 Some intermediaries suggested that the increased requirements may improve intermediaries' reputations and encourage consumers to see them as equal in standing with insurance companies, giving them a greater influence in the market. However, most of the intermediaries that thought the new regulations could level the playing field did not perceive any specific benefits.

5.55 Some respondents were concerned that the new regulations would result in one sense in a more uneven playing field within their own market, with intermediaries being more negatively impacted (in terms of cost and disruption) by the regulations than larger institutions, such as banks and insurance providers.

Insurance Undertakings

5.56 As with intermediaries, we present here the benefits and wider impacts of the new regulations highlighted by life insurance firms. In line with our general findings, Figure 5.4 indicates that by far the most commonly anticipated impact is on sales volumes. No insurance companies felt that the new rules would impact on their cross-border sales strategies.

Figure 5.4: Frequency of Reported Impacts as a Percentage of all Insurance Companies



Source: Europe Economics Survey of companies in Estonia, France, Germany, Italy, Luxembourg, the Netherlands, Poland, Romania, Slovakia, Spain, Sweden and UK.

Cost reductions

5.57 A greater proportion of insurance undertakings than intermediaries (25 per cent) indicated that the new rules would result in a reduction in costs. This is also slightly higher than the 21 per cent of all respondents shown in our General Findings. The most commonly cited driver here was the improved quality of sales and the corresponding reduction in after-sales costs (such as dealing with dissatisfied clients). Firms indicated that this in turn could reduce costs related to after-service (such as time, legal costs, administration) and bring about reputational benefits. A number of firms (25 per cent) cited that increased legal protection could arise from the new rules, which could also be linked to cost savings.

5.58 The drivers of cost reductions are somewhat different to the general findings, as savings resulting from business synergies were not frequently cited by insurance firms. The only firms that mentioned business synergies in the form of streamlining product documentation and staff training were those that are closely linked to a banking division that sells the insurance products on their behalf. Life insurance companies are otherwise unlikely to apply MiFID regulations to a sub-section of products and thus such synergies would not be relevant.

5.59 A Luxembourgish insurer with substantial cross-border activity suggested that if regulation was fully harmonised across the EU then this would reduce their documentation and (in particular) staff training costs when operating in other Member States. However, the firm emphasised that in order for any material savings to be realised the degree of harmonisation would have to be very high.

Product mix

5.60 The potential impact on the product mix of life insurance companies appears to be more limited than other impacts, but is in line with the general findings. Just over 21 per cent of life insurance companies felt that the proposed rules would have some impact on their product mix. Many of the comments from insurance firms on product mix related to intermediaries, in that the latter may move away from life insurance investment products towards simpler insurance products (e.g. non-life insurance). In general, however, this shift was not expected to affect what insurance companies sell — it would simply mean a substitution towards other distribution channels, after a period of market disruption. This is discussed in more detail in distribution strategy section.

Sales volumes

5.61 Insurance undertakings were the most likely of all firms to indicate that the proposed rules could have an impact on their sales volumes. Just over 63 per cent of insurance firms said that this impact could occur, compared with 29 per cent of intermediaries and 38 per cent of banks, as shown in Figure 5.2.

5.62 Only 21 per cent of insurance firms thought that sales might increase, the main reason given being increased consumer demand resulting from improved investor confidence.

5.63 Potential positive impacts on sales uniquely cited by insurance firms (as compared to the general findings) included increased client retention rates (including through reduced policy resignations) resulting from the suitability and appropriateness requirements and information disclosures, whereby firms would be better able to provide clients with suitable products, and clients would be more certain about the products they eventually buy.

5.64 A small number of insurance companies (13 per cent) also indicated that the improved quality of selling advice may have a positive reputational impact and thus could potentially increase sales. Reputational impact was not felt to be important among other firm types.

5.65 A far greater proportion of insurance firms, however (42 per cent of all insurance firms) indicated that new rules could have a negative impact on sales volumes. Two of the main reasons cited were the increased complexity of sales processes and of client engagement, which could both deter clients from purchasing these products (e.g. due to information overload) and make the selling of them more costly. (However, as mentioned earlier, few firms explicitly indicated that any increase in supply-side costs would affect their product mix by, for example, leading them to supply simpler products.)

5.66 Some firms with a significant proportion of their products distributed through tied agents suggested that it may become more difficult to recruit agents who can adequately comply with all the new rules (or who have not left the market due to higher regulatory costs). Firms felt that this decrease in the sales network might have a negative impact on volumes in the short term, and would at the minimum cause some degree of disruption.

5.67 The impact on sales volumes may also vary according to the way in which insurance products are sold. For example, a German insurance firm noted that as the majority of insurance investment products are sold within a pensions-type wrapper, any new regulations of PRIPs would have a significantly wider impact than in markets where the products are sold on a more stand-alone basis. In this case the respondent highlighted that the requirements for commission disclosures could be particularly costly given the importance of commission-based sales for pensions and the current differences in disclosure requirements. These increased costs may contribute to a wider reduction in sales volumes.

5.68 All of the firms that thought the new rules would have a negligible or non-existent impact on sales volumes (21 per cent of insurers in the sample) stated that they already comply with regulations similar to MiFID, at least in part. This is either due to national regulation for insurance companies — for example of firms from the UK, the Netherlands and Romania, which have relatively high regulatory scores ranging from 9 to 17, or more informal industry codes of practice (for example in Sweden, which has a very low formal regulatory score of three). Whilst the regulatory scores for Romania and the Netherlands are not as high as in some other countries, responding firms indicated that enough of the current provisions are similar to MiFID (particularly those relating to suitability and appropriateness tests) such that firms considered the incremental impacts to be negligible. Qualitative feedback from all respondents (i.e. not just those from Romania or the Netherlands) highlighted these as areas of potential high cost (although as we have noted in Section 3, there was not a strong correlation between the regulatory score in this area and the relative cost impacts).

Distribution strategy

5.69 A number of insurance firms felt that intermediaries would be more disadvantaged by the new regulations than themselves, and that this could pose difficulties, at least in the short-term, among insurance firms that rely heavily on this distribution channel if agents or brokers either left the market, switched to simpler products or were no longer considered adequate to sell the more heavily regulated products.

5.70 As discussed in the general findings, many insurance firms indicated that they rely on the advisory market to sell their products and a move away from this distribution channel would therefore generally not be feasible, despite the potential difficulties facing intermediaries. One firm did suggest that it would consider a shift to more direct sales in light of the above issue; however, the firm already undertakes some direct sales and thus a move in this direction would not involve as substantial a change as for a firm with no

current direct distribution. On the whole, though, this was not an approach that insurance companies were either keen to adopt or considered feasible.

5.71 Some insurance companies did, however, indicate that they may increase their use of independent brokers over tied agents given the generally higher levels of skills and qualifications of the former. Such a shift towards more independent intermediaries might have further implications for remuneration structures. The payment of commissions by providers to independent intermediaries raises conflict of interest issues and, indeed, such commissions are prohibited in Denmark (only for independent intermediaries) and, with the Retail Distribution Review, will be prohibited in the UK.

Cross-border impacts

5.72 None of the insurance firms indicated that the new rules would affect their cross-border selling strategies, which is different to both intermediaries and banks. The majority of the insurance firms focus exclusively on their domestic life insurance markets due to factors beyond those addressed by the new rules. Even those firms currently engaged in cross-border activity did not feel that the new rules would be significant in themselves to alter their strategies or increase their sales volumes. As mentioned earlier, a Luxembourgish insurer with significant cross-border activity thought that the harmonisation of legislation at the EU level could potentially create some long-term benefits in terms of streamlining staff training and product marketing across different Member States, which may in turn lead to an increase in cross-border sales or an expansion in the number of Member States in which they operate. However, the probability of this occurring would depend heavily on the regulations being very closely harmonised across Member States.

5.73 It was also noted that if different Member States adopt more or less stringent requirements to those proposed this could create inequalities between them and increase firms' costs of operating across borders.

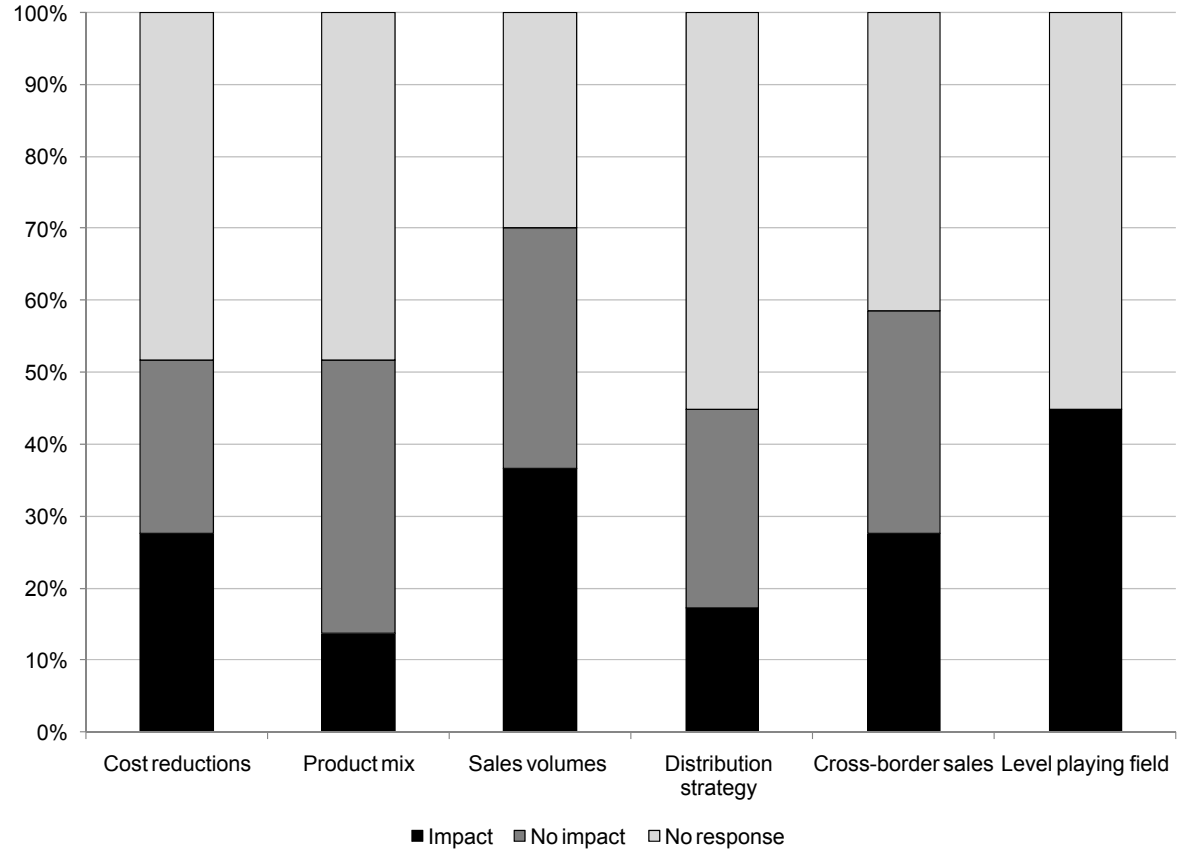
Level playing field

5.74 A very small proportion of insurance companies (four per cent) considered there to be any benefits from the levelling of the playing field either between firms or across products. This is not surprising given the fact that most insurance companies will not currently apply MiFID-like regulations to the sale of their products, and thus any synergies are not relevant.

