

**The Structured Retail Product Markets
in Hong Kong, Singapore,
Korea and Japan**

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Global Fund Services
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1. Management Summary

This report examines the structured retail products markets in four distinct Asian markets; Hong Kong, Singapore, Korea and Japan. The report provides an overview of each market focussing on:

- **Size and recent development of the market**
- **Typical product characteristics**
- **Competitive environment**
- **Distribution Channels**

This report is based on information and commentary gathered from a variety of sources. The fragmentary nature of the market, and the reluctance of some participants to talk about their business, makes it difficult to put definite figures on some aspects of the market. Nonetheless, by contacting as many people as possible in the time-frame, it has been possible to build a picture of how these four markets are developing.

The structured products market is hard to define, in view of the many different types of product that exist, but it is possible to say that the market for investments which attempt to combine capital safety with market exposure is one of the great growth areas for fund marketing around the world. In an environment where investors have a diminished confidence in a fund manager's ability to produce positive returns unaided, the hedge fund industry has been able to demonstrate the benefits of alternative strategies.

Investors tend to get their timing wrong most of the time, which is why they employ the services of professional fund managers. So it is with ironically impeccable timing, that capital guaranteed products, some of them with capped returns, are becoming hugely popular just as Asian stock markets are coming right again.

In 2004 the MSCI AC Asia Pacific Free Index and the MSCI AC Asia Pac Free Index-ex Japan rose by 16% and 19% respectively. The reality though, is that many investors have learned a bitter lesson from falling stock markets and low yielding bonds and deposits. They want a degree of certainty and are willing, within reason, to compromise on the high growth to achieve it.

Asian investors have grown comfortable with a wider range of investment options in recent years. A recent Greenwich Associates report suggests that these instruments are helping Asian institutions prepare for a credit crunch that may now be developing.

"To date we have not seen huge spikes in the trading volume of these products," says the report, "but the adoption rates revealed in our research show that these products, interest-rate derivatives, credit derivatives and structured products, are spreading rapidly through the market."

The overall level of activity in the structured products sector around the Asian region suggests a huge potential market still untapped. A senior manager at UBS commented: "The Asian market has the potential to grow much larger than the European market in the short term. There has been a significant shift in terms of attitude to these products. The products being sold have also evolved from plain vanilla capital guaranteed to more exotic structures."

Each of the four markets in this study has its own distinct characteristics. They are at different points in their development. Hong Kong, at one extreme, is well developed and exhibits a high degree of competition amongst both retail product providers and their derivatives counterparties.

Korea has demonstrated that it is a big market for structured products and is seen as the market with possibly the greatest potential in the short-term (others mention Taiwan). Many of the guaranteed products being sold in Korea do not even have westernised names, which makes the job of the non-Korean speaking researcher even harder. Foreign influence is clearly going to be a major factor in broadening the range of products available.

The nature of the structured products market, in terms of product variation to suit different investor appetites and underlying market conditions, favours product promoters with the greatest agility and imagination. The following are some of the key areas where groups may differentiate themselves:

- Structuring capability**
- Exotic option pricing capability**
- Access to a wide range of underlying markets**
- Efficient delivery platform and secondary market support infrastructure**
- Competitive vanilla option pricing**
- Credit rating**
- Access to a range of efficient funding vehicles**
- Existing distribution arrangements or potential partners**

2. Scope

Although the term is widely used in the financial community, there is no single established definition for a 'structured product'. For the purposes of this report we define a structured product as:

“A financial product that provides a pre-defined return at one or more future dates linked to one or more underlying financial prices, rates or indices. A key feature of such products is that they can be broken down into a number of separate financial instruments one of which is typically a derivative product.”

This definition will therefore exclude certain other financial investments sold to retail investors such as warrants, listed options and futures, and Exchange Traded Funds.

While working on this project, I have questioned approximately 50 people, who have provided anecdotal evidence and in some cases, actual data. The research has necessitated contact with a large number of market participants in view of the lack of any centralised data sources. Additional information has been obtained from independent research reports, investment bank research material and official bodies such as trade associations or regulators.

3. Size and Scope of the Market

The structured product market in Asia is highly fragmented, with products available in a wide range of forms (deposits, life assurance, funds, etc) and via multiple distribution outlets.

Table 1 below provides an indication of the size of these markets, based on best estimates.

Table 1: Retail Product Sales by country

Market	2004 \$bn	2003 \$bn
Hong Kong	10	12
Singapore	5	5.4
Korea	6.4	4
Japan	15	15

There are two principal reasons for the growth in the market in recent years:

- **Low interest rates:** greater control of inflationary pressures around the world has led us to a point in history where interest rates around the world are much lower than investors and depositors have been used to. Accordingly, interest rates on deposit accounts offered by retail banks and by bond and money market offerings are not offering the buyer much in the way of excess return. In some countries, investors are losing money in real terms.
- **Volatile stock markets:** Structured products give investors protection from a volatile stock market environment. Investors have not forgotten the pain inflicted by the global stocks collapse of 2000-2003. It has made them more risk averse in their attitude towards investment products. At the same time, with the growth of structured products and hedge funds, investors have been made aware of suitable alternatives to mainstream long-only equity products.

3.1 Number of Products Launched

Hong Kong

This market is highly competitive. The volume of structured products has soared, with launches at the rate of over 10 new notes or funds per month currently. Because of the fragmentary nature of the products, tranche and open-ended, retail and private placement, it is not possible to put a categorical figure on the numbers of products or amounts raised. Many products now come with two or more variations i.e. different levels of capital protection, with or without a knock-out feature.

Some providers launch regular offerings every month or every two months so that they always have a product available. HSBC comments that the number of launches in the market is very small but their size is very large. In terms of market development, it has been suggested that Hong Kong currently is a bit like the UK in early 1990s.

