



3 hyde park steps
saint george's fields
london W2 2YQ

*consulting – expert witness - training in financial product
creativity¹, communication² & control³*

warren edwardes
chief executive

t: +44 (0) 20 7724 4606
m: +44 (0) 794 191 6328
f: +44 (0) 870 132 0055

e: we@dc3.co.uk
w: www.dc3.co.uk

FINANCIAL PRODUCT DEVELOPMENT:

GAINING A COMPETITIVE ADVANTAGE IN A GLOBAL WORLD

Warren Edwardes, CEO, Delphi Risk Management Ltd

Presentation to MEFTEC 2006

Bahrain, Tuesday 14 February 2006

Full speech on:

dc3.co.uk/creative.htm and dc3.co.uk/innovation.htm

Islamic banking news: dc3.co.uk/ibnews

Warren Edwardes is CEO of Delphi Risk Management Ltd., the London-based financial instrument innovation and risk management consultancy. Prior to founding Delphi he was on the board of the British merchant bank, Charterhouse Bank as Director, Financial Engineering. He has also worked for the Equitable Life Assurance Society, the UK Government Actuary's Department and the treasuries of British Gas, Barclays Bank and Midland Bank as a strategist, dealer, asset/liability risk manager and product developer.

Edwardes' best-selling book "Key financial instruments: understanding and innovating in the world of derivatives" (Financial Times Prentice Hall) includes an Appendix on Islamic Banking as a case study on financial innovation. To date, the book has been translated into Spanish, Ukrainian and "Simplified" Chinese. This article and speech is based on chapters 2 and 3 of the book.

Edwardes has applied his innovation skill to Islamic Banking since 1985 and is Board Governor, Fellow and Publications Advisor of London-based The Institute of Islamic Banking and Insurance and has published, been quoted widely and is a frequent conference speaker, moderator and chairman on Islamic finance.

Edwardes' well received speeches include: "How to capture the big new IDEA", "Overcoming Hindervation: Removing the corporate road blocks that Hinder Innovation" "Demystifying Islamic Banking and Finance", "Demystifying Derivatives", "50 Ways to Lose Your Money - A Practitioner's Risk Check-List", "Less Technophilia - Have Faith in Fools".

Contact: we@dc3.co.uk

Website: www.dc3.co.uk

Publications and speeches: www.dc3.co.uk/publish

HOW TO CAPTURE THE BIG NEW IDEA?

Why Creativity?

If you try to do things, sometimes you'll get it wrong. If you execute everybody who tries to do something and gets it wrong, pretty soon you'll have nobody who tries to do anything. That's exactly the wrong way around. - Peter Burt, chief executive of Bank of Scotland after the collapse of his bank's arrangement with Pat Robertson, controversial US television evangelist. 10 June 1999

There will be always be innovation in the financial system but for an individual established financial institution "Why Creativity?" is a very good question. Why not just wait for a small competitor to break ranks, introduce a new product, and then replicate it?

But Creativity is not about inventing products from scratch. Many useful financial products are in use elsewhere or went out of use perhaps because of regulation or tax considerations. In the late 1980's, Banco Santander and Banco Bilbao Vizcaya trumpeted the "guerra de supercuentas" or the super-account war. They started to pay interest on current accounts. But Barclays Bank, a relatively small player in the Spanish market had paid interest on such accounts for some time before the "guerra"! In early 1998, "current account mortgages" were launched by Virgin Direct in the UK - the Virgin One Account. Some small UK mortgage banks and insurance company owned banks also provided such all-in-one accounts. Such accounts blend borrowings and savings so that any income is used to reduce borrowings whilst the borrower retains the right to re-borrow up to his pre-agreed limit at will. But despite the hype and gimmicky press conferences there was absolutely nothing new in such mortgages! Such accounts have been common in South Africa since a client of mine, the Standard Bank of South Africa, introduced the Access Bond in 1993.

