Knowledge based Software

www.frsltd.com

Research Update

June 2017

Critical implications of the UCITS 1/1/2020 derogation for PRIIPs manufacturers

PRIIPs

George McCutcheon MSc FIA

discusses PRIIPs derogation re UCITS

There is a derogation until 1 January 2020 for PRIIPs manufacturers in relation to underlying investment options which are UCITS.

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

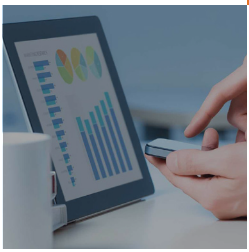
Background

There is a PRIIPs transitional exemption period under Regulation 1286/2014 until 31 December 2019 for UCITS and non-UCITS funds to which Articles 78 to 81 of Directive 2009/65/EC apply with regard to the format and content of their key investor information document (KIID) – not to be confused with the PRIIPs key information document (KID). In addition, for other PRIIPS manufacturers, Article 14.2 of the Regulatory Technical Standards (RTS) dated 8 March 2017 provides derogation until 31 December 2019 enabling them to use the UCITS KIID data in certain circumstances.

Under Article 10, the PRIIPs manufacturer can for multi-option products either (a) provide a KID for each underlying investment option in accordance with Chapter I, or (b) provide a generic KID in conjunction with specific information on each underlying investment option in accordance with Chapter I subject to the provisions of Articles 11-14. It is anticipated that most PRIIPs manufacturers will choose option (b).

The key Articles are Article 12, Article 13 (relating to the risks and costs respectively in the generic ID) and Article 14 (relating to the specific information).

The derogation applies only in the context of the PRIIPs manufacturer choosing basis (b). The derogation is in two parts – firstly in respect of the provision of the specific information on an underlying investment option though UCITS KIIDs and secondly in respect of how the generic KID is compiled.



Key Issues for PRIIP providers

- The first question is whether or not the derogation is applicable (see section "Applicability of derogation to insurers", below) – it applies for investment options being mirror funds linked to UCITS.
- There is a difference in the inherent costs disclosed under a PRIIP basis and a UCITS basis e.g. portfolio transactions costs are not disclosed under the UCITS basis. An insurer's perspective on whether or not to select to utilise the UCITS derogation is primarily concerned on the practicalities of meeting the regulatory requirement to produce KIDs but level playing field issues arise also.
- For PRIIPs manufacturers for multi-option products, the key question is whether or not the Article 13(3) criteria can be met (i.e. are all the underlying investment options UCITS?) The consequential issue is not whether they can use the UCITS KIID but rather the costs basis required for the generic KID. For most insurers, their PRIIPs multi-option products or open architecture products will fail the Article 13(3) test.
- If the Article 13(3) criteria can't be met, then the range of costs in the generic KID must be disclosed on a PRIIPs basis. If so, there are two main consequences – firstly portfolio transaction costs (including those within the UCITS) must be included and secondly performance scenario calculations are required to derive the costs figure – a vital issue to be considered in the practical implementation of a good directive.
- There is the issue of what basis applies for the European PRIIPs template for UCITS during the transitional exemption period – will costs and risks be supplied on a UCITS or PRIIPs basis?

Conclusions

- The conclusion is that the UCITS derogation option will not be chosen by most insurers. The reason is that the products will fail the Article 13(3) test and that the derogation is most useful where it applies both to the provision of the specific information and to how the generic KID is complied. If it applies just to the provision of the specific information, it is of limited value. If the Article 13(3) criteria can't be met, there is little merit in utilising the Article 14(2) derogation to use the UCITS KIID. That would actually create a hybrid solution problem for the generic KID in the sense that the range of costs would have to be on the PRIIPs basis (requiring performance scenario calculations to compute) but the risk indicator range would need to be on the UCITS basis and furthermore the range of costs would be inconsistent with both the values and the presentation format in the individual UCITS KIIDs.
- PRIIP providers will require a systematic solution – through in-house/group systems or by out-sourcing but in each case probably using specialist vendor technology.

