

Regulators' financial engineering challenge

Italy's regulators are facing some difficult challenges as a result of retail banking and insurance companies' increasing use of structured products. By Marcello Minenna

Italian banking and insurance companies have shown an increasing interest in the securities market in the past five years, spawning significant financial innovation in the retail market. But the new products are throwing up some challenging regulatory issues.

The engineering of structured products must therefore be carefully analysed, given their relevance in the Italian market. Under particular scrutiny are issues concerning fair disclosure of risk and the intermediaries' compliance with the rules of conduct in both the primary and secondary market.

The new products entering the retail market, while appealing commercially, are structured so that it is hard to assess their fair value. The cost of engineering these products, borne by the investors, does not necessarily pay for a professional financial risk management service carried out for their benefit, but instead represents the shift on to the investors of the intermediaries' risk. The investors are not able to recognise this issue because of the lack of disclosure of the fair value of these products. Eventually this cost entails an additional risk-free profit for the intermediary.

As the risk/return features of financial products become more opaque, the Italian regulator, Consob, must intervene on the rules of conduct and carry out its enforcement duties whenever necessary and appropriate. It must ensure full and correct disclosure to investors.

As chairman Luigi Spaventa announced during the presentation of Consob's last annual report, the regulator will target its activities at ensuring a fair quantification and disclosure of the risk/return features of financial products. As a result, it will require intermediaries to structure their internal proceedings to comply with the regulatory principles and criteria necessary to achieve this goal. Only a preliminary and structured quantitative analysis of such products, coupled with a thorough risk management procedure, will enable intermediaries to provide a fair disclosure of the risk/return features of financial products. This will enable in-



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vestors to make informed decisions based not only on a full awareness of the relevant risk, but also in line with their individual investment evaluations and return expectations. Moreover, the regulator's supervision will become more objective, and the intermediaries' activity will be readily verifiable in light of the general principles of fairness and transparency.

This new outlook requires the abandonment of surveillance activity focused on a formalistic correspondence of the intermediaries' activities to statutory rules and administrative regulations. For instance, a sufficient transparency level cannot be reached exclusively – through

contractual arrangements guaranteeing the repayment of the invested principal – without a full disclosure both of the risk management tools the intermediary adopts to achieve such a goal, and of the impact on investors' potential return. Also, an investment cannot be deemed to meet adequacy requirements just because the investor does not notify its risk/return profile, or provides preliminary authorisation for the intermediary's activity without a prior determination of the investor's profile. Furthermore, an activity that creates a conflict of interest is never acceptable, even if authorised by the investor, unless it creates an economic advantage for his benefit.

Quantification

In this context, it is crucial to provide investors with a new means of analysis aimed at effectively quantifying the risk/return features of financial structured products, such as the stochastic calculator available on the Consob website, as well as the securities industry's initiatives aimed at determining synthetic risk indicators.

To guarantee full disclosure of such risk/return features, the aforementioned quantitative evaluations constitute a functional means to determine the investments' adequacy, and to assess the fairness of the intermediaries' conduct vis-à-vis investors. Any such evaluations may reflect the calculations that intermediaries carry out, although they must be adapted to a different target, that is, the risk measurement for investors. As a result, the regulator's rules must be adhered to to ensure full disclosure of the risk/return features of financial products. This will produce an objective evaluation of the adequacy of the investment, and protect the effectiveness of the surveillance measures used to assess the fairness of the intermediaries' conduct. ■

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