LIA DEVELOPING YOUR FUTURE IN FINANCE

QFA Investment

LEVEL 7

Certificate in Professional Financial Advice

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All sections of the textbook are examinable so it's essential that you study it thoroughly.

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Steps to Success

Step 1

Getting Started

- Familiarise yourself with the e-learning resources provided in your Study Hub.
- Attend your Online Induction.
- Create a personalised study plan, considering the Chapter Weightings and the recommended study time.

Step 2

Textbook

- The textbook is your key resource and must be covered in its entirety.
- Pay particular attention to large chapters, see Chapter Weightings.
- Complete sample questions at the end of each chapter and revise any area you are not comfortable with.

Step 3

Pre-Recorded Lectures

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- Listen to the pre-recorded lectures while on the go, allowing yourself every opportunity to study.

Step 4

Exam Preparation Masterclass

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Step 5

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- Test yourself using LIA's 'Take a Test' online facility.
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- Test yourself under exam conditions by completing a full exam within the allocated time frame.

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- Ensure your laptop or desktop is set up correctly ahead of the exam.

The Education Team are with you every step of the journey and we wish you every success in your exam.

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DEVELOPING
YOUR FUTURE
IN FINANCE

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2024/2025 Textbook

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Financial Services Market

This chapter introduces the functions and key participants of the financial services market.

The main financial services (provided by financial services providers to consumers) are individually described as well as their purpose.

The important activities and role played by the Irish Stock Exchange are introduced with particular mention of its role as monitor of unusual share transactions (insider dealing) on the exchange.

Learning Outcomes – after studying this chapter you should know/understand:
the functions of and key participants in the financial services market;
the main financial services provided to consumers;
what capital markets are, and the difference between the primary and secondary market; and,
the main functions and markets of the Irish Stock Exchange.

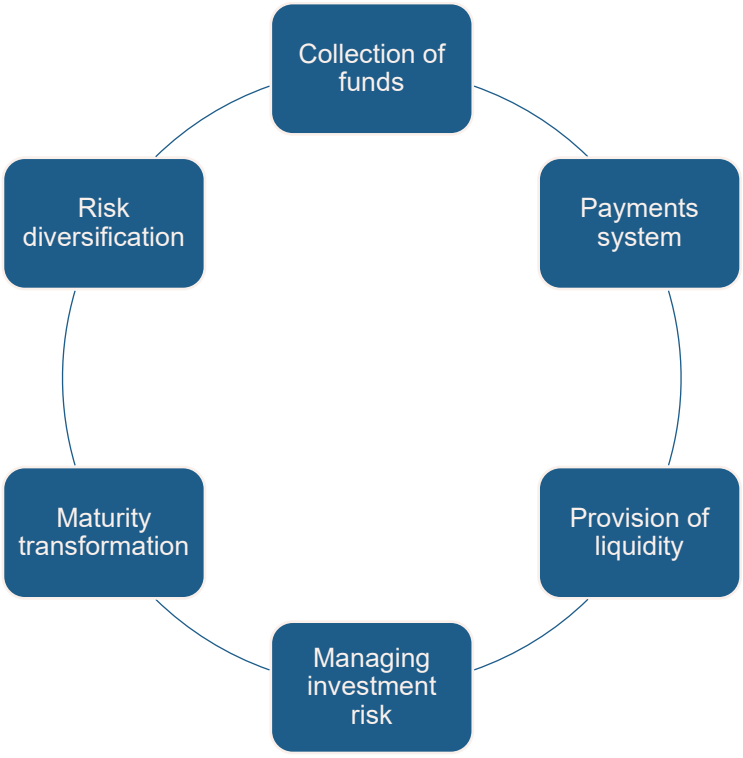
Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	1	4	6

1.1 Functions

The financial services market fulfils several different functions which are outlined in the following sections:

Collection and Channelling of Funds

By offering to pay individuals and businesses a return for their surplus funds through a wide variety of financial products from current accounts to short-term and long-term savings and investment products, financial services providers collect savings which they then invest or lend, at a margin, to individuals, businesses and the Government who require extra funds.



Provision of Payment Systems

This is something we are all familiar with as we use our local bank/building society/post office/credit union to pay bills such as telephone/electricity and gas by either standing order, direct debit, credit or debit card, cheque or draft.

More sophisticated payment systems are now also available with customers being able able to interact with their bank account using a mobile phone application (APP) and through online banking.

Provision of Liquidity

Both depositors and borrowers need to be able to access funds when required. While some borrowers require short-term money, others require long-term money to fund fixed assets and investments.

Depositors may require immediate access to their funds or can forego that requirement for a possibly higher return by committing the deposited funds for a specified (fixed) period. The financial system tries to match all these differing needs, efficiently.

Managing Investment Risk

Various types of financial services can be used by consumers and businesses alike to manage investment risks.

For example:

- Businesses who trade internationally can manage or minimise the risk inherent in trading with countries in currency other than the euro, by agreeing to buy or sell that foreign currency at a fixed rate relative to the euro, thereby eliminating their exchange rate risk.

  For example, a business who has to pay a US dollar payment to a US supplier in, say, six months, can agree today a fixed USD / Euro exchange rate with a bank thereby eliminating exchange rate risk. Specifically, this hedges the risk that the US dollar could rise in value against the euro over the next six months and hence increase the euro price of the payment.

- Home loan borrowers can eliminate the risk of interest rates rising on a loan for a specified period. Fixing an interest rate mitigates for the risk that interest rates could increase and hence their repayments will also increase.

Of course, currency and interest rate risks could go the other way as well, for example:

- The euro could increase in value against the dollar, thereby reducing the euro cost of a future dollar denominated payment liability.

- Variable interest rates could fall and reduce the borrowers loan repayments below the fixed rate they might otherwise be paying.

Maturity Transformation

Many borrowers want to borrow for a long period of time whereas many savers and investors don't want to tie up their money for such a long period of time.

Let's say a borrower wants to borrow funds for 10 years. Most depositors don't have to or want to deposit for 10 years. Therefore, there is a potential mismatch between borrower and saver.

However, because of its daily business of accepting deposit funds, a bank has a rolling over of new deposits so that it usually has sufficient funds to enable savers and investors to withdraw their funds as they wish while also being able to lend to the borrower for 10 years.

Maturity transformation is the ability to turn short-term deposits into longer-term loans and is one of the main services provided by financial intermediation entities such as banks and building societies.

Risk Diversification

Where an individual saver or investor may be unwilling to lend their money directly to one particular individual or entity for fear of default, a financial institution can spread such risk across individuals or entities. For example, an investment fund spreads the investment risk inherent in investing in individual companies by investing in a large number of companies, thereby reducing the potential impact to investors of the failure of one company.

1.2 Key Participants

The key participants in the Irish financial services market are:

The Central Bank of Ireland

The Central Bank of Ireland undertakes a number of key functions in relation to the provision and regulation of financial services in the State, in addition to its functions as a central bank. The main functions of the central bank include:

- Contributes to the formation and implementation of the Eurosystem monetary policy with the aim of maintaining inflation at below or around 2% over the medium term
- Promoting stability in the financial system
- Providing protection to the consumer of financial services
- Regulating the financial institutions with enforcement actions
- Providing a high quality regulatory framework
- Providing efficient and effective payment and settlement systems as well as currency services
- Providing robust independent economic advice

The affairs and activities of the Central Bank of Ireland are managed and controlled by the Central Bank Commission.

The Central Bank of Ireland does not set Irish interest rates due to the participation of Ireland in the euro. Euro interest rates are set by the European Central Bank (ECB) for the whole eurozone, that is, those countries who have adopted the euro as their currency. The Central Bank of Ireland is part of the European System of Central Banks.

European Central Bank (ECB)

This institution was created as the Central Bank for the countries participating in the euro currency. The governor of the Central Bank of Ireland is a member of the decision-making council of the European Central Bank (ECB).

The ECB has a number of functions but the one most well-known is its role in monetary policy. This involves influencing liquidity and interest rates to achieve the objective of price stability. In particular, the ECB sets the ECB lending interest rate called the refi (short for refinancing) rate which is the interest rate at which the ECB lends to banks in the eurozone. The current rate (March 2024) is 2.8%, which has increased from 0% in 2021.

Changes in the ECB rate can have a knock -on effect on retail banks interest rates and mortgage rates in the eurozone.

Retail Banks

The main functions retail banks provide to consumers are the provision of deposit accounts, current accounts, credit and debit cards, mortgages, personal loans and payments/funds transfer.

Retail banks also often provide other related financial services, such as insurance or investment intermediary services.

Insurance Companies

There are two main types of insurance companies:

- *General insurance companies*, which offer car, household, property and liability insurances. This type of insurance is usually referred to as non-life or General insurance, as it does not involve insuring a life, that is, the proceeds of a policy are not paid out on someone's death.

- *Life assurance companies*, offer life assurance, pensions, ill health, savings and investment policies. On average in Ireland, about 80% of the life assurance industry's new business every year is comprised of pensions, savings and investment policies; the pure 'life assurance' protection type policy now accounts for only about 20% of new business in the marketplace.

So, in reality, life assurance companies are really investment companies who invest long-term savings mainly in stocks and shares, bonds and property, on behalf of their customers.

Intermediaries

As the name implies, an intermediary acts as a 'go between' between financial institutions, such as insurance companies, and consumers, and provides advice to consumers in arranging financial products with these financial institutions.

The main types of intermediaries who provide services to consumers are:

- *Insurance* intermediaries, who advise on and arrange insurance policies, including savings, pension and investment policies for consumers with general and life assurance companies.

- *Mortgage* intermediaries, who advise on and arrange housing loans for consumers with banks and other mortgage lenders.

- *Deposit brokers*, who advise on and arrange deposits for consumers with banks.

- *Investment* intermediaries, who advise on and arrange investments for consumers, which are not insurance policies, with financial institutions.

Investment Firms

These firms provide investment advice, arrange investments, and manage investment portfolios for a wide range of investors. They are able to provide a wider range of services than Investment intermediaries.

For example, if an investor wants to buy or sell shares listed on a stock exchange, they may go through an investment intermediary first, who will then pass on the order to a regulated investment firm to execute. These firms are sometimes referred to as MiFID investment firms (MiFID stand for Markets in Financial Instruments Directive). This directive is the foundation for Financial Legislation in the EU. The latest version of the directive (MiFID II) became effective in Ireland on 3 January 2018.

Credit Unions

A credit union is a financial co-operative or mutual organisation structured as a limited liability company set up to provide savings and loan services for its own members. Its members are shareholders in the credit union, and they may also place deposits with it. So, members may have both shares and deposits in a credit union, although most credit union members only have shares in their credit union.

Members of a credit union share in the profits of the credit union through the addition of dividends to their share account, where a credit union declares such dividends.

Admission to membership of a credit union must be restricted to persons who share at least one of the common bonds specified in the Credit Union Act, 1997, that is:

- Following a particular occupation;
- Residing or being employed in a particular locality;
- Being employed by a particular employer or having retired from employment with a particular employer;
- Being a member of a bona fide organisation or being otherwise associated with other members for a purpose other than that of forming a credit union; or
- Any other common bond approved by the Registrar of Credit Unions.

In addition to their core financial services of shares, deposits and loans, some credit unions also provide additional financial services to their members, such as insurance intermediary services, online banking, current accounts, and ATM services. A limited number of credit unions are now also offering Credit Union Mortgages.

1.3 Main Financial Services Provided

The main financial services provided by financial services providers to consumers include:

Deposits Accounts

Consumers with surplus funds, either lump sums or monthly/weekly amounts, can place them with deposit taking financial institutions such as banks and credit unions for a fixed or open-ended period in a deposit account to earn a specified rate of interest.

In recent years with very low interest rates a number of banks reduced their retail deposit rates to zero, with some larger retail deposits (typiclly >€1m) seeing negative interest rates being applied. Larger corporate deposits have also had negative rates applied by most of the Banks through 2021. This means that instead of being paid interest on your deposit, the Banks charge you to hold on to your deposit.

However from 2022 to 2023, interest rates rose as Central Banks across the world acted to dampen inflation. As the core European interest rates rise, banks may start to increase their deposit rates again in the future.

Typically, Deposit accounts are used :

- As a Short-term secure savings facility, where the funds may be required within a short period;
- As a readily accessible emergency or rainy-day fund, which can be called on by the consumer immediately without penalty should he or she need capital for some unanticipated event, for example, the onset of a sudden serious illness or accident, or other circumstance causing loss of income;
- For longer term investment, where the investor does not want to take any capital risk with their investment.

Current Accounts

A *current account* (sometimes referred to as a ‘checking’ account) is a bank account, which can be used by the account holder to draw a cheque on or pay funds by electronic transfer to another person through the clearing system (explained in detail later).

Funds in current accounts do not ordinarily earn interest, although some banks do offer interest on current accounts which stay in credit at a certain specified minimum level.

Transactions on the account are usually charged for on the basis of a scale of fees. With permission from the bank, this type of account can go overdrawn which creates what is called an *overdraft*. Automated Teller Machines (ATM) cards are available for use on current accounts.

Overdrafts

An *overdraft* is an agreed permission or extention of an agreed line of credit from a bank or lending institution that is granted when an account balance reaches zero. This allows a customer to overdraw the current account to the agreed amount, even when the account has no money. It differs from a loan in that the customer draws funds up to the limit and repays it on a number of occasions if so desired and then can redraw it again. Interest is only charged on a debit balance used from time to time.

Credit and Charge Cards

Credit cards can be issued by banks and provide two primary services:

- Settlement of bills that is, purchase of goods; clothes, meals, petrol and services etc. This is possible with retailers who have agreed an arrangement with the credit card issuer to accept the card in payment.

- Availability of credit up to a certain specified limit. The cardholder gets a monthly account. The account can be settled in full or an agreed amount can be paid subject to the credit limit not being exceeded and subject to the payment of interest.

Charge cards are not credit cards as they do not offer credit; they are simply a convenient way to pay for large purchases. The charge card holder must therefore pay the card issuer at the end of each month or in some cases immediately, the full amount of purchases made with the card.

Debit Cards

Debit cards differ from credit cards, whereby payment for purchases is immediately withdrawn from the cardholder's current account. There is no credit involved. With a credit card, the total value of the transactions is typically paid for at the end of the month.

Housing Loans

These are long-term loans for the purchase of or refurbishment of residential premises, which is often the borrower's principal private residence (PPR). Housing loans are typically secured by a legal mortgage or charge / lien on the property and are known commonly as a "Mortgage".

Most retail banks provide housing loans which differ by lending terms, price and service.

Personal Loans

Personal loans have many uses and do not usually require a definition for usage. The term of this type of loan is normally less than five years and they are usually unsecured. One typical use of a personal loan is to purchase a car.

Leasing

A lease is a form of short-term (up to five years) loan availed of by personal and business customers.

Foreign Exchange

With the introduction of the euro and the wide availability of credit cards, the need for a foreign exchange service for consumers has reduced; however, the service is still needed in relation to transactions with or travel through non-euro countries, for example: to convert euros to sterling cash prior to a trip to the UK. Foreign exchange providers offer to Sell your required currency at a higher rate than what they secured it at.

Insurance Policies

The most common insurance policies available can be broken down into two categories:

- Protection policies: where the main purpose of the policy is to provide personal protection benefits in the event of death and/or serious illness, for example: the proceeds of a mortgage protection policy are used to repay a mortgaged loan in the event of the premature death of the borrower. This is important if the mortgage is against the family home

- General insurance policies:, for example, health, household and motor insurance, etc. Some general insurance companies also offer policies which provide short-term cover against accident, travel insurance, etc.

Long-Term Savings, Investment and Pensions

Life assurance companies, unit trust providers, UCITS managers (Undertakings for Collective Investments in Transferable Securities), and MiFID investment firms offer long-term savings, investment and pension products which typically invest the customer's funds into various investment securities and property:

- Unit linked saving plans, offered by life assurance companies, whose primary purpose is to accumulate long-term savings from small regular savings out of income.

- Lump sum investments, such as unit linked bonds, unit trusts, UCITS funds, tracker bonds, etc., are all designed to provide an investment return on the capital invested over the medium to long investment term.

- Financial institutions, with specialist pensions knowledge , provide products to allow accumulation of funds for retirement, such as Personal Retirement Savings Accounts (PRSA), personal pension plans, Retirement Annuity Contracts (RAC), buy out bonds (BOB), etc. and products for funds post retirement such as Approved Retirement Funds (ARFs), vested PRSA's and Annuities.

Insurance and Investment Intermediary Services

These services are provided by a range of retail intermediaries, banks and credit unions.

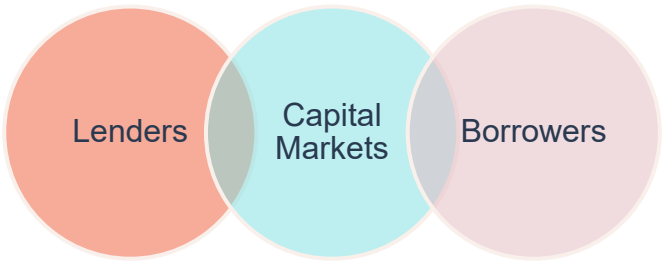
Settling Transactions - Payment Systems/Money Transmission

The payment of bills, the closing of business deals, the transfer of funds to and from different accounts all form part of the millions of transactions which take place in the domestic and international economies every day, the value for which is settled through the money transmission system operated by banks.

1.4 Capital Markets

Capital markets are markets which facilitate the raising of capital and matching those who want capital (borrowers) with those who have it (lenders). Capital markets serve a similar intermediation function as banks matching lenders with borrowers. The most common capital markets are the Stock Market and the Bond Market.

Lenders, that is, those with capital to invest, might include individuals, companies, life assurance companies, unit trust groups and pension funds. Borrowers, that is, those who want and need capital, might include individuals, companies, governments, municipalities (such as county councils), and public corporations.



Capital markets enable funds to be channelled from lenders in the economy (with surplus funds) to borrowers who need funds, by enabling those who need funds to sell financial products or securities to those with funds available for investment.

The *primary* capital market is the market through which new financial products and securities are issued and therefore the market through which borrowers raise *new* funds.

The *secondary* market is the market through which *existing* financial products, already issued, are bought and sold by investors.

Primary Market

An example of primary capital markets is the marketing and sale of an initial public offering (IPO) of shares on the stock exchange by a private company who wants to raise fresh share capital to invest in its business. The company issues the new shares for sale, which is a primary market activity.

Secondary Market

Shareholders who acquired shares in the IPO offering above may then wish to sell these shares at a later date.

The sale and purchase of these shares on a stock exchange is a secondary market activity.

The two main products in the capital markets include:

- Shares in companies: Companies can raise money (Capital) by issuing shares in the company to investors, who become part owners of the company and share in the success and failures of the company. Shares are sometimes also called *equities*.

- Bonds: A Bond is typically a fixed income instrument which is a loan made by an investor to a borrower (typically a Government or Corporate entity). These loans can be short term (if less than a year) and may be referred to as money market instruments, or as long as 100 years. Also, there have been some bonds with no maturity date at all (irredeemable). Bonds are essentially IOUs issued by the borrower stating the terms of interest and capital repayment. They can take the form of loans, debentures (loans secured on assets, such as a legal mortgage) hire purchase and lease finance arranged through a financial institution, through to bonds which can be traded in the debt markets.

1.5 The Irish Stock Exchange (ISE)

A stock exchange is a marketplace where securities, such as stocks and bonds, are bought and sold. Stock exchanges allow companies to raise capital and investors to make informed decisions using real-time price information. Exchanges can be a physical location or an electronic trading platform. Though people are typically familiar with the image of the trading floor, all exchanges now use electronic trading. The Irish Stock Exchange is owned by Euronext and approved and regulated by the Central Bank.

