31st January 2011

Response to the Consultation by Commission Services on legislative steps for the Packaged Retail Investment Products initiative

We are a group of academics, consumers associations, unions and other representatives of investors' interests who want to express a common view about the forthcoming disclosure regulation that will be introduced by the European Commission for packaged retail investment products at the end of the legislative process started with the Commission Communication of April 30th 2009.

On December 4th 2010 we sent a letter to the Commission and to the CESR expressing our shared position about the use of the *what if* approach to implement the performance scenarios required for structured UCITs by article 78, par. 3 (c) of the level 1 UCITs IV Directive (i.e. Directive n. 2009/65/EC).

In that letter (see **Annex I**) we highlighted the inadequacy of the *what if* as transparency tool since it provides a partial representation of the potential returns of a structured product. We also pointed out that the natural use of the *what if* is inside advertising pamphlets, while its unavoidable arbitrariness makes it unacceptable in a document (like the KIID for UCITs or the forthcoming KIID for PRIPs) aimed at providing "*sufficient information for the average retail investor to make an informed investment decision*", as stated in the Consultative Document on PRIPs published by the Commission on November 26th 2010.

For the above arguments and **on behalf of investors' protection**, we asked to postpone any final decision on the matter to a new *consumers test* comparing the *what if* approach against a probabilistic table where the prospective performances of the products are synthesized in four events (negative return and positive return respective below, in line or above the return from a risk-free asset), each one with a return indicator and the probability level. In the previous two tests on this matter (in October 2008 and in June 2009) consumers expressed their strong preference for the probabilistic table.

On December 20th 2010, the CESR published its final guidelines (Ref. CESR/10-1318) where the *what if* solution was confirmed. Even if we can comprehend the costs of starting a new *consumer test* and of delaying an important legislative process, we believe that the outstanding prominence of the ultimate good that this regulation should preserve, namely the savings of retail investors of any member State, would have deserved a last effort to ensure the efficacy of the regulatory provisions on transparency.

In the awareness of the importance of this matter (also to create the premises for a new, solid and well-balanced working of financial markets) and hoping that our contribution will be appreciated by the Commission, we decided to participate with this new letter to the mentioned Consultation of November 26th 2010 on pre-contractual disclosure for PRIPs.

The success of this new regulation depends, first of all, on the clear definition of its scope. We agree with the Commission (see footnote 11 of the Consultative Document) that every product with a multi-dimensional risk exposure should be classified as *packaged*.

This immediately clarifies that only standard shares do not present elements of packaging, while the uncertainty which characterizes the value of whatever non-equity product is always due to two or more risk factors **[Ans. to Q. 1-5]**. For instance, this is the case of UCITs (which by definition invest in a multiplicity of assets) and of structured bonds. But it is also the case of plain vanilla bonds. Indeed, any bond is an obligation to pay back the investors an amount which is variable depending on: (**1**) the credit worthiness of the issuer and (**2**) the movements of the yield curve **[Ans. to Q. 8]**.

We therefore believe that the scope of the PRIPs regulation should explicitly include any product which exhibits the mentioned packaging features.

The second cornerstone of the PRIPs initiative will be the contents of the KIID. We read on the Consultative Document that the KIID developed for UCITs will be a benchmark also for transparency on packaged products. However, our opinion is that the PRIPs regulation is too important (also given the variety of products comprised in its scope) to disregard some serious drawbacks of the KIID for mutual funds **[Ans. to Q. 34]**.

In the UCITs KIID, the risks of the investment are conveyed to investors through a synthetic risk indicator, based on returns' volatility. We agree that, in general terms, volatility is a straightforward indicator of the riskiness of a product, but *per se* it is just a statistic whose values can be very different depending on the sampling period of the returns and on the number of past observations used. For UCITs, the synthetic indicator is based on the volatility of the weekly returns of the last five years.

