

1 September 2016

**Re: Themed Inspection: Structured Retail Products in MiFID authorised Investment and Stockbroking Firms and Credit Institutions**

Dear CEO,

The [Consumer Protection Outlook Report](#), published in February 2016, sets out our assessment of key existing and emerging risks to consumers and lists priority themes for the industry and the Central Bank of Ireland (the Central Bank). Two potential consumer protection risks identified were that:

- 1) products are not fit for purpose, fully understood by consumers and suitable to their needs; and
- 2) in the current low interest rate environment, firms are not fully informing consumers that they are investing in higher risk products.

One of the priority themes identified on foot of these risks was the sale of Structured Retail Products (SRPs) to consumers and the Central Bank has recently completed a themed inspection of the Irish SRP market in this context.

The inspection identified that there has been a significant move away from capital protected deposit-based products towards more complex, capital at risk products. Further information on the Irish market is set out in **Appendix 1**. The Central Bank also identified that many firms had weak product governance arrangements around the development and sale of complex, risky products, particularly in identifying the appropriate target market for such products. As a result, the Central Bank is concerned that firms are manufacturing and/or selling SRPs that may not be suitable for consumers, particularly those who have a low risk appetite.

**Findings**

The inspection consisted of a desk-based review of 20 Investment and Stockbroking firms and Credit Institutions manufacturing and/or distributing SRPs, followed by on-site inspections in five of these firms. Areas of particular concern identified are as follows:

**1. Weak Product Governance Arrangements**

Firms' product governance arrangements were reviewed against the good practices set out in the ESMA Opinion on Structured Retail Products<sup>1</sup>. The Central Bank was also cognisant of the ESMA

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<sup>1</sup> [ESMA Opinion 2014/332 "Structured Retail Products – Good Practices for Product Governance Arrangements."](#)

Opinion on Selling Complex Products<sup>2</sup> which states that the vast majority of SRPs can be regarded as complex products.

Weaknesses were identified in the following areas:

- Quality of policies and procedures
- Target market identification
- Product testing
- Counterparty due diligence
- Training of distributors
- Review process

Further details on these findings and some good practices identified are set out in **Appendices 2 and 3** respectively.

A Product Performance Comparison was also carried out, measuring the final returns of products that matured in 2014 and 2015 against appropriate NTMA State Savings Products available at the time of launch of these SRPs. The Product Performance Comparison identified that over half of the SRPs that matured in 2014 and 2015 underperformed vs. State Savings available. This comparison suggests that, in some circumstances, a less complex, costly or risky product *may* meet the consumer's needs. This reinforces the need for firms to have strong product governance arrangements, particularly in relation to product testing, to ensure that they are delivering fair outcomes for consumers.

Firms must do more to put consumers at the forefront of their approach to product governance, particularly as the SRP market is moving towards more complex product offerings. Clear target market identification is the first critical stage in the process, which should inform all subsequent stages of the process.

## **2. Credit Linked Notes being sold to retail clients**

The Central Bank identified a particular type of SRP being sold to retail clients which combines a note with a derivative, in the form of a Credit Default Swap (CDS). Capital protection and income from these products are generally conditional upon the creditworthiness of multiple counterparties, namely an issuer and one or more reference entities. These products are commonly referred to as Credit Linked Notes (CLNs). 12% of SRPs sold in 2015 were CLNs.

The Central Bank considers these products to be particularly complex and risky given the layers of credit risk involved and the potential for a consumer to lose their full investment. The Central Bank is also concerned that such risks are not being adequately highlighted to consumers.

As a result of these concerns, coupled with the weak product governance arrangements identified, the Central Bank considers that CLNs may not be suitable for consumers, particularly those who have a low risk appetite.

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<sup>2</sup> [ESMA Opinion 2014/146 "MiFID practices for firms selling complex products"](#)

In light of the above, firms must carefully consider whether in the first instance it is appropriate to produce these products for retail clients. If selling these products through distributors, firms must also ensure that their chosen distributors have sufficient knowledge to fully understand and explain the features and risks of such complex products. Firms providing advice on CLNs must also carefully consider whether they are suitable for the end client given their complexity and level of risk.

