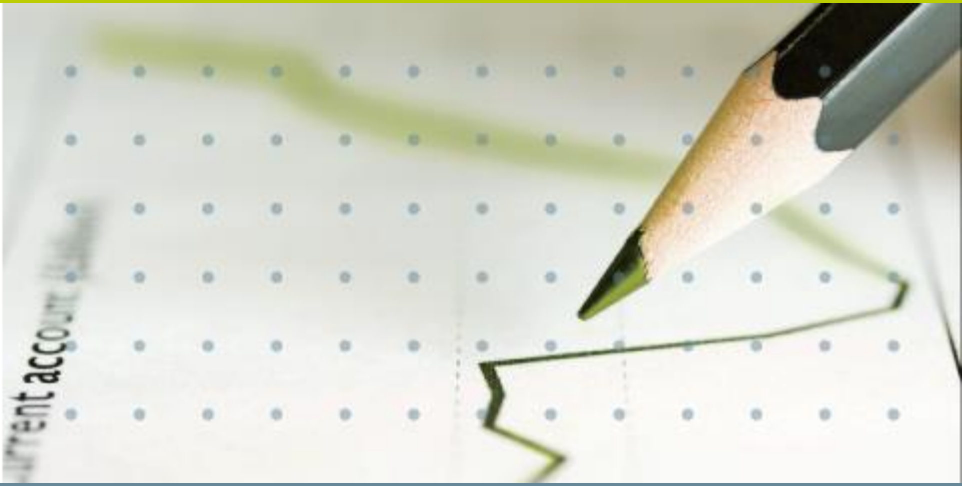
Webinar
Recent trends in the supervision and supervisory techniques of the FSMA

FSMA

FINANCIAL SERVICES AND MARKETS AUTHORITY



Jean-Paul SERVAIS

Chairman of the FSMA

23/06/2022

Publication of the Annual Report

- The FSMA has today published its 2021 annual report (available in French – Dutch only)
- The highlights of the annual report are introduced succinctly in a video message on the FSMA website
- The full text of the report is also available on the same webpage
- In this webinar, we focus on a few recent developments in the FSMA's supervision:
  - MiFID: positive trends and points needing improvement
  - Data analytics: innovative methodology for detecting closet indexing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2021

MiFID:
Positive trends & points for improvement

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Context (1)

- The importance of offering the right products to the right people has always an been important element of the FSMA's policy
- That is why, since its creation in 2011, the FSMA has conducted inspections on the following themes:
  - conflicts of interest
  - duty of care
  - product governance
  - information to clients
- Information brochure:

Context (2)

- After a series of inspections on a given theme, the FSMA publishes its results and recommendations, where relevant, in a sectoral report for the entire sector

- The FSMA will shortly be publishing 3 such sectoral reports on:
  - the **appropriateness assessment** (e.g. do clients understand what they are buying?)
  - The **suitability assessment** (e.g. does the client have the financial capacity for the investment in question, and does the latter fit with his/her investment objectives?)
  - **Product governance** (e.g. has a financial product been developed in the interest of clients?)

Context (3)

No assessment

(Execution only)

Transactions in non-complex financial instruments at the client's initiative

Appropriateness assessment

Transactions in complex financial instruments

- Or in non-complex financial instruments at the firm's initiative

Suitability assessment

Transactions with investment advice

Transactions with portfolio management

Appropriateness assessment (1)

- **How?** How well **do investors understand the products in which they are investing** and how do firms measure clients' knowledge of categories of products that are more difficult to understand (e.g. options, swaps, etc.)?

➔ **Is the investment 'suitable' for the client?**

- **Developments**: in the past decade, there has been **solid progress** in the structure and quality of questionnaires testing clients' knowledge.

Appropriateness assessment (2)

Points requiring improvement: there is **room for improvement**:

- Financial products are sometimes placed in the **wrong category**, as a result of which:

  ⇨ they could be wrongly considered non-complex

  ⇨ knowledge test does not cover the exact characteristics of the product

- In the case of **phone orders,** clients do not always receive a warning

- **Storage of client data could be improved**

Suitability assessment (1)

- **What?**
  - **Does the client understand the product categories** about which he/she is requesting advice from the bank?
  - Can the client bear the financial **risks** associated with his/her investment?
  - Can the client **do without the sum invested for long enough** and is the recommended product in line with the **objective** of his/her investment?

