



The Financial Engineering Company

# **DISTRIBUTING FINANCIAL PRODUCTS**



The New Paradigm

In collaboration with



**IBS**intelligence



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# Introduction

# 01

The world is in the midst of a technology-powered innovation, and its influence can be felt even in the older domain of financial product distribution. Investment patterns of retail and corporate investors have undergone tremendous change, and hence financial product issuers and distributors have to look at ways to reinvent themselves. These investors are demanding real-time distribution and a higher level of customization, which the product distributors have to meet. There is rising sophistication among the retail investors, particularly the mass affluent as they demand structured products in addition to the

traditional securities and conventional FX. Unsurprisingly, technology-driven transformation is where many of the distributors are turning to meet these demands and protect or even increase their share of the business.

This whitepaper, developed by IBS Intelligence and FinIQ, analyses the dynamics and factors influencing the distribution of financial products. The whitepaper evaluates the existing models and recommends an alternative technology-powered business models that can renovate the way financial products are distributed.



# Evolution of Financial Product Distribution

The increasing digitalization of the world has had an impact on the distribution models in the financial investment space as well. Financial products' distribution has come a long way from when investors had to call up their brokers to transact in even commoditized traditional products such as bonds and equities. Now even retail investors can take positions in complex financial products such as structured products in real-time from anywhere almost 24/7. Two distinct technology phases or waves have fueled this evolution.

Wave 1: Automation of exchange-based trading via technology implemented by brokers and broker-dealers.

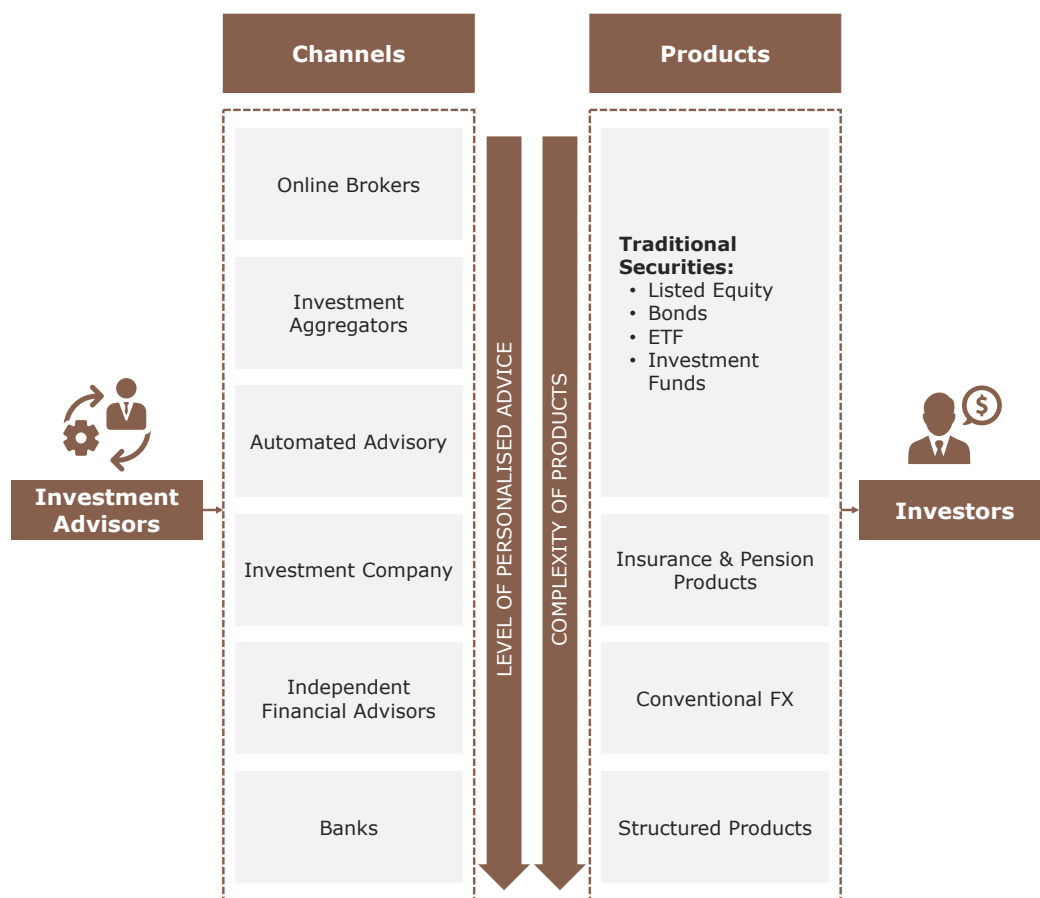
Wave 2: Technology-assisted pricing and risk management by the capital markets and sell-side manufacturers.

