Industry aims to keep it simple(r)

Overview

Post-Lehman, providers are shifting towards a new product mix in a bid to shed the image of risky complexity, writes Telis Demos

The banks and brokerages that sell structured retail products are turning to a very different kind of business for inspiration: Apple.

The fear among the brokers and creators of derivatives notes sold to individual investors is that they are perceived as the Microsoft to cash investments' Apple – the ungainly and fussy alternative to the simple and efficient – the financial equivalent of a Zune, not an iPod.

To shed much of the image of risky complexity affixed to it following the collapse of Lehman Brothers, which took with it a unit that was among the largest sellers of notes to individual investors in Europe, the retail industry is shifting towards a new product mix.

The fastest growing products globally are now those that are the easiest to understand, often offering a simple yield enhancement on existing investments, and accessible by individual investors in the form of funds or online platforms.

"At one point there were too many products in the market promising a lot but not really working," says Johan Groothaert, global head of investment products at UBS.

"Retail clients want fewer, simpler products, and want them to do what they claim to do. The issuers and distributors that have been grabbing market share are putting the client above the products," he says.

Structured products are a roughly $2tn market globally, about where they were in 2007 before the financial crisis. That is still just a sliver of mutual funds, however. Europe is also still the biggest market by far, with $1.3tn of those assets, but the US and Asia are growing, at $340bn and $540bn, respectively, according to figures compiled by UBS.

The market includes notes, some of which promise to preserve principal, as well as funds based on those notes and certificates backed by insured deposits.

All structured products are still derivatives that deliver returns to the holders based on moves in reference assets, typically used to guarantee steady income streams over time, or protect against downside in cash investments.

One factor aiding structured products' recent growth is that regulators are now looking to shape the industry, rather than punish it for Lehman's sins.

In one of the most mature markets, Belgium, a number of banks have signed up with the Financial Services and Markets Authority's moratorium not to sell overly complex products to unsuitable investors.

In the UK, the Financial Services Authority, which fined Credit Suisse for selling products to private banking clients that it said were not sufficiently explained, has published guidelines.

A review is under way by the US Securities and Exchange Commission of its opposition to funds using complex derivatives, which if favourably resolved for the industry could lead to the creation of US funds akin to what have become a driving force in the European market. More than 90 per cent of structured products in Belgium are sold via funds that hold the notes, according to UBS.

As a result of these measures and investors' general scrutiny of bank counterparty risk, the industry has shifted in terms of both players and products.

The banks that were best able to separate their structured products from their investment banks, putting them in the hands of people used to dealing with clients, have held or added market share.

> 'At one point there were too many products in the market promising a lot but not really working'

The market has also tilted towards the most capitalised and diversified financial institutions, and away from more leveraged investment banks that are perceived to have higher credit risk.

While Merrill Lynch, for example, was an early leader in Europe as the market first formed in the 1990s, BNP Paribas and Barclays Capital now have the top market penetration, followed by Société Générale, according to Greenwich Associates' 2011 survey.

UBS is the leading issuer in Asia, and HSBC is top in the US, according to Greenwich, though investment bank Morgan Stanley is also highly ranked.

"There are various things that have come into play over the last couple years, including the funding levels of banks. The products those banks can offer has an impact on their market share," says Andy Awad, managing director at Greenwich.

The product mix is also shifting. The Greenwich survey found that notes – which are derivatives sold by the bank, and which carry no protection other than what the bank as a counterparty can offer – made up only 53 per cent of the market last year.

New issuance of products in which the principal is backed by the Federal Deposit Insurance Corporation, were 39 per cent of the market, up from 32 per cent the prior year. These are products that avoid bank counterparty risk by wrapping the notes in FDIC deposit protection. They were just 15 per cent of the market in 2007, according to Greenwich.

"The credit crisis of 2008 taught investors who purchased notes a difficult lesson about credit risk. However, retail investors have returned to market-linked notes," says Glenn Lotenberg, managing director of structured products at Incapital.

In the US, FDIC-insured structured products are primarily sold through independent brokerages, such as TD Ameritrade or Charles Schwab, a regional bank such as Raymond James, or Incapital, a dedicated distributor.

