PRIIPs update

December 2015

The European Supervisory Authorities have now published the draft regulatory technical standards on PRIIPs – these pose significant challenges to firms for compliance by 1 January 2017.

INTRODUCTION

On 11 November 2015 the Joint Committee of the European Supervisory Authorities ("ESAs") published a consultation paper[1] containing draft regulatory technical standards ("RTS") on risk, performance scenarios and cost disclosures in Key Information Documents ("KIDs") for Packaged Retail and Insurance-based Investment Products ("PRIIPs"). The consultation paper poses 28 questions to industry stakeholders and comments are sought by 29 January 2016. This Briefing Note highlights the key challenges for firms in complying with the proposed rules.

The RTS will be submitted to the European Commission by 31 March 2016. By 1 January 2017, PRIIP manufacturers must prepare and publish KIDs for each PRIIP they manufacture, and from that date those selling or advising on these PRIIPs must provide KIDs to retail investors.

PRIIPs cover the range of investment products marketed to retail investors, a market estimated to be worth €10 trillion in funds under management in the EU. They include:

- insurance-based investments (unit-linked and with-profit products)
- investment funds such as UCITs and Alternative Investment Funds
- structured products
- derivatives

Products excluded from the scope of PRIIPs include occupational pensions, traditional annuities, pure life insurance products and simple deposits.

A lack of clarity still remains regarding the applicability of the requirements to products generally referred to as 'personal pensions'. The primary regulations provide for an exclusion for pension products which *"under national law are recognised as having the primary purpose of providing the investor with an income in retirement and which entitle the investor to certain benefits"*. In many territories products sold by insurers and other providers are classified as pension products for tax purposes but which are effectively no different to other forms of investment products that fall within the scope of PRIIPs. In particular they may have little or no commitment as to the form of benefits post-retirement.

The ESAs (EBA, EIOPA and ESMA) also published the results of consumer studies that have informed their drafting of the RTS. We have highlighted some interesting results of these studies.

PROVISION OF THE KID

The KID is a pre-sale information document. It must conform to a mandatory template, including certain mandatory text. The specified template is in Annex I of the draft RTS.

The KID is presented as a series of questions as follows:

- "What is this investment?"
- "What are the risks and what could I get in return?"
- "What happens if the product manufacturer is unable to pay out?"
- "What are the costs?"
- "How long should I hold it and can I take money out early?"
- "How can I complain?"
- "Other relevant information"

The KID must be provided sufficiently early for a retail investor to be able to take its contents into account when making an investment decision. The timing of the delivery of the KID can vary depending on the PRIIP in question and the needs of the retail investor.

[1] Link to PRIIPs draft RTS on EBA website

The KID must be adapted to the target market identified by the PRIIP manufacturer.

Regarding insurance-based investment products, the details of insurance benefits must include a summary of each benefit, the proportion of the overall PRIIP´s premium to be used for these benefits and the duration of these premiums.

DISCLOSURE REQUIREMENTS

The requirements regarding provision of information cover three main disclosure sections in the KID:

- construction of a risk indicator
- performance scenarios
- cost disclosure

General background product information must be provided giving a clear and easy to understand summary of the objectives of the PRIIP and the means for achieving them, describing the main factors upon which investment return depends.

1. Construction of a risk indicator

A summary risk indicator ("SRI") is to be provided in a section headed 'What are the risks and what could I get in return?' This section further outlines in narrative form what risks are involved for the retail investor in purchasing the PRIIP and the expected return.

Market risk and credit risk are considered for the overall risk indicator. The SRI comprises 7 potential classes, where 1 indicates the lowest risk class and 7 indicates the highest risk class. Further warnings must be included where there is material liquidity risk.

The risk must be assessed on the basis that products are held to maturity or a recommended holding period.

For certain products additional warnings must be included. For example, in the case of the risk of the product being significantly higher if not held to maturity or the recommended holding period, the PRIIP manufacturer must insert a warning about this fact.

