

Placement of financial instruments with depositors, retail investors and policy holders (‘Self placement’)

Reminder to credit institutions and insurance undertakings about applicable regulatory requirements

Executive summary

1. As part of their respective mandates to protect investors, depositors and policy holders, the three European Supervisory Authorities, the EBA, ESMA and EIOPA are concerned about the practices used by some financial institutions to comply with enhanced prudential requirements under the CRD/R IV, the pending BRRD, and Solvency 2, as well as the ongoing EBA stress test and the ECB’s comprehensive assessment. These practices include financial institutions selling to their own client base financial instruments that they themselves have issued and that are eligible to comply with the above requirements. This practice may breach a number of rules governing the conduct of these institutions.
2. However, the ‘loss bearing’ features of many of these products mean that consumers are exposed to significant risks that do not exist for other financial instruments. For example, investors are more likely to be subject to bail-in; and the absence of harmonised structures, trigger points and loss absorption makes it difficult for investors to understand and compare the products. Each product needs to be assessed as a unique offering, which may be particularly challenging for retail investors.
3. The three authorities, within their remits, are reminding financial institutions that capitalisation pressures should not affect their ability to comply with existing and future requirements applicable in the European Union for the provision of services to consumers, including investors, depositors and policy holders. It is expected that due to regulatory and market developments, the risks of consumer detriment described here will further increase; this reminder is aimed at preventing this.

Background

4. In the past two years, credit institutions across the European Union have substantially increased their average regulatory capital levels in an effort to become more resilient. The European Supervisory Authorities (ESAs), the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Pensions Authority (EIOPA) – anticipate that this development will continue in the future due to several regulatory developments.

5. Firstly, the Capital Requirements Directive (CRD IV) and the Capital Requirement Regulation (CRR) will require credit institutions to gradually enhance capital buffers and increase capital ratios to a total of at least 10.5% (including capital conversion buffers) by 2019.
6. Secondly, the upcoming Bank Recovery and Resolution Directive (BRRD) stipulates that banks will need to build up sufficient loss-absorbing capacities to enable a failing bank to be stabilised without the need for a bail-out using public funds. This includes a mechanism for writing down (or bailing in) shareholders followed by unsecured creditors. In a resolution situation or when authorities have declared the non-viability of a bank, they have to bear losses and be bailed in for an equivalent of 8% of a bank's liabilities before recourse to public funds and the Single Resolution Fund, which is to be funded by financial institutions. A bail-in tool for all outstanding and newly issued debt has to be applied as of 1 January 2016.
7. Thirdly, the capital adequacy threshold in the Asset Quality Review (AQR) by the European Central Bank (ECB) and the capital threshold in the baseline scenario of the ongoing EBA stress test for 2014 are 8% Common Equity Tier 1 (CET1). In addition, a threshold of 5.5% CET1 applies in the adverse scenario of the stress test. If capital levels in the comprehensive assessment or EBA stress test fall below these thresholds, remedial action must be taken. Capital shortfalls may only be covered by CET1 capital instruments. Additional capital instruments, including a mandatory conversion into CET1, such as Additional Tier 1 (AT1) capital, may be used to a limited extent, a maximum of 1% overall risk weighted assets (RWA), to cover shortfalls arising from the adverse stress test scenario.
8. Finally, in the insurance sector, insurance undertakings will be required to comply with an enhanced capital adequacy regime as set out in the pending Solvency 2 Directive, introducing a three-pillar, fully risk-based system for (re)insurance undertakings. These pillars include requirements for capital, governance/risk management and disclosure to market/supervisory reporting. In the context of this note, capital requirements need to be fulfilled by 1 January 2016.
9. With reference to their legislative remits, the three European Supervisory Authorities have assessed how financial institutions across the EU have chosen to comply with emerging (and previous) regulatory requirements when providing services to their clients. In some Member States, financial institutions were found to be raising capital from retail investors and/or their own depositors or policy holders by placing financial instruments that they had issued and that are more likely to bear first losses and be subject to a bail-in.
10. Furthermore, the existence of cross-sectoral financial conglomerates may also increase the risk of concentration; these entities may attempt to benefit from existing relationships with consumers of other financial institutions in the group, such as undertakings in the insurance sector distributing instruments from credit institutions in the same group to their customers, who may sometimes be less aware of the risks involved with these products. These instruments have been, and are being, sold using a large variety of (often non-standardised) designations such as subordinate debt securities, hybrid/convertible securities, participation capital securities, mandatory convertible bonds or contingent convertibles (CoCos), to mention a few.

