

Consumer Panel response to consultation by Commission Services on legislative steps for the Packaged Retail Investment Products Initiative

The Financial Services Consumer Panel was established under the Financial Services and Markets Act 2000 by the Financial Services Authority to represent the interests of consumers. The Panel is independent of the FSA. The main function of the Panel is to provide advice to the FSA, but it also looks at the impact on consumers of activities outside the FSA's remit. The Panel represents the interests of all groups of consumers.

This is the Panel's response to the Commission Services consultation on legislative steps for the Packaged Retail Investment Products (PRIPS) initiative. The Panel will also be responding to the review of the Markets in Financial Instruments Directive (MiFID) and Insurance Mediation Directive (IMD).

Overview

The Panel supports the Commission's work to protect retail investors and savers by establishing a level of consistency in standardisation of sales processes and pre-contractual disclosure. This approach is supported by the findings of the Commission's report on EU Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective¹. Overall we agree with the Commission's proposal to apply the new sales and disclosure regime to packaged products only. Broadening the initiative to all savings and investment products could be overly burdensome and have an unintended adverse impact on innovation in other areas of the UK market such as simplified products and models for delivering simplified advice, as well as increasing costs for consumers. Pensions savings products should also be excluded from the regime and be subject to tailored protection measures. They are particularly complex products, often with special tax treatment, that would not in our view fit easily within the PRIPS regime.

We would not wish to see the current initiative hindering flexibility at national level, however, where particular markets or products might require a different approach. It would be detrimental to consumer interests if an overly rigid or fully harmonised regime were effectively to limit the powers of national regulators to anticipate – or respond to – areas of emerging risk, or to deal with specific sectors of the national market that may not exist in the same form in other Member States.

The PRIPS market is a diverse one and, as the Paper acknowledges, a 'one size fits all' approach to disclosure would be unworkable. Particular care will need to be taken to address the communication of risk and costs. We strongly urge the Commission to undertake extensive consumer and market testing of the PRIPS Key Investor Disclosure Document (KIID), including creating a KIID for existing products, before taking a final decision on content and structure. The use and effectiveness of the UCITS KIID will also provide invaluable intelligence for the PRIPS debate. Given the enormous impact that the

¹ At http://ec.europa.eu/consumers/strategy/docs/final_report_en.pdf

PRIPS initiative will have on the investment and savings markets in all Member States, we are calling for extensive monitoring and policing of the PRIPS KIID both in terms of firms' compliance and effectiveness for consumers. In this respect it is important to bear in mind that disclosure without consumer understanding of the significance of the KIID and of the information it contains, will not be effective. We would like the Commission to undertake a post-implementation review after three years and be ready to act swiftly to the findings of the review if necessary.

Our comments on the key questions within the Paper are set out below.

Specific questions

Q. 1: Should the PRIPs initiative focus on packaged investments? Please justify or explain your answer.

Yes, products where there is an underlying as opposed to direct and/or obvious risk would benefit from straightforward and consistent standards for sales and disclosure. The application to 'simple' products such as bank savings accounts would seem to be disproportionate and not helpful to consumers, potentially adding unnecessary cost that would ultimately be passed on to consumers. In addition it is less likely (but not impossible) that investors would wish to compare a packaged and non-packaged product, although principles of transparency and comprehensible disclosure should apply to all financial products.

Q. 2: Should a definition of PRIPs focus on fluctuations in investment values? Please justify or explain your answer.

Although complexity could be a consideration, complexity alone is not the key issue. We agree that the definition should focus more on potential fluctuations in the value of the underlying assets/linked indices. This seems to be a key defining feature of the type of product to which the proposals should apply. It is important that the definition is sufficiently clear to avoid exploitation of any potential loopholes or grey areas.

Q. 3: Does a reference to indirectness of exposure capture the 'packaging' of investments? Please justify or explain your answer.

Yes, it is indirect rather than direct exposure to underlying assets that is a feature of 'packaging'.

Q. 4: Do you think it is necessary to explicitly clarify that the definition applies to fluctuations in 'reference values' more generally, given some financial products provide payouts that do not appear to be linked to specific or tangible assets themselves, e.g. payouts linked to certain financial indices, the rate of inflation, or the overall value of a fund or business?

Yes, underlying assets should include indices. This is a fairly common feature of packaged products. A case in point is Exchange Traded Funds (ETFs) and Exchange Traded Commodities (ETCs). At the Behavioural Economics Conference in Brussels in November 2010 Professor Roman Inderst warned that the sale of commodities to consumers was an area that gave him cause to question the financial services industry's claim to offer good advice. The definition should also be flexible enough to include innovative products using new reference values.

Q. 5: Do you have any other comments on the proposed definition? If you consider it ineffective in some regard, please provide alternatives and explain your rationale in relation to the criteria for a successful definition outlined above.

