



**ISLE OF MAN  
FINANCIAL SERVICES AUTHORITY**

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*Lught-Reill Shirveishyn Argidoil Ellan Vannin*

# **GUIDANCE NOTE FOR DEPOSIT TAKERS**

**(Class 1(1) and Class 1(2))**

**OTC Derivatives and Structured Deposits**

**March 2017**

## **STATUS OF GUIDANCE**

*The Isle of Man Financial Services Authority (“the Authority”) issues guidance for various purposes including to illustrate best practice, to assist licenceholders to comply with legislation and to provide examples or illustrations. Guidance is, by its nature, not law, however it is persuasive. Where a person follows guidance this would tend to indicate compliance with the legislative provisions, and vice versa.*

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## Part 1 – Deposit takers incorporated in the Isle of Man

This guidance applies to deposit takers holding either a Class 1(1) or Class 1(2) licence. For the purpose of this document they are collectively referred to as “banks” or “bank”.

### 1. Rationale

1.1 Prior to the proliferation of structured deposits, the use of over the counter (“OTC”) derivatives on the Isle of Man had been limited to a small number of banks that used simple derivatives to hedge interest rate and foreign exchange risk.

1.2 Banks in the Isle of Man who offer and market structured deposits generally hedge the risk by placing a deposit with the product originator (either a group member or a third party) as a packaged transaction. In these cases, the placement is often regarded as a pure deposit, and sometimes full regard is not taken of the potential replacement cost of the embedded or implied derivative(s) within the product. There are numerous reasons why a counterparty may not honour its obligations under a derivative contract, including legal issues. In the event of such a counterparty failing to honour the derivative contract embedded in a structured product, a bank may be exposed to replacement cost that it has not recognised for capital adequacy purposes. The Authority’s reporting forms capture such risk for capital adequacy.

1.3 Structured deposits<sup>1</sup> can be complex and, in Class 1(1) banks, may be offered to the general public. It is therefore important that banks maintain high standards of advertising and promotion at all times.

1.3.1 It is important that banks ensure their products, including structured deposits, are suitable for their customers.

Advertising and promotional literature should give clear and accurate information on the product in accordance with rule 6.12, including, but not limited to, the effects of any averaging, the underlying markets, and potential yields.

1.3.2 Any back-testing or illustrations should be representative and reasonable and include a warning that past performance is not an indicator of future performance, as per rule 6.12 (1)(d)(ii).

1.4 Rule 6.73 specifically outlines the information which has to be disclosed to a depositor prior to providing a structured deposit, which must include all the key characteristics of the product.

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<sup>1</sup> Structured deposit is defined in the Financial Services Rule Book, also see **appendix 1**.

- 1.5 Rule 6.73 (1) (b) advises that a depositor must, prior to making a deposit be advised that, where a structured deposit's return at the end of its term is zero, the depositor's real rate of return may be negative. The Authority does however note that this disclosure, in absolute terms assumes that there is inflation rather than deflation. In theory, at least two other possible states exist: that the real rate of return is zero (as inflation is zero); or that the real rate of return, relative to deflation may in fact be positive.

## 2. Overview of the Authority's Approach to OTC Derivatives and Structured Deposits

- 2.1 The Authority expects management and sales staff of a bank to have a clear understanding of a structured deposit and the risks that both the bank and its clients may be exposed to, before the product is launched.
- 2.2 The Authority expects the bank to have a clear understanding of what constitutes a structured deposit compared to some other structured products that would be investment products (see **Appendix 1** for definitions).
- 2.3 It is expected that all staff involved in the sale of a structured deposit are competent to do so, receive appropriate training and are able to respond to queries that might arise from time to time as per rule 6.74.
- 2.4 Where it is reasonably believed that a potential depositor does not understand the structured deposit and its risks, the bank must warn the potential depositor of that fact and suggest an alternative type of deposit is made (if any) – rule 6.74 (1) (c) refers.
- 2.5 The bank should recognise market risk inherent in any new structured deposit it intends to market and ensure that such risk is authorised under the market risk policy approved by the Board.
- 2.6 The Financial Services Rule Book ("the Rule Book"), Rule 8.13 (b) states that: "a licenceholder must notify the Authority, not less than 20 business days in advance, of any material cessation of, or material addition or change to, the services or products which it offers..." This requirement also applies to any overseas branches of the bank. It is therefore required that details of all new structured deposits be notified to the Authority prior to their launch. Specific definitions for additions and materiality may be found in **Appendix 1**, and general guidance to Rule 8.13 is also provided – this states: "the Authority expects to be notified of any change to an existing structured deposit and to be provided with a copy of the marketing literature. The Authority's focus is to ensure that the product is being promoted in a way that is fair and accurate. The fact that the Authority has been notified and has raised no objections should not be regarded as an endorsement or approval of the product or service."

