

European Retail Structured Products: Market Recovers Amid Lingering Counterparty Concerns

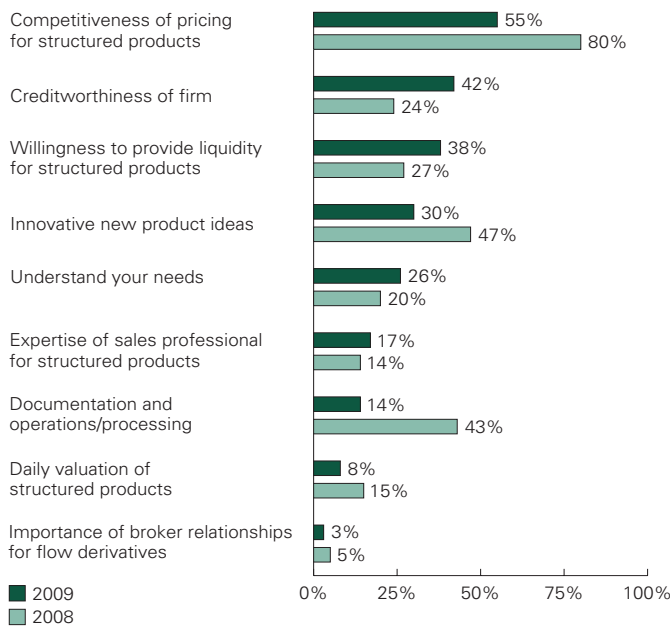
February 2010

When last year's life-or-death struggles of major financial institutions forced European retail structured product investors to face the risk of losing principal they thought was "protected," many observers wondered if the selling of these products to retail buyers would survive as a viable business. Recent research from Greenwich Associates shows that the business did indeed survive the volatility of the past 12 months, and the market appears on track for resumed growth. But issues of counterparty strength and credit risk remain serious considerations.

The results of Greenwich Associates 2009 European Retail Structured Products Study suggest that the volume of product sold by third-party distributors to retail and high net worth clients topped 2008 levels. What remains to be seen, however, is to what extent concerns about credit risk and dealer counterparty risk that emerged in the 2008 crisis will limit future market growth.

"The counterparty credit risk inherent in these products was probably not understood by many retail investors prior to the collapse of Lehman Brothers and the struggles of other major banks last year," says Greenwich Associates consultant Andrew Awad.

Key Selection Criteria

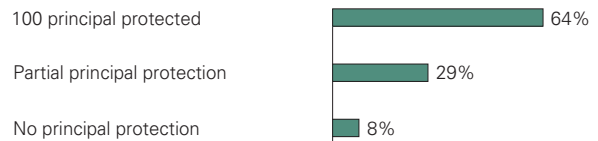


Note: Multiple responses accepted. Based on 99 respondents in 2009 and 102 respondents in 2008.

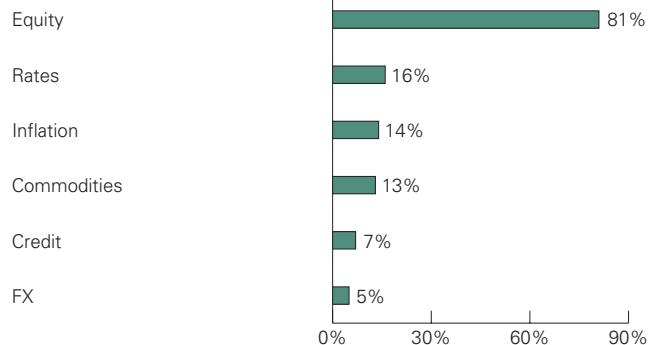
Source: 2009 Retail Structured Products Third-Party Distribution Study – Europe

Expected Future Product Demand

Capital Guarantee (101)



Underlying (104)



Note: Numbers in parentheses represent number of respondents.

