FINANCIAL
SERVICES
AND
MARKETS
AUTHORITY

Communication

FSMA_2023_23 of 3/10/2023

Study on the costs of structured debt instruments

Summary/Objectives:

The European Commission's ‘Retail Investment Strategy Package’, published on 24 May 2023, highlights amongst other the importance placed, at a European level, on the costs associated with investment products and the impact these may have on the value for money these products offer. The FSMA also devotes particular attention to this subject, to avoid products with unjustifiably high costs being offered to retail investors. In this context, the initiative was taken to conduct an analysis into the costs of structured debt instruments.

The FSMA has studied the costs of structured debt instruments offered to the public in Belgium, using the ‘Reduction in Yield’ (RIY) measurement. The analysis was conducted on 806 structured debt instruments offered to the public in Belgium between 1 January 2018 and 31 December 2022, with a KID notified to the FSMA.

The FSMA found that the costs remained on average relatively stable between 2018 and mid-2022 with a slight downward trend, which reversed towards the end of 2022, coinciding with the interest rates going up.

The average RIY of the 806 products studied was 0.72%, with half of the products having an RIY between 0.48% and 0.94%. The study also highlighted the fact that the costs vary significantly depending on the distributor.

An analysis of the different potential determining factors of the RIY shows that the costs were on average relatively higher for structured debt instruments that:

- are riskier and do not confer a right to 100% repayment of the capital at maturity;
- have a shorter maturity;
- are denominated in foreign currencies;
- have a customized or benchmark index as underlying.

These findings have not, however, been observed in the same proportion across the entire sector.

In the design of a product (which includes the determination of costs), there is a conflict of interest between the issuer and/or distributor, whose objective is to earn the highest possible margins, and the retail investor, who seeks to invest in a product offering the best possible conditions. To ensure that the interest of the customer is safeguarded in this sense, the FSMA is of the opinion that the choice of characteristics of a product should in principle not be influenced by the margin that the issuer and/or distributor can obtain on a structured debt instrument, and that the price paid for the additional risk taken by the investor should be fully devoted to structuring a more attractive pay-off.

When a structured product is distributed, the FSMA will continue to ensure that the costs inherent to structured products remain at a level at which customers' interests are properly taken into account as part of the product governance process. In its further supervisory action, the FSMA will focus particular attention on issuers and distributors that market structured debt instruments with costs that differ from the rest of the market.

---

1. The European Commission's 'Retail Investment Strategy Package' raises the issue of financial products with excessive costs, reducing their value for money.

On 24 May 2023, the European Commission published various proposals under its Retail Investment Strategy Package initiative. As part of this work, the European Commission identified four major issues that prejudice consumers and their possibility of benefiting from the investment opportunities offered by the capital market. One of the findings reveals that certain investment products destined to retail investors entail excessive costs that cannot be justified and/or do not offer sufficient value for money to the investor. The European Commission therefore proposes strengthening the product governance rules by introducing the obligation for producers and distributors to identify and quantify the costs of each product and prove that it offers value for money to the target market by comparing its costs and performance to a relevant benchmark representative of the market. Products with costs and performance that differ from the benchmark, and therefore underperform the market, should not be offered and if they are, the producers/distributors would have to justify their choice to offer the product despite this fact.

The proposals under the 'Retail Investment Strategy Package' show the importance placed, at a European level, on the issue of costs and their potential impact on the value for money of a product.

For the FSMA as well, the costs of investment products are a major concern, especially with regard to assessing a product's value for money. The FSMA considers it necessary to focus particular attention on this subject in order to avoid products with unjustifiably high costs being offered to retail investors. With the publication of its press release 'The FSMA launches 20 projects for the future' the FSMA already explained the importance it places on the subject, through the presentation of its 5th theme 'simple and cost-transparent financial and insurance products'.

In this context, the initiative was taken to conduct an analysis into the costs of structured debt instruments in order to identify the different market practices and trends observed in this market and present the conclusions that can be drawn from this.

2. Product governance for structured debt instruments: the basis has been established, but there is still room for improvement in the justification of the pricing structure

Since June 2011, the FSMA has been inviting Belgian financial market operators to sign on to the moratorium on the distribution of particularly complex structured products in Belgium. The moratorium was set up to limit the distribution of particularly complex structured products and allow investors to gain a better insight into the costs, credit risk and market value of structured products. Since then, the FSMA continuously verifies whether the distributors that have signed on to the moratorium are complying with it, and conducts detailed product analyses to evaluate compliance with the moratorium.

