Written by Andrew Crooke

Getting Distribution Right

More than ever before, distributors need fast, flexible and thorough service from product manufacturers to best compete for their share of the growing market for retail structured products in Asia.

COMPETITION IN THE private banking and wealth management sectors to meet retail demand for structured products is intense.

Much improved investor awareness of how this investment class works and why it adds value to a portfolio has developed hand in hand with the rapid accumulation of wealth across Asia. In turn, this has led to both the high net worth (HNW) and mass retail segments buying more and larger amounts of product.

Clearly, this should bode well for those involved in selling these financial instruments at all levels. But for distributors, the scarcity of resources available to help them broaden and enhance their platform is causing a lot of concern. And it is a hurdle which is getting more and more pronounced given the volume of new structures being issued every week and the amount of innovation in the Asian market.

"A big challenge we face is building the team and the systems to deliver more ideas to clients," says Maggie Tsui, managing director and head of investment services at BNP Paribas Private Bank in Hong Kong.

To keep up with this, she says more manpower is the answer. "As structures get more complicated, we need to highlight all the product features so that clients fully understand the underlyings and therefore the risks they are taking."

Distributors striving to differentiate themselves therefore expect the sell-side to play a more central role in the education process, as well as provide more comprehensive and consistent after-sales support. With so much competition for their business, it's very realistic for them to expect to get what they want.

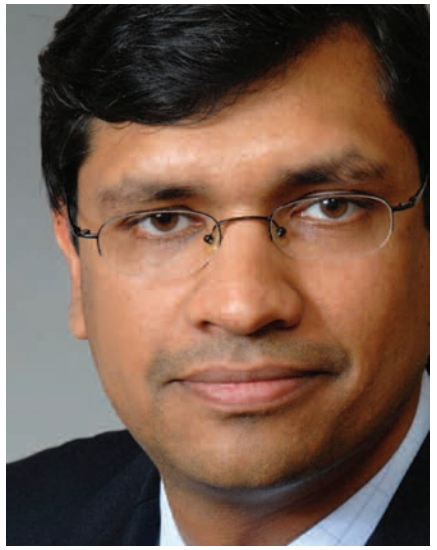
Taking a View

During the last 12 to 18 months, private clients have been demanding simpler products, according to former private banker Werner Schlossmacher, now head of investor solutions for non-Japan Asia in the private banking coverage group at Barclays Capital.

Plus, he adds, there is a lot of interest in product based on themes that the client is interested in. "This has encouraged many private banks to develop a much stronger research capability, and investment products that they buy from the providers must fit into these themes for them to be interested," he explains.

This is certainly the case for LGT Bank in Liechtenstein, for example, says Thomas Hugger, executive director and head of investment at LGT Investment Management. "Our approach is to advise our clients to invest in products or markets that correspond with our investment views at the time." If LGT Bank sees a product from a provider that fits a certain outlook or opinion that it has at a particular time, it will look to buy that for its clients. Alternatively, it might go directly to the manufacturer for a price or an idea in line with its view.

A similar thing is true at Citigroup Private Bank, where Anurag Mahesh, managing director and head of structured products for Asia Pacific & the Middle East, is also seeing



Anurag Mahesh,
Citigroup Private Bank

a distinct shift towards clients looking at getting sector-based thematic exposure - for example, focusing on the luxury goods, water, alternative energy and infrastructure themes via structured products.

"Certainly, excellent research capabilities are absolutely imperative in undertaking such an effort," he says, adding that the firm has already responded to this by setting up a global themes committee.

As part of its advisory service, when Citigroup Private Bank is making structured products available to its high net worth clients, or when clients are thinking about getting access to different asset categories, Mahesh says it is as vital to talk in detail about the house underlying views on the different asset classes as much as it is to explain the structure itself.

