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Joint ESA Supervisory Statement on expectations regarding the ‘What is this product?’ section of the key information document for packaged retail and insurance- based investment products

1. LEGAL BASIS

- 1.1. The European Supervisory Authorities (ESAs) provide this Supervisory Statement on the basis of Article 29(2) of Regulation (EU) No 1093/2010¹, Regulation (EU) No 1094/2010², and Regulation (EU) No 1095/2010³. These Articles mandate the ESAs to play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union.
- 1.2. The ESAs deliver this Supervisory Statement on the basis of Article 6(1) to (4) and Article 8(3)(c) of Regulation (EU) No 1286/2014 (PRIIPs Regulation)⁴ and Article 2 and Articles 10 to 14 of Commission Delegated Regulation (EU) 2017/653 (PRIIPs Delegated Regulation)⁵. The PRIIPs Regulation establishes a set of common rules, both in terms of format and content that must be observed by PRIIP manufacturers whenever they draw up the key information document (KID), and that needs to be prepared for all PRIIPs that are made available to retail investors. The PRIIPs Delegated Regulation includes a template for the KID, which is structured such that the retail investor is given an answer to a set of key questions.
- 1.3. This Supervisory Statement is addressed to the competent authorities, as defined in Article 4(8) of the PRIIPs Regulation⁶.
- 1.4. The ESAs Boards of Supervisors have adopted this Supervisory Statement.

2. CONTEXT AND OBJECTIVE

- 2.1. The objective of this Supervisory Statement is to achieve a high, effective and consistent level of regulation and national supervision promoting a level playing field and the protection of retail investors.

¹ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

² Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

³ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p. 84).

⁴ Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), OJ L 352, 9.12.2014, p. 1-23.

⁵ Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing 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 (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents (OJ L 100, 12.4.2017, p. 1).

⁶ Notwithstanding the fact that specific points of this Supervisory Statement describe supervisory expectations for PRIIP manufacturers, they are required to comply with the regulatory and supervisory framework applied by their competent authorities based on Union or national law.

- 2.2. The ‘What is this product?’ section is the first descriptive section of the KID⁷ and is an essential part of the document to enable retail investors to understand the key features of the product. It is also a largely “free text” section within the KID template, where it is the responsibility of the PRIIP manufacturer to use appropriate text or language and there are not pre-defined narrative explanations.
- 2.3. The answer to the question ‘What is this product?’ must be provided according to five elements:
- the type of the PRIIP (‘Type’);
 - its objectives and the means for achieving them, including by means of direct or indirect exposure to the underlying assets (‘Objectives’);
 - the description of the type of retail investor to whom the PRIIP is intended to be marketed (‘Intended retail investor’);
 - where applicable, details of the insurance benefits; and
 - the term of the PRIIP (‘Term’).
- 2.4. Taking into account different approaches taken by certain PRIIP manufacturers to describe the main features of the product, including approaches which are considered to go against the aims of the KID to provide retail investors with information that is accurate, fair, clear and not misleading, the ESAs consider it important to clarify their expectations regarding the ‘What is this product?’ section of the KID.
- 2.5. In particular, as highlighted in recitals 13 and 14 of the PRIIPs Regulation, given difficulties many retail investors have in understanding specialist financial terminology, particular attention should be paid to the vocabulary and style of writing used in the document. It is, therefore, necessary to ensure that clear and understandable language is used, which is accessible to retail investors and that the description of how the investment objectives are achieved, including the description of the financial instruments used, avoids financial jargon and terminology which is not clear to retail investors. The ESAs’ supervisory experience since the implementation of the KID has shown that these standards relating to the use of clear and understandable language, are often not adhered to by PRIIPs manufacturers.
- 2.6. This Supervisory Statement applies to all types of PRIIPs. However, a number of the issues identified so far during the supervision of the KID concern product features that are not relevant to all types of PRIIPs, and in particular are only relevant for certain types of structured products or derivatives. These features include, for example, autocallability, the possibility for early termination, and the payment of coupons or leverage. Products with these features are usually offered directly, but in some jurisdictions might also be offered as underlying investment options in a PRIIP offering a range of options for investment. In this context, in most cases, the issues are only applicable to the specific information on relevant underlying investment options, rather than the generic key information document.
- 2.7. At this stage, the ESAs have considered those elements of the ‘What is this product?’ section that apply to all types of PRIIPs, including the ‘Type’, ‘Objectives’ and ‘Intended retail

