International
Capital
Market
Association

ICMA

EBA, EIOPA and ESMA
c/o European Securities and Markets Authority
103 rue de Grenelle
75007 Paris
France

(Submitted online at www.esma.europa.eu)

17 August 2015

Dear Sirs,

ESAs' Discussion Paper JC/DP/2014/02 – Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs)[1]

The International Capital Market Association (ICMA) is responding to the above.

Setting standards internationally, ICMA is a unique organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years. See: www.icmagroup.org.

ICMA is responding in relation to its primary market constituency that lead-manages syndicated debt securities issues throughout Europe. This constituency deliberates principally through ICMA's Primary Market Practices Committee[2], which gathers the heads and senior members of the syndicate desks of 48 ICMA member banks, and ICMA's Legal and Documentation Committee[3], which gathers the heads and senior members of the legal transaction management teams of 21 ICMA member banks, in each case active in lead-managing syndicated debt securities issues in Europe.

We set out our response in the Annex to this letter and would be pleased to discuss it with you at your convenience.

Yours faithfully,

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[1] http://www.esma.europa.eu/system/files/jc_dp_2015_01.pdf.
[2] http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Primary-Market-Practices-Sub-committee/.
[3] http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Legal-and-Documentation-Sub-committee/.

Annex
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Response

General remarks

1. **Scope / vanilla bonds** – ICMA's response relates to 'vanilla' bonds (essentially fixed and floating rate and zero-coupon) only. Vanilla bonds seem outside the scope of PRIIPs given its 'packaged' nature (at least for now), and so the vanilla markets have not really been engaged. There has however been some previous confusing official messaging[4] in this respect, and references to "subordination" and to "perpetual" intruments in this DP seem to be following along those lines.

2. Corporate issuers of vanilla bonds will find it very difficult to comply with the PRIIPS regime because of the broad scope of the required disclosure (particularly relating to credit risk), the limited space to comply with that requirement in the KID and the liability that will result from failure to comply (see further below). (In addition, the on-going requirement to update the KID as changes occur during the life of the issue is a significant increased burden for corporate issuers that most will be unwilling to accept.) Therefore it is important, if retail corporate bond markets are to be preserved or increased in size (in line with the Commission's Capital Market Union initiative), that the scope of PRIIPs is clearly defined so as to exclude vanilla bonds.

3. **Purpose / liability** – Clarity as to KID purpose and liability continue to remain outstanding, with the PRIIPs Regulation limited to noting the KID's purpose is to *"help"* investors whilst some official messaging[5] has indicated KIDs must contain sufficient information to allow consumers to make informed investment decisions. It is helpful in this respect that this DP states that the *"KID shall not be the sole and unique source of information"*. However, this is again insufficient.

4. The PRIIPs Regulation's Article 11, as it stands, is very likely to create liability for the KID on a 'standalone' basis, because it imposes liability for non-compliance with Article 8 (which requires disclosure of risk, including credit risk) without limiting that liability to where the KID is read together with the full prospectus. This will very likely create liability in tort (negligence) even if implementing legislation does not create statutory liability. One is consequently compelled to take a conservative/cautious approach, in terms of KID purpose/liability, to all aspects of PRIIPs. In this respect 'certainty of funding' for any vanilla issuers brought into scope could be compromised. (The ICMA 2015Q1 newsletter[6] contains further coverage.)

5. **Limited response** – In anticipation of confirmation for the reasons given, that plain vanilla bonds will be (and remain) within a clear exemption from PRIIPs, ICMA is submitting this response, but on a limited basis only (also due to this DP's level of technical detail).

6. **'Single' risk indicator** – This DP notes that *"the level one text refers to a summary risk indicator, which combines the different risks of importance for the consumer in a summary format"* with apparent emphasis on the indicator reference being in the singular though the possibility of a *"multi-dimensional"* risk indicator is acknowledged. This DP further notes that *"given the diverging views on the integration of PRIIPs´ main risks - market, credit and liquidity - both possibilities of a single aggregated and a multidimensional risk indicator (that is, showing different risks separately) are explored"* – with upcoming consumer testing results to be also accounted for. Indeed, given concerns as to how and whether it is possible to mix the outputs of the ESA's three retained risk measures (market, credit and liquidity)[7] in a way that is not misleading (bearing in mind PRIIPs does not appear to allow omission of information as noted in paragraph4 above), one should indeed look into a single visual graphic (such as a radar graph) as a 'single' indicator though

