ISCTE Business School
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# THE (LACK OF) ETHICS IN THE DISTRIBUTION OF FINANCIAL PRODUCTS

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**Summary/Abstract**

In Portugal, the current situation in the marketing of financial products has flaws explored in this thesis, with a biased view to the delivery of these products to retail investors, in order to explain why unethical and mis-selling incidents are still happening nowadays.

Compensation schemes for commercial staff are not well structured, so measures are introduced to balance and disclose them.

The processes for commercial staff training and certification, related to the distribution of investment products, are inefficient so ways to correct the education methodologies are introduced, as they are key for commercial staff to a reliable source of adequate information and knowledge to their clients, which is essential to rebuild trust and reduce mis-selling.

There is no direct impact in the bank's balance sheet if their products are mis-sold, except clients withdrawing their money. I introduce preventive measures for banks to be accountable if their products cause mis-selling.

The current documentation supporting the selling of investment products is complex and does not provide clear information for investors to take appropriate decisions. Corrective measures are introduced to how that documentation is structured.

The sales of complex financial products to investors must be further restricted. Therefore, a model is introduced to implement limits to those processes.

The work around this Dissertation is supported by a Survey where 94 persons answered questions drafted around these topics.

**Keywords:** Ethics, Investors, Retail, Literacy, Asymmetry, Mis-Selling

**Resumo**

Em Portugal, a situação actual relativa à distribuição de produtos financeiros tem falhas que são exploradas neste tese, olhando especificamente para a entrega destes produtos a investidores do retalho, de forma a explicar como ainda acontecem incidentes de falta de ética e de vendas incorrectas.

Os esquemas de remuneração para os colaboradores das áreas comerciais não estão bem estruturados e, por isso, medidas são introduzidas para seu equilíbrio e divulgação.

Os processos de formação e certificação para os colaboradores das áreas comerciais, relacionados com a distribuição de produtos financeiros, são ineficientes e, assim, são introduzidos meios para corrigir as metodologias de educação, dado serem chave para que estes colaboradores sejam fontes fidedignas de informação adequada para os seus clientes, essencial para reconstrução da confiança e para redução das vendas incorrectas.

Não existe impacto directo no balanço de um banco se os seus produtos são vendidos incorrectamente, excepto se os clientes retirarem o seu dinheiro. Introduzo medidas preventivas para que os bancos sejam directamente responsáveis se os seus produtos forem alvo de vendas incorrectas.

A documentação actual que apoia vendas de produtos de investimento é complexa e não fornece informação clara para os investidores tomarem decisões apropriadas. Medidas correctivas são introduzidas para a estruturação dessa documentação.

As vendas de produtos financeiros complexos a investidores deverá ser mais restringida. Assim, um modelo é introduzido para implementação de limites a esses processos.

O trabalho em torno desta Dissertação foi apoiado por uma Pesquisa onde 94 pessoas responderam a questões sobre estes tópicos.


**Palavras-chave:** Ética, Investidores, Retalho, Literacia, Asimetria, Vendas Incorrectas

**Index**

**Abbreviations**

ACI: Association Cambiste Internationale

ASF: Autoridade de Supervisão de Seguros e Fundos de Pensões

B. C.: Before Christ

BCBS: Basel Committee on Banking Supervision

BdP: Banco de Portugal

BIS: Bank for International Settlements

CAO: Chief Audit Officer

CCO: Chief Compliance Officer

CCP: Certificado de Competências Pedagógicas

CEO: Chief Executive Officer

CFD: Contracts For Difference

CFO: Chief Financial Officer

CHF: Franc (currency of Switzerland)

CMVM: Comissão do Mercado de Valores Mobiliários

CNSF: Conselho Nacional de Supervisores Financeiros

CRC: Central de Responsabilidades de Crédito

CRI: Central Investments Register

CRO: Chief Risk Officer

CVA: Credit Value Adjustment

DGS: Deposit Guarantee Scheme

DSTI: Debt Service-To-Income

EAP: Economic Adjustment Program

EBA: European Banking Authority

EC: European Commission

EFAMA: European Fund and Asset Management Association

EMIR: European Market Infrastructure Regulation

ESMA: European Securities and Markets Authority

ETF: Exchange-Traded Fund

EU: European Union

EUR: Euro (currency of the European Union)

EY: Ernst & Young

FEBASE: Federação Nacional do Sector Financeiro

FCA: Financial Conduct Authority

FGD: Fundo de Garantia de Depósitos

G-20: Group of Twenty

GBP: Pound (currency of the United Kingdom)

HSBC: Hong Kong and Shanghai Banking Corporation

IEFP: Instituto do Emprego e Formação Bancária

IFB: Instituto de Formação Bancária

ISM: Investment Scoring Model

ITV: Investment-To-Value

JPY: Yen (currency of Japan)

KID: Key Information Document

LCR: Liquidity Coverage Ratio

LTV: Loan-To-Value

MiFID: Markets in Financial Instruments Directive

MiFIR: Markets in Financial Instruments Regulation

MtM: Mark-to-Market

NPL: Non-Performing Loans

OECD: Organisation for Economic Co-operation and Development

OTC: Over-The-Counter

PRIIP: Packaged Retail and Insurance-based Investment Products

PTIF: Portugal Telecom International France

PRA: Prudential Regulation Authority

REV: Retail Exposure Value

ROCITI: Return-Over-Complex-Investment-To-Income

RPD: Real Probability of Default

SEC: Securities and Exchange Commission

SLA: Service Level Agreement

SRI: Summary Risk Indicator

USD: Dollar (currency of the United States of America)

UK: United Kingdom

TSR: Total Shareholder Return

## 1. Introduction

Commercial and retail banks are keepers of money. These entities have the expertise and knowledge to manage everyone's money – it is their normal course of business. We all place a great vote of confidence on the way they handle our savings[1]. Some might say that banks are not what they used to be, and that banking culture needs to change. But commercial and retail banks should always perform their traditional tasks, as they are and will remain an essential economic agent for the population of a region or country. As the American physician Oliver Wendell Holmes, Sr. wrote in the collection of essays entitled The Autocrat of the Breakfast-Table in 1858 (chapter 2): "Put not your trust in money, but put your money in trust.". Trust is, therefore, paramount.

It is perfectly understandable that individuals place a great amount of trust in banks and in their employees (each of them being a banker[2]), particularly the trained and experienced commercial staff of the branches that are often considered the "real face of banks" for their private clients. They are the ones that we approach and meet, they are the ones who manage our accounts and know our personal details and circumstances.

Nevertheless, the EY's 2016 Global Consumer Banking Survey[3], with responses of 55.000 consumers in 32 regions (Portugal is not included), shows that, in general, customers have low trust in their banks (as primary financial service providers), particularly in the areas where these institutions are expected to provide unbiased advice (as low as 26% of all respondents have complete trust). A higher level of trust (48%) is placed in the security of money, but the Survey also shows that complete trust in banks with physical branches is ranked below the level of complete trust of their competitors: internet/telephone banks with no branches and other companies (FinTechs, for instance). Human interaction is not as essential as before…

A further fact that amplifies this problem is shown in the European Commission's Consumer Markets Scoreboard (2018)[4], with the group of investment products, private personal pensions and securities being ranked in the bottom three places for the European markets (amongst a total of 40 goods and services for consumers) since 2013, whilst in Portugal this group is placed

[1] In the book *Finance and the Good Society*, Robert J. Shiller mentions that "… banks are managers of investments on behalf of clients, just like other kinds of investment managers, but with greater claims to safety" (p. 39)

[2] Or *bankster*, to rhyme with *gangster (*as Robert J. Shiller details in the book *Finance and the Good Society)*, a term often used recently by the general public to reflect opinions of the bankers' actions in the global financial crisis that caused damage to the economies of several countries and of their people (p. 37)

[3] https://eyfinancialservicesthoughtgallery.ie/wp-content/uploads/2016/10/ey-the-relevance-challenge-2016.pdf

[4] https://ec.europa.eu/info/files/consumer-markets-scoreboard-making-markets-work-consumers_en

fourth from bottom in 2017. The document shows that clients are generally dissatisfied with their performance and score them with low trust and expectations (in Portugal, below the average of the European Union), although the number of complaints is relatively average and significantly below the number of complaints related to internet provision, fixed and mobile telephone services, for instance. The document also shows that consumers are most likely to switch their suppliers for financial products, but they are less likely to switch suppliers of their bank accounts.

So, consumers have low trust in banks… but where do we place the level of satisfaction of investors with their banks? According to page 25 of EY's 2014 Global Consumer Banking Survey[5], that includes responses of more than 32.000 retail customers from banks in 43 countries (including Portugal), only 30% of respondents reported that they are very satisfied with an investment account held at their banks, with this product being ranked 14$^{th}$ out of the 16 products measured by their level of satisfaction (only life insurance policy and mortgage ranked below, with 28% of clients satisfied).

So, the degree of trust placed by clients in their account managers is important and, therefore, implies a greater level of responsibility for the bank and for that "face to face" staff. Clients do not have direct access to financial markets and banks do, so investors wishing to obtain security and attractive rates for their savings will have to rely on their relationship banks, and that reliability (or even dependency) is even greater if the client has a low level of financial literacy, adding focus to the fiduciary duties of banks. On top of that, there is a clear disparity in the access to financial information which is relevant for an investor to take his decision, with the banks naturally having more and better data at their disposal.

Considering financial and risk literacy, it is classified as low in Portugal (according to the 2017 International Pensions Report from Allianz , Portugal is second from last in the ranking of Western European countries related to level of financial knowledge of their population as shown in page 15 of that Report, and according to the 2014 Global Financial Literacy Survey from Standard & Poor's, Portugal is ranked in number 111 out of 142 countries considering the literacy level of the population as shown in pages 23 to 25 of that document). In addition, the general financial information in the country is usually inaccurate and scarce (the leading daily newspaper, Correio da Manhã, usually has a format of 48 pages of which only 1 or 2 pages are

[5] https://www.ey.com/Publication/vwLUAssets/EY_-_Global_Consumer_Banking_Survey_2014/$FILE/EY-Global-Consumer-Banking-Survey-2014.pdf

"dedicated" to very basic economy and finance information – for comparison, crosswords and cartoon occupy 1 page altogether and sports usually occupy 6 pages).

The EFAMA's Report on Investor Education (2014)[6], which includes details of the iniciatives undertaken by its member in Portugal (Associação Portuguesa de Fundos de Investimento, Pensões e Patrimónios), clearly states that "… there remains asymmetric information challenges between financial firms and consumers of financial services.", mentioning that "… there must be regulation of products; selling rules; suitability tests and other regulatory measures…" in order to protect investors. In this report, it is also referred that investor education is essential to comply with that protection goal and can never be used as an excuse for banks not to comply with their regulatory duties, with its findings being a concern for Europeans as, generally, they have low levels of financial literacy and even have difficulty in understanding basic finance concepts such as savings and investments.

Financial markets and their products are widely used in the generation of potential opportunities for growth in investors savings'. The design of those products and instruments should allow for investors to have the possibility to fulfill their different objectives and saving profiles, even though, given the economies of scale, it is virtually impossible to generate one single product for each individual investor.

For example, let's look at the evolution of a type of investment fund introduced in the beginning of this century in Europe and now accessed by several investors in the continent: the ETF (Exchange-Traded Fund). In page 34 of the European Commission's Final report on "Distribution systems of retail investment products across the European Union"[7] (2018), we can see the asset growth in European ETFs, coming from a number of 100 in 2003 to a number around 2.000 in 2017 (and from around 16 billion to 583 billion EUR in the same period). ETFs are just a small portion of all investment funds and, looking at the Eurostat database[8] we can see that the total amount of those funds rising from 2.4 trillion EUR in 2009 to a number close to 5.8 trillion EUR in 2017 (in Portugal, it rose from 9 billion to 23.4 billion EUR in the same period), whilst invested amounts in currency, deposits and equities also rose substantially. The rise in derivatives, as a typical instrument included in the development of complex financial

[6] From the European Fund and Asset Management Association, released in March 2014 under the title "Building Blocks for Industry Driven Investor Education Initiatives and available on https://www.efama.org/Pages/EFAMA-Investor-Education-Report-Uncovers-Widespread-Financial-Illiteracy-across-Europe.aspx

[7] https://ec.europa.eu/info/sites/info/files/180425-retail-investment-products-distribution-systems_en.pdf

[8] https://appsso.eurostat.ec.europa.eu/nui/submitViewTableAction.do

products for investors, is also substantial (as an example, the turnover of over-the-counter interest rate derivatives rose from 2.6 trillion USD in April 2010 to 7.3 trillion USD in April 2019, according to the statistics of the Bank For International Settlements[9]).

The EFAMA's Report (2014) confirms that retail investors now have more access to financial markets, but the complex products being developed there remain difficult to understand by investors that have no financial sophistication. The determination of investors profiles remains subject to the individual standards of each institution, and there is no European regulation that mandates specific measures for that determination. All financial intermediaries have duties to obtain the accurate information from their prospective and current clients but, when that information is obtained, they are then free to establish investor profiles and select the products that clients in each segment can see and execute (with the exception of the selling of Contracts For Difference and binary options to retail investors imposed by ESMA[10]). But it must be said that "retail" is not an investor profile, it is a client categorization implemented by the MiFID I regulation[11]. Therefore, not a lot of changes were applied in this regard so, also in this context, levels of financial literacy cannot be disregarded in order to avoid mis-selling.

Therefore, generally investors show low trust to their banks but do not switch accounts. They have a low level of financial literacy, do not have the same information as banks and get offered complex products. In addition, commercial staff education and compensation levels are not adequate, and all these factors potentiate the lack of ethics in the distribution of financial products.

There are no specific and widely known indices that only measure ethics (or the lack of it) in the distribution of financial products or even only measuring services distributed to the financial sector. For instance, the Dow Jones Sustainability Indices[12] have, for the last twenty years, measured the dimension of entities in various industries (currently, 61 including banking) according to three areas: Environmental, Social and Governance (ESG). These last two areas cover some of the topics of this research, such as client protection, avoidance of conflicts of interest, employee compensations, amongst others, but this general and diversified index cannot

[9] https://www.bis.org/statistics/rpfx19.htm
[10] https://www.esma.europa.eu/press-news/esma-news/esma-agrees-prohibit-binary-options-and-restrict-cfds-protect-retail-investors
[11] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02004L0039-20110104&from=EN
[12] https://www.robecosam.com/csa/indices/

be used to gauge ethics in a very specific area that impacts investors in Portugal: the distribution of financial products.

## 1.a Objectives

In a country where financial literacy is low, where few clients really trust their banks, where asymmetry of financial information naturally exists and where complex products are delivered daily, we feel that remediations must be consistently implemented in the processes for distribution of financial products to retail investors in Portugal, as they could potentially help the reduction of mis-selling events in the country and also potentiate an increase in the public trust towards commercial and retail banks in Portugal.

The objective of this thesis is to introduce a combination of measures to support those remediations, as they could certainly help the essential goal of developing a more stable financial environment where clients in Portugal can feel that they are investing their savings in trustworthy banks that perform their duties in a responsible manner, and where these banks perform their business in a competitive, ethical, balanced and transparent financial market.

The measures presented will address how personnel involved in these processes will need to implement changes and will include enhancements to methodologies that banks use when distributing these products to investors. Clearly, the suitability and appropriate analysis of a client should be performed by an account manager that privileges integrity and ethical conduct in her/his role, so that investors can really place their confidence and their money in the hands of a trustable banker.

Those measures should be consistent, rigorous and invulnerable, but should also carry a possibility to be adjusted to face the constant challenges and changes in the financial markets.

1.b <u>Research Questions</u>

With the problems identified in the Introduction, this thesis will try to answer a general question in order to assess the current status in the distribution of financial products in Portugal.

General Research Question:

- Is there lack of ethics in the distribution of financial products in Portugal?

The feedback provided will provide an oversight of whether this is a real problem impacting the Portuguese financial system and its clients.

In addition, this thesis will attempt to answer questions in order to assess how the practical and efficient implementation of the presented measures could address, prevent and reduce problems in the distribution of financial products that lead to mis-selling events in Portugal.

Research Question 1:

- Can commercial staff in banks improve their ethical and professional standards towards retail investors?

For commercial staff of banks, the thesis introduces new staff policies related to their performance development and remuneration, new governance procedures and the obligation for independent and continuous certification for that staff in topics related to financial markets, its products its good market practices.

Research Question 2:

- Can banks be more trusted and accountable for the investment products they offer and/or recommend?

The thesis introduces regulatory capital requirements and governance procedures to banks, in the processes related to the distribution of financial products and analyses enhancements to eligible client classification levels and to the information provided to retail investors.

Research Question 3:

- Can retail clients be protected against excessive complexity in investment products?

A limit to the sale of complex financial products to retail investors will be contemplated in this thesis, supported by the enhancements to eligible client classification levels.

### 1.c Structure

The chosen structure for this thesis observes the following format:

- Chapter 1 introduces the topic of the thesis, its objective, the relevant research questions, this structure and the adopted methodology
- In Chapter 2, details of literature review addressing mis-selling in finance, asymmetry of financial information, investors' trust in banks and their financial literacy, education and compensation of banks' commercial staff, banks duties towards clients and complexity of financial products
- In Chapter 3, the current status in the processes for distribution of investment products is presented, and it looks at five key areas to the development of these processes: how commercial staff are remunerated, how they are trained and certified, what is the impact on banks' balance sheet arising from these activities, the banks' applicable governance framework and limits to that distribution
- In Chapter 4, conclusions and the measures for implementation are presented
- Chapter 5 details constraints to the research and suggestions for further investigation
- In Chapter 6, details of the bibliography considered as support to this thesis are included
- Finally, in Chapter 7 as Appendix 1, the Survey results are presented

1.d Methodology

To develop this thesis, I have applied my empirical experience of 25 years performing various roles in core areas where financial products are manufactured in banks: their treasuries. Also, I have also integrated in this paper my practical knowledge and competence as a certified trainer for financial markets, a role that I have performed since 2014.