Always waiting for another firm to introduce a product first in a game of catch-up may be fine, but short-sighted, in retail financial products. Plain-vanilla or standard financial product expertise is simply not good enough in the capital markets.

The Financial Times of July 7, 1999 reported that the directors of Marks & Spencer, recently "locked themselves away for a three-day strategy brainstorm". So if we agree that we must have more creativity, how best should a firm or individual achieve "Creative Thinking?" Individuals in blue jeans, sneakers and pony tails thinking random thoughts? Committees and working parties scheduling brainstorming sessions? Has anything ever useful been produced by such groups? The only things generated by such bodies are sub-committees and think tanks. The way to "The Big Idea" was in the word itself - IDEA.

The Big IDEA - Impossible

I can't imagine why I hadn't seen it before. I who had had the foresight to buy Polaroid at eight and a half!- from the film "Play it again, Sam" by Woody Allen

Picture a young girl in New England. It is her birthday party. Her father is taking photographs. The girl wants to see the pictures NOW. The father thought: "Well why can't she have the pictures now?" That father was Edwin Land, the inventor of the Polaroid camera. So, think like a child. Think like an Innocent. You can have that picture now. Think *Impossible*.

I recall a new entrant to a dealing room who was forever coming up with scatter-brained ideas. His line management often berated him for not focusing on his day-to-day work on the futures desk. Most of his ideas were indeed off-the-wall but I was one of the few around to listen to him and some of his ideas did provide me with a spark of inspiration. Of course I took all the credit and he was soon fired for not concentrating on the job at hand! The reverse had happened to me a number of times and the phenomenon of idea theft was a feature in the book "Liar's Poker." (Michael Lewis, Hodder & Stoughton, 1989)

*There's no use trying, one can't believe impossible things", said Alice. "I daresay you haven't had much practice. Why sometimes I've believed six impossible things before breakfast" said the Queen.
- Lewis Carroll in Alice in Wonderland*

There was a novel advertisement by a job seeker in the September 1998 issue of Director magazine. "Court Jester. Ageing manager seeks appointment as court jester or fool to chief executive of large public company. Will provide own bladders and fool's cap." Ridiculous? Absolutely not. The idea was that centuries ago Kings who were surrounded by yes-men and sycophants had fools who had licence to ridicule policies without fear of losing their heads. Present day Chief Executives are also surrounded by yes-men. They need someone to give them an honest opinion. Someone has to tell the emperors of the boardrooms that they are not wearing any clothes before disasters strike. I would venture to suggest that the reason for the demise of Asian economies such as Korea was not because of a low level of education. Just the opposite is the case. Economics PhDs and university professors have dominated recent governments. Korea fell because of the strict hierarchical system and respect for elders. There was a shortage of fools brave enough to point out the obvious. "But Mr. Bank President, should this bank be lending so many times its capital base to this Chaebol?" Allow your staff to help you break the mould and think the impossible.

The Big IDEA - Disasters

Remember the two benefits of failure. First, if you do fail, you learn what doesn't work; and second, the failure gives you the opportunity to try a new approach. - Roger von Oech

Now let us move to a glue laboratory. The scientist is trying to produce super-glue. But he tried and tried and the glue just did not stick. The product was a complete disaster. Have you ever heard of glue that does not stick? Well you have it in every office in the world. The scientist at 3M had inadvertently invented the PostIt note. *Disasters* are sometimes opportunities. The PostIt note is everywhere and is the most profitable product at 3M.

A decade ago at Midland Bank's Treasury we created, on the back of apparent customer demand, a tender-to-contract currency exposure contract. I did not really think it would fly for a number of reasons but coined it the SCOUT - Shared Currency Option Under Contract. Midland gained considerable publicity and several news column inches after the launch. To this date, however, not a single SCOUT has been sold but awareness of Midland's ingenuity and customer service was enhanced and plain-vanilla currency options were sold! The SCOUT is, nevertheless, still featured in numerous Dictionaries of Finance. As it did not cost a penny to produce and no brochures were printed, in terms of public relations generated the SCOUT may be the most profitable financial product ever launched!