Next steps

PRIIP manufacturers need to review the UCITS issue for PRIIPs and also decide on their PRIIPs technology solution.

Applicability of derogation to insurers

If the PRIIPs manufacturer chooses basis (a) i.e. not to provide a generic KID, then a KID on a PRIIPs basis for each underlying investment option would be required, including the product charges and portfolio transaction costs. The PRIIPs manufacturer is not permitted to provide a UCITS KIID to meet requirement (a) above.

The derogation applies where the underlying investment option is a UCITS or non-UCITS fund. Some insurers provide investment products with underlying investment options where the customer is allocated units directly in the UCITS – the derogation would apply. Other insurers provide investment products with underlying investment options where the customer is allocated units in internal funds which each invest 100% into a UCITS – so-called mirror funds- would those underlying investment options qualify? The market interpretation appears to be that it would. However, it is suggested that an underlying investment option where the customer is allocated units in an internal fund which invests into a blended mix of multiple UCITS would not qualify – the rationale being that the risk level of the internal fund (being the investment option) is not specified in a UCITS KIID. If the underlying investment option was a UCITS of UCITS, that would qualify.

Multi-option products

In assessing whether to avail of the derogation, the PRIIPs manufacturer needs to consider the two parts of the derogation i.e. not just the facility to provide the UCITS KIID for the specific information but also the implications for the compilation of the generic KID. The key question is whether or not the Article 13(3) criteria can be met (i.e. are all the underlying investment options UCITS?).

If Article 13(3) criteria is not met

- If not, then for the generic KID the range of costs must be disclosed on a PRIIPs basis.
- Disclosure of costs on a PRIIPs basis has significant consequences. It would mean firstly that the presentation format for costs would be the PRIIPs basis (viz impact on return (RIY) per year) and secondly that both product charges and portfolio transactions costs would need to be included. Having the presentation format for costs (whilst being just a range of values) in the generic KID on a different basis to the cost figures in the specific information (being the UCITS KIID) would be confusing for customers. It's not just the presentation format that would differ but also the inherent items included in the two sets of figures.
- The next issue is the computational challenge to compile the generic KID. Obviously to derive the range of values, the costs figures for each UCITS (available as an underlying investment option) would need to be computed – the UCITS cost figures in the KIID are not sufficient for that purpose. The obvious question is whether or not one could just apply an overlay of product charges and portfolio transactions costs onto the UCITS KIID cost figures. The answer is certainly not for regular premium contracts, and also unfortunately not also for single premium contracts- the formulae for converting percentage based entry/exit costs and on-goings costs into reduction in yield figures include the internal rate of return in the performance figures (a x% amc doesn't translate into a x% r.i.y. figure) - so technically the RTS performance scenario calculations are required to derive the costs figures.
- It is not clear how all this sits with the recital 18 requirement "Regardless of the form chosen, the specific information should always be consistent with the information that is contained in the key information document". The specific information is the available UCITS KIID – so consistency can only be achieved by amending the generic KID to be consistent with the UCITS KIID which seems to contradict the specific provisions in Article 13 for the generic KID.

If Article 13(3) criteria is met

- The PRIIPs manufacturer can opt to show the range of costs in the generic KID on a UCITS basis – that means using the UCITS cost format and taking the range of values based on the cost figures in the individual UCITS KIIDs
- The consequences are that firstly product costs are excluded and secondly that portfolio transaction costs are excluded

