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AFG'S Answer to the ESAs Joint Consultation Paper concerning amendments

Introduction

AFG welcomes the consultation paper of ESAs and the solutions proposed to improve the performance presentation.

We think that the issues linked to the implicit cost transactions and the disclosure of costs should also be tackled by the ESAs.

1. Do you agree that information on past performance should be included in the KID where it is available?

AFG agrees with the inclusion on past Performance in the KID where past performances are available. We think that for linear products, past performances are the most appropriate way to inform the client while performance scenarios are not appropriate.

2. Are there challenges to include past performance information for certain types of PRIIPs?

No, except for product that don't have past performances, see below Q.4

3. Do you agree that it is appropriate for this information on past performance to be based on the approach currently used in the KII? If not, please explain your reasons and if an alternative presentation would be more appropriate and for which types of PRIIPs?

We agree.

4. Do you think that information on simulated past performance should be included in the KID where actual past performance is not available? If not, please explain your reasons.

No
For structured products, past performance are not available; we recommend to not simulate any past performances. The same approach should be applied than the one of structured UCITS. The third page of their KIID presents a three cases scenario with projection that allows for understanding the rational of the product's formula depending of three market hypothesis. These scenarios are not predictive but only didactical and they proved to be useful.

For existing funds launching a new share class, using the past performance of an existing share class after adjusting the fees should be allowed, in line with the UCITS principles.

5. If you think that information on simulated past performance should be included in the KID, what approach do you think should be used to simulate the past performance, and how should this be presented in the KID?

We do not think that past performance should be simulated.

6. Do you consider these amendments to the narrative explanations to be an improvement on the current performance scenario approach?

We agree with the improvements on the current performance scenarios narratives, but with some remarks:

- *Above the table the following heading shall be used: 'Simulated future performance'. Below the heading it shall be stated in bold letters, 'Market developments in the future cannot be ~~accurately~~ predicted. These scenarios are only an indication of the range of possible returns'.*

- The following sentence should be deleted: "*and does not take into account the situation where we are not able to pay you.*"
  In fact this would induce clients to believe that the investment fund and the owned capital of the fund provider are the same thing which is never the case for asset managers.

  Alternative Proposal: "(e) under a section titled "What happens if [the name of the PRIIP manufacturer] is in financial default? […]"

  Clarification of the initial clause which should help address the issues introduced by the level 2: "an indication whether the retail investor may face a financial loss due to the default of the PRIIP manufacturer or to the default of an entity other than the PRIIP manufacturer, and the identity of that entity;" Default is used in level 2 in a generic way, and may include other type of default than financial default or bankruptcy.

- Titles of the examples shown on page 17
  General title of the section:

The section “Performance scenarios” should be renamed “Performance **information**”, as this section should include both past performance information and performance scenario information.

The sub-section “Simulated future performance” should be called ““Simulated future performance **scenarios**”

- Article 6 §4.
  “4. The key information document shall be drawn up as a short document written in a concise manner and of a maximum of three sides of A4-sized paper when printed, which promotes comparability.”

  Proposal: “4. The key information document shall be drawn up as a short document written in a concise manner and of a maximum of two double sided pages of A4 paper when printed, which promotes comparability.”

  This proposal provide more flexibility in the length of the document.

- Article 8 § 3. (d) (iii):
  “(iii) appropriate performance scenarios, and the assumptions made to produce them;”

  Proposal: “(iii) product performance history, or when not available, appropriate performance scenarios and the assumptions made to produce them.”

  Proposal: “(f) under a section titled ‘What are the costs?’, the costs associated with an investment in the PRIIP, comprising both direct and indirect explicit costs to be borne by the retail investor, including one-off and recurring costs, presented by means of summary indicators of these costs and, to ensure comparability, total aggregate costs expressed in monetary and percentage terms, to show the cumulative effects of the total costs on the investment.”

  “Cumulative effects” is harmonized with MIFID text.

