Career Ready Academy

TEXTBOOK

Structured Deposits

Final Module for COB 6

virtualclc.co.za
010 597 0835
14 Vermooten Street Alberton

Ordering information

If you would like to order the publication, please contact the author at anna@virtualclc.co.za

TABLE OF CONTENTS

INTRODUCTION

An FSP must ensure that it, its key individuals and representatives are proficient in respect of, understand, and have completed adequate and appropriate class of business training and product specific training relevant to, the particular financial products in respect of which they render financial services or manages or oversees the rendering of financial services.

Class of business training, where appropriate must include training on the following:

The range of financial products within the class of business.

The general characteristics, terms and features of financial products in the class of business and any specialist characteristics, terms and features in respect of financial products in the class of business.

The typical fee structures, charges and other costs associated with products in the class of business.

General risk associated with investing, purchasing or transacting in the products in the class of business.

Investment and risk principles, options and strategies in respect of products in the class of business.

The appropriateness of different products or product features in the class of business for different types of clients or group of clients.

The typical role players or market participants in respect of products in the class of business, including their legal structure.

The impact of applicable legislation, including taxation laws, on product in the class of business.

The impact of applicable economic and environmental factors on the products in the class of business and the performance of those products including:

- The economic and business environment and cycles.
- Inflation.
- Government monetary and fiscal policy.
- Interest rates and exchange rates.

Any inter-relationship within and between particular classes of business.

Industry standards and codes of conduct relevant to class of business

This module is the final module in order to be certified for COB Class 6: Structured deposits.

To be certified, complete all of the required modules:

- COB General Module: All Classes of Business
- COB Intermediate Module: Class 3, 4, 7 & 8
- COB Intermediate Module: Class 5 & 6
- COB Final Module: Class 6

Topic 1 Fundamentals of Structured Deposits

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Understand which type of investor structured deposits are suitable for.
- Describe the return on structured deposits
- Understand the types of structured deposits
- Name the advantages and disadvantages of investing in structured deposits.
- Describe the difference between a structured deposit and a fixed deposit.
- Name the risks associated with structured deposits.

1.1 INTRODUCTION

Structured deposit as defined in the Financial Advisory and Intermediary Services (FAIS) Act mean one of the following:

- ☐ A combination of a short-term deposit or a long-term deposit and another tier 1 financial product.
- ☐ A short-term deposit or long-term deposit where the return or value is dependent on the performance of or is derived from the return or value of one more underlying financial product, asset, rate or index on a measure of economic value or on a default event.

According to this definition a structured deposit combines a deposit with an investment product. The return on a structured deposit depends on the performance of an underlying financial asset, product or benchmark. These may include market indices, shares, interest rates, bonds or other fixed-income securities, foreign exchange rates, or a combination of these.

The full principle amount of the investment will be returned to the investor if held to maturity and the deposit institution remains solvent.

In 2014, discussions were held between the banking sector and the regulator with regard to exempting all representatives dealing with deposits from having to meet the FAIS competency requirements. However, the regulator felt that not all deposits have the same risk profile, especially products linked to investments. This led to the establishment of structured deposits as a separate product category for purpose of FAIS.

Information about existing structured deposit offering in South Africa is scarce. This might be because the product category is new and financial institutions are still developing these new products, or because the typical client is a high-net-worth individual or private banking client, and products are customised to their particular needs, with no readily available or generic product facts.

1.2 SUITABILITY OF STRUCTURED DEPOSITS

Structured deposits may be suitable for investors who want exposure to assets or markets that are not easily accessible to retail investors.

The product will suit an investor who wants potentially higher returns but are also prepared for variable returns. Structured deposits usually have a maturity date of between 2 months to 10 years, therefore the investor must have no immediate need for the funds.

It is utmost important that the investor understand the risks associated with structured deposits.

Before recommending a structured product to an investor, it should be ensured that-

- ☐ Investing in a structured deposit is in line with the investment objectives of the investor.
- ☐ The investor understands the factor that impact on return. Therefore, the investor must understand the underlying financial asset, product or benchmark and are comfortable with the exposure and the market view they are taking.
- ☐ That the investor understands the risks and that these risks match the investor's risk profile.
- ☐ The investor is comfortable with the credit risk of the deposit taking institution that the money is placed with.

