THE ANCIENT ORIGINS OF STRUCTURED PRODUCTS IN FINANCE

Presentation by: IDAD

FEIFA Masterclass
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IDAD – YOUR KEY CONTACTS

CLIVE MOORE – Managing Director of IDAD

Although Clive is best known for his work in the Structured Product sector (his first structured product launch was with Citibank in 1992) he also has considerable experience across other sectors of the investment management industry and is a director of 8AM Global, a company specialising in Model Portfolio Services. He acts as co-manager of 3 investment funds and is a Subject Specialist on Investment Management for CISI.

GEORGE BURNETT – Strategic Partnership Manager

George brings extensive experience in both Financial Services and Sales. A former key member of the IDAD Operations Team, George now serves as Strategic Partnership Manager, providing comprehensive support to FEIFA members and professional advisers across broader regions. In this role, George is responsible for cultivating and sustaining long-term relationships with our global partner firms.

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2. Risk Management in Ancient Civilisations
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PART 1

THE ANCIENT ORIGINS OF STRUCTURED PRODUCTS IN FINANCE

While Structured Products as we know them today are a modern financial innovation, the underlying principles of combining different financial instruments to manage risk and return have ancient roots.

Understanding the ancient origins of these concepts can provide valuable insights into the development of modern financial markets.

1. Ancient Trade and Early Financial Instruments

TRADE IN ANCIENT CIVILISATIONS:

- **Mesopotamia:** 3000 BCE
- Earliest examples of organised trade.
- Advanced system of weights and measures facilitated the exchange of goods.

- **Egypt:**
- Trade networks in the Nile Valley
- Not just goods but also contracts for future delivery, an early form of forward contracts.

EARLY FORMS OF CREDIT: SUMERIAN CLAY TABLETS: 2000 BCE

- Sumerians used clay tablets to document loans - interest rates/repayments terms.
- Ancient Banking Practices: Temples in Mesopotamia and Egypt functioned as early banks - loans to agricultural trade activities, often secured by collateral.

COMMODITIES AS CURRENCY:

- Grain, metals and livestock - served as a form of currency.
- Value fluctuates, leading to early risk management practices.
- Storage contracts to hedge against future scarcity or price changes.

