

What are the costs associated with a structured debt instrument?

FSMA

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Better information for consumers about costs

As part of its task of educating financial consumers, the FSMA wishes to:

1. Explain the main characteristics of structured debt instruments
2. Explain the different costs associated with a structured debt instrument
3. Explain how the annual cost impact indicator works, which investors can find in the Key Information Document¹ (KID)
4. Communicate to investors the average costs charged by issuers/distributors of structured debt instruments offered to the public



The KID is a legal document that must be prepared in accordance with the provisions of the PRIIPs Regulation (Packaged Retail and Insurance-based Investment Products). The aim of the KID is to give retail consumers essential information about an investment product. It must be provided to investors before they subscribe to a product.

What are structured debt instruments and what are their characteristics?

What are structured debt instruments?

Structured debt instruments are complex financial products with a pre-established duration, offering a return linked, according to a more or less complex formula, to the performance of an underlying asset such as an equity index or an interest rate.

There are several advantages to structured debt instruments. The fact that they often offer full or partial capital protection on maturity, coupled with an attractive potential return, can seem appealing.

However, particular attention must be paid to the costs as they can vary considerably from one product to another.



What are the main characteristics of a structured debt instrument?

- **The right to repayment (or not) of the capital** means that, irrespective of the performance of the underlying, the issuer of the product must repay you (or not) the amount you have invested at the start. However, if the issuer goes bankrupt, you could lose all or part of your capital in any case.
- **The underlying**, the return from which is used to calculate the coupon amount, may be an index, interest rate, investment fund etc.
- **The coupon calculation formula, or the product's pay-off**, determines the coupon amount(s) that will be paid to you during the life of the product and the amount that will be paid to you on maturity based on the return from the underlying.
- **Product maturity:** Structured debt instruments have a set maturity generally ranging from 2 to 12 years.
- **Currency:** Structured debt instruments are generally issued in euros but you can also choose to invest in a note issued in another currency.

What are the costs associated with a structured debt instrument?

Several types of cost

There are several types of cost associated with structured debt instruments. They are stipulated in the sales brochure.

- **Entry fees**

These are one-off fees to be paid over and above the par value¹ and constitute, along with the latter, the issue price of the structured debt instrument. These generally vary between 0 and 2.5%. Sometimes it is possible to negotiate a reduction in this percentage.

- **Distribution fees**

These are included in the par value of the product and constitute the distributor's remuneration. They can sometimes be refundable on a pro rata temporis basis in case of early redemption.

- **Structuring fees**

These are also included in the par value of the product and constitute the fees for the issuer of the product for structuring it. They can sometimes be refundable on a pro rata temporis basis in case of early redemption.

¹ The par value corresponds to the capital invested based on which the coupons are calculated and that, in the case of a structured debt instrument with a right to repayment of the capital, should be repaid by the issuer on maturity.

Several types of cost

- **Fees incurred in the case of early redemption**

If you wish to redeem your product before maturity, you will be charged brokerage fees (generally from 0.5% to 1%) by the distributor. A spread will also be applied (generally 0.5% in normal market conditions) to the price at which the issuer will buy back your product. These fees represent a percentage of the value of the product¹ at the time of redemption, which may be more or less than the initial value.

- **Foreign exchange fees**

If you invest in a product denominated in a currency other than the euro and you do not have an account in this currency, you will be charged foreign exchange fees to convert the amount invested at the time of purchase and the amount repaid at the time of redemption or on maturity. These fees therefore apply twice.

¹ The value of the product (or 'fair value') is calculated by the issuer during the life of the product based on a mathematical model that takes into account the product characteristics as well as the various market parameters such as interest rates, the return from the underlying, or the solvency of the issuer.

The annual cost impact indicator in the Key Information Document (KID)

The annual cost impact indicator in the KID

In the Key Information Document (KID), the costs of the structured debt instrument are expressed, inter alia, in terms of annual cost impact.