Banks

5.75 The wider impacts of the new regulations on banks and other credit institutions differ somewhat from both insurance firms and intermediaries. Cost reductions are much more commonly cited, as are cross-border impacts, as shown in Figure 5.5 below.

Figure 5.5: Frequency of Reported Impacts as a Percentage of all Banks



Source: Europe Economics Survey of companies in Estonia, France, Germany, Italy, Luxembourg, the Netherlands, Poland, Romania, Slovakia, Spain, Sweden and UK.

5.76 Banks in our sample, which includes bancassurers, typically already sell investment products under the aegis of MiFID itself and thus have greater first-hand experience of the regime and, in theory at least, a firmer grip upon the potential impacts of the proposed changes to the treatment of non-MiFID PRIPs.

Cost reductions

5.77 The scope for cost reductions appears to be greatest amongst banks compared to the general findings, with 28 per cent of banks indicating that their business operations could be positively impacted by the new regulations compared with 25 per cent of insurance companies and 11 per cent of intermediaries. Unlike insurance companies, the most common driver of cost reductions cited by banks are potential business synergies such as streamlining selling procedures and staff training, and realising economies of scale from more centralised legal and compliance functions.

5.78 Furthermore, respondents were of the opinion that additional information gathered on clients buying PRIPs could enhance other areas of banks' business by enabling or simplifying the sale of other products. Whilst respondents were reluctant to indicate that

such synergies would result in any dramatic cost reductions, there would clearly be some benefits to the business of such changes.

5.79 A much less commonly cited source of cost reduction was the potential improvement in the quality of advice given to customers. Only one bank indicated that an improvement in advice quality could reduce the risk of mis-selling (caused by staff confusion at the range of different regulations for different products) and thus potentially reduce costs associated with consumer complaints. Similarly, only three per cent of banks cited increased legal protection as a potential source of cost reduction

Product mix

5.80 The potential impact of the new regulations on the mix of products sold by banks is perceived to be limited, more so than compared with both insurance companies and intermediaries. A minority of respondents (14 per cent of banks) suggested that their product offering may change in response to a potential shift in consumer demand away from the more heavily regulated products towards simpler products (to avoid lengthy paperwork and confusing information overload). None, however, cited supply-side reasons for such a shift.

5.81 A potential positive impact cited by two banks was the increased potential to sell other products, or have more effective product marketing, due to the increased level of information gathered.

5.82 Many of the respondents reported no foreseen changes due to the fact that MiFID-style regulations were already in place. This was on both a formal level in Member States with high regulatory scores, such as the UK (with particular reference made to the forthcoming RDR); Italy; and Slovakia,[63] and on an industry level (in Germany, Spain, Sweden, the Netherlands and Estonia). In addition to existing provisions, and in line with our general findings, banks indicated that product mix depends on factors other than selling costs, such as customer demand and distribution capacity, which may not change as a direct result of the new rules.

Sales volumes

5.83 Anticipated impacts on sales volumes were more widespread than impacts on product mix (and nearly all negative), but not universal, with 34 per cent of banks suggesting that there would be no impact on sales volumes at all, and 31 per cent not responding to the question. Compared with insurance companies and our general findings, a smaller proportion of banks (38 per cent) felt that the new regulations would have an impact on their sales volumes. Such potential impacts were also, in some cases, reported to be only

[63] See the discussion on regulatory scores above.

short-term, such as a temporary reduction in sales due to staff training requirements and lack of familiarity with the new rules.

5.84 Those banks reporting the most significant impacts on sales volumes were those whose sales staff are separated according to the applicability (or not) of MiFID (this was particularly notable among banks from Estonia). In these cases, including the latter staff group into MiFID training was generally considered by the respondents to be infeasible due to cost and logistics. Respondents were thus of the opinion that the sale of relevant products (specifically structured deposits) could either cease or be limited to when MiFID-type investment advice for other products is provided to clients. Respondents implied that these non-MiFID PRIPs would have reduced availability to "mass-market" clients.

5.85 A UK bank did highlight that the direct sale of structured deposits specifically (e.g. via the internet or in retail branches) would most likely cease if the selling requirements changed, as these channels would not be able to adequately handle the required levels of information and client interaction. However, the respondent did not think a decline in this area would lead to an increase in other distribution channels, as an increasing number of customers prefer to buy products directly (especially via the internet) and would rather look for another, simpler product than use another distribution channel. This would have a corresponding negative impact on sales volumes for structured deposits.

5.86 Again, as with product mix, banks reporting no expected impact were generally those already applying similar rules. However, some of these firms indicated a potential for reduced customer demand if the new regulation appeared more detailed or burdensome that what was currently applied.

Distribution strategy

5.87 In line our general findings, the expected impact of the new rules on banks' distribution strategies appears to be limited, with only 17 per cent of banks reporting that the new regulations may have the potential to change their distribution strategies. In some cases, where different products are distributed by different channels (for example, simple products sold by tied agents and more complex investment products distributed directly) banks suggested any shift in product mix towards a certain type of product would also have a corresponding impact on the distribution strategy.

5.88 As highlighted in our general findings, and similar to insurance companies, banks selling their products via intermediaries suggested that they may have to undertake a more careful selection process to ensure that these brokers are equipped to comply with the new regulations. In the UK it was thought that this may result in a shift towards an even greater use of independent financial advisors compared to tied agency (in the UK independent brokers already represent a large proportion of the distribution of investment products).

Cross-border impact

5.89 The potential for the new regulations to impact on firms' cross border strategies was highlighted by 28 per cent of banks. This is higher than the impact reported in our general findings (12 per cent of all firms) as well as for both insurance firms and intermediaries. However, the impacts cited by banks were very general (such as a levelling of the playing field between Member States improving the competitiveness of cross-border firms),[64] and none of the respondents indicated a specific business strategy change that might result.

5.90 A far greater proportion of banks indicated that a potential harmonisation in regulation would not be sufficient to justify expansion in this area given the numerous other legal and logistical barriers.

Level playing field

5.91 As seen in Figure 5.2, a far greater proportion of banks compared with insurance companies and intermediaries in our sample see benefits of the new regulations in terms of levelling the playing field between firms and across different types of investment product.

5.92 Nearly half of all banks in our sample (45 per cent) highlighted this benefit, and many suggested that the current discrepancies between life insurance investment products (in particular) and other MiFID-regulated investment products are inappropriate. As banks are more likely to sell the latter type of investment product it is not surprising that they would welcome the increased standardisation of regulation across investment products.

5.93 In addition, our definition of banks includes financial conglomerates that may operate in a number of Member States. Thus the levelling of the playing field across firms in different Member States will be of additional value to them.

Costs for Supervisors[65]

5.94 In addition to these wider impacts for companies, implementing the proposed rules would also have implications for the national supervisory bodies. Our approach to estimating these costs involved seeking information on what costs supervisors expected to incur and what costs supervisors currently incurred in monitoring compliance with MiFID by investment firms.

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[64] The majority of these firms are based in Italy, where it is generally held that the regulation of structured products is the highest in the EU (and we have estimated a maximum regulatory score of 18). Banks have cited this difference as reducing their competitiveness compared with other EU firms.

[65] Seven supervisors of those located in the selected Member States provided feedback regarding potential costs. Of these, four had relatively high regulatory scores already and so expected negligible incremental costs (and would have required less time and effort to answer).

5.95 To this end, we asked supervisors in our sample Member States about the potential additional costs to the supervisor arising from the application of MiFID-style regulations to PRIPs. Of the supervisors from Member States where the current regulation is highly aligned with MiFID and that responded to these questions, none expressed the opinion that the introduction of MiFID-style regulation to PRIPs would cause them to incur anything more than minimal costs. Supervisors from Member States where the existing regulatory framework is much less aligned with MiFID, however, felt that there would be some additional costs for them.

Sectors with high regulatory scores

5.96 All of the supervisors that responded from Member States where regulation is already quite closely aligned with the proposed rules (at least for some product groups or for some category of firm) indicated that there would either be no additional costs or any costs would be minimal. For example, one noted that since their inspectors had already been trained to supervise MiFID regulation for other products as an integrated regulator, they did not foresee a need to hire new staff to expand MiFID-like regulation to PRIPs.

5.97 In another case, the supervisor felt that the main costs to them were likely to arise from monitoring the application of a MiFID-type appropriateness test for non-advised business for these products and from applying MiFID rules to deposit-based retail structured products (to which they have not yet read across MiFID rules).

5.98 One issue raised by supervisors and a key issue in terms of the likely cost impact for them was the precise form that any new regulation would take. As long as the PRIPs regime implemented was in line with current MiFID regulations and other existing EU requirements, the costs would be minimal, as in some cases the majority of (or even all) MiFID rules have already been applied to life insurance investment products, and there may be no regulatory distinction made between financial instruments and insurance financial products. Of course, this mirrors the concerns raised by a number of market participants.

5.99 There could also be potential benefits for supervisors if the proposed rules were applied to PRIPs products. One supervisor in particular felt that the employment of the same procedures and arrangements for the distributions of all financial products would help to facilitate a more focussed and streamlined supervisory activity, thereby potentially reducing cost.

Sectors with medium and low regulatory scores

5.100 Supervisors in Member States where there are currently fewer provisions applied in line with the proposed rules noted some specific areas in which their costs might increase. One supervisor noted that additional costs might arise if they were required to handle an additional volume of consumer complaints under the new regulation.

5.101 A further potential source of additional costs would be from extra on-site or off-site inspections of insurers required to ensure compliance with the applicable consumer

protection provisions as well as costs if they choose to include the issues in a published circular. Based on the current resourcing structure of one supervisory authority we can estimate that the additional costs arising from the need for additional staff to monitor the companies now falling within the remit of the regulation could equate to a maximum of one extra employee per every 30 extra companies they must monitor. However, this estimate is heavily dependent on not simply the national context but also:

- how any new regulation for PRIPs compares in terms of depth and scope to the current MiFID regulation, which covers conduct of business areas well beyond those considered here — and so would likely require fewer (perhaps even far fewer) additional resources;
- the difference/similarities between any existing conduct of business regulations and what is proposed here; and
- the structure of the market, for example in a number of Member States bancassurance is a popular distribution channel, so a substantial overlap between those firms already subject to monitoring and supervision under MiFID and those that would become subject to similar monitoring processes may exist.

5.102 However, even in this category, one supervisor did not anticipate any important impact on the current level of operating costs incurred as a consequence of the proposed regulation.

Conclusions

Wider impacts

5.103 There are a number of potential wider impacts arising from the introduction of MiFID-style regulation to the selling practices of PRIPs. We focus on the impacts on firms, as identified by the firms directly impacted by any possible regulatory changes, and discuss those accruing to customers only to the extent to which they have a bearing on firms' expectations of the development of the relevant markets. Further work would be necessary to assess overall market impacts and developments, and likely scales of possible impacts. Our work suggests that wider impacts of the new regulation will vary notably across firm type.

5.104 Banks were most likely to indicate that a harmonised regulatory regime across product types could facilitate business synergies by comparison to the other firm types. Drivers of this effect include the streamlining of selling practices and staff training, opportunities to increase sales of other products, and centralised compliance functions. This is to be expected given the generally wider range of PRIPs sold by banks (specifically including ones already subject to MiFID) than intermediaries and insurance firms.

5.105 Impacts on product mix were the most important for intermediaries, reflecting a relatively greater impact of the new regulations on their selling processes and costs, and a corresponding willingness to consider a shift in their sales focus to simpler products. Where banks and insurance companies mentioned an impact on their product mix this

was largely due to changes in customer preferences (e.g. the desire to avoid products with burdensome information requirements) as opposed to supply-side factors.

