tech bites

Paul McCarville, Principal, Clarus Investment Solutions

New KID in Town
...changes to PRIIPs due in January

"There's talk on the street, it sounds so familiar" is the first line from the great Eagles song. Although there has been plenty of talk about PRIIPs over recent years – and it has been familiar since January 2018 - the latest twist in the road has largely escaped attention. Due to be implemented next January, significant changes are on the way.

The arrival of the KID documents prescribed under PRIIPs was meant to mark a major step forward in the understanding of insurance-based investment products by consumers. And they were expected to help advisors too. Those hopes were quickly dashed when the main shortcomings of the methodology became clear:

- Performance scenarios which could be very misleading and hard to understand
- Risk categorisations which were at odds with reality
- Charges computations which could show transaction costs as negative

A review and consultation process took place in 2020 and a new set of regulatory technical standards was forwarded to the European Commission on February 3rd. They could yet be amended, but the intention is that they come into force next January. Understandably, the funds industry and life companies are up in arms and demanding a deferral, for which the case is strongly arguable. But implementing PRIIPs and the plan to supplant the UCITS documentation is well cherished by the mandarins in Europe and is already behind schedule.
So, what is of most interest in the new regulations? To make the article intelligible, I will confine myself to the mainstream funds.

A. Performance Scenarios

The new KIDs will show four scenarios, as they do currently, and using the same titles. For most funds they will only be shown for two time periods – the Recommended Holding Period (RHP) and 1 year – not three as at present. Where the RHP is 10 years or more, scenarios for three time periods will be shown. In what is a radical change from the current methodology, all scenarios other than 'Stress' will be based on rolling historic returns achieved over a period equal to the RHP plus 5 years. With RHPs for mainstream Irish unit-linked funds being generally pitched at 7 years, in most cases this will mean using 12 years of data. Likely to encompass a variety of market conditions, it should be much more representative than the 5 years previously used. The Unfavourable scenario will show the worst outcome; the Favourable one, the best. The median return will represent the Moderate outcome.

The Stress scenario will still be computed using the current probability-based, Cornish Fisher formula; the Stress outcome derived in that way cannot be better than the Unfavourable outcome.

Clearly, many funds will not have 12 years of data and the regulations go into considerable detail as regards the benchmarks and proxies which can be used to 'back-fill'.

B. Costs

One of the most ridiculous aspects of the current regime is that the Portfolio Transaction Costs disclosed may sometimes be negative. Recognising this defect, the new regulations require costs to be split into 'explicit' and 'implicit' costs; the former are actual costs (e.g. stamp duty), while the latter represent the effect of market spreads and so on. It was the implicit cost area where the problem was arising and the new regulations do not allow the computation of these costs to produce a negative outcome.

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C. Risk Representation

No changes are being proposed to the seven-banded risk system or its graduations. The proposed regulations allow the manufacturer to over-ride the calculated SRI score if deemed necessary and increase it as appropriate. One would hope that this would put an end to what has been seen under the current regulations, where property and bond funds have appeared in the same risk band.

D. Past Performance

One of the biggest debates throughout the PRIIPs process has been whether or not to show past performance. Industry lobbyists strongly favoured doing so, but that battle was lost in framing the current version of PRIIPs. The new regulations do not provide for the inclusion of past performance information in the KID, but do prescribe how it must be presented elsewhere when referenced in the KID. The format specified is very similar to what currently applies to UCITS – a bar chart covering each of up to 10 annual outcomes for the fund and its stated benchmark. There is no provision for performance over multi-year periods or since inception. The performance information shall be updated monthly.

It remains to be seen if/how the regulations are amended and whether there is a deferral beyond January. Having been fiercely critical of the current regulations I would give those involved credit for having addressed some of their worst defects. But make no mistake, the new regulations are still very much a work in progress.