⁷ Prior to this section there is a standardised section called ‘Purpose’, identification elements of the product such as its ‘Name’, and where applicable, an alert regarding the product’s complexity.

investor' and 'Term'. This does not mean that there are not issues relating to current practices for the part of this section on the insurance benefits, or indeed regarding other "free text" sections of the KID. The ESAs may, in a next step, set out their views and expectations regarding these other parts of the KID.

- 2.8. For each of the issues identified, a description is provided of some of the current practices observed, with reference to specific examples drawn from KIDs that are included in an Annex, followed by the ESAs expectations regarding how to improve the clarity and comparability of KIDs.

3. 'TYPE' OF PRIIP

- 3.1. The PRIIPs Delegated Regulation requires this part to describe the PRIIP's legal form⁸. While this might seem to be a straightforward requirement, the ESAs have identified a number of concerns regarding current practices. In particular that the same very general legal category or label is used for different products. These practices mean that this Type section can be of limited value to retail investors to properly distinguish and compare between products, and may also lead to misinterpretations by the retail investor about the nature of the product as described further below.
- 3.2. Commonly used types for certain PRIIPs are 'debt instrument' or 'debt obligation' or 'note' (or other synonyms). These labels are used for a variety of products with very different features, such as mortgage bonds, structured notes (non-leverage products) and leverage products (i.e. turbos or turbo warrants) as illustrated in Examples 1, 2 and 3 in the Annex.

ESAs' expectations regarding the 'Type'

- 3.3. Some approaches indicating only the broad legal form of the product, while potentially being accurate⁹, are not considered to be an adequate description, as they are of limited value for retail investors to identify sub-classes of comparable instruments. Therefore, the key objectives of the PRIIPs Regulation, i.e., the ability for the retail investor to understand and compare between types of products, are considered to be undermined by very generic labelling.
- 3.4. PRIIP manufacturers should:
 - a. be mindful of the legal form they use, choosing the (legal) terminology that best represents the nature of the product, and to specify it further to the extent possible;
 - b. include in the description:
 - i) an indication that the return of the product depends on the performance of an underlying asset(s)/reference value(s) (where applicable);

⁸ Article 2(1) of the PRIIPs Delegated Regulation.

⁹ See the classification already set out in Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU OJ L 173, 12.6.2014, p. 349–496 (MiFID II), Annex 1, SECTION C 'Financial instruments'.

- ii) a mention of the capital protection level, clarifying that protection is only against market risk¹⁰ (the retail investor may still lose the entire capital in case of insolvency of the PRIIP manufacturer/guarantor or any other credit event), along the following lines:

- [Full capital protection]/ [partial capital protection (x%)] / [no capital protection]/against market risk;
- [Risk of losing more than the capital invested/deposited];

3.5. PRIIP manufacturers should present the class of product in a short, concise and easy to understand way, avoiding long narratives on the details of the specific product.

4. 'OBJECTIVES' AND 'TERM' OF THE PRIIP

- 4.1. Competent authorities have frequently encountered a failure by PRIIP manufacturers to describe in sufficiently clear and understandable terms (notwithstanding the PRIIP's inherent complexity) the main features of the product, i.e. the way in which the product works and its aim, its risk/return profile (e.g. capital protected, yield enhancement); the extent of the capital protection and guarantee schemes; the possibility of early redemption (autocallability); the liquidity conditions (e.g. relevant Exchange listing/secondary market trading). As a result, KIDs are not always of sufficient quality to be truly useful to retail investors.
- 4.2. The main areas of poor practice and the ESAs expectations in relation to these are set out below. In the case of PRIIPs offering a range of options for investment that follow the approach set out in Article 10(b) of the PRIIPs Delegated Regulation, this Section is applicable only to the specific information on relevant underlying investment options, except the issue of the use of a clear language and layout (paragraphs 4.3 to 4.6), which is also applicable to the generic key information document.