5.106 The potential impact of the new regulations on sales volumes applies at least to some extent across all firm types, being of most relevance among insurance firms and banks. A key reason given across respondents, in particular by insurance firms, was the foreseen impact on customer demand, both positive (in terms of increased investor confidence and improved sales advice) and negative (in terms of an information and paperwork overload reducing the demand for these products), with the latter being more common. The nature and scale of impacts would depend on the scope of the proposals; they could be more wide-reaching in markets where insurance investment products are sold as part of a more common product package, such as a pensions wrapper if these were in scope. As with the impact on product mix, intermediaries more often reported cost-related reasons for an anticipated decrease in sales volumes than insurance companies and, to a lesser extent, banks.

5.107 Anticipated change in distribution strategies as a result of the new rules was limited. The main reason for this cited by insurers was their reliance on intermediaries for the sale of their products, which the insurers would not wish to change despite the possible increase in regulatory burden on intermediaries. Banks that used multi-channel distribution strategies for different types of products noted that any shift in product mix towards a certain type of product would have a corresponding impact on the distribution strategy, but none cited a specific strategy change.

5.108 The impact on cross-border sales strategies was also considered by respondents to likely be limited across all firms, although this may just reflect the largely domestic focus of the firms in our sample. A potential harmonisation in selling regulation was clearly not considered sufficient to justify expansion in this area (even among those firm engaged in cross-border trade) given the other legal and logistical barriers.

5.109 Three main other impacts of the new regulations were cited by survey respondents. The creation of a level playing field between companies selling various types of investment products, and between investment products themselves, was far more important for banks than insurance firms or intermediaries. This is understandable given that banks are more likely to sell a range of investment products that are currently subject to different regulation. Increased harmonisation would create business synergies within banks and increase their competitiveness vis à vis insurance companies selling largely non-MiFID regulated products.

5.110 Insurance companies anticipated benefits in terms of increased legal protection arising from improved selling practices and greater awareness on the part of the client about the risks involved with investment products. Banks and intermediaries also anticipated that this effect might reduce their after-sales costs in terms of addressing the concerns of dissatisfied clients.

5.111 The results from our survey suggest that the nature and extent of the impacts of the new regulations on firms will depend largely on firm type, i.e. on factors such as relative size, range of products sold, ability to change sales focus, and reliance on certain distribution channels. This tends to outweigh location as a factor, although there are exceptions as we describe here. Focussing on the impacts on sales volumes, wider impacts of the new regulations appear to be limited across all firm types in Italy, Sweden and the UK. Italy and the UK both have a high level of existing regulation similar to MiFID and thus the introduction of MiFID-like selling rules on certain PRIPs would not be expected to signify a major change (depending, of course, to how similar the new regulations are to MiFID). Whilst Sweden has a relatively low level of national regulation, many of the banks and insurance companies (and some intermediaries) within our sample cited industry-wide codes of practice that are similar in many respects to the envisaged MiFID-style selling rules and so should again act to mediate the extent of the change.

5.112 On the other hand, the majority of firms in France and Estonia felt there would be largely negative wider impacts on sales volumes of the introduction of new selling rules. The main view among the firms in France was that the new regulations would significantly increase the regulatory burden without adding materially to consumer protection. There was no country from which firms consistently cited an anticipated increase in sales volume.

Costs to supervisors

5.113 The costs to supervisors of monitoring and implementing the new regulations will differ according to the existing level of regulation within each sector. All of the supervisors that responded from Member States where regulation is already quite closely aligned with the proposed rules indicated that there would either be no additional costs or any costs would be minimal. Potential benefits are even likely: the use of the same regulatory and monitoring procedures for all financial products may help to facilitate a more streamlined supervisory activity and reduce costs. An important issue affecting the potential costs of all supervisors is the extent to which the new regulations compare in terms of depth and scope to MiFID regulations.

5.114 Supervisors within sectors where current levels of regulation are lower than the proposed rules cited potential increases in costs, driven by factors such as increased consumer complaints, or an increase in the number of on-site or off-site visits of firms. Survey results did not yield enough information for the robust estimation of potential costs; however, it is clear that these will not be significant compared with the costs to industry.

APPENDIX 1: APPROACH TO STAKEHOLDER ENGAGEMENT

Scope of the Study

A1.1 While the scope of the study in terms of the rules to be considered were set out by the European Commission in the Tender Specification, an initial exercise was carried out to determine the product and geographic scope of the study. These are discussed below.

Product scope

A1.2 In the Commission's Communication on PRIPs adopted on 30 April 2009, the defining features of a PRIP were identified as:

(a) products that offer exposure to underlying financial assets, but in packaged forms which modify that exposure compared with direct holdings;

(b) products that have capital accumulation as their primary function, although some may provide capital protection;

(c) products that are generally designed with the mid- to long-term retail market in mind; and

(d) products that are marketed directly to retail investors, although may also be sold to sophisticated investors.

A1.3 Following on from this, at the technical workshop held in October 2009, the packaged nature of these products, consumer exposure to risk and the emphasis on capital accumulation were highlighted as being of particular importance in identifying products that should fall within the scope of any regulation.

A1.4 There has been (and remains) substantial debate over what the appropriate scope of any proposed regulation should be within the confines of this economic definition. There are a number of reasons for this, in particular different types of life insurance investment products can have the same label across different Member States (or indeed the same products may have different labels) and differences in fiscal frameworks mean that the markets do not necessarily operate in the same way.

A1.5 For the purposes of this study (and only for this study) we have defined four life insurance investment product types that are of interest. To avoid any confusion that might arise from using national labels, we have described the four types of products on the basis of their key features. It is important to note that the descriptions of these products do not represent any legal or formal definition, they are purely to distinguish between different types of insurance products available in different markets and are only approximate:

(a) Type 1 Life Insurance Investment Product — life insurance where the policyholder purchases "units" in a fund. The value of the policy at maturity is dependent upon the growth of the fund in which the policy is invested and there is generally no guarantee

to the value of the policy when it matures, i.e. the investment risk is borne by the policyholder. In general this is referred to as a unit-linked life insurance policy and can be issued with or without a guarantee. One common example would be a eurofund.

(b) Type 2 Life Insurance Investment Product — life insurance where the policy's cash value is tied to the performance of a financial index, e.g. FTSE 100. Most policies offer guarantees that if the index is negative, the crediting rate will not go below zero. In general this is referred to as an index-linked life insurance policy and can be issued with or without a guarantee.

(c) Type 3 Life Insurance Investment Product — these offer benefits that are partly guaranteed and partly dependent on the evolution of assets chosen by the policyholder and contractually agreed (mostly UCITS). Correspondingly the insurance firm partially invests the premiums in guaranteed assets (in order to safeguard the guaranteed benefit) and partly in assets on the account and risk of policyholder.

(d) Type 4 Life Insurance Investment Product — the policyholder has some rights to participate in the profits of the insurance firm in addition to some guaranteed minimum return. The profits can result from:

- The investments' income exceeding the guaranteed minimum return
- The mortality profit (i.e. actual death benefits lower than those calculated in advance)
- The general expense profit (i.e. actual expenses lower than those charged to the policyholder)

The profits are in most cases added to the insurance policy as an annual bonus.

A1.6 Aside from these life insurance investment products, the study also covers other non-MiFID PRIPs, specifically deposit-based retail structured products. These offer a combination of a term deposit with a return linked to the performance of some defined index or financial asset. They are designed to achieve a specific payoff profile, which they achieve through transactions in derivatives such as interest rate and currency options. Whilst the terminology varies across Member States these products are commonly referred to as retail structured deposits.

A1.7 We have excluded pure protection products where the benefits are known beforehand and the invested capital is guaranteed and subject to strict solvency rules. In the case of these insurance products the policyholder does not bear any market risk (beyond that of the company going bust). These products do not therefore fall within the economic definition provided by the Commission.

A1.8 Similarly for the purpose of this study we have excluded pension products. Pensions are an extremely complex area with a high degree of heterogeneity across Member States.

In the absence of more developed thinking in this area, at this point, we did not feel that it would be appropriate to try to address the issue in the context of this study.

A1.9 Even though there is some variation between Member States as to how relevant certain products are, we feel that setting the scope in this way ensured that we captured the full range of potential costs and benefits of any future regulation.

Geographic scope

A1.10 The study covers all EU27 Member States. However, in order to allow sufficient depth the study focused the data gathering primarily on a sample of twelve Member States. The survey targeting firms will focus solely on these twelve countries. However, we sought information from other sources in respect of all EU27 Member States in order to enable the extrapolation of these results to the whole EU. For example, we collected data on national insurance markets from national supervisors, in particular with respect to:

(a) the structure of the market, including the numbers of providers and market concentration;

(b) the extent of cross border activity; and

(c) profitability, namely gross premiums, operating expenses, the number of contracts and gross claims value.

A1.11 For structured deposits the data were more limited so we relied on market size information from the European Commission and Arete Consulting.

A1.12 We consider this approach sufficient to allow a robust extrapolation of costs and benefits across the remaining Member States, whilst also remaining proportionate.

A1.13 Various criteria were considered in selecting the appropriate sample of Member States to include, such as:

(a) Whether MiFID-style rules are currently applied to the selling of insurance products (e.g. the UK, the Netherlands, Italy, Portugal and the Slovak Republic). This is both to reflect the diversity of experience within the EU and also to provide a useful comparison to those jurisdictions where a movement to such a regime would represent a more significant step;

(b) Whether the relevant market is large, e.g. important markets for life insurance policies and where deposit-based structured retail products are relatively important;

(c) The level of development in financial markets, to ensure that both developed markets, such as Germany and the UK, were included in the sample as well as transition economies with less developed financial markets; and

(d) The nature of the distribution channels in the various Member States, to ensure the diversity of distribution structures are reflected.

A1.14 The following Member States were selected:

- Estonia;
- France;
- Germany;
- Italy;
- Luxembourg;
- The Netherlands;
- Poland;
- Romania;
- The Slovak Republic;
- Spain;
- Sweden; and
- The United Kingdom.

Firm Survey

A1.15 The only way to gather information on the costs and benefits that the proposed rules would mean for companies is to ask those companies affected directly. As such a key element of our approach involved a survey of companies selling the relevant products. We focussed on three types of companies:

(a) Insurance companies;

(b) Intermediaries — i.e. brokers, tied agents and independent financial advisors; and

(c) Banks — including bancassurers, retail banks, investment banks, and other credit institutions (to note banks also act as intermediaries in some markets).

A1.16 Clearly conducting an *ex ante* assessment of the costs and benefits is complicated, particularly for those companies that are not familiar with MiFID provisions and the proposed rules more specifically. This can create a degree of uncertainty in the feedback, in particular with respect to any quantitative estimates of the costs.

A1.17 A lack of clear understanding, for example with respect to the extensiveness of any reporting requirements, can potentially result in some companies under-estimating the costs involved. Similarly, companies in this situation may rely on hearsay regarding the burdensomeness of any regulation, causing them to over-estimate the potential costs.

A1.18 Furthermore, *ex ante* assessments can be viewed as an opportunity to influence policy-making, and can thus create incentives for companies to over-estimate the costs of any regulation that they may not consider appropriate or useful.

