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Answers to the CESR Consultation Investor Protection – MIFID : complex versus non-complex

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Subject : Proposal of a framework that logically classifies (structured) products (funds)

Introduction

UCITS are separately mentioned in the MIFID Directives as automatically non-complex (cfr. art 19 Level 1, art. 38 Level 2 Directive).

KBC AM follows the idea, as delivered also through the Belgian Association of Asset Managers BEAMA, that UCITS should be non-complex since :

- conceived as retail products
- very strictly regulated
- provide a high degree of investor protection
- provide a very high disclosure to retail investors
- are subject to strict risk management rules

However, we know of the discussion that lives that probably not all UCITS can be left non-complex and that possibly criteria of non-complexity should be held against the rich range of UCITS.

Central in the MIFID complex or non-complex definition is the appropriatenesstest. Its aim is to prevent products from being sold on an execution-only basis to *retail clients* who do not have the experience and/or knowledge to understand the risks of complex products.
Complex products should indeed not to be transacted for retail customers in a non-advised basis without the appropriatenesstest being carried out : this is without the distributor or advisor asking the clients about their knowledge / experience to understand the risks and, if necessary, giving the clients a warning.
Core idea behind complex or non-complex seems to be "the ease with which **the risk** attached to the product may be understood".

CDO's, asset-backed securities are clearly seen as complex. Money market instruments as non-complex. Instruments, *non-UCITS*, that embed a derivative and callable & puttable bonds are currently also defined as complex.
Convertible shares should be treated as complex products.
Shares in companies that are traded in a regulated market (art. 19(6)), however, are automatically *non-complex.*

This seems a bit surprising since the issue is about understanding risks. Stocks have shown high volatility and sometimes have a rather illiquid character (small caps …), and have brought important losses in absolute terms rather regularly (2000-2003, 2008-2009) to retail investors.

On the other hand, not all measures within portfolio management or within investment products to reduce risk - *and which indeed may bring some additional complexity* – should lead to a definition of *complex products, is our view*. Especially not if, as a consequence, more risky product alternatives, would remain non-complex and could be advised in a less regulated process and expose the investor to important risks (e.g. without appropriatenesstest).

** Higher risks therefore do not seem to lead automatically to a higher degree of complexity : e.g. shares.

** *Risk reducing* measures or product concepts on the other hand should not all demand an appropriatenesstest, although they may introduce some more complexity.

Following criteria can be taken into account :

- the underlying is difficult to understand,
- the underlying is difficult to track,
- the difference between expectations (of performance) and realisations can be important,
- the nature of the product can change drastically during the product life cycle, especially where the initial investment can be lost to a high extent (e.g. reverse convertible bonds, already defined as complex).

Transparency therefore is a fairly crucial element in evaluating complexity.

Hedge funds have received, before and during the recent financial crisis, criticism on this aspect. Also subordinated term deposits or bonds, commodity linked products have often been named in the media and by regulators, as complex.
When applying the criteria mentioned above, it is clear that also the transparency issues may be important elements to define complexity.

We experience a common view in the sector of asset management and distributors of investment products to determine classic assets such as stocks, bonds mostly as non complex. Often they are the building blocks for other products or for balancing portfolios. We make an exception for very specific products within these assets such as
reverse convertible bonds (see criteria mentioned earlier).

Most open funds / UCITS investing in these classic investment assets deliver in addition a risk reducing diversification and an active management with the intention to improve performance or at least eliminate land mines in time that can have an important negative impact on the performance.

Investors can learn about funds in detail, *before* achieving them, thanks to the KID (from 2011, UCITS firstly), or currently on the basis of a prospectus and/or product fact sheet.

In addition, *after sales* service is provided : they deliver transparency through fund fact sheets, (semi-) yearly reports, daily net asset values, comments of the fund manager on websites , etc.