This indicator shows how costs reduce your annual return.

$$\text{Annual cost impact} = \text{Product return excluding costs} - \text{Product return including costs}$$

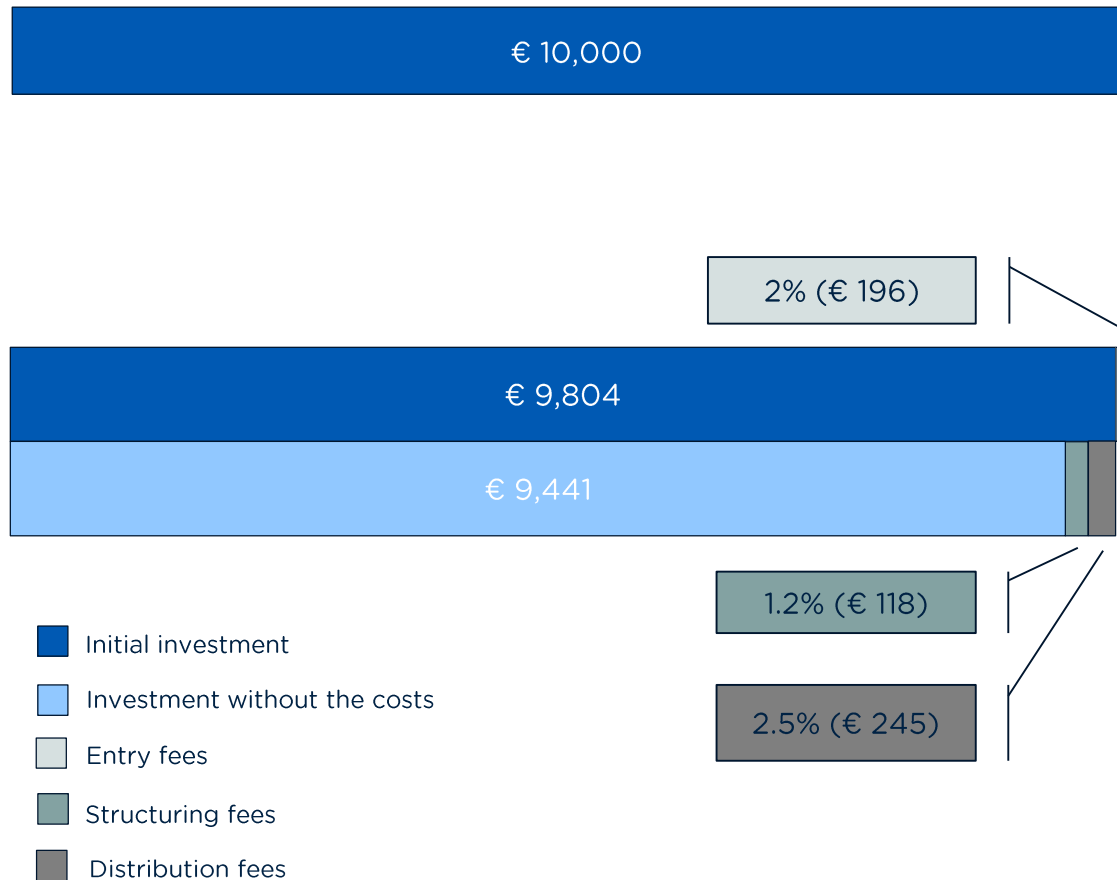
- The annual cost impact is a standardized cost indicator that enables a comparison of the costs of different products.
- Cost impact is an annual measurement. It allows products with different maturities to be compared.
- The annual cost impact includes all the costs relating to a product in so far as the issuer that prepares the KID is aware of them. Ask your distributor to inform you of any additional costs he may charge you.
- You will also find the detail of the different types of costs in the KID.

Illustration of how the annual cost impact works

1. You buy a debt instrument with nominal value of 10,000 euros.
2. It has a maturity of 8 years.
3. The entry fees are 2%.
4. The distribution fees are 2.5%.
5. The structuring fees are 1.2%.
6. Exit fees are 1%.
7. The underlying is the BEL 20 index.
8. Formula of the structured debt instrument: On maturity, the investor receives 100% of the evolution of the BEL 20 index between the issue date and the maturity date.
9. The structured debt instrument offers a right to repayment of the capital.

Illustration of how the annual cost impact works

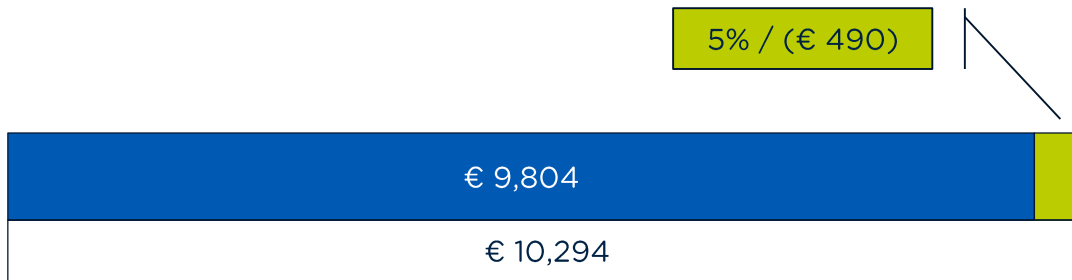
Upon purchasing a structured debt instrument