Evaluation of merits of choosing

- The PRIIPs manufacturer has to consider that the derogation applies only up until 1/1/2020
- Costs disclosure: If product costs are excluded from the generic KID, the question is where those costs are to be disclosed. In the UK, the KFDs and KFIs are not required for products that are PRIIPs (that includes PRIIPs that qualify for the derogation).
- Exit costs: If product entry/exit costs apply but not for the UCITS, the generic KID and UCITS KIID would show no entry/exit costs – a customer being hit by an exit charge might feel aggrieved (even though there is disclosure elsewhere about exit costs in generic KID in section about what happens if you leave early).
- There is also the issue of the cliff-edge effect at 1 January 2020. A prior investor after 1 January 2018 will have received the generic KID and probably the UCITS KIID. If the investor accesses the specific information post 1/1/2020, the costs information will be quite different. Leaving aside differences between presentation format (percentages in UCITS KIID and reduction in yield in PRIIPs KID), the investor would see portfolio transaction costs were now included, that possibly additional entry/exits costs were now there and that on-going costs were higher (reflecting the product amc).
- From the customer perspective, it would be better from 1 January 2018 to get the PRIIPs KID rather than the UCITS KIID as it provides a more complete picture of total costs.
- From the perspective of a PRIIPs manufacturer defending possible civil liability cases after 1/1/2020 in respect of business written prior to 1/1/2020 , the case for the defence would be stronger if the investor had received a PRIIPs KID rather than a UCITS KIID – a key point for a potential plaintiff would otherwise be that the PRIIPs manufacturer has chosen to avail of a derogation which permitted the PRIIPs manufacturer not to disclose certain costs which otherwise would have been disclosed – the plaintiff's legal team will have access to the investor's original UCITS KIID and the current PRIIPs KID and the differences could be stark. The argument could be that the PRIIPs manufacturer chose to avail of the derogation to minimise its own short-term PRIIPs implementation issues at the expense of the customer who received incomplete costs disclosure.

Applicability of derogation to insurers

The derogation applies where the underlying investment option is a UCITS or non-UCITS fund. Some insurers provide investment products where the customer is allocated units directly in the UCITS – that would qualify. Other insurers provide investment products where the customer is allocated units in an internal fund which invests 100% into a UCITS – a so-called mirror fund-would that qualify? The market interpretation appears to be that it would. However, it is suggested that an investment product where the customer is allocated units in an internal fund which invests into a blended mix of multiple UCITS would not qualify – the rationale being that the risk level of the internal fund (being the investment option) is not specified in a UCITS KIID.

Derogations

RTS Article 12 on 'What are the risks and what could I get in return?' section provides specific rules for PRIIPs with UCITS underlying investment options, applicable until 31 December 2019.

RTS Article 13 on 'What are the costs?' section provides options for PRIIPs with UCITS underlying investment options that are applicable until 31 December 2019.

> *Article14.2 "By way of derogation from paragraph 1, PRIIP manufacturers may use the key investor information document drawn up in accordance with Articles 78 to 81 of Directive 2009/65/EC to provide specific information for the purposes of Articles 11 to 13 of this Delegated Regulation where at least one of the underlying investment option referred to in paragraph 1 is a UCITS or non-UCITS fund referred to in Article 32 of Regulation (EU) No 1286/2014."*

RTS Article 14(2) derogation

Article 14 requires specific information to be provided on each underlying investment option 14(1). In relation to the specific information referred to in Articles 11, 12 and 13, PRIIP manufacturers shall include for each underlying investment option – all of the following:

(a) A comprehension alert, where relevant

(b) The investment objectives, the means for achieving them, and the intended target market in accordance with paragraphs 2 and 3 of Article 2

(c) A summary risk indicator and narrative, and performance scenarios in accordance with Article 3

(d) A presentation of the costs in accordance with Article 5

However, Article14.2 provides a derogation whereby the PRIIPs manufacturer can supply the KIID instead for UCITS investment options. So, rather than having a PRIIPs KID for a UCITS investment option, the PRIIPs manufacturer can use the UCITS KIID.

FRS Comment

The wording in Article14.2 is somewhat ambiguous in the sense that a literal reading might suggest for a multi-option product where at least one of the underlying investment options was a UCITS that PRIIP manufacturers could use KIID calculation principles for all the underlying investment options. That is not intended as is clear from recital 18 of RTS which suggests that the UCITS legislation be used only for UCITS funds and the PRIIPs legislation for other investment options. So, Article14.2 is best interpreted as referring to KIIDs which have been prepared for UCITS and which would not exist for other investment options.

