Financial Conduct Authority

Structured Products:

Thematic Review of Product Development and Governance

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Thematic Review

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Contents

Foreword

The structured product market is an important component of the financial services industry. Its products range from alternatives to cash deposits to complex investments referencing multiple financial assets or indices. As a result, this large and diverse market serves individual savers as well as sophisticated investors, corporates and financial institutions.

The FCA's recent work in this area has focused on better understanding consumer behaviour and the way that firms approach product development and governance. Our consumer research finds that retail customers struggle to understand the features common to many structured products. They also frequently overestimate potential returns. These findings reinforce the importance of firms identifying a clear target market for their products and ensuring this information permeates their design and distribution strategy.

Our discovery work with firms has identified weaknesses in the way some firms approach product design and governance. More effort is needed by firms to match product design with customer needs, demonstrate product value through robust stress-testing and provide potential customers with clear, balanced information on the product and any risks. Firms also need to improve the adequacy of product governance throughout the product lifecycle.

Our regulatory regime provides a clear framework for firms operating in this market. It is up to firms' senior management to ensure they demonstrate that they are placing customers at the forefront of how they design new structured products. In particular, firms need to take account of the financial sophistication of potential customers and ensure their approach to product development bridges any knowledge gaps.

All of the firms in our review will be asked to explain how they will ensure the fair treatment of customers for the new structured products they bring to market. In addition, we have already asked the firms where we had the most concerns to carry out further work to assess whether customers in existing products may have been disadvantaged. We will continue to monitor the structured product market to check whether firms are meeting our requirements. Should we identify further issues, we will consider what further regulatory action is necessary.

1. Executive summary

Overview

Since publishing finalised guidance on structured products in 2012[1], we have continued to review how this market serves retail clients. Evidence from our ongoing interactions with firms suggested further work was necessary to examine how firms in the retail and wholesale markets were developing new structured products. This report contains the findings from our discovery work in this area.

Structured products are used as savings or investment alternatives by a broad range of customers. Products which are deposit-based or otherwise capital protected are typically bought by retail customers as alternatives to deposit accounts. Structured capital at risk products are purchased as alternatives to investment in funds or in financial instruments such as shares or bonds. From the supply side, structured products are used by industry as well as the banking sector as a source of funding and represent a revenue source for banks and intermediaries. Structured products therefore form an important part of UK and global financial markets. Annex 1 contains further detail on the different types of structured product covered by our review.

The development and governance of structured products gives rise to several risks that firms need to manage in order to treat customers fairly. In particular, firms need to ensure they design products that have a reasonable prospect of delivering economic value to end customers and promote their features (particularly potential investment returns and downside risks) in a clear and balanced way. It is imperative that firms operating in this market understand their responsibilities when carrying out the activities they perform and carry them out in a way that protects consumers.

The FCA has clear product governance guidance for structured products setting out expectations of firms operating in this market[2]. Generally speaking, firms should:

- identify the target market and then design products that meet the needs of end customers in that target market
- stress-test new products to ensure they are capable of delivering fair outcomes for the target market of end customers
- ensure a robust product approval process for new products

1 Specific guidance for structured products was published in March 2012: FG12/09, *Retail Product Development and Governance – Structured product review*, www.fsa.gov.uk/static/pubs/guidance/fg12-09.pdf. This provides a more detailed extrapolation of the FCA's view on what the combination of Principles for Businesses (the Principles) and detailed rules require respectively of providers and distributors in certain circumstances to treat customers fairly.

2 *Responsibilities of providers and distributors for the fair treatment of customers* (RPPD), http://media.fshandbook.info/Handbook/RPPD_FCA_20130401.pdf) and, *FG12/09–Retail Product Development and Governance – Structured product review*, www.fsa.gov.uk/static/pubs/guidance/fg12-09.pdf.

- provide appropriate information to distributors and end customers, and
- monitor the progress of a product through to the end of its life cycle

Our review found some firms are falling below the standards we expect in their approach to the design, manufacture, packaging and distribution of structured products. This report summarises our findings and reiterates our existing requirements.[3]

There are six key messages from our work:

1. Retail consumers generally struggle to understand the relative merits of structured products and the factors driving potential returns. They find it difficult to compare alternatives and to make full use of analytical information. It is essential that firms take steps to bridge this gap.

2. Firms' senior management must do more to put customers at the forefront of their approach to product governance. This should begin with the identification of a clear target market during product design and then inform each subsequent part of the product development and distribution strategy.

3. Structured products should have a reasonable prospect of delivering economic value to customers in the target market. Firms must be able to determine and evidence this via robust stress testing as part of the product approval process. Products that fail this process should not be manufactured nor distributed.

4. Firms' need to provide customers with clear and balanced information on each product and any risks. This is particularly important for information explaining the likelihood of potential investment returns and any risk to the customer's capital.

5. Manufacturers need to strengthen the monitoring of their products. This includes ensuring distributors have enough information about the manufacturer's product to sell it appropriately and checking that each product is being distributed to its target market.

6. Firms need to do more to ensure fair treatment of customers (including best execution where relevant) throughout the lifecycle of a structured product.

What we did

We carried out our review through three work-streams:

- *Research with retail customers:* We carried out two pieces of consumer research investigating why retail customers were buying structured products and whether they were making informed product choices.

3 Some structured products are designed, manufactured and distributed entirely 'in-house' by a single firm. In others, the responsibility for these activities will lie with different firms. This report therefore refers to the activity being performed rather than the 'type' of firm performing them.

- *Supervisory work with retail firms (the 'retail review'):* We assessed nine firms engaged in manufacturing and distributing structured products (structured deposits and capital protected structured investment products) to their own/other retail customers. We focused on whether they were designing products customers need and understand, that are capable of delivering fair outcomes and that are subject to a robust product approval framework.

- *Supervisory work with wholesale firms (the 'wholesale review'):* We assessed 14 investment banks who manufacture structured notes for issuers. We generally focused on firms' product development strategy, governance, distribution strategy and approaches to primary and secondary trading.

