Response to the Consultation by the Board of the International Organization of Securities Commissions (IOSCO) on the project and the work undertaken by the Working Group on Retail Structured Products of the Task Force on Unregulated Markets and Product.

We are a group of academics, consumers associations, unions and other representatives of investors' interests who want to express a common view about the issues regarding Retail Structured Products that have been raised in the consultation report.

On December 4th 2010 and January 31th 2011 we sent two different letters to the European Commission and to ESMA in response to two public consultations on "the selection and presentation of performance scenarios in the Key Investor Information document (KIID) for structured UCITS" and on "the legislative steps for the Packaged Retail Investment Products initiative", expressing in both contributions our shared position about the use of the scenario analysis/valuation matrix (also known as "what-if" analysis) approach to implement the performance scenarios in the KIID for structured UCITs and PRIPs.

In these letters we highlighted the inadequacy of the scenario analysis/valuation matrix as transparency tool (issue 5 for consultation), since it provides a partial representation of the potential returns of a structured product. We also pointed out that the natural use of the scenario analysis/valuation matrix is inside advertising pamphlets, while its unavoidable arbitrariness makes it unacceptable in a document (like the KIID for UCITs or the forthcoming KIID for PRIPs) aimed at providing "sufficient information for the average retail investor to make an informed investment decision", as stated in the Consultative Document on PRIPs published by the European Commission on November 26th 2010.

We firmly believe that the main goal of regulation is to provide retail investors with adequate information on the key characteristics of financial products and the associated risks and costs so that they can be effectively supported in the selection of solutions that best suit their needs. This selection cannot avoid a probability judgement from any individual, and each of them, independently from her education, country and social condition would always ask the same question: what are the risks I am going to bear with this investment, with respect to a safer one? The proper disclosure of the probability distribution in a form easily understandable from a retail investor (e.g. a table) provides a direct answer to this question, and answering this question must be mandatory for any financial institution proposing an investment.

Moreover, the use of this powerful disclosure tool cannot be limited only to supposedly complex products, since the interaction between the complexity of a structured product and its risk is not linear. In fact, complexity can enhance returns introducing additional risk but also some relatively simple products may expose investors to high risk, like in the case of the default risk of the issuer associated to a zero coupon bond. An objective evaluation of the risks connected to simple products via the probability distribution is also needed, in order not to leave their assessment only to the investor's perceptions that can be distorted or even manipulated.

In this perspective, on behalf of investors' protection we want to share some technical considerations that clearly demonstrate the superiority of a probabilistic approach with respect to the simplistic scenario analysis/valuation matrix that, on the contrary, shows some serious drawbacks.

1. scenario analysis/valuation matrix is a marketing tool and it is not a transparency tool: scenario analysis is based on a particular evolution of the market and as such it is completely arbitrary, and

subject to manipulation and distortion. As such, it may be an important marketing tool, but cannot be confused with transparency;

2. scenarios can only be stated in terms of probability: transparency has to do with helping retailers to make clear the probability of success of their investments, while a scenario analysis/valuation matrix provides a representation of a single state of the world out of an infinity of other possible ones, and as such has zero probability; collecting all scenarios and distinguishing among good, bad and fair necessarily leads to a probability table. Without this additional piece of information on probabilities the scenario analysis/valuation matrix would only favour investors' confusion and misunderstanding since their natural interpretation would be to consider each of the three outlined "what-if "scenarios as exhausting all possibilities and having the same probability, which is clearly false;

3. comparison of different products can only be done in terms of probability: in a scenario disclosure, every product is evaluated (and not measured) in a different setting and cannot be compared across different asset classes and products unless all possible scenarios are collected (and measured) in a probability table;

4. probabilistic comparison across products in order also to be comprehensible needs a proper partition of the product implied probability distribution into some specific events. To conduct this partition the safest financial investment (i.e. the risk-free asset, *rfa*) – that at the present date in Europe can be identified in the Overnight Index Swap term structure (OIS) – is adopted. It allows to identify four main performance scenarios (negative return and positive return respectively below, in line and above the *rfa*) each one identified by the associated probability and by a value (i.e. the conditional expected return of each partition) which synthesizes the returns achievable in that scenario. 8 simple and understandable figures allows the investors to understand with what probability he will lose or gain (in this last case by focusing three growing gaining scenario, i.e. lower, in line and above the *rfa*) a certain amount of money in average. With these 8 indicators the probability distribution is partitioned in an adaptive way that is sensible to the changing markets condition and investors are allowed to get a fair comprehension of the performances and risks associated to the product;

5. financial products are designed using probability: any asset manager and structurer address the same basic question as retail investors do: how much am I likely to perform better than other products? Differently from retail investors, they must be endowed with technical tools and skills to provide an answer. So, disclosing this information must be mandatory from a regulatory point of view because sharing this information is mandatory from a deontological point of view. Moreover, given the in-house availability of the mentioned tools and skills, issuers can provide consumers with this key information without any additional burden with respect to their usual pricing and risk management activities.