Don't forget that whilst Christopher Columbus was right in looking for a Westerly route to India on landing in America he thought he had actually landed in India. That disaster turned into an opportunity for Spain. And the next time you open a bottle of Champagne

think of its origins. It too was a disaster in its day. A still wine that over-fermented and went fizzy. But it proved popular and the rest is history.

So disasters can provide sparkling results..

The Big IDEA - Everywhere

It is always at Perpignan station, when Gala is making arrangements for the paintings to follow us by train, that I have my most unique ideas - Salvador Dalí in "Diary of a genius"

Let us now move across to a forest in the Jura Mountains in France. It is wartime 1941. A scientist is out hunting with his dog. When he got home, he found that wood-burs had stuck to his woollen jacket and trousers and to his dog's coat.

He decided to examine them. Carefully inspecting the burs under a microscope, he found hundreds of little hooks engaging the loops in the material and fur. The scientist, George de Mestral made a machine to duplicate the hooks and loops in nylon. He called his new product Velcro, from the French words VELours and CROchet.

The rest is history. Today there are thousands of uses of Velcro Fasteners from rucksacks to clothing, all thanks to a man hunting with his dog in the mountains.

So, think *Everywhere*. Think when out walking. Think when in the shower. Think when listening to a boring speaker. Just switch off and think about that problem that has been bugging you.

One of Honda's most original sports-car designs, the NSX supercar, is reputed to have been sketched by Nobuhiko Kawamoto, the President of Honda, whilst doodling during a tedious board meeting. The latest in the hugely popular Harry Potter series of "children's" books was launched on July 8, 2000. Its author, J. K Rowling, revealed how she came across her ideas. Sometimes they just came like magic and other times she had to sit and think for about a week before she managed to work out how something would develop. The idea for Harry Potter actually came whilst she was travelling on a train between Manchester and London and it just "popped" into her head. It was the most interesting train journey she'd ever taken. By the time she got off at King's Cross many of the characters in the books had already been invented.

Or did it? On the 16th March 2000, a US author sued the writer and publishers of the Harry Potter books, claiming that plots and characters in the wildly popular children's series originated with her. But Nancy K. Stouffer of Camp Hill argued in her federal lawsuit that ideas for J.K. Rowling's Potter series were lifted from her 1984 book "The Legend of Rah and Muggles," which included a character named Larry Potter. There were a number of other coincidences. J.K. Rowling won the case on September 19, 2002. I was once attending an extremely tediously presented seminar on Corporation Tax. My mind wandered to solve a problem a corporate customer was having with Currency Translation Exposure. My lack of concentration led to the creation of the Perpetual Currency swap!

So do think everywhere. And, again, don't bother with those contrived brainstorming sessions and working parties! You cannot plan to create on demand. But you can organise your mind to be constantly receptive to new ideas wherever you happen to be.

The Big IDEA - Archive

It is unforgivable in the course of a meeting or conversation to let ideas float away un-captured, to be lost for all time, when so little effort and so simple a device (a notebook) can preserve them and bring them back to mind later. - Richard Branson - in a speech to an Institute of Directors annual conference

The problem, however, with thinking everywhere is that thoughts are often forgotten until somebody else thinks of them. It is then much too late! So, write it down. Archive that thought. Keep a pen and paper handy in every room of the house especially by your bed and near the shower! What about when you are driving? Forget the pen and paper. Have a Dictaphone in the car. Archive those thoughts - NOW.

Many of us have come across situations where we have proposed ideas in brainstorming meetings or around a coffee machine or even directly to the boss, only to find that someone a good deal more senior grabs the credit. I proposed fixed rate mortgages at my bank with hedging through interest rate swaps in 1986. They were new in the UK but common in the US. The idea was dismissed. Six months later, after I had moved from Product Development to another unit, my bank began marketing fixed rate mortgages with great fanfare. I was naïve enough to think that I should have got some credit for the idea!