[4] European Commission 15 April 2014 press release referencing the PRIIPs rules as responding *inter alia* to seemingly non-packaged "subordinated" notes – See http://europa.eu/rapid/press-release_STATEMENT-14-122_en.htm.
[5] ESMA 15 October 2014 speech – see http://www.esma.europa.eu/system/files/2014-1265_keynote_speech_-_the_esas_role_in_financial_consumer_protection_cnmv_conference_madrid_-_steven_maijoor.pdf.
[6] See pp.38-39 of http://www.icmagroup.org/assets/documents/Regulatory/Quarterly_Reports/ICMA-Quarterly-Report-First-Quarter-2015.pdf.
[7] Noted at 2.3.3.1, paragraph 2 in the DP.

distinctly illustrating the separate underlying risk measures. In this last respect, it is unclear what indicators (such as a radar graph) have been subject to consumer testing so far.

7. **Considerations common to risk indicators and performance scenarios** – Many of the options discussed in this DP involve estimations and/or assumptions, and it is unclear whether any accompanying narrative will adequately address any potential for investors to be misled (especially given KID space constraints) – regardless of the extent to which risk/performance measures may be a *"fair"*. Even an accurate 'relative' grading of products could be misleading in 'absolute' terms (with even any 99%/95% confidence levels being so qualified). To the extent the ESAs specify mandatory methodologies, then it would follow that the ESAs should prescribe the accompanying narrative explanations of the limitations of such methodologies.

8. This DP correctly flags that the *"predictive power"* of *"estimation based on the statistics of historical data [...] is weak"* – whilst behavioural economics seems to indicate investors are likely to erroneously latch on to estimations as predictions. This DP also seems to indicate a pervasive tension between standardisation and accuracy – bearing in mind the PRIIPs regime covers 'apples and pears' that are not really comparable. In this respect, this DP's acknowledgement that *"due to the wide scope of PRIIPs it may be necessary to amend or create variations of proposed methodological approaches in order to cover all products"* is unsurprising. Though the assessment criteria noted in this DP (that any methodology be reliable, robust, universally applicable, enable comparability and product discrimination, proportionate in terms of burden and compatible with regulatory supervision) seem sensible individually, it is unclear whether any methodology will satisfy all the criteria. This DP seems to correctly note drawbacks in all the methodology options discussed and correctly flags various pros and cons of other aspects, so adopting conclusive views / pursuing the debate in its current embodiment seems challenging.

9. **November 2014 discussion paper feedback** – Though this DP references the volume of November 2014 DP respondent views in relation to particular aspects, such volume would only be relevant to the extent the ESA's conclude as to the overall representativeness of such views – and even then it is the rationale for such views that is crucial.

10. **Risk indicators / VaR** – The DP notes, in the context of VaR, that it *"is not certain whether a short term measure could serve as a proxy for market risk in the long term"* – which seems to be a fair point.

Specific questions

Q5: Please state your view on what time frame or frames should the Risk Indicator and Performance Scenarios be based

11. Vanilla bonds are generally expected to be held to maturity, though they can be traded in the open market and there are no guarantees as to at what (if any) price a willing buyer can be found (though some 'fair weather' market making arrangements may sometimes be established).

Q6: Do you have any views on these considerations on the assessment of credit risk, and in particular regarding the use of credit ratings?

12. Regarding **risk indicators**, credit risk is not exclusive to PRIIPs and, to the extent it is not *"linked to the underlying assets"* (that this DP identifies rather as market risk for PRIIPs purposes), it does not relate to the 'demystification' of packaging that was the behind the launch of the PRIIPs initiative.

13. Whilst indeed *"credit risk could be the most important risk consumers are facing when investing in some PRIIPs"*, it does not necessarily follow that one should *"lean towards the incorporation of credit risk in the risk indicator rather than presenting it in a separate narrative"*[8] – the opposite conclusion might even be argued in this respect (bearing in mind the apparent challenges in identifying non-misleading risk indicators as noted in paragraphs 7/8 above).

[8] A point which is repeated at p.31 of this DP and also extended to market risk.

