On Wednesday 16 October, the European Supervisory Authorities or “ESAs” (ESMA, EBA, EIOPA) published their long-awaited joint consultation paper concerning amendments to the PRIIPs KID.

The purpose of this paper is to consult market participants over possible amendments to the PRIIPs KID.

The KID is meant to provide transparent and understandable information to retail investors about the risks, costs and future performance expectations of investment products, in an attempt to facilitate comparability between classes of investments. After almost 2 years of application, many practitioners have expressed doubts on whether the goal is fully achieved. Stakeholders concerns are mostly focused on following elements:

- Future performance scenarios displayed in the KID are said to be “overly optimistic”;
- Presentation of the product's costs in the KID, as well as the methodology to compute transaction costs, are seen as misleading for the retail investor; and
- For Multi-Option insurance products, the presentation of costs using ranges and the use of 2 different documents (a “Generic KID” and a “Specific Information Document”) are said to lack clarity and interpretability for retail investors.

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Furthermore, this consultation paper takes place in a context where exemption from the PRIIPs Regulation granted to UCITS investment funds has been formally extended until end of 2021 by the European co-legislators. The paper proposes avenues to resolve potential conflicts between UCITS and PRIIPs legislation, in particular the need to publish both a UCITS KIID and a PRIIPs KID for the same investment fund (which might be confusing for the retail investor). Responses to the consultation are expected by 13 January 2020. In turn, the ESAs expect to finalize their review by the end of the 1st quarter of 2020, in order to submit their conclusions and recommendations to the European Commission. Any agreed amendment to the RTS of the PRIIPs Regulation could be applied during 2021.

The consultation paper is structured around the following main topics:

• Amendment of the methodology applied for future performance scenarios;
• Inclusion of additional illustrative scenarios in the KID of Category 3 PRIIPs;
• Inclusion of information on past performance in the KID of Category 2 and 4 PRIIPs;
• Revision of the way cost disclosures are made to investors in the KID;
• Amendment of the methodology for computing transaction costs;
• Revision of the UCITS Directive and PRIIPs Regulation to resolve potential conflicts between them;
• Revision of the way cost disclosures are made in the Generic KID/Specific Information Document of Multi-Option insurance products; and
• Assessment of the costs and benefits of the various proposals.

Amendment of the methodology applied for future performance scenarios

The current methodology to compute future performance scenarios, based on probabilistic methods and historical data, is pro-cyclical in nature. Consequently, it might, in very favorable market conditions, provide investors with inappropriate expectations about the possible returns they may receive. In order to resolve this deficiency, while maintaining the simplicity of the current model, the ESAs propose a revised methodology where the estimator of the growth return of the PRIIP is no longer based on historical data. The new estimator would be the sum of a reference rate common to all asset types and an asset-specific risk premium:

• The reference rate would be based on the interest rate curve derived from sovereign bond prices of the country of the asset; and
• The asset-specific risk premium would be, e.g., for investment funds, the average dividend yield for each country and/or sector represented in the fund, weighted by their representation in the fund.

The other elements of the current approach would not be amended, in particular the estimation of variance, skewness and excess kurtosis of the distribution from historical daily returns. The ESAs advocate for this methodology, even though they remain open to alternative approaches. For instance, they mention a simplified approach where a maximum growth rate determined by asset class would be considered. This method, though very simple, has the drawback of making comparisons between investment products more difficult, since all products in the same asset class will exhibit the same growth rate.

Finally, they also propose a series of more minor or specific amendments to the current framework, as follows:

• Remove intermediate performance scenarios (with time horizons less than the Recommended Holding Period);
• Remove the stress performance scenario;
• Apply a specific methodology for money market funds, based on the implied volatility of options on German Bund, rather than on historical daily returns; and
• Create compensatory mechanisms to correct favorable or unfavorable scenario results whenever those results are seen as unrealistic.

Inclusion of additional illustrative scenarios in the KID of Category 3 PRIIPs

For structured products (Category 3 PRIIPs), the ESAs propose the use of illustrative performance scenarios. In a similar approach as currently used for so-called structured UCITS, this approach might provide more meaningful information than the current PRIIPs approach. However, it has the drawback of leaving more discretion to the manufacturer on how to define those scenarios, and in turn reduces comparability between products.

The consultation considers both the situation of standalone illustrative scenarios, and the situation where they are presented jointly with probabilistic scenarios. For insurance-based investment products, the use of illustrative scenarios is not pursued by the ESAs in their consultation.

Inclusion of information on past performance in the KID of Category 2 and 4 PRIIPs

The ESAs propose to disclose past performance information in the KID of Category 2 and Category 4 PRIIPs. The goal is not to replace future performance scenarios but rather to provide more context to them, in particular should these future scenarios show overly positive returns.

The proposed approach is the bar chart already used in the UCITS KIID, even though an alternative approach where only average past returns are disclosed is also considered. Completing the KID with this additional piece of information would however make it difficult to meet the requirement that limits the length of the document to three A4 pages.