Singapore

While growth in sales appears to have flattened in Singapore, the market for new structured products is as lively as ever. Around 40 new retail products have been launched in the past two years, a period when structured products' share of the Singapore funds market has made it the biggest sub-sector of all.

Korea

Korea's asset management market is opening up on a number of levels, not the least of which is the expansion of corporate pensions and the outsourcing of fund management taking place at the Korean National Pension Corporation. Competition is increasing also because of a consolidation amongst the current market players and the entrance of foreign competitors such as Fidelity and SocGen.

Mirroring the development of its overall financial services framework, structured products growth in Korea has been stop/start in nature. In the last two years, domestic institutions and a few foreign players have established a high level of demand for equity linked products.

Japan

According to Cap Gemini/Merrill Lynch's World Wealth Report 2004, Japan accounts for two-thirds of the high net worth investors in the broad Asian region. Guaranteed funds have been a boom area and there have been some highly successful structured product and quasi-hedge fund products, sold through banks and securities houses.

The potential market is huge but foreign players must be aware that the Japanese regulators are very strict and all prospectus and due diligence information must be in order. Compliance breaches will be dealt with severely, one only needs to remember what happened to Citigroup.

3.2 Total volumes of gross sales

Hong Kong

Capital guaranteed funds had been gaining in popularity since 2002. "There has been continuous interest in capital guaranteed funds, though the pace of introduction has slowed down," noted Hong Kong's Securities & Futures Commission in its quarterly report.

A strong equity market pushed Hong Kong fund sales up by 4.5% last year to US\$20.34 billion, according to the Hong Kong Investment Funds Association. Equity funds were more popular than either bond funds or guaranteed funds last year, the latter having recorded a 4.7% decline in gross sales to US\$3.1bn.

Sales and redemptions data of Guaranteed funds by Hong Kong investors (US\$ million)

	Gross Sales	Gross Redemptions	Net Sales
Full year 2002	3,375.73	653.51	2,722.22
Full year 2003	3,217.56	2,438.65	778.91
Full year 2004	3,065.94	2,580.21	485.73

Monthly breakdown:

Jan 04	451.96	167.87	284.09
Feb 04	91.90	408.71	-316.81
Mar 04	452.76	289.30	163.46
Apr 04	471.66	223.16	248.50
May 04	174.93	705.78	-530.85
Jun 04	252.37	73.29	179.08
Jul 04	236.50	204.21	32.29
Aug 04	211.53	93.37	118.16
Sep 04	297.55	82.21	215.34
Oct 04	131.66	90.91	40.75
Nov 04	210.12	116.79	93.33
Dec 04	83.0	124.61	-41.61

The above data understates the true figure because it only covers SFC authorised guaranteed funds managed by HKIFA members. And even then, it only includes figures from those groups who are willing to disclose their true sales figures. There is no compulsion for them to do so. As a result, the true figure could quite easily be double the official figure of \$10bn sold in the last three years.

A full list of Hong Kong retail guaranteed funds is available on the SFC's website.

Go to:

http://prsfo.sfc.hk/ip/ipcat.jsp?charset=ISO8859_1&method=p_type&initial=ALL&p_type=UT&p_fund_type=8G

Singapore

Singapore has seen a huge jump in sales of guaranteed funds in the last two years. In 2002, the total assets under management for guaranteed funds were US\$1.8 billion. By the end of 2003, that figure had grown to \$5.4bn. Industry insight suggests that fund flows levelled off in 2004, so our estimate for assets in capital protected funds in 2004 is approximately \$5bn.

Singapore's Investment Management Association does not collect sales figures for guaranteed funds, although it says it will begin collecting sales figures later this year.

The Monetary Authority of Singapore does collect market share data for various fund types, but data for 2004 is not yet available (expected Q205). The MAS web site contains a review of previous years' sales and assets under management for the various fund product sectors.

Go to: <http://www.mas.gov.sg/masmcm/bin/pt1Survey.htm#fmsurvey>

Korea

Korean institutions have been big investors in structured products. Again, it is hard to pin down exact figures because of the different way structured products come to the market.

In Korea, there are three different formats; equity linked deposits, equity linked securities and equity linked funds. The majority of equity linked securities funds are structured to guarantee at least the initial principal. So, ELS products are classified as guaranteed funds. Industry insight suggests that these three categories of structured product would have generated \$20bn in each of the last two years.

The following table contains sales data for Korean guaranteed products and equity linked notes and funds in the last two years, provided by the Korean investment funds association. Again, this data probably understates the total.

February 2005	Number of Funds	Sales(million KW)
ELS & ELF	480	6,496,145
Guaranteed Fund	77	1,326,954
December 2004		
ELS & ELF	468	6,495,463
Guaranteed Fund	73	1,014,920
December 2003		
ELS & ELF	713	4,014,224
Guaranteed Fund	102	848,112

The structured products market is seen as a key growth area at the retail level. Traditional fixed income funds have flooded the market but there is demand for high returns and for the asset managers, a need to generate higher management fees than the 0.20% typically charged on fixed income funds. Structured products will also allow managers to charge fees upfront, rather than on a daily basis.

Asset managers now have greater flexibility in structuring products. The Korean Government recently altered the rules on underlying investments, to include links to individual securities. Prior to this, the underlying link had to be an index.

Japan

Industry insight suggests that Japan has the largest number of public offerings of structured products. Unfortunately, the Investment Trust Association of Japan does not monitor the number or the size of this market. We know, from the activities of the mainstream asset managers, that this is a substantial marketplace. Recent successful launches by Man Investments and other foreign players demonstrate quite clearly what can be achieved.

The Japanese securities houses are the key to successful product distribution and the Japanese banks are now scurrying to get in on the act. In December, Sumitomo Mitsui Banking Corporation formally announced the setting up of a 'securities marketing department'. They have begun offering foreign currency bonds and structured products to their retail clients.