Clear language and layout - usefulness for the retail investor

- 4.3. It has been observed that frequently the language used in the KID is too technical and difficult to understand. At the same time, PRIIP manufacturers also use very long and complex legal descriptions, such as those found in the general terms and conditions of the product, that are not easy to read and understand by retail investors.

ESAs' expectations regarding the language and layout

- 4.4. As the KID is intended to be a useful pre-contractual document for retail investors it needs to be written in a language that is easy to understand for the intended type of retail investor.
- 4.5. PRIIP manufacturers should also consider how to appropriately structure the text so that it is easy to read, while at the same time maintaining a neutral or balanced presentation between the potential risks and benefits. Long complex sentences and paragraphs, without distinction between the different components of the product, such as the payoff structure should be avoided (e.g. as opposed to the use of bullet points, sub-paragraphs or other structuring).

¹⁰ PRIIPs Regulation, Article 8 (3) (d) (ii), and PRIIPs Delegated Regulation, Annex III, point 4(c)(i).

- 4.6. Technical jargon should be kept to a minimum and, wherever possible, replaced by an equivalent in plain language that every retail investor to whom the product is targeted can be expected to understand. Technical terms should always be defined and explained.

Automated process to prepare the KID resulting in too generic information

- 4.7. Descriptions presented in the KID can be too generic, since, in some cases, they appear to be drafted with the purpose of accommodating a large range of possible pay-offs. Such presentation is presumably a consequence of the automation of the production of the content of this section. Where automation is used, the KID is produced by an IT tool based on the parameters of the products that are provided by the structuring desk or department responsible for product design.
- 4.8. It has been argued by PRIIP manufacturers that, for certain types of PRIIPs, such automation is necessary in view of the large amount of products that are issued on the market.
- 4.9. As consequence of this automation process, KIDs often contain a generic description of how the product works in very technical and legal language, which may be followed by a table where all the relevant dates for the product are entered, as well as the name of the underlying assets(s), the coupon amounts, etc. In this case, to try to understand how these types of products work, the retail investor therefore has to combine a generic text with a table. This makes reading and understanding KIDs very difficult.
- 4.10. Yet, it has been observed by competent authorities that a much higher level of quality is achieved in other documentation prepared by the PRIIP manufacturer, such as the marketing brochures, where all the features are detailed using a bespoke text for each product. Although the purposes of these documents is different, this demonstrates, from a practical perspective, that a more manual approach, also for PRIIPs where a very high number of products are issued, is feasible in terms of the resources of PRIIP manufacturers and distributors.

ESAs' expectations regarding automated processes

- 4.11. Any automation in the process to prepare KIDs should not impair the use of clear, succinct and comprehensible language within the KID and quality checks are advised to ensure the clarity and accuracy of the drafting.

Description of capital protection and potential losses

- 4.12. The description included in KIDs is often not sufficiently clear, precise and direct in specifying that, in given circumstances, the product implies a capital loss. In those cases, the potential capital loss can be inferred only implicitly, for example, in the case of structured products, by looking at the formula used to calculate the pay-off and performing complex calculations using that formula (see Example 4 in the Annex). A better practice is to explicitly indicate the potential loss (see Example 5 in the Annex).

ESAs' expectations on the description of capital protection and potential losses

- 4.13. The description included in the KID should be sufficiently clear, precise and direct in specifying that, in given circumstances, the product implies a capital loss. More specifically:
- adverse scenarios that imply a capital loss are expected to be clearly identified and the possibility of such losses indicated explicitly (i.e. total loss/ partial loss up to x%);
 - where a PRIIP manufacturer shows only the formula used to calculate the payoff this is not considered to be fair, clear and not misleading.

