



Advice to ESMA

Response to the ESAs Joint Consultation Paper concerning amendments to the PRIIPs KID

Executive summary

On 16 October 2019 the ESAs published the Joint Consultation Paper concerning amendments to the PRIIPs KID. The ESAs Joint Consultation Paper proposes amendments to the PRIIPs Delegated Regulation aiming at (i.) allowing the appropriate application of the PRIIPs KID by UCITS and relevant non-UCITS funds; and (ii.) addressing the main regulatory issues that have been identified since the implementation of the PRIIPs KID.

The SMSG has always been a strong supporter of the overall aim of the PRIIPs Regulation: it is the first “horizontal” EU set of investor protection rules that encompasses both traditional and insurance-based retail investment products, and that aims at providing investors with an information document that enables them to understand and compare the key features and risks of a PRIIP.

In the last few years the SMSG has provided several opinions on the PRIIPs KID. In December 2018, the SMSG commented the Joint Consultation Paper issued by the ESAs in November 2018 on targeted amendments to the PRIIPs Delegated Regulation, highlighting serious issues in the PRIIPs framework.

The SMSG is aware that most of the issues that were raised on previous occasions and in this Advice need to be dealt with in the Level 1 Regulation. The SMSG therefore believes that an interim targeted review (quick fix) of the Level 2 Regulation is no substitute for the necessary review of the PRIIPs Level 1 Regulation. The SMSG highlights a potential conflict in the timing of the amendments to the PRIIPs Delegated Regulation: the amendments to the Level 2 Regulation could occur prior to the expected review of the Level 1 Regulation. In order to avoid constant changes to the regulatory framework, the SMSG advises that any amendments to the PRIIPs KID resulting from this consultation should not be implemented until the Level 1 review will be finished.

The SMSG believes that performance scenarios should only be presented when this is appropriate, meaning that they provide information reliable, clear and meaningful for retail investors. The SMSG considers that any review of performance scenarios should aim to achieve an appropriate balance between the cost of implementation and the enhanced disclosure value to investors, taking into account the reliability of the information provided by performance scenarios.

The SMSG strongly recommends the inclusion of past performance in the PRIIPs KID for all products except structured products. The SMSG is well aware that past performance is not an indicator for future performance, and that it may be prone to cognitive biases. Therefore, any information on past performance should be accompanied with the clear warning that past performance is of no utility to predict future performance.

The SMSG believes that the term “RIY” itself is not intelligible to most EU savers and may not comply with the MiFID requirement for information to be understood by the average member of the group to whom it is directed. The SMSG is also not in favour of the inclusion of the RIY in the KID for products for which the concept does not seem to be appropriate (i.e., for products other than insurance products) and suggests to consider simplified methods to measure implicit transaction costs.

In this Opinion the SMSG also provides some alternatives and technical solutions with respect to the probabilistic performance scenarios proposed by the ESAs as well as on illustrative scenarios.

I. Background

1. The key information document (“**KID**”) is a mandatory, three-page A4 information document to be provided to consumers before purchasing packaged retail and insurance-based investment products (“**PRIIPs**”). PRIIPs include investment funds, structured products, unit-linked and with-profits life insurance contracts, and structured deposits.
2. The aim of the KID is to provide the European Union's consumers with consumer-friendly information about the key features of investment products, including what they might gain if they invest, the risks they are taking, and all the costs they will have to incur, with the ultimate aim of improving transparency and comparability between products in the investment market¹.
3. On November 26, 2014 the European Parliament and the Council of the European Union adopted Regulation (EU) 1286/2014 (“**PRIIPs Regulation**”)². The PRIIPs Regulation defines the main rules and principles on KIDs. It also mandated the European Supervisory Authorities (“**ESAs**”) to develop Regulatory Technical Standards on the content and presentation of the KIDs, as well as on the timing of delivery of the KIDs.
4. The Regulatory Technical Standards were adopted by each of the ESAs' Boards of Supervisors in April 2016 and subsequently endorsed by the European Commission in June 2016 in the form of a Delegated Regulation. In September 2016, during the scrutiny period, the European Parliament objected to the proposed rules and requested changes in a number of specific areas.
5. The European Commission adopted a revised Delegated Regulation in March 2017 with amendments to address the concerns expressed by the European Parliament. This enabled the final rules to be published on 12 April 2017 as European Commission's Delegated Regulation (EU) 2017/653 (“**PRIIPs Delegated Regulation**”)³.

¹ See: <https://esas-joint-committee.europa.eu/Pages/Activities/Packaged-Retail-and-Insurance-Based-Investment-Products.aspx>.

² 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).

³ Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents.

6. The KID needs to be provided by those who produce or sell packaged retail and insurance based investment products to retail investors since 1 January 2018, while UCITS products have an exemption until December 31st 2021 (as detailed later in §9).

II. ESAs Joint Consultation Paper on PRIIPs KID

7. On October 16, 2019 the ESAs published the Joint Consultation Paper concerning amendments to the PRIIPs KID (“**ESAs Joint Consultation Paper on PRIIPs KID**” or simply “**ESAs JCP**”).
8. The ESAs JCP proposes amendments to the PRIIPs Delegated Regulation aiming at:
 - a. allowing the appropriate application of the PRIIPs KID by UCITS and relevant non-UCITS funds;
 - b. addressing the main regulatory issues that have been identified since the implementation of the PRIIPs KID.
9. With respect to §8.a. above, the PRIIPs Regulation provides a temporary exemption for management and investment companies and persons advising on, or selling, UCITS from the obligation to produce and provide a PRIIPs KID (Article 32). For such funds, a Key Investor Information (KII) document is currently provided to investors in accordance with Directive 2009/65/EC⁵ (“**UCITS Directive**”). This exemption was originally due to expire on 31 December 2019. In June 2019 the co-legislators formally agreed to extend the exemption for UCITS until 31 December 2021⁴.

