

Rethinking Regulation and Oversight to Learn the Lesson from the Crisis*

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ABSTRACT

During the last few years thousands of pages have been written to describe what happened, even if we need to dig a bit deeper to understand how come in the past four years an increasing number of events have fallen in the tails of our probability distributions, without soliciting any early intervention by the relevant Authorities. Among the main driving forces that have reshaped the financial landscape, the following ones are usually underlined: (a) a pervasive financial integration that has increased interdependence, amplified diversification opportunities and widely dispersed risk; (b) greater interactions between technical progress and financial innovation; (c) the emergence, out of the shadows, of new financial intermediation models and new complex financial products, both relying on sophisticated risk management techniques. Two examples can help in understanding the changes underway, their likely persistence and their possible drawbacks: the Originate to Distribute model and the “mutation” of Exchange Traded Funds (ETF).

To address the question on the role of regulation and oversight, we could ask whether we are living in a deterministic world, in which it is possible to learn from our past mistakes to conceive better policy tools, or in a stochastic context in which potentially disruptive extreme events inevitably belong to the tails of probability distributions.

As it cannot be excluded that also in the future we will have to face the drawbacks induced by wrong or misaligned macro-economic policies and incomplete rule-books, the Authorities have to reconsider their approach. The need of being more “proactive” than “reactive” is imposed by the complexity, rapidity and pervasiveness accompanying the mutations of the financial landscape. These dynamics inevitably open up the distance between reality on one hand and the regulatory system on the other. That’s why, not to be caught lagging behind it, they need to change their rules and oversight approaches as well. This means: less but more effective rules balanced, more focused oversight and enforcement practices, more cooperation and more investments in methodological tools for a better understanding of financial innovation.

In Europe ESMA is addressing these issues to face, in due time, any possible negative implications on retail investors, as well as on systemic financial stability. In a globally ever more interconnected context, we do need up-dated, state of the art tools to effectively keep under control and manage the growing riskiness surrounding us. The capability of foreseeing market dynamics must be strengthened, to prevent in due time that innovative products and processes are utilized to trigger, amplify or hide the vicious circle that, during the last decade, has very often transformed financial activities from being a tool into an end in itself, with potentially disruptive, uncontrolled systemic consequences.

1. Introduction

1.1 Four years ago Prof. Niall Ferguson¹ published an essay underlining that a long-term perspective is the most appropriate one to interpret the financial turmoil still surrounding us.

To be more precise, he takes the point that an effective approach for the reading of it is the “Darwinian evolutionary law”. In fact, the Financial Services Industry has many of the defining characteristics of a true evolutionary process, as we have:

- “genes”, that is an organizational memory and a specific role in the co-evolution process;
- the potential for a spontaneous “mutation” induced by technologically driven innovation;
- “natural selection” through a competitive allocation of capital and human resources, that induces differential survival;
- scope for “speciation” and “extinction”, that is the creation of entirely new species with some of the existing ones dying out all together.

He also observes that in the financial sector, along with natural selection, we have as well “institutional mutations”, that is random shifts that can introduce some more or less recurring disruptions in the form of geopolitical shocks, financial crises and regulatory interventions.

Facing the regulatory issue, Ferguson underlines that, whereas evolution in biology takes place in a natural environment where changes happen essentially at random, in the financial services it occurs within a “regulatory framework” that can play a predominant role in the shaping of it. That happens, for instance, when we prevent the extinction of some banks by bailing them out to protect retail investors and/or to pursue a macro-stability goal.

¹ Ferguson, N. and Wyman, O. (2007), “*The evolution of financial services*”, Oliver Wyman Limited.

When regulation comes into the picture, the whole evolutionary perspective is challenged, as regulation resembles more what an anti-Darwinian “creationist” would define as the outcome of an “intelligent design”.

1.2 It is quite curious that terms like “mutation” and “adaptation” have been recently used explicitly by the Financial Stability Board while soliciting the urgency to conceive a viable range of regulatory options, sound enough to address the issues posed by the so-called “shadow banking system”.

This term is widely used but there is no commonly agreed definition of it even if, broadly speaking, it reflects the growing importance of activities structured outside the regulated Banking System, but performing bank-like functions.

The provocative approach suggested by Prof. Ferguson poses two types of questions. The first one relates to the nature and persistence of what’s going on; the second concerns the role, or if you prefer the responsibilities, of the Authorities both as regulators and supervisors.