During specific checks in 2020 however, the FSMA identified that certain structured products were accompanied by high costs and that there was room for improvement in the governance of these products. In October of that same year, it issued a communication to remind of the product governance rules to be complied with when offering structured products in Belgium[1].

In July 2022, the FSMA summarized its main findings from the inspections conducted as part of a Common Supervisory Action. Producers and distributors of structured debt instruments do not sufficiently document and justify the way in which they examine the pricing structure on the basis of the needs, characteristics and objectives of the intended target market. The same applies to the way in which they verify that the pricing structure does not compromise the expected return from the product. In a limited number of cases, the company did not take into account all costs, including the distribution costs above the par value, to conduct an evaluation. The FSMA has made recommendations concerning these points.

To complement this bottom-up approach, the FSMA is now setting out a number of recommendations based on the present study to producers and distributors of structured debt instruments on the subject of product governance.

The data analysis from this study is based on the standardized RIY as included in the PRIIP KID of 806 structured notes

The FSMA is increasingly developing data-driven methods of supervision. Since the entry into force of Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (hereinafter referred to as the 'PRIIPs Regulation') in January 2018, manufacturers[2] of structured debt instruments must prepare a Key Information Document, or 'KID', to be sent to investors intending to invest in such a product. Article 37sexies of the Law of 2 August 2002 provides that the KID prepared under the PRIIPs Regulation must be previously notified to the FSMA, with the exception of certain cases. The KID for structured debt instruments offered to the public does not come under these exemptions and must therefore be notified to the FSMA.

The KID contains a section about costs, which includes 2 tables. These tables contain a cost indicator that uses the Reduction in Yield or 'RIY' method. This method consists of calculating the difference between a product's yield, with and without taking into account the different costs associated with it. This represents a 'loss' of yield due to costs. This indicator is standardized and incorporates all the costs associated with the products, in so far as they are known to the manufacturer. It should be noted that any foreign exchange costs that apply for products denominated in a foreign currency, where the investor does not have liquidity in that currency, are not included in the RIY calculation.

The RIY is an annualized measurement: it indicates the per-annum loss of yield due to costs. Because of its intrinsic characteristics, the RIY enables a study to be made comparing the costs between the

[1] Communication FSMA_2020_14 of 20 October 2020 'Reminder of the product governance rules that apply when offering structured products in Belgium'.

[2] The PRIIPs Regulation defines the manufacturer as any entity that manufactures PRIIPs or any entity that makes changes to an existing PRIIP.

different products and the different issuers and distributors. ESMA also used the RIY as a basis to analyse the costs of structured debt instruments marketed across the different Member States[3].

Between 1 January 2018 and 31 December 2022, there were 806 notifications to the FSMA of KIDs for structured debt instruments offered to the public. The RIY (on maturity) stated in these KIDs is the basis for the present study.

Since the entry into force of the PRIIPs Regulation, the FSMA has identified different market practices when it comes to inclusion or non-inclusion of the distribution costs charged to the customer above the par value of the product in the calculation of the RIY. These different practices led to the FSMA needing to make corrections in order to ensure harmonization of the data across the different distributors and issuers for this study. More specifically, in the case of distribution costs above the par value not being included in the RIY calculation, the FSMA recalculated the RIY in order to take into account their impact on the RIY.

To adhere to the spirit of the text of the PRIIPs Regulation, which aims to provide investors with an exhaustive and comparable cost indicator, it is good practice to include all costs in the RIY calculation.

In order to identify market trends in terms of costs and determine the characteristics that significantly influence costs, the FSMA has analysed the link between the costs of structured debt instruments (calculated based on the PRIIPs method) and the following product characteristics:

- a right to 100% repayment of the capital at maturity;
- duration;
- currency;
- issuer;
- distributor;
- underlying.

The averages of the costs included in this study are weighted by the number of products and not by the volume issued. As a result, the most active players on the market in terms of number of issues are more represented, even though there are significant differences in terms of the volume issued per product. Among the 20 issuers and 13 distributors that have launched structured debt instruments on the Belgian market during the period concerned, the most active as a distributor and issuer offered a little more than a quarter of the products (212 products), whilst certain distributors or issuers sometimes only offered one product over this period.

