

ESA'S CONSULTATION PAPER ON PRIIPS KID_s

A Summary

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Abstract

The new consultation document released on October 16, 2019 regarding PRIIPs builds further on the recommendations received by the industry originating from the first consultation document launched in Autumn 2018. In this document the ESAs reach out and are asking **57** questions regarding new proposals and suggestions on the following topics:

- Introduction of asset specific growth rates in order to deal with the pro-cyclicality of the current risk and performance scenarios.
- Introduction of illustrative scenarios
- Inclusion of past performance
- Transaction costs
- Transitioning UCITS to PRIIP

The ESAs also mention the possibility that the stressed and intermediate scenarios will no longer be required. The consultation document has also a section dedicated to multi-option KIDs and the use of the generic KID.

The consultation paper comes with a revised Annex IV, V and VII of the PRIIP regulation and presents the reader with some new Annexes:

- Annex VIII deals with illustrative performance scenarios.
- Annex IX covers the methodology for presenting past performance
- Annex X handles the presentation of the past performance

RiskConcile encourages the reader to contact us for our feedback or advise regarding PRIIPs-related matter. The template to answer the ESAs

questions can be downloaded from the ESMA website.¹

RiskConcile spent time and effort to keep the summary consultation document (123 pages) as short as possible. A similar challenge arises for the PRIIP manufacturers: introducing the new proposals and keeping the KID to its required maximum length of 3 A4 sides could become a real challenge.

1 New Time Line

Around year-end 2018, we were all expecting the review of the ESA's regarding the PRIIPs Regulation. This review was however replaced by a consultation paper which was supposed to drive possible amendments to the regulation as it was designed earlier in March 2017. Instead, the regulators decided in February 2019 to take more time to review the regulation and delayed at the same time the implementation of PRIIPs into the UCITS world with another 2 years. As it currently stands, UCITS funds will need to incorporate the production of KIDs as of January 2022.

On October 16, 2019 a new consultation paper was published and the industry is invited to provide input before January 13, 2020. ESAs will take the first quarter of 2020 to review all of this and present the European Commission with their findings. It could be possible that some recommendations are rolled out into PRIIPs before the end of 2021. ESAs have made it clear that they do not tend to wait before the on-boarding of the UCITS world before imposing some changes on the current framework. Nevertheless the opinion on this matter from the industry was asked in the consultation paper [Question 3 & 4](#)

2 Consumers

Earlier in 2019, ESA's have engineered different options for changing the KID. The different options are going to be submitted to a consumer panel. When deciding on their final proposals, the ESAs have made it clear that they will take into account the feedback from respondents to the current consultation, as well as the results of the consumer testing exercise.

3 Performance Scenarios

3.1 Dealing with pro-cyclicality

Performance scenario's are published in the KID framework and are without any doubt the Achilles heel of the current framework. The pro-cyclical nature of the formulas are such that funds with a good track record will have interesting and

¹https://www.esma.europa.eu/sites/default/files/library/esma30-201-535cp_pkid_response_form_rev.docx

promising performance scenarios. However the future is a bad advisor of the past. This is problematic and can mislead investors, a point which the ESAs have embraced since their previous consultation of Autumn 2018.

The recommended holding period corresponds to N returns (daily, weekly or monthly). With this time-series, the following parameters are calculated: M_1 (observed average return per period), σ (Volatility), μ_1 (Skew) and μ_2 (Excess Kurtosis). Using these inputs, one calculates the price return for the following scenario's:

Current Approach

$$\begin{aligned}
 \text{Unfavourable Scenario} &= M_1 \times N + \sigma\sqrt{N} \times (-1.28 + 0.107\frac{\mu_1}{\sqrt{N}} + 0.0724\frac{\mu_2}{N} \\
 &\quad - 0.0611\frac{\mu_1^2}{N}) - \frac{1}{2}\sigma^2N \\
 \text{Moderate Scenario} &= M_1 \times N - \sigma\frac{\mu_1}{6} - \frac{1}{2}\sigma^2N \\
 \text{Favourable Scenario} &= M_1 \times N + \sigma\sqrt{N} \times (1.28 + 0.107\frac{\mu_1}{\sqrt{N}} \\
 &\quad - 0.0724\frac{\mu_2}{N} + 0.0611\frac{\mu_1^2}{N}) - \frac{1}{2}\sigma^2N
 \end{aligned} \tag{1}$$

The main culprit is without any doubt the growth rate M_1 embedded in the different formulas. This is exactly the area where the ESAs want to make progress and a lot of respondents to the November 2018 consultation paper were of the view that this had to be changed. A valid alternative could be the introduction of risk-neutral scenarios and hereby eliminating completely the growth rate issue. In the current consultation paper the ESAs propose to use a growth rate g which is the the sum of a reference rate r_{ref} common to all asset types and an asset specific risk premium.