Autocallability and early termination due to extreme market events

- 4.14. Competent authorities have observed that for financial products with autocallability features, the description included in the KID is often not sufficiently clear, precise and direct in specifying under what circumstances the product expires before maturity with a pre-determined payoff.
- 4.15. Likewise, for financial products with early termination features, the information provided in the KID is often too vague, i.e., there is an indication that certain events which affect the underlying assets may give rise to adjustments or early reimbursement of the product, without providing further details. It is worth underlying that these extraordinary market events (e.g. delisting or the cessation of an underlying index or the closing of underlying derivative contracts by counterparties) due to extreme market movements almost always lead to total loss of the investment with the zeroing of the security value.
- 4.16. The examples in the Annex show two types of practices used by PRIIP manufacturers in the description of the autocallability feature. In Example 6 in the Annex, no data (barrier levels, dates) are included in the text and a separate table with full details is presented, which makes the KID very difficult to read and understand. In Example 7 in the Annex, some key data such as barrier levels that lead to the early redemption event are included in the text. In order to simplify the description, other data such as the observation dates are summarized using expressions such as ‘annual valuation date (concrete details may be provided in a separate table)’. Example 7 shows a better practice as the narrative uses simpler language and the inclusion of some key data in the text makes it easier to read and understand
- 4.17. Either a pure narrative description or a mix between text and tables are considered appropriate ways to provide information, provided in all cases a clear and easy to read language is used. Tables can be used to provide details or as a way to summarise the main features and facilitate comparability with other products.

ESAs' expectations on autocallability

- 4.18. The feature of early redemption should be shown prominently within the ‘What is this product?’ section, potentially at the very beginning of the description of ‘Objectives’, as well as in relation to the information on the ‘Term’ of the PRIIP.
- 4.19. Depending on the complexity of the product and abundance of data-points and observation dates, PRIIP manufacturers should try to include in the text the most relevant concrete data/levels, in particular the barrier levels and the frequency of autocall windows. Other details such as full details on observation dates could be indicated in a separate table.

- 4.20. If the product has a long list of valuation dates, it may also be acceptable to summarize the data using expressions such as 'yearly from x/xx/xx to yy'.
- 4.21. In any case, the general principle of the use of clear language needs to be considered. The PRIIP manufacturer needs to ensure the text provides a clear and easy to read description of this element.

ESAs' expectations on early termination due to extreme market movements of underlying asset(s):

- 4.22. The possibility of early termination, where applicable, should be shown along with the information on the maturity date.
- 4.23. Explanations about the early termination or unilateral modifications or delisting should be provided, specifying that the PRIIP manufacturer is entitled to terminate the product with immediate effect, if extraordinary events occur. While it is recognised that it is not always possible for the KID to include every possible ground for termination, retail investors should nonetheless be able to understand, based on the KID, the main events that could give rise to a unilateral termination and its impact on the investment.

Coupon payments

- 4.24. Different approaches have been observed to explain the timing and frequency of coupon payments. This includes, for instance:
- the use of a concise format, with observation dates summarized using expressions such as 'monthly from x/xx/xx to yy'; (see Example 8 in the Annex);
 - a mixed style, with key data (like barrier levels and coupons expressed in percentage terms) included in the text, while observation dates are presented in a separate table below the text (see Example 9 in the Annex);
 - a standardized text, generally linked to long and complex sentences, which is much harder to read. In this case, technical definitions (glossary) and other numerical data are shown in a separate table (see Example 10 in the Annex).
- 4.25. As indicated in the previous section either a pure narrative description or a mix between text and tables are considered appropriate ways to provide information, provided in all cases a clear and easy to read language is used. In the examples in the Annex, in particular in Example 10, the combination of a highly complex text and the absence of data points in the text makes the KID very difficult to read and understand.

ESAs' expectations on coupon payments

- 4.26. Depending on the complexity of the product and abundance of data-points and observation dates, PRIIP manufacturers should try to include in the text the most relevant concrete data/levels for the product e.g. coupon or barrier levels (as applicable). Full details on observation dates and calculation of initial/final values, could be indicated in a separate table if needed.

- 4.27. If the product presents a long list of dates, it may also be acceptable to summarize the data using expressions such as ‘monthly from x/xx/xx to yy’.
- 4.28. When the amount of coupons/ payments is presented in currency terms (e.g., euros), it is recommended to express them also in annual percentage terms, to facilitate the comparison with other instruments.
- 4.29. In any case, the general principle of the use of clear language needs to be considered. The PRIIP manufacturer needs to ensure the text provides a clear and easy to read description of this element.