A1.19 Another key risk of this approach is that companies decide not to respond at all because they find the exercise too difficult. Given the relatively short timeframe available for this study we considered this potentially to be a significant risk that can result in a low response rate. An important point to recognise is that, given these difficulties, the most willing participants may be those who consider the implementation of the baseline regulation to have been very onerous, or who anticipate that the proposals will affect their business very significantly. This gives a potential for bias that we would not be able to eliminate through analysis of the responses received. However, the dispersion of the results in past studies indicates that this potential source of upwards bias, if present, is not material.

A1.20 These risks must be borne in mind when conducting any survey and in analysing the results. Below we set out the approach we adopted for the survey and the ways in which we mitigated these risks.

Questionnaire design

A1.21 The aim of this questionnaire was to gather cost estimates for individual companies to comply with the relevant regulatory provisions and identify any benefits that might also accrue. To do this effectively the design of the questionnaire was extremely important. In particular it is vital that any estimates provided are set alongside an explanation of the key drivers of the costs without imposing substantial burden on companies responding to the questionnaire.

A1.22 It was also important to garner relevant financial and volume data on the firms within the sample (e.g. premiums/revenues and policy/product numbers). This allowed for more sophisticated modelling of the costs in the event of anticipated volume changes.

A1.23 The final version of the questionnaire was circulated in English. We have not found conducting questionnaires in English to be a problem in previous studies of this sort, though it does pose a potential risk, particularly in securing responses from small intermediaries that may not be comfortable in English.

A1.24 The questionnaire was piloted with a small number of companies to aid us in understanding how firms might interpret the questionnaire and thus allow us to identify any weaknesses or ambiguities in the wording.

A1.25 We also drew on feedback from a number of stakeholders, both at the EU level and the national level. Initial interviews with the European insurance and reinsurance federation (CEA), the European Federation of Insurance Intermediaries (BIPAR) and the European Banking Federation (EBF) helped to inform the design of the questionnaire, while interviews with national trade associations allowed us to verify the suitability of our proposed groupings for the national markets in each case.

A1.26 We identified all the relevant trade organisations and contacted them via email. Those that were willing to be interviewed and were interviewed before finalising the questionnaire are listed in Table A1.1 below. Needless to say, our interaction with firms in the survey and structured interview programmes was not restricted to those that are members of the trade associations identified below.

Table A1.1: Trade Associations Interviewed as part of Questionnaire Design Process

Type of trade association	Country	Trade association
Insurance	UK	Association of British Insurers (ABI)
	Netherlands	Dutch Association of Insurers (Verzekeraars)
	Estonia	Estonian Insurance Association (EIA)
	Italy	ANIA
	Poland	PIU
	Luxembourg	Association of Luxembourg Insurance Companies (ACA)
	Germany	German Insurance Industry Association (GDV)
	Slovak Republic	Slovak Insurance Association (SLAPSO)
	Spain	Spanish Union of Insurance and Reinsurance Companies (UNESPA)
	Sweden	Swedish Insurance Federation (Forsakringsforbundet)
Intermediaries	France	AGEA
	Sweden	Swedish Insurance Brokers' Association
	Spain	Spanish Insurance Intermediaries Body (Consejo General de Colegios de Mediadores de Seguros)
	UK	Association of Independent Financial Advisers
Banks	UK	British Banking Association (BBA)
	Spain	Spanish Bankers' Association (AEBANCA)
	Estonia	Estonian Banking Association

Note: when we refer to banks we include in this group bancassurers. Some banc assurers may also be covered by membership of insurance trade organisations.

A1.27 All this feedback was used to shape the final version of the questionnaire.

Identification of contacts

A1.28 Rather than create a sample and only contact a selected number of firms, given the risks to in terms of response numbers that we have described above, we initially contacted all companies that we could identify. We then monitored responses received to identify any areas where we were weak, for example if there were any particular Member States or types of company for whom we had fewer responses, we then focused on filling those gaps. In doing so we used information regarding the size of national markets and the nature of distribution channels across individual Member States to ensure that we focused on the appropriate areas. This process is discussed further later on.

A1.29 We collected email addresses for insurance companies, intermediaries and banks in each of the sample of twelve Member States using a number of different sources:

(a) from trade association websites;

(b) from the ISIS database (for insurance companies);

(c) from the our own contact database from previous studies; and

(d) from national supervisor websites.

A1.30 Where it was not possible to collect a comprehensive set of contact addresses through these sources, attempts were then made to contact trade associations to ask whether they would be happy to provide us with a list of their members' contact details. In the couple of cases where these methods all failed, email addresses were collected by hand from company websites.

Survey distribution

A1.31 We distributed the survey via email. In our experience we have found this to be the most direct and efficient approach to contacting a large number of companies, and also allowed us to circulate a link to the online version of the questionnaire. Given the timing and the associated risk for a relatively low response rate we kept the process under constant review and allowed additional time for following-up and contacting firms by phone where necessary.

A1.32 The email consisted of a covering letter in the body of the email and three attachments – the letter of support for the survey from the European Commission, a copy of the questionnaire in Microsoft Word and reference material for companies to read before completing the questionnaire. The covering letter included a short description of the study, instructions as to how to complete and return the questionnaire, contact details for Europe Economics for companies in the event they had any queries and a short paragraph about Europe Economics itself. In addition, a hyperlink was included to the online version of the survey.

A1.33 The content was initially provided in either English or French, dependent on the country in question. The decision to do so had been taken in the initial questionnaire design phase and explored with the trade organisations. In the first round of emails French companies were provided with the only the French version of the questionnaire and reference material, Luxembourg intermediaries were provided with both the French and English versions, and the remaining companies were provided with the materials in English.

A1.34 Where we only had a small number of email addresses available for a specific country and distribution channel after this process, we accepted trade association's offers to distribute the questionnaire for us where available. Where such an approach was employed we provided the trade body with all a cover letter and reference material to accompany the questionnaire which explained the objectives of the survey and the study more generally and provided direction on how to approach the questionnaire. There was clearly a risk attached to this approach that responses may be coordinated in some way. However, we felt that this risk was low relative to the potential benefits.

A1.35 In addition to sending emails, we also sent letters containing the questionnaire, reference material and a covering letter to named contacts at 94 Spanish banks, as we were only able to acquire postal addresses from the Spanish banking trade association (Asociación Española de Banca) for these companies.

A1.36 The number of companies that we distributed the questionnaire to initially are explained in Table A1. 2 below.

Table A1. 2: Number of Companies Contacted Broken Down by Company Type and Member State

	Insurance	Intermediary	Bank	TOTAL
Estonia	7	31	4	**42**
France	112	914	12+	**1038+**
Germany	164	119	23+	**306+**
Italy	158	207	10+	**375+**
Luxembourg	44	0+	104	**148+**
Netherlands	2+	1569	17	**1588+**
Poland	51	237	64	**352**
Romania	33	88	38	**159**
Slovakia	25	41	25+	**91+**
Spain	140	101+	101	**342+**
Sweden	31	266	16	**313**
UK	37	3315*	182	**3500**
TOTAL	**804+**	**6888+**	**596+**	**8288+**

** This value relates to the number of individuals emailed by the trade association, not the number of companies. Any one company was therefore likely to have a number of employees receive the email. The trade association made sure that they specified that the questionnaire should be completed on a company level, rather than individual level.*

Note: Where there is a "+", this indicates that the trade association also distributed the questionnaire to their members on our behalf, but we have not received information from them regarding the number of companies they contacted, so are unable to determine the exact number of companies the questionnaire was distributed to.

A1.37 We distributed the questionnaire on 31 March 2010 with a deadline for responses of 3 May 2010.[66] Our target was to ensure responses were spread evenly across the three categories of company. In order to mitigate the risk of a low response we implemented a number of measures:

- Where emails were returned as undeliverable, secondary and then tertiary email addresses were used if available from our initial identification of contact details.[67]
- Where we received an out of office reply, if the person in question was not going to return until after the questionnaire deadline given in the email, we contacted the relevant alternate contact provided in the automatic reply.
- Two weeks before the deadline for responses we sent out an email to remind all those firms that had not responded of the impending deadline.
- We contacted by phone any companies that had indicated their intention to respond but had not responded by the deadline to follow-up with their progress and provide any necessary support in completing the questionnaire.

A1.38 Given a slow response rate, we reviewed our approach to the survey and considered a number of back-up options that we had developed previously to address such problems if they arose. As a result we implemented the following measures:

(a) We extended the deadline until the 25th June 2010 — we had built such a contingency into our timing.

(b) To make the emails more accessible to companies they were drafted in individuals' native language for 10 of the 12 member states.[68]

(c) We introduced a programme of using native speakers to contact companies by telephone to verify that the appropriate person had indeed received the questionnaire and offer assistance in completing the questionnaire where helpful.[69]

(d) We increased the number of structured interviews to be conducted in order to use them to generate new responses (as well as to follow-up with firms that had submitted a written response as originally planned).

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66 The date of first distribution for some of the email addresses was a little later, in line with when these addresses became available. For instance, German, Dutch and Italian banks were first emailed on 6 April, Polish banks on 6 or 13 April, French intermediaries on 14 April, and Dutch intermediaries on 16 April.

67 For instance, where more than one source was used for company contact details in a certain case (e.g. ISIS and a TA website) this often meant we collected numerous email addresses for each company. The primary email address chosen was based on which source was likely to be most up to date, or if one address was for an individual rather than just a generic email address.

68 The two exceptions were Sweden and Poland.

69 With the exception of Sweden, where phone calls were undertaken in English.

A1.39 A key element of the additional structured interviews was targeting the companies in such a way as to ensure that overall the responses were as representative as possible. We considered the number of written responses from the different Member States already received and the types of companies these were from. We then made sure that particular emphasis was placed on those Member States and types of companies where we had fewest responses based on the picture we had developed of the national markets earlier in the study – principally the size of the relevant markets and the way in which the relevant products tend to be distributed in the different Member States.

Survey responses

A1.40 In total, we received 63 usable written responses. Five of these came from companies that do not currently sell the products covered by the scope of this study but nonetheless offered interesting insights and feedback on the potential impacts of any regulation on the industry. Another of the responses was provided by a trade body, which offered some qualitative feedback on what the proposed rules would mean for their members. While we have ensured that the information gathered from these six responses have been taken into consideration and discussed in the report in a qualitative way, the tables and charts below and the data analysis in the report focuses only on the quantitative responses that we received from companies selling the relevant products.

A1.41 The 58 relevant written responses are broken down as illustrated in Table A1. 3 below (to note the total number in the table is 57 because it excludes a response received from a Portuguese insurance company, since Portugal was not within our sample of Member States to cover, though we do reflect the results both qualitative and quantitative from that response in our data analysis).

Table A1. 3: Breakdown of Number of Responses Received by Company Type and Member State (excluding those from structured interviews)

	Insurance companies	Intermediaries	Banks	TOTAL
Estonia	3	1	2	**6**
France	1*	4*	3	**8**
Germany	1	2	2	**5**
Italy	0	1	9	**10**
Luxembourg	1	2	1	**4**
Netherlands	2	3	0	**5**
Poland	1	0	2	**3**
Romania	0	1	0	**1**
Slovakia	0	0	1	**1**
Spain	0	0	1	**1**
Sweden	1	2	2	**5**
UK	3	3	2	**8**
TOTAL	**13**	**19**	**25**	**57**

** indicates that one of the responses was a response compiled by the trade organisation for an average firm.*

Company Interviews

A1.42 Interviews with individual companies were undertaken to achieve two aims:

- To follow up on responses to the questionnaire already received:
  - clarifying the quantitative information given in responses in order to understand how values were determined
  - attempting to fill in gaps left in the questionnaire
  - discussing further company's general views of the potential impacts of the regulation, outside of the confines of the questionnaire structure.
- To obtain new responses to the questionnaire where written responses had not been received, in order to fill in the gaps in certain Member States.