It is recognised that some banks tailor structured products (including structured deposits) to the specific requirements of individual (and more sophisticated) customers. Such structures **do not** require notification to the Authority under section 2.4 or Rule 8.13 (b), but should be included in reporting on form SR-1B unless otherwise exempted (see **appendix 2**).

- 2.7 Banks will be required to report all OTC derivatives using form SR-1B, including those that are embedded or implied in structured deposits. It is recognised that it may be appropriate to exempt certain shorter dated products with a capped pay out from reporting requirements on the grounds of materiality (see **appendix 2**).

### 3. Procedures and Systems

- 3.1 The Authority recommends that banks formulate a review procedure for all new structured products, including structured deposits. As a minimum, the following points should be considered:

- a) Is investment business (class 2) approval required (i.e. if the products are not structured deposits)?
- b) Is an upgrade to your investment business (class 2) authorisation required?
- c) What is the potential impact on the bank's capital requirements relating to the product in the case of an implied yield of 100% of the nominal amount at maturity of the product, or the maximum pay-out in the case of a capped product?
- d) Is the yield from the product likely to be classified as interest or investment income?
- e) Are the bank's systems capable of accurately recording the product?
- f) Are all legal or jurisdictional issues clearly understood?
- g) Does the bank intend to include a disclaimer in the terms and conditions of the product to cover the failure of a derivative counterparty to honour its obligations under the contract?
- h) Do the bank's sales staff fully understand the product, and have they received the relevant training?
- i) Is the marketing material balanced as to the benefits and risks of the product, and has the suitability of the product to various customer profiles been considered?
- j) Who is the target market and do they require advice?
- k) For deposit takers holding a Class 1(1) licence, how will the product be offered to the general public?

### 3.2 Treatment of OTC Derivatives

3.2.1 The contribution to risk weighted assets (and thus capital adequacy) arising from an off balance sheet contract is calculated automatically on Form SR-1B by the multiplication of its credit equivalent amount (“CEA”) by the appropriate counterparty risk weight. More detail is provided in chapters 3 and 4 (depending on the approach to credit risk adopted by the bank) of the Authority’s guidance note on quarterly prudential returns.

3.2.2 The CEA should be calculated using the replacement cost method.

3.2.3 The CEA of an OTC contract is the sum of:

- a) The total replacement cost of all contracts with a positive value obtained by marking to market, and
- b) An amount to capture the potential future exposure on all contracts, the *add-on*.

3.2.4 The add-ons which should be used are show in the following table:

Type of Contract	Residual maturity of Contract		
	< 1 Year	>1 Year < 5Years	5 Years >
Interest Rate	0.0%	0.5%	1.5%
Foreign Exchange (including Gold)	1.0%	5.0%	7.5%
Equities	6.0%	8.0%	10.0%
Precious Metals (Except Gold)	7.0%	7.0%	8.0%
Commodities	10.0%	12.0%	15.0%

- a) These add-ons should be calculated by taking a percentage of the notional principal amount of each contract, according to the residual maturity of each contract, and summing the results.
- b) Contracts that do not fall within one of the five categories above should be treated in the same way as commodity contracts.

3.2.5 No CEA is reportable either for contracts traded on recognised exchanges that are subject to daily margining requirements, OTC contracts cleared by a

clearing house where the latter acts as the legal counterparty and all participants collateralise on a daily basis, or for OTC foreign exchange contracts (except contracts concerning gold) with an original maturity of 14 calendar days or less.

#### **4. Quantitative Requirements**

Banks should mark to market in a prudent and consistent manner. It is recognised that often no readily observable market prices are available for these products, and that banks may not have the systems or expertise to disaggregate the components of the structure. However, banks are reminded that it is a standard market convention for the seller of a structured product to also act as revaluation agent. The Authority will accept valuations from these sources.

## **Part 2 – Deposit takers operating in or from the Isle of Man which are incorporated outside the Isle of Man (“branches”)**

This guidance applies to deposit takers holding either a Class 1(1) or Class 1(2) licence. For the purpose of this document they are collectively referred to as “banks” or “bank”.