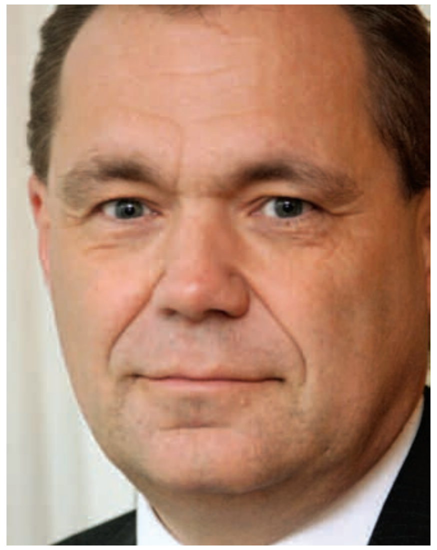
"A large part of the investment discussion is devoted to the rationale of investing in the underlying asset class and the particular market and security," he says. At the same time, advisers explain the specific product features to clients, and outline how the product would perform in different market scenarios.

Tailored and Flexible

BNP Paribas Private Bank is also looking to expand its business by increasing its research capability to provide an in-house view. "A client has to first buy into our advice, which is based on a specific investment theme, and then we use our structuring capability to propose a solution tailored to the client's investment theme," says Eric Aubin, deputy chief executive officer - Hong Kong and North Asia.

To facilitate this, he wants to receive more micro research from providers, to extract sufficient value from the investment theme. This would be in the form of details on specific stocks that fit the in-house view and tell the private bank the reasons why issuers like or dislike certain stocks.

To be able to tie in a client solution to the in-house investment theme also depends on issuers being able create appropriate product at the right time. "Investors can have a long term view on a particular investment but the timing is important," says BNP Paribas' Tsui. "We need to have the right product in the right market at the right time. Then it is a win-win for the client and the provider will win our business."



Thomas Hugger,
LGT Investment Management

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>
> **– Thomas Hugger, LGT Investment Management**

Better communication would help achieve this, she says. "The providers can make sure they are in touch with what we and our clients are doing," she says. "In particular, they need to understand what our clients are looking for and then they have to bring to them the right structures at the right time."

Eric Aubin, BNP Paribas Private Bank

Mahesh at Citigroup Private Bank agrees that a customised structured product is important from a structuring perspective. "Not many houses can sit down face-to-face with their clients and understand what they want and what their concerns are. This is becoming more and more important as a competitive differentiator as the product class matures."

In general, the transparency and competitiveness of many markets in Asia, especially in Hong Kong, is making good service, quick answers (less than one hour) and good prices crucial to differentiating providers.

"We stress this all the time," says Aubin, "because in this market, a manufacturer can be good at creating ideas and innovation, but if they are not competitive, that is no good for us."

While pricing on individual trades has clearly been a very important element in the whole product-delivery process as the structured products space has matured, it is consistency of competitive pricing that is a key differentiating factor in the mind of Mark Wang, director of global product sales, wealth management – Singapore at Credit Suisse Private Bank.

"Because today's competitive market is so efficient, innovative non-flow product can become commoditised very quickly," he explains. "So most providers are innovative, therefore placing more importance going forward on pricing and consistency to differentiate themselves."

Speed is part of the overall equation, too. "We apply a mix of a bottom-up and top-down approach to develop product," says Wang. "We see our clients' constraints when marketing to them, and we translate their needs to providers. Then whichever one of them comes back the quickest and with the most cost-effective solution will stand out."

Flexibility is also one of the key things OCBC Bank looks for from its providers. "They show us lots of ideas, but often we need them to make adjustments for us to suit customer needs," says Nicholas Tan, head of group wealth management. "Those providers which have most success with us are those which show the greatest amount of flexibility."

It is important to Tan that the provider gives him good value when structuring a deal that fits OCBC's view. For example, he explains, "if we were to look at an interest rate-linked deal in the expectation that US rates will fall slightly, it might be hard to get good pricing on this because most peoples' views are aligned. But the dealer who can stand against our view and give us a good price will be in a good position to get our business."

His job, he says, is to try to extract the greatest amount of value possible for the customer. So those providers which are willing to take on the risk to satisfy what OCBC wants for the customer, have the edge in winning the bank's business.