In April 2005, the Japanese Government will remove the deposit guarantee that has secured people's money since the time of the market bubble in 1990. This is expected to be a good opportunity for structured product players. Japanese investors are largely uneducated about these products, but they will jump a product that offers them more than bank deposits, postal savings or government bonds.

4. Products Offered

The structured products market is comprised of a very wide range of products with different characteristics, fiscal wrappers, etc. In fact continuous innovation in product design is one of the key features of the market.

In this section we provide an overview of some of the main types of products that are available in each market.

4.1 Types of product

To begin with we can identify two broad types of products: tranche products and open-ended products. Tranche products, as the name suggests, are offered for limited periods and have fixed maturity dates. Open-ended products on the other hand, are continuously available and have no fixed maturity date.

Traditionally, tranche products have been the dominant form of structured products in the retail market. The reason for their predominance is that fact that it has been difficult to provide a guaranteed return within an open-ended fund where investors can buy and sell units at any time.

In recent years however new forms of open-ended products have appeared, many using CPPI as the basis for the guarantee, which have proved popular in some markets. Instead of providing 100% capital protection however these products have tended to provide a guarantee on the unit price, which means that the level of protection provided depends on the actual unit price when the investment is made.

One of the benefits of open-ended products is that once the product is launched it can be sold indefinitely. It also creates a "track record" which can be used for future marketing purposes.

Equally though, a tranche product creates the opportunity for several marketing 'events', which is one major reason why tranche products continue to be the most common form of product.

Hong Kong

The biggest trend here is the growth in the number of structured notes. The major banks all have large teams in Hong Kong doing nothing but structured notes work. One sales person at HSBC estimated they are producing 10 equity derivative products per day.

All the investment banks are players to some extent. UBS's structured products team has grown from 2 to 12 in the past 18 months. An indication of the scale of issuance is the estimate by Nomura in Hong Kong that it has issued around US\$7.5 billion in structured notes. Nomura's specialisation is interest rate notes and the most popular products include a Callable Daily Range Accrual Note and a Callable CMS Corridor Note. The company estimates it has launched over 400 tranches of these and has raised the equivalent of around US\$5 billion.

Products are either short dated capital at risk ELNs or DCD, with perhaps a 6 week term or long dated capital guaranteed, with an average term of 4.75 years.

As the trend to offer a higher minimum return has continued so the amount of "optionality" in products has decreased. This has led to somewhat more complex payoff types as providers have struggled to offer attractive looking potential returns with limited amounts to spend on option premium.

Generally, a retail note launch will expect to raise a minimum of US\$50-60m. \$100m would be considered a success while \$500m would be outstanding. Asset managers would be looking to raise more than retail note paper because it is more costly and time-consuming to set up a fund. So for them, \$50m would be considered a failure.

Now, with so many players entering the market, the consensus seems to be that sums raised are not as high as they were. Spreads are becoming tighter and investors are looking for something new. Target redemption funds have now become very popular in the market, with shorter maturities.

Actual sales figures are difficult to find, such is the competitive nature of the market. Figures gathered in 2003 show that the most successful products, such as HSBC's Good Fortune Capital Guaranteed Fund, raised over US\$600m, with \$375m of that emanating from Hang Seng Bank. The importance of Hang Seng as a distributor is further illustrated by the HSBC Double Blossom Guaranteed Fund, which raised US\$188m, of which \$163m was sold through Hang Seng Bank.

HSBC is very much a key distributor for third party funds. For example, the SG Fund Ride Capital Guaranteed Fund II raised US\$245m exclusively through HSBC PFS. KBC's Sunflower Capital Guaranteed Fund raised US\$130m through the same channel.

Belgian bank KBC's most successful product has been the 'Good Harvest' Capital Guaranteed Fund. It is a 10-year target redemption structure with earliest termination date at the end of year 2, linked to a basket of 26 international blue chip stocks. The fund has a 10% guaranteed coupon payable at the end of year 1, and yearly potential target coupons starting at 20% and increasing by 5% p.a. up to 50%. Two tranches of this fund were launched at the same time and KBC raised US\$170m.

Deutsche Bank has been one of the most successful and innovative players. Its hedge fund linked product, CDS (Yield Enhancement) Fund and its CDO-based structured products were innovative products which, according to the bank, raised significant volumes.

Deutsche's most popular concept though, was the 'Global Elite' product, a 100% principal protection product with 11% minimum guaranteed payout and knock-out facility. No details of how much was raised, but Deutsche confirmed this product amassed the highest AUM of any of their launches. Deutsche has launched Global Elite twice and the structure has been subsequently enhanced and launched as Step-Up and Power Jump. The product has been distributed in Hong Kong by Citibank.

Other recent product examples:

ING Lion Equity Linked Note Series I

ING's debut two-year income product in Hong Kong pays a minimum of 13.2%, and a maximum 40.92%. The minimum annual coupon is 6.6%. In positive markets it pays 110% of any positive returns on an equally-weighted basket of five blue-chip Hong Kong stocks, calculated quarterly and capped at 18.6% per annum. The stocks are HSBC Holdings, Hutchison Whampoa, Sun Hung Kai Properties, China Mobile (Hong Kong) and CNOOC.

HSBC Basket Equity Linked 6

The three-year US dollar-denominated notes pay a fixed coupon of 9% in the third and sixth months, with subsequent payouts based on the worst performing stock in a basket of eight Hong Kong-listed stocks. Starting from the ninth month, the investor can receive potential monthly payouts equal to the equity return of the worst performing stock plus a base interest rate, estimated to be around 5%. Once the aggregate payouts reach a 22.8% target, the notes redeem at 100% of principal. If the target is not reached by the end of the year three, the investor receives 100% of the initial investment, so long as the worst performing share is above a strike price of 88%. If the worst performer is below this

level, the note redeems in stocks of the worst performer at the strike price.