The SRI is determined based on a matrix combining a market risk measure ("MRM") and a credit risk measure ("CRM") as shown below:

	MRM class						
CRM class	MR1	MR2	MR3	MR4	MR5	MR6	MR7
CR1	1	2	3	4	5	6	7
CR2	1	2	3	4	5	6	7
CR3	3	3	3	4	5	6	7
CR4	5	5	5	5	5	6	7
CR5	5	5	5	5	5	6	7
CR6	6	6	6	6	6	6	7

It should be noted that there is no explicit link made in the SRI between risk and reward.

<u>MRM</u>

The MRM is broken down into 7 of its own classes.

Certain product types (referred to as Category I) are allocated directly to an MRM class as follows:

- Class I – where at least the amount invested is guaranteed at the end of the recommended holding period
- Class 7 – where investors could lose more than the amount invested or derivatives classified as PRIIPs

The MRM is based on a 2.5% Value-at-Risk ("VaR") for investment funds[2], structured products and insurance products. The VaR is defined as *"the total return at the 2.5% quantile discounted to the present using the risk free rate divided by the capital investment minus one. This represents the return per invested monetary unit at the 2.5% quantile"*.

To assist in determining the VaR a standardised measure is used referred to as the annualised VaR-equivalent volatility.

The VaR-equivalent volatility is based on different approaches depending on the nature of the PRIIP:

- For investment funds (such as UCITs and AIFs) and non-guaranteed unit-linked insurance products it is based on 5 years' historical performance.
- For structured products and guaranteed insurance products (both unit-linked and with-profit) it is based on a forward simulation calibrated to historical performance. These are referred to as 'Structured PRIIPs'.

  The minimum number of simulations is 10,000. A bootstrap methodology is specified to produce the forward simulation which is

[2] UCITs (but not AIFs) are exempt from the requirements until 2020 as the existing UCITs regulations already provide for a Key Investor Information Document

complex (including for example a ‘principle components analysis’ for projection of relevant interest rate yield curves)

Once the VaR-equivalent volatility is determined the MRM class is assigned to the following ranges:

MRM class	Annualised volatility
1	< 0.5%
2	0,5% - 2.0%
3	2.0%-5%
4	5%-10%
5	10%-15%
6	15%-25%
7	>25%

Where there is a lack of appropriate data (as specified in the draft RTS) for investment funds, structured products or insurance products the MRM class is assigned as follows:

Product/ PRIIP Type	MRM class
Money market funds	2
Government bond funds	3
Corporate bond funds	4
Broad based equity funds	5
All other funds, structured PRIIPs (which do not fall into category I))	6

There are further specifications in the draft RTS with regards to illiquid investments.

<u>CRM</u>

Credit risk is assessed where the return of investment depends on creditworthiness of the manufacturer or another party bound to make a payment on a look-through basis.

A PRIIP must be allocated to a credit risk class on an increasing scale ranging from 1 to 6 based on credit ratings with an adjustment for credit risk mitigating factors (such as collateral). The following table shows the credit risk classes depending on the credit quality step:

credit quality steps	credit risk class
0	1
1	1
2	2
3	3
4	4
5	5
6	6

The credit quality steps are determined in line with the following table:

Default probability Matrix (Fitch)		Agency ratings	Credit Assessment ranges reflecting credit quality steps
1 year	5 years		
0,04%	0.28%	AAA Y AA	0 or 1
0.08%	0.69%	A	2
0.22%	1.96%	BBB	3
1.15%	8.10%	BB	4
2.22%	15.37%	B	5
28.07%	58.70%	CCC or less	6

The draft RTS further specify a detailed table of credit quality steps for other credit rating agencies.

Alternative Investment Funds (“AIFs”) and UCITs are generally allocated to CRM Class I.

Where an entity is unrated then the PRIIP should be allocated to the CRM Class 3 if the entity is a regulated as a credit institution or an insurance undertaking equivalent to European regulation. Otherwise it should be assigned to Class 5.

2. Performance scenarios

‘What if’ scenarios in tabular format are the favoured approach for illustrating future performance.

Possible performance must be shown for three scenarios over different time periods. The performance scenarios should be defined for the recommended holding period, and at an early stage and an intermediate stage when appropriate.

The three standard scenarios represent an unfavourable scenario, a moderate scenario and a favourable scenario. An additional scenario must be included where significant downside risk is not illustrated by the other three scenarios.

For insurance products, an additional performance scenario must be included reflecting the return if a covered insurance event occurs within the moderate scenario.

