Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

T +353 (0)1 224 6000

Bosca PO 559
Baile Átha Cliath 1

PO Box 559
Dublin 1

www.centralbank.ie

**22 April 2022**

**MiFID Structured Retail Product Review**

Dear CEO

The Central Bank of Ireland (Central Bank) has conducted a series of targeted reviews of Structured Retail Products (SRPs) manufactured and distributed by a sample of investment firms in the MiFID investment sector. The reviews were undertaken in light of the increasing complexity of SRPs and investor trends in a rapidly changing retail investment market. In particular, the low interest rate environment has seen a move by investors away from traditional capital-protected products, to more complex, capital at risk SRPs in the retail market. As the complexity of financial instruments increases, so too does the need for robust governance and challenge, effective controls and transparent disclosures to mitigate risks to investor protection.

In seeking to meet their investor protection obligations, firms must consider how the relevant MiFID II requirements directly apply to their role in the manufacture and/or distribution of SRPs. In accordance with MiFID II, firms must ensure that all information addressed to clients is fair, clear and not misleading[1]. MiFID II also requires firms that manufacture financial instruments to ensure those instruments are designed to meet the needs of an identified target market of end clients[2].

This letter sets out the findings of the SRP reviews, and details the Central Bank's expectations of regulated entities when implementing in practice the relevant MiFID II requirements. The purpose of this letter is to highlight to investment firms the importance of identifying a sufficiently granular target market for these complex products and to drive improvements in the quality and transparency of disclosures to investors of the risks relating to SRPs.

We are now writing to all firms to set out our expectations in relation to SRPs. The expectations outlined in this letter and further detailed in **Appendix 1** seek to enhance the standard of investor protection afforded to retail clients by regulated entities. Firms are required to review and make the necessary changes to their SRP arrangements and controls in light of these expectations.

[1] MiFID II, Regulation 32(3).
[2] MIFID II, Regulation 32(1).

## Overview

### *SRP Arrangements and Controls*

The development of increasingly complex structured products for the retail market, often with complex features[3] and characteristics, increases the likelihood that retail clients may not fully understand the product or how the return is generated, and may misinterpret the level of capital protection and risk associated with their investment. To ensure that clients are adequately protected, it is essential that firms' SRP arrangements and controls keep pace with the increased complexity in the retail investment market.

A 'decrement index[4]' is one such example observed in the market of a complex SRP feature. The use of such complex features in SRPs should be subject to robust governance and challenge to ensure they are justified and in clients' best interests. Firms must consider whether complex features will be understood by less experienced retail investors and adapt their target market accordingly.

### *Disclosures*

In addition to providing clients with information that is fair, clear and not misleading, firms must ensure that information on financial instruments includes appropriate warnings of the risks associated with investing in those instruments[5]. Transparency and effective disclosures are key to enabling investors to make informed investment decisions that best suit their needs now and in the future. Poorly presented information can adversely impact the ability of investors to assess the benefits, costs and risks of financial products and services. This is particularly the case where the product or service is complex or when there are many similar types of products on the market. Ineffective or misleading disclosures can result in investors investing in a product that is not suitable for their risk profile.

## Findings and Observations

Informed by our supervisory experience, observations of market trends, and the recently completed targeted reviews of SRPs, the Central Bank has identified a number of poor practices and weaknesses in firms' SRP arrangements and controls, which increase risks to investors. Key findings include instances where firms have failed to:

1. Identify a sufficiently granular target market.
2. Adequately consider the use of highly complex features in SRPs being manufactured and distributed to retail clients, which may be difficult for these clients to understand.

[3] Examples of complex features include inter alia decrement indices, complicated return profiles, pay-off structures involving multiple variables, and complicated barrier features that withdraw capital protection under certain conditions.

[4] A decrement index periodically deducts a fixed dividend from the underlying index, either in percentage terms or a fixed point value. Where this fixed dividend is higher than the actual dividend paid, this acts as a downward 'drag' on performance. In the case of a fixed point dividend, this negative impact is accelerated where the index falls below its initial level.

[5] MiFID II, Regulation 32(6).

