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JANUARY 2011

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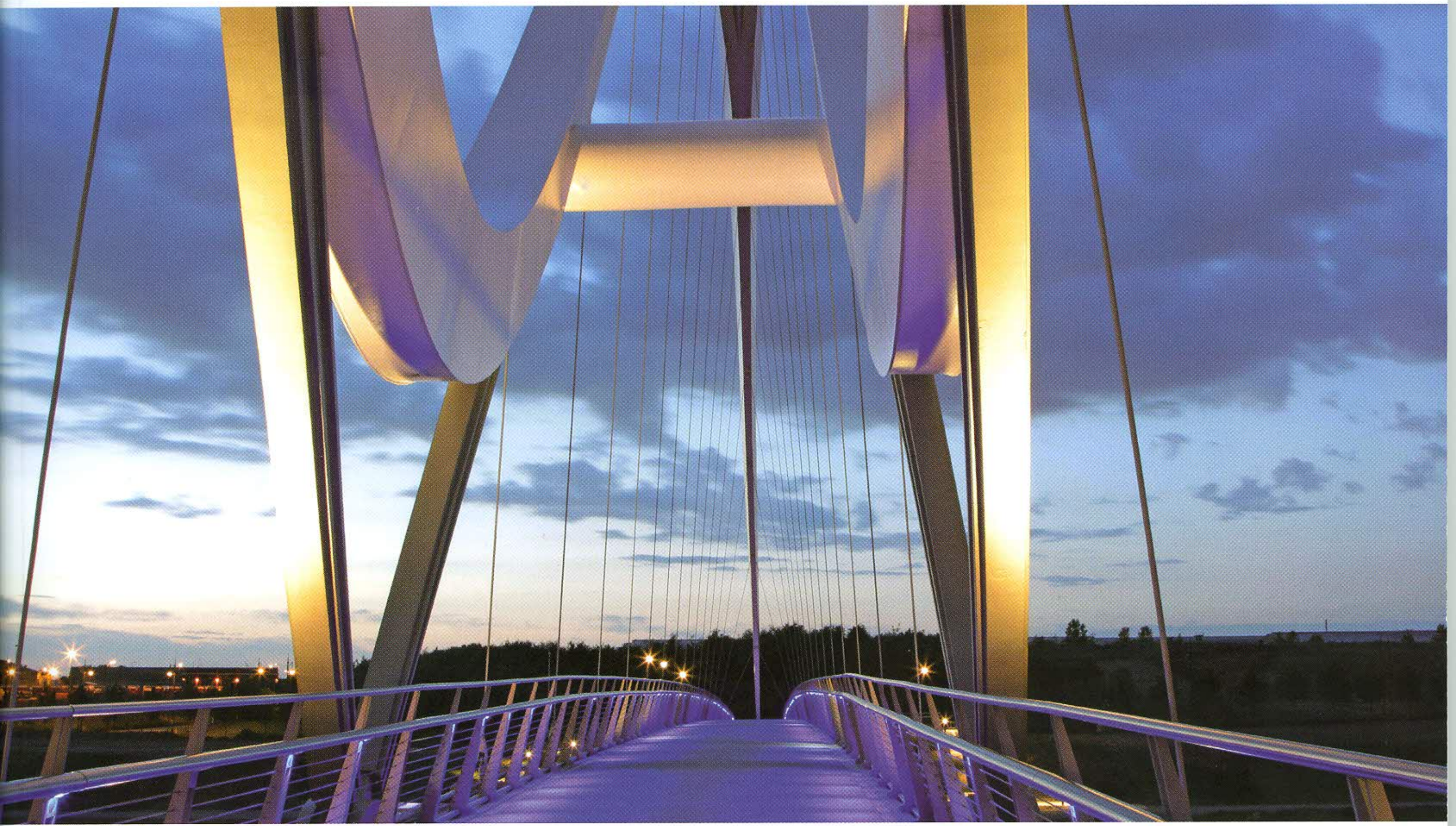

The strong to get stronger

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The 'what if' scenario

The Italian market is recovering from the financial crisis but regulatory pressures are hampering its growth and with the arguments over new regulations now being played out at a European level there is a danger of further disruptions to the market. *Clare Dickinson* reports from the Risk & Return Italia 2010 conference in Milan

A year after new risk disclosure regulations for retail products were introduced to the Italian market, there are ongoing arguments over them. Bankers are still unhappy with the rules but the regulator warned attendees of the Risk & Return Italia 2010 at the Borsa Italiana in Milan on November 25 that without such disclosures structured products cannot be sold to retail investors.

This approach to risk disclosure was first adopted in 2007 but was consolidated in 2009 under the Quaderni di Finanza number 63, which requires institutions to include quantitative risk indicators in their disclosure for non-equity products aimed at retail investors.

The merits of the measures were presented to the conference by Marcello Minenna, head of quantitative analysis at the Commissione Nazionale per le Società e la Borsa (Consob) in Rome.

The regulation has three pillars, Minenna said: a probability table that shows the probability of a return at the end of the investment; a synthetic risk indicator, showing the overall riskiness of a product; and an indicator as to the recommended investment time horizon. These three points come together in a product information sheet, which forms a core part of the prospectus.

> **"We have tried to close the gap between what a bank, insurance company and mutual fund does for measuring risk and what they can disclose about risk to retail investors"**
> **Marcello Minenna, Consob**

"If you engineer products and you price and hedge the risk of the product, it means you have computed the time horizon, the degree of risk and the potential returns. These things must be disclosed," said Minenna.

