Association of the Luxembourg Fund Industry
Association Luxembourgeoise des Fonds d'Investissement

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Response to CESR consultation paper 10-530
CESR's level 3 guidelines on the selection and presentation of performance scenarios in Key Investor Information document (KII) for structured UCITS

Introduction

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership asset management groups from various horizons and a large variety of service providers. According to the latest CSSF figures, on 31 July 2010, total net assets of undertakings for collective investment were EUR 2.019 billion.

There are 3,582 undertakings for collective investment in Luxembourg, of which 2,201 are multiple compartment structures containing 11,304 compartments. With the 1,381 single-compartment UCIs, there are 12,685 active compartments in Luxembourg.

We thank CESR for the opportunity to participate in this consultation on level 3 guidelines on the selection and presentation of performance scenarios in Key Investor Information document (KII) for structured UCITS.

BOX 2: CHOICE OF THE SCENARIOS

Q1: Do you agree with the proposals in Box 2?

While agreeing on the foundations laid down in Box 2, and while more generally strongly supporting the general purpose of the document, we would nonetheless point out the following reservations (R1 to R5):

R1. We could not converge to the identification of an unbiased terminology to define scenarios. In particular, the terms “unfavourable, favourable and medium market conditions” are subject to judgment and prone to various biases across promoters/market participants (e.g. cultural difference).

R2. The objective to transparently compare investment funds in light of risk analytics as stated by the KII (e.g. by means of the SRRI) cannot be fully approached by a scenario simulation scheme, unless there is a normative scheme. Arbitrary definitions of scenarios might also be gamed and lead to unfair competition among funds promoters.

R3. The current version lacks a tangible, more quantitative dimension to discriminate different scenarios with respect to their probabilities of occurrence. In contrast, there are several areas where a significant amount of judgment is required. In particular, we believe there is no standard way to uniformly understand “reasonable assumptions about future market conditions and price movements”.

R4. Due to the market fluctuations, scenarios bear a dynamic dimension which is more or less fundamental depending on the time-dependence structure of the structured UCITS. Scenarios might turn obsolete, even misleading, after certain conditions are met or if markets move importantly.

R5. Albeit it might be assumed to be implicit, reference to the time horizon to be selected to build the different scenarios is lacking. Since there is a considerable room a priori for judgment when selecting an appropriate time horizon, we would privilege a uniform framework where scenarios are conducted *until maturity*. This would benefit the investor as it would naturally enhance the comparability between structured products.

To address the above-stated reservations, we would suggest to adopt the following methodology (S1 to S3):

S1. The soundness and reasonability of the scenarios should be further justified and not be kept as a postulate. This could be achieved in various ways:

S1a. Calibration of the scenarios and definition of "unfavourable, favourable and medium market conditions": justification of the foundations of the scenarios and their "reasonability" could be based on historical data. We thus advocate the parameterisation of scenarios be corroborated by using historical occurrences. This method could leverage on the work done for the Synthetic Risk Reward Indicator (SRRI) which requires calculating the volatility of the fund based on its historical data.

S1b. The definition of the scenarios should be an exercise involving a range of functions within the management company (risk manager/investment manager/CRM…).

S1c. Scenarios and underlying assumptions could be independently challenged by a third-party (auditors or regulatory body).

S2. The universe of structured products is extremely broad and products are not equal in terms of their a priori complexity. We understand that while scenarios involve a projective, arguable perspective, the complexity of a structure is more factual and offers less space for argumentation. We would thus advocate to categorize the complexity of a structure alongside 6 axes, by filling in, for every structured UCITS, the following information which we believe is important to communicate to investors:

— Dimensionality: what are the qualitative risk factors of the product and how many are they?

— Are intermediate cash-flow expected? The contract price will indeed jump at the payment date and will impact the value of the contract (which we believe is important to communicate to the investor).

— Is the contract time-dependent? Are there certain key dates specified in the contract which will have a significant impact on the value of the contract, e.g. by contingently impacting the payoff structure itself.

— Decision: the investor may be involved in making a decision during the lifetime of the contract, which is likely to significantly impact gross return.

