Intelligibility test

Just because a structured product uses derivatives or sophisticated systems to measure risk performance does not mean it has to be characterised as complex and restricted to sophisticated investors, says Guillaume Eliet, managing director at the French financial markets regulator. By *Gillian Carr*, with additional reporting by *Jack Prescott*

"Retail investors should not be deprived of innovative products as long as they can perfectly understand the risk they take," said Guillaume Eliet, managing director, regulation policy and international affairs division at Autorité des Marchés Financiers (AMF), in the keynote address to the Structured Products Europe conference at the Hilton London Tower Bridge on November 18.

Eliet referred to the late Steve Jobs, founder of Apple, as someone who realised that sometimes putting an emphasis on the simplicity of a product can make it more difficult to achieve the right results for customers. It is, therefore, unfair to automatically dismiss a more complex product as being the right one, he said. "The problem is, very often retail investors do not have the appropriate knowledge to understand the risk/reward profile of some investment products. Whether this is really a question of the product being too complex [is debatable]. It might be, but it is more a question of the intelligibility of the product," said Eliet.

He acknowledged that while some regulators may be tempted to restrict the marketing or simply ban those products for retail investors, the French regulator has focused on the idea of intelligibility in order to help the financial services industry ensure it is offering the right products to customers.

One way this was done, he said, was an initiative in 2010 by the AMF and the French insurance industry to issue common guidance for the marketing of complex products. In order to protect retail investors from mis-selling, a non-exhaustive list of criteria was created to determine whether products are likely to cause investors to underestimate the risks involved. The guidance also reminded distributors of their responsibility when selecting products offered to individual customers and additionally, the AMF requested that marketing documents for products with a high mis-selling risk should carry a public warning.

This type of regulation puts a focus on intelligibility in a way that is useful for the retail customer, Eliet said. He added that pan-European regulation that focused on this area – the Markets in Financial Instruments Directive (Mifid II) and the Packaged Retail Investment and Insurance-based Investment Products (Priips) regulation – was also looking to bring similar safeguards.

In particular, he spoke about the development of the key information document (Kid) section of Priips. "The [Kid] deals with intelligibility because it will have to represent information in an accessible and consumer-friendly way and in the language familiar to retail consumers."

Eliet also noted that a discussion paper had been released by the joint committee of the three European supervisory authorities – the European Banking Authority, the European Securities and Markets Authority (Esma)






and the European Insurance and Occupational Pensions Authority – on November 17 for stakeholders to have their say. He pointed out that there would be at least two more consultation rounds in 2015 and before the rules are expected to enter into force by the end of 2016.

Advocating probability

The investor protection theme was followed by an insight into the potential and actual use in Italy of probability by retail investors. Marcello Minenna, contract professor of financial mathematics at Bocconi University and head of quantitative analysis at the Italian Securities and Exchange Commission (Consob), followed Eliet with a talk advocating a probability-based approach for calculating possible outcomes in structured products.

Minenna outlined the need to account for both market and credit risk, "After several thousand of these [projections] that come from data implied in the market we can build a line of distribution. That's not the end of the story, if we add credit risk we have to add more information from the market so we have several dimensions to manage."

He explained that one of the difficulties in factoring credit risk into a probabilistic model is that it provides rare but extreme consequences, in comparison to market performance that generally operates within more narrow parameters. "We have to make a simulation and the trajectories would go all the way down to the default level," he said.

"We need something that should be easy to understand and will capture efficiently all the statistical features of the product. The other problem that we have to face is that we have to normalise the different attitudes of the industry to compute risk, even if you calibrate your model to the market data you can have some different probability distribution." Minnena calls this model risk, but outlined methods that could normalise the differences between different methodological weightings.

He expounded the use of "granularity reduction techniques" – a process that entails grouping the thousands of probable outcomes into large groups. He recommended partitioning the probable performance of a product into three main scenarios; depicting a negative return, a neutral return and a satisfactory return with the probability of these events determined by the underlying granular outcomes. ●

In defence of backtesting

While some national regulators are hesitant about or resistant to the idea of including backtesting data in structured products marketing and support documentation, product providers should still be performing the tests internally as a means of best practice, according to a panel of regulatory experts at Structured Products Europe.

Some regulators such as Germany's BaFin and the Financial Industry Regulatory Authority (Finra) in the US have come out against the inclusion of backtesting – also known as pre-inception index performance data – in marketing material. Backtesting can be undertaken using various methods but in general involves testing the performance of a product against historical market data.

However, the panel suggested that backtesting should still be used as an internal risk management procedure for product creators. "In general, backtesting is good for testing the performance possibilities," said Christian Vollmuth, managing director of the German Derivatives Association in Berlin. But Vollmuth cautioned that creators must use backtesting in a reasonable and a moderate way. The fact that Germany's Dax index has performed well over the past five years is no guarantee that it will continue to do so, for example, and that should be made clear to investors, he added.

Patrick Armstrong, senior expert in investment and reporting at the European Securities and Markets Authority (Esma), speaking on the conference panel, said the regulator considered it good practice for firms to backtest their products prior to launch in addition to carrying out stress tests, but not necessarily to make those details public.

"We do not articulate that the results of the backtest or stress test should be withheld. This is good governance for the firm to undertake but where you have an issue is when backtests or simulations are made public," said Armstrong. He added that the problem could be one of selection bias, as a producer of an alternative index strategy is unlikely to produce a backtest that is not favourable to the product.

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