Everything has been thought of before, but the problem is to think of it again. - Goethe

In 1993, years after the innocent futures dealer was sacked, and well before knowledge management became fashionable, I developed an innovation management system for a client, the Delphi Thought Pad. This allowed anyone from receptionist to internal auditor to input thoughts even in their pre-idea stage onto a database and generate a discussion. Some people are good at ideas whilst others excel at implementing. The advantage, furthermore, is that others cannot steal the ideas of the newcomer. At bonus time, reward is given where it is due. Every contributor in the team or even outside the team takes credit as input and dates are recorded.

However full "information-sharing" is not always advisable. In cultures such as Korea, loyalty can be to university or school alumni rather than to the firm. The Economist of July 3, 1999 reported that "sharing information with Korean employees can easily backfire because most of them gossip over drinks with friends who work for competitors." The article quoted Dave Parker, president of Nestlé Korea which operated an open information system, as being alarmed at the amount of information available to his firm's competitors. In early 1999, Nestlé introduced Taster's Choice coffee packaged with a water container. A mere two weeks after the product was launched, a local competitor began selling its own copy. But perhaps this particular case was all down to local language difficulties? After all in Korea, Coffee is commonly pronounced Copy. There is also the problem caused by staff leaving for competitor banks. If full information on work-in-progress is made available to all, then staff about to leave will scan the system before resigning and structure the products for their new firm. This happened with one of the financial products I developed. And I must confess that I have re-launched financial products that I developed for previous employers.

The Big IDEA - the IDEA Kit

He who asks is a fool for five minutes, but he who does not ask remains a fool forever - Chinese Proverb

So to enhance creativity keep on your desk a simple IDEA Kit. It is no more than a bag with a LEGO block, a PostIt note, a strip of Velcro and a golf pencil.

The LEGO block represents Impossible or Innocence - think like a child and ask stupid implausible foolish questions. Raw recruits to a firm should be encouraged to ask: "Why do we do it this way?" If management does not have a good answer other than "When I want your ideas I'll give them to you" or "We've always done it this way" or something similar then the process must be changed. New fresh viewpoints should be utilised and be encouraged to question everything and report on their findings to senior management.

The PostIt note was a Disaster - the non-sticking super glue! Sometimes the best products arise when solving another problem. A solution that does not work for today's problem may be just what you needed for yesterday's unsolved and shelved problem.

The Velcro strip represents the motto: Think Everywhere.

Finally, the golf pencil reminds us to Archive those precious thoughts. Note that thought in the gym. In the car, use a Dictaphone.

No chance

Chance discoveries do not occur by chance. An environment must be nurtured to allow fleeting thoughts, those pre-ideas, to be grasped; then recognised for their potential as ideas; turned into tailor-made solutions and then finally developed into products for other customers.

Think cross-markets. Problem-solving ideas can often be captured from other markets or businesses. The most successful products are not those that use high-tech mathematics. The best financial market products are the result of the most simple of ideas - but applied in a fresh way to a completely different business. Banks have grown so large that a number of banks are re-inventing the small entrepreneurial merchant banks of twenty years ago within their banks. They are establishing multi-disciplinary cross-markets groups to include not only rocket-scientists, but also practically minded creative lawyers and accountants.

But the creative process in financial institutions does not stop at the creation of new financial products. In this or any other service industry, creativity must be employed to enhance the delivery process or simply to increase efficiency. The most creative field without doubt is finance. Whilst the morality of some financial schemes may be questionable, lessons can be learned from the creative process.

