A step-by-step guide to offering bespoke investment products to retail clients

The financial sector is dominated by standardized products. Banks offer a nearly identical range of 'off the shelf' products which appeal to customers because they're easy to compare and to the back office because they provide economies of scale.
However, the trend in financial services lately is towards greater personalization. Customers have become accustomed to the experience delivered by Amazon and Netflix, and they expect the same from their bank.
Personalization provides banks with several advantages:

Greater engagement: by meeting the needs of an individual customer rather than the masses, personalization helps to attract new clients and retain existing ones.

Brand positioning: personalization positions a bank as digital and innovative and provides a source of differentiation at a time when challengers are leveraging technology to erode the market share of the incumbents.

Higher profits: personalized investments present banks with opportunities to upsell and cross-sell to existing customers.

Stronger loyalty: customers are more likely to stick with banks that demonstrate they understand their needs.

Embracing personalization offers tangible benefits. According to the Boston Consulting Group, it boosts **revenue growth by $300 million** for a bank with $100 billion in assets. Further research by Accenture into the UK banking ecosystem shows challengers, which have adopted the best practices of the latest generation of apps, have an average net promoter score of 62 compared with 19 for the incumbents.
Customers have different goals and risk profiles, so the most effective way to deliver an optimal experience is by offering them personalized investment products. In this whitepaper, we explain the process of creating and distributing bespoke investments using structured securities, Futora's field of expertise.

1 Establishing internal goals

The first step is to establish the bank's goals in providing personalized investments.
In terms of marketing, the bank needs to decide what **types of customers** it would like to attract. Structured securities offer exposure to a variety of asset classes reflecting every risk profile. For instance, a regular retail customer might want exposure to an equity such as Google or Amazon, but a more sophisticated customer might require exposure to FX, interest rates or cryptocurrencies.
A bank also needs to consider its **sources of funding** and funding costs. Banks typically raise funds from three sources: attracting deposits, the money markets or by issuing bonds. If attracting deposits and growing revenues derived from net interest margin is a priority, adding bespoke investments to the product range will help achieve this goal.

2 Understanding the customer

To understand how personalized investments meet the customer's needs, the bank must answer four questions:

What is the customer's investment goal?
Does the customer want to generate income or participate in the upside of an investment?

What is the customer's investment horizon?
Is the customer prepared to invest their funds over a longer-term horizon of five to ten years, or do they want a quicker return?

What is the customer's risk profile?
Some structured securities are fully capital protected, while others put the entire capital at risk. Sophisticated investors are typically comfortable choosing a product that reflects their risk profile, but retail investors should seek the advice of a financial advisor or relationship manager.

What category does the customer fall into according to MiFID?
The Markets in Financial Instruments Directive, which we review in the regulatory section of this whitepaper, obliges banks to classify customers as retail clients, professional clients or eligible counterparties based on their expertise, experience and knowledge. This process aims to ensure the customer receives the right level of protection and transparency.

3 Types of bespoke investment products

Banks can issue bespoke investments in a security wrapper or a deposit wrapper.

Security wrapper

For a security wrapper, the bank needs a capital markets division to underwrite the security and publish a prospectus detailing the opportunity so customers can make an informed decision. In this case, the investment is securitized, which means the bank can distribute it directly to its own customers or sell it to other financial institutions.

Issuing a security wrapper is expensive. The necessary infrastructure is typically limited to what's referred to as the sell-side- bigger banks with an investment arm, such as Barclays, or investment banks like Credit Suisse and Deutsche Bank.

But that isn't to say smaller players can't participate in this $7 trillion market. They can distribute securitized products created by the sell-side or issue bespoke investments of their own in a deposit wrapper.

Deposit wrapper

Every bank accepts deposits- it's the fundamental business model on which the industry was built. They generate a profit from the difference between the interest income they receive from borrowers and the funding rate they pay to depositors, known as the net interest margin.

To create a structured investment product in a deposit wrapper, instead of paying the customer the funding rate, the bank uses it to buy a derivative such as an option, a warrant or a swap. The derivative provides exposure to an underlying asset like an equity, commodity or currency. The customer earns a return from the performance of the asset. For instance, in a participation product, a common type of structured investment, if the participation rate is 75%, and the asset rises by 10%, the return is 7.5%.

A deposit wrapper offers peace of mind as a 'deposit' implies full capital protection. The customer isn't privy to the financial engineering required to create a bespoke investment- their money remains with their primary bank and may be covered by guarantee schemes which protect deposits of up to €100,000 held in EU banks and £85,000 in the UK.

Full vs partial protection

Depending on local regulations, banks can offer fully or partially capital protected products. Fully protected products allow the customer to participate in the upside of the underlying asset without risk to their initial capital, while partially protected products put a certain percentage of the initial capital at risk.

Partially protected deposits provide a higher potential upside because the bank can increase the amount it spends on the derivative. If a customer is willing to accept protection of 95%, that means it can add 5% to the funding rate. Partially protected deposits might seem counterintuitive, but they're sold in many territories across Europe.

