

PRIIPs Level 3 Q&A

An overview of the European Supervisory Authorities' first set of Q&A for PRIIPs

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On the 4th July 2017 the Joint Committee of the European Supervisory Authorities (ESAs) published its first set of Q&A regarding interpretation of the [PRIIPs Level 2 Regulatory Technical Standards or RTS](#). The Q&A (which listed 72 questions and answers) is focussed on technical matters linked with the presentation, content and review of the Key Information Document (KID), including the methodologies underpinning the risk, reward and costs information. This briefing note summarises our views on the main points of interest in the Q&A.

The European Commission (EC) has also recently published a [communication on Level 1 issues](#) which we have summarised in a separate [Milliman briefing note](#).

Introduction

The Q&A is targeted at more technical methodological issues rather than the main scope and KID dissemination issues covered in the EC's Level 1 communication.

There questions and answers in the Q&A cover the following broad areas (the number of questions in each section is indicated in brackets):

Market risk assessment (17)	Methodology for assessing credit risk (8)
Summary Risk Indicator (1)	Performance Scenarios (2)
Derivatives (4)	Methodology for the calculation of costs (40)

Market risk assessment

- Firms must follow the appropriate classification methodology set out in the RTS when deciding where a product fits in the four Market Risk Measure (MRM) categories. Firms cannot voluntarily decide to include a PRIIP in any particular MRM category. This precludes, for example, just classifying a product under Category 1 in order to avoid carrying out detailed calculations regarding the MRM.
- For insurance-based investment products which do not fall into Category 4, the categorisation only depends on the characteristics of the payoff of the PRIIP and the availability of past performance data.
- It is confirmed that insurance products with investment guarantees are very likely to fall into Category 3 or 4 and therefore require monte-carlo simulations of potential future performance.
- Where there are risk or cost sharing mechanisms (e.g. with-profits style business) in an insurance-based investment product it would indicate the PRIIP should be included under Category 4 (i.e. with-profits style business).
- When deciding whether a PRIIP exhibits non-linear performance characteristics a materiality assessment may be made as to whether the overall payoff structure is non-linear in determining the product's categorisation. This affects whether a monte-carlo simulation approach needs to be followed or not.
- A PRIIP must meet the minimum past performance data requirements (either actual or benchmark/proxy data) in order to avoid being included under Category 1. For example, a newly launched fund where there is no appropriate benchmark/proxy would have to be included under Category 1 even if the fund is mandated to target a specific level of volatility. In this situation the MRM defaults to a high level of 6 on the 1-7 range.
- Annex II paragraph 14 of the RTS relates to the calculation of the MRM for Category 2 products which "are managed according to investment policies or strategies that pursue certain reward objectives by participating through flexible investment in different financial asset classes". The answer to Question 10 in the Q&A clarifies that where there has been a material change in the investment policy then the past performance data is not directly relevant to the determination of the MRM.

In such an instance the MRM should be determined based on the maximum of (a) the VAR Equivalent Volatility (VEV) of "the returns of the pro-forma asset mix that is consistent with the reference asset allocation of the fund at the time of the computation" and (b) "the VEV which is consistent with the risk limit of the fund, if any and appropriate."

A rebalancing of asset allocations according to an existing investment policy is also clarified as not being a material change in the investment policy.

The answer to Question 17 states that for a fully protected product the present value of the redemption value can be used as a floor in determining the MRM even where there is insufficient past performance data. With regard to the performance scenarios in such an instance, it seems implied that “a reasonable and conservative best estimate of the expected values for the performance scenarios” should be used in accordance with RTS Annex IV paragraph 18 as the product would fall into Category 1 given the insufficient past performance data.

Methodology for assessing credit risk

- It is confirmed that in all instances a look-through approach should be followed (and adopting a cascade assessment where necessary) subject to a 10% of overall NAV threshold with regards to individual exposures.

Note: a “look-through” approach means for PRIIPs which are exposed to underlying investments which themselves entail credit risk or in turn make underlying investments that entail credit risk, the credit risk should be assessed in relation to the credit risk entailed both by the PRIIP itself and the underlying investments. In the case of credit risks assessed on a “cascade” basis, all credit risk exposures should be separately assessed, per layer, and the credit quality step assigned should be the highest credit quality step (i.e. worst credit quality).

