Society of Actuaries in Ireland

Are Consumers being told the truth? PRIIPs, ESMA and other impediments

24th January 2019

Disclaimer

The views expressed in this presentation are those of the presenters and not necessarily of the Society of Actuaries in Ireland

Introduction

Paul McCarville

- Chartered Accountant, QFA
- 4 years in corporate lending – Ulster Bank – 1983-1987
- 21 years at senior level in asset management
- Director / Head of Client Services & Marketing, Setanta, 1998 – 2007
- Director – Verus Advisory Ltd, 2011-

Joe Mottley

- B.E, M.Sc. (Public Sector Analysis), Associate Member of IIMR, QFA
- 22 years at senior level in asset management
- Director / Chief Investment Officer, Setanta, 1998 – 2007
- Director, Diversification Strategy Fund, 2007 –

Introducing Clarus

- Partnership established in 2008
- Authorised Advisor status
- One of a handful of advisory firms to adopt ‘independent’ status
- Clients: *wealth management advisors and other intermediaries, pension funds, not-for-profit entities, corporates and some individuals*

Independent *and* ***Impartial***

Primary Clarus Services

1. Portfolio design & selection of components
2. Modelling long-term outcomes
3. Diligence on investment managers & funds
4. Ongoing portfolio monitoring
5. Consulting work
6. Licence proprietary risk profiling software
7. Expert Witness

Outline

- How Risk is Represented
- Representations of Potential Outcomes
- Disclosure of Costs
- PRIIPs and ESMA
- Life Companies and the Advice Process
- Conclusions

Purpose?

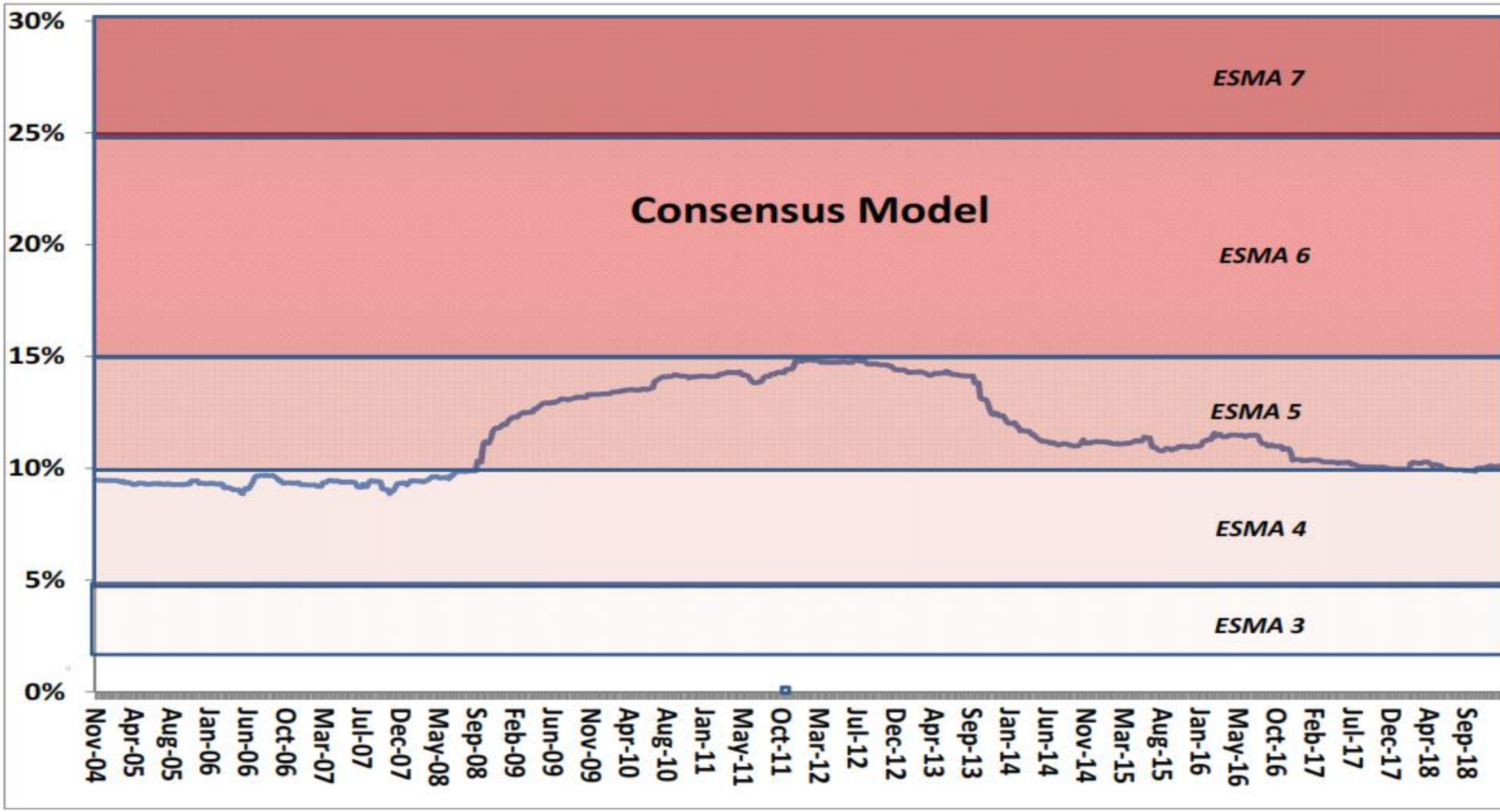
1. Share our perspective on issues of common interest
2. Stimulate debate around the implementation of SOAI's *Financial and Economic Assumptions* through LA-8
3. Encourage the SOAI to challenge flawed regulation
4. Focus on the impact of tools being provided by lifecos
5. Suggestions to improve these tools

