

ATTACHMENT | FINAL

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## ESA public hearing on the implementation of the EU PRIIPs Regulation

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Advance paper with summary comments by EUSIPA

### GENERAL COMMENTS:

1. The ESA Consultation Paper on PRIIPs is arguably most noteworthy for the topics which it **does not** provide detailed technical rules for. Specifically in the "What is this product" section as a core part of any product description, but also on some non-content related topics such as the updating requirement, some of the proposed RTS have the character of high level principles, especially compared to the very detailed rules proposed for the risk section and the performance scenarios. In some cases where the proposed RTS do not provide detailed rules, this could be fine as long as clarity is provided in the near future that practical implementation of the relevant requirements will be left to market participants, and **there will be no further guidelines at a later point on level 3 or from national regulators**. However, other relevant questions will in any case require regulatory answers, e. g. those concerning the determination of competent authorities in cross-border scenarios (other points include the scenarios covered by Art. 13.3 and 13.4 of the PRIIPs Regulation, grandfathering provisions and detailed specifications on the product scope of the Regulation)<sup>1</sup>.

2. In any case, it is of paramount importance especially for product manufacturers that all detailed rules which they will have to follow when producing and further processing KIDs are issued in their final form in sufficient time before the PRIIPs Regulation becomes applicable. As for UCITS KIIDs and some current national law product information sheets (such as the German PIBs), the production process will be set up in automated systems for certain product areas (in some national markets, a large number of structured products are issued to the market each year). The challenges arising in connection with setting up such systems are similar to those following from certain new MiFID 2/MiFIR rules requiring an IT based implementation. Final formal guidance on all relevant PRIIPs rules will, on a rough estimate basis, therefore be needed **substantially longer than six months** before the Regulation becomes applicable.

3. The industry represented by our association would be very happy to work together with the three ESAs in establishing relevant questions that need to be answered before product manufacturers can start drafting KIDs, and providing proposals for answers where relevant. However, given that the Consultation Paper does not cover a large number of practical

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<sup>1</sup> A further paper listing single items that need clarification will follow (such as product scope, grandfathering, KID update, main derogations from the KID provision duty, use of generic KIDs, wholesale market situations, etc.), in addition to EUSIPA's reply to the PRIIPs Consultation Paper.

questions yet, we are already highly concerned about the chances of receiving all relevant detailed rules in time for preparing all necessary KIDs until the end of next year.

4. In addition, as recognized by regulators as well as the European Commission in connection with both MiFID 2/MiFIR and PRIIPs, there are strong thematic interconnections between some of the new investor protection rules in MiFID 2 - such as cost disclosure, performance scenarios, target market and some other specific product governance requirements - and PRIIPs.

**We would therefore like to draw urgent attention to the fact that a decision to delay the implementation of the MiFID 2 investor protection rules would have strong implications for PRIIPs as well, and would in all likelihood result in manufacturers not having sufficient clarity on all content details for providing all required KIDs until the end of next year.**

#### **ON THE RISK INDICATOR:**

5. The rules proposed in the Consultation Paper do not reflect the state of discussion in the Consultative Expert Working Group (CEWG) set up by the three authorities. Whilst we understand that the authorities are in no way bound by the advice of the group, we are surprised by the lack of any reference to its findings, as well as the absence of testing the SRRI methodology on product samples prior to recommending technical choices.

6. In terms of the substance of the approach proposed in the Consultation Paper for the determination of the risk class, there are a number of general points which we find highly problematic.

7. Firstly, the Consultation Paper proposes a **mixed qualitative and quantitative approach**. In a first step, products are qualitatively assigned to different risk categories. That alone already prevents individual financial products to be compared against each other, i.e. an overall consistent risk classification. 8. Furthermore, the **product scope for this qualitative distribution** (Category I or Category V PRIIPs) **has neither been defined clearly for all product types**; in particular, there would have to be a clear statement that the term "derivatives that qualify as a PRIIP" used here does not include (structured) transferable securities.

8. The quantitative approach then applying - for most products - on the second level largely follows the methodology currently in place for the calculation of the SRRI shown in UCITS KIIDs, which was not amongst the approaches favored by the Expert Group.