The performance is to be shown net of costs (see below).

A further section should cover default risk either by the manufacturer or the underlying investments and whether or not there are any mitigants against this risk such as an investor compensation scheme.

There is no personalisation of performance illustrations. The performance is to be presented in monetary units corresponding to an investment size of €1,000 for investments other than insurance-based products, €15,000 for single premium insurance-based investment products or €1,000 per annum for regular premium insurance products.

Performance must also be shown in percentage terms as the average annual return.

For with-profits insurance business a reasonable projection of future bonuses can be included in the scenarios.

Good governance over the appropriateness of scenarios must be established and maintained. The manufacturer must 'demonstrate the reasonableness and appropriateness of their approach'. Signposting must be provided in the KID to where further information on the scenarios can be found.

There will be guidelines setting out detailed requirements on the assumptions that should be used for performance scenarios.

3. Cost disclosure

This section should contain information on the costs including two tables entitled 'Costs over time' and 'Composition of costs', as detailed in Annex VII to the draft RTS.

> The cost figures include a standardised summary breakdown of the different cost components, aggregated cost figures, and a presentation of the accumulation of the costs in monetary and percentage term.

A single figure must be shown as the summary cost indicator of the total aggregated costs of the PRIIP. The ESAs have favoured the Reduction in Yield ("RIY") approach for this.

The following graphic shows the prescribed table of 'costs over time':

Investment amount [€]	If you cash in after [short term] year	If you cash in after [medium term] years	If you cash in after [recommended holding period] years
One-off costs	€[]	€ []	**[]**
+ Recurring costs	€ []	€ []	**[]**
+ Incidental costs	€ []	€ []	**[]**
= Total costs	€ []	€ []	**[]**
RIY	[]%	€ []%	**[]%**

The following graphic shows the prescribed table of 'composition of costs':

<table>
<tr><td rowspan="2">One-off costs</td><td>Entry costs</td><td>[]%</td><td>Impact of entry costs taken before investment</td></tr>
<tr><td>Exit costs</td><td>[]%</td><td>Impact of costs taken when you exit the investment upon maturity</td></tr>
<tr><td rowspan="2">Recurring costs</td><td>Portfolio transaction costs per year</td><td>[]%</td><td rowspan="2">Impact of recurring costs taken from your investment each year</td></tr>
<tr><td>Other recurring costs per year</td><td>[]%</td></tr>
<tr><td>Incidental costs</td><td>Performance fees</td><td>[]%</td><td>Impact of performance fees</td></tr>
</table>

The impact of early exit charges must also be shown in this section.

Annex VI to the draft RTS contains considerable detail on the types and categorisation of costs, and treatment of disclosures for specific costs such as transaction costs and performance related fees on investment funds, and those borne on structured products and insurance products.

There has been broad criticism in the past of referring to the biometric risk premium on insurance products as a 'cost'. The draft RTS require the difference between the biometric risk premium charge and the fair value of the associated benefits to be included in the aggregate costs. Manufacturers would be permitted to just disclose the full biometric risk premium charge given the potential burden of having to estimate a fair value. Clearly there is a strong incentive for insurers to only use this option for products with marginal insurance cover since it leads to an overestimation of costs.

The consultation also seeks further feedback on possible ways of illustrating insurance benefits and costs.

MULTI-INVESTMENT OPTIONS

Articles 12 through 15 outline what and how information needs to be presented where a PRIIP offers different underlying investment options e.g. insurance unit-linked fund offerings. The manufacturer has to choose between two approaches according to which is more appropriate to the retail investor.

In the first approach, the PRIIP manufacturer would produce separate KIDs for each option, containing information about the PRIIP in general and about the option in particular.

In the second approach, the PRIIP manufacturer would separate the information that would normally be in a single KID. The PRIIP manufacturer would instead produce a generic KID for the PRIIP in general, and then provide specific information about the options (including on their description, their risks and rewards, and their specific costs) within a separate document or documents.

