DDV PRIIPs-Report 2

Deutscher Derivate Verband

Initial analysis of proposed Summary Risk Indicator (SRI)

As part of the implementation of the PRIIPs Key Information Document regulation, market participants are given the opportunity to provide comments on the recently published Joint Consultation Paper by the European Supervisory Authorities (ESAs). As representatives of the structured products industry, the DDV will be providing detailed comments on the paper.

This particular report (2) follows our initial analysis of the proposed methodology in the Consultation Paper underpinning the market risk assessments which, together with the credit risk assessment, form the Summary Risk Indicator (SRI). The first report (1) evaluated the Market Risk Measure (MRM) for equities and stock indices with the conclusion that blue chips and broad equity indices fall into the highest risk classes with no differentiation to products with potential losses higher than the invested amount (i.e. CFDs). This report (2) focuses on test calculations of the SRI for products, bonds as well as standard investment funds, also taking into account the Credit Risk Measure (CRM).

MAIN FINDINGS AND CONCLUSION

- **The CRM shows gaps between issuers with similar creditworthiness having huge consequences in the distribution of capital guaranteed PRIIPs. A one notch difference in rating (e.g. A vs. BBB, which is not rare) leads to a gap of two SRI classes, which is a big disadvantage for BBB (still investment grade) rated issuers.** ***[see reference A2 and A3 in the table below]***

- **The MRM provides little or no differentiation between PRIIPs with risk reducing / protection features (barrier products, floored products) and "delta one" investments in the corresponding underlying.** ***[see reference B1 and D1, E1-3, F1-2 in the table below]***

- **The MRM shows counterintuitive results, e.g. a decrease of risk with increasing holding period / maturity for structured products with partial protection. This is misleading for investors and disregards fundamental findings in capital markets' theory and practice.** ***[see reference D1-3 in the table below]***

- **The proposed SRI methodology is very sensitive to only minor adjustments in product features, leading to unintended regulatory arbitrage. For instance, a reduction of protection / barrier levels by 5 % could lead to a drop of 5 SRI classes.** ***[see reference F1-3 in the table below]***

- **We are of the overall opinion that the current SRI approach and corresponding classification scheme are not accurate and reliable and do not comply with the overall aim of comparability among financial products, which was addressed heavily in Level I of the PRIIPs regulation.**

In addition, page 4 of the Consultation Paper indicates the input of the Consultative Expert Group which the ESAs established for advice on the methodologies for disclosure of risks, rewards and costs of retail investment products. We have doubts as to whether the Consultative Expert Group has agreed to this MRM approach. The potential omission of the input would have a strong impact on the reliability of the MRM.

RESULTS AND METHODOLOGY*

Risk indicators were calculated for the following PRIIPs and underlying instruments:

- Bonds: Results are shown for plain bonds with different issuer ratings leading to different values for the CRM class. Funds: Results are shown for UCITS investment funds (money market, bonds and equity funds)
- Equity underlying: Result is shown for EURO STOXX 50 due to its high popularity as an underlying or benchmark for (structured) products.
- Structured Products – Partial Protection Note: Structure with a protection / floor on 45 % of the current underlying level (EURO STOXX 50). Results are shown for different maturities / holding periods.
- Structured Products – Discount Structure: Covered call structure with a product's price below the underlying price and capped participation at the strike level (volatility reducing structure). Results are shown for different maturities / holding periods at a constant strike level of 90 % of the current EURO STOXX 50 level.
- Structured Products – Barrier Reverse Convertible Structure: Structure offers annual coupon payments and pays out the nominal amount at maturity. It includes protection at a certain barrier level at maturity. If the underlying price is below the barrier at the end of maturity, the product pays out the underlying price. Results are shown for different maturities / holding periods and two barrier levels (65 % and 60 % of the current EURO STOXX 50 level).

Product type	Product description	Ref.	Protection feature	Maturity / Holding period (years)	VEV	Risk Indicator			
						SRI	MRM	CRM	Diff: SRI vs. Underlying
Bonds	**Plain Bond** (AAA-rated issuer)	A1	100 %	irrelevant	0 %	**1**	1	1	-
	Plain Bond (A-rated issuer)	A2	100 %	irrelevant	0 %	**1**	1	2	-
	Plain Bond (BBB-rated issuer)	A3	100 %	irrelevant	0 %	**3**	1	**3**	-
Reference: Equity Index	***EURO STOXX 50 (ES 50)*** *(popular underlying for all equity-based structured PRIIPs)*	*B1*	-	*irrelevant*	*21.60 %*	***6***	-	-	-
Standard Investment Funds (Money Market, Bond, Equity)	**Cash EUR** (Money Market Fund)	C1	-	irrelevant	0.04 %	**1**	**1**	-	-
	Eurozone Sovereigns 1-3 (Bond Fund)	C2	-	irrelevant	1.30 %	**2**	**2**	-	-
	Eurozone Sovereigns 3-5 (Bond Fund)	C3	-	irrelevant	2.39 %	**3**	**3**	-	-
	Eurozone Sovereigns 10-15 (Bond Fund)	C4	-	irrelevant	6.25 %	**4**	**4**	-	-
	Global Equities (Equity Fund)	C5	-	irrelevant	14.73 %	**5**	**5**	-	-
	Eurozone Equities (Equity Fund)	C6	-	irrelevant	19.97 %	**6**	**6**	-	-

Product type	Product description	Ref.	Protection feature	Maturity / Holding period (years)	VEV	Risk Indicator			
						SRI	MRM	CRM	Diff: SRI vs. Underlying
Structured Products (Partial Protection Note)	**Partially protected ES 50 tracker** (A-rated issuer)	D1	45 %	1	15.90 %	6	6	1	0
	Partially protected ES 50 tracker (A-rated issuer)	D2	45 %	5	10.08 %	5	5	1	-1
	Partially protected ES 50 tracker (A-rated issuer)	D3	45 %	10	7.00 %	4	4	1	-2
Structured Products (Discount Structure)	**Discount Certificate** (A-rated issuer, strike 90%)	E1	Volatility reduction	1	15.67 %	6	6	1	0
	Discount Certificate (A-rated issuer, strike 90%)	E2	Volatility reduction	3	17.00 %	6	6	1	0
	Discount Certificate (A-rated issuer, strike 90%)	E3	Volatility reduction	5	17.95 %	6	6	1	0
Structured Products (Barrier Reverse Convertible)	**Barrier Reverse Convertible** (A-rated issuer, barrier 65%)	F1	Barrier/Partial protection	1	21.58 %	6	6	1	0
	Barrier Reverse Convertible (A-rated issuer, barrier 65%)	F2	Barrier/Partial protection	3	19.26 %	6	6	1	0
	Barrier Reverse Convertible (A-rated issuer, barrier 60%)	F3	Barrier/Partial protection	1	0.00 %	1	1	1	-5
	Barrier Reverse Convertible (A-rated issuer, barrier 60%)	F4	Barrier/Partial protection	3	19.29 %	6	6	1	0

*As opposed to the formula given in the Consultation Paper, the assumption of log normal underlying prices (instead of normal distribution) is used for calculating the VaR Equivalent Volatility (VEV). This approach consistently follows the model prescriptions within the Consultation Paper. VEVs for products without a predefined maturity are calculated on the basis of a recommended holding period of 5 years using underlying price spaces.

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