2. On discontinuities

2.1 Elaborating a bit on the first question, we could start by asking, as somebody did, if we are experiencing a severe winter or, rather, the prelude of a new glacial era.

During the last few years thousands of pages have already been written to describe what happened², even if we need to dig a bit deeper to understand how come in the past four years an increasing number of events have fallen in the tails of our probability distributions, without soliciting any early intervention by the relevant Authorities.

You are certainly already aware of how difficult it is to handle a tail. In fact, when some event falls more and more systematically in one tail, very likely our models are no longer up to the task of properly describing the outside world.

² On the dynamics and on the foreseeable occurrences of the crisis: Roubini, N. and Mihm, S. (2010). “*Crisis Economics*”, Allen Lane, London; Stiglitz, J.E. (2010), “*Freefall: America, Free Markets, and the Sinking of the World Economy*”, Norton.

So, first of all, we have to investigate the nature of any possible new structural set-up, to be able to adjust our tools to the new occurrences. In other words we have to find out if new species have already taken form, protected by the shadows surrounding the financial system: that is, outside the remit of what is already known, properly regulated and effectively overviewed.

2.2 The experience of the last decade is telling about all that. In a simplistic way financial market dynamics could be described as characterized by new business practices, supported by innovative financial products, within a regulatory environment pervasively grounded at micro-level, but unable to intercept the macro-systemic implications in due time.

Among the main driving forces that have reshaped the financial landscape, the following ones are usually underlined:

- a pervasive financial integration that has increased interdependence, amplified diversification opportunities and widely dispersed risk;
- greater interactions between technical progress and financial innovation; foremost,
- the emergence, out of the shadows, of new financial intermediation models and new complex financial products, both relying on sophisticated risk management techniques. All this has significantly increased “participation costs”³ for “uninvolved” and “uninformed” investors and opened up the possibilities for some intermediaries, like banks, to reduce these costs by acting as an interface, through innovative products, between market complexities and their customers.

Two examples can help in understanding the changes underway, their likely persistence and their possible drawbacks. The first one is a case of “co-evolution”; I am referring to the intermediation model labeled OTD (Originate to Distribute) conceived some years ago. The second is an example of the “mutation” of Exchange Traded Funds (ETF), induced by the underlying product innovation in progress.

³ Allen, F. and Santomero, A.M. (1998), “The theory of financial intermediation”, *Journal of Banking and Finance*, Vol. 21, Issues 11,12; Allen, F. and Santomero, A.M. (2001), “What financial intermediaries do?”, *Journal of Banking and Finance*, Vol. 25, Issue 2.

2.3 The basic structure of the OTD model can be described as follows: instead of holding their originated loans to maturity, banks started repackaging and selling them to other investors through increasingly complex securitization techniques⁴. Consequently, credit risk was no longer on the banks' books, but potentially dispersed among a multitude of investors very often unaware of the underlying riskiness.

The rosy side of this approach leads one to believe that the new model permits a more efficient allocation of credit risk, by reducing illiquidity cost and freeing up capital on the supply side while, on the demand side, by opening the credit risk market to investors in search of higher yields and greater diversification opportunities and by dispersing it among a larger number of investors with different risk appetites.

However, along with the just mentioned advantages, this structural change also entails a number of dangers; some intrinsic to its mechanism, others more related to the greater interdependence of the financial system. In fact, the present financial turmoil has brought out the weaknesses of the OTD model; the recent sub-prime collapse is a good example of its malfunctioning. We can list five of them:

- the pricing of the new structured financial products (ABS, CDO, CDS...) is not so trivial, as these instruments are very often complex, illiquid and opaque. Their valuation depends on sophisticated and data intensive models; consequently an incomplete set of data may induce substantial "model risks" and exacerbate, as recently happened, the model failure problem⁵;
- the role of rating agencies is crucial as they serve as third-party certifiers of the quality of structured products; in so doing, they face technical and incentive problems. In fact, these products are not usually traded on secondary markets so no public information on their value is available; therefore, conflict of interests can be particularly acute. Moreover, while their evaluations are expressed in discrete time, market standards would require a continuous flow of information;

⁴ This move is perfectly in line with the idea that banks, in order to survive in the new landscape, have had to reinvent their business approach developing new innovative products, as suggested by Allen, F. and Santomero, A.M. (1998) (2001).