Revision of the way cost disclosures are made to investors in the KID

The current presentation of costs in the KID, and in particular the concept of “Reduction in Yield” (“RIY”) raises some concerns, as it is said to be misleading and difficult to interpret for the retail investor. Here are a couple of examples:

• The methodology to compute the RIY makes several assumptions which, by nature, do not necessarily reflect the actual situation of individual investors;
• Showing costs at 3 different time periods might contribute to an overload of information for the investor;
• Entry and exit costs are amortized over the Recommended Holding Period, so that investors might misinterpret the actual charge they will incur.
• Penalty fees in case of early redemption might not always be well understood by retail investors;
• The current prescribed narrative does not allow the manufacturer to reflect the range of different performance fee structures; and
• There is a lack of detail in the fee structure of real estate and private equity investments.

The consultation proposes four revised structures of the KID’s cost disclosures, but favors one of them more particularly. The ESAs’ goal with this proposal is to clarify the concept of RIY percentage, to make sure it is well understood by retail investors. With this in mind, they propose to split into 2 different tables (i) the information around RIY percentage, and (ii) the total cost information in monetary terms and description of the different costs.

Amendment of the methodology for computing transaction costs
The main concern expressed by market participants around transaction costs lies with the “arrival price” or “slippage” methodology put forward by the PRIIPs Regulation.

This method captures the bid-ask spread of each transaction, but also the impact of market fluctuations between the time of the investment order and the time of its execution in the market. Application of this methodology can result in negative costs, which might confuse the investor. In addition, the application of the slippage method raises practical challenges, in particular for some OTC securities and derivatives. Finally, the slippage method might lead to larger fluctuations in the level of costs.

Overall, the ESAs are of the opinion that the current PRIIPs methodology should be maintained, though slightly amended. The consultation paper requests feedback on the following two alternatives:
• Introduce a proportionality threshold whereby a PRIIP manufacturer would be able to use a simplified approach when only a small number of transactions or a small portfolio turnover are observed; or
• A more principles-based approach, less prescriptive on the use of the arrival price method, providing a more general derogation to this method and allowing the use of alternative approaches in a larger range of situations.

In both cases, they also propose to prevent disclosure of transaction costs that would be lower than total explicit costs (such as brokerage fees and taxes). In other words, this prevents negative implicit transaction costs.

Revision of the UCITS Directive and PRIIPs Regulation to resolve potential conflicts between them
The consultation paper studies how articles of the UCITS Directive might be integrated into the PRIIPs Regulation, to resolve a series of potential conflicts between the two legislations.

For instance, if nothing changes in the respective legislations:
• Both a UCITS KIID and a PRIIPs KID would need to be provided to retail investors for the same investment product. A natural evolution would be for the PRIIPs KID to replace the UCITS KIID.
• UCITS KIID would still be required for non-retail investors of UCITS funds. A possible solution is to allow for the use of a PRIIPs KID in such instance.
• UCITS KIIDs, updated at least yearly, are not provided again to existing investors, while PRIIPs KIDs should be

Revision of the way cost disclosures are made in the Generic KID/Specific Information Document of Multi-Option insurance products
The current PRIIPs Regulation provides for two different approaches as to how to structure the KID for these types of products:
• A separate KID can be prepared for each investment option; or
• A Generic KID can be provided, covering in general terms the types of investment options offered, as well as separate information documents on each underlying investment option.

In the latter case, there are challenges for retail investors to understand the interaction between the “Generic KID” and “Specific Information Documents”, in particular concerning the costs of the different options offered to them. The main reason for this comes from the fact that costs are presented as ranges. Another difficulty arises when investors would like to allocate their insurance premiums across a combination of options. In such a case, cost disclosure might lack clarity.

The ESAs are looking for the right balance between the current situation and a situation where the costs of all possible options (or combinations of options) would be disclosed. In that spirit, they propose to require full disclosure for a limited number of most relevant options, for instance four of them.

In addition, the ESAs are looking for a way to narrow the ranges of costs disclosed to investors. A potential method would be to present different ranges of costs for the different classes of risk of the various options, instead of one single range applicable to all of these classes.

Assessment of the costs and benefits of the various proposals
The ESAs conclude their consultation paper by assessing the costs and benefits of the different proposals.

Overall, all proposals would induce material one-off costs for PRIIP manufacturers, for the adaptation of their IT systems and tools. Methodological proposals (e.g., for growth return of performance scenarios and for transaction costs) are meant to better reflect reality and intuition.

Proposals made to provide additional or clarified information have the benefit of an increased transparency and awareness of the retail investors. However, they increase in turn the quantity of information provided to retail investors, and therefore may create additional confusion.

How can Deloitte help?
Deloitte’s advisory specialists and dedicated services will help you design and implement your business strategy in light of the future evolution of the regulatory framework and market trends.

With its broad array of services, our PRIIPs KID Reporting Services can help PRIIPs manufacturers comply with the upcoming PRIIPs requirements. Our experts can also advise on how assessing the implications of the new methodologies envisaged in this consultation paper.
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