The big banks in the US and Europe, such as Bank of America and JPMorgan, are also using so-called "open architecture", according to Mr Lotenberg. This involves using third-party indexes or trading algorithms distributed by independents such as the US's Incapital, or Belgium's Finvest.

"It's a very creative activity that doesn't necessarily need to sit in a bank. A lot of boutiques develop and establish algo strategies," says UBS's Mr Groothaert.

Mr Awad of Greenwich says: "The crisis had set structured products back, but we're back on a growth trajectory thanks to fairly dramatic growth among independents."

At the same time, low interest rates due to central bank easing are aiding growth among products that do not protect principal, or offer only an issuer's guarantee that makes the investor a creditor to the bank.

Issuers that are paying higher rates to lend are passing on those yields to retail. Issuance of notes referencing fixed income, commodities and currency assets grew sharply last year, to 47 per cent of the global market from 32 per cent in 2010.

However, the industry is caught in a Catch 22, chafing against the mandate of keeping things simple, while low rates urge development of complex notes that can still generate yield.

"The low interest rate environment is driving people toward yield-oriented investments. But it's also making it harder for investment banks to provide them," says Incapital's Mr Lotenberg. "Issuers are again facing the challenge of providing yield without over-engineering the product."

The Grand Place in Brussels: Belgium is one of the most mature markets for structured products Getty

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Back to school: educating advisers and retail investors about how structured products work is a top priority Alamy

Providers see the need to educate market investors

Distribution

A better understanding of the products might spur sales, writes **Madison Marriage**

Last year proved tricky for structured product providers because as market volatility increased, so demand for their offerings fell.

But this year, as frustrated developed market investors attempt to combat low interest rates. their appetite for these products is expected to return.

However, their distribution is likely to be affected by new regulation, rising costs and the level of investor understanding of complex financial products.

Henrik Takkenberg, European head of public distribution at UBS, says appetite for structured products has returned since March, noting rising demand for niche areas such as commodity, tnterest rate, inflation-linked and foreign exchange products, as opposed to the equity-linked alternatives which dominated the market until 2007.

Oumar Diawara, head of structuring and protected active management at Natixis Asset Management, agrees the market will regain pace this year.

He says: "Appetite is weaker at the moment, but there is ultimately interest in these products. For private banks in particular, they are an indispensable part of their offering."

Natixis AM is keen to ensure new products are as relevant as possible for clients, having recently developed one which gains from highs in the Eurostoxx 50 but offers protection when the index's performance falls between 0 and 20 per cent.

Pascal Pillon, product engineer at Natixis AM, says it has been well received within distribution networks as clients feel they will benefit even if markets are uncertain. He hopes it will raise €1bn in its first year.

While providers are confident investor appetite for structured products is returning, many are aware that lack of education may be holding back sales.

A report published by the UK's Financial Services Authority in March said firms should "ensure that they provide information to the distributor base that can be understood by the recipients with the lowest level of knowledge".

Benoit Petit, managing director of cross-asset solutions at Lyxor, says educating advisers and retail investors about how structured products work is "very important", adding "the success of this industry depends on it". Mr Petit believes if clients had a better understanding of what structured products offer, sales might receive a boost. He recommends distributors develop online tools to simulate how a product generates income over its lifespan.

> One firm is building a range of 'accurate but simple' commercial documents and e-learning tools

Mr Diawara agrees. He says: "When end-clients truly understand the products, sales are better." He notes the difficulty of reaching and informing all 35,000 advisers within the banking network of Natixis AM's parent group, BPCE. To reach such a large audience, his firm is building a range of "accurate but simple" commercial documents and e-learning tools.

While providers aim to improve understanding, they are swimming against a tide of regulation flowing from a number of European authorities.

Yet UBS's Mr Takkenberg believes regulation could act as a positive force for distribution.

The UK's Retail Distribution Review, which from 2013 bans payment of commission to advisers, could benefit providers as advisers become more open-minded about product selection.

Mr Takkenberg says: "[Advisers] will likely move to a fee-based model and will [stop] always selecting products from the same producer.