### **1. Rationale**

- 1.1 Prior to the proliferation of structured deposits, the use of over the counter (“OTC”) derivatives on the Isle of Man had been limited to a small number of banks that used simple derivatives to hedge interest rate and foreign exchange risk.
- 1.2 Structured deposits can be complex and, in Class 1(1) banks, may be offered to the general public. It is therefore important that branches maintain high standards of advertising and promotion at all times.
  - 1.2.1 It is important that branches ensure that their products, including structured deposits, are suitable for their customers.
  - 1.2.2 Advertising and promotional literature should give clear and accurate information on the product in accordance with rule 6.12, including, but not limited to, the effects of any averaging, the underlying markets, and potential yields.
  - 1.2.3 Any back-testing or illustrations should be representative and reasonable and include a warning that past performance is not an indicator of future performance, as per rule 6.12 (1) (d) (ii).
- 1.3 Rule 6.73 specifically outlines the information which has to be disclosed to a depositor prior to providing a structured deposits, which must include all the key characteristics of the product.
- 1.4 Rule 6.73 (1) (b) advises that a depositor must prior to making a deposit be advised that, where a structured deposit’s return at the end of its term is zero, the depositor’s real rate of return may be negative). The Authority does however note that this disclosure, in absolute terms, assumes that there is inflation rather than deflation. In theory, at least two other possible states exist: that the real rate of return is zero (as inflation is zero); or that the real rate of return, relative to deflation may in fact be positive.



## 2. Overview of the Authority's Approach to OTC Derivatives and Structured Deposits

- 2.1 The Authority expects management and sales staff of a branch to have a clear understanding of a structured deposit and the risks that both the bank and its clients may be exposed to, before the product is launched.
- 2.2 The Authority expects the branch to have a clear understanding of what constitutes a structured deposit compared to some other structured products that would be investment products (see **Appendix 1** for definitions).
- 2.3 It is expected that all staff involved in the sale of a structured deposit are competent to do so, receive appropriate training and are able to respond to queries that might arise from time to time as per rule 6.74.
- 2.4 Where it is reasonably believed that a potential depositor does not understand the structured deposit and its risks, the bank must warn the potential depositor of that fact and suggest an alternative type of deposit is made (if any) –rule 6.74 (1) (c) refers
- 2.5 The Rule Book, Rule 8.13 (b) states that: “A licenceholder must notify the Authority, not less than 20 business days in advance, of any material cessation of, or material addition or change to, the services or products which it offers...” This requirement also applies to any overseas branches of the bank. It is therefore required that details of all new structured deposits be notified to the Authority prior to their launch. Specific definitions for additions and materiality may be found in **Appendix 1**, and general guidance to Rule 8.13 is also provided – this states: “the Authority expects to be notified of any change to an existing structured deposit and to be provided with a copy of the marketing literature. The Authority’s focus is to ensure that the product is being promoted in a way that is fair and accurate. The fact that the Authority has been notified and has raised no objections should not be regarded as an endorsement or approval of the product or service.”

It is recognised that some branches tailor structured products (including structured deposits) to the specific requirements of individual (and more sophisticated) customers. Such structures **do not** require notification to the Authority under section 2.4 or Rule 8.13 (b).

## 3. Procedures and Systems

The Authority recommends that branches formulate a review procedure for all new structured products, including structured deposits (this may be part of the bank’s procedures). As a minimum, the following points should be considered:

- a) Is investment business (class 2) approval required (i.e. if the products are not structured deposits)?
- b) Is an upgrade to your investment business (class 2) authorisation required?
- c) Is the yield from the product likely to be classified as interest or investment income?
- d) Are the bank's/branch's systems capable of accurately recording the product?
- e) Are all legal or jurisdictional issues clearly understood?
- f) Does the bank/branch intend to include a disclaimer in the terms and conditions of the product to cover the failure of a derivative counterparty to honour its obligations under the contract?
- g) Do the bank's/branch's sales staff fully understand the product, and have they received the relevant training?
- h) Is the marketing material balanced as to the benefits and risks of the product, and has the suitability of the product to various customer profiles been considered?
- i) Who is the target market and do they require advice?
- j) For deposit takers holding a Class 1(1) licence, how will the product be offered to the general public?

## Appendix 1 – Glossary/Definitions

**“bank”** is the Isle of Man incorporated deposit taker (part 1), or the head office, or otherwise as applicable, of the branch (part 2).