➔ Is the recommended investment 'suitable' for the client?

- **Developments**: in the past decade, there has been **positive development** in compliance with conduct of business rules (high-quality questionnaires, automated systemic checks, timely provision of information).

Suitability assessment (2)

Points requiring improvement: the new **MiFID II** rules in particular remain a challenge, such as:

- The **possibility of alternative investments**, taking into account the costs and complexity of the financial instruments, are not given sufficient attention.

- There is **insufficient cost-benefit analysis** where an investment in the portfolio is replaced by another (switching), as a result of which there is a combination of a purchase and a sales transaction.

- **Insufficient explanations** are provided as to why a given product is suitable for the client. Such explanations must be provided in the suitability statement.

Product governance (1)

- **What?**
  - Are the products developed by firms and included among the products they offer **in the client's interest**?
  - Can they meet a specific **need on the part of a client**?
  - Are the **costs associated with the product reasonable**?

- **Developments**: The foundation has been laid, but a number of **processual aspects need improvement**, certainly when it comes to structured debt instruments

Product governance (2)

Points requiring improvement: more attention needs to be paid to:

- **Justifying the cost structure:** the focus is still too much on what a product yields for the bank, rather than on the underlying needs of the client. **The remuneration for the bank is sometimes very high**, but is the client's interest still the priority?
- The **identification of client needs:** banks **do not sufficiently document the needs of their clients** and how their products meet those needs

Product governance (3)

- **Complexity that is specific to structured debt instruments** (e.g. complex underlyings, such as **house indices**): this is not taken sufficiently into account when determining the target market and distribution strategy

- **Use of scenario analysis**: product developers are required to carry out an analysis of the expected return of a product under various scenarios (e.g. a favourable, neutral and unfavourable scenario). **If a neutral scenario suggests a negative or very low return for a product, firms must be able to demonstrate that the product is nevertheless in the interest of a given target group**.

Measures (1)

- Every inspection leads to an **individual report** with measures to be taken. Firms must submit a **recovery plan** on which the FSMA will carefully follow up.
- **3 types of measures** in the inspection reports:
  - **Order**: the FSMA orders recovery measures to be taken by a deadline that it imposes
  - **Recommendation**: identifies shortcomings in internal control. The FSMA expects the firm to draw up an action plan for addressing the shortcomings
  - **Point requiring attention**: point brought to the attention of management without an action plan being required over the short term

- Overview of measures in the latest inspection cycle

	Appropriateness Assessment	Suitability Assessment	Product Governance	Total
Orders	9	11	10	30
Recommendations	23	32	10	65
Points for attention	10	13	4	27
Total	42	56	24	122

Measures (2)

- The FSMA also adopts **sanction measures** where necessary in response to its inspections and publishes any agreed settlements on its website

- Recent examples of significant **agreed settlements** relating to the MiFID rules:

Year	Sum	Comments
2020	EUR 800,000	Shortcomings in applying MiFID I and II rules (including failure to collect information on client's knowledge)
2022	EUR 500,000	Non-compliance with MiFID rules of conduct regarding suitability and appropriateness of the services

Conclusions

- In the past ten years, there has been **a positive trend** in compliance with the MiFID rules of conduct, which have come to be better integrated into the sector and have proven their added value.

- **There remain a few points requiring improvement.** Several of those points concern the way in which products are developed (product governance), including the associated fees and potential return.

- **The FSMA explains all these points for improvement in detail** in three sectoral reports that are soon to be published, and **will carefully monitor compliance with these points** during its future inspections

