

Fund Ratings in Flux: PRIIPS v ESMA



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Since the beginning of 2018, the Irish unit-linked world has lived with two fund risk rating systems, as the newly-mandatory PRIIPs code muscled in alongside the incumbent ESMA system. In this piece we evaluate and compare the two and ask what the future will bring.

From the early part of the current decade, the ESMA¹ fund risk rating scale has been deployed almost universally by the providers of Irish unit-linked funds. All but one of them quotes a risk rating for every fund which is calculated in line with the ESMA methodology. (The exception, Irish Life, uses a customised scale). Moreover, the majority of risk-graduated multi-asset fund suites are built around the ESMA bands. We count 13 such suites from Irish life companies, accounting for some €16bn of assets, with nine of the 13 based on the ESMA architecture.

How did we get there so quickly? In the wake of the global financial crisis, there was a general acceptance that investment risk should command greater attention, so that clients' portfolios and their risk tolerance would be better matched. But there was no consistency among the bespoke risk rating scales then in use by providers, resulting in utter confusion for the customer and the adviser.

The ESMA system was developed (and made mandatory) at EU level for UCITS funds, coming into force in 2012. The regulation obliges all UCITS to publish a regular Key Investor Information Document (KIID), which shows a Synthetic Risk and Reward Indicator (SRRI) calculated in line with the ESMA methodology. The SRRI was never mandatory for unit-linked funds, but it was enthusiastically embraced by life companies in Ireland, with the active encouragement of the broker community. And it was undoubtedly a big step forward from the Tower of Babel which prevailed beforehand.

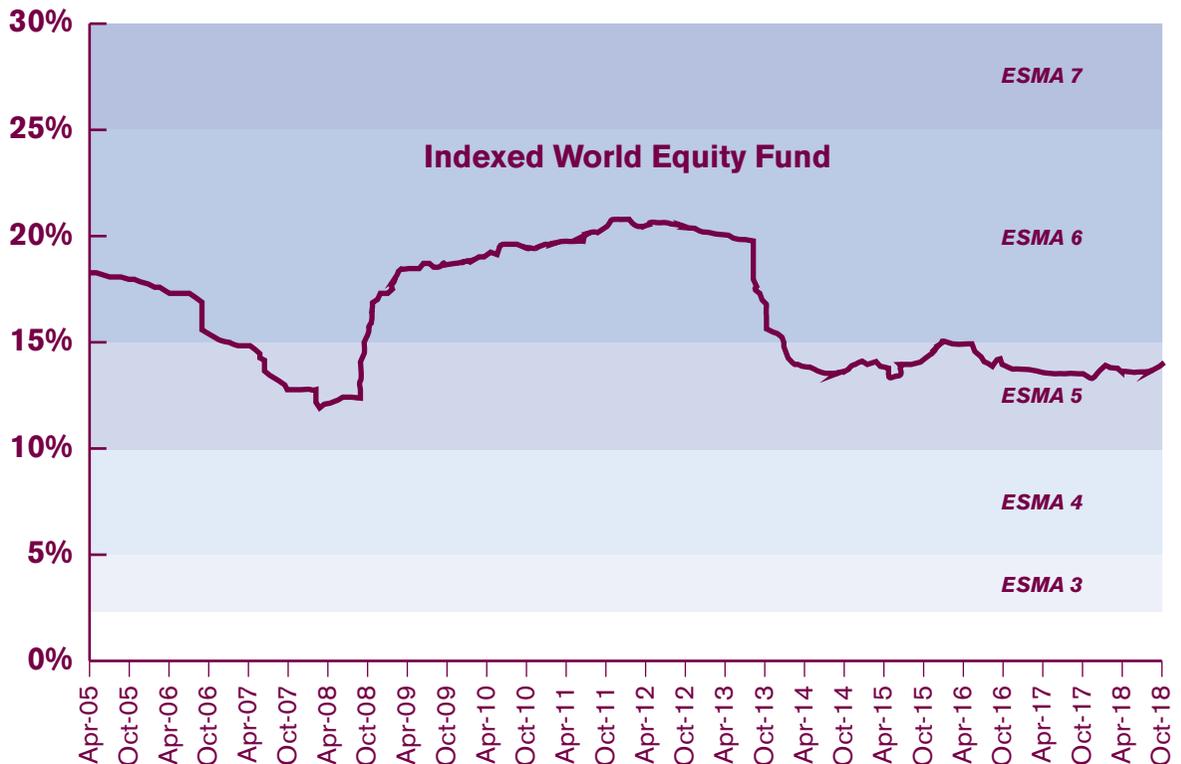
Calculation of ESMA Ratings

A brief reminder for those not familiar with the ESMA calculation: It is based on the volatility of the fund's periodic returns measured over the past five years. The volatility number is determined by the annualised standard deviation of weekly returns; where weekly data is not available monthly returns may be used. It is thus a measure of how widely the returns of a fund might fluctuate, the assumption being that greater fluctuation implies higher risk. It also embeds the implicit assumption that the fund's returns follow a Normal ('bell curve') Distribution. That holds reasonably well for most asset classes in everyday conditions, but can break down at times of extreme market stress.

