INTRODUCTION

PROVIDING SAFETY AND SIMPLICITY

Investors burned by the collapse of Lehman Brothers are shying away from exotic structures and looking for less complicated products and greater transparency. But they also know that the highly volatile markets mean that there are big opportunities to be found, writes Nat Mankelow

There has been a sea change in how private bankers and wealth managers approach the use of structured products to enhance and diversify their clients' asset allocation, as a direct consequence of the most severe financial storm since the 1930s.

According to the views of Europe's leading structurers, and comments made by some of the biggest users and distributors of structured products, we are now witnessing a dramatic flight to quality and safety as investors seek to ease the pain wrought by the collapse of Lehman Brothers – one of the industry's major counterparties and previously a key provider of structures.

Yet the industry is heading into 2009 with renewed optimism that a recovery in volumes and sales will be driven by, as Pierre Bes, managing director and head of private coverage at Barclays Capital, says "being intelligent and innovative in our solutions, which need to be overall transparent, simple, and liquid."

"[THE INDUSTRY NEEDS TO] COME UP WITH SIMPLE AND SAFE SOLUTIONS ON STABLE UNDERLYINGS"
PIERRE BES, BARCLAYS CAPITAL

SAFETY FIRST

Exotic structures with barriers and trigger levels are no longer in demand, claims Mr Bes. Instead, the industry needs to "come up with simple and safe solutions on stable underlyings," he adds.

This is not to say that one of the better features of structured solutions in recent times – being able to take a view on an exotic underlying like volatility for instance – will be lost as the market shifts priorities from products sold on best price and best coupon to products underpinned by robust liquidity and credit quality.

Stefan Wagner, head of structured products, Emea, at Citi, identifies two distinct patterns developing for 2009. "What we are seeing from the private banking side is a restructuring of existing deals to reflect what has happened in the market. For new business there is a clear flight to quality from stocks to indices and out of emerging market exposure into developed markets. On the product side and in terms of equity structures, you either find yourself in a short-dated leverage recovery over the next 18 months, or a long-dated growth play ranging 7-8 years."

Massimo Passamonti, head of exotic structuring at Commerzbank, says the current environment of high volatility makes it challenging, though not impossible, to structure products that have a capital guarantee, which were so popular in 2007. "The more risk sensitive client would like to have and take benefit from exposure to capital guarantee products but this is very difficult at the moment," he says. "Consequently we are trying to develop products which are short volatility – so with a nice pay-up feature in a high volatility scenario and being capital guaranteed at the same time."

Mr Passamonti points to the German retail market as warming to these types of products, called barrier bonds. These are essentially products with a barrier on the downside; if none of the underlyings touch the barrier the investor receives a coupon at the end of year. Typically investors prefer to have longer maturities on these kinds of products so they can benefit more from high volatility.

And ramped up volatility – with short-term implied volatility currently at record levels – is presenting structurers with the immediate challenge to tailor cleverer solutions for the more risk averse client base, believes Mr Bes.

"It doesn't make things easier to come up with capital protected products, but we can find them," he says.

Benoit Petit, head of private banking equity derivatives, Europe, at Société Générale, says it is really a case of different structures for different mandates. "Difficulties in the market since September have lowered the volumes for advisory clients, which is not the case for discretionary mandates of private banks."

HIGHLY VOLATILE BUT LOW IN PRICE

For both advisory and discretionary businesses, non capital guarantee structures with very low barriers are proving a popular choice among private banking clients. "It is an interesting time to go into these products" explains Mr Petit. "They are defensive with low barriers, and because the level of volatility is very high, structuring a product negatively sensitive to volatility is very affordable, indeed the higher the volatility, the cheaper the structure."

For capital guaranteed products, "demand is still important, even if volumes have decreased as compared to the same period last year", adds Mr Petit, "and we manage to do structures on short-term maturities."

The increasing cost of options might also lead, logically, to the use of constant proportion portfolio insurance (CPPI).This is a type of derivative-based portfolio insurance giving investors a safety net, should the value of their assets fall beyond a specific target, combined with a dynamic trading strategy.

"People are starting to get more interested in CPPI, like five to six years ago, and I think institutions could go back to CPPI," reckons Mr Passamonti.

On the contrary, Mr Wagner says the take-up in CPPI has been largely flat. "We haven't seen a big increase in interest in CPPI right now and this is because it is mainly used for underlyings in which you couldn't buy options. These are probably the more illiquid underlyings and not what clients are currently interested in."

SocGen's Mr Petit agrees. "The CPPI market is very volatile. You can imagine private banks are afraid of CPPI because the risk of monetarisation is very high, so they prefer to go to option-based structures," he adds.

At Citi, a recent client feedback gathering session has proved fruitful in terms of identifying trends in the

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structured product marketplace. "Investors are looking to access a lot of the distressed assets that are appearing as hedge funds deleverage and sell underlyings or products," says Stefan Wagner. "These are some of the best deals I have seen out there now. They are big opportunities to access some very good yield product – it has never been as good as now. You can access them either outright or via a structure."