Lehman Brothers' Minibond Series 16

The 5.5-year notes are credit linked to a basket of six global credits – American Express, Bank of America, HSBC, Hutchison Whampoa, JP Morgan and Standard Chartered. Investors can choose between a US dollar tranche and Hong Kong dollar tranche. Coupons on the Hong Kong dollar tranche are 3.2% per annum during years one to four and 3.75% for the remaining life of the note; while coupons on the US dollar tranche are 4.2% per annum during years one to four, and 4.75% for the remaining life of the note.

Bank of China International's Lucky Coupon ELN

The two-year notes pay a fixed coupon of 6% in the first quarter, with further quarterly coupon payments dependent on the performance of a basket of six Hong Kong-listed stocks. If all of the stocks are above a certain barrier level at the quarterly observation dates, the investor receives a 6% coupon for that period. This barrier level lowers after each observation date. So, all six stocks must be above 100% of their initial value at the first observation date six months after launch for the 6% coupon to be paid. That falls to 98% after nine months, 96% after 12 months, 94% after 15 months, and so on. If, at maturity, all the stocks are above an 88% barrier, the investor receives 100% of the investment plus the final coupon of 6%. If any of the shares are below the 88% barrier, however, the investor receives the shares of the worst performing stock at that strike price. The note is callable by the issuer after one year and on each quarterly coupon date after that.

Schroder Performance Step-Up Guaranteed Fund

This six-year fund pays 4% after the first six months. Between year two to six, the investor receives the greater of a 1% coupon or 100% of the performance of a basket of 20 international stocks. From year three onwards, the coupon cannot be lower than that of the previous year. But there are also two lock-in features. If any stock is above its initial level at the observation date, that stock's growth will be locked in at an estimated 6.5% for subsequent calculations. Meanwhile, the biggest negative stock performance will be set at zero each year (assuming the stock hasn't already been locked in at 6.5%). When 18 out of the 20 stocks in the basket are locked in, the fund will terminate early and investors will receive the step-up coupon and 100% of their principal back.

Singapore

Capital guaranteed funds are still the most popular type of fund in Singapore according to the Monetary Authority. MAS figures show assets under management for guaranteed funds rising 41% to S\$7.635 billion, (£2.4bn), with an average tranche size equivalent to around £20m and product issues growing to 119 funds from 82 in 2002.

DBS has had considerable success with its 'trigger' products designed by Lyxor. One report stated the bank raised \$500m on its first trigger product, the DBS Target 120, but that remains unconfirmed. The subsequent ten-year Trigger Express Guaranteed Funds pay 10% three months into the life of the investment, irrespective of returns, and knock out when the underlying rises by 15%. Performance is based on the 6 worst-performing stocks in a basket of 30 global blue chips.

Following the successful launch of the first trigger fund in Singapore - competitors such as UOB Asset Management have launched similar products. Lyxor has also manufactured other Trigger Capital Guaranteed Funds for sale through Standard Chartered Bank and HSBC.

This type of product would appear to have the ingredients for long term success. Current market experience suggests that investors want a high fixed coupon, uncapped positive return and a real chance at having the fund mature well before the final maturity. It's also a reasonably easy concept to get across at a time when product complexity is one of the biggest obstacles for product promoters.

Korea

Bond funds are the dominant feature of Korea's fund markets, as a result of traditionally high interest rates and the high volatility of its equity market. Over 90% of the market is made up of trust funds due to the fact that mutual funds were not introduced until 1999 and open-ended funds were not available until 2001.

From 2003, the Korean market has begun to open up, and new investment vehicles have been introduced, including structured products and ETFs. The introduction of new asset management regulation is likely to bring Korea, often described as a very difficult market to do business in, more into the mainstream. The Asset Management Business Act, which came into effect last year, sets the terms for local and international regulation. Any foreign management company intending to sell funds in Korea must submit an application to the Financial Supervisory Commission through its sales agent.

Equity linked retail products were introduced to Korean investors about four years ago. Korean retail structured products are almost all equity linked. In the early days, clients wanted principal guaranteed products but, as we have seen in other markets, once investors become more comfortable with the concept, they want the option of a higher return.

In 2002, the Korean banks launched the first Equity Linked Deposits. The following year, Securities Companies were given the green light for OTC trading and from that point on, structured products have really taken off. Since 2003, equity linked securities and ELNs issued by Korean securities companies, combined with ELS Funds are the main retail products. The most commonly available ELN/ELS products are 1 to 3 year notes.

Fixed interest notes are also popular in Korea. They are usually structured as 10 year notes with a call provision. According to Samsung Securities, sales of fixed interest notes totalled around US\$7bn from 2001 to 2003, before interest rates slumped to historic lows. In 2004, around US\$3~4bn was raised in the fixed interest structured market.

Other products have been launched, including gold index linked funds and fund of funds. Korea is seen as one of the key growth markets for structured product providers in the Asian region.

The Industrial Bank of Korea's structured products division, a joint venture with SG Asset Management, was established last December. IBK SG has launched three ELNs since January. They are a KOSPI 200 linked Auto Call-type note, a KOSPI 200 linked principal guaranteed two way knock out, and a Two Stock auto call type. IBK SG is now planning to follow the trend for pendulum or swing type products and to develop hedge fund linked products. The firm is confident sales will exceed \$500million.

Japan

In the retail space, there are only limited opportunities for selling structured notes. The retail distributors prefer to sell unit trusts by public offering. There have been instances where promoters of a note have converted it to a unit trust for the Japanese market.

The unit trust will normally purchase the principal protected note referring to either an equity or funds. In terms of equity links, the most popular product is linked to the Nikkei (some link to the Topix) and denominated in Japanese Yen.

