

BANKING GUIDANCE NOTE (BGN 8.0)
OTC Derivatives and Structured Products

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Financial Supervision Commission Barrantee Oaseirí

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Part 1 – Banks incorporated in the Isle of Man

1. Rationale

- 1.1 Until recently, the use of over the counter (“OTC”) derivatives on the Isle of Man has been limited to a small number of banks that used simple derivatives to hedge interest rate and foreign exchange risk.
- 1.2 The Commission has identified that banks are marketing structured products and are hedging 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 little regard has been 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 a 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 Commission’s reporting forms SR-4 and SR-1 now capture such risk for capital adequacy.
- 1.3 Structured products are becoming increasingly complex, and are now being offered to the general public. It is therefore important that banks maintain high standards of advertising and promotion at all times.
 - 1.3.1 Although capital protected structures are regarded as banking (deposit) products, it is important that banks ensure the product is suitable for their customers.
 - 1.3.2 Advertising and promotional literature should give clear and accurate information on the product, including, but not limited to, the effects of any averaging, the underlying markets, and potential yields.
 - 1.3.3 Any backtesting or illustrations should be representative and reasonable.

2. Overview of the Commission’s Approach to OTC Derivatives and Structured Products

- 2.1 The Commission expects management and sales staff of a bank to have a clear understanding of a structured product and the risks that both the bank and its clients may be exposed to, before the product is launched.
- 2.2 The Commission expects the bank to have a clear understanding as to whether the structure is considered a banking or investment product. (See **Appendix 1** for definitions).

- 2.3 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.
- 2.4 The Banking (General Practice) Regulatory Code 2005, paragraph 49 states that: "The bank shall notify the Commission before making any addition or material change to any of the services or products it offers (including unregulated services or products). 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 Commission prior to their launch. Specific definitions of additions and material may be found in **Appendix 1**, and general guidance re Code 49 is provided in **Banking Guidance Note (BGN 1.0)**.

It is recognised that some banks tailor structured products to the specific requirements of individual customers. Such structures **do not** require notification to the Commission under section 2.4, but should be included in reporting on Form SR-4 unless otherwise exempted (see **appendix 2**).

- 2.5 Banks will be required to report all OTC derivatives using Form SR-4, including those that are embedded or implied in structured products. 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 Commission recommends that banks formulate a review procedure for all new structured products. As a minimum, the following points should be considered:
- a) Is investment business approval required?
 - b) Is an upgrade to your Investment Business 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 payout 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) Does 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) 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 arising from an off balance sheet contract is calculated automatically on Form SR-4 by the multiplication of its credit equivalent amount (“CEA”) by the appropriate counterparty risk weight. Counterparties that normally attract a 100% risk-weight are risk weighted at 50% for this calculation.

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 Commission will accept valuations from these sources.

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

1. Rationale

- 1.1 Until recently, the use of over the counter (“OTC”) derivatives on the Isle of Man has been limited to a small number of banks that used simple derivatives to hedge interest rate and foreign exchange risk.
- 1.2 Structured products are becoming increasingly complex, and are now being offered to the general public. It is therefore important that branches maintain high standards of advertising and promotion at all times.
 - 1.2.1 Although capital protected structures are regarded as banking (deposit) products, it is important that branches ensure that the product is suitable for their customers.
 - 1.2.2 Advertising and promotional literature should give clear and accurate information on the product, including, but not limited to, the effects of any averaging, the underlying markets, and potential yields.
 - 1.2.3 Any backtesting or illustrations should be representative and reasonable.

2. Overview of the Commission’s Approach to OTC Derivatives and Structured Products

- 2.1 The Commission expects management and sales staff of a branch to have a clear understanding of a structured product and the risks that both the bank and its clients may be exposed to, before the product is launched.
- 2.2 The Commission expects the branch to have a clear understanding as to whether the structure is considered a banking or investment product. (See **Appendix 1** for definitions).
- 2.3 The Banking (General Practice) Regulatory Code 2005, paragraph 93 states that: “The bank shall notify the Commission before making any addition or material change to any of the services or products it offers (including unregulated services or products).” It is therefore required that details of all new structured deposits be notified to the Commission prior to their launch. Specific definitions of additions and material may be found in **Appendix 1**, and general guidance re Code 93 is provided in **Banking Guidance Note (BGN 1.0)**.

It is recognised that some branches tailor structured products to the specific requirements of individual customers. Such structures do not require notification to the Commission.

3. Procedures and Systems

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

- a) Is investment business approval required?
- b) Is an upgrade to your Investment Business licence 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) Does 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) How will the product be offered to the general public?

Appendix 1 – Glossary/Definitions

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 Products

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

Structured products can be considered banking (deposit) products where the product offers capital protection (the customer will receive repayment on maturity of a minimum of the original principal). However, it should be noted that the customers are exposed to a credit risk to the bank.

Examples of structured banking products 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.

Any structure that offers 100% capital protection in terms of the original placement currency, other than the effect of inflation, or where the customer suffers charges arising from partial or full repayment prior to contractual maturity, should be considered as a banking product. All structured products that put customers' capital at risk are regarded as investment products and would be subject to the relevant Investment Business Codes, and require the bank/branch to have the appropriate investment business authorisation to sell such products.

The following examples of structured products should be considered as investment business, even though, at first sight, they may appear to be banking 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.

New products

The Banking (General Practice) Regulatory Code 2005, paragraphs 49 and 93, states that: "The bank shall notify the Commission before making any addition or material change to any of the services or products it offers (including unregulated services or products). [re code 49 - This requirement also applies to any overseas branches of the bank]."

The following is guidance as to how paragraphs 49 and 93 should be applied to structured products.

- a) "Addition" is any structured product 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 Commission has previously been notified, further notification should be made where the risk profile has altered, for example:
 - o Links to different indices
 - o Addition of further indices
 - o Changes to optionality
 - o Addition of new elements such as foreign exchange and derivative transactions
 - o Different maturity terms
 - o 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.

"bank" is the Isle of Man incorporated bank (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 bank incorporated outside the Isle of Man

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 product, 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 Commission 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 products 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 Commission for agreement to exclude the implied derivative contract from the Form SR-4 on the grounds of materiality. The prior agreement of the Commission 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.