— Order of the contract: the contract dependence vs. the underlying risk factors might be more or less direct (e.g. when embedded options are involved) and should disclose all contingencies related to the realization of the underlying.

— Path-dependency: some contracts propose a performance which depends on the sequence followed by a given underlying, and not only its final state.

While we are under the opinion that there should be proper explanation as to the complexity of the structures, we also recognize the fact that an appropriate wording formulation should be communicated to non-technical investors. A practical way to do it would be to create a "complexity score" of the structured UCITS (integer between 0 and 6), depending and reflecting its classification alongside the six above-detailed components.

S3. Scenarios are not all equal in terms of stability and validity over time:

— On the one hand, the passage of time mechanically turns scenarios obsolete, essentially because maturity is approaching.

— On the other hand, the market state and the risk factors themselves are evolving through time, and in order to properly reflect these changes, scenarios should be amended accordingly.

We understand that ensuring an accurate maintenance of the scenarios is a very ambitious, somewhat unrealistic, challenge in terms of the subsequent implications it would trigger (e.g., regarding the frequency of updates of the KII document). To be pragmatic, we hereunder propose situations whereby it would be necessary to update scenarios to give a fair view of potential returns to investors.

S3a. In the event of markets conditions having *significantly* changed since the launch of the structured product, the assumptions used to build the initial scenarios should be clearly updated to reflect the new states of the risk factors. Typically, scenarios should be updated whenever these represent remote situations unlikely to happen, e.g. by historical standards.

S3b. To reflect the passage of time, the scenarios should be systematically updated, irrespective of the nature/complexity of the underlyings. We suggest the scenarios be updated on a regular basis (we recommend an update on a yearly basis at minimum) to reflect the shortening maturity. Annualised returns should be recomputed to reflect the new market conditions.

S3c. For time-dependent contract, we recommend scenarios be updated to reflect the time dependency of the payoff. Scenarios that have become irrelevant because of some event defined in the contract (anniversary dates), or because some triggering threshold would have been hurt (e.g. in the case of payments structure which are contingent to the hypothesis of having not exceeded a certain minimal bound) should be removed from the initial document. Leaving them may give an unfair view of potential return to an investor.

S3d. A dimension inherent to the complexity of the payment structure is also certainly to take into account; the same update frequency should not be applied for each structured product. Practically, the update frequency should be as a rule of thumb a function of the complexity of the financial instrument. A clear link between the update frequency and the complexity matrix (see point S2) could be established. The more complex the instrument, the most frequent the update. We are under the opinion that the triggering conditions and the update policy regarding scenarios updates should be defined within a specific policy at Management Company's level.

Q2: Are there any other scenarios which these guidelines should address?

We acknowledge that the definition of a scenario-based approach is a major breakthrough. We believe in the capacity to capture, out of the three scenario proposals (unfavourable/medium/favourable), a range of contrasted payoffs and behaviours of the structure. Yet, we estimate that some dimensions (D1 and D2) are left uncaptured, and would advocate including them:

D1. Lack of extremely unfavourable scenario: we would suggest to systematically give the investor the possibility to refer to a scenario, which, despite presumably unlikely, would characterize the encountered losses in such a situation. We suggest segregating the scenario over two components:

D1a. Simulation of extreme behaviours in risk factors: in case of capital-protected structure, it is likely that these losses would be already captured under unfavourable conditions. This is but not systematic however, since some products might exhibit a deterioration potential which supersedes the losses computed through the unfavourable conditions. For instance, some structures are founded on a capital-guarantee scheme which is itself contingent to market conditions (knock-out features, for instance). In this case, a separate scenario should be built depicting the return profile if the capital guarantee is knocked out.

Under the terminology "extreme behaviour of risk factors", we thus suggest to devise scenarios for which the risk drivers simultaneously fail, exception made of counterparty risk (so-called pay-off related risk factors).