Therefore, classic UCITS commonly are transparent or in many cases can be followed and understood better than individual stocks or bonds (e.g. where the changing or changed rating is not well available to the public).

These classic asset class UCITS and in the same line, mixed UCITS balancing these classic asset classes, can remain to be defined non complex.

Special attention has to go to the structured funds (UCITS or non-UCITS).
We will make a distinction between capital protection and other structured funds.
However, within structured funds altogether, criteria can be defined to make a more clear distinction between complex and non-complex.
This document will try to define these criteria.

Overview

The focus is on equity and interest rate linked option-based structured products commercialised towards a retail, private banking or institutional public; excluded are for example hedge funds, subordinated term deposits, commodity linked products …

Today, all such products are labelled non-complex. The classification developed further on does not in itself stamp products with the label complex or non-complex. We have no prejudice towards the buyer (his/her ability to understand) or the seller (his/her ability to explain).

The approach is pragmatic and takes call and put options as the starting point. We argue that these should be considered non-complex. Call and put options are viewed as the main building blocks or benchmark. We define call and put options by a set of criteria which are then projected on the structured products. The classification simply observes which criteria the structured product has in common with the main building blocks.

One could logically conclude that complexity tends to grow if the structured product has less in common with the main building blocks. Still the proposed framework yields only four product types. Equally important, their distinction is logical and based on observable criteria.

Benchmark and why it is considered non-complex

Call and put options are placed at the centre of the proposed framework and are considered non-complex. One motivation could be that they have been around for ages, literally. Another motivation could be that call and put options were the first derivatives to be heavily traded on listed exchanges, also by the wide public. Our main motivation however is more fundamental and relates to the fact that call and put options simply allow to slice a standard equity position in two. An open equity position is commonly accepted to be non-complex. Should the upper part (=call option) and the lower part (=put option) of such open equity position, when looked at separately, be considered complex? We assume not.

We are not alone in this view. In the feedback to CESR consultations concerning this subject, within MIFID, it was remarkable to see that a group of (academic) respondents challenged MIFID's position that instruments embedding a derivative should always inherently be regarded as complex. This group suggested that the determining factor should be whether the presence of derivatives *created or increased risks.*

We refer to the core idea behind complex or non-complex , that seemed to be "the ease with which **the risk** attached to the product may be understood".

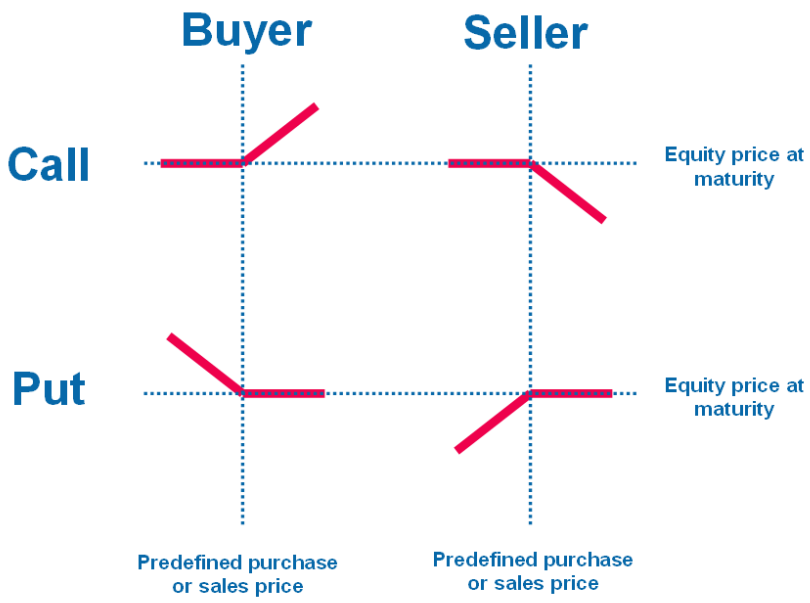
Structured *deposits*, whose initial capital is fully guaranteed, are excluded from the definition complex, as "they are strictly banking products that do not fall within the scope of MIFID".
Recent history has shown that the guarantee of some individual banks constituted a higher risk than diversified portfolio's of fixed income portfolio's (under strict criteria in terms of rating, rules of diversification, liquidity) as can be found in the legislation of some member countries.
In addition, prices are not easily available and certainly not through channels that are easy to find for the retail client.