## Distribution Channels

The financial product distribution

channels have been heavily regulated across the globe. Regulatory authorities across the world introduced new regulations around product design and distribution. For example, Markets in Financial Instruments Directive (MiFID II), and Packaged Retail & Insurance-based Investment Products Regulation in Europe, Treat Customers Fairly act in Hong Kong, DDO Act in Australia, etc. These regulations impacted the variety of channels available for the financial products manufacturers to distribute these investment products. The distribution of investment products is still mostly a commission-based remuneration model. The three most frequently used channels for retail investors in ASEAN countries are banks, insurance companies, and independent financial advisors. However, there has been a significant rise in the use of technology-enabled channels such as online brokers, investment aggregators, and automated advisory channels.

**Differing preference for distribution channels: A report from European Commission suggests that in the UK, financial products are primarily distributed using non-affiliated intermediaries such as private banks and independent financial advisors, accounting for over 50% market share. Comparing with this, captive channels of product manufacturers command a majority share of the market in Germany.**



As illustrated in the figure, investors have a greater preference to use high touch channels for their investments in complex products. The function of advisors could be to educate more about and cross-selling the complex products to their clients. In comparison, other channels have lower volumes of complex products, but investors equally leverage them for vanilla, standardized products such as ETFs, insurance products, etc. While the use of channels differs across geographies, channels such as banks and independent financial advisors tend to more widely used. **The penetration of technology has meant that online-focused “direct-to-customer” channels such as automated advisory,**

**online brokers, and investment aggregators are increasingly being used for straight forward financial instrument distribution.**

One common thread across all the channels is that technology is the critical enabler. Usually, financial product distribution is in the domain of specialists. However, technology innovations and educational resources available via means of technology mean that increasingly more Relationship Managers and Advisors in a financial institution can sell a broader range of financial products. However, the appropriateness of the investment considering the investor profile and risk appetite is of paramount importance.

# Structured Product Distribution Practices

## Rise of structured products

One financial instrument among these that require dedicated and specialised selling is structured products. Structured products were launched in the UK in the 1990s and soon spread across Europe and the USA. However, in the 2000s Asia/Pacific region started to witness substantial growth in the adoption of structured products, and by 2014 Hong Kong alone exceeded the total volume of Europe for that year. Japan held a significant share in structured products in Asia as the structured products market in Japan was estimated at around US\$ 570 billion in 2015. However, during 2017-2018, as US/China trade dispute was escalating, and some major Asian economies were slowing down, this has affected the equities market (the Shanghai composite index fell by almost 25%). Looking into the challenges in the equities market, investors in North Asia (South Korea, Taiwan, and PRC, etc.) and ASEAN countries (Singapore, Malaysia, Thailand, etc.) moved towards structured products.

The subdued returns from traditional investment products such as equity, bonds, etc. have meant that empowered investors are looking at alternative instruments to beef up their portfolio return. Especially the affluent mass segment is demanding that their advisors incorporate alternative investments within their portfolio offerings. Structured product issuers are also seizing this opportunity to increase the proliferation of these products.

