INCAPITAL

Structured Investment & Fixed Income Expertise

Guide to Understanding Counterparties

Research-Backed Investment Thinking

IncapitalEurope.com

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About Incapital Europe

Incapital Europe Limited

Incapital Europe Limited is a London-based affiliate of Incapital LLC, a US-based securities and investment banking firm. Incapital develops, underwrites and distributes structured investments and fixed income securities for institutional and professionally advised individual investors.

Market Leadership

In the US, Incapital LLC is the leading independent distributor of structured investments and fixed income solutions designed for individual investors. Since 2000, over $200 billion of new issue corporate and US Agency securities have been issued through retail note programs. Incapital has been recognized by Institutional Investor as an e-Finance top 40 firm five times in the last seven years and has been awarded 'U.S. Structured Products Distributor of the Year' for four of the last six years.

Incapital Europe began its London-based operations in 2003. In 2010, Incapital Europe acquired the business of Blue Sky Asset Management, a UK-based structured investment specialist with industry leading experience and credentials. Industry awards gained by Blue Sky include 'Best in the UK' 2008, 'Best Research Process' 2008 & 2009, 'Most Useful Industry Website' for investors in the UK' (*Financial Times,* 2009), and 'Best Structured Product Provide, Highly Commended', 2010.

An Independent Platform

Through combining trans-Atlantic capabilities, Incapital delivers the leading global independent platform in structured investment and fixed income securities.

With a diverse range of new issue and secondary market offerings, developed in close consultation and collaboration with wealth management advisers, Incapital Europe champions research-backed, client-centric, 'intelligent' structured investment and fixed income solutions. This expertise includes the scope to develop bespoke and exclusive solutions for high net worth investors.

Best Structured Product Provider

US distributor

Most Useful Industry Website for investors in the UK

Best Research Process

US distributor

Best Research Process

Introduction

Structured investments provide investors with the opportunity to invest in stockmarkets and other asset classes with pre-defined risk and returns potential. Since the early 1990's, structured investments have evolved rapidly worldwide and are now widely regarded as mainstream investment solutions by many investors. In the UK, in 2009, nearly 100 providers issued approximately 1000 products, collectively responsible for retail sales of nearly £14 billion*. Sales volume of this magnitude reflects the diversity of offerings - and demonstrates the wide appeal and flexibility of structured investments to add value in many ways in investors' portfolios.

Investing with the benefit of defined risk and returns potential clearly empathises with the interests of many investors. Especially during periods of stockmarket uncertainty or volatility, structured investments can quantify and specifically state the levels and types of investment risk that may apply to an investor 's capital and/or investment returns - providing innovative and compelling investment solutions, as alternatives or complements to traditional investment funds. However a key risk borne by investors in structured investments is 'Counterparty risk'.

Counterparties are the institutions that issue ie, provide, the securities that deliver the investment returns, including repayment of capital, of structured investments. At its most basic, the simple fact is that structured investments depend entirely upon their Counterparties - in particular, their solvency throughout the investment term. This guide aims to provide an introduction to the role and relevance of Counterparties in structured investments, and offers an overview of relevant 'due diligence' considerations for advisers and investors who may be considering investing in structured investments, including Incapital Europe's investment Plans. It also provides a description of Incapital Europe's approach, in general terms, in certain areas, in relation to Counterparties.

Further information, including the Incapital 'Counterparty Platform' and Incapital 'Counterparty Observers', can be found on the Incapital Europe website: IncapitalEurope.com.

Structured investments can quantify and specifically state the levels and types of investment risk that may apply to an investor's capital and/or investment returns. However, a key risk borne by investors in structured investments is 'Counterparty risk'.

Counterparties are the institutions that issue the securities that deliver the investment returns, including repayment of capital, of structured investments.

Source:* StructuredRetailProducts.com

Counterparties

Incapital Europe works with leading global investment banks and other major financial institutions in developing structured investments for investors. Different banks/institutions specialise in different global markets and asset classes, presenting potentially different strengths, benefits and advantages. Incapital Europe operates with independence, and seeks to deal with the leading institutions in each market, leveraging their specialisation, with particular emphasis on maximising the value of investment thinking, pricing and service. After an analysis of investment issues and investment opportunities, the institutions selected by Incapital Europe issue the securities (ie the financial instruments or assets) that deliver the investment features of Incapital Europe's structured investments.