Risks of consumer detriment

11. There are multiple reasons why institutions raise capital from their own clients: it is cheaper and easier to comply with capital requirements in comparison to selling and capitalising non-core assets; some credit institutions may not have access to alternative funding sources; others may wish to use links that they have built with their regional retail depositors and/or retail investor base or may consider existing banking customers to be more receptive and therefore a more suitable sales target; or because investors may be seeking a higher yield investment in a generally low interest rate environment.
12. However, selling practices used in connection with such capital raising may put investors, depositors and policy holders at risk and could breach a number of requirements governing conduct of business. The following observations illustrate this point.
13. Firstly, the CRR allows for the use of contingent capital as additional Tier 1 capital. Various types of products qualify as contingent capital, including debt securities with mandatory conversion to equity or write-down features in the event that certain regulatory capital ratios fall below certain trigger points. However, these trigger points are bank-specific, as a result many characteristics of these products are not harmonised. This can make it difficult for retail investors to understand and compare products. Risks to consumers could be exacerbated further due to an increasing number of credit institutions recommending to their clients to exchange old-style Tier-1 securities that are compliant with CRD III into new capital structures that are compliant with CRD V, including convertible debt.
14. Secondly, the potential mandatory conversion under the forthcoming BRRD means that investors in additional capital instruments are exposed to the risk of a bail-in. A possible bail-in could include the conversion of debt instruments into capital to attain required levels of CET1. After equity has been bailed in, losses will have to be imposed evenly across holders of subordinated debt (second in line in a bail-in), and then evenly across senior debt-holders (third in line). Although the BRRD specifies some creditor safeguards, these investor risks are exacerbated further due to the uncertainty surrounding how a bail-in would be executed in practice. There is yet to be a bail-in under the new regulatory framework therefore the actual process and the effects on debt investors remain untested.
15. In the context of a bail-in under the BRRD, banks may decide to issue subordinated debt instruments, in particular CoCo securities. Depending on the trigger levels set in their terms, CoCos may absorb losses after regulatory capital, but before any senior debt. While few types of loss absorption mechanisms are recognised for regulatory purposes, the terms and conditions of the instruments tend to differ significantly. In addition, many CoCos come with features that retail investors may find difficult to understand, such as coupon skips; non-cumulative settlements; perpetual maturities with call features; principal loss absorption through equity conversion or security write-down; and junior to subordinated debt conversion in a liquidation scenario. Each product needs to be assessed as a unique offering, which may be particularly challenging for retail investors. In addition, these products are generally not appropriate for direct investment by retail investors.
16. The fourth observation concerns the distribution of unit-linked insurance products. The recent low interest rate has facilitated the distribution of these products, and in some cases

insurance undertakings have been persuading their customers to switch from their existing products with guarantees to unit-linked policies. The distribution of unit-linked policies could, under these market conditions, lead to conflicts of interests.¹ Furthermore, conflicts of interest are likely to arise if regulatory capital instruments issued by credit institutions belonging to the same group are distributed through unit-linked policies.