The growing market currently is in US dollar denominated hedge fund linked products. In the next phase, commodity linked structures are likely to be seen in Japan. "Best of" products are quite widely used but there are no "Worst of".

Man Investments raised well over US\$1 billion from Asian investors last year, much of it invested in capital guaranteed structures. In particular, Mitsubishi Securities has had great success selling the Man hedge funds and protected products to retail investors in Japan.

Structured hedge fund products are starting to take off in Japan's high-end retail market, according to local commentators. Man was able to sell \$515m worth of its Global Multi-strategy Principal-protected Fund to individual investors in September. The Global Multi-strategy Principal-protected Fund is 60% invested in zero coupon bonds and the remaining 40% is leveraged up to three times to create participation in the underlying multi-style hedge fund portfolio.

Although the minimum investment equated to \$10,000, the average investment was much higher, and people typically invested the equivalent of \$100,000, according to Mitsubishi Securities.

4.2 Wrappers

The term "wrapper" refers to the form in which a product is offered to the end investor. Typical wrappers include:

- Bank Deposits
- Notes
- Funds
- Life Assurance bonds

The wrapper used by any particular provider will be driven by the nature of the company itself and the fiscal and regulatory regime in a given market. A life company will typically use the IFA market and investment linked insurance bonds will be the most likely wrapper used.

Retail banks will tend to favour the deposit wrapper. Or, depending on the structure, it may be more appropriate for investors to be sold a fund or note. This is increasingly the case in Singapore, where the local regulator has warned product promoters against making it appear that a structured product has the same risk profile as a bank deposit.

Proportion of different structures sold in Hong Kong

1. Notes	10%
2. Deposits	5%
3. Life assurance bonds	5%
4. Funds	80%

Proportion of different structures sold in Singapore:

1. Funds	30%
2. Deposits	30%
3. Insurance linked investments	20%
4. Notes	20%

Korea

Since notes are predominantly sold to institutions or the high net worth investors via private placement, it is not easy to quantify them. Outside

of this segment, deposits represent approximately 40% of total sale and funds 60%.

In terms of product types, short-dated ELNs are reportedly popular; the average term is one year. More recently, longer maturity products have also come to the market. Following the trend for knock-outs, almost all the new longer maturity products have early redemption conditions.

Japan

In Japan, over 90% of structured products distributed in the retail market use the unit trust wrapper. Responsibility for filing of prospectus and authorisation with the JFSA for funds or note registered offshore falls on the distributor. If a product is appropriately registered offshore, the authorisation process should take two or three weeks at most.

4.3 Product Evolution

Product innovation is a crucial element in structured product marketing, so as markets mature, it is natural to see new ideas being tested. Product providers report there is a gradual shift taking place, toward non principal guaranteed products, as investors gain confidence in structured products. Commodities remain a popular play for alternative asset managers and Asian investors will probably see a lot more of these in 2005.

There is also a discernible shift away from “worst of” structures. A number of people contacted for this report commented on the growing number of ‘best of’ structures that are appearing. However, product manufacturers have shied away from true ‘best of’ options, where the pay-out is linked to the best performing stock, because they are more expensive to structure, making it harder to create an attractive issue. A practical alternative is a pay-out linked to the average return of a set number of stocks in a basket. This is bound to smooth away the very best returns, but in terms of product structuring, it gets around the problem of pricing for the single best performing stock in a basket. We expect to see more of these products in Asia during 2005.

Groups able to structure products to meet this demand are also able to charge higher fees for the privilege. This may be a battle ground for the future, but at the moment, investors probably do not have sufficient knowledge to differentiate between one product guaranteeing a total pay-out over the life of the product and one paying a high fixed coupon six months or a year into the life of the fund. One charges an up-front management fee of less than one per cent, the other fully five per cent.

5. Major product promoters

Hong Kong

The following groups are considered major players in Hong Kong

HSBC Asset Management

Deutsche Bank

SocGen Asset Management
Hang Seng Asset Management
Schroders
Citigroup

Barclays Capital
CSFB
BNP Paribas
UBS

Barclays Capital has been manufacturing structured products in Asia for the past 2 years, distributed through third parties. The underlyings have been a variety equities, bond, interest rates and commodities. The bank has noticed a significant growth in funds-linked notes in the last few months.

The products are mostly principal protected close ended notes. For some counterparties, Barclays do swaps and will then package them into structured deposits or funds. Barclays has around 10 structured products in the pipeline for 2005, mostly white labelled.

Among the newer entrants, whose issuance has grown in the past 12 months, ING, Calyon, UBS, CSFB and J P Morgan are notable for introducing own-brand structured products.

J P Morgan acts as a product provider (hedge provider) to guaranteed funds, ELNs, CLNs and deposit linked products. By its own estimation, it has introduced about 15 new products in 2003 and 30 in 2004. New products in this instance are defined as radically different products from what has been traded in the past. The product types are a mix of close-ended (fixed maturity) funds and notes, of one or more tranches.

The most popular launch has been an Equity Target Redemption Note, which has been issued in around 40 tranches so far. The firm will not reveal any sales figures however.

The group's first own-brand product, named Abacus, was launched in November 2004. The 10 year equity target redemption note was credit linked to a basket of six international reference entities. If there is a default, the note is redeemed and the investor receives the recovery value of the defaulted credit.

The note pays an 18% coupon in the first year, with subsequent payments based on the three worst performers in the 25 stock basket. The product is distributed by Bank of China, Citic Ka Wah, BEA and Shanghai Commercial Bank.

Singapore

The following groups are considered major product promoters in Singapore:

DBS
OCBC Asset Management
SocGen Asset Management
Deutsche Bank
Citigroup

UOB Asset Management
Schroders
CSFB
BNP Paribas
UBS

UBS and Soc Gen/Lyxor were highlighted by one respondent as the top product promoters in Singapore.

