

# Communicating Investment Risk Working Party

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## Communicating Investment Risk Working Party

- Membership:
  - Maria McLaughlin
  - Colin Murray (chair)
  - Marie Phelan
  - Emily O’Gara
  - Hendri Solomon
- With thanks to Yvonne Lynch critiquing and Louis Hui for the numbers



# Communicating Investment Risk Working Party

- Objectives:
  - survey existing methods of communication
  - summarise latest developments
  - analysis of effectiveness of various methodologies
  - propose quantitative & qualitative methodology
  - link in with existing disclosure & risk measures
  - generate debate



# Communicating Investment Risk Working Party

- Agenda:
  - Current investment risk communication methods
  - Disclosure regimes by country
  - European developments
  - Review of Consumer Protection Code
  - Calibration of risk levels
  - Conclusions / Proposed Key Investment Template
  - Questions / Comments



# Current investment risk communication methods

- Current methods
  - Description of risks
  - Historic quantitative measures
  - Risk ratings
  - Moneymate
- Issues with current methods
  - Consistency
  - Complexity
  - Quantitative vs. Qualitative
  - Relative risk rating vs. impact of risk



## Disclosure regimes by country

- Two approaches
  - Description of Risks
    - No specific requirements to provide numerical quantification of risk
    - Ireland, UK, Australia
  - Risk rating/classification
    - Established regulation/guidance/industry level standards
    - Italy, Netherlands, Canada



## Disclosure regimes by country – Description of Risk

- Ireland
    - Many Irish life assurance firms have their own methodologies for presenting individual fund risks (e.g. risk ratings)
  - UK
    - Key Features Document (KFD) must address “the material risks associated with the product, including a description of the factors that may have an adverse effect on performance or are material to the decision to invest”
    - Two studies/reports on ‘Good and poor practices’
  - Australia
    - Product Disclosure Statement (PDS) require typical and material factors that affect returns, including risk to be disclosed clearly
- Issues: value to customer; jargon; broad statements



## Disclosure regimes by country – Risk Rating

- Italy
  - Regulatory approach based on three pillars centred around investor decision making process:
    - Pillar 1: Return profile/probability scenarios {within a given degree of product risk}
    - Pillar 2: Degree of Product Risk {matching investor's risk appetite}
    - Pillar 3: Recommended Time Horizon {matching investor's liquidity preferences}
  - Comments
    - + Detailed, scientific approach that captures volatility of benchmark & of fund managers; captures payback times; consistent with internal models relevant to S2
    - Intensive calculation process; heavily dependent on risk-free rate & results can be quite volatile; appropriateness of risk-free asset with no costs as benchmark; customers may not understand probability tables / payback period.





## Disclosure regimes by country – Risk Rating

- Netherlands
  - Disclosure template (mostly in graphical form) focused on improved disclosure of risks and returns to consumers
  - Prescribed basis, distribution and parameters for calculating range of projected values (3 bases) and risks
    - Risk level a combination of the level of guarantee and the average of the worst outcomes below the lowest 10<sup>th</sup> percentile

<b>Risk Level</b>	<b>GUISE level &amp; Product guarantee</b>
Very Small	Full amount guaranteed
Small	>80% guaranteed plus GUISE of 95%
Quite Large	<80% of premium guaranteed and GUISE of 90%
Large	GUISE between 75% and 90%
Very Large	GUISE less than 75%



# Disclosure regimes by country – Risk Rating

- Netherlands (continued)

**What are the risks?**



**Risk that you will lose your deposit**

If the product is terminated prematurely (1 year)

After the full term (10 years)



**What can happen in the worst-case scenario?**

if the product is terminated prematurely, you could lose your entire deposit.

at the end of the full term (10 years), you could lose your entire deposit.



