



A report on Packaged Retail Investment Products from the International Regulatory Strategy Group

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The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to contribute to the shaping of the international regulatory regime, at global, regional, and national level, so that it promotes open, competitive and fair capital markets globally which support sustainable economic growth. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views. It is an advisory body both to the City of London Corporation, and to TheCityUK, a new independent practitioner-led body which has been established to coordinate the promotion of the UK-based financial services industry.

For this report there were present representatives of banks, insurers, asset managers and brokers. Both product providers and distributors were represented.

Summary

Across the EU, citizens need to save more, especially for retirement income. The evidence is that many consumers are not comfortable making investment decisions. They must be helped.

The Commission's PRIPS initiative is an important measure which has the potential to give consumers much better outcomes.

To succeed, the initiative must cover all substitutable products, regardless of legal form. Rules on disclosure and on the nature and cost of advice and distribution must produce identical outcomes for the consumer.

In addition, nothing should be done to damage the welcome diversity of product and distribution methods available to consumers.

1. The challenge for the European consumer

- a. "Over the last 50 years, life expectancy has risen by about five years in the EU. The latest demographic projections reveal that a further rise of about seven years could materialise by 2060. Combined with low fertility rates, this will lead to a dramatic change in the age composition of the population. As a result, the old-age dependency ratio will double: where at present there are four people of working age for every person over 65, by 2060 there will be just two people of working age for every person over 65.
- b. The financial and economic crisis has seriously aggravated the underlying ageing challenge. The scale of fiscal deterioration following the crisis is equivalent to offsetting 20 years of fiscal consolidation, implying that fiscal constraints will be very strong in the next decade. Estimates suggest that the crisis will put further pressure on public pension spending over the long term because economic growth is set to be considerably lower and there is great uncertainty as to the timing of the full recovery."
- c. The European Commission's recent Pensions Green paper sets out the challenge. This is not just a high-level policy issue. It will become a stark part of people's lives over the next decades. There is only one way through this. People will have to forego consumption, either through taxation or saving. Both have a role to play. But these imperatives show why an improvement in the medium and long-term savings market in Europe is vital.
- d. At the moment, consumers often view the process of obtaining advice about suitable products with little confidence - either in the process itself or the outcome - though they know that advice is necessary in order to assist with making an informed investment decision.
- e. The most recent Consumers Market Scoreboard from the Commission said:

"Consumer market malfunctioning is characterised by the existence of consumer detriment which can appear even in very competitive markets. Consumer markets may suffer from malfunctioning caused not only by anti-competitive practices, but also by failure of traders to

comply with laws designed to protect consumers against fraud, misleading or deceptive advertising, unfair commercial practices and unfair contract terms. In addition, for many goods and services, complex or voluminous information which is difficult to understand prevents consumers from making well informed decisions. For example, more than a third of European consumers say that they have difficulties comparing offers from different providers of various financial services.”

- f. In light of this, it is perhaps not surprising, if extremely worrying, that in the Scoreboard investment services achieve the lowest scores consistently across all measures and most countries. They also form a very small part of household expenditure. That could lead to satisfaction that the detriment caused is not too great. The truth is that this situation will result in levels of saving across Europe, particularly for retirement, which will turn out to have been too low. By then it will be too late to rectify. Action is needed now.
- g. Improving the quality and comparability of information available to consumers is crucial, but, on its own, will not suffice since, generally, consumer confidence and financial literacy is poor. It is no surprise that consumers turn to advisers to assist them in making financial choices. Products are becoming more complex yet many consumers are not receiving the high-quality advice they need. This may be explained by conflicts of interest inherent in the sales process or, in some cases, by shortcomings in professionalism among advisers. Consumers have a right to expect high quality impartial advice based on their needs, not on the self-interest of the adviser or of the financial services provider. They also have a right to expect that their adviser is trained and qualified to an appropriate level.
- h. Addressing these deficiencies in the marketing of retail investment products is an important challenge for the industry and policymakers today. It is vital that they start to deal with these deficiencies in a way which is relevant and coherent and meets the needs of consumers looking to save for tomorrow. The consumer interest must be the touchstone in this debate. Consumers deserve nothing less.
- i. The actions initiated by the European Commission under the banner of PRIPs (Packaged Retail Investment Products) are a significant step in the right direction and will be supported by all in the industry who have consumer betterment as their goal. But the technical difficulties are many and complicated.
- j. There need to be objective criteria against which to judge any proposals. They must view the issues from the consumer perspective and not from that of the fragmented industry. Many regulators, too, are unused to viewing retail financial services as a whole, which is how consumers view it. Too often, satisfactory answers to prudential issues are viewed as the be-all and end-all of investor protection, but prudential answers are a necessary but not sufficient condition for full investor protection.
- k. The PRIPs initiative should be judged against four criteria;