The ESAs JCP notes that “[a]s things stand, in the absence of legislative changes, from 1 January 2022, *UCITS will be required to prepare a PRIIPs KID and UCITS KII*. In view of this, the European Commission are [sic] expected to table legislative proposals in due course to address the requirements that would apply to UCITS from 1 January 2022 onwards.” (emphasis added).

10. With respect to §8.b. above, the main areas of the PRIIPs KID addressed in the ESAs JCP refer to:
 - a. performance scenarios, including the methodology for constructing performance scenarios and a possible alternative to present illustrative performance scenarios (Sections 5 and 6 of the ESAs JCP);
 - b. how past performance information could be included in the KID (Section 7 of the ESAs JCP);
 - c. calculation and presentation of costs (Section 8 of the ESAs JCP);
 - d. possible changes in view of the exemption in Article 32 of the PRIIPs Regulation being due to expire and the possible use of the PRIIPs KID by UCITS from 1 January 2022 (Section 9 of the ESAs JCP);

⁴ Article 32(1) of the PRIIPs Regulation was amended by Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014, OJ L 188.

- e. PRIIPs offering a range of investment options (Section 10 of the ESAs JCP).
11. In the Final Report following the joint consultation paper concerning amendments to the PRIIPs KID published on 8 February 2019 (JC 2019 6.2) (“**February 2019 ESAs Final Report**”), the ESAs stated that “*the ESAs intend to focus their work on the need for amendments to the PRIIPs Delegated Regulation...However, where the information collected and analysis conducted on the application of the KID during the course of this work would indicate that changes to the PRIIPs Level 1 Regulation may be needed in order to achieve the optimal outcomes in relation to the requirements in the PRIIPs Delegated Regulation, the ESAs will consider whether it is relevant to additionally recommend such changes to the co-legislators.*” (emphasis added).
 12. The ESAs JCP states that “[t]he ESAs have not included any specific recommendations to change the PRIIPs Regulation within this consultation paper. The ESAs are however conscious that some of the concerns expressed by stakeholders relating to performance scenarios, costs and MOPs might not be entirely resolvable through a change in the PRIIPs Delegated Regulation.” (emphasis added).
 13. A review of the PRIIPs Regulation was originally envisaged to take place by 31 December 2018, according to Article 33 of the PRIIPs Regulation. However, in June 2019 the co-legislators decided to extend this date until 31 December 2019⁵.

The timing of the proposed amendments to the PRIIPs Delegated Regulation and the interplay with the review of the PRIIPs Regulation will be discussed later in this Advice.

III. General Comments

14. The Securities and Markets Stakeholder Group (SMSG) is grateful for the opportunity to provide ESMA with comments on the ESAs Joint Consultation Paper on the PRIIPs KID.
15. The SMSG wishes to reiterate that it has always been a strong supporter of the overall aim of the PRIIPs Regulation: it is the first “horizontal” EU set of investor protection rules that encompasses both traditional and insurance-based retail investment products, and that aims at providing investors with an information document that enables them to understand and compare the key features and risks of a PRIIP (Article 1 of the PRIIPs Regulation). The UCITS KII has been considered a successful example of a brief retail pre contractual document applicable to a uniform subset of products.
16. In December 2018, the SMSG⁶ commented on the Joint Consultation Paper issued by the ESAs on November 2018 on targeted amendments to the PRIIPs Delegated Regulation (“**November 2018 ESAs JCP**”)⁷, highlighting serious issues in the PRIIPs framework with respect to the scope of the regulation, the performance scenarios and information about costs.

⁵ Article 33(1) of the PRIIPs Regulation states that: “By 31 December 2019, the Commission shall review this Regulation”. Article 33(1) of the PRIIPs Regulation was amended by Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014, OJ L 188.

⁶ SMSG reply to the Joint Consultation Paper concerning amendments to the PRIIPs KID, 4 December 2018, ESMA22-106-1591.

⁷ Joint Consultation Paper concerning amendments to the PRIIPs KID, 8 November 2018, JC 2018 60.

17. Timing of Level 1 review and Level 2 amendments.

The SMSG is aware of the fact that many of the issues that were raised on previous occasions and in this Advice need to be dealt with in the Level 1 Regulation. The SMSG therefore believes that an interim targeted review (quick fix) of the Level 2 Regulation is no substitute for the necessary review of the PRIIPs Level 1 Regulation.

The SMSG highlights a potential conflict in the timing of the amendments to the PRIIPs Delegated Regulation: the amendments to the Level 2 Regulation might occur prior to the expected review of the Level 1 Regulation.

Considering that the Commission is expected to perform the legally required PRIIPs review in the short term, as the deadline was December 31, 2019, the SMSG considers that the ESAs should not implement any amendments to the PRIIPs KID resulting from this consultation until the Level 1 review will be finished.

Amending the PRIIPs Delegated Regulation prior to the review of the PRIIPs Regulation risks undermining the appreciation of the PRIIPs regulatory framework by the various stakeholders. Additionally, confronting manufacturers of PRIIPs with constantly changing requirements for developing the PRIIPs KID will further increase costs, that might eventually be borne by retail investors.

18. Reliability of the information provided by the performance scenarios.

The PRIIPs Regulation requires PRIIP manufacturers to include “*appropriate performance scenarios, and the assumptions made to produce them*” in the KID (Article 8 (3) (d) (iii)). The current PRIIPs Delegated Regulation sets out how this is to be done.

In the November 2018 JCP the ESAs discussed the concerns, expressed by stakeholders, that the existing performance scenarios risk providing retail investors with inappropriate expectations about the possible returns they may receive⁸.

The SMSG believes that performance scenarios should only be presented when this is appropriate, meaning that they provide reliable information and are clear as well as meaningful for retail investors⁹.

The SMSG also believes that the best way to bring this forward would be to adapt the methodology by categories of products. For instance, illustrative scenarios should be considered for linear PRIIPs with the objective of delivering meaningful information to unsophisticated investors.

