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European Association of Co-operative Banks comments on

Consultation Report

Regulation of Retail Structured Products

Ref.: IOSCO – CR05/13 – April 2013

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The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.000 locally operating banks and 72.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 217 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 56 million members and 858.000 employees and have a total average market share of about 20%.

EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149 • lobbying register 4172526951-19
www.eacb.eu • e-mail : secretariat@eurocoopbanks.coop

General Remarks

The Members of the European Association of Co-operative Banks (EACB) are pleased to receive the opportunity to comment on IOSCO's *consultative report on Regulation of Retail Structured Products*.

EACB welcomes IOSCO's consultative report aiming towards more efficient selling practices in order to enhance investor protection for retail clients, as we agree with the envisaged introduction of a level playing field concerning the rules for the sale and disclosure requirements for retail structured products.

European co-operative banks are characterised by a decentralised network of branches with a very strong retail base serving approximately 181 million retail clients in the European Union. Co-operative banks are therefore amongst the major distributors of a large variety of retail investment products.

While we appreciate IOSCO's reflections and proposed ideas, we would like to draw attention to the European Union's wide-reaching activities in the areas covered under this consultation. From a European perspective, some proposed provisions are already covered under the Market in Financial Instruments Directive (MiFID) and UCITS IV legislation (which requires Key Investor Document for European investment funds) while others are currently discussed in the MiFID revision and the Key Investor Document (KID) initiative which aims to provide a KID for all structured products sold to retail investors.

Detailed Remarks

Please find below our detailed remarks to the posed questions.

Question 1

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?

EACB is unable to comment on survey results of national markets and jurisdictions.

Question 2

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?

EACB is in favour of a level-playing field for all participants, as we consider regulatory arbitrage an issue that needs to be addressed appropriately at EU and on an international level.

Question 3

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?

In general, we can agree with IOSCO's suggestion of a value-chain approach to address every step of the product's lifecycle. Nonetheless, this approach needs to clearly distinguish the responsibilities connected to each part of the chain together with who will take liability for these actions. We are clearly against nominating several players in this value-chain to be responsible for the same task (i.e. the production of the disclosure documents should lie with the product manufacturer/issuer and the not the distributor). Only through this approach can a coherent value-chain approach be guaranteed.

Question 4

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?

Investment products are created to suit investors' needs and demands in order to be successful in the market. Therefore issuers/product manufacturers already need to analyse and evaluate these prior to designing appropriate products.

Question 5

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.

The use of modelling certainly has its benefits in specific cases such as highlighting the impact of a certain possible future scenario on the investment return. We would nonetheless argue that modelling is more beneficial in the product creation than distribution stage. Requirements for such disclosure should nonetheless never be of too descriptive nature, as models are subjective, as they look only at a certain scenarios through the use of a certain set of variables. We would argue against the use of models in conjunction to a product's performance, as this hypothetical scenario could be misconstrued as some sort of performance guarantee by investors.

Question 6

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 already exist with all our manufacturers/issuers and are applied each time a new product is created.

While we agree with internal approval processes, we cannot agree with regulatory pre-approval. We believe that product manufacturers and issuers should have the chance to react quickly to changing demands in the market and provide clients with tailor-made products. Pre-approval would create a substantial delay for bringing a product to the market in a timely manner. Furthermore questions arise when deliberating the criteria and standards that this approval process should be based on. It might be the case that the standards which are considered appropriate for the retail market at a given time might change over time, therefore making these pre-approval standards defunct. Besides, it also has to be considered that investors could also start to mistake a pre-approved product with a product suited to their individual investor needs which might lead to a wrong investment decision.

Question 7

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?

We believe that product setting standards are inhibiting product innovation, which in turn inhibits the development of new products hindering competition between different manufacturers/issuers. We are rather of the opinion that regulators could set disclosure standards to enable investors to easily compare different products' features, risks and costs.

Question 8

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?*

The European Union already has extensive disclosure standards. While currently all UCITS investment funds have to be accompanied with a 2-page Key Investor Document (KID), the current PRIPS initiative is extending this idea to all structured products sold to retail investors.

Question 9

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?

While we agree, in principle, with summary disclosure, we would like to highlight the difficulties in condensing the legally required (and sometimes extensive) disclosure documents into two to three-page summaries. In order to make this task achievable, there has to be no direct liability to the product manufacturer/issuers resulting when simplifying certain elements in the summary document. We see this document as a starting point for disclosure information that should pinpoint the investor to other sources of information (such as the full disclosure documents). We therefore would like to highlight the EU's UCITS KID liability which only make the product manufacturer liable if wrongful information is presented in the KID.

