Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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European Banking Authority
European Insurance & Occupational Pensions Authority
European Securities & Markets Authority

17 February 2015

Dear Sir, Madam,

Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs)

This letter accompanies the response by the Financial Services Consumer Panel to the questions posed by the ESA's joint discussion paper on the Key Information Document under the PRIIPs Regulation. The Consumer Panel is grateful for this opportunity to set out its views on the content and format of the KID.

Under the terms of the 2000 Financial Services and Markets Act as amended by 2012 Financial Services Act, the UK's Financial Conduct Authority (FCA) is required to set up and maintain a panel to represent the consumer interest. The panel set up under the Act - the Financial Services Consumer Panel - operates independently of the FCA. The emphasis of its work is on activities that are regulated by the FCA, although it may also look at the impact on consumers of activities that are not regulated but are related to the FCA's general duties.

The Panel takes a close interest in the transparency and fairness of fees charged to retail investors, as fees have a significant impact on investment returns. For example, illustrative calculations by the UK's Department for Work and Pensions in November 2013 show that an individual who saves throughout their working life into a retirement scheme with a 1% annual charge could lose around 24% of their pension pot at retirement as a result of charges[1]. Although the PRIIPs Regulation will not apply to pension products, the above example is nonetheless illustrative of the impact costs and charges can have on the returns a retail investor can expect.

The Panel is broadly supportive of the direction the ESAs appear to be taking on disclosure of costs through the Key Information Document in this discussion paper. However, the Panel feels that its scope, though ambitious, does not fully reflect the complexities of retail fund structures, the asymmetries of information between firms and investors, and the conflicts of interest in the asset management industry, which results in a weak principal-agent relationship.

The Panel also has concerns about the narrow definition of the concept of 'risk' adopted by the ESAs, as the risk indicator should also include the impact of hidden, indirect, costs. There is also the possibility the calculation and disclosure methodologies will not be comprehensive and may not reflect similar provisions in the second Markets in Financial Instruments Directive (MiFID 2). The Panel looks forward to engaging in more

[1] DWP, Pensions Bill 2013, Information Pack for Peers

detail on the substance of these issues with the ESAs when the technical consultation paper is published later this year.

The Panel would also like to take the opportunity here to highlight a number of shortcomings in the Level-1 Regulation and the EU's approach to conduct in the investment market more broadly, particularly as regards the focus on disclosure over structural reforms, and the limited scope of products covered by the PRIIPs Regulation. Whilst we accept that these issues are now settled in law, it nonetheless wants to share our concerns with you from an early stage in view of the 2018 review of the legislation as required by Article 33 of the Regulation.

Products out of scope

Key Information Documents will only work if EU legislation governing investment products, including PRIIPs and MiFID 2, applies across all fund structures, including unit-linked pension funds, and adopts a cost disclosure and fund governance model that aligns the interests of firms and customers.

In this regard, the Panel is particularly disappointed that pension products are not subject to the provisions of the PRIIPs Regulation. In the UK alone, over 12 million people will be auto-enrolled in private sector defined-contribution pension schemes by 2018[2], which appear beyond the scope of this legislation.[3]

Moreover, the PRIIPs Regulation will not apply to manufacturers of UCITS funds until 31 December 2019, and possibly not at all[4]. This will lead to divergent disclosure practices for different types of retail investment products, with less stringent requirements applicable to UCITS despite the fact that these are the most popular type of retail investment.[5]

The transitional period envisaged by the PRIIPs Regulation for UCITS manufacturers is already likely to complicate adherence to MiFID 2 for investment firms, as the latter will have to rely on UCITS management companies voluntarily providing them with the information on transaction costs which investment firms will be required to disclose to their customers. There are therefore a significant number of investment products that will not be subject to these new rules on pre-sale disclosure.

The Panel would urge the ESAs, when providing information to the European Commission ahead of the review of the Regulation in the coming years, to recommend extending the scope of the information and disclosure rules laid down in the PRIIPs Regulation to include both pension products and UCITS.