9. Also, the methodology to compute the risk indicator for structured product as a VaR Equivalent Volatility (Category III PRIIPs page.38 to 40, sections 30 to 52) **refers to a principal component analysis for curves**, but the benefits of such PCA are unclear. References to a PCA should be deleted as we believe the **VaR should be simply computed with the actual market parameters and model used to price (and hedge) the product**. Using the manufacturer's

market data and model to compute the VaR of structured product falling under PRIIP Category III, is the only way to **ensure consistency between market data and a forward-looking risk indicator**.

In addition, for structured products, while the methodology refers to the SRRI, we note a significant difference in the model used to compute the VaR. The UCITS SRRI model is based on Black Scholes while the PRIIPS proposal is a bootstrap of historical returns. We wish to highlight the operational complexity of this proposed computation method which does not seem to bring a clear advantage over its UCITS equivalent. As a consequence, we would recommend using a Black Scholes model.

10. Moreover, also the scaling within this methodology has apparently been taken over from the SRRI approach. For UCITS, this methodology meant that practically all equity funds were assigned to the highest or second highest of the seven risk categories. Extending this approach to all equity-based PRIIPs would mean to create a **highly distortional effect in the form of unjustified discrimination of equity underlyings**. Ultimately, such application of the risk indicator would create a judgement bias on the retail point of sale triggering an abstention from distributing equity-linked products (which extends to both a lacking selling effort of the distributor and a diminished interest of the investor). We consider such effect to be highly unwanted. It seems in particular **contradictory to the ideas underlying the recently launched Capital Markets Union (CMU)** concept which is meant to encourage equity investment by private households so to foster long-term capital accumulation, i.e. for retirement planning, next to improving market-based finance for corporates.

11. Finally, we are concerned that not all relevant types of risks have been sufficiently been thought through yet. For example, it seems to us that the Consultation Paper does not reflect the particular aspects of credit itself as the underlying of a structured product.

#### **ON PERFORMANCE SCENARIOS:**

12. The approach proposed in the Consultation Paper requires the scenarios primarily to be based on the "recommended holding period" (which could be something like "five years"), which, for products with a fixed maturity date, would often not correspond to the latter. This would mean that the scenarios would, in the absence of payouts under the products before their maturity dates, have to be calculated based on exchange (or OTC) prices. In addition, two other scenarios would have to be displayed for shorter "interim holding periods". At least for structured securities, scenarios on this basis would be highly problematic from a methodological perspective. Figures calculated on this basis would not provide reliable statements about the expected return of a product. Instead we would suggest that, for products with **fixed maturity dates, only one performance analysis should be required with reference to such maturity date**.

13. Generally three scenarios would be required. However, different to the practice for certain national law product information documents (as the German PIB), the middle scenario would be called "moderate" and would have to be calculated based on the expected return. This kind of approach appears doubtful from a methodological perspective, as it could mislead investors to expect the realisation of that scenario with a high degree of certainty.

A better way would be to allow that the "moderate" scenario can be set freely according to reasonable discretion of the issuer, or to turn this into a "neutral" scenario. In addition, it should be possible to include more scenarios, if the structure and functioning of the product cannot be fully captured by three scenarios.

#### **ON THE COST INDICATOR:**

14. The RIY concept defined in the Consultation Paper as the difference between the annual internal rate of return for a "cost free scenario" and the annual internal rate of return of the moderate scenario is unclear because it does not relate to the concept of fair value or total costs.

Our understanding is therefore that the RIY would be computed as a Total Cost annualized, defined broadly as the Total Cost divided by the tenor of the product. This would ensure numbers in the cost table add up, and comparability with UCITs funds.

15. With regards to fair value, our recommendation would be to define it in the same way that the Issuer Estimated Value has been defined in Germany because the Consultation Paper is not fully consistent on this topic. For example, there are differences with regard to the treatment of hedging costs (general definition of "fair value" on the one hand, explicit requirement for this to be counted as cost on the other). Insofar as reference is made in the Consultation Paper to establishing the "fair value" by way of referring to the positions reported in the balance sheet of the issuer we would stress that the issuer's balance sheet **does not show the value of individual products** issued.

The proposed treatment of spreads probably needs to be readjusted at least partly (depending on the outcome of the detailed assessment of cost disclosure jointly under PRIIPs and MiFID II - discussions within the industry ongoing).

Furthermore, the holding period assumed for the presentation of costs would need to be aligned with the holding period used for performance scenarios (in case of its amendment as suggested above, using the fixed maturity date). Given the length restriction that will apply for KIDs, the presentation of the prescribed cost items in the KID would better be restricted to only one table (instead of two, as proposed in the Consultation Paper).

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