These institutions are commonly referred to as 'Counterparties'. Counterparties are therefore responsible for the repayment of capital at maturity, subject to any stockmarket risk; any protection from stockmarket falls (whether it is total, ie no stockmarket risk, or a defined level, eg utilising a protection 'barrier' linked to the underlying Index/asset); and any growth or income potential provided by a structured investment.

The securities that Counterparties issue are usually Medium Term Notes, Warrants, or other securities, which are similar to corporate bonds and other debt instruments - often referred to generally as 'bonds'. In effect, an investment in a structured investment is a loan to the Counterparty, in exchange for the returns of the investment, which are specifically structured to match the investment objectives (ie features) and fixed maturity of the Plan.

Counterparties must meet the contractual terms of the bonds that they issue - and their ability to do so largely depends upon their solvency. The risk that they might fail to meet the terms of their bonds is known as 'Counterparty risk', sometimes also referred to as 'credit risk'. A Counterparty failure during the investment term of a structured investment Plan, for instance through insolvency, such as bankruptcy, administration or liquidation, is likely to cause a 'default', ie the Counterparty will fail to make the payments due during the investment term and/or to repay their debts, ie the bonds, at maturity. Usually the risk of a major financial institution failing to be able to meet its commitments in this way can be considered small - but a default or failure puts a structured investment, and any growth or income potential it provides, at risk - so the risk must be understood by investors.

In addition to considering the investment capability and service of different banks/institutions, assessing the financial strength of prospective Counterparties is an important aspect of Incapital Europe's Counterparty evaluation and selection process. The following pages provide background information regarding recognised methods of assessing the financial strength of an institution, ie measuring their 'creditworthiness'.

Structured investments are not risk free - but they do generally define risk, usually quantifying and specifically stating the levels and types of any risk(s) that may apply to capital and/or returns. However, as already detailed, a key risk borne by investors, in structured investments, especially capital protected structured investments, is Counterparty risk. This specifically refers to the risk of the Counterparty issuing the securities backing a structured investment defaulting on its obligations (for instance through insolvency) during the investment term, or at maturity.

Credit Ratings are recognised indicators of the financial strength of an institution. Credit ratings are assigned by independent organisations known as Credit Rating Agencies (CRAs), and the three leading CRAs, designated as Nationally Registered Statistical Rating Organisations (NRSRO’s) by the US Securities and Exchange Commission (the SEC), are Standard and Poor's, Moody's and Fitch Ratings.

Ratings are normally in the form of letter designations, such as AAA, A+, BB, C, etc. These provide investors in the debt securities of these institutions, such as a bond, with an indication of the institution’s strength and ability to meet its obligations in repaying both the principal capital and any income due from the security.

A brief overview of each agency and the ratings designations utilised by each is provided on the following pages. It should be noted that credit ratings are agency opinions of an issuer ’s overall financial capacity (its credit worthiness) to meet its financial commitments – but, in the context of structured investments, credit ratings do not apply to any specific financial obligation. It is also worth highlighting that Credit Rating Agencies are not infallible - and indeed have come under regulatory scrutiny and general criticism recently. A credit rating is not, therefore, a recommendation to purchase, sell, or hold a financial obligation, and a rating is not a comment on, or implied suitability of, any particular structured investment Plan, for any particular investor.

Credit ratings are a recognised indicator of the financial strength of an institution. Credit ratings are not, however, a recommendation of, or implied suitability of, any particular structured investment Plan, for any particular investor.

Standard & Poor's (S&P) is perhaps the most well known Credit Rating Agency (through its US-based S&P 500 Index, etc). S&P dates back to 1860, when Henry Poor published information about the financial and operational state of U.S. railroad companies. The company as it is known today was formed in 1941 with the merger of Poor's Publishing and Standard Statistics. In 1966 S&P was acquired by The McGraw-Hill Companies, which now encompasses the Financial Services division that publishes financial research and analysis on stocks and bonds.

S&P Rating Designations

S&P issues both short-term and long-term credit ratings, rating institutions/bonds on a scale from AAA to D. Intermediate ratings are also offered at each level between AA and CCC (i.e., AA+, AA-, A+, BBB+, etc) to show relative standing within the major categories (+ indicates the higher end of the rating category, - represents the lower). S&P also offers guidance (termed a 'credit watch') as to whether an institution/debt obligation is likely to be upgraded (positive), is (stable) or is likely to be downgraded (negative).

The 'credit watch' positive/negative guidance indicates that a rating may be raised (positive) or lowered (negative) in the short to medium term – circa 6 months to 2 years – although it is not necessarily a precursor to a ratings change.