D1b. Information on counterparty risk: we deem important to highlight that capital protection is strictly speaking never guaranteed and submitted to the non-default of the counterparty. While we do not necessarily recommend to calibrate defaults (taking into account the exposing/complex nature of an attempt of parameterization of loss-given-defaults and probability of default), we could alternatively propose to communicate the rating of the counterparty.

D2. As a generic rule, we would suggest to build as many scenarios as deemed necessary to give a fair estimation of the payoff structure and to properly capture all its major aspects. For complex structures, we would expect additional scenarios to be devised so as to illustrate the working of the payoff formula. Taking again the example of a complex structure with interim contingent payments, interim observation dates might entail significant change in the subsequent payment or the final payoff formula (for instance, a equity basket linked performance paying 3 times the final performance of the basket at maturity except if at a pre-specified interim observation date, the performance of the basket is negative. In this latter situation the structure would pay only one time the performance of the basket).

BOX 3: PRESENTATION OF THE SCENARIOS

Q3: Do you agree with the proposals in Box 3?

While agreeing on the foundations laid down in Box 3, we would nonetheless point out the following reservations (R1 to R5):

R1. The term “illustrative examples” does not sound appropriate in this context. We recommend using the terms “illustrative potential outcomes” or alternatively “illustrative scenarios”, which in our opinion do reflect more profoundly the randomness attached to the materialization of a return sequence (a so-called scenario).

R2. We believe the term “not equally probable” conveys a potentially misleading, subjective message. Investors may consider the best scenario to be the most likely.

R3. We would recommend to privilege tables vs. graphs to describe the different scenarios. We think that tables are more readable and easily understood by non-technical investors. For complex instruments, graphs should be used only when tables are not appropriate or do not capture all the refinements of the structured product.

R4. To ensure comparability between structured products, ALFI agrees to the need for computing annualised gross returns. However, we urge to include a disclaimer stating the following information:

a. The used annualisation methodology

b. A disclaimer according to which actual yearly performance may differ significantly from annualized return. In other words, the annualized return does not constitute a guaranteed performance and it is highly likely that the actual performance may differ significantly

c. An indication to the fact that the investor may incur a significant loss if he decides to put back the structured product to the issuer. Given the market conditions at that time, the price may be significantly lower. Alternatively, this information may also be disclosed in the risk section.

d. Moreover, we recommend not annualising returns for investments below one year. While technically conductible, this raises a fundamental issue which is due to the fact that the actual performance is not repeatable for the whole year. For example, a structured product pays a coupon of 10% after six-month if the underlying index has not hit a certain threshold. If we annualize that performance, it would be equivalent to an annual return of 21%. This would only be possible if the investor was given the chance to reinvest his initial investment and profits in the same structured product after 6 months **and** the product would pay again a coupon of 10% after six-month. This scenario would be unlikely. For investments below one year, annualizing inflates dramatically gross returns (positively or negatively).

R5. As long as reading remains clear, we would advocate the use of the same scale for the different scenarios. However, it would be appropriate to present the results with different scales, provided the range of the different outcomes is broad. For example, a structured product may leverage five times positive returns and mirror perfectly negative returns. It is clear that the range of positive returns used to build an optimistic scenario will be much higher (due to the leverage effect) than the range of negative values (no leverage). In this case, we would recommend using different scales to improve readability of the scenarios.

Q4: Is there any other guidance which should be given about the presentation of scenarios?

Submitted to an audience made of professionals of the investment fund industry, the examples included in the appendices, in particular the description of the structured product and the corresponding explanatory tables and graphs, were considered as globally confusing and not straightforward to understand.

As a way to overcome this problem, we would recommend consolidating the different scenarios on a single table (or graph). This would enable the investor to have a clear, synthetic overview of the different outcomes of the structured product. We indeed believe that a non-technical investor may become confused by the huge amount of information (both literacy and figures) contained in the document, and that an effort in consolidating the results (executive summary) would be welcome. Additionally, it is a general concern that the requirement of a narrative explanation for each of the scenarios may conflict the requirement of limiting the KII for a structured UCITS to three pages. Pragmatic suggestions to circumvent this issue could lie in replacing the narrative explanation by a cross-reference to the full prospectus.