ESMA and risk

- SRRI based on Standard Deviation of weekly returns over 5 years
- Banded as follows:

Risk Class	Volatility Intervals	
	equal or above	less than
1	0%	0.5%
2	0.5%	2%
3	2%	5%
4	5%	10%
5	10%	15%
6	15%	25%
7	25%	

ESMA SRRI – *an unstable measure*



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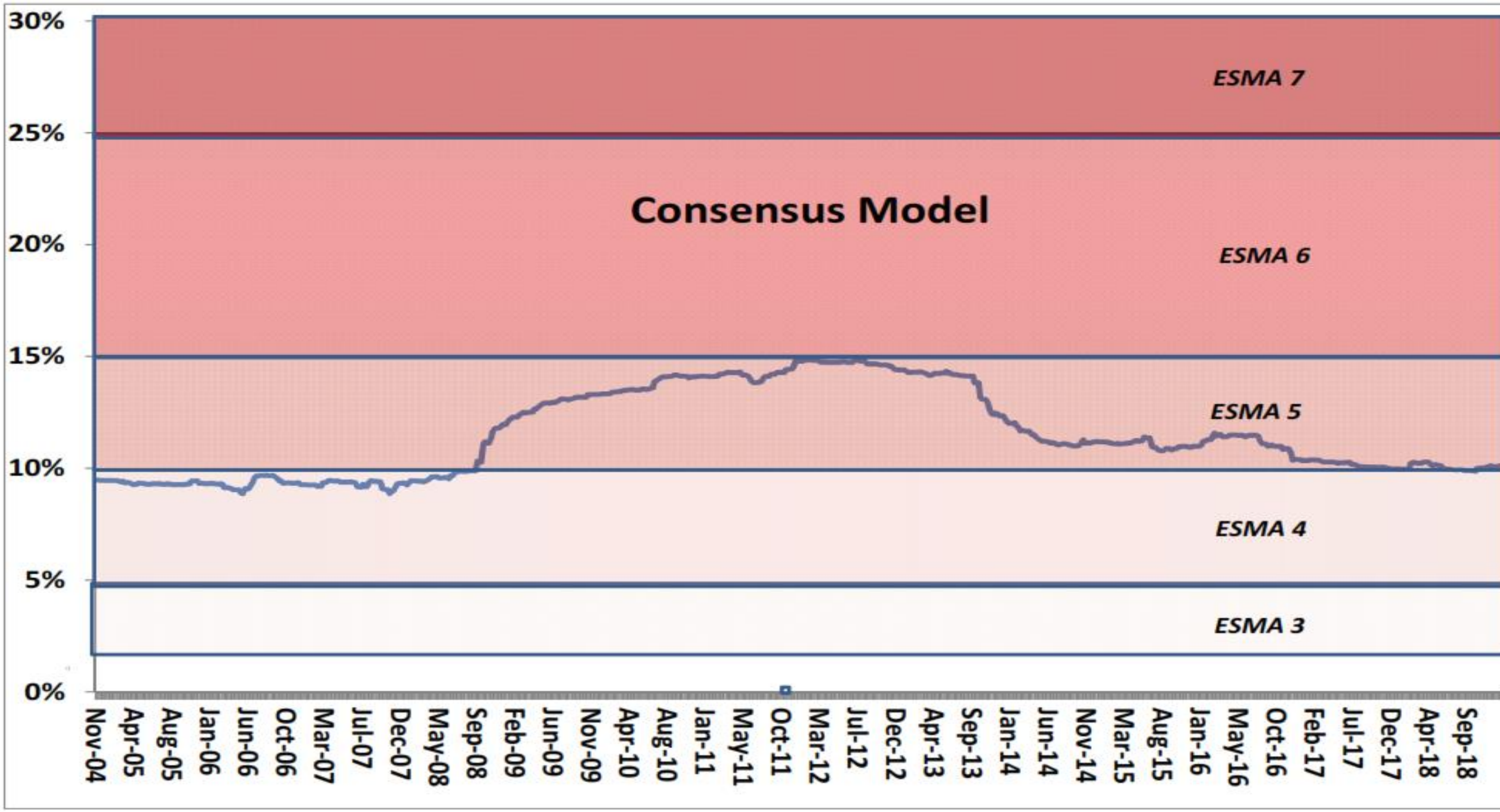

5 years is too short

ESMA SRRI – *in practice*

- Instability causes a potentially serious difficulty for advisors in terms of continuing suitability

- Likely to mislead - a Consensus/Managed fund rated as '4' on a scale of 1-7 will be seen as 'medium' risk

  - *Recognised by some providers and intermediaries*

  - *Much less focus on ESMA in UK??*

PRIIPs and Risk?

- Also 5 years of weekly returns but a slightly different measure (VAR equivalent Volatility - VEV)

- Banded as follows:

MRM class	VeV range
1	<0.5%
2	0.5% - 5%
3	5% - 12%
4	12% - 20%
5	20% - 30%
6	30% - 80%
7	>80%

'MRM' is **Market Risk Measure**. Combines with *Credit Risk Measure* to produce SRI.

PRIIPs and ESMA - *compared*

MRM class	VeV range	ESMA range
1	<0.5%	<0.5%
2	0.5% - 5%	0.5% - 2%
3	5% - 12%	2% - 5%
4	12% - 20%	5% - 10%
5	20% - 30%	10% - 15%
6	30% - 80%	15% - 25%
7	>80%	>25%

The underlying computations under PRIIPs and ESMA are different <u>but for most mainstream products, produce very similar values</u>

PRIIPs and ESMA – *risk outcomes*

- Product outcomes will be distributed completely differently because of the banding regimes
- ESMA very skewed towards <u>lower end of risk spectrum</u>
- PRIIPs very skewed towards <u>higher end</u>
- Both fundamentally flawed (5 years of data)

Alternative to 5 years?