17. With the support of the national authorities in the 28 Member States, the three ESAs have conducted an analysis into how credit institutions have placed the instruments mentioned above. The assessment identified instances in which the following practices appear to have occurred:
 - investors have received no, insufficient or misleading information about product characteristics, prices or risks;
 - investors have received no, insufficient or misleading information about the financial status of the issuing bank;
 - investors and existing depositors have been approached through aggressive selling techniques;
 - existing depositors have been proactively approached by credit institutions and given the impression that a recommended product is as safe as a deposit or is protected by a deposit guarantee scheme, neither of which has been true;
 - investors have been exposed to misleading marketing and advertising;
 - investors have received unsuitable advice; and
 - investors have been sold inappropriate products during non-advised sales.
18. When this kind of behaviour results in investor detriment, the issuers of these instruments also suffer, in particular damage to their reputation and reduced confidence from markets and investors which can, in turn, reduce the take-up of issuances of this kind in the future. The main causes of these types of consumer detriment are the combination of high product complexity and poor management of conflict of interest within an entity, or a group of entities, issuing and distributing these instruments, and the inappropriate remuneration of staff placing these instruments. In addition, financial institutions may choose to issue such products through non-European subsidiaries, which can create additional uncertainty about the extent to which the investor is protected.
19. These observations suggest that financial institutions providing services to their clients need to be reminded about the existing regulatory obligations that apply to any instrument that they decide to place.

¹ This has already been subject to a supervisory recommendation concerning the marketing of debt securities in one Member State.

Existing regulatory obligations

20. The provisions in the Markets for Financial Instruments Directive (MiFID) that are relevant to the above activities are already in force under MiFID I.² In the insurance sector, undertakings should also follow the relevant rules governing conflicts of interest, remuneration, the provision of information and respecting the consumer needs and demands. With regard to requirements applicable to deposits, financial institutions must not claim that a product is as safe as a deposit (i.e. repayable at par at maturity) or that it is protected by a Deposit Guarantee Scheme, if no such protection exists.
21. The most relevant requirements in terms of protecting investors are described below. Firms should ensure they comply with these requirements when providing any investment services to existing or potential retail investors in relation to the financial instruments mentioned in the sections above.³
22. There are also some relevant changes currently being proposed in the ESMA's draft advice to the Commission on MiFID II. These changes are also set out below.

MiFID I and relevant ESMA work based on MiFID I

Conflicts of interest

23. Investor protection issues arising from the sale of the financial instruments described above already arise, from an organisational point of view, in the potential conflict of interest between the credit institution selling its own financial instruments (or selling financial instruments issued by entities of the same group), and the interests of their existing or potential clients. In practice, this means that prudential pressures cannot be allowed to override the obligations on firms to act honestly, fairly and professionally in accordance with the best interests of clients when placing existing or new financial instruments, either on an advised or non-advised basis, and to organise the provision of their services in compliance with these overarching obligations.
24. In the context of the existing organisational requirements and operating conditions for the provision of different services, MiFID I (Article 18) sets out the requirements for firms to:

'take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients...'
25. This is supported by the provisions in the MiFID Implementing Directive (Articles 21-23) which specify, among other things, how firms must identify conflicts of interest, establish, implement and maintain an effective conflicts of interest policy to identify and manage

² Namely, Directive 2004/39/EC (MiFID I) and Implementing Directive 2006/73/EC (the MiFID Implementing Directive). While this reminder is mainly addressed to credit institutions selling the financial instruments identified above to investors, the requirements in this reminder also apply to credit institutions providing investment services as well as to investment firms. Most of these requirements are also relevant for asset managers when providing investment services to their clients, pursuant to Article 6(3) of Directive 2009/65/EC (the UCITS Directive) and Article 6(4) of Directive 2011/61/EU (the Alternative Investment Fund Managers Directive).

³ Many of the MiFID requirements mentioned in this document also apply to relationships with non-retail clients. However, the focus of the document is mainly the provision of services to retail clients.

and/or disclose conflicts of interest, and record services or activities involving a material risk of damage to the interests of clients.

