



## **A GUIDE FOR PRODUCT PROMOTERS**

September 2013

### **ABSTRACT**

The FCA finalised guidance on retail product development and governance (March 2012) requires that product providers incorporate product stress testing and analysis into the product development and distribution process. Investment Product Research offers product promoters independent, reliable and robust analysis that can demonstrate compliance with the regulations, and which can be used to increase sales by providing advisers with the information that they require.

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## 1. IPR Research

IPR is an independent structured product research business that offers independent, impartial, quantitative analysis of structured products.

### FCA FINAL GUIDANCE

The March 2012 final guidance from the FCA on the development and governance of structured products requires product promoters to develop products to meet specific investor needs. Providers are required to independently stress test products and to describe the risk and return that a product will offer to advisers and investors. The IPR risk, return and probability analysis has been developed specifically in response to this paper and allows product distributors to stress test products, and to describe the nature of the risk and return to advisers and investors at the time of sale, and through the life of the product.

We could not see any independent research company that operated in this space that produces the analysis that the regulator requires, and so we have established a framework that allows us to stress test and evaluate products in a way that is in-line with the regulations

### INFORMATION ADVISERS NEED

Our research offers more than a regulatory comfort blanket. At the heart of our proposition is the belief that investors and advisors will use structured products more if they have the tools to be able to identify the product that is most suitable for each investor. We believe that an honest, accurate and clear description of the returns that a product is likely to deliver and the risks that an investor faces will encourage demand. If advisers have confidence that they understand what returns an investor can expect, and what risks they face, then they are more likely to recommend a product.

IPR analysis can become an important sales tool for product promoters. IPR provides the analysis and information that advisors need to identify the most appropriate product for each client, and to document this process. IPR analysis will increase sales because it addresses the advisers concern that they need to be able to justify and document the reasoning behind their recommendation.

IPR offers an independent SRR1 volatility assessment, risk score and expected return for each product, and so allows products to be compared with each other, and also with other investment options.

### PRODUCT DEVELOPMENT

We also share the FCA's view that products need to be developed to meet the needs of investors, rather than to optimise their "appeal". This means that an evaluation of the risk an investor faces and the nature of the potential return must be part of the product development process.

IPR provide a framework that can be used by structuring professionals through the product development process. We have developed a range of ways to measure risk and a stress testing process that can be used together, or individually. Issuers can replicate our re-sampling process. The measures of risk and return can be used with re-sampled or deterministic data sets

## 2. FCA Requirements

The March 2012 FCA paper on the promotion of structured products makes it clear that

- Products need to be developed to meet customer demand and needs.
- Products have to be stress-tested to check that they are capable of delivering a fair outcome
- There is an on-going requirement to monitor the progress of a product

### STRESS TESTS

The FCA paper deals with stress-testing specifically. Stress tests need to be

- Robust, with defined parameters so that they are consistent
- Transparent
- Test the product under a variety of market conditions.
- Independent of the product design team
- Intrinsic into the product development process.
- Assume the investors perspective

#### *Action*

Back testing has become the norm for most product providers, but this does not provide a reliable or robust assessment of the likely future performance of a product. Deterministic Monte Carlo analysis requires the tester to have a view of the likely future risk premium / volatility and correlation of the underlying assets.

#### *Solution*

IPR have developed a re-sampling process to test products. This uses the data that we have on each underlying to create new possible paths that can be used to test the product. These new paths will have a risk premium and volatility that is consistent with the behavior of the underlying

### PRODUCT DEVELOPMENT

The FCA paper makes it clear that products need to be developed to meet the needs of investors with different risk profiles and capacity for loss.

#### *Action*

This requirement implies that a product provider is capable of estimating how risky a product is. Specifically providers are required to assess the likelihood of making a positive return or a loss.

#### *Solution*

IPR have developed a number of risk measures which can be used on their own or to map a product onto market standard risk measures

- Expected shortfall
- Left Hand Volatility
- SRRI risk score

## ISSUER ANALYSIS

Providers are also required to carry out broad due diligence on issuers. Credit ratings are insufficient; providers need to look at CDS levels, other market information and the issuer's balance sheet.

### *Action*

Most investors are now aware of the need to look at each issuer CDS as well as their risk rating. What is really required is an assessment of the impact of credit risk on the risk and return a product offers

### *Solution*

The IPR stress test included a credit-adjusted number that includes the probability of issuer default.

