

PRIIPs provisions that still require clarification at Level 3

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Contact person:	Alexandru Ciungu, Policy Advisor, Macroeconomics & Taxation	E-mail:	Ciungu@insurancееurope.eu
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Introductory comment

Insurance Europe welcomes the ongoing efforts of the European Commission (EC) and the European Supervisory Authorities (ESAs) to provide much-needed guidance to the industry for the implementation of the revised Regulatory Technical Standards (RTS) for the Packaged Retail Investment and Insurance Products (PRIIPs) Regulation. The contents of the recently-published EC Communication as well as those of the first batch of ESAs Q&As offer very valuable explanations, in particular with respect to the treatment of closed book products and the credit risk assessment for insurers. Nevertheless, Insurance Europe believes that several clarifications are still required in upcoming batches of ESAs Q&As. These clarifications are essential to ensure that the industry has the necessary degree of legal certainty to appropriately implement the various provisions of the PRIIPs regulation.

Main clarifications needed

■ Transaction costs for insurers

Transaction costs of traditional insurance-based investment products are in general marginal due to insurers' "buy and hold" strategy. In addition, insurers have a widely diversified portfolio of assets which is more varied than the portfolio of a regular fund. In this context, the methodology suggested by the ESAs in the RTS and in the first batch of Q&A is too burdensome since it requires the identification and quantification of (marginal) transaction costs in insurers' security/guarantee asset portfolio. A proportional method that allows a quantification of transaction costs per asset class as a whole would be needed instead.

- ➔ *Transaction costs are included in the costs for managing capital investments. The total costs for managing capital investments are to be disclosed according to Articles 34 (II) (9)(a) and 42 of the Directive on the annual accounts and consolidated accounts of insurance undertakings (91/674/EEC). The use of these figures should be allowed instead of a separate disclosure of transaction costs in the PRIIPs Key Information Document (KID).*

The current methodology also doesn't work for insurance products because for some asset classes the necessary historical data is lacking, whereas for others (such as alternative investments) the current RTS do not provide a methodology at all.

➔ *If the necessary historical market data is not available for PRIIPs (this applies not only to new PRIIPs), approximate solutions should be possible for the calculation of transaction costs. Possible ways to achieve this:*

- *An extension of methods developed for new PRIIPs in Annex VI (21) RTS to other PRIIPs that do not have all the necessary historical market data.*
- *An application of the table with standardised percentages introduced in Annex VI, part 1, 25 of the Joint Consultation Paper JC 2015 073. An additional advantage of this table is that it will rightly yield positive values for transaction costs. According to the current methodology, negative transaction costs are possible and it would be rather difficult for manufacturers to explain them to consumers.*

■ **Specific information for MOPs underlying options**

The information in the generic KID should include information about the overall product, whereas the specific information for underlying options should relate to that option only (and not include information about the overall PRIIP). Information and indicators should relate only to the underlying investment options and should not be aggregated with the information on the overall insurance product itself when it comes to specific information. However, the EC has not provided the legal certainty needed by the sector on this point.

- ➔ *Level 3 should clarify that the specific information for underlying options should not include information related to the overall PRIIP.*
- ➔ *Level 3 should clarify in particular that the statement contained in Recital 18 of the RTS, stating that "In addition, the specific information on the underlying investment options should always reflect the features of the PRIIP through which the underlying investment options are offered.", does not mean that the specific information will need to aggregate the information on the underlying options together with information about the overall product. Recital 18 should mean that - for example - the respective share class of a fund that is offered in a MOP should be described in the information on the underlying investment option.*

Within some Multi-Option Products (MOPs), the underlying investment option is meant to be held for the entire recommended holding period (RHP). Therefore, for some products, it could be helpful from a consumer perspective to adjust the RHP in the specific information on the underlying investment option (Article 14 of the RTS) to the RHP of the MOP, while for other products it could be more meaningful to use different holding periods.

- ➔ *Flexibility at Level 3 is necessary to allow holding periods of underlying options to be adjusted to the holding period of the overall MOP.*

Article 13 (2) of the RTS states that the transaction costs in relation to existing UCITS or non-UCITS funds (referred to in Article 32 of PRIIPs) may be calculated according to the methodology set out in point 21 of Annex VI whereas article 13 (3) states that for "Non-Mixed MOPs" the range of charges for the PRIIP may be specified in accordance with Article 10 of Commission Regulation (EU) No 583/2010.