Our supervisory work was focused specifically on firms' approach to product design and governance, particularly how they assessed the value of prospective products from the customer's perspective. The scope of our work did not include how structured products were sold to customers and so the project did not assess firms' financial promotions, product literature, sales processes and/or the quality of advised sales. Further detail on the structure of our review is contained in Annex 2.

Findings

Consumer research

Our consumer research highlights that retail customers struggle to understand the complex features common to many structured products. It also shows how consumers will frequently overestimate the potential returns available from structured products, which has a negative impact on the quality of their decision-making.

These findings reinforce the need for firms involved in developing structured products to ensure they take account of the objectives and financial sophistication of customers in the target market. This will help ensure products are designed to meet identified consumer needs, sold via appropriate distribution channels and communicated in a way that investors can understand.

Discovery work with firms

Our work with retail and wholesale firms suggests some firms are producing structured products without sufficient regard to our previous guidance. Specifically, we observed that some firms failed to:

- define a clear target market of end customers at the product design stage and identify relevant need(s) which their product would serve

- conduct sufficiently robust analysis and stress-testing

- properly assess whether products are likely to represent value for money for end customers, and/or

- monitor how the product was distributed to check that distributors had sufficient information about the product and its target market to fulfil their own obligations towards the end customer

We are concerned that the product governance approaches of some firms in this market are not meeting our expectations and there is a risk that flawed product design could result in poor consumer outcomes.

Who does this report affect?

This report is relevant to all firms involved in any stage of the design, manufacture, packaging and distribution of structured products.[4] Although the scope of our review did not include an assessment of sales of structured products to end customers, many of its conclusions will be relevant to firms involved in point of sale activities. Representatives of trade and consumer groups may also find its contents relevant.

Next steps

Our Response

All of the firms we assessed will be asked to explain how they will ensure the fair treatment of customers for the new structured products they bring to market. We have already asked some of the firms from our retail review to conduct further work to determine whether any of the issues identified may have affected customers in existing products. It is possible that this will result in further remediation work by these firms and could lead to redress for some customers. It could also lead us to consider the use of other regulatory tools.

We believe the existing rules and guidance provide a clear framework for firms to develop products in a way that supports the delivery of good consumer outcomes.[5] Our regime is also consistent with the approaches set out by the International Organisation of Securities Commissions (IOSCO) and the European Securities and Markets Authority (ESMA). In our view, the regime is clear; the problem appears to be one of firms not meeting the requirements.

Within the next two years, two forthcoming EU Directives – the Packaged Retail and Insurance-based Investment Products Regulation (PRIIPS) and the recast Markets in Financial Instruments Directive (MiFID II) – will also impose more detailed requirements on firms manufacturing and distributing structured products to retail customers.

As part of our supervisory work, we will continue to monitor the structured product market to assess whether and how firms have reacted in response to our existing guidance and the findings contained in this report. If our concerns are not addressed, or if we identify further issues, we may take further regulatory action[6], including but not limited to enforcement action or making new rules to advance our consumer protection and competition objectives.

What do firms need to do next?

All regulated firms involved in the structured product market – whether manufacturing, packaging and/or distributing – should carefully consider this report, alongside our Principles, rules and guidance. Firms' senior management should satisfy themselves that they are meeting regulatory requirements and that their approaches support the delivery of good consumer outcomes.

In addition, firms should consider the forthcoming EU Directives in good time to ensure they are able to comply with the additional requirements as they come into force.

4 This includes (but is not limited to) investment banks (manufacturers of single structured products), distributors acting as agent (primarily financial advisers), distributors acting as principal (such as private banks, wealth managers and retails banks) and structuring entities (involved in re-packaging or white-labelling of products).

5 RPPD and FG12/09.

6 In June 2014 we took enforcement action against Credit Suisse International and Yorkshire Building Society after identifying concerns with the financial promotions issued to customers for specific structured products.

2. Regulatory responsibilities

We have published various guidance documents, supplementing the Principles for Business, relating to structured products. This report reminds all firms involved in the supply chain for structured products of their regulatory responsibilities.

The Principles for Business apply to all authorised firms. The following Principles are particularly relevant in identifying the responsibilities of product providers and distributors of structured products towards consumers who buy their products:

- Principle 2 ('A firm must conduct its business with due skill, care and diligence').
- Principle 3 ('A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems').
- Principle 6 ('A firm must pay due regard to the interests of its customers and treat them fairly').
- Principle 7 ('A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading').

The 'Responsibilities of providers and distributors for the fair treatment of customers' (RPPD) makes clear that what a firm has to do to meet the requirements of a Principle will depend upon the activities being undertaken and the circumstances. These include the riskiness or complexity of the product or portfolio, whether the firm is the product provider or a distributor, and the financial sophistication of the end customers in the target market. Firms should bear all of these factors in mind in order to interpret the requirements of the Principles.[7]

In relation to product providers[8], and without prejudice to the more detailed guidance in the RPPD, the following responsibilities are of particular relevance in relation to the design, manufacture and distribution of structured products.

Design of structured products

When designing structured products, Principles 2, 3 and (where applicable) 6 are particularly relevant. In particular, a firm should:

- identify the target market, namely which types of customer the product or service is likely to be suitable (or not suitable) for
- ensure that the complexity of the investment proposition is a reasonable match to the level of financial sophistication and understanding of the product's target market, so as

7 See RPPD 1.6.

8 In the context of product governance, a 'provider' includes persons who offer services such as portfolio management (through distributors or otherwise) as well as those who develop, manage or package products such as life insurance, general insurance or investment products. See RPPD 1.12.

to give prospective customers a fair opportunity to evaluate the product and understand the likelihood of a range of returns (including the possibility of receiving no return on their capital or making a loss)

- stress-test the product or service to identify how it might perform in a range of market environments and how the customer could be affected, and

- have in place systems and controls to manage adequately the risks posed by product design

Selection of distribution channels for structured products

When selecting distribution channels, Principles 2 and (where applicable) 6 and 7 are particularly relevant. In particular, a firm should:

- Consider whether this is a product which should be sold with advice.