Disclosure versus structural reform

The Panel has long argued for meaningful disclosure to consumers to enable them to make informed decisions about investing. However, it has serious concerns about the feasibility of conveying information on a wide variety of fund structures within a standardised format in a way that would enable retail investors to make informed choices.

In this regard, the Panel would like to draw attention to its recent discussion paper on investment costs[6] and its recommendations on simplification of fund structures. Whilst we acknowledge this is outside the scope of the present discussion paper, the Panel

[2] Pensions Policy Institute (July 2014), "How will automatic enrolment affect pension saving?".
[3] Regulation 1286/2014 of the European Parliament and of the Council, article 2(2).
[4] Idem, article 32.
[5] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012SC0185&from=EN#page=11
[6] http://www.fs-cp.org.uk/publications/pdf/investment_discussion_paper_investment_cost_and_charges.pdf

nonetheless feels this is an option that should be considered within the context of a future review of the EU legislative and regulatory framework.

In the Panel's view, any review of the PRIIPs Regulation should include consideration of more structural reforms of the retail investment market, as current structures are simply too complex for most retail investors to understand, irrespective of commendable efforts to improve disclosure.

In particular, a future revision of the UCITS Directive could provide an opportunity to enhance its provisions on fund governance by strengthening the oversight role and powers of the depositary.

I hope that you will find the Panel's contribution useful, and we will continue to engage with you in the coming months and years to work towards implementation of the PRIIPs Regulation and related legislation.

Sincerely,

Sue Lewis
Chair
Financial Services Consumer Panel

Annex

Q1. Do you have any views on how draft RTS for the KID might be integrated in practice with disclosures pursuant to other provisions?

Key Information Documents will only work if EU legislation governing investments, including PRIIPs and MiFID 2, applies to all fund structures, including unit-linked pension funds, and adopts a cost disclosure and fund governance model that aligns the interests of firms and customers.

In order to be as effective as possible, the disclosure regime under the PRIIPs Regulation should cover as many products as possible and be aligned with the disclosure methodologies mandated by related EU legislation, in particular MiFID 2.

It is already foreseen under recital 78 of MiFID 2 that disclosure under that Directive may draw on information provided by manufacturers through the PRIIPs KID. Accordingly, we would encourage the definitions, methodologies and assumptions made under the two disclosure regimes to be interoperable. To provide for a consistent disclosure framework and to ensure both consumers and firms benefit for legal clarity, we would urge the ESAs to seek alignment with MiFID 2 as much as possible.

In parallel, it will be important to bring UCITS within scope of the PRIIPs Regulation as soon as possible, as the current 'Key Investor Information Documents' required by the UCITS Directive fall short of the comprehensive disclosure requirements envisaged under the PRIIPs Regulation.

This inconsistency will leave consumers with less comprehensive information on the risks and costs associated with investing in UCITS than they would receive when investing in products covered by PRIIPs, even though UCITS are the most widely-used investment vehicle for retail investors in the EU.[7]

EU law should not permit disparate levels of disclosure for similar products any longer than necessary, and the Panel regrets that UCITS funds were not included in the scope of the PRIIPs Regulation from its date of application.

Q3. Do you agree that market, credit and liquidity risk are the main risks for PRIIPs? Do you agree with the definitions the ESA's propose for these?

We would strongly challenge the assumption underpinning the discussion paper, as outlined on page 25, that risks are purely stock market-related, such as the potential for loss of capital or liquidity issues.

Research[8] undertaken on behalf of the Consumer Panel has shown that asset manager conduct and practice, the weak principle-agent relationship, and the arbitrage between different fund structures are also very relevant when it comes to the risks associated with an investment product.

However, our research primarily shows that the level of costs and charges applied against underlying assets has the largest effect on return. (See response to Question 4) Therefore, when considering market risk, costs and charges applied must be taken into account.