### **3. Capital Protected/Protection**

In the context of firms' regulatory disclosure requirements, the term 'capital protection' or 'capital protected' is deemed to be relevant material information to be disclosed to consumers. However, the use of such terminology can create a perception of safety which may not be consistent with the product's features and risks. Various types of SRPs are being marketed as capital protected, however, this 'capital protection' varies depending on the set up of the product.

In order to provide information to consumers that is fair, clear and not misleading, the Central Bank expects firms, for any products where capital is at risk, to include capital at risk warnings in a prominent position on all information to clients. This includes but is not limited to brochure cover page, key features documents, webpages and other marketing materials. Products including CLNs and other conditional products fall into this category.

Additionally, firms must clearly set out to clients whether or not an SRP contains a deposit element which is eligible to be covered by the Deposit Guarantee Scheme or another EU guarantee scheme. Firms should also set out clearly the level of cover afforded and where additional information about the cover can be obtained.

#### **Legislative Obligations**

As previously referenced, ESMA has set out the good practices expected of firms in its opinion on Structured Retail Products. Firms should also be aware that the forthcoming EU Directives, the Packaged Retail and Insurance-based Investment Products Regulation (PRIIPS) and the recast Markets in Financial Instruments Directive (MiFID II), will also impose more detailed requirements on firms manufacturing and distributing SRPs and other financial instruments. Firms should consider these EU Directives to ensure they fully comply with the additional requirements as they come into force.

Firms should also consider the requirements of the Prospectus Directive when producing and selling SRPs. Firms may need to produce a prospectus in accordance with the Prospectus Directive dependent on the specific features of each product and the features of the offering.

#### **Next steps**

All firms are required to immediately consider the issues identified above and take all remedial action necessary to ensure that they are acting in the best interests of consumers. The Central Bank expects that this letter will be discussed and minuted at the firm's next board meeting. Additionally, the Central Bank is engaging directly with those firms where issues have arisen, and is considering the appropriate use of its supervisory powers to address the issues identified.

The Central Bank will have regard to the contents of this letter when conducting future supervisory engagement.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Helena Mitchell', written in a cursive style.

**Helena Mitchell**  
**Head of Consumer Protection**  
**Supervision Division**

## Appendix 1

### Irish Market

The Irish market consists mainly of two types of SRPs: Deposit-Based SRPs and Note-Based SRPs. The main types of Deposit-Based SRPs offered are Structured Deposits, 90/95% Capital Protected Bonds, and Conditional Capital Protection Bonds. The main types of Note-Based SRPs offered are Conditional Capital Protection Notes and Credit-Linked Notes (CLNs).

The inspection identified that 9 firms are manufacturing SRPs. However, three of these providers accounted for 58% of the market by sales in 2015.

- 371<sup>3</sup> products were launched in 2015, which accounted for sales of €971m (227 were deposit based products and 144 were note based products);
- 352<sup>4</sup> products matured in 2014 and 2015, which accounted for sales of €1,224m (249 were deposit based products and 103 were note based products).

From comparing products matured in 2014 and 2015 against those launched in 2015, it was noted that there has been a move towards more capital at risk products as follows:

- Structured Deposits have decreased from 50% to 20% of the market;
- There has been a resultant increase in 90/95% Capital Protected Bonds (↑26%) and Conditional Capital Protection Notes (↑9%); and
- CLNs have appeared in the market, accounting for 12% of the market.

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<sup>3</sup> It should be noted that many of these were successive issuances of the same product i.e. Deposit Bond 1, Deposit Bond 2.

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## Appendix 2

### Weak Product Governance Arrangements Identified

#### a) Inadequate Policies & Procedures

Firms should have policies and procedures in place for Product Governance. Policies and procedures examined were found to be inadequate as follows:

- The steps to be followed as part of the process are not always clearly defined;
- Roles and responsibilities of staff involved are not always defined;
- Failure in many cases to identify records to be kept about critical steps in the product governance process; and
- No formal process in place to consider consumer protection risks when developing new products.