## INFORMATION FOR ADVISERS

The needs of advisers and investors are different. It is not sufficient for product promoters to simply describe the way that the value of a product is calculated, the investor and their adviser need to understand how likely it is that a product will generate a profit, or lead to a loss

- Investors need to understand the scale of the risk that they face, and the chance of a loss.
- Providers need to give advisers more information over and above the information in the financial promotion
- Advisers need to be given information that allows a product to be compared with other retail solutions

### *Action*

Providers need to create reports that give advisers additional information. Client facing material also needs to include more information about the probability of gains and losses

### *Solution*

Product providers can use the Adviser Briefing Document generated by IPR with advisers. Providers can also extract the data and use the analysis as part of their own communication with advisers, and in their client facing material

## ONGOING INFORMATION

A significant section of the FCA paper relates to the on-going responsibility of the provider. This is a major departure from previous policy.

- Firms are required to review existing products
- Have an on-going communication strategy
- Communicate material changes in the nature of the product

### *Action*

Product providers need to have a strategy for on-going communication with advisers. This needs to be based on current analysis of the risk/return of existing products

### *Solution*

The IPR analysis is updated each week. The current fact sheet will take the current asset price and the level of the underlying assets into consideration when recalculating the risk/return measures

### 3. IPR Analysis

IPR provides product promoters with the information that adviser's need, and which product providers are required to give;

- Quantitative, independent, comprehensible, accurate and reliable analysis of the risk and return offered by structured products
- IPR operate a clear, transparent, auditable process based on observable market data
- The provider can incorporate IPR data to their site to offer advisers filtering tools based on product terms, risk and return information that investors need in order to identify the short list of products that are suitable for their needs, attitude to risk and capacity for loss.
- The data can also be used within ranking tools that allow the short list of products to be ranked by advisers and investors
- The filtering, screening and ranking process allows advisers to document the process that they went through to identify the product that they recommended. This can be used as part of the suitability report.
- IPR offer product fact sheets as PDF's that detail the risks and returns that a product offers. The product fact sheet are created at the start of the offer period. There is also a [weekly] fact sheets after the strike date that updates the risk and return analysis to reflect changes in the level of the underlying, and the product price.

#### IPR STRESS TESTING

IPR test products under 3 different scenarios

- historic back test
- future stress test
- future stress test with a credit adjustment

The standard future stress tests are done using a statistical re-sampling process. This is a process that enables the creation of multiple new index series that are based in the performance of the underlying assets that can be used to see what returns the product would have offered. Re-sampling has been academically tested, and has the benefits of being able to generate statistically credible and stable results without the need to make any assumptions about the performance of the underlying. There is no need for complicated derivative models, and no need to make assumptions about the volatility or risk premium of the underlying asset.

IPR are also able to offer a deterministic stress test where the provider, or some 3<sup>rd</sup> party, provides the base information that allows the analysis to be completed

- Underlying risk premia
- Underlying volatility (surface)
- Underlying dividend assumptions
- Correlation (smile)
- Chance of issuer default

The principal output of the analysis for each scenario includes

- The expected return
- The probabilities of each kick-out event
- The probability of a barrier breach
- The chances of remaining with a range
- The chance and amount of any positive return
- The chance and amount of any loss
- The volatility of the product and the risk rating
- A number of measures of risk versus return

IPR operate an open model. IPR welcomes the scrutiny of issuers, products developers and promoters. Issuers are able to audit and replicate the process that we follow, and the values that we calculate.

## 4. Services for Advisers

IPR promotes its services to independent and restricted investment advisers, to the main structured product panel approval teams, and to national IFA firms that require advisers to have independent research to support a recommendation. IPR provides information about a product that is consistent from one provider to another. Product approval teams can easily compare one product with another knowing that both the input and output is consistent across all providers

### *IPR process and output*

To access any information users will have to register. Users will be required to provide information about themselves and the company they work for.

Registered users will be able to see

- Whole of market pre-strike product list with summary product information
- Risk score
- Expected Return

The free research is expected to attract a large number of advisers who are interested in structured products

## SUBSCRIBERS

The bulk of the analysis will only be available to subscribers. Subscribing to IPR offers a number of benefits. Most of these are included as part of the basic subscription package.