[7] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012SC0185&from=EN#page=11
[8] http://www.fs-cp.org.uk/publications/pdf/investment_jaitly_final_%20report_full_report.pdf

Q4: Do you have a view on the most appropriate measure(s) or combinations of these to be used to evaluate each type of risk? Do you consider some risk measures not appropriate in the PRIIPs context? Why? Please take into account access to data.

In our view, the data that have been proposed for inclusion in the risk calculation suffers from significant shortcomings. In section 3.6.1 of the discussion paper, the ESAs have taken performance scenarios as the reference point for calculating risk. However, we believe that this approach is inherently flawed because of the inadequacies of performance data on investment funds.

As outlined in the Panel's research, such performance data is based on annual or 5-year periods, but the impact of alterations such as fund name changes, closures or mergers make performance and cost tracking virtually impossible for the long-term retail investor. A risk indicator based on such data would not provide consumers with meaningful information.

With reference to statements such as 'probability distribution of expected returns of the product fed by historical data' (paragraph 3.6.1 of the discussion paper), the Panel would note that from a behavioural perspective, most retail investors do not distinguish between 'risk' and mathematical probability.

The Panel is of the view that some measure of the 'effect of charges', i.e. a Reduction in Yield such as is currently used in the UK, should be included in the measurement for market risk. The level of disclosed and undisclosed charges will have a direct effect on the return of the investment and should therefore be included. At the very least portfolio turnover rate should somehow be evaluated as a high level of transactions is traditionally associated with higher risk, and is therefore very relevant.

Q5: How do you think market, credit and liquidity risk could be integrated? If you believe they cannot be integrated, what should be shown on each in the KID?

It is imperative that whatever method of displaying risk is decided upon, that this is easy for consumers to understand. Preferably some sort of risk rating should be adopted that amalgamates all three main risk elements. If one single rating cannot be realistically shown, then a system similar to the 'traffic lights' food nutrition rating system could be adopted with levels of market, credit and liquidity risk shown in one diagram but with green, amber and red levels shown beside each risk label.

Q6: Do you think that performance scenarios should include or be based on probabilistic modelling, or instead show possible outcomes relevant for the pay-outs feasible under the PRIIP but without any implications as to their likelihood?

The Panel believes that any performance scenarios should be based on the most likely or realistic outcome for a given investment. Any performance scenario must show the negative as well as the positive effects, and positive return should be shown after costs, charges and an assumption for inflation are taken into account.

Most importantly, a consistent approach must be taken by all providers of KIDs particularly on assumptions for growth and inflation. However, providers could be made to make an assumption for the effect of their own costs and charges based on, for example, costs applied against the underlying assets over the past 3 years.

Q8: What time frames do you think would be appropriate for the performance scenarios?

If historic data is to be used then a longer time frame such as 10 years plus should be used. As per the response to Question 4, the Panel's recent research shows that performance data based on annual or 5-year periods does not provide meaningful information and can produce results that are misleading.

Q9: Do you think that performance scenarios should include absolute figures, monetary amounts or percentages or a combination of these?

The final format of performance scenarios should be based on extensive consumer testing to ensure that whatever format is decided upon, consumers can relate to it. However, too many scenarios will prove to be confusing.

The key information consumers need to know is the potential loss they might make, meaning that a simple table indicating how much might be lost in monetary terms should the underlying asset decrease in value would be helpful.

Many consumers find it difficult to relate to percentages and may not understand the true nature of the risk if it is relayed in percentage terms. However, if the potential for loss can be illustrated in monetary terms, i.e. the potential amount of the capital invested that could be lost if the underlying asset decreased in value, that would be a more meaningful message.

Q10: Are you aware of any practical issues that might arise with performance scenarios presented net of costs?