1.5.1 Markets

The Irish Stock Exchange PLC, trading as Euronext Dublin is also authorised by the central Bank of Ireland to operate its four securities markets; Euronext Dublin Main Securities Market, Euronext Growth, the Global Exchange Market (GEM) and the Atlantic Securities Market (ASM). :

- The **Main Securities Market (MSM)**, the principal market for Irish and overseas companies, which admits a wide range of security types such as shares, bonds and funds to listing and trading. The ISE Main Securities Market is regulated under MIFID Regulations (which govern the operation of European investment firms).

- The **Euronext Growth Market**, Euronext Growth is suited to small- and mid- sized companies (SMEs) that want to raise funds to finance growth. Listing requirements are simplified and reporting requirements are lighter than for the regulated market. Euronext Growth is open to both professional and individual investors. Although a controlled market, it is not regulated as defined under MiFID Regulations. It offers an alternative route for organisations that are at earlier stages of development.

- The **Global Exchange Market**, a specialist debt market for professional investors. It is *not* a regulated market for MiFID purposes.

- The **Atlantic Securities Market** for those large companies who would like to trade on both the Irish and US markets.

1.5.2 Functions

The Irish Stock Exchange:

- Operates and regulates the Irish Stock Exchange markets, including monitoring listed companies' compliance with the listing rules, both at the time of the application for the admission of securities to listing and trading on the exchange, and on an on-going basis;

- Admits stockbroking firms to membership (once authorised by the Central Bank);

- Assesses applications for listing on the exchange;

- Investigates and reports insider dealing to the Director of Corporate Enforcement (DOCE) in relation to Irish companies admitted to the exchange's ESM and GEM markets, under the Companies Act;

- Reports suspected market abuse on the MSM to the Central Bank of Ireland;

The type of securities listed on the ISE's MSM, include:

- Equities, that is, shares in publicly listed companies;
- Debt securities, that is, bonds, issued by companies;
- Irish Government bonds, called treasury bonds;
- Exchange traded funds (ETFs);
- Investment funds.

1.5.3 Market Abuse Regulations

The Market Abuse Regulations together with the Market Abuse Directive on criminal sanctions apply to all securities listed on the Irish Stock Exchange.

It would not be right if the directors/employees of a company whose shares are listed on a stock exchange were able to buy and sell shares on the basis of their inside knowledge of forthcoming results (good or bad) which, if known to the market at large, might lead to an increase or to a decrease in the company's share price from its current price. Using such information in this way is referred to as *insider dealing* and it is illegal.

Inside Information

This is Information, which has not been made public by the company, but relating, directly or indirectly, to the company, and which, if it were made public, would likely have a significant effect on the prices of its financial instruments.

It is the responsibility of the Directors to determine whether information constitutes inside information. Where information is determined to constitute inside information, it must be made public as soon as possible.

Insider Dealing

Insider dealing arises where a person who possesses inside information uses that information to acquire or dispose of, for their own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates, for example, shares or debt instruments of the company.

All persons in possession of inside information are prohibited from dealing in any securities of the company while in possession of inside information relating to the company for the period of time that information is relevant. An Example might be knowing the adjusted Sales Revenue of a company prior to announcement of quarterly earnings.

Closed Dealing Period

The directors of a company are prohibited from dealing in the securities of the company on their own account or for the account of a third party, directly or indirectly, during a closed period of 30 calendar days prior to the publication of the company's' interim and annual report, unless specific limited circumstances apply.

Market manipulation

A company may not engage or attempt to engage in market manipulation which includes giving false or misleading signals as to the supply of, demand for, or price of, its securities.

Let us look at an example of what we mean by insider dealing.

Case Study

Mary is a secretary at *Woodblock plc*, which is quoted on a regulated market, like the Main Securities Market of the Irish Stock Exchange. She has just typed a letter from the company's Managing Director to their bankers explaining why the company's financial results are likely to be much worse than anticipated some months ago.

Mary has inside information, that is, information which if known in the marketplace would be likely to cause a movement in the share price from where it might otherwise be, that is, a movement up or down.

The public perception of Woodblock plc is one of a successful company tipped to do well and to continue producing good results. Mary's father owns 100,000 shares in Woodblock. If Mary advised her father of the contents of the letter and he sells his shares on the basis of this inside information, this would represent *insider dealing and* criminal charges could follow.

The ISE monitor all share transactions on the exchange and have a sophisticated mechanism for detecting unusual share transactions and patterns which may indicate insider dealing, for example, large blocks of shares in a particular listed company being bought just before a public announcement of a takeover of the company at a substantially higher price than its current share price.

Sanctions

The Central Bank has expanded powers under the Regulations to impose a range of administrative and criminal sanctions for breaches of the Regulations. Administrative Sanctions on companies include fines, of up to €15m or 15% of annual turnover.

Individuals can be fined up to €5 million for insider dealing, unlawful disclosure or market manipulation. Criminal Sanctions can include imprisonment of 2 to 4 years, depending on the relevant offence.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- The main functions of the financial services system ☐
- The key participants of the financial services system ☐
- The main financial services which financial institutions provide ☐
- What capital markets are, and the difference between primary and secondary capital markets ☐
- The main functions of the Irish Stock Exchange, including the main types of securities listed on the exchange ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. In relation to its dealings with customers in the US, a business based in Ireland is directly subject to WHICH form of investment risk?

   A. Exchange rate.
   B. Liquidity.
   C. Interest rate.
   D. Inflation.

2. Admission to membership of a credit union is restricted by law to persons who:

   A. share a specified common bond with other members.
   B. hold both shares and deposits in the credit union.
   C. are not clients of a retail bank.
   D. are not already a member of another credit union.

3. Overdrafts are charged interest:

   A. only when the overdraft limit has been exceeded.
   B. when used.
   C. if not used.
   D. only when fully drawn.

4. Before being admitted to membership of the Irish Stock Exchange, a stockbroking firm MUST:

   A. have a turnover of at least €5 million.
   B. have at least ten investment advisers.
   C. be authorised by the Central Bank.
   D. have minimum assets of €100 million.

02

The Economy

The economic policy options (monetary policy/fiscal policy) and how they can be used to influence the economy, are introduced. The importance of accurately measuring economic growth and understanding the measurement (gross domestic product (GDP) and gross national product (GNP)) is introduced. The causes of both inflation and deflation and their impact on an economy are also discussed.

Unemployment is defined and described based on a number of underlying causative factors.

The main features of the European System of Central Banks are introduced.

Learning Outcomes – after studying this chapter you should understand:
the difference between monetary and fiscal policy as a means to influence the economy;
the difference between gross domestic product (GDP) and gross national product (GNP) to measure economic growth and development;
the difference between inflation and deflation and their respective causes;
the different causes of unemployment;
the benefits of international trade; and,
economic and monetary union and the structure of the European System of Central Banks.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	2	3	5

2.1 Instruments of Economic Policy

The principal economic instruments which are available to influence the economy are:

- *Monetary* policy; and
- *Fiscal* policy.

2.1.1 Monetary Policy

Monetary policy is the term applied to the control of interest rates and the magnitude of the money supply in the economy, which includes the availability of credit. Most of the worlds money supply is actually provided for through the issuance of credit.

Monetary policy is under the control of the monetary authority that is, the *European Central Bank* for those countries within the eurozone and a country's national Central Bank for other countries.

An instance of the application of monetary policy would be the lowering of interest rates designed to stimulate economic demand. Such action would be appropriate when a country's economic activity is stagnant or in a declining mode.

On the other hand, increasing interest rates might be used to reduce overall supply of money in the economy in times of inflationary pressures. Higher interest rates reduce the level of credit and money available in the economy available to buy goods and services and may slow inflation driven by demand.

2.1.2 Fiscal Policy

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to both monitor and influence a nation's economy.

It is manifested in the annual budget which the government in Ireland introduces, normally, in October. The main source of government revenue is obtained through taxation and if this revenue is greater than government expenditure there is said to be a budget *surplus*.

On the other hand, if government expenditure is greater than revenue there is a budget *deficit,* which has to be balanced by government borrowing, principally through the issue of bonds (in the absence of increasing revenues through increasing taxation or reducing expenditure by cut backs on public services, etc.). This borrowing adds to the magnitude of the country's *national debt*.

2.2 Economic Growth

Economic growth and development can be measured using either or both of the following techniques:

- *Gross domestic product (GDP)* measures the total value of goods and services produced in the Irish economy in a year, irrespective of whether the factors of production/economic resources are owned by Irish or foreign entities or people.
- *Gross national product (GNP)* measures the total value of goods and services produced by Irish owned businesses of production/economic resources in a year.

In many countries, there is little difference between the value of *GDP* and the value of *GNP* in which circumstance it matters little which of these measures is used.

In the case of Ireland, the value of our GDP is usually greater than the value of our GNP, this is explained by the fact that many foreign owned firms operate in the Irish economy (thereby contributing to GDP) whereas there are relatively few Irish firms operating in foreign countries.

Since GNP measures the value of goods and services produced by Irish owned factors of production - and therefore the income accruing to the Irish owners of these factors - GNP is a more reliable indicator of changes in the standard of living of Irish people rather than GDP, because included in GDP is income earned in the Irish economy by foreign owned factors of production; such income may be repatriated to other countries.

2.3 Inflation and Deflation

Inflation is the term used to describe a *continuing rise* in the price level of goods and services. The long-term rate of inflation target for the ECB is 2%pa. However, at the end of 2022 inflation in the Eurozone was running at 10.4%pa and in Ireland at 8.2%pa.

Deflation is the term used to describe the opposite situation to *inflation* that is, a *continuing fall* in the price of goods and services. This means that the same amount of money now buys more goods and services than before. Deflation is negative inflation.

2.3.1 Causes of Inflation

There are a number of potential causes of inflation including:

- An increase in the level of demand for goods and services in the economy without a corresponding increase in supply leaves an unsatisfied demand at existing prices. This shortage enables suppliers to increase their selling prices and thus their profits.

  This type of inflation is referred to as ***demand pull inflation*** as it is caused by a pull or increase in demand for goods and services, without a corresponding increase in the supply of such goods and services.

- An increase in the price of production (economic inputs), and hence prices for goods and services, for reasons other than excess demand, for example, higher energy costs and/or increased wages for employees.

  This type of inflation is referred to as ***cost push inflation*** as it is caused by an increase in costs of production of goods and services which are passed on to consumers in the form of higher prices.

- An increase in the cost of industrial raw materials imported from a country with a higher inflation rate. This results in an increase in costs and puts upward pressure on prices and inflation in the importing county.

  This is referred to as ***imported inflation***.

- The addition by manufacturers and service providers of a specific percentage to their selling costs in order to recoup general overheads and also to provide a level of profit. If such a policy is in operation, then the application of a constant percentage mark-up over costs during a period of rising costs will add further to the inflationary process.

  Similarly, if a tax was imposed on all inputs which a producer uses, the adding of a constant mark-up in order to determine selling prices would mean that the producer is fuelling further the environment of rising prices through seeking to earn a profit on the tax which they are paying.

  This type of inflation is referred to as ***mark-up inflation*.**

- ***Increase in taxation*.** Increases in expenditure taxes such as VAT and excise duty increase the price level of goods and services subject to such taxes. By increasing the cost of living, it can have a knock-on effect of a demand by workers for compensating increases in income.

  Knock-on effects of this nature add further to the inflationary process. In addition, increases in direct taxes such as income tax will also impart an inflationary impulse to the economy if workers attempt to negotiate wage agreements on the basis of "real" take home pay.

- Consumer's ***expectations of inflation****;* this may also cause the inflationary process to continue. When people experience a sustained period of price increases they build the expectation of continuing price increases into their assessment of the future.

  For example, if workers are negotiating a real increase in wages of 2% (that is, after inflation) and if from past experience they expect an inflation rate of 4% during the period of the agreement then they will seek a nominal wage increase of 6% that is, a real increase of 2% and 4% to cover inflation.

  Inflationary expectations also influence the demand for goods and services, potential purchasers of an item are unlikely to be deterred by high prices if they are of the opinion that inflation will cause prices to be even higher in the near future.

2.3.2 Causes of Deflation

Many of the items listed above as causes of inflation can cause deflation when operating in the opposite direction; for example:

- A decrease in the level of demand for goods and services due to an economic downturn;

- A decrease in the price of production;

- A decrease in the cost of raw materials;

- A reduction in producers 'mark-up' percentage;

- A decrease in taxes;

- Consumer's expectation of continuing deflation. If prices of consumer goods and services are falling, consumers may react by delaying expenditure in the expectation of lower prices later on. This delayed expenditure can lead to a further reduction in the demand for goods and services and so feed the deflationary trend further.

- Technological Advances: Advances in technology, the application of new technologies or efficient systems in production can create a lower cost of production and a subsequent increase in supply, driving the price of these products down.

2.4 Unemployment

Unemployment is defined as the number of people who are willing to work at existing wage rates but are not currently employed, while *full employment is* defined as a situation where everybody in the economy who is prepared to work at existing wage levels is in employment.

It is not conceivable that all of those available for, and willing to work will in fact find employment, a comment which is obvious in the light of the causes of unemployment which are discussed below.

- **Classical (or real wage) unemployment** occurs when the wage rate is at a level above the market rate leading to a surplus of labour supplied.

This situation may be as a result of the operation of minimum wage legislation or it may be due to the ability of a strong trade union which succeeds in achieving for its members a wage rate above the market rate - the primary writ of trade unions is that they negotiate on behalf of their existing members rather than taking on board the wider macroeconomic point of view.

- **Frictional unemployment.** This applies when there is a reduction in the demand for labour in a particular occupation even though jobs are available in other occupations and / or firms.

  Unemployment of this nature may be due to lack of knowledge of vacancies by those seeking employment, and/or a degree of geographical immobility; a mismatch between employment training programmes and the needs of industry would also give rise to this type of unemployment.

- **Seasonal unemployment** is due to seasonal variations in the level of demand for labour for example, the tourist industry during the winter period. Firms attempt to overcome this problem by offering a complementary range of products which provides an all the year-round demand for their products for example, the provision of indoor recreational facilities.

- **Structural unemployment** refers to unemployment which is the result of a change in the structure of an industry brought about by technical progress, the forces of competition and/or relative factor prices for example, the computerisation of office work and the automation of factory work.

- **Demand deficient unemployment** is brought about by swings in the pendulum of business activity and hence in the demand for labour. During the recovery and boom periods of the economic cycle there is a high demand for labour while unemployment rises during recessionary periods, when demand in the economy for labour falls.

- **Institutional unemployment.** This arises because of obstacles to the mobility of labour. The mobility of workers may be hindered by the non-availability of an adequate social structure, including houses and transport, in areas where jobs are available.
  Closed shop practices by trade unions which limit entry to certain occupations or professions together with high social welfare payments which cushion the economic deprivation of unemployment also contribute to institutional unemployment.

2.5 International Trade

Countries trade with each other so that their inhabitants can enjoy a higher standard of living. This trade in the case of Ireland is based on the following considerations:

- Certain natural resources such as petroleum products are naturally available only in other countries. Countries which do not have such resources can only acquire them through trade.

- Other countries can produce goods which would be difficult (if not impossible) to produce here because of the absence of certain conditions, for example, climatic conditions to produce certain fruits.

- Other countries can produce certain goods more cheaply than we can. Therefore, it may be more advantageous for us to import them rather than produce them ourselves at a higher cost.

The decision to engage in international trade is similar to the decision of an individual to engage in the division of labour and to concentrate on a particular occupation.

Just as an individual trades in order to acquire those goods and services which he or she cannot produce themselves, or which they can acquire at lower opportunity cost through trading, a country does likewise by engaging in international trade.

The benefits of international trade include:

- *Total output is increased*. There is an increase in total output if countries specialise in the production of those goods in which they are relatively more efficient and engage in trade.

- *More extensive choice of goods*. Goods that cannot be produced domestically can be imported through trade.

- *Goods should be cheaper*. Since each country is concentrating on the production of those goods at which it is most efficient, unit costs of production should be lower than if each country attempted to be self-sufficient. In addition, because the scale of operations will be greater, *economies of scale* will be experienced.

- *Encourage competition and efficiency*. International trade intensifies competition and in this way, lessens the likelihood of dominant domestic firms being in a position to attain market dominance with the attendant opportunities to exploit the geographically protected domestic market.

- *Fosters links between countries*. Countries which trade with each other tend to develop links which makes the possibility of wars between them less likely. This was the reason for the beginning of the economic co-operation which has culminated in the establishment of the European Union.

- *Continuing growth in world trade*. An appreciation of the advantages of international trade is manifest in the international movement over recent decades towards the freeing up of world trade.

One downside of international trade, as we have seen during the Covid19 Pandemic and the Russian invasion of Ukraine, is that we don't have control of the supply chain, which can lead to supply shortages and severe price increases.

2.6 Economic and Monetary Union

2.6.1 Background

The *Treaty of Rom*e established the European Economic Community (EEC). Commencing with a 10% tariff reduction on intra-community trade in 1959, the policy of tariff reduction continued until 10 years later, there existed a common market between the member countries.

In January 1973, the EEC grouping of six countries was enlarged to nine with the accession of UK, Denmark and Ireland.

Since then, the number of countries in the EU increased to 28, of which 20 share a common currency, the euro. With the departure of the UK there are 27 EU members.

On the 23rd June 2016 the United Kingdom voted on a referendum (known as Brexit) to leave the European Union. At midnight on the 31stJanuary 2020 the UK officially left the European Union. UK nationals no longer have the freedom to work, study, start a business or live in the EU.

The UK is treated the same for tax purposes for investments by Irish citizens as if it were part of the EU.

2.6.2 Degrees of Economic Integration

It will be noted from the foregoing that over time European economic co-operation was deepened as agreements were entered into to proceed through the following stages of deeper economic integration:

- *Free trade area* = Free movement of goods within an area.
- *Customs union* = A free trade area plus a common system of tariffs and taxes on goods being imported from outside the customs union.
- *Common market* = A customs union plus free movement of capital and labour within the common market area.

Brexit highlights the importance and complexity of the above arrangements, as the UK and the EU struggled to negotiate terms for working together post Brexit.

2.6.3 Monetary Union

An economic union is a prerequisite for a successful monetary union.

The main features of an economic union are a trading area (or market) within which *persons*, *goods*, *services* and *capital* can move without hindrance. These features are usually referred to as the *four freedoms*.

The main features of a monetary union are:

- The complete liberalisation of capital transactions;
- The irreversible locking of exchange rates;
- Complete convertibility of currencies;
- The introduction of a single currency, the euro;
- The conduct of a uniform monetary and exchange rate policy.

2.7 The European System of Central Banks (ESCB)

2.7.1 Structure

The European System of Central Banks (ESCB) consists of the European Central Bank (ECB) and the national central banks of all 27 member states of the European Union

The governors of the national central banks of the participating countries along with the executive board of the ECB form the governing council of the ESCB.

This council, which is responsible for formulating all aspects of monetary policy within the eurozone, is the most important decision-making body within the ESCB. Its decisions are taken by a simple majority with the President of the ECB having a casting vote.

The day-to-day management of the ECB is undertaken by an executive board which consists of the President of the ECB and its Vice-President together with four other members chosen by the heads of states of the eurozone countries.

This executive board oversees national central banks, commercial banks and other forms of financial institutions.

2.7.2 Objectives

The role of the ECB is:

- To manage the euro,
- To keep prices stable, and
- To conduct EU economic & monetary policy.

The main aim is to maintain price stability, which in turn safeguards the value of the euro. Price stability is essential for economic growth and job creation – two of the European Union's objectives – and it represents the most important contribution monetary policy can make in that area.

The ECB has defined price stability as "*a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% Price stability is to be maintained over the medium term."* The HICP is the measure of inflation which the ECB uses to define and assess price stability in the euro area as a whole in quantitative terms. It is based on changes in prices across the euro area of a wide range of consumer goods. It does not (as the Irish Consumer Price Index does) include mortgage costs.