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4 Creating and managing bespoke investment products

Once the funding rate has been confirmed, the bank must shop around with the sell-side to secure the best deal for the customer because prices can vary broadly. The nature of personalized investments means this is a time-consuming process- the bank has to make a fresh approach for each customer unless they want exposure to the same underlying asset. Leveraging technology to automate this process is essential. To complete the transaction, the counterparties must have two agreements in place:

an **International Swaps and Derivatives Association (ISDA)** master agreement and a **Credit Support Annex (CSA)**. The ISDA master agreement is a standard contract which governs over-the-counter (OTC) derivative transactions, outlining the terms and the schedule. The CSA outlines the terms for the collateral provided by the parties to make sure they can cover losses.

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If a bank wants to distribute securitized products, it needs to sign distribution agreements with the sell-side or work with a vendor that provides distribution as a service. The bank must also have a relationship with a clearing house such as Euroclear or Clearstream. A clearing house acts as an intermediary between the two parties involved in a security transaction. It settles a transaction through a process known as delivery versus payment (DVP), ensuring the sell-side delivers the security and the bank pays for it.

Next, the bank needs to book the security in its various internal systems. That means creating records in the accounting, depository and risk management systems for every bespoke investment issued. **This is another resource-heavy activity which can and should be automated.**

Finally, the bank must manage the product lifecycle to ensure the customer receives an optimal experience. That involves:

Calculating the value of the structured product on an ongoing basis so the bank can provide timely and accurate updates.

Issuing **payments** if the underlying asset generates income.

Settling the investment if the value of the underlying asset has risen when the derivative expires.

5 Regulatory regime

Two key financial regulations apply to issuers of bespoke investment products.

Packaged Retail Investment and Insurance-Based Products (PRIIPs)

PRIIPs is an EU regulation which came into force at the start of 2018 and is designed to improve the transparency around products sold to retail investors. It requires the bank to publish key information documents, known as KIDs, for each product it distributes.

KIDs must contain:

- Information about the manufacturer
- The main factors influencing the product's potential return
- The product's risk profile, on a scale of one to seven
- An indication of how much an investor could lose
- An explanation of the costs of investing in the product
- Predicted returns under various scenarios

Markets in Financial Instruments Directive (MiFID)

MifID is another EU regulation which aims to improve transparency and harmonize regulations across the region's financial markets. Its original scope was quite broad, setting out:

- Codes of conduct for investment firms
- Authorization requirements for markets
- Regulatory reporting requirements
- Trade transparency rules and best execution
- Rules governing what kind of securities can be traded
- Risk profiling of customers

MiFID came into effect in 2007, but following the 2008 financial crisis the EU replaced it with MiFID II to make the markets safer, more efficient and to promote even greater transparency. MiFID II also brought a wider range of assets into its remit.

Target market

One of the main requirements of MiFID involves identifying the right target market for an investment product. The regulation states that the bank has to assess the suitability of each customer according to the five categories listed below. MiFID classifies structured products as complex investments, so these assessments should be extremely thorough.

The type of client: The bank must classify customers as retail clients, professional clients or eligible counterparties

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Knowledge and experience: The bank must assess the customer's understanding of the product, its features and any thematically related areas. This category is particularly important for structured products as their complexity effectively narrows the target market.

Ability to bear losses: The bank must specify the percentage of losses a customer is able or willing to experience, from minor to total loss, or alternatively the maximum amount of capital a customer should invest.

Risk tolerance: The bank must assign each customer a risk profile, for example speculative, balanced or conservative in relation to the risks of structured products. It can use the risk indicator included in PRIIPs to support this classification.

Client objectives and needs: Establishing the customer's investment goals isn't just one of the first steps the bank should take when launching a bespoke product, it's also a requirement of MiFID.

Compliance function

In June 2020, the European Securities and Markets Authority (ESMA) published final guidelines on the requirements of a provider's compliance department as outlined in MiFID II. The ESMA updated the original guidelines issued in 2012 to offer greater clarity and to standardize the implementation and supervision of the requirements.

The guidelines added responsibilities for product governance, complaints management and remuneration policy. According to the product governance requirements, compliance departments must have more input into the manufacture and distribution of new products, ensuring they're distributed to the appropriate target market based on their complexity, another important consideration for providers of bespoke investments.

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Introducing

FUTORA

Creating and distributing personalized investments and ensuring compliance with financial regulations requires significant resources in terms of a bank's workforce and tech solutions. Ideally, the tech solution implemented at each stage will be integrated to automate the entire process.
That's where Futora comes in.

Automate bespoke investment products

Futora has developed a solution which automates the issuing of bespoke investment products, from classifying customers to sourcing securities, clearing and booking trades and settling transactions.

Reduce costs and increase profits

Our solution removes the prohibitive costs which exclude smaller banks from offering personalized investments to retail clients, and it boosts profits by allowing banks to raise additional funds, broaden and diversify their investment offerings and tap into new markets segments.

Regulatory reports

Futora also has a deep understanding of the regulatory regime governing structured products thanks to the experience of our team of senior executives and seasoned professionals who previously worked at Modelity Technologies, a leading provider of regulatory solutions for financial institutions.

To learn more about how Futora can help your bank issue bespoke investment products

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