Finance Watch response to the IOSCO consultation on the regulation of retail structured products

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Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. Its members represent, collectively, many millions of European citizens and include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

Finance Watch is funded by grants, donations and membership fees. It does not accept any funding from the financial industry or political parties.

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Preliminary remarks

Setting up an appropriate level of protection for retail investors involves finding a difficult balance between freedom of choice, individual responsibility and protection against detrimental products and practices. The vast number of mis-selling cases over the past years suggests that this balance is not yet achieved.
Mis-selling cases are incredibly costly for all stakeholders, they lead to redress and reputational costs for the industry, are a drain on regulators resources and have a detrimental impact on investor confidence.
We therefore strongly welcome this consultation and the survey of existing regulatory regimes. We believe that their tried and tested principles are a sound basis on which to build a robust framework.

However as mis-selling cases are often not linked to structured products, we regret that the scope of the consultation is limited to those, and believe that a broader scope including all retail investment products would address more comprehensively investor detriment.
Product failure can indeed be linked to excessive complexity or an excessive level of risk, but also to product features taking advantage of investors' behavioural biases, excessive costs or products not meeting the needs of investors, all features that can be found also in non-structured products.

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Issue 1 for consultation: Do you think the survey results accurately reflect the regulation and markets of the respondent jurisdictions? Are there any other relevant facts, regulations or dynamics that the Working Group should consider?

We believe that the survey results reflect accurately the regulation and markets of the respondent jurisdictions.
We think however that the Working Group should consider as well product investment rules within UCITS as valuable conclusions could be drawn from these regarding the impact of product rules on all stakeholders, on choice and innovation, on investors' confidence and on mis-selling cases.

Issue 2 for consultation: Do you believe that inter- or intra-jurisdictional regulatory arbitrage is an issue within the retail structured product market where there is an integrated market? Why or why not? What if there is not an integrated market and different regulators within jurisdictions are involved? If so, do you think that the regulatory tool proposed above will help to address the issue? What alternative measures could IOSCO members consider?

We do believe that both inter and intra-jurisdictional regulatory arbitrage are issues that must be addressed, and that a level playing field is desirable between financial products using different wrappers, issued by different types of institutions, or issued by different countries.
We thus support the proposal to adopt a functional approach and have identical rules regardless of the base instrument or the reference asset.
We also believe that rules in a jurisdiction should apply to all products sold in this jurisdiction, regardless of the issuing country.

Issue 3 for consultation: Do you think that it would be useful for IOSCO members to take a *value-chain* approach to retail structured products? What issues do you think members could encounter in pursuing such an approach? How could those issues be overcome?

We support IOSCO proposal to adopt a value-chain approach, as experience from several national regulators shows that issues can arise at all stages in the manufacturing and distribution process.

Possible issues include assigning responsibilities along the chain to the respective entities, and complexity linked to the supervision of several types of stakeholders, that may be regulated by different regimes.

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However we believe that a clear definition of responsibilities combined with a functional approach should overcome these difficulties.

Issue 4 for consultation: Do you think that IOSCO members (that have the legal framework that would permit them to do so) could make issuers consider improvements to their market assessment process in light of their findings (where market assessments are required)? What do you consider to be the role of IOSCO members in the development and sale of retail structured products?

We believe that making issuers responsible for identifying and assessing target investors is a sensible approach that should be part of the investor protection toolkit. We especially support the use of multiple criteria for the assessment, as it recognises the fact that suitability is multi-dimensional, including financial capability, risk appetite, tolerance for capital loss and investment timeframe.

Issue 5 for consultation: Could the use of modelling as contemplated by this regulatory tool have an impact on the production of better value products and products that perform as intended or better disclosure? If yes, why? If not, why? What are the risks with using modelling as contemplated by this regulatory tool? Do you think investors would benefit from having access to the results of the modelling? Could IOSCO members require issuers to provide other information on the potential performance of the product? Please explain.

We are not convinced that the use of modelling would have a direct impact on the creation of better products. Assessing whether a product represents good value for money is mostly about the margin embedded in the product. As a manufacturer chooses its level of margin, it does not require any modelling to assess whether the margin is excessive or not.
The designer of a financial product also knows without modelling whether the loss/gain potential is unlimited or capped, whether the risk distribution is of a tail nature or rather high probability / low impact.