In recent years, with inflation seen to be under control, the ECB has focused on its other responsibilities of ensuring that economic policy is helping to support stronger economic growth/preventing recession. This has resulted in interest rates remaining very low for a long period. The recent resurgence in inflation has resulted in the increase in interest rates for the first time in a number of years.

2.7.3 Independence of ECB

The ECB is independent of national central banks, national governments and all other bodies in its formulation of policy and decision making. Neither the ECB, nor a national central bank, nor any member of their decision-making bodies can seek or take advice from Community institutions or bodies, from any government of a member state or from any other body.

To strengthen further the independence of the members they are appointed for a single non-renewable term of office so that their decision making will not be influenced by considerations of re-election.

By these and other provisions an attempt has been made to institutionalise the independence of the ECB; since the ECB is not under the control of the European Parliament the independence granted is greater than that enjoyed by the US Federal Reserve System, which is subject to the US Congress.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- The difference between *monetary* and *fiscal* policy ☐
- The difference between *gross domestic product* and *gross national product* ☐
- The different causes of inflation ☐
- The different causes of deflation ☐
- The different types of unemployment ☐
- The main benefits of international free trade ☐
- The main features of the European System of Central Banks ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. Monetary policy in the EU countries who are members of the Eurozone is under the control of the:

   A. European Commission.
   B. European Central Bank.
   C. The national central banks of each individual country.
   D. International Monetary Fund.

2. The total value of goods and services produced by Irish-owned factors of production, is referred to as:

   A. Gross Domestic Product (GDP).
   B. Net Domestic Product (NDP).
   C. Gross National Product (GNP).
   D. Net National Product (NNP).

3. Deflation can be caused by:

   (i) an increase in sales tax.
   (ii) a reduction in producers mark up %.
   (iii) a decrease in the level of demand for goods and services.

   A. (i) only.
   B. (iii) only.
   C. (i) and (ii) only.
   D. (ii) and (iii) only.

4. The participants in the European System of Central Banks are the national central banks of all countries participating in the Euro and:

   A. the Finance Ministers of each country.
   B. the Prime Ministers of each country.
   C. the European Commission.
   D. the European Central Bank.

03

Investment Asset Classes

In this chapter, the main asset classes are described, and their return compared and categorised. Alternative asset classes are also detailed and how they differ from the main asset classes. Investment concepts such as volatility, correlation and diversification are introduced. Their importance is discussed in relation to portfolio selection and how an investor can seek to optimise investment returns using modern portfolio theory.

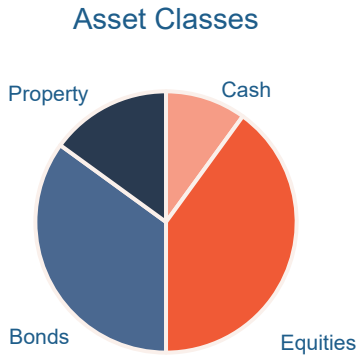
Learning Outcomes – after studying this chapter you should be able to understand and discuss:
the main investment asset classes and their historic pattern of returns;
the main alternative investment asset classes and how they differ from the main investment asset classes;
what volatility of investment returns means and how it can be measured;
the correlation of investment returns;
the difference between optimising and maximising investment returns;
the investment benefits of diversification;
what the yield gap means and how to calculate it; and,
what the equity risk premium means and how to calculate it.
ESG Investing, how it is regulated, and how customers are informed and advised.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	3	11	15

3.1 Main Investment Asset Classes

An asset is a resource with an economic value which can be owned by a person or entity and which is hoped, will provide a future benefit. There are different types of assets, often referred to as *asset classes*, whose financial characteristics differ and which savers and investors can invest in directly, or through collective investment funds; for retail investors these collective investment funds are called Packaged Retail and Insurance-Based Investment Products (PRIIPs)).

The main or traditional investment asset classes are:



- ***Cash*** such as deposits and deposit equivalents, that is, money market instruments and funds.

  This category includes not just deposits but money market type investments which could be considered to be 'near' cash or cash equivalent, that is, which carry a capital guarantee and can be turned into cash instantly or within a very short period.

  Some suggest that cash is not an investment asset class in the true sense of the word, as it is not seen as a long-term investment (given its likely long-term low or negative returns relative to inflation) but rather as a means of holding liquidity in an investment portfolio pending future investment in bonds, shares or property.

- ***Bonds*** (also known as *fixed interest securities)*, can be issued by a government, a public authority or a company.

  Bonds are a form of borrowing, by the issuer of the bond. In effect, the investor buys an IOU provided by the bond issuer for a fixed period of time. The bond issuer may undertake to pay a rate of interest (referred to as a *coupon*) on the nominal or face value of the bond and may or will undertake to repay the nominal value of the bond at some specified date or dates in the future. This is known as the maturity date. Bonds vary in their term, from months up to 100 years or more, although typically most bonds will have a maturity date of less than 15 years.

  The rate of interest or coupon is typically determined by the credit worthiness of the bond issuer and the interest rate environment. The more credit worthy an issuer is, the lower the rate of interest paid on the bond as the risk of default by the issuer of an interest payment or repayment of capital at maturity is lower.

  Some bonds may undertake to link returns to an index, such as the rate of inflation, usually the CPI. These are referred to as *index linked* or *inflation linked* bonds. Bonds issued by the Irish Government are referred to as *treasury bonds*. Bonds issued by the UK Government are referred to as *gilts* referring to the fact that they are judged as offering 'gilt edged' security, that is, a guarantee by the UK Exchequer.

- ***Equities****,* refer to, shares (or stock) publicly quoted on a trading floor known commonly as a stock exchange. A Share is a unit of equity ownership in a business which allows the owner to share in the fortunes or misfortunes of the business.

  Investing in shares provides part ownership in a company and typically compensates investors with a share of the company's profits through the payment of ***dividends*** **as well as increased capital growth**.

  Not all companies pay a dividend as a form of return, with some companies aiming to provide investors with their returns through price appreciation of the shares over time.

This is achieved by re-investing a portion of the profits in the business (which could otherwise be paid out as a dividend) in the hope of an increased return which in turn adds additional value to the business. Shares are considered a '***real asset***' as companies can often maintain their profits through price increases when inflation is rising in an economy.

Shares (particularly those of larger companies) can be bought and sold easily and rapidly on a stock exchange to raise cash, if required. This refers to their liquidity.

Shares may be pooled into collective investment funds as defined by the fund manager. Examples of collective investment funds/PRIIPs include:

- Index funds which aim to match the movement in a particular stock market or other index of shares, for example, FTSE 100, (Top 100 stock market listed companies, by market capitalisation, in the UK),

- Exchange traded Funds (ETF) which may be linked to an index such as a particular geographic market or thematic, such as a particular business sector, for example technology,

- Unit linked funds which offer some insurance coverage as well as investment exposure and

- Unit trust funds which allow assets to be held in trust for investors

• ***Property, sometimes referred to as Real Estate***, that is, usually commercial property such as offices, factories and shops. The term *property* usually covers investing:

  - Directly into one or more commercial properties;

  - In the shares of a property company (for example, REITS – Real Estate Investment Trusts) listed on a stock exchange or possibly in a private company not so listed which invest in a range of different commercial properties; or

  - In a collective investment fund/PRIIP which in turn invests in a range of commercial properties.

  The benefits of investing in a property via a PRIIP, versus direct investment in property, are that the fund managers can diversify their portfolios with a large number of different property assets. Physical Property, however, is not classed as a liquid asset as it takes time to sell the underlying properties in the portfolio and complete the legal conveyance.

  When investing in Property there are a number of things that investors should watch out for, such as the quality and location of the properties. If looking at a Property fund, understanding the occupancy rate, rental yield, and whether or not there is any borrowing or gearing on the property. What sort of tenants are currently *in situ* and how long is the average lease length across the fund? If the properties are outside of Ireland (UK for example) is there currency risk? Finally, understanding if the property is, Retail, Office, Industrial/Logistics, or Residential or a mix of all four.

  Property is considered a "real asset" as owners can typically increase the rental income when inflation is rising in an economy, therefore maintaining the real return from the asset.

Within each of the main asset classes outlined above there may be subcategories.

- Equities may be classified in many different ways. The simplest of these is their classification by their size based on their market capitalisation, such as Mega Capitalisation (cap) companies (>$200Bn), large cap companies (>$10Bn), Mid Cap companies ($2-10Bn) and small cap companies (<$2Bn).

- Bonds can be classified by those issued by sovereigns (that is, governments) or corporates (issued by companies);

- Property may also be subdivided into retail, office, industrial, and residential.

The main investment asset classes can be initially compared at a high level as follows (but see Chapter 3.4 below regarding comparative volatility of returns):

	Cash	Bonds	Property	Equities
Potential returns	Low	Medium	High	High
Investment time span to optimise returns	Short	Medium	Long	Long
Potential protection against inflation	Low	Medium	High	High
Liquidity	High	High	Low	High

3.2 Historical Returns

The returns on asset classes can be presented in two distinct forms: A ***Nominal*** rate of return is the return on investment before taking account the rate of inflation and ***Real*** rate of return is the return after adjustment for inflation. It is very important to understand which return is being quoted when interpreting the various historic returns from each asset class.

Statistics prepared annually by *Credit Suisse*[1] show the annual *real* rate of return (that is, return after offsetting inflation over the same period) for US equities and bonds over the last 123 years, as follows:

Real investment returns by asset class (% per annum)

Equities	6.4
Bonds	1.7

What the statistics show is that equities produced the most volatile but highest real return over the very long-term (123 years)

Property returns are not shown in the report; however typically property has produced returns closer to equity returns and slightly above bond returns over the longer term.

Equities, property and index linked bonds are sometimes therefore referred to as '*real'* asset classes, due to their past proven ability to provide returns in excess of the rate of inflation over the long-term, that is, they offer the best protection against the financial impact of inflation.

On the other hand, bonds (non-index linked) and cash are sometimes referred to as *monetary* asset classes, as compared with the *real* assets terminology applied to equities and property.

[1] *Source: Credit Suisse Average real Investment returns yearbook 2023, page 15.*

3.3 Alternative Asset Classes

There are other types of investment assets, sometimes referred to as *alternative*[2] assets classes, such as:

- Private equity, that is, shares in private companies which are not listed on a stock exchange. These shares are sometimes referred to as unlisted as the shares are not listed on a stock exchange;
- Precious metals, for example, gold and silver;
- Works of art, classic cars;
- Collectible coins, vintage wine, etc.;
- Commodities, such as gold, copper, oil, etc.;
- Foreign currencies, for example, holding foreign currencies as an investment, in the hope or expectation that that currency will appreciate in value relative to the investor's 'home' currency, for example, against the euro;
- Crypto assets, are broadly defined as private digital assets that use cryptography and are designed to work as a medium of exchange or as a store of value. The most common of these are cryptocurrencies;
- Derivatives and futures: investments whose value is derived from other types of investments, such as bonds, equities or commodities;
- Infrastructure investment: for example, toll roads, toll bridges, Airports etc.

These alternative asset types differ from the main asset classes in a number of ways:

- They are frequently less liquid than bonds and equities, so that it may not be possible to easily sell an investment in such assets at short notice without suffering a significant loss, or indeed in some cases it may be difficult to find any buyer for the asset. Investment in such assets may therefore not be readily accessible.
- The minimum investment required to invest in such assets is frequently much higher than the minimum required to invest in traditional asset types. For example, a minimum investment in private equity funds might be at least €250,000.
- Investing in alternative assets may not be regulated and protected as investing in traditional asset types.
- Alternative assets are generally riskier assets than traditional asset types, due to significant volatility in values and difficulty in establishing fair open market values. For example, derivatives can exhibit extreme volatility in values. Higher risks may, however, bring potentially higher returns.
- Investment returns of alternative asset classes tend to be negatively correlated (or at least not as strongly positively correlated) to the returns provided by traditional asset classes such as bonds and equities. For example, at times of crises when equity values may fall, gold may increase in value as it may be perceived to be a safe haven of value. Therefore, by diversifying part of a portfolio into alternative asset classes, the investor hopes to reduce overall investment volatility in the portfolio and improve returns.

[2] *Alternative to the main asset classes.*

3.4 Volatility of Investment Returns

The comparison of the main investment asset classes set out above is not complete because it does not describe the volatility associated with those returns; that is, the extent to which the returns of the underlying assets vary over a given period.

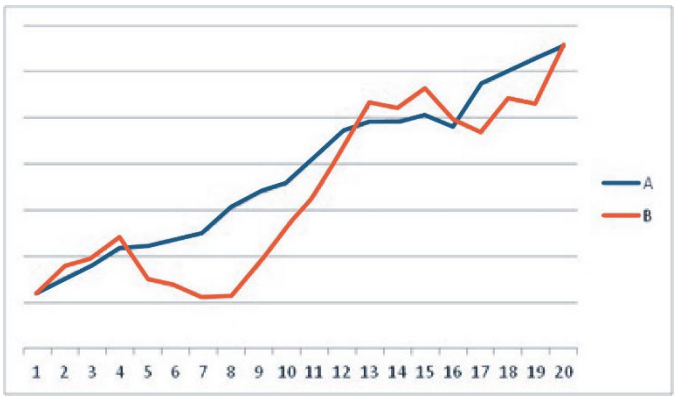
Investment markets do not move in straight lines, but they vary in their movements over short periods of time. This zig zag pattern of returns is referred to as investment volatility and it has an important impact on the behaviour of, and outcomes for, savers and investors.

3.4.1 Volatility

Investment risk is the probability of loss. The term *volatility*[3] is a way of describing and measuring *investment risk*. Higher returns tend to come in conjunction with higher risk, that is, higher volatility of returns.

Let's take two notional asset types A and B. We will assume that both investments on average produce a return of 4% per annum, but that B's returns will be twice as volatile as A's.

The chart shows the annual value of an initial €1,000 investment over 20 years, based on these assumptions:



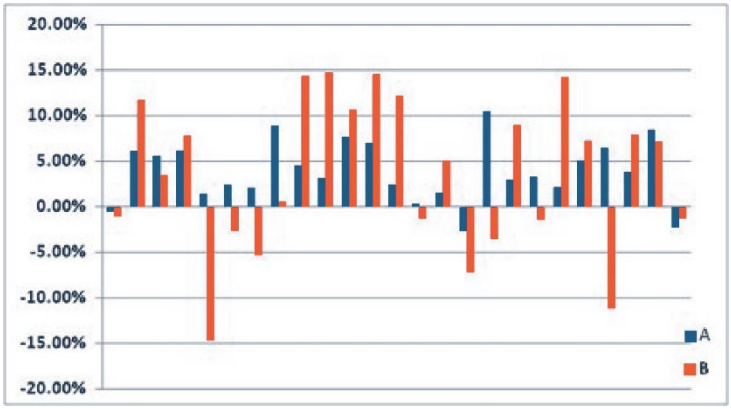
Looking at this chart we see that while B produced a similar return to A at the end of the 20-year period, its value along the way was often down at certain years and so was more volatile than A, which had a steadier cumulative growth in value.

The zigs and zags of A and B's values from year to year are examples of investment *volatility* or *risk*. B was a more volatile investment than A in this example, but did produce the same return over the investment period.

The concept of Risk and Return is very important for advisors to understand and be able to explain to their clients. Whilst there is a connection between taking higher risk in the pursuit of higher returns, this should not be assumed to always be the case. If we assumed that higher risk guaranteed higher returns, then in theory it wouldn't actually be higher risk. We should not confuse the long term outcome (reward) with the short term volatility (risk) experienced in order to achieve long term returns.

[3] *The term 'variance' is also sometimes used.*

If we look at the comparison of yearly investment returns, which gave rise to the values above, we can see that B had a much wider spread of returns around the average annual return.



So, in the case of the two investments, the question is … why invest in B when it experiences a higher volatility of returns, that is, with more risk of not getting the same return of 4% per annum.

This illustrates the dual concepts of **risk and return**.

3.4.2 Standard Deviation of Returns

The standard deviation is the most frequently used measure of spread of returns around the mean (or average) return, and is a way of measuring the extent to which the return for one observed period (for example, month or year) varies from its long-term average return for such a period.

The standard deviation of investment returns measures the dispersal (or spread) of returns around the mean for the period being measured.

A low standard deviation implies that the returns in any period are close to the average return over the full period. A high standard deviation implies that the returns in any period are often well below or about the average.

In investment A above, the assumed annual returns were:

- Mean: + 4%. Over the long-term the investment will return a 4% per annum return.
- Standard deviation: 4%. This means that most (approximately 68%) annual returns for A will, over the longer term, fall within a range of 0% to + 8%. (These numbers derive from taking the annual return 4% plus or minus one Standard deviation of 4%)
- The expected investment returns for Investment A are therefore 4% ±4% i.e., ranging from 0% to 8%.

The assumed annual returns for B were:

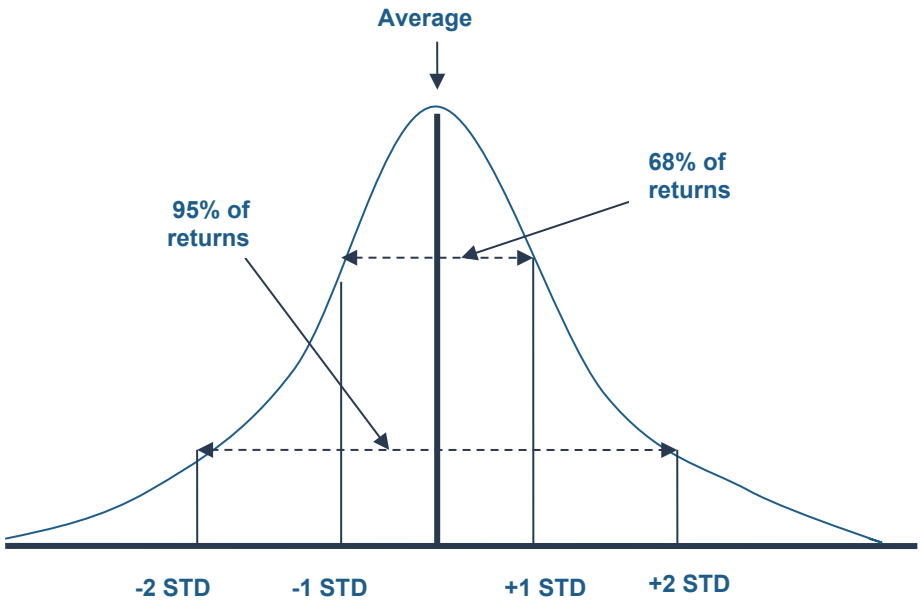
- Mean: + 4%. Over the long-term the investment will return a 4% per annum return.
- Standard deviation: 8%. This means that most (approximately 68%) annual returns will for B, over the longer term, fall within a range of – 4% to + 12%. (These numbers derive from taking the annual return of 4% plus or minus one Standard deviation of 8%)
- The expected investment returns for Investment B are therefore 4% ±8%

It was the higher standard deviation of returns observed for investment B that gave rise to its more volatile pattern of returns.

Therefore, the higher the standard deviation of an investment relative to its mean or average return, the more volatile its returns will be, that is, the riskier the investment.

One way to calculate the standard deviation of a series of returns is to use the STD function in Excel or any equivalent function in other spreadsheets.

The standard deviation therefore measures the level of dispersal of observed investment returns, around the mean or average return for the period in question.



If we assume that investment returns are subject to the *normal distribution* pattern over the long-term, what this means is that the distribution of returns for a large number of observed returns around the mean return for that period forms a bell curve pattern, as shown above:

The normal distribution says that 68% (that is, about 2/3) of a large number of investment return outcomes will fall INSIDE the range of:

[Mean – (1 x standard deviation)] to [mean + (1 x standard deviation)].