Source: 2009 Retail Structured Products Third-Party Distribution Study – Europe

In the wake of the crisis, distributors of these products now view creditworthiness as a minimum requirement for consideration. Every year, Greenwich Associates asks private banks, regional dealers, insurance companies and other distributors of retail structured products to name the criteria they use in selecting sell-side firms for structured products. Traditionally, price has driven the selection process, with upwards of 80% of distributors citing it as an important consideration. From 2008 to 2009, however, the share of distributors citing price as a critical selection factor dropped to 55%. Moving in the opposite direction were "creditworthiness," which increased to 42% from just 24%, and "willingness to provide liquidity," which jumped to 38% from 27%.

Nearly 65% of third-party distributors say they are using ratings from credit ratings agencies to monitor the creditworthiness of counterparties, and a similar proportion say they are using credit default swap spreads for the same purpose. More than half of the 135 private banks, regional dealers, insurance companies and other distributors surveyed use proprietary credit analysis to measure counterparty creditworthiness.

Issues of credit and counterparty risk loom especially large in this market due to the high proportion of retail investors that use structured products to achieve investment returns, while guaranteeing their investment principal. By a wide margin, distributors rank principal protection as the feature most attractive to their end clients, followed by enhanced income and access to otherwise difficult to obtain underlyings. For 2010, two in three third-party distributors in Europe predict the greatest retail demand to be for 100% principal protected products and another 29% expect increasing client demand for products with partial protection. Only 8% percent expect growth will come in products that offer no principal protection at all.

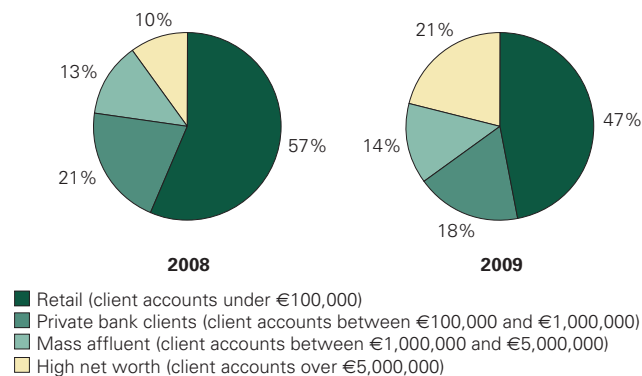
Assuming counterparty credit issues can be mitigated, more than half of third-party distributors expect usage of structured products to increase. “More than 20% of distributors say they expect usage of retail structured products to increase significantly if these issues are addressed,” says Andrew Awad.

Meaningful Market Shifts

The volatility of the past 18 months has caused some significant shifts in the composition of the retail structured product market. First and foremost, the share of these products actually sold by third-party distributors to the pure “retail investors” declined significantly, dropping to just 47% in 2009 from 57% in 2008. Much of that lost share went to clients classified as “high net worth,” who accounted for 21% of total volume in 2009, up from only 10% in 2008. In the other client categories, “mass affluent” was stable as a share of total volume, while private bank clients were stable to slightly lower.

“These results demonstrate not only the extent to which retail investors pulled back from this market, but also that

Structured Products Distribution by Client Type



Note: Based on 83 respondents in 2008 and 87 respondents in 2009.
Source: 2009 Retail Structured Products Third-Party Distribution Study – Europe

more sophisticated investors seem to have retained much of their appetite for retail structured products,” says Andrew Awad.

In another notable shift, products with fixed income underlyings grew to make up 27% of the overall market in 2009 from 22% in 2008, while equity underlyings declined to 57% from 69%. Also on the rise were commodities underlyings, which increased to 6% of the market from 2%. “Our data suggest that this shift was a temporary move driven by the turbulent market cycle,” says Andrew Awad. “When we ask third-party distributors to predict where future market growth will come from, 81% say equity underlyings, while approximately 15% would say rates, inflation or commodity underlyings.”