- Canadian mutual funds – 10 years
    - *Considered CESR/ESMA and rejected*
- One Irish life company uses data from 2000 with recent years over-weighted
- Clarus uses data from September 2007

Skew of bands – *impact?*

ESMA

Research shows a strong bias to the middle choice

For long-term savers, '4' is very conservative:

- *Pension investors typically need a return of **c. 5%** gross to meet their expectations*
- *A fund at ESMA 4 has a very low probability of delivering a 5% return*

Skew of bands – *impact?*

ESMA

- In practice, Bands **1** and **7** redundant.
- Latterly, very little in Band **6**
- Band **2** unviable

PRIIPs

- Most funds in bands **2** & **3**

Little meaningful differentiation

Life after ESMA??

Q. What happens to all the ESMA-targeted fund suites?

➡ No possibility of replicating using PRIIPs

A.1 Continue to use ESMA?

A.2 Replace ESMA? With what?

PRIIPs and risk

Some of the first round of KIDs showed Fixed Interest funds in Band 3

..........while at the same time..........

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..........while at the same time...........

Property funds were in Band 2 !!

PRIIPs and Return – *there is a problem!*

- PRIIPs producing too many nonsensical and misleading outcomes:
  - *11% of investment company KIDs show future returns of over 20% in the Moderate scenario**
  - *51% of investment company KIDs show future returns of between zero and 10% in the Unfavourable scenario**

Source: *'Burn before reading'* – Association of Investment Companies *(Sept 2018)

PRIIPs and Return – *the FCA responds*

The FCA has said:

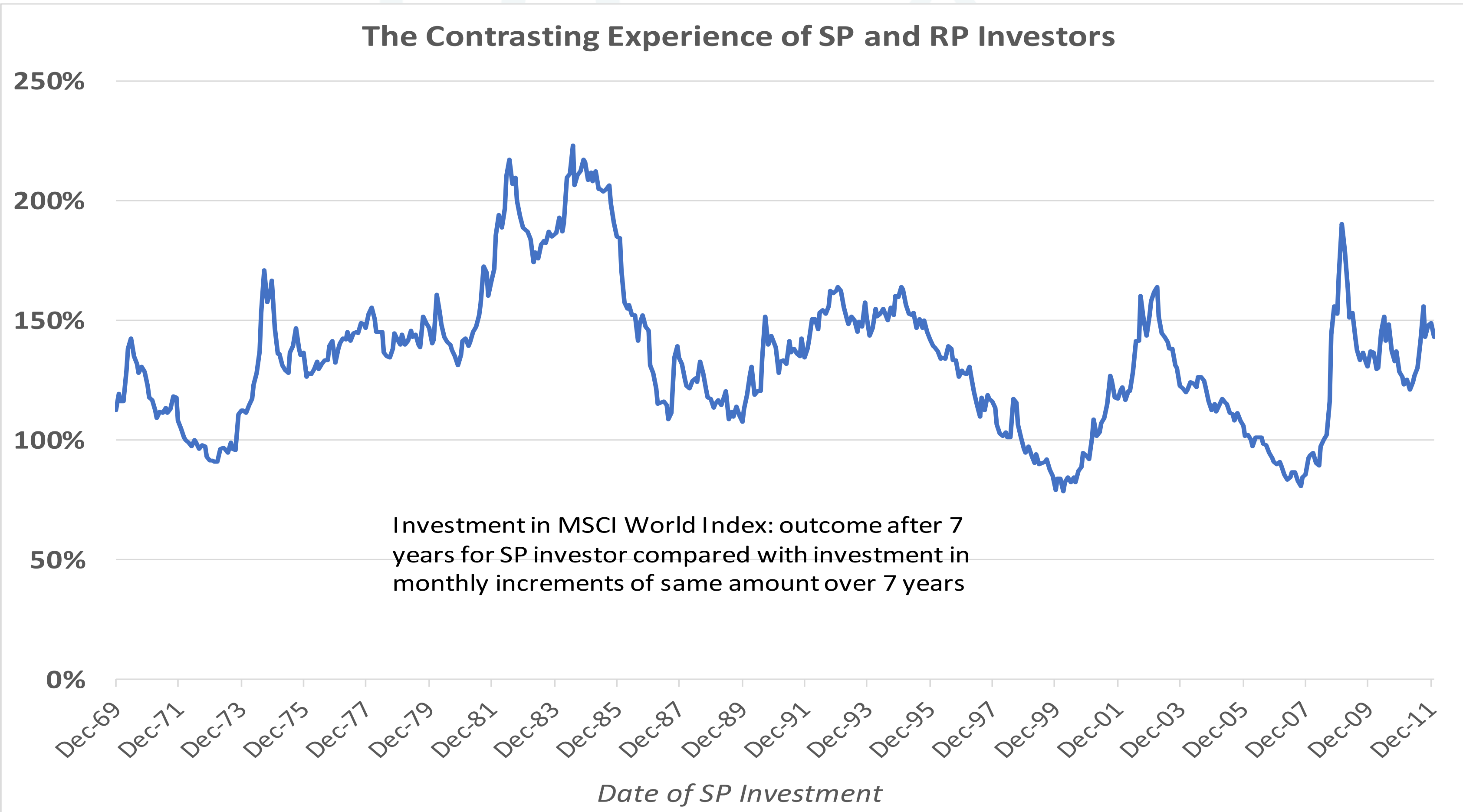
‘Where firms selling or advising on PRIIPs have concerns that the performance scenarios in a particular KID may mislead their clients, they should consider how to address this, for example by providing additional explanation as part of their communications with clients.’