14. The November 2014 DP feedback that quantitative *"credit or CDS spreads are not available for all manufacturers and require a liquid bond or CDS market; spreads may be impacted by elements other than credit risk evolution, such as liquidity, and the different impacts are hard to isolate; spreads may be highly volatile, possibly leading to a very unstable risk measure"* seems coherent.

15. Equally, there seems to be some coherence in the DP's statements that:

    (a) *"credit ratings they have been criticised after the financial crisis (i.e. an overreliance upon credit ratings), but measures have been taken on a European level"* – though the latter qualification (presumably relating to the various CRA Regulations adopted by the European Commission September 2014) seemingly mitigates the underlying *"drawback"*;

    (b) *"not all PRIIPs´ manufacturers have a credit rating (especially small manufacturers); credit risk could be derived from the rating of peer companies but this could reduce the objectivity of the assessment"* – though credit ratings (unlike credit or CDS spreads) can be specifically (albeit expensively) commissioned;

    (c) *"credit ratings may not reflect as promptly a change in credit risk as information directly derived from market data"* – though this assumes such data is available.

16. That the *"ESAs consider that credit ratings could be used as a primary measure of overall credit risk"* is unsurprising given the relatively limited options available. Also unsurprising, in relation to *"obligors [being] subject to a prudential framework [potentially being] a mitigating factor justifying a more favourable credit risk assessment"*, are that *"the recent financial crisis has shown that entities subject to prudential supervision are not infallible"* and the reference to the developing bail-in regimes – without forgetting that the purposive calibration of such prudential regimes might not necessarily be aligned to the needs of PRIIP investors.

17. To the extent the ESAs' consider the Basel Committee on Banking Supervision's ongoing work, including its December 2014 consultative paper on proposed revisions to the standardized approach for credit risk, to be relevant to credit risk assessment in the PRIIPs context, it may be relevant for the European Commission to reconsider the PRIIPs legislative timetable.

Q7: Do you agree that liquidity issues should be reflected in the risk section, in addition to clarifications provided in other section of the KID?

18. See paragraph 11 above regarding vanilla bond liquidity. Presumably only risks should be reflected in the risk section, with risk being the potential to lose something of value. To the extent a relevant liquidity aspect is not a risk, such as the existence of a committed market-making facility, it would presumably appear elsewhere in the KID (although in turn one might consider whether failure of the committed market-making facility might be a risk to cover in the risk section).

Q8: Do you consider that qualitative measures such as the ones proposed are appropriate or that they need to be supplemented with some quantitative measure to some extent?
Should cost and exit penalties for early redemptions be considered a component of the liquidity risk and hence, be used to define a product as liquid or not for the KID purpose?

19. See paragraph 11 above regarding vanilla bond liquidity.

Q15: Please express your views on the assessment described above and the relative relevance of the different criteria that may be considered.

20. Regarding **performance scenarios**, vanilla bonds either pay out in full or default, in which case there are no guarantees as to what may be recouped – and investors in investment grade bonds focus on likelihood of default and not 'loss given default'.

21. The coupons of floating rate bonds may indeed vary over time in ways that cannot be anticipated, inter alia given socio-political drivers. A hypothetical scenario approach might conceivably focus on providing two relatively extreme scenarios, without a middle scenario that retail investors might well home-in on as consequently probable to crystallise. However, given the recent and whole

(since 1694) history of, for example, the Bank England's base rate[9], even that seems potentially misleading.

Q22: Do you think that performance in the case of exit before the recommended holding period should be shown? Do you think that fair value should be the figure shown in the case of structured products, other bonds or AIFs? Do you see any other methodological issues in computing performance in several holding periods?

22. In terms of performance scenarios on early exit, see paragraph 11 above.

Q59: To what extent are those two approaches similar and should lead to the same results?

23. In terms of vanilla bond '**costs**', there are arguably no costs involving the issuer, with any custody and secondary market transaction execution expenses involving unknown third parties. In terms of trying to proxy onto a 'fair value' as *"the value of the liability that the manufacturer records on its balance sheet when the product is sold"*, issuers generally receive less than 100% of the proceeds of an issue (as they bear issuance fees/expenses), yet are liable to redeem 100% of face value at maturity.

[9] See graph published by The Telegraph: http://s.telegraph.co.uk/graphics/Lightbox/published/503/images/THUMB.jpg.