

PRIIPs – an update

DEAR READER

In this newsletter, we would like to pick up the topic of Key Information Documents (KID) for packaged retail and insurance-based investment products (PRIIPs), the regulation which was published in the Official Journal of the EU on December 9, 2014.¹ Last week on April 7, 2016, the Joint Committee of the European Supervisory Authorities (EBA, EIOPA, ESMA – together the ESAs) has published its final proposal for draft Regulatory Technical Standards (RTS) in regards to PRIIPs. These standards outline in more detail how the presentation, content, review and provision of KIDs will have to be implemented, and include the methodologies underpinning the risk, reward and costs information.²

In this newsletter, we will shed some light on remaining legal and regulatory uncertainties, operational challenges and expected impacts for financial institutions manufacturing PRIIPs and the distributors selling and/or advising those PRIIPs to retail investors.

When setting up this piece of regulation, the regulators' main objective was to create a level playing field among financial products for retail investors in regards to the product information presented to investors at point of sale. The PRIIPs KID's aim is to provide pre-contractual information in order to support the retail investors in considering and comparing options before they reach an investment decision.³ A vast range of products sold to retail investors

(including derivatives) are covered under PRIIPs. Even collective investment schemes sold to retail investors under the UCITS regime will ultimately fall under the PRIIPs regulation, but have a transition period until 2019. By then, the UCITS KIID will have to be replaced by the PRIIPs KID.⁴

The PRIIPs KID is just the tip of the iceberg seen by the client. Product manufacturers will face large operational efforts and data crunching to gather the comprehensive data necessary for proper KID production. The main challenge will be to master the volume and handle the time constraints when producing KIDs, especially if different types of products are involved, each requiring tailored data and calculation models.

The regulation has, despite the enormous impacts on operations, data and systems, a very tight time schedule.

LAYOUT AND CONTENT

According to the explanations given in the Regulatory Technical Standards, the KID is to be a short document (max. three sides of A4), written “in a consumer-friendly manner, and focused on key summary information to be provided pre-contractually, before the retail investor makes a commitment to invest in a PRIIP.” The KID is not be understood as an exhaustive product documentation, but should rather be seen as a summary document to facilitate product comparison.⁵

The PRIIPs regulation sets strict standards on the layout of the KID and pre-defines the sections it contains and the information to be included in each section. The details of

the content and information presented was partially left to the regulatory technical standards (RTS), which were now published by the ESAs.

The following topics are a selection of key issues that we would like to discuss and draw your attention to.

PRODUCT DESCRIPTION

Art. 8 lit. c (iii) PRIIPs states under the title “What is this product?”, the nature and main features of the PRIIP, including a description of the type of retail investor to whom the PRIIP is intended to be marketed.

The above description shall reflect the target market identified by the PRIIP manufacturer’s product oversight and governance processes. The PRIIP manufacturer shall take into account the financial interests, knowledge, objectives and characteristics of the types of retail investors for whom the PRIIP has been designed, including their ability to bear investment loss and their investment horizon.⁶

According to Art. 16 (3) MiFID II ⁷ product manufacturers shall be obliged to identify the potential target market for each product which implies specification of the type(s) of clients with whose needs, characteristics and objectives the product is deemed compatible.

Questions remain regarding the alignment of the target market under the two regulations. Due to lack of clear definition by the legislator, various product representatives and bodies across the EU are evaluating possible methodologies to define the target market compliant with MiFID II. First results show a technical target market specification, which is structured along six to eight parameters. As the MiFID II target

market serves an internal operational distribution suitability purpose, complexity remains with the financial institution. It is questionable whether a sophisticated target market description serves the purpose of a consumer-friendly information document.

It is out of question, that the ESAs need to provide additional guidance on the target market concept to prevent different target markets concepts by different market participants. Different target markets for the same type of product would create confusion and would contradict the goal of the PRIIPs KID.

COSTS

The cost parameters to be disclosed have been heavily discussed and are still very controversial. The costs of a PRIIP need to be disclosed as Reduction in Yield (RIY). The RIY shows what impact the total costs you pay will have on the investment return you might get. The total costs take into account one-off, ongoing and incidental costs. Each category subsumes different cost items depending on the kind of PRIIP.⁸

Great concern is caused by the transaction costs foreseen in the RTS. For example in regards to UCITS, transaction costs shall be calculated on an annualised basis, based on an average of the transaction costs incurred by the PRIIP over the previous three years.⁹ This means, the companies would not only need to archive future reference prices but also to determine historical values. In order to comply with the calculation method and compute an annual average over the last three years, product providers have to recalculate all transactions since 31.12.2013 for products in scope from 31.12.2016 and for UCITS from 31.12.2015

as they are granted a transition period until 31.12.2019

Last week the German Investment Funds Association BVI heavily criticized the proposals of the European Supervisory Authorities (ESAs). "It is particularly the plans for the calculation of transaction costs that systematically lead to wrong or even patently absurd results", says Thomas Richter, CEO of BVI.¹⁰

