Financial Risk&Regulation

The MNB's new recommendations on automatic portfolio management services and performance fees applied by investment fund managers

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MNB has published several recommendations in the recent period, two of which are discussed in this newsletter, which are related to portfolio management services. The first sets out the requirements for unit-linked life insurance automatic portfolio management services. That aims to increase transparency and, where possible, added value. The other recommendation addresses performance fees regarding investment funds, highlighting the high-watermark (HWM) model, and, as before, seeks to ensure that the interests of customers are protected, including through providing appropriate information and healthy incentives.

Requirements for automatic portfolio management services for unit-linked life insurance

Objectives of the recommendation

Automatic portfolio management services (hereafter APMS) are frequently used extra services provided by an insurer in connection with unit-linked life insurance, which purpose is to transform the investment return-risk profile in a way that is favorable to the client. Based on the MNB 7/2021. (VI. 21.) recommendation APMS is a service in which framework the insurer initiates the conversion between the funds included in the APMS and the redirection in accordance with the terms and conditions of the APMS in the event of the occurrence of the events specified therein, without a direct order of the client, on the basis of future insurance premiums to be paid. The following services are not covered by the recommendation:

– Target date asset funds;

– Statuses of a single asset fund with different investment composition depending on market movements;

– Automatic portfolio recovery services; and

– Investment activities related to the termination and closure of asset funds.

By formulating recommendations, the MNB aims to:

– Ensure the professionalism of the operating conditions and parameters, the support for mathematical and statistical mechanisms;

– Stimulate price / value based competition, increasing added value; and

– Develop the marketability, transparency and customer information.

Service expectations

MNB expects that if the insurer provides an earlier version of the APMS that does not comply with the recommendation, it should offer the possibility of modification to its customers. The offer must be published on a regular basis, but at least annually, on the individual invoice in a manner that is noteworthy, so that the client can evaluate the merits and consider the possibilities of modification. APMSs can also be claimed by the customer for all or part of the savings. The specific content and conditions of the APMSs related to the underlying strategy and goal are determined by the insurer. However, in the case of different requirements depending on the choice of parameters, it is always expected to inform customers in a way that is suitable for drawing attention. It is recommended to include in the APMSs only asset funds for which the daily net asset value is determined on the first business day following the relevant day. The MNB considers it expedient to include asset funds in the APMSs that have the aggregate risk indicator indicated in the PRIIPs KID document.

MNB expects the insurer to check the possible fulfillment of the activation boundary conditions of the APMS automation for each valuation day on the valuation day. An additional requirement is that, in an automatic conversion, the settlement rate should be the closing rate of the net asset value determination date or, at most, the subsequent valuation date. The insurer is responsible for providing the client with the basic information necessary for choosing the APMS. It is also expected that the insurer may change the operating conditions and parameters of the APMSs solely for the benefit of the client on the basis of the results of the regular, but at least annual, review.

Expectations related to internal audit responsibilities

In its recommendation, MNB expects the insurer's internal audit to periodically review the application of APMSs in accordance with the terms of the contract, as well as back-testing on efficiency, usefulness and operation in accordance with pre-defined strategic objectives. It is also important to evaluate material conditions, including IT systems and the involvement of transaction-related processes. In addition, the insurer should evaluate the regulation of processes in internal policies and procedures, which should include approvals, order of transactions, and deadlines and exceptions, should be assessed.

Strategy expectations

The recommendation lists possible strategies for which the relevant recommendations are expected to be applied. However, the insurer also has the option of developing different strategies, but in such cases the MNB expects to justify in an internal document that the deviation is beneficial to the customer.

The **stop-loss strategy** limits the loss of invested capital or the return on it. The level of the threshold is expected to be in line with the risk level of the asset fund and, after the conversion, future regular fees will continue to be invested in the same asset fund at unchanged rates (no redirection). In the event of a redirection, the insurer must inform the customer in an appropriate manner of the asset fund into which the premiums will be paid. During the conversion or redirection, the insurer is expected to transfer the client assets to an asset fund in which the expected risk of reductions arising from the investment is lower than the initial fund. It is necessary to state the low-risk asset fund in the contractual terms of the APMS. Furthermore, the insurer is expected to inform its customers in the terms and conditions of the service that a loss may occur in excess of the loss calculated at the time of exceeding the given value.

Through a **start-buy**, the timing of the payment of one-time or regular fees and the time of investing in an asset fund may differ so that the purchase price is not determined by when the client made the payment. In this case, too, it is necessary to clearly indicate in the contract terms the alternative low-risk asset fund. When the strategy is activated, there is an automatic conversion according to predefined ratios.

The purpose of **take profit strategy** is to realize part or all of the positive valuation difference achieved on the invested capital for the client. It is necessary to define the concept of valuation difference in the description of the strategist.

Customer information requirements

MNB expects the insurer to provide information on the main features of the service contract prior to concluding the contract and to present the following in a manner suitable for drawing attention (also on the website):

- Basic characteristics of APMS (basic concepts, operation of applicable strategies, responsibilities); and
- The possibility and manner of exercising the right of termination, highlighting the available notice period, the possible channels for its submission, the formal requirements and the consequences.

In addition, in case of conversion or redirection, the client is expected to receive all relevant information about the change in the portfolio and the associated costs. MNB considers it a good practice to prepare an easy-to-understand customer prospectus illustrated with examples.

Expectations regarding performance fees applied by investment fund managers

The MNB 11/2021 (VII. 1.) recommendation is based on ESMA's guideline of 5 November 2020 and aims to establish uniform and transparent rules for performance fees applied by investment funds.