The SMSG appreciates all the efforts made by the ESAs to address the problem of pro-cyclicality and to revise the methodology in order to produce, for appropriate products, probabilistic performance scenarios that are not based on the observed historic growth rate of the asset, which is a very challenging task. However, as the ESAs JCP clearly points out: “[*f*]uture outcomes are impossible to predict”. This

⁸ This is because the current methodology is pro-cyclical in nature. The methodology generates outcomes with high returns when the product has experienced high returns over the previous five years, and will generate lower returns when the opposite is true.

⁹ Level 1 PRIIPs Regulation requires the introduction of “appropriate performance scenarios, and the assumptions made to produce them” in the section titled “What are the risks and what could I get in return”. ESAs have tried to conceive and bring forward meaningful solutions for all cases as they were asked to do, under the assumption that it was possible to find one size fits all meaningful appropriate “future” scenarios. This assumption appears to be not suitable for reasons that are detailed in this Opinion. In addition, some members of the SMSG note that there is no mention of “future” scenarios in Level 1 text.

statement underlines the need to ensure that investors do not confuse future performance scenarios with expected returns, as they are simulated future returns generated on the basis of specific technical assumptions.

The SMSG also believes that the provision of a clear definition of “performance scenario” could be useful to define the meaning of this concept and to guide the interpretation of the figures that are provided under such heading.

The SMSG is also aware of the tasks assigned to the ESAs. In the “Specific Comments” Section of this Advice the SMSG provides some alternatives and technical solutions for ESAs consideration.

19. Past performance.

The ESAs JCP proposes to include past performance in the KID for linear PRIIPs (AIFs, UCITS and unit linked insurance-based investment products) and for linear investment options (AIFs, UCITs, internal insurance funds).

The SMSG is in favour of including information on past performance in the PRIIPs KID¹⁰. Since long, the SMSG has continuously voiced its concern over the fact that standardized, easily comparable data on historical performance (of both the product and of its chosen benchmark) was eliminated under the PRIIPs Regulation. We have reiterated at various occasions¹¹ that without any information on past performance (including comparison with benchmarks), EU citizens will be prevented from knowing: whether the product has generated any positive performance in the past or - on the contrary - has reduced the value of their savings; whether the product has met or exceeded its stated investment objective; whether the product has matched the performance of its chosen benchmark or not.

The SMSG therefore strongly recommends the inclusion of past performance in the PRIIPs KID for all products, except structured products. Past performance could be based on a standardized recommended holding period and compared to a benchmark based on a historical time frame which should not be shorter than 5 to 10 years¹², similar to the past performance information in UCITS KIIDs. Past performance should not rely on simulated returns, but only on actual returns. If historical returns over a minimum period of 5 years are not available, the KID should clearly state the lack of a sufficiently long time span to present past performance.

The SMSG is well aware that past performance is not an indicator for future performance, and that it may be prone to cognitive biases, as investors may tend to overweight the most recent results in their assessment of expected performance. Therefore, any information on past performance should be accompanied by the clear warning that past performance is of no utility to predict future performance.

¹⁰ Question 26 of the ESAs JCP states: “Would you be in favour of including information on past performance in the KID?”.

¹¹ We refer to the Advice to ESMA dated 17 February 2015 (ESMA/2015/SMSG/005), to the Reply form for the Technical Discussion Paper on PRIIPs dated 23 June 2015, to the SMSG letter to the President of the European Parliament and the Chair of the ECON Committee, among others, dated 13 October 2015 (ESMA/2015/SMSG/028), to the SMSG Opinion dated 5 February 2016 (ESMA/2016/SMSG/006), to the SMSG letter to the Vice-President of the European Commission dated 20 July 2018 (ESMA22-106-1084), to the Advice to ESMA dated 4 December 2018 (ESMA22-106-1591).

¹² The SMSG recommends to use the current UCITS presentation, i.e. annual figures, not shorter than one year and up to 10 years where available, also considering that investors are already used to that presentation.

20. Complexity of the calculation and cost-benefit analysis.

In order to reduce the issue of the historical drift that was present in the current methodology for performance scenarios, the ESAs propose to infer the expected growth rate of an asset from the sum of a reference rate plus a risk premium that is specific to the asset. For equity-based instruments, the methodology for the probabilistic performance scenario suggested in the ESAs JCP implies that PRIIP manufacturers are supposed to estimate the average dividend yield paid to the PRIIP and attributable to the holder of the PRIIP. To calculate this average dividend yield the manufacturers are expected to employ the average dividend yield for each country/sector represented in the fund weighted by its representation in the fund. The methodology assumes that other classes of assets, such as government bonds, corporate bonds and foreign exchange instruments, would be treated in a similar manner as equities. The remaining parameters needed for the calculation (i.e., the variance, skew and excess kurtosis of the return distribution) are obtained from the 5-year history of daily returns of the PRIIP for funds and fund-like products; or from the 5-year history of daily returns of the assets underlying the PRIIP (structured products).

While appreciating the crucial need to correct the issue of the historical drift, the SMSG believes that the proposed solution of asset class-specific risk premia ought to be further explored. Further improvements should address the issue of dealing with products having multi-country components (e.g., Eurostoxx 50) for which a reference to a specific sovereign bond would be problematic (see also §24 on this issue).

In addition, notably for multi-underlying equity products, the proposed “look-through” methodology, which implies to look at the composition of the product security by security, appears too burdensome. The benefit in terms of improved investor comprehension of the product seems low compared to the cost of the calculation and the accuracy of the prediction. Alternative simplified approaches – also based on common asset class growth rates (as in § 5.7 “Other probabilistic methodological approaches” of the ESAs JCP) – should be considered, subject to an empirical assessment of their reliability.

The SMSG considers that any review of performance scenarios should aim to achieve an appropriate balance between cost of implementation and enhanced disclosure value to investors, taking into account the reliability of the information provided by performance scenarios.

21. The scope of the probabilistic scenarios and the treatment of costs in performance scenarios.

The SMSG believes that probabilistic scenarios are not the best solution for investment funds, for which we suggest to use illustrative scenarios.