- ➔ *It should be clarified how transaction costs and insurance costs should be taken into account in the generic KID.*

When a manufacturer chooses to use the UCITS Key Investor Information Document (KIID) pursuant to Article 14(2) of the RTS and the generic KID approach pursuant to Article 10(b) of the RTS, the translation obligations should be clarified.

- ➔ *If the generic KID must be prepared in the official language of the country in which the PRIIPs is sold, but the KIID for a UCITS underlying option in that PRIIP is not available in that language, are manufacturers allowed to provide the KIID in whatever language it is available in?*

■ Treatment of annuities

For those annuities that are in the scope of the PRIIPs Regulation, it remains unclear how the RTS apply, given the characteristics of such products.

- ➔ *Single premium annuities with immediate annuitisation have no capital accumulation phase, so they should be out of scope as it is not possible to calculate the indicators for these products as demanded in the PRIIPs regulation and the RTS in a meaningful way.*
- ➔ *For other annuity products, only the accumulation phase should be considered for the calculation of the indicators with the recommended holding period corresponding to the typical start of the pay-out phase. In addition, there should be the possibility in the KID to describe the characteristics of the product, especially the pay-out phase in form of annuities.*
- ➔ *Finally, Level 3 should clarify how the RTS apply for those annuities that remain in the scope of the PRIIPs Regulation, in particular:*
 - *That, as the KID is not a personalised document, insurers should be allowed to provide a KID for one single age ('example age, average age, ...') or an age range,*
 - *How performance scenarios should be defined (is it possible to accumulate the annuities paid until the specific periods to be reported? Capitalised with an interest rate? which interest rate?),*
 - *How the cost part of the biometric risk premium should be calculated.*

Technical issues

Reference	Topic	Issue that needs clarification at Level 3
Article 12 RTS	Insurance benefits of a MOP	It should be clarified how Article 3 (4) RTS applies with regard to the generic information document: In the case of products offering a range of options for investment, the performance of the insurance benefit may depend on the underlying investment option. ➔ <i>Therefore, similarly to Article 12(1)(c), Article 12 RTS should provide for a derogation from Article 3 (4) RTS.</i>
Annex II, RTS	Expert judgement	Considering the difficulty of some of the methodologies provided in Annex II, it should be clarified that, like in Solvency II, and based in similar principles, insurance undertakings can make use of expert judgement.
Annex II, 14 RTS	Calculation of Market Risk	Do tactical tilts to strategic weights require that pro-forma historic fund returns be calculated as per point (a)(ii) "the VEV of the returns of the pro-forma asset mix that is consistent with the reference asset allocation of the fund at the time of the computation"? Calculation of the VEV as per (a)(ii) above will require the ability to run back tests on any new asset mix, which could create a significant burden. While Annex IV, point 4 of the amendments state that "the scenario values under different performance scenarios shall be calculated in a similar manner as the market risk measure", there is no reference in the performance scenario methodology to the scenario described in Annex II, part 1, paragraph 14. ➔ <i>Is the intention therefore that the approach described in paragraph 14 above does not apply to the calculation of the performance scenarios?</i>