⁵ Danielsson, J. (2008), "Blame the models", in *The First Global Financial Crisis of 21st Century*, Cepr (2008).

- the incentive for banks to act as delegated monitor for their borrowers is substantially weakened as the loan generator no longer holds its risk. Therefore, the interest of banks to avoid the deterioration of their loan portfolios is greatly diminished;
- once structured financial products are sold there is no telling where the risk will end up; maybe in unregulated high-leveraged institutions (such as conduits, hedge funds or vehicles) that may pile up substantial credit, maturity and liquidity risk as well;
- it is self-evident that under these conditions, lacking sufficient information, any adverse event might trigger enormous losses and lead to a liquidity squeeze in money markets, with relevant stability implications.

As a result, while systemic events have been perceived less likely thanks to diversification and risk dispersion, their impact and costs went up because of the overall increase in leverage and interdependence. That's why the "tail" risk turned out to be larger than commonly thought and the probability of extreme events has been systematically underestimated for a long time.

So as to complete the picture, it can be useful to remember that in 2002-03, given the low interest rate environment induced by the lax US monetary policy, the just mentioned structured-credit-products have helped the institutional investors to obtain suitable returns and, in the following two years, the banks to fund an increasing demand for loans, easing in the meantime their credit risk assessment standards.

Broadly speaking, it has also been underlined that, because of the OTD model in place, a more diffused short-termism has influenced the decisions of households, banks and institutional investors, along with the views of the rating agencies⁶.

2.4 To introduce the ETF⁷ *mutation*, we can move from the significant reduction of the investors risk appetite induced by the financial crisis, and from

⁶ Linciano, N. (2008), "La crisi dei mutui subprime. Problemi di trasparenza e opzioni di per le Autorità di vigilanza", *CONSOB Documenti*, No. 62, settembre.

⁷ Etf's are investment products that track an index, trade continuously on exchanges and are redeemable daily. Their main advantage is to combine low diversification costs of index linked and basket products with the high liquidability of individual stocks on regulated markets. Before the *mutation* I am going to describe, ETFs have been labeled

the financial intermediaries' attempt to curb this trend, by adding some innovative features to the existing plain vanilla investment funds, marketed as ETFs since the early 90's as a cost and tax efficient alternative to mutual funds.

In fact, with time, the investors' expectations of higher returns for their investments through plain vanilla-like financial products - flexible, transparent and liquid as tradable, like stocks, on an exchange or a platform - has been faced by intermediaries looking for alternative investment vehicles to structured products and adding complexities to the ETFs underlying replication schemes.

Now-a-days ETFs are definitely growing in complexity and moving away from being a plain vanilla cost and tax efficient alternative to mutual funds, not only because of the broader range of indexes and strategies they track, covering equities, bonds, commodities, currencies and sector specific asset aggregations.

The point is that along with "physical" replicating or "cash-based" ETFs - which replicate the performance of an underlying index by usually investing in a sample of the securities in the index - "synthetic" or "swap-based" index-tracking ETFs are becoming more and more diffused. Broadly speaking, in this type of ETFs the provider sells ETF shares to investors, invests the amount received in a collateral basket (that can differ greatly from the reference index) and swaps the performances of the basket securities for the return from the reference one.

Recently a new breed of "exotic structures" showed up, the so called "leverage" ETFs delivering returns that are multiples of the daily performance of the index or benchmark they track and "leverage inverse" ETFs that deliver a return that is a multiple of the inverse performance of the underlying products⁸.

We have already mentioned some of the benefits associated with this product innovation, both for investors and market participants. Among them: lower fund

as "non-complex" and marked as such for retail investors under the UCITS regulatory regime.

⁸ For an interesting analysis of the recent evolution of ETFs, see the informative paper by Srichander Ramaswamy (2011), "Market Structures and Systemic Risk of Exchange-traded Funds", *BIS Working Papers*, April 2011. On the risk implications for authorities, investors and providers see the note of the Financial Stability Board (2011), "*Potential financial stability issues arising from recent trends in Exchange-traded Funds*", April.

management fees, cost and tax efficiency, easier access to an amplified set of asset classes and new types of risk; we can also add the possibility to avoid both high rebalancing costs and tracking error issues associated with physical replication, to take short positions to hedge existing exposure cheaply and to implement tactical asset allocation decisions.