Although it is preferable to use data on performance net of costs, the SMSG considers that – for products having the same asset allocation – simulated performance figures in the probabilistic approach would differ only because of differences in terms of costs. The SMSG notes that information about costs are already available in a different appropriate section of the KID.

IV. Specific Comments

22. The estimation of future performance scenarios: description of the ESAs proposal for probabilistic performance scenarios.

The ESAs JCP states that “[t]he methodology for performance scenarios assumes that the model results in the distribution of returns for the PRIIP (or the assets underlying the PRIIP) observed over the past 5 years. The historical distribution of returns is used to estimate the distribution of returns of the PRIIP at the end of the recommended holding period.” The use of historical returns generates a pro-cyclicality issue: the methodology generates outcomes with high returns when the product has experienced high returns over the previous five years, and will generate lower returns when the opposite is true.

To address the issue of pro-cyclicality the November 2018 ESAs JCP considers different probabilistic approaches to estimate performance scenarios and discusses the possibility to include risk premia jointly with risk free rates.

The ESAs JCP explores how the risk premia could be defined and proposes to amend the current methodology by changing the estimator of the growth rate so that the observed historic growth of the asset is no longer used. In particular, based on certain academic studies, the ESAs propose a methodology that employs the dividend rates or yields to estimate asset specific risk premia.

According to the proposed methodology, the expected growth rate for a particular asset will be the sum of a reference rate common to all asset types and an asset specific risk premium:

$$\textit{Expected return for the asset} = \textit{Reference rate} + \textit{Risk premium}$$

23. The reference rate: SMSG comments (I).

The reference rate is common to all asset types and is given by the interest rate curve derived from sovereign bond prices of the country of the asset.

If the ESAs would indeed decide to use this procedure to set the reference rate, the SMSG suggests to indicate explicitly how to identify the country of the asset and which maturity should be considered in order to estimate the ‘Reference rate’ for a country. Different maturities may produce significantly different estimates for the ‘Reference rate’.

24. The reference rate: SMSG comments (II).

The SMSG notes that for multi-underlying products (e.g. products based on the main European indices involving equities from several jurisdictions) the reference to a single sovereign curve may be problematic. A more practical alternative reference would be the risk-free swap curve of the relevant currency of the underlying, which can be easily obtained from reliable external market data providers.

However, the SMSG also notes that the two alternatives are significantly different. While the swap curve may be considered as close to “risk-free”, a sovereign curve instead includes the country default risk premium. Consequently, they cannot be considered as equivalent.

This choice between sovereign curve and swap curve as reference rate also has implications on the way the risk premium is defined. If we consider, e.g., an equity risk premium common to all EU Member

States, the reference rate might preferably include the country risk premium (e.g., via the sovereign curve), otherwise the country specific risk premium would not be considered at all¹³.

25. The risk premium: description of the ESAs proposal.

The risk premium depends on the asset type. The ESAs JCP presents at page 19 the following proxies for the risk premium:

Asset Type	Risk Premium
Equity instruments	Dividend rate (and all other distributions, including share buybacks)
Bond instruments	Coupon rates less the reference rate
Fx instruments	Expected forward rate less the reference rate
Commodities	Expected forward rate less the reference rate
Real-estate funds which invest in property	Dividend rate

The choice of dividend rate and all other distributions is based on the paper *Discount Rates*, by John Cochrane, published in August 2011 in the Journal of Finance (“**Cochrane paper**”).

26. The risk premium: SMSG comments (I).

For equity instruments, the proposed dividend-yield methodology assumes a one-to-one correspondence between returns and dividends in the estimation of the expected return rate. Based on the previous table, the expected return rate for a stock is

$$\text{Stock expected return} = \text{Reference rate} + \text{Dividend rate}$$

This implies that stocks paying no dividends will end up with no risk premium (i.e., as the country government bond).

The SMSG suggests to consider an ad-hoc methodology for stocks paying no dividends, also referring to the historical behavior (taking into account, if deemed relevant, the suggestions that we propose in the §34 with respect to alternative probabilistic approaches to estimate performance scenarios).

27. The risk premium: SMSG comments (II).

With respect to the one-to-one correspondence between returns and dividends in the estimation of the expected return rate, the empirical evidence seems to suggest that the sensitivity of the expected stock returns to the dividend yield is larger than 1: about 4 for a 1-year horizon and about 20 for a 5-year horizon.

¹³ A reference, although not recent, on this issue is A. Damodaran, What is the riskfree rate? A Search for the Basic Building Block, December 2008, <http://people.stern.nyu.edu/adamodar/pdfiles/papers/riskfreerate.pdf>.

Based on the Cochrane paper, the expected return rate for a stock is

$$\text{Stock expected return} = \text{Reference rate} + b \times \text{Dividend rate}$$

The empirical evidence for the US equity market estimated in the Cochrane paper shows the multiplier “b” in the previous equation equal to 3.8 for a 1-year horizon and 20.6 for a 5-year horizon:

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Table I

Return-Forecasting Regressions

The regression equation is $R_{t \rightarrow t+k}^e = a + b \times D_t/P_t + \varepsilon_{t+k}$. The dependent variable $R_{t \rightarrow t+k}^e$ is the CRSP value-weighted return less the 3-month Treasury bill return. Data are annual, 1947–2009. The 5-year regression *t*-statistic uses the Hansen–Hodrick (1980) correction. $\sigma[E_t(R^e)]$ represents the standard deviation of the fitted value, $\sigma(b \times D_t/P_t)$.

Horizon <i>k</i>	<i>b</i>	<i>t</i> (<i>b</i>)	<i>R</i> ²	$\sigma[E_t(R^e)]$	$\frac{\sigma[E_t(R^e)]}{E_t(R^e)}$
1 year	3.8	(2.6)	0.09	5.46	0.76
5 years	20.6	(3.4)	0.28	29.3	0.62

Apart from the specific values of the multiplier “b” found for the US equity market, the SMSG notes that the level of the multiplier “b” might change over time and differ across markets.