As the paper explains, the definition of PRIPS is a key question and a complex one. As we have already indicated, in order to accommodate innovation and product variation the definition must be flexible, but not too wide. It would be damaging to consumers if products such as pensions were to be caught within the definition due to the particular features and purpose of these products which require a quite specific regulatory regime. It is important, however, to minimise the possibility that high-risk products which may not appeal to consumers buying through the medium of the PRIPS regime are not revised/reworked so that they can be sold under a pensions wrapper – the Commission will need to ensure that there is no risk of regulatory arbitrage. As working definitions are developed we would like to see them applied to a wide range of existing products across Member States to assess their effectiveness – which products would be covered, and which would not. Given the impact that the proposals will have on the retail investment market, it is important that sufficient time is given to researching the most appropriate definition.

Q. 6: Should simple (non-structured) deposits be excluded from the scope of the initiative? Please justify or explain your answer.

Yes, the nature of the product does not require the proposed PRIPS-type sales and disclosure regime and would in all likelihood increase the cost of such products for consumers with no real benefit.

Q. 7: Do you consider option 1 or option 2 preferable for achieving this? Please explain your preference, and set out an alternative if necessary, with supporting evidence.

Option 2 seems most appropriate and has the benefit of simplicity, provided that it would capture products such as ETFs and ETCs. The Panel has not conducted any research in this area.

Q. 8: Should such an exclusion be extended to financial instruments which might raise similar issues as deposits (e.g. bonds), and if so, how might these be defined? Please justify or explain your answer.

We suggest testing the option 2 exclusion against a range of deposit/bond instruments, as well as ETFs and ETCs. An assessment could then be made as to which products fall within the definition and which do not, and whether this meets the objectives of the PRIPS regime.

Q. 9: Should pensions be explicitly excluded from the PRIPs initiative at this stage? Please justify or explain your answer.

Yes. Pensions are relatively complex products, often with special tax treatment at national level, that fulfil an important long term savings need. There are other particular national issues such as the interaction between private pension arrangements and State schemes/benefits on which investors will need specific advice and pre-contractual information. In these circumstances a specific tailored protection regime is required. We do not think the standardised approach to PRIPS, which is right for a wide range of products as we have said in this response, is a suitable regime for pensions. As we have

already indicated, steps would have to be taken to avoid the possibility of regulatory arbitrage between the regimes.

Q. 10: Should annuities be treated in the same fashion? Again, please justify or explain your answer.

and

Q. 11: Do you have any comments on the proposed manner of achieving this exclusion?

and

Q. 12: Do you agree that variable annuities might need to be treated as a special case? If so, how should these be defined, and how do you think they should be addressed?

We do not think that annuities should be excluded from the PRIPS regime. The decision to buy an annuity, and which type of annuity from the many available, is an important one for consumers and it is appropriate that these products are included within scope. There is some evidence that many people in the UK buy annuities which do not best meet their needs and do not deliver the best outcomes. The effective application of PRIPS regime standards might help to minimise the risk of inappropriate sales/purchases.

Q. 13: Do you see benefits from such an indicative list being developed? If not, please provide alternative proposals and evidence for why these might be effective.

Indicative (but not exhaustive) lists could be helpful in implementing the new regime, but they should be regularly reviewed and updated. They would have to anticipate and not simply reflect product development, to avoid the risk of the lists becoming obsolete and unhelpful almost overnight.

Q. 15: Should direct sales of UCITS be covered by means of including the relevant rules within the UCITS framework?

and

Q. 16: Do you have any comments on the identified pros and cons of this approach, and any evidence on the scale and nature of impacts (costs as well as benefits)?

The UCITS framework is the appropriate regime to deal with these issues. Bringing them within the scope of MiFID seems confusing and inappropriate, given the highly developed and successful UCITS regime. The Panel does not have any specific evidence on the costs that might be associated with this approach, but given the almost unique place of UCITS in the retail investment market – and, we understand, the high level of consumer recognition of the features of these products – there would be clear benefits for consumers in maintaining the tailored UCITS approach and a level of distinction between UCITS and other PRIPS. It is important nevertheless that key information is presented to consumers in a consistent way, whether the products in question are UCITS or PRIPS.

Q. 17: Should the design of the KIID be focused on delivering on the objective of aiding retail investment decision making? If you disagree, please justify or explain your answer.

Yes; that is the correct focus and the objective that each product KIID should deliver.

Q. 18: Should the KIID be a separate or 'stand alone' document compared with other information that might be necessary, e.g. background information, other disclosures, or contractual information? Please justify or explain your answer.