PRIIPs and Return – *our suggestions*

- Go back to showing past performance **with strongest warnings**
  - *No projected returns*
- Provide a proper benchmark comparison
- Where target return, use that
- Multi-asset: return of peer group?

Other Projections of Return

Investment experience of SP and RP can be radically different!



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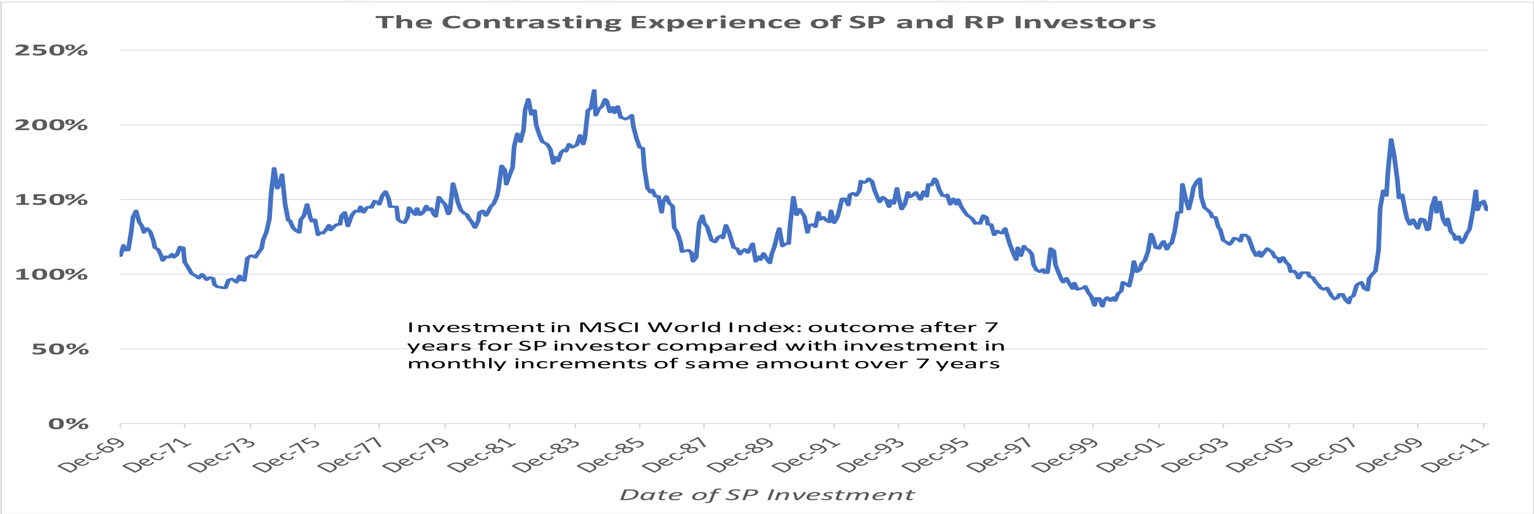

