



DAV

DEUTSCHE  
AKTUARVEREINIGUNG e.V.

Comments of Deutsche Aktuarvereinigung e.V.

**ESA's Joint Consultation Paper  
PRIIPs Key Information Documents**

Cologne, 19 January 2016

## **Introduction / Summary**

The Deutsche Aktuarvereinigung (DAV) is the German association of actuaries and in this capacity appreciates the opportunity to comment on the Joint Consultation Paper on PRIIPs Key Information Documents – Draft Regulatory Standards.

Generally, we wish to point out that we fully support the objective to provide consumers with clear and transparent information on the key characteristics of a product, thus enabling the customer to compare various PRIIPs and make an informed choice according to his interests, risk profile and goals. This initiative will further strengthen consumer protection in the financial services industry.

As many actuaries are advising or working in insurance companies our subsequent comments will concentrate on material issues addressed in the Consultation Paper affecting life-insurance products.

In brief, our main recommendations are:

- Risk:
  - As the main objective of the PRIIPs Regulation is to ensure comparability for all products we propose not to choose different risk indicators for different categories of PRIIPs.
  - For DAV it is key that all guarantee schemes are taken into account in the credit risk assessment as risk mitigation factors.
  - As regards the methodology to compute the VaR equivalent volatility we recommend a forward-looking simulation approach.
  - A change of the risk measure would be appropriate, such that not only a point estimate of the loss distribution is considered, but also the extent of risk that is to be expected when some critical threshold is breached.
- Costs:
  - We welcome the decision to apply a Reduction-in-Yield (RIY) approach when determining the cost indicator of a product.
  - The biometric risk premium should be included in the section “What is this product?”. We welcome that the ESAs do not see the biometric risk premium as a cost.
  - To ensure both, the comparability of products and a level playing field of manufacturers, only annualised costs in monetary terms should be presented together with the Reduction in Yield indicator.
  - We urge the ESAs to reduce the complexity of information on costs and to aim at simplification and understandability.
- Time Frame:

The German actuaries are very concerned about the extremely short period provided to implement the KID for PRIIPs. A one-year extension of the PRIIPs implementation deadline in order to allow the industry to effectively implement the KID is recommended.

## **Question 1**

*Would you see merit in the ESAs clarifying further the criteria set out in Recital 18 mentioned above by way of guidelines?*

With regard to the comprehension alert of the PRIIPs Regulation, recital 18 of the PRIIPs Regulation includes criteria to be used for assessing whether to include the alert or not. As the Consultation Paper itself points out the ESAs are not mandated to provide Regulatory Technical Standards (RTS) on this specific topic.

As there is a large variety of PRIIPs at the national level the criteria need not be further specified by the ESAs but clarifying them, if necessary, should rather be left to competent national authorities.

## **Question 2**

- (i) Would you agree with the assumptions used for the proposed default amounts? Are you of the opinion that these prescribed amounts should be amended? If yes, how and why?*
- (ii) Would you favour an approach in which the prescribed standardized amount is the default option, unless the PRIIP has a known required investment amount and price which can be used instead?*

The calculation and presentation of figures both in the Risk and Reward and the Costs sections of the KID entails the use of standardised example investment amounts. As DAV we do not believe that this is of use for the client: If the client invests significantly less/more than the prescribed amount the impact of the underlying fee-structure might be significantly different - thus such a presentation might be rather misleading. The impact could be even higher in case there is a "fee consideration" in order to cover potential mortality premiums. With today's technical possibilities it is no problem to calculate and present figures for the Risk and Reward assessment based on the client's preferred investment amount instead.

Moreover, the duration of the product will have a high impact on the performance of the product. For insurance-based investment products a duration of 30 years and longer is no exception; therefore a duration of ten years as proposed will not provide the client with realistic expectations.

In any case, at least realistic amounts of both single and regular premiums should be considered – especially to demonstrate the impact of the fee structure (fixed as well as relative). For insurance-based products monthly regular premiums of 100 € (i.e. 1.200 € a year) might be a reasonable choice; for single premiums perhaps 20.000 €.