28. The risk premium: SMSG comments (III).

The Cochrane paper suggests alternative inputs to estimate the risk premium in certain asset classes, different from those indicated in the ESAs JCP. Refer to the table below and the original Cochrane paper for details.

Asset Type	Risk Premium in the JCP	Factor in the Cochrane paper
Equity instruments	Dividend rate (and all other distributions)	Dividend rates
Bond instruments	Coupon rates less the reference rate	Credit spreads
Fx instruments	Expected forward rate less the reference rate	Interest rate spreads
Commodities	Expected forward rate less the reference rate	
Real-estate funds	Dividend rate	Price/rent ratios

For bond instruments, the SMSG notes that the credit spread – based on appropriate data validation procedures – appears to be a more reliable estimator of the riskiness of a bond, especially for off-the-run bonds (i.e., bonds issued some time ago), for which the coupon rate may be not aligned to the current market rates. By contrast the credit spread is aligned to current market rates as it takes into account the current bond price.

29. The estimation of future performance scenarios: an alternative proposal.

The SMSG notes that with the proposed methodology for many PRIIPs it would be impossible to determine only one sector and/or one country and/or one rating. Moreover, this proposal opens the door to interpretation as to what should the yield be for structured products linked to mutual fund underlyings. Lastly, this proposal seems overly complicated in the implementation stage for manufacturers and does not meet the general objective of simplifying the framework.

To avoid these issues, the SMSG proposes to use - for equity instruments - a fixed risk premium determined by the ESAs¹⁴. For other products, the SMSG agrees with the ESAs proposal. This solution has the advantage of being granular enough (thanks to the split per asset class and the remaining dependence of the specific asset's return distribution to its volatility, skewness and kurtosis), implementable (by deleting the split per country, sector or rating) and harmonised (as the rate is determined – and updated – by the ESAs, the data used by manufacturers will be the same, the results would thus be comparable for retail investors)¹⁵.

The SMSG also considers, however, that the risk premium provided by the ESAs should be split between total return products (dividends received) and price return products (no dividend received)¹⁶ and can be presented as indicated below:

	PRICE RETURN PRODUCTS			TOTAL RETURN PRODUCTS		
	Reference rate	Risk premium	Expected return	Reference rate	Risk premium	Expected return
Equities	Swap rate of the relevant currency and for the relevant designed maturity	0%	Swap rate of the relevant currency and for the relevant designed maturity	Swap curve of the relevant currency	Fixed (published and updated by ESAs)	Swap curve of the relevant currency + Fixed risk premium
Bonds		Coupon rate less the reference rate	Coupon rate	Not applicable (no dividend received)		
Cash		0%	Swap rate of the relevant currency and for the relevant designed maturity			
Commodities		Expected forward rate less the reference rate	Expected forward rate			
FX / Rate		Expected forward rate less the reference rate	Expected forward rate			

¹⁴ The fixed risk premium could be developed along similar lines to the Damodaran paper cited on page 28 of the ESAs JCP.

¹⁵ In Denmark the business association of banks (Finance Denmark) and the association of insurance and pension funds (Insurance & Pension Denmark) have recently launched an approach called “Common returns assumptions on Pension- and Investment products” (<https://www.pensionsprognoser.dk/samfundsforudsætninger>).

¹⁶ The notion of splitting the risk premium between total return and price return products is stated in the ESAs JCP (see the first paragraph of page 20).

The SMSG notes that

- a. for bonds falling in the price return products category, the coupon rate as expected return may be not aligned to the current market yields. We suggest to use the yield of the instruments, that takes into account the current price of the security;
- b. for equities falling in the price return products category, the swap rate as expected return may not be representative of the standard risk-return relationship that predicts expected returns larger than the risk free rate for instruments that are expected to be risky, like equities.

30. Investors reliance and reliability of future performance scenarios.

The SMSG considers that investors will rely on the information provided by the performance scenarios. This implies that the reliability of the estimates (see also §18) as well as the correct understanding by investors of meaning and limits of performance scenarios are relevant matters.

In this respect the SMSG considers that the PRIIPs KID should contain a prominent warning that the forecast of returns described in the performance scenarios “*are not a reliable indicator of future performance*”, as requested by Article 44 (6) (e) of the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016, concerning “Fair, clear and not misleading information requirements”.

In addition to the reliability of the information provided, the SMSG also considers that intelligibility by investors is important. In that respect the SMSG advises the ESAs to use more resources on testing how consumers perceive the information in the KID. It is crucial that the recipient of the information can actually understand and use the information given.

31. The presentation of future performance scenarios.

The PRIIPs Regulation requires PRIIP manufacturers to include appropriate performance scenarios in the KID. For most PRIIPs the prescribed methodology requires an illustration of how the PRIIP could perform according to four different scenarios:

- a. unfavourable (at the 10th percentile of the distribution of returns);
- b. moderate (at the 50th percentile);
- c. favourable (at the and 90th percentile); and
- d. stressed (a worst-case scenario).

The figures presented in the first three scenarios are generally derived from a model which simulates possible outcomes based on the returns (or prices) over the previous 5 years.

The SMSG notes that a stressed scenario could be particularly useful when the historical distribution of returns is strongly positive (i.e., a bull market period). In such cases a stressed scenario could serve to mitigate the risk that the experienced strongly positive historical returns over the previous five years can be seen as the norm or the expected outcome of the product.

The SMSG notes that presenting four scenarios is adding complexity for the reader and the fact that out of the four scenarios only one is favourable might also hinder any interest to invest in riskier and more long-term assets and strategies. The SMSG considers that an alternative to presenting a worst-case scenario could be to explain in plain words any plausible bull market bias.

32. The role of simulated past performance in the construction of performance scenarios.

The SMSG appreciates all efforts made by the ESAs to propose a methodology to produce performance scenarios able to address the pro-cyclicality issue. In that respect, the revised methodology proposed in the ESAs JCP no longer employs the observed historic growth rate.