- **Access to a wider range of products;** subscribers will be able to see the whole database. This includes products that have struck already and institutional products
- **Customise product list;** subscribers will have the ability to customise their product list and select the analysis that they see from a wide range of available options
- **Suitability report;** having filtered, screened and ranked products, subscribers will be able to print off a report that describes the process that they have gone through to create the short list of products that they then consider for the client. This report can be used to supplement the advisers suitability report
- **Issuer / promoter documentation;** subscribers will be able to download the promotional material, term sheets, brochures, sales aids and application forms provided by the issuer and promoter

- **Adviser briefing document;** the ABD is a PDF document that has all of the product analysis. Subscribers will be able to download the ABD as a record of the analysis that they have received and reviewed in order to support their recommendation
- **Private placement;** the product list will contain all of the public offers that IPR are able to see. Subscribers will be able to ask IPR to upload private placements that they have invested in, or are interested in. Subscribers are also able to ask IPR to upload other deals that we have not already included.
- **Secondary market.** Invisiv will offer analysis on post-strike products. Our analysis will reflect the changes in the level of the underlying assets, and the current price of the product. Subscribers will be able to access the secondary market analysis, and to download updated ABD's on these products
- **Product testing;** Subscribers are able to get access to the product testing site. This allows subscribers to upload products that are being proposed to them, or simply to look at the analysis of new ideas that are being considered.
- **Distribution of research;** Subscribers are able to download the data that IPR provide and to distribute this to their clients
- **My portfolio;** subscribers are able to identify the products that they are interested in. This then facilitates the automated distribution of ABD's by e-mail. Subscribers can then set up alerts that will be triggered by changes in the product price, or of any of the underlying calculations



## 5. Services for Product Promoters

There are some existing product listing / information services that are free for advisers, and which are paid for by issuers. These offer a fettered list of products. Product promoters and issuers do not have to pay for a product to be included on the IPR product list, or for the analysis that IPR make available to subscribers. Product promoters and issuers are invited to send the details of new products to IPR so that they can be uploaded to the site.

Product promoters and issuers do have to pay if they want to use IPR as part of their product development process, and if they want to use IPR data as part of their communication with advisers and investors

### BENEFITS OF IPR FOR ISSUERS AND PROMOTERS

IPR offers significant benefits for issuers and promoters through the product design and distribution process, and then through the term of the product. The analysis that IPR generates enables product promoters to demonstrate that they are complying with the process that the FCA wants firms to follow when developing new products.

- Products should be developed to meet the needs of specific clients; the most important criteria here is an evaluation of the product risk. IPR analysis allows developers to test a range of products against a variety of different ways to measure risk
- Products need to offer an acceptable return, (this is not the same as a fair value calculation, which is a measure of the profit of the issuer and promoter). IPR research will allow developers to calculate the expected return of a product and also the chance and scale of the positive returns that an investor can expect to receive.

IPR analysis means that issuers and promoters can show that they have used independent research to calculate the nature of the returns and risks that an investor faces

- New products can be tested to see if they meet the needs of target clients
- Different product shapes can be compared against each other
- The analysis can be included in product ideas that are circulated to advisers, or tested with investors before the decision to launch a new product is made. The analysis will help investors and advisers evaluate a product by helping to illustrate the chances of various events happening
- Products can be tested against minimum standards; is the return sufficient to justify the risk. Is the risk acceptable in isolation?
- The analysis can be included in the initial sales material so giving investors more colour and information about the sort of returns that they should expect to get
- Regular statements to investors and advisers can include updated analysis

### TEST SITE [£2,000 PER MONTH]

Product issuers and promoters will be able to use the test site to upload product ideas that are being considered to see how they score. The test site allows promoters to evaluate products against minimum criteria, and to compare one product with another to see the effect of proposed changes on the risk and return.

Access to the test site allows a promoter unlimited access to test and evaluate products. The test site allows users to generate a product fact sheet. This can be used by the adviser

- to test ideas with potential advisers and investors

- to evaluate new ideas proposed by issuers
- as part of the product development process, documenting the iterations that the provider has looked at when developing a product

The test site includes a library of existing shapes that can act as a benchmark for a new proposition as well as other assets that providers may want to use as a benchmark.

IPR research provides a number of templates that allow product promoters to input new product shapes. The templates cover most of the standard shapes offered in the UK. IPR will create new templates as required. The cost of a new template (£2,000) will be rebated against the charge for Initial and Monthly product research if the template is used to support a product that goes into production.

## INITIAL PRODUCT RESEARCH [£500 PER PRODUCT]

### *Free upload of new products*

Once the decision to issue a product has been made if the issuer or promoter sends the details to SRP then the product will be uploaded into the product list for no charge to the issuer, and so will be visible to registered users and subscribers. If providers also provide all of their marketing material, sales aids, brochures, final terms, then these will also be uploaded to the IPR site.

The initial research will include calculations of

- the overall expected return
- the chance of any positive return, and the positive return that may be expected
- the chance of loss, and the scale of loss
- the product volatility, risk score, and 90<sup>th</sup> percentile confidence Expected Shortfall
- IPR also provides a detailed breakdown of the chance of each trigger being breached.

