Performance anxiety

European regulators have introduced guidelines for a new key investor information document under Ucits IV, and are expected to extend aspects of the rules to other retail structured products. But some participants feel the use of performance scenarios is a backward step. By ***Alexander Campbell***

European regulators want to shine a light on the murky world of retail structured products. The crucial issue, they say, is one of disclosure. Investors often did not understand the risks of certain products, overwhelmed by reams and reams of dense, legal jargon within prospectuses, designed more to protect the issuer from legal challenge than provide a clear, easy-to-understand explanation of the risks involved.

This is set to change. The European Securities and Markets Authority (Esma) (formerly the Committee of European Securities Regulators (Cesr)), has developed rules for a key investor information (KII) document to be included with new issues, designed to act as a two- or three-page summary of how a product works, the fees charged and the key risks. Issuers of structured Ucits funds will also be obliged to present at least three performance scenarios within the KII document – a requirement finalised on December 20.

Regulators are now turning their attention to the broader universe of packaged retail investment products (Prips). A consultation paper by the European Commission (EC) was published last year, and proposes to apply aspects of the Ucits KII document regime to Prips as well.

However, the performance scenarios for Ucits structured funds have been criticised by a group of academics, who claim they are subjective, statistically meaningless and cannot be compared across products. Instead, they believe an alternative, quantitative approach pioneered by Italian securities regulator Consob should be rolled out across the European Union – and reckon this methodology should also be considered for Prips.

As it stands, structured Ucits investments must contain at least three scenarios of potential performance within the KII document to illustrate the payout under certain market conditions – broadly defined as unfavourable, favourable and neutral. The issuer has plenty of scope to decide what these scenarios should be: the guidelines merely state the examples used in the favourable and unfavourable scenarios should be "based on reasonable assumptions about future market conditions and price movements".

On top of these 'what-if' scenarios, Cesr announced last July that the KII document for all Ucits investments should include a synthetic risk and reward indicator – essentially, a single numerical gauge of the risk a product poses, ranked on a scale of one to seven. The indicator is based on the volatility of the fund using weekly or monthly returns covering the previous five years. For structured funds, the indicator should be calculated on the basis of the annualised volatility corresponding to the 99% value-at-risk at maturity.

Both requirements could be rolled out for Prips. In the EC consultation paper published on November 26, the commission acknowledges it is not possible to harmonise and standardise disclosures for all Prips to the same extent as Ucits funds. It also concedes the synthetic risk and return indicator and performance scenarios cannot just be copied-and-pasted over to Prips. While it might be possible to adapt the risk indicator methodology used for structured Ucits funds to a broader range of retail structured products, adjustments may be necessary to take counterparty risk or liquidity into

account. The performance scenarios may be more problematic, though. The EC says it is not clear how they might be applied more widely, and suggests further work is needed to identify possible approaches.

The EC is clear on one thing, though – the product information provided to retail investors should be much clearer, and presented using simple language. As such, some participants believe it is likely some form of risk-indicator and performance-scenario regime will be rolled out to Prips.

While agreeing on the general principles, the methodology used within Ucits has attracted plenty of criticism from industry participants.

In the case of the synthetic risk indicator, participants warn investors may become over-reliant on this single measure of risk, in a similar way to how institutional investors relied on ratings prior to the crisis. Many also warn a risk indicator is over-simplistic, and unlikely to capture the various risks to which a product is exposed at any moment in time.

Tim Hailes, associate general counsel for structured products at JP Morgan in London and chairman of the Joint Associations Committee (JAC), a group comprising the European Securitisation Forum, the International Capital Market Association, the International Swaps and Derivatives Association, the London Investment Banking Association and the Securities Industry and Financial Markets Association, believes it would be very difficult, if not impossible, to construct an indicator that would enable investors to make like-for-like comparisons of the risks associated with different structured products.

"The JAC remains uncomfortable with the synthetic risk and reward indicator. The industry recognises there should be alternative ways to communicate the risk-reward proposition to consumers than the wordy narrative thought up by the lawyers. A number of structured product providers already include more straightforward questions and answers, pictorial representations, symbols or other mechanisms to help improve investor understanding," says Hailes.

Others go further. "The synthetic risk indicator is too simplistic and probably misleading," says a structured products head at a major bank in London.