- Review how evolving activity in the course of distribution remains consistent with (or deviates from) what was originally planned or envisaged for the distribution of its products or services given the target market. This involves collecting and analysing appropriate management information (MI) such that the firm can detect patterns in distribution as compared with the planned target market, and can assess the performance of the distribution channels through which its products or services are being distributed.

- Act when it has concerns, for example, by ceasing to use a particular distribution channel.

Information relating to structured products provided to distributors

When providing information to distributors or other firms involved in the manufacture or sale of the structured product, Principle 2 is particularly relevant. In particular, a firm should ensure the information is sufficient, appropriate and comprehensible in substance and form, including considering whether it will enable distributors to understand it well enough to give suitable advice (where advised sales are envisaged) and to extract any relevant information and communicate it to the end customer. As part of meeting this standard, the provider may wish to consider – with regard to each distribution channel or type of distributor – what information distributors of that type already have, their likely level of knowledge and understanding, their information needs and what form or medium would best meet those needs (which could include discussions, written material or training as appropriate).

Investors' post sale service

In the area of post-sale responsibility, Principles 2 and (where applicable) 6 and 7 are particularly important. In particular, a firm:

- In supplying information directly to the investor, must ensure that the information is communicated in a way which is clear, fair and not misleading.

- Should periodically review products whose performance may vary materially to check whether the product is continuing to meet the general needs of the target audience that it was designed for, or whether the product's performance will be significantly different from what the provider originally expected and communicated to the distributor or customer at the time of the sale. If this occurs, the provider should consider what action to take, such as whether and how to inform the investor of this (to the extent the investor could not reasonably have been aware) and of their option to seek advice, and whether to stop selling the product.

Whether acting as a 'pure manufacturer' (for example where a product provider creates a product to meet criteria or designs specified by a distributor, or creates components of the structured note which are put together by the distributor) or whether the provider has a more direct relationship with the end customer, firms must generally act with due skill, care and diligence in accordance with Principle 2. The skill, care and diligence that are 'due' under Principle 2 will be determined taking all the circumstances into account. A firm must also take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems (Principle 3).[9]

Whether a particular role or function is fulfilled by the distributor or provider (or both) may vary based on the product or service, or particular arrangements in place, and it may be possible for a firm to act as both provider and distributor at the same time in respect of different products or services. Where a distributor firm commissions a product and undertakes some product design activities, some of the product governance responsibilities relating to manufacturers will fall on them. Generally speaking, firms need to be careful in identifying their own responsibilities and in ensuring the proper and clear communication of their understanding of their responsibilities to other firms in the product development and distribution chain. Whether providers and distributors can agree on a (different) apportionment of responsibilities between themselves will depend on the circumstances. In particular, it depends on the nature of the regulatory responsibility, the extent to which such an agreement would be reasonable, whether the arrangement is clear to both parties and properly recorded, and the systems and controls used to monitor whether the agreement continues to be appropriate in the circumstances.[10]

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9 See RPPD 1.15.

10 See RPPD 1.15(1) and 1.16.

3.
Findings from our consumer research

Innovation in financial markets has led to many financial products becoming increasingly complex. We have highlighted previously how complexity can affect the quality of the decisions consumers make about financial products.[11] For example, consumers will often use shortcuts or rules of thumb that can lead to systematic errors in their expectations of the value or performance of complex products.[12]

We wanted to better understand the way that consumers behave in the retail structured products market. Specifically, why were retail customers choosing to purchase structured deposits and capital protected structured products ahead of potential alternatives (particularly cash deposits), and how well were they able to understand and make informed decisions about whether to buy them?

We carried out two pieces of complementary research to do this:

- Independent qualitative research: examining the motivations and product understanding of customers who had purchased or planned to invest in structured deposits and capital protected structured products.
- Behavioural research: examining whether there are systematic biases in investors' evaluation of the expected performance of structured deposits and whether giving targeted information improves this evaluation.

Evidence from independent qualitative consumer research

We commissioned a piece of independent qualitative consumer research with customers who had invested or planned to invest in structured deposits or capital protected structured investment products[13]. The research focused on:

- why consumers choose to invest in structured products and what they perceive to be valuable about the product class
- the factors that motivate consumers to purchase structured products compared to potential alternatives
- what consumers understand about these products and their features, and
- how well consumers can assess likely product performance

11 *Occasional Paper No.1–Applying behavioural economics at the Financial Conduct Authority,* www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-1

12 'Behavioural biases' such as the extrapolation of past performance, focusing on headline returns, loss aversion and exponential compounding bias may lead to errors in consumer expectations as to the value or performance of such products.

13 The research was carried out by the independent market research firm, Ignition House, and is based on the findings from 100 face-to-face, qualitative consumer interviews lasting 60 – 90 minutes. Consumers were shown a range of stimulus materials to test their' ability to understand common product features and assess the product value versus potential alternatives. The report with the detailed findings is available: www.fca.org.uk/your-fca/documents/research/structured-products-qualitative-research-with-consumers

In summary, the research found that:

- consumers predominantly sought a 'safe' investment (as regards risk of capital loss) and superior performance as compared with cash deposits. Taken at face value, structured deposits and capital protected structured products appear to address these underlying financial needs
- firms' sales processes have a strong influence on whether consumers buy structured deposits and capital protected structured products instead of alternatives
- the 'push' nature of the sales process, coupled with the relatively short decision-making timescales, mean that, left to their own devices, some consumers will not compare products before making their purchase decision
- consumers expect structured deposits and capital protected structured products to outperform alternative savings products, and product holders say they will be disappointed if products do not do so
- consumers had a good understanding of basic product features and where structured deposits and capital protected structured products fit in the savings and investment landscape, but struggled with the details
- few consumers had a good understanding of the underlying factors driving potential returns, and most did not consider likely market levels when making investment decisions
- consumers struggle to assess potential product outcomes or performance, particularly compared to savings products, and
- when consumers are given more information about the potential outcomes of structured products, they often make different decisions.