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Ongoing Support

In addition to tougher competition for sales and speedy delivery, the quality and scope of a provider's after-sales service is increasingly important in a distributor's decision-making process.

Ongoing research and liquidity are two important criteria Aubin cites when he is choosing a provider. "For those banks which are already quick and competitive, the after-sales service and product innovation aspects of their service are where they differentiate themselves," he says.

Agrees Wang at Credit Suisse Private Bank: "We almost always offer our clients a secondary market for all the structured derivatives we propose to them; clients do quite frequently try to exit within the life-cycle of a trade. So our providers must be able to offer this liquidity also."

Having the ability to advise clients to take profits or losses during the life-cycle of a product, rather than waiting until maturity, is important to keeping Asia at the forefront of structured products generally, says Schlossmacher at Barclays Capital. "This requires the distributors and providers to be able to show clients real time mark-to-market, to unwind products on time, and to show a commitment to the secondary markets."

Equity Remains in Favour... But for How Much Longer?

Most client interest in structured products over the past 12 months has been focused on equity underlyings as the markets have rallied.

That ties in with the outlook of many houses. "In our view, equities are likely to out-perform the fixed income market in 2007," says Anurag Mahesh at Citigroup Private Bank. "We are, however, a bit cautious on emerging markets on valuation concerns, even though we continue to believe in the secular appeal of these markets. US and Europe are, in the view of our strategists, the two most compelling markets in the equity space - on the interest rates side, we believe that the US Fed should be cutting rates once this year as the base case is for the US economy to have a soft landing."

In the current environment, therefore, clients are broadly looking to add the beta to a particular asset class, says Mahesh. "In the equity asset class, valuations in general are still attractive and as mentioned, we do believe that equity asset class should broadly out-perform fixed income. However, given that the current bull market is in the fourth year, a lot of clients are not looking to take a very aggressive view of the equity market." And given that Citigroup believes that equity markets should rally up by high single digits to low double digits over the year, clients want an instrument that generates coupons in excess of these returns.

Selling volatilities is one way to add such "structural alpha" to a client's portfolio, translating into higher coupons, says Mahesh. "Another way to achieve this goal is to buy correlation while selling volatility in order to provide incremental returns. This is achieved by a client taking view on several equity indices or stocks rather than just looking at one stock or index."

Private clients are likely to mirror some of the caution over the equity markets that analysts at the private banks are starting to show. And this should lead to demand for relative value products in the first few months of this year, a trend which will accelerate if there are any corrections in the market, says Werner Schlossmacher at Barclays Capital.

"This relative value will come from equity-linked products that compare the performances of three to four underlyings, for example," he explains, "so still allowing the investor to benefit from exposure to a particular stock, but not just relying on the one-way movement of a particular underlying."

In fact, there has already been some innovation within this space over the past few months, says Mark Wang at Credit Suisse Private Bank.

For an investor who thinks the Nikkei 225 will outperform the S&P 500, for example, they can now buy a derivative product that gives them a return if that happens - even if the Nikkei declines, he explains. The key is that it outperforms the S&P 500.

"This has largely come about in response to the equity markets being so high," says Wang. "Because we have been getting quite a few calls from clients questioning if it is possible to invest on an absolute performance basis, we are offering them relative performance. We have been marketing this to all our private clients in south and north Asia. This type of product is likely to gain in popularity."

Maggie Tsui at BNP Paribas Private Bank says they have also started to put an airbag on the downside given the caution that equity-biased investors are showing towards indices that have reached four to five-year highs. For example, she explains, if three of the stocks don't hit 65 per cent of their issue level, on maturity clients get their principal back rather than the level of the worst-performing stock.

For the time being, she says the emphasis will remain on more equity-related structured products. "We are looking for the US and European equity markets to grow by between five to 10 per cent this year. We are very positive in Asia, especially India and China. Our upside potential is about 20 per cent. And we don't foresee any deteriorating corporate earnings this year."

BNP Paribas Private Bank is also focusing on currency-related structured products in 2007. And it is putting more emphasis on funds, especially since it has advised clients to put money into hedge funds over the past few years.

