Structured Products and the FSA Review

Points for consideration
Structured Products and Diversification – Life after the FSA Review

Reaction and debate rumbles on following the Financial Services Authority’s (FSA) review of advice given to clients who invested in Structured Investment Products (SIPs) backed by Lehman Brothers. The initial findings were published in October last year. Providers, distributors and IFAs alike have been discussing the papers ever since, trying to better understand and clarify the guidance offered by the FSA. The guidance builds upon recent industry improvements in literature and takes a common sense approach to fully understanding the nature of any Structured Product with all its associated risks as well as using Structured Products as part of a client’s portfolio. Ultimately, the industry should now have a strong foundation upon which to build a sensible framework for plan managers and advisers to work with going forward.

Structured Investments or Structured Deposits?

It is worth clarifying that the review focused on SIPs and that the findings and guidance relate solely to this type of structure and not Structured Deposits. The FSA clearly differentiates between SIPs and Structured Deposits as the latter are treated as cash-based products and as such are not subject to the same guidance principles. They are covered by the Financial Services Compensation Scheme for the first £50,000 of each eligible claim and therefore do not contain the same inherent risks. Icesave is a recent example which highlights the willingness to fully protect all deposits. The next key point to clarify is that the FSA are offering “guidance” on best practice and not laying out prescriptive processes that should be followed by all firms recommending SIPs. Advisers should focus on adopting the principles contained in the guidance and tailor their own firms’ business models accordingly. The FSA template, which I will cover in more detail shortly, has been issued to assist advisers during the advice process, not to replace it. However, following numerous meetings and debates with many colleagues across the industry it does appear that some of the findings and subsequent guidance may have been taken too literally by some firms and, in some cases, to the possible detriment of independent advice.

FSA Findings – Counterparty Risks

The FSA findings were many, however I would like to focus on their comments regarding counterparty risk and in particular product and counterparty concentration risk; or, in simple terms, their guidance on portfolio diversification.

“We take the view that Structured Investment Products are unsuitable for customers who do not want to take any risk with their capital or have no capacity for loss.”

The above statement only applies to SIPs and not to Structured Deposits; it is extremely clear and without ambiguity. Consequently, even where full capital protection is provided within the structure, the nature of the counterparty risk is sufficient to exclude Structured Investments from being classed as suitable products for these types of clients. On reflection this seems eminently sensible.

Therefore the question is where clients can tolerate some investment risk what is deemed as best practice?

The FSA would now expect that counterparty risk should be fully explained to the investor and also covered in detail in the suitability report. The adviser should also have conducted more robust due diligence on the counterparty(ies) covering a number of factors and more broadly than simply referring to a credit rating. Many institutions’ ratings have benefited from uplifts where the institution is seen as systemic to the UK banking system, however the FSA’s inference going forward is that no institution will be “too big to fail”. A more pragmatic approach is now needed and full consideration should be given to relative financial strength, the bank’s appetite for risk, credit default spreads (where available), credit outlook and financial reporting. Reference has also been made to counterparties’ “fundamentals” as shown on their balance sheet, i.e. capital, liquidity and leverage ratios.

From our launch in 2008, Investec Structured Products has provided full information to allow advisers to assess our creditworthiness at the “fundamentals” level in
addition to our ratings provided by Fitch and Moodys.

FSA Findings
- Portfolio Concentration

As well as reiterating their views on counterparty risk the FSA also make strong reference to product and counterparty concentration risk and have provided an advice template to assist advisers when recommending SIPs. The FSA has suggested that a client’s portfolio should not contain more than 25% in SIPs and not more than 10% with any single counterparty, even where that counterparty is highly rated, i.e. upwards of AA. Although diversification can lead to a higher probability of loss, any loss would be smaller and therefore more manageable. Unfortunately, even the biggest banks can default and an over-concentration of exposure could have a devastating effect on any portfolio. Diversification of credits makes perfect sense and avoids disasters later on.

Gary Dale, Investec Structured Products

make a more efficient portfolio for the client by incorporating a variety of structures and diversifying counterparties.

Diversification

- DERIVATIVES diversification

Diversification in its simplest form is a risk management technique that involves mixing a wide variety of investments within a portfolio. It is the spreading out of investments to reduce risks thereby minimising the risk from any one investment. In other words, investors can reduce their exposure to individual asset risk by holding a diversified portfolio of assets and, in relation to SIPs, a diversified portfolio of counterparties. Dealing with underlying assets first, Investec Structured Products has recently added additional asset providers across our range of retail plans offering the choice of more than one counterparty with similar return profiles. Investec Bank plc, as the Plan Manager, now offers other versions of some of our Structured Deposit and SIPs incorporating an alternative asset provider. Our plans are to develop this further by adding appropriate counterparties as our retail collection evolves. Using an alternative asset provider gives clients more choice and the ability to create a more diversified and balanced portfolio and meets with the FSA’s guidance on counterparty diversification without the need to choose multiple plan managers. Advisers are now able to not only recommend an Investec Structured Product where an appropriate return profile has been selected, but also with certain plans, discuss the benefits of choosing more than one asset provider within the same plan manager. This offers increased diversification, reducing the impact of any single default within an investor’s portfolio.

To diversify is defined as becoming more diverse or varied; the real skill is doing it in an appropriate and efficient way.

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