The support of various books and papers on the field of study was also fundamental, as ethics in the financial markets' space has always been an interesting subject for me and one that I closely follow on a regular basis.

Also, for this thesis, I cannot disregard the importance of the various codes and regulations that have been implemented throughout the world covering financial markets, as they have supported the delivery of my training programs to commercial staff in various financial institutions in Portugal covering the retail market.

In addition, I have implemented an online Survey entitled "Comercialização de Produtos Financeiros" in April 2016[13], being sent to 199 individuals employed by banks located in Portugal. At the time, all these individuals performed roles in the following departments of banks that provided investment services to retail clients: audit (6 individuals), commercial (44), compliance (19), human resources (5), legal (7), management (24), marketing (7), risk (8) and trading (79). There was no specific or biased distribution to obtain knowledge from these areas as they were randomly selected and, therefore, I have selected a Survey where I could not identify which individuals corresponded to each answer (in the end, 94 individuals participated in the Survey, 47.2% of the initial sample). Nevertheless, most of these individuals have worked in several banking roles throughout their professional lives, so I could expect a desired diversity in their responses given their background and experience. The 10 initial questions of the Survey covered the topics I have addressed in this thesis for application in Portugal:

- Ethics in the distribution of financial products
- Investors trust and appetite for investments
- Involvement of governmental/regulatory entities
- Documentation to support the distribution of financial products
- Literacy level of investors

[13] Full results available on Appendix 1

- Compensation balance and levels for commercial staff
- Adequacy of commercial staff

## 2. Literature Review

The subject of ethics in financial markets is largely covered in working papers and in books, but very few of those works include analysis on the impact of unethical behaviour and procedures in the distribution of products that target retail investors.

Argandoña (1995) mentions a quote from Termes where it is said that the main virtue of a banker is prudence or practical rationality, and then argues that it is difficult to exercise it in the current environment of financial markets. Therefore, given that asymmetry between banks and their clients will always exist (these institutions have direct access to the market, individual clients do not) as well as the resultant "blind" trust that clients put in banking institutions (Antunes, 2017), the responsibility for unethical practices must fall in the scope of the financial regulators and the entities that they regulate, regardless of the markets' conditions at any particular time.

Meyer (2013) refers that banks in Europe have to act honestly, fairly and in a professional manner towards investors, to guarantee that provision of services is in the best interests of the clients according to the MiFID II regulatory package[14], but mentions that such information is sometimes provided on a biased way to influence retail clients into buying a specific product, concluding that banks systematically take advantage of their power in order to obtain profits at the expenses of these clients. Kane (2001) adds that fair dealing with clients is an ethical norm (amongst others) that shows an "…simultaneous obligation to render good that is due to others and to avoid evil that would harm them.". Kim (2016) claims that banks have fiduciary duties to their clients, requiring them to place their interest first to the entity's own profit, as acting in the clients' best interest is the highest required integrity level expected of banks.

Historically, banks developed products on a frequent basis, their staff had aggressive objectives for their distribution (in number of sales, in delivery time and in income produced) and were well rewarded for their commercial performance (no real equilibrium between fixed vs variable pay). Therefore, with those competitive targets impacting the everyday life of an account manager, ethical standards were lowered in a substantial way. Consequently, many mis-selling incidents occurred, as products were not correctly distributed and several individuals invested

[14] The Directive 2014/65/EU of the European Parliament and of the Council and the Regulation (EU) No 600/2014 of the European Parliament and of the Council (both published in the Official Journal of the European Union, 15 May 2014) are applicable in the European Union as behavioral rules aimed at the distribution of financial products to customers (private individuals and corporations)

their money in instruments which were not adequate to their investment and saving profiles, causing serious damages to them and to their families. Kim (2016) mentions the definition of mis-selling as a term "…used often now to mean that consumers have been somehow misled into buying products or services". According to Franke, Mosk and Schnebel (2016), mis-selling instances are "…misrepresentation of information, overly complex product design and non-customized advice.", acknowledging that the MiFID II regulatory package addresses the mis-selling problems but it is not as effective as it was intended to be, as it doesn't consider different groups per literacy levels (amongst other factors). To correct that, Franke, Mosk and Schnebel (2016) suggest a three pillar approach, trying to mirror the Basel II Accord[15], that includes implementation of specific rules for banks to interact with retail clients and a review process to ensure the practical application of those rules, whilst it must also guarantee that market discipline is supported by increasing transparency and disclosure of the quality of services to retail clients.

Nogueira (2011) refers the Portal do Cliente Bancário[16] managed by Banco de Portugal, as a tool that provides information to support clients in their financial decisions, mentioning that "..desconhece-se se, para um cliente bancário, por exemplo, com reduzido nível de escolaridade, conseguirá o mesmo tirar partido da utilização daquela informação e aplicações para tomar as decisões financeiras que melhor se enquadram nos seus objectivos e necessidades.". This Portal has information about investments, but only the ones in the scope of Banco de Portugal (such as term or structured deposits).

Fullerton (2013) further suggests that asymmetry of information is a result of the actions of a financial advisor with unethical behaviour, not its origin. Kim (2016) refers that clients are forced to rely on banks in order to obtain knowledge and information, because of this asymmetry. Júdice (2018) adds that it is common understanding that clients and banks are not in a level playing field in relation to the possession of available information about a product, and the fact that banks have more and better information could impact the quality of the investment decisions as clients have no way to correctly evaluate the products that they are being sold to. Kim (2016) also mentions that this asymmetry is the first "ingredient" of "mis-selling" disputes, resulting on that dependency, and that such "…asymmetry and the consumer's reliance on the financial institution for necessary information serve as practical barriers for consumers to find the best products satisfying their needs.". Franke, Mosk and

[15] From the Basel Committee on Bank Supervision and available on https://www.bis.org/publ/bcbs107.htm
[16] https://clientebancario.bportugal.pt/

Schnebel (2016) conclude that retail clients are not as sophisticated as bank employees, so they must be offered protection against mis-selling by their account managers in those institutions.

In the research, Kim (2016) states that many civil cases of mis-selling of derivatives, as a typical type of complex products, relate to clients claiming misleading communications with their banks, such as no disclosure or insufficiently detailed disclosure of important aspects of a financial product.

I will argue later that such asymmetry needs to be reduced so that clients can become increasing aware of the risks facing their investments.

According to Antunes (2017), the concept of financial literacy goes beyond the knowledge of financial matters, as it includes characteristics of how such knowledge impacts the behavior and actions of citizens when they are facing financial decisions. On their analysis of the MiFID II regulatory package, Franke, Mosk and Schnebel (2016) state that "…it is obvious that financial literacy of many retail clients is far below that of banks and their employees.", and that this difference potentiates asymmetries in information which pave the way for mis-selling, also referring that the package ignores that retail clients are all different and heterogenous. Júdice (2018) refer that retail clients have, in general, a lower level of financial literacy when compared to professional clients. Franke, Mosk and Schnebel (2016) also add that, as a result of their in-depth interviews with employees of the large banks with head-office in Frankfurt, the MiFID II regulatory package show no distinction between clients (retail, professional or institutional clients) in terms of documentation and information that they must be provided, concluding that that lack of distinction could originate more equality but not exactly more efficiency.

Antunes (2017) presents findings from the first Banco de Portugal's report on the financial literacy of Portuguese population (2010)[17], stating that there are important asymmetries in the level of financial literacy of different population groups, with the lower scores being found in older persons and with less academic qualifications. Antunes (2017) also analyses a second report, conducted by the Conselho Nacional de Supervisores Financeiros[18] (2015) and verifies that no major changes have occurred since the first 2010 report. Franke, Mosk and Schnebel

[17] https://www.bportugal.pt/sites/default/files/relatorio_do_inquerito_a_literacia_financeira_da_populacao_portuguesa_2010.pdf

[18] https://www.bportugal.pt/page/divulgacao-dos-resultados-do-2o-inquerito-literacia-financeira-da-populacao-portuguesa

(2016) further suggest a Principle for the second pillar of their third pillar approach, stating that "The bank's responsibility for good client advice is higher, the less financially literate the client is.", adding that "Negotiation of banks with clients should also be differentiated according to the level of the information asymmetry between the bank and the client, hence to the level of the client's financial literacy.".

To address this topic, I will later present changes to the distribution methodologies of investment products so these discrepancies can be corrected.

This dissertation thesis includes a critical view on how the distribution of financial products and services developed and expanded (or exploded?) since the beginning of this century, having been helped by the development of technology and of product complexity, as well as by the existence of ineffective rules and laws to govern that distribution. According to Franke, Mosk and Schnebel (2016), the design of a complex product can be another form of mis-selling, alongside the lack of accurate information provided by banks, adding that unclarity driven by complexity should be prevented by regulators. Célerier and Vallée (2014) investigate the motives for financial complexity in Europe and found that, when applied to investment structured products, it has increased significantly between 2002 and 2010, further showing that traditional commercial and retail banks offer more complex products to retail investors, as these products produce higher relative margins to the banks and these clients have limited financial sophistication given their low income and savings capacity.

Júdice (2018) refers a study from United Kingdom's Financial Conduct Authority (2013)[19] mentioning that the retail market has complex products and services, therefore bringing significant challenges to clients on their accurate understanding of those products and services. Kim (2016) suggests that "…the decision of whether to execute a financial transaction, especially complex ones, requires substantial level of expertise, knowledge and the ability to integrate many different kinds of information.", and very few retail clients possess this. Meyer (2013) argues that investment products are highly complex and of easy access to retail investors, but these customers cannot identify the accuracy and fairness of their price.

Meyer (2013) also mentions the experimental study of Carlin, Kogan and Lowery (2013) showing that low levels of liquidity, high levels of volatility and poor efficiency on prices are all a consequence of increased complexity in financial products, concluding that their study

[19] https://www.fca.org.uk/publication/finalised-guidance/fsa-fg13-01.pdf

confirms the view that retail investors do not handle complex decisions well. Júdice (2018) also mentions that, sometimes, financial information is complex and the typical retail client, with low level of literacy, cannot be assured to understand all information at disposal, regardless of the depth and detail of how that information is available.

Célerier and Vallée (2014) suggest that a cap on complexity could be imposed, with specific measures determined by regulators as it happens in the United States, where certain investment opportunities can be taken by qualified investors. Furthermore, Meyer (2013) mentions the example of Belgium where its regulator asked banks not to issue highly complexed products (from August 2011 onwards) and refers that other regulators in Europe were also considering banning these products. Franke, Mosk and Schnebel (2016) mention the MiFID II regulatory package as it contains requirements for new products' approval processes that must analyse if highly complex products are appropriate to certain types of clients, asking banks to report on the limits set for those products. Tuch (2014) also refers the MiFID II regulatory package as a regime that will "…provide greater protection for clients trading complex products, by amending the scope of application of the appropriateness duty.".

I favour a similar approach that limitation on financial products must be imposed and, therefore, will suggest a more robust and practical application of these measures in Portugal.

Kim (2016) suggests that substantial commissions and incentives earned by salespersons working for banks is a contributing factor to a "mis-selling" environment. Franke, Mosk and Schnebel (2016) mention that the MiFID II regulatory package adopts measures and limits to prevent those salespersons selling products in order to maximize their compensation, targeted at the avoidance of conflicts of interest and to the strengthening of the fiduciary duties of banks. Franke, Mosk and Schnebel (2016) then add that "…competence and responsibility for the design of the compensation system." should remain with banks, and they can even include incentives so that each staff member is motivated to deal in a careful manner with a client.

Silva (2014) mentions that, currently, remuneration schemes offer concerns not only for the banking system, suggesting that balance between compensation and entity performance is one of those concerns, proposing that correcting interventions to these schemes should consider the possibility of variable compensation not being awarded solely in relation to income earned particularly for institutions under exceptional governmental intervention. Kellis (2005) refer that many stakeholders opine that regulation must be in place to guarantee that executive compensation (for a CEO, for instance) is accurately defined, arguing that such laws are essential to ensure fairness and ethics. Furthermore, Kellis (2005) also mentions that media challenges the moral grounds of executive compensation, saying that its levels are excessive and unfair, whilst considering that it can be corrected by an increase of the levels of integrity of the business community, not by imposed regulations.

Martins (2016) suggests that the classic paradigm of remuneration, with fixed salaries and no variable pay, is not adequate to the development of an organisation as it doesn't allow connection between pay, performance and results, further arguing that a modernization of that classic paradigm values employees' actions, their proactivity and their diversity. Martins (2016) also adds that, in an interview conducted to an employee of a retail bank in Portugal, it is referred that the institution's remuneration system only allows for commercial staff to have chances of earning rewards by selling products to clients and, therefore, that causes discontent to staff not facing clients as they do not have the same potential benefits.

It is up for regulators to apply strict guidelines to the compensation of commercial staff, such as balanced compensation and measurement of individual performance, whilst they must be applicable for all banks and not being left in the hands of those entities.

Caetano (2014) refers that a community doesn't evolve without continuous development of the competences of its citizens, mentioning that lifelong and lifewide learning are closely connected with ongoing educated societies. Caetano (2014) also mentions that training and development tools should target, amongst other factors, the addition of individual competences and motivations for an adequate performance of roles.

Referring the Financial Conduct Authority's "Final Notice to Santander UK plc"[20], Kim (2016) mentions on its findings that "the firm's online tools and training programmes for the advisers were not deemed adequate for the firm to obtain sufficient and necessary information about the consumers' knowledge and experience, investment objectives, risk profiles, and the ability to bear the risk of investment.", as this information was deemed necessary prior to their recommendation of investment products.

Kim (2016) also argues that banks should provide detailed and transparent information on mis-selling compensation processes to clients, particularly concerning monetary penalties for the institutions' wrongdoing. If these processes are voluntary, clients might be discouraged as they might not understand if the compensation was fair, leading to a poor level of consumer

[20] https://www.fca.org.uk/publication/final-notices/santander-uk-plc.pdf

protection. I support this disclosure, and that these entities should allocate respective capital for these measures, as explained later in this Dissertation.

## 3. The Current State of Affairs in the Distribution of Investment Products

Over the years, particularly after the financial crisis of 2007/2008, investors have been looking for a greater diversity of investment products given the sharp drop in the interest rates (and their maintenance in low levels) verified in the main currencies transacted in the world's financial markets: USD, EUR, CHF, GBP and JPY. With some of those currencies still having their daily reference indexes showing negative levels (for example, the Euribor 3 months, as the standard benchmark for Euro-denominated interest rate products, is quoting below 0% since the Summer of 2015), it is natural that investors are looking to alternative ways to obtain positive growth to their savings.

In order to achieve better returns, investors need to consider risk in their investments. If a term deposit (the simplest investment product) offers you a 0.25% rate for 1 year, you need to apply your money in riskier products if you are searching for higher rates for that term. Traditional investors avoid risk and the unknown, yet most of us take risks on a regular basis in order to achieve a reward (financial or physical). Some researchers considering that to be the effect of an organic chemical installed in our brains, the dopamine[21], a hormone responsible for our feelings of pleasure, desire and motivation. The possibility of earning additional money and rewards is clearly stimulating for most human beings.

The financial crisis caused several impacts to the dynamics of the financial markets and amplified a very serious threat to our savings: their security. When you place your money in an institution and/or in a product, there is always a degree of credit risk that needs to be carefully analyzed by every investor. That risk might translate into a real problem if the institution keeping your money does not fulfill its responsibilities or goes into default and, therefore, you might end up not recovering your initial investment. In the last 10 years, several banks were forced to close their operations, went bankrupt, received public bailout and/or were bought by other institutions (to name a few examples), because of their excessive risk-taking activities. Some of those institutions had even used the client's money to their own "benefit", inducing that, all over the world, many investors lost all the money placed, invested in and, I can even mention, trusted to those entities.

In addition, several countries were impacted by the consequences of the financial crisis, particularly in Europe. The reputation of the traditional "risk free" investment, usually

[21] http://content.time.com/time/health/article/0,8599,1869106,00.html and referred by Robert J. Schiller in his book *Finance and the Good Society* (p. 139)

considered to be the prime debt instrument of a government (sovereign) treasury bond and widely used in financial models, was damaged when troubled countries faced a serious risk of defaulting on their own debt (Greece, an European Union country, technically did). The public debt of countries like Portugal, Spain, Ireland and Italy had their ratings deteriorated to levels close to (or even below) the minimum investment grade level (in Portugal's case, the public debt was classified as toxic or junk by Moody's between 5th July 2011 and 12th October 2018[22]).

So, irrespective of each investment profile of an individual, a variety of issues need to be addressed by an investor prior to their decision of where to place its savings.

The direct access to financial markets is somehow restricted to private individuals, so they need to rely and trust on banks to build, market and deliver saving products and instruments to them. These entities have free and continuous access to these markets, are heavy regulated and maintain efficient processes for the development of products and services to keep current customers happy (and attract new ones).

Therefore, in face of enormous uncertainties and high volatility in the markets, it is natural that private investors became firm believers that the banks that survived the crisis were better positioned to show or advice the best available products for their investment profile. That high level of reliance and trust places a substantial level of responsibility in the management of those banks, so their organization structure for the distribution of financial products must necessarily be robust and follow the best ethical, integrity and conduct principles.

Here lies the root of the problem: basically, there were (and still are) many flaws in the chain of the distribution of financial product, from the origination stage right across to the placement of those products with the clients.

Is it unfair to say that all banks (and their staff) took advantage of the reduced financial knowledge of most of the population? Well, we cannot generalize but, even if not clearly assumed, several evidences show that some institutions did not treat their customers fairly.

Fullerton (2013) explores the possibility of unethical selling of products by banks in that country. I have looked at that paper in order to compare the Portuguese reality with that of a country in Europe that also faced an Economic Adjustment Programme[23] but where financial

[22] https://pt.countryeconomy.com/governo/ratings/portugal
[23] https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance/financial-assistance-ireland_en

literacy is higher[24] and where their individuals invest more in bonds and shares[25]. My main objective with that comparison is to analyse if similar situations could occur in a completely different setting and culture. Amongst other factors, the researcher decided to analyse, through several interviews what was "…the role of management on meeting sales targets and upholding ethical standards" in Ireland, and his findings identified that aggressive sales to meet objectives could be deemed important for commercial staff to keep their job so, sometimes, they could result in unethical selling techniques and, therefore, causing a negative relationship between sales targets and ethical practices. The researcher also looked at "…whether commission based versus salary based remuneration impacts on the perceived levels of unethical selling…" in his country, with his findings being split on what should be the standard in order to promote ethical behavior. Whilst some interviewers state that advisors should be paid a salary to avoid hard and unethical selling as a result of commission-based compensation, other interviewers seems to think there is nothing wrong with commissions as long as there is an understanding that advisors are salespeople with their type of advice being approved by the regulators.