### *Using IPR analysis*

If the issuer or promoter want to use the information contained in the initial research as part of the sales strategy, and to circulate the Adviser Briefing Document (ABD) to advisers and investors they have to pay a license fee to IPR. Paying the initial fee allows the product promoter to use all of the data calculated by IPR.

- **PDF;** Most advisers require independent product research to support their recommendation. IPR will supply an ABD for use by the provider as part of their sales process. The ABD can be distributed by the provider electronically or as a paper document. The document may also be published on the providers web site and available to download
- **Data;** the analysis in the ABD will be supplied as a data file to allow the provider to use this data within their client facing material, sales aids and web site
- **Free access to the ABD for registered users on the IPR web site;** registered users will be able to access the advanced research and ABD for all products where the promoter has paid for the Initial Product Research

## WEEKLY ANALYSIS (£10 PER WEEK, £500 PER ANNUM, PER PRODUCT)

Product promoters can use SRP research on existing products to inform advisers and investors about the current risk/return characteristics of a product. The nature of a product can change considerably over time. Products that offered capital protection at the issue date can become risky if the asset price has increased. Products with capital at risk can become increasingly bond like if markets rise, and more equity like if markets

fall. The dynamic nature of risk/return, and the increasing requirement for disclosure mean that there is an on-going requirement for product promoters to keep investors and advisers informed about the product that they own.

Advisers will also demand more information. Increasingly advisers will want to review structured product holdings alongside other assets held by a client. Advisers can subscribe directly to IPR and receive the updated information directly. They may prefer to buy products from a distributor that supplies this information to them as part of their service proposition

IPR updates all of the analysis on each product each month. The risk/return nature of a product can change significantly over time as the level of the underlying assets change, and as the product price changes. Subscribing to able to use the IPR will allow product promoters to offer the information that they need to offer and the information that advisers will increasingly demand

- the current expected return
- the chance of loss, and the scale of any expected loss
- the current volatility and risk rating
- the expected return from the current date to the maturity of the product
- the chance of a positive return, and of the product triggering early

This information can be published through the provider's web site, and distributed with the statements and valuations sent to investors

The analysis will be available in a number of formats

- **PDF;** IPR will supply a monthly ABD for use by the provider as part of their sales process. The ABD can be distributed by the provider electronically or as a paper document. The document may also be published on the providers web site and available to download
- **Data;** the analysis in the monthly ABD will be supplied as a data file to allow the provider to use this data within their client facing material, sales aids
- **Free access to the Monthly ABD on the IPR web site;** registered users will be able to access the advanced research and ABD for all products where the promoter has paid for the Initial Product Research

## BESPOKE AND PRIVATE PLACEMENT

Both the initial and weekly product research are available on bespoke products and private placements. The analysis can either be excluded from the IPR web site or access can be restricted to the registered investor that has bought the product

## INVESTMENT RESEARCH

IPR are working with most of the main providers of investment research. IPR can risk rank products using the ATR (attitude to risk) and CFL (capacity for loss) scale used by each of the different providers, so enabling advisers to easily determine if a product has a risk score that is compatible with the ATR of the investor. For most advisers a product risk ranking that is consistent and compatible with the risk ranking that they use for the rest of their business will mean that it becomes much more straightforward to integrate advice on a structured product into the advice process.

IPR has entered into commercial arrangements with some of the research providers below that will allow the product promoter to use the research providers risk score. For others IPR will provide information that enable to research provider to evaluate a product. Some of these research providers will also list structured products

on their web site along with funds and other assets that have the same risk score. This will enable users of the research provider's services to see what products have a risk ranking that is compatible for the investor's attitude to risk.

Product promoters can pay for IPR to offer each providers risk ranking individually. Paying for a 3<sup>rd</sup> party risk ranking will

- Unlock the different risk rankings on the IPR site, and so allow advisers to filter products using that providers scale and allow the product promoter to use the risk rankings as part of their product promotion
- Weekly on-going risk ranking will update the risk ranking using the agencies ATR scale. Product promoters will be able to publish and distribute the updated risk ranking on their post strike products
- Some of the research providers have a facility that will allow the product promoter to list the product on the research providers web site

IPR is working with each of the risk rating agencies below. Each of these businesses operates in a different way and can offer services that will support a product promoter. The pricing for each agency is incremental and separate. Product promoters can pick and choose what services they want to buy

#### *Research providers*

- Distribution Technology
- Synaptics
- Defaqto
- Morningstar / OBSR / Ibbotson
- Financial Express
- Structured Retail Products
- Moody's / Barrie and Hibbert