From the perspective of fund-linked structured products, now, with interest rates potentially at their peak in the cycle, would be the logical time to buy structured products, says Patrick Tuohy, senior director and Asia head of the alternative funds group, investment management at HSBC Private Bank.

But, he says, with the equity markets on a high, nobody wants to buy guaranteed funds because clients compare how much money they have made in the last six months.

"Yet if there ever was a reason for private clients to buy structured products, now is the time to think about it," urges Tuohy.

"For the time being, in our private banking platform, fund-linked products comprise less than 1 per cent of client assets." It seems to be the shrewdest investors which are starting to look at having some form of principal protection in their portfolio, he says.

"Structured products for diversified hedge fund portfolios are generally what clients should be doing; using them as an engineering tool rather than just principal protection," says Tuohy. "They should think either about putting some leverage in there, or doing something interesting with income by possibly taking strips out of it, or alternatively, locking in a proportion of their annual returns."

For Thomas Hugger at LGT Investment Management, when the products being sought after on the equity side are less bullish, this could be the driver for more capital-protected product. "I also think structured products going forward should offer a way for investors to participate on the downside," he says. "I have so far seen very few products that offer this, but at the end of last year we started to receive some enquiries."

In terms of demand at the mass retail level, according to SF Wong at DBS, this year is more likely to be theme-based, and over time will become increasingly similar to the private banking and asset management business where more and more customers would consider asset allocation rather than betting on fancy structures.

With rising interest rates last year, Wong says DBS saw strong demand in Hong Kong in particular for equity-linked products. The bank's 'retailised' credit-linked products in the form of mini bonds were also popular where the underlying collateral has some structured credit behind it, including CDOs.

In a further sign of the maturing retail market, Nicholas Tan at OCBC Bank says he has seen a recent trend where structured products are crossing over into the sphere of more traditional product such as unit trusts and bancassurance. "For example," he says, "we have seen quite a few bancassurance products recently being used where the underlying is a structured note that is wrapped with and insurance wrapper and sold as a bancassurance product. I see this trend continuing in 2007."

This is now starting to happen, he says. Already in the CDO world, for example, product is not only being sold back to banks, but there is true market-making now, which is something he is hoping will happen in structured products.

Despite the wishes of distributors, Nicholas Leung, head of The Bank of East Asia's (BEA's) investment product support department, says a lot of providers - including the larger global houses - place little emphasis on the after-sales aspect of the process.

He wants issuers to give him quarterly updates on the performance of the underlying, and explanations as to why it

Maggie Tsui, BNP Paribas Private Bank

has performed in that way and what their expectations are for the next quarter. "It seems that because their profit is locked in, they tend to focus their effort in areas other than providing after sales service," he says.

In contrast, he adds, the mutual funds he works with do give constant performance updates. "They are increasingly challenging the structured products providers by starting to offer structured funds. And they offer daily liquidity."

Joint Responsibility for Education

For the private banking industry, educating end clients and relationship managers is key

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to the sustainability of the market, many players agree.

Distributors acknowledge their responsibility in driving this process, alongside the growing sophistication surrounding structured products generally - and the market is constantly learning about the pitfalls of new products and strategies.

But the sell-side should play a more central role in this education process, says Hugger at LGT Investment Management. "For example, when we buy a product from ABN AMRO, they provide us with practical information which we can then pass on to clients to help them understand various structures and features."

He says it would be helpful if all manufacturers could provide this sort of information, in the form of a fact-sheet in addition to the termsheet, clearly explaining a product's advantages and disadvantages.

"Clients expect an open platform from us, to provide them with fair and transparent terms and conditions, pricing and advice," he explains. "It is our duty to draw clients' attention to the fact that not all gold shines."

The difficulty is that clients sometimes think they understand a product, but are then disappointed if half-way through its life-cycle they see it is not participating in the way they hoped it would, he explains. "That is the type of client education we need to do a lot of," says Hugger, "to advise that structured products are more of a buy-and-hold strategy, and that, excluding warrants, most of the time they are not trading vehicles."