The fund's rating on the seven-point scale is determined 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% | |

¹ European Securities and Markets Authority



Where the fund does not have a sufficiently long history, suitable proxies (such as market indices) should be used to back-fill the data. There are more complex calculations required for 'non-linear' investments such as structured products, but we will ignore them here.

The Pros and Cons of ESMA

The ESMA scale has the undoubted advantage of simplicity. It is a one-dimensional measure, straightforward to calculate and quite easy to understand even for those with no expertise in statistics.

But it also has some major drawbacks. Its greatest flaw is instability. A good risk measure should ask *'how bad does it get in worst-case conditions?'*, rather than just *'how does it behave in normal times?'*, and ESMA fails to do that. Five years might seem like a long-time interval, but it is not typically long enough to span a full cycle and so capture the elevated volatility which comes with bear markets. As a result, the ESMA rating of a fund may wander between bands. The chart (above) illustrates the point.

A representative passive global equity fund currently resides in Band 5, thanks to the fairly benign market conditions of recent years. But the turbulence of the global financial crisis, and the dotcom crash before that, pushed it well into Band 6 at other times. So which is the better indication of its true riskiness?

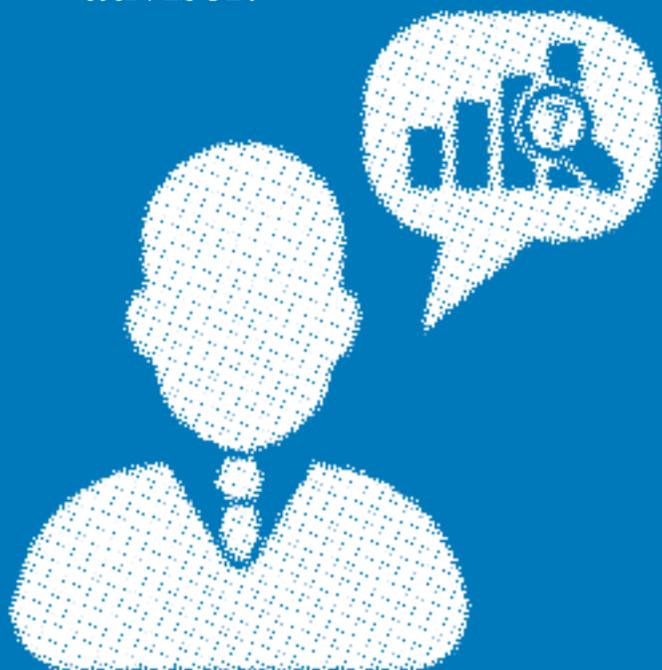
It's worth noting that other financial regulators take better account of this by demanding that the fund risk measure be based on a longer history of returns. In Canada, for example, the standard is 10 years, but even that is not now long enough to encompass the 2007-2009 bear market.

Secondly, the banding system is skewed towards the lower end of the risk spectrum, so that the middle of the range (Band 4: 5%-10%) is quite low relative to what is most appropriate for long-term savers. We would fear that, for example, a young pension investor with a moderate risk appetite could be drawn to the apparently sensible 'middle-of-road' risk choice, which would position him/her with too little risk and expected return for his/her circumstances; investors with long time horizons and many future contributions can benefit from volatility.

Third, by measuring volatility alone, the system takes no account of other important dimensions of risk such as credit risk and liquidity risk. The onus remains on brokers and fund providers to make these other risks clear to the investor, but it is all too easy to neglect them and assume the ESMA number paints the full picture.

We should point out that some of the Irish lifecosts may adjust the 'raw' ESMA measure to take into account a sensible forward-looking assessment of the fund's risk, which can mitigate the issue of the measure being unstable and misleadingly low at times.