The SMSG notes that Article 44 (6) (a) of the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016, concerning “Fair, clear and not misleading information requirements”, requires that the information on future performance should not be “*based on or refer to simulated past performance*”.

The SMSG notes that this requirement prohibiting the use of simulated past performance, jointly with the requirement to estimate relevant parameters from the 5-year history of daily returns¹⁷, implies that the revised methodology proposed in the ESAs JCP can be applied only to products with at least 5-year of historical (i.e., real) daily returns (see previous §20 for details).

33. Other probabilistic approaches to estimate future performance scenarios (I): a comparison of the dividend-yield and the simplified methodology.

The ESAs JCP acknowledges “*the inherent uncertainty in any future growth assumptions. The ESAs are therefore considering possible simplified alternatives and are interested in stakeholders’ views on these types of approaches*”.

With respect to the proposal of “*maximum growth rates determined solely by asset class*” described in § 5.7 of the ESAs JCP, the SMSG appreciates the effort to propose a simplified and transparent method. However, the SMSG also notes that such a method might produce performance scenarios that are not very reliable. The SMSG suggest to consider an empirical analysis to compare the predictive power of this methodology compared to the dividend yield methodology.

34. Other probabilistic approaches to estimate future performance scenarios (II): some proposals.

More generally, the calibration of the expected return to estimate future performance is an empirical issue and several approaches might be tested to assess their validity. Alternative probabilistic approaches to the estimation of the expected return that might be assessed are the following:

- a. to use the 5-year period and add a long run mean-reverting adjustment in order to smooth out extreme returns;
- b. to extend the sample period to 15 or 20 years (as the ESAs JCP considers that extending the historical period to 10 years does not eliminate the problem of pro-cyclicality) in order to fully cover even longer market cycles, and average out extreme returns;

¹⁷ We refer to variance, skew and excess kurtosis of the return distribution. See p. 20 of the ESAs JCP.

- c. to choose the length of the sample period in such a way that it includes both a peak value and a bottom value (i.e., a full market cycle);
- d. to add a judgmental view about the expected return.

The judgmental view referred to in previous point d. is consistent with the ‘compensatory mechanism’ proposed in the ESAs JCP. However, the ESAs JCP also highlights that the use of views is not fully consistent with the intention of providing comparable information to investors. The SMSG shares this position.

35. Illustrative scenarios and structured products.

The ESAs note that illustrative scenarios, similar to the approach that is currently used for so-called structured UCITS, may provide more meaningful information for structured products (category 3 PRIIPs), as it is very challenging to define a revised methodology that adequately fits structured products without risking inappropriate results.

The ESAs also note that the critical factor in understanding the future performance of a structured product is understanding how the formulae determining pay offs are sensitive to different underlying factors.

The SMSG notes that the illustrative scenarios do not constitute “future scenarios” and only serve to illustrate the different paths of the value of the product in response to the behavior of the underlying risk factor.

The SMSG, also considering the concerns with respect to the probabilistic performance scenarios outlined above, believes that illustrative scenarios for structured product may replace probabilistic scenarios, especially for simple products where it allows to show how a specific pay-off reacts to the variations of its underlyings¹⁸.

Some members of the SMSG believe that illustrative scenarios are much less adequate for more complex structures, with multiple underlying assets or with a path-dependent pay-off (i.e. when an outcome depends on the prior realisation of specific conditions). They also believe that the illustrative approach would leave discretion to manufacturers on the scenario selection. As observed by some consumer associations¹⁹, such an approach could be prone to an arbitration risk, as some manufacturers could calibrate the key product features (e.g. setting barrier at specific levels in order to avoid showing capital losses on the reference period or creating complex underlying index rules to the same effect) so as to

¹⁸ Question 23 of the ESAs JCP reads “Do you think illustrative scenarios should be included in the KID as well as probabilistic scenarios for structured products?” and Question 24 reads “If not, do you think illustrative scenarios should replace probabilistic scenarios for structured products?”.

¹⁹ See the reply of the Bund der Versicherten (BdV - German Association of Insured) to the ESAs consultation of 23 June 2015 on the PRIIPs Technical discussion paper, which states: «*Performance scenarios should always be based on probabilistic modelling. We would like to emphasize that the recently established Fraunhofer Institute for Product Information Centre for Pensions (PiA) at Industrial Mathematics (Kaiserslautern) chose the probabilistic approach, because any what-if-approach can be manipulated too easily (cf. our comments on Q 2 and Q4). We fully agree upon the statements on what-if approaches outlined in the DP (p. 47). If the choice is left to the manufacturer, “... there is no guarantee that the picture it provides of the product is accurate or realistic, as it depends on the choices of the manufacturer. This approach is relatively easy to manipulate, and comparability is low because manufacturers can choose different scenarios.” If there is a pre-scribed approach, “...there is a risk of manufacturers designing their product to optimize presentation given the predefined scenarios that may introduce distortions in the market.”*». Document available at <https://www.bunddersicherten.de/files/stellungnahme/pdf/de/esa-tdp-priips-bdv-replyform.pdf>.

present unduly enhanced performance simulations. This would certainly affect the PRIIPs objectives of fairness and comparability. For that reason, some have argued that the introduction of illustrative scenarios would require a prior Level 1 amendment in the PRIIPs Regulation.

Other members of the SMSG are instead concerned about the reliability of probabilistic approaches for more complex structured products. They also believe that comparability across manufacturers is difficult to achieve with a probabilistic approach as the calibration of the parameters in such approaches is subject to a certain degree of variability due to expert judgement. In particular, correlation across factors plays a key role in the pricing of structured products, especially those with multiple underlying assets.

The risk of manipulation and the limited comparability across manufacturers hold therefore for both the probabilistic approach and for the illustrative approach (although for different reasons).