2. Risk Management in Ancient Civilisations

HEDGING RISK IN AGRICULTURE: BABYLONIAN CODE OF HAMMURABI:
CIRCA 1754 BCE

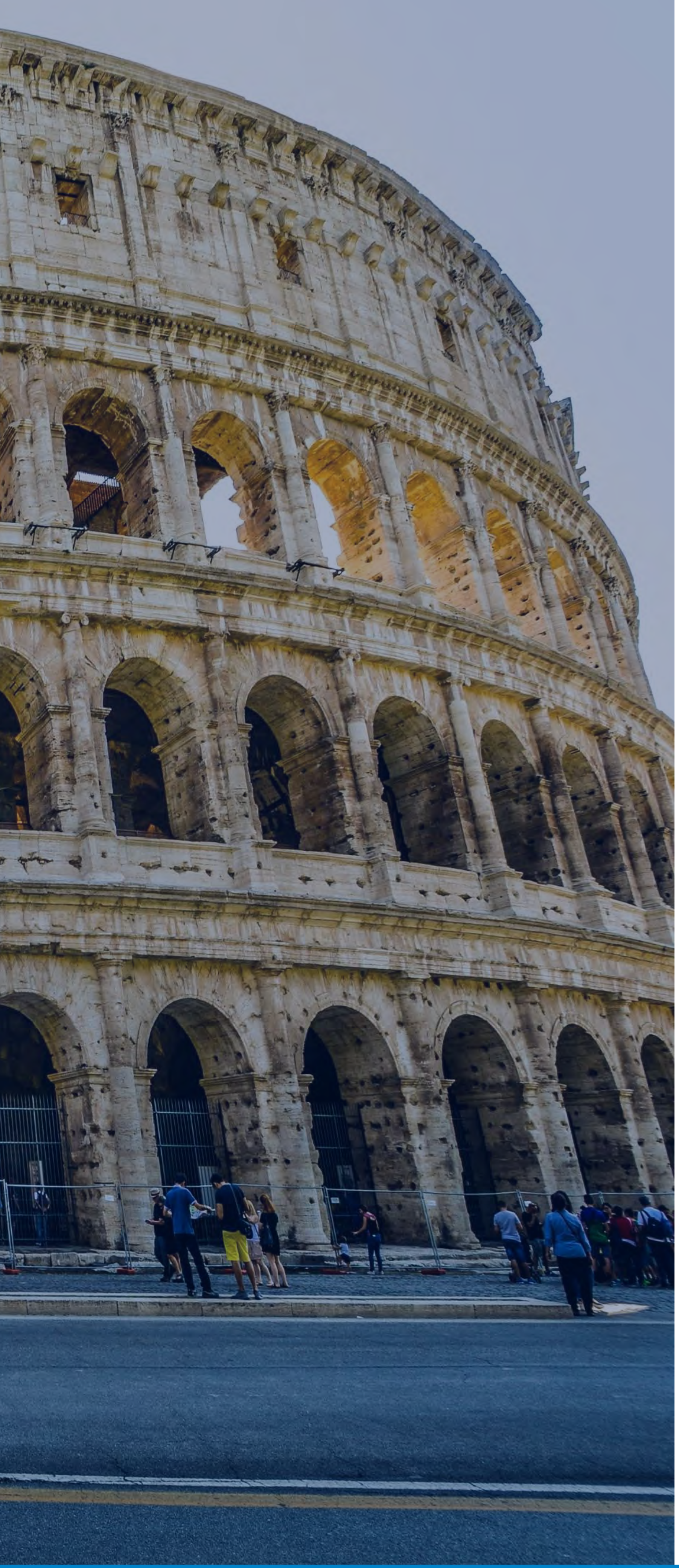
- Legal framework for contracts - considered early forms of insurance or risk transfer.
- E.g., losses due to natural events were shared between parties.

- **Ancient Greek and Roman Agriculture:**
- Farmers used crop-sharing agreements to mitigate the risks - poor harvests.
- Akin to modern-day Options or Insurance Contracts.

MARITIME TRADE AND EARLY INSURANCE:

- **Phoenicians and Greeks:**
- Roman legal system introduced more complex financial instruments.

- **Roman Republic**:
- Contracts know as “bottomry” were used - a shipowner borrowed money to fund a voyage and would repay the loan only if the voyage was successful.
- Transferred the risk of the voyage to the lender.



3. Roman Contracts and Financial Innovation

ROMAN LEGAL FRAMEWORK:

- Contracts (contractus) became widespread, led to formalisation of financial agreements.

ROMAN FINANCIAL INSTRUMENTS:

- **Futures Contracts**: Romans used contracts similar to modern futures.
- Buyer and seller would agree on a price for goods to be delivered at a future date.

- **Financial Innovations:**
- Romans engaged in financial activities resembling modern structured finance - annuities, pensions and debt securitization.

SOCIETATES:

- Partnerships in ancient Rome - for the pooling of resources.
- Sharing both the risks and rewards, much like today's special purpose vehicles (SPVs) used in structured products.

4. Medieval Developments and the Birth of Early Derivatives

MEDIEVAL TRADE FAIRS AND BILLS OF EXCHANGE: ITALIAN CITY-STATES:

- Italian merchants developed bills of exchange.
- Transfer of credit across different regions, reducing the need to carry large sums of money.
- Precursors to modern promissory notes and derivatives.

FORWARD CONTRACTS IN MEDIEVAL EUROPE:

- Merchants engaged in forward contracts, agreeing to buy or sell goods at a future date for a predetermined price.
- Managing risks associated with price fluctuations.

EARLY OPTIONS:

- **Venetian Traders:** Venice
- Major trading hub - development of early option-like contracts
- Traders could pay a premium for the right to buy or sell goods at a future date without the obligation to do so.

5. Transition to the Renaissance and Early Modern Finance

RENAISSANCE BANKING:

- The Medici Family – Florence:
- Pioneered modern banking techniques, including the use of letters of credit and complex financial transactions that allowed for the transfer of funds across Europe.