Looking at the case of Portugal, reports suggest that unethical selling was also applicable in the country, but what can investors do when they realise they are being a target for mis-selling? They can file a complaint to the regulator, typically involving the Comissão do Mercado de Valores Mobiliários (CMVM, the securities regulator).

Let's consider a real example of investment in a complex financial product that did not go according to the plans and expectations of Portuguese investors.

The amounts invested in "Notes db Rendimento Portugal Telecom Finance 2020 – Credit Linked Note"[26], a structured investment product initiated in August 2013 and with a tenor of over 6 years and 8 months, could have been more protected. Under the scope of the CMVM and initially with credit risk of two reputable institutions at the time, Deutsche Bank's entities (issuer and hedging counterparty) and PTIF (reference entity), the product was expected to reimburse the full capital at maturity, but it suffered the impact of the bankruptcy credit event of Portugal Telecom International Finance BV (PTIF) that was declared in 1st July 2016[27]. In

[24] Ranked 17th out of 142 countries (compared to Portugal's 111th place) in the 2014 Global Financial Literacy Survey from Standard & Poor's available on https://gflec.org/initiatives/sp-global-finlit-survey/
[25] 11.55% of the population holds shares or bonds (compared to 2.21% in Portugal, acccording to the OECD report for Financial Education in Europe: Trends and Recent Developments, published in 2016 and available on https://www.oecd.org/education/financial-education-in-europe-9789264254855-en.htm
[26] https://web3.cmvm.pt/sdi/pfc/docs/fsd28024.pdf
[27] https://www.isda.org/2016/07/01/isda-emea-credit-derivatives-determinations-committee-portugal-telecom-international-finance-b-v-bankruptcy-credit-event/

addition, it was expected to pay a fixed coupon of 4.5% in the first year and variable coupons of Euribor 3 months + 3% for the remainder of the term but, in the end, the note ended up paying coupons for only 3 years and investors obtained only 125,69 Euros for every 1.000,00 Euros invested, so a capital loss of over 84% of the invested initial amounts[28].

So, a significant (and unexpected?) harm for the saving of several retail investors. But did they claim to the competent regulator, the CMVM?

If we look at their 2016 Annual Report[29], 1.112 claims have been filed, a decline of 35% from the number of claims in 2015 and even lower than the number of claims in 2014 (1.278).

Of those 1.112 claims, only 145 (13%) were related to complex financial products such as the product described above, when that percentage was 7% in 2015.

In 2017[30], there were 1.384 claims (a rise of nearly 25% compared to 2016), with 166 being related to complex financial products (12% of all claims).

As a summary[31]:

| | Total Claims | Claims for Complex Products | YoY Evolution |
|---|---|---|---|
| 2012 | 589 | 200 | N/A |
| 2013 | 445 | 67 | -67% |
| 2014 | 1.278 | 102 | +52% |
| 2015 | 1.712 | 120 | +18% |
| 2016 | 1.112 | 145 | +21% |
| 2017 | 1.384 | 166 | +14% |
| 2018 | 462 | 116 | -30% |

[28] https://observador.pt/especiais/obrigacoes-pt-perdas-dos-pequenos-investidores-chegam-aos-500-milhoes-de-euros/
[29] Relatório Anual sobre a Atividade da CMVM e sobre os Mercados de Valores Mobiliários https://www.cmvm.pt/pt/EstatisticasEstudosEPublicacoes/Publicacoes/RelatorioAnualDaCMVM/Pages/Relat%C3%B3rio-Anual-2106.aspx
[30] http://www.cmvm.pt/pt/EstatisticasEstudosEPublicacoes/Publicacoes/RelatorioAnualDaCMVM/Pages/Relat%C3%B3rio-Anual-2017.aspx
[31] All reports available on https://www.cmvm.pt/en/EstatisticasEstudosEPublicacoes/

What can we infer from these statistics? No real trend in the total number of claims nor in the ones related to complex products (with their relative weight being low when compared to bonds and shares).

Therefore, the majority of the claims filed with the CMVM in Portugal are not related to complex financial products, they are actually related to non-complex products which are considered the most transparent assets for investors (if they are listed on exchanges, there is plenty of information available for their analysis).

The fall in the total number of claims in 2018 could be related to the introduction of the MiFID II regulatory package in that year, particularly as the Key Information Document (KID)[32] was introduced. By default, the KID contains a section entitled "How can I complain?" but are retail investors really using it?

A similar profile is found in the claims filed with Banco de Portugal, as the regulator with direct responsibility of deposits (included structured) in Portugal. On the 2018 "Relatório de Supervisão Comportamental"[33], it is showed that 15.254 claims were received by this regulator, being 4.811 of those related to deposit accounts. But the vast majority of those (92.1%) were related to current accounts and only 0.3% concerning structured deposits. Overall, a mere 14 claims in the whole year related to this important investment product.

This research considers five key areas that are essential to the processes of financial products' distribution to retail investors. It draws from other countries' researches on unethical distribution of financial products, as detailed in the Literature Review, and it is based in the existence of real cases where investors suffered the consequences (and financial institutions as well, since their reputation was damaged) of mis-selling, inappropriate behaviors and inadequate procedures in these banks that are presented in this Chapter.

[32] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0653&from=EN

[33] https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/rsc_2018_pt.pdf

### 3.a Remuneration Policies

In Portugal, several banks adhere to the "Acordo Colectivo de Trabalho do Sector Bancário"[34], an agreement between the subscribed banks and the financial sector national federation (FEBASE) which is also applicable to employees affiliated in the regional banking unions. It is a framework for employment in the banking sector and contains various procedures that must be followed by the entity and by its staff. Amongst them, the Acordo introduces category levels for all employees (p. 99), where top management is in Group A, commercial, technical and operational staff are in Group B and support functions are in Group C. In order to obtain a certain professional category, minimum levels will need to be achieved (for instance, a Director must have at least 16). The Acordo also contains details of base fixed salaries according to each level (there are 18 in total)[35]. Importantly, the agreement does not contain details of a recommended or mandatory structure for variable pay (such as bonus), not even for commercial staff.

Naturally, families, as economic agents, are expected to be compensated by their labour through salaries, regardless of whether their employer is a financial institution, another family or even the state. In the same manner, and like any other company, banks will look for additional income (in the form of profits) and continuously try to maximize them in order to maintain a stable course of business. Usually, in the public rankings, banks are classified according to the size of their balance sheet, the value of their assets, their profitability and according to the size of their customer base (it is common assumption that more clients bring more money – funds and profits - and potentially more negotiation power is given to that bank towards other clients, competitors and regulators). To attract and retain clients, banks "fight" for market share (general and specific), trying to come up with the best services and products so clients can transact with (and trust) those institutions on a continuous basis.

To fulfill these objectives, banks around the world define regular targets to acquire and retain clients, obtain their funds and generate income (amongst other objectives). To name a few common examples:

[34] Latest general version from 5th July 2016 is available on https://sbn.pt/Portals/0/Convencoes/ACT_SectorBancario_08ago2016.pdf
[35] Latest version from 2018 is available on https://www.sibace.pt/wp-content/uploads/2019/08/tabelas-2018.pdf

- Launching deposit campaigns in the end of the year in order to attract funds that are then reflected in the banks' year-end balance sheet[36];
- Marketing of retirement saving plans when there are rumors of a change in applicable taxes that could negatively impact clients;
- Opening of a retail branch in a new geographical area for the bank, then launching several initiatives[37] to convince clients to move their accounts/funds from branches of competitor banks already located in the area;
- Subscription of new shares in a listed company, so bank might lower standard fees to issuer, so they can obtain exclusivity in the marketing for that issuance in order to attract new clients.

Ultimately, who will be responsible to deliver on these objectives? The marketing and production staff will build the service/product strategy, and the commercial staff will contact the clients to fulfill that strategy.

Regardless of the strategy and its purpose, banks usually implement aggressive targets to its completion (usually, valid only for a pre-defined period). Therefore, commercial staff are given challenging objectives and they need to be fully aligned to the task at hand.

This is where the variable remuneration of commercial staff plays a big part, and sometimes the value of that remuneration can be quite substantial for staff members, especially for the ones with a low fixed salary. For example, let's suppose your role is to be an account manager at a bank, you are not an investment advisor (you can only "provide information" on products and services) and have a fixed monthly salary of EUR 1.000 per month. Usually, your targets are not very aggressive but, in a given month, you have the chance to additionally earn the same amount of money if you convince 100 clients of your branch to fill a customer satisfaction survey which was deemed important by the bank's management. It is understandable that, on that month, you will focus your attention on contacting clients more frequently and try to convince them to complete the survey. As it is an objective for the branch (and not just your own), it is perfectly normal that you push your colleagues to do the same.

[36] An example from Singapore, where rates for savings accounts opened in the last months of 2019 are more than 1% higher the standard base rate https://info.maybank2u.com.sg/promotion/deposits-banking/fresh-funds-top-up.aspx

[37] Some media campaigns in the United States of America are detailed in this website https://www.medialogic.com/blog/financial-services-marketing/grand-openings-state-marketing-new-branches/

On that example, are we expecting negative impact from your clients? Well, some of them might not want to be contacted or do not want to complete the questionnaire, but its request should not cause impact to the expected return of their investments nor to the security of their savings.

Instead, what if your commercials targets for that month were related to the capture of client funds to invest in a new structured non-capital guaranteed deposit launched by your bank? You will still contact clients but probably only a few of them, given that the investment profile of the others might not be suitable for the structured deposit. So, you have a lower customer base and now your objectives are linked to the amount of funds captured (not client responses to survey, as in the previous example). The potential impact to clients is greater, both to the expected return of their investments and the security of their savings. So, to additionally earn the same amount of money (EUR 1.000, your bonus) on top of your monthly salary, you need to be extra careful (and extra trained) on how you convince clients to place their funds into the structured deposit.

On this example, will your "selling" technique change if your potential bonus is higher, for instance EUR 2.000, which might be related to the profitability of the structured deposit (higher commission to the bank) and not applicable on the survey request (in fact, it actually costs money)? Well, you will be tempted to "sell" the structured deposit more aggressively (leaving the "providing information" area, crossing the line and "give advice"?) and even be tempted to contact clients whose investment profile is still not suitable for the structured deposit (very dangerous territory). If the client portfolios are not clearly defined, you can be inclined to contact clients usually managed by your colleagues in the branch. Your usual care and conduct could be laxed…

As Mother Theresa once said: "I fear just one thing: Money! Greed was what motivated Judas to sell Jesus".

These situations were standard procedures for commercial staff up until recently. They can still occur nowadays, but the number of instances should continue to reduce given that some regulations are trying to control, limit and diminish their occurrence.

In the financial industry, particularly in banks, the relationship between the compensation earned by a staff member and the income she/he brings to the entity can be very diversified. For instance, if you are a proprietary trader in an investment bank, your remuneration might be a percentage number of the money that your trading activities originate. Of course, these practices also vary in different geographies but in the most developed financial centres (London, New York and Hong Kong) this type of activity is very common as they try to lure talent on a consistent basis, sometimes offering very high pay checks (relatively) for youngsters that are willing to trade on a 12 hour consecutive period. When we look at commercial staff, then the compensation can be closely connected to the income brought by their sales activity, and again substantial money can be paid to the best performers. Should a company pay their staff according to their performance (measured by the amount of income generated by their actions)?

In the book "City lives" (1996), Ross Jones (currently, Member of the Board of Directors of Bourne Park Capital Ltd.[38]) mentioned in 1992 that "In the old days the old boys in the stock market used to make an absolute fortune but there was still a certain structure. We're losing structure. It's going to get nastier. I look at the people retiring and I find it distressing that the people coming up don't have the same values." (p. 157). In the same book, Charles McVeigh III (currently, Chairman of Citigroup's Corporate and Investment Banking-Global Wealth Management Partnership[39]) stated that "The sort of family atmosphere that existed in our business – merchant banks and investment banks alike – was largely shattered by the drive for performance and the meritocratic undercurrent that has crept in everywhere." (p. 158), regarding the status of ethics in the financial industry around 1993-1994. Not much has changed since the beginning of the 90s.

In March 2004, Sir John Bond, Chairman of Hong-Kong Shanghai Banking Corporation (HSBC, one of the largest banks in the world), made the bank's annual earnings presentation to analysts and the press. He had received 3.5 million USD in compensation for his services in 2003, whilst a group of five members of HSBC's investment bank netted close to 61 million USD of compensation. The book "Traders guns & money: Revised edition" (Great Britain, 2010) introduces this example (p. 148) to show how traders can have their independence and earn much more than the management of the bank that they work for, mentioning that Sir John explained the difference by stating "They're probably more value to shareholders than I am.". The book further mentions (p. 149) that bonus (at that time, a substantial percentage of the compensation package) can be discretionary but, in practice, there is a formula (mostly hidden,

[38] https://www.bourneparkcapital.com/group-structure/
[39] https://www.bridgesfundmanagement.com/team/charles-mcveigh/

unless negotiated in an employment contract) that shows your percentage according to the amount you earned to the bank.

Philippon and Reshef (2009) show in their study an upward trend to the relative wages of personnel in finance and insurance since the beginning of the 1980's, and a similar pattern is shown in the level of education of those persons when compared with persons in other economic sectors. Furthermore, Philippon and Reshef (2009) also show that, in the same time period, an increase in deregulation is accompanied by an increase in those relative wages.

Tuch (2014) argues that remuneration based in variable commissions is a risk to the quality of the advice that staff in banks can provide and, therefore, to the fiduciary duties of those entities in acting in the client's best interests.

In Júdice's opinion (2018), regulatory measures to limit variable pay and income objectives are attempts to mitigate risks occurring from potential conflicts of interest between banks and their clients, discouraging sales of products just because they are profitable for the bank and, therefore, putting more emphasis on a serious, fair and transparent advice.

The authors of the paper "The fundamental principles of financial regulation" (2009)[40] suggest that interventions need to be made in order to correct the perceived distortion of the compensation of personnel working in the financial system (art. 6.2). For that purpose, they propose five potential techniques to reduce that distortion: 1) bonus should be primarily paid in shares, with the requirement for employees to hold them for a long period; 2) bonus should be calculated according to risk-adjusted returns; 3) paid bonus would have a clawback provision to be applied in case of losses occurring; 4) reduce incentives for risk taking activities solely by decision of individuals; 5) better alignment between individual and corporate interests.

In the proposed legal rule "Pay versus performance" (presented by the United States Securities and Exchange Commission "SEC" in April 2015[41]), regulators propose that listed companies in the country should disclose the remuneration practices of their executive officers (in its Introduction and Proposed Amendment), putting great emphasis on how connected can the paid compensation of these executives be with the stock and financial performance of their company (resulting in the Total Shareholder Return, TSR, as a metric to compare both). The idea behind this rule, which complements the Subtitle E – Accountability and Executive Compensation (124

[40] https://www.princeton.edu/~markus/research/papers/Geneva11.pdf
[41] https://www.sec.gov/rules/proposed/2015/34-74835.pdf

Stat. 1899) of the Dodd-Frank Wall Street Reform and Consumer Protection Act[42] (implemented by the One Hundred Eleventh Congress of the United States of America in July 2010), is to permit an evaluation of different policies across these companies, allowing for a clear identification of the metric and procedures that can be compared in their peer group, therefore assisting shareholders and investors in the understanding of how each management body oversees these practices, and potentially help in the election process of new directors. The Act published in 2010 only requested disclosure of the pay versus performance in annual meetings of the shareholders, through solicitation of those shareholders or of any proxy.

The changes proposed by the SEC are positive and offer proper transparent measures to identify potential disruptions in the companies' governance models.

The MiFID II regulatory package (applicable in Portugal), regulates how financial instruments are distributed in the European Union and contains measures that need to be implemented by financial intermediaries in order to protect their clients investing in financial instruments. Therefore, appropriate and balanced remuneration policies need to be in place to ensure that these entities do not offer compensation packages to their staff that might be conflicting with the entities' duty to act in the best interests of their clients, allowing avoidance and prevention of potential conflicts of interest with the entities' own interests. With these policies, the intention is that commercial staff do not hard sell products that might not be suitable and appropriate to the needs of their clients. The Directive mentioned above also recommends that those policies are defined, approved and overseen by the management body of each entity, to ensure that proper control and monitoring is performed by a key function with overall responsibility in the entity's activity in the market. For example, the Remuneration Policy for Novo Banco[43], one of the leading banks in Portugal, started to be applicable in 10th April 2019 (after the introduction of MiFID II in 3rd January 2018), and already included several requirements imposed by that regulatory package. Furthermore, this Policy identifies on page 5 the commercial staff as a separate group from all other staff ("Colaboradores afetos a estruturas de negócios"). It then details the variable pay applicable for that group (p. 19), that their commercial incentives can be paid quarterly and that commercial campaigns could award compensation payment with no specific pre-defined timing, whilst also requiring that management and control functions supervise and review the Policy.