Yes. It is important that the KIID is a stand alone document relating to the product only (ie not the distribution channel), although realistically there will be some areas where investors could be referred elsewhere for additional information, such as access to compensation and redress. This does not mean however that the KIID alone would provide all the information that the potential investor would need in order to take an informed decision on a particular product and it would be important to ensure that the KIID is used appropriately by both advisers and potential investors.

Q. 19: What measures do you think will be necessary to ensure KIID remain streamlined and focused solely on key information?

Active research, supervision and enforcement at national level would ensure that KIIDs are developed and used in the way intended. This would involve extensive consumer and market testing but this would, in our view, be the most effective way of ensuring that the KIID delivers what is needed.

Q. 20: While the same broad principles should be applied to all PRIPs, should detailed implementations of some of these principles be tailored for different types of PRIP? Please justify or explain your answer, and provide examples, where relevant, of the kinds of tailoring you might envisage.

and

Q. 21: Do you foresee any difficulties in requiring the KIID to always follow the same broad structure (sequence of items, labelling of items)? Please justify or explain your answer.

If the Commission is to succeed in achieving consistent standards across the retail investment and savings markets facilitating comparison between products, there will need to be a reasonably rigid framework for the KIID, but with a high level of flexibility to accommodate the wide range of products that are to be covered by the new regime, including new products entering the market. We do envisage circumstances where there would have to be tailoring to specific products. For example, beyond the 'packaged' nature of the product there are few similarities between say structured deposits and spread-betting. If the KIID is to be effective there has to be sufficient scope for individual tailoring to allow for meaningful information to be provided in each case. It is possible there could be particular issues too where products include life cover, or where there are specific tax issues to be explained. Further detailed consideration will have to be given to, for example, how to deal with structured deposits where past performance may not be relevant or appropriate, but where there could be a case for including information about the percentage of products from a particular manufacturer have been on target. We recommend a full review of the effectiveness of the KIID after 3 years, including an extensive programme of consumer research.

Q. 22: Do you foresee any difficulties in requiring certain parts of the key information and its presentation (e.g. on costs, performance, risks, and guarantees)

to be standardised and consistent as possible, irrespective of tailoring otherwise allowed? Please justify or explain your answer.

The Panel has no specific evidence available, but it is possible that the differing charging methods/basis for products, the synthetic risk indicator, the approach to showing past performance - please see our response to question 21 above - and the use of projections could all be problematic. We would like to see specific options being put forward for detailed discussion. As regards costs, the emphasis should be on providing the information consumers will need in order to take an informed decision, including a breakdown of the elements of the cost as well as an overall figure.

Q. 24: Should the content of the KIID be controlled so that there is no possibility for firms to add additional information unless expressly allowed for?

Yes, there should be active monitoring by national regulators of KIIDs actually used by firms and swift enforcement action in cases of non-compliance. To be effective the KIID will have to be prescribed to a certain level and strict limits placed on what – if anything - firms can add. It will defeat the object of producing the KIID if, for example, firms are able to use it for inappropriate comparison with other products.

Q. 25: Do you foresee any difficulties in applying these broad principles to the KIID for all PRIPs, as the building blocks on content and format for a 'level 1' instrument? Please justify or explain your answer.

The description of the broad principles as “building blocks” is appropriate and we have no specific comments at this stage on the general requirements as shown in the paper. Rather than focusing on whether a level 1 or level 2 instrument is appropriate, the starting point should be the desired outcomes and how these can best be achieved. The diversity of the products to be covered by the new regime will call for a high degree of flexibility in the KIID framework, but we suggest that it will be at the later stages of the development of the KIID that specific issues or difficulties will become apparent.

Q. 26: Are there any other broad principles that should be considered on content and format?

We have no additional suggestions at this stage. As we have said, further considerations may arise as the KIID proposals are developed in more detail.

Q. 27: Should product manufacturers be made generally responsible for preparing a KIID? Please justify or explain your answer.

As the KIID relates only to the product, it is right that the product provider/manufacturer only is responsible for producing the information contained in the KIID, although clearly in many cases the product provider would want to take into account the views of distributors. For advised sales there should be a separate regime for disclosure of the service provided and the cost.

Q. 28: Are you aware of any problems that might arise in the distribution of particular products should responsibilities for producing the KIID be solely placed on the product manufacturer?

No, it will be for any distributor to ensure that he/she has the appropriate information from the manufacturer to present to the client and also to provide further and separate information about the distribution process and its cost.

Q. 29: If intermediaries or distributors might be permitted to prepare the documents in some cases, how would these cases be defined?

Only the product manufacturer/provider should be responsible for providing the information that is contained within the KIID, whoever actually produces the document.