Consob is asking financial institutions to utilise the quantitative models used in proprietary trading in a form that can be understood by retail investors. "We have tried to close the gap between what a bank, insurance company and mutual fund does for measuring risk and what they can disclose about risk to retail investors," explained Minenna.

Minenna pointed to his statement made at previous conferences that these disclosures are a useful enforcement tool. The regulation means that Consob is able to see data and get feedback about things that do not work or are not coherent.

Investors are given between 10 and 30 days to change their minds about an investment so the product provider is given an opportunity to update the prospectus and send a letter to all the investors who may have bought the products according to incorrect information. This gives them a chance to reconsider their investment.

This has not been welcomed by the market, which has criticised the measures as being too complex. However, consumer associations and academics support Consob's approach.

Increased transparency for retail investments is being developed at a European Union (EU) level, Minenna reminded attendees. The EU is considering changes to the Markets in Financial Instruments (Mifid) directive, the Undertakings for Collective Investments in Transferable Securities (Ucits) rules and new guidelines for Packaged Retail Investment Products (Prips), which will include a Key Information Document (Kid) that is likely to include some kind of probability table.

Instead of the probability scenarios required by Consob for the Italian market and that were originally intended to be included in the revised Ucits directive, the Committee of European Securities Regulators (Cesr) has proposed a 'what if' approach as outlined in its July 2010 consultation document.

Cesr's stance has prompted a movement of Italian academics who support Consob's approach and argue that a 'what-if' scenario is not transparent. They want the idea of a probability table similar to that required in Italy to be re-introduced to the directive. Shortly after the conference a letter was written by a group of leading Italian academics detailing their concerns.

Minenna indicated that he agreed with some of the criticisms voiced in response to this proposal. "In the real world, when you compute price hedging or a probability table, you compute 100,000 trajectories, which return you an entire probability distribution," said Minenna.

Minenna is clear that the 'what-if' scenario is not the right route to go and that if risks are not properly disclosed to retail investors, it could be the end of the European structured products market.

"If you want structured products, you have to disclose the risks in a proper way. The only alternative is that sooner or later, when the next problem with retail investors arises – such as a Lehman Brothers or Icelandic banks – the only solution would be to only sell plain vanilla towards retail investors," he said.

He added that improved disclosure is important in order to rebuild investors' confidence in the financial system and lay the foundations for a full recovery of the market.

While not wanting to directly comment on the ongoing battles over regulation, delegates did express concerns over the extent to which the market is regulated. "Italy is one of the most regulated countries in terms of structured products sold to retail and this, together with tough equity market conditions, has had an effect on the distributor's ability to distribute products in 2010," said Fabio Filippi, head of retail and private banking structured products at BNP Paribas in London, speaking in the conference sidelines.

Unlike most other European markets, Italy has separate requirements for retail prospectuses beyond what is used for institutional investors, which can limit retail offerings, some delegates commented.

The stringent regulatory regime has partly been behind the push to list products on the Borsa Italiana either as the primary method of offering or after the initial offering period. This is done to meet requirements under the EU Mifid rules but also to lighten the regulatory burden for Italian issuers and distributors.

"The distributor is required to draw up a factsheet called 'scheda prodotto' if the product is not listed with additional information besides the prospectus and terms," explained Mauro Giangrande, vice-president at Deutsche Bank db x-trackers and x-markets in Milan. "Between the other pieces of information you have to highlight the cost embedded in the structured, the expected fair value at the end of the offering and a back test. For this reason we list everything."

A listed product is viewed as inherently less risky than the same product if it is not listed. "It is something that changes the risk representation of the product," said Minenna. "When you quote you reduce the minimum time horizon of the product with respect to its maturity since investors can dismiss it at the first date the costs will be reasonably recovered."

With the growth of the listed products market, exchange-traded notes (ETNs) are being introduced to Italy. But the idiosyncrasies of the Italian market are also being played out there, as discussed in the conference sidelines.

As these instruments are new to the Italian market, Borsa Italiana has struggled to find a place for them. Under Italian financial law there is no such thing as an ETN, which means that while in London and Frankfurt the exchanges set up dedicated ETN segments, when Barclays Bank came to list its VStoxx ETNs in Milan, it came across some hurdles.

"Italy is one of the most regulated countries in terms of structured products sold to retail"
Fabio Filippi, BNP Paribas

"There is no specific segment at Borsa Italiana for ETNs as, under Italian law, these instruments qualify as certificates and can therefore only be listed and traded on the Sedex certificates segment," explained Daniele Penna, investor solutions for Southern Europe at Barclays Capital in London.

"Having said that, there is one main feature that differentiates the iPath ETNs from many other certificates currently listed and traded on Sedex: the early redemption at NAV for amounts over 25,000 units."

However, Lyxor listed its ETNs under Borsa Italiana's exchange-traded commodities (ETC) section because they track commodities, like rest of the ETCs on the exchange. These products are issued through a Special Purpose Vehicle, whereas Barclays' ETNs are issued by the bank and investors in them are therefore exposed to Barclays' credit risk.

A few market participants present at the conference expressed concerns about this way of listing ETNs, saying that there is a danger that this will confuse investors.

Although many providers are moving towards exchange trading, the lack of clarity over listing ETNs is stopping some from participating in this particular listed products market. A fact that Fabrizio Fiocchi, a structurer at Banca IMI in Milan noted.

But despite the growth in listed products, the third-party distribution market is still active because it caters to a different type of investor, explained Fabrizio Boaron, head of investor solutions for Southern Europe at Barclays Capital in London, speaking before his presentation on Barclays' Italian-listed ETNs. He noted that some investors will never buy on exchange.