But these benefits come at high costs, also from a stability perspective. The complexity and the opacity characterizing these financial products significantly undermine the investors' capability of understanding, monitoring, and consequently anticipating, the underlying counterparty, collateral and liquidity risks. These events can create relevant problems also to the providers and amplify market vulnerability to an unexpected liquidity demand from investors.

Finally we must mention the potential of contagion and systemic risk that can stem from the conflicts of interest of some banks, in the dual role of ETF provider and derivative counterparty. Moreover, the existence of market making arrangements along with securities lending on a large scale - a business practice that helps in making up fee income to compensate for thin margins on physical ETFs - can challenge the capability of the provider to face unexpected liquidity demand from investors during periods of market stress. This practice can also create incentives to amplify leverage along the ETF chain.

ETFs are a clear example of how financial innovation, by adding further layers of complexity through leveraged products and options, can amplify opacity and risk for investors and, at the same time, trigger uncontrolled systemic threats soliciting the Authorities to reconsider in depth their attitude, and tools, towards innovative processes, so as to intercept in due time what can be detrimental for an efficient and sound functioning of the financial markets.

3. Rethinking regulation and oversight

3.1 To address the question on the role of regulation and oversight, we can start with some of the basic questions soliciting the self-diagnosis under way on the part of many Regulators throughout Europe. Namely we could ask what an enlightened Regulator is expected to do in this context and whether we are

living in a deterministic world, in which it is possible to learn from our past mistakes to conceive better policy tools for the future or, on the contrary, in a stochastic context in which potentially disruptive extreme events inevitably belong to the tails of probability distributions.

Should we share Ferguson's position our conversation would entail a quick conclusion, because we would already know the answer. In fact, in his Darwinian world there is no way of learning from the past, as new shocks and discontinuities are always round the corner and there is no way of preventing them. Consequently, should we have the presumption of controlling them, for instance by conceiving some stricter regulations, we would pave the way to prolonging the survival of the unfit, thus impairing the virtuous working of "creative disruption".

I do not share Ferguson's views, as I am convinced that what happened is not an "out of the blue" discontinuity, but the result of a misunderstood dynamic process that has transformed and will continue to reshape the global financial landscape. As it cannot be excluded that also in the future we will have to face the drawbacks of some "random shifts" - induced by wrong or misaligned macro-economic policies and incomplete rule-books - I am more in favour of suggesting that the Authorities should reconsider their attitudes, rather than opt for a do-nothing approach.

So far, they have reacted to the financial turmoil with a lot of good common sense, still backed by tools conceived during the 30's, but with more information and stronger international cooperation supporting their initiatives. These new conditions have significantly helped the traditional approach in keeping the pervasive cross-border drawbacks under control, at least before the financial crisis began to fuel the worries on sovereign debts.

Even if this success represents the most telling answer to those in favor of a more pervasive deregulation process - provided that we accept the potential moral hazard stemming from lenient policies that lead to bank bail-outs - I think that we need to very carefully reconsider our regulatory and oversight approach, if we want to learn the hard lessons from the recent market turmoil.

3.2 If we take for granted that the Authorities must be committed to maintaining financial stability and systemic risk management tasks among their priorities, we cannot avoid stressing that from now on they should pay more attention to some issues, so far disregarded, that have recently surfaced.

Among them let me first mention the capability of understanding the drawbacks of not properly addressed micro-issues on people's confidence, potentially ending up in macro-systemic disruptions. To do that, the Authorities will have to sharpen their attitude in addressing the interconnections between the need to protect retail investor savings from the risks underlying complex and opaque financial products.

In addition, it is urgent to keep under control - regulate, monitor and overview - wholesale markets, where systemically relevant institutions usually operate and where the seeds of financial crisis grow, without any control.

From the Regulators' perspective, a quantum leap is needed in several directions. Three of them should be underlined:

- the need to invest more in knowledge and in state of the art methodological tools for a better understanding of the innovative trends. Authorities should be more ambitious in conceiving something that could enable anticipating the structural forces underlying market dynamics.

An in-depth understanding of the working of financial innovation and of interconnected business practices' dynamics must be one of their top priorities, to avoid unnecessary banning of products or processes in emergency spells, and to be able to properly and effectively regulate over the long period.