RISE OF CAPITAL MARKETS: EARLY 17TH CENTURY

- Establishment of stock exchanges in cities like Amsterdam - aid the groundwork for the development of structured products.
- Investors began trading shares and bonds, with sophisticated contracts emerging to mange risks.

EARLY JOINT-STOCK COMPANIES:

- Companies like the Dutch East Indian Company issued shares that could be traded, and investors used options and futures to hedge risks associated with these investments.
- Set the stage for modern structured finance.

PART 1

CONCLUSION – THE LEGACY OF ANCIENT FINANCIAL PRACTICES

Summary:
From the ancient Sumerians and Egyptians to the Romans and medieval Europeans, early financial practices laid the foundation for the development of modern structured products.

Legacy and Influence:
The principles of risk management, diversification, and contract innovation seen in ancient financial practices continue to influence modern structured products.

Final Thought:
The history of structured products is not just a story of modern innovation.
It’s a continuation of ancient practices that have evolved over millennia to meet the ever-changing needs of investors.

PART 2

EARLY BEGINNINGS - MODERN EVOLUTION AND IMPACT OF STRUCTURED PRODUCTS IN FINANCIAL MARKETS

OVERVIEW

PART 2
Early Beginnings and Evolution (1980s – 1990s)
Growth and Popularity in the 2000s
Impact of the Global Financial Crisis
Modern Developments and Current Trends
The Future of Structured Products

Summary: Definition and Basic Concept of Structured Products

1. Early Beginnings and Evolution of Modern-Day Structured Products

1980s: THE BIRTH OF THE MODERN STRUCTURED PRODUCT:

- Structured products originated in the 1980s, primarily in Europe.
- Early forms were simple interest rate derivatives and bond-like instruments.

- **Key Drivers:**
  - **Innovation in Financial Engineering:** Growth of derivatives markets allowed for greater flexibility in product design.
  - **Regulatory Developments:** The liberalisation of financial markets aided the creation and distribution of these products.

1990s: EXPANSION AND DIVERSIFICATION:

- The 1990s - expansion of structured products into equity-linked and credit-linked instruments.
- Development of the first equity-linked note (ELN) - a combination of bond-like safety with equity market participation.

- **Market Participants:**
  - Early adopters included high-net-worth individuals and institutional investors seeking tailored solutions.

2. Growth and Popularity in the 2000s

2000s: THE BOOM PERIOD:

- The early 2000s marked a period of rapid growth as structured products became mainstream.

- **Drivers of Growth:**
  - Lower-Interest Rate Environment: Investors sought higher returns.
  - Increased Investor Sophistication.
  - Product Innovation.

GLOBAL REACH:

- Structured products began to spread beyond Europe - to Asia and North America.
- Expansion into **retail markets -** accessible alternatives to direct market equities.

2002: IDAD was formed by Clive Moore.

3. Impact of the Global Financial Crisis

2007-2008 FINANCIAL CRISIS: A TURNING POINT:

- The financial crisis exposed significant risks - particularly those linked to mortgage-backed securities.
  - **Structured Products Under Scrutiny:**
    - CDOs (Collateralised Debt Obligations), were at the heart of the crisis due to their complexity and lack of transparency. As well as the effective corruption that led to them being ‘over-rated’ by rating agencies.
    - Investors faced significant losses, leading to a re-evaluation of risk management practices.

POST-CRISIS REGULATORY CHANGES:

- Introduction of stricter regulations
- Improve transparency and protect investors (e.g., Dodd-Frank Act in the US).

- **Market Impact**: Temporary decline in the issuance of structured products as market confidence waned.

LESSONS LEARNED:

- Importance of Transparency. Enhanced disclosure and understanding of **underlying risk** become essential.
- Shift in Product Design: Movement towards simpler, more transparent products.

4. Modern Developments and Current Trends

RECOVERY AND INNOVATION:

- The market for structured products rebounded in the 2010s - renewed focus on transparency and investor protection.