The Panel takes a close interest in the transparency and fairness of fees charged to retail investors, as fees can have a significant impact on investment returns. For example, illustrative calculations by the UK's Department for Work and Pensions in November 2013 show that an individual who saves throughout their working life into a retirement scheme with a 1% annual charge could lose around 24% of their pension pot at retirement as a result of charges.[9]

Therefore, in order for the performance scenarios in the KID to give retail investors an accurate picture of potential returns, the costs used in the calculation of different performance scenarios must be as comprehensive as possible. Although the PRIIPs Regulation applies only to manufacturers of retail investment products, many of the costs (excluding distribution costs) that will be charged to the investor can in principle be stated or estimated with some degree of accuracy at the point of manufacture.

Accordingly, any cost the manufacturer is aware of should be included in the KID in a way that enables the investor to compare the costs of one PRIIPs product with another.

However, in the Panel's view, a key hurdle to be overcome in this regard is that in many instances, the true and total costs – including those that must be included in the KID - simply are not known because of opaque cost structures in the retail investment market.

After a review of a wide range of studies and methods of calculation, researchers commissioned by the Panel in 2014 concluded that the full costs borne by savers are simply not known, and many costs are deducted from the fund directly.[10]

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[9] DWP, Pensions Bill 2013, Information Pack for Peers

[10] http://www.fs-cp.org.uk/publications/pdf/investment_%20david_pitt_%20watson_et_al_final_paper.pdf

The main reasons are simply that many costs are not properly measured or declared. Even fund managers frequently do not appear to know: in its survey of fees, consultancy Lane Clark & Peacock found that around two-thirds of investment managers could not provide information on transaction costs.[11]

Moreover, explicit costs charged to the customer – included within the annual management charge (AMC), the total expense ratio (TER) and the ongoing charge figure (OCF) – are a poor guide to the full costs. This was the conclusion of a 2000 study commissioned by the UK's Financial Services Authority[12] and holds true in more recent studies.

In one study, "total" charges, excluding transaction charges, were calculated (with difficulty) from published, but not necessarily comprehensive, mutual fund[13] price lists. They were typically more than twice the annual management charge in a number of countries, including the EU member states such as the UK.[14]

The problem is so entrenched that even institutional investors of multi-billion pound pension funds may not know the full costs of investing. It took a major study by Hymans Robertson, a pensions consultancy, to find potential for significant savings in the UK's Local Government Pension Scheme by switching to passive investments away from generally underperforming actively managed funds.[15]

Similarly, it is reported that Railpen Investments, a £20 billion pension scheme, took many months and encountered great difficulty to estimate that the headline fees it paid to asset managers were around a fifth of total costs.[16]

In November 2014, the Panel published a discussion paper[17] which outlined a number of recommendations to address these issues. In particular, the Panel considers that disclosure of costs (and risks) is only effective if those to whom the details are provided can understand and act on the information; overly complex disclosure to consumers would be counterproductive in many cases.

In addition, disclosure by itself would not immediately change the incentives for fund managers to control those costs that can be charged against the value of funds and are consequently hidden from the investor.

The Panel has therefore recommended that competent authorities consider the introduction of a single investment management charge; all other intermediation costs, charges and expenses incurred by the investment manager, including transaction costs, would be borne directly by the firm and reflected in the single charge. Such a change would require firms to price their services in a way that they remain profitable yet competitive.

Q12: Do you have any views, positive or negative, on the different examples for presentation of a summary risk indicator? Please outline advantages and

[11] Lane Clark & Peacock (May 2013), "LCP Investment Management Fees Survey 2013".
[12] James, K. (February 2000), "The Price of Retail Investing in the UK", FSA Occasional Paper Series 6.
[13] Mutual funds" (US terminology) are comparable to Europe's Undertakings for Collective Investment in Transferable Securities (UCITS) or collective investment schemes (CIS).
[14] Khorana, A., H. Servaes and P. Tufano (March 2009), "Mutual Funds Fees Around the World", Review of Financial Studies, Vol. 22, Issue 3, 1279-1310.
[15] Department for Communities and Local Government (May 2014), "Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies. Consultation".
[16] Professional Pensions (27 August 2014), "Railpen to reduce external managers over fee concerns".
[17] http://www.fs-cp.org.uk/publications/pdf/investment_discussion_paper_investment_cost_and_charges.pdf

disadvantages, and provide any other examples that you are aware of that you think would be useful.