General expectations of the MNB

MNB's general expectation regarding the performance fee is that it is charged in a verifiable, non-manipulative manner, and the method used includes at least the following elements:

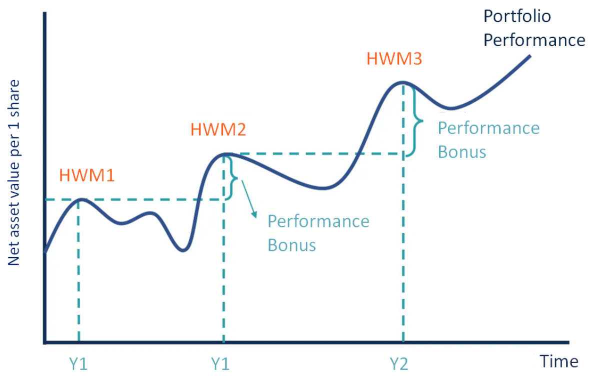
- A benchmark for measuring the relative performance of the fund;
- Frequency and date of settlement;
- Performance reference period;
- The amount of the performance fee; and
- The frequency of the calculation, which must coincide with the frequency of the calculation of the net asset value (e.g. if the fund calculates its net asset value on a daily basis, the performance fee must also be calculated and shown in the net asset value calculation on a daily basis).

Performance fees are always expected to be commensurate with the fund's actual investment performance and artificial increases from new subscriptions should not be taken into account when calculating the fund's performance. MNB expects the fund manager to always be able to demonstrate how the performance fee model of the fund it manages provides a reasonable incentive for the fund manager and how it meets the interests of investors. The performance fee shall be determined, paid and reimbursed in the same way, and the amount of the performance fee may be determined per investor.

High-Water Mark (HWM)

The performance fee calculation based on HWM is popular in the market, so it is specifically mentioned in the recommendation. HWM is the highest net asset value per unit. This forms the basis of the High-Water-Mark model (HWM model), which is a performance fee model according to which the performance fee can only be charged if a new maximum net asset value per unit is reached during the performance reference period.

If a fund uses the HWM model, the performance fee can only be paid if the new HWM exceeds the last HWM during the performance reference period.



Consistency between the performance fee model and the fund's investment objectives, strategy and policy

The fund manager must have an appropriate process in place to verify and review that the performance fee model is in line with the fund's investment objectives, strategy and policy and to monitor:

- The suitability of the chosen performance fee model for the fund; and
- The adequacy of the benchmark, taking into account the fund's investment policy, strategy, risk-return profile, risk differences between the investment objective and the benchmark, and consistency indicators.

If a fund is managed on the basis of a benchmark index and a performance fee model based on it is used, the two indices must be identical at least as follows:

- The fund has a performance target linked to the performance of the benchmark; and
- The elements of the fund held in the portfolio are based on the elements of the reference index

The benchmark index used to compile the portfolio is expected to be the same as that used to calculate the performance fee. However, if the fund is managed on the basis of a benchmark index but the elements of the fund's portfolio are not based on the elements of the benchmark index, the benchmark index used for the portfolio composition is expected to be consistent with the benchmark index used to calculate the performance fee. Consistency needs to be assessed primarily on the basis of a similar risk-return profile of different benchmarks. The fund manager should consider the following consistency indicators based on the type of fund asset class: expected return, potential range of investment vehicles, beta exposure relative to the underlying asset class, geographical and sectoral exposure, fund return distribution, liquidity ratios, maturity, credit rating category and volatility. The Recommendation sets out additional requirements for each benchmark.

Frequency of performance fee settlement

MNB expects that the interests of the fund manager and the unit-holders should be reconciled, as well as that investors should be treated fairly, and that the performance fee should be settled no more than once a year, except in some specific cases included in the Recommendation. It is also expected that the settlement date should be the same for all series of units of the fund for which a performance fee is charged. In the event of the termination or merger of the funds or the redemption of all investment units, MNB sets further requirements in its Recommendation.

Recovery after negative performance (loss)

MNB expects the performance fee to be paid only if the fund has achieved a positive performance in the performance reference period. A performance fee may also be charged if the fund outperforms the benchmark but has performed negatively, provided the investor receives a clear warning to that effect. The aim is for the fund manager to design the performance fee model in a way that does not encourage excessive risk-taking. The performance of the fund manager may be remunerated over a period of time that is consistent with the holding period recommended to the investor.

Publication of the performance fee model

MNB expects investors to be properly informed (in PRIIPs KIDs or in key investor information) if a fund allows the payment of a performance fee even in the event of a negative performance. An additional requirement is that the fund manager must be able to justify the choice of the reference index in the prospectus.

It is a basic supervisory expectation that all information necessary for investors to understand the performance fee model and calculation methodology is clearly defined, and that the prospectus includes specific examples. KIDs must indicate the information needed to justify the charge, the basis on which the charge is calculated and when the charge is applicable. If the fee is linked to a reference index, its name and the corresponding past performance must also be indicated. The annual and half-yearly reports and ex-post prospectuses must include the effect of the performance fees for each relevant series (amount of the fee actually charged, percentage of performance fees within the net asset value of the series).

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Along with the international regulatory environment and domestic practice, MNB is constantly expanding and clarifying its expectations, which significantly affects the participants of the financial markets and their compliance with legal requirements. KPMG experts are available to interpret and implement supervisory expectations and provide relevant professional advice to develop appropriate practices.

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