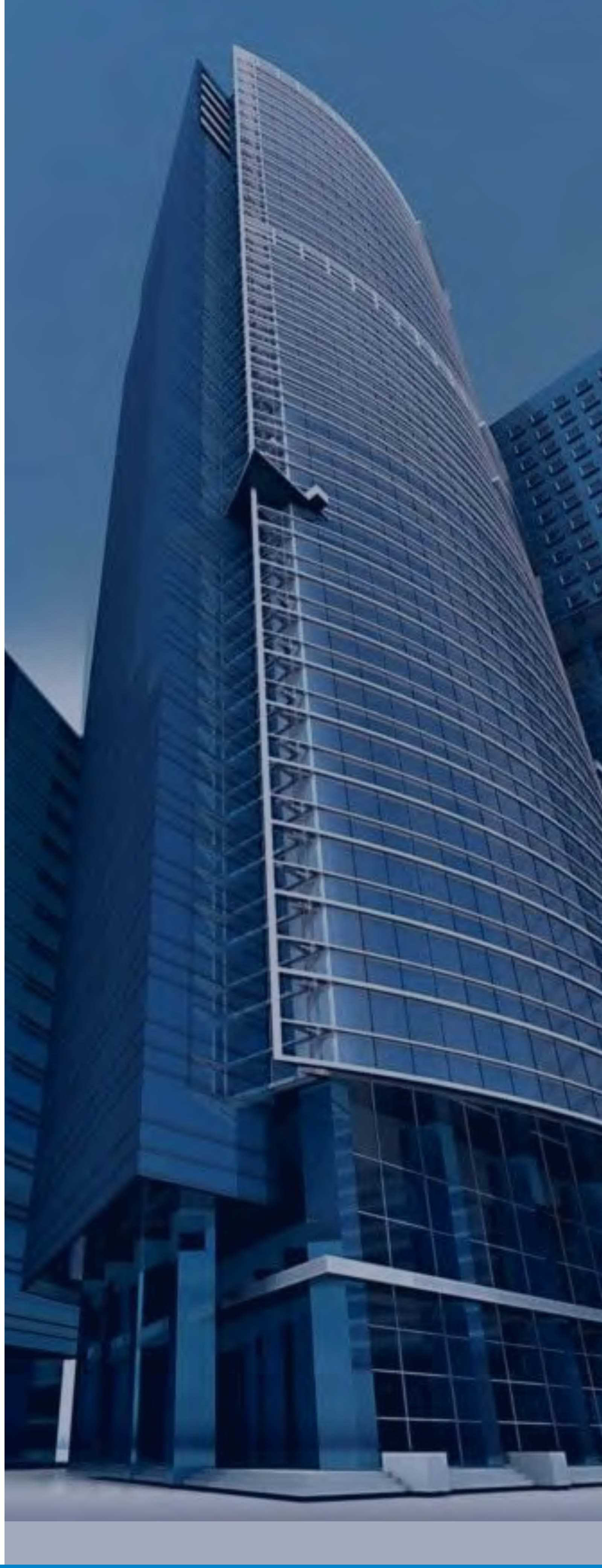
- **Technological Advancements:**
  - Introductions of digital platforms - access to structured products for retail investors.

REGULATORY ENVIRONMENT:

- Ongoing regulatory scrutiny - meet the needs of investors and are marketed appropriately.

GLOBAL PERSPECTIVE: DEVELOPED AND EMERGING MARKETS:

- Europe, Asia, Middle East and North & South America - structured products are gaining popularity among a new class of investor.



PART 2

CONCLUSION: THE FUTURE OF STRUCTURED PRODUCTS

RECAP:
SPs evolved from simple derivatives in the 1980s to multifaceted, globally traded financial instruments.
Shaped by financial innovation, regulatory change and market demand.

LOOKING AHEAD:
Structured Products – likely influenced by technology advancements, regulatory development and shifting investor preferences.

FINAL THOUGHT:
Offer significant opportunities for both institutional and retail investors.
However, understanding the history, risks, and evolving nature of these products is crucial for making informed investment decisions.

WHAT IS A STRUCTURED PRODUCT?

WHAT ARE STRUCTURED PRODUCTS?:

- A fixed term Investment that is designed to offer a pre-defined return for a pre-defined risk.
- Linked to the movements of an underlying asset e.g.: Stock Market Index.