Therefore, if the mean annual return was 5% per annum and the standard deviation was 4% and investment returns followed the normal distribution, about 2/3 of a large number of annual returns would be expected to fall **INSIDE** a range of [5% - 4%] to [5% + 4%], that is, about 2/3 of returns would be between 1% to 9%, the dark area below:

Another way of putting this is to say that about 1/3 of returns will typically fall **OUTSIDE** the range of [mean – (1 x standard deviation)] to [mean + (1 x standard deviation)].

Therefore, if the mean annual return was 5% per annum and the standard deviation was 4% and investment returns followed the normal distribution about 1/3 of a large number of annual returns would fall OUTSIDE the range of [5% - 4%] to [5% + 4%], that is, 1/3 of returns would typically be either less than 1% or more than 9%, the dark area below:

The normal distribution also says that 95% of a large number of investment return outcomes will fall **INSIDE** the range of two standard deviations, that is:

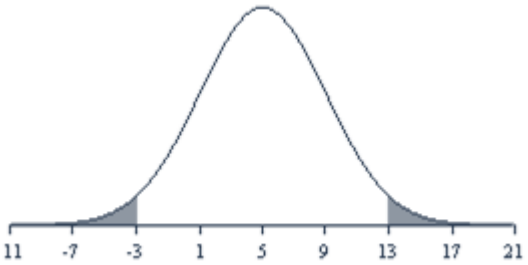
[Mean – (2 x standard deviation)] to [mean + (2 x standard deviation)].

Therefore, if the mean annual return was 5% per annum and the standard deviation was 4% and investment returns followed the normal distribution, then 95% of a large number of annual returns would typically fall INSIDE a range of [5% - 2 x 4%] to [5% + 2 x 4%], that is, about 95% of returns would be between -3% to 13%, as shown in the dark area below:

Another way of putting this is to say that about 5% of returns will fall **OUTSIDE** the range of:

[Mean – (2 x standard deviation)] to [mean + (2 x standard deviation)].

Therefore, if the mean annual return was 5% per annum, the standard deviation was 4% and investment returns followed a normal distribution, about 5% of a large number of annual returns would typically fall OUTSIDE the range of [5%- 2 x 4%] to [5%+ 2 x 4%], that is, 5% of returns would be either less than -3% or more than 13%, the dark area below:



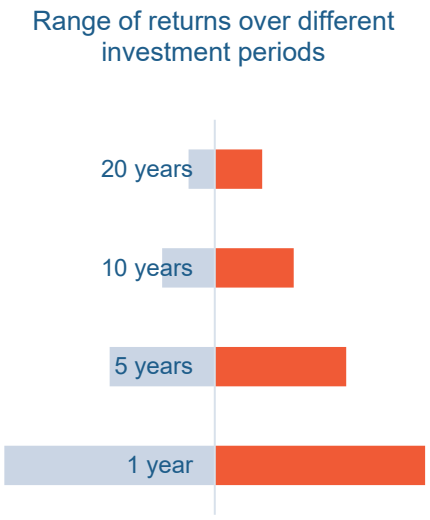
The projected standard deviation of returns is a common way to categorise investment funds by their level of risk, with a low standard deviation score suggesting a low risk fund, and a high standard deviation score suggesting a high-risk fund. It is important to note that the standard deviation measures the spread of returns about the mean and is therefore a measure of volatility.

3.4.3 Asset Class Analysis of Returns

Analysis of returns produced over long periods in the past by the various asset classes shows:

- Equities are likely to produce more volatile returns than bonds, which in turn are more likely to produce more volatile returns than cash.
- The volatility of returns from all asset classes reduces, the longer the investment period measured.

  So, for example, equity returns over a five-year investment period tend to be less volatile than returns over a one-year period, while equity returns over a 10-year investment period tend to be less volatile again than returns over a five-year investment period, and so on.



This can be represented by this chart, showing the historical range (that is, minimum and maximum) of equity returns over different investment hold periods.

Of course, there is no guarantee that asset classes will produce returns in this manner in the future; however, observed returns over long periods of time do suggest that volatility of returns for all asset classes tends to reduce the longer the investment hold period.

We can therefore complete the summary comparison table of the main investment asset classes by adding in a *risk* row, which refers to the anticipated volatility of investment returns:

	Cash	Bonds	Property	Equities
Potential returns	Low	Medium	High	High
Risk (as defined by Standard Deviation)	Low	Medium	High	High
Investment time span to optimise returns	Short	Medium	Long	Long
Potential protection against inflation	Low	Medium	High	High
Liquidity	High	High	Low	High

3.5 Correlation of Returns

Correlation when related to investing is a statistic that measures the degree to which two securities or assets move in relation to each other. The concept of correlation is very important in understanding the basics behind diversification and why certain assets are mixed into investment portfolios.

- ***Positive correlation***, that is, their returns tend to move up and down together at the same time and in the same direction.
- ***Negative correlation,*** that is, their returns tend to move in opposite directions, so that if one is going down in value, the other is likely to be moving up in value.
- ***No correlation***, that is, their returns tend to move independently of each other. There seems to be no connection between the returns produced by one investment as compared with the other. They may move up and down together at different times and at other times they may not.

The degree or correlation is calculated on a scale of plus 1 to minus 1 as follows:

- **-1**. That is, 100% negative correlation (perfectly uncorrelated), meaning that, returns from the two investments move exactly in inverse relationships to each other. If one increases in value over a particular period by 10%, the other would be expected to decrease in value by 10% over the same period.

- **0.** That is, no connection (no correlation) between the returns produced by the two investments.

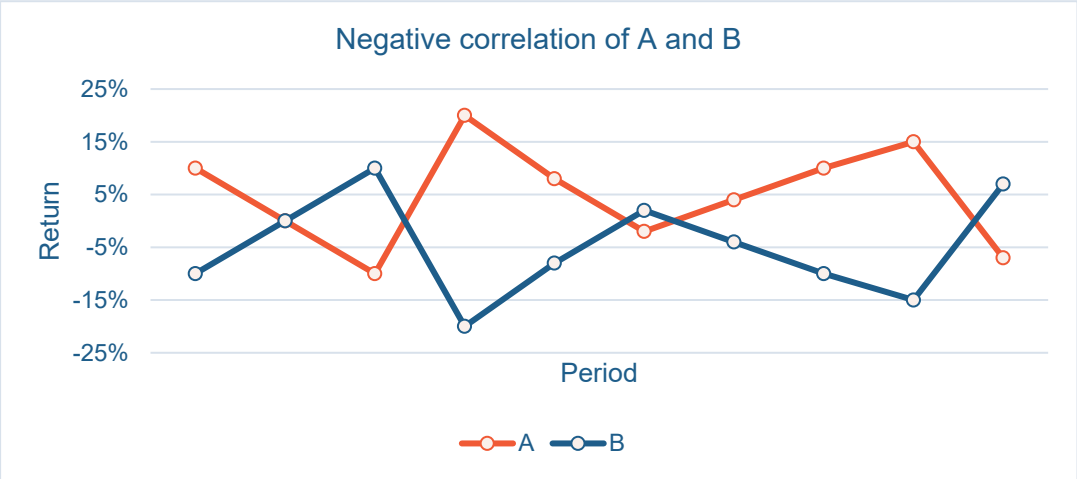
- **+1**. That is, 100% positive correlation (Perfectly correlated), meaning that, returns from the two investments move exactly in direct relationship to each other. If one increases in value by 10% over a particular period, the other would be expected to also increase in value by 10% over the same period.

Let's assume we have four investments, A, B, C and D which over similar periods produce the following returns:

Period	Investment return produced by…			
	A	B	C	D
1	10%	-10%	3%	10%
2	0%	0%	2%	0%
3	-10%	10%	1%	-10%
4	20%	-20%	3%	20%
5	8%	-8%	0%	8%
6	-2%	2%	-1%	-2%
7	4%	-4%	2%	4%
8	10%	-10%	20%	10%
9	15%	-15%	15%	15%
10	-7%	7%	25%	-7%

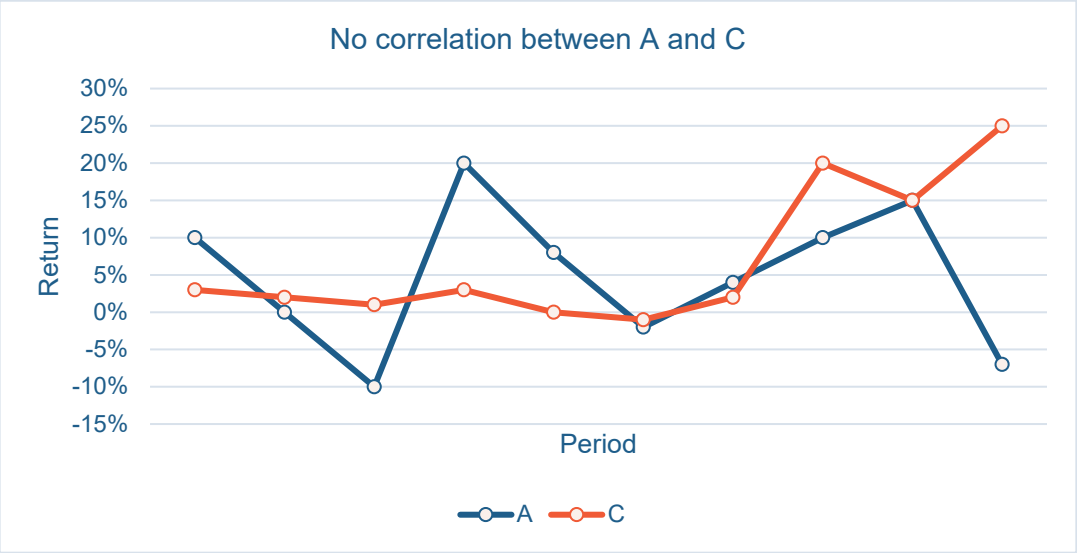
We can see that A and D's returns for each period are exactly the same and hence we would say they have a positive correlation of 1 that is to say they are 100% positively correlated.

If we look at A and B's returns for each period, we can see that they move exactly in *opposite* directions to each other. Every time A goes up or down in value, B seems to do the exact opposite.



A and B have a correlation factor of **-1**, that is, they are 100% negatively correlated.

If we look at A and C, however, we see that there does not seem to be any discernible relationship between the pattern of their investment returns over that period:



A and C have a correlation factor of nearly 0, over this period, that is, their returns do not seem to be related in any manner.

Of course, in practice, different investments are rarely 100% positively or negatively correlated; the degree of correlation may well be less than 100% but still be significant.

In constructing an investment portfolio, to reduce investment volatility, the ideal is to have a mix of asset classes and assets which are *not* highly correlated to each other in terms of their investment returns. So, if one investment goes down in value, another may be likely to go up to compensate or at least not fall in value to the same extent. However, some degree of positive correlation is inevitable if a positive investment return is to be obtained over time, for a given level of risk.

Students should note however that the concept of correlation as applied to Modern Portfolio theory requires some caution and should not be relied upon in every situation. Correlations of assets as described above do change over time and in doing so can change the benefits of asset diversification within a portfolio.

3.6 Optimising Investment Returns

As we have seen, different investments and asset classes tend to have different levels of volatility of returns, or risk.

Investors seek to *optimise* investment returns by:

- Seeking the highest possible return for a given level of risk they are willing to take; or
- Seeking the lowest level of risk to achieve a specific desired level of return.

Therefore, *optimisation* of returns is very different to *maximisation*. Maximising investment returns can be said to be looking for the highest absolute level of return, regardless of the level of risk taken.

Optimisation, on the other hand, involves attempting to get the best asset mix to give the highest likely return for the level of risk or volatility the investor is willing to tolerate. In the previous examples of investments A and B in Chapter 3.4.1, A is the better investment as it seeks to deliver the same 4% per annum average return as B, but with much less risk. Optimisation of returns is also known as *modern portfolio theory*.

Everyone likes volatility when investment values are going up! Nobody has a problem with an investment increasing by 10% in a week, but everyone has a problem with the value reducing by 10% in a week, particularly if the client does not have a high tolerance for risk in the first place.

In any given year, even in good periods, the World Stock market could be down say 15% at some point during the year. In addition, every seven or eight years the market will be down two or three times that; minus 30% to 50%. In the past forty years for example there have been eight major downturns, 1981, 1987, 1990, 1998, 2002, 2008, 2020 and 2022.

Diversification of asset class which are negatively correlated in a portfolio can be used to reduce Volatility (or risk) by dampening the effect of highly volatile asset classes. Efficient Diversification across different asset classes and within each asset class, is about putting investment 'eggs' in a number of different 'baskets'.

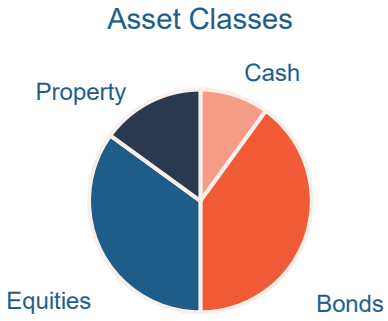
3.7 Diversification

There are two main types of investment diversification:

- Diversification *between* different asset classes, that is, between cash, fixed interest, property, alternatives and equities; and
- Diversification *within* the same asset class, between different securities of that class, for example, investing in a broad range of different shares through an equity fund; potentially seeking diversification across business sectors / geographies / currencies.

3.7.1 Between Different Asset Classes

The factor which has most impact on investment returns is *the asset allocation* decision as to the split of an investment portfolio between the main investment asset classes, for example, between cash, bonds, property and equities.



Of course, no one can predict in advance what *asset allocation* will produce the *optimum* return in the future, for any particular portfolio.

However, a diversification between bonds and equities/property is important as traditionally fixed interest securities (bonds) tend to produce returns which are not *correlated* to returns produced by property and equities; that is, if one is down, the other tends to be up.

Since asset values are derived by discounting the future value of earnings, to their present value, interest rates play an important part in that valuation. While not always holding true:

- If interest rates increase, equity and property values may fall if investors become more attracted to the returns offered by bonds and deposits and may move out of equities and property, thereby driving down the price of these asset types.
- If interest rates fall, equity and property values may increase as investors may start to move out of lower yielding fixed interest securities and into equities and property in search of a higher return.

However, this traditional relationship does not always hold true and there will be periods when returns across asset classes may seem to be correlated, as has happened after the onset of the great financial crises in 2007.

3.7.2 Within Asset Classes

Diversification within the same asset class can also lead to a reduced volatility of returns.

For example, an equity unit fund which invests in one share could be an extremely volatile fund, as the fund would be totally exposed to the fortunes of one share. For example, if the fund had invested only in Anglo Irish Bank, the value of that fund would have been wiped out following the nationalisation of the bank by the Government in early 2009.

An equity fund which, on the other hand, which invests in a large number of different shares is likely to be less volatile than a fund which invests in a smaller or more restricted range of securities. This type of diversification is a way of reducing the investment risk.

Diversification with the same asset class can take different forms, including:

Cash

- Deposits of different terms;
- Fixed and variable rate deposits;
- Different deposit takers.

Fixed Interest

- Government bonds and corporate bonds;
- Bonds of different durations, for example, short, medium and long;
- Covered, uncovered bonds;
- Bonds issued by companies engaged in different industry sectors, for example, financials and non-financials;
- Bonds denominated in different currencies.

Property

- Shops, offices, industrial, residential;
- Different geographical areas and countries.

Equities

- By industry, for example, financial, food, pharmaceutical, technology, energy, etc.;
- By market capitalisation; Mega, Large, Medium or Small Cap
- By main geographical area of operations, for example, Aisa Pacific, US, Eurozone, Emerging markets etc.

3.7.3 What is *Not* Diversification

An adviser might advise clients to spread their investment portfolio among different investment managers without examining the assets contained within each fund, examples might include an adviser who advises a client to invest:

Example #1

€100,000 in managed funds, €50,000 be placed with Life Co A, and €50,000 be placed with Life Co B.

Both funds have reasonably similar asset allocations, for example, about 60% in equities, 20% in property, and 20% in fixed interest and cash.

In this example, the only real diversification is between two different life companies and investment managers, and the different manager's ability to make the right investment decisions.

There is no substantial diversification between the two investments, as both funds have very similar asset allocations. These two managed funds are likely to produce highly correlated returns, and hence volatility is not being substantially reduced, as compared with just investing in one of the managed funds.

Example #2

€50,000 with Life Co B, to be split €25,000 in its managed fund, and €25,000 in its equity fund. The managed fund is currently invested about 75% in equities.

In this example, because the managed fund has a high equity content, its return is likely to correlate closely with the return produced by the equity fund, and hence the volatility of the two funds is likely to be similar but not the same.

Example #3

€50,000 with Life Co C, to be split €25,000 in its managed fund and €25,000 in its with profit fund. The with profit fund has an asset allocation very similar to their managed fund.

Again, in this example, because the investment allocations are very similar between the managed fund and the with profit fund, the long-term returns are likely to be similar. However, the main difference could be the benefit of smoothing and any guarantees that may be offered by the with profit fund.

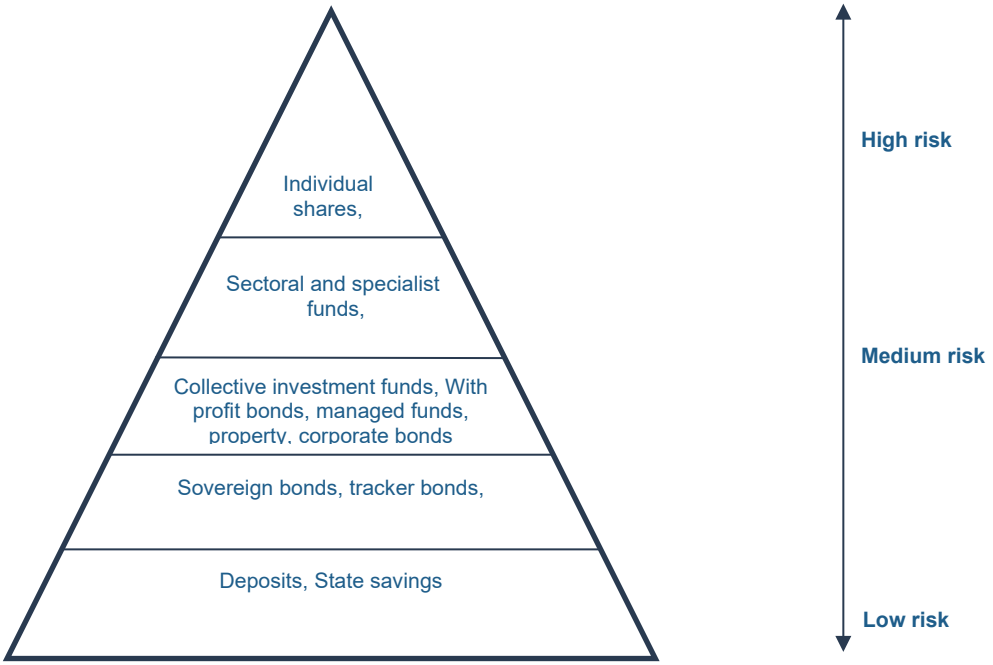
Therefore, to make an accurate assessment of a clients investment portfolio, it is important to 'look through' specific investment products and their underlying funds to determine the asset allocations of the particular investment.

3.7.4 The Portfolio Approach

Investment advice should be predicated on the investment objective and portfolios are the most efficient vehicles to manage that objective for three main reasons:

- Clients will often have a mix of different savings and investment needs; which may be short-term, medium or long-term in their nature,
- The investment objectives may be to maintain the purchasing power of their money, achieve capital growth, or derive an income, etc. So, a portfolio of different investment products and fund options, may be required to meet the client's particular financial needs and objectives.
- Different investment products have different features and a mix of products may be required to meet a client needs, in particular cases.
- Diversification across and within asset types helps to manage volatility of returns and hence risk, but not avoid it entirely.