A1.43 The interviews to obtain new responses were targeted in order to ensure that our final sample of responses was as reflective of the structure of distribution across the 12 Member States as possible. Of those companies that had not already provided a written response, some interviewees were companies that had expressed an interest via phone or email but had been unable to complete the questionnaire, others were companies that we had been in contact with by telephone in our earlier process of chasing responses. In a few cases the relevant trade bodies also offered support by identifying companies that might be most likely to engage with the process.

A1.44 Those contacts identified as targets for structured interviews were contacted by telephone in the first instance. The contact was then emailed to provide them with more information about the purpose of the interview, and, for those who had not yet completed the questionnaire, background on the study and the questionnaire and relevant supporting documents. Those companies for whom a written response had not already been received were asked to complete part one of the questionnaire before the interview, in order to provide some context for the discussion and save time during the arranged telephone call.

A1.45 These interviews were held from June 2010 until the end of July 2010.

A1.46 In total, 29 structured interviews were undertaken – 11 as follow-ups to questionnaires already received and 17 as new responses. The break down by country is illustrated in Table A1. 4 below.

Table A1. 4: Breakdown of Structured Interviews

	Insurance companies	Intermediaries	Banks	TOTAL
Estonia	0	1	0	**1**
France	0	1	2	**3**
Germany	1	0	0	**1**
Italy	1	2	0	**3**
Luxembourg	2	0	1	**3**
Netherlands	1	2	1	**4**
Poland	0	0	1	**1**
Romania	2	1	0	**3**
Slovakia	1	1	0	**2**
Spain	1	0	0	**1**
Sweden	2	1	0	**3**
UK	2	1	1	**4**
TOTAL	**13**	**10**	**6**	**29**

Overview of Respondents

A1.47 In total, we compiled 75 usable responses from the interviews and the written responses received (81 if we include the five from companies that do not currently sell the products covered by the scope of this study the qualitative response provided by the trade body). The 75 responses are broken down as illustrated in Table A1. 5 below. In each case we have also indicated the number of responses for which we have cost estimates.

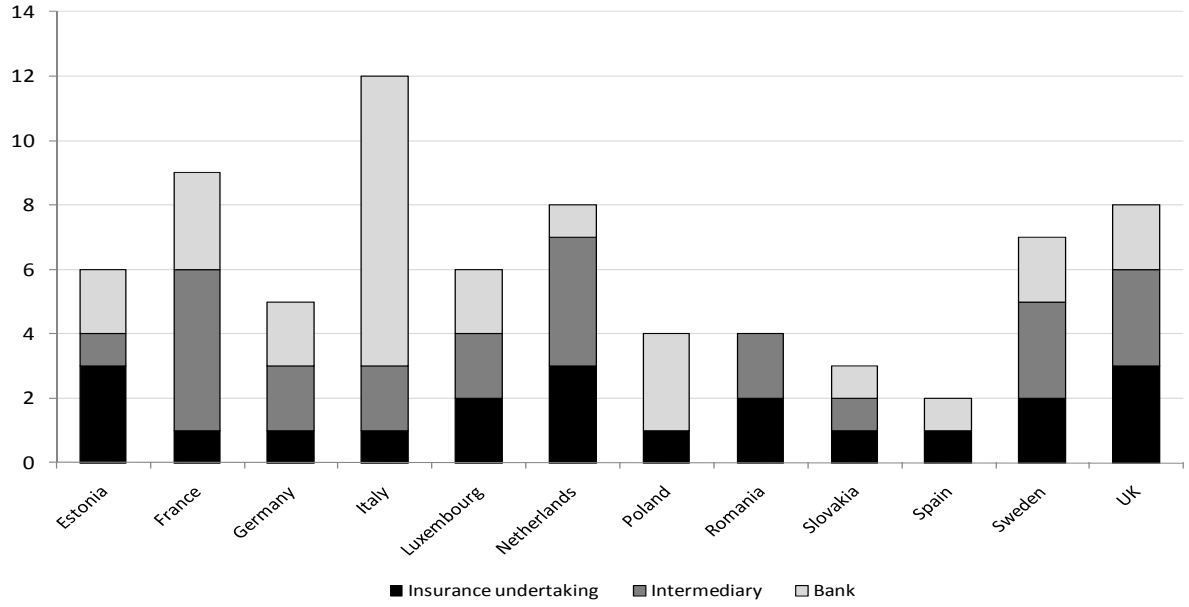
Table A1. 5: Breakdown of All Responses Received by Company Type and Member State

	Insurance companies	Intermediaries	Banks	TOTAL	Number of quantitative estimates of costs
Estonia	3	1	2	6	**6**
France	1*	5*	3	9	**7**
Germany	1	2	2	5	**4**
Italy	1	2	9	12	**5**
Luxembourg	2	2	2	6	**6**
Netherlands	3	4	1	8	**6**
Poland	1	0	3	4	**4**
Romania	2	2	0	4	**4**
Slovakia	1	1	1	3	**2**
Spain	1	0	1	2	**2**
Sweden	2	3	2	7	**4**
UK	3	3	3	9	**8**
TOTAL	**21**	**25**	**29**	**75**	**58**

*Note: * indicates that one of the responses was a response compiled by the trade organisation for an average firm. The totals including the Portuguese response are: total number of responses=76, quantitative cost estimate=59, total number of responses from insurance companies=22.*

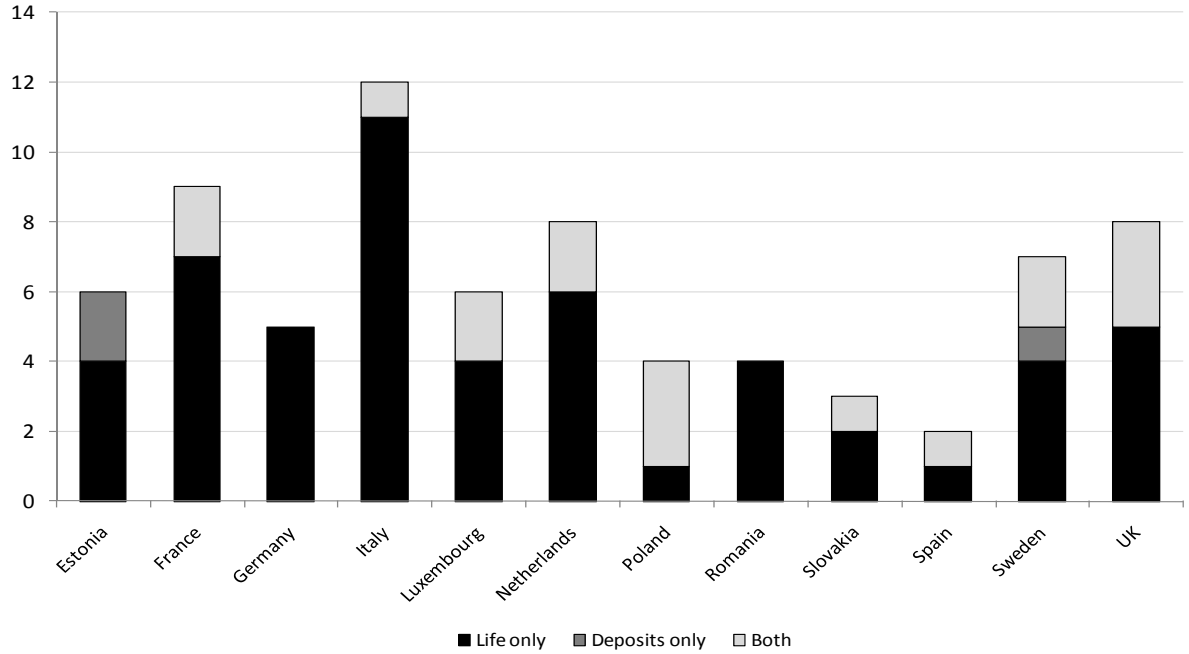
A1.48 In the charts below we provide an overview of the respondents. In general the respondents reflect the nature of the distribution channels in individual Member States and the sizes of the relevant markets. To illustrate this we have provided charts on the distribution of respondents across Member States, by type of company and by the type of products that they sell.

Figure A1. 1: Distribution of Respondents across Member States Broken Down by the Type of Company



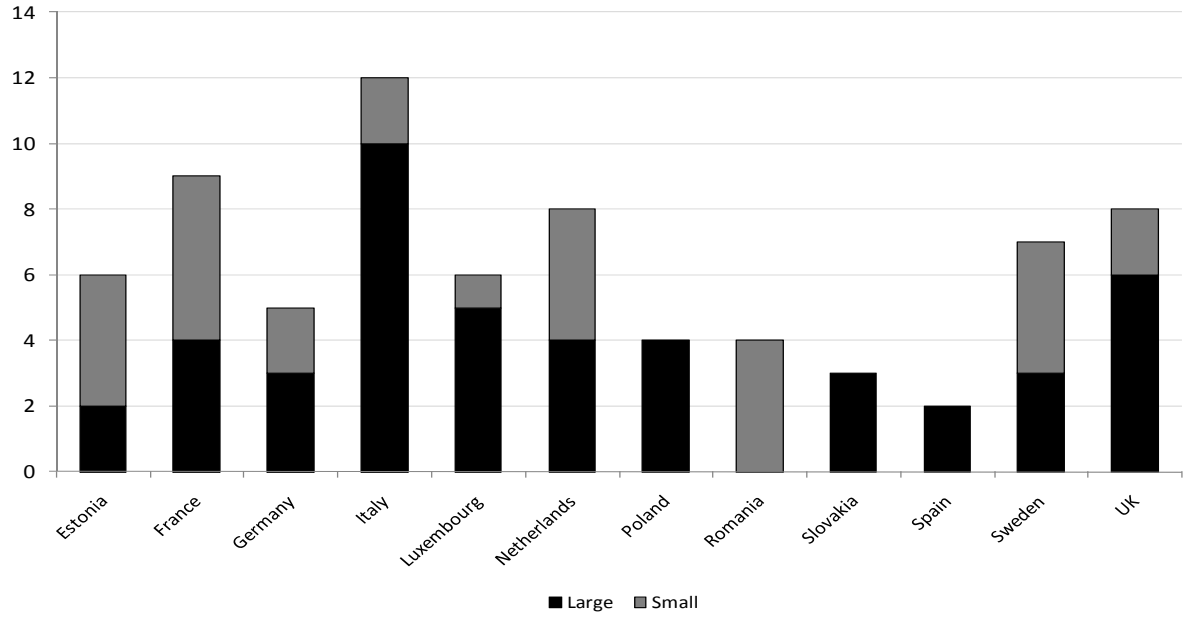
Note: One response was received from a Portuguese insurance company. Since Portugal was not included in our sample we have not included the data in this chart, however, we have used the response provided in all the other data analysis.

Figure A1. 2: Distribution of Respondents across Member States Broken Down by the Types of Products they Sell



Note: One response was received from a Portuguese insurance company. Since Portugal was not included in our sample we have not included the data in this chart, however, we have used the response provided in all the other data analysis.

Figure A1. 3: Distribution of Respondents across Member States Broken Down by the Size of the Company



Note: One response was received from a Portuguese insurance company. Since Portugal was not included in our sample we have not included the data in this chart, however, we have used the response provided in all the other data analysis.