Five years is a very long period in the perspective of volatility estimation. As a consequence the resulting volatility would be not representative of the current riskiness of PRIP at the subscription date, and it would be rather a quite general information. In addition, volatility of weekly returns exhibits smaller fluctuations than volatility of daily returns. The combination of these two effects typically results in an indication which is not up to date and, hence, not useful to investors interested in the true risk exposure of a product.

As envisaged at page 23 of the Consultative Document, we propose a re-calibration of the risk-ratings to ensure the meaningfulness and the comparability of this key information for the new universe of PRIPs. In particular, we believe that a valid calibration should lay on robust quantitative methodologies based on forward looking simulations of the potential daily returns of a product over its time horizon **[Ans. to Q. 36]**.

In order to improve comparability, for many PRIPs information on risks should also be supplemented by that on potential performances **[Ans. to Q. 37]**. Indeed, risk and reward are always strongly connected, that's why information on performances should be given for any PRIP with a well-defined maturity as part of the informative set needed by investors **[Ans. to Q. 40-41]**.

We confirm our view that performance information should not be offered through the *what-if* approach. Out of an infinity of possible results of the investment, this approach considers three elementary outcomes, selected at the convenience of the issuer. As witnessed by several studies and by tests on large samples of individuals, this representation fosters biased beliefs, since the three elementary scenarios are perceived as exhaustive of all performances achievable by a product and they are also considered as having the same 33% probability of occurring.

Both these beliefs are clearly false. The probabilistic approach is a much better alternative to concretely support investors, as it encompasses the entire probability distribution of the product's final performances and summarizes it in four events of paramount importance for any investor: experiencing a loss (negative return), or getting back the amount invested plus a return below, above or in line with the risk-free alternative.

Information on probabilistic performance scenarios should be supplemented by the breakdown of the product price at inception. The fair value of the PRIP at the issue date will be the discounted expected value of the final probability distribution under the risk-neutral measure. In this way the investor will be immediately aware that any gap between price and fair value is a cost he is paying, either explicitly or not **[Ans. to Q. 38-39]**.

Beside the above information, the logic of risks representation behind the transparency on PRIPs and the relevance of investors' liquidity preferences in affecting their investment decisions suggest to include, as further information item inside the KIID for PRIPs, an indication of the time horizon of the investment as currently prescribed by some national regulators (see hereafter for a concrete example) **[Ans. to Q. 26]**.

Indeed, every retail individual who is evaluating where to invest his savings wants to know how long he has to wait before getting back its money or maximizing its potential returns. It is a legitimate question which should be answered inside the KIID, and proper methodologies should be used by product manufacturers to determine the time horizon of a product in an objective way and consistently with its costs and level of risk. Moreover, the availability of this information directly from the issuer/manufacturer would make easier the adequacy tests which – according to MiFID discipline – distributors must conduct with a special attention to the correct matching between the time horizon of the product and the holding period of any single investor.

We all hope that our comments and suggestions could help the Commission to finalize transparency requirements on PRIPs which would be both objective and useful to retail investors in comparing the various products on a fair basis and in selecting those which better suit their needs.

The KIID on PRIPs is a big opportunity to move definitely towards a new transparency regulation which really puts at the first place the needs of retail investors and requires issuers to provide clear answers to few key questions:

1. How volatile is this product?
2. How much can I lose in absolute terms and relatively to the risk-free alternative? With what probability?
3. How long should I keep it before to disinvest without losses?

In Italy, since a few years the Securities and Exchange Commission (CONSOB) has adopted a risk-based approach to transparency which answers the above questions for many investment products other than equity. For instance, about the time horizon of the investment, CONSOB requires issuers/product manufacturers to consider the distribution of the first passage times of the theoretical value of a product for a barrier corresponding to the price paid by the investors and to give investors a clear indication of the year by which the investment will have repaid at least the costs incurred.

In **Annex II** to this letter we considered an hypothetical PRIP and we compared, in a table, its KIID filled respectively according to the level 3 UCITs IV measures (left column) and according to the mentioned CONSOB's approach (right column). It is a very useful example of the importance of choosing the right informative set and the proper solutions to produce and to represent it.