There are two main types of Structured Products:

1. Structured Deposit – Capital Protected
2. Structured Investment – Capital at Risk

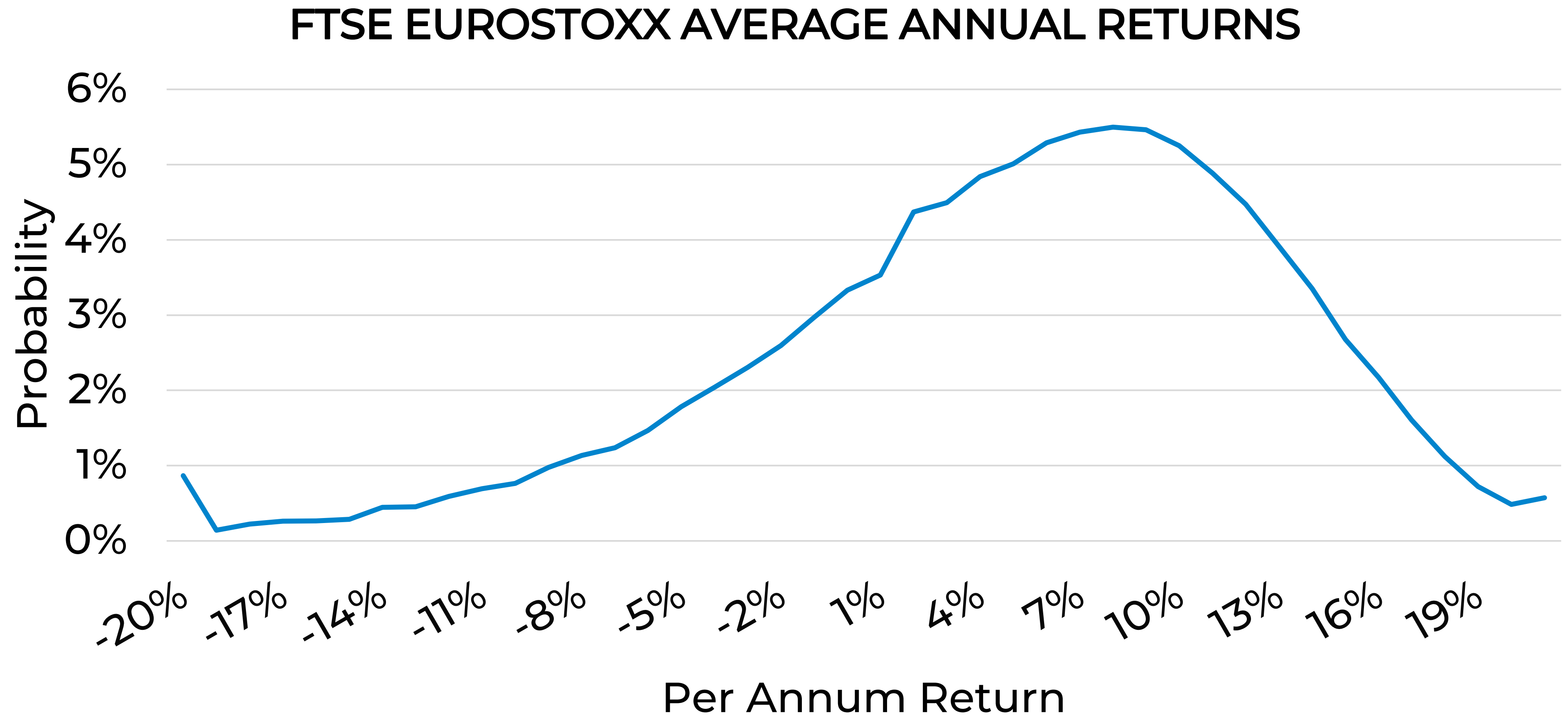
KEY FEATURES:

- **Customisation:** Tailored to meet specific needs of investors.
- **Risk/Return Profits:** Structured to offer different levels of capital protection, participation in asset performance , and returns.
- **Examples:** equity-linked notes, credit-linked notes, and principal protected notes.