You can't solve a problem by thinking about it too much. Creativity cannot be planned. Inspiration, by its very nature, often comes to you when you are alone. Perhaps in the shower - just when you do not have a notebook at hand. Good ideas just hit you. Recall Archimedes in the bath shouting out "Eureka". No doubt his modern equivalent financial innovator would yell "Euroclear". Perhaps some can innovate through brainstorming, mind mapping and lateral and objective thinking and all that sort of thing. I just find that the most successful and marketable of ideas are the most obvious ones. There is no better way to hinder innovation than to plan to innovate.

Post Script

Given that genuine new ideas are hard to come by and very difficult to patent, perhaps the quickest way to a new idea is to get it from someone else. Keep your mouth shut and ears

open especially in bars in the City of London or Wall Street. Read the Financial Times on the train or the aeroplane. And don't talk in the back seat of a taxi. Your excited deal-talk may well be broadcast to the taxi-driver's paymasters working for a competitor. The idle sentence may just provide a missing ingredient to a new product.

I was on a train to London's city in 1985. The passenger sitting next to me was reading a report. It was headed "Lloyds Bank - Product Development Department". It proved to be fascinating. You should have seen the look on his face when I thanked him and gave him my business card - "Midland Bank - Head of Product Development". And things just don't change. Martin Waller of The Times reported ("Open Lap", March 10, 2000 City Diary), that two days earlier a banker travelling on a train in London had his laptop open. He was reviewing a report on "the benefits of a proposed merger" between two large banks. What is more, the headline was in 32-point type.

There is a bank, which will remain nameless, that is permanently interviewing for staff. If a candidate says something useful, his ideas are recorded. But the talkative candidate is discarded as being untrustworthy. Somehow, keeping quietly mysterious does not help the candidate either. There is, of course, no job on offer!

And beware of the boastful. I have come across an amazing number of financial markets people who proudly boast about their firm's work. I recall a lunch a former bank employer hosted for some investment bankers. We had worked together on a major deal. I was flabbergasted when my show-off boss coolly and calmly told them what we were working on. In my experience the most leaky are the most senior. Perhaps the key to successful innovation is skilful ego-massaging?

As an innovation management consultant, it is not always possible to get a client to sign a written confidentiality agreement. Over the course of a year, I hinted at a structure to a long-standing "friend", a treasurer of a bank. He said that he really needed to understand the structure and that I should explain it to him with an oral confidentiality agreement. A week later he advised me that he could not proceed with the advisory contract proposed. I was shocked and felt more than a little naïve a month later when the Financial Times reported that his bank had launched my product.

The Times of 21st April 2000 reported on Liz Jones, who dreamt up an advertisement for Maltesers chocolates. The Sussex University Media Studies student sent in a story board to the advertising agency describing the idea but it was rejected by the advertisers as "*it would be dangerous if young children tried to copy it.*" Not long afterwards, however, amazingly similar press and television advertisements were launched by Mars.

Miss Jones said that "*getting a really good job in advertising is what I want and getting some credit for this idea might help.*" The advertiser and Mars both deny plagiarism. Joe Boyd, director of the DMB&M, now called D'Arcy, dismissed Miss Jones' claims saying "*It was entirely coincidental that we came up with an idea that bore some similarity to her idea.*"

So make sure all proposals are in writing - and with a watertight confidentiality agreement or not at all. Beware.

And finally

But coming up with a great idea and turning it into a successful product just is not good enough. Polaroid was used as a case study into how to think like a child - Think Impossible.

But you have to keep on doing it. But don't just rest on your laurels. A combination of one-hour photo labs and multi mega pixel digital cameras resulted in Polaroid's demise. On 12th October 2001, Polaroid Corporation filed for bankruptcy protection sealing the fate of one of the best-recognised brands in the world. As the Financial Times wrote on the day: "*Polaroid, founded by one of the greatest inventors in US history, Edwin Land, proved incapable of making the transformation into a consumer products group. Products such as a Barbie camera, sunglasses and a flashlight fell flat. The popularity of the I-zone faded quickly, as adolescents turned to other fads.*"