Question 10

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.

For some investment products such as those involving a derivative – which is a common feature in retail structured products, especially in those with a capital guarantee – there is no explicit cost. It can be argued that there are mainly 'implicit' costs. This means that the client gets exposure to a given financial asset and this exposure embeds a cost in terms of the existence of different conditions than those of the market (i.e. degree of exposure, options' strike level, other options such as knock-in clauses, etc.).

However, these costs can be very difficult or impossible to measure because (among others facts):

- The existence of a ”commercialisation period” (again a common feature for some retail structured products) within which the producer engages itself to maintain the offered terms and conditions, irrespective of market fluctuations. This results in different ‘implicit’ costs for each client, because the implicit value of the embedded derivative exposure relative to market value is different for each contract.
- Moreover, even in the case that the product was designed with exactly the same prices as the market prices for the manufacturer, the retail structured products product tends to be a ”funded” investment while the manufacturer only hedges the derivative (unfunded) side of the product (for example, in a structured deposit or bond). That means that the client can have an implicit ‘opportunity cost’ in terms of the interest he/she could obtain in an alternative investment, but this cost could be calculated with different methods with different results.
- Market prices in derivatives are neither established benchmarks nor standardised references, which furthers complicates the calculation of the implicit ‘costs’ involved. For example, the manufacturer would obtain a different market quote for a € 10 million global transaction (hedging the investments of 1.000 clients) than for a € 1 million one, being both exactly the same underlying investment. The manufacturer could even decide not to hedge its position, having then to assess which market reference to calculate implicit costs with, while due to the very customised and non-standardised characteristics of these investments, there might not exist real transactions on that product.
- Retail structured products do offer to the client an exposure to an underlying investment. However, the structuration of this exposure through PRIPs allows retail clients to gain it in a very cost-efficient way, even better than they could get it in the financial market. In this sense, the implicit ‘cost’ is most of the times an implicit ‘saving’ for retail investors.

Question 11

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?

We would argue that some of the same problems as in trying to produce disaggregated costs, are also present in calculating the fair value. As a fair value calculation can be approached on a number of different ways, these valuation approaches might differ significantly from one product manufacturer/issues to the other. We believe that this could also lead to significant confusion with the investor.

Question 12

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.*

We can generally agree that the disclosure of scenarios might help the retail client understand the performance of an investment product under certain conditions. Nonetheless, we would like to reiterate our answer to Question 5 in which we highlighted the problem that scenarios are not predictions of the future. It has to be ensured for the sake of investor protection that these scenarios cannot be misconstrued as performance guarantees by retail clients and therefore lead to misguided investment decisions.

Question 13

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?

While we agree with the concept of backtesting, we have strong reservations whether retail investors would benefit from the disclosure of information, as this would draw away attention from more important key features.

Question 14

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?

We believe that a better understanding of not only retail structured products, but also other financial instruments (and even the working of banks in relation to lending and borrowing) could be achieved through financial education.

Nevertheless, the ideas presented in the consultation report on page 51 bear some shortcomings. Firstly, mandatory programmes could lull investors into a false sense of security which could ultimately lead to a situation where investors are less willing to inform themselves about a specific product. Secondly, it is unclear, how it can be ensured that the content of these learning modules is always up-to-date, considering the rapidly changing product environment and its legal basis. Who should be liable for the up-to-datedness and correctness of these learning material?

Besides, we think that the freedom of choice of individual investors should not depend on the attendance to any particular course. We consider especially inappropriate, if the distributors of financial products should be responsible to prove the successful attendance of investors to such courses.

Question 15

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 type of requirements? Would the requirements have an effect on distributor behaviour?*

We are completely against requiring or encouraging product manufacturers/issuers to take responsibility of all possible distribution channels, as he is not in a position to restrict these channels. As already highlighted above, we are for a strict separation of liability between the different player and would therefore leave this responsibility solely in the hands of the distributors.

Question 16

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 would like to caution that all requirements in relation to post-sales activities have to be looked at with caution. Current legislative models of sales of retail structured products distinguish between once-off investment advice and on-going portfolio management. We therefore believe that a once-off investment advice should not lead to extensive post sales requirements that would lead to more information being automatically sent to the investor without the help of his/her adviser to interpret this information correctly.

Contact

The EACB trusts that its comments will be taken into consideration. Should there be any need for further information or any questions on this paper, please contact:

Ms Marieke VAN BERKEL
Head of Retail Banking, Payments and Financial Markets
m.vanberkel@eurocoopbanks.coop

or

Mr Andreas STEPNITZKA
Senior Adviser for Financial Markets
a.stepnitzka@eurocoopbanks.coop