Therefore, we follow the idea that under specific strict regulation, capital protected funds should be defined as non-complex, apart from specific formulas that we explain later in this document.

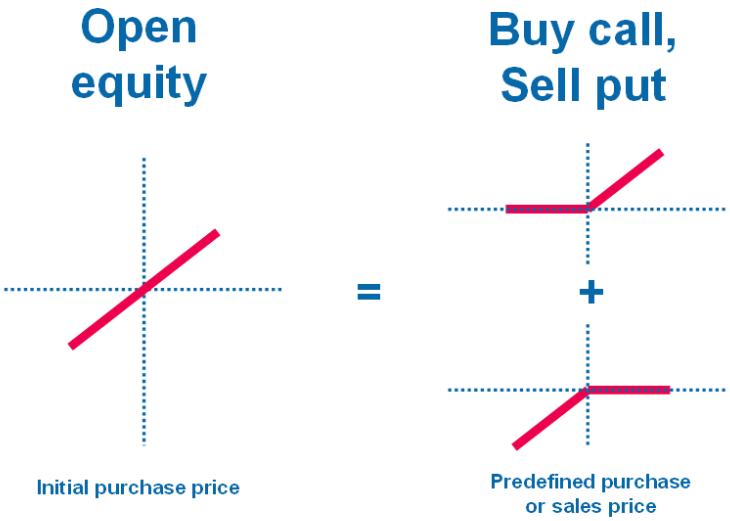
<u>Call and put options : only parts of the pay off function of classic assets (such as for instance stocks)</u>

Remember a call option gives the holder the right, not the obligation, to purchase the underlying equity at maturity at a predefined price. Such call option enables the holder to enjoy increases of the share price above the predefined purchase price but protects him against share prices

ending below the predefined purchase price (not taking into account the premium paid). The seller of the call suffers from increases in the share price since his losses equal the gains of the call buyer (assuming none is delta-hedging his position). A put option on the other hand gives the holder the right, not the obligation, to sell the underlying equity at maturity at a predefined price. Such put option enables the holder to profit from decreases of the share price below the predefined sales price but prevents him from enjoying increases of the share price above the predefined sales price (not taking into account the premium paid). The seller of the put suffers from decreases in the share price since his losses equal the gains of the put buyer (assuming none is delta-hedging his position).



The following graph illustrates how an open equity position can be considered a combination of buying a call and selling a put. The left part shows the profit and loss situation of an open equity position. The right part shows how the profit and loss situation can be obtained by bying a call option and selling a put option. The options both have the same maturity and predefined purchase or sales price. The underlying equity is the one from the open position on the left.



This property of call and put options is well known. It illustrates their main reason of existence, namely to provide investors with contracts offering asymmetric exposure. The property also relates to a cornerstone in option valuation known as put-call parity.

Criteria used to classify structured funds

Now we have the definition of a call and put option in mind, and realise their relation with an open equity position. What are then considered the main set of criteria to benchmark structured products?

Firstly, we consider the element of capital protection. The feature of capital protection (mostly, at maturity) is risk reducing. It has to be set up with a well diversified portfolio of fixed income assets, (securities under regulation), and well defined as to avoid liquidity or credit risks as much as possible, to receive the definition of non-complex. We see a case for a level playing field with structured (guaranteed) deposits.

Other structured products (without capital protection) have a higher change to be defined as complex.

We consider a new framework with three additional criteria :

- Does the structured product have a fixed maturity ?
  Call and put options clearly have.