**“branch”** means a branch in the Isle of Man of a deposit taker incorporated outside the Isle of Man.

### ***New products***

In addition to the general Rule Book guidance that is in place for Rule 8.13 re structured deposits, the following is additional guidance as to how Rule 8.13 should be applied to structured deposits:-

- a) “Addition” is any structured deposit that has not been offered on identical terms previously.
- b) “Material change” is any change to the structure and/or risk profile of a product, even if the basic structure has already been approved. Whilst a product might be structurally similar to a product for which the Authority has previously been notified, further notification should be made where the risk profile has altered, for example:
  - Links to different indices
  - Addition of further indices
  - Changes to optionality
  - Addition of new elements such as foreign exchange and derivative transactions
  - Different maturity terms
  - Different returns (e.g. 100% of growth of the FTSE 100 index against 50% of growth in the FTSE 100 index)

Please note that the above list is not exhaustive and should be considered as being for guidance only. The Authority has included specific rules 6.73 / 6.74 regarding structured deposits covering disclosure of product particulars and depositor interaction. These rules are aimed at improving the transparency of any offerings and the basic level of skill the Authority would expect bank staff to have when promoting these products or dealing with any enquiries.

### ***OTC Derivatives***

OTC derivatives are interest rate, foreign exchange rate, equity, precious metals, commodity, and other contracts which are not exchange traded and not subject to margining requirements.

### ***Structured Deposits (as defined in the Financial Services Rule Book)***

Means a deposit which is repayable at maturity on terms under which interest or a premium will be paid or is at risk, according to a formula involving factors such as —

- (a) an index or combination of indices (excluding variable rate deposits whose return is directly linked to one interest rate index such as Euribor or Libor);
- (b) a financial instrument or combination of financial instruments;
- (c) a commodity or combination of commodities or other physical or non-physical non-fungible assets; or
- (d) a foreign exchange rate or combination of foreign exchange rates;

### ***Structured Products***

Structured products are combinations of two or more financial instruments, at least one of which must be a derivative, which together form a new product.

Structured products can include structured deposits, as well as investment products.

Examples of structured deposits are shown below. The list is not exhaustive, and is for illustrative purposes only:

- a) A fixed term bank deposit that offers a yield based on the performance of an equity index or indices
- b) A fixed term bank deposit that offers a yield based on a foreign exchange rate remaining within a specified range over the period of the deposit.

All structured products that put customers' capital at risk are regarded as investment products and would be subject to the relevant regulations, and require the bank/branch to have the appropriate investment business (class 2) authorisation to sell such products.

The following examples of structured products should be considered as investment business (class 2), even though, at first sight, they may appear to be banking (deposit) products. The list is not exhaustive, and is for illustrative purposes only:

- a) Products that offer guaranteed yields over the life of the product, but repayment of capital is dependent on the performance of the underlying (usually an equity index or indices). These products have offered a high headline rate of interest, but exposure to the underlying is geared (i.e. the capital amount could be reduced by 2% for every 1% fall in the underlying index).
- b) Dual currency deposits are fixed term deposits that offer a higher yield than standard deposits, but expose the depositor to the risk that the deposit may be repaid in a second currency at an agreed exchange rate. (Even though the pre-agreed "strike" rate may be more advantageous than the exchange rate at the time of the agreement, the revaluation of the amount received on maturity could be lower than the original investment).

- c) Hybrid structures will often combine a capital protected product with an additional risk in order to increase the headline yield. An example of this would be a Sterling product where the yield is based on the performance on the FTSE 100, with no exposure to a possible fall in the index, but with a possibility that repayment may be in USD if the GBP/USD exchange rate is above a specified level on maturity of the product. In this case the risk to an appreciation of Sterling against the USD dollar overrides the implied protection of the exposure to the FTSE 100 index, and this should therefore clearly be classified as an investment product.

## Appendix 2 – Exemptions and Materiality

There may be certain circumstances where it would not be appropriate for a bank to disaggregate options from a structured deposit, either on the grounds that the bank can show that they are not exposed to replacement cost or future exposure risk, or on the grounds that, whilst risk is present, it is immaterial in respect of the bank's overall capital adequacy position. Some examples are shown below, but these are not exhaustive and should be considered as being for guidance purposes only. The Authority is willing to consider other applications for exemptions on a case by case basis:

- a) Where the bank's client terms and conditions clearly state that in the event of the bank's counterparty being unable to fulfil its commitments under the derivative, the bank is not obliged to honour its commitment to the customer and therefore has no exposure to replacement cost.
- b) Where the bank deals directly with its parent company, and receives an explicit guarantee from the parent that they will pay the required yield on maturity. No exemptions due to the parent's derivative counterparty's failure to honour the option(s) will be accepted.
- c) For structured deposits with a maximum period to maturity of three months, and a capped maximum return of 10 % p.a., an application may be made to the Authority for agreement to exclude the implied derivative contract from the Form SR-1B on the grounds of materiality. The prior agreement of the Authority must be sought for each product for which the bank seeks exemption, and a limit on the outstanding nominal amounts at risk would normally be agreed.