Investing in knowledge is the only effective antidote to the temptation of prohibiting because of our inability to early detect and fully understand the micro and systemic implications of the growing financial complexities we are living in. Some shortcuts can be useful, or even necessary, in the short term, but they can hardly be an effective solution beyond that;

- the urgency of being more "proactive" than "reactive" is imposed by the complexity, rapidity and pervasiveness accompanying the mutations in the financial landscape.

However, as we will see later on, the regulation process takes a long time to be completed. Paradoxically, the complexities and the growing interconnections characterizing the financial landscape are amplifying the

time needed to identify the inadequacies, to conceive an appropriate and shared set-up, to implement the rules at national level.

These dynamics inevitably open up the distance between reality on one hand and the regulatory system on the other. That's why, not to be caught lagging behind it, they need to change their rules and oversight approaches as well.

Probably, less but more effective rules balanced with a more focused oversight and enforcement practices in a more cooperative context, represent the only recipe at our disposal;

- to be successful, we also need to be more active in fostering an effective convergence of the Authorities' approaches, to prevent any potential regulatory and oversight arbitrage. It is an issue still open that, to be solved, requires strongly-rooted international cooperation, not within easy reach so far, at least outside Europe.

The global financial services industry operates under a multitude of legal and regulatory frameworks, many of which overlap and sometimes are inconsistent with each other.

This happens because Regulators are solicited to face a number of conflicting interests and objectives, some of which are also exposed to political scrutiny. For instance: protecting the consumer adds costs indiscriminately to all providers; encouraging new entrances creates new risks; some maintain that increasing transparency can punish innovators; more level playing fields by lightening rules may favor the least efficient incumbents; investor protection can lead to prolonging the life of failed business models.

As things stand at present, it is not surprising that the practices implemented by the Authorities in different countries are not homogeneous and, in many cases, have proved unfit in preventing systemic problems diffused at the global level.

It is self-evident that no dominant global "intelligent design" can spontaneously emerge in a context where there is no universally recognized matrix of success, and where political interferences are a regular occurrence. So far, increased convergence by means of cooperation represents the only credible move to promote the cultural change we need to find a way-out.

3.3 In Europe we are trying to overcome these contradictions working along different lines.

First of all, it has been decided to set up a new European System of Financial Supervision⁹, that consists of the European Systemic Risk Board (ESRB) and the three European Supervisory Authorities: the European Securities and Markets Authority (ESMA) based in Paris, the European Banking Authority (EBA) based in London and the European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt.

The “*incipit*” of the regulation establishing ESMA¹⁰, issued by the European Parliament and the Council, is telling about the philosophy underlying this move:

- *(recital 1) “The financial crisis in 2007 and 2008 exposed important shortcomings in financial supervision, both in particular cases and in relation to the financial system as a whole. Nationally based supervisory models have lagged behind financial globalization and the integrated and interconnected reality of European financial markets, in which many financial institutions operate across borders. The crisis exposed shortcomings in the areas of cooperation, coordination, consistent application of Union law and trust between national supervisors.”*
- *(recital 2). “... the European Parliament has called for a move towards more integrated European supervision in order to ensure a true level playing field for all actors at the level of the Union and to reflect the increasing integration of financial markets in the Union ...”*

To comply with this strong policy orientation, the security regulators are working both on a “single rule book” and fostering “regulatory convergence”, with the aim of improving the efficiency and integration of our financial market. Proportionality is a tool we are relying on to promote a virtuous integration process. Namely the new regulation is soliciting ESMA to “... *protect public values such as the integrity and stability of the financial system, the transparency of markets and financial products and the protection of investors...; ... should also prevent regulatory arbitrage and guarantee a level*

⁹ De Larosière, J (2009), “*The High-Level Group on financial supervision in the EU*”, Brussels, 25 February.

¹⁰ REGULATION (EU) No. 1095/2010, November 2010.

playing field, and strengthen international supervisory coordination ...” (recital 11)

As for the rule book we are experiencing the difficulties of keeping it up-dated.

On one hand the delivery of any directive or regulation has to comply with a time-consuming process conceived so as to allow for an in-depth confrontation between different Institutions, the Authorities and market participants on how to face the technical issues along the policy lines established by the European Commission. Also the compatibility with business and market practices in place in different countries, legislative set-ups and political priorities are relevant ingredients in this process. Consequently, many cross-border issues are to be faced as well.

