Response to the Consultation by EBA, EIOPA and ESMA on the Discussion Paper (JC/DP/2014/02) on Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs).

We are a group of academics, consumers associations, unions and other representatives of investors' interests who want to express a common view about the issues regarding Packaged Retail and Insurance-based Investment Products that have been raised in the consultation report.

On December 4th 2010 and January 31th 2011 we sent two different letters to the European Commission and to ESMA in response to two public consultations on "the selection and presentation of performance scenarios in the Key Investor Information document (KIID) for structured UCITS" and on "the legislative steps for the Packaged Retail Investment Products initiative", expressing in both contributions our shared position about the use of the scenario analysis/valuation matrix (also known as "what-if" analysis) approach to implement the performance scenarios in the KIID for structured UCITs and PRIPs. Also, on 17th June 2013 we submitted a public response to the IOSCO consultation on Retail Structured Products (CR05/13), highlighting our strong preference for the use of probability scenarios as a tool to properly inform the retail investor about the risks of the product.

In these letters we highlighted the inadequacy of the scenario analysis/valuation matrix as transparency tool (question 6 of consultation), since it provides a partial representation of the potential returns of a structured product. We also pointed out that the natural use of the scenario analysis/valuation matrix is inside advertising pamphlets, while its unavoidable arbitrariness makes it of little use in a document (like the KIID for UCITs and the forthcoming KIID for PRIIPs), especially if the final aim of the document is to provide "sufficient information for the average retail investor to make an informed investment decision", (as previously stated in the Consultative Document on PRIPs published by the European Commission on November 26th 2010).

With the present letter, we want to confirm again our reasoned opinion about the usefulness and validity of probability scenarios by responding concretely to the majority of the questions arisen in the discussion paper. As presented in the Annex, the probability scenarios can be supplemented by a couple of quantitative indicators related to the costs and the recommended holding period of the investment, that complete and enhance greatly the information conveyed to the retail investor.

We firmly believe that the main goal of regulation is to provide retail investors with adequate information on the key characteristics of financial products and the associated risks and costs so that they can be effectively supported in the selection of solutions that best suit their needs. This selection cannot avoid a probability judgement from any individual, and each of them, independently from her education, country and social condition would always ask the same question: what are the risks I am going to bear with this investment, with respect to a safer one (question 1 of consultation)? The proper disclosure of the probability distribution in a form that we consider easily understandable from a retail investor (e.g. a table) provides a direct answer to this question, and answering this question must be mandatory for any financial institution proposing an investment. Scenarios can only be stated in terms of probability: transparency has to do with helping retailers to make clear the probability of success of their investments, while a scenario analysis/valuation matrix provides a representation of a single state of the world out of an infinity of other

possible ones, and as such has zero probability; collecting all scenarios and distinguishing among good, bad and fair necessarily leads to a probability table (question 6 of consultation).

Comparison of different products can only be done in terms of probability: in a scenario disclosure, every product is evaluated (and not measured) in a different setting and cannot be compared across different asset classes and products unless all possible scenarios are collected (and measured) in a probability table.

Hence we confirm our view that performance information should not be offered through the scenario analysis/valuation matrix approach (question 6 of consultation). Out of an infinity of possible results of the investment, this approach considers three elementary outcomes, selected at the convenience of the issuer. As witnessed by several studies and by tests on large samples of individuals, this representation fosters biased beliefs, since the three elementary scenarios are perceived as exhaustive of all performances achievable by a product and they are also considered as having the same 33% probability of occurring.

Both these beliefs are clearly false. The probabilistic approach is a much better alternative to concretely support investors, as it encompasses the entire probability distribution of the product's final performances and summarizes it in a set of events (3 or 4, question 11 of consultation) – calculated on a time frame that is specific for each product and corresponds to the recommended holding period (question 8 of consultation) – of significant importance for any investor: for example experiencing a loss (negative return), or getting back the amount invested plus a return below, above or in line with the risk-free. To conduct this partition the safest financial investment (i.e. the risk-free asset, *rfa*) – that at the present date in Europe can be identified in the Overnight Index Swap term structure (OIS) – could be adopted. It allows to identify three to four main performance scenarios (negative return and positive return respectively below, in line and above the *rfa*) each one identified by the associated probability (question 11 of consultation) and by a value (i.e. the conditional expected return of each partition) which synthesizes the returns achievable in that scenario (question 9 of consultation). These are simple and understandable figures allows the investors to understand with what probability he will lose or gain (in this last case by focusing three growing gaining scenario, i.e. lower, in line and above the *rfa*) a certain amount of money in average. With these 8 indicators the probability distribution is partitioned in an adaptive way that is sensible to the changing markets condition and investors are allowed to get a fair comprehension of the performances and risks associated to the product. Anyway, the idea – reported in one the examples – of presenting probability in a number of frequencies (question 13 of consultation) can be considered a second-best option in conveying the necessary information to the investors in a graphical fashion.