Cautious Optimism Among Institutional Buyers

In 2009, Greenwich Associates for the first time published separate reports on retail structured products and structured products purchased by institutions categorized as “buy-and-hold” institutions, as opposed to “on-sellers.”

Within this year’s study sample of 113 European “buy-and-hold” institutional investors, the research results reveal the following patterns in product usage:

- A stable 88% did trades of single-stock/basket-based products in both 2008 and 2009;
- The share of institutions doing trades of index-based products increased slightly to 82% in 2009;
- The share of institutions doing trades of structured volatility/correlation products trades decreased slightly to 44%.

Meanwhile, reported notional trading volumes in this market fell by half, due in large part to significant year-to-year declines in asset values within institutional portfolios.

As in the retail market, the financial struggles of financial service firms and client perceptions of broker-dealer counterparty risk are having a strong impact on equity derivatives trading among European institutions. Currently, 42% of European institutions cite the creditworthiness of potential counterparties as an important factor considered when selecting a broker for a structured equity/securitized products trade, up from 39% in 2008. “Starting last year, creditworthiness became a necessary condition required by most institutions to even consider working with an individual broker,” says Greenwich Associates consultant John Colon. “All other considerations became secondary.”

Looking ahead to 2010, 53% of European institutions expect to increase their use of structured equity/securitized products, and one third expects their use to remain stable from 2009 levels. “Although counterparty risk and creditworthiness remain real concerns, European institutions are cautiously optimistic about the prospects of this business for the coming year,” says John Colon.

Retail Structured Products — Europe

Share and Quality Leaders



European Retail Structured Products Market Penetration	Market Penetration
BNP Paribas	55%
Société Générale	44%
J.P. Morgan/Bear Stearns	44%
Barclays Capital	38%
Deutsche Bank	37%

Note: Based on 135 respondents. Top 5 leading dealers cited including ties.
Source: 2009 Retail Structured Products Third-Party Distribution Study – Europe

European Retail Structured Products Quality
Barclays Capital
BNP Paribas
Société Générale

Note: Based on 135 respondents. Leading dealer cited including ties, listed in alphabetical order.

Greenwich Leaders: Retail Structured Products

The competition to provide third-party distributors with structured products for their retail clients has been dramatically altered by the events of the past year. After months of crisis, distributors and their clients have elevated counterparty creditworthiness to an essential requirement: Broker-dealers seen as carrying significant levels of counterparty risk need not apply.

For brokers that meet the minimum condition of creditworthiness, competition in this market remains fierce. To succeed in this business, a “manufacturer” must do more than provide high quality product at a competitive price. As Andrew Awad explains, “Third-party distributors are looking for firms that excel across the entire structured product lifecycle, from all aspects of origination — including product design, innovation and pricing — to sales coverage, marketing support, execution and post-trade servicing, including product valuations and monthly reporting and secondary market support —

providing dealable quotes and providing consistent liquidity.”

The Greenwich Leaders in Retail Structured Products have established deep penetration into the third-party distribution marketplace by building and maintaining strong capabilities across this spectrum of services. Even among this group of market leaders, however, three firms stand out. Barclays Capital, BNP Paribas and Société Générale are the 2009 Greenwich Quality Leaders in retail structured products. Greenwich Quality Leaders are firms that have distinguished themselves from the field by receiving client quality ratings that top those of their competitors by a statistically significant margin.

Consultant Andrew Awad advises on the retail structured products and fixed-income markets globally. Consultant John Colon advises on the equity markets in the U.S. and Europe.

Retail Structured Products Life Cycle



Source: Greenwich Associates

Methodology

Greenwich Associates conducted telephone interviews in Europe with 135 private banks, savings banks, insurance companies, fund managers, and other distributors during the third quarter of 2009. The universe of targeted companies was compiled through primary research conducted by Greenwich Associates and input from five leading manufacturers of structured products. Interviews were conducted in the following countries: Austria, Belgium, Finland, France, Germany, Iceland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, and Switzerland.

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