We believe however that the use of modelling might contribute to better disclosure by showing the probability distribution of returns net of costs.
Provided that the modelling accounts for all the relevant risks, including all market risks and counterparty risk, and that the disclosure format is intelligible, such disclosure would provide several benefits: it would incentivize manufacturers to keep margins at a reasonable level, and flag products emphasizing high potential returns with a low probability of occurring.

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Issue 6 for consultation:
Internal approval process
Do you think that a mandated internal approval process for issuers is warranted, or do most issuers already have this process in place? If the issuers already have such an internal approval process in place, how could it be improved? What should be the key elements in such an internal approval process? How effective are internal approval processes in vetting products before they are issued?
Regulatory pre-approval
Do you think it appropriate that regulators pre-approve products before they can be issued? Does the Consultation Report correctly describe the benefits and risks of such a process? If not, what are the benefits and risks? What do you think should be the criteria, standards and requirements for approval by the regulator? Please provide reasons.

Internal approval processes can be a useful tool, insofar as their findings are put on equal footings with commercial concerns in the decision-making process. Experience shows indeed that as perfect as a process may be, its effectiveness relies significantly on the relative weight given to its findings in the design phase of a product.
The effectiveness of such processes requires also the independence of people conducting the process from trading and sales management for obvious reasons.

Key elements of such a process should include the criteria mentioned earlier, such as value for money, design based on the needs of investors using feedback from previous products and target market assessments.

A regulatory pre-approval could be an effective tool to address issues related to product failure, but we are concerned that in practice such a tool would create an excessive burden and drain on regulators' resources. Hence we favour alternative approaches, such as product standards or warning labels.

Issue 7 for consultation: Do you think it appropriate that regulators play a role in setting product standards for retail structured products? If regulators do set such criteria, how should they do this, and what are the risks to the regulator and the market?

Based on the number of mis-selling cases and evidence that intervention at the point of sale is insufficient, we believe that regulators should either set products standards or introduce warning labels to address issues related to product failure.

Among the several possible approaches to address product design flaws, we believe that these are preferable to regulatory pre-approval, in that they provide ex ante guidance to the industry and are less burdensome for the regulator.

We believe that a functional approach setting up principles on product features would address most cases of investor detriment linked to product failure.
Based on our own analysis of mis-selling cases and existing regulations we find that most detrimental features fall into one or several of five categories: unfamiliar underlying assets, excessive complexity, features taking advantage of investors' behavioural biases, excessive level of risk in the product and bad value for money linked to excessive margins.
We therefore propose the following six principles to be used either as product standards or as criteria for a warning label.
Several national product regulations already use some of these criteria and they have thus been tried and tested.

Investment products shall be considered not suitable for retail investors if one or more of the following conditions are met:
1. The product invests in underlying assets not commonly invested in by non-professional investors;
2. The final return is conditional upon the occurrence of events uncommon for non-professional investors, such as the level of regulatory capital of a financial institution;
3. A number of different mechanisms or asset classes are used to calculate the final return on the investment, creating a risk of misunderstanding on the part of the investor;
4. The investment return includes packaging features that take advantage of investors´ behavioural biases, such as teaser rates and iterative pay-off formulas;
5. The global exposure of the financial product, measured by its monthly Value-at-Risk calculated within a 99% confidence interval at the time of trade, is above 20%.
6. The investment product does not provide fair and balanced outcomes for the investor.

<u>Principle (1): is about ensuring that retail investors can access all the traditional assets, but are not offered excessively complex or exotic assets, such as correlation.</u>
Example 1: A financial instrument where performance is linked to the correlation over a certain period between an oil company's share price and the level of a commodities index.
→ In this case, the investor must be able to anticipate changes in the correlation between a share and the underlying index, which generally requires a high level of expertise.

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Principle (2): is about ensuring that the return is not conditional upon the occurrence of events that non-professional investors would not be able to assess.
Example 2: A contingent convertible bond that automatically converts into shares if the regulatory capital of the issuing bank declines below 5%.
→ Assessing the probability of regulatory capital declining below a specific predetermined level would require a high level of expertise from the investor.

Principle (3): is about excessive complexity
Example 3: A financial instrument that offers the average performance of the CAC 40® index over a five-year period at maturity, plus or minus an annual coupon payment that depends on the performance of the bond market:
i) For each year where the CMS 10 year® rate is more than 55 bp higher than the CMS 2 year® rate, and the CAC 40® index posts a gain, a 4% coupon is paid at maturity.
ii) For each year where the CMS 10 year® rate is less than 20 bp higher than the CMS 2 year® rate and the CAC 40® index posts a loss, the final return is reduced by 1%.
→ Two asset classes determine the ultimate performance of this financial instrument: equities and fixed income. It is difficult, if not impossible, for retail clients to grasp the market scenarios that they should be anticipating.