For the above arguments, we confirm our view that performance information should not be offered through the scenario analysis/valuation matrix approach (issues 5 and 12 for consultation). Out of an infinity of possible results of the investment, this approach considers three elementary outcomes, selected at the convenience of the issuer. As witnessed by several studies and by tests on large samples of individuals, this representation fosters biased beliefs, since the three elementary scenarios are perceived as exhaustive of all performances achievable by a product and they are also considered as having the same 33% probability of occurring.

Both these beliefs are clearly false. The probabilistic approach is a much better alternative to concretely support investors, as it encompasses the entire probability distribution of the product's final performances and summarizes it in four events of paramount importance for any investor: experiencing a loss (negative return), or getting back the amount invested plus a return below, above or in line with the risk-free.

Information on probabilistic performance scenarios should be supplemented by the breakdown of the product price at inception in order to highlight costs and fees (issue 10 for consultation). The fair value of the structured product at the issue date will be the discounted expected value of the final probability distribution under the risk-neutral measure (issue 11 for consultation). In this way the investor will be immediately aware that any gap between price and fair value is a cost he is paying, either explicitly or not.

Beside the above information, the logic of risks representation behind the transparency on structured products and the relevance of investors' liquidity preferences in affecting their investment decisions suggest to include, as further information item inside a short form or summary disclosure (issue 9 for consultation), an indication of the time horizon of the investment as currently prescribed by some national regulators (see hereafter for a concrete example).

Indeed, every retail individual who is evaluating where to invest his savings wants to know how long he has to wait before getting back its money or maximizing its potential returns. It is a legitimate question which should be answered inside the short form or summary disclosure, and proper methodologies should be used by product manufacturers to determine the time horizon of a product in an objective way and consistently with its costs and level of risk.

Historical information about the past performances of a structured products should carefully be avoided (issue 13 for consultation), since it clearly can be misleading for the investor; past information can be recovered inside a standardized synthetic risk indicator, based on returns' volatility. We agree that, in general terms, volatility is a straightforward indicator of the riskiness of a product, but per se it is just a statistic whose values can be very different depending on the sampling period of the returns and on the number of past observations used. We believe that a valid calibration of a standardized synthetic risk indicator based on volatility should lay on robust quantitative methodologies based on forward looking simulations of the potential daily returns of a product over its time horizon that can be regularly updated during the lifecycle of the product (issue 8 for consultation).

As partially mentioned in the consultation report, in Italy since a few years the Securities and Exchange Commission (CONSOB) has adopted a risk-based approach to transparency which answers the above questions for many investment products other than equity. For instance, about the time horizon of the investment, CONSOB requires issuers/product manufacturers to consider the distribution of the first passage times of the theoretical value of a product for a barrier corresponding to the price paid by the investors and to give investors a clear indication of the year by which the investment will have repaid at least the costs incurred.

In Annex I to this letter we considered an hypothetical structured product and we illustrate, in a table, a short form or summary disclosure filled according to the mentioned CONSOB's approach (issue 9 for consultation). It is a very useful example of the importance of choosing the right informative set and the proper solutions to produce and to represent it.

We all hope that our comments and suggestions could help the Working Group to finalize the project and the work undertaken on Retail Structured Products and to propose transparency requirements on

structured products which would be both objective and useful to retail investors in comparing the various products on a fair basis and in selecting those which better suit their needs.

We firmly believe that these are crucial steps to be enacted in order to fulfil the prior commitment of any national regulator, i.e. to protect investors and restore their confidence in the financial system by endowing them with the best disclosure tools required to overcome the otherwise unavoidable informational asymmetries they suffer with respect to the subjects who have issued or designed the financial products.

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ANNEX I

SHORT-FORM OR SUMMARY DISCLOSURE OF AN HYPOTHETICAL STRUCTURED PRODUCT

CONSOB RISK-BASED APPROACH

Product Description
The product has a floor of 80% and a cap of 120% of the amount invested. Its payoff depends on a formula linked to the return of a basket of three shares over the last 4 years.

Fund Structure: **Return-Target**
Investment Time Horizon: **4 Years**

Degree of Risk

low	medium-low	medium	MEDIUM-HIGH	high	very high

Unbundling of the price

Bond component	88.13%
Derivative component	6.92%
Total financial value	95.05%
Costs	4.95%
Price	100%

Table of probabilistic performance scenarios

Scenario	Probability	Median Value (w.r.t. 100 €)
The return is negative	42.3%	88 €
The return is positive but lower than the return of the risk-free asset[1]	13.8%	103 €
The return is positive and in line with the return of the risk-free asset	29.8%	115 €
The return is positive and higher than the return of the risk-free asset	14.1%	119 €

[1] The Overnight Index Swap (OIS) term structure is used to identify the risk-free thresholds.