Generic KID

Articles 12 and 13 relate to the generic KID whereas Article 14 relates to specific information on each underlying investment option i.e. the fund KID.

What's interesting is that Article 12.2 prescribes that the synthetic risk and reward indicator (SRRI) must be used where Article 14.2 is applied whereas Article 13.3 says that PRIIP manufacturers may specify the range of charges for the PRIIP in accordance with UCITS legislation.

Article 12 requires that the range of risk classes be shown – it is clear that the SRRI must be used as the risk indicator for an UCITS investment option if the Article 14(2) derogation is applied. The generic KID has no requirement to show a range of values for the performance scenarios.

RTS Article 12(2)

Where PRIIP manufacturers use the key investor information document in accordance with Article 14(2), for the purposes of specifying the risk classes referred to in point (a) of paragraph 1, they shall use the synthetic risk and reward indicator pursuant to Article 8 of Regulation (EU) No 583/2010 in relation to UCITS or non-UCITS funds as underlying investment options

Application of Article 13.3 derogation

Under Article 13, the PRIIPs manufacturer is required to show the range of costs for the PRIIP in the 'Costs over time' and 'Composition of costs' tables set out in Annex VII. That covers both UCITS investment options and other investment options.

The question arises as to what exactly the Article 13.3 derogation means in practice. The derogation applies only to multi-option products where all of the underlying investment options are UCITS. In that scenario, it appears that portfolio transactions costs can be excluded.

RTS Article 13(3)

Where PRIIP manufacturers use the key investor information document in accordance with Article 14(2) with UCITS or non-UCITS funds as the only underlying investment options, by way of derogation from Article 5, they may specify the range of charges for the PRIIP in accordance with Article 10 of Regulation (EU) No 583/2010.

UCITS Charges compared to PRIIPs costs

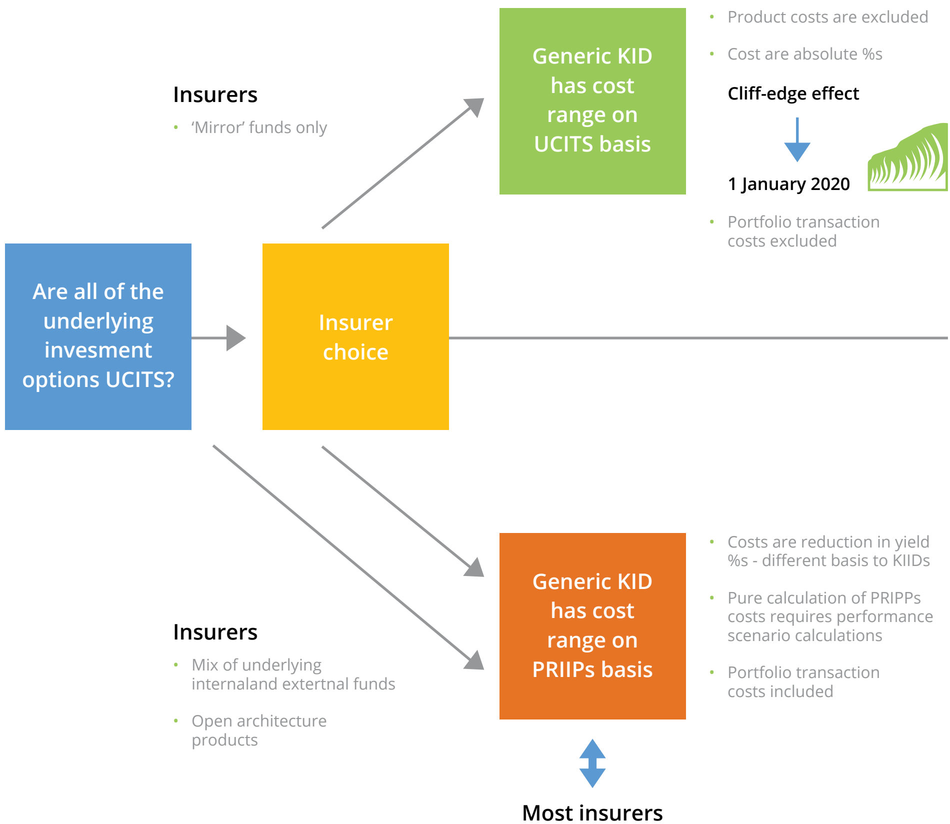
There are a number of differences between PRIIPs costs and UCITS costs.