Lack of information about the underlying assets

- 4.30. Information about the asset(s) underlying the PRIIP is sometimes insufficient or very limited: in many cases, only the name of the reference asset is provided.
- 4.31. This is considered to be particularly important for products which have a custom index as the underlying. Custom indexes use more or less complex rules to select the components to invest in, and are generally based on a theme and on financial filters and weighting schemes. The awareness of these rules is as important as the payoff description, in order to understand the economic rationale of the product. Due to the lack of information about the underlying asset, the KID cannot be considered as sufficient for the retail investor to take an informed decision.

ESAs' expectations on information about the underlying assets

- 4.32. PRIIP manufacturers should endeavour to describe in a clear and accurate way the specific nature (share, bond, commodity, index, etc.) and business sector of the underlying asset(s) or reference value(s), to allow the retail investors to evaluate the product's aim and to identify the drivers of its performance.

Description of leverage factor

- 4.33. For leveraged products, competent authorities have observed that in several cases KIDs do not offer enough information about the relationship between the payoff of the product and the underlying asset, and about the dynamic or constant nature of the leverage factor (see Examples 11 and 12 in the Annex), its value (or maximum value if dynamic), and the factors that underpin its variability.

ESA's expectations regarding leverage

- 4.34. In order to allow retail investors to better understand the payoff of those products, the functioning of the leverage factors and the risks related to them, it is recommended to clarify as part of the ‘Objectives’:
- the type of leverage effect (constant or dynamic); in the case of dynamic leverage, further specify how it varies/ which factors underpin the variability;

- b. the value that the leverage effect can assume (if constant, a single figure; if dynamic, the value at the moment of issuance, or during the life of the product, including the maximum level, if known);
- c. an indication that the leverage effect can reach very high levels, in case it is not possible to specify the maximum level of the dynamic leverage;
- d. with particular reference to CFDs, that the retail investor may be required to increase the margin due to market changes and that his/her position may be closed early if the margin call is not fulfilled.

5. 'INTENDED RETAIL INVESTOR'

5.1. Competent authorities have observed that the description of the target retail investors contained in KIDs is, in some cases, too high level and abstract. It is expected that this is, in part, a consequence of the automation of the production of the KID as referred to in Section 4 above. In case of a PRIIP offering a range of options for investment that follow the approach set out in Article 10(b) of the PRIIPs Delegated Regulation, this Section applies only to the specific information on each underlying investment option. The issues identified include:

- Customer knowledge is typically described as a level of required knowledge using labels such as 'basic', 'sufficient', and 'extended'. In some KIDs, these categories are not well defined, and it is difficult for the retail investor to decide, for instance, whether his knowledge is 'sufficient' or not.
- Indications for the intended investment horizon sometimes refer to the remaining time to maturity of the products, and when indications are given for the appropriate risk tolerance, a reference is usually made to the risk section of the KID, using generic expressions without specific information in this section.
- Loss-bearing capacity: in some KIDs the potential for unspecific losses ('low losses', 'there may occur losses', 'has to bear any losses') are described. In other cases an indication of the loss-bearing capacity of the retail investor is missing, or is described using generic expressions applicable to all products (for example that the retail investor should be able to bear the total loss of capital even in products with low or medium summary risk indicator or partial protection of capital).

ESAs' expectations regarding the intended retail investor

- 5.2. PRIIP manufacturers should describe the target retail investors identified in a concise and clear manner, and the description should include all the aspects stated in Article 2(3) of the PRIIPs Delegated Regulation, such as but not limited to the ability of retail investors to bear investment loss and their investment horizon preferences.
- 5.3. The description in the KID should be product-specific, and generic or unclear expressions should be avoided. Where labels or categories are used in the KID, these terms should be clear and understandable by the type of retail investor that is intended to be targeted, and where applicable these terms should be briefly explained.