The Panel is not aware of any concrete evidence showing whether the different examples of visual representation of the summary risk indicator (as shown in section 3.7.1) are effective in informing potential retail investors about the risk they may be taking on. However, the Panel supports the display of a visual indicator as it may help those consumers who struggle with more abstract representations of risk.

In this regard, it will be important that the consumer testing exercised organised by the European Commission as part of the PRIIPs Regulation implementation process will include testing of any proposed visual summary risk indicators.

Q16: What are the main challenges you see in achieving a level-playing field in cost disclosures, and how would you address them?

The Panel has welcomed the inclusion in the PRIIPs Regulation of a requirement for the KID to include disclosure of costs of all types, whether direct, indirect, one-off or recurring in nature. However, it acknowledges that the difficulty will be in achieving a truly representative figure of the costs associated with a particular product. As noted, it would be useful to align cost calculation methodologies with the approach to be adopted under MiFID 2 as much as possible.

In order for the KID to provide consumers with a meaningful tool for comparison between different products, the information on costs must be as comprehensive as possible. Although the PRIIPs Regulation applies only to manufacturers of retail investment products, many of the costs (excluding distribution costs) that will be charged to the investor can be stated or estimated with some degree of accuracy at the point of manufacture.

In the Panel's view, a key hurdle to be overcome in this regard is that in many instances, the true and total costs – including those that must be included in the KID - simply are not known because of opaque cost structures in the retail investment market. This prevents meaningful comparison between different investment products covered by the PRIIPs Regulation, undermining the usefulness of the Key Information Document.

After a review of a wide range of studies and methods of calculation, researchers commissioned by the Panel in 2014 concluded that the full costs borne by savers are simply not known, and many costs are deducted from the fund directly.[18]

The main reasons are simply that many costs are not properly measured or declared. Even fund managers frequently do not appear to know: in its survey of fees, consultancy Lane Clark & Peacock, found that around two-thirds of investment managers could not provide information on transaction costs.[19]

Moreover, explicit costs charged to the customer – included within the annual management charge (AMC), the total expense ratio (TER) and the ongoing charge figure (OCF) – are a poor guide to the full costs. This was the conclusion of a 2000 study commissioned by the UK's Financial Services Authority[20] and holds true in more recent studies.

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[18] http://www.fs-cp.org.uk/publications/pdf/investment_%20david_pitt_%20watson_et_al_final_paper.pdf
[19] Lane Clark & Peacock (May 2013), "LCP Investment Management Fees Survey 2013".
[20] James, K. (February 2000), "The Price of Retail Investing in the UK", FSA Occasional Paper Series 6.

In one study, "total" charges, excluding transaction charges, were calculated (with difficulty) from published, but not necessarily comprehensive, mutual fund[21] price lists. They were typically more than twice the annual management charge in a number of countries, including the EU member states such as the UK.[22]

The problem is so entrenched that even institutional investors of multi-billion pound pension funds may not know the full costs of investing. It took a major study by Hymans Robertson, a pensions consultancy, to find potential for significant savings in the UK's Local Government Pension Scheme by switching to passive investments away from generally underperforming actively managed funds.[23]

Similarly, it is reported that Railpen Investments, a £20 billion pension scheme, took many months and encountered great difficulty to estimate that the headline fees it paid to asset managers were around a fifth of total costs.[24]

In November 2014, the Panel published a discussion paper[25] which outlined a number of recommendations to address these issues. In particular, the Panel considers that disclosure of costs (and risks) is only effective if those to whom the details are provided can understand and act on the information; overly complex disclosure to consumers would be counterproductive in many cases.