ESAs first proposed the introduction of a standardised table, based on longer-term market data for the implicit transaction costs (as those are arising in connection with net transactions). This proposal was discarded, the proposal now published in the RTS is a new method not customary in the market and is intended to fix the difference between the actual price upon the purchase or sale of a security and a predetermined reference price as the transaction costs. This model does not only conflict with the PRIIPs regulation but also with MiFID II and the ESAs own understanding, according to which transaction costs are third-party costs for the execution of securities transactions, but not the difference between a reference price and the actual execution price.¹¹

In less liquid markets, the draft RTS proposals would largely result in incorrect or even negative transaction costs. For example, if a government bond (Greece) with a 6.4 % coupon, maturing in 2020, was entered for purchase into a data provider system on April 7, 2016, at 9 p.m., with a reference price of 105¹² and the portfolio manager bought the security at a price of 104.125 after several inquiries with brokers, according to the ESAs approach the transaction costs would be negative in relation to the actual purchase price.

Within the insurance industry several concerns have been brought forward as well. Michaela Koller, director general of Insurance Europe, commented: "Insurance Europe is concerned that consumers will receive incorrect information about insurance products, which will wrongly appear more expensive and more risky than they actually are." Insurance-based investment products provide additional insurance protection to investors that other investments products don't. As the KID covers all products, there is not much room for individual product specifications. Without explaining that other products don't include this additional protection resp. insurance feature, the investment products seem more expensive than other products.¹³

RISK & REWARD

For the section 'What are the risks and what could I get in return' of the KID, the draft regulatory technical standards require a summary risk indicator (SRI) comprised of seven categories. Market and credit risk are the major factors of risk that have been identified, alongside liquidity risks.¹⁴

The different risk categories are assessed based on the underlying of the PRIIP and through a mapping table the final SRI is evaluated. For simple products this is straight forward, however highly diversified products or funds-of-funds most likely face operational nightmare in relation to data availability and accuracy. The SRI does not indicate a breakdown of the different risks and does not explain why the product is in the lowest or highest category.

Besides an SRI, PRIIP manufacturers shall also present performance scenarios by means of a pay-off diagram as well as a table that discloses the expected returns under different market scenarios.¹⁵ It is highly

questionable whether such information will benefit the average retail investor.

PROVISION OF THE KID

In regard to the provision, a person advising on, or selling a PRIIP shall provide retail investors with the KID in good time before those retail investors are bound by any contract or offer relating to that PRIIP.¹⁶

The RTS specify that the key information document shall be provided sufficiently early to allow retail investors enough time to consider the document before being bound by any contract or offer relating to that PRIIP, and disregarding whether or not the retail investor is provided with a cooling off period. Furthermore the person advising on or selling a PRIIP shall assess the time needed by each retail investor to consider the key information document, taking into account the knowledge and experience of the retail investor, the complexity of the PRIIP as well as the explicitly expressed urgency by the retail investor were the PRIIP is advised resp. sold upon initiative of the client.¹⁷

Knowledge and experience of the retail investor as well as the complexity of the PRIIP are already assessed within the Suitability & Appropriateness framework of MiFID II and are a prerequisite to selling a PRIIP to a retail investor. We are of the opinion, that there is room for improvement in regards to the alignment with the obligations under MiFID II.

For specific types of products (e.g. structured products/ derivatives) which are more complex, time to market can be critical as certain parameters may change over the day with markets and therefore the PRIIPs KID provided to the client in the

morning may not be executable anymore by afternoon.

Uncertainty remains on how “sufficiently early”¹⁸ will be interpreted within the different advisory scenarios across different channels and how operational processes will be aligned to consider this obligation.

According to Art. 7 PRIIPs the KID shall be written in the official languages, or in one of the official languages, used in the part of the Member State where the PRIIP is distributed, or in another language accepted by the competent authorities of that Member State, or where it has been written in a different language, it shall be translated into one of these languages.

Especially within private banking, practical questions arise from a cross border context. For example, in the case where the PRIIPs KID is not available in the language of the Member State where the PRIIPs is distributed but is available in the retail investor’s national language or correspondence language, is it possible to provide the retail investor with a KID in its national language/ correspondence language?

LIABILITY OF THE PRODUCT MANUFACTURER/ DISTRIBUTOR

According to Rec. 12 of PRIIPs the PRIIP manufacturers — such as fund managers, insurance undertakings, credit institutions or investment firms — should draw up the key information document for the PRIIPs that they manufacture, as they are in the best position to know the product. PRIIP manufacturers should also be responsible for the accuracy of the KID. Where it is impractical for the PRIIP manufacturer to draw up the key information document, it should remain possible for this task to be delegated to others.

As distributors of PRIIPs need to provide a PRIIPS KID to the retail investor, it is assumed that 3rd country products without PRIIPs will no longer be distributed in the EEA.

This will result in a spillover effect on Swiss products that are distributed in Switzerland to retail investors domiciled in the EEA. Swiss product houses could come under pressure to provide a PRIIPs KID to stay on the product shelf of distributors that have a large exposure towards EU domiciled retail investors.