  Transaction costs are not detailed at level 1, but with this amendment, we exclude the option of implicit costs such as implicit transaction costs. See additional comments at the end of the document.

7. Do you have any comments on the analysis set out in this Section of other possible options to improve the future performance scenarios?

Risk free rate method
AFG does not support the risk free rate methodology, as it does not illustrate the differences between asset classes, as the ESAs acknowledge it in the benefits and costs analysis, especially for equity investments.

Limiting the number of scenarios
We do support the limitation of the number of scenarios*, as it is easier and simpler for a client to understand but we think that the unfavorable scenario should be used instead of the stressed scenario as:

- The stressed scenario is being calculated according to a different formula and based on different assumptions than the other scenario
- The range of possible performances would be unsymmetrical and distorted downward

*"A range of returns "– highest and lowest- is easier to grasp than 4 scenarios. The range should be accompanied with a disclaimer highlighting that this is a probability; e.g. "X% of the returns have been within this range in the last 5 years", therefore this would educate the investor with the notion of range of returns and probability.

<u>Extending the historical period used to measure performance</u>

Some AFG members see some value in extending the historical period used to measure performance for certain specific products

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This means that a potential future regime (which also assumes performance scenarios to be in place for linear products) would have to provide sufficient flexibility, such as:

- (1) Flexibility must be given to PRIIPs invested in real assets (real estate, infrastructure, etc.). For these types of PRIIPs it should be possible to link the observation period to the length of the economic cycle (depending on sufficient data).

- (2) For closed –end products such as private equity products, we believe that extending the historical period up to the equivalent of the maturity of the specific product would provide more relevant information.

8. Do you have any views on how the presentation of the performance scenarios could otherwise be improved?

AFG highlights the difficulty for real estate investment products to cope with the scenario performance methodology but also with the risk indicator and the cost calculation.
Special attention should be dedicated to this asset class and adapted measures would be relevant in regard to the PRIIPS requests.

9. Do you agree with the proposals described in this section?

<u>MRM calculation for regular investment or premium PRIIPS</u>

We agree with the idea of taking into account the fact that invested amounts accumulated over time reduces the risk and that a separate MRM could be calculated to show this.

<u>Products with autocallable features</u>
Yes, we agree.

<u>Narratives for the Summary Risk Indicator</u>
We agree with the extension of the SRI narrative to 300 characters from 200, which will give higher flexibility for particular cases if needed.

Narrative for Performance fees- composition of costs table

We agree with the change of the performance fee narrative to:

> "The impact of the performance fee. We take these from your investment if *[insert a brief explanation of the conditions under which performance fees are charged with a of maximum 100 characters in plain language]"*

Growth assumption for the reduction in yield (RIY) calculation

We do not support the proposition to include a unique performance scenario of 3 % for calculating the RIY:

- No fundamental reason for the choice of 3%
- It doesn't show the differences between asset classes
- Difficult to explain to a retail client

We think that the calculation of the RIY should be based on a zero performance scenario.

The concept of the RIY (reduction in Yield) used to display costs to the investor is complex and unclear. The fact that the costs include a time horizon and a yield represents a new disclosure that clients are not familiar with and that they could easily misunderstood. While we understand the reasoning and the added value of the RIY, we think we should also give the consumer a cost disclosure he's familiar with.

The costs currently disclosed are purely theoretical; consumers should be given the opportunity to see and understand the costs without any theoretical assumption.

Illustrations : examples of the two tables currently requested in the PRIIPS KID (full PRIIPS KID attached)

Table 1 : cost disclosure in RIY

Investment: € 10,000			
	If you cash in after 1 year	If you cash in after 2 years	If you cash in after 3years (recommended)
Total costs	€ 202	€ 311	€ 427
Impact on return (RIY) per year	2.02 %	1.50 %	1.33 %

Table 2: cost disclosure in RIY

This table shows the impact on return per year			
One-off costs	Entry costs	0.34 %	The impact of the costs you pay when entering your investment. This is the most you will pay, and you could pay less.
Ongoing costs	Portfolio transaction costs	-0.04 %	The impact of the costs of us buying and selling underlying investments for the Fund.