The reference rate r_{ref} shall be read from the accepted market-standard interest rate curve for the currency and country of the asset derived from the prices of sovereign bonds of the country.

According to the ESAs, the proposed methodology can be applied to a number of different types of PRIIPs and gives meaningful results without suffering procyclicality.

Current Approach

$$M_1 = \sum_{i=1}^{M_0} \frac{r_i}{M_0}$$

$$M_0 = \text{Number of logreturns } r_i$$

Proposal

$$\Rightarrow g = r_{\text{ref}} + \text{risk premium}$$

Because g is an annualised growth rate it will be applied on the length T of the recommended holding period expressed in years. The equations hence slightly change:

Proposal

$$\begin{aligned}\text{Unfavourable Scenario} &= g \times T + \sigma\sqrt{N} \times (-1.28 + 0.107\frac{\mu_1}{\sqrt{N}} + 0.0724\frac{\mu_2}{N} \\ &\quad - 0.0611\frac{\mu_1^2}{N}) - \frac{1}{2}\sigma^2N \\ \text{Moderate Scenario} &= g \times T - \sigma\frac{\mu_1}{6} - \frac{1}{2}\sigma^2N \\ \text{Favourable Scenario} &= g \times T + \sigma\sqrt{N} \times (1.28 + 0.107\frac{\mu_1}{\sqrt{N}} \\ &\quad - 0.0724\frac{\mu_2}{N} + 0.0611\frac{\mu_1^2}{N}) - \frac{1}{2}\sigma^2N\end{aligned}\tag{2}$$

Remarks:

For recommended holding periods T shorter than 1 year, performance in percentage terms shall reflect the projected return over that period and not as an annualised return.

For those PRIIPs where there is no initial investment or price paid (forwards, futures, CFDs or swaps), the percentage shall be calculated considering the notional value of the contract and a footnote shall be added to explaining this.

In the document, it has been pointed out that not all different kind of PRIIPs have been tested with the new approach and the ESAs are reaching out via the consultation document to the industry for further testing and feedback. At the same time the ESAs are open to alternative suggestions from market participants.

RiskConcile is more than happy to examine to what extent your PRIIPs are impacted by the new growth rate proposals. Do not hesitate to contact us and provide us a couple of share-class you want to see calculated under the new proposed requirements (info@riskconcile.com).

3.2 Removing Stress and Intermediate Scenarios ?

The ESAs have received numerous comments in the previous consultation regarding the stress scenario's published in the KIDs and the challenges for category 3 products dealing with such intermediate scenarios. RiskConcile has responded to the 2018 consultation document pin-pointing the numerical consequences of the suggested approach. We advocated the use of an American Monte Carlo technique to find the quantiles for different intermediate points of path-dependent structure products.

The ESAs now mention the removal of such intermediate and stress scenario's as a "possibility". The feedback received on the previous consultation paper indicated that many considered the existing performance scenarios to provide an

overload of information. [Question 8](#)

The numerical challenge to provide intermediated scenarios for Category 3 PRIIPs has been recognised by the ESAs. Some assets come for example with a negative calculated yield. In the questionnaire attached to the consultation document there seems to be no longer interest to seek input from market practitioners to remediate the calculation of these intermediate scenarios. This clearly indicates to us, that intermediate scenarios will be moved off the table for structured products (Category 3) and exotic options (Category 1).

3.3 Dividend Methodology

The replacement of M_1 which is based on the historical returns of the PRIIPs by a reference rate increased with an asset specific premium will have a major impact on the risk and performance data.

$$g = \text{Reference Rate} + \text{Asset Specific Risk Premium} \quad (3)$$

In Equation 2 M_1 was replaced by g . In the consultation paper, the ESAs present a case study concerning one single PRIIP (a large cap German equity fund) to illustrate the positive impact resulting from the new M_1 .