1. In accordance with the PRIIPs Regulation, in the calculation of the annual cost impact in the KID, it is supposed that you invest 10,000 euros including entry fees.
2. You pay 2% entry fees (196 euros). As a consequence, it is only 9,804 euros (10,000/1.02) that will be taken into account for the calculation of the coupon and the repayment on maturity.
3. From this amount of 9,804 euros, the structuring fees of 1.2% (118 euros = 1.2% X 9,804) and distribution fees of 2.5% (245 euros = 2.5% X 9,804) still need to be deducted. Then we obtain the value of the investment without the costs (9,441 euros)

Illustration of how the annual cost impact works

On maturity (after 8 years)



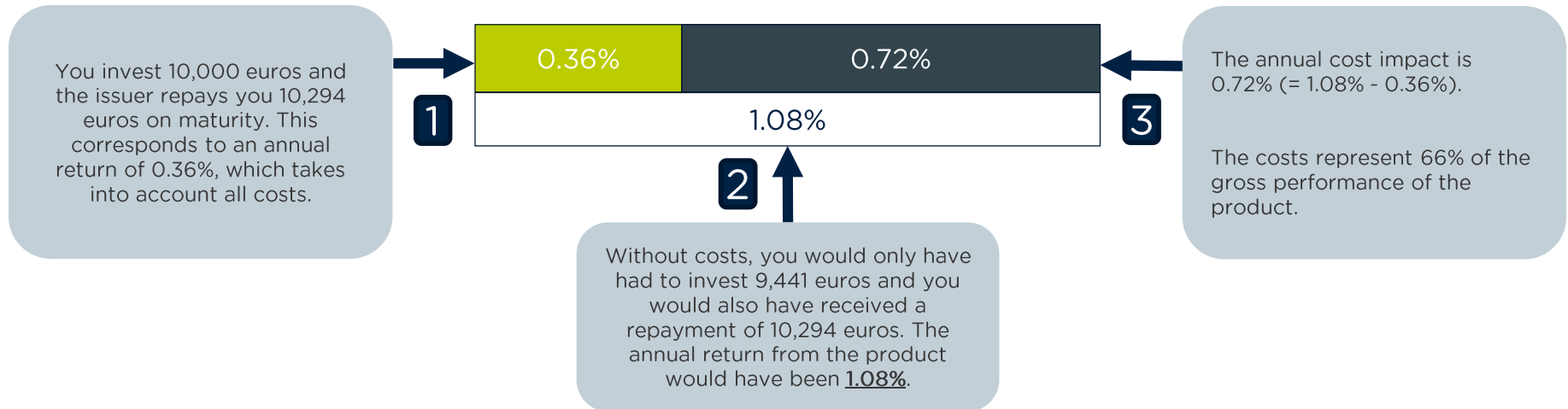
■ Initial investment

■ Performance

The BEL 20 index has **grown 5%** between the issue date and the maturity date (moderate scenario in the KID). Based on the formula of the structured debt instrument, the investor receives the performance of the index (5% on maturity). This corresponds to a coupon of **490 euros** (9,804 euros X 5%).

Illustration of how the annual cost impact works

Gross return and return net* of costs on maturity (after 8 years)



In the KID, below the first table of costs, you will find an explanation on this subject that indicates what the return would have been before and after the cost deduction.

$$\text{Annual cost impact} = \text{Product return excluding costs} - \text{Product return including costs}$$

*The net return does not take into account any taxes.

Illustration of how the annual cost impact works

Table of costs in the KID

EUR 10,000 investment

	If you exit after 1 year	If you exit after 8 years
Total costs	EUR 657	EUR 559
Annual cost impact	6.96%	0.72%



If you redeem the product before maturity, you have to pay exit fees (1%) on top of the entry (2%), distribution (2.5%) and structuring (1.2%) fees. This represents a total of 657 euros ($6.7\% \times 9,804$). Expressed in terms of annual cost impact and taking into account a return of 0%¹, costs come to 6.96% per year.

If you keep the product until maturity, you have to pay entry (2%), distribution (2.5%), and structuring (1.2%) fees. This represents a total of 559 euros ($5.7\% \times 9,804$). Expressed in terms of annual cost impact and taking into account a coupon of 5% paid on maturity, the costs come to 0.72% per year. **This corresponds with the average costs an investor pays on the Belgian structured debt instruments market.**

¹ As indicated in the KID, the annual cost impact calculation supposes that at the end of the first year, you will recover the amount you have invested (annual return of 0%).