	Other ongoing costs	1.03 %	The impact of the costs that we take each year for managing your investments.

1. The investor is induced to believe that his entry costs are 0.34% while in reality he will pay 1% ; 0.34% correspond to 1% amortized over 3 years…should he stays invested 3 years.
2. The investor is induced to believe that he will pay 1.03% per year while this 1.03% is based on an assumption that the product will have a return of 2.65% per year and that the investor will hold the product for 3 years; the real ongoing costs will of course be different (and maybe radically different) . Besides, it is difficult to compare with another investment.

Our proposal is to offer the investor the opportunity to see the costs the way he is used to with a clear and understandable way, either by

- using a zero performance scenario in the two tables
  Or
- adding a column showing fees *in flat* in the second table (see below) . Table 1 remains unchanged.

Table 2: our proposal

This table shows the annual fees				
		Without RIY	**With RIY**	
One-off costs	Entry costs	1 %	0.34 %	The impact of the costs you pay when entering your investment. This is the most you will pay, and you could pay less.
Ongoing costs	Portfolio transaction costs	-0.04 %	-0.04 %	The impact of the costs of us buying and selling underlying investments for the Fund.
	Other ongoing costs	1 %	1.03 %	The impact of the costs that we take each year for managing your investments.

10. Do you have any comments on the proposed approaches in relation to the analysis and proposals in this section?
(*intégrer des éléments narratifs du KIID UCITS dans le KID PRIIPS*)

We do welcome including some UCITS KIID narratives into the KID PRIIPS but, due to the time constraints, we think it cannot be properly selected and implemented in the scheduled calendar.
That is why we do call for a report of the extension to UCITS until then.

Regarding the maintaining of a UCITS KIID for professional investors, we are strongly against it; maintaining two different formats will be a source of major confusion. Besides, Professional investors are capable (and more capable than retail investors) to fully understand the information disclosed in the PRIIPS KID.

11. Do you have any comments on the preliminary assessment of costs of benefits?

12. Are you able to provide information on the costs of including information on past performance for different types of PRIIPs?

13. Are there significant benefits or costs you are aware of that have not been addressed?

AFG would like to state that the switch over from the UCITS KIID to the PRIIP KID will carry substantial costs for the fund industry. This is exacerbated by the Commission's and ESAs' rushed timeline to make this shift happen before the end of 2019.

As many IT budgets have already been decided for the next calendar year, such massive IT projects will consume unnecessary amounts of money and resources. Furthermore, given that many UCITS ManCos and AIFMs have delegated the production of the UCITS KIID to third parties, we are hearing that there is already a bottleneck for all of these service providers to successfully manage the transition to the PRIIP KID for the vast number of UCITS and AIFs by 2019.

The situation is not made easier by the fact that there are many unresolved questions after having gone through the ESAs' consultation that make contingency planning for the "targeted" amendments even harder.

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Additional comments

AFG is disappointed that the ESAs are focusing this consultation only on essentially performance scenarios while there are other issues that need to be tackled as well to ensure that retail investors are not provided with misleading information. The most important issues relate to the methodology used to calculate transaction costs.