Q. 30: What detailed steps might be taken to improve the transparency of the social and environmental impacts of investments in the KIID for PRIPs?

and

Q. 31: How might greater comparability and consistency in product labelling be addressed?

The Panel would like to see specific consultation and consumer testing of labelling of products claiming to be 'ethical' or otherwise socially or environmentally focused, before the inclusion of any such description in the KIID. This would involve research to assess the key features of existing products and to identify common areas for labelling.

Q. 32: Should the summary prospectus be replaced by the KIID for PRIPs? Please outline the benefits and disadvantages you see with respect to such an approach.

Yes. The Panel supports the use of an appropriately tailored KIID for packaged retail investment and savings products. Consistent standards of disclosure will assist informed decision-making.

Q. 34: Do you agree with the suggested approach for UCITS KIIDs?

The Panel does not think it appropriate that the KIID for UCITS should be delayed or revised at this stage of implementation. As the benchmark for the PRIPS KIID, the effectiveness of the UCITS KIID and experience of firms and consumers over the next twelve months or so should provide a great deal of useful information for future PRIPS work. There could of course be an argument for changes to be made in the light of experience and as a result of the UCITS IV post implementation review, but this is a separate issue.

Q. 35: Are there any disclosures, e.g. required by the existing regimes, which you believe the PRIPs KIID should not include, but which should still be disclosed, e.g. separately to the KIID? Do you have any practical examples for such elements?

The KIID relates to the product rather than any advice service being offered, so there will be separate disclosure of the cost and basis of advice.

Q. 36: What in your view will be the main challenges that will need to be addressed if a single risk rating approach is to work for all PRIPs?

The risk rating is probably the most difficult aspect of the KIID, particularly – as we have said before – given the range of products to be captured by the regime. In 2007 the Panel published its own research into risk ratings² which concluded, amongst other things, that very few consumers had a clear idea of what risk actually was – most saw it as the potential to lose money generally rather than making distinctions between risk to capital and risk to returns. The research showed that while there was a broad appetite for a

² Risk Ratings Research by iff Research, May 2007 at www.fs-cp.org.uk

standardised risk scale it would only be effective if it could improve consumer understanding of risk. More recently, in their paper on CESR's recommendations for the calculation of a synthetic risk reward indicator³ the ABI and IMA noted that CESR's approach produced excessive bunching, with one-third of asset classes and one half of authorised funds having category 6 as their modal risk category, and no asset class having category 1 or 7. Clearly this is a vitally important but difficult area. For example, the presentation of structured deposits with guarantees as less risky is a concern, given fluctuations of underlying assets and evidence from Which? about the underperformance of such products. It is important that the different nature of risk associated with the product is shown. We strongly support the use of extensive consumer and market research as the most effective means of developing a risk rating. This would include applying various models to a wide range of existing products, to assess the results.

Q. 37: Do you consider there are any other techniques that might be used to help retail investors compare risks?

We do not have any suggestions for other techniques that have been subjected to full consumer testing, but as we have said we are supportive of standardised information and disclosure as an aid for consumers. For advised sales we would expect the adviser to be able to help the consumer to make these comparisons, or to advise on the outcome, although consultation recently published by the FSA highlights the need for further guidance for some advisers on assessing suitability and client attitude to risk.

Q. 39: How can retail investors be aided in making 'value for money' comparisons between different PRIPs?

In assessing value for money investors will need to understand how much a product costs; what it is designed to deliver; and the risks of the product failing to deliver. All of these points rely on clear and understandable disclosure of product features ahead of sale and, of course, for clear advice in advised sales. This is another area where post implementation review by national regulators, including consumer research, will be invaluable in informing the development of the PRIPS regime. Swift and effective enforcement action at national level supported by monitoring by the new EU regulatory bodies should go some way to ensuring that consumers have the information they need on which to base their decisions as the new regime is introduced.

Q. 40: Do you consider that performance information should always be included in a KIID?

To be consistent with the overall policy approach to PRIPS, performance information should always be included, but a means of demonstrating performance information for structured deposits in particular will have to be found.

Q. 41: What in your view will be the main challenges that will need to be addressed in ensuring performance information can be compared between different PRIPs?

The main challenge is the wide range of products that are to be included within the new regime. We have used before the example of spread betting and structured deposits as typifying the diversity of PRIPS and we are not in a position to comment on the technical issues that might arise in trying to devise a methodology that would facilitate a meaningful comparison. The models that are developed should be subjected to consumer testing to assess their effectiveness.

³ March 2010 at www.investmentuk.org

Q. 42: Do you agree that a consistent approach to the description of guarantees and capital protection in the KIID should be sought, e.g. through detailed implementing measures, for different PRIPs?

Yes, consistency is important to the success of the regime.

Q. 43: What information should be provided to retail investors on the cost of guarantees?

Wherever possible the cost should be shown as part of the cost of the product – but further work including extensive consumer testing is required to determine how this should be done.

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