MAKING SENSE OF STRUCTURED DEPOSITS

There are a variety of structured deposits being offered in the market today. They have many characteristics that are similar to investments and may be complex. The purpose of this guide is to help you understand what structured deposits are and what you should look out for before investing in such products.

We start with a case story of how one person had bought a structured deposit without fully understanding how it worked.

CASE STORY

Mr Daniel Goh put $50,000 of his savings into a 5-year equity-linked structured deposit, offering principal protection and a higher return compared to a fixed deposit. The exact size of the return would depend on the performance of a basket of stocks. Two weeks after buying the product, Mr Goh needed money urgently and approached the bank to withdraw his structured deposit. The bank informed him that this would be regarded as an early withdrawal. The bank explained that it would have to unwind the positions it had taken in the underlying stocks at their prevailing market value. This would result in a loss of $7,000 on his original investment of $50,000.

WHAT IS A STRUCTURED DEPOSIT?

A structured deposit is essentially a combination of a deposit and an investment product, where the return is dependent on the performance of some underlying financial instrument. Typical financial instruments linked to such deposits include market indices, equities, interest rates, fixed-income instruments, foreign exchange or a combination of these.

HOW DO STRUCTURED DEPOSITS COMPARE WITH FIXED DEPOSITS?

Structured deposits have some important characteristics that distinguish them from traditional 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.

Variable returns - Structured deposits generally provide the possibility of higher returns compared to fixed deposits. However, you should balance this possibility of higher returns against the risk of variable returns. In some scenarios, you may get lower or no returns at all.

Variable maturities - Structured deposits have maturity periods that vary from as short as 2 weeks to as long as 10 years. This means that you may not be able to use your money for other purposes before maturity. Some structured deposits include an agreement that enables the bank to redeem or "call" the deposit before the maturity date for reasons specified in the terms and conditions of your contract. Where a structured deposit is callable, you can expect to receive, at a minimum, the full value of your principal. Depending on the circumstances, this early redemption feature may benefit you. For example, if you wish to use your money in other ways, you can get back your principal (and possibly, additional returns) as soon as redemption occurs. You may, however, be exposed to reinvestment risk. This is the risk of having to invest your money in a low interest rate environment when interest rates fall.

Depending on market conditions and your specific investment needs, a structured deposit may or may not be a good investment to put your money in. You should ask your financial adviser to explain the risks and returns of the product under various market conditions.

WHAT HAPPENS IF I NEED TO WITHDRAW MY DEPOSIT BEFORE THE MATURITY DATE?

Structured deposits, like fixed deposits, are meant to be held to maturity. Your principal will be repaid in full only at maturity. If you withdraw your deposit before the maturity date, you may lose part of your return and/or principal. The amount payable to you depends on the market value of the underlying financial instrument that your structured deposit is linked to, which cannot be pre-determined.

You 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 you may not be able to withdraw your deposit immediately. Check the terms and conditions for early withdrawal of the deposit with your bank.

WHAT SHOULD I CONSIDER BEFORE INVESTING IN A STRUCTURED DEPOSIT?

Structured deposits come in different forms. You should consider whether a structured deposit fits with your financial goals, risk appetite and personal situation. When choosing a structured deposit, consider the following:

- ☑ **Liquidity.** Consider your liquidity needs as your money will be tied up for a period of time and early withdrawal may result in loss of part of your return and/or principal. Make sure that you have sufficient savings set aside before investing in structured deposits.

- ☑ **Risks.** Determine whether you have the risk appetite for these products. Structured deposits are riskier than normal fixed deposits. You should understand the risks involved and what will happen in a worst-case scenario. If you are unsure, seek financial advice from a professional.

- ☑ **Returns.** As structured deposits are tied to underlying financial instruments such as market indices, equities, interest rates, fixed-income instruments, foreign exchange, or a combination of these, you should understand how the performance of these instruments affect the return on your deposit. Remember that past performance is not necessarily indicative of future performance.

☑ **Terms and Conditions.** Read the terms and conditions and other documentation of the structured deposit carefully before making any commitment. If you do not understand how the product works, seek clarification. Do not buy anything you do not understand.

WHAT INFORMATION SHOULD A FINANCIAL ADVISER DISCLOSE TO ME WHEN RECOMMENDING A STRUCTURED DEPOSIT?

Structured deposits will be regulated under the Financial Advisers Act (FAA) from 1 June 2005. From this date, persons advising on such products are subject to the standards of conduct set out in the FAA Guidelines on Structured Deposits. Under the FAA, only qualified financial adviser representatives are allowed to market or provide financial advisory services on structured deposits.