## **Question 3**

*For PRIIPs that fall into category II and for which the Cornish Fisher expansion is used as a methodology to compute the VaR equivalent Volatility do you think a bootstrapping approach should be used instead? Please explain the reasons for your opinion.*

The Cornish-Fisher expansion builds on a transformation of a normal distributed random variable. Hence, if the approach is used to derive the VaR of some random variable  $X$  –  $X$  e.g. corresponds to log-returns in our exercise – the

approach is the better (worse) the more (less) the "true" probability distribution of  $X$  exhibits similarity to this transformed normal distribution. If the true underlying probability distribution of  $X$  is far from being (a transformed) normal – e.g. when a guarantee product is considered – this approach will yield a (potentially very) different result as compared to sampling different returns by means of Monte-Carlo simulation (e.g. applying a bootstrap).

Following the current proposal, the Cornish-Fisher expansion shall be used for PRIIPS of so-called "Category II". This category includes for example UCITS-funds (Annex II, Part I, Paragraph 10). In contrast, the bootstrap approach shall be applied for products of "Category III" which includes "any guaranteed product not falling in Category I or Category IV" (Annex II, Part I, Paragraph 15).

Now, consider the following hypothetical example

(i) Investment I:

Direct investment in an investment vehicle qualifying for Category II  
Then: Cornish-Fisher has to be applied

(ii) Investment II:

Direct investment in Investment I with an additional (far out of the money) guarantee of e.g. 50%, hence qualifying for Category III  
Then: Bootstrap has to be applied.

Although, both investment products might exhibit the very same risk exposure, they will be treated differently. Therefore, the DAV strongly recommends to apply the same methodology to calculate VaR for all PRIIPs considered.

In our view a simulation approach like Bootstrap would probably be more appropriate than applying the Cornish-Fisher method; still we recommend a forward-looking simulation approach instead.

#### **Question 4**

*Would you favour a different confidence interval to compute the VaR? If so, please explain which confidence interval you would use and state your reasons why.*

The current approach of deriving the MRM relies on mapping some calculated VaR to an annual volatility. After the annual volatility has been derived the corresponding MRM is set by definition. Currently, the VaR is derived at a confidence level of 2.5%.

VaR is essentially a quantile of some probability (loss) distribution  $X$ , i.e.  $VaR(X)\alpha$  is defined such that  $\mathbb{P}(X \leq VaR(X)\alpha) = \alpha$  holds. Hence, it only tells us some point-estimate of the loss distribution and not which amount of loss might actually

happen when some critical threshold has been breached. This criticism of VaR in correspondence with Basel II regulation has already been raised by academics<sup>1</sup>.

Therefore, the actual confidence level chosen to derive the Value at Risk is very delicate: Increasing it too far (say e.g. 10%) does potentially not tell anything about risk, since with the 10%-quantile, one might not be positioned in the tail of the considered distribution. Decreasing it too far (say e.g. 0.1%) does potentially not tell anything about the risk that "is to be expected" because a 0.1%-quantile might correspond to a (very) rare and extreme event. Therefore, the question whether the currently proposed level of 2.5% is actually too far out or too far in the tail cannot be answered in general for each and every PRIIP. In our view, no clear indication of which quantile should be preferred over another is easily provided.

Finally, following Daniélsson et al. (2001) one might be able to construct PRIIPS that reduce the  $Va(X)\alpha$  at the expense of shifting further risk into the tail below the  $VaR(X)\alpha$ . Hence, leaving the PRIIP with a lower MRM, but having more risk in the tail which should not be intended by the regulation.

In summary, a change of the risk measure would be appropriate, such that not only a point estimate of the loss distribution is considered, but also the extent of risk that is to be expected when some critical threshold is breached. This appears to be of far more importance than the actual choice of confidence level. A possible risk measure would be the Conditional Tail Value at Risk, i.e.  $CVa(X)\alpha = \mathbb{E}\mathbb{P}[X | X \leq VaR(X)\alpha]$ .

## Question 5

*Are you of the view that the existence of a compensation or guarantee scheme should be taken into account in the credit risk assessment of a PRIIP? And if you agree, how would you propose to do so?*

For DAV it is key that all guarantee schemes are taken into account in the credit risk assessment as risk mitigation factors.