Data Analytics: Innovative methodology for detecting Closet Indexing

FSMA

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Jean-Paul SERVAIS

Chairman of the FSMA

Context

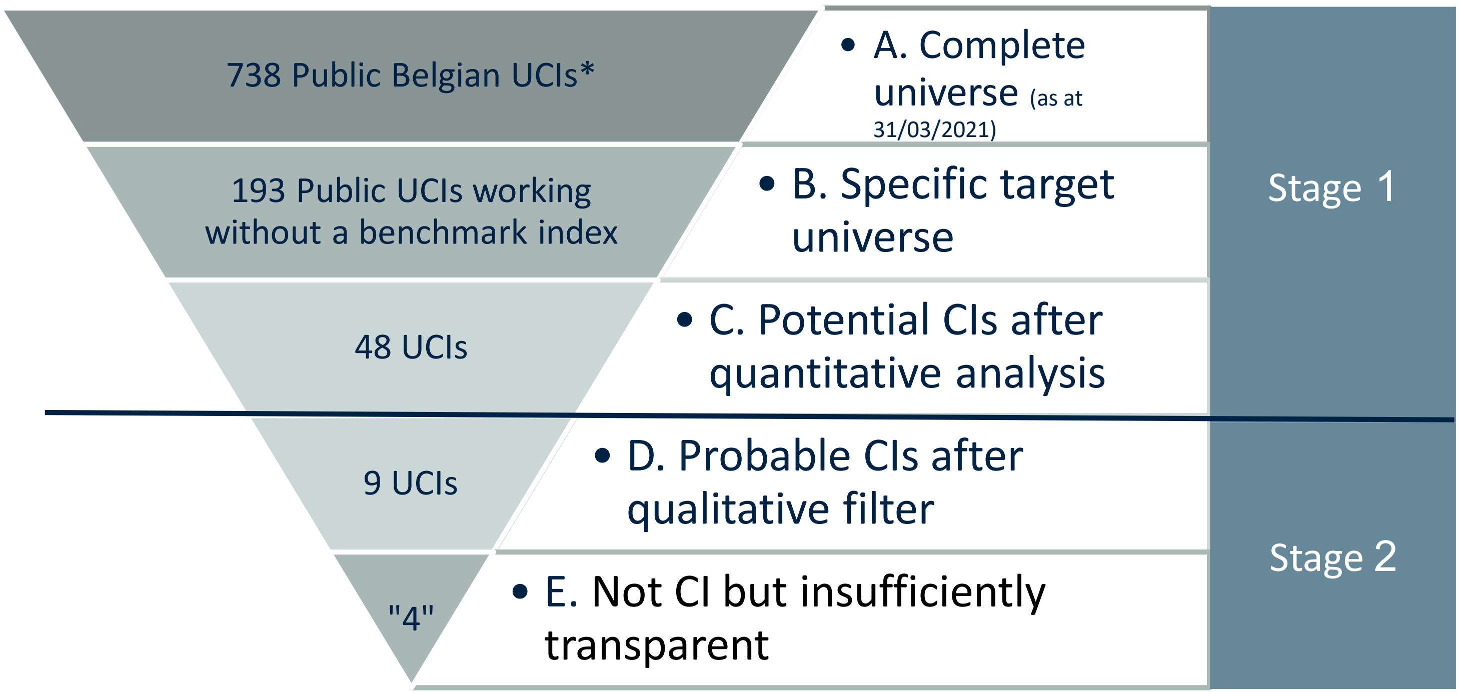
- An efficient analysis of the enormous volume of data is essential to a supervisor in order to identify trends, detect risks and set priorities
- The FSMA has an expertise centre for data analysis that makes available the necessary know-how and experience for the various supervisory activities
- Example of a specific application of data analytics: detecting Closet Indexing

Closet Indexing – a practice that is disadvantageous to investors

- Closet Indexing (CI) is the practice whereby a fund that is said to be actively managed, namely, on the basis of investment decisions made by the fund manager and not based on a benchmark index, nevertheless very closely tracks a specific index
- This practice is disadvantageous to investors, since they do not receive the service or the risk/return profile they expect on the basis of the fund's information documents, although they may be paying higher fees than those generally charged for passive management

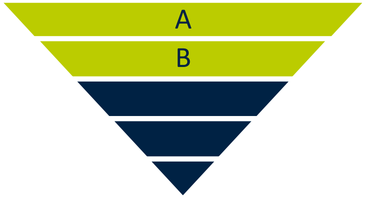
The FSMA’s innovative methodology

Schematic overview



* UCI = fund or compartment

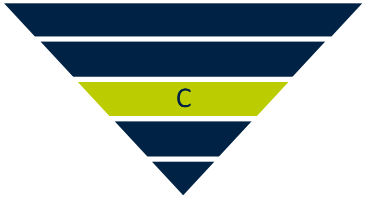
Stage 1: 738 → 48



A. Analysis of all Belgian public UCIs (738 UCIs), **without restrictions on investment policy** (shares, bonds, mixed, etc.) by size or fee amount