And flattish volumes across pretty much all product areas have not depressed those manufacturers targeting the risk-taking part of the client base, says Mr Passamonti at Commerzbank. "What [the clients] are doing is quite interesting. They are taking benefit from the current high volatility by significantly reducing their maturities. We have sold a number of products with one-month maturities and low protection to small private bankers and Swiss-based boutiques."

Mr Passamonti, echoing the thoughts of many in the industry, believes structurers are correctly positioning themselves as providers of transparent solutions, which are less complex but not necessarily short on innovation. "We are starting to work on more transparent themes and products as investors realise that opaque or complex products contain hidden risk, so buying a product that is extremely exotic is something investors won't do in the near future," he adds.

Jean-Eric Pacini, head of structured products, BNP Paribas London, confirms there is now more transparency for clients and 'user-friendly' features are becoming more common. "This is true and we have been stressing this for sometime to our clients. There is now more value added in the underlying, and a more simplified payoff," he says.

Interestingly the rout in hedge funds – with redemptions escalating post Bear Stearns and Lehmans – could benefit the product's end user, suggests Barcap's Mr Bes. "Hedge funds are often operating within a 'black-box' framework, thus offering limited liquidity and transparency and being mono-strategy", he says, believing that structured solutions and liquid systematic alpha strategies could offer attractive alternatives to investors.

"Since the beginning of the credit crisis, people have been putting massive amounts in safe assets and cash. Private banks are trying to find solutions to invest this cash, especially as they need to be ready to offer the right products when the confidence comes back."

But one thing investors are not looking for is a single exposure to the credit market, financial market and banks in particular, confirms Mr Bes.

Citi's Mr Wagner puts special emphasis on the conservative client being quite rightly shy of owning a structured solution where the credit risk "mingles" with the equity, commodity or FX risk of the underlying. "In terms of opacity of the market and calls for transparency, this is reflective in that investors don't want an equity view and market view mixed up with the credit view just because it was packaged that way in a securitised format," adds Mr Wagner.

At SocGen, Mr Petit is seeing a number of clients returning to more complex products, especially within discretionary mandates. "We are doing some hybrid structures, for example with exposure on the Euro Stoxx 50 or the iTraxx: The entry point to the credit market is very attractive and the spreads are huge. We also propose good trades on volatility."

CREDIT, LIQUIDITY, AND COUNTERPARTY RISK

Tied into credit risk, which still presents an opportunity for the investor (as well as a concern), is the issue of counterparty exposure, which has heightened as a result of the failure of Lehman Brothers (losses mounted on Lehman-issued structures even on capital guaranteed backed products).

Mr Pacini at BNP Paribas acknowledges that, post-Lehman, credit risk and the whole view of the banking sector's creditworthiness has become the major theme for this year. "Nine months ago, clients would tell us BNPP structured notes offer great credit but other banks' structured notes are better because they offer better gearing on the same option due to the higher yielding funding – so there was a credit risk.

"However many clients would respond that no large bank would ever fail. But of course it turned out wrong in one case and there was a broader pain linked to the mark-to-market changes linked to credit.

"Some people have developed a total paranoia against

"COUNTERPARTY RISK IS A KEY ISSUE FOR PRIVATE BANKS"
BENOIT PETIT, SOCIÉTÉ GÉNÉRALE

credit risk as a result. It is a double-edged sword for us at BNPP; before other banks offered better funding and their structured products looked better. Now however, BNPP's credit default swaps at around 50 basis points is close to that of the US government and yet some clients are still concerned about any bank's paper."

Barcap's Mr Bes adds: "It is particularly important to remain close to your clients in this current environment and to keep a good level of communication. Investors are worried about the financial system in general and often a dialogue can contribute to bring back a little bit of confidence".

As PWM went to press, he had spent a morning calling his top clients with the news that Barclays was seeking to raise £5.8bn (€7.1bn) from investors in Qatar and Abu Dhabi. "The ability for banks to strengthen their capital base is very important and there is no doubt that the stronger institutions will come out of this crisis with an increased market share," he says.

Citi's Mr Wagner argues that some clients have faired better than others with respect to Lehman. "Looking at the private banks we work with, many have been good with diversifying their portfolios to not be fully exposed to any one single credit risk. I think most work under an 'assets under management' model, so are incentivised based on the absolute value of the portfolio. Private banks have been weathering the credit storm better than the broader retail market."

But having a limited exposure to a defaulting credit doesn't mean the issue of counterparty risk is not a core concern, believes Mr Petit. "Counterparty risk is another concern we are currently addressing," he adds. "It is a key issue for private banks. Many were investing in medium term notes so you can imagine they were not so happy when they lost 80 percent of the money," he says. He is currently working on a new structured product for clients, whereby there is no counterparty risk.