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[42] https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf

[43] https://www.novobanco.pt/site/cms.aspx?plg=15d331a6-23f6-41c7-94fe-99e01416628b

Since its first publication, ACI – The Financial Markets Association[44] has consistently updated the original version of The Model Code (Paris, 1975), a document containing guidance of good market practices for market professionals in several asset classes of financial markets. As the global trade association for wholesale financial markets with education, ethical conduct and membership as their core values, ACI was well placed to develop and implement these principles in several jurisdictions. As such, the Model Code was recognised by several central banks and regulators as being the standard to follow by all market professionals, particularly the ones working in treasuries and supporting areas (front, back and middle office) of banks, including corporate/commercial dealers that also had to follow its content. Nevertheless, despite the global acceptance and its constant updates, the last version of The Model Code[45] (Paris, 2015) didn't include reference to remuneration or compensation methodologies to address the problems described above. Simply, professionals in the market understood that a balance was not needed, as it was considered "normal" to reward performance in a large way. With the publication of the FX Global Code[46] (Basel, 2017), where ACI participated on its drafting as a member of the Market Participants Group that cooperated with the Foreign Exchange Working Group[47], the Association decided to retire The Model Code and requested all of its 9.000 members to adhere to the good market practices for the foreign exchange market (the largest in the world by volume) that are reflected in this code[48]. In the principle 6 of the FX Global Code, within the Governance section, it is detailed that Market Participants (entities and individuals involved in this market) "should have remuneration and promotion structures that promote market practices and behaviours that are consistent with the Market Participant's ethical and professional conduct expectations.". Throughout that principle, examples of appropriate factors to be considered are mentioned, such as the balance of fixed and variable compensation, how and when it is paid, alignment of the entity's interest with that of the individual staff member, amongst others. Although the code is voluntary, principles-based and not rules-based, it is being adopted in several jurisdictions around the world, with the central banks pushing for their ongoing implementation in the processes and procedures of all Market Participants (virtually, any company and its personnel engaging in activities in the foreign exchange market).

[44] https://acifma.com/about-aci
[45] https://acifma.com/download-model-code
[46] https://www.globalfxc.org/docs/fx_global.pdf
[47] https://www.globalfxc.org/history.htm?m=62%7C378
[48] https://acifma.com/news/aci-financial-markets-association-supports-fx-global-code

Franke, Mosk and Schnebel (2016) mention that, in financial markets, strict and rigid rules are not as efficient as principles, with the latter being more difficult to implement. Then, they add that a balance must exist between rules and principles, and that it should be supervised by a regulator with expertise in retail segment, adding that their three pillar approach could be a methodology to practical implementation of these measures. Franke, Mosk and Schnebel (2016) also suggest that the first of the pillars should only contain rules that offer no distinction between client groups.

Everyone likes to earn money, there is no doubt about it. But cashing in as a result of constantly deceiving uninformed clients that trust their savings to a reputable institution is not ethical and certainly can be qualified as malpractice and improper behavior (which, in some jurisdictions, in punished by the law).

3.b Staff Training and Certification

On a sizeable financial institution, with several branches and account managers dedicated to the retail market (where most investors come from) which are spread over a diversified geographical area, a substantial proportion of the time of those managers is spent on training for the distribution of new services or products launched by their bank.

A few years ago, as a standard requirement prior to the launch of new services or products, the European Banking Authority implemented the "Guidelines on product oversight and governance arrangements for retail banking products"[49] (EBA/GL/2015/18 from 22 March 2016) to oblige banks to create and deliver, amongst other procedures, New Product Approval processes to guarantee that all stakeholders are aware of the characteristics and features of a particular product that is about to be launched, and to assure that they can evaluate the potential impact of that product in their particular area and in the bank as a whole. After all those impacts are analysed and controlled, the product is ready for delivery. But there is no mandatory supervision on how the training sessions for product education, an essential point in the internal distribution strategy, must be organised and implemented.

Those training sessions are usually delivered by staff that build the products (structurers, for instance) or marketing personnel. In a bank with many branches, most of the training is done by electronic means, like video conference, webinars and e-learning platforms. Caetano (2014) mentions that e-learning includes all electronic learning, teaching, information and communication using an internet connection. The intensified usage of those electronic means has several potential reasons: usually, short time between launch and delivery of marketing campaign; not enough resources to appropriately train the respective staff in every branch; cost efficiency, etc. Therefore, Caetano (2014) refers that, in a campaign directed at the retail segment, the face-to-face training, as the traditional way of banking education, is frequently not an alternative considered by the banks.

In the course of study, Caetano (2014) interviewed four persons working in institutions that deliver e-learning, and they are unanimous to mention that physical training is still the most common alternative. Nevertheless, they recognise that e-learning is being preferred in training sessions for large number of employers located in different venues, as it allows for a considerable cost reduction and efficient allocation of time when compared to physical training.

[49] https://eba.europa.eu/documents/10180/1141044/EBA-GL-2015-18+Guidelines+on+product+oversight+and+governance.pdf

On those interviews, another common opinion is that e-learning methodologies serve the interest of the institutions delivering the training, not particularly the needs of their employers that receive the training. Furthermore, they consider that e-learning is more suitable for technical expertise, whilst physical training is appropriate for behavioural subjects.

Fonseca (2008) thinks that continuous education is an essential path for human resources to feel more appreciated, so investment in education should favour practical experiences that allows professional development.

Caetano (2014) further suggests that one of the problems with e-learning is the lack of qualification of trainers to deliver teaching via electronic means. That fact helps to potentiate methodologies of regularly uploading theoretical (not practical) studies into an internet platform, as they are quick and easy processes to deliver training. Caetano (2014) also comments on the deficient certification of e-learning tools in Portugal and their quality, but there is very light reference to the trainers' qualification to perform those roles, beyond their expertise in the field of study. They can be experts in the topic, but do they know the basis training techniques in order to be effective trainers? The interviewers mention that traditional trainers must adapt to e-learning methodologies, be a facilitator of the training or a tuitor, not necessarily an expert in the field of study (although that would be the ideal scenario).

In terms of objectives, training sessions for distribution of financial products mainly try to achieve that: 1) the commercial staff understand the details, features and risks of a service and/or product; 2) the commercial staff apply the most appropriate selling techniques, so they can attract the target client audience and deliver the objectives of the marketing campaign designed by the bank.

So, can we assume that these training sessions are biased, with focus on the selling of a specific service or product (as fast as possible) and not in all its characteristics (and risks)? Well, that is still the case in many institutions, the pressure to "sell sell sell" still dominates the way the training sessions are built and delivered. Common features of such a training session might be:

- Limited short time spent on explanation of risks to investors
- More "positive" scenarios shown (related to potential future behaviour of product) and reduced time to show "not so positive" scenarios
- Considerably time spent on potential income (which is usually very attractive) to commercial staff if they sell the product

- Comparison with competitive products from other institutions, often individually selected to show that "our" product is "always better"

Another point of concern is the training ability of the staff that delivers the training sessions, such as structurers or marketing personnel… are they certified trainers? If yes, when have they obtained that certification? Do they "train" in a constant basis or very rarely? Are they aware of the most basic training techniques (such as presenting topics and not full statements on slides, not turning their back to the audience, speaking clearly and helping the group to interact, amongst others) or are just there to present the product? And how about their audience, is it always "the same" (ie, banking staff)?

In Portugal, a certified trainer is an individual that obtains the Certificado de Competências Pedagógicas (CCP), which is recognised by the Instituto de Emprego e Formação Profissional (IEFP)[50], a public body that regulates employment and professional training. The CCP demands 90 hours of training to obtain such certification[51] (usually, in face-to-face training for trainers' courses, the mandatory attendance is a minimum of 80 hours). Those sessions are organised so that trainees work on several topics such as communication techniques, dynamics of working on groups, simulations and role-plays, evaluation and feedback, technology aids, etc. Very practical sessions to prepare an individual to train others.

Until September 2010, the CCP was valid for a maximum period of 5 years, subject to renewals if its holder attended a continuous education course. From then on, that maximum validity is no longer applicable[52] and even expired CCPs (by September 2010) became valid again thereafter. So much for the need for continuous education…

Up to 14th October 2019, over 434.000 CCP certificates have been issued according to the statistics of the IEFP[53], but how can we assure that they are being correctly used in internal training sessions for new products if:

- There is no regulatory requirement for banking staff to be CCP-registered when they are training their colleagues?

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[50] https://netforce.iefp.pt/pt-PT/WPG/Home/CertificacaoFormadores

[51] As detailed in the area "Como se organiza a formação" in this section of the IEFP's website: https://netforce.iefp.pt/pt-PT/UTE/Home/FPIF

[52] As detailed in Article 1 of Portaria nº 994/2010 published in Diário da República nº 190/2010, Série I from 29th September 2010 https://data.dre.pt/eli/port/994/2010/09/29/p/dre/pt/html

[53] https://netforce.iefp.pt/pt-PT/UTE/Home/Estatist_Show

- Internal trainers that do not belong to human resources departments are not evaluated by these departments?
- Compliance departments usually do not oversee or verify how the training sessions are being performed, unless there is a specific requirement?
- Most "trainers" are not qualified to train, they might be experts in the product but do not have teaching knowledge and competence?

In 2016, I have approached my fellow members of ACI Portugal[54] (a non-profit association for financial markets professionals, established in 1967 and with most of their members working in roles for banks) to invite them to attend a session of the International Speakers Toastmasters Club[55], a regional group based in Lisbon belonging to Toastmasters International[56] (a global organisation with around 16.800 clubs and 358.000 members worldwide). In regular Toastmasters sessions, attendees have the chance to practice and learn communication and leadership skills, performing different roles and tasks, following their individual path on their own rhythm to be competent in one or both of those skills. The idea was to replicate one of the sessions so ACI Portugal's members could be encouraged to further enhance those skills. The Board of ACI Portugal partnered with the idea and allowed the session to be held in their Head-Office, so the expectation was for a good attendance.

In the end, despite the joint promotion that lasted for over 1 month, only 14 people attended the session which was held in a mid-week evening. Of those, only 2 were members of ACI Portugal (at the time, the total number of members was above 100). This is only an example, but there are many more to show that financial markets professionals have a scarce interest in the development of their training and communication skills and techniques as they frequently mention that, to train, all they need is to master in the field or topic of the study.

As Aristotle once said: "Those who know, do. Those that understand, teach."[57]

The "Final Report, Guidelines for the assessment of knowledge and competence"[58] (published in December 2015 by the European Securities and Market Authority "ESMA" as a supporting document for the Directive 2014/65/EU of the European Parliament and of the Council)

[54] http://www.aci-portugal.com/
[55] https://www.toastmasters.org/Find-a-Club/04023798-international-speakers
[56] https://www.toastmasters.org
[57] As Robert J. Shiller refers in his book *Finance and the Good Society* "Educators are of central importance to the functioning of the financial system." (p. 103)
[58] https://www.esma.europa.eu/sites/default/files/library/2015-1886_-_final_report_on_guidelines_for_the_assessment_of_knowledge_and_competence.pdf

contains requirements that staff in financial intermediaries need to have in order to give investment advice or provide information about financial instruments to their clients. Therefore, they need to assure that such possession of the relevant knowledge and competence complies with their obligations under Articles 24 and 25 of the related Directive, which detail the general principles of the information to clients, the assessment of suitability, appropriateness and reporting to clients, under the scope of provisions to ensure investors are sufficiently informed and protected.

Under this Report, natural persons working for investment firms need to have appropriate qualification such as tests or training courses that include and meet both the criteria and the structure detailed in the Guidelines. In addition, the staff will need to demonstrate appropriate experience in the performance of their roles, with a minimum of 6 months on a full-time basis. Staff that do not comply with both knowledge and competence may be blocked from providing the investment services and needed to be supervised in her/his role of distributing products to investors, subject to a maximum period of 4 years.

The criteria and structure detailed in this Report (p. 36 to 38) covers necessary knowledge and competence for, amongst other topics, products and markets expertise, ethical and conduct standards, the tax and cost impacts in financial instruments, the type of services offered by the firm and their characteristics, the functioning of financial markets and their venues, the valuation and pricing of investment products, the economic indicators and their reflection on markets, the performance of scenarios (past and future), the prevention of money laundering activities and market abuse, documentation and data related to investment products, etc. In addition, for staff providing investment advice, the criteria and structure also demands knowledge and competence in suitability requirements for client advice, asset portfolio management and diversification[59].

This process is ongoing, as the Guidelines require a continuous professional development or training to ensure that staff are always up to date with the requirements, particularly when new joiners are hired or when new products or services are developed. So, investment firms need to assess on an annual basis the compliance of their staff to these criteria.

The Report was released by ESMA and it refers that the criteria for knowledge and competence establish minimum standards set at a European level, but the National Competent Authorities

[59] Defined in the Fifth Edition (1992) of the *Dictionary of Economics* as “The holding of shares in a range of firms in a portfolio in order to spread the risk.” (p. 119-120)

(ie, regulators in each country) can implement stricter requirements to address the specific needs of their local markets. Furthermore, this document presents orientations for personnel that provides advice to clients needing to have higher standards in their level and intensity of knowledge and competence when compared with the personnel that just gives information to clients. Finally, the Report also refers that the compliance function within investment firms should analyse and review the compliance of the Guidelines presented in the document (p. 36), with a reporting to the management body on their efficiency and correct implementation.

This process allowed for careful and detailed preparation from investment firms as the Report was released in December 2015 in English version, therefore more than a year before the initial date for application of the MiFID II regulatory package (then planned for 3 January 2017). Furthermore, by the time of the publication of this Report, the European Parliament had already informed the European Commission that it was ready to accept a one-year delay of the MiFID II application (to 3 January 2018)[60], which was followed by a similar proposal published by the European Commission in February 2016[61]. Subsequently, in March 2016, the Report was published in several languages, including Portuguese[62]. Therefore, investment firms in Portugal (and in the other European countries in scope of the MiFID II) had more than 20 months to prepare their training and qualification methodologies in order to assure that relevant staff complied with the knowledge and competence requirements detailed in the Report.

What happened in practice? In Portugal, the National Council of Financial Supervisors (CNSF), formed by the Banco de Portugal (BdP, the central bank), the Comissão do Mercado de Valores Mobiliários (CMVM, the securities regulator) and the Autoridade de Supervisão de Seguros e Fundos de Pensões (ASF, the insurance and pension funds regulator), released a Public Consultation in late December 2016 (with answers accepted until 9 February 2017)[63] to allow investment firms to respond to the CNSF's proposed implementation and transposition of the Directive 2014/65/EU of the European Parliament and of the Council into local laws (noting that the corresponding Regulation (EU) Nº 600/2014 of the European Parliament and of the Council, commonly known as MiFIR, is directly applied, not needing a formal transposition into local laws). Naturally, those documents included suggestions (although very light) on how

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[60] http://www.europarl.europa.eu/news/en/press-room/20151127IPR05110/statement-on-mifid-ii-potential-delay-of-the-entry-into-force
[61] https://europa.eu/rapid/press-release_IP-16-265_en.htm
[62] https://www.esma.europa.eu/sites/default/files/library/2015-1886_pt.pdf
[63] http://www.cmvm.pt/pt/Legislacao/ConsultasPublicas/ConselhoNacionalDeSupervisoresFinanceiros/Paginas/20161229a.aspx

to apply the Guidelines for the assessment of knowledge and competence in Portugal but, in February 2017 there was only over 10 months left until the implementation of the MiFID II regulatory package, with the relevant personnel having to comply with the structure and criteria detailed in the Report before its entry in place…

Subsequently, in June 2017, the CMVM released its Public Consultation 3/2017 (with answers accepted until 2 August 2017)[64] specifically targeted at requesting investment firms to respond on the CMVM's proposal of minimum requirements for the assessment of knowledge and competence of their staff in Portugal. In the Article 2 of that documentation, CMVM suggests that personnel providing investment advice need to have a minimum of 130 hours of training (in their first assessment, and then 30 hours of annual training) whilst staff giving information to clients needing to have a minimum of 80 hours of training (in their first assessment, and then 20 hours of annual training), with everyone involved having to pass a minimum score of 70% in a presential test to be done at the end of the training (proof of compliance had to be supplied to the CMVM but only if the regulator requested it). Importantly, the CMVM also suggested that the training could be internal or external, and added to the criteria to be taught the knowledge and competence of anti-terrorist financing procedures, as well as of relevant control functions in the distribution of financial instruments. Roughly, only 5 months left till the MiFID II entered into force and the Portuguese market was still discussing requirements… By then, the banks and the Instituto de Formação Bancária (IFB) were already discussing training methodologies to be delivered to all staff in scope of this regulatory package.

The MiFID II regulatory package entered into force in the European Union on 3rd January 2018 but, in Portugal, the draft national law for its implementation only arrived in the local parliament for discussion on 7 February 2018 (the final law was published on 20 July 2018)[65]. It is estimated that over 20.000 staff from 27 financial intermediaries in Portugal had done their training and took their tests[66] by February 2018, with the vast majority having complied with those requirements still in the last months of 2017 and mostly through e-learning methodologies with external providers, such as the IFB[67], a recognised institution that has served the banks in diversified training formats and content since its creation in 1980. Other institutions opted to hire Deloitte, a well-known global financial services provider, to deliver online training

[64] https://www.cmvm.pt/pt/Legislacao/ConsultasPublicas/CMVM/Paginas/20170621.aspx?v=
[65] https://dre.pt/pesquisa/-/search/115740680/details/maximized
[66] https://www.publico.pt/2018/02/27/economia/noticia/mais-de-20-mil-bancarios-ja-fizeram-o-trabalho-de-casa-1804520
[67] https://ifb.pt/cursos/dmif-ii-formacao-inicial-prestacao-de-informacao-consultoria-para-investimento/

covering the Guidelines whilst some institutions adopted internal training (with their own staff acting as trainers).

A robust training and certification program can only benefit the commercial staff distributing financial instruments, their employers and certainly their clients. More can be done to improve this process, and it is not late to do so, given the annual requirements imposed by the Guidelines.