Particular adaptations to the generic KID that must be made in the case of supplying separate underlying investment option KIDs include:

- that it must contain the range of the lowest to highest SRI risk classifications of the potential underlying options
- that it explains how the performance of the PRIIP as a whole depends on the underlying investment options instead of showing the performance scenarios (which must be shown in each of the underlying investment option KIDs)
- that it shows the range of the recurring and incidental costs for the PRIIP and show the range of the total aggregated cost figures

The draft RTS would appear to give some flexibility as regards the level of detail that is required on underlying investment options in terms of presenting them as a range of 'investment profiles'. This may alleviate the need to produce individual KIDs for each underlying investment of 'open-architecture' product offerings which had been feared by industry – these structures can provide access to thousands of underlying investments.

ONGOING MANAGEMENT OF KIDS

Articles 16 to 20 of the draft RTS cover review, revision and republication of the KID. At a minimum the KID must be updated at least every 12 months.

Where the manufacturer becomes aware of something that might affect the accuracy of an existing KID it must review the KID 'without undue delay'. The KID must be published on the PRIIP manufacturer's website within 5 days of its finalisation.

Reasons that might give rise to the re-issuing of a KID include:

- emergence of new market data – market data must be monitored and if the MRM class would have been different over the majority of dates in the prior four months then the new MRM class should be used and consideration given as to whether the KID should be updated (i.e. if the overall SRI rating changes)
- likewise a change in CRM class must be monitored and a change in its class must prompt an update to the KID
- any change in investment strategy must always prompt a review
- a change of postal address of the manufacturer

CONSUMER TESTING

In the lead up to developing the draft RTS field studies have been carried out by the ESAs in collaboration with the European Commission to assess consumers' abilities to understand various ways of presenting investment related information. The questions posed to consumers were aimed at eliciting (i) their engagement with the material, (ii) their understanding of the material, and (iii) their ability to use the material to make comparisons between products. The main conclusions from the studies included:

- simpler approaches were generally understood better than more complex approaches
- a one-dimensional format for the SRI was more successful in leading to good decisions. A neutral colour format was preferred over for example a red to green rating to avoid the higher risk rating classes being necessarily associated with a danger warning which may not be appropriate

- in demonstrating performance scenarios probability measures or funnels of doubt did not perform well. In fact a simple tabular approach was most successful. Only showing net returns in the performance scenarios was also preferred.

Most difficulty for consumers was seen in the area of capital guarantees (e.g. failure to understand what was guaranteed and what was not), understanding of likelihood of performance scenarios and an appreciation that cost disclosures could be estimates.

CHALLENGES AHEAD

Firms should expect that implementation of the KID requirement will be costly and require a significant amount of resource and planning.

We see significant challenges ahead for firms in successfully meeting the requirements in time for the 1st January 2017 deadline. Major challenges include:

- significant data gathering exercises on past performance, cost allocations, credit ratings, risk profile, etc.
- achieving consistency with other existing product literature
- building of simulation models needed to produce the SRI
- development of governance structures around the assessment of appropriateness of risk ratings, determination of recommended holding periods and target customers, signing-off of complete KIDs, etc.
- improvement of documentation management systems and dissemination of KIDs
- drafting skills to write KIDs in clear and understandable language and in the appropriate language for the target market
- training of advisors on how to use the KID with their clients

HOW MILLIMAN CAN HELP

A PRIIPS implementation project needs to be on the agenda now for product manufacturers and detailed planning should begin setting out how the various requirements can be met with ongoing milestones to achieve success. We can assist you across various tasks including:

- carrying out a gap analysis and development of a roadmap to successful implementation
- computing the PRIIP's SRI by identifying and analysing the risk class of the PRIIP and support you in setting out the PRIIP´s risk and reward profile
- developing appropriate performance scenarios
- reviewing ongoing appropriateness of SRI and the performance scenarios in light of emerging experience
- analysing cost allocations and developing the cost disclosure tables
- review of completed KIDs

Our consultants have been involved in advising our clients on product disclosures both domestically in Ireland and across the EU market in many territories. We have undertaken a wide range of work for clients including:

- Reviewing and drafting product disclosure information
- Reviews of benefit, risk and cost descriptions over a wide range of insurance products
- Preparation and review of tables of benefit and cost illustrations
- Assisting with development of governance structures including in the area of product development and distribution

As a result, we have a wide range of experience that can be brought to bear to benefit your business.

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