Annex II, 17 RTS	Ongoing premium for category 2 and 3 PRIIPs	<p>The VEV formula is designed to capture the VEV of single premium investments only. It does not work for ongoing premiums. If, for example, the overall MOP uses ongoing premium, then the PRIIPs information on the underlying investment options in accordance with Article 14(1) RTS should also use ongoing premium. Otherwise consumers will not be able to compare information in the generic KID and in the underlying options.</p> <p>It should be clarified how the VEV formula applies for ongoing premiums for PRIIPs of Categories 2 and 3.</p> <p>→ For category 2: Between t and $t+1$</p> <ul style="list-style-type: none"> choose a random number α in $[0, 1]$ calculate a 1y yield distribution value that corresponds to the quantile α between t and $t+1$ applying the Cornish Fisher methodology add the next regular premium, repeat the procedure between $t+1$ and $t+2$ <p>Using this methodology 10000 paths and the corresponding percentiles are generated. The risk class is determined according to Annex II (16) and (17) RTS. The performance scenarios are determined according to Annex VI (12) and (13) RTS.</p> <p>→ For category 3: Calculate</p> $V_T^{(2.5)} = \sum_{t=1}^T 1000 \cdot e^{r \cdot (T-t+1)},$ <p>where $V_T^{(2.5)}$ is the PRIIP pay-out according to the 2.5% quantile of the distribution of the pay-out at the recommended holding period.</p> <p>The VEV is then calculated as:</p> $VEV = \frac{\sqrt{3.842 - 2 \cdot T \cdot r} - 1.96}{\sqrt{T}}$
Annex II, 14(a)(ii) RTS	Proxy for flexible funds	<p>The RTS states that “the VEV of the returns of the pro-forma asset mix that is consistent with the reference asset allocation of the fund at the time of the computation”. This requires that firms look specifically at the current asset allocation, and customers may be provided with an unrealistic expectation of return. The mandate of a flexible fund specifically directs that a flexible approach should be taken to allocation. For flexible funds the allocation of funds using a proxy based on the current allocation may result in a return that is materially different from the projected scenarios due to the allocation being changed during the recommended holding period and so an unrealistic expectation of return given to the client.</p> <p>→ What possible proxy/ benchmark could be used for flexible funds other than the fund history of that fund, without giving the customer a false expectation of return?</p>
Annex II, 22(a) RTS	Clarification of calculation	In annex II, paragraph 22(a) the word logarithm is used. It should be clarified this refers to the natural logarithm.
Annex II, 23(a)(v) RTS	Clarification of calculation	In annex II, paragraph 23(a)(v) refers to “calculating the covariance matrix between the different tenors by summing over returns”. It should be clarified whether this should actually refer to “calculating the covariance matrix

		between the different tenors by summing over products of returns and then divide by the number of observations minus 1".
Annex II, 23(b) RTS	Clarification of calculation	In annex II, paragraph 23(b), it seems that it was forgotten to indicate that the average return should be added back first.
Annex II, 22(c) RTS	Calculating the return	<p>The indication is to calculate the return by summing the different "simulated" returns through bootstrapping during the observed period. For example, if a 2-year holding period is considered with a daily time step (i.e. 260 days x 2 years= 520 returns), for each of the 10,000 simulations with the sum of the 520 daily returns, to calculate the total return over the 2 considered years; however, it may occur that the sum of the 520 daily returns gives a <-100% final return, which does not have any economic nor financial meaning.</p> <p>Will there be any indications or suggestions about how to operate in these cases, for example by applying a -100% floor? In general, a longer holding period corresponds to a higher number of simulations, that could have similar characteristics, i.e. with returns <-100%.</p>
Annex II, 22(c) RTS	Correction for risk-neutrality	<p>Each of the 10,000 simulated returns needs a correction to ensure that the simulated average return is equal to an expected risk-neutral return and to avoid that the simulations follow the implicit drift of the <i>historic row</i>.</p> <ul style="list-style-type: none"> • The first issue is with the formula that should be used to calculate the return ("Final value of the return") after the corrections. All the variables of this formula are scalar, which would lead to 10,000 equal returns. • The second issue is with the methodology, when applying a correction for risk neutrality, the resulting simulations at the end are only usable for final returns (that appear risk-neutral) but not for the intermediate returns, which means that they are not usable for products where the pay-off is a function of the underlying asset even during the holding period. <p>Additionally, it seems that there could be an error in the following formula:</p> $\text{Return} = E[\text{Return}_{\text{risk-neutral}}] - E[\text{Return}_{\text{measured}}] - 0.5 \sigma^2 N - \rho \sigma \sigma_{\text{ccy}} N$
Annex IV RTS	Scenario calculation for income funds	<p>Should a fund use the total return price series for all share classes? The potential outcome of this may be that the client mistakenly thinks they are going to receive the income and the projected return that assumes reinvestment of that income.</p> <p>If the total return time series are used as a basis for the calculation to capture the total return of the investor and to be in line with the requirements of the UCITS KIID SRRI, this implies that dividends must be included within the return calculations.</p>
Annex IV, 2 RTS	Stress scenario	It could be further clarified that the stress scenario does not include the expected market return (which the favourable, moderate and unfavourable scenarios do have), making the stress scenario incomparable with the other performance scenarios?
Annex IV, 11 and Annex IV, 9	Stress scenario	In Annex IV, 11 the following formula for the stress scenario is given:

