

Ref: CESR/10-530

**Consultation paper of the Committee of European Securities Regulators (CESR) on
CESR's level 3 guidelines on the selection and presentation of performance scenarios in the
Key Investor Information document (KII) for structured UCITS**

Dear Sirs,

the mentioned paper represents a significant and unexpected backward step made by the CESR in terms of the adoption of a coherent and quantitatively grounded methodology aimed at representing the potential performance of structured UCITS in a “fair, clear and not misleading” way, as explicitly required by the art. 36 of the Commission Regulation No 583/2010.

In this note I will be glad to reply to the questions raised by the Consultation document. I also suggest reading this contribution jointly with my answers to questions asked in the CESR's Consultation papers 09-522 and 09-716.

I quote the question numbers of the Consultation Paper.

Question 1

I disagree (see also Question 2 below).

The use of exogenous scenarios (unfavourable, favourable, medium) is arbitrary both in their definitions (e.g. favourable to the product?, favourable to the market in general?, favourable to the product's underlying?) and in their quantification. In addition, it does not provide any indication on the scenario's probability so that an implicit and misleading assumption of uniform distribution could erroneously be induced. Moreover, in the case of complex structures, important features and risks could not be properly described in a small number of “illustrative examples”. In general, the proposals in Box 2 introduce a high degree of arbitrariness in the choice of number and type of scenarios leaving issuers and sellers with too much room in the highly sensible phase of presenting and illustrating the structured UCITS **risks**. In this way, the fundamental aim of a “fair, clear and not misleading” content of the key investor information set is clearly jeopardized.

Question 2

The scenarios should be accompanied by a risk-neutral probabilistic assessment of their occurrence (better represented as a “probability table” in a similar way to the Italian regulation now in force)

and should include the following events (to be appropriately defined and addressed by the guidelines):

- Negative return scenario;
- Scenario where the return is positive or zero but lower than that of the risk-free asset;
- Scenario where the return is positive and in line with that of the risk-free asset;
- Scenario where the return is positive and higher than that of the risk-free asset;

However, the most important improvement would be the adoption of the unbundling approach as the underlying methodology for the calculation and representation of the scenarios. Such methodology is useful both for new and old funds and could be used in order to identify the replicating portfolio and the implied volatility of the fund. In this respect, a proper risk disclosure could be obtained through the Monte Carlo simulation approach and the adoption of the above mentioned “probability table” in which the potential returns of the structured fund are compared with those of a risk-free asset, a concept well defined both in theory and practice.

Moreover, the Monte Carlo approach would be more comprehensive, informative and reliable than a “what-if scenario” approach. In fact, the above mentioned unbundling approach, along with the representation in the KID of the “probability table”, is forward looking and requires its calibration to market data. It is forward-looking as required by funds with an important forward tilt in their management style (such as structured UCITS) and, in general, can be extended equally well to all types of funds with the benefit that investors would be provided with a key information about potential returns over the recommended holding period and of the relative likelihood of the occurrence of such potential returns.

The “probability table” and its underlying methodology should be preferred not only for the reasons of economy, theoretical foundation, practical diffusion and coherence with the risk management tools used in financial markets as well as by independent advisors. It also allows a proper comparison with a common, objective, and well known investment opportunity, the risk-free asset, so that the fund’s risks can be quantified and made understandable and an easy comparison between alternative products is guaranteed.

As documented in the testing phase, the reading of results via “probability table” is preferred to other devices and this approach can be evenly and uniformly extended to all non-relative funds.

In order to practically show the relative performance of the “probability table” approach with respect to the “what-if scenario” approach, in terms of information precision, clarity, market-consistency and objectivity, I include, in the Annex, a re-examination of the three examples provided in the Consultation Paper.

Question 3

I disagree (see Question 2 above and 4 below).

Question 4

Scenarios should be accompanied by an indication of their likelihood of occurrence and such a measure – to be clearly defined and addressed by the guidelines – should be based on a

quantitatively grounded methodology coherent with the unbundling and risk neutral principles widely used in the markets.

In the light of the above comments, and taking into account the importance of the discussed issues for a successful and effective KII document, I would suggest to implement a **new consumer test** focused on the practical comparison of the two competing approaches.

ANNEX

The examples of the Consultation Paper reconsidered in the “probability table” approach

I include three practical applications of the “probability table” approach based on the examples shown in the Annex of the consultation document. Clearly, in the spirit of the reference paper, they are provided as simplified cases and, given that the consultation document does not provide enough information on the underlying structured UCITS in order to carry out all the calculations, I first detail the most relevant additional assumptions. Note that, once market data are made available, all calculations require a few minutes.

Example A

Example A refers to a fund indexed to the average performance of a benchmark.