3.4 Reference Rate (r_{ref})

The reference rate r_{ref} for an asset is given by the interest rate curve derived from sovereign bond prices of the country of the asset. [Question 9](#)

3.5 Asset Specific Risk Premium

A suggestion for the risk premium has been made for different asset classes: real estate, bonds, FX instruments, commodities and equity.

- **Equity:** The dividend yield of the appropriate country/sector estimated from an appropriate source and all other cash distributions, including share buybacks
- **Bond:** The difference between the coupon rate and the reference rate.
- **Real Estate:** Dividend rate of the PRIIP estimated from an appropriate source if the dividend is received by the holder of the PRIIP and share buybacks.
- **Commodities:** Implied annual yield implied by the expected forward price of the commodity if available on a liquid market less the appropriate reference rate.

A real look-through approach is suggested. The dividend yield has to be calculated using the average dividend yield of the countries and sectors of the holdings in the portfolio. The risk premium is based on the average weighted dividend yield. For bonds the yields is based on the country and rating. The proposal to use the dividend rate and all other distributions to the holder of the PRIIPs is based on academic evidence. Nevertheless, the ESAs come with several observations and questions:

- **Question 10** The expected yields should be determined by the composition of the PRIIP decomposed by asset class, country and sector or rating. This captures regional and sectorial differences. Do you agree with this approach? If not, what approach would you favour?
- **Question 11** One possible input is to use historical dividend yields to determine the growth rate g . The ESAs are seeking answers to the question where reliable expected dividends could be sourced from.

4 Structured Products

Apart from the fact that intermediate and stress scenario's are not longer on the menu, there is no major overhaul for structured products. The bootstrap mechanism where logreturns are sampled from the history of the underlying asset still stands, with the exception that the risk neutrality is modified through the introduction of the expected growth rate g .

For Category 3 PRIIPs, the historical sample of the logarithm of daily returns of each asset is shifted by a constant factor. The mean of the shifted historical sample of the logarithm of daily returns of the asset must be equal to g .

The paper briefly mentioned that 63 different structured payoffs were tested in the preparation of the current PRIIP regulation and that repeating the tests using the proposed methodology resulted in largely similar results. No details on those tests were provided in the consultation paper.

The final section of the consultation document presents the draft amendments to the PRIIPs Delegated Regulation. We could not trace anything back regarding structured products and options where the payoff is based on curves (CMS, caps, floors, etc...).

5 Money Market Funds

Money Market funds remain a Category 2 PRIIPS but are considered as an investment product where the value accrues over time. The unfavourable, moderate and favourable scenarios are still derived from to the 10th, 50th and 90th percentile.

These returns are no longer based on a formula but correspond quantiles obtained from a Monte Carlo Simulation. Here 50.000 paths are constructed, where each path covers the recommend holding period of the instrument. The simulation covers the following steps:

1. Simulate 50.000 paths
2. For each path sample a random variable x_i from a Standard Normal distribution.
 $x_i \sim N(0, 1) \quad \forall i \in [0 \rightarrow 50.000]$
3. Calculate from each x_i a corresponding compounded return r_i for the period T :

$$r_i = \exp \left(g \times T + \sigma \sqrt{N} \times \left(x + P_1(x) \frac{\mu_1}{\sqrt{N}} + P_2(x) \frac{\mu_2}{N} + P_3(x) \frac{\mu_1^2}{N} \right) \right)$$

with

$$g = \text{expected growth rate}$$

$$\mu_1 = \text{skew}$$

$$\mu_2 = \text{excess kurtosis}$$

$$\sigma = \text{volatility}$$

$$N = \text{Number of days in the period } T$$

$$P_1(x) = \frac{x^2 - 1}{6}$$

$$P_2(x) = \frac{x^3 - 3x}{24}$$

$$P_3(x) = \frac{5x - 2x^3}{36}$$
(4)

4. The simulated value of the PRIIP at the end of the period T is obtained by multiplying the initial value with the compounded return r_i
5. The percentiles of the simulated returns give us the values for the favourable, moderate and unfavourable scenarios.