Education also needs to be in the form of making mark-to-market behaviour of product widely understood and followed, and clearly explaining the risks of new asset classes so that investors fully understand what they are buying, says Schlossmacher.

Related to education is the need to keep product simple, says Hugger. "A dangerous trend that has emerged in the structured products space is that as each provider searches for new and more complicated product, the termsheets and disclosure get longer." He prefer them to follow the 'KISS' philosophy: "Keep it Simple, Stupid". That way, private clients can understand it, he explains. "Maybe the industry should come up with a kind of uniform termsheet since every structurer uses a different format."

This is important for LGT. "Probably 95 per cent of our clients are not ultra sophisticated, and if a relationship manager has to spend 20 minutes explaining a new product, rather than 5 minutes as it should, a client tends to think it is too complicated."

Educating the frontline staff, who are interacting with clients on a daily basis, is indeed a crucial part of a distributors' responsibility.

Nicholas Tan, OCBC Bank

Says Mahesh: "It is also worthwhile to think about a dedicated capital markets or structured products distribution channel. Despite the costs, we believe that this channel is worth investing in. Over the last five to six years, this distribution effort has been another differentiating factor at Citigroup. Since capital markets are fast moving, it is important for the sales person to be in touch with the markets and the clients on a much higher frequency. Hence this channel effectively complements the relationship managers."

Satisfying Mass Retail

Certainly the balance of the responsibility for educating mass retail customers buying structured products lies with the distributors. The difficulty, however, is trying to explain certain structures in layman terms.

One of the biggest challenges OCBC Bank faces in growing its platform revolves around the type of interaction it has with its own sales people, and also its customers - to get both parties in a position to understand what the product is and what it is meant to do.

"The challenge in educating clients is less acute among our private banking clients because they are much more aware of the risks they are taking," says Tan. "When we broaden and tailor product for the mass retail segment, however, education becomes more important and this is where there are more concerns about the potential for mis-selling."

For example, he explains, these customers are primarily interested in the returns of the product, whereas the bank tries to focus on explaining its view and whether this matches the customer's view. "We only want to sell a product when our view matches theirs, but it is generally difficult to persuade a customer to talk about the underlyings."

To overcome this, the bank has to reinforce to these customers that the product will perform in a certain way, which is based on a view which the customer also shares. "Then we can explain how it is structured and what the risks are, before talking about returns," says Tan.

Education in the Hong Kong retail market is also very focused on pay-offs, says Leung

Nicholas Leung, The Bank of East Asia

at BEA, but seldom on important things such as the overall structure, implied volatilities, fees and rationale for the selection of certain stocks.

Generally, Leung says retail investors see certain disadvantages with investing in structured products: mainly a lack of transparency and lock-ins - especially when they see very high equity levels compared with what they are likely to get later as a pay-off.

While these investors are gradually getting savvier, he says they are still not very

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sophisticated and they don't understand the fees charged on structured products. By comparison, they are familiar with mutual funds and they way they operate.

"To win the loyalty of retail customers, structured product providers need to make deal terms more flexible, as well as making it easier for investors to buy in after the initial offering period ends, once they have seen some positive performance," he urges. "This would be on different terms, but providers should allow new money to come in, for example after three to six months of the product lifecycle."

Adds Leung: "I am seeing this happen to some extent in the private placement market, so I am confident it will eventually happen in the mass retail market."

At the same time, providers need to become more flexible about when investors can take their money out, he says. "If there were more win-wins in the eyes of the retail customer, structured products would become a lot more popular."

Attractive Packaging

To maintain the momentum in the industry, Leung says there is a need to broaden the range of assets for retail customers, for example by introducing products based on indices, mutual funds or hedge funds, or by giving them country exposure such as Vietnam, where there is a lot of interest but limited access at the moment.

The trick is to come up with new ideas and structures that retail customers regard as giving them a good deal. "A lot of emphasis is on how we package the product to look like it is beneficial from the customers' perspective. This involves a good marketing strategy," says Leung.