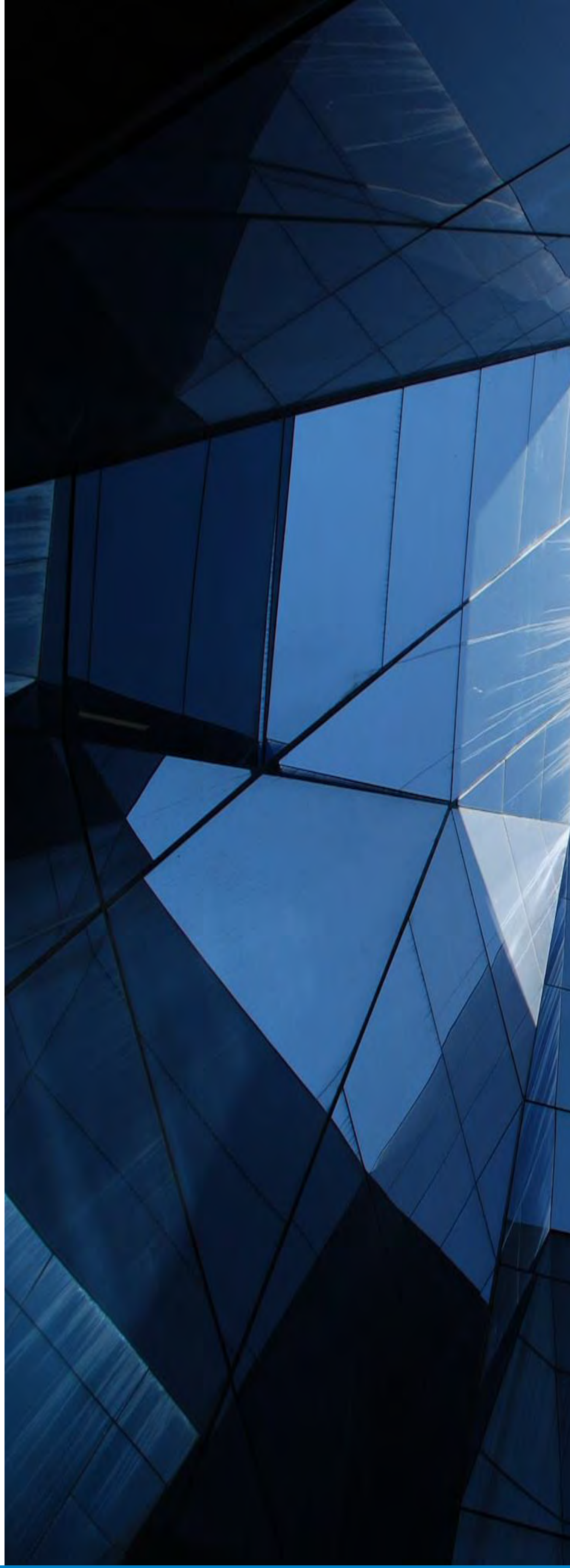
What's the point of Structured Products?

FTSE EUROSTOXX AVERAGE ANNUAL RETURNS

Typical Bell Curve shows probability of returns from stockmarket investing.