3. Findings arising from characteristics of the global market

a. The average RIY was 0.72% but an upwards trend is observed at the end of 2022

The FSMA found that:

[3] https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1677_asr_performance_and_costs_of_eu_retail_investment_products.pdf

- during the period studied, investors paid very different costs depending on the structured product chosen, with an RIY going from 0.02% to 2%. The average RIY for the 806 products studied was **0.72%.** This average is close to the observed median (0.69%). Half of the products had an RIY between 0.48% and 0.94%, whilst an RIY of 1.16% or higher was found in one tenth of the products studied;
- extreme values (above the double of the average) were identified in a limited number of products. We note that these extreme values concerned specifically two distributors and/or products with a particularly short duration. It was also found that certain issuers that are less active on the Belgian market apply costs significantly higher than the average;
- over the entire period from 2018 to mid-2022, which was characterized by persistent low rates, **costs show on average a slight downward trend**. However, the FSMA has seen this trend reverse in the second half of 2022, which coincides with an economic context of interest rates increasing. This new economic context gives market players the opportunity to offer structured debt instruments with a potential return that is at least as much as in the recent past, while allowing them to earn higher margins.

The spread of the RIY values seems to indicate that there may be certain characteristics that make the costs vary considerably from one product to another. This study sought to identify the characteristics that could significantly influence costs.

b. <u>Costs vary more significantly by distributor than by issuer</u>

The FSMA found that:

- one distributor came out considerably above the market average with a significantly higher average RIY (1.10%). The least costly distributor also deviated from the average (0.43%). These differences in costs can also be observed, albeit to a lesser extent, among issuers. The issuer with the highest costs had an average RIY of 0.96%. Certain issuers that are less active in Belgium apply costs significantly higher than the average;
- we can also see that certain distributors call on external issuers, i.e. that do not form part of the same financial group, to offer structured products to their clientele. Others exclusively distribute products issued by an entity that belongs to the same financial group. In the first case, debt instruments have a tendency to entail higher costs.

These relatively significant differences in costs between distributors (or issuers) calls into question the effectiveness of competition in the market. In the current Belgian context, it seems unlikely that an investor would compare all structured products on offer before deciding to buy. On the contrary, the investor will no doubt be the customer of a limited number of distributors and will, as a rule, only have easy access to the products offered by these distributors. **To encourage investors to evaluate the costs of structured products, the FSMA has published a communication on the results of this study, directed at retail investors.**

4. Findings arising from specific product characteristics

a. <u>Certain distributors apply higher costs to products with no – or only partial – capital protection</u>

The FSMA found that:

- among the 806 products analysed, two thirds offered a right to full repayment of the capital (or more) on maturity, whilst those with a partial right to repayment (above 0% and below 100%) represented one fifth. The 86 products with no capital protection were exclusively distributed by 5 distributors, with one representing the bulk of these with more than half of the products;
- we can see that on average, the lower the right to repayment of capital, the higher the RIY. As a result the products that:
  - offered a minimum of 100% repayment had an average RIY of 0.70%;
  - offered no right to repayment of the capital, or a right to repayment of the capital lower than 100%, were 7bps more costly, i.e. with an average RIY of 0.77%.

As this finding was not observed across the board for all distributors/issuers, it needs to be qualified. An analysis of the correlation between the level of right to repayment of the capital and the level of costs per distributor highlights a major disparity: for a limited number of distributors, it can clearly be seen that the level of right to repayment of the capital has a major effect on the level of costs, whilst for other distributors, this correlation is less apparent.

For products without full capital protection, issuers have a broader structuring margin given that a lesser – or no – part of the amount subscribed by the investor had to be used to partially – or not at all – repay capital on maturity. The ensuing amount available was either able to be invested in derivatives to potentially generate a higher return for the investor, or kept by the distributor and/or issuer as part of their margin. The present study seems to show that over the past 4 years, the second option was favoured by a limited number of distributors.

b. Products with a short maturity have higher costs

The FSMA found that:

- over the past 5 years, issuers and distributors have mainly offered mid-term or long-term products, ranging between 6 and 10 years;
- as the maturity went up, the RIY went down. For 5-year products, it was 0.89%, then 0.76% for 6-year products and 0.60% for 10-year products;
- the correlation between product duration and costs is more apparent when the analysis is made per distributor.

As can be expected, the amortization of the one-off costs borne by the distributor and/or the issuer (for example marketing expenses, regulatory expenses or product structuring expenses) over a longer period appears to be the cause of a lower RIY for products with longer maturities.

On the other hand, as with structured debt instruments with a lower than 100% right to repayment of the capital on maturity, a longer product duration allows the creation of a product with a lower savings component, which offers the issuer and/or distributor the possibility of charging higher costs, whilst keeping the potential return unchanged.