1.3 THE RETURNS ON STRUCTURED DEPOSITS

The return is calculated according to a formula set out in the structured deposit's terms and conditions.

A structured deposit is different from a fixed deposit. Structured deposits may provide the potential for higher returns compared to fixed deposits, but the investor takes on more risks, including the possibility that returns are lower than expected.

At maturity, the investor will receive the principal amount of the structured deposit. But just like traditional deposits, the return of the principal and any returns is subject to the credit risk of the bank holding the deposit.

If the deposit is withdrawn early, the investor may not get back 100% of the money invested.

1.4 TYPES OF STRUCTURED DEPOSITS

The following types of structured deposits are considered in the subsections following:

- ☐ Equity-linked deposits
- ☐ Bond-linked deposits
- ☐ Rate-linked deposits
- ☐ Credit-linked deposits

Structured deposits may be offered in tranches. Each tranche has either a fixed offer period or is available until the tranche is fully subscribed. The tranches may come with differing features and returns.

1.4.1 Equity Linked Deposit

Equity-linked deposits are deposits where the return is a variable interest rate linked to the return of a single share, basked of shares, equity index or a basket of indices.

What is an index?

An index in finance is a statistical measure of change in a securities market. Equity and bond market indices consist of a hypothetical portfolio of securities representing a particular market or a segment of it. In most cases, the relative change of an index is more important than the actual numeric value of the index.

1.4.2 Bond-Linked Deposit

Bond-linked deposits are deposits where the return is a variable interest rate linked to a return of a single bond, basked of bonds, bond index or a basket of bond indices.

1.4.3 Rate Linked Deposit

Rate-linked deposits are deposits where the return is a variable rate based upon a formula that is tied to the performance of one or more rate for example a market interest rate such as JIBAR (Johannesburg Interbank Agreed Rate) or the inflation rate.

Returns may be directly linked to the specified interest rate, i.e. if the specified interest rate rises, the returns will rise and if the interest rate falls, the returns fall. But some returns are inversely related, i.e. when the specified interest rate falls, the investor get better returns and if the interest rate rises, the investor return falls. Such products are usually called inverse floaters or reverse floaters.

Payments may also rise or "step up" on fixed dates if deposit is not redeemed by issuer. An example is the 7-day step-up notice deposit made available by RMB. This product offers investors a 3-month JIBAR linked return whilst at the same time allowing for increased liquidity with a 1-week notice period. The investor is rewarded for their loyalty and thus as duration of the investment term increases, the investment's returns increase according to the pre-quoted dynamic spread.

Rate linked deposits are usually callable by the deposit taking institution which cap the potential for higher gains and also introduce reinvestment risk.

The most common type in South Africa is the inflation link deposit. The interest earned on an Inflation-Linked Deposit is calculated using the inflation rate (a variable rate), together with a fixed top-up rate.

$$\text{Inflation} - \text{Linked Deposit Return} = \text{Inflation Rate (variable)} + \text{Top Up Rate (fixed)}$$

The inflation rate is linked to the consumer price index (CPI) in South Africa, as published monthly by Statistics South Africa. This rate is applied in arrears portion of your rate will change monthly according to changes in the inflation rate.

1.4.4 Credit-Linked Deposits

Credit-linked deposits are deposits where the payment of the interest rate partially or in full is linked to the credit quality of a specified entity or entities.

If there is a credit event, for example the entity becomes insolvent or defaults on its loans, there may be no return payable on the deposit.

1.5 STRUCTURED DEPOSITS VERSUS FIXED DEPOSITS

In the case of fixed deposits, the returns and maturity periods are fixed. Structured deposits, on the other hand, have variable returns, and in some cases, variable maturities as well.

The table following considers the main features of structured deposits and fixed deposits.