The use of a proper partition of the probability distribution offers the most natural way to integrate market and credit risks, since it is built starting from the simulated trajectories of the value of the financial product, that obviously embed the initial and changing market conditions (question 5 of consultation).

Moreover, financial products are designed using probability: any asset manager and structurer address the same basic question as retail investors do: how much am I likely to perform better than other products? Differently from retail investors, they must be endowed with technical tools and skills to provide an answer. So, disclosing this information must be mandatory from a regulatory point of view because sharing this information is mandatory from a deontological point of view. Moreover, given the in-house availability of the mentioned tools and skills, issuers can provide consumers with this key information without any additional burden with respect to their usual pricing and risk management activities. Eventually, the reference to the risk-neutral measure used to calculate the fair price of the product should ensure also consistency across firms and products (question 7 of consultation).

Information on probabilistic performance scenarios should be supplemented by the breakdown of the product price at inception in order to highlight costs and fees (question 18 of consultation). Obviously the fair value of the structured product at the issue date will be the discounted expected value of the final probability distribution under the risk-neutral measure. In this way the investor will be immediately aware that any gap between price and fair value is a cost he is paying, either explicitly or not.

Beside the above information and the present regulation requirements, also the logic of risks representation behind the transparency on structured products and the relevance of investors' liquidity preferences in affecting their investment decisions suggest to include, as further information item inside a short form or summary disclosure, an indication of the recommended holding period of the investment; currently this indicator is prescribed by some national regulators (see in the Annex for a concrete example).

Historical information about the past performances of a structured products should carefully be avoided (question 6 of consultation), since it clearly can be misleading for the investor; past information can be recovered inside a standardized synthetic risk indicator, based on returns' volatility. We agree that, in general terms, volatility is a straightforward indicator of the riskiness of a product, but per se it is just a statistic whose values can be very different depending on the sampling period of the returns and on the number of past observations used. We believe that different valid calibrations of standardized synthetic risk indicators based on volatility could be laid on more robust quantitative methodologies based on forward looking simulations of the potential daily returns of a product over its recommended holding period.

Despite not mentioned in the consultation report, we want to remember that in Italy since a few years the Securities and Exchange Commission (CONSOB) has adopted a risk-based approach to transparency for insurance products as Index and Unit linked, which implements consistently a probability approach[*].

In Annex I to this letter we considered an hypothetical PRIIP and we illustrate, in a table, a short form or summary disclosure filled according to the mentioned CONSOB's approach (question 13 of consultation). It is a very useful example of the importance of choosing the right informative set and the proper solutions to produce and to represent it.

We all hope that our comments and suggestions could help the regulatory Authorities to progress towards the draft Regulatory Technical Standards in the perspective to propose transparency requirements on PRIIPS which would be both objective and useful to retail investors in comparing the various products on a fair basis and in selecting those which better suit their needs.

We firmly believe that these could be crucial steps in the process of fulfilling the prior commitment of EU regulators, i.e. to protect investors and restore their confidence in the financial system by endowing them with the best disclosure tools required to overcome the otherwise unavoidable informational asymmetries they suffer with respect to the subjects who have issued or designed the financial products.

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[*] Technical details about this approach, that address the majority of the questions regarding the implementation of performance scenario via probability, can be found in Minenna M. (2011) "A Quantitative Framework to Assess the Risk-Reward Profile of Non-Equity Products", Risk Books.

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ANNEX I

SHORT-FORM OR SUMMARY DISCLOSURE OF AN HYPOTHETICAL PRIIP

CONSOB RISK-BASED APPROACH†

Product Description
The product has a floor of 80% and a cap of 120% of the amount invested. Its payoff depends on a formula linked to the return of a basket of three shares over the last 4 years.

Product Structure: Return-Target
Investment Time Horizon: 4 Years

Degree of Risk

low	medium-low	medium	MEDIUM-HIGH	high	very high

Unbundling of the price

Riskless component	84.13%
Risky component	10.92%
Total financial value	95.05%
Costs	4.95%
Price	100%

Table of probabilistic performance scenarios

Scenario	Probability	Median Value (w.r.t. 100 €)
The return is negative	42.3%	88 €
The return is positive but lower than the return of the risk-free asset‡	13.8%	103 €
The return is positive and in line with the return of the risk-free asset	29.8%	115 €
The return is positive and higher than the return of the risk-free asset	14.1%	119 €

†CONSOB - Quaderno di Finanza n.63 “Un approccio quantitativo risk-based per la trasparenza dei prodotti non-equity”, April 2009.

‡ The Overnight Index Swap (OIS) term structure is used to identify the risk-free thresholds.