5.4. In view of current practices, it is also considered relevant to address a number of specific cases:

- a. The intended investment horizon should not be described only in a generic sentence, such as 'clients must be able to keep the product until the maturity'. A more specific timeframe should be referred to, such as 'very short', 'short', 'medium' or 'long', or the number of years of investment deemed compatible with the product.
- b. Where the summary risk indicator is mentioned, the concrete level could be shown to improve readability (for example the retail investor should be willing to assume a risk of 3 out of 7, that is medium-low risk) rather than a generic sentence that can be applicable to all products, such as 'investors shall be able to bear the risk implied in the summary risk indicator'.
- c. Where the description of the loss bearing capacity of the intended retail investor takes into account the credit risk or risk of default as well as the market risk, this needs to be indicated in clear terms in order to ensure coherence with other information in the KID, such as the level of the summary risk indicator or regarding any capital protection / guarantee.

6. ANNEX – EXAMPLES

Example 1 - Mortgage bonds

Mortgage backed securities (MBS) are investment products secured by a mortgage/pool of mortgages typically backed by real estate holdings. MBS are similar to bonds since they allow investors to receive periodic payments (interest and principal), somewhat like coupon payments in bonds.

As per the definition laid down in Article 2(1)(28) of Regulation (EU) No 600/2014 (MiFIR)¹¹, MBS qualify as ‘structured finance products’ – ‘(...) securities created to securitise and transfer credit risk associated with a pool of financial assets entitling the security holder to receive regular payments that depend on the cash flow from the underlying assets’.

These particular bonds are generally labelled in the ‘Type’ section of the KID as ‘debt obligations’ without any other specification. It could be argued that this description is accurate. However, when only this term is used, such a broad categorization, under which many different types of PRIIPs may fall, and which lacks reference to any of the particular product features, is of limited value to retail investors to properly distinguish and compare between products carrying the same label.

Example 2 - Structured notes (non-leverage products)

These products, that may take the form of transferable securities¹² or notes, are securitised derivatives, i.e. pre-packaged investments that derive their performance from a particular underlying asset(s) or reference value(s), through a non-traditional pay-off formula that embeds the use of derivatives and a variety of features¹³.

Capital repayment and periodic coupons are in the majority of cases not guaranteed and the product can bear losses up to the total amount of the capital invested.

These securitised derivatives have a variety of commercial names, and in many jurisdictions the label “Certificates” is commonly used to refer to the broad category. These Certificates, as per Article 2(1), point (27) of MiFIR, are simply defined as ‘(...) securities which are negotiable on the capital market and which in case of a repayment of investment by the

¹¹ Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 84).

¹² Article 4(1), point (44) of MiFID II ‘(...) those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as: (a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares; (b) bonds or other forms of securitised debt (...)’.

¹³ Usually for the offering of these products the pre-approval of a Prospectus is mandatory, and detailed, long, complex and legalistic “terms and conditions” documents are publicly available (ESMA Register, website).

issuer are ranked above shares but below unsecured bond instruments and other similar instruments’.

In the ‘Type’ section of the KID, however, these products are often labelled as ‘debt obligations’ or ‘notes’ or ‘bearer bonds’ without any other specification. Again, it could be argued that these labels are accurate. Nevertheless, the lack of further information on the nature and specific features of the product may lead to a misinterpretation by the retail investor, especially about the risks of capital loss and early redemption.

Example 3 - Leverage products (i.e. turbos or turbo warrants)

Turbos (or knock-out warrants) are another very popular type of securitised derivatives with an embedded mechanism of dynamic leverage that, together with the knock-out barrier or level, may result in the early termination of the product with a settlement amount of zero (and consequent total loss of capital). These products are typically listed on exchanges.

Other than this commercial name alone, the following Type labels have been found for Turbos: ‘*This product is a **bearer bond** issued under [country] law represented by a global certificate and evidenced in the form of a book entry transferable Open End Turbo Warrant’; or “*This product is a transferable security”.**

Example 4 – Capital protection and description of losses

The ‘Objectives’ sub-section contains a long sentence concerning the potential capital loss, such as the following: ‘*if the final reference level is lower than the barrier level, you will receive a cash payment directly linked to the performance of the underlying. The cash payment will be equal to (i) the nominal value of the product multiplied by (ii) the final reference level divided by the exercise level*’.

