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MiFID Structured Retail Product Review – Supervisory Guidance

Dear CEO

Following a series of targeted reviews of Structured Retail Products (SRPs), the Central Bank of Ireland (Central Bank) published a 'Dear CEO' letter on SRPs (SRP Letter) in April 2022. We are now publishing this further Supervisory Guidance to supplement this letter and provide clarification to firms on complying with the relevant MiFID II investor protection requirements and meeting the expectations set out in the SRP Letter. It is relevant to firms who currently (or plan to) manufacture or distribute SRPs and/or produce marketing material for SRPs. This Guidance is based on further engagement with firms and observation of marketing practices since the issuance of the SRP Letter.

The two Q&A's in this document specifically address two aspects of the SRP Letter:

1. **Decrement Index**
2. **Presentation of back-testing**

The intention of these Q&A's is to promote consistency in the interpretation and application of the expectations set out in the SRP Letter, specifically with regard to these two important information disclosure items. By providing this additional clarity, the Central Bank expects that firms will take every available measure to ensure the information they provide to clients regarding their SRPs is fair, clear and not misleading, in compliance with MiFID II.

1. Decrement Index

Q. How should firms interpret the following expectations set out in the SRP Letter in relation to the disclosure of the use of a Decrement Index and the associated impact and risks?

- *Where firms conclude, following appropriate governance and robust challenge, that the use of a decrement index is appropriate and justified, a specific warning should be included in a prominent position in the marketing communications to inform investors of the potential negative impact on their return.*

- *The product documentation should fully explain the feature, how it works, and how it will impact upon the client's potential return in different scenarios, including under stressed conditions.*

A. In marketing material for SRPs that use a decrement index, firms should include a prominent warning on the front cover of the marketing material or brochure and on the page on which the decrement index is described in further detail (which should be early in the marketing material or brochure and in a prominent location). The warnings should be in a separate text box for visibility. Examples of such warnings are set out below.

In cases where the fixed dividend deduction of ***[%] / [fixed point value]*** is higher than the actual dividends paid, firms should use one or more example scenarios to illustrate how this can cause a 'drag' on performance in a stable market. These scenarios should illustrate the cumulative effect of this drag on performance over the lifecycle of the product. The scenarios should be based on the most recently available data.

Where the SRP uses a fixed dividend deduction in the form of a fixed point value (as opposed to a %), firms should also be cognisant that this drag on performance will be accelerated where the index falls below its initial level and a sustained fall in markets will accelerate the decline in the value of the index. This should be clearly reflected in the firm's example scenario illustrations.

The following is an example of a decrement index warning for the front cover of the marketing material or brochure:

> "*The value of this product is impacted by a Decrement Index with a* ***fixed [x] % / [fixed point value]*** *dividend withdrawn each year. A Decrement Index is a complex product feature that may have a negative effect on the return of your investment at maturity. More information on page X.*"

The following is an example of a decrement index warning for the page on which the decrement index is described in further detail:

> "*Decrement indices typically use a fixed dividend technique. When the fixed dividend deduction of* ***[%] / [fixed point value]*** *is higher than the actual dividends paid, this acts as a 'downward drag' on performance. This means that an amount is deducted from the value of the underlying index regardless of how the index has performed on an ongoing basis. Clients need to be cognisant of this, given that the final value of this index will determine the level of capital protection and investment return you will receive as shown in the illustrative example below.*"

2. Presentation of back-testing

Q. How should firms interpret the following expectations set out in the SRP Letter in relation to the presentation of back-testing information?

- *The Central Bank considers that where firms are using past performance representations that only capture periods of positive client outcomes, this may not reflect the true likelihood of future capital loss for clients. As such, firms should consider how it is appropriate and in the best interests of clients to present past performance in this manner going forward.*

- *The Central Bank expects firms to ensure that the presentation of historical data is not misleading, particularly where it uses overlapping periods with a large number of simulations in only positive market conditions, as there is a heightened risk of creating an unrealistic or unfair perception of the risk of capital loss.*

- *The Central Bank expects that the risk of capital loss must not in any way be diminished, downplayed or masked by the firm's presentation of past performance information.*

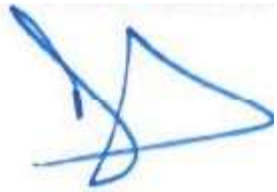
- *Firms are expected to ensure that all information presented is balanced, accompanied by prominent and clear warnings, and consistent with the risk profile of the product.*

A. In 'capital at risk' SRPs where the return of investor's capital is dependent upon market performance, the presentation of large numbers of overlapping back-testing simulations, presenting overwhelmingly positive outcomes and illustrating minimal instances of capital loss, has the potential to be misleading for investors. The simulations viewed by the Central Bank in some marketing materials or brochures use daily hypothetical launch dates of products, which results in thousands of simulated instances of performance over the reference period. Given the relatively positive market conditions observed in recent years, this often results in thousands of positive simulations over a short period that presents zero or minimal examples of capital loss.

This can present an overwhelmingly positive outlook for the product for retail investors that is unbalanced and has the potential to diminish the investor's perception of the risk of capital loss. Firms may continue to illustrate the performance of the underlying asset over an appropriate period. However, where the selected period predominantly displays positive performance and shows little or no cases of capital loss, firms should avoid presenting a large number of overlapping simulations.

Should you have any queries in relation to the contents of this letter, please contact mifidconductofbusiness@centralbank.ie.

Yours Sincerely



Des Ritchie

Head of Division

Consumer Protection – Investment Firms and Client Assets

Central Bank of Ireland