Once rules are definitely released and coherently adopted at a national level, regulation is continuously challenged by innovation dynamics, which impose a tiring, but unavoidable, up-dating process. At present the Transparency Directive, Markets in Financial Instruments Directive (MIFID) and Market Abuse Directive (MAD) are under review, just to mention the most relevant ones.

Along with the need to reconsider the existing regulatory set-up, there is a strong commitment to regulate what is still unregulated. The urgency of keeping under control what has abnormally been spelt out of the shadow banking system during the last few years, has recently speeded up the need for new rules finalized to regulate hedge funds and private equity with the new Alternative Investment Fund Manager Directive. The objective is to conclude defining the “level two rules” by the end of the current year, after public consultation.

Together with the just mentioned efforts, the awareness of the necessity of constantly keeping the financial innovation process under control is growing among Regulators. Intercepting, understanding, identifying the implications, monitoring and regulating are among the challenges the Authorities are supposed to face going forward.

Good examples of this orientation are the discussion paper on the ETFs the ESMA *Operational Working Group* is preparing¹¹ and the work underway on the algorithmic or high-frequency trading (HFT) practices.

The document on ETF is aimed at disclosing the complexities and identifying viable regulatory orientations for these types of funds, as well as at thinking over some overarching guidelines needed to correctly handle some “ingredients” common to other “exchanged traded products” (ETP), some of which are still unregulated. In this field we have many open issues for debate, such as the suitability of some financial products for the retail market and the stability risks posed by the securities lending and collateralization practices.

As for the HFT, its potential impact on systemic risk (by amplifying market shocks or inducing liquidity shortages) fuels worries from a macro-prudential angle. Also some potential negative effects on the ordered functioning of financial markets deserve some scrutiny; namely any drawbacks that can disrupt the traditional role of the financial markets as server of the real economy. In this field threats are traced back to the potential disruptions of the price discovery system, the users and suppliers of saving matching, the distribution of risks, the efficient allocation of capital finalized to the growth of the economic system. So far, worries are blurring the optimism of those heralding the positive impact of these practices on the infra-day (almost instantaneous) bid-ask price lining.

3.4 The growing attention to the innovation dynamics is in line with the core tasks entrusted to ESMA, as stated in its Regulation. More specifically, in connection with the regulatory and supervisory treatment of new or innovative financial activities (art. 9 of the ESMA Regulation), the new Authority is expected to perform a two-fold task:

- first, contribute to macro-financial stability, by providing advice to the European Parliament, Council and Commission;
- second, promote transparency, simplicity and fairness in the market for consumer financial products so as to foster consumer protection.

¹¹ ESMA (2011), “ESMA’s policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS”, *Discussion paper, 2011/220*.

ESMA evaluations could go as far as prohibiting or restricting the marketing of financial activities (innovative products or practices) which appear to put at stake the protection of investors, the orderly functioning of the markets and/or the stability of the European financial system. Moreover, to ensure an adequate monitoring of innovation, ESMA is going to set up a “financial innovation committee” to address, in due time, any possible negative implications on retail investors, as well as on systemic financial stability.

The two-fold task mentioned above entails a two-fold challenge.

First of all the commitment to strengthen retail investors protection goes well beyond the responsibility of Security Regulators, as the retail investors’ decisions cover products issued by different typologies of intermediaries – banks, insurance companies and funds – regulated by an heterogeneous set of rules and overviewed by different competent Authorities. Regarding this specific point, in April 2009 the Commission asked the European Regulators to face the protection issue applying an horizontal approach homogeneously covering all the Packaged Retail Investment Products (PRIIPS), independently of the issuer legal set-up (structure). Businesses constituencies, more than technical issues, could delay the convergence process.

Along the narrowing path that leads to macro-financial stability, Authorities must use their prohibition power wisely. First of all it would be wrong to bar, *de facto*, the evolution of the innovative processes. In a globally ever more interconnected context, we do need up-dated, state of the art tools to effectively keep under control and manage the growing riskiness surrounding us, along with stability issues that never, in the recent past, stemmed from the financial innovation process “*per-se*”.

Once the above mentioned short cut has been avoided, the capability of foreseeing market dynamics must be strengthened, to prevent in due time that innovative tools and processes are utilized to trigger, amplify or hide the vicious circle, that during the last decade has very often transformed financial activity from being a tool into an end in itself.