A similar example could enter in a *consumers test* that the Commission could perform before publishing its final provisions on pre-contractual disclosure for packaged products.

Moreover the organization of public seminars in which Academics and Regulators could present and compare different quantitative approaches for risk disclosure is of a paramount importance for crucial decisions such as those under discussion in this consultation.

The suggestions exposed in this letter, the proposed *consumers test* and public seminars, will give an important support to the Commission in order to set forth, in an effective way, the new transparency regulation on PRIPs.

We firmly believe that these are crucial steps to be enacted in order to fulfill the prior commitment of the Commission, of the ESMA and of any national regulator, i.e. to protect investors and restore their confidence in the financial system by endowing them with the best disclosure tools required to overcome the otherwise unavoidable informational asymmetries they suffer with respect to the subjects who have issued or designed the financial products.

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ANNEX I

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To: Mr. Giuseppe Vegas
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ITALY

This letter is to notify to You a position shared by a group of academics, consumers associations, unions and other representatives of investors' interests concerning the proposals expressed in 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, as a part of the implementation process (level 3 guidelines) of the revised UCITS Directive (2009/65/EU).

The above mentioned group - whose views are quite similar to those submitted by several participants to the consultation process - wants to express disappointment for the choice made by the CESR to implement the *performance scenarios* of article 78, par. 3 (c) of the level 1 UCITS Directive according to a *what-if* solution instead that by means of the so-called *probabilistic table*.

Since we are conscious that transparency is the main topic of this century, particularly with respect to retail investors, we see this choice is a significant and unexpected backward step. It is in fact the main goal of regulation to provide retail investors with adequate information on the key characteristics of financial products and the associated risks and costs so that they can be effectively supported in the selection of solutions that best suit their needs. This selection cannot avoid a probability judgement from any individual, and each of them, independently from her education, country and social condition would always ask the same question: **what are the risks** I am going to bear with this investment, with respect to a safer one? The probabilistic table provides a direct answer to this question, and answering this question must be mandatory for any financial institution proposing an investment.

The choice of dismissing the *probability table* as mandatory disclosure is an unforgiveable setback for the following reasons:

1) ***what-if* is a marketing tool and it is not a transparency tool**: what-if analysis is based on a particular evolution of the market and as such it is completely arbitrary, and subject to manipulation and distortion. As such, it may be an important marketing tool, but cannot be confused with transparency;

2) **scenarios can only be stated in terms of probability:** transparency has to do with helping retailers to make clear the probability of success of their investments, while a *what-if* scenario provides a representation of a single state of the world out of an infinity of other possible ones, and as such has zero probability; collecting all scenarios and distinguishing among good, bad and fair necessarily leads to the probability table. Without this additional piece of information on probabilities the *what-if* would only favour investors' confusion and misunderstanding since their natural interpretation would be to consider each of the three outlined *what-if* scenarios as exhausting all possibilities and having the same probability, which is clearly false;

3) **comparison of different products can only be done in terms of probability:** in a *what-if* disclosure, every product is evaluated (and not measured) in a different scenario and cannot be compared across different asset classes and products unless all possible scenarios are collected (and measured) in a *probability table*;

4) **probabilistic comparison across products must rely on a common reference, the safest financial investment:** the probabilistic table provides a representation focused on four main performance scenarios (negative return and positive return respectively below, in line and above the risk-free asset) each one identified by the associated probability and by a value which synthesizes the returns achievable in that scenario. In this way investors get a fair comprehension of the performances attainable by the product, both in terms of capital preservation and of chances of earning more than from the riskless asset;

5) **financial products are designed using probability:** any asset manager and structurer address the same basic question as retail investors do: how much am I likely to perform better than other products? Differently from retail investors, they must be endowed with technical tools and skills to provide an answer. So, *disclosing* this information must be mandatory from a regulatory point of view because *having* this information is mandatory from a deontological point of view. Moreover, given the in-house availability of the said tools and skills, issuers can provide consumers with this key information without any additional burden with respect to their usual pricing and risk management activities.