3.c Balance Sheet Impact

In 1988, the Basel Committee on Bank Supervision (BCBS), working under the auspices of the Bank for International Settlements (BIS), released the first Basel Accord, commonly known as Basel I[68]. As sets of regulations aimed at banks all over the world, the Basel Accords requires that impacted institutions provide a minimum level of adequate capital in their balance sheet so they can face the risks undertaken by their regular banking activities. So, Basel I introduced capital ratios so that banks could face and manage the credit risk exposure related to their assets. In 1996, that first Accord was amended to include market risk[69], in order to ensure that banks' balance sheets were adequately covered by capital to face risks arising from their trading (at the time, the volume of derivatives traded, particularly over-the-counter/off-exchange, was starting to grow substantially). Having been published in 2004, Basel II entered into force in 2007 with operational risk being added to the key risk types, alongside credit and market risk. Amongst other measures, the second Accord is focused on minimum capital requirements for these three risks, but have not included liquidity risk, which was the main problem facing banks with the impacts of the financial crisis that reached its peak in 2008. Several institutions became insolvent as a result of that crisis and, therefore, the BCBS started to develop and implement ratios, such as the Liquidity Coverage Ratio (LCR) implemented in 2011[70] that assures banks have sufficient liquidity for 30 days (cash and other high-quality liquid assets) to survive a crisis in the financial system occurring in that period. Now formally in place with Basel III, with final implementation having started in early 2019[71], the LCR is another remediation process that aims to address the needs of banks to face challenges faced by their risk-taking activities.

For the second pillar of their three pillar approach, regarding the supervisory review process, Franke, Mosk and Schnebel (2016) propose, for its first Principle, that a bank needs "…to act in the best interest of the client subject to the condition that it earns the competitive cost of capital inherent in this business segment.", as that will support a necessary understanding between the clients' interests and those of the bank, which is fundamental to ensure suitability of the retail business of the institution.

Antunes (2017) argues that banks need to be held accountable to the type of information provided, particularly when they are showing marketing material for prospective investments

[68] https://www.bis.org/publ/bcbs04a.htm
[69] https://www.bis.org/publ/bcbs119.htm
[70] https://www.bis.org/publ/bcbs189.htm
[71] https://www.bis.org/basel_framework/

of their clients in specific products. According to this study, these entities must assume liability towards investors, so a capital allocation at the inception of the products could guarantee that financial penalties for potential claims of misconduct and mis-selling are accounted for.

Usually, banks have several over-the-counter (OTC) derivatives in their portfolio, and they are used in a variety of areas, such as risk management, assistance on investment products, proprietary trading, etc., just to name a few. These instruments are frequently considered as the culprits of the financial crisis, particularly the credit derivatives that were built to leverage investment exposure to the real estate market in the United States. Given that, the G-20 stated at their famous Pittsburgh Summit in September 2009 that "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest."[72], as this forum of world leaders then believed that significant risks to the banking sector could be reduced if OTC derivatives would start trading through a central counterparty with full transparency (not bilaterally and with no transparency disclosure to the general public as it happened then).

Banks, in their constant search for an attractive rate to pay the invested funds of their clients (at least, more than the default term deposit rate), will look for financial instruments that could assist pursuing this goal. In doing so, banks often use OTC derivatives as products that can be combined with the invested funds in order to potentially achieve a higher rate of return, but there is always a risk (that can range from not obtaining that "promised" return to losing the total amount of the savings trusted by the investor). Currently, a bank very active in the distribution of investment products that may have several structured and complex instruments delivered to retail investors has no direct impact in its balance sheet, even if those products are performing poorly and the invested funds are at risk.

Shortly after the financial crisis, the Credit Value Adjustment (CVA) was introduced by the BCBS[73], aimed at ensuring that banks have adequate capital to protect their balance sheet against the creditworthiness of their counterparty in a derivative transaction. So, CVA is a charge to the fair value or to the price of a derivative, to allow that future changes in that credit quality are covered by enough capital. So, balance sheets from banks can be covered against the risk of their derivative exposures, usually through portfolio measurement and not by individual product.

[72] http://www.g20.utoronto.ca/2009/2009communique0925.html
[73] https://www.bis.org/publ/bcbs189.pdf

Therefore, banks are now subject to capital requirements to assure they are protected against the exposure of the derivative products, both in changes of their pricing (capital requirements for market risk) and in changes to their credit quality (CVA), but the latter is mostly used for exposure to their market counterparty, not to small investors.

The usage of Mark-to-Market (MtM) is essential to reflect both changes in derivatives, as a regular record of the value of an instrument in the financial markets. For most instruments, it is known daily, but it changes frequently intraday, providing a very good measure for accounting purposes. MtM is frequently zero when the transaction is executed, and then can become negative or positive until its maturity date, depending on the market evolution of the price of derivative and the credit quality of its counterparty. So, a derivatives' exposure can be measured by the change of its MtM, as this value reflects the real market price of that instrument, provided it is fully settled in its entirety prior to maturity.

The Regulation (EU) Nº 648/2012 of the European Parliament and of the Council, commonly known as EMIR (European Market Infrastructure Regulation)[74], introduced, from August 2012, legal requirements for financial intermediaries in Europe to report their derivative transactions, with a view to increase the transparency of the OTC derivatives (after transactions are done) and to reduce the associated risks of the derivatives' market. Reporting applied from February 2014[75] and, in August 2014, the EMIR demanded that financial counterparties and non-financial counterparties holding a substantial size of derivatives in their portfolio (in gross notional value, ranging from 1 billion EUR in credit or equity derivative contracts to 3 billion EUR in interest rate, foreign exchange or commodity derivative contracts) also needed to report, on a daily basis, the MtM valuation of these derivatives contracts. So, although the sizes are significant, the idea of daily reporting brought transparency to the market. But the MtM on a packaged investment product, where funds are placed and even where OTC derivatives might be used, are difficult to assess and evaluate as they include money market standard instruments (such as a deposit) that has no MtM valuation. In addition, there are no current reporting obligations for those instruments which are frequently used by all investors, from retail to private banking customers.

When presenting investment products to clients, regardless of their risk profile, bank staff should always show a substantial diversity of suitable instruments for each client, and carefully

[74] https://www.bis.org/publ/bcbs128.pdf
[75] https://www.slaughterandmay.com/media/2046726/emir-reporting-of-derivatives-from-12-febuary-2014.pdf

detail their characteristics, such as their structure, advantages, risks and appropriateness. Those instruments must always be subject to a detailed comparison with other alternatives, to allow investors to be fully informed before they take their investment decision. In that process, the instruments must be showed unconditionally, irrespective if the expected margin for the bank in a specific product is considered small. They must be presented considering the risk profile and objectives of the client, and the available products offered by the bank. But, how to control leveraged activity from banks particularly geared to the development and distribution of highly complexed investment products (usually, with unknown rate of return and dependent on the price evolution of other assets, leading to negative returns being often shown), sometimes with a substantial leverage exposure, to potentially allow very attractive returns to investors (and sizeable margins for the bank)?

Over more than 30 years, since the launch of Basel I, there were no initiatives aimed at ensuring that banks need to allocate minimum capital requirements to face the risks posed by their (somehow excessive) distribution of financial products to investors. It might be argued that these are not risks primarily faced by the bank, but by the customer, as most investment products require that investors place their money with a bank, therefore these funds become a liability for those banks (not an asset). But the responsibility lies with the financial intermediaries as they own the product factory and they have direct access to the markets daily (individual investors do not have that level of access).

Therefore, it is my firm believe that some measures would be required for banks in Portugal to be more careful on how financial instruments are distributed, and they must certainly look at improving their marketing strategies in order to deliver the most appropriate products to all retail clients. These efforts have been implemented by some recent regulations, but banks must adopt and embed their own voluntary practices in order to remediate the mis-selling and unethical behavior. Looking at the CMVM table for claims, it is true that they haven't risen exponentially for complex financial products, and their relative weight is low compared to the total number of claims. But, do we get that detail in the bank's report of claims? Looking at the 2018 activity from Millennium BCP[76], there were 63 claims for "Investimento e Poupança", but no detail if those are for complex or non-complex products.

[76] One of the largest banks in Portugal, with their 2018 claims being published here https://ind.millenniumbcp.pt/pt/Institucional/provedor/Documents/2018/Sintese-Relatorio-Atividade-2018.pdf

Do investors send their claims to the relevant channels? Do investors know they can claim directly to the regulator? Are they confident that their claims will be handled appropriately?

3.d Internal Frameworks

In order to assure that banks implement strict and robust processes to control their risk-taking activities, the Basel Accords have also implemented requirements for their governance models to be developed in an efficient manner, to allow accountability of actions of their senior managers is guaranteed, and also to make sure that certain functions and roles can perform their tasks independently on a responsible and stable environment, with no interference nor dependency of profitability expectations or other financial targets. The implemented framework should, therefore, make certain that compliance, audit and risk management functions are always safeguarded and performed with efficiency.

Argandoña (2012) argues that the financial crisis of 2007/2008 was a "…crisis of leadership or governance in a wide range of institutions,…", mentioning that cases of bad governance and lack of competence happened in various organisations, further stating that this was an ethical crisis by analysing three different perspectives: the moral of individuals, the social and theoretical ethics, as well as the problems at the organisational levels of the entities involved in finance. Concerning the third perspective, Argandoña (2012) quotes this statement from John Kay in the Financial Times[77] (17th February 2009) on page 7: "The requirement was for an understanding of the mechanics of structured products combined with the economic knowledge to put them in context and the management skills to run the organisations that marketed them.", mentioning that this understanding was lacking, an opinion backed by the Financial Times' columnist. Governance models targeted at the distribution of financial products are insufficient and do not provide adequate management oversight on the appropriate processes and procedures.

To accommodate the Basel requirements, several banks have created roles of Chief Compliance Officer (CCO), Chief Audit Officer (CAO) and Chief Risk Officer (CRO), with these functions starting to be included in their management boards, alongside the traditional Chief Financial Officer (CFO) and the Chief Executive Officer (CEO). The individuals performing those roles, placed at the top level of seniority, are taking full responsibility of the risks (and its controls) undertaken by their entities, and the degree of their involvement and accountability is being exhaustively detailed in procedures and methodologies for risk-taking activities (past, present and future).

[77] https://www.ft.com/content/d7e9fdf4-fd05-11dd-a103-000077b07658

With these initiatives, banks should be more protected from internal and external risk, making their balance sheet more robust than ever. That can only be beneficial for the economic environment, particularly if those banks are large commercial retail banks, but these measures also help to smoothen the impact that some investment banks had in the government debt of countries and their respective economies (how Greece was "helped" to join the Eurozone in 2001 is still fresh on a lot of minds[78], particularly when their subsequent debt crisis arose in 2008…).

These changes are important but, nevertheless, much more is needed to change the patterns of the past. Several discussions are ongoing on where there should be a fourth line of defence of their institutions (to include external supervision by regulators and also external audit[79]) and, whilst management board as the first line is being adopted by several firms, questions are being asked on how the independency of those functions can be assured, particularly when those members in the board are also responsible for the profitability and definition of the business strategy for each entity. Should the local/regional financial regulator help in defining those lines of defence, or must every institution be responsible for their own organization charts and respective responsibilities? How about the role of an external audit function, is it needed to assure that all institutions in a country align with the common best practices to avoid excess risk?

So, the implementation of robust governance models is extremely relevant to achieve the goals of the Basel Accords: preserve and enhance the stability of banks, prevent fraud and systemic risk, as well as regulate the capacity and solvability of banks.

Corporate governance can be defined as a system of procedures, laws, practices and behaviours associated with the structure of decision-making powers and auditing of organisations. In those models, the functional profile of the relevant roles (stakeholders) is determined, as well as their professional relationship towards the development of the entities' business model. Those models serve to optimise performance, prevent and manage potential conflicts of interest, safeguard the reputation of the organisation and guarantee its continuity, amongst other objectives.

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[78] https://www.spiegel.de/international/europe/greek-debt-crisis-how-goldman-sachs-helped-greece-to-mask-its-true-debt-a-676634.html

[79] At a national and international level, as can be seen in these links https://www.bis.org/fsi/fsipapers11.pdf, https://www.bportugal.pt/sites/default/files/anexos/documentos-relacionados/intervpub20180702.pdf and https://www.bportugal.pt/sites/default/files/anexos/documentos-relacionados/intervpub20161110.pdf

To comply with corporate governance models, individual members must guarantee they are suitable and always perform their functions on an independent manner, that they have robust technical qualifications and professional experience, whilst also assuring availability and diversity (to avoid excessive accumulation of roles). Appropriate remuneration mechanisms are also important, to ensure a balance between fixed and variable pay and prevent unnecessary risks that could cause an immediate problem for the institution.

As mentioned, the key risk types for the Basel Accords are credit, market, operational and, later introduced, liquidity. Those Accords provide guidance on how to implement internal frameworks and governance models to address these risks, as well as implement several capital requirements to control them. But nothing there is referred on frameworks for controlling excessive risk-taking practices in the distribution of financial products to investors, as those Accords target prudential regulation to protect the banks' balance sheets, being a type of supervision that oversees factors that can impact the stability of individual banks and analyses how prepared is a financial institution to face exogenous risks, ignores endogenous risks and also ignores the systemic relevance of individual institutions. Investor protection objectives are usually covered by behavioural supervision that overlooks factors that impact the stability of the financial system as a whole and promote market integrity, efficiency and competition.

These models lack the integration of a Chief Distribution Officer, as a role placed in the top decision levels of an institution, where she/he can take full accountability on how/where/what/when investment products are distributed to retail investors. This role cannot be performed with persons subject to potential conflicts of interest, they are still accountable for the revenues produced by the distribution of financial products, but the assessment and evaluation of that person cannot be dependent on that financial performance (must be supervised by a compliance function). Currently, several institutions place sales and marketing managers in areas reporting to the decision-making powers, but a change of pattern is needed. A sales area is normally involved in the delivery of products to the end client, and those products are usually created by the "internal factories" assisted by the marketing areas. Too often, the distribution of those products follows a profitability objective, which is needed for sustainability of the institution, but it cannot be the sole motive. Factors like client retention, their suitability and appropriateness, assuring they receive a fair treatment, etc., need to be considered at the very early stage of product development, not put aside as potential blocks in the continuous search for a quick profit. For me, a fusion of sales and marketing roles is a good procedure, but they need to merge and upscale, and by that I support a Chief Distribution Officer with a role in the management board of the banks involved in the placement of investment products with retail clients.

In commercial banks with several retail clients, individuals performing these roles cannot be independent as they do not have a control function on other roles, such as the CCO or CAO. Their activities will need to be closely and strictly monitored by an internal Compliance function, as the area that ensures that financial regulations are applied and complied with inside every financial institution. So, regulators will serve as an external audit function, with key responsibilities for no compliance lying with the person performing this role. Besides, the chain of product conception to its delivery is dependent of many internal/external areas, and these procedures need to be robust to ensure no flaws in the process. Nevertheless, these individuals also need to embed the full responsibility of the risk-taking activities of the areas under their management, whilst also needing to be fully adequate, experienced and with a balanced remuneration that supports the efficient performance of their functions. Segregation of duties also need to be assured, as well as SLA (Service Level Agreements) between areas to guarantee that all processes run smoothly from the moment they start. We have already mentioned the New Product Approval processes, they are key for an efficient engagement and development of the distribution chain.

On the product delivery phase, it must be assured that the marketing material and accompanying documentation is more robust, so that investors have all information at hand before they decide their investment strategy. Recently, the MiFID II regulatory package and the regulation Packaged Retail & Insurance-based Investment Products (PRIIP)[80] introduced a mandatory and standardised documentation to support the distribution of investment products in Europe. Therefore, the KID[81] forms part of the PRIIP and has been drafted with a common format in order to guarantee that investors can compare products, obtain enhanced protection and increased transparency. Limited to 3 pages in A4 format, the KID needs to be well written and presented in a clear language, and contains basic information of the product, its characteristics, risk indicators, performance scenarios, costs and their composition, information on potential inability to pay out, recommendation of holding period, how to file a complaint, amongst other topics. Júdice (2018) argues that the standardisation and reduction of the KID could lead to

[80] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R1286&from=EN

[81] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/consumer-finance-and-payments/retail-financial-services/key-information-documents-packaged-retail-and-insurance-based-investment-products-priips_en

some doubts in the selection process of the information that must be included in it or excluded from it. Being a pre-contractual document, it will be part of the legal documentation that needs to be distributed and signed prior to the execution of the transaction.

Therefore, I believe that a more detailed approach to investment in financial products could be key for an increased security of these instruments. As such, the internal framework to be implemented in all financial intermediaries will need to follow stricter guidelines, to ensure a healthier and more trustable environment for investors.

3.e Distribution Limits

Currently, personnel working in commercial areas of banks have many targets to achieve on a regular basis, particularly the individuals responsible for the relationship with retail clients. From obtaining new customers or accounts, to securing car insurance contracts, personal loans or even cross-selling business, they are frequently visiting and contacting those clients to market the products developed by their banks, as the income generated from these "sales" are extremely important to the profitability of these institutions. According to page 25 of EY's 2014 Global Consumer Banking Survey[82], the average banking product owned by retail clients ranges from 3.2 for traditionalist clients (classified on the Survey as less educated, with limited income and with 7% of their assets under management) to 11.5 for upwardly mobiles (young, highly educated, with high income, investable assets and with 25% of their assets under management). The Survey analyses data from the main countries located in all regions of the world and seems to show that client retention is important everywhere (including in Portugal), as satisfied customers will tend to stay with a bank that takes good care of their money, particularly today as new technologies are helping the creation of virtual banks where manual interaction is reduced to a minimum, causing increasing competition to traditional banking models and a natural reduction of the number of retail branches and of the commercial staff in banks (the Statistics area of Portuguese Banking Association's website[83] shows a 27.2% decline in the number of branches in Portugal, from 5.570 in December 2013 to 4.054 in December 2018, and a 18.4% fall in the number of human resources working in commercial areas in the same period). With an opposite trend, the number of basic bank accounts (according to the Banco de Portugal, a current account where the client can access essential banking services[84]) continues to rise substantially[85], coming from 9.646 in the end of 2013 to 59.173 in the end of 2018, even though that statistic alone is not sufficient to confirm that new clients are opening accounts in banks, as a client might hold several accounts in various banks (could be a natural consequence of the introduction of the DGS in Europe in 2014, as this Scheme guarantees up to 100.000 EUR per account).