- Is the structured product linked to a single underlying ?
  Call and put options clearly are.

- Is the value of the product directly linked to the performance of the underlying ?

The value of call and put options clearly is.

Not only will we use only these three criteria, we will also apply them strictly in this order. Hence the first criterium will be more discreminatory than the second or third.

Before we demonstrate the suggested framework by means of several examples, we take one step back and list a number of considerations one could make on the proposal.

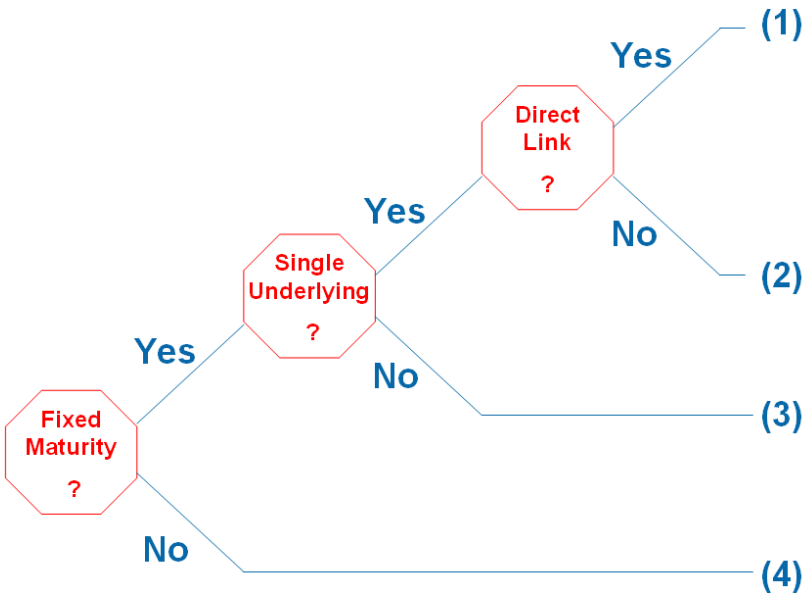
- The suggested framework does not a priori classify structured products in a particular category based on their reputation, history, … The three criteria provide a neutral guideline to check the differences between the structured product and a benchmark.

- The suggested framework makes no further distinction between structured products with or without capital protection. Unless of course the structured product offers an upside potential using options that do violate the criteria. *Earlier, however, we defended the case that capital protected structured funds* anyhow *have a strong argumentation to non-complexity because on the lower risk involved.*

- The suggested framework does not link the alleged degree of complexity with the product's risk classification. A main driver for a typical risk classification is the dispersion of the likely outcomes around what is expected. As we will hopefully demonstrate in the examples below, it makes perfect sense to possibly detect a "low risk" product with less resemblence to the main building blocks than a "high risk" product. A "high risk" product should hence not *necessarily* be considered more complex than a "low risk" product, and vice versa.

Examples

The graphical representation below assists in drilling down the scheme that guides the classification. We move from left to right, each time confronting a main criterium from the benchmark with the features of the structured product at hand. Note how the second and third criterium are no longer considered if the structured product does not meet the first criterium of having a fixed maturity. Using the three criteria this way, the proposed setting makes us end up with only four product types. Their would be eight possible types if we allow the three criteria to appear in all possible combinations. However, using the three criteria this way not only allows to maintain the overview. It is deemed also to make sense from a conceptional point of view, as the examples will illustrate.



If we scroll down the product types a structured product is claimed to move further away from the main building blocks. Does this mean complexity grows? Pressumably. But assuming complexity grows as we move down the graph, where can one find the cut-off between complex and not complex. Theoretically, there are five possible opinions.

We next illustrate the proposed framework.
If necessary, we can provide the practical features of currently existing or earlier launched products to acknowledge their projection to the product types.

Type (1) :

- Call and put options belong to this category by definition.

