D0583C
15.05.2009

**EBF Response to CESR's Call for Evidence on Possible Implementing Measures Concerning the Future UCITS Directive**

**CESR Ref. 09-179**

General remarks

1. The European Banking Federation (EBF)[1] welcomes the opportunity to respond to CESR's call for evidence on technical issues relating to Key Information Document (KID) disclosures for UCITS.

2. European banks are among the main distributors of retail investor products, and the EBF's interest in this issue is primarily from a distribution perspective. Banks have the experience of the day-to-day contact with clients and, from this perspective, much welcome the work on the KID. It is expected that this will be an important tool for investors to better understand the products offered to them and to make choices between different products.

3. The EBF 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. In this context, it is also important to be aware of the ongoing discussion about introducing KID-style disclosure documents for other kinds of retail investment products, as announced in the European Commission's Communication on "packaged retail investment products" published on 30 April. The EBF considers that **depending on the solutions agreed in that discussion for other investment products, it might be necessary to reconsider the set-up of the UCITS KID**.

5. The KID should also be seen in a **broader context of financial education and both written and oral information about investment 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, although the banking industry is in many Member States involved in such efforts by carrying out its own projects of financial education or by advising the public sector on such activities.

6. Nevertheless, the KID rightly starts from the assumption of a relatively unsophisticated investor. As background to the current consultation it is therefore important to bear in mind the **fundamental objectives of the KID of informing investors in a concise and simple way**. This should in a first step enable the

[1] Set up in 1960, the European Banking Federation is the voice of the European banking sector (EU & EFTA countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.

a.i.s.b.l.

10 rue Montoyer B- 1000 Brussels
+32 (0)2 508 37 11 phone
+32 (0)2 511 23 28 fax
http://www.ebf-fbe.eu

investor to better understand the product, and in a second step to make a choice between different products.

7. In some cases CESR considers a trade-off between a more scientific approach on the one hand, and one that is more understandable on the other hand. Keeping in mind that the nature of the document as such is not scientific, it is the view of the EBF that it is justified *a priori* to give preference to that option which is clearer and more easily understandable for less experienced retail investors.

8. At the same time, as a result of the simplification necessary to construct the KID every choice that is made up-front, especially on arbitrary assumptions, will heavily influence the substance of the document and thereby the investor's choice. This will both have an impact on the level playing field between different products and will likely be misleading for those investors who are not fully aware of the significance of these assumptions. The scope for arbitrariness should therefore be kept as limited as possible.

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.?

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?

9. The EBF has previously expressed a 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. However, in recognition of the findings from the consumer testing exercise which have demonstrated that many investors have a preference for a synthetic indicator the EBF would support the introduction of such an indicator.

10. Nevertheless, CESR's 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.

11. The EBF would in addition identify important limitations in CESR's proposed calculation methodology. The **proposed calculation basis is rather narrow in that it is limited to past volatility but does not take account of other types of risks**.

12. Furthermore, even as far as volatility is concerned the meaning of the synthetic indicator is restricted to shorter time horizons, as past volatility does not take account of the possibility of extreme events occurring in the future. For example, volatility levels before the financial crisis were at rather low levels. From today's point of view they would have resulted in misleading indicators for many types of funds.

13. Other difficulties from CESR's proposals arise from the fact that investors' general risk appetite and related to that, the perceptions of risk categories diverge between Member States, whereas the KID, including the risk-reward indicator, is meant to be fully harmonised across the EU.

14. European banks therefore believe that the **synthetic indicator should at least be complemented with some additional narrative information**, which should both explain the rationale and the limits of the indicator and give some examples about risk and reward outcomes.

15. CESR should furthermore consider whether it would be more appropriate to calculate the synthetic indicator on the basis of Value at Risk. As set out below in our response to Question 7, this would in particular have the advantage of also being meaningful for structured funds, which is not true for an indicator based on past volatility.

| Questions 5-6<br><br>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?<br><br>Can you suggest another option to tackle situations where the methodology may not be expected to cover all risks for this kind of fund? |
|---|

16. The EBF would **prefer alternative measures to the use of a risk 'add-on'.** 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 would thus be misleading in any case.

17. Moreover, the risk add-on would constitute a **break with the otherwise stringent calculation methodology** for the synthetic risk-reward indicator. This would make

it overall **less reliable and less useful** for those retail investors who understand the general principle and use of the indicator.

18. All three alternatives that CESR suggests are more reliable in the view of the EBF than that of risk add-ons. Where such **alternative measures are used, such as e.g. representative indices, this should however also be specified in writing**.

<u>Question 7</u>

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?

19. The EBF agrees with the distinction made between market funds, strategy funds, and structured funds, which each target different types of investment profiles. As noted above, European banks 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.