Evidence from behavioural research

In addition to the qualitative research, we carried out behavioural research which is published as Occasional Paper No 9 – *Two plus two makes five? Survey evidence that investors overvalue structured deposits*.[14] We conducted a survey of 384 retail investors who had previously bought or would consider buying structured deposits or other structured products. We used the same hypothetical structured deposits as in the independent consumer research to achieve comparability of findings.

The survey investigated:

- to what extent investors understand how different types of structured deposits work, focusing on products tied to the performance of the FTSE100 index
- whether there are systematic biases in investors' evaluation of the expected performance of the structured deposits, relative to investors' views about the expected growth in FTSE100 index, and
- whether giving targeted information improved this evaluation

14 Occasional Paper No 9 – *Two plus two makes five? Survey evidence that investors overvalue structured deposits* http://www.fca.org.uk/news/occasional-paper-no-9

The behavioural research found that:

- Investors significantly overestimated the expected returns of all structured deposits tied to the FTSE index, including the most simple, while their own expectations of the FTSE growth were on average quite conservative. The average overestimation was 80% (equivalent to 1.9% per year).

- Most investors ranked structured deposits as more attractive than best buy cash term deposits, which offered 3% per year, although the structured deposits would have been likely to return less than this.

- Giving the investors information on what would happen under hypothetical FTSE100 performance scenarios had little effect on improving product evaluation.

- Disclosure of likely product returns and chances of beating the best buy cash deposit reduced the bias and led to lower perceived attractiveness of the structured deposits.

The findings suggest that investors had significant misperceptions about the expected performance of structured deposits, even when they had relatively modest expectations of the underlying measure that product returns were linked to. When investors assess structured deposits individually, it is possible that the typical product features interact with consumer behavioural biases and lead to unrealistic expectations about performance. Targeted disclosure of additional information in our survey improved the evaluation somewhat, but only had a moderate effect overall. It remains to be explored how improved disclosure of targeted information about the products or advice can mitigate the effects of investor biases.

Conclusions

Our research highlights how the complex features common to many structured products challenges retail customers' ability to understand how they work, assess the returns the products are likely to produce and make informed decisions on whether they are appropriate for their needs.

It is clear that there can be considerable asymmetry between firms' and consumers' understanding of how structured products work and the likelihood of them outperforming relevant alternative products. This reinforces how important it is for firms developing structured products to ensure the role(s) they perform supports the delivery of good outcomes for consumers.

We assessed how effectively firms were delivering against these responsibilities by carrying out discovery work examining how a sample of firms approached product development and governance.

4.
Findings from our discovery work with firms

The following section contains the detailed findings from our supervisory work with retail and wholesale firms.

Target market identification

Our expectations

Firms should recognise that identifying a target market is very important, not only for generating ideas for products, but to ensure that products address specific investor needs and are designed in a way that the end customer can understand. Consideration of target market factors should permeate all aspects of product development and distribution, as noted above, as well as ensuring the selection of appropriate distribution channels and the promotion of the product accompanied by sufficient and correct information.[15]

Our findings

The firms in our review had identified the distribution channels for their structured products. However, we were concerned that most firms were unable to evidence that they had taken sufficient steps to identify the needs of a specific target market for their products and then use this information to inform decisions on product development, the selection of distribution channels and their marketing/promotion strategy.

Although some firms in our retail review had undertaken their own market research and/or consumer testing, this tended to be focused on identifying the factors that made potential products attractive to customers (and could be used to market them more successfully), rather than understanding and seeking to serve the needs and objectives of end customers. Firms were also influenced by feedback from intermediaries regarding which types of product were likely to sell.

The firms in our wholesale review typically used a matrix describing the notional target market for different types of product. One firm sought to manage the risks in this area by using a template that contained a detailed list of product features and linked them to investment requirements of end customers in a defined target market. Some firms adopted the principle that only 'simple products' should be sold to retail investors, however, the definition of a 'simple product' was not always consistent and some did not have a clear view on what a 'simple product' was (and whether these 'simple' products were understood by their customers). We were concerned this could result in products being manufactured (and subsequently distributed) without adequate consideration of the target market, customer needs and the appropriate channels for distribution.

15 RPPD, para 1.17 (1) and FG12/09, pp 15-16.

Analysis of product complexity
To provide further insight, our retail review included an assessment of the complexity of a sample of structured deposits and capital protected structured investment sold to retail clients.

We used product information requested from firms in our retail review to assess the complexity of a sample of retail structured deposits and capital protected structured investment products sold to retail customers.[16] We rated each product on a complexity scale ('low', 'medium' and 'high') based upon the number of features each product contained, the complexity of each feature in isolation, and on how the interaction between multiple features affected the outcome of the product. Our analysis suggested that most of the structured products in the sample were of 'medium' or 'high' complexity.

We are concerned that the complexity of the products firms are creating for retail customers is at odds with the findings from our consumer research. The research suggested retail customers will often struggle to understand the features common to many structured products, undermining the quality of their decision-making. Firms should therefore ensure their approach to product design and distribution – including the distribution channels used and the information provided to consumers – adequately reflects the needs and financial sophistication of their target market.

Selection of distribution channels

Our expectations
Firms should decide whether their structured product is one where customers would be wise to seek advice. If a structured product has complex features which are difficult to explain to customers, firms should take particular care with the use of non-advised distribution.

Provider firms should consider the needs of the retail consumer at the end of the supply chain regardless of the distribution strategy that they are using. Distributors should not be regarded as the 'end customer'.

