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Response to CESR´s Consultation paper on technical issues relating to Key Information Document (KID) disclosures for UCITS

AZ ZKA: EG-INV-RE

AZ BVR: EG-INV-RE

Dear Mr Comporti,

We are grateful for the opportunity to comment on CESR's Call for Evidence. Please find enclosed our comments to the CESR's consultation paper. In case of any query, please do not hesitate to contact the signer on the right.

Yours sincerely,

on behalf of the Zentraler Kreditausschuss
Bundesverband der Deutschen
Volksbanken und Raiffeisenbanken e.V. BVR
National Association of German Cooperative Banks

by proxy Selle   by proxy Lange
Daniel Selle   Dr. Diedrich Lange   **Enclosure**

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Response to CESR´s
Consultation paper on technical issues relating to
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General remarks

1. The Zentraler Kreditausschuss ZKA[1] welcomes the opportunity to respond to CESR's consultation paper on technical issues relating to Key Information Document (KID) disclosures for UCITS.

2. German credit institutes are among the main distributors of retail investor products, and the ZKA's interest in this issue is primarily from a distribution perspective. Credit institutes have the experience of the day-to-day contact with clients and very much welcome from this perspective the work on the KID which they expect will be an important help for investors to understand the products offered to them and to make choices between different products.

3. The ZKA expects that these developments will at the same time encourage competition on the markets for retail investment products. This will also be supported by the full harmonisation of the KID, which is in addition to ongoing efforts to further deepen the single market for UCITS.

4. However, it is important to recognise that the KID will only be helpful for those investors that already have a certain basic understanding of investment concepts and products. It is therefore important to continue, in parallel to the KID, efforts to enhance general levels of consumer literacy. This is in the first place a public task but in many Member States, the banking industry is involved in such efforts by carrying out its own projects of financial education or by advising the public sector on such activities.

Chapter 1: Risk and reward disclosure

Questions 1-4

Would the proposed calculation methodology lead to a categorisation of funds' potential risk and reward profiles which is clear, appropriate, comprehensive and easy to implement?

To what extent does it provide a comprehensive approach to risks, including liquidity risk, counterparty risk etc.?

[1] The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (VdP), for the mortgage banks. Collectively, they represent more than 2,200 banks.

Could implementation of the methodology and flanking measures lead to some funds being classified in a category significantly lower than the one in which they should belong?

Does the methodology allow appropriate discrimination between different funds across the universe of UCITS funds so that there is no excessive 'bunching' of funds in one or two categories?

5. The ZKA has a strong preference for a narrative approach, which would avoid problems of over-simplification and entice potential investors to try and better understand the product offered to them. Whilst failing to sufficiently consider the opportunities, the quantitative indicators lend excessive focus on the risk. This is neither in line with the language nor with the gist of the Directive. What is more, it fails to give adequate consideration to the investment horizon or the investment goal; this tends to discriminate against stock investments.

However, the ZKA notes the findings from the consumer testing exercise which have demonstrated that many investors have a preference for a synthetic indicator.

6. Nevertheless, CESR's very thoughtful presentations and considerations of different cases demonstrate the limits that a synthetic indicator would inevitably have. This is both with regard to the general assumption of building the methodology on past data and with regard to special cases of e.g. guaranteed funds. The ZKA therefore believes that the narrative information, could possibly be complemented with a synthetic indicator which should both explain the rationale and the limits of the indicator and give some examples about risk and reward outcomes.

7. At the same time, the ZKA believes that CESR's proposed calculation methodology is overall appropriate and should in general be conducive to the defined objectives.

Questions 5-6

What are the merits and limits of using a risk 'add-on' when a large part of a fund's return history is derived from a proxy?

Can you suggest another option to tackle situations where the methodology may not be expected to cover all risks for this kind of fund?

8. The ZKA would prefer alternative measures to the use of a risk 'add-on' as such an add-on would not only, by definition, exaggerate the likely risk of the product. As the indicator is designed to display risks and rewards at the same time, a risk add-on would also exaggerate the expected return from the investment and might thus disappoint investors. Besides, the risk add-on would also constitute a break with the otherwise very stringent calculation methodology for the synthetic risk-reward indicator. This would make it overall less reliable and useful for those retail investors which have already understood the general principle and use of the indicator.