36. Illustrative scenarios and non-structured products (mainly investment funds)

Some members of the SMSG believe that illustrative scenarios should be considered for linear PRIIPs with the objective of delivering meaningful information to unsophisticated investors. In such cases the KID might include educational scenarios for the asset class so that the retail investor is able to understand how the funds reacts when the key risk factor (e.g., interest rates) changes over time.

37. Illustrative scenarios joined with past performance for non-structured products.

Illustrative scenarios could be joined with information on past performance of the fund. Possible scenarios for the product could, for instance, be extracted from the past performance. The average return over the recommend holding period of the product could constitute the moderate scenario. The highest return observed during the recommend holding period could be the basis for the favourable scenario. The same for the worst return of the period with respect to the unfavourable scenario. If the past years were in a bull period, the worst case illustrative scenario should probably not be based on past performance or the document should add a clear warning about the representativeness of such a worst case scenario.

An interesting feature of this solution is that it eases the comparison across funds, especially if they have comparable strategies and underlying asset classes. The assumptions made to produce such scenarios are easy to explain and understand by end investors. The disclaimer “past performance is not indicative of future results” should of course be prominent. The experience of investors with the current KIID, where investors benefitted from the knowledge of past performance, might be usefully exploited, limiting the emergence of new information documents.

Some members of the SMSG believe that current scenarios used in UCITS KIID for formula funds²⁰ are the most appropriate for this specific type of fund, while other members consider that this would not be appropriate for funds which would be deemed to fall under category 3.

²⁰ Currently, the UCITS KIID asks for scenarios only in the case of formula funds, otherwise called by ESMA «certain types of structured UCITS». ESMA defines them as “UCITS which provide investors, at certain predetermined dates, with algorithm-based pay-offs that are linked to the performance, or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features” (CESR/10-1318). These scenarios are much needed to illustrate the different paths of the formula

38. The presentation of costs: description of the ESAs proposal.

Information on costs is currently presented in two separate tables. Table 1 (costs over time) shows the total or aggregated costs that are expected to be paid depending on the holding periods and how these total costs impact on the investor's return. Table 2 (composition of costs) shows a breakdown of different types of costs.

These cost tables use a reduction in yield (RIY) approach. The ESAs consider that the RIY is the most pertinent cost indicator for all PRIIPs at the level of overall costs in percentage terms and the RIY approach allows for a fair and meaningful comparison between all types of cost structures.

39. The presentation of costs: SMSG comments.

The SMSG believes that the term "RIY" itself is not intelligible to most EU savers, also because it is not actually used in current reporting or KIIDs in the fund industry. Therefore, the concept itself does not seem to comply with the MiFID requirement for information to be understood by the average member of the group to whom it is directed (Article 44 of the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016, concerning "Fair, clear and not misleading information requirements", especially for fund investors (as, by contrast, it may be appropriate for some specific products like insurance contracts)).

The SMSG suggests to avoid imposing RIY on funds.

40. The amendment proposed in the ESAs JCP: description of the ESAs proposal.

The goal of the amendment proposed in the ESAs JCP is to try to ensure that the RIY percentage figures are understood. The main amendments are the following:

- a. to disclose the main assumptions upon which the RIY is based;
- b. To separate more clearly the RIY (impact on return figure) and the total monetary cost figures;
- c. to avoid the use of the term "Reduction in Yield" itself and explain the concept differently.

41. The amendment proposed in the ESAs JCP: SMSG comments.

The SMSG is not in favour of the inclusion of the RIY for products where the concept does not seem to be appropriate (i.e., for products different from insurance ones).

The SMSG particularly shares the amendments intended to avoid the term "Reduction in Yield" and explain the concept differently for products where it may be appropriate to use it, like insurance products. One improvement would be to explain more clearly the link between the RIY (impact on return figure) and the total monetary cost figures by adding the total cost in %.

for the investor and do not constitute "future scenarios", but "prospective scenarios" for a type of fund where the presentation of past performance is not relevant.

The disclosure of too many figures in one table should be avoided in order to facilitate the comprehension by retail investors.

With respect to questions 39 of the ESAs JCP (“Do you agree with the ESAs’ preferred option 3 to revise the cost tables?”) and 40 (“If not, which option do you prefer, and why?”) some members of the SMSG are in favour of Option 4, supplemented by the disclosure of last year actual total costs, with monetary values based on a hypothetical future performance and including the impact of entry/exit fees. Other members of the SMSG are in favour of table 1 of Option 1 and table 2 of Option 2. There is no support for Option 3.

The SMSG also notes that Table 2 of Annex 2 of MiFID 2 already has a complete and understandable framework to present “all costs” of a financial product and service to the end-investor.

With respect to question 33 of the ESAs JCP (“Do you agree that a fixed intermediate time period / exit point should be used instead of the current half the recommended holding period to better facilitate comparability?”) some members of the SMSG are in favour of a fixed intermediate time period/exit point to better facilitate comparability. Other members of the SMSG, conversely, regarding the objective of comprehension of the product first and its effects, suggest using half the recommended period.

42. The estimation of transaction costs: description of the ESAs proposal.

The current approach to estimate transaction costs is based on:

- a. the ‘slippage’ methodology, for PRIIPs active at least 3 years and investing in liquid assets;
- b. ‘estimated costs’ and a ‘new PRIIPs’ methodology in other cases.

Stakeholders raised issues mainly with respect to the ‘slippage’. This approach captures the difference between the price that is actually paid for an asset and the market price that existed at the time of the decision to trade. Slippage captures the bid-ask spread as well as the market impact. Market movements are also included. However, the calculation over a 3-year period is supposed to average out such market-related effects.

The ESAs JCP proposes two options: the first option includes adjustments to the current methodology for OTC transactions and those involving non-financial or real assets and introduces a simplified approach where there is a low number of transactions or portfolio turnover; the second option refers to a more principles-based approach to identify the reference price.