Under the “probabilistic table” approach, and assuming:

- the structured fund is a formula based UCITS;
- according to the formula, at the “final date” the fund pays the amount invested (net of initial costs) incremented by a multiplicative factor calculated as the ratio between the “average” and the value of the “underlying benchmark” at the “initial date”;
- the “initial date” is 10 September 2010;
- the “final date” is 10 September 2015;
- the “average” is the arithmetic average of 60 monthly observations of the “underlying benchmark” between the 16 July 2010 and 16 July 2015;
- the “underlying benchmark” is the DJ Euro Stoxx 50 index;
- the amount invested is 100% (gross of initial costs);
- the initial costs are 1%;
- the multiplicative factor cannot be less than 100% as there is a legally enforceable guarantee of the return of the amount invested;
- the structured fund is exposed to credit and counterparty risk (equivalent to a constant 50bps spread) with a relatively high recovery rate (90%);

the potential performance of the structured UCITS would be represented as follows:

Scenario	Probability	Invested capital* at maturity (Median value)	Equivalent annual growth rate (Median value)
Return is negative	17.32%	0.95	-1.02%
Return is positive or zero but lower than that of the risk-free asset	58.60%	1.00	0.00%
Return is positive and in line with that of the risk-free asset	18.52%	1.08	+1.55%
Return is positive and higher than that of the risk-free asset	5.56%	1.37	+6.50%

* The initial value of the invested capital is assumed to be 1.00

Example B

Example B refers to a structured UCITS with a payoff based on the average performance of a basket of shares over time. For instance: a UCITS with an investment strategy to achieve a payoff based on the yearly performance of a basket of 5 shares calculated over 2 years.

The final payoff is the average of all the performances of each share in the basket. The performance is calculated as the underlying value of each share in the basket after 2 years with any growth capped at 9.5%. There is a legally enforceable guarantee of the return of the amount invested.

Under the probabilistic approach, and assuming:

- the structured fund is a formula based UCITS;
- according to the formula, at the “final date” the fund pays the amount invested (net of initial costs) incremented by a multiplicative factor calculated as the ratio between the “average” and the “initial observation”;
- the multiplicative factor is capped at 109.5%;
- the multiplicative factor cannot be less than 100% as there is a legally enforceable guarantee of the return of the amount invested;
- the “initial observation” is 10 September 2010;
- the “final date” is 10 September 2012;
- the “average” is the arithmetic average of all the performances of each share in the basket;
- the underlying basket includes the following shares: AEGON N.V. , AIR LIQUID SA, ALLIANZ SE, ALSTOM S.A., ANHEUSER-BUSH INBEV NV, which are the first 5 shares of the DJ Euro Stoxx 50 sorted alphabetically;
- the amount invested is 100% (gross of initial costs);
- the initial costs are 1%;
- the multiplicative factor cannot be less than 100% as there is a legally enforceable guarantee of the return of the amount invested;
- the structured fund is exposed to credit and counterparty risk (equivalent to a constant 50bps spread) with a relatively high recovery rate (90%);

the potential performance of the structured UCITS would be represented as follows:

Scenario	Probability	Invested capital* at maturity (Median value)	Equivalent annual growth rate (Median value)
Return is negative	8.70%	0.92	-4.08%
Return is positive or zero but lower than that of the risk-free asset	68.24%	1.00	0.00%
Return is positive and in line with that of the risk-free asset	4.10%	1.03	+1.49%
Return is positive and higher than that of the risk-free asset	18.96%	1.10	+4.88%

* The initial value of the invested capital is assumed to be 1.00

Example C

Example C refers to a structured UCITS designed to last for up to 8 years, but with an early ‘kick-out’ feature. If at an annual measurement date, Eurostoxx is at least at its level on the start date, the payout is the original investment increased by 8% for each of the years since the start date. If this happens at the end of the second year onwards, the equivalent annual growth rate will be less than 8%. If at each annual measurement date, the performance of the Eurostoxx index remains below its level at the start date, the payout after 8 years depends on the CAC 40 index:

- if the CAC 40 index has dropped by 50% or less since the start date, the original investment is paid back;
- if the CAC 40 index has dropped by more than 50% since the start date, the payout is the amount originally invested reduced by the percentage decrease in the Eurostoxx index.

Investors’ capital is therefore at risk.

Under the probabilistic approach, and assuming:

- the structured fund is a formula based UCITS;
- underlying indices are DJ Eurostoxx 50 and CAC40;
- the “initial date” is 10 September 2010 and “final date” is 10 September 2018;
- the amount invested is 100% (gross of initial costs) and initial costs are 1%;
- the structured fund is exposed to credit and counterparty risk (equivalent to a constant 50bps spread) with a relatively high recovery rate (90%);

the potential performance of the structured UCITS would be represented as follows:

Scenario	Probability	Invested capital* at maturity (Median value)	Equivalent annual growth rate (Median value)
Return is negative	41.18%	0.29	-14.34%
Return is positive or zero but lower than that of the risk-free asset	8.10%	1.00	0.00%
Return is positive and in line with that of the risk-free asset	43.44%	1.16	+1.87%
Return is positive and higher than that of the risk-free asset	7.28%	1.64	+6.38%

* The initial value of the invested capital is assumed to be 1.00

As can be seen even in these simple examples, as well as in real life cases (see prospectuses of many products offered in Italy), the probability of occurrence attached to the positive scenario is often relatively lower than the probability of other scenarios, its associated final payoff is frequently close to the one associated to the risk-free asset and downside risks are quantified and made comparable. As already noted, market data at the issuance date will force issuers to objectively present the risks of the product using the same framework and numbers used for its pricing.

Conversely, in the “what-if scenario” approach, the favourable market condition could be opportunistically chosen by the issuer in order to benefit from a signaling effect on the return figure and the “unfavourable” scenario could hide and grossly underestimate the risks involved.

With my best regards,

Riccardo Cesari

Bologna, September, 9th, 2010