Press Release **1 September 2016**

Central Bank inspection finds firms offering more complex and risky Structured Retail Products to consumers

- **Significant move away from capital protected deposit-based products towards more complex, capital at risk products**
- **Weak product governance arrangements identified around the development and marketing of Structured Retail Products**
- **Sale of Credit Linked Notes to consumers raises particular concerns**

The Central Bank highlighted in its Consumer Protection Outlook Report 2016 the risks to consumers from firms selling higher risk products in the low interest rate environment as well as poor product oversight and governance. One of the priority themes identified in that Report was a review of the Structured Retail Products (SRPs) market in Ireland as these products are being offered to consumers as an alternative to deposits. The Central Bank is of the view that SRPs are not always a suitable alternative for consumers, given their complexity and potential for partial or total loss of investment.

The main findings of the inspection are:

- 371 SRPs were launched in 2015, consisting mainly of two types of products: Deposit-Based SRPs and Note-Based SRPs, accounting for sales of €971m.
- There has been a significant move away from the sale of capital protected deposit-based products towards more complex, capital at risk products.
- A Product Performance Comparison identified that over half of the SRPs that matured in 2014 and 2015 underperformed vs. State Savings available at the time of launch of these SRPs;
- Weak product governance arrangements were identified in a number of firms in areas including target market identification and product testing;
- Credit Linked Notes are being sold by a small number of firms to consumers and, in some cases, the higher risks associated with such products are not being adequately highlighted;
- Various types of SRPs are being marketed as 'capital protected', however, the level of capital protection varies depending on the set up of the product.

Director of Consumer Protection, Bernard Sheridan, said: "The need to ensure the protection of consumers who invest in higher risk products remains a priority for the Central Bank. It is important that consumers are fully informed about the risks they are taking on and that they receive appropriate advice. Not all Structured Retail Products are the same, they can be very complex and risky and may not be suitable to meet consumers' needs if they have a low risk appetite. Credit Linked Notes are particularly complex and can carry a much higher risk than other products and may not be suitable for most consumers."

The Central Bank is engaging directly with those firms where issues have arisen and is considering the appropriate use of its supervisory powers to address the issues identified. The Central Bank has also issued a letter to all relevant firms, detailing the findings of this inspection together with recommendations to enhance their compliance arrangements, where relevant.

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Notes to editors

About the themed inspection
The inspection consisted of a desk-based review of 20 Investment and Stockbroking firms and Credit Institutions manufacturing and/or distributing Structured Retail Products, followed by on-site inspections in five of these firms.

About Structured Retail Products (SRPs)
The ESMA Opinion 2014/332 "Structured Retail Products – Good Practices for Product Governance Arrangements" defines SRPs as compound financial instruments that have the characteristic of combining a base instrument (such as a note, fund or deposit) with an embedded derivative(s) that provides economic exposure to reference assets, indices or portfolios. In this form, they provide investors, at predetermined times, with pay-offs that are linked to the performance of reference assets, indices or other economic values.

Tracker bonds were a popular type of SRP a number of years ago. However, the SRP market has now moved towards more complex, capital at risk products.

Irish Market
The Irish market consists mainly of two types of SRPs: Deposit-Based SRPs and Note-Based SRPs. The main types of Deposit-Based SRPs offered are Structured Deposits, 90/95% Capital Protected Bonds, and Conditional Capital Protection Bonds. The main types of Note-Based SRPs offered are Conditional Capital Protection Notes and Credit-Linked Notes (CLNs).

The inspection identified that 9 firms are manufacturing SRPs. However, three of these providers accounted for 58% of the market by sales in 2015.

- 371[1] products were launched in 2015, which accounted for sales of €971m (227 were deposit based products and 144 were note based products);
- 352[2] products matured in 2014 and 2015, which accounted for sales of €1,224m (249 were deposit based products and 103 were note based products).

From comparing products matured in 2014 and 2015 against those launched in 2015, it was noted that there has been a move towards more capital at risk products as follows:
- Structured Deposits have decreased from 50% to 20% of the market;
- There has been a resultant increase in 90/95% Capital Protected Bonds (↑26%) and Conditional Capital Protection Notes (↑9%); and
- CLNs have appeared in the market, accounting for 12% of the market.

About Credit Linked Notes (CLNs)
The Central Bank identified a particular type of SRP being sold to retail clients which combines a note[3] with a derivative, in the form of a Credit Default Swap (CDS). Capital protection and income from these products are generally conditional upon the creditworthiness of multiple counterparties, namely an issuer and one or more reference entities. These products are commonly referred to as Credit Linked Notes (CLNs). 12% of SRPs sold in 2015 were CLNs.

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[1] It should be noted that many of these were successive issuances of the same product i.e. Deposit Bond 1, Deposit Bond 2.
[2] It should be noted that many of these were successive issuances of the same product i.e. Deposit Bond 1, Deposit Bond 2.
[3] A note is generally a debt instrument under MiFID. Debt instruments can include bonds, other forms of securitised debt and money market instruments.

By investing in such a note, the client takes on a role similar to that of a protection seller who provides protection for the risk of a credit event. In return, the client receives payments for assuming the risk of a credit event.

CLNs can be divided into a number of subgroups.

- CLNs where the income payment and capital repayment are linked to the creditworthiness of a single reference entity.
- CLNs which are linked to a "basket" of various reference entities.

CLNs have a wide variety of offer conditions. For example,

- If a credit event occurs, the income payment and capital repayment can be reduced proportionally on some CLNs or may, in fact, not be made at all, if a credit event occurs to one reference entity in the basket.
- CLNs, where the income payment varies depending on a reference rate, are also being offered to Irish consumers. In this case, the (non-) occurrence of the credit event only determines whether or not the income payment and capital repayment are made. However, the size of the income payment is based on a reference rate such as the 3-month Euribor.
- A CLN was also identified where 95% capital protection was conditional upon the creditworthiness of a guarantor and 1 reference entity. There was no income produced but rather a return at maturity based upon the performance of an underlying fund.

MiFID

MiFID (the European Communities (Markets in Financial Instruments) Regulations 2007) is a comprehensive regulatory regime covering investment services and financial markets in Europe and introduces common standards for investor protection throughout the European Union. It applies to both investment firms and credit institutions when providing investment services, and to regulated markets. MiFID came into effect on 1 November 2007.

The MiFID Regulations set out a three-tier categorisation system classifying parties as a) professional clients, b) retail clients or c) eligible counterparties. Different levels of regulatory protection are afforded to each category, with retail clients receiving the highest level of MiFID protections.

MiFID is currently being revised to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection. MiFID II is due to come into effect in January 2018 and will impose more detailed product governance requirements on all firms.