Questions 13 & 14

6 Volatility σ

In the current Regulatory Technical Standards for PRIIPS, the volatility is sourced from the historical returns of the asset using a horizon of minimum 2 up till 5 years of daily returns. Sourcing σ from historical returns would still be allowed according to the consultation document, but for PRIIPS targeting a specific interest rate such as Money Market Funds, **the volatility shall be the at-the-money volatility of the 1 year European options on a similar rate.**

Asset Class	M_1
Equity	A%
Bonds	B%
Property	C%
Cash	D%
Hybrid	E%

Table 1

7 Compensatory Mechanisms

The ESAs recognise that the methodological changes do not guarantee that the favourable or unfavourable scenarios lead to satisfactory results. There has been no comprehensive testing of all product types in all possible market conditions of the new dividend yield approach. Therefore a compensatory mechanism is introduced. Similar to the other proposals in the consultation document, this item is open for suggestions. Given the relevancy and materiality of this issue, ESAs are in particular seeking feedback from stakeholders on this proposal regarding compensatory mechanisms [Questions 15, 16 & 17](#).

Such a mechanism would allow favourable or unfavourable scenarios to be adjusted if their outcome would be conflicting with respectively the highest or lowest return observed in the past. Unfavourable scenarios could even be lowered if these would not match the expectations of the manufacturer.

8 Other Probabilistic Approaches

Having an asset-specific growth rate is seen by the ESAs as a clear advantage compared to the historical rate M_1 that solely depends on the historical performance of the PRIIP. At the same time the ESAs now introduced a new source of uncertainty: the asset specific risk premium. A simplified approach would be to introduce (or should be read "impose"?) growth rates per asset-class which could be reviewed from time to time. Table 1 illustrates this. The data in the table with the simplified growth rates have to be calculated and regularly reviewed by a regulatory supervisory body. [Questions 18, 19 & 20](#).

9 Illustrative Scenarios

Similar to the current approach used in structured UCITS funds, the point of using illustrative scenario's has been made in the consultation paper. The main disadvantage of this approach is the discretion of the manufacturer to select the scenarios to illustrate the payoff mechanism of a structured product. This is in contrast with the risk-neutral probabilistic method currently used for Category 3

PRIIPs. Questions 18, 19 & 20

If Category 3 PRIIPs need to be accompanied by illustrative scenarios, the ESAs require this do be done net of cost. This is important since most illustrative scenarios found in marketing documents are always on a nominal basis excluding any implicit or explicit cost.

10 Inclusion of Past Performance

The inclusion of past performance in the KID surfaced for the first time in the 2018 consultation document. Based on the received feedback, the ESAs will not require the incorporation of the past performance for Category 1 and 3 PRIIPs. It was also considered that if the past performance is included, it will always be together with future performance. The inclusion of past performance will be part of the consumer testing. The question is rightfully raised that adding new material to the KID could conflict with Article 6(4) of the PRIIPs Regulation that limits the length of the KID to 3 sides of A4. Questions 26, 28,30 & 31

11 Costs

This section got a lot of coverage in the consultation document. Not a surprise given all controversy regarding this topic in the current technical standards for PRIIPs. **The ESAs consider the reduction in yield to remain the prominent cost indicator.**

11.1 Issues

The following issues were raised by market participants in the 2018 consultation paper:

- Inconsistency with other legal frameworks such as MiFID.
- Confusion between the total monetary cost and the return figure in the RIY table.
- Having a reduction in yield (RIY) calculated for 3 different periods (1 year, RHP² and RHP/2) is too much information
- The prescribed narratives in the table "Composition of Costs" does not work for certain category of instruments. It also does not cover a wide variety of performance cost structures.

²Recommended holding period

- The RIY has to be calculated using future performance which has led to different methodologies, hereby increasing confusion.
- The fact that the entry cost is amortised over the full RHP creates confusion because not all investors will hold the PRIIP for the full recommended holding period.

11.2 ESAs' Proposals

The ESAs are seeking input on the representation of the entry / exit costs in the KID's reduction in yield number. [Questions 33 & 34](#).

The ESAs are also contemplating to merge the performance and carried interest [Question 37](#)

The ESAs are of the view that the disclosure of the costs of real estate or private equity funds should therefore be specified in more details. There is a lack of clarity of how the fees related to the management of the underlying real estate is reflected. [Question 38](#)

The ESAs also propose to overhaul the structure of the cost tables. Currently there are two tables:

- one deals with the costs over time and contains the reduction in yield
- the second table presents the composition of the costs with the corresponding prescribed narratives.