Capturing the big idea is but the first part of innovation. Innovation involves more than creative thinking. Innovation involves the development of ideas into products and services. And those members of a team with creative minds are often not those best equipped to develop the thoughts into products. And vice-versa. So develop an ideas management methodology and system that utilises the best abilities of all in the workplace and win co-operation by giving credit where it is due. As a financial engineer working in a bank, I often found that my products were being sold by my sales and marketing colleagues. They were the ones to get the bonuses. So I just had to close some big deals myself to prove my worth. In mid-1998 I heard Peter Hain, a UK minister being interviewed on the BBC. "*Do tell me about your new idea, minister*" the interviewer asked. The idea may well have been Peter Hain's but somehow I doubt it. Surely a government minister (or a chief executive) should be spending his time evaluating and managing ideas generated by his large team. Mr. Hain should have said: "*I'd be delighted to tell you but the idea actually came jointly from my researcher Ms. X and civil servant, Mr. Y.*"

SEVEN PILLARS OF INNOVATION

Six people seated around the walls of a darkened room. In the open middle space is a chair. Who finds it? Those that sat still and philosophised about where chairs are usually placed in rooms? The innovator who would locate it is the one who'd get up, walk and stumble until he discovered it. Nobody ever found anything whilst sitting down. So QED don't be afraid to stumble. - Charles Kettering

Ease of entry

In the financial market the barriers to product development are incredibly low. Unlike in the industrial world, a manufacturer of a financial product such as a fixed rate mortgage or an inflation-linked deposit product does not have to create the product and stock shelves. Even in the retail financial services, with the product offered at a fixed rate, the bank always has the right to withdraw the offer. There is usually a "Special Limited Offer" splashed on prominently. The costs of producing a retail product are limited to the costs of stationary, staff training and computer systems.

In the wholesale financial markets, the costs of developing products are even lower. One of the most successful product launches in my experience was that of a currency option based structure. The object of the product was to lower the costs for corporations wanting to tender for overseas contracts. Let us consider a group of UK firms bidding separately for a contract in the US. The theory was that they could buy one currency option to sell US Dollars and buy GB Pounds and split the costs of the option amongst themselves. This product was the Shared Currency Option Under Tender, the SCOUT. We drew up legal documentation, produced marketing literature and called the press. The product launch successfully generated widespread publicity but not a single SCOUT was sold! I don't believe that any client even asked for a quotation. But so what? Who knows to this day that the product was a complete

flop in terms of business generated. But it increased awareness of the bank's capabilities in treasury products and led to standard options business.

Copyright

It is interesting to examine innovation in another industry - the software industry. In some ways the financial product business is quite similar to the software business. They are not capital intensive - they are both ideas intensive. If Apple or Netscape has a good idea for a way of doing something then until very recently the business process could not be successfully patented. The software code could be protected and the look and feel but the basic idea could not. Apple produced graphical user interfaces (GUIs) well before Microsoft's Windows, SuperCalc and Lotus 123 preceded Microsoft's Excel and Word perfect had a dominant market share of word processing well before Microsoft launched Word. In software, the firm that wins is not necessarily the firm that innovates.

So it has been in the world of financial product innovation. In the late 1980's Spanish banks began to pay interest on cheque accounts. The competition was described in war-like terms: as "La Guerra de Super Cuentas." Banco Santander was generally credited with having started this "super account war." But it was Barclays Bank that introduced interest on current accounts into its relatively small operation in Spain. Fixed rate mortgages cannot be patented.

It now appears that financial products can be patented in the US. The business process through which a firm develops, markets and manages a financial product defined by the business process can be patented. This will ensure that the ideas generated by product developers provided they can be fully formulated will be protected. I am in the process of patenting two financing schemes so I cannot yet vouch for the efficacy of this intellectual property protection process.

