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Comments on the Consultation Paper CESR/10-530 “CESR’s level 3 guidelines on the selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS”

With reference to the consultation paper “CESR’s level 3 guidelines on the selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS”, published last 20 July 2010, we would like to submit our comments.

As a general comment, we express our concerns on the choice made by the CESR with regard to “performance scenarios”. In fact, in the proposed guidelines “What-if scenarios” have been preferred to the “probabilistic table” despite retail investors have repeatedly expressed their dislike for the former and their favor for the latter.

First, we refer to two recent studies, requested by the European Commission, in which a consortium of two suppliers (YouGov Plc and IFF Research Ltd) undertook a comprehensive and detailed investigation of the effectiveness of different forms of disclosure to consumers.

In terms of clarity and understanding, the first study (“Interim Research Report, Research on KII Disclosures for UCITS Products Prepared for European Commission by IFF Research and YouGov October 2008”) concluded there is strong evidence that the representation of a probabilistic table is better than a graphical representation, especially when more than one figure is included¹. Moreover, the second study (“UCITS Disclosure Testing Research Report, Prepared

¹ See page 119: “Performance scenarios relate to a particular form of communicating risk and reward for structured funds. The key considerations for performance scenarios concern the relative effectiveness of communicating risk through i) a table showing the likelihood of achieving different rates of return; ii) graphs to show the possible return of the fund under favourable and less favourable conditions; and iii) a graph displaying backtesting data showing how the fund would have performed under historic market conditions. The following are the key recommendations that we believe would help improve the performance scenarios section:

- On the test of clarity the evidence strongly supports the use of a table. Investors suggest this form of communication could be improved by defining technical terms and explaining probability in more detail. In relation to comprehension, improvements need to be made to the wording of messages about product guarantees which are set out in the initial strategy section. These are poorly understood by investors.
- *In terms of understanding, a graph displaying back testing data was broadly misunderstood and we do not feel this approach facilitates consumer comprehension. The key issue concern the table showing different rates of return versus graphs to show possible returns under different conditions. On the basis of the qualitative*

for European Commission by IFF Research and YouGov, June 2009”) documented the same result and suggested to integrate the information included in the table with a column showing the amount invested².

Second, respondents to the past consultations on the KID, especially those representing retail investors and the academia, have expressed their preference towards the use of a “probabilistic table” and considered “what-if scenarios” – broadly supported by the asset-management and banking industry – less clear and more difficult to understand.

Therefore, it is our opinion that in the proposed guidelines, CESR have not taken into due consideration investors’ preferences and desiderata in terms of clarity and understanding, and have over-weighted the concerns expressed by the industry.

Moreover, the proposed guidelines seem not to fully meet the principles defined in the Article 36 of the Commission Regulation EU No 583/2010 implementing Article 78(3c) of the revised UCITS Directive (2009/65/EU). In fact, Article 36 requires the use of “potential performance scenarios” for structured UCITS and it provides scenarios to be computed and represented in compliance with the following key principles in order to avoid misleading and opportunistic representation:

- the scenarios shall be based on reasonable and conservative assumptions about future market conditions and price movements;
- the scenarios shall be accompanied by a statement that they are examples, do not represent a forecast of what might happen, and not have an equal probability of occurrence.

Therefore, the use of “what-if scenarios” is not explicitly required by Regulation 583/2010 and moreover, as their representation in adherence to the proposed guidelines incorporates, by construction, several elements of discretion linked to the subjective perception of a favourable, unfavourable and medium market conditions, it is safe to say that it is also not compliant with the above mentioned Regulation. Finally, we believe “what-if scenarios” would inevitably be perceived to have equal probability of occurrence – even with the appropriate disclaimers and statements highlighted in the document – as no information is given to investors on the scenarios’ relative likelihood to occur.

The choice of “what-if scenarios” instead of the representation of a “probabilistic table” appears also to be in contrast with the recent document “CESR’s guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document” (CESR/10-673) in which it is explicitly stated that the synthetic risk indicator for structured UCITS should be calculated using a historical-simulated Value-at-Risk at maturity.