The structured product landscape has also evolved since the 2008 financial crisis. Some of the prominent trends within this sphere are:

- Lower commission margins due to regulatory pressures
- Smaller ticket sizes allowing increased retail participation and improved volumes
- Increasing focus on commoditizing structured products to enable easier distribution
- The emergence of structured notes as a preferred instrument for HNIs and UHNIs, with higher counterparty capital investment to minimize credit and liquidity risk

**The adoption of technology to help non-institutional, or high-net-worth advisors and clients, get access to complex products is an important trend taking place**

*CEO, US based Financial Investment Platform*

### **Structured products distribution channels**

Along with the financial instrument, the ecosystem has also evolved, moving from a highly manual function to bringing in automation and efficiency in the manufacture and distribution of the product. Undeniably, the complex nature of the instrument results in unique manufacturing and distribution challenges as the hallmark of these products is their customization, and that does not lend itself well to standardized channels sales. This is also illustrated by an industry survey that indicated that structured products are the most difficult to automate, followed by exotic derivatives, fixed income products, and commodities.

This has resulted in the creation of primarily two channels for structured product distribution viz manual advisory channel and automated platform channel. Manual channels are mainly responsible for investment themes and payoff innovation, while platforms leveraging technology create an efficient distribution.

The leading proponents of automation and increased digitization are the large issuers who can benefit from economies of scale through the use of a single issuer platform. The platform brings in higher efficiency, production cost reduction allowing smaller ticket sizes and personalized products on the distribution side.

There was a notable shift from manual channels to platforms, as indicated by structured products trading volumes. However, there is a demand for both manual and platform channels. More standardized products with high potential for automation are typically available to advisors to sell directly through platforms. The platform provides an opportunity to have a single product for an individual client. On the other hand, more complex structures are routed through the manual channels where advisors create a more customized and subscription product.





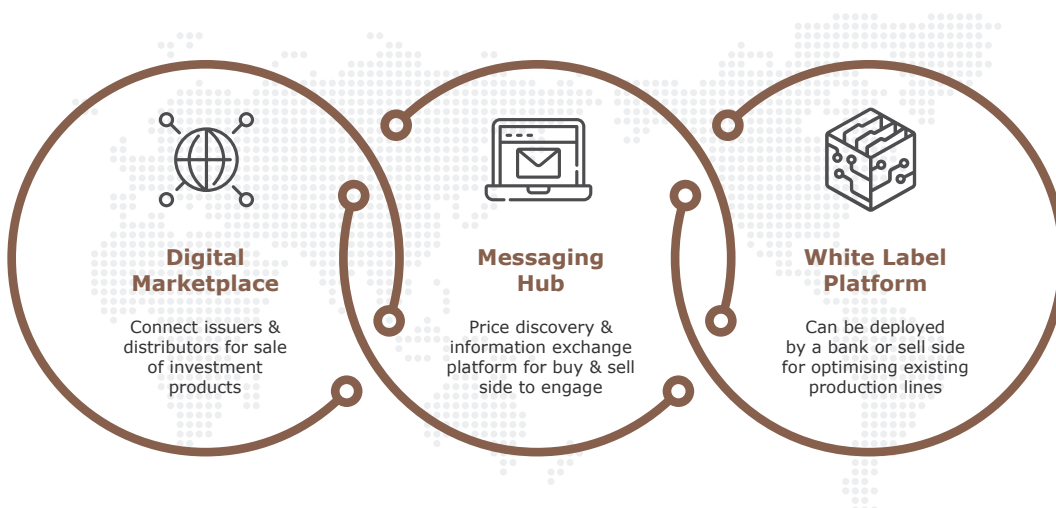
## Multi Issuer Platforms to the fore

The next leap in the distribution of structured products was the emergence of multi-issuer platforms (MIPs). A common challenge for all the sell-side issuers is to make their structured product offering widely available and provide quotes in a timely manner. On the other hand, distributors would prefer options in the structuring, pricing, labeling, and documentation of financial instruments sold to their clients.

A multi-issuer platform essentially connects the issuers and distributors,

leading to a more efficient marketplace. It provides the efficiency afforded by the platforms along with the customized offering of a manual advisor. A multi-issuer platform also optimizes the investment performance of clients, enables services providers to compare the prices of structures products, and also monitors risks.

Several multi-issuer platforms have mushroomed globally to provide benefits to the asset management ecosystem. Some of the more prominent ones are FinIQ, Contineo, LeonTeq, SIMON, Halo, Luma, to name a few.



