Society of Actuaries in Ireland

Proposed Principles

for

Communicating Investment Risk

May 2013

1 Background

As the range and complexity of investment products and fund types increase, consumers struggle to keep up with and interpret the corresponding risks. For some time, the financial services industry has searched for effective ways to communicate investment risk. This has been driven by the need to ensure that clients choose products that suit their requirements and also by the increasing force of regulation both at EU and local level. There is a divergence of approaches in communicating investment risk and, as a result, considerable debate on their effectiveness and comparability.

As investment products continue to evolve, communication of the associated risks must evolve too. The Society of Actuaries in Ireland ("Society") has produced this paper to address this point. The purpose of the paper is to propose a set of principles for communicating investment risk that should underpin the development of a new regulatory framework.

2 Contents

This paper includes the following sections:

- Scope of regulatory framework
- Overall Principles
- Consumer Information
- Risk Rating Principles
- Governance Principles
- Calculation Principles
- Summary

3 Scope of regulatory framework

We envisage that a regulatory framework developed in accordance with the principles proposed in this document would apply to all packaged retail investment products, such as investment funds (non-UCITS[1]), life assurance/pension policies with an investment element[2] and retail structured products.

This paper is not intended to address disclosure in respect of Undertakings for Collective Investment in Transferable Securities (UCITS – governed by the UCITS IV Directive), pure protection products, non-life products (such as motor and home insurance), directly held shares and retail deposits, occupational pension schemes and directly held government and corporate bonds. These could be covered by other regimes.

[1] Undertakings for Collective Investment in Transferrable Securities – governed by the UCITS IV Directive.

[2] Currently governed by the Life Assurance (Provision of Information Regulations), 2001, Occupational Pension Schemes (Disclosure of Information) Regulations, 2006, or Trust RACs (Disclosure of Information) Regulations, 2007, as applicable, and associated Actuarial Standards of Practice issued by the Society of Actuaries in Ireland.

4 Overall Principles

Disclosure of investment risks and illustrations of investment returns should:

i. Be fair, clear and not misleading; and

ii. Enable a comparison across products and product providers.

The development of a regulatory framework for the disclosure of investment risk and illustrations of returns should have regard to these fundamental principles. It should also take into account relevant international developments, including European developments on disclosure for UCITS and Packaged Retail Investment Products (PRIPS). Therefore, the framework should aim to dovetail with these developments and improve on them where possible.

In Section 5 we provide suggestions on Consumer Information, having regard to the above principles. This leads on to Sections 6 - 8 where we set out principles governing the production of certain aspects of the Consumer Information.

5 Consumer Information

Information provided to the consumer would consist of, as a minimum, a two page product information document and a one page document for each fund.

5.1 Two Page Essential Information Document

A two page document would provide the essential information on each product. Entities may produce further information as they see fit but this should be separate from the essential information. The essential information document should include the sections listed below. The headings for each section can be standardised.

1. **Product name and what the product is designed to achieve**

   This would consist of a simple description of the aims of the product.

2. **Product risk and reward**

   This would include a risk rating (see Section 6) and would reflect the combined risk rating where a combination of funds is chosen. This information should be updated and reissued following alterations by either the consumer or provider.

3. **Charges and effect of all expense charges**

   The charges would be expressed as a percentage of premium or funds and as the equivalent monetary amount in the first year.

   The effect of all expense charges would be expressed as a reduction in the long term risk free rate of return.

For products with risk benefits such as life assurance or critical illness cover, sample costs of the risk benefits would be shown. The risk costs would be taken into account in calculating the range of possible outcomes.

4. Range of possible outcomes

A range of outcomes which reflects the risks of the product should be shown.

A central illustration should not be shown as it is a low information item that risks being interpreted as a high information item – i.e. consumers may give it more credibility than is warranted. Instead, a graphical illustration should show, say, the 25th and 75th percentile outcomes over the illustration period. This would show, in monetary terms, illustrative maturity amounts and (where applicable) pensions for the same percentiles. It should also show a comparison with premiums paid.

Rounding of illustrative maturity amounts and pensions

Illustrative maturity amounts and (where applicable) pensions would be rounded to very few significant figures, to avoid the impression of spurious accuracy.