Transparency. The consumer should be made aware of the type of advice they are being offered, the nature of the product, and the costs of the advice and of the product.

Simplicity. The products may not be simple but all communication with the consumer should be intelligible and free of technical terminology which they will not easily understand.

Choice. Consumers should be made aware of different sources of execution, advice and products. This will require work in addition to that envisaged by the PRIIPs regime. Wherever possible, a key outcome of the PRIIPs initiative should be to point consumers to competing sources of advice and products.

Value. The value of advice is hidden in much of the financial services markets in Europe. In the UK, 50% of people believe advice is free. That is because the cost of advice or distribution is bundled into the product. Consumers therefore do not understand the cost of advice, do not value it and do not understand that the advice market is a market like any other. Without being able to see the cost of the product or the service there can be no competition in the marketplace. And competition can often deliver as much benefit to consumers as regulation.

- I. This is also a challenge to the whole industry. Products which offer little or no value when advice and distribution costs are factored into the equation cannot be consistent with the promotion of consumer interests. The current juxtaposition of the demographic, economic and fiscal drivers offers an unusual, possibly unique opportunity to address these issues. It would be tragic to miss the chance to offer European consumers a substantial improvement in their treatment, and thus build a base from which they can increase their confidence in financial services. It may be decades before such an opportunity arises again.

This paper seeks to set out the main issues which must be considered and offers some thoughts on the way forward.

2. The challenge in current regulations

- a. Consumers are largely indifferent to the package a particular benefit comes in and they are largely agnostic as to how their savings and investment needs are met. Nor do they much care which industry supplies it, let alone which piece of regulation governs the process or the product.
- b. In Europe there is a wide range of products delivering roughly similar economic effects.
- c. Similarly, there is a wide range of routes to access these products: without advice, with advice paid for directly by the consumer, with advice which is paid for by the product provider.
- d. Again the adviser may offer product types from across the market or from a more restricted range, or may offer only the products of their employer or parent.

This wide range of choice should be beneficial for consumers, although they are often not aware of the range of potential choices available in the market. However, the controls on the advice process facing the consumer vary depending on the product or provider, leading to concerns about potential distortions in that advice. Regulation should be designed to address these concerns and to enhance the possibility for competition.

- e. Competition between investment products in the retail market can be beneficial for retail investors and the economy at large, creating incentives to deliver products that respond to changing market conditions and evolving investor needs. The packaging of investment products can also offer advantages such as providing retail investors with opportunities for spreading risk or targeting specific risk and reward outcomes, or enabling consumer access to professional portfolio management expertise that would otherwise be too costly.
- f. Information and expertise asymmetries between the manufacturers and distributors of products on the one hand and financially unsophisticated retail investors on the other can limit consumers' ability to make genuine comparisons between products without some degree of dependency on professional advice. 'Packaging' investments can increase this asymmetry by, for instance, adding complexity. This can make key investment characteristics less transparent and introduce additional layers of cost which may not be readily apparent. Regulation has been designed to address these concerns for some products and providers, but not for all. There are other complexities and considerations. Too often, regulators equate "complexity" with riskiness. Many complex products offer outcomes to investors which are clear and deliverable even if the underlying strategies are complex. There should be a simple presentation to investors of the material and relevant risks in all products.
- g. Unfortunately, the fragmentation of regulation in the EU means that different products and the regulation of their distribution are subject to different EU Directives or national rules. UCITS funds fall under the UCITS Directive, insurance products fall under the Insurance Directives, and listed structured debt instruments ("structured notes") fall under the Prospectus Directive and Transparency Directive. Other investment products will fall to be regulated under the Alternative Fund Managers Directive.
- h. On the distribution side, the two major pieces of Community law applicable are MiFID (Markets in Financial Instruments Directive) and the IMD (the Insurance Mediation Directive), both of which are under review and will be subject to revision in the near future.
- i. Currently, there are important differences in the disciplines applied by these different pieces of legislation. For example, MiFID includes detailed provisions on the avoidance, management and disclosure of conflicts of interest and on the payment of inducements to intermediaries. The IMD includes different conflict of interest rules, requiring intermediaries to inform clients as to whether they are giving advice based upon a fair analysis (using a sufficiently large number of insurance contracts) or whether they have contractual obligations with one or more insurer. Moreover, in the IMD, all insurance intermediaries have to set out the reasons underpinning any advice given on the basis of information provided by the client.
- j. There is, in addition, a patchwork of regulations covering different aspects of retail products and services.

