BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

Better Finance response to ESMA Consultation on Draft guidelines on complex debt instruments and structured deposits

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The European Federation of Investors and Financial Services Users
76, rue du Lombard, 1000 Brussels - Belgium
Tel. (+32) 02 514 37 77 - Fax. (+32) 02 514 36 66
E-mail: info@betterfinance.eu - http://www.betterfinance.eu

Executive Summary

Better Finance, the European Federation of Investors and Financial Services Users, welcomes this Consultation since the retail investor often suffers from excessive complexity of financial products and markets, and more importantly sometimes suffers an inadequate portraying of complexity and risk .

Question 1

Better Finance strongly disagrees with the example of “inflation-index bonds” (item iv) - also called inflation-linked bonds – as deemed to embed a derivative and therefore as being considered “complex” investment products, and therefore as being subject to mandatory appropriateness tests by the investment firm.

Below are the reasons for our disagreement:

a. Inflation-linked bonds are a very useful investment product for EU households who are too often subject to the “monetary illusion” and are exposed to lose a lot of the real value (purchasing power) of their pension savings because of this illusion. This risk is reinforced by misleading offers from financial intermediaries selling protection of nominal “capital” after 20 or 30 years which is not worth much considering the very high probability that the real value of this protection will be extremely low due to compounded inflation over these 20 or 30 years.

b. Forcing EU households who want to protect the real purchasing value of their long term and pension savings (inflation-linked bonds are often proposed with maturities up to 30 years) to have to get advice from intermediaries instead of being able to invest on an “execution only” basis may well increase very significantly the cost of investing in such securities for EU households, rendering it damageable given the current very low level of interest rates. For example, investing in an inflation-linked bond with a 1% interest return and pay a 1% commission per annum on assets transforms this investment in a losing proposition for the investor. We urge ESMA to always consider and to thoroughly assess the impact of its guidelines on the price (fees) and return of such guidelines to EU citizens as end-investors and savers. We urge ESMA not to focus too much on risks and “complexity” at the expense of decent returns in an era of “financial repression”.

Actually, once again, the Cost-benefit analysis by ESMA (Annex III) focuses on costs – benefits for financial firms, largely ignoring the additional costs for EU citizens as savers and investors when classifying a useful and simple investment product as "complex" and therefore most likely "advice" fee-laden.

c. Inflation-linked bonds do not qualify for the assessment required by article 25 (10) of MiFID II. Indeed, inflation-linked bonds are not "bonds incorporating a structure which makes it difficult for the client to understand the risk involved". Better Finance challenges both the difficulty to understand the inflation protection feature and the existence of any significant risk generated by the inflation protection "structure". Inflation protection is a well understood "structure" by many EU households and the risk involved in this "structure" is extremely low if existing at all. Actually the interest rate of the most popular and simple short term saving product in France ("livret A") is linked to inflation.

d. If ESMA wanted to label inflation-linked bonds as "complex" because of this inflation protection feature, then in order to be consistent in its guidelines, ESMA should also label such products as "Livret A" (a structured deposit according to MiFID II recital 39) as "complex" as well, which frankly would not make any sense, and would be heavily detrimental to consumers and savers. ESMA should then fully justify to EU citizens why an intermediated inflation-linked product would be deemed simple ("non complex") and the not intermediated one offering a similar feature (inflation linked bonds) would be deemed "complex" and therefore subject to costly constraints for savers and investors.

e. Better Finance does not agree that inflation-linked bonds embed a derivative. First the issuers of such bonds are typically Governments, and the reason is that Governments have a natural hedge for this inflation protection liability: an important part of their income is also linked to inflation, in particular important tax revenues such as VAT. For sure, issuers of such securities do not use in any way derivatives to hedge this "structure" they offer to investors.

Second, inflation – as measured by consumer price indices – does not fit with any of the examples of "variables" given by ESMA (para 13). It is:

- not the price of a security,
- not the level of a "market index"
- not an interest rate
- not a foreign exchange rate.

In particular, CPI is not a "market index" as it is typically computed and communicated by Public Authorities and relates to the real economy not to financial markets. There is no such thing as an inflation "market".

Lastly, Better Finance is not aware of any tradable derivative on inflation, which could therefore be used by investors as a proxy to inflation-linked bonds or other inflation-linked savings to protect their purchasing power. We would be very interested to learn of the existence of such tradable (not OTC) inflation protection derivatives.

Question 2

Better Finance does not agree with the definition of embedded derivative proposed in the guidelines in Annex IV, which is too broad and too vague.

As explained above in detail in paragraph 1.e. inflation protection is not an embedded derivative. Therefore, ESMA must define embedded derivatives much more precisely, for example by using the one it mentions in para. 13, clarifying what it means by "market index".

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