3.5 To conclude, a few hints on recent oversight reorientation.

The rapidity of innovative dynamics, basically driven by the need of intermediaries to survive in an ever more competitive environment by piling up greater rewards inevitably associated with riskier activities, represents a strong incentive in the search for new business opportunities on the edge of the shadows of the financial system and for aggressively interpreting the existing rules, so as to curb compliance costs.

These intermediaries' attitudes, together with the amount of time needed to conceive and up-date an effective rule book, are soliciting Authorities to come up with a more attentive overview strategy, aimed at verifying on an *a priori* basis whether business practices and organizational set-ups are accurate enough to assure the necessary conditions for a compliant interpretation, on a continuous basis, not only of the formal wording of the rules, but also of the overarching principles they are based on.

These reorientations are already under way in the search for tools, or practices, to better address retail investor protection, even if with some country-specific differences. Let me give some examples.

In the UK, the FSA has recently submitted for consultation a paper anticipating a *“significant shift towards...introducing more prescriptive requirements for the governance of product development and introducing specific product interventions such as prohibiting the sale of specific products for specific customer segments”*¹².

Along the same lines the Belgian Authority (FSMA) is facing the issues posed by complex products (*“produits structurés qui sont considérés comme inutilement complexes”*), inviting the financial intermediaries and distributors to voluntarily suspend (*“moratoire volontaire”*) their sale to retail investors, until the definition of new selling rules is fully in place¹³.

In Italy some years ago Consob, along with strengthening its oversight activities, decided to invest in methodologies to facilitate a better understanding and handling of the complexities brought to the fore by market dynamics. In this perspective, for instance, we have addressed the issue of how to manage the liquidity risk of illiquid bonds and to measure and disclose

¹² FSA (2011), “Product Intervention”, *Discussion Paper*, DP11/1, January.

¹³ FSMA (2011), “Moratoire sur la commercialisation de produits structurés inutilement complexes”, *Communication FSMA_2011_02du*, 20 juin.

risks, rewards and breakevens (over the investment time horizon) of complex structured financial products¹⁴. This, not only widened transparency and enabled investment decisions to be rooted in an enriched set of information, but also helped in defining our priorities and backing our oversight and enforcement actions, by better assessing the compliance and soundness of the market participants' business practices. All that is self-evident if we use, for instance, a rigorous unbundling of complex financial products to detect and measure the underlying riskiness of their components, instead of relying on the simplistic distinction between "complex" and "non-complex" products for setting our transparency requirements and oversight priorities. Moreover it is worth underlining that the adoption of rigorous measurement methodologies represents the necessary condition not only for understanding the micro-implications of financial innovation, but also for properly detecting the market dynamics that might end up in systemic disruptions.

The just mentioned initiatives are good examples, in spite of their differences, of the attempts under way to fill the gap between the rules and business practices throughout more proactive approaches, in response to the incompleteness of the rule book, to the drawbacks induced by the choice of applying it to an underlying playing field still un-level in Europe and, above all, to the challenges stemming from the financial innovation dynamics.

The ongoing financial crisis has taught us that a rigorous understanding of market complexities can help in shortening not only the distance between market practices and regulation, but also the differences between the oversight approaches the Authorities are deploying. It is for sure that the larger these distances are, the more likely the possibility is of ending up with an ineffective and burdensome set of rules. Rules that in the past proved very often not to be up to the task of assuring the ordered functioning of the markets, the prevention of wrongdoings, a fair competition among market participants and an effective protection of the retail investors.

That's why I am convinced that the key task of realising a level playing field must go beyond market participants and cover the competent Authorities as

¹⁴ Minenna M., Boi G.M., Russo A., Verzella P., Oliva A. (2009), "A quantitative risk-based approach to the transparency on non-equity investment products", *CONSOB Working Paper*, No. 63, April; Minenna M. (2011), "Enter the quant regulator", *Risk Magazine*, May.

well. A shared, rigorous approach to financial innovation would be a good starting point and a move in the right direction.

While working on this, it must be stressed that any effort to promote cross-border convergence and cooperation also in the oversight area is crucial, to prevent potential “supervisory arbitrage”. That would render the efforts to implement an up-dated and effective single rule book for the European financial markets almost useless.

So far, the existence of partially uncoordinated initiatives at work is telling not only about the European Authorities need for new tools, but also of the challenging effort they are still committed to make, so as to conceive something that can resemble a viable, shared, possibly “intelligent”, new regulatory and oversight design.