Figure A1. 4: Numbers of Respondents across the three Company Types that sell the different Types of PRIPs

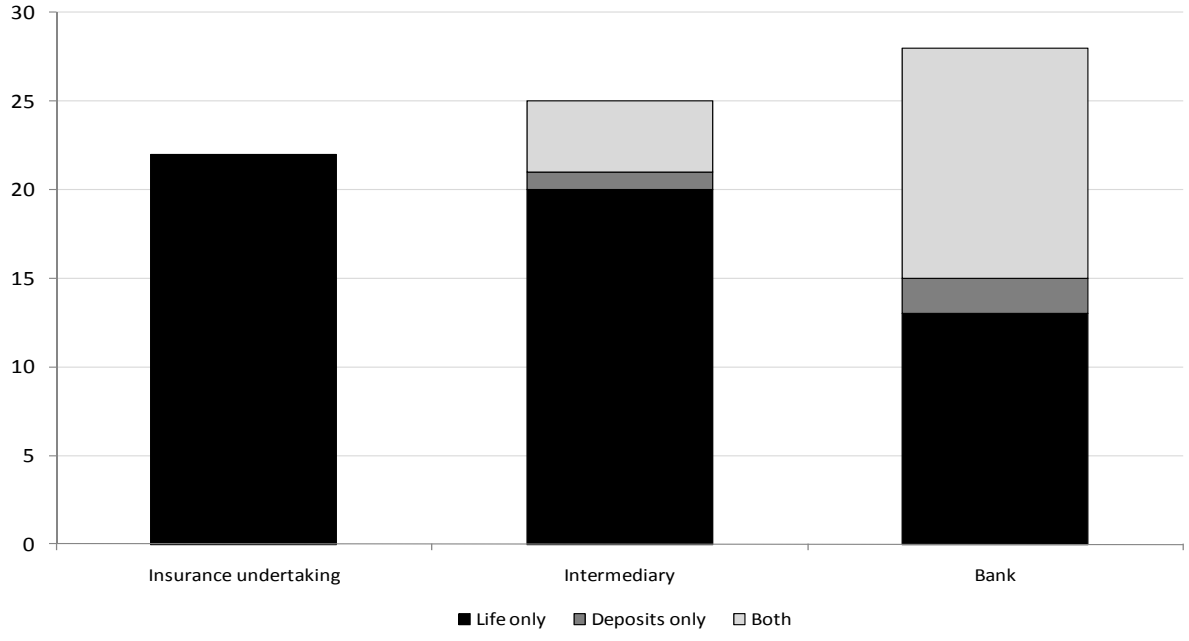


Figure A1. 5: Numbers of Respondents across the three Company Types that are Small or Large

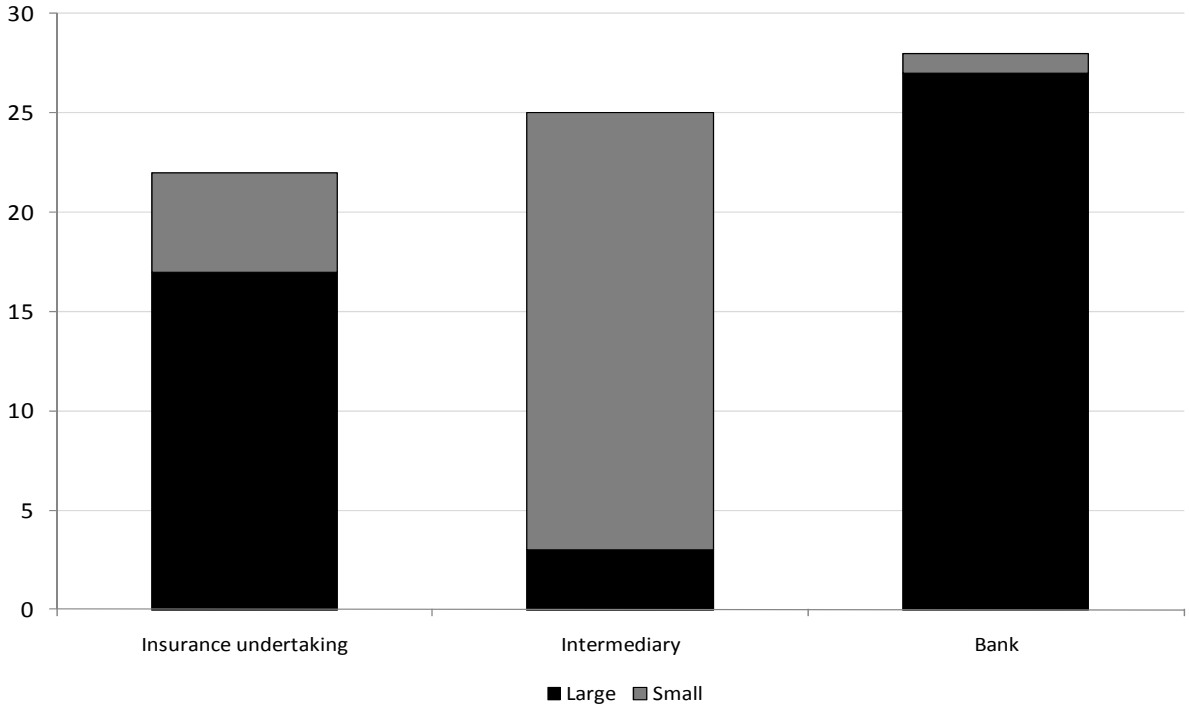


Figure A1. 6: Percentage of Respondents that sell Various Types of Products

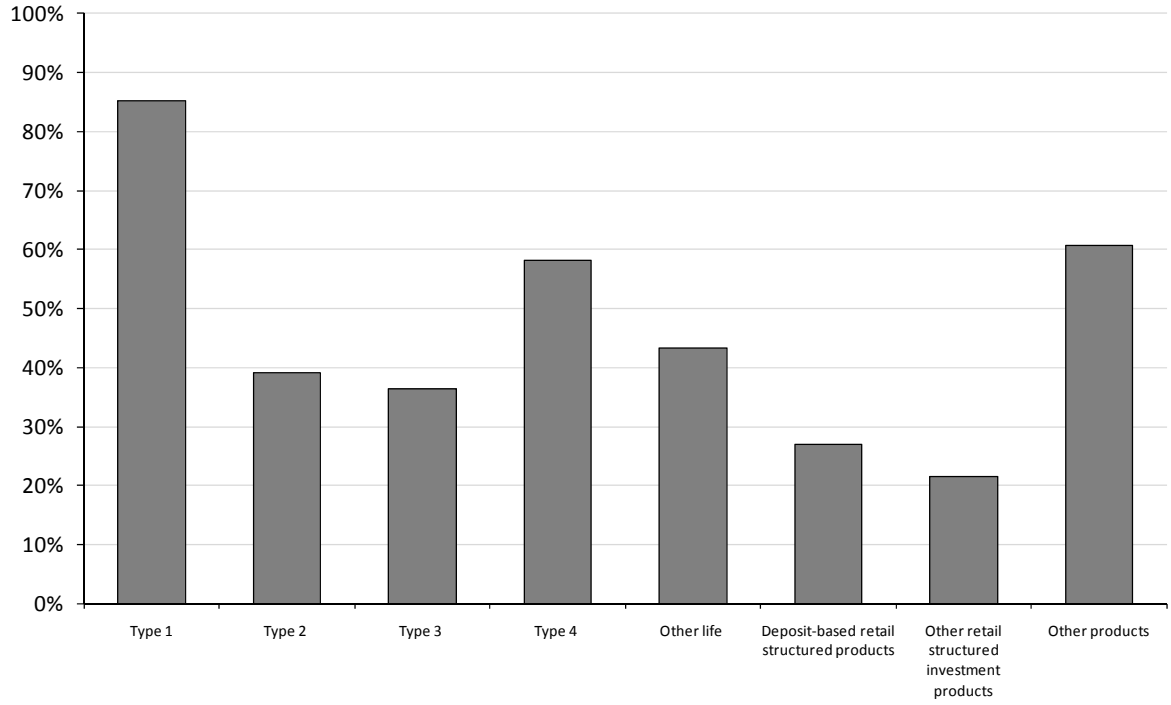
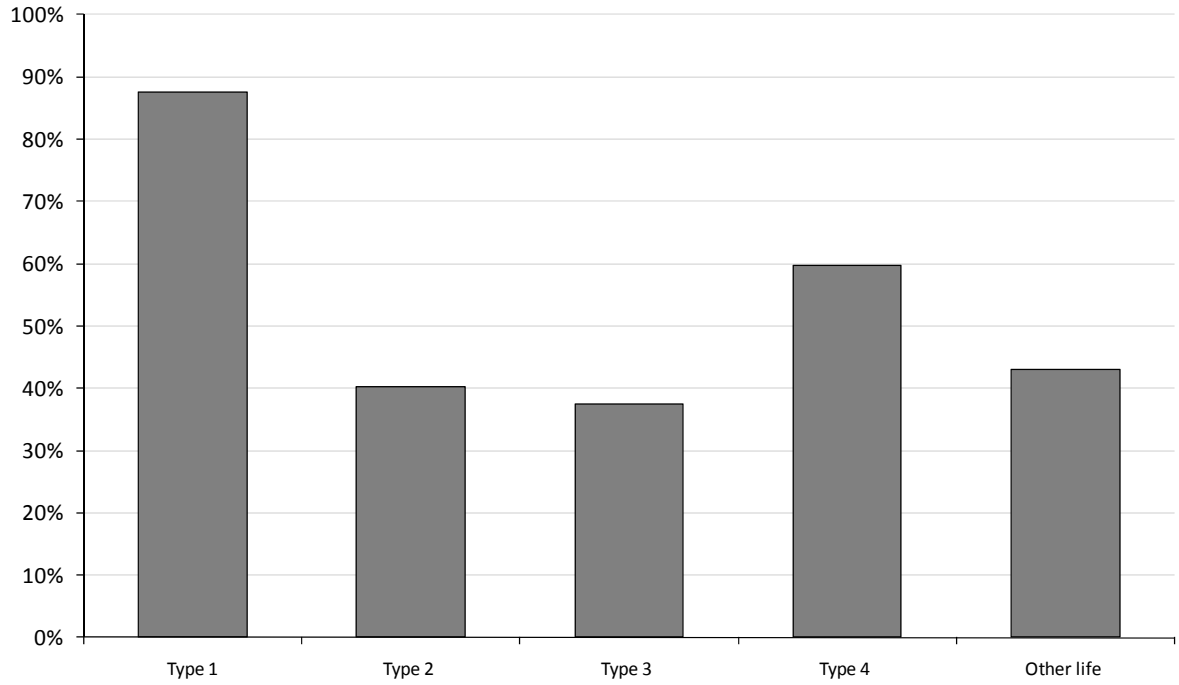


Figure A1. 7: Percentage of Respondents selling Life Insurance Products that sell the individual Types of Life Insurance Products



Supervisor Questionnaire

A1.49 We also surveyed national supervisors. This allowed to develop an overview of the existing national regulatory frameworks and their alignment with MiFID, and to gather information on any changes in national regulation that are likely to take place in the future.