"The UK is setting a benchmark and many large distributors across Europe are debating internally whether to meet the higher standards set by the UK, even if they are not legally obliged to. The ripple effect will mean best practices are adopted throughout the industry."

Thomas Wulf, secretary general of the European Structured Investment Products Association, adds that the European Commission's proposed Packaged Retail Investment Products Initiative (Prips) could assist product providers.

Under Prips, Key Investor Information Documents will need to be provided for all structured products distributed across the EU. Mr Wulf believes "developments such as standardising documents should help with distribution".

However, providers also fear regulatory initiatives could hinder product development and distribution.

In July 2011, the Belgian Financial Services and Markets Authority issued a moratorium to restrict the distribution of structured products deemed unsuitable for retail investors. Lyxor's Mr Petit says "this has completely changed the competitive landscape [in Belgium]", and he fears similar initiatives elsewhere, notably Switzerland, may be pushed through in the next 12 months.

Natixis' Mr Diawara, meanwhile, highlights that to meet Basel III requirements, firms are preparing for the introduction of liquidity coverage ratios in 2015 and net stable funding ratios in 2018.

This will "undoubtedly have an impact on structured product activity as banks need to prioritise liquidity, [meaning] there will be less interest in selling savings products", he says.

Watchdogs and low interest rates are double trouble

Product design

The demands on providers are growing, writes **Chris Newlands**

Structured products are hitting the headlines. Unfortunately for product providers they seem to be doing so for the wrong reasons.

Just two weeks ago, the US Financial Industry Regulatory Authority (Finra) fined UBS, Citigroup, Morgan Stanley and Wells Fargo more than $9.1m (€6.9m) for allegedly mis-selling leveraged and inverse exchange traded funds to retail investors, while in the UK the FSA felt it necessary to issue guidance to providers following continuing concerns over the sale of complex investments.

Of particular concern for regulators is how products are designed. The FSA's advice, published at the end of March, reiterated recommendations it made last November, requiring providers to ensure products met consumers' needs and were pre-tested before going on sale.

The watchdog's proposals were drawn up after a review of seven unnamed major structured product providers found "weaknesses" in the way those companies set up their structured offerings.

The FSA says: "Structured products are rising in popularity and we are concerned that the growing number of structured product sales, as well as increasing product complexity, is placing a strain on firms' systems and controls."

As such, it urges providers to "identify their target audience and then design products that meet the target audience's needs", rather than concentrating on funds that "merely contribute towards the firm's bottom line".

UBS, one of the four firms sanctioned by Finra, says it is committed to the "common goal" of "investor protection", and that it takes this very seriously when putting its products together.

Patrick Grob, European head of structured equity derivatives sales at UBS, says: "Investor protection is a common goal of regulators and one that UBS is very committed to."

Being a wealth manager as well as an investment bank, he adds, means that "investor protection has always played a key role at UBS and enters product design at a very early stage", he says, adding that there is currently increasing demand for capital-protected access to actively managed funds.

"The development of new products starts with an analysis of what investors would like to invest in, given the current markets, or how their current investments can be made more efficient," he says.

Nevertheless, the Swiss bank was last month handed a fine of $1.5m after Finra ruled that the firms' brokers had recommended unsuitable leveraged and inverse ETFs to many clients with conservative investment objectives and risk profiles.

But it is not only regulators exerting an influence on product design. The low-interest-rate environment is also proving a challenge for providers.

Benoît Picard is head of structuring and asymmetric solutions at BNP Paribas Investment Partners. He says the price of a structured product is mainly driven by interest rates and the level and volatility of its underlying assets.

"Therefore, if interest rates are low or volatility is high the potential return can be impacted and it becomes more difficult for structured products providers," he says. "To continue to offer attractive pay-offs, fees need to be fixed below the level of interest rates."

Mr Picard, who maintains that the regulatory crackdown has been "useful in levelling the playing field among structured product providers", adds that the most popular structures being used at the moment are those intending to offset low interest rates.