- Bonds + Call (e.g. plain vanilla call on 3 to 8 years): capital protection and upside directly linked (possibly capped) to the performance of an index or basket.

- Bonds – Put (Reverse Convertible) Remark : the changing nature of this product (e.g. reverse convertible) can bring surprises to the investor (expectations versus realisation). Therefore, the definition complex can be more applicable than with the other cases under Type (1).

- Bonds – Put + Calls (e.g. plain vanilla call, with more than 100% participation (“booster”) in the upward evolution, but maximal 100% participation in the downward evolution (loss comparable with shares))

- Cliquet or Click funds (locking in the result, mostly on a yearly basis and then resetting starting point, often capped to a maximum return) : capital protected; even though the fixed maturity is split up in several periods, the periodic “clicks” are directly linked to the performance of one single underlying index.

Type (2) :

- Capital protected formulas with actively changing participation over time : clearly a fixed maturity product, with a single underlying. The active management of the underlying, based on a target volatility technique, distorts however the direct link between the full maturity performance of the underlying (e.g. an index such as the DJ Eurostoxx 50) and the return for the investor. Note that this does not have to imply the distortion is necessarily in the investor’s advantage or disadvantage.

- Type 2 products also include all structured products with barriers, digital effects or lookback features, but still linked to a single underlying and with a fixed maturity. .

- Formulas that don’t participate in baskets or an index as such. They are however linked to a basket of shares where each *individual share performance* is monitored to determine the final payoff, not the basket evolution as such. This would make them belong to type 3. Yet, structures like these are not exposed to correlation and contain a set of single stock options of type 2. We realise this justification is technical and assume such structures would nevertheless be classified as type 3.

Type (3) :

- In general, type 3 products derive their payoff (still at a fixed maturity) as a function of the individual performances of the shares or indices in the underlying basket. Technically such structures share the property of being directly exposed to correlation. Products like (brand names :) Performance Picker and Number of Shares Up also derive their payoff as a function of individual performance of stocks in a basket but in a way which is not impacted by correlation, hence the remark in the previous bullet.

- Equity linked structures with a digital feature and a barrier on individual share level, where the scenario and pay off for the investor depends on the performance/share price (with daily observations).

Type (4) :

- Type 4 structured products are possibly terminated prior to their final maturity. The reason for the early termination can either be based on the performance of the product itself (autocallables) or at the discretion of the issuer (callables). There also exist products which can be early terminated at predetermined conditions by the investor (puttables) but such products have only been marginally present in the Belgian market.

- Autocallables : typically the structure is terminated if a predefined return target has been met or if the index exceeds a barrier level. Including autocallability on average has a cost at inception. Even though the early termination feature classifies the product as very

- Callables : callables are early terminated at the discretion of the issuer. Including callability in general is benefitial to the option's cost at inception. This is because callability means that the investor is selling an option, ie the right to early terminate, to the issuer. As a result, a callable is early terminated at a moment where the product yields attractive returns. Otherwise the issuer would not call. The simple fact that the early termination is triggered at the issuer's discretion and not by the product's performance like with autocallables, makes the early termination more difficult to reconcile.

Bullet-point summary

The proposed framework to logically classify structured products summarizes as follows :

- products with capital protection, certainly of type 1 deliver no high risk and contain derivatives with straight pay off structures, the risk (of equity linked formulas) is far less than individual stocks, have a strong case for non-complexity
- since : an open equity position is taken to be non-complex
- when split in two an open equity position is composed of a call and a put option
- a call and a put option are used as the benchmark for the classification
- the benchmark is described by means of three observable criteria
- structured products are confronted with these criteria in a particular order
- the result is four product types, able to capture all structured products in scope
- ranking the product types allows to assess their resemblance with the benchmark, or the lack thereof
- ranking the product types presummably results in an order of growing complexity, but since the classification is based on observable criteria it does not highlight the borderline between "complex" and "not complex"