# Disclosure regimes by country – Risk Rating

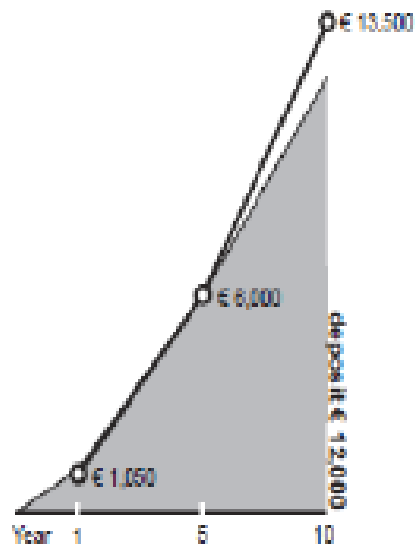
- Netherlands (continued)

What could the [Name of product] yield?



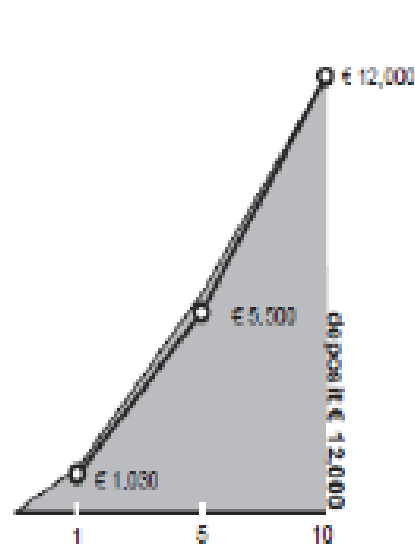
The resulting yield based on historical data

The yield is greater than the deposit



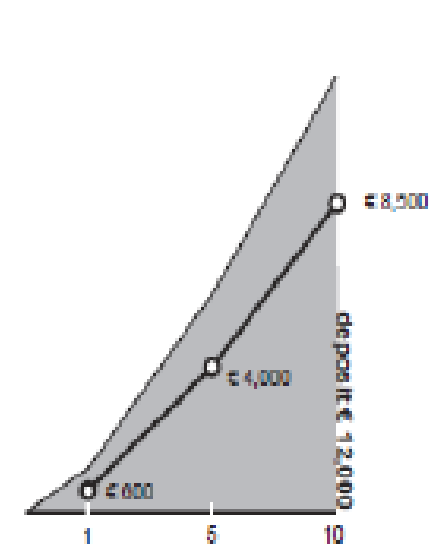
The resulting yield based on a forecast of a 4% increase in the value of the investment

The yield is about the same as the deposit



The resulting yield based on a pessimistic forecast

The yield is lower than the deposit





## Disclosure regimes by country – Risk Rating

- Canada
  - Funds are classified by the Canadian Investment Funds Standards Committee (CIFSC) into specified categories based on risk characteristics of the underlying assets
  - Separately the Investment Funds Institute of Canada (IFIC) have issued guidelines on the basis to be used by fund managers/providers in determining a fund volatility risk rating.
- Comments
  - Prescribed bases/industry level classification provide consistent risk rating to consumer
  - Complex Italian compared to relatively simple Dutch approach



## European developments - UCITS IV Directive / CCSR guidance

- Aims to update regulatory framework for UCITs.
- Includes standardised summary document to improve investor information – Key Investor Document (KID).
- Horizontal thermometer depicts synthetic risk and reward indicator (SRRI):

Lower risk Higher risk  
----->  
Typically lower rewards Typically higher rewards





## European developments - ABI and Investment Management Association research

- 2010 paper “Developing a risk rating methodology”:
  - volatility is a good measure – based on fund benchmarks rather than actual funds - 10 years’ data required;
  - further recommendations for structured products, enhanced income products, property & hedge funds, absolute return funds;
  - for multi-asset funds the risk rating should be based on highest risk asset that fund permitted to invest in;
  - committee should be set up to decide on fund ratings, methodologies, etc.