Over the last few years, to address the challenges of digital banking where proximity to the bank account manager became less relevant, traditional banks have developed new techniques

[82] https://www.ey.com/Publication/vwLUAssets/EY_-_Global_Consumer_Banking_Survey_2014/$FILE/EY-Global-Consumer-Banking-Survey-2014.pdf
[8383] http://www.apb.pt/studies_and_publications/statistics/
[84] https://www.bportugal.pt/en/page/what-basic-bank-account
[85] https://clientebancario.bportugal.pt/pt-pt/evolucao-de-contas

for client retention and cross-selling activities. For example, you are looking to buy a house and approach your bank for a mortgage proposal. The bank will gladly show their best conditions for how much money they could lend and what credit spread they will charge, but will also mention that these conditions would be subject to you subscribing insurance policies with a company of the group as well as asking for you to domicile the salary with them. Or they might even say that you need to subscribe and maintain a minimum number of products with the bank. That's right, you ask for a 30-year loan and you might need to keep, for that period of time, your credit card with the bank (with a minimum monthly utilization), your standing orders for utility bills and the access to your bank account through their mobile application (just to name a few examples). Another bank might say that these conditions could guarantee a reduction of your credit spread but, one way or another, banks tend to use a client's loan request to deliver these efficient methodologies to engage with them on a long-term basis.

Are there any limits to the number of products a bank should sell? Not really, as ultimately the decision lies with the client. In the example above, banks offer minimum conditions (i.e., in the shape of specific products) to satisfy a direct request of a client (a mortgage), but the individual person always has the final say and she/he can always walk away from that proposal, from that bank and from similar proposals of other banks. Of course, these institutions have access to large amounts of funds and the traditional banking model of granting loans to clients has helped billions of families around the world to purchase their homes. If you walk away from these proposals and institutions, you might end up having to rent a house for the rest of your life. So, we need banks to finance our needs, and it is only natural that they lend you money subject to some minimum criteria that must be met.

As Aristotle (384-322 B.C) mentioned: "Creditors have no real affection for their debtors, but only a desire that they may be preserved such that they may repay." (in Nicomachean Ethics[86], p. 160)

In addition to these requirements, banks will need to analyse the credit quality of the proposed borrower requesting a loan. So, for mortgages, these institutions tend to use numerical credit scoring models[87] to evaluate the probability of default associated with the loan under analysis. These models are also used in consumer loans and assume a standardization of statistical models integrated into an estimation software that will analyse all the input (besides the client's current

[86] https://en.wikipedia.org/wiki/Nicomachean_Ethics
[87] A sample is presented in the book *Principles of corporate finance* (p. 853-855)

information, it considers historical data of housing market in that geography for that type of client, amongst other factors) in order to reach a decision. Frequently, human judgement is not fundamental to these types of models, and sometimes it is not even considered.

When evaluating whether to grant loans to individuals, banks are recommended to assess two additional and very important criteria: the Debt Service-To-Income (DSTI), as "the ratio between monthly instalments of total credit agreements and the borrower's income, net of taxes and contributions to social security" and the Loan-To-Value Ratio (LTV), as "the ratio between housing loan(s) and the minimum between the purchase price and the appraisal value of the house granted as collateral"[88]. With those purposes in mind, Banco de Portugal, as the Portuguese macroprudential authority for the financial system, issued a Recommendation on 1st February 2018[89], under the principle of "comply or explain", with the aim of promoting the implementation of reasonable credit standards to loans granted by the banks resident in Portugal to individual clients.

On that Recommendation, the calculations for the DSTI and the LTV are presented, as well as the respective limits for those ratios that banks should observe when assessing the solvability of the intended borrower.

So, it is recommended that the LTV is not greater than 90% for loans granted to purchase property for permanent and own use of the borrower (not for rentals). In practice, given the continuous rise in housing prices in Portugal over the last few years and the fact that appraisal values haven't risen as much, this has meant that several borrowers are getting loan amounts which are below 90% the house's selling price.

How about the DSTI? As the basic and general measure, it is recommended that banks should not provide loans where the resulting ratio is greater than 50%, considering all credit loans (not just for mortgages). As a conservative methodology, some banks even suggest lower ratios[90], as credit expenses are just a part of the total expenses incurred by an individual. No wonder the DSTI is commonly known in Portugal as "taxa de esforço" (effort rate) as paying expenses and debt is a clearly an achievement (and sometimes, struggle) for some families.

[88] https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits
[89] https://www.bportugal.pt/sites/default/files/2018_doclimites_pt.pdf
[90] https://ind.millenniumbcp.pt/pt/Particulares/solutions/Vamos_a_Contas/Pages/pf_Posso-contrair-credito.aspx

The limitations recommended to the LTV and the DSTI have the objective of providing banks with additional ways to reinforce the credit evaluation of those borrowers in order to strengthen the resilience of the financial system in Portugal.

An important support to the implementation of these measures is the Central Credit Register (CRC) of Banco de Portugal[91], where individuals can, at any time, check the details of all their credit responsibilities to resident banks in the country (with details of total debt amounts, number of products, potential and also non-compliant responsibilities). Subject to data protection requirements, this tool allows debtors to have a complete overlook of their indebtedness levels but it is also applicable for banks to have an oversight (on an aggregated, non-detailed basis) of the credit responsibilities of an individual or entity asking for a new loan. Therefore, it is a very useful and updated database for borrowers and lenders.

These measures alone do not guarantee that all loans will be fully repaid and doesn't even ensure that all interest payments will be honoured by the borrowers. But they have certainly helped the Portuguese financial system to reduce its Non-Performing Loans (NPL) ratio, which is a calculation of the total amount of defaulting loans over the total amount of loans in the country. In fact, according to the statistics of Banco de Portugal[92], the NPL for housing has fallen from 7.2% in December 2015 to 4.6% in September 2018, with the total NPL falling from 17.5% to 11.3% in the same period (p. 8), showing opposite trends when compared to the period 2011 to 2014, when Portugal was subject to the Economic Adjustment Programme (EAP)[93] led by the European Union and by the International Monetary Fund (in that period, the NPL for housing increased from 5.8% to 5.9%, and the total NPL increased from 7.7% to 11.9%[94] as can be shown in slide 33). Despite the positive trend, continuous monitoring and preventive methods are needed on an ongoing basis in order to control excessive risk and exposure.

I have mentioned the credit scoring models, the DSTI, the LTV and the CRC as useful tools to analyse credit. In order to implement limitations to investments, with particular focus on the restriction of selling complex products to retail investors, I introduce an application of the basic features of these methodologies and tools to the distribution of investment products so they can

[91] https://www.bportugal.pt/en/area-cidadao/formulario/231
[92] https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/overviewportuguesebankingsystem_2018q3_en.pdf
[93] https://ec.europa.eu/economy_finance/publications/occasional_paper/2014/op202_en.htm
[94] http://www.apb.pt/content/files/Novembro_-_Overview_do_Sistema_Bancrio_Portugus_ING.pdf

assist regulators implementing levels for those limits. Currently, for most of the complex products (except for Contracts For Difference, commonly known as CFD, and binary options), there is no strict regulatory ban implemented to their distribution, so commercial staff are generally "free" to market the products they want. In December 2013, the CMVM signed a protocol with 19 banks in Portugal related to the distribution of complex financial products to retail investors.[95] In that document, the signatory banks "…also undertake to refrain from marketing…" products which are classified in the high risk or very high risk categories (graphic alerts with orange and red colours, as detailed in the CMVM Regulation nº 2/2012[96]), but it "…does not cover reception of orders, transmission or execution of orders concerning such products provided that the service is provided by confirmed customer initiative.". But, for example, the protocol did not contain restrictions to the sale of complex financial products containing yellow graphic alerts (even though these products could be issued by an entity not subject to prudential supervision in the European Union and the invested funds could be subject to a maximum 10% loss) and it did not limit the amounts invested in these products. It is also worth noting that the protocol did not include all banks in the country and that the products could still be obtained by the client. As a consequence of that protocol, some banks started to apply precautionary measures and restrict the sale of some products to unsophisticated investors, particularly after they undertake the necessary suitability analysis of the proposed investment but, in the end, the decision if solely of their management whether they want to implement caution or not to these processes. By having no strict regulatory ban then, banks could be flexible with their limitations, and those could often change depending on their business targets.

[95] https://www.cmvm.pt/en/Comunicados/Comunicados/Pages/20131210h.aspx
[96] https://www.cmvm.pt/pt/Legislacao/Legislacaonacional/Regulamentos/Pages/Reg2012_02.aspx

## 4. Conclusions

The methodologies, regulations and codes currently impacting the distribution of financial products in Portugal still do not prevent occurrences of mis-selling, manipulative, abusive and unethical behavior. A culture change is urgently needed, but other requirements must be implemented so that investors can regain trust that the banks are providing services and products with no conflicts of interest with their activities or of their employees. We will need several entities working towards these developments, including regulators such as the CMVM and Banco de Portugal. Commitment is also necessary from banks delivering products and services to retail clients, as these changes can only improve the current status if they are adopted and embedded by the financial community.

Much more needs to be done.

In the Introduction, I have inserted this General Research Question:

- Is there lack of ethics in the distribution of financial products in Portugal?

The answer to that question can only be a resounding YES and I feel that to be supported by the empirical and statistical evidence mentioned in this paper. In Portugal, the processes to distribute these products are inadequate and they potentiate the occurrence of unethical behaviors, with that being aggravated by the low level of financial literacy and information asymmetry in the country, amongst other problems. It is a clear problem in Portugal, hence all the attempts from regulators to address it and to offer enhanced protection to retail investors that are constantly subject to mis-selling events.

Financial products should always be distributed and delivered by banks that always safeguard ethical principles, integrity and fairness to the investor which places trust and savings in that bank.

To prevent, reduce and potentially eliminate the impact of mis-selling situations, low trust, asymmetry of information, unethical behavior, low literacy and high complexity, I introduce the implementation of five measures to amend the processes related to the distribution of financial products in Portugal, with those measures helping to answer the remaining three Research Questions.

Research Question 1:

- Can commercial staff in banks improve their ethical and professional standards towards retail investors?

Research Question 2:

- Can banks be more trusted and accountable for the investment products they offer and/or recommend?

Research Question 3:

- Can retail clients be protected against excessive complexity in investment products?

The presented measures are:

- Development of new staff policies related to performance development and remuneration of commercial staff in banks

  → For Research Question 1

- Implementation of mandatory and independent certification of commercial staff

  → For Research Question 1

- Introduction of regulatory capital requirements for banks' behavior

  → For Research Questions 1, 2 and 3

- Enhancement of internal frameworks related to the governance process in the distribution of financial products

  → For Research Questions 1, 2 and 3

- Application of more limits to the sale of complex financial products to retail investors

  → For Research Question 3

4.a First Measure - Remuneration Policies

Although the regulatory package of MiFID II is applicable in Portugal and the FX Global Code can be adopted by banks in the country, appropriate remuneration structures and policies should combine the topics mentioned and must cover all areas related to the distribution of financial products to investors in the country. Therefore, I introduce the following methodologies to be implemented in Portugal:

- A balance must be in place, applicable for every staff member, regarding the amount of earnings generated by the sale of non-complex and complex products. Therefore, commercial and trading staff should have sales objectives which are consistent with this desired balance, with their activities frequently monitored to investigate potential misconduct and in order to avoid mis-selling and unethical behaviour. I introduce that financial performance cannot have more than 30% weight on the annual evaluation of a staff member involved in the distribution of financial products, and those individuals cannot be dismissed only by poor financial performance in one year. Therefore, it would be useful that the activity of product distribution and trading is closely connected to the actual compliance of ethical standards, so I favour the introduction of performance evaluation methodologies that effectively reward employees (not necessarily in cash, but more through promotion mechanisms) that consistently implement good practices in their roles. These methodologies would favour the promotion of staff that are complaint free from clients, and consistent training on good market practices should be at the forefront of the evolution of these individuals as persons and market professionals;
- As a regulatory obligation, firms should establish the procedures suggested by all applicable and relevant principles of the FX Global Code (where, for instance, principle 6 related to the remuneration and promotion structures should be mandatory for commercial banks), following the example of Banco de México (the central bank) that, despite the voluntary nature of the Code, requested for all banks in the country to adhere to these guidelines for good market practices (failure to do so will have to be thoroughly explained to Banco de México and the respective banks will not be allowed to execute transactions with the central bank) as explained in the "Informe de entidades sobre su determinación de adherencia al Código Global de Conducta de acuerdo a la Circular 22/2017"[97];

[97] https://www.banxico.org.mx/mercados/codigo-global-conducta-divisa.html

- Full disclosure of the ratio between annual compensation paid to commercial staff and the amount of money their activities generate to the bank, following the proposal mentioned above of the SEC. By allowing public comparison between peers, investors and the general public would have full transparency on how banks are awarding compensation to the account managers that deliver financial instruments to their clients.

4.b Second Measure - Staff Training and Certification

The process for training and certification contained in the "Guidelines for the assessment of knowledge and competence" was well intended but it contained several problems from the start, and these problems posed challenges to its practical application in Portugal. Additional features should have been reflected in the Final Report by ESMA or be implemented by the CMVM, for the process to be more robust and allowing for its improved efficiency, so that the general public and the investors could be more confident with the methodology. For me, the course of action for application in Portugal should be:

- Certification of trainers: all trainers delivering the content of the criteria and structure detailed in the Final Report, should hold a valid and updated certification to train, such as the CCP, regardless of the training methodology chosen by the financial intermediary. As an example, the IFB requires that all their trainers hold a CCP, but the certification I introduce would enlarge this, covering all individuals, including internal staff, that delivered the courses. In another example, some institutions in Spain opted to partner with universities to deliver the content of the Final Report[98], not considering internal training delivered by their personnel. This measure would ensure that trainers were qualified and assessed in training methodologies, beyond their knowledge of financial markets;
- Validation of the training methodologies: the Final Report should have requested an independent validation of each training structure (prior to its implementation), to be validated by the National Competent Authority in Portugal, to guarantee complete oversight of the correct application of the Guidelines in the Final Report and to ensure responsibility that this important part of the MiFID II regulatory package was being put in practice in an effective manner;
- Validation of the exams: the final tests should have been delivered in Portugal by an external, independent and reputable entity, structured around randomly selected questions with the content always mirroring the criteria and structure included in the Guidelines, and not being subject to adaptations by each financial intermediary (which is possible under the delivered format, but can lead to a problem if a staff member resigns from your entity and accepts a similar role in the competition). This standardised measure would guarantee that a robust and supervised process was in place, ensuring that a transparency and equal

[98] https://cincodias.elpais.com/cincodias/2017/06/01/mercados/1496331469_554724.html

format was delivered in every country. As an example, the ACI Suite of Exams[99] contains certificates that are recognised, recommended or even mandated by regulators in some jurisdictions, being exams delivered and valid in every corner of the world. For instance, in the United Kingdom, the ACI Diploma is recognised by the Financial Conduct Authority (FCA) in their Appropriate Qualification tables[100] for key activities in the distribution of financial instruments (in scope of the UK's Retail Distribution Review), such as "Giving personal recommendations on and dealing in securities which are not stakeholder pension schemes, personal pension schemes or broker funds" and "Giving personal recommendations on and dealing in derivatives". The content of this exam includes product and market expertise in various asset classes (foreign exchange, money market, fixed income and derivatives) as well as fundamental analysis, technical analysis and risk management, but it does not cover investment advice. For that, and in order to be properly qualified by the FCA, takers of the ACI Diploma need to complement it with appropriate qualifications in Regulation and Ethics, Investment Principles and Risk as well as Personal Taxation. To complement its offering of exams, ACI has implemented a Trainer Accreditation Policy in April 2019[101] to ensure that content for ACI exams delivered by external entities is properly monitored and controlled, so that exam candidates understand that these qualifications are bullet proof and provide what they are aimed for: "…globally acknowledged, portable, professional qualifications that enhance career prospects, improve job performance and set benchmarks within the industry.". Nevertheless, the Guidelines should have included these measures to guarantee an efficient delivery of this process.

