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SAFETY OF THE CAPITAL INVESTED IN THE STRUCTURED PRODUCTS AVAILABLE AT THE FINANCIAL MARKET IN POLAND

Abstract: The aim of this article is to answer the questions of whether an investment in the structured products on the Polish financial market provides the capital safety declared by the issuers of such products and whether a customer – a non-professional investor in particular – is able to correctly asses the capital protection level on the basis of the information available to him. The study covered the structured investment products subscribed to on the Polish market during the first quarter of 2013.

Keywords: structured products, capital safety, scope of capital guarantee.

1. Introduction

The recent decrease in interest rates offered on deposits and the prospects for economic recovery have triggered a parallel increase in the activity of companies offering structured products. These instruments embody the characteristics of traditional banking products and of products related to the capital market. According to S. Das [Das 2001, pp. 1, 2], structured products are those which are a combination of fixed income instruments and derivatives, usually profiled as forwards or as options for specific underlying assets. A similar definition of a structured product is offered by Polish authors, K. Jajuga and T. Jajuga, who state that it is a hybrid instrument constituting a combination of a debt instrument and an option (a regular or multivariate one) [Jajuga, Jajuga 2006, p. 394].

The practice related to these products' performance allows a negative assessment of their profitability potential. The market data collected by Open Finance show that only four out of 10 structured products maturing in 2012 produced some profit, and the interest earned from a number of them did not exceed the bank deposit rates[1] [Krasoń 2013, p. 1]. The research conducted by the Financial Supervision

[1] Performance of 5% pa or higher was reached by 93 structured products, i.e. 16% of all the matured products. The average rate of return of 585 structured products maturing in 2012 was 1.44%.

Commission, covering the period 2000–2010, also indicates low efficiency of these products. In the analyzed period the average return rate for a client on investment in structured products amounted to 3.31% on an annual basis and was lower from the average return rate on term deposits (4.30%) [Mokrogulski, Sepielak 2010, p. 46]. The negative assessment of these products' profitability gave rise to doubts about the safety of capital invested in them.

The aim of this article is to answer the questions of whether an investment in the structured products on the Polish financial market provides the capital safety declared by the issuers of such products and whether a customer – a non-professional investor in particular – is able to asses correctly the safety level on the basis of the information available to him. The subject of the study were the structured investment products subscribed to on the Polish market during the first quarter of 2013 (67 products in total) and having various legal statuses, namely deposits (36 products), unit-linked insurance policies (19 products), certificates of deposit (six items), group unit-linked life insurance policies (five products), or foreign mutual investment funds (one product).

Safety of the funds invested in structured products was analysed in three aspects: the capital protection level declared by the product issuer, the possible capital loss in the event of early withdrawal of funds, and the risk of issuer's default.

The source of information about the products on offer were the information documents available at the issuers' websites[2] and at the websites dedicated to the structured product market, such as http://www.structus.pl/ or http://www.analizy.pl/.

2. Capital protection level declared by the product issuer

Prior to deciding to purchase a structured product, the investor should investigate how large a part of the potential investment would be protected. This can be done by reviewing the respective product information documents published by issuers in various forms and under various names, like product data sheet, terms of deposit, information materials, general insurance conditions, annex to the general conditions, fees and limits tables, product information brochure, prospectus, etc. Sometimes identification of all the product parameters makes it necessary for an investor to read even a few multi-page information documents.

Establishing the investment guarantee level declared by a product issuer should not pose any difficulty for investors. This information is given both in the advertising

[2] During the period analysed, structured products were offered by: banks (Alior Bank SA, Bank Millennium SA, BGŻ SA, Bank Pocztowy SA, Bank Zachodni WBK SA, BNP Paribas Bank Polska SA, BRE Bank SA and its daughter companies dedicated to retail banking, i.e. mBank and Multibank, Citi Handlowy, Deutsche Bank PBC SA, Eurobank SA, ING Bank Śląski SA, Kredyt Bank SA, PKO BP SA and Raiffeisen Bank Polska SA), insurance companies (Nordea Polska Towarzystwo Ubezpieczeń na Życie SA, PZU Życie SA, Towarzystwo Ubezpieczeń na Życie WARTA SA, KBC Towarzystwo Funduszy Inwestycyjnych SA) and financial consulting firms (Expander Advisors Sp. z o.o.).

materials and in the information documents. The structured products may be offered with full, partial or conditional protection of capital and sometimes also with a guaranteed minimum rate of return.