Firms should review whether distribution in practice corresponds to what was originally planned or envisaged for distributing their products, given the target market. This involves collecting and analysing appropriate MI so the firm can detect patterns in distribution compared with the planned target market, and can assess the performance of the channels through which its products are being distributed.

Firms should carry out due diligence on distributors:

- initial due diligence would include an assessment of any risks posed to the fulfilment of the firm's legal and regulatory responsibilities, and

16 We asked the nine firms involved in our retail review to provide us with details of all structured deposits and capital protected structured investment products sold between 1 June 2008 and 31 May 2013. This consisted of 1,452 products covering approximately £21.5 billion of investment by approximately 1.3 million customers.

- continuing due diligence would include monitoring their distributors to ensure that products are reaching their target market

Firms should act on their assessments of distributors. Such action could include amending consumer or adviser literature for future product tranches, providing enhanced training for distributors, ceasing to use a particular distribution channel, or limiting distribution to specific channels.[17]

Our findings

Our wholesale review found that firms used a variety of distribution channels to sell their structured products. These included private banks, wealth managers, financial advisers (of varying size) and the branch networks of retail banks and building societies.

While all of the wholesale firms had 'know-your-distributor' processes in place for on-boarding, the depth of due diligence performed varied. Some firms' ongoing monitoring of distributors was also insufficient. Many firms appeared to take assurances from distributors at face value without having sufficient information to satisfy themselves that distributors' policies and procedures were appropriate for their product and target market.

Whilst the firms in our wholesale review provided specific product training to financial advisers (where they were one of the distribution channels used), they provided very little assistance where sales were conducted through private banks (on the assumption that banking staff in sales functions had the necessary product knowledge). Firms need to ensure that their chosen distribution channels have enough information to form an adequate understanding of their products.

Product stress-testing and modelling

Our expectations

Firms should adequately stress-test products to identify how they are likely to perform in a range of market conditions, and how the customer could be affected. For structured products we have made clear that[18]:

- stress-tests should be forward-looking as well as backward-looking, given the limited value of 'past performance' in replicating potential future returns
- stress tests should analyse the resilience of the product over its proposed term, in particular so that the product's risk profile may be properly assessed
- where there is a value for money test versus an alternative, such as a comparison with the returns from cash products, there should be a sufficiently demanding hurdle rate (or 'threshold') to reflect the opportunity cost of the 'next best' use of the customer's money, and
- the output from the stress-testing and modelling exercises should be considered by the firm as part of its new product approval process both for the initial and any subsequent tranches

In addition, for quantitative modelling we have made clear that firms should undertake simulations to understand expected profitability from the investor's point of view. In particular,

17 FG12/09 pp22-23.

18 FG12/09 pp20-21 and p31

they should consider what a reasonable comparison is for the next best use of the investors' money. Any assumptions made must be reasonable, based on publicly available data, and should not result in a misleadingly favourable impression of potential returns. Firms should also establish thresholds on the probability of stressed outcomes that are likely to be acceptable for the intended target market.

Where firms outsource stress-testing and modelling to a third-party, they need to undertake appropriate due diligence to satisfy themselves that the third-party's methodology is sufficiently robust. In particular, firms need to ensure that adequate information on modelling assumptions and outcomes is available – to inform product design and underpin the development of marketing materials – in the same way as if the stress-testing and modelling was performed in-house.

Our findings

Firms' approaches to stress-testing and modelling

Our retail review focused on the stress-testing and modelling approaches firms used to analyse the potential returns for prospective structured products. The majority of the firms we assessed carried out modelling that included:

- Back-testing: using historical asset prices to estimate the distribution of possible outcomes for new products.

- Forward simulations: using a variety of modelling frameworks to estimate the distribution of possible outcomes for new products.

On reviewing the methodologies used more closely we were concerned that further steps should be taken to minimise statistical bias that could adversely influence an end customer.

The firms in our retail review generally used historical back-testing to evaluate product performance. Whilst this helped inform product design, we were concerned that firms had not always made adjustments to compensate for the following issues with back-testing:

- economic conditions vary over time so the period over which the back-testing takes place has a significant impact on the outcomes

- when back-testing is based upon multiple time periods that overlap, the results may not always be an accurate reflection of a product's potential performance, and

- firms compared the potential performance of the product produced by their back-testing to the current yields available and did not take account of the yields available historically. This has an obvious benefit in an environment when rates are lower (as they are currently), as the performance of certain products tends to correlate with the interest rate available at time of issuance

All of the firms in our retail review conducted forward simulations to evaluate potential product performance. While most firms used standard modelling approaches, we identified the following common weaknesses:

- The selection and calibration of modelling approaches did not reflect the statistical properties of prices observed in the real world. For example, the distribution of equity returns resulting from a local volatility model may not necessarily match the equity returns observed in the real world. Further, if the growth rate is adjusted to include an equity premium in a local volatility model, the distortion may increase.

- Some firms used unrealistic and/or optimistic growth rates. For example, the relevant growth rate may differ if the underlying is an equity (investor receives dividends) or an equity index (investor pays the dividend). This distinction was not addressed by most firms, despite the majority of products offered being dependent on equity index performance.

The net effect of these issues is the production of modelling simulations that may not accurately reflect potential market scenarios and could lead to more optimistic estimates of potential product performance.

Firms' approaches to assessing value for money

In our retail review, all but one of the firms subjected prospective structured products to a value for money test. These firms identified an appropriate hurdle rate (or threshold) that the modelled returns for each product needed to outperform in order to proceed through the product approval process.

In some firms, the basis of their thresholds appeared reasonable, reflecting the next best use of the customer's money. For example, firms designing structured deposits as an equity-linked alternative to the returns generated by fixed-term cash deposits used the returns from the leading fixed-term cash deposit rates available within the market to determine their threshold.