Seven pillars of financial innovation

There are seven main pillars of financial innovation:

- Competitive Innovation
- Regulatory Innovation
- Accounting Innovation
- Taxation Innovation
- Religious Innovation
- Ignorance Innovation.
- Technological innovation

Competitive Innovation

The largest institutions in any industry are often not the leaders in the early-stages of innovation. In the words of the slogan that never was: "We're number one. Why try harder?" It is the second-placed firm that has to say "We try harder" to paraphrase the Avis' slogan countering Hertz's "We're number One".

But in a free market with low-cost ease of access though the internet, unless firms can develop new financial instruments that meet the changing needs of the market place they will be by-passed. It is no good just being on the right track. If you just stand there you will be run over.

So competitive innovation seeks to provide a firm's clients with better solutions to its problems. Banks thereby hope to generate a higher market share or a higher profit through satisfying the customer's needs – the famously touted “needs-driven approach”. I came across a bank marketing director who religiously stuck to this approach and proudly stated that he never mentioned products to customers. At the end of the day a bank's marketing team has to provide a customer with a product or a service.

I would hazard to say that of the seven pillars of financial innovation this is the most difficult and rarest. There is no free lunch here and margins are slim with such innovation. But unsurprisingly the other forms of financial innovation described below are dressed up for customer consumption to look like Competitive Innovation.

Regulatory Innovation

The Eurobond market was created in London by the London merchant bank, SG Warburg as a result of two main forces. Firstly, there were regulatory restrictions and fiscal impositions in the United States. Secondly, because of the cold war the USSR was not keen to invest its funds in the U.S. A relatively free Eurobond market was developed in London for borrowers and investors who wished to avoid US controls.

In 1978 I got my first job in the balance sheet management department of a major British bank. At that time there were very strict quantitative controls on bank lending in the UK. The growth in Interest bearing eligible liabilities (IBELs) was controlled with strict penalties imposed by the Bank of England on banks that exceeded permitted growth. Several regulatory arbitrage schemes were employed to maintain bank lending but avoid paying penalties. The bank loaned money through Bankers Acceptances which if sold on did not count as IBELs. Lending was also done through the bank's Paris branch. Such offshore lending even denominated in Sterling did not count for IBELs. And where possible lending was carried out between “make-up days”, the dates on which the monthly balance sheets were drawn up for Bank of England reporting purposes. This was to such an extent that the bank's IBELs used to fall after the make-up days by as much as 30 per cent. My bank was the only UK bank that did not have penalties imposed on it.

Regulatory Innovation could also include products such as credit derivatives and insurance derivatives. There is a grey area between insurance and banking and the treatment of similar instruments is quite different between them. It pays to be able to choose to book structures in either an insurance company or bank on a case by case basis.

A number of products have also been target specifically at fund managers with tight regulatory controls. Many such managers are not authorised to use derivatives. But they can buy investments with built in derivatives structures to provide them with the gearing and risk pattern they seek. Such products were designed specifically for some highly regulated investment funds. In some cases individual institutional investors have bought entire issues of highly geared bonds.

Accounting Innovation

The Break Forward featured later was a case of both Accounting innovation and Taxation Innovation. Finance directors were reluctant to pay currency option premiums upfront. After all, they did not have to do so for standard forward exchange contracts. So I developed the Break Forward out of a currency option with no explicit option premium. The premium was embedded in the packaged product which consisted of two contracts – a forward contract at a rate worse than market and a “free” option to unwind. The cash value of the difference between the two contracts amounted to the future value of the option premium. Corporate treasurers knew what they were doing and understood that they were buying options. This was fully explained to them. But the Break forward structure was easier to explain to boards of directors who had been comfortable with Forwards. A case of Accounting Innovation.

Taxation Innovation

The two case studies featured in Part III on the Break Forward and The Perpetual Swap both were largely tax driven innovations. It is all very well coming up with solutions to customer problems but unless a third party (the tax man) is contributing to the pot, the profitability of deals is often insufficient to justify the effort.