The combination of diversification of an investment portfolio between different types of products and asset classes is sometimes represented by a pyramid, with low risk/return assets forming the base of the portfolio and riskier assets forming a smaller part of the portfolio, for example:



It is not suggested that the pyramid above is proportional, that is, that each investor should have more in deposits than in shares, for example. Rather the point of the pyramid is to represent the concept and benefits of:

- *Diversification*; and
- Placing certain low risk investments as the core or base on which more volatile investments can then sit; the client may be better able to take the risk of more volatile investments if he or she has a core or base of secure assets.

- Of course, the precise mix in any case will depend on each client's individual circumstances at that time and their investment objective.

3.7.5 Long Term Investment

Benefits of Long Term Investing

In general, the longer an investment in property, bonds, or equities is held, the better the returns, for three main reasons;

- Volatility of returns is reduced over time. Investment markets as we know are ever changing and have ups and downs; the longer an investment is held, the better chance of riding out down periods and ending up with a positive return. Research has shown that the longer the investment is held, the lower the volatility of returns is likely to become, and hence the risk of capital loss is reduced.

- Some investment products require the investment to be held for a particular minimum period, in order to benefit from a guarantee that may be offered by the products, for example, a tracker bond, etc.

- Various charges and costs of investment can be spread over a longer period, and so reduce their impact on the investment return achieved.

It is for this reason, therefore, that many investment products recommend a minimum investment period of five years and longer, in order that the investor maximise his or her chances of obtaining a positive return.

The longer the period for which the investment may be held, the more opportunity there is for the investor to invest in equities and property, which traditionally over time have produced the highest returns.

For this reason, therefore, the client's age and expected investment term play a big part in deciding on the optimum asset allocation deemed suitable for an individual investor.

The shorter the remaining investment term, the shorter the period in which to recover any investment loss the investor may suffer. This table shows the investment return required to recover a given investment loss, over different periods of time:

Loss incurred	Gain required to recover loss	Annual rate of return required to replace loss over			
		3 years	5 years	10 years	20 years
10%	11%	3.6%	2.1%	1.1%	0.5%
20%	25%	7.7%	4.6%	2.3%	1.1%
30%	43%	12.6%	7.4%	3.6%	1.8%
40%	67%	18.6%	10.8%	5.2%	2.6%
50%	100%	26.0%	14.9%	7.2%	3.5%
60%	150%	35.7%	20.1%	9.6%	4.7%
70%	233%	49.4%	27.2%	12.8%	6.2%

So, for example, a 30% investment loss can be recovered over 10 years with a subsequent annual return of 3.6% per annum, but if the loss has to be recovered over five years the return required to make up the loss more than doubles to 7.4% per annum.

Therefore, while long-term investment may produce the best returns, the term of the client's savings and investments needs must be taken into account and matched as closely as possible.

Liquidity

One way to increase the potential of a client being able to hold risk investments for a longer period is to ensure that the client has sufficient *liquidity* in his or her investments, that is, that there are funds readily accessable to the client without incurring penalties or fees, and which are not subject to investment market fluctuations.

Example

John has €100,000 total savings. He invests the full amount in a unit linked managed fund.

After a year John needs €15,000 but the fund is down 20%. If John makes a partial encashment at that stage of €15,000, he will have achieved a negative return on that portion of the investment of at least 20% (more when charges are taken into account).

If on the other hand, John had invested, say, €80,000 in the managed fund and, say, €20,000 in different deposits all accessible within 30 days' notice, he would have been able to maintain the managed fund investment intact and take the €15,000 he needed after a year from the deposit part of his portfolio.

By maintaining part of a portfolio in liquid form, the investor therefore increases the possibility of benefiting from long-term investment in riskier assets with the balance of his or her portfolio.

3.8 The Yield Gap

Investors in equities expect to get a return from:

- Dividends; and
- Capital appreciation, that is, that they hope to sell their shares at some time in the future for a higher amount than they paid.

The term *yield gap* refers to the difference between the average gross (that is, before tax) *dividend* yield currently offered by equities and the gross guaranteed annual yield offered by long-term government bonds (which are assumed to be risk free) at a particular point in time, that is:

[Average annual equity yield LESS guaranteed annual yield on long dated bonds]

It is a useful measure of how equity is priced relative to government bonds. For example, if long-term government bonds were offering a guaranteed annualised return of 4% per annum, but the average gross (that is, before tax) dividend yield at that time from equities was, say, 3% per annum, then the *yield gap* at that time would be:

[3% LESS 4%] = -1% per annum

This is *a negative yield gap* and is an indicator that the equity is over priced compared to long dated bonds.

Why would investors be prepared to accept a lower dividend yield on equities, than they could obtain by investing in bonds?

There are three main reasons:

- Investors expect dividend income from shares to increase in the future. As will be seen in *Chapter 5*, dividends from well managed companies tend to increase faster than the rate of inflation, over the long-term.

- Returns from fixed interest bonds are fixed and are therefore subject to the effects of future inflation.

- Investors also expect to obtain capital appreciation from equities, that is, that their share price will increase in value.

The yield gap can sometimes be *positive*:

- For example, if long-term government bonds were offering a guaranteed annualised return of 2% per annum, but the average gross (that is, before tax) dividend yield at that time from equities was, say, 4% per annum, then the *yield gap* at that time would be:

[4% LESS 2%] = +2% per annum

- In this case, equities are said to under-priced relative to bonds. One reason for this could be that we are facing a recession, resulting in a fall in equities prices and therefore a higher dividend yield. It could be perceived therefore that investors are using government bonds as a safe haven to shelter their investment for the foreseeable future.

3.9 Equity Risk Premium

The term *equity risk premium* refers to:

[Total expected equity return (dividends + capital growth) LESS guaranteed return from long (risk free) government bonds]

It is a measure of the extra *projected* return equities provide, in return for the greater risk taken by investing in equities.

If medium to long dated government bonds are offering investors a guaranteed risk-free return of about 3% per annum, then investors in equities would want a higher total return than this to compensate them for the risks involved in investing in equities. Otherwise, why bother taking the risk?

Over long periods of time during the twentieth century US and UK equities have produced a long-term return (dividends + capital appreciation) in excess of fixed interest securities of about 5% per annum, that is, equity investors received a premium or additional return of about 5% per annum for investing in risky assets like shares, as compared with investing in risk free fixed interest assets.

Over periods of time when equities have performed poorly, the equity risk premium may be negative, that is, investors would have been better off investing in safe fixed interest assets like government bonds. At other times, when equities are booming, the risk premium can be considerably in excess of 5% per annum.

Some experts now believe that the equity risk premium in the future will be much lower than the average 5% per annum experienced during the latter part of the 20th century and could narrow to as little as 2% per annum.

3.10 Sustainable Investing: Introduction

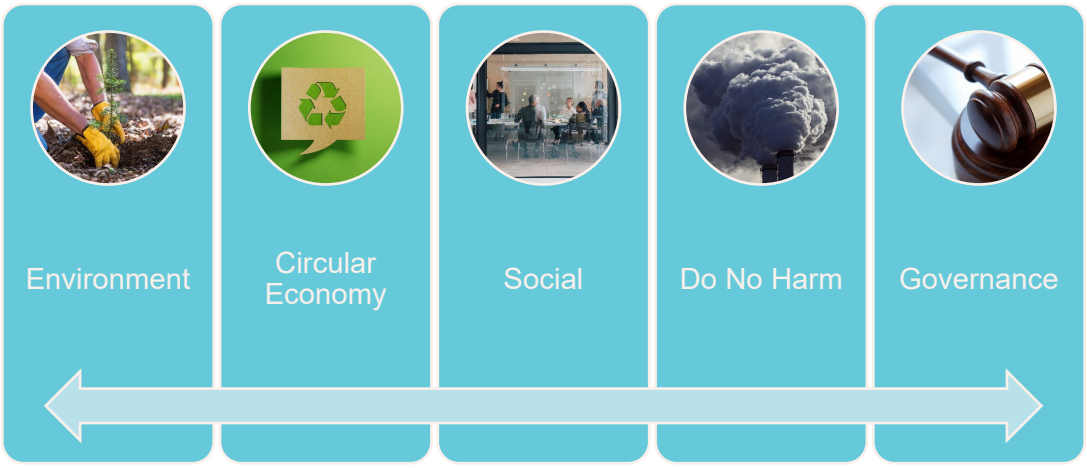
Through the adoption of the Paris agreement on climate change and the UN 2030 agenda for sustainable development in 2015, governments around the world have chosen a more sustainable path for our planet and economy.

With the implementation of 17 sustainable development goals as defined in the UN 2030 agenda, it is hoped that these will prepare for a future that ensures stability, a healthy planet, fair, inclusive and resilient societies and prosperous economies. Sustainability, the transition to a low-Carbon, a more resource efficient and circular economy are key in ensuring long term competitiveness of the EU economy.

Sustainable investing means making capital allocations into:

- An economic activity which contributes to an environmental objective or
- The circular economy or
- Into an activity that contributes to a social objective

provided such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices".



Over the last number of years Environment, Social and Governance (ESG) investing became a main stream topic, with much greater awareness by investors, both institutional and retail regarding ESG factors but ESG investing has evolved into the concept of sustainable investing which is much more broad.

The European Commission launched its Sustainable Finance Action Plan in March 2018 which included three legislative measures aimed at

(i) Creating an EU Sustainability classification system, also known as Taxonomy,

(ii) Requiring disclosures relating to environmental, social and governance (ESG) factors and

(iii) The creation of low carbon and positive carbon impact benchmarks against which key performance indicators can be measured.

Sustainable investing balances traditional investing with Environmental, Social and Governance (ESG) factors but now integrates the concepts of promoting the circular economy (recycling) and 'do no specific harm' factors into investment decision-making processes. The concept of do no specific harm, prevents narrow investment processes which might focus on one particular environmental or social objective without due consideration or at the expense of other such objectives.

Sustainable investing factors cover a wide spectrum of issues which are not part of a traditional financial analysis, and might include, for example, how corporations respond to climate change, how good they are with water management, how effective their health and safety policies are in the protection against accidents, how they manage their supply chains, how they treat their employees and whether they have a corporate culture that builds trust.

The impact of sustainable investing regulation on Financial Advisors will be considered further in 3.10.6.

Before getting into the detail of Sustainable investing let's briefly explain Ethical and Socially Responsible Investing (SRI), and some investment principles set out by the United Nations; all of which informed the EU in developing its Sustainable Investing plans.

3.10.1 Responsible Investment and the EU sustainable Finance framework

In 2005, the United Nations established a body which developed Principles for Responsible Investing ("PRI"). It set out six fundamental principles on how ESG could be incorporated into investment practices and behaviours in order to develop a more sustainable financial system. It provides an independent assessment, and rating of, fund managers against ESG benchmarks. Accountability lies at the core of this process. As these principles become mainstream in fund management, legislation and regulation has ensured open disclosure and compliance.

There are six Principles for Responsible Investment which offer a menu of possible actions for incorporating ESG issues into investment practice.

- Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
- Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
- Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
- Principle 6: We will each report on our activities and progress towards implementing the Principles.

Signing up to the PRI allows an organisation to publicly demonstrate its commitment to responsible investment and places it at the heart of a global community seeking to build a more sustainable financial system.

Building on these principles, the EU Sustainable Finance Framework outlines the methodology and associated procedures to classify financial products and services on the basis of their sustainability. The framework specifies the classification logic, the eligibility criteria the applicable environmental and social due diligence requirements and the verification process required to establish a consistent and comprehensive methodology for the classification and reporting of financial products and services as sustainable.

3.10.2 What is Environmental, Social and Governance (ESG) Investing?

Environmental, social, and governance (ESG) are criteria and factors that socially conscious investment managers use to analyse potential investments. They are used in addition to traditional investment and supporting financial criteria when deciding whether to invest or not. These criteria and factors can also be used by product/fund providers, financial brokers and retail customers in screening and selecting investments.

The goal of ESG investing is to ensure sustainable long term investment returns while also ensuring that the impact of the investments on society and the planet have been considered.

Environmental (E) criteria evaluate a company's impact on the natural environment, such as climate change, biodiversity, carbon emissions, air, and water pollution.

The criteria may include a company's energy use, their policies on pollution, or natural resource conservation. The criteria can also be used to evaluate any environmental risks a company might face and how the company is managing those risks.

Social (S) criteria review the impact of a company's actions on society and communities, including human rights, health and safety issues, labour standards, product liability, privacy, and data security.

This may mean looking at a company's business relationships to establish if they work with suppliers who hold the same values as it claims to hold. Do the company's working conditions show high regard for its employees' health and safety and does the company donate a percentage of profits to charity or local communities. Gender diversity in the workplace has been an important aspect of the Social side of ESG, with research showing the companies with an inclusive, gender-balanced and diverse workforce perform better overall, and have a more efficient decision making capacity.

Governance (G) focuses on how companies are governed, including diversity, transparency, ownership, board independence, ethics, and executive compensation.

Under Governance investors may want to know that a company uses accurate and transparent accounting methods and that shareholders are allowed to vote on important issues. Other areas of concern may be wanting assurances that companies avoid conflicts of interest in their choice of board members and that they don't use political contributions to obtain unduly favourable treatment or engage in illegal practices.

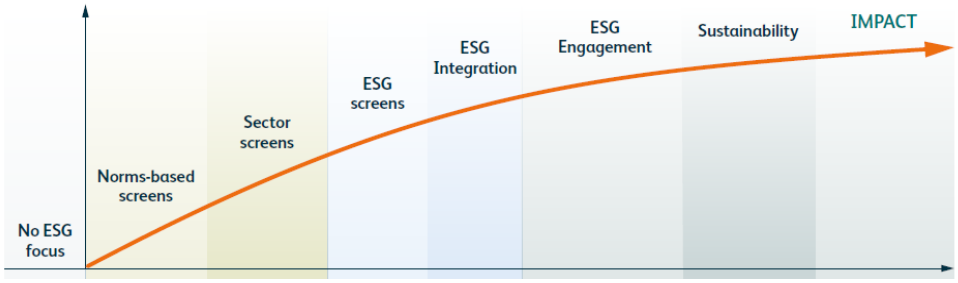
So why does ESG matter?

Investors have traditionally considered the 'financial' elements of an investment, including growth prospects, the prospective income from shares or bonds, or how much rent a building can generate. ESG considerations today have changed the focus of investors and executives dramatically to consider issues other than just returns and profits and to look at the bigger picture to examine the 'extra financial' elements that can have material effects on a given business or industry. It is leading to much more diversity on corporate boards, safer work practices, better waste management and allowed many retail investors the opportunity to make investments consistent with their moral values.

ESG Investment Strategies:

Under ESG there are a number of strategies that investors may employ which can range from excluding certain industries to engaging with company management (as a shareholder) to try to encourage a positive impact for society or the environment.

An example of some of the strategies that ESG investment fund managers who design ESG funds, might include is shown in the graphic below;



1. Norms-based screens: May be investment exclusions based on generally accepted international standards such as controversial or civilian weapons.

2. Sector Screens: May be the exclusion of investments from an entire sector such as gambling or tobacco producers.

3. ESG Screens: Selecting investments that rank highest on ESG criteria within their respective sectors.

4. ESG Integration: The consideration of ESG factors within the analysis of investments.

5. ESG Engagement: Where shareholders vote and interact with company management on ESG issues with a view to advising and influencing positive change.

6. Sustainability: Investing in assets that make a positive contribution to the environment, economy or society alongside financial return.

7. Impact: Investing with the purpose of generating a measurable social or environment return alongside financial return.

Some examples of ESG issues that investors may want to consider could include:

- Pharmaceutical companies selling safe and cost effective medications.

- Social media platforms being held accountable for data protection, consumer privacy and fair comment.

- Car companies managing fleet fuel economy, emissions reductions and passenger safety.

- Airlines should ensure aircrafts have the latest safety features when they go to market.

- Children's toy companies ensuring there are no harmful chemicals in their products.

ESG Investing: – Active versus Passive:

There is much debate in the Investment industry around the difference between how both Active and Passive managers implement ESG into their investment strategies. Some argue that active managers have much greater capacity to apply more strict ESG criteria because they can chose their holdings and can decide not to hold a particular company or sector within their fund.

Passive index managers on the other hand are pretty much compelled to hold every stock within the Index that they are tracking (such as the S&P 500). Some argue that while passive investors can engage with the companies they invest in via shareholder voting, active managers have additional leverage because of negative or exclusionary screening or basically having the ability to 'walk away'.

This however is not quite the case as we are beginning to see the implementation of dedicated, ESG specific, passive Indexes. These can be sector specific or at a global level, where the index may closely mirror the world index but with a number of accepted exclusions.

One such index is the State Street world ESG screened index equity fund. The investment policy of this fund is to track the performance of the MSCI World ex UNGC and CW index.

- UNGC refers to United Nations Global Compact violators which are international norms in relation to the environment, human rights, labour rights and anti-corruption.

- CW refers to controversial weapons producers. Overall, this allows for a passive investor to avoid holding the really 'bad' stocks from within some global mainstream indices.

The streamlining of standards and terminology may benefit us in the coming years to better understand the pros and cons of integrating ESG into both Passive and Active investment strategies.

ESG versus Ethical Investing

As the name implies ethical investing is about investing using one's ethical or moral principles as a guideline. Generally, ethical investing will mean that fund managers have to filter out certain types of companies, or entire sectors of the market. Each fund management company will have its own ethical guidelines, but one particular company in the Irish market currently excludes the following industries from their Ethical Investment funds:

1) The Defence industry

2) Stem cell research

3) Tobacco

4) Animal testing for cosmetics

5) Pornography,

6) Fossil fuels.

Ethical investing gives investors the power to allocate capital towards investment in which the practices and values align with their personal or religious beliefs. As we examine the area of ESG a little closer what you will see is that whilst Ethical investing is about excluding exposure to a range of stocks and sectors, ESG doesn't necessarily require exclusions but can entail fund managers investing in, and working closely with, a range of companies (such as fossil fuel producers) to try to encourage positive change over time.

ESG versus Socially Responsible Investments (SRI)

Socially responsible investing also known as social investment is an investment that is considered socially responsible due to the nature of the business the company conducts. Socially responsible investments can be made into individual companies with good social values, through socially conscious Investment funds or through exchange traded funds (ETF's).

Somewhat similar to Ethical investing, socially responsible investments exclude investments in companies that produce or sell addictive substances like alcohol, gambling or tobacco in favour of seeking out companies that are engaged in social justice, environmental sustainability and alternative energy/clean technology efforts.

Of course, just because an investment fund touts itself as socially responsible doesn't mean that it will provide investors with a good return.

3.10.3 Sustainable Investing: Regulatory Provision

There are three main directives which provide a framework of regulation for Financial advisors who provide investment advice and govern how insurance based investment products (IBIPs) are provided to clients and these include:

The Insurance Distribution Directive (IDD)

The IDD lays down rules concerning the activities of insurance and reinsurance distribution in the EU. It applies to any individual or legal entity who is established in a Member State and who wishes to distribute insurance and reinsurance products.

A recent amendment to the IDD now requires a clients' sustainability preferences to be documented as part of the establishment of their investment objectives. Since August 2022, Financial Advisors are required to establish a customer's individual sustainability "preference" during the factfind process.
Once the client has declared a sustainability investment preference, they can then decide how much capital to allocate to that investment and for what purpose, for example;

- Does the client wish to have a minimum investment in economic activities which contribute substantially to one or more environmental objectives, for example, such as climate change, pollution prevention, sustainable use of water and marine sources?

- Does the client wish to invest a minimum amount of capital in sustainable investments; for example, an ESG fund?