20. In addition, the **proposed methodology does not cover all UCITS types**. In particular, the methodology is not applicable to funds with a non-normal distribution such as structured funds. Risks involved in structured funds, more generally, cannot be measured by volatility. While they could be measured by a value-at-risk model, this would pose additional questions about e.g. comparability between different types of funds. Another possibility would be that of using different indicators, which would however make interpretation more difficult for retail investors.

21. In this light, the EBF finds additional support for its conclusion that **whatever the approach chosen, it must be supported by a narrative description**.

<u>Question 8</u>

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?

22. The EBF does **not agree that the use of an exclamation mark would be an appropriate way to draw potential investors' attention to the limits of a synthetic risk-reward indicator**. Such a sign would likely discourage investors from the particular product, without enticing them to understand the reasoning for adding an exclamation mark. This is despite the fact that the product might otherwise be very suitable for them. Therefore, instead of using an exclamation

mark more emphasis should be put on a written description of risks and rewards which as noted above, should at least accompany the indicator.

<u>Questions 9-11</u>

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?

23. 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 judgements with regard to both the overall model and the parameters.

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

25. The **modifications that CESR considers to the risk category are arbitrary and would not help investors to better understand the probability distribution of likely outcomes**. Instead, they would diminish the informative value of the indicator. It would be preferable, in the view of European banks, 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.**

<u>Questions 12-13</u>

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?

26. Even though the methodology proposed by CESR would be easy to implement and to supervise for traditional types of funds, it would not be relevant for other types of funds such as structured funds.

European Banking Federation

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?

27. The EBF believes that **seven categories are too many and would create confusion about the use and the meaning of the intermediate categories**. This objection would be all the more relevant if non-linear scales were to be used to classify funds into different categories. The EBF would instead propose the use of **five categories**.

28. Moreover, it is important that **investors are aware of this classification being a simplification, and of the fact that risks and rewards are linked**. The categories should **allow retail investors to make a conscious choice about the level of risk that they are prepared to take in return for correspondingly higher expected outcomes**, rather than to steer them away from higher risk/ reward categories.

29. Despite its concerns about over-simplification, the EBF has sympathy for the use of non-linear scales which might be important for particularly risk-averse investors. On the other hand, the EBF reiterates its **objections to the default use of the highest risk-reward category** for some specific types of funds. Such an approach would be different from the use of a non-linear scale in its complete break with the defined methodology.

30. Furthermore, once that it is decided to use a synthetic indicator it would be consistent to limit the descriptions in that indicator to a number. This would be as clear as possible for less sophisticated investors. Retail investors with a certain level

of understanding about financial matters would however greatly benefit from an additional descriptive risk/ reward section. Such a section might over time also help less sophisticated investors to acquire some additional knowledge and understanding about financial matters and investment decisions.

| |
|---|
| Questions 20-22<br><br>Do you agree with the proposed list of disclaimers to be used in relation to the synthetic risk and reward indicator?<br><br>Are any of the disclaimers not directly useful or helpful?<br><br>Can you suggest any other warnings that are missing from the proposal? |

31. The EBF agrees with the proposed list of disclaimers and believes that all of them are relevant.

Chapter 2: Past performance

| |
|---|
| Questions 23-28<br><br>Is the proposed framework of general requirements for the presentation of past performance with a bar chart sufficient and appropriate?<br><br>To what extent is there a risk of divergent practices in different countries so that comparability of UCITS across the EU would be hampered?<br><br>Should CESR recommend a more prescriptive approach in terms of bar chart presentation?<br><br>Is the methodology easy for UCITS providers to implement?<br><br>Are the proposed technical recommendations in terms of presentation helpful, workable and sufficient?<br><br>Should any other issues be taken into account regarding presentation of past performance? |

32. The EBF finds CESR's considerations for the presentation of past performance overall reasonable and expects that they would be easy to implement. The Federation does also not see a need for further harmonisation above that which is currently suggested.

| |
|---|
| Questions 29-31<br><br>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?

33. The EBF 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.

34. The EBF 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?

35. It is inevitable that there is some room for judgment as to when a fund would be considered to have had different characteristics. In order to avoid any incentive to stretch this interpretation and in anticipation of retail investors' likely preferences, the EBF's preference would be in favour of good practice 2.