9. All three alternatives that CESR suggests to the use of risk add-ons therefore seem more reliable in the view of the ZKA. Where such alternative measures are used, such as e.g. representative indices, this should however also be specified in writing.

Questions 7-8

Does the methodology cover all UCITS types? More specifically, do you agree with the proposed approach of distinguishing between market funds, strategy funds, and structured funds (including guarantee funds) and the adaptation of the calculation methodology to each of these fund types?

As regards the use of a 'risk add-on' and an exclamation mark (!) in situations as presented in the above section, what are the merits and limits of each solution? Can you suggest another option to tackle the described situations?

10. The ZKA agrees with the suggested methodology and the distinction made between market funds, strategy funds, and structured funds. As noted above, we would not find the use of a risk add-on the right tool to address cases where the traditional methodology cannot be used in a straight-forward way. Instead, the use of an exclamation mark would be a good way of drawing potential investors' attention to an explicitly formulated statement about the potential limits of the indicator.

Questions 9-11

Are the proposed solutions (systematic classification into category 7, use of a 'risk add-on' or a modifier) to tackle situations of a potentially changing risk profile appropriate and commensurate? What are the merits and limits of each option?

In particular, do you agree that category 7 should be the highest risk and reward category as well as the special category for certain funds e.g. those with severe event risk?

Do you foresee any other situations where the methodology may not be expected to capture appropriately the risk profile of the fund? If so, what solution should be considered?

11. In order to give certainty to potential investors that the risk profile of the chosen fund is unlikely to be subject to sudden and unexpected changes of the holding period, the method chosen should provide intrinsic stability. This would be an argument against the use of simulations (as e.g. suggested in §68), which would require both judgements about the overall model and with regard to the parameters.

12. However, the examples given by CESR in this section about guaranteed funds or 'bonus notes' demonstrates again the need for investors to have a certain level of understanding about how the meaning and restrictions of the synthetic risk and reward indicator and about the functioning of the product.

13. The modifications that CESR considers to the risk category are arbitrary and would not help the investor to understand better the probability distribution of likely outcomes. Instead, it would diminish the informative value of the indicator. It would be preferable, in the view of the ZKA, that the general methodology be applied as consistently as possible. Modifications and the impact of special events should in addition be explained in writing, and possibly with the help of one or two examples.

Questions 12-13

How easy would the methodology be for UCITS providers to implement and for regulators to supervise?

Should any other issues be taken into account regarding the calculation methodology?

14. The ZKA would concur with CESR's assessment that the proposed methodology should be easy to implement and to supervise.

Questions 14-19

Do you agree with the proposed scale and that the number of categories should be 7?

How should the methodology define appropriate volatility 'buckets'? Do you agree that a non-linear scale might be needed to tackle issues of stability, granularity and fair distribution of funds along the scale? Would it be sufficient to prescribe numeric parameters to each 'bucket', or would additional definitions be necessary?

Which form of non-linear scale would be the most appropriate? What would be the merits and drawbacks of such a scale?

Do you agree that the categories should not carry any descriptions other than a number (and the '!' modifier if appropriate)?

Do you agree that some funds belong in category 7 due to their special characteristics (see above explanations)?

For funds which have a specificity in terms of risk, do you agree that the modifier should take the form of an exclamation mark (!)? Does the exclamation mark have an overall meaning which might be contrary to the above-mentioned purpose for the general public in some Member States? If so, is there any other type of warning presentation that would be more appropriate?

15. From the point of view of a distributor bank, it remains unclear how the risk categorisation interacts with its own obligations under Art. 19 (4) MiFID. Can the risk categorisation be adopted for the purposes of the KID or is the bank obligated to carry out an independent valuation?