For example, Solvency II, as in previous insurance directives, provides for a withdrawal right to the benefit of policyholders, while there is nothing comparable in the MiFID since it is largely concerned with market-traded instruments. Similarly, Solvency II also ensures stringent solvency requirements for capital guarantees provided by life insurance companies. Other types of product provider are subject to different rules on prudential provision behind guarantees.

UCITS (and their national equivalents, which now fall under the AIFMD) provide investor protection in that the underlying assets of the fund are held by a depositary, independently and separately from the balance sheet of the provider, the fund manager. Also, the depositary performs an important oversight (i.e. quasi-regulatory) function.

- k. Moreover, some products and distribution channels are not covered at all by regulation. Direct sales by product manufacturers (for instance, portfolio managers or insurance companies) may be subject to different disciplines from sales or advice by intermediaries. In addition, there are no European rules on the distribution of structured term deposits, which are not financial instruments as currently defined by MiFID, although this is currently under review.
- l. The answer to this situation must be to ensure that products which offer similar outcomes for consumers are treated in the same way and that the advice process is regulated to be in the best interests of the consumer, regardless of the financial institution, distribution mechanism or product.

3. The PRIPs initiative

- a. The European Commission has launched a welcome initiative on PRIPs. In this, they aim to define products offering similar outcomes for consumers and to ensure that their treatment in the distribution/advice chain brings effective consumer protection and is not dependent on the nature of the product or provider.
- b. In Europe there is a wide range of products delivering roughly similar economic effects.
- c. The original proposal was for a new horizontal piece of legislation covering all PRIPs and covering both product disclosure and the regulation of selling and marketing practices. The latest consultation paper proposes a new legislative instrument covering only product disclosure. Co-ordination of selling and marketing regulation would be achieved via enhanced provisions as part of the reviews of MiFID and the IMD. This will most likely turn out to be sub-optimal from a consumer perspective. Unless handled with great care, this could lead to ongoing differences in regulation across products, not least as regards scope.

4. Scope - Equivalent regulatory treatment for equivalent products

- a. In order to ensure that regulatory arbitrage does not drive consumers towards one particular product or another, the same principles should apply to all retail investment products. When considered from the perspective of the consumer, it is the economic function of the product that should decide its regulatory treatment and not the legal form in which it is packaged. All of the product types under consideration in the PRIPs project have the same core economic function – they are investment products sold to retail investors.

5. Example of regulatory inconsistency causing harm to consumers

- a. A consumer aims to save a % of their salary but seeks some form of protection against significant losses. One option is an investment product offering a financial return linked to an index, such as the DAX or FTSE, but with a partial guarantee to ensure the savings cannot fall below a certain level. That need can be satisfied by:-
- **funds**, designed by a fund manager or insurance company
 - **insurance** contracts, designed by an insurance company
 - **deposit** accounts, designed by a bank but with special "investment" features utilizing derivatives
 - **bonds**, designed by a bank, also with special "investment" features utilizing derivatives
- b. Each option above has different European requirements for disclosures and for control of the advice process, varying from rigorous to non-existent. The reason for these discrepancies is not determined by the needs of the consumer, but whether the seller is an insurance company, bank, asset manager or other type of institution. In our view, it makes no sense to proceed from the premise of corporate structure when designing legislation. Corporate structure is required for determining prudential matters, not for conduct of business issues. Similar products and services should be regulated in similar ways.