The investment guarantee is resulting from the composition of a structured product, i.e. from it being composed of at least two products where one generates profit on investment and the other is to rebuild the funds contributed by the investor and depleted by the cost of acquiring the profit-generating instrument (option price) and by the premium charged by the issuer. The instrument performing towards the capital reconstruction is a secure instrument whose type depends on the legal form of structured product selected by the issuer. This can be a zero-coupon bond, a savings deposit, an insurance policy, a certificate of deposit, a mutual fund unit, etc.

A vast majority of structured products covered by the survey (approx. 90%) offered full capital protection, which means that unless a customer withdraws early, he will recover at least 100% of the funds invested. The safest products are those which in addition to a recovery of capital provide a guaranteed rate of return, for instance at the level of a few percent. Among the products examined, only one[3] was offered with a guaranteed rate of return, the value of which varied in subsequent subscriptions between 2.5 and 4%, while others offered only incomplete or conditional protection or did not provide any protection at all.

Upon choosing a structured product it should be remembered that a product that guarantees a higher level of capital protection will also offer less chance of significant profits, and vice versa – a relatively low level of capital protection can be rewarded with a higher rate of return.

In order to increase the potential profitability of such investments, their designers resort to offering products without full capital protection. With a capital guarantee reduced to below 100%, the amount available to purchase an option increases.

Incomplete capital protection (e.g. 90%) means that a customer investing in this product accepts the risk of a loss, with the maximum possible volume of such loss known in advance. The value of incomplete capital guarantee for products subscribed to during the first quarter of 2013 ranged from 90 to 97%.[4]

Another, somewhat less transparent, solution is a conditional guarantee where the 100% capital guarantee works only if a specific condition is met. The condition most frequently applied is that the 100% protection will remain active provided that during the term of investment the underlying instrument (e.g. the WIG20 index) never drops by 30% or more (counting from baseline).[5] The capital invested by the customer is therefore fully protected only with moderate declines in the index value.

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[3] The “ILT Pewny Procent” (“ILT Safe Interest”) product offered by ING Bank Śląski SA.

[4] The lowest level of protection was offered by Ekspander with their product Spokojna Przystań III (Peaceful Haven III).

[5] Such a condition of capital protection is included for instance in the terms and conditions of Certyfikat Ekspresowy (Express Certificate), a product offered by Deutsche Bank PBC and linked to the WIG 20 index value.

However, on the market there are also products for which a correct assessment of the capital guarantee scope is more difficult. The problem concerns the so-called "Pareto-like" products[6] which are a combination of a savings scheme and a structured product with full capital guarantee. The issuers of these products offer protection of the premiums total invested during the investment period and not a capital guarantee offered with all the other products. This change in terminology is very important and can mislead the investor in his investigation of the capital protection level. The premium invested is not equivalent to the capital invested: the value of premium invested is the paid-in funds less the management fee charged for investment management. For example, with a product called "db Inwestuj w Przyszłość – Stabilny Wzrost VII" ("db Invest in the Future – Stable Growth VII") offered by Deutsche Bank PBC SA, a customer purchasing this product was required to pay in the initial premium of PLN 2,000 and undertook to pay regular monthly premiums of PLN 200 for the next 10 years. The premium invested was ten times the initial premium amount, i.e. PLN 20,000. The premium invested (i.e. the total amount of investment) was charged a management fee, collected each month from the regular premiums. In the product data sheet, the customer could read that the guaranteed protection level of the premium invested was 130%. The declared guarantee value could be interpreted as a capital guarantee with a 30% rate of return. However, as stated above, the guarantee applies to the premiums invested, i.e. the paid-in funds less the management fee, which for this product is calculated as an annual percentage (3% pa) of the total premium invested and is collected monthly from the regular premiums payable over the first 10 years of the policy validity period. This means that over the 15 years of product validity the fee would deplete the funds paid in by the investor by 30%. If an option produces no profit, after 15 years the customer will receive only what he paid in, and in fact (after an adjustment for inflation) much less.