3. Present fair and balanced past performance (back-testing) information, supported by appropriate context and narrative.
4. Display capital at risk warnings in prominent positions for products where the client's capital is at risk.
5. Ensure consistent levels of clarity and comprehensiveness in disclosures.
6. Disclose adequately the risk and potential impact of restructuring to clients prior to sale.

**Central Bank Expectations**

The Central Bank expects firms to adhere to high standards of investor protection, acting in the best interests of their clients at all times. Firms should be proactive and meticulous in ensuring that they do business in a way that protects clients when manufacturing and distributing SRPs. At a minimum, firms' governance processes must encompass the following:

1. Conducting an assessment of the target market in a proportionate manner, one that considers the nature and complexity of the product. The more complex the SRP, the more comprehensive and granular the target market assessment must be.
2. Where complex features are proposed, firms must consider if they are appropriate for the retail market and whether they are likely to be understood by the target market. The approval of the use of such features should be subject to robust governance and challenge which should be clearly documented by the firm.
3. Where past performance (back-testing) information is presented, firms must ensure that it is fair and balanced, supported by clear narrative and context, and does not diminish the potential likelihood of capital loss. Care must be taken to avoid presenting an overly-optimistic or unbalanced picture of the likely investor outcomes.
4. Firms must ensure that capital at risk warnings are in a prominent location in all marketing communications and advertisements.
5. In the case of complex products such as SRPs, firms must take special care when designing and presenting marketing information to ensure that individual statements, as well as the tone and overall content when read together, remain fair, clear and not misleading.
6. Firms must ensure the risk that a product may be restructured is disclosed to clients prior to sale.

**Appendix 1** to this letter provides further detail on the Central Bank's key findings and expectations, together with good practices observed. Examples of good practices identified include instances where firms demonstrated a more thorough target market assessment, clearly stating whether a client is inside or outside the target market for the product in their marketing communications, or where firms included dedicated sections in their product brochures that prominently highlighted the 'Summary Risk Indicator' (SRI) score from the PRIIPS KID.

**Actions Required**

The Central Bank requires all firms who manufacture, distribute or otherwise offer SRPs to conduct a thorough review of their SRP arrangements and controls, including:

- Presenting this letter as a formal agenda item for discussion at the firm's next Board meeting, and for the discussion to be recorded in the meeting minutes.
- Undertaking a full review of current SRP arrangements and controls against the findings and expectations outlined in this letter, to include SRP design, manufacture and distribution, processes, procedures, training materials, templates and disclosures.
- Documenting the review including *inter alia* details of actions taken or planned to address matters raised in this letter. This review should be completed and an action plan discussed and approved by the firm's Board by the end of Q3 2022. The action plan must include clear and reasonable timelines for implementation of mitigating actions with appropriate governance and sign-off.

Firms who do not currently manufacture or distribute SRPs are not required to complete the above actions. However, should a firm commence the manufacture or distribution of SRPs in future, it is expected that the contents of this letter would inform the firm's SRP arrangements and controls and the firm will be expected to meet the expectations set out in this letter going forward.

The findings set out in this letter are not exhaustive. Firms should continually evaluate the effectiveness of all arrangements and controls relating to the manufacture and distribution of SRPs to ensure that they are meeting the highest standards of investor protection and delivering fair outcomes that put their clients' interests to the fore.

The Central Bank reminds firms of their obligation to comply with all relevant requirements of MiFID II when manufacturing and distributing SRPs. The Central Bank continues to monitor developments in the retail investment market[6] and will have regard to the contents of this letter as part of future supervisory engagements.

In circumstances of non-compliance by any firm with any regulatory requirements relevant to the matters raised in this letter, the Central Bank may, in the course of future supervisory engagement, or when exercising its supervisory and/or enforcement powers in respect of such non-compliance, have regard to the consideration given by a firm to the matters raised in this letter.

[6] Consumer Protection Outlook Report 2022.