New entrants: Macquarie Bank has set up an equity derivatives desk in Singapore to focus on the structured products markets. The move marks the first step beyond Hong Kong and Korea for the Australian bank's Asia ex-Japan derivatives business.

Korea

Already one of the fastest growing derivatives markets in Asia, Korea has boosted activity by allowing securities houses, both foreign and domestic, to offer structured products.

Until last year only 6 securities companies were allowed to handle the OTC products.

Korean Securities Companies

Samsung

LG

Shinhan

Hana

Dongwon

Daewoo

Banks have their own books, so they can also trade in OTC products. KEB, IBK, Citi (merged with KORAM) are the most active players. They work with CSFB, UBS and other foreign investment banks.

New entrants: A few more securities companies will gain licenses for OTC products and some foreign investment banks also get involved. Lehman Brothers is the first foreign securities house to be allowed to trade over-the-counter equity derivatives in Korea. The country's regulator, the Financial Supervisory Commission (FSC), gave the approval as part of a wide ranging licence that allows the US bank to trade a range of fixed-income and equity derivatives.

Schroders will be among the firms to take advantage of last year's regulatory developments in Korea, which make it easier to forge structured products. Schroders was the first to issue local capital-protected funds before a regulatory clampdown three years ago closed the market to new products.

Other major product promoters in Korea are Deutsche Bank, Goldman Sachs, HSBC, JP Morgan and Citigroup.

Japan

The Nomura Group is the dominant player in structure products in Japan, as an issuer and product promoter. Of the international players, Credit Agricole Asset Management has, by its own estimation, 25% of the structured products business in Japan.

Hedge fund players are also finding the structured funds market to be a good source of assets under management, particularly at a time when they have been struggling to grow their portfolios. The bear market for hedge funds in the middle 6 months of 2004 convinced a handful of hedge fund of funds managers to divert their attentions to the capital protected funds area. Distributing through securities companies, the likes of Man Group have been able to raise a billion dollars in a few short months.

6. Distribution

This section examines the principle distribution channels for structured products in each of the four markets.

Hong Kong

Bank distribution accounts for the major portion of structured products sales, though the IFA market remains a significant channel for private placement. Depending who you talk to, the quality of products being sold through IFA channels are considered to be questionable.

HSBC estimates that it and Hang Seng Bank control 70% of the market, with Bank of China taking another 15%. Further down the list, the local Chinese banks are also used by international managers. For example, capital protected products are available through Hong Kong branches of Asia Commercial Bank, Bank of China, Bank of Communications, Chiyu Banking Corporation, CITIC Ka Wah Bank, Liu Chong Hing Bank, Nanyang Commercial Bank and Wing Hang Bank.

The major insurance distributors in Hong Kong

Manulife

NTUC

Great Eastern

AIG

AXA

Prudential

AVIVA

Singapore

The most effective distribution of structured products in Singapore is done by the local banks through structured deposits. Local banks selling structured products are DBS, OCBC, UOB, Maybank and then Citibank, Standard Chartered and HSBC.

Korea

In Korea, only licensed securities companies are allowed to issue ELS/ELN products. Samsung, LG, Goodmorning-Shinhan, Dongwon, Daewoo and Hana are the top Securities companies. Samsung Securities, LG and Goodmorning Shinhan are considered to be the most effective distributors.

In Korea, investment trust companies are not allowed to distribute structured products directly. Neither do the insurance companies play a

role as a product provider or market maker. The major commercial banks can sell ELF/ELD products and Kookmin Bank, Shinan Bank and Hana Bank control 60% of the market between them. The following table is an indication of the equity linked deposits sold by the banks in Korea.

ELD (Bank Products)

(Cumulative data during 2004. 1~11)

	Amount	% of individuals	(unit :100million KRW)	
			net increase	
Kookmin	14,300	96.00%	-	2,483
Shinhan	9,020	92.30%	-	729
Chohung	7,600	94.70%		26
Woori	5,530	81.00%		314
Hana	9,800	87.90%	-	2,645
Citi	3,700	100.00%	-	793
KFB	2,800	79.40%		9
KEB	5,320	84.70%	-	1,053
IBK	3,294	82.60%		184

Japan

As mentioned above, the Japanese domestic banks and securities houses have embraced structured products as a way of capturing the imagination of people who would previously only consider postal savings or government bonds.

6.1 Distribution Costs

The standard commission on structured product and alternative investment products generally is 4% front end commission. Trail commission is also paid to distributors who channel substantial business. The trail fee is normally in the range of 25 to 50 bps.

The Asian investor's fondness for shorter product terms may have the effect of reducing front end commissions. Conversely, it has been observed that in certain countries in the region, double digit commissions are available on some structured products. The only person losing out in that situation is the investor.

A retail distributor would be looking to take at least 1% a year. A mainstream Chinese bank distributor like Dah Sing Bank offers its premium customers at least a 2% discount on the sales charge on funds

6.2 Product Complexity a Challenge

The products themselves are getting more complex, making it increasingly difficult for distributors to explain the products and their

key risks to retail investors. Hong Kong's regulator, the Securities and Futures Commission (SFC), expects distributors to have qualified staff able to sit down with retail investors and explain the risks of the investment. According to the SFC's Code of Conduct, banks have a duty to act in the best interests of their customers, meaning that distributors have a responsibility to assess the suitability of a certain product for their client. Indeed, most product providers have distribution agreements in place with retail banks, setting out strict requirements on how the product should be sold.

A recent 'mystery shopper' test carried out by *Structured Products* magazine in Hong Kong, tested the quality of structured products advice given by the seven banks in the Central district of Hong Kong. Taking into account quality of the advice given, based on four measures, HSBC and Citibank came out best in this test. Hang Seng Bank also scored well, and close behind were Dah Sing Bank and Standard Chartered Bank. The quality of advice given at the Central branches of Bank of China and Bank of East Asia was considered very poor.