Table A1. 6: Responses Received

	Life insurance products	Deposit-based retail structured products
Austria	Financial Market Authority	Financial Market Authority
Belgium	Banking, Finance and Insurance Commission (CBFA)	Banking, Finance and Insurance Commission (CBFA)
Bulgaria	National Bank and the Financial Supervision Commission	National Bank and the Financial Supervision Commission
Cyprus	Insurance Companies Control Service	Ministry of Finance**
Czech Republic	National Bank	National Bank
Denmark	Finanstilsynet	Finanstilsynet
Estonia	Financial Supervision Authority	Financial Supervision Authority
Finland	Financial Supervisory Authority (FIN-FSA)	Financial Supervisory Authority (FIN-FSA)
France	Prudential Supervisory Authority (ACP)	Prudential Supervisory Authority (ACP)
Germany	Federal Financial Supervisory Authority (BaFin)	
Greece		Bank of Greece
Hungary	Financial Supervisory Authority (PSzÁF)	Financial Supervisory Authority (PSzÁF)
Ireland	Financial Regulator	Financial Regulator
Italy	Commissione Nazionale per le Società e la Borsa (CONSOB) Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo (ISVAP)	Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo (ISVAP) Commissione Nazionale per le Società e la Borsa (CONSOB)
Latvia	Financial and Capital Market Commission (FKTK)	
Lithuania	Insurance Supervisory Commission (ISC)	Bank of Lithuania
Luxembourg	Commissariat aux Assurances** (response pending)	Commission de Surveillance du Secteur Financier**
Malta	Financial Services Authority (MFSA)	
Netherlands	Authority for the Financial Markets (AFM)	Authority for the Financial Markets (AFM)
Poland	Financial Supervisory Authority (FSA)	Financial Supervisory Authority (FSA)
Portugal	Instituto de Seguros de Portugal (ISP)	Banco de Portugal
Romania	Comisia de Supraveghere a Asigurarilor	National Bank of Romania**
Slovakia	National Bank of Slovakia	National Bank of Slovakia
Slovenia	Insurance Supervision Agency Financial Supervisory Authority	Financial Supervisory Authority
Spain	Asociación Española de Banca (AEB)* Consejo General de Colegios de Mediadores de Seguros*	Asociación Española de Banca (AEB)* Consejo General de Colegios de Mediadores de Seguros*
Sweden	Financial Supervisory Authority (Finansinspektionen)	Financial Supervisory Authority (Finansinspektionen)
UK	Financial Services Authority	Financial Services Authority

A1.50 Since the potential costs to the supervisors of implementing and administrating the proposed regulation and the costs to industry more broadly are also of interest to us, we explored these issues via the questionnaire as well. The longer version of the questionnaire covering these additional issues was only distributed to supervisors from those Member States that form part of our sample.

A1.51 We received feedback on this from a third of supervisors to whom the longer questionnaire was distributed. Those supervisors from whom this information was obtained are listed in Table A1. 7 below.

Table A1. 7: National Supervisors that Provided some Information on Potential Implementation and Administrative Costs

Country	National supervisors that provided some cost information
Estonia	-
France	-
Germany	BaFin
	Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo (ISVAP)
Italy	Commissione Nazionale per le Società e la Borsa (CONSOB)
Luxembourg	-
Netherlands	-
Poland	-
Romania	Banca Națională a României (National Bank of Romania)
Slovakia	National Bank of Slovakia
Spain	-
Sweden	Financial Supervisory Authority (Finansinspektionen)
UK	Financial Services Authority

APPENDIX 2: METHODOLOGY FOR EXTRAPOLATION

Overview

A2.1 A key objective of this study is to generate estimates for the incremental cost impact of the proposals on the financial services industry across the EU. There are a number of potential approaches to generating such an extrapolated estimate from the data set available to us. We describe below the methods that we have adopted here, the strengths and weaknesses of these and set out, of course, the results. In addition, we briefly discuss some alternative approaches and describe why we have not chosen to implement these.

Estimates by Firm Type

A2.2 This approach simply takes the median and weighted mean estimates of incremental cost by firm type (insurer, bank, intermediary) and applies these to the overall operating cost of that firm type in the EU. The median is less influenced by outliers than an arithmetic mean described in Sections 3 and 4. The weighted mean is more sensitive to the results from larger firms and less so to those from smaller firms — as such it is well suited to extrapolation to industries with a reasonable degree of concentration such as insurance and banking.

A2.3 Operating cost data on life insurers are reasonably available, the same data for the segment of these businesses relating to linked products a little less so. Similar data are available on the banking sector.[70] Such data on intermediaries are less available, and we have used estimates based upon statistics from BIPAR and also from our own survey results as to estimate average firm size. To these figures we applied estimates, informed by the work conducted of what proportion of firms and hence of total operating spending by each firm type was due to those firms actually involved in the distribution of life insurance investment products and deposit-based structured retail products.[71] This was through dialogue with market participants (e.g. in identifying firms who were willing to participate and considering their reasons given for non-participation) and trade associations — since our sample of firms includes those active in the relevant markets, it was not in itself helpful in this regard.

A2.4 The main advantage of this approach is that it slices the data up to the least extent that would provide meaningful results. (The results obtained by the different firm types mean

[70] For the insurance sector data, our sources here were our own survey of national supervisors, the CEIOPS statistical annex (2008), the CEA's 2008 "Insurance in figures" and Datamonitor's latest report on the UK's "Life Insurance and pensions" sector. For banking, OECD data are available on the banks from most countries in the EU (see, in particular, the OECD's Banking Statistics 2010 which contains data on 18 Member States). The insurers from these countries account for 98 per cent of the opex in that firm type and it seemed reasonable to apply the same metric to the banks.

[71] For insurers, we took 90 per cent of the total as being derived from firms involved, at least to some extent, in the distribution of life insurance investment products; for banks, we took 80 per cent of total opex as being relevant to those banks retailing

that a simple application of the estimates based upon the whole sample without distinguishing between say an insurer and an intermediary would not provide robust results). A summary of the one-off and ongoing impacts (expressed as a percentage of operating costs is shown below).

Table A2.1: Median and Weighted Mean Estimates of One-off and Ongoing Incremental Compliance Costs

	Median		Weighted mean	
	One-off costs: total operating costs	Ongoing costs: total operating costs	One-off costs: total operating costs	Ongoing costs: total operating costs
Insurers	0.445%	0.038%	0.361%	0.090%
Banks	0.059%	0.021%	0.026%	0.007%
Intermediaries	2.035%	1.903%	0.475%	0.093%

A2.5 However, it does not take into the influence of the regulatory score upon the outcomes: implicitly, it assumes that the sample has a similar distribution along this dimension as the underlying population.

A2.6 Similarly, it is implicitly assumed that the degree of involvement of the firms participating in the study in non-MiFID PRIPs is typical of all firms so involved. Whilst firms were approached on a random basis it is not unlikely that those agreeing to participate in the study were those who perceived themselves as having more at stake (i.e. a firm with above average involvement in the distribution of non-MiFID PRIPs would be more likely to participate than one with average or below average involvement in that market). We do not have access to sufficiently detailed or robust information to adequately adjust for this, and so it may result in a degree of upward bias in the estimates.

Estimates by Firm Type and Regulatory Score

A2.7 This follows the same approach except that a further element of sub-division of the sample is implemented according to regulatory score. This means that medians and weighted means are calculated for each firm type according to whether that firm is located in a Member State with a low, medium or high regulatory score.

A2.8 These regulatory scores, where applicable, differentiated between insurers and insurance intermediaries. In addition, in respect to banks, where a bank in our sample identified

some form of non-MiFID PRIP. This reflects the facts that these products (particularly linked life insurance products) are both mainstream and more likely to be sold by a large firm than a small one (particularly in the banking sector).

itself as selling life insurance investment products of any type, we used the regulatory score applicable to insurance intermediaries. For those banks, on the other hand, that sold only deposit-based retail structured products we applied the regulatory score applicable to that product type. No bank that indicated that it sold both life insurance investment products and deposit-based retail structured products identified itself as selling more of the latte than the former.

A2.9 These results are then applied to estimates of total operating cost that have been similarly sub-divided. The proportion of products distributed through the different channels contributed to the sub-division of total operating costs between the different categories of regulatory correlation.

A2.10 The main incremental advantage over the previous approach is that it addresses the issue identified in A2.5 above.

A2.11 However, the further sub-division of the sample means that each data point exerts a greater influence on the median and weighted mean calculated for that sub-division and the overall result is likely to be less robust. It would, of course, have been interesting to further decompose the estimates according to distribution channel or firm size. However, the information on the overall market is not sufficiently granular to enable this to be done meaningfully in practice (even if the additional sub-division of our sample was presumed robust).

Summary of Estimates

A2.12 We set out below the estimates generated by using these two approaches, first for one-off costs and then for ongoing costs.

Table A2.2: Extrapolation of One-off Cost Estimates

	Medians €m	Weighted mean €m	Medians, decomposed by regulatory score €m	Weighted means, decomposed by regulatory score €m
Intermediaries	106.2	24.8	187.3	56.8
Insurers	205.3	166.5	249.3	178.4
Banks	209.2	91.4	154.3	125.7
Total	520.7	282.6	590.9	360.8

A2.13 In most cases, the medians generate higher estimates than the weighted means. This is consistent with the proportional cost impact being higher for smaller firms. (We have not used straight arithmetic means for the above calculations: with small samples such as the one here, and given that small firms are believed on average to experience higher proportionate costs, these mean values are always likely to be biased upwards.)

A2.14 When decomposed by regulatory score, the "medium" category containing Dutch and Romanian intermediaries is influenced by one data point with a particularly high estimate — this is above the median but features prominently in the weighted mean in this sub-category. This drives up the one-off estimates for the "intermediary" category in that approach.

A2.15 There is a somewhat similar effect with the estimate for the insurer category and the result is a somewhat broad range of estimates. The operating costs of life insurers attributable to linked life insurance investment products (as opposed to life insurance as a whole) are in the order of €16 billion across the EU. This means that the one-off estimates represent between 1.1 per cent and 1.6 per cent of *these* costs, i.e. non-trivial values. However, we remind the reader that such linked products do not precisely tally with our Types 1–4, with the level of operating cost attributable to the latter grouping expected to be higher.

A2.16 For these reasons, we consider that central estimates of the likely impact can be made as follows: for insurers, a one-off impact of €175–€250 million; on banks of €125–€175 million and on intermediaries of €50–€125 million. This would mean total one-off costs of €350–€550 million.

A2.17 Turning to ongoing costs, we describe below the results of the extrapolation exercise undertaken.

Table A2.3: Extrapolation of Ongoing Cost Estimates

	Medians €m	Weighted mean €m	Medians, decomposed by regulatory score €m	Weighted means, decomposed by regulatory score €m
Intermediaries	99.2	4.9	100.2	18.8
Insurers	17.6	41.6	118.1	51.1
Banks	73.2	24.1	45.4	36.3
Total	190.0	70.5	263.7	106.1

A2.18 The extrapolation based upon the medians generated by first decomposing the sample according to the regulatory score is driven upwards by the same factors as the one-off cost estimates. This does not mean that such a result can be wholly disregarded, rather that we simply give it less weight in seeking to establish a likely central estimate of the ongoing impacts.

A2.19 As we have noted previously, the ongoing cost estimates generated by firms are more dispersed than the one-off estimates, making the extrapolation of these more difficult and subject to judgement. Informed by the above, we make our central estimate of the ongoing cost as follows: for insurers, €50–€80 million (i.e. up to 0.5 per cent of

expenditure attributed by life insurers to the development and distribution of linked products); for banks, an impact of €35–€60 million and for intermediaries an ongoing annual impact of €25–€80 million. This gives a total of €110–€220 million in ongoing costs.

Other Approaches

A2.20 We briefly describe some alternate approaches below.