43. The estimation of transaction costs: SMSG comments.

The SMSG notes that the PRIIPs Regulation requires the inclusion of “both direct and indirect costs” borne by the retail investor and associated with an investment in the PRIIP (Article 8 (3) (f)).

The SMSG also notes that the inclusion of market impact costs may result in estimates that may not be easily understood by retail investors and appreciates the use, although imperfect, of a minimum transaction cost where implicit transaction costs are negative.

The SMSG suggests to consider simplified methods to measure implicit transaction costs, like the use of an estimate of the half bid-ask spread common to all the securities belonging to the same asset class in a certain time frame. This method, although not able to reflect the liquidity of the specific instrument

and the specific trade, has the advantage of simplicity and mitigates the risk of biasing the comparison across funds because of differences due to discretionary choices made by the PRIIP manufacturer when measuring transaction costs²¹.

The SMSG also suggests to consider the disclosure of the portfolio turnover rate (where applicable) as a proxy to assess the impact of transaction costs.

Some members of the SMSG do not support the arrival price method for implicit costs and note that the calculation of the slippage over a 3-year period is not always able to average out market movements. They also note that the inclusion of implicit costs, and especially the market impact, as a “cost” information to a retail client is counterintuitive. The ESAs explain that the Level 1 PRIIPs Regulation asks that all direct and indirect costs be included, but they are not sure that market impact is an indirect cost to a particular fund investor. In addition, they believe that there are methodological and reliability problems linked to the effective measure of the market impact of orders placed on behalf of a fund on the market. They think that this measure may be interesting to research on market orders functioning, for asset managers in want of better comprehension of how markets work, for hedge funds that are looking for patterns or are taking advantage of micro movements of markets, for brokers and market venues, etc. They believe that it appears less legitimate to be included in an ultra-short pre-contractual document for retail.

Other members of the SMSG believe that market impact is an important component of transaction costs and the slippage methodology is a recognized approach to estimate transaction costs. However, they also believe that the slippage methodology deserves additional discussions in order to examine how to deal with the issues that have been raised.

44. The Recommended holding Period.

The SMSG notes that a shortcoming of the current PRIIPs KIDs is the lack of standardization of the recommended holding period (“**RHP**”). Another shortcoming is the lack of alignment of the RHP with the objective of the product. If the RHPs for products belonging to the same category are not comparable, users of the KIDs will not be able to compare appropriately products as both performance and costs are calculated on different RHPs. The SMSG therefore suggests to standardize RHPs – where possible and for similar types of products (especially in terms of investment horizons) – to ensure meaningful comparability of performance and costs across products.

45. Multi-Option Products.

First, regarding the amendments proposed for KIDs for Multi-Option Products (“**MOPs**”), the SMSG advises to introduce a definition of what exactly is an “investment option”. The PRIIPs Regulation does not provide a specific definition which would be essential to define a MOP.

The SMSG further considers that there are challenges for retail investors to understand the interaction between the “generic KID” and the “specific information” for the underlying investment option, and to compare different MOPs, in particular concerning the costs.

²¹ The SMSG propose that ESMA could provide a table containing estimates of the half bid-ask spread for different asset classes (like the one provided for free in France by the *Association Française de la Gestion financière* – AFG for its members).

Such challenges may arise from the disclosure of two types of pre-contractual information documents (the UCITS KIID and the PRIIPs KID) which can render difficult the comparability and aggregation at the level of the contract. A generic KID for MOPs in our view therefore does not serve the purpose of the PRIIPs Regulation which is presenting the retail investor with an overview of the total costs of a product at manufacturer level. Likewise, a generic KID would not allow to present relevant performance scenarios.

The main proposal from the ESAs is to provide “complete” or “total” information for a limited number of the most relevant options, defined as the most frequently selected options or a combination of options. For the remaining options, the existing approach in the PRIIPs Delegated Regulation would still apply. Going forward this would mean that for one MOP various, differently designed KIDs would have to be produced by manufacturers to the detriment of retail investors, as comparability would further deteriorate. Further, the SMSG sees difficulties in choosing the most frequently used options. This frequency may also change over time which would force manufacturers to produce differently designed KIDs for the same MOP. Nevertheless, it could be envisaged in a foreseeable future that digital tools can provide solutions to allow retail investors to calculate risk, performance and costs of a particular MOP.

The SMSG therefore considers that it would be preferable to design one KID per option that can include the total cost for the retail investor (i.e., cost of the option itself *plus* cost of the wrapper = full cost of the MOP). If this option is not chosen by the ESAs, at the very least, each option specific information document should disclose the total cost of this option for the saver (the cost of the option itself plus the cost of its wrapper, often an insurance contract). This would allow the disclosure of the total cost of the product (instead of having the investor to compute it by himself), which is a key goal of the Level 1 PRIIPS Regulation.

Some members of the SMSG are also concerned about products in which the retail investor has a choice between hundreds of underlying funds and thus the investor have thousands of underlying investment options. For such MOPs, it would difficult to identify four representative options or to produce a KID per option. Further analyses and impact assessment are needed to deal with such products.

46. Future enhancement to the PRIIPs KID and PRIIPs KID database.

The SMSG takes this opportunity to point out additional concerns not explicitly addressed in the consultation. While some national regulators, like e.g. the Belgian Financial Services and Markets Authority (FSMA), have established databases for PRIIPs KIDs, others have not. But even at the FSMA, the PRIIPs KID database is not publicly accessible for investors.

The SMSG would therefore welcome initiatives to encourage the timely availability to investors of standardized, ideally machine-readable PRIIPS formats, which could form the basis for the development of a broad range of value-added services to investors.

Some members of the SMSG also suggest the introduction of a publicly accessible database where all PRIIPs KIDs would be stored. Such a public database should preferably be managed by the ESAs and be connected with the national regulators. Other members are concerned that imposing a common database would be a source of additional costs and delays in the issuance process, with no evident benefit proportionate to the cost.

Adopted on 13 January 2020

[signed]

Veerle Colaert

Chair, Securities and Markets Stakeholder Group