7. A Summary of Regulatory Issues

Hong Kong

As of December 3, structured notes issuers have had to get all their advertising material authorised, a first attempt by the SFC to bring more consistency to the market. Under the SFC's Code on Unit Trusts and Mutual Funds, every item of marketing material produced for a new fund has to be approved by the regulator. Until the end of last year, no such requirement existed for structured notes. So long as product providers were licensed dealers, they were allowed to produce advertising material without the need for SFC authorisation.

The additional cost is estimated to be HK\$30,000 charged by the SFC for the approval of advertisements. According to Andrew Malcolm, a partner at law firm Linklaters in Hong Kong, the development of capital guaranteed products within a fund wrapper "results from funds being perceived as the only available wrapper for those products in the past because the prospectus regime was thought to be unavailable or just too difficult. We have now reached the point where that clearly isn't the case, and the static products are now being correctly re-wrapped as notes."

Indeed, the volume of notes issuance has soared over the past year after regulations surrounding the prospectus regime were re-interpreted during the course of 2003, making it less cumbersome to issue structured notes. The trend has already been established and it looks like the number of notes in issue will increase steadily.

That is not end of the story though, because a review of the Companies Ordinance is being carried out, which may result in changes to the prospectus rules for structured notes. Some industry commentators are suggesting that all financial packaged products could come under the law for funds, but that would be a radical move and is not a likely event at this point.

Singapore

Singapore's central bank has issued marketing guidelines to protect consumers from buying structured products believing they work like bank deposits. The guidelines come after a public consultation by the Monetary Authority of Singapore, which is concerned that investors are often confused about the risk profile and lock-up periods involved with structured products and that in some cases the sales process and marketing literature is misleading.

Under the new guidelines, a product can only be labelled a deposit if the principal is not exposed to any risk other than the credit risk of the issuer, and is repaid in full at maturity. The MAS says that risks of a structured product, including the fact that the investor may not receive 100% of the principal if the deposit is not held to maturity, must be clearly disclosed to every investor. Investment products that don't meet the deposit definition must instead comply with provisions under the Securities and Futures Act, if it is a capital markets product, or the Financial Advisers Act if it is an investment product.

Korea

The introduction of new asset management regulation is likely to bring Korea, often described as a very difficult market to do business in, more into the mainstream. The Asset Management Business Act (AMBA), which came into effect last year, sets the terms for local and international regulation. Any foreign management company intending to sell funds in Korea must submit an application to the Financial Supervisory Commission through its sales agent.

Before the AMBA, activities of Investment Trust Management Companies were restricted to the management of Investment Trust funds only, and activities of former asset management companies under the previous Securities Investment Companies Act, were restricted to the management of Securities Investment Companies (mutual funds).

Under the new regulation, the activities of the two are integrated and thus, an AMC can manage both funds and investment companies. It may also engage in investment advisory business, contingent on the

appropriate licence. Minimum capital requirements for an AMC have increased from KW7 billion to over KW10 billion.

Japan

New proposed regulations on the capitalisation of financial institutions involved in securitisation could have implications for the structured products manufacturers. The Japan Financial Service Agency is proposing to increase the minimum capitalisation levels for local financial institutions that deal with securitised products. The financial community is dismayed that the new law may deprive them of the chance to conduct securitisation business.

8. Entry Strategies

This final section briefly sets out some ideas for possible entry strategies for a new player looking to engage in the structured products markets of each country.

8.1 Key success factors for new entrants

In order for a new player to be successful it will need to identify its own strengths and weaknesses. These may be in terms of:

- **Structuring capability**
- **Exotic option pricing capability**
- **Access to a wide range of underlying markets including equity, bond, etc**
- **Efficient delivery platform and secondary market support infrastructure**
- **Competitive vanilla option pricing**
- **Credit rating**
- **Access to a range of efficient funding vehicles**
- **Existing distribution arrangements or potential partners**

This last point is perhaps the most crucial. Effective distribution comes from a combination of a competitive product and a simple sales message delivered through an efficient channel. There are many different channels to choose from. The one thing they have in common is how effective they can be if you provide them with the right level of support.

Investors in Asia tend to be sold to on the basis of headline numbers, so it is perhaps not surprising to find that structured products are sometimes mis-sold and their particular properties misunderstood. This is a recipe for trouble, as product providers in Europe discovered when a popular type of structured product failed to deliver what it promised. There was a huge backlash against the product promoters and the distributors. The way structured products are sold in Asia, it is arguably only a matter of time before a similar situation occurs somewhere in the region. This poses potential business risk for institutions concerned.

Proper presentation of the pros and cons of each product, in a way that can be understood by those selling the products and those buying them, will not only make the sales process more effective, it will guard against disappointment in the long term.

Richard Newell
March 2005

Appendix>
Notes from interviews carried out in Hong Kong, April 2005

Deutsche: “The figures being quoted by some for Korea are suggesting the market is bigger than Hong Kong. \$25bn is one oft-quoted figure. But if there is \$5-7bn raised in Hong Kong each year, how can there be \$25bn in Korea? The figures are questionable. There is possibly an element of double counting between equity linked securities and equity linked funds. You have to go through a securities house to issue one and an asset manager to issue the other.”

Deutscheon Hong Kong: Recent structured note launches (Q1/05) have raised anything from \$2m to \$25m. “That’s not enough when you net off regulatory and advisory costs. Fixed costs mean that it’s only really effective if you can raise \$100m. With the competition so fierce now, I would expect to see some fall-out, especially amongst the smaller players.”

Mentions a lot of ‘Johnny-come-lately’ promoters, who will be shaken out.

“There’s a tremendous amount of inflation going on with these sales figures. The challenge is to drill down and see what the figures really represent.”