B. The analysis focuses on UCIs **with active management that is not based on a benchmark index** (193), since this category seems more likely to involve CI practices

Stage 1: 738 → 48 (continued)



C. Quantitative analysis

- **Detecting Closet Indexing is far from straightforward**
  - There are many indices (and especially combinations thereof) that a fund can track. The supervisor's task of detecting this is complex, given that actively managed funds do not systematically mention these indices
  - The analyses conducted in Europe generally focus on how closely a fund correlates with a set of important indices. Yet potential combinations of indices are not examined, although experience shows that a fund may track a combination of indices

- **Innovative aspect of the FSMA's analysis:**
  - conducted by creating an extensive set of combinations of indices
  - conducted over shorter periods (3-year and 5-year periods) and may be repeated periodically

Stage 1: 738 → 48 (continued)

C

- **Methodology**
  - Several customary benchmark indices were selected. Based on those, 35,000 combinations among those indices were created
  - For each of the 193 actively managed Belgian UCIs, we examined how closely their movements were in line with each of those 35,000 combinations
  - The correlation was evaluated on the basis of various indicators (tracking error, R^2 and Beta) and the ESMA thresholds are used
  - The correlation was evaluated on the basis of various indicators that capture the different types of correlation
    - The tracking error shows the deviation of the monthly returns of a fund from the returns of the benchmark index/combination of indices

$$\sigma(R_t^{funds} - R_t^{Benchmark})$$

    - The Beta shows how closely a fund tracks a given combination of indices. The R^2 indicates how well a given combination of indices explains all movements in the fund's return

$$R_t^{funds} = \alpha + \beta * R_t^{Benchmark} + \epsilon_t^{\{funds,benchmark\}}$$

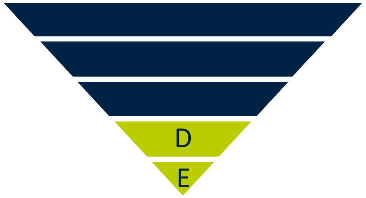
Stage 1: 738 → 48 (continued)

- **Each of these measures of correlation must exceed certain thresholds** before one can conclude that this is a probable CI. In addition to the thresholds suggested by ESMA, various other thresholds were tested in order to be able to test the sensitivity of the results against those thresholds

- **Accidental correlations** between the movement of a fund and a combination of indices is possible because of a high correlation in markets. Analyses over shorter periods are particularly sensitive to accidental correlations, as a result of which the expertise of the supervisory service is needed to analyse the results.

- Based on the three-year and five-year analyses, we ended up with **48 unique UCIs** that were identified, over the periods analysed, as potential closet indexers

Stage 2 (48 → 4)



D. Qualitative filter (aimed at ensuring that the funds identified are probable CIs)

- Analysis of the persistence of the results of the quantitative analysis over time and in relation to the indices
- Comparison of the constitution of the fund portfolios with the constitution of the indices

➔ **9 UCIs are probable CIs**

E. Quest for probative evidence

- Analysis of the internal control reports and the reports submitted to the UCI's boards of directors.

➔ **Conclusion: No UCI is practising CI, BUT…**

4 UCIs are not sufficiently transparent

- In the case of 4 funds, the FSMA carried out an in-depth analysis, based chiefly on internal documents
- The analysis showed that these 4 funds are managed with reference to an index. However, this is not stated in the information provided to clients
- These are not cases of CI, since the intention is not for the funds to closely track that index. But the fact that the funds use an index, for example in order to outperform the benchmark, does have to be communicated to investors
- ➔ **The 4 funds will update their documentation in order to enhance transparency vis-à-vis investors**

Conclusion on Closet Indexing

- No CI practice has been detected among the selected Belgian public UCIs
- 4 UCIs do not provide the necessary transparency regarding their use of a benchmark index
- The FSMA’s analytical tool allows for a very thorough screening of the entire market, and thus goes further than the analyses conducted to date at European level
- The analysis can be repeated regularly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