Zero coupon bonds and deep discounted securities were initially tax driven products in addition to their portfolio immunisation benefits. In most jurisdictions, capital gains was generally until fairly recently taxed much more favourably, if taxed at all, than income. Interest was converted into capital gains by various methods. Such schemes are no longer tax efficient.

Taxation Innovation is on the wane as many jurisdictions now have the right to retrospectively tax what they deem to be tax avoidance schemes.

Religious Innovation

Religious Innovation here largely refers to Islamic banking. There have been a great number of such financial instruments that have only paid lip-service to such objectives. But Islamic banking is more than the prohibition of interest. In conventional banking terms, it is about the introduction of a no pain no gain system of banking or venture capital investment. But the vast majority of Islamic banking schemes amount to converting interest into capital gains. The processes here were very similar to the tax minimisation schemes involving interest elimination. Fifteen years ago zero coupon bonds and treasury bills were acceptable. Whilst these instruments are no longer Islamically acceptable, other interest into capital gains structures leaving no risk to the investor are still acceptable.

Religious Innovation is not just limited to Islamic banking. Many non-Islamic countries have usury laws to control maximum interest rates payable by consumers. And recently a number of ethical investment funds have been created to channel funds into firms not dealing with items such as tobacco , alcohol and armaments.

Ignorance Innovation

As stated above, Competitive Innovation seeks to generate new customer solutions through a “needs-driven” approach. But what is often not obvious is that the “needs” referred to are those of the bank traders and directors’ bonuses rather than those of their customers. Ignorance innovation is plain and simple “ripping-off” customers not through any fraud or misrepresentation but through creative financial engineering. And the customer may be

perfectly happy with the product and the excess profit engineered may well be opportunity profit. If the customer knew how to structure such deals for itself then it would have obtained a much better package price for the structure.

Sometimes the ignorance may apply not to the corporate treasurer doing the deal but to his superiors. Such innovation falls under Accounting innovation.

Perpetual Floating Rate Notes were issued by banks in the mid 1980's. FRNs traditionally had maturities between 5 years and 15 years. Naturally, they did not count as primary capital in the same way as did retained earnings or shareholders' funds. So banks issued FRNs but with no maturity date. The structure was akin to preference shares but with floating rates. There was no obligation to repay the "loans" at any time. The ability of an investor to realise his investment crucially depended on an active and liquid secondary market. And this was limited as banks that held other banks' Perpetual FRNs found that their capital base was reduced by regulators in line with their holdings of such "Perps". Gradually it dawned upon investors the true nature of these Perps. They had bought bank liability instruments that they believed were almost like deposits but paying 25 basis points over LIBOR. As investors stormed out of positions in the Perpetual FRNs, prices crashed within days to 80 per cent of the par value they had been trading. The yield was now a more reasonable but still low 250 basis points over LIBOR for bank equity. A case of what appeared to be Regulatory Innovation was really Ignorance Innovation

Technological Innovation

Technological Innovation I think should be obvious at the end of this conference. Just look at the title of this conference and through the titles of the numerous speeches in both streams. Just pay a visit to the exhibition stands.

Conclusion

Of the seven types of financial innovation it would be nice to think that genuine needs-driven Competitive Innovation was the most common. Regulatory Innovation will no doubt continue. Accounting Innovation will depend on performance management systems. It is much more easy to generate accounting profits than real profits and every competent financial engineer is capable of manipulating his management accounts. Religious Innovation which includes Ethical innovation is increasing as Western banks provide Islamic financial instruments and retail investors increasingly seek "green" investments. Ignorance innovation will always be around but to a much lower degree. Corporations and retail investors are increasingly likely to cry foul and take banks to court. Even if there is a settlement out of court or the bank wins the case any whiff of sharp practice can seriously damage a bank's reputation. And finally, there has been and is going to be plenty said about Technological Innovation at this conference and there is no need for me to add anything at this juncture.

Warren Edwardes, CEO, Delphi Risk Management Ltd

Presentation to MEFTEC 2006

Bahrain, Tuesday 14 February 2006