- Does the client want to consider the negative impact on people, the environment (including carbon emissions, ecosystems, biodiversity, marine pollution) or society?

Where the client does not state a preference, they may be considered "Sustainably Neutral" and IBIPs with and without sustainability related features may be recommended.

Where an assessment results in no products matching the sustainability preferences of the client, this must be explained to the client after which their preferences can be adapted.

The EU Taxonomy Directive

To achieve a common language and a clear definition of what is 'sustainable' a standard classification system was needed. This has led to the creation of a common classification system for sustainable economic activities, called the EU taxonomy.

A taxonomy is a scheme of classification, especially a hierarchical classification in which subjects or items are organised into groups or types, so that users of the system can easily find the information they are looking for.

The EU Taxonomy for sustainable investments is a green classification system that translates the EU's climate and environmental objectives into criteria for specific economic activities for investment purposes. It recognises as green, or 'environmentally sustainable', economic activities that make a substantial contribution to at least one of the EU's climate and environmental objectives, while at the same time not significantly harming any of these objectives and meeting minimum social safeguards.

The EU Taxonomy Regulation establishes six environmental objectives:

i. Climate change mitigation

ii. Climate change adaptation

iii. The sustainable use and protection of water and marine resources

iv. The transition to a circular economy

v. Pollution prevention and control

vi. The protection and restoration of biodiversity and ecosystems.

The purpose of EU taxonomy is to provide companies, investors and policymakers with appropriate definitions and architecture for which economic activities can be considered environmentally sustainable. This should create security for investors, protect private investors from greenwashing, and help companies to become more climate-friendly.

EU taxonomy over the coming years will greatly influence the integration of ESG factors into the investment world. It will provide guidance and clarity to investment fund providers in the creation of their PRIIPs. Companies will be enabled to integrate environmental and sustainability strategies into their operations and thereby attract green investors, and achieve positive environmental impacts.

The Sustainable Finance Disclosure Regulations (SFDR)

The Sustainable Finance Disclosure Regulation (SFDR) forms part of the Sustainable Finance Framework (outlined in 3.10.1) and applies to all financial firms (including financial advisors) since 10th March 2022. It was introduced to improve transparency in the marketing of sustainable investment products by making the sustainability profile of products more comparable and better understood by end-investors.

It was also introduced to prevent greenwashing and to increase transparency around sustainability claims made by financial market participants. Greenwashing is a general term used where companies attempt to exaggerate the green credentials of an investment.

It applies to two categories of financial firms:

1) Financial advisors who provide investment advice

2) Financial market participants that manufacture and sell financial products and perform portfolio management services.

Examples of firms in these two categories include:

- Asset Managers including alternative investment fund (AIF) managers and UCITS fund managers

- Banks

- Financial Advisors (intermediaries)
- Pension fund providers
- Insurers.

The SFDR requires all financial advisors who provide investment advice on Packaged Retail and Insurance based investment products (PRIIPs) (see Chapter 7) and MIFID products to comply with the Sustainable Finance Disclosure Regulation (SFDR) level II.

Specifically, financial advisors are required to:

(i) Consider and factor in sustainability in their advisory process,

(ii) Provide information in accordance with the SFDR both on their website and specifically with each customer at a product level (at the pre-contractual stage)

(iii) Incorporate sustainability investment considerations into their financial fact find, with proactive questions regarding whether the client would like to take sustainable investments into consideration for any potential investment that they might make.

Article 3 of the SFDR requires that:

1) Financial market participants publish on their websites, information about their policies on the integration of sustainability risks in their investment decision making process and

2) Financial advisors publish on their websites information about their policies on the integration of sustainability risks in their investment advice or insurance advice.

3.10.4 Principal Adverse Sustainability Indicators (PASI)

The most impactful element of the new SFDR regulation is the introduction of *principal adverse sustainability indicators* (PASI). These essentially provide a framework under the “Do no specific harm” criteria under the SFDR Framework.

The EU has identified 64 adverse impact indicators that must be assessed by companies, of which 18 are mandatory to report, and 50 will be voluntary. They will focus on standard environmental, social and governance (ESG) factors with which investors are familiar. The compulsory factors range from carbon emissions, fossil fuel exposure and waste levels (E) to gender diversity and due diligence over human rights (S) and a company’s record on exposure to corruption, bribery, or other scandals (G).

A selection of the Principal Adverse Sustainability Indicators (PASI's)	
Adverse Sustainability Indicator	Metric to Measure Sustainability Indicator
Green House Gas (GHG) Emissions	GHG Capture emissions GHG Carbon Footprint Percentage of non-renewable energy v's renewable energy resources Energy consumption
Biodiversity	Activities negatively effecting biodiversity sensitive areas
Waste	Hazardous waste ratio
Water	Emissions to water
Social & Employee Matters	Violations by companies of the UN Principles on responsible business practices in the areas of human rights, labour, the environment & corruption Unadjusted gender pay gap Board gender diversity Exposure to controversial weapons

3.10.5 The Impact of SFDR on Funds

The promotion of transparency of funds and mandates into categories is laid out by Articles 6, 8 and 9 of the SFDR.

These guidelines for classification make it easier for investors to distinguish and compare between the many sustainable investing strategies that are now available. Investing in Article 8 or Article 9 funds is a potential way for investors and advisors to distinguish between the differing levels of sustainability to protect themselves against greenwashing because addressing sustainability (called 'sustainability integration') is binding for investments which claim to meet Article 8 and 9 criteria.

For financial advisors, the main articles of the SFDR includes:

SFDR Article 6 which promotes the transparency of the integration of sustainability through the precontractual disclosures by market participants including:

- The manner in which the sustainability risks are integrated into their decision making

  AND

- The result of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available

Where financial market participants deem sustainability risks not to be relevant, the descriptions must include a clear and concise explanation as to the reasons why.

Sustainability neutral funds, do not integrate any kind of binding sustainability controls into their investment process and can include stocks that may be excluded by ESG or Green focused funds such as tobacco companies or coal producers.

While these will be allowed to continue to be sold in the EU, provided they are clearly labelled as non-sustainable, they cannot be promoted as ESG funds.

SFDR Article 8 Funds: Also known as “light Green Funds” promotes, among other characteristics, Environmental or Social characteristics provided that the underlying companies also follow good governance practices (ESG).

To be labelled Article 8 under SFDR a fund must ‘promote’ Environmental or social characteristics or a combination of both, but doesn’t need to have sustainable investment as its specific objective. One way for a fund to promote environmental and social characteristics under Article 8 is to adopt the mandatory *principal adverse sustainability indicators* (PASI) (see Chapter 3.10.4 above).

Firms are required to make disclosures on their website on how the firm assesses PASI and establishes fund-level disclosures on a ‘comply or explain’ basis. This means that firms which do not consider the PAIs must provide a statement that specifies clear reasons behind the decisions and whether they will consider them in the future. However, this ‘’opt-out’’ option is not available for firms with more than 500 employees.

SFDR Article 9 Funds: An Article 9 fund is defined as a fund that has sustainable investment or a reduction in carbon emissions as its specific objective and is also known more commonly as a “Dark Green” fund. Specifically, sustainable investments are defined in the Disclosure Regulation as any of the following:

- Investments in economic activity that contributes to an environmental objective;
- Investments in economic activity that contributes to a social objective and in particular an investment that; contributes to tackling inequality, fosters social cohesion, social integration or labour relations; and
- Investments in human capital or economically or socially disadvantaged communities;

provided that such investments do not significantly harm any of those objectives, take the principal adverse impact indicators into account and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

One example of a fund currently available in the Irish market (a Global Ecology ESG fund) outlines its ESG credentials by advertising that the fund seeks to increase the value of your investment through holding sustainable investment assets pursuant to Article 9 of the Disclosure regulation.

The fund invests in a broad range of shares of companies from around the world that offer products or technologies that promote a cleaner and healthier environment or are environmentally friendly. These would include companies in the fields of air pollution control, alternative energy, recycling, water treatment and biotechnology.

In this particular fund the prospectus specifically calls out that the investment is focused primarily on investing in securities that contribute to an environmental objective. The fund claims to offer investors a high level of diversification with an exposure across a range of assets with strong Environmental, Social and Governance characteristics.

Article 9 is in effect a ‘best in class’ measure of sustainable investments. However, fund managers find it difficult and challenging to meet Article 9 requirements. And so most ESG funds are being classified as Article 8. Indeed, many funds classified as Article 9 have switched back to Article 8 classification.

3.10.6 How Financial Advisors must deal with Sustainability Preferences

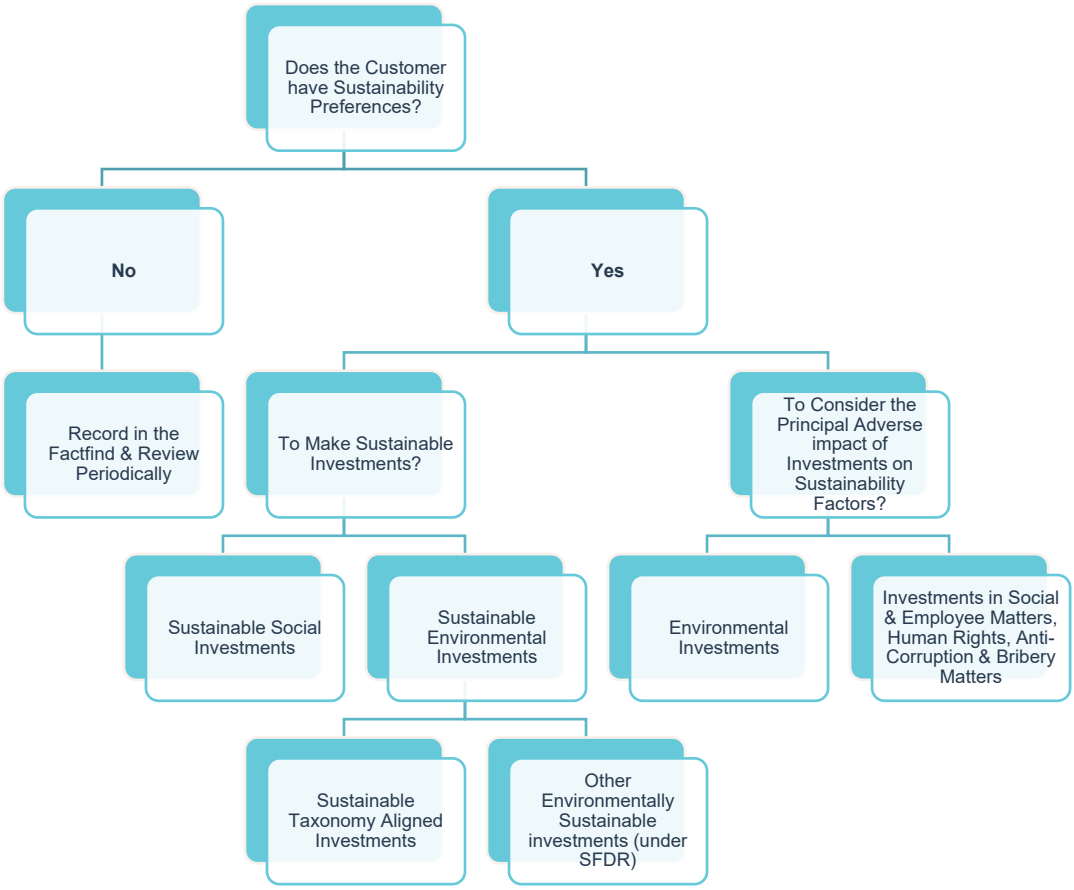
Since the 2nd August 2022, all financial advisors, when providing advice on Packaged Retail insurance Based Investment Products (PRIIPs) are required to consider and factor in their clients' sustainability preferences in their advisory processes and to provide information in accordance with the SFDR at the entity level and at the pre-contractual stage.

Specifically, financial advisors must establish whether a client wants a certain minimum proportion of sustainable investments to be included in any product recommendation.

The advisor must also establish specifically, whether the client wants the possible impact on people, the environment or society of the investment to be considered in their investment product. This could be focussed on carbon emissions, biodiversity & ecosystems and pollution prevention control and are known as sustainability preferences.

Sustainability preferences establishes a customer's choice as to whether, and if so, to what extent one or more sustainability investment products should be integrated into their investment.

The following pathway guidance captures the sustainability preferences of customers as part of the investment advice recommendation process.



Where a client confirms they do not have a preference for sustainable investments, the advisor may consider the customer as sustainability neutral and recommend products with and without sustainability related features. However, this must be documented clearly as part of the fact find process.

Where a client confirms they do have a preference, the advisor must establish the amount which the investor would like to invest in such an investment and whether they prefer to align with Sustainable environment / Social investments or prefer to invest in IBIPS which consider the principal adverse impact of investments.

Example

Mary wishes to start an education fund and has confirmed she has a preference for sustainable investments during the fact find process. She would like some of her investment to help prevent climate change.

Mary's financial advisor must document Mary's preferences and clarify whether there are suitable funds available, which might satisfy Mary's sustainability preferences before making a suitable recommendation.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- The *main* investment *asset classes* ☐
- The *alternative asset classes* ☐
- The concept of the *volatility* of investment returns ☐
- *Correlation* of investment returns ☐
- Optimising investment returns; modern portfolio theory ☐
- How investment risk can be reduced by *diversification* ☐
- What the *yield gap* is and how it is calculated ☐
- What the *equity risk premium* is and how it is calculated ☐
- Sustainable Investing ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. Which one of the following would be considered to offer investors the LOWEST level of protection against inflation, over the longer term?

   A. Deposits.
   B. Corporate bonds.
   C. Property.
   D. Equities.

2. Which one of the following investment types has shown the HIGHEST level of volatility of returns over the longer term?

   A. Deposits.
   B. Corporate bonds.
   C. Equities.
   D. Government bonds.

3. If the mean annual return of a particular investment is 5% and its standard deviation is 9%, you would expect 1/3rd of annual returns provided by that investment over the long term to fall OUTSIDE a range of:

   A. -4% to +5%.
   B. -5% to +5%.
   C. -4% to +14%.
   D. -5% to + 9%.

4. Investment managers who agree to the principles of responsible investing:

   A. incorporate ESG issues into their investment analysis and decision-making processes, policies and practices.
   B. only consider ESG issues in their investment decisions.
   C. do not have to report on their activities and progress towards implementing the principles.
   D. only consider ESG issues in their ownership policies.

04

Deposits

This chapter is devoted to the many types of deposit products that are available and their features and benefits including the tax treatment of interest by a consumer.

The importance of annual equivalent rate (AER) as a means of validly comparing competing deposit rates is discussed. The Central Bank's Consumer Protection Code (CPC) which places obligations on banks in relation to the operation of deposit accounts are summarised.

Outline details of the cover provided under the Irish Deposit Guarantee Scheme (DGS) is given as well as a listing of the covered institutions.

Learning Outcomes – after studying this chapter you should be able to:
understand the key features, benefits, limitations and risks of different types of deposit products;
be aware of how competing deposit products can be validly compared;
know how interest from different types of deposit products is taxed in the hands of a consumer;
know the main features and coverage of the Irish Deposit Guarantee Scheme;
know what the Consumer Protection Code (CPC) obligations on banks are in relation to the operation and marketing of deposit accounts; and,
distinguish between deposit agents and deposit brokers.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	4	8	10

4.1 Introduction

Virtually every client will have a deposit account of some type with a bank and/or a credit union[4]. Deposits typically pay an interest rate and provide capital security.

However, there are many different types of deposits, each with their own particular features.

4.1.1 Uses of Deposit Accounts

Deposit accounts are very often a consumer's first savings account. Deposit accounts are of course multi-purpose and can be used by an investor for return and for security. Some liquidity is prudent and required in everybody's financial affairs and deposit accounts are a good option for this. Those wishing to save for a future event taking a goal-based approach will likely use a savings account to match their circumstance (whether that be near term or more long term), going on holiday, buying a car, getting mortgage-ready, future education, or getting married. Of course, those with lump sums may wish to take an even longer term. Given these diverse circumstances deposit providers have created a range of deposit products to fit a consumer's need.

Businesses also use deposit accounts for managing their cash positions.

4.2 Deposit Account Features

Deposit accounts vary according to a number of characteristics which are outlined below and which are explored in the following sections:

Characteristics of Deposit Accounts	
Funding Requirement	Lump Sum or Regular savings
	Minimum Investment
	Minimum Balance
Availability	Branch or online
	Nature of Deposit taker
Access	Term or notice period
Crediting of Interest Rate	Tiered?
	Fixed or Variable
	Frequency of crediting
	Accumulated or paid out
	Taxation of Interest

4.2.1 Minimum Investment/Remaining Balance

Some accounts may impose a specified initial minimum investment. For example, a monthly income account may require a higher minimum investment compared with, say, an equivalent growth or accumulation type account.

Some accounts may also impose a requirement of a minimum remaining balance, after withdrawals.

If the balance goes below this minimum remaining balance, the rate of interest on the account may revert to a much less favourable rate.

[4] Technically, a 'deposit' held with a credit union may in fact be a share account, that is, the individual holds shares in the credit union, and not a deposit account.

4.2.2 Online or Branch

Some accounts may pay a higher interest rate for the same amount for an online deposit account which is opened and operated only online, than for a branch 'paper' based account. Indeed, more commonly nowadays, some deposits accounts are only available on an online basis.

4.2.3 Access to Funds

Deposits vary according to the nature of access to the funds invested:

- *Demand accounts*, that is, where the capital and accumulated interest can be withdrawn on demand, that is, where no notice (or a very short period of notice, such as one day) of withdrawal is required. Sometimes a demand account is referred to as a *call* account, as the funds are *on call* at all times, or as an *instant access* account.

- *Notice accounts, that is,* where the deposit is open ended in term, but a period of prior *notice* must be given to withdraw funds from the account, for example, seven days, 30 days, etc.

- *Fixed term deposits,* that is, where the funds are placed on deposit at a fixed rate of interest for a fixed period, 30 days, three months, six months, one year, two years, etc., after which the funds become available for fresh investment. There may be no, or very limited, access to funds during the fixed term.

In general, the longer the period the investor agrees to tie up his or her funds, the better the return the deposit taking institution will offer, with demand or instant access account usually offering the lowest return. Currently given the interest rate environment there is little or no premium for committing deposits for the medium/ longer term.

As indicated above, some deposit accounts require a minimum period of notice to make a withdrawal, for example, 30 days' notice account, while term accounts tie up the funds for the term of the deposit.

However, some notice or term accounts may allow, at the bank's discretion, a certain maximum level of withdrawal to be made from the account without the required period of notice or before the end of the fixed term. In some cases, an emergency withdrawal amount, up to a certain level, may be made without charge, but in other cases a charge will be made.

Fixed term deposit accounts may impose a *breakage* or redemption charge where a withdrawal is required before the end of the term, that is, where the investor wants to 'break' the deposit before it has run its agreed term. The charge is made to reflect the increased cost to the bank of replacing that deposit with one on which it may have to pay a higher rate.

4.2.4 Tiered Interest Rates

Tiered interest rates refer to an account where the rate of interest payable at any time varies according to the balance in the account at that time, that is, the rate of interest is tiered relative to the deposit balance.

4.2.5 Fixed or Variable

A *variable* interest rate means that the rate being paid at any time can be changed by the deposit taker, and may increase or decrease generally in line with broader interest rate movements and the capitalisation of institutions.

A *fixed* interest rate, on the other hand, is, as the name implies, fixed for a period, usually the period of the deposit, regardless of what happens to variable interest rates during this period. For example, a term deposit for one year may quote a fixed rate of, say, 2.0%, which is then added to the account at the end of the one-year-term, less Deposit Interest Retention Tax (DIRT) if applicable.

Banks may use their fixed rate term deposit funds, for example, to fund fixed rate loans and mortgages for a similar period.