16. In our view, the risk categorisation only makes sense if it is also used as a basis for the suitability test and the appropriateness test under the provisions of MiFID. Otherwise, there is a danger that different statements might confuse the customer. In this case, however, a clear policy on the issue of liability for faulty disclosures would be necessary. Especially intelligibility should become the trademark of the KID; it would not be helpful to limit oneself exclusively to the UCITS Directive. *In lieu* of this, is also worth safeguarding the intelligibility in the context of other Directives, for instance MiFID.

17. What is more, the practical problems in using the risk categories should not be underestimated. Since the implementation of MiFID, the IT systems of distributor banks have already been using risk categories that have been tested and tried on the ground. These vary between banks and depend on the respective structure of the customer base. Furthermore, they do not only cover UCITS products but value each and any of the financial instruments which are distributed by the bank.

18. We therefore suggest abandonning any plans for a specific system on risk categorisation. For a distributing bank, particularly the strict imposition of 7 classes will probably not be feasible. At least a clear and unequivocal definition of the relations with regard to the obligations of a bank under Art. 19(4) MiFID will be necessary.

19. CESR is right to question how investors might interpret the use of an exclamation mark. The ZKA has considered alternative symbols but believes that an exclamation mark would still send the right signal of requesting investors' attention and leading them to look for the information that justifies the use of the exclamation mark.

20. An alternative would e.g. be the use of an asterisk, which is more easily overlooked and moreover has negative connotations in terms of restrictions and 'small print'. Printing the category number in italics might also be overlooked or interpreted as a typo. The use of a tilde '~' before and after the category number could be interpreted as a simple 'circa' sign, which might be mistaken in the case of some extreme outcomes. On the whole, the ZKA therefore believes that the use of an exclamation mark would be most appropriate.

Questions 20-22

Do you agree with the proposed list of disclaimers to be used in relation to the synthetic risk and reward indicator?

Are any of the disclaimers not directly useful or helpful?

Can you suggest any other warnings that are missing from the proposal?

21. In our view, the risk categorisation only makes sense if it is also used as a basis for the suitability test and the appropriateness test under the provisions of MiFID. The disclaimers would contradict the goal of an aggregated presentation. Already CESR's sample list, on its own, takes up half a page. We feel that it shall be sufficient to point out that the KID merely constitutes non-exhaustive product information and that the customer will have to consult the detailed sales prospectus for more comprehensive information.

Chapter 2: Past performance

Questions 23-28

Is the proposed framework of general requirements for the presentation of past performance with a bar chart sufficient and appropriate?

To what extent is there a risk of divergent practices in different countries so that comparability of UCITS across the EU would be hampered?

Should CESR recommend a more prescriptive approach in terms of bar chart presentation? Is the methodology easy for UCITS providers to implement?

Are the proposed technical recommendations in terms of presentation helpful, workable and sufficient?

Should any other issues be taken into account regarding presentation of past performance?

22. The ZKA finds CESR's considerations overall reasonable and expects that it would be easy to implement. The ZKA does also not see a need for further harmonisation above that which is currently suggested.

Questions 29-31

Is the proposed framework on past performance calculation sufficient and appropriate to allow comparability?

In particular, are the proposed technical recommendations concerning the inclusion of charges and fees, the display of currency, the selection of the NAV date and the treatment of income helpful, workable and sufficient?

Do any other issues need to be addressed to achieve a sufficient level of harmonisation?

23. The ZKA overall agrees with CESR's considerations, including the suggestions to restate the currency of the NAV, the choice of the NAV calculation date, and the treatment of income.

24. The ZKA furthermore agrees that tax considerations could not be part of the KID, which is designed to be used in the same way for all investors and in all Member States.

Questions 32-35

Regarding the display of past performance that occurred prior to a material change, do you think that both options (good practice 1 and good practice 2) should be allowed?

Or, for the sake of comparability should only one good practice be retained? If so, which one?

Is there a need for harmonised guidelines at a European level concerning the definition of material changes or do you think that it should be addressed by each Member State at a national level?

Do you see any other issues that should be taken into account as regards the presentation of past performances where there are materiality changes?