	Structured Deposits	Fixed Deposits
Minimum deposit	A higher minimum investment amount may be required	Minimum amount for a fixed deposit can be less
Maturity period	Varies from 2 weeks to 10 years.	Varies from 1 month to 3 years.
Principal	Principal (or capital) will be repaid in full at maturity or if bank redeems (or "calls") deposit before maturity.	Principal (or capital) will be repaid in full at maturity.
Returns	Potentially higher returns compared with fixed deposits.	Returns are usually lower.
Risks involved	Riskier than traditional deposits because returns depend on performance of other assets or indices. Investor may receive no returns although investor would be repaid the principal invested at maturity. Where a structured deposit is callable, the investor may be exposed to reinvestment risk, i.e. risk of having to reinvest your money at less attractive rates. Investor is also exposed to credit risk of deposit-taking institution.	Considered low risk as institution are obligated to repay the principal in full at maturity. However, depositors are exposed to credit risk of deposit-taking institution.
Early withdrawal by depositor	The investor may lose part of return and/or principal if deposit is withdrawn before maturity. Amount repaid depends on market value of underlying asset or index linked to structured deposit. Structured deposits may not be valued daily. If so, the investor may not be able to withdraw the deposit immediately.	Early withdrawal may attract certain bank charges and a penalty may be payable.
Early redemption / callable by issuer (variable maturity)	Structured deposit may allow the bank to redeem (or "call") the deposit early. This means the maximum returns to the investor are capped.	No early redemption by bank.
Guaranteed payments	Some structured deposits provide higher guaranteed early payments compared to traditional fixed deposits. Such payments are usually only for the first few months or years; payments in later years may be variable.	Interest is guaranteed and fixed throughout term of fixed deposit (provided there is no early withdrawal).

Table 1.5. 1: The Features of Structured Deposits and Fixed Deposits

1.6 ADVANTAGES OF INVESTING IN A STRUCTURED DEPOSIT

The following are advantages of investing in a structured deposit:

- ☐ The combination of capital protection and index-linked growth potential gives investors the opportunity to receive higher returns than could be achieved through traditional savings accounts.
- ☐ Market exposure is limited to ensure investors receive their initial deposit regardless of how the index performs.
- ☐ Structured deposits guarantee that regardless of the performance of the underlying asset, the investor will always get back the initial investment if held until maturity.

1.7 DISADVANTAGES OF INVESTING IN A STRUCTURED DEPOSIT

The following are disadvantages of investing in a structured deposit:

- ☐ The reduction in risk is offset by the lowered potential for reward. This means investors probably won't receive the full benefit of any index rise and nor will they receive dividend payments.
- ☐ The complexity of structured deposits can leave many investors confused.
- ☐ Structured deposits are not the same as standard bank or building society savings accounts as there is no guarantee of returns being achieved.

1.8 RISKS ASSOCIATED WITH STRUCTURED DEPOSITS

The subsections following considers the risks associated with structured deposits.

1.8.1 Withdrawal Before Maturity Date

There may be substantial losses to the principal amount if investor chooses to end the investment early.

The investor should also bear in mind that structured deposits may be subject to periodic valuation, which may not be on a daily basis. This means that the investor may not be able to withdraw your deposit immediately.

Check the terms and conditions for early withdrawal of the deposit with the deposit taking institution.

1.8.2 Credit Risk

If the deposit taking institution defaults, the investor may lose all of the investment. The deposit taking institution may also be exposed to the credit risk of a counterparty depending on the structure of the product.

1.8.3 Reinvestment Risk

If the structured deposit is callable, the investor may have the risk to reinvest the money at less attractive rates.

1.8.4 Liquidity Risk

There is limited liquidity for structured deposits unlike direct investment in the underlying asset. The investor cannot sell a structured deposit to another investor, the only recourse for redemption is the deposit taking institution.

1.8.5 Market Risk

The return on a structured deposit is dependent on the performance of the underlying investment instrument. If the underlying investment may not move in the direction or by the amount, the investor expects.

If returns are capped, the investor bear the risk of foregoing the potentially higher returns that could be received from investing directly in the underlying asset.

1.9 TAXATION ON INTEREST EARNED

This interest income is subject to income tax and is taxed at your marginal tax rate. Individual taxpayers enjoy an annual exemption on all South African interest income they earn, set by SARS every year. For both 2018 and 2019, this exemption is R23,800 for individuals under 65 years old and R34,500 for individuals 65 years and older.

The deposit taking institute does not withhold tax from interest earned and the holder must declare the interest income to SARS.