



STRUCTURED PRODUCTS IN CHALLENGING TIMES:

Tim Hailes, Chairman, Joint Associations Committee on Structured Products

Good Morning Ladies and Gentlemen. I am conscious that any remarks on this topic against the backdrop of continued market volatility and the ‘credit crunch’ inevitably runs the risk of being overwhelmed by circumstances. As a lawyer by training and profession the use of language has always been an important consideration and it rather appears to me at the moment that anything “structured”, “engineered” or “complex” in the world of financial products is regrettably being tarred with the same proverbial brush. When you add the word “retail” to the equation you have the perfect storm. I will come back to that in the context of my closing remarks about the ‘post-stabilisation environment’ when policy makers will, no doubt, revisit the issue of regulating financial markets.

Before I do that though I want to talk to you about the ongoing work of the Joint Associations Committee, which I have the privilege of chairing, comment on the role I believe structured products will continue to play in the wider retail investment world and briefly talk to the topic of product convergence and the so-called “substitute products” debate. I realise that is a lot of territory to cover in a relatively short space of time - but I am confident that the distinguished speakers participating in the various panels over the course of the morning will have a lot more to add. I very much look forward to hearing their views.

The JAC

The Joint Associations Committee arose from a series of meetings in 2006 held in response to a recognition on the part of the industry that “retail structured products” were in danger of falling between the cracks of the established mandates of the 5 sponsoring trade associations. ISDA, the ICMA, SIFMA, LIBA and the BBA had all strayed into the path of retail structured products in one shape or form combining, as they do, certain features of traditional securities with derivatives product technology - but no single trade group felt a sense of exclusive ownership. The JAC now comprises a distribution list of well over 1,000 contacts globally and embraces both the “buy” and “sell” side of the market as well as their professional advisers (such as law firms and others). It continues to be very much a consensus driven process with

participants determining whether written work product is desirable and otherwise acting as a 'clearing house' for the sharing of information and experience in the retail structured products markets globally. Whilst many members encounter issues arising from the distribution of structured securities many increasingly distribute structured returns through funds and almost all provide products to insurance companies and other investors who may repackage the risks into other forms of retail investment. Copies of both sets of the published JAC Principles are available along with the accompanying press releases at the conference today.

Retail Structured Products: Mistaken Identity and Future Role

Our paper to the European Commission on substitute products was our last written work product - but we have certainly had plenty of potential topics to talk about as the ripple effects of the credit crunch have spread.

It does have to be said very clearly that structured investment products are not the same as mortgage backed securities, off balance sheet structured vehicles or other financing structures that caused the credit markets to seize up. As The Wall Street Journal has commented "...in a case of mistaken identity, structured investment products have been erroneously lumped into the structured credit products catch-all bucket".

The issues which have affected retail structured products thus far have not arisen from the fact that they are structured, but rather from the fact that they are subject to the same influences as any other product. By way of example, the position of investors in Hong Kong facing the prospect of near total loss on Lehman "minibonds" has caused the market to really refocus attention on something extremely simple: traditional issuer default risk or creditworthiness - not on the fundamental features of the products themselves. Similarly, investors in "Pinnacle notes" in Singapore are facing potentially significant losses precisely as a result of the extreme drop in the value of the asset portfolio collateralising the notes - which included the credit of Freddie Mac and Fannie Mae.

These Asian market examples are illustrative of a very important point about retail structured products: the financial technology is not itself inherently "good" or "bad". Structured products can provide risk diversification, flatten volatility or enhance investment portfolios. In fact it is the almost endless combinations of characteristics, risk/reward profiles and benefits and limitations which makes them so versatile. The question is not so much whether they are here to stay as to how they are delivered and to whom. The FSAs "treating customers fairly" regime emphasises that the objective - of both regulators and regulated - is not to consider products in the abstract, but to ensure that the right product is sold to the right customer. This seems to us to be the correct approach.

Product Convergence

[APPLES AND ORANGES SLIDE]

Sometimes a picture speaks a thousand words. I first used this slide at the ISDA AGM in Singapore back in spring 2006 to illustrate the increasing convergence of the

worlds of over-the-counter derivatives, securities and mutual funds. Expressing it in a slightly different, perhaps more ‘lawyerly’ form:-

[TREE STRUCTURE SLIDE]

What this illustrates is that the same basic ‘risk-reward’ proposition can often be delivered through a multiplicity of routes and it is that fact that lies at the heart of the “substitute products” debate, the work of the European Commission in this area and informs some of the commentary in the recently published “Retail Distribution Review” from the UK Financial Services Authority.

I do not intend to repeat the content of the JAC submission to the European Commission on this topic as it is available for download from the sponsoring trade association websites but the co-existence of differing regulatory regimes does not automatically mean that arbitrage opportunity exists or that investor detriment is to be taken as a given. Many reasons exist for structuring products in particular ways – examples are the applicable tax regime and different cultural preferences for investment styles and vehicles. It certainly remains the case in the European Union that retail financial markets differ significantly between each other.

However, as a general observation, the techniques which can be used to regulate the retail sales of financial products can broadly be separated into ‘product regulation’ and ‘distribution regulation’. I want to spend my last few minutes commenting on these tools in a post market stabilisation environment when attention will quite rightly turn from ‘fire fighting’ to potential regulatory change.

Policy Making in the post-stabilisation environment

Politicians and regulators are prone to ‘legislate to prevent the last crisis’. In the specific context of retail investment products lessons can, of course, be learnt from the fall out from the credit crunch – especially in relation to the various misselling and misbuying allegations that have arisen in a number of markets. Fortunately the regulatory response to date has generally been measured and a lot of the very constructive work undertaken by both the industry and regulators before the unfolding of events in September remains largely intact.

It is right that every aspect of the financial markets should be closely scrutinised, and retail structured products are not - and should not be - exempt from such scrutiny. However, the fundamental issues - clear disclosure, product transparency and appropriate structuring - are the same now as they were before the market turmoil. In this area it is incumbent on both the industry and the regulators to ensure that the progress which had been made before September is built on rather than swept away in a tide of new regulation.

Finally, I will turn to the future. It seems to me that retail structured products have a promising future. National differences relating to marketability and tax will continue to demand the use of a wide variety of product wrappers, and the ability to deliver a full range of these in multiple jurisdictions will be a core competence for those who seek to lead the industry. Issuers will require to be able to move easily between sometimes unfamiliar wrappers, and it will remain key to the resilience of the market

that products are fully understood by all involved. The regulatory environment (and therefore wrapper requirements) will continue to vary significantly between jurisdictions, and these differences may increase in some areas. Finally, a healthy competitive pressure will continue to drive product structuring. Regulators may have some influence on these developments, but for those who seek to grow this business, there will be no substitute for a responsible, client focused, product aware business strategy.

Concludes

As promised I am conscious of condensing a lot of information into a relatively short space of time. I am grateful for your kind attention in that regard and am sure that many of the topics I've touched upon this morning will be the subject of much further comment and discussion over the course of this morning and beyond. Thank you.