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# Research Update:

5th May 2017

# PRIIPs system challenges

Following on from the adoption by the European Commission of the revised regulatory technical standards, PRIIP providers urgently need to address how they will produce the required key information documents.

In this research update, George McCutcheon discusses this important issue in more detail.


## Background

The key information document KID is a three-page document to provide the retail investor with information on risk, performance scenarios and costs as prescribed in the Directive.

## Key Issues for PRIIP providers

- The 1/1/2018 implementation date for PRIIPs is a show-stopper for PRIIP manufacturers – if they can't produce KIDs, they can't write business.
- PRIIP providers will require a systematic solution – either through in-house/group systems, by out-sourcing or by using specialist vendor technology
- Key information documents are much more than a regulatory requirement to provide some additional documents – they will be a key component of point of sales illustration material. PRIIPs providers could be exposed to civil liability risk in respect of KIDs that are misleading, inaccurate or inconsistent with the relevant parts of legally binding pre-contractual and contractual documents or with the requirements laid down in Article 8 of the Directive

## Next steps

PRIIP manufacturers need to decide on their technology solution.

## Calculations

There are three components to the calculations

The risk indicator (1-7) is a measure of volatility – it's derived from the volatility inherent in the five-year unit price history

The unfavourable, moderate and favourable performance scenarios are based on a prescribed formula – the Cornish Fisher expansion the 10,50 and 90 percentiles – utilising actual costs and five-year unit price history

Costs are derived as reduction in yield figures

The figures matter -it's not a box-ticking exercise – civil liability can arise:

| | |
|---|---|
| 1 | Risk Indicator |
| 2 | Performance Scenarios |
| 3 | Costs |

## Calculation challenges

The calculation challenges are in two parts – firstly the data collation calculations and secondly the KID calculations.

In respect of data collation there is a need to calculate portfolio transaction costs – whilst asset managers will provide this in respect of external collectives, insurers will need to calculate firstly portfolio transaction costs in respect of their trades in such external collectives and secondly the portfolio transaction costs in respect of their funds with direct investments in asset classes.

There is also the substantive issue that a revised set of historic unit prices (based on the current asset mix) is required for the KID calculations for PRIIPs with flexible investment in asset classes. Examples of such PRIIPs would be Fund of Funds (whether fund of internal funds or fund of PRIIPs) or funds with direct investments in multiple asset classes.

PRIIPs manufacturers need to determine for their KID generation operating model whether the recalculation of the historic unit prices will be part of the KID technology solution or whether they will need to do the recalculations as part of the data collation process as inputs to the KID technology solution.

The KID calculations are in respect of risks, performance scenarios and costs. Some 38 different figures need to be calculated for the KID and the calculations are not easy. Also, a PRIIPs manufacturer could have hundreds, possibly thousands of KIDs to be produced.

### Calculation challenges

- **Data collation**
  - Portfolio transaction costs
  - Revised 5-year unit price history for FoF
- **KID figures**
  - 38 different figures

## Specific calculation challenges for insurers

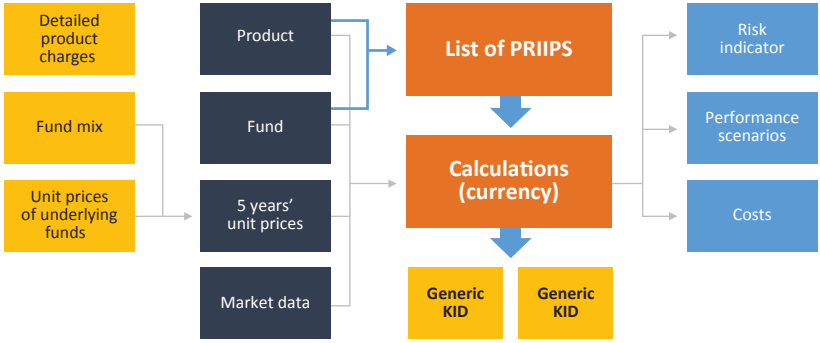
Insurers face specific calculation challenges even in cases where their investments are primarily external collectives and KID figures for the external collectives are available from asset managers through the European PRIIPs Template.

Insurers will need to incorporate their own charges into the KID. They will need a different approach for fund of PRIIPs because the KID figures computed as weighted averages of the external collectives' KID figures would be incorrect e.g. if the external collectives were negatively correlated. They also need KIDs for regular premium KIDs. A single integrated solution for producing KIDs for all PRIIPs product types would be best.

- Own charges (bid/offer spreads, exit charges, amc)
- Fund of Funds
- Regular premium contracts
- Insurers have the required dataset in-house (just need costs of ECs)
- Reduced dependency on multiple data uploads
- One integrated solution

## Calculation process

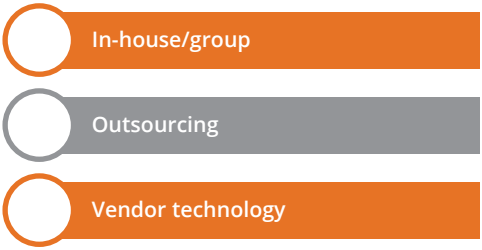
The calculation process is set out below. The data items required are a list of PRIIPs products, their associated product charges, a schedule of permissible fund links for each PRIIP, the 5-year unit price histories of the funds, details of the fund charges and the current asset mix of funds with flexible investment in multiple asset classes and 5-year price history of those asset classes.