In addition, disclosure by itself would not immediately change the incentives for fund managers to control those costs that can be charged against the value of funds and are consequently hidden from the investor.

The Panel has therefore recommended that competent authorities consider the introduction of a single investment management charge; all other intermediation costs, charges and expenses incurred by the investment manager, including transaction costs, would be borne directly by the firm and reflected in the single charge. Such a change would require firms to price their services in a way that they remain profitable yet competitive.

Q19: Do you agree with the costs and charges to be disclosed to investors as listed in table 12? If not please state your reasons, including describing any other cost or charges that should be included and the method of calculation.

In Chapter 4 of the discussion paper, the ESA's focus is on providing consumer-friendly cost disclosure. While we welcome this focus on simple numbers and comparability, we would reiterate that it should not distract from the overall disclosure model.

In this regard, the Panel has concerns that the ESAs have not adequately addressed the issue of undisclosed costs, which can be very significant and should therefore be known to the investor or, at the very least, their intermediary.

The discussion paper appears to assume that such costs, including transaction costs, are not easily identifiable or that they are embedded in a way that makes analysis impossible (section 4.2.1, page 49 of the discussion paper).

[21] Mutual funds" (US terminology) are comparable to Europe's Undertakings for Collective Investment in Transferable Securities (UCITS) or collective investment schemes (CIS).
[22] Khorana, A., H. Servaes and P. Tufano (March 2009), "Mutual Funds Fees Around the World", Review of Financial Studies, Vol. 22, Issue 3, 1279-1310.
[23] Department for Communities and Local Government (May 2014), "Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies. Consultation".
[24] Professional Pensions (27 August 2014), "Railpen to reduce external managers over fee concerns".
[25] http://www.fs-cp.org.uk/publications/pdf/investment_discussion_paper_investment_cost_and_charges.pdf

The Panel's research into investment costs also challenges the idea that transaction costs are wholly unknown in advance and that the risks of the fund manager securing efficient costs should be borne by the fund and therefore the investor. It indicated that this is a key area where conflicts of interest between asset managers and their service providers come into play: deals are arranged that might benefit the asset manager or other share classes in the fund, rather than the retail investor.

The Panel looks forward to engaging in more detail on the substance of these issues with the ESAs when the technical consultation paper is published later this year.

Q20: Do you agree that a RIY or similar calculation method might be used for preparing 'total aggregate cost' figures?

As regards the method of calculation, the Panel would not want the implementing measures to be overly prescriptive or granular, taking into account the fact that the Regulation will cover a wide range of products with differing features. PRIIPs manufacturers should use costs that have been actually incurred as a proxy for the expected costs and charges, and make reasonable assumptions *only* where such a proxy is not available. However, where actual costs are used then a Reduction in Yield calculation would be acceptable, although the Panel does have concerns that some consumers may struggle to understand the results.

Q24: Do you have any views on possible assumptions that should be made, and how these might be calibrated or set?

The Panel considers that implementation of the PRIIPs Regulation in this regard should be based on the approach adopted by ESMA for MiFID 2: in the case of ex-ante information, where the disclosure provided to the client is based on reasonable assumptions, the disclosure should be accompanied by an explanation stating that projection is based on assumptions and could deviate from costs and charges that will actually be incurred.

However, wherever possible firms should use, as a proxy, costs that were previously incurred. We could not support an interpretation of the Regulation that would allow manufacturers to apply a blanket policy of (under-)estimating 'problematic' costs where they could rely on more accurate previous experience of the costs associated with a specific product.

The Panel strongly believes that, without inclusion of accurate predictions of transaction and performance fees in the estimated cost, an aggregate cost figure will not provide consumers with the information needed to make an informed decision about making an investment.

Q29: How do you think should cumulative costs be shown?

The Panel would strongly urge you to consider whether the costs should be presented as a single annual charge, which will aid comparability and prevent firms from charging retail investors 'hidden' costs such as transaction costs, which are usually defrayed against the value of the funds invested rather than charged directly to the consumer.