> 'To continue to offer attractive pay-offs, fees need to be fixed below the level of interest rates'
> **Benoît Picard, BNP Paribas IP**

"Risk control mechanisms are also currently commonly being used to increase the attractiveness of payoffs and smooth performance in this volatile environment," he says.

According to Treeve Coomber, a senior investment consultant at Towers Watson, many of his firm's institutional investment clients are currently interested in structures that protect against economic scenarios that might reduce their solvency.

Mr Coomber says: "Our clients are interested in a combination of equity put options, bond call options and swaptions that can protect against scenarios, including a significant equity market fall or a prolonged low interest rate environment."

He adds that while "structures that protect against further falls in interest rates are at historically elevated levels, short term equity protection through options is at historically attractive levels".

According to research by structuredretailproducts.com for the UK, retail investors have continued to pour money into the sector, investing more than £1.3bn in January and February, compared with less than £900m in the same period last year.

Rulemakers are looking to bolster investor protection

The SEC's report last year identified 'weaknesses' Getty

Regulation

Development and marketing are under scrutiny, says **Baptiste Aboulian**

It is not a list in which you would like to be included. According to the US Financial Services Authority, the development and marketing of structured products is among its top conduct risks in the retail sector.

These products, alongside unregulated collective investment schemes and traded life policy instruments, are more likely to be mis-sold because of their level of complexity, says the FSA.

Not that this is limited to the UK.

In the aftermath of the financial crisis and faced with growing appetite from retail investors for structured products, regulators have turned their attention to how companies bring these products to market.

Whether in the US, France or the UK, regulators have found that investors do not always know or understand the full risks – and benefits – of the products they are buying.

In July 2011, the US Securities and Exchange Commission issued a report identifying industry weaknesses seen in sales of structured products, including "questionable sales practices" and unsuitable products being recommended.

In response to these deficiencies, the SEC made recommendations to improve surveillance of sales practices and said it "was considering additional steps in the future [...] that may bolster investor protection".

There has also been a forceful approach to the regulation of structured products in the UK, where the regulator is trying to be more interventionist and avoid problems before they occur.

In a recent speech, the future head of the Financial Conduct Authority, Martin Wheatley, who dealt with the Lehman Brothers minibond scandal during his previous tenure as head of the Hong Kong's financial watchdog, set out his strategy for monitoring companies.

Mr Wheatley said: "We are looking at whether companies have product development and approval processes that are well-designed and can weed out harmful or inappropriately marketed products."

This has already been applied to structured products. Last year, the FSA assessed seven big providers of structured products, looking at how they design their products, how they identify target markets and how they handle their "post-sales responsibilities".

> Regulators have turned their attention to how companies bring products to market.

Perhaps inevitably, it found weaknesses in product development.

"Overall, companies still [focus] too much on their commercial position, potentially at the expense of consumer outcomes," the FSA said in introduction to new guidance on product governance that was recently issued in response to concerns.

Manufacturers of structured products are now required to identify the target audience and design products that meet its needs, stress-test new products, ensure a robust approval process, and monitor the product after it has been sold.

In an industry used to self-regulation, the FSA guidance has been received with a mixture of acceptance and unease.

Jamie Smith, chairman of the UK Structured Products Association, says: "It was not much more than tidying the loose ends. There hasn't been a huge amount of lobbying or outrage because people felt it's already what they do. It didn't get anyone out of business. It was a healthy MOT."

The guidance has had a quick impact on manufacturers, who have been forced to review the way they record what they do. Crucially, they have also changed the way they bring products to market.

Mr Smith says: "In the past 12 months, there has probably been a shift to products linked to major underlying assets and to simpler pay-offs."

Marc El Asmar, global head of sales, cross asset solutions at Société Générale Corporate and Investment Banking, says: "Given our capacity to do different sorts of products, and in order to comply with regulation, we try to now offer simpler pay-offs, keeping at heart clients' risk-reward profile."

However, others have concerns about product distribution and the level of interaction providers need to have with end clients.

James Harrington, head of commercial implementation, platforms and distribution at Legal & General, says: "Sales by independent financial advisers are regulated by the FSA and it's their job to make sure the IFAs work within the rules. It's not the job of manufacturers to monitor the suitability of such sales further than is current practice regarding unusual sales patterns."