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

Yours sincerely

**Miriam Dunne**
**Acting Head of Division**
**Consumer Protection – Investment Firms and Client Assets Division**
**Central Bank of Ireland**

## Appendix 1

### Structured Retail Products (SRPs)

The Central Bank's key findings and expectations, together with any good practices observed from industry are set out in the following tables:

| **1. Conduct an assessment of the target market in a proportionate manner, one that considers the nature and complexity of the product. The more complex the SRP, the more comprehensive and granular the target market assessment should be.** | |
|---|---|
| ***Overview:*** | Manufacturers and distributors are required under MiFID II to ensure that the target market for their products is specified at a sufficiently granular level, to avoid the inclusion of any groups of clients for whose needs, characteristics and objectives the product is not compatible. The granularity of the target market should differ depending on the complexity and nature of the product. |
| ***Finding:*** | While firms are generally considering the five categories[7] set out in the Guidelines on MiFID II Product Governance Requirements[8] when identifying the target market in their marketing communications, the Central Bank has observed differing levels of detail applied by firms when identifying the potential and actual target market for SRPs, with some firms identifying a broader target market than others. |
| ***Good Practice Identified:*** | The Central Bank has identified a good practice where firms demonstrated a more thorough assessment in their marketing communications by providing additional narrative under each category and clearly stated whether a client is inside or outside the target market for the product. |
| ***Central Bank Expectations:*** | • In line with MiFID II requirements, the Central Bank expects that firms manufacturing and/or distributing complex products, such as SRPs, should consider the features and characteristics of the product in granular detail when identifying the target market. This should be done in a manner that is proportionate to the complexity of these products. It should, for example, be done at a considerably greater level of granularity for SRPs than for more straightforward products, given their complexity, and the resultant target market assessment should be reflected in the product's marketing communications.<br>• It is important that distributors of SRPs refine the target market[9] provided by the manufacturer based on the needs, characteristics and objectives of their client base. |

[7] The type of clients to whom the product is targeted, Knowledge and experience, Financial situation with a focus on the ability to bear losses, Risk tolerance and compatibility of the risk/reward profile of the product with the target and Clients' Objectives and Needs.
[8] Guidelines on MiFID II Product Governance Requirements Para. 18.
[9] Guidelines on MiFID II Product Governance Requirements V.3. Guidelines for distributors.

| **2. Where complex features are proposed, consider if they are appropriate for the retail market and whether they are likely to be understood by the target market. The approval of the use of such features should be subject to robust governance and challenge which should be clearly documented by the firm.** | |
|---|---|
| ***Overview:*** | Using the principle of proportionality, the Central Bank expects that where SRPs have highly complex features that make them difficult to understand, this should trigger an assessment to determine whether these products are suitable for the retail market. The Central Bank does not consider, for example, that a complex, capital at risk SRP could have a broad target market extending to all retail clients, or include clients with a low appetite for risk or limited financial expertise, given the risks and complexity attached to such products. |
| ***Finding:*** | The Central Bank observed the use of increasingly complex features[10] in SRPs intended for sale to retail clients. A specific example identified is the use of an underlying decrement index in SRPs that targets dividend-paying stocks within the index, which can result in a 'drag' on performance. Firms are not undertaking a sufficiently in-depth assessment of whether this is a suitable feature for an SRP aimed at the retail market. There is a risk that investors will not be fully able to understand the impact of such a strategy on the performance of the underlying index, and the potential negative impact on their investment return.<br><br>The use of such complex features in the retail market creates a risk that investors may not fully understand how the product works or how it will behave under certain conditions. This can make it difficult for retail investors to assess the actual level of risk involved. |
| ***Central Bank Expectations:*** | • The Central Bank expects that firms should comprehensively assess in the first place whether the decrement index is a suitable feature for an SRP aimed at a retail target market.<br>• 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.<br>• 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.<br>• Where this or other particularly complex features are present in a product, this should act as a trigger for firms to:<br>➢ Reassess whether the product is suitable for the retail market.<br>➢ Assess whether the feature is likely to be understood by retail clients.<br>➢ Ensure that the approval of the use of such features for the retail market is subject to robust governance and challenge and that this is discussed at relevant Committee meetings and clearly documented.<br>➢ Reconsider whether the target market has been refined to a sufficiently granular level to ensure it only captures those clients with the required levels of risk appetite and expertise to understand such features. |