However, we identified concerns with the robustness of the threshold used by some firms. In these cases, we were concerned that weaknesses in how firms determined an appropriate threshold meant that they did not provide a realistic reflection of the next best use of a customer's money. We were concerned that this could result in products passing through a firm's product approval process (and ultimately being sold to clients) that did not reflect the opportunity cost of the returns available from other, less risky alternative products.

The majority of firms' value for money assessments considered whether modelled product returns would exceed a chosen threshold. We identified two main weaknesses in the approaches some firms adopted:

- Some firms' threshold tests placed undue reliance on the maximum possible returns suggested by their modelling, rather than the most likely returns. We felt this created a risk of products being issued that might underperform relative to the next best alternative (for example, in the case of structured deposits, the rate of return paid by fixed-term deposits) and therefore offer poor value to the target market. It could also result in misleading potential product returns being disclosed to customers within relevant product literature.[19]

- Firms did not always take into account any difference in credit risk between the issuer or guarantor of the structured product and the provider of the alternative product, and factor this into their value for money assessment.

A number of firms employed external specialists for the quantitative modelling and/or assessment of a product's expected return. Some firms appeared to be using these results as validation for their decision to approve a product post-launch rather than as a tool by which to test the proposition prior to launch. They were not always able to demonstrate they had conducted appropriate due diligence on these third parties and on the robustness of the methodology being used. As with any element of product design and development, product manufacturers are responsible for the modelling, whether they conduct it themselves or commission it from a third party.

19 Albeit this was not something the scope of the review included.

Analysis of 'mark-to-market' and maturity values to verify firms' stress-testing and modelling
As part of our retail review, we analysed the actual or prospective returns of a sample of structured deposits and capital protected structured investment products sold to retail clients over a five-year period (June 2008 to May 2013).

We did this by requesting either the final maturity value or the current mark-to-market value (i.e. the notional value to customers at a point in time) for the sample. We then compared the average actual or current return against two benchmarks: the National Savings & Investments (NS&I) five-year deposit rate (NS&I Guaranteed Growth Bond) and the market-leading fixed-term deposit rates for that year. No adjustments were made for relative differences in counterparty risk or fees that may have been incurred.

Our simple analysis found that:

- on average unadjusted product results were below the comparable benchmarks
- the range of outcomes was widely dispersed, and
- some products were unlikely to perform as well as the comparable benchmarks by the end of the product term

Caution is required in interpreting this performance analysis. This is because product results can differ substantially if the issue date aligns with certain market events. For example, at an early point in an extended equity market rally rather than at a later stage where market growth has either slowed or the likelihood of strong continued growth is statistically less likely. The period reviewed contains significant rises and falls in the equity index.

Overall, this analysis suggests that, depending on the economic environment, these types of products may not deliver returns in line with the customer expectations highlighted by our research. This reinforces the need for firms to ensure they understand the needs of customers within the target market for their products and provide customers with clear information on potential product outcomes.

Information to distributors

Our expectations
Manufacturers should ensure that the information provided to distributors is sufficient, appropriate and comprehensible in form and substance, including consideration of whether it would enable distributors to understand it sufficiently to provide suitable advice (where advised sales are envisaged) and to extract any relevant information and communicate it to the end customer. As part of meeting this standard, the manufacturer may wish to consider – with regard to each distribution channel or type of distributor – what information distributors of that type already have, their likely level of knowledge and understanding, their information needs and what form or medium would best meet those needs (which could include discussions, written material or training as appropriate).

Our findings

Our wholesale review found that firms saw a clear separation between manufacturers' and distributors' responsibilities for overseeing marketing material and their controls reflected this delineated position. Manufacturer firms are therefore reliant on their distributors ensuring the information provided to the end customer is accurate and provided in a manner likely to be understood by the target market, including the information arising from the manufacturer firm's product analysis (for example, the output from their stress-testing and modelling). We were concerned that the level of ongoing due diligence performed by manufacturers on distributors could inhibit their ability to check that products are reaching the target market.[20]

Key findings from the Credit Suisse International (CSI) and Yorkshire Building Society (YBS) enforcement cases

We continue to monitor financial promotions in the structured product market. The enforcement actions taken against Credit Suisse International (CSI) and Yorkshire Building Society (YBS) in June 2014[21] resulted from this monitoring and contain important messages for firms involved in the development and distribution of structured products. In particular:

- The product brochures and financial promotions issued by CSI and YBS gave undue prominence to the maximum potential return of the products being sold. Disclosure documents highlighted the potential maximum return as one of key promotional features of the product even though CSI and YBS knew, on the basis of the analysis undertaken, that it was almost impossible to achieve the maximum return.

- Customers required a high level of sophistication and experience in order to understand the likelihood of achieving anything above the minimum return from the products. Given the profile of the customers the products were sold to, there was a significant risk that they would not possess sufficient understanding of structured products to fully understand the products from the content of the product disclosure materials.

- CSI failed to provide a sufficiently clear, full and prominent explanation to customers of the basis for calculating the level of charge that would apply to their investment in the event of customers withdrawing from the product early (i.e. before it matured). Customers were therefore unable to understand the basis for calculating the charge to be applied to their investment.

- Financial promotions are often the primary source of information for customers seeking to understand a particular product prior to making the decision on whether to invest. Firms producing such materials must ensure that the content of their communications offer clear, fair and not misleading information about the product that does not focus unduly on potential returns at the expense of highlighting risks consumers should take into account.

20 The Final Notices for YBS and CSI are available on the FCA's website (www.fca.org.uk/your-fca/documents/final-notices/2014/credit-suisse-international and www.fca.org.uk/your-fca/documents/final-notices/2014/yorkshire-building-society).