Example 4: Product with the following payoff profile at maturity:
i) The average quarterly performance over 5 years of a strategy index that overweights the 20 highest-performing CAC 40® stocks in the previous month and underweights the 20 lowest-performing stocks.
ii) If, at a set quarterly date, the index is up by more than 10% over the previous quarter, a 6% coupon or bonus will be paid at maturity.
iii) If at a set quarterly date, the index is down by more than 30% from its starting level, then the product is liquidated (or terminated) and redeemed before maturity. In this case, the full decline in the index is subtracted from the initial capital outlay, and any bonuses acquired in the previous quarters are added.
→ High risk of misunderstanding. Four different mechanisms come into play in the calculation of the final return: the effect of averaging, a strategy that is intrinsic to the underlying index, a bonus for exceeding an upper bound and a loss for exceeding a lower bound.

Principle (4): is about products exploiting investors' shortcomings.
Example 5: A financial instrument guaranteeing during the first 2 years a fixed coupon of 6%, followed by a variable rate of return conditional upon the realization of certain events.
→ Packaging features like the described "teaser rate" play on the behavioural biases of retail investors, in this case on the preference for immediate attractive returns. It

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creates a risk that the investor will focus unduly on this feature without fully realizing the related future risks.

Example 6: A structured note whose quarterly coupon is paid according to the following formula:
Coupon = previous coupon + 5x Min(CMS 10y – CMS 2y ; 0).
→ The iterative nature of the return can compound losses but not gains at a quick rate, which would be very difficult if not impossible for most retail investors to anticipate.

Principle (5): aims at capping the level of risk in the product at a level similar to UCITS.
The proposed 20% monthly VaR cap is consistent with UCITS and aims at limiting the leverage of investment products sold to retail investors.

Principle (6): targets products where there is a strong imbalance between the potential for gain and the potential for loss.
Products including limitative conditions undermining significantly their utility, or products whose probability-weighted positive and negative potential returns at trade date are significantly unbalanced: a strong imbalance between the potential for gain and the potential for loss is an indication that the manufacturer or distributor took an unfairly large share of the return, to the detriment of the investor.

We believe that the related risks of this approach for the regulator and the market are limited. The success of UCITS funds is evidence that product rules do not have an adverse impact on choice and innovation but rather contribute to restoring investor confidence. UCITS product investment rules are indeed a key element of the soundness of its framework and of the popularity of these funds.

A short warning / disclaimer could address the risk that investors believe that the regulator has vetted the product for them.

Issue 8 for consultation: How prescriptive is it appropriate for IOSCO members to be in setting issuer disclosure standards? What topics or items could benefit from specific explanation requirements? Do you think that risk indicators or minimum information requirements are useful? If so, what should the indicators or requirements be? How else could disclosure to investors on retail structured products be improved? Is there any disclosure that should be prescribed or proscribed?

We believe that issuer disclosure standards should be prescriptive, as in the UCITS or PRIPs frameworks, to ensure standardization and comparability of information.

Specific explanation should be required for the objectives of the investment product, its risks and return mechanism, its costs and the recommended holding period.
In addition, in the case of products involving several choices from the investor, such as funds of funds or unit linked insurance contracts, a summary of the different choices to be made by the investor should be included.

A synthetic risk indicator would be a very good tool, provided it has the appropriate design and methodology: for it to be meaningful, its underlying methodology needs to encompass all major risks, including non-market risks such as the counterparty risk.
The data sample used must be broad enough and include stressed scenarios; failure to do so might miss tail risks in the indicator with the result of attributing undeservedly low risk to some products.

The format must also find a balance between intelligibility and transparency. A very simple format like a grade or traffic light highlights clearly high risks and returns but is not transparent, as investors have to rely on a methodology that they don't understand, and as it does not provide indications of possible losses. Such a format creates also a risk that investors will focus unduly on the indicator, to the detriment of other key information in the document.
Scenario analysis tables are more transparent, provide indications on potential losses and force investors to engage more with the product thereby reducing the risk of excessive focus on the indicator. The related risks are that investors fail to realize that the scenarios are indicative, and that high risks are less clearly highlighted.