SP experience acutely sensitive to valuation at time of investment

Should product illustrations etc. differentiate between SP and RP? **YES!!**

Bonds and Lump Sum Investors

LA-8 (Oct 17) guides max 2.5% for fixed income returns….

Current market yield levels:

Germany 10Y	0.3%
Ireland 10Y	1.2%
BoFAML € Svgn > 5Y	1.2%

Euro Svgn medium-term returns - a sample of current forecasts:

Source	**Medium-Term Projection**
Robeco	-1.0%
Research Affiliates	0.2%
BNP Paribas	0.3%
BlackRock	0.3%
Franklin Templeton	0.9%
SSgA	1.2%
JP Morgan	1.8%

Are we setting fair expectations for the Irish SP investor in bonds??

Potential Impact on ARFs

Value of €1m ARF invested in bonds (€000s):

	@ 2.5% gross return	@ 0.5% gross return	@ -1.5% gross return
Year 5	820	728	643
Year 10	625	462	329
Est. Depletion - year	**24**	**20**	**16**

- 1% AMC assumed
- €50K drawdown p.a.

ARFs

- Previously wealth management vehicles
- In future majority likely to be core source of income
  - *Withdrawals probably* € *amounts, not percentages*
- Sequence risk comes into play when withdrawing € amounts
- We advocate stochastic modelling to illustrate range of outcomes and probabilities around depletion?

ARFs

- Provision of a range of depletion scenarios will support a proper discussion and informed decision
  - *also protect advisor*
- Likely to highlight a serious tension between attitude to risk, capacity to bear risk and the return needed
- Better have proper discussion (and document!!) now than grief when ARF blows out

Pension Calculators

- Range of assumptions being used - highest and most common is 5% gross (lowest 3.1% net)
  - *Too high for anything bar highest risk funds*

- Only one lifeco reduces return in later years

But

- Many pension products build in lifestyling

- Or clearly understood that de-risking will take place

Disclosure of Cost – *current reality?*

- Non PRIIPs disclosure poor:
    - *Consumer cannot understand*
    - *Does not embrace a full enough set of costs*

- PRIIPs very much on right track but flawed:
    - *Adoption of different RHPs by providers*
    - *Use of RIY based on Moderate return outcome*
    - *One cost component which can be significantly negative*
        - *10% of investment companies with equity portfolios have KIDs showing transaction costs of zero, or which are negative**

Source:** ***'Burn before reading' **– Association of Investment Companies** ***(Sept 2018)***

Disclosure of Cost – *a better way?*

- Disclosure on a ‘standardised’ basis
- Lifecos to provide to one or more third parties to be accessed by advisors?
- Lifecos have shown willingness

Lifecos and the Advice Process?