Finally, the proposed guidelines appear to be a mere repetition of the provisions of the Commission Regulation EU No 583/2010 and not to effectively tackle the practical and theoretical

research, our recommendations lean towards an improved tabular version for communicating risk and reward information for structured funds. However, given that there are mixed consumer preferences for both tabular and graphical formats, we suggest developing a variant taking the existing table but with the information presented as a pie chart. This improvement would show probabilities in the form of a percentage and have accompanying text yet also provide a visual for those who find this more engaging”.

² See page 151: “This information is difficult for respondents to understand. Overall the tabular approach is preferred. The graphs were felt to be intimidating (particularly by less experienced investors). Understanding of the table might be enhanced by including a column to show the initial amount invested (rather than documenting this in the text above).”.

issues that have been described above, and introducing degrees of freedom which may jeopardize the objectivity and comparability of the results represented in the KID. As a consequence, it is hoped that CESR would revise the proposed guidelines incorporating the “probabilistic table” which have been empirically shown to meet investors’ preferences and desiderata in terms of clarity and understanding of KID, as well as the following suggestions.

Box 2

Question for the consultation

1. Do you agree with the proposals in Box 2?
2. Are there any other scenarios which these guidelines should address?

With reference to Box 2, we consider the “probabilistic table” the only fair, clear and not misleading representation of the potential performance of structured UCITS. In addition, as the “probabilistic table” is calculated through a risk-neutral methodology and calibrated to market data, it can convey an objective, reasonable and not-opportunistic representation of such potential performance.

Moreover, the use of a risk-neutral measure (at the foundations of the modern theory of asset pricing and risk management techniques and procedures) gives the opportunity to compare structured UCITS potential performances with the performance of a risk-free asset. The use of the risk-free asset for the comparison as a common reference point avoids discretionary choices by the intermediaries and allows a comparison across different products. This is because the risk-free asset can be thought as the numeraire of the risk profile of the different structures existing in the market.

Box 3

Question for the consultation

3. Do you agree with the proposals in Box 3?
4. Is there any other guidance which should be given about the presentation of scenarios?

With reference to the representation of a structured UCITS potential performance, we disagree with the proposed guidelines. The only way not to make investors perceive scenarios have equal probability of occurrence is to convey the whole distribution of the structured UCITS potential performance at maturity, through a probabilistic table describing the following four events:

- **negative return scenario:** the final value of the invested capital (capital net of subscription costs and charges) is lower than the notional capital (i.e. capital gross of subscription costs and charges);
- **scenario where the return is positive or zero but lower than that of the risk-free asset:** the final value of the invested capital is higher than or equal to the notional capital, but lower than the final value resulting from investing the notional capital in the risk-free asset over the same time horizon;
- **scenario where the return is positive and in line with that of the risk-free asset:** the final value of the invested capital is higher than the notional capital, and in line with the final value resulting from investing the notional capital in the risk-free asset over the same time horizon;
- **scenario where the return is positive and higher than that of the risk-free asset:** the final value of the invested capital is higher than the notional capital, and higher than the

final value resulting from investing the notional capital in the risk-free asset over the same time horizon.

As far as guideline Box 3 point 4 is concerned, we believe it would not be effective and enforceable as relevant published information cannot be verified by the competent authorities.

Finally, taken into account the importance of all the issues that we discussed above and that are, in our opinion, still partially addressed by the CESR in the proposed guidelines, we would positively welcome a new consumer test focused on the effectiveness of the “probabilistic table” approach versus the “what-if scenarios” approach. In fact, the adoption of the second methodology clashes with the unequivocal result (i.e. the “probabilistic table” regarded as the most effective form of disclosure to consumers) the recent studies requested by the European Commission and mentioned above, documented.

We hope that you will find these comments useful, and remain at your disposal should you wish to discuss this response.

Yours faithfully,

Dr. Agostino Megale
(President)