New product approval governance

Our expectations

Firms need to have transparent and auditable product approval frameworks for new structured products which:

- have clear roles and responsibilities for those involved
- incorporate effective scrutiny and first and second line of defence challenge at appropriately senior levels
- embed the delivery of fair outcomes for end customers
- adequately manage any conflict of interests between the firm and the end customer (for example, in the pricing of debt issued by the firm)
- have clear criteria for when an abridged or 'light' process may be used (for example, new issuances of the same product)
- have clear criteria for what constitutes a 'new' product
- take account of changes in the external environment, and
- have a review mechanism to prevent product design 'creep'

Firms should also ensure that the product approval process is not compromised as a result of commercial, time or funding pressures, allows for review and challenge by the compliance, risk and legal functions, and is not undermined by senior management over-ride.[21]

Our findings

Our wholesale review found that in some firms there was a lack of recent reviews/tests undertaken by compliance and/or internal audit on structured products. Given the retail focus of many of these products, firms should review their current/planned arrangements to ensure compliance and/or internal audit coverage of this area is adequate.

Our retail review suggested that the governance around the launch of new products in some firms was overly focused on the profitability of the product rather than meeting identified investment needs for customers in the target market. We had particular concerns about how firms assessed whether new products represented value for money for end customers.

Approach to market pricing

Our expectations

One of the core principles of our approach to wholesale conduct is to ensure that firms put the interests of the customer at the forefront of their businesses. Senior management is responsible for ensuring that robust business practices are operating in all their trading activities ensuring fair treatment, delivering best execution and promoting a culture that proactively identifies and manages conflicts of interest. These responsibilities are fundamental to the delivery of fair outcomes for customers.

21 RPPD 1.176 and FG12/09, p13.

Our findings

We have identified two areas in which firms need to consider their responsibilities under the Principles when pricing structured products. This should include best execution practices where relevant.

Pricing of the new issue

As part of the structuring process in delivering a new issue, the underlying risk (e.g. interest rate) is hedged for the issuer. In arranging the hedge, the manufacturer has a responsibility to ensure they obtain the most competitive price on that hedge (this can be any combination of swaps and derivatives). In cases where this hedge is provided in-house, there is inherent scope for conflicts of interest which must be addressed by the manufacturer. Ultimately, the manufacturer needs to ensure that this hedge is competitive as it constrains the overall product pricing which has a bearing on outcomes for end customers.

Buy-backs

Typically, structured products are designed to be held to maturity and the primary and secondary pricing data is in most cases only made available by the manufacturing firms (or business units) to distributors. This means customers can only access such data via private banks or financial advisers. Nevertheless, the provision of a secondary market often forms a major part of the product offering and some firms underlined the importance of this to their overall structured product franchise, particularly in times of market stress. For example, a sample of firms operating secondary market trading on a 'best endeavours' basis provided continuous liquidity during the 'financial crisis' (2007-2009).[22]

The price for a buy-back will be driven by a number of key inputs, principally, the issuer's buy-back spread (largely driven by issuer appetite and the pricing of their credit in markets at the time) and the cost of unwinding the hedge. In calculating this buy-back price, firms need to be particularly mindful of the impact on the end customer as in most situations the product holder is essentially captive, with the firm being the only source of secondary market liquidity.

22 Identified through a review of a limited sample of product marketing materials.

5.
Next steps

Action being taken with the firms in our review

All of the firms we assessed will be asked to explain how they will ensure the fair treatment of customers for the new structured products they bring to market. We have already asked some of the firms from our retail review to conduct further work to determine whether any of the issues identified may have affected existing products. These firms have been asked to assess their historic approach to product design against our Principles for Businesses, rules and guidance, and determine whether customers in existing products may have lost out as a result of any deficiencies in their approach. It is possible that this could result in further remediation work by these firms, including redress for some customers. It could also lead us to consider the use of other regulatory tools.

Action being taken in the market for structured products

We believe the existing rules and guidance provide a clear framework for firms to develop products in a way that supports the delivery of good consumer outcomes and are not planning to amend this in the short term. Within the next two years, two forthcoming EU Directives – the Packaged Retail and Insurance-based Investment Products Regulation (PRIIPS) and the recast Markets in Financial Instruments Directive (MiFID II) – will also impose more detailed requirements on firms manufacturing and distributing structured products to retail customers:

- **The Packaged Retail and Insurance-based Investment Products Regulation (PRIIPS)**[23] aims to improve transparency in the investment market for retail investors by requiring product manufacturers of investment products, including structured products, to produce a 'Key Information Document' (KID) summarising key features and risks. It will also require whoever is advising on or selling the product – whether a distributor or the product manufacturer (in case of direct sales) – to provide a KID to retail investors. The Regulation will be directly applicable from 31 December 2016.

- **The recast Markets in Financial Instruments Directive (MiFID II)**[24] will introduce specific product governance requirements for manufacturers and distributors. These requirements are likely to be similar to the current FCA and ESMA guidance on the subject. MiFID II will also include structured deposits within the scope of the directive for the first time. This means MiFID provisions on conflicts of interest, investor protection and organisational requirements will be applicable to structured deposits (e.g. requirements on product design, disclosure, inducements, staff remuneration, non-advised sales of complex products and suitability of advice). The MiFID II measures will come into effect on 3 January 2017.

23 http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/20120703-proposal_en.pdf
24 http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065

In the meantime, the existing guidance on the 'Responsibilities of providers and distributors for the fair treatment of customers', and on structured products specifically, provides a clear framework for firms to design and distribute products in a way that supports the delivery of good consumer outcomes.[25] This is consistent with the approach set out by the International Organisation of Securities Commissions (IOSCO) in its report into the regulation of structured products published in December 2013[26] and the European Securities and Markets Authority (ESMA) document setting out good and poor practices in relation to product governance arrangements for structured retail products.[27]

The design and distribution of structured products that provide clear economic benefits to firms but where there is unclear economic value to the customer, or where product risks are inadequately disclosed, are examples of firms failing to place the interests of customers at the forefront of their business. As part of our supervisory work, we will continue to monitor the structured product market to assess whether and how firms have reacted in response to our existing guidance and the findings contained in this report. If our concerns are not addressed, or if we identify further issues, we may take further regulatory action to advance our consumer protection and/or competition objectives, including but not limited to one or more of:

- remedial action on previously issued products
- enforcement action
- updating the existing structured products guidance (FG12/09) to include additional material to make our expectations clearer
- turning the existing guidance concerning product governance (in the RPPD and FG12/09) into detailed rules
- using our product intervention powers to compel structured product manufacturers to provide specific disclosure information on the modelled probability of achieving certain returns
- compelling distributors to include specific information prominently in financial promotions and product literature, and
- limiting the distribution of certain types of complex structured products to certain types of retail customers

What do firms need to do next?