For life insurance products in Germany there are three levels of "guarantees" which ensure consumer protection:

1. Product level: Premiums in life insurance are calculated on the basis of reasonable actuarial assumptions and sufficient to enable the insurance undertaking to meet all its liabilities, and in particular, to establish adequate premium reserves for the individual contracts.
2. Enterprise level: Solvency II sets the solvency capital requirements each enterprise has to fulfil according to its individual risk portfolio. The insurance claims take precedence over other claims against the insurance undertaking (Solvency II, Article 275(1)(a))

---

<sup>1</sup> Daniélsson, J., Embrechts, P., Goodhart, C., Keating, C., Muennich, F., Renault, O. and Shin, H. (2001). An Academic Response to Basel II. Available at <http://www.lse.ac.uk/fmg/documents/specialPapers/2001/sp130.pdf>.

3. Insurance industry level: Furthermore, in Germany an insurance guarantee scheme called "Protektor" ensures that consumers are compensated for possible losses should levels 1 and 2 fail.

So, if a PRIIPs manufacturer is secured by a protection scheme which covers the possible loss of a client in case of default this should lead to a classification of the PRIIP as CR1.

Moreover, the client should be informed not only about the guarantee but also and in particular about the various protections schemes.

### **Question 7**

*Do you agree with an adjustment of the credit risk for the tenor, and how would you propose to make such an adjustment?*

For DAV it is key that all guarantee schemes are taken into account in the credit risk assessment as risk mitigation factors.

For life insurance products in Germany there are three levels of "guarantees" which ensure consumer protection:

1. Product level: Premiums in life insurance are calculated on the basis of reasonable actuarial assumptions and sufficient to enable the insurance undertaking to meet all its liabilities, and in particular, to establish adequate premium reserves for the individual contracts.
2. Enterprise level: Solvency II sets the solvency capital requirements each enterprise has to fulfil according to its individual risk portfolio. The insurance claims take precedence over other claims against the insurance undertaking (Solvency II, Article 275(1)(a)).
3. Insurance industry level: Furthermore, in Germany an insurance guarantee scheme called "Protektor" ensures that consumers are compensated for possible losses should levels 1 and 2 fail.

So, if a PRIIPs manufacturer is secured by a protection scheme which covers the possible loss of a client in case of default this should lead to a classification of the PRIIP as CR1.

In our view, it is most important that the specific features of insurance-based investment products are appropriately taken into account to ensure that consumers receive adequate information about the products they purchase.

### **Question 8**

*Do you agree with the scales of the classes MRM, CRM and SRI? If not, please specify your alternative proposal and include your reasoning.*

From our perspective it is key that the consumer is provided with transparent, easy to understand and reliable results which enable him to compare different PRIIPs and make an informed choice. The methodology from which the scales of the classes is derived here does not lead to results fulfilling these requirements.

Instead, we strongly recommend a forward-looking simulation approach.

### **Question 9**

*Are you of the opinion that for PRIIPs that offer a capital protection during their whole lifespan and can be redeemed against their initial investment at any time over the life of the PRIIP a qualitative assessment and automatic allocation to MRM class 1 should be permitted?*

*Are you of the opinion that the criteria of the 5 year tenor is relevant, irrespective of the redemption characteristics?*

As the main objective of the PRIIPs Regulation is to ensure comparability for all products we propose not to choose different indicators for different categories of PRIIPs.

The 5 year period seems rather irrelevant for German PRIIPs – the only reason to look at the 5 year period in the context of life insurance could be to show an indication towards the 5 year term with respect to surrender values within the Insurance Contract Act (Versicherungsvertragsgesetz, VVG).

### **Question 10**

*Are you aware of other circumstances in which the credit risk assessment should be assumed to be mitigated? If so, please explain why and to what degree it should be assumed to be mitigated?*

For DAV it is key that all guarantee schemes are taken into account in the credit risk assessment as risk mitigation factors.

For life insurance products in Germany there are three levels of “guarantees” which ensure consumer protection:

1. Product level: Premiums in life insurance are calculated on the basis of reasonable actuarial assumptions and sufficient to enable the insurance undertaking to meet all its liabilities, and in particular, to establish adequate premium reserves for the individual contracts.
2. Enterprise level: Solvency II sets the solvency capital requirements each enterprise has to fulfil according to its individual risk portfolio. The insurance claims take precedence over other claims against the insurance undertaking (Solvency II, Article 275(1)(a)).
3. Insurance industry level: Furthermore, in Germany an insurance guarantee scheme called “Protektor” ensures that consumers are compensated for possible losses should levels 1 and 2 fail.

So, if the PRIIPs manufacturer is secured by a protection scheme which covers the possible loss of a client in case of default this should lead to a classification of the PRIIP as CR1.