4.2.6 Crediting of Interest

Interest may be paid or credited to the deposit account at different intervals, for example, daily, monthly, half yearly, yearly, etc. The more frequently the interest is credited to the account for the same rate of interest, the better. The investor then earns interest on the interest earned and the effect of compound interest starts to apply.

Consequently, most deposit takers will reduce the annual rate of interest payable the more frequently the interest is credited to the account.

Some deposit takers have offered 'interest in advance' fixed term deposit accounts, where the interest is credited to the account in the first month, and the return of capital is then provided at the end of the fixed term. Withdrawal of funds within the fixed term is subject to a charge.

4.2.7 AER

The term AER is short for the ***a****nnual* ***e****quivalent* ***r****ate*. It is used as a means of expressing the return quoted on a deposit in terms of the equivalent *annual* rate of interest payable at the end of the year**.**

The Central Bank's Consumer Protection Code requires that any advertisement for a savings or deposit account must show the AER along with the relevant interest rate quoted for any particular term, and that both rates must be given equal prominence.

Advertised deposit interest rates may not be comparable with each other, depending on the frequency of crediting interest to the account. Using the AER is a means of bringing the competing deposit rates to the same standard, so that they can then be validly compared.

Example

Joe wants to place €1m on deposit.

Bank A advertises a rate of 2% for a deposit account, where interest is credited to the account once a year.

Bank B also advertises a rate of 2% for a deposit account, where interest is credited to the account every 6 months.

Which is the better rate?

Bank A will credit interest at 2% at the end of the year i.e. €20,000.

Bank B on the other hand, as you can see below, will pay 'interest on interest', totalling €20,100. The AER is 2.01%

Months	Balance at start of period €	Interest credited €	Revised balance €
6	1,000,000	10,000	1,010,000
12	1,010,000	10,100	1,020100

If a financial institution, quotes an AER for an account, there may also be terms and conditions attached to that account which can stop you from getting the full rate. For example, you may not get the full rate if you withdraw your savings before a certain date.

The AER does not take into account fees or charges.

4.2.8 Income Accounts.

Some deposit accounts may be *income* accounts, that is, where the interest (net of any applicable DIRT) is paid out to the investor on a regular basis, for example, monthly or quarterly. This would be suitable for those investors who need to take income from their investments. Usually, the more frequently interest is paid out, the lower the annual rate of interest paid. Of course, income accounts are not relevant at the current low interest levels.

4.3 Benefits of Deposits

Deposits offer investors the following potential benefits:

- Security of a capital guarantee within limits; (See Chapter 4.11 regarding the Irish Deposit Guarantee Scheme);
- Flexibility, ready access to funds, for those accounts offering such access;
- A fixed investment return, in the case of fixed rate deposits;
- Income /return, which can be paid out as frequently as monthly in certain cases;
- Providing risk balance as part of a diversified investment portfolio;
- Tax free returns from certain products, for example, State savings products (other than deposit accounts) and deposit accounts where the depositor can be exempted from DIRT.

4.4 Limitations of Deposits

Certain potential limitations which may apply in some cases, for example:

- Minimum investment requirement to obtain a particular advertised rate;
- Possible requirement to maintain a certain minimum balance to obtain a particular advertised rate;
- Maximum investment limit;
- Restrictions on access to funds in the case of notice and fixed term deposit accounts;
- Reduction in return if funds are accessed early, through early redemption fees, etc.
- Reduction in return where interest paid out as income; the reduction increases the more frequently the income is paid out;

- Capital guarantee may be qualified in some circumstances.

- Costs are to some extent hidden. The interest rate quoted will be lower than the rate the bank pays for the money in the first place (to its shareholders or another bank for example). With very low interest rates, banks can not rely on this form of charging, and are instead introducing/increasing explicit fees for holding the bank account.

4.5 Risks in Holding Funds on Deposits

Deposits are traditionally looked on as '*risk free'* investments (on the basis that the capital is always secure[5]), and every client's investment portfolio will have some part invested in deposits, for example, an emergency fund which can be called upon at short notice.

However, deposits do, contrary to popular conception, carry some risks for investors:

- The real value of the capital invested will be reduced over the long-term by inflation; this is a significant 'silent' risk attached to long-term investment in deposits, i.e. that the net return earned after tax will not keep pace with inflation.

- The tax rate applying to deposit interest, could increase, reducing the net return to the depositor; for example, while currently falling, the current DIRT rate at 33% is significantly higher than the prevailing rate of 20% in 2009.

- The deposit taking institution could default and become unable to repay its depositors in full, and any deposit guarantee scheme may not fully cover the deposit, for example, a deposit of more than €100,000 with a single bank or credit union.

- The rates currently being paid on a variable rate deposit while negligible could fall further and in some instances depending on the deposit amount, may indeed provide a negative interest rate. Instead of being paid money, you may be charged money instead. Initially this was only applicable to corporate investors, but some banks changed this policy in 2021 to include some larger personal deposit holders also.

- A depositor could lose out by being invested in a fixed term deposit at a time when variable rates subsequently increase above the fixed rate.

- A depositor may not be able to access their funds at a time when they need to, for example, in a long-term fixed rate deposit with no or limited access to funds allowed during its term.

4.6 Taxation of Deposit Interest

Deposit takers who are established in the State or who operate in the State through a Branch are obliged to deduct tax at source from certain deposit interest paid to accounts held by them in the State; this tax is referred to as **d**eposit **i**nterest **r**etention **t**ax, or *DIRT* for short.

4.6.1 Deposit Interest Retention Tax – DIRT

DIRT at the rate of 33% (unchanged since 1st January 2020) is deducted at source by deposit takers from interest paid or credited on deposits.

DIRT is a final liability for income tax purposes, that is, the payment of retention tax at the standard rate by individuals liable to income tax at the higher rate is regarded as satisfying the individual's full liability to this tax.

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[5] Apart from some tracker bond deposits which may provide a minimum guaranteed return of less than the amount invested (see Chapter 9).

However, in certain circumstances, an individual will also be liable to pay PRSI in respect of the deposit interest received (see Chapter 4.6.4).

The universal social charge (USC) does **not** apply to deposit interest that has been subjected to deposit interest retention tax.

4.6.2 Exemption from DIRT

In certain circumstances deposit accounts can be exempted from DIRT, that is, allowed to receive interest gross, subject to supply of Revenue reference numbers to the deposit taker and/or completion of an appropriate Declaration.

- Non-residents, that is, where none of the persons beneficially entitled to the interest is resident in the State.

- Registered charities, that is, charities that have a Revenue CHY number.

- Pension funds and PRSA providers.

- Approved retirement funds (ARFs).

- Companies. However, although companies can be exempted from DIRT at source, the gross deposit interest is liable to corporation tax in the company's hands at 25%. So being exempted from DIRT does not mean that the interest is tax free in the company's hands, but just simply that it can be paid and received gross by the company.

- An individual who is over age 65 or whose spouse/civil partner is over age 65, can receive deposit interest gross (without DIRT being deducted at source), if their total income (including deposit interest) for 2024 is likely to be under the relevant income tax exemption limit for 2024 of:

  - €18,000 for a single person; or

  - €36,000 for a couple (married or civil partners) (combined income).

  A depositor seeking exemption from DIRT on this basis must complete a Revenue form DE1, before the deposit taker will agree to pay interest gross, without deduction of DIRT.

- An individual who is permanently incapacitated from maintaining themselves or whose spouse/civil partner is so incapacitated, can be exempt from DIRT in 2024 if not otherwise liable to income tax on gross deposit interest because:

  - Their total income (including the deposit interest) is under the relevant income tax exemption limit for 2024 or

  - When account is taken of their overall taxable income for 2024 with due allowances for tax credits, etc., they will have no liability to income tax.

  A depositor seeking exemption from DIRT on this basis must complete a Revenue form DE2, before the deposit taker will agree to pay interest gross, without deduction of DIRT.

- Trusts set up by public subscriptions for the benefit of individuals who are permanently and totally incapacitated can be exempt from DIRT arising from the investment of the trust funds, provided the income from the trust or the investment returns from the investment of the trust funds is the sole or main income (that is, more than 50%) of the individual.

4.6.3 Reclaiming DIRT

The following can reclaim DIRT already deducted from deposit interest:

- ***Companies***. If the company is not taxable on its profits and income, for example, has substantial trading losses which it can offset against its income, it can reclaim any DIRT suffered on deposit interest earned, where it had not completed a declaration to obtain a Dirt-free return.

- ***Individuals*** (or their spouse/civil partner) who are over age 65 and whose total income was less than the relevant income exemption limit in the year.

- Individuals who are permanently and totally incapacitated can reclaim DIRT arising from the investment of a **compensation award for a qualifying personal injury**, where the investment returns are the sole or main income (that is, more than 50%) of the individual. This also extends to the investment of compensation awards from the Hepatitis C and Magdalene Laundry compensation schemes (without the need to meet the incapacity rule).

- Individuals who received compensation awards for Thalidomide children can reclaim DIRT arising from the investment of such awards (without needing to satisfy the '50% rule').

- First time buyers of residential property in certain circumstances can reclaim DIRT.

4.6.4 Potential Exposure to Other Taxes?

Universal Social Charge (USC)

Deposit interest (both Irish and offshore deposits) and credit union share account dividends are ***not*** subject to the universal social charge (USC).

Pay Related Social Insurance (PRSI)

The self-employed, including proprietary directors of small companies, pay PRSI at Class S on all of their earnings apart from pensions, such as gross deposit interest, dividends and rental income.

Employees who pay tax under Schedule E and those in receipt of occupational pensions who do not have other earned income, are only liable to PRSI at 4% on their taxable investment income, including their gross deposit interest, if their taxable investment income exceeds €5,000 in a year.

Therefore, most depositors who are not self-employed are unlikely to have a PRSI liability on their deposit interest, unless they have other substantial taxable investment income such as rental income.

Note that liability to pay PRSI ceases for all at age 66.

Note also that, unlike DIRT, PRSI on investment income is not deducted at source. Those liable must pay under Revenue's self-assessment system.

Example #1

Martha works in the public service and received €1,340 of gross deposit interest in 2024. She has no other investment income. She is aged 42.

Martha is not liable to PRSI on this deposit interest in 2024 as it does not exceed €5,000.

Example #2

Olive works for a bank and also has an investment property yielding €12,000 per annum of taxable rental income. She received €1,340 of gross deposit interest in 2024. She is aged 42.

Olive is liable to PRSI at 4% on this gross deposit interest in 2024 as her total gross investment income is in excess of €5,000.

Example #3

Olive is self-employed and received €2,400 of gross deposit interest in 2024. She is aged 67.

Olive is not liable to PRSI on this deposit interest in 2024 as she's over age 66.

4.7 State Savings Schemes

There are a number of State guaranteed savings schemes and investment products:

1. Deposit Accounts.
2. National Instalment Savings, a 12 month savings plan, which is then left on deposit for up to a further 5 years;
3. Lump sum investment bonds which offer a guaranteed minimum return at different durations over different investment terms:
   - Savings Certificates; investment term 5 years.
   - Savings Bonds; investment term 3 years.
   - National Solidarity Bonds which offer two different investment terms of 4 years and 10 years.

All savings held in State savings deposit accounts, savings certificates, savings bonds, National Instalment Savings and the National Solidarity Bond are fully guaranteed by the Irish Government, regardless of amount.

Deposit Accounts are liable to DIRT, in the same way as all deposit accounts. However, National Instalment Savings and Lump sum investment bonds (2 and 3 above) are completely tax free.

Such savings are hence not covered by the deposit guarantee scheme (see later), as they are separately fully guaranteed by the Irish State, that is, not subject to a €100,000 limit as applies to deposits under the deposit guarantee scheme.

Over the years there have been a series of Issues of the various state savings products. Each series had its own guaranteed rates of return, which reflected interest rates prevailing at the time, as well as the government's need to raise funds. What follows in the next section is the latest Issues available.

4.7.1 National Instalment Savings[6] (16th Issue) 6 Year Term Total Return 10%

National Instalment Savings (16th Issue) is a 12-month regular savings plan. The plan works by saving on a regular basis for 12 months, minimum €25, maximum €1,000 per month. At the end of this period, the sum saved is then left on deposit for a further period, of up to 5 years.

No interest is paid during the first 12-month contribution period, and indeed, under the latest Issue, no interest is added for a further 24 months after that. The interest rate is 10% and the AER at the end of the six-year period is 1.75%. Earlier withdrawals attract lower rates.

Example

Ann saves in the National Instalment Savings for a year. After a year (referred to as the contribution period) she has saved €1,000.

	Encashment Value	
After a further one year	€1,000	AER 0%
After a further two years	€1,000 x 1.015 = €1,015.00	AER 0.60%
After three further years	€1,000 x 1.025 = €1,025.00	AER 0.71%
After four further years	€1,000 x 1.06 = €1,060.00	AER 1.3%
After five further years	€1,000 x 1.10 = €1,100.00	AER 1.75%

Withdrawals at any time between anniversary dates receive the value set out above for the last anniversary date. So, for example, if Ann were to cash in her plan after 4 further years and 6 months, she would receive €1,025.

Returns are tax free and hence are not subject to DIRT, USC or PRSI. Withdrawals are usually subject to seven working days' notice.

After saving for the year, the contribution period stops, but there is an automatic annual renewal facility whereby a new savings plan starts immediately, without the need to complete a new application form.

Savings may be made by direct debit, by direct payment at a post office, or by way of group deduction schemes operated by certain employers.

4.7.2 State Investment Bonds

The State offers four different lump sum investment bonds. The current offerings are:

- Savings Certificates (5 year, 25th Issue);

[6] *Ireland State Savings are managed by the National Treasury Management Agency (NTMA)*

- Savings Bonds (3 year, 18th Issue);
- National Solidarity Bond 10 Year (9th Issue).

At the end of every year a specific bonus is added to the bond. Interest pro rata for the number of days held since the last anniversary date, is added on encashment between anniversary dates, for the Savings schemes only. but nothing extra is added for the period since the last anniversary date for the solidarity bond.

Guaranteed Minimum Return

After	Savings Certs (25th Issue)	Savings Bonds (18th Issue)	National Solidarity Bond 10 year (9th Issue)
1 year	0.00%	0.0%	0.00%
2 years	1.5%	2.0%	1.00%
3 years	2.5%	**4.00%**	2.00%
4 years	4.5%		3.00%
5 years	**9.0%**		6.00%
6 years			8.00%
7 years			10.00%
8 years			13.00%
9 years			16.00%
10 years			**22.00%**

The bolded return(s) above shows the highest guaranteed return at the relevant duration where there is more than one bond providing a guaranteed return to that duration. All rates are correct as of January 2024.

The AER of these guaranteed returns are as follows:

Guaranteed minimum return (AER)

After	Savings Certs (25th Issue)	Savings Bonds (18th Issue)	National Solidarity Bond 10 year (8th Issue)
1 year	0.00%	0.00%	0.00%
2 years	0.75%	1.00%	0.50%
3 years	0.83%	**1.32%**	0.66%
4 years	1.11%		0.74%
5 years	**1.74%**		1.17%
6 years			1.29%
7 years			1.37%
8 years			1.54%
9 years			1.66%
10 years			**2.01%**

Note that returns are not provided uniformly over the term of the bond in question; rather the returns are heavily loaded towards the end of the investment period to encourage investors to remain invested.

Therefore, for example, investors in the current issue of savings certificates should ideally be prepared to hold their investment for at least five years to get the higher returns.

Like savings certificates, the returns from savings bonds are loaded towards the end of the investment period, as the guaranteed returns are 0% for year one, 2.0% for year two, and 4% for year three. An investor in savings bonds should therefore ideally be prepared to hold their investment for at least two years.

Likewise, the returns for the 10-year National Solidarity Bonds are heavily weighted towards years eight, nine and ten, giving a cumulative bonus percentage of 13%, 16% rising to 22%.

The minimum investment in each of the current version of the bonds is €50 and the maximum per person is €120,000 per Issue. So, an individual could invest up to €360,000 in total in the three bonds.

Holdings held in joint names are divided in two for the purposes of the individual limit on investments; for example, a couple could invest €180,000 in each of the bonds above, as this is treated as a holding of €90,000 per person.

Returns are tax free and are not subject to DIRT, USC or PRSI.

Seven working days' notice must be given to make an encashment from any of the bonds above.

4.7.3 Other Deposits

Credit Union Share Accounts (DIRT)

A credit union share account is an account held by an individual with a credit union in respect of which the individual is deemed to be a shareholder of the relevant credit union and receives *dividends* rather than deposit interest in respect of their account.

Dividends from credit union shares accounts are subject to DIRT as if the dividends were deposit interest.

Offshore Deposits

Where an Irish resident receives interest from a deposit account held with a deposit taker based in another EU member State (and not operating through a branch here), the deposit taker is not subject to Irish DIRT legislation and so the interest may be paid gross to the Irish depositor, or subject to a local withholding tax. Any such withholding tax deducted locally may be offset against DIRT if chargeable. Note that if the bank is operating through a branch in the Republic of Ireland, this deposit is not an offshore deposit, and DIRT is chargeable in the normal way.

Gross deposit interest received by an Irish resident from deposit accounts held in other jurisdictions is treated as taxable income of the depositor and taxed in his or her hands at a fixed income tax rate of 33%, that is, the same rate as the prevailing DIRT rate applying to interest from Irish deposit takers.

Deposit takers across the EU seek a tax identification number (TIN) from each non-resident depositor and automatically exchanges details of gross interest paid to non-residents to the tax authorities of depositor's country of residence.

Example #1

Mary, who is an Irish resident has opened a deposit account with a bank in the Netherlands.

The Dutch bank has established her identity and country of residence and PPSN. The Dutch bank will therefore pay interest gross to her, without deducting of tax.

The Dutch bank will return details of Mary and her deposit interest to the Dutch tax authorities who will in turn returns details of all Irish resident depositors to the Irish tax authorities annually.

Where withholding tax is withheld from an interest payment to Irish residents, the depositor is taxed on the gross interest, before the application of the withholding tax, but is entitled to a tax credit against their Irish tax liabilities in respect of the withholding tax deducted at source.

Example #2

Mary, who is an Irish resident, has opened a deposit account with a bank in Austria.

The Austrian bank pays Mary €1,000 of interest, but applies a withholding tax of 35%, and so actually pays Mary €650.

In Ireland, Mary is taxed on €1,000 of interest at 33%, but with an allowable tax credit of the withholding tax deducted of €350. Mary has no further liability to income tax.

4.7.4 Tracker Bond Deposits

A particular type of deposit, called a *tracker bond*, is offered periodically by some institutions.

A tracker bond is a fixed term deposit account, which provides a return after a specified term, typically three to six years, that has two separate components:

- A guaranteed return of a specified percentage (usually 90% ~ 100%) of the original capital sum invested in the bond; and
- Interest which accrues at the end of the term which is calculated by reference to the rise, if any, in a particular stock market index or basket of indices or a basket of specified shares or commodity indices.

Tracker bond deposits are covered in more detail in Chapter 9.

4.7.5 "Benchmark Returns"- State Savings Schemes

State savings returns (other than State savings deposit accounts) are often referred to as *benchmark* returns for the individual investor, that is, returns against which other competing savings and investment products are judged. This is because they offer:

- A State guarantee on both the capital invested & investment Returns.
- No charges or penalties on early withdrawals.
- Immediate access. Funds are usually available within seven working days.
- Tax free returns. Returns are not subject to income tax, DIRT, USC or PRSI.

As State savings returns are tax free (other than State savings deposit accounts) and not subject to DIRT or PRSI, in order to make a fair comparison with advertised gross deposit rates, which will be subject to DIRT and possibly PRSI, returns offered *by State savings products* should be 'grossed up' by the expected DIRT tax rate, currently, 33%, or by 37% where the depositor will be subject to PRSI at 4% on his or her deposit interest.