All regulated firms involved in the structured product market should carefully consider this report, alongside our Principles, rules and guidance. Firms' senior management should and satisfy themselves that their existing approaches are in line with regulatory requirements and deliver fair outcomes for consumers.

25 FG12/09, *Retail Product Development and Governance – Structured product review*, www.fsa.gov.uk/static/pubs/guidance/fg12-09.pdf.

26 www.iosco.org/library/pubdocs/pdf/IOSCOPD434.pdf

27 www.esma.europa.eu/content/Structured-Retail-Products-Good-practices-product-governance-arrangements

Annex 1
Background information on structured products

This publication deals with different types of structured product, principally structured notes, structured investment products (including 'capital-at-risk' and 'capital protected') and structured deposits. Further background on structured products and information on each type of product is provided below.

Structured products are generally manufactured by bank structuring desks. Investors may be institutional, sourced by the manufacturing bank's (manufacturer firm) own sales force, or may be retail in nature. In the latter case, distribution will often be through an intermediary 'retail distributor' (i.e. a different firm from that manufacturing the product).

Broadly speaking, structured products are compound financial instruments that have the characteristics of combining a base instrument (typically a medium term note) with an embedded derivative that provides economic exposure to reference assets, indices or other economic values. Investors are provided with payoffs at predetermined times linked to the performance of the reference assets.

Structured products have proven attractive to investors as they can offer (or be viewed as offering) access to potential investment outcomes that alternative products may not readily replicate. However, the complex features common to many structured products mean they may not be appropriate for certain types of investor. It is therefore imperative that firms involved in the manufacture of structured products ensure their activities deliver good consumer outcomes.

Structured notes

Most structured notes take the form of a debt security combined with a derivatives contract. They are issued by a variety of institutions (but typically investment banks) and pay the investor a return linked to the performance of reference assets such as a basket of shares or an index.

Structured capital-at-risk investment product (SCARP)

A structured capital-at-risk product (SCARP) is as a product, other than a derivative, which provides an agreed level of income or growth over a specified investment period and displays the following characteristics:

- the customer is exposed to a range of outcomes in respect of the return of initial capital invested
- the return of initial capital invested at the end of the investment period is linked by a pre-set formula to the performance of an index, a combination of indices, a 'basket' of selected stocks (typically from an index or indices), or other factor or combination of factors, and
- if the performance is within specified limits, repayment of initial capital invested occurs but if not, the customer could lose some or all of the initial capital invested

Non-SCARP ('capital protected') structured product

A non-SCARP structured product is one that promises to provide a minimum return of 100% of the initial capital invested so long as the issuer(s) of the financial instrument(s) underlying the product remain(s) solvent. This repayment of initial capital is not affected by the market risk factors but is subject to counterparty (credit) risk.

Structured deposit

A structured deposit is a deposit paid on terms under which any interest or premium will be paid, or is at risk, according to a formula which involves the performance of:

- an index (or combination of indices) (other than money market indices)
- a stock (or combination of stocks), or
- a commodity (or combination of commodities)

Annex 2
Review methodology

Our supervisory work assessed firms operating in both the retail and wholesale parts of the structured products market. We also conducted consumer research to investigate why retail customers were buying structured products (structured deposits and capital protected structured investment products) and whether they were making informed product choices.

Work with consumers ('consumer research')

As part of our more consumer-orientated approach, we carried out two pieces of complementary consumer research to investigate how retail customers evaluated structured products and whether they were making informed product choices.

Independent qualitative research

We commissioned an external market research agency, Ignition House, to carry out qualitative research to help us to understand what retail customers wanted, needed and expected from structured deposits and capital protected structured investments. The research also tested whether certain products were too complex for retail customers to understand and properly evaluate. A key element of this test was to try to identify whether specific product features (or combinations of features) were likely to exceed the capability of specific customer groups.

The research included 100 individual depth interviews with retail customers who had either purchased a structured product in the last 12 months, or who were proxies who had the same characteristics as customers in the target market.[28] A report with the detailed findings from the research has been published separately [add hyperlink to IH report].

FCA quantitative research

The FCA's Chief Economist Department, working with Professor Neil Stewart from Warwick University, carried out a survey with retail investors from a consumer panel. The survey investigated how retail investors who bought or were likely to buy structured products understand and evaluate a set of capital-protected structured deposits, all based on the FTSE 100 index and embedding mainstream market features. A report with the detailed findings from the research has been published separately [add hyperlink to OP].

Work with retail firms (the 'retail review')

We assessed 9 firms engaged in the manufacture of structured products (structured deposits and capital protected structured investment products) for retail clients, focusing on their approach to product governance, development and design. We were particularly interested in:

- how firms identify the target market for prospective products
- the complexity of structured products firms sell to retail customers.
- how firms ensure prospective products will deliver value for money, and

28 88% of the sample were product holders.

- how firms assess the potential performance of prospective products through stress-testing and modelling (including back-testing and forward simulation)

We undertook this work by conducting a desk-based review of information supplied by all nine firms, followed by interviews with key staff in a smaller sample of firms.

Work with wholesale firms (the 'wholesale review')

We assessed 14 wholesale firms engaged in the manufacture of structured notes for issuer clients, focusing on firms' strategy, governance, sales (including distribution) and primary and secondary trading. We undertook this work by conducting a desk-based review of information supplied by all 14 firms, followed by interviews with key staff in a smaller sample of firms.

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