[10] Examples of complex features include decrement indices, complicated return profiles, pay-off structures involving multiple variables, and complicated barrier features that withdraw capital protection under certain conditions. This list is not exhaustive and firms should maintain their own lists to ensure that complex features are assessed and challenged in an effective manner.

| | |
|---|---|
| | ➢ Reassess whether marketing communications and disclosures prominently highlight and adequately explain such complex features.<br>➢ Review relevant product procedures and training documents to ensure they adequately explain complex features.<br>• Given the observation of increasingly complex features in products for the retail investment market, firms are expected to maintain their own list of complex features and characteristics and ensure it is updated regularly and subject to appropriate levels of review and governance. |

| ***3. Where past performance (back-testing) information is presented, ensure it is fair and balanced, supported by clear narrative and context, and does not diminish the potential likelihood of capital loss. Care must be taken to avoid presenting an overly-optimistic or unbalanced picture of the likely investor outcomes.*** | |
|---|---|
| ***Overview:*** | The presentation of past performance information must always be carefully considered in the context of the investor's ability to understand the information, and whether there is a risk it could be misinterpreted by retail clients. The performance period selected can have a significant impact on the results and the message communicated to retail clients.<br><br>MiFID II requires that, where firms provide information to retail clients that contains an indication of past performance[11], the firm shall ensure that the information includes appropriate performance information which covers the preceding five years, or the whole period for which the financial instrument has been offered, the period since the financial index has been established or indeed such longer period as the firm may decide. MiFID II also requires that, where providing clients with information about financial instruments[12], firms should include information regarding the functioning and performance in different market conditions, including both positive and negative conditions. |
| ***Finding:*** | ***Presentation of Past Performance (back-testing) information***<br>The Central Bank identified instances where the past performance presented was based upon multiple overlapping time periods of positive performance, and large numbers of simulations were applied to illustrate positive outcomes. These results may not always present an accurate or balanced reflection of a product's potential future performance or the likelihood of capital loss. |
| ***Good Practice Identified:*** | ***Performance Periods***<br>The Central Bank has identified firms, where applicable, using past performance representations that extended beyond five years, in order to capture different market conditions where client outcomes were both positive and negative. The Central Bank considers that this is a good practice as it mitigates the risk of presenting a biased representation of past performance. |
| ***Central Bank Expectations:*** | ***Performance Periods***<br>• The Central Bank encourages firms to adopt the approach outlined in the 'good practice' above, where relevant, covering a long enough time period to represent a variety of market conditions, including both positive and negative outcomes. |

[11] Commission Delegated Regulation (EU) 2017/565 of 25 April 2016, Article 44 (4).
[12] Commission Delegated Regulation (EU) 2017/565 of 25 April 2016, Article 48 (1).

| | |
|---|---|
| | • Firms should include a clear narrative alongside any past performance representations to ensure that appropriate context is provided to clients. Firms should consider market conditions in this regard.<br>• The back-testing methodology used and rationale for selecting specific performance periods should be fully explained.<br>• 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.<br><br>***Presentation of Past Performance (back-testing) information***<br>• Firms must 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.<br>• The risk of capital loss must not in any way be diminished, downplayed or masked by the firm's presentation of past performance information.<br>• Firms must ensure that all information presented is balanced, accompanied by prominent and clear warnings, and consistent with the risk profile of the product. |

| ***4. Ensure that capital at risk warnings are in a prominent location in all marketing communications and advertisements.*** | |
|---|---|
| ***Overview:*** | The landscape of the SRP market in Ireland is changing, with a continued move away from traditional deposit-based SRPs to more complex note-based products and, as such, the clear and prominent disclosure of capital at risk warnings is more crucial than ever. |
| ***Finding:*** | The Central Bank identified cases of firms not displaying capital at risk warnings in prominent positions for products where the client's capital is at risk. Some of these products included kick out bonds and asset-backed securities, where this is especially important given the level of complexity and risk of capital loss. |
| ***Central Bank Expectations:*** | • The Central Bank expects firms to include capital at risk warnings in prominent positions in all marketing communications and advertisements for SRPs where clients' capital is at risk.<br>• The onus is on firms to ensure that they are compliant with their obligations under MiFID II to provide information to clients in a manner that is fair, clear and not misleading. |