Mr Harrington believes the requirements on stress test are also "irrelevant" because products either provide a pay-off or they do not. He adds: "I don't think there will be more regulation because I don't think it is all that complex.

"There is plenty of guidance to ensure investor protection already."

Some regulators believe what investors really need is better disclosure and comparison.

This is something that could be achieved with the EU's upcoming Packaged Retail Investment Products initiative.

But companies are also aware of Mr Wheatley's comments on the fact that regulators have to move on from the past belief that transparency is the sole solution. Producers of financial products cannot be expected to do the "right thing", he says, especially given the commercial pressures they face.

More intrusion into their affairs is to be foreseen.

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Exchange traded products or ETPs are often described as structured products and the boundaries between these two types of financial instruments can seem unclear. In an additional article online, **Chris Flood** talks to industry experts and explains how the two financial instruments differ.

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Extra layer of mystery in guessing outcomes

Most structured products promise a payout at a given time based on an index or other investment target Dreamstime

Performance

One way to think about products is to ask whether they meet expectations, says Sophia Grene

It is hard to assess the performance of structured products, particularly when one is used to dealing with investment funds, where performance measurement is a much-developed science. With a fund, you can say it rose (or fell) by xx per cent, and is better (or worse) by xx per cent than its peers. With a structured product, the pay-off is a completely different shape.

Most structured products promise a payout at a given time based on a particular index or other investment target.

The times are independent of other products in the market, being set usually by marketing departments, and the outcome is likely to be either exactly as promised, or not at all.

The products themselves also track widely different underlying investments and have different relationships with them.

This difficulty of measurement may explain why it seems virtually impossible to gather historic data on the success of structured products generally.

The UK Structured Products Association is mulling the possibility of gathering such information, but is only at the stage of considering whether it would be useful to investors.

Stuart Fowler, of wealth management adviser Fowler Drew, points out that "you can't judge from the past, even quite long past period, what the future pay-offs will be because they depend on too many parameters, and not just the unknowable specific path of markets relative to your own set of option exposures".

In other words, in addition to the impossibility of predicting market direction, structured products have the extra layer of mystery as to how each individual structure will interact with market movements.

A better way to think about performance of structured products is perhaps to ask to what extent they meet customer expectations.

"In the vast majority of cases, they do what the investors expected," says Jamie Smith, chairman of the UK Structured Products Association. The only exception, he says, is when the issuer defaults, the most notable case being Lehman Brothers.

He then corrects this to say that structured products deliver results according to a predetermined formula. But, he concedes: "Just because the formula has worked doesn't mean the client is happy."

> Using a specific structured product to express a view on the market is a reasonable strategy

An example of this would be products using constant proportion portfolio insurance, which were popular in the early years of the past decade.

These were intended to protect investors from large drops in a risky asset class by investing a certain proportion in a less risky asset, and increasing that proportion as the riskier asset fell.

Unfortunately, most products were not designed with the expectation of the risky asset falling significantly at the beginning of the product's lifespan and then rising for the rest of the time.

This led to a situation where the entirety of the investment was in the low-return, low-risk asset for almost the entire life of the product, missing out on all the growth of the risky asset.

Mr Smith describes this as "a situation not too dissimilar to default, when extreme market conditions that were thought to be extremely unlikely then come to pass".

Using structured products as a long-term strategy, replacing maturing products with similar new ones, is not a sensible move, according to Mr Fowler, as the cost of the options is a function of volatility and so any insurance against volatility will be self-defeating.

However, using a specific structured product to express a view on the market is a reasonable strategy, although it is important for an investor to understand this is what they are doing and what the risks are.

Those risks are both the market risks, which are likely to be hedged, as that is usually the purpose of structuring a product, and the operational risks, such as counterparty risk.

The counterparty is not always revealed by the product provider, even though its credit rating is likely to be included in the promotional literature, so it is not always straightforward to assess that risk.

Investors must also be aware of what protection they have and from which compensation scheme.