Line of best fit equations

A2.21 One further method would have been to estimate the fixed cost and variable cost drivers as an absolute value and as a proportion of total operating expenditure (or turnover) respectively. The equation for the line of best fit for the graph of (say) one-off cost (y) is:

$$y = vx + fc$$

A2.22 The intercept (fc) gives an estimate of fixed cost for each of the firms in our sample, while the gradient (v) estimates the variable cost, with the dependent variable being either operating expenditure or market revenue. This is, at face value, an attractive approach. Indeed, line of best fit equations have been calculated and are described in the respective sections of the study.

A2.23 However, we do not consider this approach capable of generating robust results from our dataset. One problem — already highlighted in the main body of the report — is that the line of best fit equations generate clearly anomalous results for the banks, for example implying a negative incremental cost for a bank with operating costs of less than €500 million. This is despite none of the banks of that size reporting a cost impact below zero and is likely due to the actual relationship in the sample being non-linear.

By contract or customer numbers

A2.24 We have obtained data on total contract numbers for life insurance as a whole and for linked policies in particular for most, but not all, countries within the EU (however, data on the analysis within this of single and regular premium policies are much less common).

A2.25 However, a large number of survey and interview participants considered customer number data to be overly sensitive to share meaning that an extrapolation based on this approach would be difficult to execute adequately.

APPENDIX 3: STANDARD COST MODEL ESTIMATES

Description of the Model

A3.1 The EU Standard Cost Model (SCM) is a model presented in the Annex 10 to the EU Impact Assessment Guidelines[72] as the preferred method of assessing the net costs of information obligations or administrative costs imposed by EU legislation. Administrative cost is defined as:

> "the costs incurred by enterprises, the voluntary sector, public authorities and citizens in meeting legal obligations to provide information on their action or production, either to public authorities or to private parties."

A3.2 On the basis of this definition of administrative costs only the conflict of interest and inducement provisions are relevant in constructing the SCM estimate. The SCM only covers the costs involved with meeting legal obligations to provide information on their action or production. S&A obliges companies to seek additional information from the client rather than providing any information to third parties. In contrast:

(a) The conflict of interest provision requires companies to provide clients and potentially the authorities with information on any conflicts of interest. There are two main sources of administrative cost associated with this provision: the first is the requirement to put in place an effective conflicts of interest policy; the second to keep a up to date record of all the services undertaken in which a conflict of interest has arisen or may arise.

(b) The inducements provision requires companies to disclose any costs associated with the provision of investment services may fall within the definition of relevant provisions according to the guidance. Administrative costs would be created by the need for the company to disclose such costs and retain more detailed information on these costs ready to be provided upon request.

A3.3 The only area for which the S&A provisions may be relevant for calculating the SCM is the requirement set out in the Implementing Directive to provide a retail client agreement. However, since this is likely to require only minimal additional cost, for transparency we have excluded S&A provisions as a whole from our estimate of the SCM.

A3.4 There are two important distinctions to be made in considering costs:

(a) Recurring/ongoing versus one-off — one-off costs are costs incurred only once, while ongoing costs reflect the recurring costs associated with running the business.

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[72] European Commission, *Part III: Annexes to Impact Assessment Guidelines ('The Annexes')* (2009) <http://ec.europa.eu/governance/impact/commission_guidelines/commission_guidelines_en.htm>

(b) Business-as-usual costs versus administrative burdens — this distinguishes between costs that result from collecting and processing information that would be incurred in the absence of the legislation and the administrative burdens associated with the additional costs that result from processes undertaken solely due to the legislation. In each case costs can be divided into one-off and ongoing costs.

A3.5 In terms of estimating the SCM both the one-off costs and ongoing costs must be considered, but only in so far as they are incremental to business-as-usual costs. The core concept of the model is that costs should be calculated as the average cost of the administrative activity (price) times the total number of activities performed per year (quantity). The price is calculated by multiplying the time required for performing that action with the average tariff rate for workers that perform that action, and the quantity is calculated by multiplying the number of actions required by their frequency.

Estimating the SCM

A3.6 The standard step by step procedure set out in the guidance is described in brief below:

(a) Step 1 — identify the information obligations and classify them according to a typology[73] published in Annex 10.

(b) Step 2 — for each type of information required, identify the type of action required based on the typology[74] published in Annex 10.

(c) Step 3 — obtain a picture of the target groups, which may be classified by size, type and location.

(d) Step 4 — identify of the frequency of the required actions, i.e. on average the number of times per year an action is required to be taken.

(e) Step 5 — identify the relevant cost parameters, i.e. the time spent performing the action and the hourly pay of those performing the action. In addition, there could be costs of *equipment and supplies* where the parameters would be (i) acquisition cost and (ii) depreciation period. Lastly, there could be *outsourcing costs*, where the parameter is what the service provider charges on average per information obligation per entity per year.

(f) Step 6 — estimate the average time spent on a task and the average hourly wage of those performing the task, based on information for all entities after removing any outliers.

(g) Step 7 — estimate of the number of entities in each target group.

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[73] See 'Box 1: Types of obligation', The Annexes 49-50.
[74] See 'Box 3: Types of required action', The Annexes 51.

(h) Step 8 — extrapolate data to EU level.

A3.7 The results of this exercise are presented in the standard summary format.[75]

Our Assumptions

A3.8 In constructing out estimate we have made a number of assumptions. These are described below.

Step one

A3.9 Based on the requirements set out in the COI and inducement provisions we identified the non-labelling information for third parties information obligation as being the most relevant in both cases.

Step two

A3.10 In terms of the administrative actions required to fulfil the information obligations set out in the COI and inducement provisions the most relevant for both one-off costs and ongoing costs are as follows:

(a) Familiarising with the information obligation

(b) Training members and employees about the information obligations

(c) Buying (IT) equipment & supplies

A3.11 In addition to these actions we have also included the costs of "designing information material (leaflet conception etc.)" in the one-off estimates. Meanwhile, ongoing costs may also be generated by "inspecting and checking (including assistance to inspection by public authorities)", and as such have been included in the ongoing cost estimates for the SCM. The estimates for inspecting and checking used here are based on more general information we collected the ongoing incremental costs that would be generated by additional internal/external reporting and internal audit and monitoring.

A3.12 For our estimates we have used information gathered on the costs associated with consultancy and legal advice on what the companies need to do to comply as a proxy for "familiarising with the information obligation". In our calculations we have treated this as an outsourced cost, though for larger companies with more developed compliance functions it is likely that this would be done in-house.

[75] Downloaded from http://ec.europa.eu/governance/impact/docs/eu_cost_model_report_sheet_v2.xls.

Step three

A3.13 Given the differences identified between the types of costs encountered and the scale of the costs across different types of business, we have used the type of business to distinguish between the different target groups. As such we consider intermediaries (in the narrow sense used in the report, i.e. brokers, tied agents and IFAs only), insurance companies and banks (in the broad sense used in the report, i.e. including savings banks, bancassurers etc) individually.

Steps four to six

A3.14 For one-off costs we have assumed that the actions would only have to be undertaken once (i.e. once per year and for one year only). For ongoing costs we have made the following assumptions in terms of the frequency of the actions per year:

(a) Training — we have assumed, in line with most companies training schedules, that any training would take place only once per year on an ongoing basis.

(b) Inspecting and checking — we have assumed that this also occurs on an annual basis. This is likely to vary across companies, but based on the feedback from companies, once a year is (on average) a reasonable assumption.

(c) IT costs – once per year, as these are, for example, driven by an annual maintenance or subscription cost.

A3.15 For wages (or "tariff per hour" as set out in the template), we have used an average of the hourly labour cost for financial and insurance activities (NACE_R2) for 2008, as quoted by Eurostat, in the following Member States:

- Belgium
- Bulgaria
- Czech Republic
- Denmark
- Germany (including ex-GDR from 1991)
- Estonia
- Spain
- Latvia
- Lithuania
- Hungary

- Malta
- Poland
- Romania
- Slovenia
- Slovakia
- United Kingdom

A3.16 Since the only acquisition identified for the purposes of our estimates relate to IT systems we have not included a depreciation period. We have assumed that the system would continue indefinitely or until the company updated their IT as a natural part of their future development (i.e. unrelated to the introduction of the proposed rules). The one-off cost of the initial acquisition has, therefore, not been adjusted for depreciation.

A3.17 Using this information we have estimated an average cost per type of company for each action.

Step seven

A3.18 The number of entities in the EU as a whole for each of the target groups was estimated as follows:

(a) Intermediaries — BIPAR identifies the approximate number of insurance intermediaries in its member associations. Based upon our work we then scaled this figure down to make allowance for those intermediaries only retailing non-life products.

(b) Insurance companies — CEIOPS in its Statistical Annex 2008 identifies the number of firms operating in all of the individual markets of the EU. For most countries, this Annex also identifies the number of firms active in the linked-life insurance segment. The proportion of all firms that were so active was extrapolated across from those countries where such data were available to those where the number of firms active in the linked-life insurance segment was not separately identified.

(c) Banks — the ECB identifies the total number of credit institutions in each Member States in its EU Banking Structures report (October 2008). Again, this was scaled down to reflect observation obtained through this study that not all banks are active in the relevant markets.

Step eight

A3.19 The final extrapolation to the EU as a whole was constructed using the average cost estimates and the numbers of entities in the EU as a whole (identified in step seven). This was an automatic calculation using the formula built into the excel template for the

SCM. To note, the administrative burden estimated equates to the administrative costs. This is because the cost estimates we received from companies were provided on an incremental basis, i.e. excluding any costs that they would incur in the absence of the regulation. As such we did not need to include any estimate of the Business as Usual costs.

Results

A3.20 Since we are only considering the costs associated with the COI and inducements provisions, but cost estimates were provided to us on an aggregated basis for all the proposed rules, we have constructed an estimate range based on differing assumptions about what proportion the two provisions represent in terms of the additional costs. Based on previous studies (such as the LECG report[76] where the individual elements of MiFID were considered separately) and our own analysis in this report and previous ones on related topics, we have constructed estimates for the SCM for the two provisions representing 10 per cent of the midpoint estimate of one-off and additional ongoing costs and 30 per cent of the midpoint estimate of one-off and ongoing additional costs (these represent the lower and upper bounds).

A3.21 We feel that this represents the most accurate range, given that:

(a) Previous studies suggest that COI and inducements represent a much smaller additional burden than S&A — based on the LECG report the additional costs created by the COI represents only eight per cent of the costs created by the S&A provisions.[77]

(b) A key driver of the costs based on feedback from industry is the extra time they will need to spend with the clients, particularly for the S&A provisions – this is not covered by the SCM which instead focuses on the administrative burden created by information obligations.

A3.22 Our results for the SCM estimates are illustrated in Table 5.2 below.

[76] LECG, 2005, "MiFID Implementation, Cost Survey of the UK Investment Industry" (for the UK FSA).

[77] This is based on the LECG report's estimation of an average one-off systems cost of € 341,024 and an average one-off training cost of € 28,357 for the appropriateness provisions and a mean cost of €30,000 to comply with CoI provisions. €30,000 represents eight per cent of the €399,381 combined cost of the appropriateness provisions and CoI.

Table 5.2: One-off and Ongoing Cost Estimates under the SCM

	One-Off Costs		Ongoing Costs	
	Lower bound	**Upper bound**	**Lower bound**	**Upper bound**
Intermediaries	€8,750,000	€26,250,000	€5,250,000	€15,750,000
Insurance companies	€21,250,000	€63,750,000	€6,500,000	€19,500,000
Banks	€15,000,000	€45,000,000	€4,750,000	€14,250,000
Total	**€45,000,000**	**€135,000,000**	**€16,500,000**	**€49,500,000**