36. The EBF furthermore believes that some work will have to be done by CESR at Level 3 of the Lamfalussy framework to come to a common understanding, as much as possible, of what would be considered to constitute 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? |

37. The EBF 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.

38. If it is left to the discretion of Member States to decide on the choice of benchmarks this should not result in the co-existence of different KIDs in different Member States.

| |
|---|
| Questions 38-40<br><br>Does the proposed recommendation rejecting the use of a benchmark as a proxy for non-existent performance data provide appropriate investor protection?<br><br>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?<br><br>Are there conditions under which such practice could be allowed without prejudicing investor protection? |

39. The EBF 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 that it would be helpful for more active investors who are using several sources of information. At the same time, it would not be misleading for those investors who would primarily rely on the KID.

| |
|---|
| Questions 41-42<br><br>Has CESR correctly identified all the conditions under which a track record extension could be allowed?<br><br>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? |

40. The EBF 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?

41. The EBF agrees in principle with CESR's considerations. In practice, however, EBF members believe that the concerns about potential retail investors comparing the performance of different management companies against each other might be less relevant. 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 who have access to additional and more sophisticated analytical tools. Therefore, option c) of requiring absorbing funds to display only their own past performance would be a satisfactory solution in providing the kind of pre-contractual information that retail investors are typically interested in.

Questions 45-46

Do you agree with the approach proposed by CESR as regards back-testing on Option A (back-testing)?

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

42. The EBF does not share CESR's view that back-testing should generally not be allowed. Rather, **back-testing is in particular useful for structured funds to give investors a meaningful impression about the returns that they might expect from a particular product**.

43. It is true that such an approach is dependent on the important assumption of future market conditions being similar to past market conditions. However, this assumption is also implicit when past returns are displayed for traditional funds. Given that CESR nevertheless recommends the **display of past returns for traditional types of funds, it would be consistent to also allow back-testing for structured funds**.

44. Furthermore, using the methodology of back-testing is still a **more objective approach to simulate investment returns than that of forecasted scenarios in isolation**. Potential concerns about representativeness could be mitigated by using longer periods of time where the product underlyings have displayed different types of behaviour.

45. The EBF is also not convinced by CESR's concerns around gaming. Gaming is in principle also possible for other products. CESR does not substantiate why it would be of particular concern in the case of back-testing.

46. The possible benefits of back-testing are also recognised in the **Markets in Financial Instruments Directive (MiFID), which allows "historic simulations"** under certain conditions that ensure investor protection. Therefore, not allowing back-testing for UCITS KIDs would result in competitive distortions as compared to non-UCITS investment products.

<u>Questions 47-53</u>

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?

47. Performance scenarios can be a **good way of giving investors an impression about realistic future scenarios and to help them to better understand the functioning of the product**.

48. In that case, such performance scenarios should be the **same for all national KID versions and must not become a source of divergence**.

49. The EBF 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 EBF as the three scenarios could be displayed within one single box.

<u>Questions 54-57 (Option C)</u>

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?

50. On balance, in view of the considerable judgement that would be involved in using probability tables the EBF believes that **plain performance scenarios would be fairer and clearer and would more likely avoid misunderstandings – i.e., the EBF would not support Option C**. Otherwise, any judgements that would be made upfront would heavily impact on investors' likely choices but would not give them a real possibility to re-consider the underlying assumptions as such. This would be both intransparent and contrary to the objective of helping investors to make a choice that is as much as possible their own, rather than being driven from outside.

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?

51. The EBF 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.

52. 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 between different funds.

Question 60

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

53. 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. 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?

54. The EBF 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?

55. The EBF 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?

56. The EBF agrees with CESR's thinking on portfolio transaction costs. In view of the objective of enhancing comparability between products, the EBF 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.

Question s 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?

57. The EBF 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?

58. The EBF 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?

59. The EBF agrees with CESR's thinking in this regard and welcomes CESR's commitment for further work on the definition of materiality.

Concluding remarks

60. The EBF is looking forward to the introduction of the KID, which is intended to help retail investors understand products offered to them and to make comparisons between different products. The Federation broadly supports the development of discussions so far as regards the set-up of the KID, as well as CESR's thinking around many more specific issues as set out in CESR's call for evidence.

61. The EBF has however some more fundamental concerns on a few issues addressed in CESR's call for evidence. This is in the first place with regard to the calculation of a synthetic indicator. CESR's considerations demonstrate the limits that such an indicator would inevitably have, whatever its way of calculation. In the view of the EBF an accompanying narrative description is therefore indispensable to provide additional explanations and help investors interpret and put into context the information given in the narrative indicator.

62. The EBF also points to the fact that an indicator based on past volatility has a limited validity as such. In addition, it cannot be used for structured funds. CESR could therefore consider deriving the synthetic indicator instead from value-at-risk models.

63. Furthermore, the EBF recommends using an indicator with five rather than seven categories, which would be more straight-forward both for the allocation of funds to the categories and for interpretation by investors.

64. The EBF advises against the use of exclamation marks. A synthetic indicator has important limitations in any case. Rather than steering investors away from particular products, the intention should be to entice investors to better understand products and their functioning, as well as the nature of particular risks.

65. The EBF does not agree with CESR's recommendations against back-testing but believes that back-testing is useful for structured funds. In particular, it is the most objective way of conveying an impression about the functioning of the fund. This is also recognised in the MiFID, which allows back-testing under certain circumstances.