# Technology Challenges for Distributors

# 04

For the issuers and distributors to take advantage of these new platforms, a significant review is essential for their technology infrastructure stack. Issuers will need to ensure a high degree of automation with its financial instrument production process. This would include automation of pricing, risk management practices, documentation management, issuance procedure, etc., to take maximum advantage of platforms. Being able to leverage technology to connect to the platforms would reduce the cost of sales.

On the other hand, distributors can

leverage technology to offer complex products such as structured products to their clients, proving to be a source of competitive advantage. The challenge for distributors is to bring the service as close to the client advisors as possible. If tailor-made investment advice can be efficiently converted to investment strategy, it serves the optimum purpose of wealth management, personalized and individualized service. The empowerment for the client-facing user, backed by robust technology, can potentially enable even generalists to offer investment advice along with the specialists.



As expected, there are a few challenges that issuers and distributors need to overcome as they embark on their technology transformation journey to electronification and automation of complex financial instruments such as structured products. The most prominent challenges are listed below:

- 1. Project cost & complexity:** The primary challenge cited by most of the financial services firms as the process of automating the production and distribution of financial instruments requires changes across the entire technology stack. The process of developing and implementing the underlying technology is a daunting task for most organizations.
- 2. Legacy Infrastructure:** Many firms are still using legacy technology infrastructure, and this is the biggest hindrance to adopting new technology. Managing to navigate and implement new technology is often constrained by the existing

infrastructure. For example, trying to implement a real-time risk calculation for structured products with the unavailability of real-time prices becomes quite complicated at best of times. Trying to embed it into an existing technology stack compounds the issue.

- 3. Business case justification:** This is a non-technical challenge, but a major stumbling block nonetheless. Getting the executive buy-in for embarking on a significant project with relatively uncertain payoff is often a challenge.

Another consideration issuers and distributors need to review is the potential need to overhaul the existing technology architecture. There is a need to reconsider the current interaction between the back-office system, risk management engine, execution engine, and OMS. In the next section, we propose a new architecture that would make the entire technology stack more efficient.

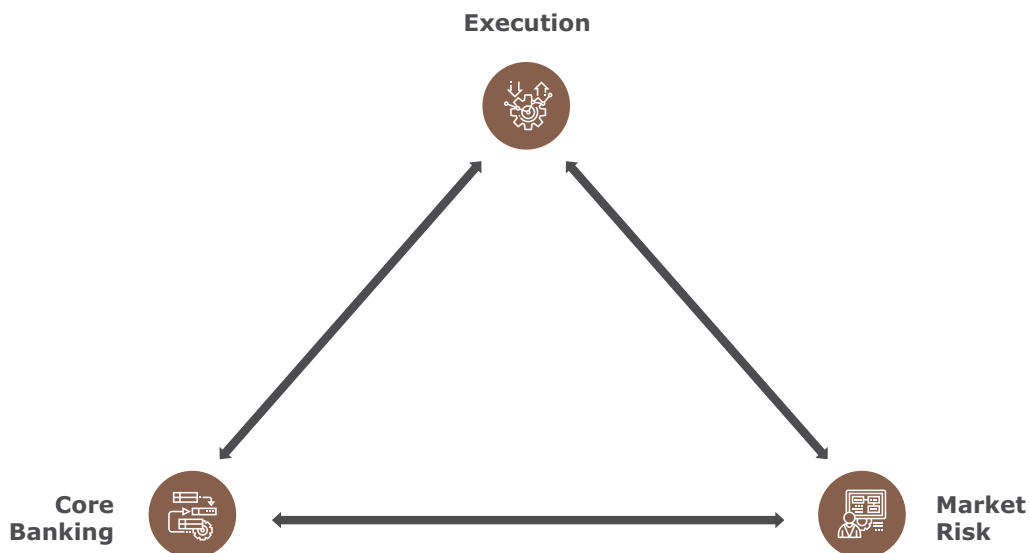


# OMS Anchor – The New Paradigm

# 05

Traditionally, the role of the OMS has always been restricted to a single aspect of the entire distribution workflow. The trade initiation is done in the OMS by a specialist where it undergoes validation and checks. Then the trade flows to execution systems where it is executed in the relevant forum. Then the risk engine kicks in verifying the post-trade processes, and finally, the entry is recorded in the back-office system.