- The Credit Risk Measure (CRM) may affect the brief explanation of the classification of the risk of the product included with the Summary Risk Indicator (SRI). Therefore, it should always be calculated, even for PRIIPs with an MRM of 6 or 7 (for which the SRI equals the MRM and is not dependent on the CRM).
- The answer to Question 25 clarifies that a CRM of 2 would be expected to apply to a PRIIP issued by an insurer that is subject to the Solvency II Regulation and complies with the minimum capital requirement thereunder at the time of issue. For such an insurance-based investment product the manufacturer still needs to follow the look-through approach and adopt a cascade assessment where necessary in respect of the PRIIP as a whole.

Summary Risk Indicator (SRI)

The answer to Question 26 confirms that the ‘currency risk’ warning only needs to be included where the currency of the PRIIP and the currency where the product is being marketed differ. Underlying market risk within the associated investments in connection to currency exchange rate movements is reflected in the MRM.

Performance scenarios

Two minor points are made regarding the intermediate holding periods for products and the presentation of regular savings plans.

Derivatives

This section of the Q&A comments on the possibility of providing representative KIDs for groups of similar derivatives, enhancing the presentation of pay-off graphs and the extent to which derivatives not traded on an exchange might be treated in a similar manner to those that are. Emphasis is placed on the overall requirement for KIDs to be accurate, fair, clear and not misleading and reflect contract terms and relevant market conditions. It is noted that the requirement to be fair and not misleading may require a KID which represents a range of maturity dates (e.g. 3 to 6 months) for the derivative and, for example, to contain performance scenarios and costs information reflecting the worst outcome for the investor within each maturity range.

Costs

This is the most extensive section of the Q&A. It is subdivided into sections covering costs disclosure for investment funds, PRIIPs other than investment funds (e.g. structured products) and insurance-based investment products, as well as transaction costs.

The highlights include:

- Transaction taxes (e.g. stamp duties) and VAT should be reflected in the cost calculations where applicable. Taxes directly paid by the investor do not have to be reflected in a KID. The RTS requires that firms should state within the performance scenarios section “The figures do not take into account your personal tax situation, which may also affect how much you get back.” It is unclear how taxes ‘deducted at source’ should be treated (for example premium taxes and exit taxes deducted by insurers in some case).
- A full look-through approach is necessary in estimating costs albeit the first layer of costs may be sufficient in so far as a look-through approach has already been applied to that layer if a KID is prepared for each of the underlying investments.
- It is reiterated that the specified application of the Reduction in Yield method must be followed rather than a more approximate method in respect of spreading entry and exit costs, for example.
- The transaction costs methodology is explained in some detail. It is expected that firms will apply the detailed methodology for existing funds including sourcing information for historic trades on the “arrival price” and the settlement price with a simplification of using opening prices or previous day closing prices for the arrival price where intra-day prices are unavailable. Individual transactions may have incurred negative transaction costs on this basis and should be included in the overall calculations as negatives. The resulting aggregation of transaction costs over the prior three years should then be reflected as an annualised average cost in calculating the Reduction in Yield effect to be shown in a KID. This

- Reduction in Yield should be shown as negative where calculated as such without being set to zero.
- For existing PRIIPs where complete transaction cost data has not been historically recorded prior to 2018 there is still an onus on firms to seek relevant data from market data sources where possible.
- For insurance-based investment products, any applicable performance fees within underlying investments should be reflected in the other ongoing costs line, not on a separate performance fee line in the “composition of costs” table.
- All cost ratios must be calculated at least once a year.

How Milliman can help

We have been monitoring PRIIPs developments since the outset of the project and our consultants have been involved in advising our clients on product disclosures both domestically in Ireland and across the EU market over the last number of years.

We have undertaken a wide range of PRIIPs work for clients including:

- PRIIPs scoping
- End-to-end production of complete KIDs
- Production of quantitative elements of KIDs including risk ratings, performance scenarios and cost disclosures
- Data sourcing and data quality review for KID production
- Review of KID elements including narratives and numerical disclosure tables
- PRIIPs implementation planning and project management
- Checking of overall compliance with the PRIIPs requirements

As a result, we have a wide range of relevant experience that can benefit your business.

For more information contact your usual Milliman consultant or one of the contacts listed below.



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