Transaction cost methodology

Transaction costs consist of "explicit" costs (such as broker commissions, transaction taxes, etc.) and "implicit" costs. While there is no disagreement over what constitutes explicit costs, it was never fully clear how to calculate the implicit cost element. MiFID II and IDD tried to provide further clarity by **stating that "underlying market risks" (i.e. market movements) should not be considered a cost.[1]**

Ignoring this essential clarification, the ESAs designed a completely new and complex approach (in the course of the Level-2 implementation process) on how to estimate these implicit costs, the "arrival price" methodology. As AFG has consistently pointed out from the outset, this methodology contains a systematic flaw. In essence, the ESAs decided that when calculating transaction costs, market

[1] MIFID Article 24(4) (c) :[The information about all costs and charges, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, shall be aggregated to allow the client to understand the overall cost]. IDD, see art.29 (1) (c)

movements (also called "slippage" – i.e. the time between the order and its execution) should be considered a cost and should be added to the market spread. Therefore, any movement of the market between the time of the order and the time of the execution (thereby capturing market risk) is to be considered a "cost" to clients. The PRIIP KID therefore regards such implicit costs, that mostly capture a measure of the best-execution of a trade, as an explicit cost to investors and equates them to all other types of costs (such as management fees) incurred by investors.

This methodology results in consistently under- or overestimating transaction costs. The first is particularly relevant if the fund manager executes trades in opposing moving markets (i.e. sells in an upward market and vice versa). This behaviour automatically results in negative transaction costs, which leads to highly misleading disclosures for investors. Funds displaying overall negative transaction costs are the most visible outliers of this systemic flaw, but incorrect costs are captured for each single transaction being recorded for each fund.

This exposes another flaw of the arrival price methodology, as it also assumes that the same high level of transparency (i.e. availability of price data) inherent in some liquid equity markets exists for all other financial markets. This is not the case. Due to the less transparent nature of trading in, for example, the bond markets or less liquid markets, it is much more difficult to discover the necessary arrival prices. MiFID II and MiFIR seek to increase transparency in the non-equity markets through extensive changes to the EU's market structures, but these changes have only become (partly) applicable from 03 January 2018 onwards and will take years to take full effect.

In the meantime, information needed for the PRIIPs transaction cost calculation is not available, inappropriate or very hard and expensive to come by. The very theoretical and analytical nature of the methodology requires the development of extensive operational procedures and controls that result in significant costs for all fund managers, but which are especially hard to bear for smaller companies that cannot leverage economies of scale. As can be seen from our examples below, these costs are not proportional to the very limited added value of the information for the end investors, when other methods can provide more realistic estimates for much less cost.

Overall, evidence made it clear that the current "arrival price" methodology is not fit for purpose – due to the impact of market movements in the overall cost figure – and is not providing fair, clear and non-misleading information to retail investors.

The reason for this is that the underlying slippage calculations are influenced by the trading strategy that a fund manager employs. For example, it is possible for a fund manager to submit a limit order at the market open for execution once the stock reaches a specific price later in the day. Alternatively, the fund manager can wait until the stock price has moved to the desired level before submitting a market order for immediate execution. In both cases, the execution price may be identical but in slippage terms the orders will look very different as the slippage cost measurement of the first strategy will include more market movement, despite the same economic outcome.

Proposed solution

We think that the implicit cost transactions requests should be deleted from level 2 and a definition of the costs in line with MIFID and IDD should be introduced in the level 1.

Real estate funds

AFG would like to reiterate its request to the ESMA regarding the treatment of the property management costs for non-listed real estate investment funds. The present position is based on the principles established by the PRIIPs' regulation:

- the comparability between all the products of investment covered by the regulation; and
- the precision in the information provided by PRIIPs product's manufacturer to non-professional investors.

From these principles flow the following conclusions:

- the non-listed real estate investment funds do not have to be the object of an upper level of requirement with regard to the other investment funds;
- operating costs of real estate assets (incidental expenses and maintenance costs) are incurred by any real estate owner: they are not specific to investment fund management and thus, should not be taken into account, nor be disclosed to the investor through the PRIIPs KID;
- operating expenses of a building (maintenance & repair, insurances, taxes and household waste) is a constituent element of the net return of a real estate asset. The scenarios of performance take into account all these property charges; and
- costs and charges disclosed in the PRIIPs' KID must be taken into account only once, according to the principle of non-double counting of cost set forth in point 77 of the PRIIPs' RTS.

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