The choice between products with full or partial capital protection should depend on each investor's acceptable level of risk. Where risk acceptance is low and the investor does not accept even a partial loss of the capital paid in, full protection is a preferable option. Where – at the cost of a potential partial loss – he can hope for attractive returns, even if not guaranteed, he may be tempted to purchase a product with incomplete capital protection.

3. Possibility of a partial capital loss in the event of early withdrawal of funds

The capital protection declared by the structured products' issuers is not applicable in the event of early withdrawal of funds. The possibility of capital loss in case of early withdrawal of the invested funds in a structured product results from the

[6] In 2009 Noble Bank was the first company to offer a Pareto-based product – New Frontier.

construction of this product. As it has already been mentioned, capital guarantee is possible by the investment of some funds in a safe instrument which is supposed to reach the desired value upon the investment maturity amounting to the value of means put in by an investor. Prior to the investment finalization the secure instrument will not manage to restore the capital, while the withdrawal of means from an investment into a risky financial instrument (working for profit), the value of which is directly dependent on market conditions, may result in a loss. While investing in a structured product an investor has to take into account the possibility of partial capital loss, however, it is crucial that he/she is correctly informed about it before entering into an agreement. Such information should specify how the earlier payment will be calculated, as well as whether and what charges he/she will have to cover as the result of earlier termination of an investment.[7]

Structured products, with the exception of those listed at WSE,[8] are low-liquidity investments, and a significant part of them[9] entails freezing the investment capital for quite a long time (2–4 years, or even 10–15 years with the aforementioned "Pareto-like" products). Issuers do offer the option to withdraw the funds invested but sometimes fix the time when this can be done, e.g. once or twice a month (unlisted deposit certificates) or within 2–3 working days from a note of intent to exit the investment (insurance policies and deposits, respectively).

Early termination of such an investment usually entails extra charges. The magnitude of these charges and the customer's chance to identify them beforehand is varied.

With structured products in the form of deposits – as opposed to standard deposits – investors not only lose the right to receive the interest that they would otherwise receive at the investment's maturity (with standard deposits the loss is only partial) but also incur the liquidation charges. In the analysed group of products, early termination of structured products offered by BGŻ SA only[10] did not entail any extra charges, while all the other issuers did collect such charges. Some issuers charged fees fixed at 3%[11] regardless of the time of early termination, with others the early termination charges decreased linearly for each month passing towards the investment maturity with the initial rates varying between 6 and 4%.

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[7] In addition, it is also important what the available dates of early termination of the investment are and whether there are any restrictions imposed (e.g. a withdrawal request may be filed only once a month), but this does not affect the capital safety level.

[8] Among the products examined, only Certyfikat Ekspresowy (linked to the WIG 20 DB PBC index value) was listed at Warsaw Stock Exchange.

[9] Of the 67 products available during the period analysed, around 40% required investing funds for a period of two to four years.

[10] Investment Deposits BGŻ, http://www.bgz.pl/dla_ciebie/lokaty/lokata_inwestycyjna/subskrypcje/inwestycyjna_XXVI.html.

[11] Structured currency deposits, e.g. USD Dollar Plus, Polish Złoty Plus, USD Polish Złoty Stabilization BZ WBK, Investment Deposits Phoenix VII and German Growth I.

With insurance-based structured products, an early termination could entail:

– surrender of the account, which means reducing the value of paid-in funds by the fees charged during the contract term (e.g. entry, transactional or management fees),
– liquidation charge, which for the products analysed varied widely and was expressed either as an amount (e.g. PLN 200) or as a percentage (ranging from 1 to 17%), with the percentage rate calculated on various bases (e.g. on the current premium value or on the product of premium invested and the number of full calendar months remaining till the end of liability period).