#### b) Target Market not clearly identified

As part of the design process, some firms failed to appropriately identify the target market prior to issuing SRPs e.g. target market identified simply as retail clients. Some firms' target market descriptions are high level and do not consider financial needs, investment objectives, knowledge and experience. There was a lack of evidence of firms conducting robust research to identify the appropriate target market. Failure to adequately identify the target market may result in SRPs of varying complexity and risk being aimed at the general "retail" market.

#### c) Product Testing

Manufacturers should use modelling and statistical test analysis when designing SRPs. This should, where relevant, include back-testing and simulations of future performance scenarios i.e. performs well, offers no return and performs poorly - including a scenario where a counterparty involved in the product fails. This scenario analysis should be presented in the marketing material to enable consumers to view a range of potential performance scenarios, including those that may result in the loss of capital protection and/or capital loss.

Most manufacturers, which were in scope of the themed inspection, stated that they conducted testing on their SRPs. However, upon examination, some manufacturers were found to be conducting insufficient testing as part of the design process for new SRPs. It was also not clear how some firms that did conduct testing applied the results to inform the design of new SRPs.

Failure to conduct such testing and to use the results to inform new SRP design may result in products being manufactured that do not have a reasonable chance of delivering value to the consumer.

#### d) Counterparty Selection

The Central Bank expects firms to have a counterparty approval process which sets out the parameters within which counterparties can be approved. Firms should carry out sufficient due diligence of counterparties to the SRP. This should include, at a minimum; credit ratings, rating

outlook, fundamentals on the counterparty's balance sheet, credit default swap (CDS) spreads and other market information.

Upon examination, a number of manufacturers did not have a defined counterparty approval process in place. Insufficient due diligence had been conducted on selected counterparties in some cases. For example, some firms solely used credit ratings in their assessment of counterparties.

**e) Training of Distributors**

The Central Bank expects manufacturers which sell their SRPs through appointed distributors to provide adequate training, in order that distributors gain a detailed understanding of the products' features and are fully aware of the risks of each SRP that they sell and/or provide advisory services for.

Although most manufacturers inspected stated that they provided training to the distributors of their SRPs, upon review, some manufacturers were found to have inadequate training processes in place. Training practices were often inconsistent and ad-hoc in nature and did not always factor in the risk and complexity of products i.e. it was not evident that sufficient consideration was given to explaining the features of riskier and/or more complex SRPs. Without sufficient training, distributors may not have the appropriate level of knowledge and understanding of the SRPs for which they provide advisory services to enable them to sell the right products to the right consumers.

**f) Review Process**

Manufacturers should consider the performance of existing and previous SRPs when designing new products. This monitoring and analysis should inform the design of new SRPs and should also be used to review and improve the firm's product governance arrangements.

Upon examination, most manufacturers did not sufficiently demonstrate that they had a robust review process in place to monitor the performance of the SRPs they produce. It was not evident that these firms were using analysis of past product performance to inform the selection of product features and improve the overall design process for new SRPs.

## Appendix 3

### Good Product Governance Arrangements Identified

#### a) Approval Process

- Layered product approval process including a dedicated forum for challenging the product design from a consumer protection perspective.
- Additional layers of challenge for products with significantly different features from previous offerings.

#### b) Counterparty and underlying asset selection

- Use of approved lists for counterparties and underlying assets.
- Setting of parameters for key product features e.g. minimum credit rating and CDS prices for counterparty selection.
- Significant due diligence being conducted prior to the selection of the underlying asset in the product e.g. Interviewing underlying fund managers as part of research and design process, and provision of detailed information to distribution channels.

#### c) Product Testing

- Back-testing the product and comparing results to relevant benchmarks to determine if the product has a reasonable prospect of delivering value to the consumer and assessing if a less complex, costly and risky product could meet the needs of the consumer.

#### d) Monitoring & Review

- Monitoring the performance of existing SRPs (such as average return, how often the advertised return was paid out, how often products caused a loss to consumers, loss of capital protection), and consideration of this analysis during design of new SRPs.
- Applying the results of the review process as part of a feedback loop to periodically amend and improve the firm's product governance arrangements.

#### e) Disclosure to consumers

- Use of graphical illustrations in the marketing material to present the range of potential performance scenarios, including examples of loss of capital protection and capital loss.