When the new rules come into effect, your financial adviser must provide you with a fair and adequate description of all material information on the structured deposit including:

- Nature of the product and how it works, including the underlying financial instruments used.
- Details of the product provider.
- Benefits that are likely to be derived from the product, the amount and timing of benefits and whether the benefits are guaranteed or non-guaranteed. Examples of how structured deposits work, including a worst-case scenario, should be provided. Be wary of headline rates or examples showing benefits that are unrealistic and unlikely to be achieved.
- Risk factors that may affect your returns or put your principal at risk.
- All fees or other charges.
- Early termination clauses including the fact that the principal is only guaranteed if the product is held to maturity.
- Any warnings, exclusions or disclaimers in relation to the product.

For more information on the FAA and the FAA Guidelines on Structured Deposits, visit the MAS website at www.mas.gov.sg. You can also refer to the guide, "Dealing With A Financial Adviser: What To Look Out For?" at www.mas.gov.sg/consumer.

More information on structured deposits and how they compare with Singapore dollar fixed deposits can be found in the full version of this guide available at www.mas.gov.sg/consumer.

APPENDIX 1

This table illustrates the main features of structured deposits and Singapore dollar fixed deposits. It should not be taken as representative of all situations.

Features	Structured Deposit	S$ Fixed Deposit
Minimum deposit	Structured deposits may require a higher minimum investment amount (usually $5,000).	The minimum amount for a fixed deposit can be as low as $1,000.
Maturity	Structured deposits have maturity periods that vary from as short as 2 weeks to as long as 10 years.	Fixed deposits have maturities ranging from 1 month to 3 years.
Principal	Your principal (or capital) will be repaid in full: (i) At maturity; or (ii) If the bank redeems it before maturity. This will apply only if your structured deposit includes an option that enables the bank to redeem or "call" the deposit before the maturity date for reasons specified in the terms and conditions of your contract.	Your principal (or capital) will be repaid in full at maturity.
Early withdrawal by the depositor	If you withdraw your deposit before the maturity date, you may lose part of your return and/or principal. The amount that you will be paid depends on the market value of the underlying financial instrument that your structured deposit is tied to, which cannot be pre-determined. You 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 you may not be able to withdraw your deposit immediately. Check the	If you withdraw your fixed deposit before maturity, the bank may levy certain charges. In most cases, your bank would have taken a corresponding commitment on your deposit with a counterparty. When you withdraw your deposit early, your bank may have to levy charges to cover the cost of its own commitment. Check the terms and conditions for early withdrawal of the deposit with your bank.

Features	Structured Deposit	S$ Fixed Deposit
Early withdrawal by the depositor (cont'd)	terms and conditions for early withdrawal of the deposit with your bank.	
Early redemption by the issuer	Structured deposits may have clauses which allow the bank to exercise an option to "call" or redeem the deposit early. Such clauses allow banks to cap the maximum returns you may receive. However, at a minimum, you should expect to receive the full amount of your principal (or capital).	Fixed deposits do not have clauses that allow the bank to redeem the deposit early.
Risks involved	Structured deposits are generally less risky than direct investments in other financial instruments such as stocks and bonds because the bank is obliged to repay the principal in full at maturity or when it redeems the deposit before the maturity date. However, they are riskier than traditional deposits because their returns are dependent on the performance of other financial instruments that they are tied to. In some scenarios, you may get no returns at all and only get back your principal. Where a structured deposit is callable, you may be exposed to reinvestment risk. This is the risk of having to invest your money in a low interest rate environment when interest rates fall. Structured deposits have maturity	Fixed deposits are considered low-risk as they are typically placed in the money market over a short period of time (for example, overnight).

Features	Structured Deposit	S$ Fixed Deposit
Risks involved (cont'd)	periods that vary from as short as 2 weeks to as long as 10 years. This means that you may not be able to use your money for other purposes before maturity, for example, investing your funds in a fixed deposit or an alternative financial instrument offering higher interest rates when interest rates rise.	
Returns	Structured deposits generally provide the possibility of higher returns compared to fixed deposits. This is in line with the higher risks you have to bear. The return on a structured deposit is dependent on the performance of the underlying financial instrument (such as market indices, equities, interest rates, fixed-income instruments, foreign exchange, or a combination of these) to which the structured deposit is linked. The returns that you receive may further depend on two other components: (i) the "cap" rate on the underlying financial instrument; and/or (ii) the participation rate. The following examples will explain these two concepts. These examples are meant for illustrative purposes and may not be representative of all situations.	Returns on fixed deposits are typically lower as they are less risky than structured deposits. This is because the funds are normally placed in the money market over a short period of time (for example, overnight).
	Example: Take the case of a 5-year equity-linked structured deposit with a 5-year maturity. Assume that the specific equity index to which the deposit is linked rises by 20% at maturity:	

