Enter the quant regulator

If regulators want to improve the level of disclosure for retail investment products, they need to abandon a narrative description of the risks in favour of quantitative indicators. This is the only way to close the information gap between the industry and investors, argues ***Marcello Minenna***

Retail investors have always been at a disadvantage when buying non-equity financial products. While structuring banks have access to cutting-edge models, retail investors typically do not have the technical expertise to understand the risks or implicit costs associated with a particular product. Instead, they are reliant on the information provided by the banks or distributors. It is up to regulators to set the rules of the game to ensure there is sufficient transparency, both within the prospectus and at the point of sale.

There has been some improvement in the rules governing the marketing and sale of financial products to retail investors, particularly in the wake of the financial crisis – but there is still some way to go. Regulations still tend to use simplistic labels to group products, and require long descriptions of their main features rather than focusing on information that provides a realistic snapshot of the risks.

Roughly speaking, there have been three phases of evolution in the regulation of retail investment product offerings in Europe. The first covers the period before the implementation of the Markets in Financial Instruments Directive (Mifid) in 2007. During this phase, a prospectus could run to hundreds of pages, with lengthy descriptions of multiple risk factors, written in legal jargon, which were often not specific to the individual features of the product. There was also little analysis of the risks and the possible consequences – either positive or negative – for the investor. As a result, the issuer had significant leeway in choosing what to say to the investor and how to say it.

At the same time, there was a lack of support for investors at the point of sale. Suitability and appropriateness tests tended not to be conducted, and distributors only had to comply with general principles of good conduct – for instance, always operating in the interests of the client. These were not typically backed up by more detailed rules, making it difficult to enforce effectively. Supervisors had minimal responsibility, as long as the prospectus covered all the risks – regardless of whether important information was hidden in long and virtually incomprehensible prose.

The second phase coincided with the introduction of Mifid. Crucially, the regulation imposed disclosure obligations on distributors. It also saw the start of a process to improve the transparency of prospectuses by adding certain key information – essentially, a summary of how the product works and the main risks. However, the information provided by the distributor was independent from that communicated by the issuer via the prospectus, so investors might receive information that was not consistent or comparable.

There were also weaknesses in the two sets of requirements. The summary of key

> "There is still a reliance on the old descriptive approach and the classification of products based on legal or commercial labels"
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