Given these arguments, which are grounded on the basic principles of finance, we ask:

1) Why was the *what-if* approach presented in the consultation document as the only viable solution to implement level 1 provisions?

2) Is the dismissal of the probability table as mandatory disclosure in favour of the *what-if* approach consistent with the preferences of retail investors? We are aware of studies requested by the European Commission on the effectiveness of different forms of disclosure to consumers. How do the results of these studies fit with the proposal made in the consultation paper?

3) Where and when were the arguments in favour of the *probability table* expressed by the respondents to past consultations on the KII contrasted? Why have they only been dismissed with no argument?

If any decision will be taken without answering these questions we are afraid we will have to conclude that the struggle for transparency will remain on the exclusive domain of academics and consumers' associations. We want to be confident that this will not be the outcome. Therefore, on behalf of investors' protection, we believe that it is necessary, as suggested by some participants to the consultation process, to start with **a new consumer test** focused on the effectiveness of the *probabilistic table* approach versus the *what-if scenarios*.

Moreover, it is our opinion that the final guidelines which will be published by the CESR in this matter should not be allowed to weaken the level of investors' safeguard which has been reached by the virtuous solutions based on probabilistic approaches adopted by some member countries, including Italy.

In this perspective, if at the European level there would remain a huge discrepancy among the several regulators and stake-holders about what approach should be pursued, we firmly believe that, in the light of the prior task of investors' protection, the better solution should be to endow each competent authority with the power to apply its disclosure regime on performance scenarios to all structured Ucits marketed inside its borders irrespective of the country where these products are issued.

Indeed, even if this solution could appear a violation of the maximum harmonization principle, nobody could disregard that the blind pursuit of this latter principle at the cost of a weakened investors' safeguard would be fully equivalent to miss the opportunity of achieving a Pareto optimum, which, by definition, will improve the position of some consumers without additional damages for the others.

We would appreciate your immediate attention on this matter.

Best regards.

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ANNEX II

KIID OF AN HYPOTHETICAL PRIP:
LEVEL 3 UCITS IV MEASURES *VERSUS* CONSOB'S RISK-BASED APPROACH

Product Description

The product has a floor of 80% and a cap of 120% of the amount invested. Its payoff depends on a formula linked to the return of a basket of three shares over the last 4 years.

Level 3 UCITs IV measures	CONSOB
Nature of the product: Structured (equity-linked)	**Fund structure:** Return-Target **Investment time horizon:** 4 years

Synthetic Risk Indicator

Low Risk — High Risk

1	**2**	3	4	5	6	7

Degree of Risk:

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low	medium-low	medium	**MEDIUM-HIGH**	high	very high

Costs

Fees applied at the subscription or at the exit date	
Subscription Fees	1.5%
Exit fees	0%
Ongoing Fees	1.5%

Unbundling of the price

Bond component	88.13%
Derivative component	6.92%
Total financial value	95.05%
Costs	4.95%
Price	100%

What-if

Unfavourable Scenario

Shares	Shares Return
1	-29%
2	-35%
3	-7%

Average return of the basket of shares	-24%
Return of the product	-20%

Neutral Scenario

Shares	Shares Return
1	7%
2	-4%
3	3%

Average return of the basket of shares	2%
Return of the product	0%

Favourable Scenario

Shares	Shares Return
1	24%
2	40%
3	13%

Average return of the basket of shares	25%
Return of the product	20%

Table of probabilistic performance scenarios

Scenario	Probability	Median Value (w.r.t. 100 €)
The return is negative	42.3%	88 €
The return is positive but lower than the return of the risk-free asset	13.8%	103 €
The return is positive and in line with the return of the risk-free asset	29.8%	115 €
The return is positive and higher than the return of the risk-free asset	14.1%	119 €