- PRIIPS costs are computed based on reduction in yield over the recommended holding period whereas UCITS charges are computed as percentage costs.
- A significant difference is that UCITS charges do not include portfolio transaction costs.
- UCITS costs are not required to display a total costs figure.
- The UCITS on-going charges figure is based on the last year's expenses.

Decision tree for insurers

The first step is to determine whether or not the Article 13(3) criteria can be met. If not, then there is a prescribed approach. If met, then the insurer has a choice in terms of displaying costs – whether to use the UCITS basis or the PRIIPs basis.

Underlying investment options and PRIIPs derogation



The choice would have regard to a number of criteria

- Competitive issues – e.g. the effect of inclusion/exclusion or portfolio transaction costs
- The cliff-edge issues of having one PRIIPs approach prior to 1/1/2020 and another thereafter resulting in a step-change at 1/1/2020 in PRIIPs KID figures and in the PRIIPs system technology changes required for 1/1/2020
- System technology issues

Pros and Cons

Generic KID has cost range on UCITS basis

Advantages

- Portfolio transaction costs are excluded - competitive consistency with UCITS manufacturers

Disadvantages

- Portfolio transaction costs are excluded
- Cliff-edge effect → 1 January 2020
- Product costs excluded

Generic KID has cost range on PRIIPs basis

Most insurers

Advantages

- Portfolio transaction costs are included - no cliff-edge effect
- No cliff-edge effect generally

Disadvantages

- PRIIPs systems needed earlier
- Portfolio transaction costs are included - competitive disadvantage with UCITS manufacturers
- Inconsistencies in costs basis if Article 14(2) applied - absolute %s for KIID and reduction in yield % for generic KID
- Pure calculation for PRIIPs costs requires performance scenario calculations

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.

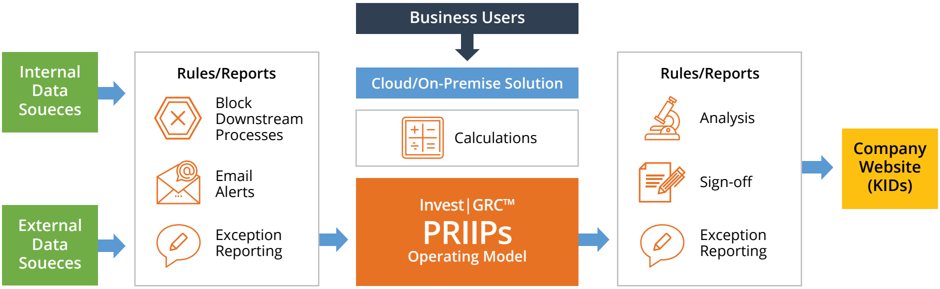
- In-house / group
- Outsourcing
- Vendor technology

Glossary

RTS: COMMISSION DELEGATED REGULATION (EU) .../... of 8.3.2017 supplementing Regulation (EU) No 1286/2014

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 single results database.



UCITS Charges

The charges shall be presented in a table structured in the following way

One-off charges taken before or after you invest	
Entry charge Exit charge	[ ] % [ ] %
This is the maximum that might be taken out of your money [before it is invested] [before the proceeds of your investment are paid out]	
Charges taken from the fund over a year	
Ongoing charge	[ ] %
Charges taken from the fund under certain specific conditions	
Performance fee	[ ] % a year of any returns the fund achieves above the benchmark for these fees, the [insert name of benchmark]

- A percentage amouth shall be indicated for each of these charges
- In the case of a performance fee, the amount charged in the fund's last financial year shall be included as a percentage figure.