6. Criteria to define a PRIIP

- a. In both its Issues Paper (October 2009) and Update Paper (December 2009), the Commission sets down conditions to be fulfilled in order that a product be considered a PRIIP. It is crucial to have these criteria set down to ensure that there is equivalent regulatory treatment for equivalent products.
- b. We propose that the following elements are met for a product to be considered a PRIIP:
- There is an element of packaging;
 - The product is capable of meeting an individual investor need for capital accumulation and/or income; and
 - The product is exposed to an investment risk (whether direct or indirect).
- (This definition matches very closely the Commission's most recent proposal.)
- c. The European Commission has expressed a desire to develop a white list of products that should be regarded as PRIIPs to complement the legal definition they will issue. This will be difficult, in view of the different descriptions of products in current usage across the EU. If such a list were to be developed, it should not be exclusive, must be sufficiently flexible to accommodate future changes and should not be based solely on the label of a product. It needs to be accompanied with a description/criteria to clarify which products with the same label are in scope so that it is clear how new, innovative products could come into scope.
- d. Care will also be needed to avoid unintended effects where EEA intermediaries deal in products where the product provider does not have its head or registered office in the EEA.

- e. Alignment with current Directives and treatments may be difficult. Under MiFID, not only shares, bonds and UCITS may be traded by retail investors, but also derivatives. The proposed definitions of PRIPs – both the Commission’s and in the recent 3L3 Task Force Report – can be read as including derivatives, but it is not clear whether this is the intent. There are differing views among providers and distributors about whether or not derivatives should be caught by any PRIPs requirements, just as there are differences in view about the inclusion or not of personal pension products. The key question for regulators should be what the consumer might reasonably expect to be regulated and how.
- f. From this perspective, there can be no doubt that insurance products that are technically contracts with the insurer and on its balance sheet are PRIPs when their outcome for the consumer is identical to other products viewed from the point of view of the consumer.

7. The nature of advice

- a. Both current Directives have difficulty treating what will come to be known as PRIPs. The IMD deals not only with investment products but also with general insurance products which are out of PRIPs scope and where the products and their outcomes are easier to describe and consumer detriment arising from them is likely to be less than from an investment product.
- b. MiFID distinguishes between execution-only transactions which retail customers may conduct in securities and UCITS, and cases where advice is given. There is a further complication in that a distinction is made between complex and non-complex products. Complex products may only be accessed by retail customers without advice if the intermediary has conducted an appropriateness test.
- c. MiFID also has rules on inducements which try to deal with the issues both in wholesale and retail markets
- d. There may be an argument for carving out the parts of the Directives which relate to PRIPs and creating a new, fit-for-purpose legislative architecture rather than applying string and sticking plaster to the current texts. Alternatively, the approach suggested by the Commission of defining structured deposits as MiFID products could be applied to all PRIPs, regardless of provenance.
- e. In any event the rules must allow a wide range of distribution models, ranging from true execution-only, through a fully-integrated approach to a wholly-independent advice process. This would maintain the range of distribution methods which offer choice to consumers. It would be highly damaging to consumers if products that they currently access without advice were no longer available on this basis. There is little evidence that current regulation and practice in the execution-only field has led to consumer detriment.
- f. Today’s requirements on disclosure and suitability of advice under MiFID aim to give investors the necessary transparency regarding the nature of the services the distributor is offering. However, there is reason to believe that this is not enough to ensure that the aims are always

met. Therefore, MiFID should also set standards as to how exactly this disclosure should take place, notably at the point of sale (e.g., design of disclosure form, etc.)

- g. A crucial requirement for effective implementation is that the information is provided proactively, in an understandable format and early in the sales/advisory process. In this respect, the customer needs to know the nature of the advice he or she is receiving. In particular, the following information should be disclosed:

The nature of the distributor's duties to the client. In particular the adviser should make clear at the outset of the provision of advice whether she/he is acting independently and will be remunerated solely by the client, or whether she/he will receive remuneration from a product provider or distributor.