AAA	The highest rating assigned by Standard & Poor's. The capacity to meet financial commitments is extremely strong (the world's major companies and governments).
AA	Differs from AAA only to a small degree. The capacity to meet financial commitments is very strong.
A	Rated 'A' means somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than higher-rated categories. However, the capacity to meet financial commitments is still strong.
BBB	'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to meet financial commitments.

Website: standardandpoors.com

Moody’s

Moody's Corporation is the holding company for Moody's Investors Service which performs financial research and analysis on government and commercial entities. Moody's was founded in 1909 by John Moody who, similar to Henry Poor, offered investors an analysis of security values through publishing a book that analyzed the railroads and their outstanding securities. Moody's claims that it was the first to rate public market securities. In 1913, Moody expanded his base of analyzed companies, launching his evaluation of industrial companies and utilities and ‘Moody's ratings’ become a factor in the bond market. On July 1, 1914, Moody's Investors Service was incorporated.

Moody’s Rating Designations

Moody's issues both short-term and long-term credit ratings, rating institutions/bonds on a scale from Aaa to Caa. Intermediate ratings are also offered at each level between Aa and Caa (i.e., Aa3, Aa2, Aa1, Baa3, Baa1, Caa2, etc) to show relative standing within the major categories. 2 indicates a mid-range ranking; 3 indicates the lower end of the generic rating category.

Aaa	Judged to be of the highest quality, with minimal credit risk.
Aa	Judged to be of high quality and subject to very low credit risk.
A	Considered upper-medium grade and subject to low credit risk.
Baa	Subject to moderate credit risk, considered medium-grade and as such may possess certain speculative characteristics.

Website: moodys.com

Fitch Ratings

Fitch Ratings is a part of the Fitch Group. The firm was founded by John Fitch on December 24, 1913 in New York City as the Fitch Publishing Company. Fitch is the smallest of the 'big three' NRSRO's, covering a smaller share of the market than S&P and Moody's, although it has grown with acquisitions and frequently positions itself as a 'tie-breaker ' when the other two agencies have ratings similar, but not equal, in scale.

Fitch Rating Designations

Fitch issues both short-term and long-term credit ratings, rating institutions/bonds on a scale from AAA to D. Intermediate ratings are also offered at each level between AAA and CCC (i.e., AA+, AA-, A+, BBB-, etc) to show relative standing within the major categories. (+ indicates the higher end of the rating category, - represents the lower). Fitch also offers guidance (termed a 'rating outlook') as to whether an institution/debt obligation is likely to be upgraded (positive), is (stable) or may be downgraded (negative).

The 'credit watch' positive/negative guidance indicates that a rating may be raised (positive) or lowered (negative) in the short to medium term – circa 6 months to 2 years – although it is not necessarily a precursor to a ratings change.

AAA	The highest credit quality, denotes the lowest expectation of credit risk. Assigned only in the case of exceptionally strong capacity for payment of financial commitments, highly unlikely to be adversely affected by foreseeable events.
AA	Very high credit quality, denotes expectation of very low credit risk. Indicates very strong capacity for payment of financial commitments, not significantly vulnerable to foreseeable events.
A	High credit quality, denotes expectations of low credit risk. The capacity for payment of financial commitments is considered strong, but may be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.
BBB	Good credit quality, indicates that there are currently expectations of low credit risk. The capacity for payment of financial commitments is considered adequate but adverse changes in circumstances and economic conditions are more likely to impair this capacity. This is the lowest investment grade category.

Website: fitchratings.com

Different Credit Rating Designations

Credit Rating Agencies assign ratings based upon views of 'worst possibilities' in the 'visible' future, as opposed to the past record or the present status of the institution/bond. Long term ratings (as defined by the Credit Rating Agencies – which are the ratings referred to in this guide and shown on the Incapital Europe 'Counterparty Platform') – are therefore a reflection/appraisal of the long-term financial outlook and credit risks for institutions, as assessed by the Rating Agencies.

The table below highlights the differences and similarities in the credit rating symbols of the three main Credit Rating Agencies – detailing the long term rating scales for investment grade debt.

Standard and Poor's	Moody's	Fitch Ratings
AAA	Aaa	AAA
AA+ AA AA-	Aa1 Aa2 Aa3	AA+ AA AA-
A+ A A-	A1 A2 A3	A+ A A-
BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-

In addition to noting the obvious (but sometimes confused) differences between the different Credit Rating Agencies and their symbols it is also important to note that even institutions with the same credit rating from the same Rating Agency do not present absolutely equal credit strength/risk. In a broad sense institutions might be alike in their financial position, but as there are only a limited number of rating designations available, for use in grading thousands of risks, the symbols cannot reflect the numerous shadings of risk that actually exist.