## European developments - European Commission PRIIPs initiative

- PRIIPs = Packaged Retail Investment Products.
- Initiative aims to create consistent approach and regulatory environment for all PRIIPs.
- Scope / products to be covered.
- Pre-contractual disclosure rules.
- Rules on selling practices.
- Consultation responses.



## Calibration of risk levels

- Received fund information from several life insurers
- Compared various measures as predictors of risks
- Calculated over 5 year interval and compared with subsequent vol the following year
- Calculated correlations

	<b>Volatility</b>	<b>Downside deviation</b>	<b>Sharpe</b>	<b>Sortino</b>	<b>VaR</b>	<b>Max Drawdown</b>	<b>Range</b>
<b>2010</b>	91%	89%	21%	18%	89%	87%	71%
<b>2009</b>	91%	92%	-12%	-8%	93%	89%	93%
<b>2008</b>	86%	92%	-67%	-52%	88%	85%	80%





## Conclusions

- 2 page document for each fund
- 2 page document at product level
- Sample charges expressed in monetary form
- Intermediary remuneration expressed in monetary form
- Using CESR/ESMA rating methodology for mainstream funds but allowing combinations
- Wording around each risk levels
- Risk level subtitle
- Warning “If you do not understand it....”
- Stochastic analysis proportional to the risks of the fund and potential variation in outcomes (e.g. gearing, skewness, kurtosis)
- Special treatment for concentration/illiquidity risks etc.



# Proposed Key Investment Template – Equity Fund – Page 1

## “ABC Equity Fund”

A high risk fund with potential for high returns

- 
- Managed by ABC Fund Managers

### Objectives and Investment Policy

- Invests in a range of equities across European markets only.
- Units may be redeemed on demand. Units are dealt on a daily basis.
- Benchmark is MSCI Europe Index.
- All income is reinvested.
- No hedging instruments are used.

### Risk and Reward Profile



1	2	3	4	5	6	7
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- This is a high risk fund and is expected to demonstrate significant positive and negative movements over short periods of time.
- There is a significant chance that you will lose a significant portion of your original investment over the term of the investment.
- The risk category shown is not guaranteed and may shift over time.
- The lowest category does not mean risk free.

### Charges for this Fund

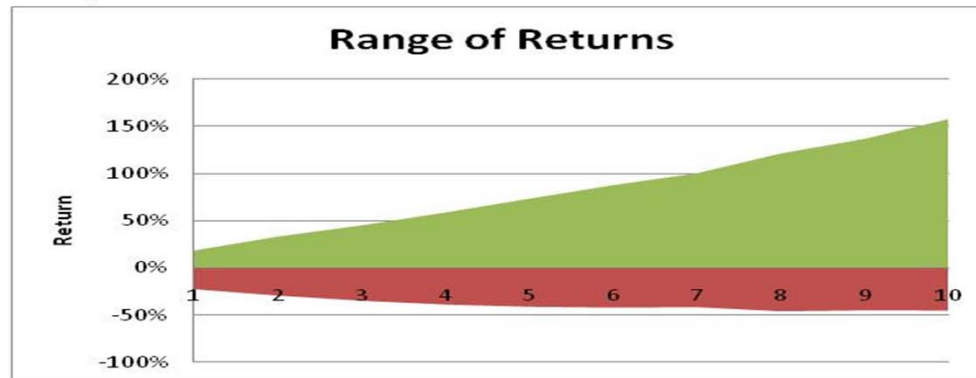
The charges you pay are used to pay the costs of running the fund, including the costs of marketing and distribute it. These charges reduce the potential growth of your investment.

Type	Percentage	Amount based on €50,000
Entry Charge	5%	€2,500
Exit Charge	0%	€0
Annual Charge	1.5%	€750



# Proposed Key Investment Template – Equity Fund – Page 2

## Range of Returns



The graph above illustrates a possible range of returns. Returns may exceed or fall below the range shown.

The returns are net of policyholder tax at [].