25. It is inevitable that there is some room for judgment as to when a fund would be considered to have had different characteristics. Concerning the presentation of past performances, we advocate in favour of using good practice 1. We feel that for the majoritiy of funds using good practice 2 would result in a mandatory absence of data on past performances. If each and any material substantive change meant that giving data on past performances would no longer be permissible, people would always have to wait until data for a complete calendar year were available (partly up to 23 months). After all, if for instance a fund changes the investment policy in February 2012, variant 2 would signify that for the time being – more precisely up until the year 2014 – there will only be blanks, i.e. data on past performances in 2013 could not be shown in the KID. In a 10 year chart, for the next few years, these would incrementally still remain in existence. If however, the investment policy changes once more in 2020, people will only be left with the blanks again. Any potential coexistence of both methods might lead to cherry picking and a lack of transparency.

26. The ZKA furthermore believes that some work will have to be done by CESR at Level 3 of the Lamfalussy framework to come to common understanding, as much as possible, of what would be considered as material changes.

Questions 36-37

Are the conditions identified by CESR under which inclusion of a benchmark alongside the fund performance could be allowed, sufficient and appropriate?

Should any other issues be taken into account regarding the inclusion of a benchmark alongside the fund performance?

27. The ZKA agrees with CESR's proposals with regard to the use of benchmarks, including that a benchmark should only be displayed where it is identified in the fund's strategy and objectives.

Questions 38-40

Does the proposed recommendation rejecting the use of a benchmark as a proxy for nonexistent performance data provide appropriate investor protection?

To what extent could the lack of inclusion of a benchmark for years in which the fund did not exist hamper the disclosure of the risk and reward profile of the fund?

Are there conditions under which such practice could be allowed without prejudicing investor protection?

28. The ZKA has sympathy with CESR's concerns about displaying a benchmark as a proxy for past performance, in view of the risks of misunderstanding. As investors will nevertheless wish to obtain an indicator about past performance, a possibility would be to allow some written information about past performance of the benchmark, possibly combined with a link to a benchmark. This would require investors to undertake additional steps and research of their own, meaning it would be helpful for more active investors that are using wider sources of information, but would not mislead those less knowledgeable investors which would primarily rely on the KID.

Questions 41-42

Has CESR correctly identified all the conditions under which a track record extension could be allowed?

Do you agree with CESR's approach that track record extension should be allowed when a fund changes its legal status in the same Member State? If this were to be addressed by each Member State at a national level, how great a risk is there of divergence and a lack of comparability? Should the approach be more prescriptive in this case?

29. The ZKA agrees with CESR's suggestions with regard to track record extension.

Questions 43-44

Has CESR identified the right conditions under which track extension for fund mergers could be allowed?

Should any other issues be taken into account regarding track extension for fund mergers?

30. The ZKA agrees in principle with CESR's considerations. In practice, however, the ZKA believes that the concerns about potential retail investors comparing the performance of different management companies against each other might be less relevant. This is because retail investors are more likely to compare individual funds against each other, rather than to compare management companies. Comparisons of management companies would more likely be made by professional analysts, which have access to other, more sophisticated analytical tools than retail investors. Therefore, option c) of requiring absorbing funds to display only its own past performance would be a satisfactory solution as it gives the pre-contractual information that retail investors would typically be interested in.

Questions 45-46

Do you agree with the approach proposed by CESR as regards back-testing?

Are you aware of any other merits that might support further consideration of this option?

31. The ZKA agrees with CESR's concerns about back-testing.

Questions 47-53

Do you agree that option B is capable of meeting the Directive requirement for performance scenarios?

Regarding the graph or table presentation, what are the technical merits and limitations of each option?

To what extent does each option provide the investor with the elements needed for an appropriate understanding of how the fund works? Is one option clearer and more comprehensible from the investor's perspective? Is there any technical feature which may be subject to misinterpretation by the investor?

Is there a need for a more prescriptive approach to the number and type of scenarios that should be selected in order to ensure appropriate comparability of funds? Should any technical feature be supplemented?

Is comparability with the possible risk-free asset return helpful?
Is this approach easy for UCITS providers to implement?

Should any other issues be taken into account regarding prospective scenarios?