References

Recital (35) of Regulation 1286/2014 "While undertakings for collective investment in transferable securities (UCITS) constitute investment products within the meaning of this Regulation, the recent establishment of the key investor information requirements under Directive 2009/65/EC means that it would be proportionate to provide to such UCITS a transitional period of five years after the entry into force of this Regulation during which they would not be subject to this Regulation. After the expiry of that transitional period and in the absence of any extension thereto, UCITS should become subject to this Regulation. That transitional period should also apply to management companies, investment companies and persons advising on, or selling, units of non-UCITS funds when a Member State applies rules on the format and content of the key information document, as laid down in Articles 78 to 81 of Directive 2009/65/EC, to such funds."

Recital (18) of RTS "In order to provide those funds with a consistent transitional legal regime, PRIIP manufacturers should be allowed to continue using those key investor information documents in respect of PRIIPs offering those types of funds as the only underlying investment options, or alongside other underlying investment options. Where PRIIP manufacturers opt to use the key investor information documents in case of PRIIPs offering those types of funds alongside other investment options, the generic key information document should show a single range of risk classes in the format of the PRIIPs risk scale. The range of risk classes for all underlying investment options offered within the given PRIIP should combine synthetic risk and reward indicator pursuant to Article 8 of Commission Regulation (EU) No 583/20109 for the UCITS or non-UCITS funds and summary risk indicator in accordance with this Regulation for other underlying investment options. Where the PRIIP offers only UCITS or non-UCITS funds as investment options, the PRIIP manufacturer should be allowed to use the presentation and methodology pursuant to Article 10 of Regulation (EU) No 583/2010. Regardless of the form chosen, the specific information should always be consistent with the information that is contained in the key information document."

Article 10 of Regulation (EU) No 583/2010

1. The 'Charges' section of the key investor information document shall contain a presentation of charges in the form of a table as laid down in Annex II.

2. The table referred to in paragraph 1 shall be completed in accordance with the following requirements:

   (a) entry and exit charges shall each be the maximum percentage which might be deducted from the investor's capital commitment to the UCITS

   (b) a single figure shall be shown for charges taken from the UCITS over a year, to be known as the 'ongoing charges,' representing all annual charges and other payments taken from the assets of the UCITS over the defined period, and based on the figures for the preceding year

   (c) the table shall list and explain any charges taken from the UCITS under certain specific conditions, the basis on which the charge is calculated, and when the charge applies

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). 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)

Founded in 1999 by actuaries and IT specialists, Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing, investment administration, asset reporting and compliance oversight software specifically designed for the Life Assurance and Asset Management industries.

FRS offer a proven range of modular, intuitive technology solutions which allow customers to pro-actively monitor and administer investments as well as mitigate risk by continually monitoring breaches and exceptions to critical investment processes.

These solutions include:

Invest|Pro™ securely automates multiple complex fund administration processes within a single application. The Invest|Pro™ unit-pricing and investment administration software is scalable, modular and flexible.

Invest|GRC™ empowers insurers and asset managers to meet PRIIPs and KID requirements. In addition, it automates Pillar III asset reporting standards in the Solvency II world via a single, analytics-driven database, combining data from internal and external sources.

Invest|OPS™ automates the validation of operational activity performed by outsourcing partners, enabling firms to supervise outsourced functions, data and to manage the associated risks.

FRS

Knowledge based solutions

For more information contact
george.mccutcheon@frsltd.com
or visit www.frsltd.com

Financial Risk Solutions
2 – 4 Clanwilliam Terrace
Grand Canal Quay
Dublin 2
Ireland

Telephone:
Ireland +353 (0) 1 234 0000
UK +44 (0) 203 598 4484

Fax:
+353 (0) 1 234 0001

Email:
frank.carr@frsltd.com

Registered in Ireland
Registration no. 318216