5. Illustration of the effect of inflation

An illustration of the effect of inflation should be provided. For example, the effect of inflation if no return is achieved could be shown. That is, €1 today will be worth € [] after [] years assuming a zero growth and future inflation of [] p.a. This is to show investors the effective potential future depreciation in the real value of their assets due to inflation (e.g. if they do not invest their assets).

6. Commission

The commission percentage together with a corresponding example in a monetary amount should be provided (e.g. €x in year 1).

5.2 Fund Information

A separate one page document should be provided for each fund containing generic information as follows:

- Name of the fund
- Objectives, benchmarks and investment policy
- Risk and reward profile of the fund (risk rating)
- Charges for the fund (%)
- Practical information (who to contact for further information etc)

This document could be available via a website rather than being provided directly in hard copy.

6 Risk Rating Principles

The risk ratings used in the disclosure of investment risk should:

- Use a methodology similar to that set out by the European Securities and Markets Authority (ESMA) for UCITS - that is, risk ratings would be identified on a scale of 1 to 7 and would be based on volatility;

- Use a standard wording, as defined by a regulatory body, for each level of risk, from 1 to 7;

- Be accompanied by a standardised warning for all products - for example, "If you do not understand the risks of this product, do not purchase it"; and

- Reflect concentration and liquidity risk.

7 Governance Principles

Within the proposed framework, every product-providing entity should be required to have a Risk Ratings Committee. This committee should determine and review the risk ratings for new and existing products including in particular complex products where the risks are not easily quantified and communicated. The Risk Ratings Committee could form part of an overall process under which the entity assesses the suitability of products for a target market.

Other proposed responsibilities of the Risk Ratings Committee are to:

- Review risk ratings for existing funds on a regular basis, and

- Ensure that consumers are notified if a product's risk rating changes risk category for a defined period of time.

8 Calculation Principles

Within the proposed framework, calculation of the range of outcomes illustrated in the "Essential Information" document (Section 5.1) should be based on the following principles:

1. Calculations should be on a stochastic basis using a model created and maintained by the CBI.

The calculations should provide investors with a range of illustrative outcomes to assist them in determining the risks and potential returns of the product. This does not mean that each illustration would have to be done on a stochastic basis – rather, illustrations may be produced using pre-prepared tables generated from a model determined by a regulatory body.

2. Subject to 3, the central rate of return should be a long term real risk free rate of return.

The rate of return should be net of inflation and should not change frequently. It should be reviewed by a regulatory body annually.

3. A risk premium can be included where the underlying assets merit this.

An overall maximum risk premium could be set by a regulatory body.

4. The product provider must satisfy itself as to whether the projection model illustrates all the risks of the product and be prepared to demonstrate their findings in this regard to third parties on request. Additional information should be provided if the model does not illustrate all the risks.

Validation of the suitability of the model could be through internal review or an external audit. Detailed information on the specification of the model would be required.

9 Summary

Consumers need clear, transparent and intelligible information about the investment risk inherent in products provided by financial institutions. This information should empower them to make a truly informed decision and to choose a level of risk suitable to their individual circumstances. To this end, the Society proposes that the principles outlined in this document should underpin the development of a new regulatory framework for the disclosure of investment risk to the consumers of investment products.

In summary, we propose that;

- The regulatory framework should have regard to the fundamental principles that disclosure of investment risks and illustrations of returns should be fair, clear and not misleading and should enable a comparison across products and product providers.
- A new regulatory framework should reflect international developments in this area.
- Consumers should be provided with a two page document outlining the essential information of each product and a one page document for each fund.
- The risk ratings used in the disclosure should be identified on a scale of 1 to 7, be based on volatility and reflect also both concentration and liquidity risk. In addition, a specified standard wording should be used for each level of risk and all products should be accompanied by a standardised warning such as "If you do not understand the risks of this product, do not purchase it".
- Every product-providing entity should have a Risk Ratings Committee to determine and review the risk ratings for new and existing products.
- Illustrative outcomes provided to consumers should be calculated on a stochastic basis using tables provided by a regulatory body and should, where possible, reflect all risks of the product. Additional information must be provided where risks are not represented in the model.

The Society welcomes engagement and discussion on the principles outlined in this paper.

10 Queries

Please direct any queries on this paper to Ms. Yvonne Lynch, Director of Professional Affairs, at the contact details at the end of the paper.

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