We may see an increase in non-protected and non-guaranteed products.

An example would be Soc Gen's recent Alpha Fund, a non-protected fund launched in January, which apparently didn't do very well (raising \$13m apparently).

The only comparable survey of global structured products Ken has seen was carried out by the US group A. T. Kerney, who last published a report 2-3 years ago. They attempted to quantify the revenue potential of global structured products. Their methodology included spending weeks with each of 10 or more banks, over a period of 6-12 months. They were provided with the data on an assurance of anonymity.

In the past three years, Sinopia has sold \$6bn of structured products, including HSBC-branded products. That works out at about \$2bn per year, fairly evenly split. The business they have done, for third parties, is at least double that. So that is another \$12bn in the last three years. 95% of this is structured products, perhaps 5% CPPI. CPPI has not been well received in the market. "For distributors, CPPI means more explanation. With the guaranteed structures you have seen, they have been based on the idea of deposit substitution, rather than high growth. Investors looking for a higher level of interest than bank deposits. So you don't want to have to put across too complicated a message. CPPI presents a selling hurdle because there is more to explain.

Inevitably, CPPI will become more widely accepted, as the number of 'active' products grows, but I'm doubtful whether it will grow a lot. You are more likely to see a shift to 100% or less than 100% guarantees before we see significant growth in CPPI products.

Unfamiliarity with underlyings is another hurdle. "This has implications for hedge fund linked products and will possibly prevent them from taking off in the retail market."

The growth of structured products in Asia was based on a combination of factors: low interest rates and equity market stagnation. It represented 90% of gross sales of fund products in 2002 and 2003. It reached saturation point in Hong Kong, late 2004. "We think it will still be a major product type though."

Now edging down towards 50/50 split between global equity long only funds and alternatives.

80% of structured products now take the form of equity linked products "we've seen a couple of multi-asset products (equity, bond, commodity). Some players have come in with credit-linked notes (DB, Lehman) which have been fairly successful.

Q - Define "Successful"

"Anything around \$100m in a single tranche would be considered successful. But the novelty factor wears off quickly and it is now such a highly competitive market in terms of products, terms, new players, so the tranches become smaller with each issue.

Each new product is different which is another reason why the players are so secretive. “In Europe, we tend to see products linked to the FTSE in the UK for example. You can do 10 tranches of essentially the same structure, but here it is quite different. Each new product has a different underlying. The complexity of underlyings has moved from simple call structures three years ago to now, where you have correlation and target redemption products in the market.”

In January 2005, 10 to 13 new products came to the market and raised very little money, by most people’s estimates. Some of the big names have even struggled

On a private placement basis, there is some success being achieved. The Income Plus products from Citibank have raised \$4bn in 13 tranches. They are CPPI products, with investment return linked to a basket of stocks: “Private placement notes are certainly working. I get the sense this is the major market for the banks. You don’t have to get involved in all the marketing materials and regulatory hurdles.”

“To be active in each Asian Market, you need a presence in each one. The regulations and market characteristics are so different.”

“You have as many views on what is the most popular product and the best underlying as you have banks. There is a genuine concern that many of the products really don’t perform. I wonder what effect this will have on the overall market for structured products. Some of these products don’t perform, let’s be clear about that. You could argue that it’s principal protected, so what’s the problem, but some of the products are right out there, and they will not provide the upside.”

“Asset managers are under a lot of strain because they are being squeezed by their distributors. They also have a big marketing spend for each launch. A typical example is the launch by Schroders which took every single advertising hoarding along a stretch of the MTR subway system. On the one hand this will be attractive to distributors, but there has to be the return on investment.”

Fund of hedge funds are harder to get across to the retail market. The difficulty when you are selling a fund-based product is actually selling the underlying managers. It’s much easier to sell a link to an index.

Nomura International suggested the total sales figures I put forward were understated, especially for Japan. They concluded that the figure for Hong Kong was actually fairly accurate, but that Japan should be much larger – easily \$30bn. 2003 figures would be equally as big.

In Japan, Nomura is doing \$50m tranches on a daily basis.

“In Japan you have a captive market. Anything offering 5% or 6% they will buy, and in a variety of currencies, dollar, sterling, aussie. A mix of equity linked notes, credit linked and corporate bond.”

The basic product is always the same, a range on something. The products they see most are callable, fixed rate, range accrual, target redemption, snowballs, some guaranteed products (denominated in HK\$ but is LIBOR or CMS).

Interest rate products are 25% of the market, equity linked 50%. Equity linked notes and deposits – an example would be a 6 month deposit linked to Hong Kong bank stock, some baskets of blue chips, or index linked (HSI, Nikkei, Dow).

The remainder is FX linked, which are sold a lot in the retail market. Almost every commercial bank is offering these.

CDO, LBO, basket of credits (first to default) – “these are not that popular in HK at the moment. People don’t really understand credit risk. What they care about is the coupon and something they know, even if it is a company like Hutchison.”

In Singapore the market for CLNs is bigger. They also have range accrual on the local interest rate index, target redemption and FX linked.

In Korea, 70-80% of the market is equity linked, the rest is credit and FX linked.

Japan is mostly US\$ denominated FX linked structures. Some mutual funds may offer elements of hedge funds, but it is mostly done within structured notes.

The European influence in Hong Kong and Singapore is very strong. The major players are Calyon, BNP Paribas, Deutsche, and JPM has a high number of French people on their team.

A lot of structured products are moved through private banking channel. It is much more difficult to move quickly in the retail area because of the long lead time required. “The reason we are successful is we can bring something to the market quickly. And if we feel the conditions have changed, we can quickly unwind the position for the benefit of our clients. Principal protection is very popular – we can use CPPI much easier than retail distributors. We can launch a product, raise \$20m or \$30m and move on.”