### **Question 12**

*Do you think the risk indicator should take into account currency risk when there is a difference between the currency of the PRIIP and the national currency of the investor targeted by the PRIIP manufacturer, even though this risk is not intrinsic to the PRIIP itself, but relates to the typical situation of the targeted investor?*

Yes, of course the risk indicator should consider a potential currency risk if the pay-out is in the different currency as the premiums. Several aspects drive this recommendation

- Over the (long lasting) lifetime of the policy (particular volatile) exchange rates may heavily influence the performance of the PRIIP
- The underlying charging structure may be in favour/disfavour of a (volatile) exchange rate

### **Question 13**

*Are you of the opinion that the current Consultation Paper sufficiently addresses this issue? Do you think it is made sufficiently clear that the value of a PRIIP could be significantly less compared to the guaranteed value during the life of the PRIIP? Several alternatives are analysed in the Impact Assessment under policy option 5: do you see any additional analysis for these assessment?*

According to the PRIIPs Regulation a single risk indicator (Article 8(3)(d)) is supposed to combine and summarise all relevant factors. Thus, the presentation of several risk indicators for different stages before maturity as suggested in option 5.2 would be contrary to the level 1 text.

In our view, a risk indicator based on short and standardised holding periods for all products - especially for long-term products, such as insurance-based investment products – would rather obscure the real risk of the product. Moreover (see option 5.1), it could be confusing to the consumer if the time horizon for the risk indicator and the product as in Article 8(3)(d) is not the same.

Instead, it would be better to explain the informative value of the risk indicator and its limitations. The PRIIP Regulation foresees an entire section of the KID for the description of what happens if consumers take out money early (Article 8(3)(g)(iv)). There seems to be no reason to repeat the same information in different forms in different sections, this would only lead to confusion.

### **Question 15**

*Given the number of tables displayed in the KID and the to a degree mixed consumer testing results on whether presentation of performance scenarios as a table or a graph would be most effective, do you think a presentation of the performance scenarios in the form of a graph should be preferred, or both a table and a graph?*

As regards performance scenarios in general, we regret the fact that so many details are left to the manufacturers' discretion. We recommend a prescription of the (basic) model as well as the necessary parameters by a central European authority. This will ensure comparability of results and also grant sound legal protection for the manufacturers. In case the choice of parameters is left to the judgement of the manufacturers more supervision will become necessary to make sure that these are chosen with due diligence.

Furthermore, it is key that consumers understand the meaning of intermediate values. For insurance-based investment products intermediate values are not the same as final values of a product with a shorter holding period, i.e. the value after 15 years of a product with a term of 30 years is not the same as the final value of a product with a term of 15 years. This should be clearly explained to the consumer in a narrative manner.

Finally, regarding the proposed guidelines we recommend not to apply the PRIIPs Regulation before all guidelines are developed and published. Consumers must be able to trust in the information provided with the KIDs, which is not fully available until all provisions for the underlying performance scenarios are known and implemented.

### **Question 18**

*Do you agree that the monetary values indicated in the first table are a sum of costs over the respective holding periods? Or should the values reflect annualized amounts? If you prefer annualized amounts, which method for annualisation should be used (e.g. arithmetic average or methods that consider discounting effects)?*

To ensure both, the comparability of products and a level playing field of manufacturers, only annualised costs in monetary terms should be presented together with the Reduction in Yield indicator.

The total costs for the whole investment period do not provide the consumer with appropriate information as they prohibit an effective comparison between, for example, a product with a few months investment period and one characterised by a 30 years investment period. A product with a longer term would automatically – even if it is cheaper – look more expensive than a product with a shorter term.

As regards the method of annualisation, it is important that compound interest effect is taken into account.

### **Question 19**

*Do you think that estimating the fair value of biometric risk premiums as stated in paragraph 55(b) of Annex VI would raise any technical or practical difficulties?*

The DAV welcomes that the ESAs acknowledge that the aggregation of the investment costs and the full biometric risk premium would be inappropriate.

From an actuarial viewpoint we would first like to emphasise that considering the full biometric risk premium as cost is not appropriate.

Premiums for protection against biometric risks are not costs as policyholders receive benefit payments from insurance cover in return for these premiums.

Moreover, these premiums are not linked to the costs of the investment element of life insurance contracts. Therefore, it is important to display the total price for protection against biometric risks alongside with the total price of the PRIIP in the “What is this product?” section of the PRIIPs KID.