There is a significant chance that you will lose a significant portion of your original investment

## Commission

Your adviser will receive the following payments

Type	Percentage	Amount based on €50,000
At Entry	5%	€2,500
On each policy anniversary	0.5%	€250

## Practical Information

Policy provided by Insurance Company Limited.

You can obtain further information at [].

You have the right to surrender the fund at any time or switch to another fund.

This information has been certified by :

[]

Managing Director of Insurance Company Limited



# Proposed Key Investment Template – Single Premium Pension Product (P1)

## Single Premium Pension Policy

### What is a Single Premium Pension Policy?

- You are a male aged 55 years old and are intending to retire at age 65
- You invest a single lump sum into the policy
- On retirement, you can use some of the funds to purchase an annuity, take cash or invest in an ARF (if permitted).
- You cannot encash the policy but you can transfer it to another pension product or another pension provider. Early transfers attract a surrender penalty.
- On death, the value of the fund will be passed to your dependents.
- Invested in ABC Equity Fund Managed by ABC Fund Managers (see separate leaflet)

### What is the Product Risk and Reward Profile?

Lower risk <-----> Higher risk  
Typically lower rewards <-----> Typically higher rewards

1	2	3	4	5	6	7
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- The choice of fund makes this a high risk product and is expected to demonstrate significant positive and negative movements over short periods of time.
- There is a significant chance that you will lose a significant portion of your original investment over the term of the investment.
- The risk category shown is not guaranteed and may shift over time.
- The lowest category does not mean risk free.

### What are the charges you pay for this product?

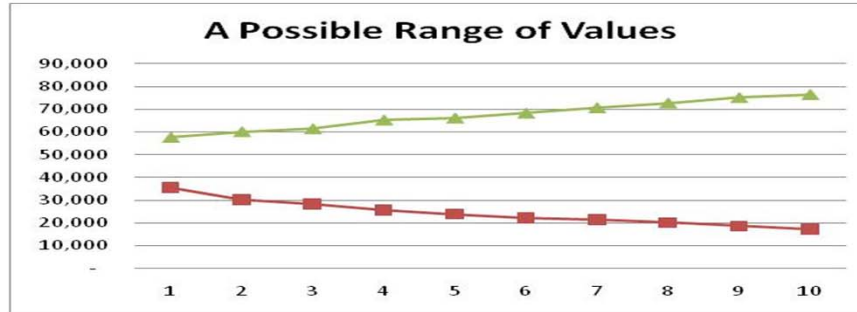
The charges you pay are used to pay the costs of running the product, risk benefits and other costs including the costs of marketing and distribute it. These charges reduce the potential growth of your investment. The following are based on 0% investment return. What you retain depends on the actual performance of the fund and may be greater or lesser than the figure shown.

	After 1 year	After 5 years	After 10 years
Total Premiums	€50,000	€50,000	€50,000
Costs of insurance	-€ 0	-€ 0	-€ 0
Other costs	-€ 3,500	-€ 4,950	-€ 7,281
Surrender cost	-€ 0	-€ 0	-€ 0
Tax	-€ 0	-€ 0	-€ 0
What you retain	=€46,500	=€45,050	=€42,719



# Proposed Key Investment Template Single Premium Pension Product (P2)

What you might receive?



The graph above illustrates the projected fund value after inflation is taken in to account. Returns may exceed or fall below the range shown.

The equivalent projected pensions (after inflation) are

- €1,500 p.a. (lower end of the range)
- €4,500 per annum (upper end of the range).

Pension is based on a retirement age of 65 single life.

There is a significant chance that you will lose a significant portion of your original investment

## Commission

Your adviser will receive the following payments

Type	Percentage	Amount based on €50,000
At Entry	5.0%	€2,500
Every year thereafter	0.5%	€250

## Practical Information

Policy provided by Insurance Company Limited.

You can obtain further information at [].

This information has been certified by :

[]

Managing Director of Insurance Company Limited



# Communicating Investment Risk Working Party

- Questions / Comments?