Further information, including the current credit ratings ascribed to major banks, can be accessed via the 'Incapital Counterparty Platform', which can be found on the Incapital Europe website: IncapitalEurope.com.

In addition to credit ratings, another instrument used to assess the credit strength and quality of issuers is Credit Default Swap (CDS) spreads. CDS's are credit derivatives that were introduced relatively recently, in 1997, in the 'over-the-counter' market (where buyers and sellers of derivatives trade directly with each other, rather than via recognised exchanges).

Generally, a CDS is a swap agreement/transaction between two parties, in relation to loans, bonds or other debt instruments issued by a company (often called the reference obligation). At a basic level, the buyer of a CDS usually owns the reference obligation e.g. the bonds of a counterparty, and pays a fee to the seller, for a CDS, to get protection, ie insurance, against credit risk. In exchange for paying this fee, the buyer of the CDS will be compensated by the seller if a credit event impacts upon the reference obligation. Potential credit events include default, bankruptcy, debt restructuring, etc. If such credit events occur, the seller of the CDS will receive the reference obligation (now in distress) and the buyer will receive cash to compensate the credit loss. CDS providers include financial institutions, eg banks and hedge funds.

Credit Default Swaps are quoted in the market in the format of an annualised spread, over LIBOR, known as the CDS spread similar, conceptually, to the premium paid for an insurance contract. For example, the CDS spread quoted for a bond issued by XYZ company may be 100 basis points (1 basis point equals 0.01%). If the CDS buyer wants to protect £10 million investment in an XYZ bond, then the buyer has to pay the CDS seller an annual fee of £100,000 (typically paid quarterly).

As a CDS provides protection, ie insurance, against a credit event impacting upon a debt instrument, the CDS spread should widen, ie increase, if the credit derivatives market perceives that the credit strength/quality of the issuer of the debt will deteriorate and, vice versa, if the market perceives the credit strength/quality of the issuer will improve it should narrow, ie decrease. This makes economic sense - the CDS will cost more if the perceived risk of a credit event, eg a default, in respect of the reference obligation increases (or vice-versa).

Credit analysts use CDS spreads as an additional indicator and tool to assess the credit quality of corporates, including financial institutions that issue structured investments. Structured investments are often issued as debt on a bank's balance sheet, and hence the CDS spread is a relevant parameter to examine, within an overall analysis of the credit strength of Counterparties.

It is important to note, however, that just like credit ratings, CDS spreads should not be relied upon in assessing the credit risk of a Counterparty in isolation (especially bearing in mind that credit quality is only one factor that can affect the CDS spread).

Further information, including the current CDS spreads of major banks, can be accessed via the 'Incapital Counterparty Platform', which can be found on the Incapital Europe website: IncapitalEurope.com.

Disclosure of Counterparty Details

Following regulatory guidance provided by the UK's Financial Services Authority in 2009, the literature for structured investments is now expected to detail the identity of the Counterparty that is providing the assets that back any structured investment. In addition, basic information regarding the Counterparty's financial strength (for instance their credit rating and any further pertinent information) is required.

Incapital Europe details underlying Counterparties explicitly and any other relevant information in its Plan literature – and provides further due diligence input to Professional Advisers during the offer period for any Plan. This Guide dovetails with our Plan brochures, to offer further explanation of relevant information, highlighting additional issues relating to understanding Counterparties. Incapital Europe also provides the Incapital 'Counterparty Platform' and Incapital 'Counterparty Observers', which offer credit rating, credit default swap levels and other credit-risk related information and updates (which can be freely accessed by professional clients via the Incapital Europe website: IncapitalEurope.com).

Incapital Europe readily confirms details of all Counterparties that have previously been utilised in openly available Plans. As an independent firm, Incapital Europe ensure that such disclosure is possible – and will not utilise any Counterparty that prevents or is not supportive of full disclosure of their involvement as a structured investment, at the point of Incapital Europe marketing any Plan.

Professional advisers and prospective investors should always ask for - and expect to be provided with - specific Counterparty details prior to investing in a structured investment Plan.