Different market practices observed with regard to early redemption costs applied

The FSMA found different market practices in the way distribution costs are applied in the case of early redemption. Certain distributors apply distribution costs payable by investors when subscribing to a product, but that will not be repaid pro rata to the remaining duration in the case of early redemption (these are called 'upfront' costs). Other distributors charge 'recurring' distribution costs, which allows the investor to recoup part of the distribution costs corresponding to the remaining duration of the product in the case of early redemption.

A choice by the distributor not to repay these costs pro rata is not in any case to the benefit of customers, and penalizes them in the case of early redemption. Moreover, the data from this study do not show that products with non-refundable distribution costs are less costly than products with 'recurring' distribution costs. The FSMA cannot rule out that non-repayment of costs is a strategy to increase the distributor's margin, without taking the investor's interests into account.

c. Higher costs for foreign currency products

The FSMA found that:

- Over the past 5 years, the large majority of structured debt instruments (80%) were issued in euros, 15% in US dollars, and a little less than 4% in Norwegian Krone;
- structured debt instruments issued in foreign currencies, the large majority of which in Norwegian Krone and US dollars, included higher costs than products issued in euros;
- an issuance in a foreign currency that has higher interest rates than the euro[4] gives issuers a higher amount for the derivative, which would give them the opportunity to earn a higher margin while giving an identical pay-off.

d. Lower costs for interest rate products

The FSMA found that:

- between 2018 and 2022, at more than 40% of products issued in the period, the most recurring type of underlying was a customized index[5]. The other types of most commonly used underlying's were benchmark indexes and interest rates;
- products with an interest rate as an underlying had, on average, lower costs than other products. However, for interest rate products, the right to repayment of 100% of the capital on maturity was always offered. For these products, it is therefore difficult to ascertain whether the costs are determined by the capital protection or the underlying;
- the difference between the costs of stock index products and interest rate products could partly be explained by the index licensing fees.

5. The FSMA's supervisory approach and recommendations

[4] Foreign currency interest rates were higher over the period studied than those that applied to the euro. As a result, the value of the savings component of the structured debt securities issued in foreign currencies was lower than that for products issued in euros.

[5] As a reminder, these are complex and customized indexes that concern one or more investment themes and that are established by algorithms using complex mathematical calculations based (for example) on the volatility of—and dividends from—the shares they are made up of.

In the design of a product (which includes the determination of costs), there is a conflict of interest between the issuer and/or distributor, whose objective is to earn the highest possible margins, and the retail investor, who seeks to invest in a product offering the best possible conditions.

As a result, as part of the product governance process, when a structured product is distributed, the FSMA will continue to ensure that the costs inherent to structured products remain at a level at which customers' interests are properly taken into account.

Rate increases or improvements in market conditions should be used for the benefit of the customer, by offering a more attractive pay-off, whilst the issuer's and distributor's margin should remain stable.

Based on the findings in the present study, the FSMA recommends:

- **that the absence of capital protection on maturity is not used for the distributor or the issuer to earn a higher margin on the products, but serves to offer a higher potential return to the investor;**
- **that the decision of the distributor not to repay the costs pro rata in the case of early redemption is justified under the product governance process;**
- **that the distributor/issuer ensures that the costs are not higher for products issued in a currency with rates higher than the euro.**

6. Conclusion

Partial capital protection, issuance in a foreign currency or longer duration increases the risk associated with the structured debt instrument. This additional risk gives the issuer and/or the distributor the opportunity either to offer a higher potential return to the investor, or to earn a higher margin for an equivalent potential return. In view of this conflict of interest between the issuer/distributor and the investor, the latter's interests should be safeguarded.

The FSMA recommends that issuers and distributors ensure that the additional risk taken by the investor is fully allocated to structuring a higher potential return.

Moreover, the FSMA wishes to indicate to the sector that when designing a product, the interests of the customer should prevail, and any increase of rates or improvement of market conditions should lead issuers and distributors to offer structured debt instruments with a higher potential return.

Finally, the MiFID legislation sets out that distributors and producers must ensure that costs are compatible with the needs, characteristics and objectives of the target market. In the presentation of the Retail Investment Strategy Package by the European Commission, which indicates that structured debt instruments with unjustifiably high costs do not always offer value for money to the retail investor, the justification of costs was also highlighted. The margins earned by the issuer/distributor depending on certain product characteristics, unless justified by other aspects, go against this principle. For debt instruments with one or more of these characteristics, distributors and producers should be particularly attentive to justifying these higher costs.