Regulation of the issuance of structured financial products for retail investors

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Structured financial products for retail investors, in Germany often in the form of "certificates", represent a significant market segment which continues to grow. Through the course of the financial crisis, however, and particularly upon the collapse of the investment bank Lehman Brothers, these products gained much negative attention among the broader German public. Reinforced by media coverage about the stories of affected individual investors, the call for strengthened consumer protections against faulty or misleading financial advice grew louder. As an initial response, legislators enacted a requirement to provide summary documents called Key Investor Information Documents (KIIDs), outlining the key information, risks and costs in clear language. This paper takes a closer look at the design and effectiveness of KIIDs particularly with regard to the scenarios chosen by issuers to illustrate the products.

On the basis in German national law of Section 5a of the Regulation Specifying Rules of Conduct and Organisational Requirements for Investment Services Enterprises (Wertpapierdienstleistungs-Verhaltens- und Organisationsverordnung, WpDVerOV), the German Federal Ministry of Food, Agriculture and Consumer Protection (BMELV) published a standardised template for Key Investor Information Documents involving financial products with the aim of making the information more understandable and improving comparability among different investment providers. The objective of this FIRM-sponsored research project, entitled "Regulation of the issuance of structured financial products for retail investors", is to examine the degree to which the current regulatory requirements serve to protect investors. It specifically focuses on the scenarios provided within PISs, particularly against the background of a recently published study commissioned by the BMELV [see Habschick et al. 2012] which, among other findings, comes to the conclusion that the presentation of illustrative scenarios should be regulated.

Justification for, and necessity of, governmental regulation

Research studies have analysed the extent to which issue prices of structured products deviate from their theoretical fair values. While this margin was several percentage points just a few years ago [see Wilkens/Erner/Röder 2003], it has diminished substantially in recent times – at least for standard products, for which margins are now significantly below one per cent [see e. g. Baule 2011]. There are, however, great differences depending upon complexity, with complex products marked up with far higher margins than simple structures [see Stoimenov/Wilkens 2005]. In a recent study of the U. S. market, Henderson and Pearson [see Henderson/Pearson 2011] found that the average mark-up was eight per cent – and this for products with termination rights on the part of the issuer.

These margins alone, however, do not constitute a justification for governmental regulation. Under banking regulation theory, an intervention of this kind might be based upon a need for investor protection. Analogous to Dewatripont and Tirole [see Dewatripont/Tirole 1993, 1994], who base a need for banking regulation upon the inability of investors to monitor their investments, or only at an excessively high cost, one might find justification for regulating the market for structured financial products in the excessive costs which investors would other incur in order to gain a correct understanding of the product and its pricing. This, for example, is suggested by empirical studies by Rieger [see Rieger 2012], which demonstrate a strong relationship between erroneous estimations among investors regarding the probability of certain future price patterns and the inclusion of structured financial products from which issuers profit because of precisely these misestimates.

In the KIIDs which they provide, issuers frequently explain their products with the aid of illustrative scenarios. In this way, the payout of the instrument is depicted under various future scenarios of how its key value driver, such as the German stock index DAX, might perform. Studies based upon product term sheets in the U. S. market suggest that the selection of these scenarios is strongly biased toward those which are favourable to investors [see Olazábal/Marmorstein 2010, Bernard/Boyle/Gornall 2011]. This could mean that investors are being deliberately misled, which would in turn necessitate regulation (or more stringent regulation) of these scenarios. It is at this point that the current research project enters in.

Scenario bias in KIIDs – but at all not what one might expect

In order to examine this accusation of systematic bias by the banks which issue these structured products, the project undertook the first broadly comprehensive analysis of their "suggested expected return", meaning the expected return as suggested by the illustrative scenarios in each sales prospectus. The study encompassed the KIIDs of all discount certificates, bonus certificates and express certificates from relevant issuers on the German market which were outstanding on the defined study date (approx. 19,000 KIIDs). The study also included comparable documents for all structured

financial products issued on the U. S. market in May and June 2012 (approx. 1,000 documents).

The results of the study stand in surprising contrast to the findings of previous studies, which analysed only small numbers of prospectus documents. In the great majority of cases, the average return of the scenarios presented was found to be negative. Overall, the average "suggested expected return" was -15 per cent on the German market and -6 per cent on the U. S. market. At the issuer level, the average scenario return was likewise negative for all issuers in the German market. These figures provide rather strong evidence against the frequently heard accusation that the banks which issue these products distort the scenarios to mislead investors. Far more to the point, the findings raise the question of whether these scenario-based suggested returns have any influence on investors at all – and thus what priority should be given to such scenario-based analysis in terms of regulatory measures.

Influence of scenarios far less than assumed

In order to answer this question, the current project examined the extent to which scenario selection in sales prospectus documents influences an investor's perception of the products which they represent. This was done by preparing fictitious KIIDs describing examples of certificate products (discount, bonus and express) and presenting these to more than 300 volunteers. The presented scenarios varied with regard to average scenario return (i. e. upward and downward bias) as well variability of scenarios returns (as a measure of "suggested risk").

Quite astonishingly, the selection of scenarios in each KIID had virtually no measurable influence on the subjects' assessment of each certificate product. In particular, investor estimates of the expected return of each certificate showed no relationship to the upward or downward bias of the scenarios presented. The same was found for the variability of scenario returns: Products with a broader dispersion of illustrative scenario outcomes were not regarded by investors as being any more risky.

These findings strongly suggest that potential investors are largely immune to attempts to influence their investment decisions through biased scenario selection. This leads to the next question: Do these illustrative scenarios provide any benefit at all? The study addressed this question by gathering and examining further empirical data on the comprehensibility and perceived complexity of the certificate products presented. This was achieved by entirely excluding illustrative scenarios from a percentage of the (fictitious) KIIDs. While the inclusion of scenarios had no evident influence on investors' ability to grasp simple products, they were found to diminish the perceived complexity of more complex product structures. Specifically, the subjectively determined difference in complexity between bonus and express certificates was markedly less when illustrative scenarios were included within the KIID.

Conclusions

With regard to the question initially posed by the project, the conclusion may first be drawn that banks do indeed already fulfil regulatory requirements in their present usage of illustrative scenarios. In most cases, these scenarios are electronically generated for customers "on the fly", i. e. on the basis of current market data. Through this arrangement, the information which is provided to the potential investor is always up to date. Contrary to the frequently heard claim that the returns under the illustrative scenarios are biased toward outcomes favourable to investors, the study findings show that the scenarios rather tend to present negative potential outcomes. On top of this, the choice and presentation of scenarios were found to have virtually no measurable influence on investor perception of structured products in terms of expected return and risk. More stringent regulation of scenarios as presented in KIIDs would therefore seem unnecessary. The future focus should instead be directed at finding ways to improve investor understanding of these products.

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