26. It is therefore necessary for firms to ensure that they have adequate organisational arrangements in place and to ensure that financial instruments that are targeted for offering by a firm to (existing or potential) clients, do not pose any risks to the clients' interests as a result of capitalisation pressures.
27. The duty to manage conflicts of interests applies across the firm and its respective functions and businesses. For example, in the context of the sale of own financial instruments, this will mean that a firm must properly identify and manage the conflicts that arise between the part of the firm that is seeking to manage the firm's capital requirements and the part of the firm that is seeking to recommend or sell financial instruments to clients (e.g. disclosure and other conduct of business rules).
28. In its recent opinion on 'MiFID practices for firms selling complex products', ESMA reminded financial institutions about conflicts of interest arising in the sale of own instruments:⁴

'Conflicts of interest arise in the sale of complex products especially when the selling entity is the issuer or is acting as the counterparty of the transaction. The compliance function should consider if incentives relating to the product create conflicts of interest (...). NCAs should monitor that firms make sure that any such conflicts are identified and managed'.

Remuneration

29. The remuneration of staff is also particularly relevant. The conflicts of interest requirements specified above would also apply to any reward or remuneration arrangements that may incentivise employees of institutions to sell the institutions' own financial instruments over other instruments, to the detriment of clients.
30. In its guidelines on remuneration, ESMA has made explicit reference to the design of remuneration policies and practices in the specific situation of firms selling their own instruments (similar considerations can be expressed about the sale of financial instruments issued by entities of the same group). In particular, the guidelines state that:

'Remuneration policies and practices should be designed in such a way so as not to create incentives that may lead relevant persons to favour their own interest, or the firm's interests (for example in the case of self-placement or where a firm promotes the sale of products that are more lucrative for it), to the potential detriment of clients'.⁵

⁴ Opinion on MiFID practices for firms selling complex products (ESMA/2014/146).

⁵ Guidelines on remuneration policies and practices under MiFID (ESMA/2013/606).

Information to clients – clear, fair and not misleading

31. Article 19(2) of MiFID I and Article 27 of the MiFID Implementing Directive describe how all information, including marketing communications, addressed by the firm to clients/potential clients must be fair, clear and not misleading.
32. Article 19(3) of MiFID I and Articles 30 and 31 of the MiFID Implementing Directive also specify the type of information that should be provided to clients or potential clients so that they are reasonably able to understand the nature of the information about the investment firm and its services and the nature and risks of the service or product being offered to them, including the requirement to provide appropriate guidance on and warnings about the risks. Proper client information should also include a description of the conflicts of interest policy maintained by the firm, which includes references to the measures adopted to manage conflicts arising from the sale of own financial instruments (or financial instruments issued by entities of the same group). The firm would not be compliant with this information requirement if this element is concealed or omitted.
33. In the ESMA Opinion on MiFID practices for firms selling complex products, ESMA expressed concerns about how MiFID I information requirements are applied by firms in an era of increasingly complex financial instruments⁶. These concerns hold true in the case of financial instruments described in the previous sections of this document. In its opinion, the ESMA indicated that information provided to clients should include the following: the potential benefits and returns in the simplest way possible, the scope and nature of any guarantee or capital protection offered, the potential consequences for clients seeking to sell or exit early from the investment.

The provision of investment advice

34. Article 4(1)(4) of MiFID I defines investment advice as the provision of personal recommendations to a client, either at the request of the client or at the initiative of the firm, in respect of one or more transactions relating to financial instruments. Article 52 of the MiFID Implementing Directive further specifies this definition by clarifying that the personal recommendation should be presented as suitable for the investor or potential investor or should be based on the consideration of the circumstances of that person.
35. The provision of investment advice triggers the obligation to obtain the necessary information regarding the client's or potential client's personal characteristics to enable the firm to recommend to the client or potential client the financial instruments that are suitable (see the section on suitability and appropriateness).
36. As already reminded by ESMA, the presentation of a financial instrument as suitable for the investor, either in an explicit or in an implicit form, constitutes investment advice in accordance with MiFID⁷. In this respect, even in situations in which a firm provides a

⁶ Opinion on MiFID practices for firms selling complex products (ESMA/2014/146).