A combination of the two formats could address these issues: a scenario analysis table giving an order of magnitude for the worst case loss and best case scenario, combined with a risk label (e.g. very low, low, medium, high, very high) on the side of the table.

We believe that some disclosures could be detrimental to the investor and should not be allowed:
- Overly generic language: some information documents use very generic language to disclose risks, such as "the product may be exposed to the risk of currency fluctuations". Such language does not provide any meaningful information and should thus not be allowed.
- Simulated historical returns: in case disclosure standards include historical returns of financial products, it is essential to ensure that these are only disclosed when the data sample if large enough to be meaningful and that only achieved past returns are disclosed. Disclosing simulated past returns would indeed provide a perverse incentive for manufacturers to fine-tune their product so that it displays the best simulated past returns and gets an undeserved good risk assessment.

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Issue 9 for consultation: Do you think it appropriate that IOSCO members mandate or encourage short-form or summary disclosure? Would such disclosure be helpful to investors in understanding the products that they are purchasing? What are the risks associated with such disclosure?
At what point in time should investors be provided access to this disclosure and what responsibility should the issuer have with respect to the content of the disclosure?
What information do you believe IOSCO members could require to be included in a short-form or summary disclosure?
If IOSCO members require the use a short form or summary disclosure, should this disclosure allow comparisons across products and, if so, what products should be able to be compared?

As many consumer studies and impact assessment studies have evidenced the fact that many investors find information documents too long, full of jargon and frequently don't read them, we believe that summary disclosure should be encouraged or mandated, together with an increased focus on the intelligibility of information through the integration of behavioural economics findings.
Information disclosed in an engaging format should contribute to informed investment decisions and reduce the overreliance on advice.
It must be ensured that such shorter and more engaging information does not create an illusion of simplicity and implicitly promote structured products to the detriment of simpler and cheaper alternatives.

Such disclosure should be provided before the purchase and the manufacturer should be responsible for the content to be fair, clear, non-misleading and following the mandated format and content.

We think that the information to be included should be similar to the European Commission PRIPs proposal.
The document should also include a reference to existing simpler and cheaper alternatives. We believe that this last point is important if we want to address unnecessary complexity in the product offer.
We also believe that disclosing the probabilities attached to potential returns as proposed in the consultation report would be very useful information, as many retail investors fail to realize that returns and probabilities are inextricably linked.

One of the purposes of such a summary document would be to foster comparability between all the products in the scope. As mentioned earlier we believe that the scope should be wider and include all retail investment products to ensure equivalent transparency and comparability between all products.

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Issue 10 for consultation: Do you agree that disclosure of disaggregated costs be made public or, alternatively, exchanged between the issuer and the distributor or the IOSCO member? Do you consider there to be an alternative mechanism to make disaggregated costs more transparent for retail investors? Do you think that the disclosure of such disaggregated costs would be useful to retail investors? Please explain.

We fully support the public disclosure of disaggregated costs, including implicit and explicit ones. Such a disclosure is indeed fundamental to ensure transparency, comparability, restore investor confidence and to incentivize the manufacturing of products offering good value for money.

France's findings that retail structured products sold in Europe include an average premium of 6% excluding fees, in a context where the risk free rate is below 2%, is evidence that competition is not working properly for retail structured products. Improved disclosure fostering transparency and comparability would increase competitive pressure on prices where it is currently too low, with a positive impact for investors.

Implicit costs are of particular importance, as most costs in structured products are embedded during the structuring phase and are never disclosed nor paid upfront by the investor. Such costs are typically financed through a reduction in the potential return and are thus opaque.

Issue 11 for consultation: Do you think disclosing the estimated fair value of a structured product at the time of issuance will be helpful to investors? If so, why? If not, why not? What alternative information could be disclosed?

Disclosing the fair value of a structured product at issuance would be very useful to investors as it would inform them in a comprehensive and simple way about implicit costs embedded into the product.
We believe that a good disclosure format for such information would be to disclose the difference between this fair value and the issuing price within the costs section of information documents.

Additionally and in order to ensure the meaningfulness of the fair value, manufacturers should provide on request to regulators the underlying data used to calculate the fair value in their internal model, so that regulators are able to perform random checks.

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Issue 12 for consultation: Do you think it appropriate that IOSCO members prescribe disclosure of scenarios? If so, what should these scenarios be? Do you consider there to be an alternative/simpler method of disclosing scenarios to retail investors? Please explain.