[99] https://acifma.com/about-education
[100] https://www.handbook.fca.org.uk/handbook/TC/App/4/1.html
[101] https://acifma.com/aci-trainers

4.c Third Measure - Balance Sheet Impact

Financial intermediaries in Portugal should have a direct impact on their balance sheet if their distribution of financial products is excessive and geared towards the massive delivery of complex products to retail investors. Therefore, the following methodologies should be implemented in the country with a view to control and limit that distribution:

- Introduce the Retail Exposure Value (REV) measurement: develop an enlargement of the MtM technique in order to create a robust methodology to evaluate all products and risks included on an investment product specifically targeted at the retail sector. If the product has derivatives in it, their valuation will still be performed with the traditional MtM but the overall value of the investment product will need to factor two additional points: 1) the net present value[102] of the funds placed by the client, considering market values and credit risk spreads to assess the cost of capital; 2) the real risk of default of the bank where the funds were placed, regardless if the product is considered "capital guaranteed at maturity", here named as Real Probability of Default (RPD). In order to calculate 1), financial intermediaries will need to ensure the values and spreads are correctly obtained in the market, but also constantly assess its liquidity in order to guarantee that funds are at immediate disposal of clients should they decided to cancel the product, and therefore settle the outstanding REV, at any time before its natural maturity date. To calculate 2), financial intermediaries will need to consider the characteristics of the Deposit Guarantee Schemes (DGS)[103] for amounts invested up to 100.000 EUR in the European Union, as they assure that the investor always recovers up to that invested money but fails to specify the exact date (currently, up to 15 days in Portugal). Also, the DGS pose risks if several persons decide to activate this protection scheme at the same time. Up to now, DGS haven't been severely tested in Europe and, as they are managed by a fund (in Portugal, the Fundo de Garantia de Depósitos or FGD[104]), the amounts placed can also vary. Amounts over 100.000 EUR are not covered by the DGS so, in these situations, it is even more important to evaluate the real credit risk of the institution that built the investment product, so we can obtain complete transparency and guarantee that our funds will be recovered in any situation. For that, the REV will also need to factor scoring or rating models, with a

[102] Defined in the Fifth Edition (1992) of the *Dictionary of Economics* as "The discounted value of a financial sum arising at some future period" (p. 335), meaning the actual value of the investment today.
[103] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/deposit-guarantee-schemes_en
[104] https://www.fgd.pt/

constantly updated probability of default of the issuer also being factored in the model. Therefore, the Total REV would be calculated on a monthly basis, at a minimum, and as a result of:

$$\text{Total REV} = (\text{IF} + \text{MtM}) * (1 - \text{RPD})$$

Where:

IF = Net Present Value Amount of Invested Funds in EUR

MtM = Net Present Value of the Sum of the Mark-to-Market valuations (in EUR) of all Derivatives included in the Investment Product

RPD = Real Probability of Default of the Issuer of the Investment Product

- Introduce capital requirements to support the REV: for investment products issued by financial intermediaries that include derivatives, I introduce specific ratios so that these entities can allocate enough capital in their balance sheets to face the risks of these products. This capital would be specifically allocated in a portion of the balance sheet that could be directly recovered by the National Competent Authority in Portugal (in case of a proven mis-selling or misconduct of the issuer towards retail investors) and the proportion of capital would differ according to the weighting of the MtM of the derivative included in the REV, with more capital required if the investment is losing value (for instance, by having a substantial negative MtM to the client). The introduced table for capital allocation would look like this:

| Total REV Range | Weight of Invested Funds in the REV | Weight of Derivatives MtM in the REV | Capital Requirement (% of REV) |
|---|---|---|---|
| >= 120% | > 75% | <= 25% | 5% |
| >= 100% and < 120% | > 75% | <= 25% | 8% |
| >= 80% and < 100% | > 75% | <= 25% | 15% |
| >= 50% and < 80% | > 75% | <= 25% | 25% |
| >= 0% and < 50% | > 75% | <= 25% | 35% |

| Total REV Range | Weight of Invested Funds in the REV | Weight of Derivatives MtM in the REV | Capital Requirement (% of REV) |
|---|---|---|---|
| >= 120% | < 75% | >= 25% | 10% |
| >= 100% and < 120% | < 75% | >= 25% | 20% |
| >= 80% and < 100% | < 75% | >= 25% | 30% |
| >= 50% and < 80% | < 75% | >= 25% | 40% |
| >= 0% and < 50% | < 75% | >= 25% | 50% |

- Introduce capital ratios for concentration risk in investment products: in the document "Basel II: An International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version"[105] that supports the Basel II Accord, some measures are introduced to assist its second pillar related to the supervisory review process. These measures include a framework for risk concentration that can be present in the balance sheet of banks, resulting from assets, liabilities or off-balance sheet items (such as OTC derivatives). Defined in that document as "…any single exposure or group of exposures with the potential to produce losses large enough (relative to a bank's capital, total assets, or overall risk level) to threaten a bank's health or ability to maintain its core operations." (p. 214), this topic focus particularly on concentration of credit risk as lending is the primary activity of most banks (so, an asset-based impact). Therefore, it centers on exposures to individual or group counterparties, on exposure to a geographic region (and currency), on exposure to an economic sector, amongst others. The first pillar of the Basel II Accord refers the minimum capital requirements for credit risk, but this document further requests banks to consider capital adequacy to concentration risks under its second pillar. Therefore, to complement this, some national regulators, such as the Banco de España (central bank) and the Prudential Regulation Authority (PRA, in the UK) have developed models to evaluate the concentration risks of banks in their respective jurisdictions as well as provide tables (an example is included in page 20 of the PRA's Statement of Policy from December 2017[106] entitled "The PRA's methodologies for setting Pillar 2 capital") with the necessary capital charges (add-ons) according to specific levels of concentration. Therefore, the good example of these tables should be taken and introduced in Portugal, with a similar structure to implement requirements for the necessary allocation of capital related to the level of concentration of investment products marketed by a financial intermediary, with their split being organized according to the investment profiles of the retail investors: conservative, moderate and aggressive. The capital add-on would be calculated and monitored on a monthly basis, according to the Total REV of all investment products placed with investors classified with those three profiles. The buckets for concentration risk would range from Diversified (1) to Excessive (5) considering the percentage of the earnings of the last three years that was generated from the distribution of financial instruments to retail investors. A structured table could look like the one below,

[105] https://www.bis.org/publ/bcbs128.pdf
[106] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2017/the-pras-methodologies-for-setting-pillar-2a-capital-december-2017

where additional capital buffers are naturally required when the concentration risk is qualified as above average:

| **Concentration Risk Bucket** | **Diversified** | **Low** | **Average** | **High** | **Excessive** |
|---|---|---|---|---|---|
| | **1** | **2** | **3** | **4** | **5** |
| ***Conservative Investment Profile*** | | | | | |
| **Capital Add-On over Total REV** | 2% | 4% | 6% | 10% | 14% |
| ***Moderate Investment Profile*** | | | | | |
| **Capital Add-On over Total REV** | 4% | 6% | 8% | 12% | 16% |
| ***Agressive Investment Profile*** | | | | | |
| **Capital Add-On over Total REV** | 6% | 8% | 10% | 15% | 20% |

4.d Fourth Measure - Internal Framework

Unfortunately, the KID does not introduce features that, for Portugal, are extremely relevant to understand what products can be delivered to which type of resident clients in the country. Therefore, I believe that procedures for local application could be:

- Higher number/level of risk indicators: currently, the KID only contains 7 levels, from lower risk (1) to higher risk (7), considering the presented matrix to calculate market and credit risks for the SRI (Summary Risk Indicator), whilst liquidity and foreign exchange risk are described in the supporting text. That looks insufficient to cover all the range of investment products that are being distributed in Europe. For example, often classified as risk (1) are some Euro-denominated structured deposits for a specific tenor (for example 2 years) where a minimum investment return (positive) is guaranteed if a basket of stocks performs below the target/expectations, and a maximum investment return (even more positive) is obtained if the basket of stocks performs at or above the target/expectations. Seems like a simple product, where the investor needs to place the money for 2 full years to assure no capital loss. But what if the deposit taker (a bank) defaults in between? In Europe, the investor is protected by the DGS for a maximum of 100.000 EUR invested but these structured deposits have no limitation to the amount invested, so often investors can place multiples of those amounts in these products, which are (oddly?) still classified as risk 1 (lower risk possible)… I understand the necessity for standardisation and simplification, but the wrong signals are being given. I favour a higher number of risk levels as they can help investors understand where the real risk lies (in this example, a potential loss for amounts invested above 100.000 EUR), so we could have level (1a) of risk for amounts below 100.000 EUR, level (1b) for amounts between 100.000 and 300.000 EUR, etc. In addition, the DGS hasn't really been tested seriously, so a potential default of a bank with significant systemic risk can cause a stress to its procedures and, therefore, deliver even more problems to the investor. With more risk levels, investors will have more important information to support their investment decisions. For example, let's look at a PRIIP launched in April 2018 with a tenor of 3 years[107]. It is not a deposit, therefore does not have the assurance of the DGS for amounts up to 100.000 EUR. Naturally, the investment in the underlying stock market does not guarantee total reimbursement of the

[107] https://ind.millenniumbcp.pt/pt/Particulares/Investimentos/Documents/DIF/DIF_RendAcoesValorGlobaiAutocallableIV_18EUR.PDF

invested capital at maturity (only 90%), but the product cannot be early reimbursed and does not even ensure that the depositary bank (Banco Comercial Português, S.A.) will pay back the invested capital (or even just the 90% of that amount). Even with these restrictions, the product is only classified as risk 5 (out of 7) and its sale is not restricted to retail investors (it even says to which type of retail investor it is meant for);

- Enlarged classification of complexity: non-complex financial products (initially defined in page 37 of the Directive 2004/39/EC of the European Parliament and of the Council, commonly known as MiFID I) usually include instruments with large information available in the market and with performance not dependent of other assets, such as exchange-traded equities and bonds but also money market instruments. In contrary, certain investment alternatives are composed of complex financial products (not defined in MiFID I, but considered for every product that is not non-complex[108]), generally identifying those with an unpredictable profitability, usually dependent of the evolution of other assets and that can often assume negative value to the investor. Therefore, complexity of the instruments brings significant risks to the investors but also allow them to potential achieve higher returns when compared to the standard products. Consequently, several regulations demand that financial intermediaries guarantee an increased level of information and disclosure to their clients when distributing complex financial products to them, and some entities even restrict the sale of these products to professional investors only (where an assessment of their experience, knowledge and competence in financial markets instruments is needed, in addition to understanding their financial situation, risk tolerance and investment objectives, amongst other criteria that must be analysed before the transaction is executed). Classifying products just as complex and non-complex is too reductive, as there are many factors that can impact the real complexity of the product, so I favour a 5 level classification, with no complexity (1), low complexity (2), average complexity (3), high complexity (4) and very high complexity (5). For instance, one of those factors is liquidity so a new listed stock coming straight out of an Initial Public Offering in an Eastern European market that has reduced liquidity cannot be compared, in complexity terms, with the stock of Nestlé SA and Royal Dutch Shell Plc (two of the most liquid stocks in Europe[109]). Today, both are classified as non-complex. In my measures, the new stock would be classified as (2) or (3), whilst the Swiss and Dutch stocks would

[108] https://www.esma.europa.eu/sites/default/files/library/2015/11/ipisc_complex_products_-_opinion_20140105.pdf and https://www.esma.europa.eu/sites/default/files/library/2015/11/09_559.pdf
[109] https://www.ft.com/content/aee985d4-9cb2-11e9-9c06-a4640c9feebb

be on (1). With more granularity on this classification, investors will be more aware of the real risks of complexity in their products;

- Introduction of literacy levels according to its level in Portugal: given the different stages of development and culture diversity within the European Union (at the time of writing, still composed of 28 countries), it is natural to believe that financial literacy is not at the same level in every country. Countries with matured financial markets, such as the United Kingdom and Germany, could have installed measures and procedures to educate the population on finance topics, whilst countries with relatively new financial markets, such as Estonia and Latvia, still search for the best ways to develop their markets and the knowledge of their national residents. In page 65 of the OECD report for Financial Education in Europe: Trends and Recent Developments, published in 2016[110], we can see that 2.21% of the population in Portugal (aged 15 or above) had holdings of shares or bonds, a long way behind Sweden where over 45% of the population had these products at the time of the survey. Do Portuguese people invest less because they don't know the basics of finance or is that a consequence of our mostly illiquid stock market? There can be many explanations to these low numbers, but at the time Portuguese investors could already buy stocks outside the Lisbon Stock Exchange, so I am more inclined to believe in the low level of literacy in the country. But then, if we look at the table of page 17 of the same report, Portugal does not rank badly in the level of financial knowledge level (where 82% of adults understand risk and return, 87% understand the definition of inflation and 73% understand the concept of diversification). Another important statistic from this report is that only 6% of adults in Portugal look for independent information on financial products and investments, with the vast majority trusting their bank account managers, which only stresses how important is for commercial staff in banks to be fit for purpose. Given the diversity of the statistics, these kind of independent reports from such a reliable entity as the OECD should be used to classify countries according to their level of financial literacy, therefore causing potential restrictions of distributing complex financial products in Bulgaria or Romania, for instance. Therefore, local classification could be built according to three levels of literacy: low level (1), average level (2) and high level (3). Further analysis could be done on how to assess what levels of literacy there are in the European Union, but the mentioned report seems to be a good starting point for assuring a structure where Portuguese investors would be classified according to their knowledge level;

[110] https://www.oecd.org/education/financial-education-in-europe-9789264254855-en.htm

- Age restrictions in the distribution of financial products: as we know, different age groups may have different investment objectives. Young adults usually take more risk and look for quick/high returns regularly facing low liquidity, where matured adults tend to be less risky and look for products with stable, liquid and not volatile returns. Does that mean that banks tend to prefer educating the clients that could deliver immediate higher margins (young adults) given the complex products in which they invest? Or do banks take preference in education initiatives for longstanding clients such as the matured adults, even if they produce lower margins and have a more limited investment time? According to the OECD report, most of the financial education efforts at national level target young adults, so a balance seems to be necessary. Nevertheless, because of different risk profiles per the age of investors, I favour the introduction of potential restrictions to the distribution of investment products to matured adults. Therefore, as an example, complex products with leverage could not be sold to adults placed in pre-retirement or retirement age, given the potential for rapid erosion of the invested capital in those products. In addition, for instance, investment in risky offshore non-deliverable currencies should also be restricted to these adults, given their low (or inexistent) conversion outside the country of their origin (very poor liquidity). Going deeper into some asset classes, I would also restrict the sale of high yield funds given their typical low level of credit quality. With these restrictions, pensioners would be protected against risky investments that can seriously impact their life quality in a time when they are resting after years and years of labour;
- Asset diversification levels according to new risk indicators levels, complexity classification, literacy levels and age distribution: will all the four measures above for the KID, financial intermediaries would need to build and present a matrix to define the percentage of investment in each asset class that could be appropriate for each investor. The assets would include, amongst others, medium/long term interest rates, money markets, foreign exchange, equities, bonds and commodities, whilst the percentage would need to factor if the investment is direct or indirect (for instance, in a structured product or a fund). For example, I favour that matured adults with a low literacy level could not have more than 25% of their invested capital in non-leveraged complex products, whilst younger adults could have this percentage slightly increased, even if their literacy level is low. In another example, I would add that younger adults with high literacy could have between 50 and 75% of the invested capital in complex products such as investment in volatile commodities.

4.e Fifth Measure - Distribution Limits

Regulators in Portugal should implement more laws such as the recent CMVM Regulation No. 5/2019 that "Restricts the marketing, distribution and sale of contracts for differences and prohibits the marketing, distribution and sale of binary options in Portugal to retail investors"[111], following guidance from ESMA, with that same purpose, to be implemented throughout the European Union, given the risks associated with these highly-complex instruments. So, the sale of complex products to retail investors in Portugal should become subject to the:

- Introduction of an Investment Scoring Model (ISM) so that banks could analyse the investors profile and risk tolerance to every complex investment product that is being considered. With no human judgement, these standardized models would consider stress scenarios in order to evaluate the probability of retail clients losing their invested capital if those situations would materialise. As in the credit scoring models, the ISM would capture historical data to be input in a software so its scores could be known and implemented to the decision process of whether a bank can distribute a new investment product to a client. The final decision from the client is important but, for the purpose of the analysis, banks would need to consider that a complex investment product could be blocked to a client if the ISM score was not appropriate, potentially going against the client decision (even if she/he decides to sign and affirm that they really want that product);
- Creation of the Return-Over-Complex-Investment-To-Income (ROCITI), as a ratio between the annual income obtained in complex investment products by an individual client and hers/his natural annual compensation (for example, from salary), both being net of taxes and contributions to social security. The ROCITI would then be limited to a maximum of 5% when annual interest rates in Portugal are below 0% (as it happens currently, with 12 months Euribor quoting at -0.298% on 18th October 2019[112]) and would be limited to a maximum of 10% when annual interest rates in Portugal are quoted at or above 0%. The purpose of the ROCITI and of its limit is not to impose restrictions to the amounts earned by investments, but the ratio would help to analyse if the investor is not taking excessive risk and not really complying with his risk profile. For instance, an investor losing his employment (i.e., not being able to generate a regular salary) would not be allowed to invest his savings in complex financial products;

[111] https://www.cmvm.pt/en/Legislacao/National_legislation/Regulamentos/Pages/20190617m3.aspx?v=
[112] https://pt.euribor-rates.eu/taxas-euribor-actuais.asp

- Establishment of the Investment-To-Value (ITV), as a ratio between the amounts invested in complex investment products and the total assets under management. The ITV would then be applicable to each retail client with a bank account in Portugal and regardless of the investment and risk profiles considered by each bank. The ITV would then be limited, for investments up to 3 years, to a maximum of 15% at the time of the new investment, with that percentage being lowered to 10% for investments in longer tenors. With this measure, investments would be automatically subject to a stop-loss, a common methodology applied in trading with the objective to limit the capital loss from an investment;
- Implementation of a Central Investments Register (CRI, acronym in Portuguese for Central de Registos de Investimento), managed by the CMVM and where investors could access a database where all their financial investments and assets under management would be listed. That database would contain the measures above introduced to the KID for each investment, such as the respective classification of the risk indicator level (together with the corresponding asset diversification level), its classification level for complexity, the literacy level of the investor and any details of the investor's age restrictions. Of course, it would also include all characteristics of each investment product such as amounts, prices, tenor, risk/reward profile, risk tolerance, maximum return, maximum loss, amongst other details. Similarly to the CRC, this database could also be accessed by banks to check the overall aggregated level of investments of each individual client, so they could assess whether or not to consider a new investment (with that assessment being subject to the ISM and to the ROCITI and ITV ratios).

The measures introduced would remediate the identified problems in the processes of distributing financial products to investors, particularly targeted at helping the ones classified in retail segments. I am not looking to a complete overhaul of the current system, as much has been done already by regulations, laws and codes of good market practices, but more is needed in order to prevent that unfortunate situations happening again.

Per se, the above measures might not stop the mis-selling of financial products and services in Portugal but should significantly reduce the appetite for banks to market them aggressively and, thus, reducing the number of instances where Portuguese savers and investors suffer severe damages to their savings and, therefore, to their financial situation.

## 5. Limitations

As mentioned, the concept and drafting of this Dissertation was mainly based in empirical evidence, given my professional experience, personal interest and knowledge of the topic.

Unfortunately, in Portugal, there is no index or barometer to gauge the real level of ethics in the distribution of services (such as financial products) to investors. Therefore, this was considered a limitation to this research, as lack of ethics in these processes is real, not just a perception but where the actual number of cases is unknown.

This fact is further evidenced by the low number of claims reported to regulators and to banks on investments in complex financial products, as they are very few considering the whole spectrum of investors in Portugal and the number of products marketed by the local banks. In addition, banks located in the country are not obliged to report the specific claims related to complex financial products, and that low transparency limits the work of this thesis.

When a mis-selling event becomes known to the public, the media tends to cover it in a deep and wide manner, as companies in the sector usually amplify the "bad" news in order to increase public attendance to their vehicles and, therefore, generate revenues to their shareholders. Apart from that, there is no real public disclosure of these incidences and, generally, no further education of the "lessons learned", which may be important in order to avoid another occurrence. That is also a limitation, as it would have been useful to investigate more of these events and further explore the reasons for their existence.