The range of investment product categories on which the distributor advises, e.g., mutual funds, investment products within life insurance policies, etc;

The number and names of product providers on which the distributor advises, identifying any product providers with whom the distributor has a potential affiliation;

The basic principles of the fee arrangements that the distributor has with different product providers and distributors for different product categories, together with a table of comparable commissions/revenues payable on related, competing PRIPs, for example. The adviser's disclosure must be delivered in a form that the investor can easily understand, comprising all items and arrangements whether they be:

- (i) direct or indirect,
- (ii) one-off or recurring,
- (iii) at the time of purchase, in the holding period, or at the exit of the investment.

8. The basic criteria and process for selecting products on the distributor's shelf

- a. Restoring the balance between investors and distributor helps the former to compare the offering of different distribution channels, with the understanding that clients are not necessarily best served by incurring the lowest possible cost but rather by finding the right product combination that meets their investment goals. It ultimately increases competition for products that best serve investors' needs. Effective implementation would also lead to more competition between distribution channels for the most client-centric distribution model.
- b. For all PRIPs, the adviser should additionally be obliged to disclose separately all advice and distribution cost items. The UCITS Key Investor Information Document (KIID) will require UCITS to meet a high level of disclosure of fund costs, investment risk and performance (or reward). It does not, however, mandate the separation of the cost of the product and the cost of advice.
- c. The investor should understand exactly what he or she is paying in order to make better-informed investment decisions. More transparency on cost should lead to investors being able to drive down the prices of services offered and/or increase the quality of advice provided.

9. Disclosure documents

- a. The duty to produce and provide the Key Investor Information Document is a central part of the PRIIPS initiative. In order to meet clients' needs both the format and content of a KIID and also the requirements on providing it or making it available must be appropriate. A one-size-fits-all approach is unlikely to work well.

The form and content of the KIID

- b. The UCITS KID/KII is being held up as the template for all PRIIPS products. It is a good starting place but it must be acknowledged that, for some PRIIPS, risks which are not contemplated in the UCITS work will be central to an investor's understanding. Equally, the simplistic synthetic risk indicator in the UCITS KIID, which many believe to be dangerously misleading to consumers, would have no place in products where volatility is not an issue. More complex products may bring with them a different set of risks but may not themselves be riskier. The risks need to be communicated, but also the overall level of risk.
- c. Comparisons involve highlighting differences as well as similarities. The problem which could be created by a single, harmonized disclosure document used across multiple product types is that it may well have the effect of communicating to investors that there are no significant differences between these products. It is important to understand the differences between products.
- d. There is a great deal of work necessary before a single disclosure template can be offered with any confidence across such a wide range of products, and experience in the UK of its "Key Features Document" shows that it needs to be kept under review and its contents limited to key points and in plain language. We suggest, though, that the core elements of product disclosure must be costs, risks and performance (i.e. reward). The debate should not be whether such disclosures are necessary, but a technical discussion about how to achieve timely disclosures that are broadly comparable across different types of product, without masking the important differences between products and the different distribution channels chosen. The results then have to be conveyed in language which a non-expert can comprehend.

Services provided in relation to PRIIPS

- e. The duty to produce and either provide or make available the KIID should be appropriately tailored depending on the product and service concerned. For example, in a discretionary management arrangement, the client has no trade-by-trade decision making role and so has no need to see a KIID before or after the trade.
- f. By contrast in the execution-only space, the client takes the decisions himself, and may value the opportunity to trade rapidly where prices move intra-day. The execution-only intermediary has no role in the selection of the product. Where the PRIIPS product is sold on the secondary market the product provider has no involvement in the sales process – which is conducted between two investors (a buyer and seller).

- g. The intermediary's duty is to secure the best execution in the transaction and this is already effectively regulated by the MiFID rules. Here the duty should generally be on the PRIPS provider to produce the KIID and make it available, for example on the website. The execution-only intermediary should have no duty to provide the KIID. The risk is that inappropriate obligations will disrupt the sales process and damage the consumer interest by delaying the transaction or inappropriately increasing the price of dealing.
- h. Advisers (including non-discretionary investment managers) should be required to provide a copy of the KIID to the client when they advise the client to buy a PRIP, in good time before he decides to trade.

Conclusion

The PRIPS initiative has the potential to substantially improve the experience of consumers when buying retail financial products. It will be difficult to get right, and will involve the industry in implementation costs, but it is a vital piece of work at a crucial time.