AFME comments on ESA analysis of bond features and request for formal guidance

The table below replicates the analysis set out in the ESAs' Letter to the Commission dated 19 July 2018. AFME comments on each of the conclusions reached by the ESAs and presents the relevant legal basis and/or arguments to support the issuance of formal guidance on specific bond features (by way of Q&A or otherwise), which our members encourage so as to mitigate the negative impact of the current market uncertainty in relation to the scope of the PRIIPs Regulation in the context of bonds.

Type of feature	Considerations	ESAs' conclusion	AFME comments
Perpetual	There are not considered to be any fluctuations in the amount repayable due to the fact that a bond is perpetual	Out of scope	AFME members support this view and would find it helpful if it could be confirmed in formal guidance.
Subordinated	There are not considered to be any fluctuations in the amount repayable due to the fact that a bond is subordinated.	Out of scope	AFME members support this view and would find it helpful if it could be confirmed in formal guidance. Members consider both senior preferred and senior non-preferred debt to be 'subordinated' for these purposes.
Fixed rate	There are not considered to be any fluctuations in the amount repayable. This would include: - bonds with coupon payments fixed at a defined interest rate until maturity, including at zero; - bonds with pre-defined changes in the coupon rate at fixed times prior to maturity.	Out of scope	AFME members support this view and would find it helpful if it could be confirmed by way of formal guidance. A fixed rate note would not, in principle, meet the definition of a PRIIP[1] being *an investment where, regardless of its legal form, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets that are not directly purchased by the retail investor*. However, the only instrument specific guidance that the industry currently has at its disposal in relation to fixed rate notes emanates from the FCA Policy Statement, Annex 2, Point 6 which does not provide the same level of granularity on the regulator's view as the statements in the ESAs' Letter.

[1] Article 4 PRIIPs Regulation

Type of feature	Considerations	ESAs' conclusion	AFME comments
Variable rate	The amount repayable is considered to be subject to fluctuations based on changes in the coupon rate. It is relevant to consider the basis for those fluctuations and whether there is any structuring. Pre-defined increases in the coupon rate (i.e. coupon step-ups) which are not linked to a reference value or to the performance of one or more assets which are not directly purchased are not considered to result in a bond being a PRIIP. This is considered to include changes due to a ratings downgrade of the issuer, change of control event, or tax or regulatory event. Where there is a direct link (with or without a spread that reflects the credit risk of the issuer) to an interest rate index, it is still considered to be an asset that is directly held unless there is additional structuring, such as a cap or floor (other than at zero); c.f. definition of a structured deposit.	Not all variable rate bonds are considered to be in scope, but is dependent on the specific feature.	AFME members support this view and would find it helpful if it could be confirmed in formal guidance. Members believe that the statements below support a conclusion that a product which references an <u>interest rate</u> in a linear way, is not a PRIIP. Therefore, it would seem non-controversial to confirm this by way of formal guidance. Further, our members would find it helpful if formal guidance could confirm that the same is true for <u>inflation-linked</u> instruments. The rationale for this is explained further below (see 'inflation-linked'). **Interest rates** Statements from the European Commission and European Supervisory Authorities at a workshop in July 2016 support the view that exposure to interest rates is a <u>direct</u> (rather than indirect) result of a debtor-creditor relationship across such common retail products as mortgages, overdrafts and deposits. We also note that floating rate deposits are not regarded by ESMA as amounting to PRIIPs. Further, the ESAs Discussion Paper 2014 specifically states that "Under the exceptions, the only deposits that are in scope are those as defined in MiFID II (structured deposits); deposits "solely exposed to interest rates" (Recital 7) are out of scope. The MiFID II definition excludes variable rate deposits which are 'directly' linked to an interest rate index such as the EURIBOR or LIBOR. However, if these deposits exhibit performance caps and/or their return is linked in a non-linear way with the underlying interest rate, then they are in scope.[2]". By analogy, floating rate bonds with a linear link to interest rates are not PRIIPs.