It must also be said that, generally, Portuguese banks are not the original factories where these products are generated from. Frequently, given the low liquidity level of the local financial market, these banks do not run trading books in most derivatives, an essential component of complex financial products. Therefore, local banks usually buy products made at large global institutions such as Barclays Bank, Deutsche Bank, Goldman Sachs, etc., which have their own factories and are usually considered the leaders in financial products design, development and trading. Buying a product built in the United States of America might not be the best approach when we are looking to deliver it to a Portuguese investor. The low development and engagement of Portuguese banks in this area is also a limitation to this research, as not enough information is available on their real involvement in the origination of financial products.

Therefore, with all these limitations, we had to resource to personal awareness of unethical behaviors and mis-selling practices, as practical tools to support the Literature Review and the various statistics and Surveys presented in this thesis.

## 6. Further Research

The processes for distribution of financial products in Portugal are fundamental to restore investors' trust in banks and in these products as alternatives for their portfolio of investments.

The measures detailed in this thesis are supportive of the needed development for these processes, but further work is required they can help rebuilt the trust permanently.

Therefore, to assist the review of these processes, I propose further studies in the following areas:

- Investment in complex financial products by retail investors subject to independent, non-restricted advice or robot-advice only, ensuring advisors and tools are robust, properly qualified and have access to relevant information so they can properly support the investment decisions of their clients;
- Implementation of changes to investor protection schemes (such as the Fundo de Garantia de Depósitos, covering 100.000 EUR for any type of deposits), to include more layers in the amounts protected, so there is increased flexibility of amounts for specific products, such as structured products that have high risk and complexity;
- Specific and confidential interviews to commercial staff and marketing personnel of banks to investigate their practices of mis-selling and unethical behaviors (as well as the reasons for them to occur) in the distribution of financial products;
- Design, build and implement a public index for measuring ethical conduct in financial services, with a component related to investments in complex financial products;
- Analyse the specific and direct consequences for banks if they do not comply with the appropriate regulations and conduct standards related to the recommendation of appropriate investment products to clients;
- Investigate the adequacy of the existing regulatory protections that aim to safeguard clients and protect them against inappropriate purchase of complex products

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## 8. Appendix 1: Survey Results

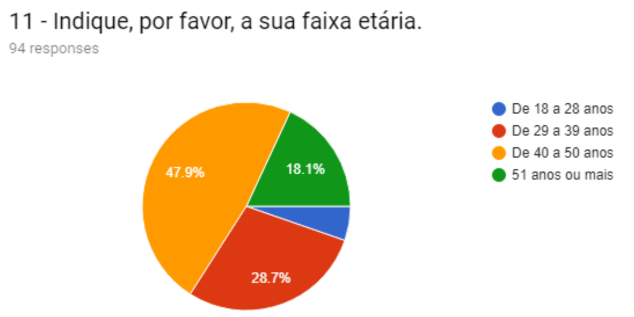
The Survey was sent via Google Forms and the 12 questions were addressed in Portuguese. The first participation arrived on 27th April and the last one on 19th May (I have imposed the time limit of one month to the Survey), with the 10 initial questions being based in the theme of this thesis, whilst the remaining 2 questions asked the age range and the experience of respondents in the financial system.

When drafting the initial questions, my immediate focus was to provide clear, multiple choice and comprehensive answering alternatives to allow respondents having enough and ample room to respond. With that, my intention was to obtain clear data to analyse for the purpose of this Dissertation. Therefore, 80% of those questions have five alternative answers presented in vertical bar charts, with the other 2 questions having four alternative answers presented in pie charts.

Those drafted questions requested opinions from respondents, not facts, statements or real situations faced by them. Also, with these questions I did not look for institutional views from respondent's employers nor of their practices, my idea was for these individuals to provide insight on their general market knowledge with relation to the challenges in the distribution of financial products in Portugal.

When publishing the Survey, I did not select individuals by age or experience in financial sector, but I was happy to see that close to 80% of the respondents had more than 11 years of experience in financial markets roles, as they have witnessed several events happening in those years (the global financial crisis is one and the EAP's impact in Portugal is another one) and have seen how the distribution of financial products evolved in those critical years.

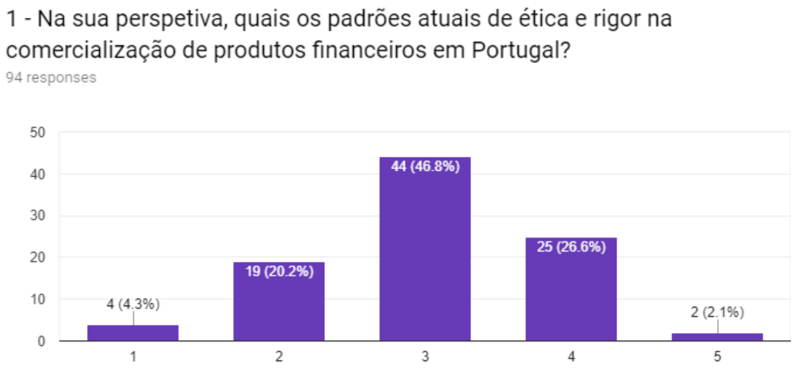
The age range of those 94 respondents was requested in the Survey, in Question **(Q) 11**:




The years of experience in roles in the financial system was also requested, in **Q12**:

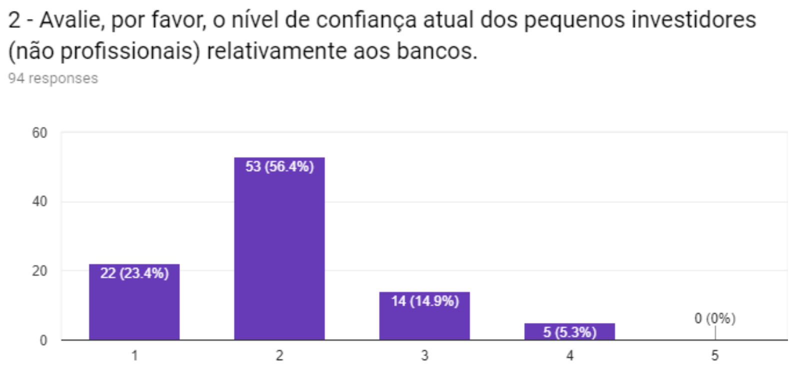

These are the 10 initial questions of the Survey, with free translation of the original in Portuguese into English:

**Q1** – In your view, what are the current ethical and rigor patterns in the distribution of financial products in Portugal? Please classify from 1 (low) to 5 (high).



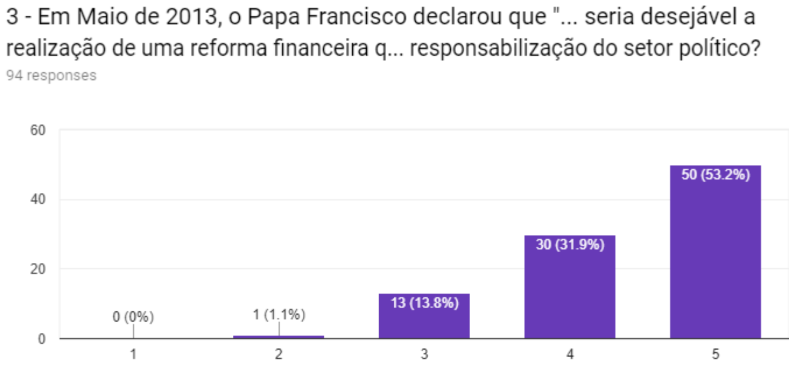

Comment on the results: Average scores, with a light skew to high patterns. Probably unsurprising as the Survey was sent to personnel with roles in banks that distribute those products to retail clients but, nevertheless, there should be no complacency here, as ethical patterns should always be high (and 71% of respondents answered average or low).

**Q2** – Please evaluate the current level of trust that non-professional investors place in banks. Please classify from 1 (low) to 5 (high).




Comment on the results: Clearly, the current level of trust is low with nearly 80% of respondents classifying it in the lowest two scores (1 and 2). None of the 94 respondents classified the current level of trust as high.

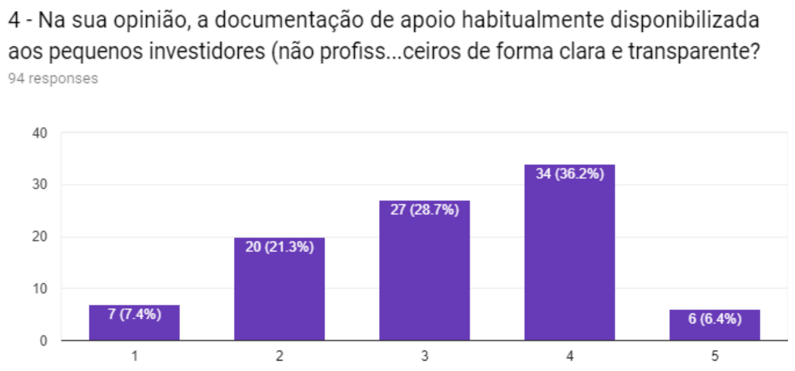
**Q3** – In May 2013, Pope Francis declared that "There is a need for financial reform along ethical lines that would produce in its turn an economic reform to benefit everyone. This would nevertheless require a courageous change of attitude on the part of political leaders." Do you agree that, for these reforms to be successful, the accountability of the political sector is essential? Please classify from 1 (totally disagree) to 5 (totally agree).




Comment on the results: 80 out of the 94 respondents (over 85%) think that the political sector must be held accountable to guarantee the success of the financial reforms. But the continuous tangle between political decisions and the implementation of regulatory decisions is not helping that needed success[113] .

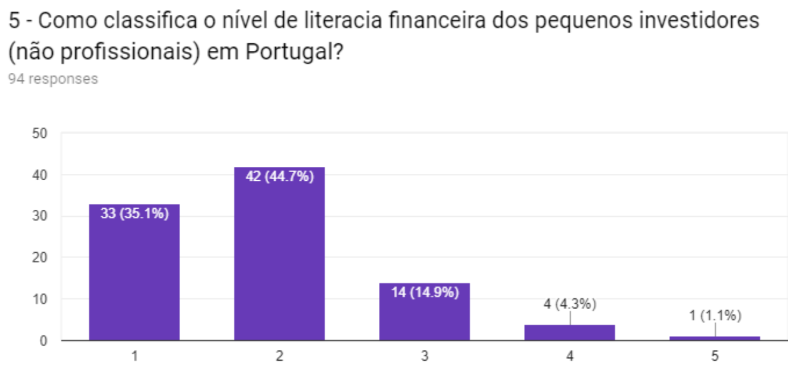
[113] The European Commission proposed the revision of the MiFID regulatory package on 20th October 2011 to the European Parliament and the Council https://europa.eu/rapid/press-release_IP-11-1219_en.htm but, after intense discussions in the trialogue, it was only published on 15th May 2014

**Q4** – In your opinion, the supporting documentation usually delivered to non-professional investors identifies the advantages and the risks of financial products in a clear and transparent format? Please classify from 1 (totally disagree) to 5 (totally agree).



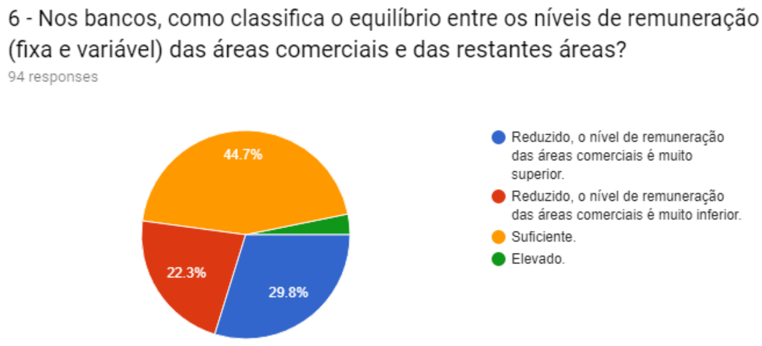

Comment on the results: For me, these are surprising results, as several investors claim that the standard documentation is too long and unprecise. I estimate that these scores are evenly distributed as some respondents do not work in areas directly related to the elaboration of these types of documentation and, therefore, might only share their experience as banking customers.

**Q5** – How do you classify the level of financial literacy of non-professional investors in Portugal. Please classify from 1 (low) to 5 (high).



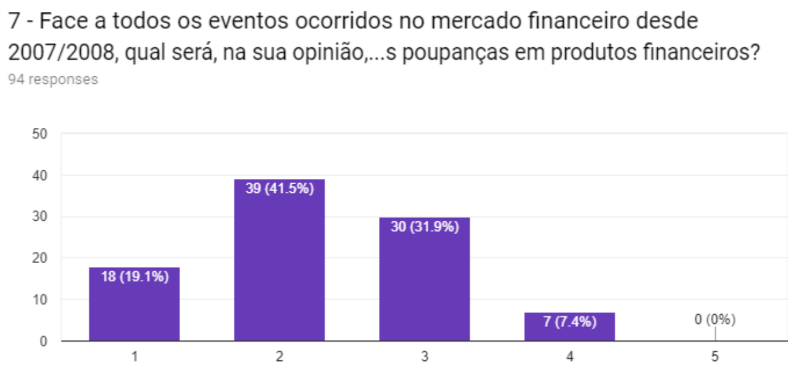

Comment on the results: No real surprises, the problem is identified, and it is real.

**Q6** – In banks, how do you classify the balance between the remuneration levels (fixed and variable) of commercial areas and other areas?



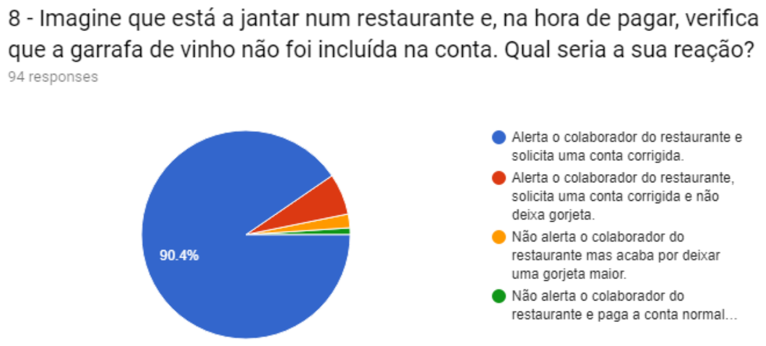

Comment on the results: Basically, 52% of respondents say that balance is low, whilst 48% say that balance is adequate or high. The fact that the results are almost evenly split only reinforces the fact that more is needed to correct the current balance towards a balanced majority, in order to prevent misbehavior, aggressive and unethical sales.

**Q7** – Given all the events happening in financial markets since 2007/2008, in your opinion what is the current appetite for investing savings in financial products? Please classify from 1 (low) to 5 (high).



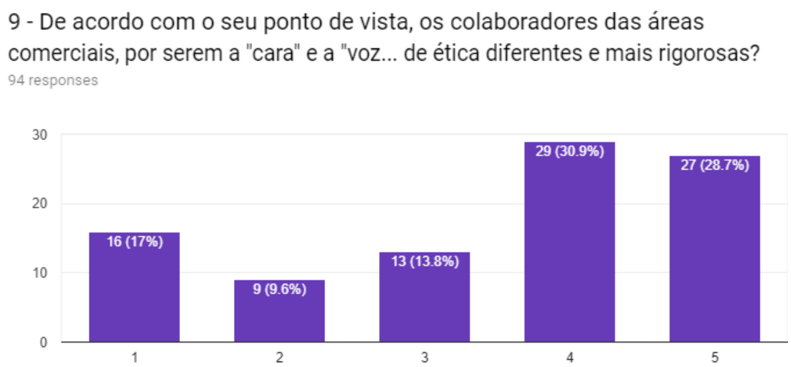

Comment on the results: 61% of the respondents thought the appetite was low in April 2016, but if we add the 'average' responses we come close to 93% of the respondents thinking the appetite to invest savings in financial products was not high, suggesting a connecting with the low levels of trust expressed in Q2 of the Survey.

**Q8** – Imagine you are having dinner in a restaurant. When the bill arrives, you notice that the wine bottle was not included in the list. What would your reaction be?



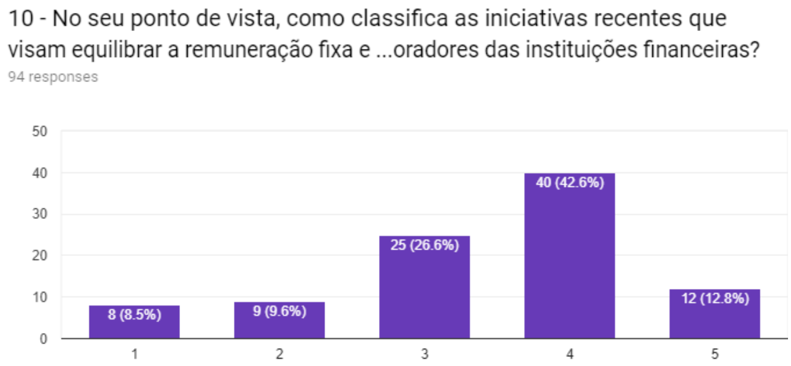

<u>Comment on the results</u>: An individual question to test the ethical behavior of each respondent resulted in a resounding demonstration of their fairness and integrity. If these results are verified in life, there is clearly hope for the financial system in Portugal.

**Q9** – In your opinion, do commercial staff, as they are the "face" and the "voice" of the banks to their clients, should be subject to different and stricter ethical and conduct procedures? Please classify from 1 (totally disagree) to 5 (totally agree).




<u>Comment on the results</u>: Balanced scores but with nearly 60% of respondents saying they agree or totally agree that commercial staff needs to be better prepared to face investors.

**Q10** – In your opinion, how do you classify the recent initiatives that are trying to balance the fixed pay and the variable pay of banks staff? Please classify from 1 (negative) to 5 (positive).




Comment on the results: Analysing the results of this question, it looks like the culture change has already started, with only 18% of the respondents answering that these initiatives are negative!