Separating fair value and costs as suggested by the ESAs is in our view a fall-back solution since this separation is difficult to understand for the retail investor and prohibits the comparison of investment costs.

### **Question 20**

*Knowing that the cost element of the biometric risk premium is included in the total costs calculation, how do you think the investor might be most efficiently informed about the other part of the biometric risk premium (i.e. the fair value),*

*and/or the size of biometric risk premium overall? Do you consider it useful to include the fair value in a separate line in the first table, potentially below the RIY? Or should information on the fair value be disclosed in another part of the KID (for instance, the "What is this product?" section, where the draft RTS currently disclose biometric risk premiums in total, and/or in the performance section)? What accompanying narrative text do you think is needed, and where should this be placed, including specifically narrative text in the cost section?*

The DAV welcomes that the ESAs acknowledge that the aggregation of the investment costs and the full biometric risk premium would be inappropriate.

From an actuarial viewpoint we would first like to emphasise that considering the full biometric risk premium as cost is not appropriate.

Premiums for protection against biometric risks are not costs as policyholders receive benefit payments from insurance cover in return for these premiums.

Moreover, these premiums are not linked to the costs of the investment element of life insurance contracts. Therefore, it is important to display the total price for protection against biometric risks alongside with the total price of the PRIIP in the "What is this product?" section of the PRIIPs KID.

Separating fair value and costs as suggested by the ESAs is in our view a fall-back solution since this separation is difficult to understand for the retail investor and prohibits the comparison of investment costs.

## **Question 21**

*Given evidence as to the difficulties consumers may have using percentage figures, would you prefer an alternative presentation of the second table, solely using monetary values instead? As with the first table, please also explain what difficulties you think might arise from calculating monetary values, and whether this should be on an annualized basis, and if so, how?*

First, we would like to draw the attention to the differences in the visual representation of the risk class and costs of PRIIPs as suggested by the ESAs: While the risk indicator includes only one number corresponding to the total risk of the product and is easy to understand for consumers, the costs are displayed in two tables which not only exceed the requirements of level 1 text but also include 15 numbers in the first table and five numbers in the second table.

It is highly questionable whether the consumer understands this abundance of information and is able to detect the key information on the costs till maturity of the product. Therefore, we urge the ESAs to reduce the complexity of information on costs and to aim at simplification and understandability.

Second, the PRIIPs Regulation on the structure of the KID and ESAs proposal are not in line: The Regulation clearly separates the sections 'What is this product?' with the assumption of a regular holding period and 'How long should I hold it and can I take money out early?'. Therefore intermediate values of the product should be included only in the section on the surrender value of the product.

To ensure consistency with the Regulation as well as understandability and comparability of information for consumers, we recommend displaying the following cost figures:

- RIY for the holding period of the contract, which shows the total impact of costs in percent and includes all costs: direct and indirect, one-off and recurring costs;
- Annualised total costs in monetary terms.

## **Question 28**

*Do you have any comments on the problem definition provided in the Impact Assessment?*

*Are the policy issues that have been highlighted, in your view, the correct ones? If not, what issues would you highlight?*

*Do you have any views on the identified benefits and costs associated with each policy option?*

*Is there data or evidence on the highlighted impacts that you believe needs to be taken into account?*

*Do you have any views on the possible impacts for providers of underlying investments for multi-option products, and in particular indirect impacts for manufacturers of underlying investments used by these products, including where these manufacturers benefit from the arrangements foreseen until the end of 2019 under Article 32 of the PRIIPs Regulation?*

*Are there significant impacts you are aware of that have not been addressed in the Impact Assessment? Please provide data on their scale and extent as far as possible.*

The German actuaries are very concerned about the extremely short period provided to implement the KID for PRIIPs. Comparable experience with a product information document for a German old-age provision product called "Riester-Rente" offered by various manufacturers in the German finance industry and its implementation gives a sound background to point out that three to four months for the industry to implement the KID is unrealistic. Manufacturers will need more time to develop and implement methods which will result in trustworthy, meaningful, comparable, and stable information for consumers.

The DAV, therefore, calls for a one-year extension of the PRIIPs implementation deadline in order to allow the industry to effectively implement the KID.

Furthermore, the DAV would like to highlight its key messages on the key information that are reflected throughout the paper.