Compensation Scheme Rules

Incapital Europe utilises external Administrators and Account Managers for its structured investment Plans. During the offer period for any Incapital Europe Plan, all investments received are dealt with in accordance with Client Money rules, with the Administrator/Account Manager holding investment monies in ring-fenced Client Money Accounts, pending the Strike Date, ie start, of any Plan. At the Strike Date all the investment monies are used to purchase the underlying securities provided by the Counterparty, which are then held by the Account Manager in a ring-fenced Nominee Account, for the beneficial ownership of investors, throughout the investment term of the Plan.

Both Incapital Europe and our Administrators/Account Managers are regulated by the Financial Services Authority (FSA) and are covered by the Financial Services Compensation Scheme (FSCS). Investors in any Plan should understand, however, that whilst FSCS rules may apply in the event of the insolvency of the bank holding the Client Money Accounts, during the offer period or after maturity, or due to the insolvency of the Administrator/Account Manager, at any time, the Scheme rules do not normally apply solely because a Counterparty defaults upon their obligations. This is because, even if the Counterparty is FSA regulated, a counterparty's obligation is simply to issue the securities - and the possibility, or risk, of their default is inherent in the securities (the same as the possibility of a price fall is inherent in an equity).

It should therefore be understood by investors in structured investments that the Financial Services Compensation Scheme (FSCS) does not cover performance related issues in respect of investments, which means that Counterparty default, ie the insolvency of a Counterparty, or significant falls in an underlying Index or Asset, resulting in a breach of any Plan's level of defined protection, would not result in compensation being available through the FSCS.

It should also be understood by investors in structured investments that Plan assets (ie the underlying securities) are held on their behalf and they do not have a direct legal interest in the securities or rights against the issuing Counterparty, in the event that the Counterparty defaults, ie becomes insolvent.

There is a distinction to be made with regard to FSCS rules and structured deposits - as the default of a licensed deposit-taker, that meets the conditions of the FSA's compensation scheme rules, may qualify for FSCS protection.

Financial Services Compensation Scheme (FSCS) rules may apply to the insolvency of an Account Manager, but do not normally apply in the case of Counterparty default, ie Counterparty insolvency, which is considered to be a 'performance issue'.

Incapital Europe's Approach to Counterparties

Incapital Europe operates with independence from all Counterparties, without any institutional bias, providing a significant benefit and advantage to investors. This is distinct from the majority of structured investments, where providers are often linked to an internal bank or solitary Counterparty.

Incapital Europe's approach to Counterparties places emphasis on balancing and combining various aspects of evaluation, selection and monitoring. Credit ratings and credit default swap spreads are both important indicators of the credit quality and financial strength of Counterparties, however Incapital Europe does not place over reliance on either indicator, especially in isolation - and both are taken into account, with similarities, differences and/or anomalies considered and assessed. Further, in addition to assessing headline indicators of corporate strength, ie credit ratings and credit default swaps, Incapital Europe considers financial ' fundamentals' and wider aspects of Counterparties' background. This includes Group, ie parent company, aspects, such as the jurisdiction for regulatory purposes and the strength of the Sovereign State, where relevant, as well as the specifics of how individual Counterparties manage their derivatives business, their structuring capabilities, and their commitment to post-sales service for investors.

In addition to the specific aspects of 'understanding Counterparties', in terms of their role and relevance in structured investments, together with the input that is offered regarding sensible consideration of Counterparty due diligence and assessment, two general points are worth highlighting in conclusion:-

- **'Flight to Quality':** Discerning investors should seek providers and structured investments that utilise Counterparties that are highly rated and regarded, taking into account various and combined factors in a balanced approach. Higher headline rates can be achieved by providers who utilise (or are internally linked to) weaker Counterparties – but investors should differentiate between headline rate driven products and potentially better value investment integrity.
- **Diversification:** As with any type of investment, prudent investors should also seek to diversify their portfolios – which in terms of structured investments most importantly means considering the underlying Counterparty, and limiting, or diversifying, exposure to or reliance upon any single Counterparty, in order to mitigate 'concentration risk'. Incapital Europe's independence from all Counterparties facilitates potential diversification of Counterparty exposure through the range of institutions that we work with.

Incapital Europe emphasises the importance of advisers and investors adopting a balanced approach in their consideration of structured investments, assessing Counterparties sensibly, carefully and prudently.

The Importance of Professional Advice

Incapital Europe believes professionally advised investors make better investment decisions, that can impact positively upon long term investment performance. Incapital Europe's investment propositions are therefore made available exclusively through independent wealth management firms and investment advisers, who select investments on merit to meet precise investor needs and interests. Incapital Europe always recommends investors discuss their investment needs with an independent Professional Adviser before making investment decisions.

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