In the UK, so-called structured deposits are covered by the Financial Services Compensation Scheme's deposit insurance scheme, but others will have recourse to the Investment Compensation Scheme only in rare circumstances.

The UK's Financial Services Authority has recently issued guidance to independent financial advisers, warning them that they must take care that each product sold is appropriate for the customer's needs.

There may be many cases where structured products are entirely appropriate, but in each case there are many issues for an investor to consider, from the counterparty risk to the question of whether they understand the range of possible outcomes.

Opinions vary on sales to insurers and funds

Institutions

David Rowley finds growing interest is not entirely driven by the suppliers

There is a "feeding frenzy" among investment banks trying to sell structured products to insurers, according to Charlie Pears, head of business planning and insurance strategy at Insight.

Mr Pears is not a huge fan of the solutions as a means of tackling the capital requirements of Solvency II and cautions that, wherever possible, direct investments should be sought instead.

"In essence Solvency II is about transparency and looking through to the real underlying economic risk that an insurer faces," he says. "So there have been lots of attempts by incredibly smart people to devise different structures which would if anything obfuscate that, by taking an investment or an economic risk which is quite risky, to wrap it in a structure and present it as lower risk."

This view is shared by another leading liability driven investment (LDI) manager, if not by all in the consulting community.

A key objection for Stuart Jarvis, managing director in the client strategy team in multi-asset client solutions at BlackRock, is the difficulty of working out just how much investment banks are profiting from these exercises.

Zero cost collars, where an investor is insured against a fall in the value of an asset but any upside is used to pay for this protection, are a case in point.

These appeal to employers fearful of their balance sheet being impacted by a shift in their pension fund deficit before an annual report, or to insurance companies keen to keep their capital structure steady at a time of renewed nervousness over a Greek default.

Mr Jarvis says: "You might have poor pricing on one or both sides of the trade, but that is hidden, so the fact that it is zero premium does not necessarily make it a good pricing, it just stops it being an immediate hit on day one. As the market moves you could be in or out of the money."

The concerns over fees for another such structure which fixes the correlated pricing of equity and bond holdings are such that Mr Jarvis says he has not yet actually seen any traded.

But the growing interest in structured products is not entirely supply driven and consultants and pension funds that have spent the last seven years getting used to LDI are becoming more adventurous.

One of the people who kick-started LDI is Rob Gardner, co-founder of the consultancy Redington. He in part concurs with Insight and BlackRock that the first stage approach for investors is not necessarily in direct deals with investment banks, but in simply giving LDI managers greater freedom.

"You can use various instruments to create an outperformance over just a static real yield hedge, a number of pension funds have been doing that.

"So if your LDI mandate allows you might have a US treasury asset swap underneath [your main swaps], which gives you a healthy pick-up over Libor to help improve your performance.

Stuart Jarvis: it is hard to work out banks' profits

"That way you can eke out an extra 50 basis points of performance by allowing your fund manager to have greater instrument selection and greater ability to play relative value. That is the easiest incremental hedge from where you are."

He sees some easy wins for big investors in some of the more straightforward structured products such as secured funding liquidity swaps. In these an investor with a large portfolio of gilts and index linked gilts will loan them out to a bank for anything from one year to five years. The banks in turn pay a fee which might be anywhere between 50bps over Libor to 150bps. The bank will post collateral of around £125m worth of assets for every £100m borrowed.

Mr Gardner says insurance companies in Germany have done billions of euros of these deals while their UK counterparts have completed deals worth hundreds of millions of pounds. He foresees high growth for such activity while banks are still in difficulty.

Cardano, which recently advised and executed a multi-billion-euro deal for Dutch financial services firm Rabobank that combined equity and interest rate protection in one trade, addresses the issue of counter-party risk in such transactions.

Phil Page, client director at Cardano UK, measures the default risk as typically no greater than investing in a whole range of asset classes that pension funds commonly use, including equity, bonds and property.

Compounding the differences of opinion with LDI managers, Alasdair MacDonald, head of investment strategy at Towers Watson, suggests that longevity swaps, options and swaptions can be seen "as a way of outsourcing dynamic risk management to a bank – something at which a bank has a competitive advantage".