Who pays *for financial engineering?*

Marcello Minenna, enforcement officer with Consob, the Italian securities market regulator, argues that it is often difficult for investors to assess the value of structured retail products

Marcello Minenna says new products are throwing up some Challenging regulatory issues

The Italian retail investment markets have witnessed significant financial product innovation over recent years, as banks and insurance companies have become increasingly interested in the opportunities offered by securities markets.

But those new products are also throwing up some challenging regulatory issues. The engineering of structured products must be carefully analysed; in particular, Italian regulators are scrutinising the issues of fair disclosure of risk and the compliance by financial intermediaries with the rules of conduct in both the primary and secondary markets for structured products.

The new products we see entering the retail market, while they are undoubtedly commercially appealing, are structured so that it is hard to assess their fair value. And the cost of engineering these products, borne by the end-investors, does not necessarily pay for a professional financial risk management assessment carried out for their benefit. Instead, pricing represents the shifting of the intermediaries' risk on to investors. Investors are not able to recognise this risk pricing issue because of the lack of disclosure of the fair value of these structured products.

Consob will target its activities at ensuring a fair quantification and disclosure of the risk/return features of Financial products

Announcement by Consob chairman Luigi Spaventa

Because the risk/return features of financial products are becoming more opaque, Consob must intervene to enforce the rules of conduct and carry out those enforcement duties whenever necessary and appropriate.

As Consob's chairman Luigi Spaventa announced at the time of the agency's last annual report, Consob 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 thorough quantitative analysis, coupled with a thorough risk management procedure, will enable intermediaries to provide a fair disclosure of the risk/return features of financial products. Not only will this enable investors to make fully informed decisions, but Consob's supervision will become more objective and the activities of intermediaries will be readily verifiable in light of the general principles of fairness and transparency.

This new outlook requires traditional regulatory surveillance activity, focused on a formalised relationship between intermediaries' activities and statutory rules and administrative regulations, to be abandoned. In the case of structured products this means, for example, that we cannot achieve a sufficient level of transparency simply through a contractual arrangement that guarantees the principal. We also have to have full disclosure of the risk management tools used by the intermediary to achieve that guarantee. And we must have full disclosure of how those tools might affect the return to the investor.

So it is crucial that investors are provided with a new way of analysing and effectively quantifying the risk/return features of financial structured products. There is some progress here. In Italy, investors can access a stochastic calculator on the Consob website, and there are also initiatives by the securities industry in the development of synthetic risk indicators.

To sum up: quantitative evaluations and the full disclosure of risk/return features are needed to determine the adequacy of a structured investment product, and the fairness of the conduct of the financial intermediary towards investors.