| **5. In the case of complex products such as SRPs, take special care when designing and presenting marketing information to ensure that individual statements, as well as the tone and overall content when read together, remains fair, clear and not misleading.** | |
|---|---|
| ***Overview:*** | Marketing communications can play a key role in determining investor behaviour and influencing investment decisions. Clear, transparent information is key to enabling investors to make informed decisions that best suit their needs now and in the future.<br><br>MiFID II requires that clients or potential clients are provided with appropriate information with regard to financial instruments, including guidance on and warnings of the risks associated with investment in those instruments[13]. In addition, MiFID II requires firms when referencing any potential benefits of an investment service or financial instrument in marketing communications, to also give a prominent indication of any relevant risks[14]. |
| ***Finding:*** | ***Key product risks were not disclosed in a consolidated manner***<br><br>Whilst the review determined that firms were generally disclosing the key product risks, the clarity and comprehensive nature of the disclosures varied from firm to firm. It is important that key product risks are disclosed in a clear and comprehensive manner, in order to assist clients in making informed investment decisions and assist investment advisors when explaining the key risks of the product they are advising on.<br><br>***Varying standards in how marketing communications are identified as such***<br><br>Firms are reminded of the requirement in MiFID II that marketing communications be clearly identifiable as such[15]. The Central Bank identified varying standards in how firms applied this requirement in practice, with some marketing communications not clearly labelled as such. It is firms' responsibility to ensure their marketing communications are clearly identifiable by their intended audience as such, in order to avoid any ambiguity or uncertainty on behalf of clients or potential clients reading the materials. |
| ***Good Practices Identified:*** | ***Use of Summary Risk Indicators in marketing communication***<br><br>The Central Bank noted that some firms included dedicated sections in their product brochures that prominently highlighted the 'Summary Risk Indicator' (SRI) score from the PRIIPS KID, including detailed narrative explaining the implications and meaning of the score. |

[13] MiFID II, Regulation 32(6).
[14] Commission Delegation Regulation (EU) 2017/565 of 25 April 2016, Recital (67).
[15] MiFID II, Regulation 32(3).

| | |
|---|---|
| ***Central Bank Expectations:*** | • ***Disclose key product risks in a consolidated manner* -** The Central Bank expects firms to comply with these requirements by providing information on key product risks in a consolidated manner within a dedicated section of the product marketing communications. This should be located in the introductory stages of any marketing communications.<br><br>• ***Marketing communications should be clearly identifiable as such* -** The Central Bank expects that firms consider all SRP product documentation and revise as necessary to ensure that marketing communications are clearly identifiable as such, and include sufficient information to make it clear that the communication is intended for marketing purposes only. Marketing communications should be deemed to be identified as such when they include a prominent disclosure of the term "marketing communication".<br><br>• ***Use of Summary Risk Indicators in marketing communications* -** Firms should consider adopting this practice, as it gives context to the risk profile of the product. When read in conjunction with the product descriptions, scenario analysis and relevant risk warnings, it may assist retail investors in analysing the risk of the investment, comparing the product to other financial instruments, and making an informed investment decision. |

| ***6. Ensure the risk of product restructuring is disclosed to clients prior to sale.*** | |
|---|---|
| ***Overview:*** | The performance and functioning of investment products, and how they respond to market conditions, may differ significantly depending upon their individual structures and characteristics. Market conditions can trigger substantial changes in how certain products function and perform, and this can have significant implications for investors. |
| ***Finding:*** | The Central Bank found that a number of SRPs were restructured due to poor performance of an underlying asset in prevailing market conditions, and that the Covid-19 pandemic was seen as a driving factor in some cases. |
| ***Central Bank Expectations:*** | • Given the risk that other products in the marketplace could face similar issues going forward, it is important that firms, where appropriate, are prominently disclosing the risk and potential impact of restructuring to clients prior to sale.<br><br>• It is also important that firms disclose all product risks prior to sale in a manner that enables clients to assess and make an informed investment decision.<br><br>• This is particularly relevant for asset-backed securities, given that the underlying asset in these products may be heavily exposed to changes in market and economic conditions that could necessitate restructuring. |