The performance scenarios have also come under attack from a variety of consumer associations, as well as a group of 34 academics. In December, the academics sent a letter to Cesr and the EC highlighting the shortcomings of the scenario approach – as it happens, a matter of days before Cesr confirmed it would apply this methodology for structured Ucits funds.

The letter, seen by *Risk*, claims what-if scenarios are completely arbitrary and subject to manipulation and distortion. Furthermore, it argues a what-if scenario is a single state of the world out of an infinity of other possible ones, and as such has zero probability. Perhaps most seriously given the regulatory focus on transparency, the group points out that every new issue could be evaluated using a different scenario and so cannot be compared across asset classes and products.

Signed by the likes of Oldrich Vasicek, founding partner of Moody's KMV, Umberto Cherubini at the University of Bologna, Francesco Corielli at Bocconi University and Helyette Geman at Birkbeck College, University of London, the letter instead calls on regulators to consider a more quantitative approach in which all possible scenarios are calculated. A probability table would then provide a representation focused on a number of main performance scenarios – a negative and positive return below, in line and above the risk-free rate, each identified by an associated probability.

A similar methodology is already in place in Italy, having been introduced by Consob in 2004. The first pillar of a three-pillar approach requires issuers to publish a table showing the probability scenarios of the return of the investment at the end of the time horizon recommended to investors. A probability is assigned to a negative return scenario, a scenario where the return is positive or zero but lower than that of the risk-free rate, a scenario where the return is positive and in line with the risk-free rate, and one where the return is above the risk-free rate. The only requirement for issuers is that their models for calculating these probabilities must comply with the risk-neutrality principle.

A representative value also has to be published, corresponding to the median of the final payout associated with each of the four events, determined via numerical simulations.

The second pillar covers the overall riskiness of a product, based on the volatility of daily returns – analogous to the synthetic risk and reward indicator introduced by Cesr. The calibrations are performed by running forward-looking risk-neutral simulations (as opposed to using five years of historical data under the Cesr approach) and by developing prediction intervals on future volatility based on the continuous limit of proper Garch models. A third pillar covers the recommended investment time horizon, taking the recovery of costs into account.

One of the designers of the Consob methodology is Marcello Minenna, head of the regulator's quantitative analysis unit in Rome. Speaking at *Risk*'s Quant Congress USA conference in New York in 2010, he noted the quantitative approach, combined with more qualitative oversight, had provided early warning of recent upheavals in the structured products market. "The quantitative analysis unit I direct started to use a watch-list of the issuers whose credit risk is particularly high. The list is fed by the results of the joint analysis of several credit risk indicators, such as credit default swap spreads, discount margins and ratings, and is under continuous monitoring," he said.

When Consob detects changes in the risk status of an issuer, it can compel product providers to update their prospectuses to reflect the higher risk in the overall risk ratings, as well as the lower expected payout in the probability tables.

In two recent cases, this approach provided enough warning for Italian

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investors to avoid serious harm, Minenna claimed. "The weakness of Lehman Brothers was clear from 2007, simply by looking at the evolution and the volatility of its credit spreads. In the early months of 2008, the credit spread widened further. Consequently, in April 2008, Consob intervened to ensure all insurance companies that were offering retail products embedding Lehman's bonds promptly updated their prospectuses and also published clear disclaimers, giving investors the opportunity to exit from the product several months before the default of Lehman in September 2008," he said.

"Similar initiatives were undertaken in spring and summer 2008 to provide investors with timely updated information on the deteriorating risk profile of products containing bonds issued by the Icelandic banks Kaupthing, Landsbanki and Glitnir. Thanks to these enforcements, Consob had no litigation with any investor associated with the two biggest episodes of default experienced over the past few years," Minenna added.

The Italian requirements look to be far more complicated than the approach specified for structured Ucits funds by Cesr/Esma. However, academics claim

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structurers are already conducting much of the analysis required by Consob.

"The work to calculate the probability numbers is part of the production process of the financial product. If a financial institution does not use probability to gauge the structure of the product and to price it once the probability is adjusted to allow for risk premium, not only does it not disclose the nature of the product to the clients, but it would also not be aware of the product it is about to place. So, if the work of probability analysis were not undertaken, the problem would be much more serious than a mere disclosure issue," says the University of Bologna's Cherubini. Assuming banks are not acting so carelessly, the probability table should not lead to much additional cost and effort for product providers – unlike the what-if approach, he adds.