Features	Structured Deposit	S$ Fixed Deposit
Returns (cont'd)	1. If your return is only determined by a "cap" rate stated in your contract, say a maximum return of 15%, you will not be able to get a return of more than 15%. 2. If your return depends only on the participation rate (usually pre-determined in your contract), say 40% in this example, you will only be able to participate in 40% of the 20% rise in the equity index i.e. 40% x 20% = 8%. 3. If your return is determined by both a "cap" rate as well as a participation rate, you will receive 40% of the 15% "capped" return. Your potential return is therefore 40% x 15% = 6%. The final return in each of the examples above is not the effective rate of return. You may wish to ask your financial adviser to help you work out the effective rate of return.	

Guaranteed payouts	Some structured deposits may come with the promise of a higher guaranteed early payout compared to traditional fixed deposits. However, these payouts are different from the normal interest payouts as they are typically only paid in the first few months or years and the payouts in subsequent years may be variable. You may wish to consult your financial adviser on the effective rate of return over the tenor of the deposit.	Interest is guaranteed and fixed throughout the tenor of the fixed deposit (provided you do not withdraw the fixed deposit early).

APPENDIX 2

There are a variety of structured deposits being offered in the market. The following table gives a brief description of the different kinds of structured deposits available and highlights some of the risks unique to each type. The table provides general information and is not meant to be exhaustive.

Type of Structured Deposit	Description	Risks Involved
Equity or Bond-linked	• Equity-linked deposits are linked to stocks, or a basket of stocks, as determined by the issuer. • Equity-linked deposits may also be linked to an equity index (for example, the S&P 500) or a group of indices. • Bond-linked deposits are linked to bonds (for example, Singapore Government Securities).	• Returns are dependent on the performance of the equities/bond market. You are exposed to the risk that the markets do not move in the direction you anticipated. • You are also exposed to the risk that the issuer of the bonds or stocks becomes insolvent. If this happens, your returns may be zero. • In some cases the issuer may cap returns, or may exercise its right to cap returns if the equities/bond market perform far beyond expectations. With returns capped, you bear the opportunity cost of potentially higher returns had you invested directly in the equities or bonds.
Dual/Twin Currency	• Dual/Twin currency deposits involve a base currency (the currency in which the deposit is made), an alternate currency and the setting of a pre-agreed exchange rate between the two. You may select the two currencies.	• You are exposed to the risk that foreign exchange rates do not move in the direction you anticipated.

Type of Structured Deposit	Description	Risks Involved
Dual/Twin Currency (cont'd)	• At maturity, banks have an option to repay you in either the base or alternate currency, at the pre-agreed exchange rate. • Interest will be higher compared to a traditional foreign currency fixed deposit.	• You should also bear in mind that if the maturity proceeds (principal plus interest) are paid in the alternate currency, you may experience a loss on your principal when you convert it back to your base currency. You should only invest in such products if you are comfortable with receiving your money at maturity in the alternate currency.
Interest rates-linked	• Returns for such deposits are usually linked to a formula that makes reference to a specific floating interest rate (for example, the Singapore Interbank Offer Rate). • The formulas used for such deposits may display a number of characteristics. Instead of being directly related to the specified interest rate, your returns may be inversely related i.e. when the specified interest rate falls, you may get better returns. Such products may be called "inverse floaters" or "reverse floaters". • The payouts on such deposits may also rise or "step up" at pre-determined points in time if the deposit is not redeemed by the issuer.	• Your returns may depend on the direction in which interest rates move, or the pace at which interest rates change. • You are exposed to the risk that interest rates do not move in the direction you anticipated, or the interest rate curve is steeper or more gradual than you had anticipated.

Type of Structured Deposit	Description	Risks Involved
Credit-linked	• Unlike other structured deposits, returns on this type of deposit is not linked to the performance of a financial instrument, but rather the occurrence of what is known as a "credit event" (for example, if a specified company becomes insolvent or defaults on its loans).	• Your returns are entirely exposed to the credit risk of the specified company, or any other party that the issuer has entered into a contract with. You will need to be able to assess the likelihood of a credit event occurring to this party.