If products are structured by a manufacturer by combining different PRIIPs and 3rd country products that would fall under PRIIPs if issued in the EEA, how is the liability structured? The structurer needs to rely on the underlying PRIIPs KIDs as well as on the available information of the 3rd party products. This could create great concern, especially in the insurance industry.

Retail investors that have not received a KID or have been provided with a wrong KID and which sustain damage, have good chances to withdraw the investment resp. get their original invested money back.

OPERATIONAL CHALLENGES

It is expected, that most market participants will face large operational challenges implementing the new KIDs. Collective investment schemes went already through the process of implementing the UCITS KIID which is quite similar. However, the PRIIPs KID is more challenging as it is designed for all possible retail products in the financial industry and will need much larger effort to be implemented. We see challenges with the availability of data that might need to be gathered on a retrospective basis, accounting systems need to be adapted to

provide the correct cost splits and time to market will be crucial for products like derivatives, meaning the KID needs to be created within seconds.

To reduce costs of implementation and aid the development of the KID by PRIIP manufacturers, the ESAs plan to develop detailed guidance on the methods to follow for the calculation of the SRI, the performance scenarios and the cost information to be included in the KID. The ESAs also plan to issue detailed 'FAQs' to aid in interpretation and to develop supporting level three guidelines and guidance where this is needed in view of supervisory convergence and easing of implementation.¹⁹ However, given the fast approaching implementation deadline end of 2016, PRIIPs manufacturers will likely not have the time to wait for such additional guidance.

CONCLUSION

The implementation of PRIIPs will cause some headache along the line. The impact of the regulation should not be underestimated and will likely cause massive operational impacts for certain product providers but also within distribution channels. As uncertainties regarding the calculation methods still remain and the legislative process for the ESAs' Regulatory Technical Standards will take its time, we expect that the level 2 guidelines will not be adopted before Q3 2016. This would mean, that product providers will only have a few months left to prepare the PRIIPs KIDs until they need to be available on December 31 this year. ESAs acknowledged most of the practical problems raised in the consultative process, but said not to be in the position to change the timeline or scope of the PRIIPs regulation.

The published RTS provide first clarifications, however we see need for level three guidelines and guidelines. The ESAs have promised these in due course, however in order to cope with the timeline, product providers need to act immediately and therefore are facing legal uncertainties.

We strongly advise all product manufacturers to properly assess the PRIIPs requirements as well as the derived data requirements in regards to their products. Large impacts will result from data availability and data management. Distributors should assess the different distribution scenarios and channels in regards to the availability of the PRIIPs KIDs across their retail investor product range.

Please don't hesitate to contact us in case of specific questions, more information or other inquiries.

Best Regards

Your Weisshorn Consulting Team

Footnotes

- ¹ Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs)
- ² [Http://www.eba.europa.eu/-/esas-finalise-key-information-documents-for-retail-investors-in-the-eu](http://www.eba.europa.eu/-/esas-finalise-key-information-documents-for-retail-investors-in-the-eu)
- ³ [Http://www.ftseglobalmarkets.com/news/esma-esas-issues-rtis-on-kid-under-priips.html](http://www.ftseglobalmarkets.com/news/esma-esas-issues-rtis-on-kid-under-priips.html)
- ⁴ Regulation (EU) No 1286/2014, PRIIPs Art. 32
- ⁵ JC 2016 21, final draft regulatory technical standards in accordance with regulation (EU) No 1286/2014, 31.03.16, page 6
- ⁶ Joint Consultation Paper PRIIPs Key Information Documents, 11.11.2015, p. 23.
- ⁷ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
- ⁸ JC 2016 21, final draft regulatory technical standards in accordance with regulation (EU) No 1286/2014, 31.03.16, page 75 f.
- ⁹ JC 2016 21, final draft regulatory technical standards in accordance with regulation (EU) No 1286/2014, 31.03.16, page 58
- ¹⁰ [Https://www.bvi.de](https://www.bvi.de), Press release 07/04/2016
- ¹¹ [Https://www.bvi.de](https://www.bvi.de), Press release 07/04/2016
- ¹² For illustration purposes only, quotes have not been calculated
- ¹³ [Http://www.actuarialpost.co.uk/article/proposed-priips-kid-will-mislead-consumers-9339.htm](http://www.actuarialpost.co.uk/article/proposed-priips-kid-will-mislead-consumers-9339.htm)
- ¹⁴ JC 2016 21, final draft regulatory technical standards in accordance with regulation (EU) No 1286/2014, 31.03.16, page 3 & 6¹ JC 2016
- ¹⁵ Final draft regulatory technical standards in accordance with regulation (EU) No 1286/2014, 31.03.16, page 51
- ¹⁶ Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014, Art. 13 (1)
- ¹⁷ JC 2016 21, final draft regulatory technical standards in accordance with regulation (EU) No 1286/2014, 31.03.16, page 24
- ¹⁸ JC 2016 21, final draft regulatory technical standards in accordance with regulation (EU) No 1286/2014, 31.03.16, page 24
- ¹⁹ JC 2016 21, final draft regulatory technical standards in accordance with regulation (EU) No 1286/2014, 31.03.16, page 9

Contact us:

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