He also argues the quantitative approach is easier to understand – it is frequently used in the Italian financial press, for example. "If out of 300 pages of the prospectus, this figure is used by analysts and journalists to get across the quality of an investment proposal, I think it is a success," says Cherubini.

Risk has been given a comparison of the disclosure that is required under the structured Ucits rules and that demanded by Consob under the probability table methodology (see figure 1). The hypothetical four-year fund has a payout referenced to a basket of three stocks, and has a cap set at 120% and a floor at 80%. Under the Cesr/Esma approach, a single unfavourable scenario shows the investor could see a –20% return on the fund if the three stocks fall by the amount specified under the scenario. That is balanced by a neutral scenario and a favourable scenario – in the latter case, all the component stocks rise and the investor receives a positive return of 20%. In contrast, the Consob methodology shows the investor has a 42.3% chance of receiving a negative return and only a 14.1% probability of finishing with a positive return higher than that of the risk-free rate.

The two synthetic risk indicators are also different. The Cesr/Esma indicator classifies the products at the low-risk end of the spectrum. The Consob indicator, however, categorises the fund as medium- to high-risk. This could partly be due to the five years of data required to calibrate the indicator under the Cesr/Esma methodology, says Riccardo Cesari, professor of mathematical finance at the University of Bologna.

"Five years is a very long period. As a consequence, the resulting volatility would not be representative of the riskiness of a Prip at the subscription date. In addition, volatility of weekly returns exhibits smaller fluctuations than volatility of daily returns," he says.

Dealers acknowledge the difference between the two methods – but the London-based head of structured products says he would be happy with either approach. "We're generally comfortable with either approach as long as there is a clear consensus about what is required. But the Consob approach is purely factual. The Cesr/Esma methodology involves you making a determination about the scenarios, and that's more risky."

Whichever approach is eventually taken for Prips, it is likely to take time to bed down. The London-based structured products head claims some firms initially experienced problems with the quantitative approach in Italy. "It was quite a mess for the first 12 months after implementation. Banks had to do a lot of additional work in some cases. In all aspects of regulation, the specifics of implementation are at least as important as the general principle. Other countries could ideally learn from the Consob case."

Similarly, he believes the Cesr/Esma methodology could become more polished and useful to investors as banks become familiar with the process. "Saying the choice of scenarios is subjective is a fair criticism, but I think it is offset by the emphasis on the marketing material being fair and transparent. If anything, the issuers are likely to downplay the favourable side," he says.

The Prips consultation paper closed at the end of last month, but the rules are still very much in the early stages. The next step will be the publication of a level one document, which will outline general principles, probably late this year or early in 2012. Regulators must then draw up more detailed rules, likely to emerge in 2013, with the final guidelines coming into force from 2014. During this period, the group of academics hopes the regulators will ditch the use of performance scenarios in favour of a more quantitative approach.

"If the probability analysis is not carried out, it would be like a pharmaceutical firm distributing drugs that had not been tested and measured in any lab," says the University of Bologna's Cherubini. ■

1 Representation of a structured Ucits fund according to Cesr/Esma guidelines and the risk-based approach of Consob

Fund description

The fund has a floor of 80% and a cap of 120% of the amount invested. Its payout depends on a formula linked to the return of a basket of three shares over the past four years.

Cesr – Esma	**Consob**
Nature of the fund: formula, equity-linked	**Fund structure:** Return-target
	Investment time horizon: Four years

Synthetic risk indicator

Low risk ◄——————————► High risk

1	**2**	3	4	5	6	7

Degree of risk:

low	medium–low	medium	**MEDIUM–HIGH**	high	very high

Costs

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

Unbundling of the price

Bond component	88.13%
Derivatives 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%
Fund return	–20%

Neutral scenario

Shares	**Shares return**
1	7%
2	–4%
3	3%

Average return of the basket of shares	2%
Fund return	0%

Favourable scenario

Shares	**Shares return**
1	24%
2	40%
3	13%

Average return of the basket of shares	25%
Fund return	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