An Italian job?

Consob's *Marcello Minenna* says the Italian regulator might just have the answer to regulatory conundrums.

The recent financial crisis highlighted the fact that one of the main sources of weakness in the financial system is a lack of transparency regarding the material risks of financial products widely found in the portfolios of both institutional and retail investors. Subsequent regulatory policy worldwide has been driven by two guiding forces: more stability and more transparency. New and more binding capital requirements have been established by Basel III rules in order to increase the buffer available for banks to deal with periods of financial distress. At the same time regulators revised disclosure provisions for financial products, especially those with the most sophisticated structures.

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In Europe, this process has focused on several existing directives that regulate the format and contents of pre-contractual disclosures provided to retail investors, mainly through the prospectus. Directives for funds (Ucits), prospectuses, life insurance and for distributors (Mifid) are all currently under review (or have been updated) with the aim of increasing transparency and allowing investors to compare products by means of 'key information'.

Similar goals also inspired the EU Commission Prips (packaged retail investment products) initiative launched in April 2009, which seeks to harmonise regulations for disclosure and sales, horizontally, regardless of a product's wrapper.

The successful translation of these admirable premises into a new and effective regulatory regime requires recognition that disclosure cannot be left, as in the past, to a prospectus with hundreds of pages detailing all products features but where no risks are concretely disclosed. Prospectuses should enable investors to gain a clear and exhaustive comprehension of the overall degree of risk of an investment, its recommended time horizon, its costs and potential returns.

The latest European regulations on pre-contractual disclosure make some important steps in this direction, but a bigger effort is needed in order to truly improve investor protection. Some attempts have been made to introduce synthetic risk-reward indicators, but these proved unsuitable for certain products. Another approach saw Cesr propose its 'what-if' scenarios in July 2010, showing potential outcomes for performance scenarios for structured funds (Ucits). This has the advantage of being quite easy to implement by issuers, but (as several consultation participants observed) by relying on subjective assumptions it leaves room for discretional representations of a fund's possible payoffs, and it also fails to convey the probability of each scenario crystallising.

Another hurdle is that of defining products 'horizontally', across different wrappers. For instance, the Prips' Task Force on 6 October defined products as 'packaged' if the amount payable to the investor is exposed to the evolution of the value of some underlying assets by mechanisms other than direct holding. This was supplemented by a non-exhaustive list of Prips.

> "It could make the difference between old-fashioned and modern transparency surveillance"

This definition ignores some basic quantitative finance concepts. So, asset-backed securities (ABS) are 'packaged' because they put together tranches with different credit enhancements, while subordinated bonds cannot be considered 'packaged' even though their economic characteristics can be replicated by combining a bond with a credit derivative as in the case of the cited ABS.

Moreover, Prips' definition only partially overlaps with Cesr's recent Mifid guidelines about 'complex' and 'non-complex' products, making uniform disclosure requirements more unlikely than before. Indeed, according to Mifid's Level 1 directive, regulated funds (Ucits) are non-complex products, but they are 'packaged' products in the view of the Prips Task Force. Subordinated bonds, as above, are neither 'complex' nor 'packaged', but nevertheless Cesr thinks they need increased transparency requirements. It is hardly surprising then, that in order to cover the distance between a label- and a risk-based classification there is an internal debate in the Mifid regulatory group on whether to introduce a further category: 'super-complex' products!

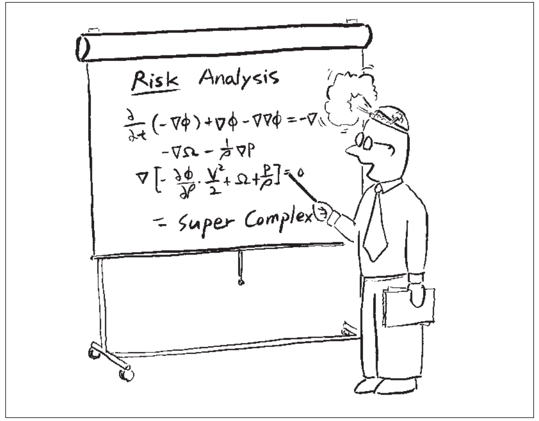
What should be done to avoid further fragmentations in the regulatory framework? In my opinion, Consob has hypothesised an answer: its risk-based approach for mutual funds, insurance policies and other non-equity products, such as many subordinated bonds.

To allow comparability this approach relies on terms derived from financial engineering, distinguishing three kinds of investment: 'return target', 'risk target' and 'benchmark' products. For each product, key information is provided by three synthetic quantitative indicators ('pillars') which illustrate to investors: (1) the recommended investment term; (2) the degree of risk; (3) the probabilistic scenarios of a product's returns together with a table unbundling of the costs (even implicitly) of the products' components to investors.

With these three indicators and a short description of the products' investment policy or financial structure investors can make informed decisions. Indeed, these indicators suggest an easily applied three-stage suitability test. First, eliminating financial products, which do not fit an investor's intended holding period. The second phase would remove possible investments exhibiting a degree of risk (2nd pillar) inconsistent with an investor's risk appetite.

Finally, the investor is able to identify the most efficient and preferred product using the strategy and probability scenarios (3rd pillar). The three pillars can be easily determined by the manufacturer for whatever product (simple or complex, packaged or unpackaged) simply by using internal pricing and risk management models, provided they are compliant with a few best practice requirements to ensure that this information is objective.

The appeal of this approach is that it offers an integrated representation of the impact that various risk factors and the pricing environment have on the specific financial structure of the product and, consequently, on its potential final payoff. The recommended term represents the time by which



costs (including implicit ones) can be recovered from a probabilistic perspective, taking into consideration the cash-flows and underlying risks of a product, using a Monte Carlo-style simulation.

The degree of risk mapped through a suitably calibrated volatility grid that translates this metric into qualitative attributes such as low, medium/low, medium, medium/high, high, very high is a tool that would enhance the comparability of products' riskiness. Moreover, it stimulates the need, much discussed at a regulatory level, for a high frequency evaluation of the fair value of a product.

Providing information on the potential performances conveyed by the table of probabilistic return scenarios is of striking utility. In the case of a structured bond, for example, this table would show the probability of a negative return against a comparable risk-free asset, a return lower than risk free, a return in line with risk free instruments and a return higher than a risk free option. In this way, different investment opportunities become immediately clear and comparable, even when they include either explicit or implicit derivative components associated that carry market or credit risk, as in the case of subordinated securities.

A probability table could be the response to a number of issues that have arisen in European work-groups on the theme of disclosure. For structured funds (Ucits) it could be a valid alternative to the 'what-if' approach; for Prips it could be the additional risk rating the EU Task Force has envisaged for packaged products with a predetermined holding period its last report (point 114); and it could also solve the issue raised by Cesr about the enhanced transparency of products such as subordinated bonds.

The risk-based approach adopted by Consob is challenging for both industry and regulators. It could make the difference between old-fashioned and modern transparency surveillance, the latter being the natural evolution of some basic intuitions present in the prospectus requirements of many countries but with an increased meaningfulness thanks to a solid grounding in quantitative methods.