In the consultation document the ESAs keep the concept of two tables, but introduce 4 possible new layouts for the costs in the KID. Each of these layouts is explained in detail and a sample is provided in Section 12.6 of the consultation document. [Questions 39,40,41 & 42](#)

In our write-up we will only present the ESAs's preferred layout. The table below illustrates how the reduction to yield is split across 3 lines and 3 columns: 1 year , 5 year and RHP. The 5 year column is only required when dealing with PRIIPs that have a recommended holding period of at least 8 year. On top of this, the monetary figures are no longer present in this table

When you invest [10.000 / 1.000 EUR per year]. We have assumed the product performs as in the moderate performance scenario	If you end / exit / surrender / terminate after 1 year	[for PRIIPs with RHP>8] If you end / exit / surrender / terminate after 5 years	If you exit after RHP
Impact on return over time			
Return per year before costs	%	%	%
Return per year after costs	%	%	%
Reduction in return each year due to costs	%	%	%

The second table incorporates the specific description of the different costs and recuperates the monetary breakdown of costs at different time periods from the current costs over time section:

Type of Cost		Description	Costs over time		
			If you end / exit / surrender / terminate after 1 year	[for PRIIPs with RHP>8] If you end / exit / surrender / terminate after 5 years	If you exit after RHP
One-off costs	Entry Costs		EUR	EUR	EUR
	Exit Costs		EUR	EUR	EUR
Ongoing costs	Management fees and other costs		EUR	EUR	EUR
	Transaction Costs		EUR	EUR	EUR
Incidental Costs	Performance Fees or Carried Interests or Other				
Total Costs			EUR	EUR	EUR

11.3 Transaction Costs

11.3.1 Allowing simplified approach

The ESAs stick to the view that a difference should be made between explicit and implicit transaction costs and that transparency has to be provided to the investors. At the same time the ESAs recognise the problems of a true reflection of the costs as a result of the requirement to use the slippage ('arrival price') methodology. It is considered important to adjust the approach for OTC instruments and real assets. The ESAs are proposing to introduce a proportionality threshold whereby a PRIIP manufacturer would be able to use a simplified approach where there is a low number of transactions or portfolio turnover.

The answer to the question of what such an appropriate threshold should be, remains open [Question 43](#)

11.3.2 Negative Transaction Costs

The ESAs intend to adjust the rules such that negative transaction costs can never be disclosed.

11.3.3 Amending the Arrival Price Method: Two options

The consultation document covers a proposal to amend the current prescribed arrival price methodology. At the same time it is also including a draft proposal for a more principal based approach. The latter option is definitively not the preferred approach of the ESAs, but has nevertheless been presented in the consultation document. This principle based approach provides a simplified methodology for new PRIIPs and allows alternative approaches based on third party data.

12 Multi-Option Products

12.1 Confusion around Costs

For insurance products with a multitude of underlying investment options (MOP), there are for the moment two possibilities in the PRIIP-regulation:

- A separate KID for each investment option (Article 10(a))
- A generic KID covering in general terms the types of investment options offered and separate information on each underlying investment option (Article 10(b)).

The main issue identified by the ESAs is linked to the lack of information regarding the costs. The generic KID shows a range of costs making it difficult to understand what costs come from the underlying investment option and what costs are sourced from the insurance contract itself. Moreover there is no information for investors that are seeking to allocate their investment across a combination of different underlying assets.

The ISAs proposal focuses on a range of measures:

- **Working out the costs for the most relevant investment options**
Providing a full cost calculation for every combination underlying to a particular insurance contract was considered not feasible. Instead the ESAs propose a minimum of four options or combinations of options to be worked out in the generic KID. Given that this approach would apply to a limited number of options, it is not considered to be unduly burdensome for the manufacturers. [Questions 50,51& 52](#)
- **Extra Narrative**
An extra narrative will be required in order to explain to the retail investor whether all the costs are included in the KID (or not) when making a particular choice amongst the different investment options.
- **Narrowing the range of costs**
The ESAs are considering to narrow the range of the costs. Several possibilities are proposed, one would be to have a cost range per underlying risk class. [Questions 53 & 54](#)