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The Advent of PRIIPs

As we know, the PRIIPs² disclosure regime came into force at the start of 2018. All non-pension retail funds outside the UCITS universe are required to publish a KID (Key Information Document) conveying a range of information which must comply with a rigid specification. Rather awkwardly, the PRIIPs risk measure is radically different in some respects from the ESMA system.

The PRIIPs measure is known as SRI – Summary Risk Indicator. It differs from ESMA in three main respects. First, the volatility measure (termed the MRM – Market Risk Measure) is derived from a more complex statistical calculation known as the Cornish Fisher Expansion. The detail need not concern us here, but it was chosen to better capture the tendency for markets to make very large moves more often than the Normal Distribution model would predict. In statistical parlance, the actual distribution has ‘fat tails’ and, moreover, the extreme moves are more likely to be in a negative direction. However, the calculation is still based on only five years of past returns data, and in fact a shorter history may be accepted if the data frequency is weekly or daily.

Secondly, the SRI addresses credit risk as well as market volatility. For asset classes subject to credit risk (such as corporate bonds, loans, money market instruments, etc) there is a detailed process for determining the Credit Risk Measure (CRM) on a six-point scale. The SRI is then derived by blending the MRM and CRM according to rules which ensure that if either is a high number then the SRI defaults to an equally high number.

The third and most visible point of difference is the banding system. For funds holding equities, mainstream sovereign bonds or physical property the credit risk assessment does not come into play, so the SRI is determined directly by the MRM; and it is distilled onto a seven-point scale determined as follows:

| Annualized Volatility | MRM Class |
|-----------------------|-----------|
| < 0.5% | 1 |
| 0.5% – 5.0% | 2 |
| 5.0% – 12% | 3 |
| 12% – 20% | 4 |
| 20% – 30% | 5 |
| 30% – 80% | 6 |
| > 80% | 7 |

² *The Packaged Retail Investment and Insurance Products Regulation*

A cursory glance at the table below shows just how much it contrasts with the ESMA scale.

| 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% |

And while the volatility number is derived via a different calculation, in practice the outcomes tend to be quite similar for mainstream 'linear' funds. We ran comparisons on a range of representative funds and in almost every case the results were separated by only a fraction of one percentage point. While the ESMA scale poses the concern that a naïve investor might be unwittingly drawn to too low a risk level, the opposite might be true of PRIIPs.

Pitfalls

There are times when the mechanical application of a volatility-based risk formula can yield perverse results. For example, on one lifeco's KIDs the current PRIIPs risk rating of its Eurozone Bond fund is '3' while its Property fund is '2'. Intuitively, this is nonsense; we know that the downside risk of property is far greater, but the provider had no choice but to comply with the EU regulation. The same potential weakness exists with ESMA, but because it is applied here on a 'voluntary' basis the fund providers may apply sensible adjustments if they are called for.

Which is Better?

In our view the PRIIPs measure is an improvement on ESMA, though both are far from perfect. The inclusion of credit risk in the PRIIPs framework is a good enhancement. PRIIPs also looks to take some account of liquidity risk; if the volatility calculation is based on monthly returns (as, for example, from a property fund), the Market Risk Measure is automatically bumped up by one band. The two share the fundamental flaw of instability, due to not looking back over a long enough returns history.

However, the PRIIPs measure may be less likely to cross bands simply because its bands are wider. Both are guilty, in our view, of having banding spectrums which are skewed away from what would be most sensible for the average personal investor.

Where To From Here?

We are now in the position where every life company reports one fund risk rating in its main materials which is based (in all but one case) on ESMA, and for non-pension products there is an entirely different rating quoted in the KID material. This is far from ideal, and is likely to pose confusion for customers and indeed advisers. A few examples drawn at random from provider websites illustrate the point:

| Fund | Main Risk Rating | PRIIPs Risk Rating |
|--|------------------|--------------------|
| Standard Life European Smaller Companies | 6 | 4 |
| Irish Life Indexed European Gilts | 4 | 3 |
| New Ireland Global Emerging Markets | 6 | 4 |
| Zurich Life Fund of REITs | 6 | 4 |
| Aviva Corporate Bond | 3 | 2 |
| Friends First Irish Commercial Property | 5 | 2 |

As of now the ESMA system is mandatory for disclosure by UCITS funds. But on 1st January 2022 the PRIIPs regime is due to be extended to UCITS, and at that point it seems that the ESMA framework will cease to exist for regulatory purposes. For better or worse, PRIIPs will be the sole official system. The Irish life assurance community will face some tough choices on this and must decide whether to abandon what it has invested in ESMA. No option will be easy, but the priority must surely be to minimise confusion for the retail investor.