The trade workflow for all securities, whether it is traditional security, conventional FX, or more complex products, has been more or less following the same. However, this brings in inefficiency as each of these products has its characteristics – in terms of standardization, commoditization, market participation, availability of market data, etc.



## Current Drawbacks

Traditional execution system does not have to receive the transaction repository, portfolio data, client data; hence they are limited to just fulfilling the client order. There is not a lot of validation towards the sanctity or the

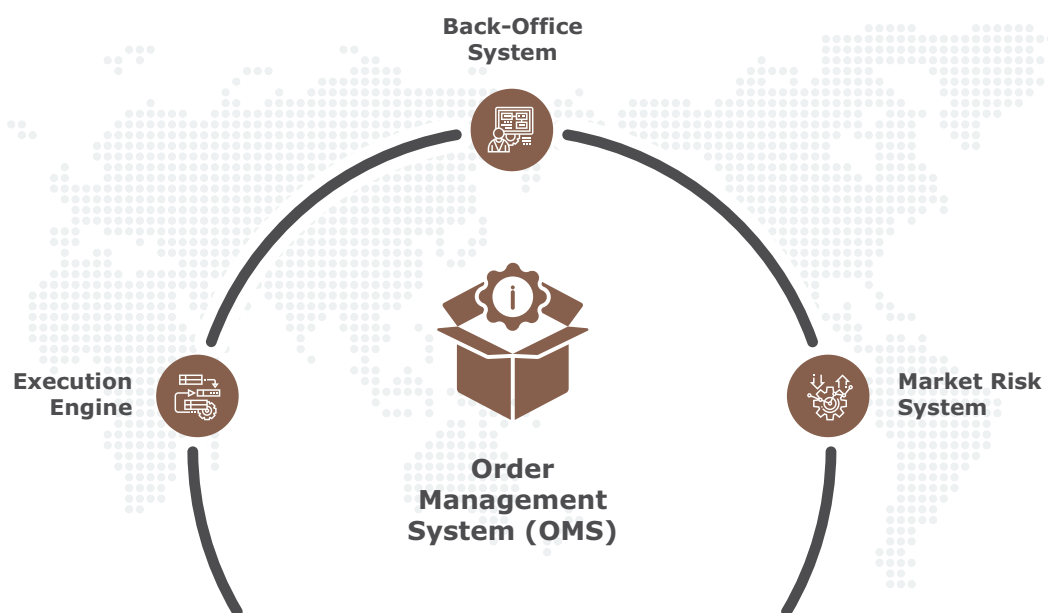
rationale for the order.

Similarly, market risk systems are not aligned to capture or monitor the client workflow. They are limited to tracking portfolio position and risk after the trade has happened, demoting it to a record-keeping

and monitoring system instead of a smart, transaction-aware system.

Usually, the existing technology systems do not have the necessary capabilities or product knowledge, especially in the case of complex

transactions. These drawbacks necessitate a tweak in the architecture, where the most informative system, the OMS, becomes an anchor and drives the trade processing in the entire workflow.



## New-age architecture

With OMS at the heart of the trade workflow system, it leads the client bound trading activity. As it is the client-facing system, it holds most of the requisite trade information data. With the back-office system, market risk system, and the execution engine interfacing with OMS, this data can be passed on to make the entire workflow smarter and more efficient. There would be a continuous two-way communication from OMS to the other systems and it removes the need for the three systems to interact with each other.

For example, in a traditional post-trade processing risk management system, there is no record of the intention behind the trade. The

system will not know the investment rationale, profitability of trade, evolution of trade, the term sheet for trade, client, or institution-initiated trade. With OMS directly connected to the risk engine, this information can be easily shared if required.

The industry has been evolving with OMS becoming more powerful as envisaged in the recommended architecture. OMS has merged with execution engines to manage the complete lifecycle of trade order and execution and to bring in efficiency and take advantage of obvious synergies. It would not be remiss to say OMS would become all-encompassing, offering seamlessly integrated, multi-asset trading functionality with back-office and risk management capabilities.