This diversity makes interpretation of the costs related to early withdrawal very difficult. An example would be the following information contained in a table of fees and limits: "a liquidation fee, calculated as 0.49% of the product of premium invested and the number of full calendar months remaining till the end of liability period as of the date of receipt of a surrender note from the entity managing the insurance contract."[12] It is unlikely that the customer will interpret that as a possible maximum loss of 17.15% of the premium invested if he withdraws within the first month of the investment period lasting 36 months, and yet that is the correct deduction. The customer should obtain the information on the maximum possible loss which is the information allowing a direct comparison of the fees applicable to various products without having to make calculations.

Doubts as to the non-professional investors' capacity for identifying the exit costs for an investment may also arise from the incomprehensible language of information documents. An example would be the following wording contained in an annex to the general conditions: "'Current value of Premium' shall mean the value determined by the Insurer as of each Determination Day and shall equal at least the sum of the value of a financial instrument ensuring the Bonus payment and the policy value as discounted on such Determination Day by the rate equal to the rate applicable to interest rate swaps (IRS) on the interbank market for PLN with maturity period corresponding to the time remaining till the end of the insurance period, as increased by 300 basis points."[13]

A proper understanding of the above content requires a knowledge level at least equivalent to that of a student of economics, and there is no such reservation related to subscriptions.

With regard to the insurance-based structured products, offered in the form of unit-linked life insurance policies, it should also be noted that an early withdrawal

[12] Annex to the general terms and conditions of insurance. Table of fees and limits for individual structured insurance contracts. Świat Zysków – Subscription #32: Optymalny Koszyk – product offered by PZU SA, http://www.analizy.pl/fundusze/dokument/pobierz/prod_strukt/PSPZU031/ZWU/2012-12-03.

[13] Financial Terms and Conditions of Insurance Contracts, an Annex to the Statement of Accession to the corporate life and endowment insurance offered to the existing customers of Raiffeisen Bank Polska SA, subscription: Smartfonowa Rewolucja, http://www.analizy.pl/fundusze/dokument/pobierz/prod_strukt/PSRAI111/OWU/2013-03-11.

entails redemption of the account value, calculated against the unit price (current as of the redemption day) that is subject to significant fluctuations.[14] The impact of fees charged during the contract (e.g. transactional or management fees) on the value of early redemption must also be considered. The liquidation fee is charged on top and regardless of the aforementioned charges.

The largest cost of an early withdrawal may be faced by those investors who during the initial year withdraw from a long-term investment product of Pareto type, since they have the right to redeem only 25%[15] of the account balance. This value increases with each subsequent year of the investment term. Another key factor is that any delays in transferring the current premium payments may result in immediate termination of the contract and a resulting loss of a large part of the capital.

The structured products listed at Warsaw Stock Exchange (bonds and structured certificates) offer an option of early withdrawal through selling the instrument on the secondary market or returning it to the issuer.

4. The risk of issuer's default

Safety of the capital invested in structured products is also affected by the risk of default on the part of the issuer in connection with his insolvency or bankruptcy. In order to secure the rights of customers in the event of financial institutions' insolvency, governments set up statutory guarantee systems. In Poland such systems are in operation, but the extent of cover for claims arising from individual financial products varies.

In the event of insolvency of an "issuer" of any products that have the form of a deposit, customers' claims are 100% protected up to the limit of PLN 100,000. This guarantee arises from the statutory protection of claims, offered through the Bank Guarantee Fund (BGF) [Ustawa z dnia 14 grudnia 1994…]. However, if the funds are held in an investment deposit, which is a combination of a deposit and mutual investment fund units, the BGF guarantee applies to the deposit component only, while the unit-linked part is not exposed to such an insolvency since in the event of a mutual investment fund bankruptcy, the fund's assets get transferred to another fund (TFI). Conversely, the structured products in the form of certificates are only protected by BGF if they have been issued under the Banking Act [Ustawa z dnia 29 sierpnia 1997…]. Those issued under the Act on Trading in Financial Instruments [Ustawa z dnia 29 lipca 2005…] are not covered by the system. Neither does the

[14] Its value often drops significantly – if there were any previous subscription of the product, it is advisable to see check their performance history.