BEA's recently-launched second QDII product was an innovative deal that does just that by alleviating concerns which many Chinese retail customers have about currency appreciation. "We protect them against this through the structure, by hedging the renminbi at the same time as exposing Chinese investors to global markets with the potential for upside participation," explains Leung. Because the investors see this product as addressing their concerns and needs, they buy it.

Another popular product in the Hong Kong market was one sold by DBS over the last year. It took advantage of the increasing focus by retail investors on investment themes - and on China - to launch a China A share-related basket where the underlyings comprise mainland banks and insurance companies.

Keeping up with Demand

The prospects for the continued demand for structured products throughout the spectrum of retail clients are bright.

"We believe the growth in the structured products market is sustainable," says Tan at OCBC. "Although there has been some criticism about products that have underperformed in certain sectors, we have many repeat customers and demand is still high."

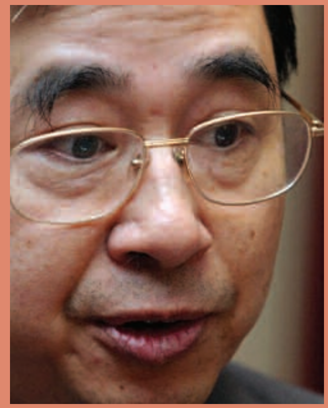
The difficulty the banks face - whether they are private or retail banks - is finding sufficient numbers of talented people to advise clients and sell product. The structured products market has grown by about 15 to 20 per cent per year, but it is very hard to get experienced people, says Aubin at BNP Paribas Private Bank. And raining people internally is a much slower and more long-term process.

Which means it is up to the product providers to step in and, in this fast-changing landscape for structured products, provide the pre- and post-sales services that the distributors say will make the difference between whether issuers win a mandate or not. ■

DBS Carves a New Path for Retail Distribution

Most banks either want to manufacture product or sell it to clients through retail or private banking channels. Not DBS, which has taken a very different approach to building its structured products business. Instead, it has created an end-to-end service from manufacturing through to after-sales service.

The rationale, says SF Wong, DBS' managing director, head of advisory sales, global financial markets, and regional head of the investment product group, is simple: the bank regards an end-to-end service as a more efficient model.


SF Wong, DBS

"We developed our investment product group to merge the product development capabilities of our global financial markets, private banking and consumer banking businesses, to share resources internally and to leverage off the strengths of each one," he explains. The sales, distribution and product sides of the cycle work very closely with the manufacturing side, supported by internal market strategists and research analysts within the bank, to come up with investment products and structures.

This relies on an experienced group of investment specialists and sales people who understand the market and are very knowledgeable about how the structures work. They must do a lot of due diligence before even bringing an idea to the clients.

Educating and training the sales force is the starting point, says Wong. "Our frontline sales staff are certified by the relevant authorities in the countries where they work, and we ensure our legal and compliance team vets every internal and external communication."

In relation to individual products, qualified relationship managers then look at the profile of each customer and assess their risk profile to understand their needs, he says. Knowing Your Customer is vital in this process.

The sales process must not be too technical, but it has to highlight the risks, says Wong. "Post-sale is also a key aspect of the process; sales staff need to know how to build relationships with their customers, and manage any unhappiness that may arise from a disappointment in product performance."

To manage client relationships well, it is important that the sales team is able to explain the performance of the products, and that clients see the bank's commitment to them. "We have a specialised unit that formally investigates a customer complaint to determine if any mis-selling was involved," says Wong. "If there was no mis-selling, a team member from the product side will work with the relationship manager to explain to the customer about their product - what happened and why."

It is all part of an end-to-end process, rather than separate parts of the business, he adds.

One of the big challenges Wong says DBS faces in growing the platform is the increased competition, especially in markets such as Hong Kong and Singapore. "More and more banks are moving into the wealth management and distribution business, so competition for business and talent is very high."

Investment in systems is one way Wong says DBS tries to stay ahead of the competition. "We want to automate as many of the processes and functions as possible, from the front to the back office, to ensure that our sales staff can spend more time servicing their clients."