Scenario analyses would be useful for retail investors, as they would provide a view of the magnitude of the potential returns they might get under different scenarios.

We would propose three scenarios. A first scenario could be the worst case scenario inside a 99% confidence interval over the life of the product, a second scenario could be a median one, and a third scenario could be the best case within a 99% confidence interval over the life of the product.
In case the product doesn't have a maturity, then the horizon used should be the average holding period for this type of investment.

It should also be ensured that the observation period of risk factors is adequate and includes periods of stress.

As a fair proportion of retail investors struggle with charts and percentages, the disclosure format of such scenarios should be subject to consumer testing.

Issue 13 for consultation: Do you think that disclosure of backtesting is useful to investors? What are the risks associated with such disclosure? Is there any other way to use backtesting to help retail investors?

We do not believe that disclosure of backtesting would be useful to investors, as we think that the risks and drawbacks clearly outweigh the benefits.
Simulated historical returns might be perceived by retail investors as an indication of potential returns despite all warnings.
More importantly backtesting would wrongly incentivize manufacturers to fine tune their products so that they display the best simulated performance for specific data sets unlikely to represent the future, and would thus provide misleading results.
The use of several data sets would partly mitigate this issue, however as long as the manufacturer knows the data sets, it can be tempted to adjust the product parameters and features accordingly.

We believe that only real past performance should be allowed to be disclosed, and should not be featured too prominently on any information document in order to mitigate the risk of investors reading too much into it.

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Issue 14 for consultation: What education tools could IOSCO members use when educating retail investors on retail structured products? What guidance could IOSCO provide to its members to facilitate better investor understanding of retail structured products?

Retail investors would benefit from having access to education tools such as:
- Online modules providing a basic course on finance and financial products.
- Online modules providing a checklist of questions that investors should ask themselves and their advisor before purchasing a financial product.
- Online modules testing investors' financial capability through multiple choice questionnaires. Such a tool would raise awareness on financial capability and address the issue of overconfidence.
- An online fee calculator helping investors figure out the amount of fees and other costs that they would be paying.

A link to these tools could be provided on a pre-contractual summary information document and paper copies should be available on request.
IOSCO could provide guidance on their design to help its members improve investor understanding of retail structure products.

Issue 15 for consultation: Do you think it appropriate for IOSCO members to require or encourage issuers to take some form of responsibility for the actions of the distributors that distribute their products? What impediments might IOSCO members face in implementing these types of requirements? Would the requirements have an effect on distributor behaviour?

As issuers have more information and knowledge on the products that they manufacture than distributors, and as they are sometimes in a position to exert commercial pressure on distributors to adopt the best practices, we find some merit in proposing that issuers take some form of responsibility for the actions of distributors. However we are not convinced that manufacturers should be held liable for commercial decisions taken by distributors and fear that it would be difficult and costly to implement in practice.

We would instead favour requesting that issuers commit to making available to distributors all information and training necessary for them to be able to determine the most suitable distribution strategy.
In exchange, distributors could share with issuers their distribution strategy, possible complaints and customers' feedback and requests in order to improve product design.

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By issuers we understand entities involved in the manufacturing of the final product sold to retail investors; on some markets there are typically several entities involved in the manufacturing, from the entity providing the total return swap and the capital guarantee to the entity bundling the swap, guarantee and zero coupon bond to get the packaged product.
By distributor we mean entities purchasing the final product from a manufacturer and selling it as such to retail investors.
When an entity performs both manufacturing and distribution, it should be liable for the responsibilities attached to both functions.

Issue 16 for consultation: What other areas of activity could IOSCO members consider in the post sales period? Please explain. Are there issuers, that are not distributors, that make a secondary market in retail structured products (i.e., would the regulatory tool on secondary market making ever be relevant)?

We fully support most of the post-sales measures described in the consultation report:
- informing investors of worrying negative developments in particular regarding the rating or counterparty risk is clearly value added information for retail investors that may enable them to make more informed decisions regarding an early redemption where possible.
- reviewing issued products with the double objective to act on product failure and use the information to improve the design of future products is also useful.
- publishing the actual return of structured products issued in the past would also improve transparency and partly address the issue of non-performance.
Disclosing the actual returns of past products could counterbalance biased advice and help dispel the myth that more complex products offer higher returns.
- effective complaints handling procedures is also part of the service that retail investors should expect from their intermediary.
- product intervention powers must also be part of the regulatory toolkit, in order to address investor detriment linked to product failure that has not been prevented from happening.

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