⁷ Provided that the other legal elements of the definition of investment advice are met (Questions & Answers – Understanding the definition of advice under MiFID, CESR/10-293).

disclaimer to the client that no recommendation is being given, that firm could still be viewed as providing investment advice⁸.

Suitability and appropriateness

37. All firms providing investment advice or portfolio management have an obligation under MiFID I to assess whether financial instruments or services are suitable for their clients (Article 19(4) of MiFID I and Articles 35 and 37 of the MiFID Implementing Directive). This should include an assessment of the following 'necessary' information about the client or potential clients: knowledge and experience of the specific type of product or service (to understand the risks involved); financial situation; and investment objectives, so as to enable the firm to recommend investment services and financial instruments that are suitable for the client (or potential client).
38. The unique combination of significant product complexity and the severe conflict of interest may present not only a challenge to the client's ability to understand but also the knowledge and ability of sales staff. Firms have to ensure that investment advisors in retail markets in particular have adequate qualifications before they provide investment advice. Furthermore, the inherent conflict of interest could compromise the integrity of sales staff, leading to the risk of unsuitable sales. Therefore, firms should devote special attention to the training of sales staff responsible for relationships with clients and, in particular, staff providing advice.
39. The extent of information collected may vary. In determining what information is 'necessary' and relevant, investment firms should consider: the type of financial instrument that the firm may recommend (including its complexity and level of risk) and the nature, needs and circumstances of the client. While the extent of the information to be collected may vary, the standard for ensuring that a recommendation or an investment made on the client's behalf is suitable for the client remain the same.
40. For example, when providing access to new, complex, risky or illiquid financial instruments, firms should carefully consider the need to collect more in-depth information about the client than they would collect for less complex or risky instruments. The financial instruments mentioned in the sections above clearly present characteristics of risk or complexity or lack of liquidity and firms must pay special attention to ensure compliance with these requirements.
41. Similarly, it is crucial for firms to consider the situation of the client or potential client to ensure compliance with the suitability obligation specified in the MiFID; for example, more in-depth information would usually need to be collected for potentially vulnerable clients accessing investment advice for the first time. This is to ensure that firms can assess the client's capacity to understand, and financially bear, the risk associated with the proposed instruments. As prescribed by Article 37 of the MiFID Implementing Directive, firms should not encourage a client or potential client not to provide information required for the purpose of the suitability assessment.
42. In addition, when assessing the suitability of the financial instruments or services provided to their clients, all firms should ensure the identification and mitigation of concentration risk.

⁸ For example, if a firm stated that a certain financial instrument would suit a particular client's needs, the inclusion of a disclaimer saying that this was not advice would be unlikely to change the nature of the communication as a personal recommendation to the client.

The ESMA guidelines on certain aspects of the MiFID suitability requirements (ESMA 2012/387) clearly state that:

'A firm should establish policies and procedures which enable it to ensure that the advice and portfolio management services provided to the client take account of an appropriate degree of risk diversification'.