RTS		$Scenario_{Stress} = e^{W_{\sigma_S} \sqrt{N} \left(z_{\alpha} + \left[\frac{(z_{\alpha}^2 - 1)}{6} \right] \frac{\mu_1}{\sqrt{N}} + \left[\frac{(z_{\alpha}^3 - 3z_{\alpha})}{24} \right] \frac{\mu_2}{N} - \left[\frac{(2z_{\alpha}^3 - 5z_{\alpha})}{36} \right] \frac{\mu_1^2}{N} - 0.5 W_{\sigma_S}^2 N \right)}$ <p>The formulas for the remaining three scenarios are given in Annex IV, 9. as follows:</p> <p>(a) The unfavourable scenario:</p> $\text{Exp} [M1*N + \sigma \sqrt{N} * (-1.28 + 0.107 * \mu_1 / \sqrt{N} + 0.0724 * \mu_2 / N - 0.0611 * \mu_1^2 / N) - 0.5 \sigma^2 N]$ <p>(b) The moderate scenario:</p> $\text{Exp} [M1*N - \sigma \mu_1 / 6 - 0.5 \sigma^2 N]$ <p>(c) The favourable scenario:</p> $\text{Exp} [M1*N + \sigma \sqrt{N} * (1.28 + 0.107 * \mu_1 / \sqrt{N} - 0.0724 * \mu_2 / N + 0.0611 * \mu_1^2 / N) - 0.5 \sigma^2 N]$ <p>The structure of all the formulas is very similar except from the mean term $M1*N$. Is this term missing in the stress scenario intentionally or should it be added?</p>
Annex IV, 13	Clarification of calculation	It is not indicated where to apply the adjustment, to the equity scenario, to the interest rate scenario, or to both. It should be clarified whether the adjustment should only be applied to the equity scenario generation, in line with the formula for category 2 PRIIPs of paragraph 11.
Annex V, Part 2 RTS	Insurance premium as part of the total investment	<p>It should be clarified that as in table 1 in Annex VII (Cost over time), investment should be the total payment made by consumer (i.e. 10000 EUR single premium or 1000 EUR p.a.) and insurance premium is part of it. Furthermore, since insurance costs are part of the total costs, biometric risk premium is a part of the total investment.</p> <p>→ The RTS uses terms "biometric risk premium" and "insurance premium". It should be clarified that terms have the same meaning.</p>
Annex VI (12 and 14)	Determination of the arrival price	<p>In the case of an equity fund where the mandate is to track the performance of a particular index, trades are placed for close of business prices. This is a requirement of the fund mandate in order to track the index as closely as possible. For administrative purposes these trades / orders to transact may be placed / transmitted at any time during the day but are required to be filled at the close of business price.</p> <p>Paragraph 12 describes the purchase arrival price as "the price of the instrument at the time the purchase order is transmitted to another person for execution" with an equivalent description of the sale arrival price. Our interpretation based on paragraph 12 is that for an index tracking equity fund, the arrival price should be the mid-market price at the agreed execution time, i.e. close of business. However, paragraph 14 defines arrival price as "the mid-market price of the investment at the time when the order to transact is transmitted to another person". This appears to contradict paragraph 12 and would suggest using an arrival price at a point in time which is not consistent with the mandate of the fund and introduces significant market movement into the cost calculation for index tracking equity funds.</p> <p>→ Can it be confirmed that, where this is required by the fund mandate, the arrival price may be determined based on the agreed execution time of a trade?</p>

Annex VII RTS	Invested amount	<p>There are currently products where the maximum invested capital is less than € 1,000 a year. On the other hand, products exist with minimum single-premium investment of more than € 10,000.</p> <p>→ <i>In this case, the typical premium should be used instead. Only by doing so consumers will be not misled in thinking that they can invest €1000 yearly/ €10000 as a single premium.</i></p>
Annex III, Annex V, Annex VII RTS	Mandatory text elements	<p>It should be confirmed that the general rule (PRIIPs manufacturers must prepare key information documents that are accurate, fair, clear and not misleading) takes precedence over the detailed rules in the RTS and therefore, if a pre-formulated text element is in contradiction with the product, it could be amended to comply with the general obligation to give accurate and non-misleading information.</p>
Appendix I, ESAs Q&As (first batch)	List of indexes	<p>It should be clarified that the list of indices provided at page 32 of the first batch of ESAs Q&As is not exclusive. As there are many other indices on the market, there is no reason that these should be prescribed.</p>

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