1. Provision of risk profiling tools

2. Tools which model outcomes

3. Volatility - targeted fund solutions

Risk Profiling tools

- To us, 'good' looks like:
  - *enough questions, but not too many*
  - *clear and understandable*
  - *focus solely on psychometric disposition to risk*
  - *corroboration*
  - *not too many outcomes*
  - *explanatory notes*

- The FCA has said* that it is important

  "…users understand how the tool works and any limitations of the outputs it generates…"

*FSA (now FCA) - FG 11/5 *"Assessing Suitability" (2011)*

MiFID II on risk profiling

'….firms shall take reasonable steps to ensure that the information collected about their clients is reliable. This shall include … ensuring all tools, such as risk assessment profiling tools … are fit-for-purpose … with any limitations identified and actively mitigated through the suitability assessment process'

'…..aspects of the tools, such as the underlying assumptions and the scoring mechanisms, can require detailed information to fully understand. Advisers and discretionary managers have a responsibility to demand all relevant information from the tool provider to determine whether a tool is appropriate for use with their customer base.'

Risk Profiling – *misunderstood and misused*

- Mechanical ‘mapping’ widespread:
  - *Lack of understanding?*
  - *Desire for simplicity?*
- Many seem to believe <u>that this is what the regulator would expect!!</u>
- CB might take an interest…FCA has been critical
- So central to suitability that bound to end up before courts

The Issue with ‘Mapping’?

1. RPT ‘number’ far from science

2. Number may vary substantially from one RPT to another

3. ESMA unstable / heavily skewed

➡ Any relationship between an RPT ‘number’ and an ESMA number is accidental

An expert view

Bruce Moss - Director/Founder of **eValue**

"While risk questionnaires are important and very useful, their purpose is simply to divide people into 'risk buckets'. There is no absolute linkage between a risk profile and an investment strategy or asset allocation to which it is mapped."

How do the RPTs measure up?

Of six provided by lifecos:

- One purports to capture ***capacity***
- One adjusts for ***time horizon***
- Five have seven outcomes
- Minimal notes - essentially disclaimers
- Majority do not highlight inconsistencies
- One has 4 Qs plus a slider…total of 16 possible As*
- Another has 7 Qs plus two sliders / 30 possible As*

➡ Some are very good

**plus slider outcomes*

Risk Profiling – *room to improve?*

- More robust questionnaires
  - *Academic literature suggests that >10 Qs needed*
  - *Focus exclusively on attitude to risk*
- Seven outcomes too many:
  - *Hard to support from more flimsy RPTs?*
  - *Four enough in our view*
  - *Creates an irresistible urge to 'map' to ESMA*
- Corroboration feature
- Explanatory notes!

Better Modelling of Outcomes?

- Realistic rates of return
- Comprehensive costs – *not just AMC*
- Differentiate between LS / RP / ARF
- Incorporate stochastic modelling
- Taper where de-risking explicit or implicit
    - *Pensions Authority calculator does*

Tapering in practice

- Fund of €500k* at NRA minus 10 years:

Return Assumption / last decade	Outcome (€000)
No tapering – use 4%	740
Tapering from 4% to 2%	665
Tapering from 4% to 1%	631

**No contributions assumed*

Volatility-Targeted Funds

- Now the core of investment product offering – c. €15bn assets

- Quite a disparate group:
  - *different volatility band frameworks – ESMA v. bespoke*

- A challenge for the advisor to understand and explain the distinctions – *more support should be provided?*

Volatility-Targeted Funds – *caveats*

- Distribution of total market (Jun-18):

ESMA Band or Equivalent	Total Value (€m)	% of Total
2	185	1%
3	4,062	28%
4	7,575	52%
5	2,549	18%
6	194	1%
Total	**14,564**	**100%**

- Is the prevailing advice and product 'architecture' guiding some investors towards inappropriately low risk levels?

- Over-active volatility control may not be best suited to the needs of some investors? (i.e. long-term RP savers – DC members etc.)

Conclusions

- Realistic, differentiated return projections
- Greater use of stochastic simulations
- Better disclosure of costs
- Refine pension calculators
- More thought to risk profiling

Finale

- The Society's members are in pivotal roles in the lifecos

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<u>Use that power and influence!</u>