43. In practice, this will mean that the assessment carried out by the firm on both the instrument and the client's situation before making a personal recommendation, should be commensurate with the sophistication, riskiness, uniqueness of the instrument proposed and the personal situation of the client. Therefore, sales staff need a comprehensive skill-set to perform a correct assessment in the context of a highly complex product structure.
44. The suitability assessment is the responsibility of the investment firm and firms should avoid stating or giving the impression that the client decides on the suitability of the investment. Similarly to what was explained in the section on investment advice, firms should avoid indicating, for example, that a certain financial instrument was deemed suitable by the client, or requiring the client to confirm that an instrument or service is suitable⁹.
45. For non-advised sales of complex financial instruments (investment services other than investment advice or portfolio management), Article 19(5) of MiFID I and Articles 36 and 37 of the MiFID Implementing Directive require firms to assess whether the service or product envisaged is appropriate for the client, taking into account the client's knowledge and experience (that is, whether the client is able to understand the relevant financial instruments and their risk).
46. Article 19(5) of MiFID I requires that, if a firm considers, on the basis of information received from its client, that the product or service is not appropriate for that client, then the firm must warn the client that this is the case. Where the client has not provided sufficient information to the firm in order for it to make a determination on appropriateness, the firm must issue a warning to the client or potential client that it has not been allowed to determine whether the product or service envisaged is appropriate for the client.
47. As for the suitability assessment, firms shall not encourage a client or a potential client not to provide information required for the purpose of the appropriateness assessment. Furthermore, the overarching obligation to act honestly, fairly and professionally in accordance with the best interest of clients applies to all investment services provided by firms.
48. Irrespective of the investment service provided and the relevant test undertaken by the firm (suitability or appropriateness), the requirements on information provided to clients specified in the relevant section above apply. Information provided to clients receiving any investment services (on an advised or non-advised basis) should always include a clear and sufficiently detailed description of the nature and risks of the financial instruments to enable the client to take investment decisions on an informed basis.

Product governance

⁹ A more complete analysis of the MiFID suitability requirements is included in the ESMA guidelines on certain aspects of the MiFID suitability requirements (ESMA/2012/387).

49. In its opinion on ‘Structured Retail Products – Good practices for product governance arrangements’¹⁰ ESMA also notes that retail investors may find it difficult to understand the drivers of risks and returns of structured retail products (SRPs) and specifies a non-exhaustive list of examples of good practice illustrating arrangements that firms could put in place to improve their ability to deliver on investor protection.
50. The good-practice examples include arrangements in relation to: general organisation of product governance arrangements; product design; product testing; identification of the target market; distribution strategy; transparency on costs; and exit opportunities. The ‘Definitions’ section of the opinion makes it explicit that the good practices presented should also apply to firms distributing their own SRPs.

MiFID II proposals

51. MiFID II will strengthen without materially altering the MiFID I provisions set out above in relation to conflicts of interest, clear, fair and not misleading information, suitability and appropriateness.¹¹ In addition, ESMA has been asked to provide technical advice to the Commission for the adoption of Commission delegated acts under MiFID II in a number of areas, including organisational and conduct of business requirements. In its draft technical advice, ESMA is dealing with the different obligations mentioned above. Of particular relevance are the proposals developed by ESMA for draft technical advice on conflicts of interest, including underwriting and placing.
52. The ESMA consultation paper on the draft technical advice to the Commission on MiFID II primarily aims to avoid firms over-relying on the disclosure of conflicts to clients, and instead increase the emphasis on the effective management and avoidance of conflicts (including the regular review of conflicts of interest arrangements). In addition, the ESMA consultation paper also proposes more tailored requirements specific to conflicts of interest management in the context of underwriting and placing, including the placing of own instruments (or instruments issued by other entities of the group) by firms.
53. In particular, the draft technical advice to the Commission states that investment firms and credit institutions engaging in the placement of financial instruments issued by themselves or other group entities to their clients, including their existing depositor clients, must have in place clear procedures for the identification and management of the potential conflicts of interest that arise in relation to this type of activity. These procedures may include considering refraining from engaging in the activity where conflicts of interest cannot be appropriately managed to prevent any adverse effects on clients.
54. The EIOPA has received a similar mandate from the European Commission for technical advice following an amendment of the Insurance Mediation Directive (IMD) by MiFID II. EIOPA has published a Discussion Paper on conflicts of interest in sales of insurance-based investment products, which focuses on the conflicts of interest that could harm consumers and on how these conflicts of interest can be best avoided or managed. Specific issues related

¹⁰ ESMA/2014/332

¹¹ Article 23 of MiFID II explicitly states that investment firms shall be required not only to identify but also to prevent or manage conflicts of interest.

to insurance distribution activities include questions on proportionality and handling third-party payments ('inducements').