[2] https://esas-joint-committee.europa.eu/Publications/Consultations/20141117_JC_DP_2014_02_-_DP_PRIIPs_KID.pdf

Type of feature	Considerations	ESAs' conclusion	AFME comments
			Inflation-linked It would be helpful if formal guidance could clarify that an inflation linked bond providing a floating rate of return calculated in a linear fashion is not a PRIIP either. This is because the inflation-linkage in this case is a way of adjusting the nominal interest rate to turn it into a real one and does not affect the basic nature of the bond, which is still a directly held asset.
Puttable	Provisions that allow the investor to sell the bond back to the issuer are considered to be a contractual right to exit the investment and not to result in a bond being a PRIIP.	Out of scope	AFME members support this view. We therefore recommend incorporating this position within formal guidance. Change of control put provisions are clauses granting a contractual right to exit the investment. A PRIIP[3] is *an investment where, regardless of its legal form, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets that are not directly purchased by the retail investor*. An important distinction must be drawn between an instrument's **investment objectives**[4] and terms that govern the amount due to an investor when exercising their redemption right. For example, Article 2(1) of the Delegated Regulation confirms that the "investment objectives" of a PRIIP shall identify the main factors on which the return depends, the underlying investment assets or reference values, and how the return is likely to be determined, as well as the relationship between the PRIIP's return and that of the underlying investment asset or reference values.

[3] Article 4 PRIIPs Regulation

[4] Article 2(1) of Delegated Regulation 2017/653

Type of feature	Considerations	ESAs' conclusion	AFME comments
			The normal course return of a bond may be fixed and known to the investor at the outset. Such a bond would not make reference to any underlying assets or reference values in calculating that return in the way envisaged by the investment objectives of an in scope PRIIP. However, such an instrument may nevertheless, as part of its general terms and conditions, contain a provision that provides a mechanism for calculating the return to the investor in the case of the investor exercising his/her right to terminate the bond before maturity where there is a change of control in the issuer (rather than as part of the intended lifecycle of the bond). To put this another way, where there is no relationship between an instrument's return and that of an underlying investment asset or reference value, other than in the case of an early termination event, such instrument should not meet the definition of a PRIIP. In line with the drafting of the Delegated Regulation, the investment objective of the KID can be distinguished from the disinvestment procedure, which is set out in a separate provision of the Delegated Regulation[5]. By way of example, a change in control clause will provide as follows: *"Upon the occurrence of a "Change of Control (each as defined herein), noteholders have the right to require the Issuer to redeem all or any part of your Notes at a redemption price in cash equal to 101% of their principal amount, together with accrued and unpaid interest, if any."* This highlights the elements of investor control and the redemption price, which is above par, to support the out-of-scope analysis.

[5] Article 6 of Delegated Regulation 2017/653

Type of feature	Considerations	ESAs' conclusion	AFME comments
Callable	It is considered that provisions that allow the issuer of the bond to redeem the bond before maturity constitute a contractual termination of the investment and therefore do not inherently result in a fluctuation based on an exposure to a reference value. However, such features may result in that bond being a PRIIP, where the amount repayable at redemption is not fixed and fluctuation is caused by exposure to a reference value. The inclusion of a clause that allows the issuer to pay off the remaining debt early using a reference rate to determine the net present value of future coupon payments that will not be paid (i.e. make whole) is expected to mean that the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values. However, where the mechanism to calculate the discount rate is known in advance to the retail investor, this could be considered as a separate case, which does not satisfy the criteria in Article 4(1).	Not all callable bonds are considered to be in scope, but some are expected to be on the basis of the specific feature.	AFME members interpret the ESAs' comment to mean that bonds that include a clause that allows the issuer to pay off the remaining debt early using a reference rate[6] to determine the net present value of future coupon payments that will not be paid (i.e. a make whole clause[7]) will not, because of that feature alone, be deemed PRIIPs. AFME members support this view and would find it helpful if it could be confirmed in formal guidance. Further, AFME members would like to provide supporting evidence as regards this conclusion. A PRIIP[8] is *an investment where, regardless of its legal form, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets that are not directly purchased by the retail investor*. An important distinction must be drawn between an instrument's **investment objectives**[9] and terms that govern the amount due to an investor when the issuer exercises a redemption right. For example, Article 2(1) of the Delegated Regulation confirms that the "investment objectives" of a PRIIP shall identify the main factors on which the return depends, the underlying investment assets or reference values, and how the return is likely to be determined, as well as the relationship between the PRIIP's