[15] "db Inwestuj w Przyszłość – Stabilny Wzrost VII" ("db Invest in the Future – Stable Growth VII") offered by Deutsche Bank PBC SA, http://www.analizy.pl/fundusze/dokument/pobierz/prod_strukt/PSDBC164/ZWU/2013-02-01.

guarantee cover any claims arising from investments in structured bonds.[16] In the event of issuer's insolvency, the customer may only file or enforce claims under the general provisions of Civil Code.

The situation is different if a structured product takes the form of a life insurance policy or a corporate unit-linked life insurance policy. In the event of insolvency of the insurance company who issued the product, the customer will recover 50% of his total claim value, the payment never being in excess of 30,000 euro as this is the limit of protection offered by the Insurance Guarantee Fund [Ustawa z dnia 22 maja 2003…].

The availability and scope of claims protection are therefore quite diverse and directly dependent on the issuer and the legal form of a specific structured product. A structured product buyer may have a problem with identifying both the issuer and the legal form of the product. A customer purchasing a structured product from a bank does not always know whether it is the bank's own product or e.g. an insurance product issued by an insurance company cooperating with the bank, or whether the bank offers a corporate unit-based life insurance policy that they purchased from an insurance company to become a policyholder. In the information documents, the structured product issuers very rarely include the information on the (non-)coverage by the capital protection system (the notable exceptions are BZ WBK SA and Bank BPH SA). A potential customer should be made aware which part of his investment is protected and what is the nature of such protection. Where the funds invested are not covered by the statutory guarantee system, the customer should at least be made aware of the issuer's creditworthiness.

5. Conclusions

The study results allow the following conclusions.

1. The information documents prepared by the structured product issuers are frequently incomprehensible and/or confusing for customers, and yet it is on their basis that the investors are supposed to make their investment decisions. The variety of forms and scope of the data presented makes any comparisons difficult and the incomprehensible legal language makes it hardly possible to understand the content.

2. The capital protection levels declared by the structured product issuers as applicable at the investment maturity are presented clearly enough, with the exception of long-term products with regular premiums.

3. It is far more difficult for an investor to use the information documents available for determining the amount of costs that would have to be incurred upon an early exit or whether, in the event of the issuer's bankruptcy, his claims will be covered by the statutory capital guarantee system.

[16] In many regions of the world, particularly in Asia, the structured products having the form of bonds issued by the Lehman Brothers Group companies have gained great popularity. The 2008 collapse of the investment bank meant a loss of most of the capital invested in these products.

4. In order to strengthen the position of investors, the Polish Financial Supervisory Commission should compel the issuers to introduce product data sheets standardized in terms of form, scope of information included and terminology used.

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BEZPIECZEŃSTWO KAPITAŁÓW LOKOWANYCH W PRODUKTACH STRUKTURYZOWANYCH DOSTĘPNYCH NA RYNKU FINANSOWYM W POLSCE

Streszczenie: Celem artykułu jest uzyskanie odpowiedzi na pytanie: czy inwestycja w produkty strukturyzowane dostępne na polskim rynku finansowym zapewnia gwarancję kapitału deklarowaną przez emitentów tych produktów oraz czy klient – szczególnie nieprofesjonalny inwestor – jest w stanie na podstawie dostępnych dokumentów informacyjnych prawidłowo zweryfikować poziom tej ochrony? Przedmiotem badań były lokacyjne produkty strukturyzowane subskrybowane na rynku polskim w I kwartale 2013 r.

Słowa kluczowe: produkty strukturyzowane, bezpieczeństwo kapitałów, zakres gwarancji kapitałów.