Illustration of how the annual cost impact works

Table of costs in the KID

EUR 10,000 investment

	If you exit after 1 year	If you exit after 8 years
Total costs	EUR 657	EUR 559
Annual cost impact	6.96%	0.72%



In this example, all the costs are one-off, which means that you have to bear all the costs of the product, irrespective of the period for which you keep it. If you redeem your product after 1 year, the annual cost impact would be high (6.96%) compared to keeping the product until maturity (0.72%). In fact, in the first case, you pay additional exit costs and the costs are only spread over 1 year, whilst in the second case, they are spread over 8 years.

Illustration of how the annual cost impact works

The performance scenarios¹ present returns after deduction of costs

Scenarios		If you exit after 1 year	If you exit after 8 years
Minimum	EUR 10,000. There is no minimum guaranteed return if you exit before 8 years. You could lose some or all of your investment.		
Stress	What you might get back after costs	EUR 8,824	EUR 9,804
	Average return each year	-11.76%	-0.25%
Unfavourable	What you might get back after costs	EUR 8,824	EUR 9,804
	Average return each year	-11.76%	-0.25%
Moderate	What you might get back after costs	EUR 9,265	EUR 10,294
	Average return each year	-7.35%	0.36%
Favourable	What you might get back after costs	EUR 9,706	EUR 10,784
	Average return each year	-2.94%	0.95%



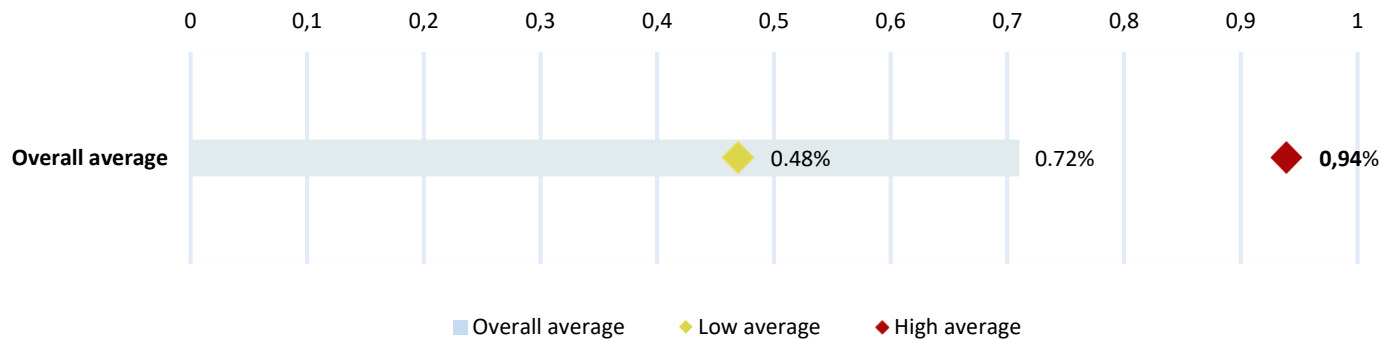
The moderate scenario in the KID illustrates a case in which you have a right to a coupon of 5% on maturity and a repayment of 10,294 euros, which corresponds with a repayment of 10,500 euros, from which the entry fees of 2% are deducted ($10,294 = 10,500/1.02$)
The annual return is 0.36%.

¹ As a reminder, the scenarios in the KID are based on past results and certain assumptions. Markets could develop differently.

What are the costs of structured debt instruments offered to the public in Belgium?

Annual cost impact

The average of the total costs, expressed in terms of annual cost impact if the product is kept until maturity, for structured debt instruments offered to the public in Belgium between January 2018 and December 2022 (806 products) is the following:



Source: FSMA

The annual cost impact was an average of **0.72%**. The high average is **0.94%** and the low average is **0.48%**.

These percentages can be used to determine whether the total costs of the structured debt instrument in question are higher or lower than the market average.

The low and high averages respectively represent the 25th and 75th percentiles of the distribution. This means that 25% of structured debt instruments have total costs lower than the low average and 25% of structured debt instruments have total costs higher than the high average.

Conclusions

Costs can vary considerably between structured debt instruments.

1. Always analyse the fees for different structured debt instruments.
2. Compare different distributors.

It is essential to carefully examine costs when deciding to invest, but other product characteristics should equally not be overlooked. You should pay particular attention to properly understanding the underlying and the risks associated with such an investment, such as the market risk and the credit risk.