## Technology Solutions

This will require a systematic solution for PRIIPs manufacturers – some will be able to utilise parent company solutions, some might develop in-house solutions, others might decide to outsource and others will use vendor technology.

Selection criteria will include regulatory dead-lines, implementation timescales, availability of in-house resources and opportunity cost, philosophy on outsourcing, availability of vendor technology solutions, commercials and evaluation of strategic issues.




## European PRIIPs Template

In summer 2016 a Cross-European Working Group started designing a template/framework designed to help asset managers provide data and information regarding their products to insurers. Insurers need such input because they will have to provide PRIIP KIDs for their insurances that have an investment component managed by an independent (asset) manager. The group produced a version 1 of such a framework ("European PRIIPs Template") and submitted it to EFAMA and Insurance Europe for endorsement.

The EPT approach would work best for insurers whose portfolio is primarily mirror funds (viz internal funds linked to a single external collective) or who transact with a relatively small number of external asset managers.

**The EPT approach would not resolve some difficult calculation challenges for insurers:**

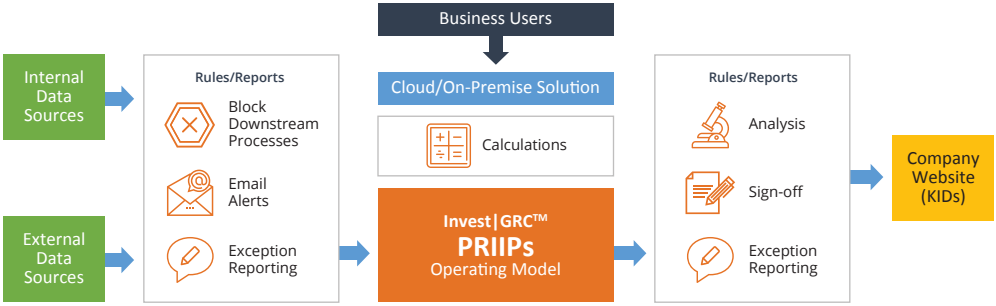
- Funds holding direct equities, fixed interest, property, etc rather than just PRIIP vehicles
- Fund of Internal Funds or Fund of PRIIPs
- Regular premium contracts
- Cases where the recommended holding periods of the insurer products differ from the RHPs of the EPT PRIIPs

A relevant consideration is that adopting the EPT approach would mean that the insurer was introducing an unnecessary dependency on asset managers in respect of point of sale illustrations material. Bearing in mind that an insurer as a PRIIP provider must monitor the continuing validity of the KID effectively requiring quarterly recalculation, it appears wholly unnecessary to introduce this dependency particularly when the insurer with an appropriate technology solution could generate the KID data itself.

The dataset required from asset managers is actually quite small – what's needed is the cost figures data i.e. portfolio transaction costs % and other recurring costs %. It needs to be the latest available data but it's unclear from the RTS at what frequency the costs data needs to be recalculated -possibly just once a year. The insurer will have the 5-year price history of its internal fund and can generate the KID data from that together with the costs %s for the external collectives. If the cost data is yearly, the insurer doesn't require further data (certainly for category 2 PRIIPs) from the asset manager at quarterly intervals to compute the KID figures.

## Invest|GRC™ Operating Model

Any technology solution will have elements of this operating model – covering the three components of firstly data collation and validation, secondly the calculations and thirdly the document production. Best strategic design would have all the KID figures in a results database.




## Biography; George McCutcheon MSc FIA:

Mr. McCutcheon is a graduate of University College Dublin in Mathematical Science and is a Fellow of the Institute of Actuaries. He is a director and co-founder of Financial Risk Solutions (FRS), a software company specialising in the licensing of fund administration software to life assurance companies.
He has presented a number of papers at the Life Convention of the Institute of Actuaries and has co-authored a number of papers for the Society of Actuaries in Ireland.

# About Financial Risk Solutions (FRS)

Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund accounting software to the Life Assurance and Pensions industries. It was founded in 1999 by actuaries and IT specialists and is one of the leading software providers in its sector. Its Invest|Pro™ product family is a recognised leading benchmark in the investment administration area and leading customers include MetLife, Mobius Life, SEB, IFDS Percana, and Accenture Managed Services.

FRS's mainline product Invest|Pro™ manages unit pricing and portfolio valuations, asset/liability unit matching, box management, trade order management, taxation, investment accounting, financial reporting and compliance with investment mandates in a single application. Product types covered include unit linked funds, portfolio bonds, self-invested/directed pensions and shareholder funds. Invest Pro™ was specifically designed to securely automate complex fund administration processes.

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