6 Such as Government bond yields

7 Make whole clauses allow an issuer to manage its liabilities, while at the same time protecting the investor from financial disadvantage. The issuer can repay the bonds only by paying a "make-whole" premium, in addition to the redemption amount of par, to compensate bondholders for the loss of future interest payments. The calculation of the premium to the investor is based on a customary formula to determine the current market value of the bond using a standardised underlying reference value – e.g. Treasury bonds. The clause is designed to ensure that investors receive back at least the market value of the bond at the time of early redemption and in no case less than par. This gives investor an opportunity to reinvest in an equal of (usually) better credit at the same yield

8 Article 4 PRIIPs Regulation

9 Article 2(1) of Delegated Regulation 2017/653

Type of feature	Considerations	ESAs' conclusion	AFME comments
			return and that of the underlying investment asset or reference values. The normal course return of a bond may be fixed and known to the investor at the outset. Such a bond would not make reference to any underlying assets or reference values in calculating that return in the way envisaged by the investment objectives of an in scope PRIIP. However, such an instrument may nevertheless, as part of its general terms and conditions, contain a make whole provision that provides a mechanism for calculating the return to the investor in the case of bonds terminating before maturity at the election of the issuer (rather than as part of the intended lifecycle of the bond). To put this another way, where there is no relationship between an instrument's return and that of an underlying investment asset or reference value, other than in the case of an early termination event, such instrument should not meet the definition of a PRIIP. In line with the drafting of the Delegated Regulation, the investment objective of the KID can be distinguished from the disinvestment procedure, which is set out in a separate provision of the Delegated Regulation[10]. We have set out the following example of a make-whole clause to further illustrate this point: "*The Issuer may, having given not less than [X] days' notice to the Noteholders, redeem all or some only of the Notes then outstanding on any Optional Redemption Date and at the Make-Whole Redemption Amount together, if appropriate, with interest accrued to (but excluding) the relevant Optional Redemption Date. Any such redemption must be of a principal amount not less than the Minimum Redemption Amount and not more than the Maximum Redemption Amount.*

[10] Article 6 of Delegated Regulation 2017/653

Type of feature	Considerations	ESAs' conclusion	AFME comments
			Make-Whole Redemption Amount *means in respect of each Note (a) the outstanding principal amount of that Note or (b) if higher, the aggregate present value, as determined by the Calculation Agent, of the remaining scheduled payments of principal and interest on that Note (not including any portion of such payments of interest accrued to the relevant Optional Redemption Date) discounted to the relevant Optional Redemption Date at the Reinvestment Rate (as determined by the Calculation Agent on the Reinvestment Rate Determination Date) on the basis of the same frequency and by reference to the same day count fraction as is applicable to such payments on the Reference Bond*" AFME members note that the payment of the make-whole amount to investors affected by a redemption notice is intended to avoid an economic disadvantage for such investors due to the redemption, by paying at least the nominal amount or, if applicable, a compensation amount in excess of this, taking into account the current market value of the securities at the time of redemption. This compensation amount is determined by reference, inter alia, to the yield of Government bonds with comparable maturities. In substance, however, such determination is meant to reflect the value of the relevant bonds themselves; only as part of this valuation, external factors such as the yields of government bonds are used here. Thus, materially, the relevant calculation process is not linked to external reference values but serves to determine the intrinsic value of the financial instrument itself and uses external parameters only to approximate this value.
Convertible	Where the investor or issuer may convert the bond into shares of the bond issuer (or shares of another company) the amount repayable is considered to fluctuate based on the performance of an asset that is not directly purchased.	In scope	AFME Members acknowledge this view and note that there are differing views across Europe on this issue.