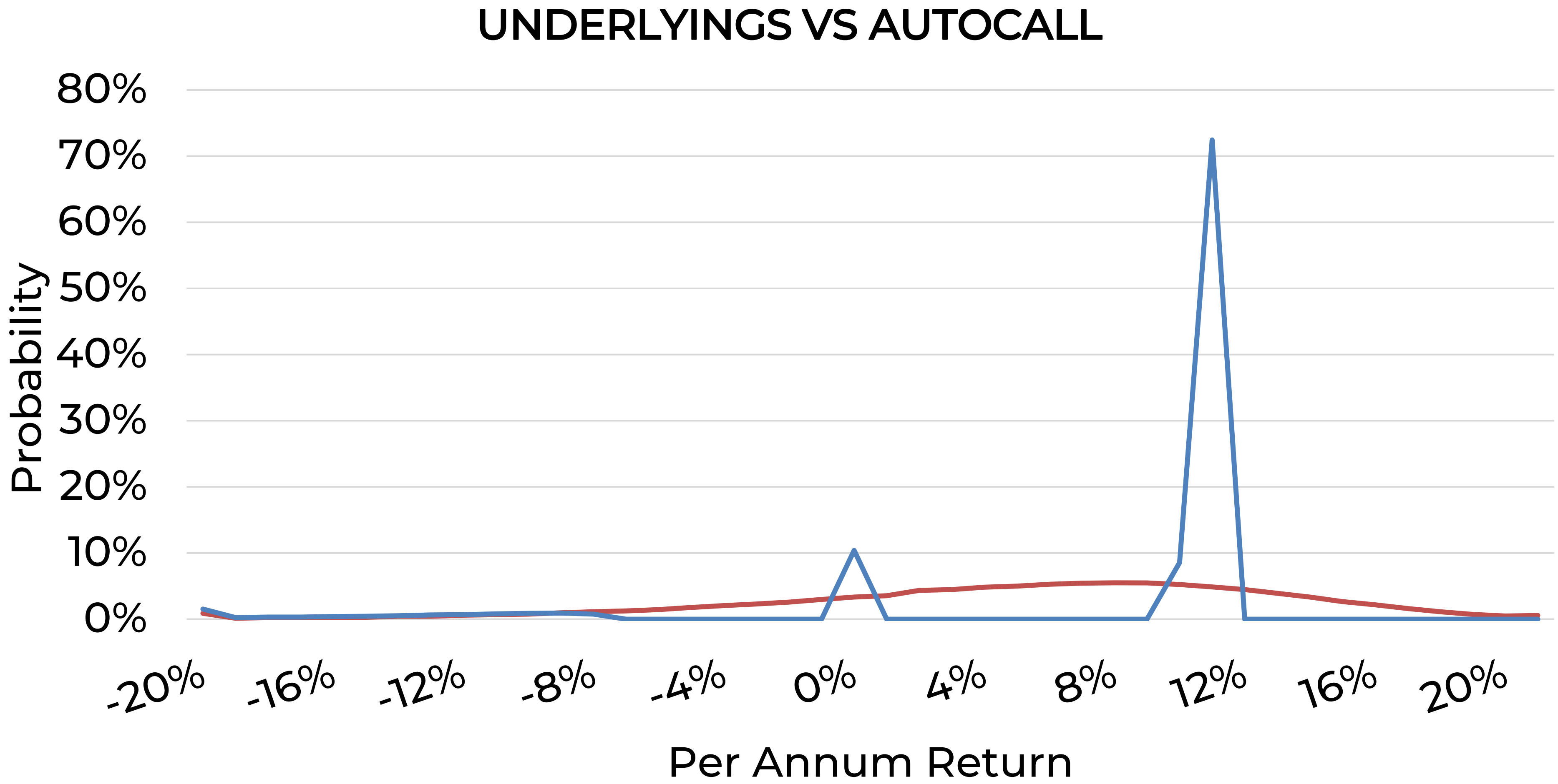
Source: FVC FTSE 100/Eurostoxx 50 Annual Autocall November 2024



What’s the point of Structured Products?

UNDERLYINGS VS AUTOCALL

Massively increased probability of achieving desired return.



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STRUCTURED DEPOSIT –
TARGET MARKET: CASH INVESTORS/HOLDINGS

Structured Deposits are fixed term deposit accounts

01
CAPITAL PROTECTED – no market risk. Legal obligation to return the original deposit at end of term.

02
Return: pre-defined, based on the performance of a reference asset
E.g.: Equity Index – FTSE 100.

03
FSCS Depositor Protection up to £85,000.00 per eligible claimant.

04
Subject to income tax, interest paid gross. Suitable for all wrappers (including UK res/offshore bond).

STRUCTURED INVESTMENT – TARGET MARKET: EQUITY INVESTORS

Structured Investments

01
Fixed Terms.

02
Sometimes Capital at Risk.

03
Clearly defined capital protection features.

04
Contract based investment - Legally binding on Issuer.

THREE KEY CONSIDERATIONS

Separate the wheat from the chaff

Counterparty Risk	Credit Rating CDS Level/Cap Ratios Market Intelligence	Small Banks without much of a balance sheet Subordinated Debt Unusual Credit Risk
Underlying Risk	Risk/Reward still applies Stock or Index? FTSE 99	Stocks come and go; an Index never dies
Payoff	If you don't understand – don't consider! Clear and precise "if X happens you get Y"	Objective is NOT to generate highest fees for the Issuer or Distributor!

THANK YOU

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