**Industry has found the order management anchoring the overall workflow very efficient, and soon the three downstream systems have gone to the sidelines playing limited roles as far as the client-initiated trades are concerned.**

*Milind Kulkarni, CEO, FinIQ*

### **Trade automation**

This development also lends itself to the ongoing automation of trade processing. Right from pre-trade validation of customer suitability, compliance, funding, and credit to at trade activities of liquidity seeking and pricing availability and

finally post-trade documentation and reconciliation, the architecture facilitates automation. The key capability for trade automation is the sanctity of data. With OMS anchoring, the data resides in one place allowing automation using workflow streamlining and newer technologies.

# Potential Benefits Achieved

# 06

The use of the technical architecture with OMS at the heart of product distribution and acting as the standard interface between back-office, risk management, and execution engine brings in some obvious benefits for financial product distribution. In this

section, we have highlighted some advantages, which makes the product distribution process more efficient and democratizes the channels while keeping the risk and compliance management in check.



## Benefit #1 | Easier New Product Creation

The use of OMS as an anchor, combined with platforms, allows banks and financial institutions to enable all client-facing employees to create new products or variations of existing products on a real-time basis. This has the twin benefit of tailoring investment strategy to align very closely with the profile and goals of investors and, at the same time, significantly reduce time-to-market for these products, without the need to wait for software releases.

## Benefit #2 | Efficient Information Flow

The centralization of the information in the OMS ensures more efficient flow throughout the process. This leads to a more data-rich trade processing workflow. Right from the availability of qualitative data for post-trade systems and risk systems, data can be leveraged for better decision making and compliance. The natural linkage to the back-office system allows quicker retrieval of holding and balance information.



### **Benefit #3 | Improved Risk & Compliance**

In this era of substantial compliance requirements, especially in light of opening up product distribution across some non-human driven advisory channels, there is a need for robust risk management and compliance system. This architecture allows compliance policies, either internal policy or regulator mandated to be set at any point of trade processing – pre-trade, at trade, and post-trade. Also, because of stricter governance of best execution in the interest of clients, the system can demonstrate and recommend best execution strategies.

### **Benefit #4 | Channel Optimization**

Financial product distribution has always been the domain of specialists such as wealth advisors due to the

technology and ethical challenge of allowing generalists to distribute them. However, the use of platforms overcomes the technology challenge allowing departments across entire universal banks such as retail, wealth, corporate, private banking channels to sell the same product. The bankers across these departments no longer must depend on traders, brokers, or structures to offer the product to their clients. They have access to the same tools and capabilities as these specialists.

### **Benefit #5 | Improved Execution**

The architecture enables super-fast and efficient execution of client orders in the relevant markets. Banks can now quote competitive sales spreads, safe in the knowledge that there won't be hedging delays leading to slippages.



# Outlook

## Shaping The Future Of Financial Product Distribution

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**Digital is 100% the future, just like virtually every other business, the move from 0 to 100% into digital is just a matter of time.**

*CTO, Leading Global Asset Management Firm*

Technology wave across the financial services industry is having its impact on the financial product distribution space as well. Digitalization has started becoming ingrained in the thinking of executives, and its effect will only compound going forward. This is especially true in the case of structured products and exotic options and derivatives which has lagged due to its inherent complexities. **The automation of product initiation and processing, new opportunity identification, market structure changes are the result of increased digitalization.**

**Incumbent banks**, which used to have a monopoly over structured product distribution, now have to compete with niche fintechs bringing in innovation along with issuers and distributors across the product distribution value chain. Technologies such as Artificial Intelligence,

machine learning, the distributed ledger will have a significant impact in the future as digitization structures the data on which these technologies thrive. For example, deploying artificial intelligence and machine learning will allow customization of offerings for investors according to client investment profiles.

Hence, rapid change powered by digitization in the financial product distribution industry is inevitable. Automation across the board, smart decision making on behalf of clients, the proliferation of digital channels is the way of the future. Banks need to internalize the inevitable shift and be the leader of innovation in technologies if they want to continue to enjoy the heft they currently enjoy.

FinIQ

The Financial Engineering Company