32. The ZKA agrees that it is the preferable solution to use performance scenarios instead of a display of past performance for structured and guaranteed funds.

33. The ZKA acknowledges the reasons for CESR's preference for a table over a graph. On the other hand, it could be expected that the use of graphs would be clearer and more comprehensible for retail investors. The two-page limit would not be a problem in the view of the ZKA as the three scenarios could be displayed within one single box.

Questions 54-57
Are the methodological requirements which underpin probability tables sufficient, clear and appropriate?

Would such an approach cover all types of fund for which neither past performance nor a proxy can be used?

Is this approach easy for UCITS providers to implement?

Should any other issues be taken into account as regards the use of probability tables?

34. On balance, in view of the considerable judgement that would be involved in using probability tables the ZKA believes *a priori* that plain performance scenarios would be fairer and clearer and would more likely avoid misunderstandings.

Chapter 3: Charges

Questions 58-59
Do you think that a summary measure of charges would help investors to understand the overall cost of investment in a UCITS?

Which presentation would be preferable: using a narrative with a percentage figure or a table of cash figures?

35. The ZKA understands from CESR's findings that the trade-off to be made is between accuracy where charges are displayed in separate categories and as percentages, and ease of understanding where charges are displayed in a summary measures and in absolute figures. Ultimately, the preferable option would depend on each individual investor.

36. At this juncture, we advocate in favor of disclosing the charges as a percentage figure. In any case, should CESR decide on the summary measure and absolute figures then the assumptions on which these calculations are based must be fully harmonised to avoid misinterpretations and competitive distortions.

Question 60

Do you agree that Option 1, using a single ex-post figure, is the best one?

37. Clearly, there is a choice to be made about target groups on the basis of the knowledge that the majority of users of KIDs would be assumed to have, also taking into account to what extent these investors would be supported in their investment decisions by financial advisers. CESR's considerations in this section seem to rely on the assumption of an investor with a relatively limited understanding of financial matters. In that case, it would seem an acceptable trade-off against additional clarity that the investor would not understand that the total amount of charges might vary from one year to another. This is exactly the reason why we preferred above the presentation in percentages in our response to question 59. If this trade-off is not desired then it would arguably be more consistent to present charges in separate categories.

Question 61

Do you agree with the proposed methodology in Annex B for identifying which items should be included in the ongoing charges figure and for harmonising the calculation?

38. The ZKA agrees.

Questions 62-63

Do you agree with the proposals to:

i) Show the ongoing fund charges figure excluding performance fees?

ii) Explain performance fees through a narrative description?

iii) Not show an actual figure for the amount previously charged?

Do you agree with the proposal to signpost where more detailed information can be found?

39. The ZKA agrees.

Question 64
Do you agree with the proposal to highlight the potential impact of portfolio transaction costs on returns through a warning in the charges section and, in certain circumstances, the strategy/ objectives or risk and reward sections of the KID?

40. The ZKA agrees with CESR's thinking on portfolio transaction costs. In view of the objective of enhancing comparability between products, the ZKA also agrees that the disclosure of portfolio transaction costs in the KID would be misleading for retail investors. It supports CESR's proposed solution about a specific notice to be made in the charges section.

Questions 65-66
Do you agree with the proposal to include a warning with regard to future charges?

Are there any circumstances not covered by the proposals which could lead to investors being misled about potential increases in charges?

41. The ZKA agrees.

Questions 67-68
Have all the relevant issues in estimating an ex-ante ongoing charges figure for a new fund been identified?

Do you agree with the proposed manner of dealing with these issues?

42. The ZKA agrees.

Questions 69-71
Do you agree with the proposal to replace an ex-post figure with an estimated ex-ante figure where there are any material changes in the charging structure?

Do you agree with the proposed wording to explain the estimated figure?

Can you suggest how materiality should be defined in the context of changes to the disclosed charges figure?

43. The ZKA advocates for a solution where the reference to potential modifications in the event of material changes shall be sufficient. This is due to the fact that the applicable charges

are already stated in the prospectus, hence there should not be any surprises at this juncture. The ZKA welcomes CESR's commitment for further work on the definition of materiality.