Example 5 – Capital protection and description of losses

A better practice, as opposed to Example 4, is to explicitly indicate the potential loss: ‘*if the final reference level is lower than the barrier level, you will receive a cash payment equal to the notional Amount reduced by the underlying performance. In this case you will suffer a partial or total loss of the amount invested*’.

Example 6 – Autocallability feature

'If, at any Valuation Date of the Amount of Early Redemption, the closing price of Underlying is equal to or greater than the Barrier for Early Redemption, the product will be settled at the corresponding Early Redemption Date, and you will receive the Notional Amount.'

In this case, all the relevant observation dates and barrier levels are presented in a separate table and not included in the text. Although the use of tables is acceptable, in this example the combination of a highly complex text and the absence of data points in the text, makes the KID very difficult to read and understand.

Example 7 – Autocallability feature

'If the value of the underlying asset, at any annual valuation date is equal to or greater than 70% of its initial value, the product will be settled and you will receive back the nominal amount.'

This example shows a better practice as the narrative uses simpler language and the inclusion of some key data in the text (the barrier levels that lead to the early redemption event) makes it easier to read and understand.

Example 8 – Coupon payments

Concise format, with observation dates summarized using expressions such as 'monthly from x/xx/xx to yy':

'if the final value of underlying asset is equal to or greater than 90% of its initial value, on each monthly observation date starting from x/xx/xx to xx/xx/xx, you will receive on the applicable settlement date a coupon of 2,5% on the Nominal amount.'

Example 9 – Coupon payments

Key data is included in the text, while observation dates are presented in a separate table below the text:

'On Observation Date if the Closing Price of the Underlying is 90% or more of the Initial Level, you will receive on the applicable Settlement Date a coupon of 2,5% on the Nominal amount. Otherwise you will not receive a coupon.'

Example 10 – Coupon payments

Use of a standardized text (long/complex), with numerical data in a separate table:

'A conditional coupon must be paid at the relevant Conditional Coupon Type on (..) the Notional Amount each time the following condition (the Conditional Coupon Condition) is met: if, on a Conditional Coupon Valuation Date, the underlying closing price is greater than or equal to the relevant Conditional Coupon Barrier. Otherwise, the coupon will be omitted but will not be permanently lost.'

Example 11: Dynamic leverage

For Turbos and other products with knock-out barriers, the leverage factor is defined by the ratio between the price of the underlying asset multiplied by the number of whole units or the number of fractions of the underlying value to which the Turbo refers and the price of the Turbo on the same date. However, since the price of the Turbo is not linearly dependent on the price of the underlying, the ratio that defines the leverage is not constant over time, and its variability is not known *ex ante* and it could reach very high levels (i.e. double digits or more) when the price of the underlying is close to the knock out level¹⁴.

KIDs usually do not provide an explicit field containing the information on the leverage factor (quantitative value), nor a methodology for specifying the functioning of this factor, its variability and the possibility that it reaches very high levels.

Generally, a short generic sentence is used to describe the leverage effect in the KID: *'The objective of this product is to provide you with disproportionate (leveraged) participation in any price movement of the Underlying. This has the effect, inter alia, that you are exposed to a very high risk of a total loss of your investment.'*

Example 12: Constant leverage (i.e. contracts for difference (CFDs))

CFDs are derivatives contracts between two parties that pay a return, directly linked to the price movements of an underlying asset, amplified by a leverage effect.

The retail investor has to deposit an *initial margin* (which corresponds to the initial investment that is a percentage of the underlying value or notional value); this margin changes day by day (upward or downward) depending on the performance - positive or negative - of the underlying asset. Negative changes in the trading account could lead to a total or partial erosion of *initial margin*; in that case, an additional deposit may be required and losses may be higher than the initial sum invested.

¹⁴ If the price of the underlying is equal to or lower than the knock-out level, at any time during the observation period (duration of the product), the product is closed with zero value.



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The constant leverage factor is not always explicitly disclosed in the KIDs; in many cases the investor has to derive it by looking at the initial margin (i.e. a margin of 10% of underlying value corresponds to a leverage factor of $10 = 1/0.1$; it means that the return of the product will be 10 times that of the underlying asset).