Example

The National State savings Certificate three-year version offers a guaranteed tax-free return after three years of 4%. In order to compare this with a similar three-year fixed term deposit where the depositor will be subject to DIRT at 33% and PRSI at 4% on the deposit interest, the 4% rate should be 'grossed up' by (33% + 4%)

4% after tax is equivalent to $^{4.0\%}/_{(1\text{-}37\%)}$, that is 6.34% gross deposit rate subject to DIRT at 33% and PRSI at 4%.

4.8 Comparing Deposit Accounts

There are a number of other factors that should be considered, when comparing different deposit accounts in order to determine the most suitable account for a particular consumer's investment:

- The interest rate available.
- The minimum investment required initially to obtain the relevant rate.
- Whether the advertised rate is dependent on maintaining a certain minimum balance in the account? What rate applies if the balance in the account falls below this minimum amount?
- The *period of notice* of withdrawal. For example, a 90-day deposit, that is, where funds are tied up for 90 days, will offer a higher return than a demand deposit account, where you can withdraw your money at any time.
- Access to funds under fixed term accounts, where the bank or credit union may allow some limited access during the term. What breakage or redemption cost will apply to such withdrawals? Is there a regular income facility?
- Whether the deposit rates advertised are fixed or variable; if variable, whether the rate is fixed by reference to some other rate or index.
- Whether the capital sum is guaranteed at all times, or only at certain times or subject to certain conditions.
- The financial security of the particular bank or credit union, including the extent of any statutory or government guarantee provided in relation to that deposit. See Chapter 11 below.
- Any restrictions on the availability of that rate and account, for example, is it internet access only?

4.9 Regulation

4.9.1 Consumer Protection Code (CPC) Obligations on Banks

The Central Bank's *Consumer Protection Code* (CPC) imposes a number of obligations on banks in relation to the operation of deposit accounts:

4.9.2 Crediting Interest

A bank must ensure that any funds received by it to be lodged to a consumer's term or notice deposit account directly or via a deposit agent, are credited to that account by close of the business day on which the funds are received. Where the funds are not credited on the day they are received, credit for those funds must be backdated to the day the funds were received.

4.9.3 Annual Statement of Account

In relation to all term and notice deposit accounts with a balance in excess of €20, the bank must at least annually, provide to a consumer a statement of the account which includes, where applicable, the opening and closing balance and all transactions, interest credited, all charges and taxation details.

4.9.4 Advertising Deposit Rates

A bank or deposit intermediary must ensure that where an interest rate for a deposit account is displayed in an advertisement, it clearly states:

- Whether the interest rate quoted is fixed or variable, and if fixed, for what period and, where relevant, an indication of the rate that will apply thereafter;
- The relevant interest rate for each term quoted together with the annual equivalent rate (AER), and each rate must be of equal size and prominence;
- The minimum term and/or minimum amount required to qualify for a specified rate of interest, if applicable; and
- If any tax is payable on the interest earned.

A bank or deposit intermediary must ensure that:

- The AER as contained in an advertisement is not misleading;
- Any assumptions used in the calculation of the AER are reasonable, up to date and clearly stated; and
- A record of the manner of the calculation of the AER is maintained.

4.9.5 Provision of Information Regarding the Deposit Guarantee Scheme

Institutions must provide information about the deposit guarantee scheme (DGS) (see Chapter 4.11 below) (including explaining what deposits are *not* covered by the scheme) to prospective depositors, and have an acknowledgement of the receipt of that information, before taking a deposit from a prospective depositor.

Institutions must also confirm whether the deposit is covered by the DGS on their annual statements of account provided to depositors.

4.9.6 Provision of Information Regarding Maturing Fixed Term Deposits

A bank must ensure that at least 10 business days prior to the maturity of a fixed term deposit with a term of 30 days or more, it alerts the consumer about its impending maturity and the maturity date.

4.9.7 Deposit Takers

There are four main types of deposit taking entities who take deposits from individual investors:

- *Retail banks,* that is, banks who take their deposits both through their retail branch network and online.
- *Non-retails banks*, that is, banks who do not operate through a retail branch network. These banks may obtain their deposits from other banks and/or directly from the public possibly by post, through intermediaries or via the internet.
- *Credit unions.*
- *Post office savings bank.*

4.10 Deposit Takers Reporting Obligations to Revenue

The Return of Payments (Banks, Building Societies, Credit Unions and Savings Banks) Regulations 2008/2009 require deposit takers to:

- Seek a depositor's tax reference number, in certain cases; and
- Make certain automatic returns to the Revenue Commissioners in respect of interest and dividends paid to depositors. A deposit taker is required to *automatically* report electronically to Revenue details[7] of all account holders where interest or dividends of more than €300 is paid or credited to the account in a calendar year, by no later than 31st March following the end of that year.

The report due from a deposit taker in respect of the 2024 calendar year must be made to Revenue no later than 31st March 2025.

There is also a reporting obligation in the first calendar year in respect of all new deposit accounts, even if the interest paid or credited to the account in that first year is less than €300. So, even if there is no interest payable, the new account must be reported.

This is an anti-avoidance provision designed to catch existing account holders splitting their accounts into a series of new smaller accounts with a view to each of the smaller accounts being under the annual €300 interest/dividend reporting threshold. By having to report new accounts with interest under €300 in the first year, it allows Revenue to spot if existing large account holders are splitting up their account into a series of smaller accounts.

The Revenue reporting obligation also applies to State savings products even though returns from such products, other than deposit accounts, are tax free in the investor's hands.

4.11 Deposit Guarantee Scheme (DGS)

The Irish *deposit guarantee scheme* is a statutory scheme to compensate depositors in the event that a bank, building society or credit union established and authorised in the State becomes unable or unwilling to repay its deposits because:

a. The Central Bank of Ireland has determined that, for the time being, the institution concerned appears to be unable, for reasons which are directly related to its financial circumstances, to repay the deposit and has no current prospect of being able to do so;

[7] *Name, address, gross interest, DIRT deducted if any, and the account holder's PPSN (for accounts opened after 1st January 2009).*

b. A court has appointed a liquidator or examiner to the institution; or

c. A court has made, for reasons which are directly related to the institution's financial circumstances, any other ruling that has the effect of suspending depositors' ability to make claims against it.

While the scheme is referred to as the deposit guarantee scheme, it covers not just deposits (demand, notice, fixed term) but also current account balances, as well as share accounts in credit unions. The scheme is administered by the Central Bank of Ireland.

4.11.1 Funds Covered

While the scheme is referred to as the deposit guarantee scheme, it covers not just deposits (demand, notice, fixed term) but also current account balances, as well as share accounts in credit unions.

The deposit element of a deposit tracker bonds is covered by the DGS *only* if at least 100% of the original investment amount is guaranteed to be repaid at the maturity date of the bond.

However, deposit tracker bonds, which **do not** guarantee a return of the full investment amount at maturity, issued on or before 2nd July 2014, are still covered by the DGS up to their maturity date.

The bonus part of a deposit tracker bond is never covered by the DGS.

4.11.2 Maximum Cover

In the event that a bank building society or credit union covered by the DGS becomes unable to repay its deposits, the Central Bank of Ireland will repay a verified eligible depositor, within 10 working days, 100% of their total deposits held with that financial institution, subject to a maximum compensation payment related to that institution of €100,000 per named depositor.

Example #1

John has a single deposit of €30,000 with Large Bank plc, who are covered by the DGS.

Large Bank plc have gone into liquidation and are unable to repay its depositors. John has no other deposits with Large Bank plc. The Central Bank of Ireland will pay John €30,000 under the deposit guarantee scheme.

Example #2

Mary has five separate deposits, totalling €125,000, with Large Bank plc, who are covered by the DGS.

Large Bank plc have gone into liquidation and are unable to repay its depositors. Mary has no other deposits with Large Bank plc.

The Central Bank of Ireland will pay Mary the maximum of €100,000 under the deposit guarantee scheme.

Because the DGS limit relates to the maximum held by a depositor with a particular financial institution, depositors with large funds may select to split their deposits over a number of different financial institutions, if they wish their funds to be fully covered by the DGS.

Example #3

Mary has €150,000 on deposit with Bank A, who are covered by the deposit guarantee scheme. The maximum coverage of the DGS on this deposit is €100,000.

However, if Mary split her €150,000 into two separate deposits with different banks covered by the DGS, for example, €100,000 with Bank A and €50,000 with Bank B, her full funds would be covered by the DGS.

In the case of **joint deposit accounts**, each deposit holder is treated for the purposes of the scheme as having a deposit of their share of the account, for example, typically 50%.

Example #4

John and Mary have €150,000 in a joint deposit account with Large Bank plc, who are covered by the DGS.

Large Bank plc have gone into liquidation and are unable to repay its depositors. John and Mary have no other deposits with Large Bank plc.

The Central Bank of Ireland will pay Mary and John €75,000 each under the deposit guarantee scheme.

Therefore, in effect joint deposits are covered by the deposit guarantee scheme up to €200,000, where each account holder is entitled to 50% of the deposit.

Example #5

John and Mary have €150,000 in a joint deposit account with Large Bank plc, who are covered by the DGS. Mary also has €20,000 in a separate deposit account in her own name with Large Bank plc.

Large Bank plc have gone into liquidation and are unable to repay its depositors. John and Mary have no other deposits with Large Bank plc.

The Central Bank of Ireland will pay under the DGS:

- Mary €95,000 (that is, 50% x €150,000 + €20,000) that is, €95,000, and
- John €75,000 (that is, 50% x €150,000).

4.11.3 Special Deposits also Covered Under the Deposit Guarantee Scheme

There are some special deposits including current accounts (referred to as a *temporary high balance*) which are also covered by the DGS in excess of €100,000 for a six-month period from the time these funds are lodged to the institution. Qualifying deposits are protected up to a limit of €1 million (although unlimited cover is provided for claims relating to personal injury) for a period of six months after the deposits have been credited to an account or from the moment when such deposits become legally transferable.

These special deposits include:

- Funds related to the purchase and sale of a private residential property;
- Sums paid to the depositor in respect of:

- Benefits payable under an insurance policy;
- A claim for compensation for personal (including criminal) injury; (these deposits are covered by the DGS for the six-month periods without limit);
- State benefits paid in respect of a disability or incapacity;
- A claim for compensation for wrongful conviction;
- A claim for compensation for unfair dismissal;
- Redundancy (whether voluntary or compulsory);
- The depositor's marriage, judicial separation or civil partnership;
- The depositor's divorce or dissolution of his or her civil partnership; or
- Benefits payable on retirement;
- Benefits paid to the depositor on a person's death;
- A claim for compensation in respect of a person's death; or
- A legacy or other distribution from the estate of a deceased person.

Example

Jack has just retired and received a lump sum retirement payment of €240,000 which he or she then lodges to a new deposit account with a bank covered by the DGS.

The full €240,000 deposit is covered by the DGS for six months, if maintained at that level for the six-month period. Thereafter, the cover falls back to the normal maximum €100,000 limit.

4.11.4 Which Depositors are Covered?

The following *are* covered by the DGS:

- Individuals;
- Sole Traders;
- Partnerships;
- Clubs, associations, schools and charities;
- Companies;
- Small self-administered pension schemes

Depositors not covered by the DGS, are those deposits made by or in respect of:

- Banks;
- Insurance companies;
- MiFID investment firms;

- PRIIPs.
- Public authorities;
- Transactions related to a criminal conviction for money laundering or terrorist financing;
- All pension schemes and retirement funds (ARF) and other than small self-administered pension schemes.

In the case of sole traders, personal and business accounts are combined for the purposes of the €100,000 limit, so that there isn't a separate €100,000 guarantee for personal savings and another €100,000 limit for the sole trader's business deposits.

Example #1

Fiona is a sole trader. She has a personal deposit account of €85,000 with Large Bank plc and another €20,000 in her business current account.

Fiona's maximum cover under the DGS is currently €100,000, as her personal and business account are combined for the purposes of the €100,000 limit on cover.

In the case of a partnership, one €100,000 limit applies to the partnership accounts, regardless of the number of partners and accounts, but each partner is entitled to their own €100,000 limit in respect of their personal deposit accounts, that is, funds not related to their role as a partner.

Example #2

Jack is a 50% partner of J & M, Chartered Accountants. He has a personal deposit of €40,000 with Large Bank plc, and the partnership has another €70,000 on deposit with the same bank.

Jack's maximum coverage under the DGS is currently:

€40,000 (personal) + 50% x €70,000 (partnership) = €75,000.

4.11.5 Institutions Covered

The institutions currently covered by the deposit guarantee scheme include:

- Allied Irish Banks
- EBS
- Permanent TSB
- Bank of Ireland
- Credit Unions (deposit and share accounts).

Retail deposits held in Irish branches of foreign banks are **not** covered by the Irish deposit guarantee scheme. However, such deposits are covered by an equivalent deposit guarantee scheme of the relevant bank's home State; cover is harmonised in the EU at €100,000 and is £85,000 for UK registered banks.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] The main features of deposit accounts, including credit union share accounts
- [ ] How deposit interest is taxed in the hands of the investor
- [ ] The main State savings and deposits products
- [ ] Revenue reporting obligations on deposit takers
- [ ] Consumer Protection Code obligations on banks in relating to deposits
- [ ] Comparing deposits
- [ ] The deposit guarantee scheme
- [ ] The main benefits limitations and risks of deposits for investors

Sample Questions

The answers to these questions can be found in your Study Hub.

1. A call deposit account is also known as:

   A. a demand account.
   B. a notice account.
   C. a fixed term deposit account.
   D. a put account.

2. A civil partner couple can be exempted from DIRT in 2023 only if:

   (i) at least one of them is over age 65.
   (ii) their combined total income for 2023 is less than €36,000.
   (iii) their total deposits with all deposit takers does not exceed €200,000.

   A. (i) only.
   B. (i) and (ii) only.
   C. (ii) and (iii) only.
   D. (i), (ii) and (iii).

3. Interest payable on the State Savings Deposit Account is:

   A. subject to DIRT on the full amount.
   B. tax free, without limit.
   C. tax free up to €100 per annum; the balance is subject to DIRT.
   D. tax free up to €250 per annum; the balance is subject to DIRT.

4. Jack took a redundancy package from his employer and received a sum of €187,000. He lodged this to a deposit account with Large Bank plc, which is covered by the Irish Deposit Guarantee Scheme.

   If Large Bank plc fails in the following month and is unable to repay Jack his deposit, what MAXIMUM amount will he be entitled to receive from the Deposit Guarantee Scheme in respect of this deposit?

   A. €87,000
   B. €90,000
   C. €100,000
   D. €187,000

05

Shares

The process to form a company is outlined as well as the set-up documentary requirements of the different company types. Company ownership, and the different types of shares (ordinary, preference) are compared. Key numerical measures used to assess and compare share value, such as dividend yield, earnings per share, P/E ratio and net asset value, are examined. How an investor trades in quoted shares (buying and selling) placing an order with a stockbroker and how settlement is delivered is also discussed. The main international stock market indices are named and described.

Financial derivatives are introduced and described in outline terms.

The chapter closes by summarising the benefits, limitations and risks of investing in shares.

Learning Outcomes – after studying this chapter you should be able to:
understand what shares are and different types and rights of ordinary and preference shares;
know what the following terms mean and how each is calculated: *authorised share capital, issued share capital, gross dividend yield, dividend cover, earnings per share, PE ratio, net asset value, market capitalisation and EBITDA;*
know how a company is formed;
be aware of the accounting principles of a company's account, including its balance sheet, profit and loss and cash flow statements;
have a general appreciation of buying and selling quoted shares, including registration of share ownership;
be aware of factors affecting quoted share prices & Know the Stock Market Indices
be aware of different types of investment firm services, authorised under MiFID;
appreciate what a derivative is, including contracts for difference and covered;
outline the benefits and risks of unquoted shares;
know the tax benefits of investing in Employment and Investment Incentive shares;
know how returns from investing in shares are taxed, including USC and PRSI, in the hands of a consumer; and
outline the main benefits, limitations and risks of investing in shares.

Chapter weightings	**Number of questions which may appear**		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	5	14	18

5.1 A Company

A company is a legal form of business organisation. It is a separate legal entity and, therefore, is separate and distinct from those who run it or own it. The company (and not the individual shareholders) is the appropriate person to be sued in the event that debts are incurred by the company which remain unpaid.

The Companies Registration Office (CRO) is the statutory authority for registering new companies in the Republic of Ireland. The CRO has a number of core functions:

- The incorporation of companies and the registration of business names.
- The receipt and registration of post incorporation documents.
- The enforcement of the Companies Act, 2014, in relation to the filing obligations of companies.
- Making information available to the public.

Once incorporated, a company will be required to file annual returns, and in most cases they must also file annual accounts. Almost all of the information filed with the CRO is available for public inspection, usually for a small fee.

The requirements for registration differ depending on the company type.

5.2 Types of Companies

There are three main types of companies whose shareholders' liability is limited, that is, the shareholders' liability, should the company fail, is limited to the amount, if any, remaining unpaid on the shares held by them (in most cases there is nothing left unpaid, as generally investors pay up the full amount due for the shares at the outset).

- **Private company limited by shares (LTD)**: the members' liability on wind up of the company is limited to the amount, if any, unpaid on the shares they hold. These companies have the same capacity to engage in ventures etc., as an individual. They have a simple *one-page constitution*; they do not have a memorandum or articles of association, as the other two types of companies below must have. The company can have one or more directors, but if only one director another person must act as company secretary.

  Most private companies are of this form.

- **Designated Activity Company (DAC**): these are companies whose activities are limited to specific 'objects' or purpose. An example might be a bank or a life assurance company. Such companies must have:

  - A document which regulates the company's relationship with the outside world, known as its *memorandum of association*.
  - A document which controls the company's relationship with its own shareholders and the respective rights of shareholders between themselves, known as its *articles of association.*
  - Stated objects (reason) for which it was incorporated.
  - At least two directors.

- **Public Limited Company (PLC)**: unlike LTD and DACs, shares in a *public limited company (PLC)* are generally transferable from one person to another without the permission of the other shareholders, and a stock exchange provides a mechanism to match buyers and sellers of such shares.

- A PLC must, like a DAC, have a memorandum and articles of association.

- Shares in a public limited company may be (but are not required to be) listed on a stock exchange unlike shares in a LTD or DAC. The term *listed* refers to the fact that a particular share can be bought and sold on a stock exchange. The term *quoted* is also sometimes used.

- A shareholder is entitled to benefit from a share of the profits and losses of the company in which he or she owns shares:

  - A share of ongoing profits may be distributed to shareholders regularly, in the form of *dividends* expressed as a fixed monetary amount per ordinary share held, for example, €1.45 per ordinary share. Some, but not all, companies pay dividends to their shareholders.

  - A shareholder may realise a capital profit by selling his or her shares at a value higher than he or she paid for them. Of course, there is no guarantee that will happen; quoted share prices can rise and fall from day to day in line with market expectations for the company's outlook and general stock market conditions.

Shares which can be bought and sold on a stock exchange are also generally referred to as *equities*. A Packaged Retail Investment and Insurance-based Products (PRIIPs) fund (see Chapter 7) investing in shares is usually called an *equity* fund.

The stock market is therefore a place where buyers and sellers of certain investment securities are matched. Effectively the stock market provides a *market* for these securities.

A stock market which is subject to regulatory oversight is referred to as a *regulated market.*

5.3 Company Formation

A company is a legal entity which is governed by the Companies Act 2014. During its formation, Form A1 is completed and submitted to the Companies Registration Office (CRO) together with a constitution. While a one document constitution is required if the company is a LTD company, a memorandum and articles of association is required for all other company types.

5.3.1 The Company Constitution

The constitution of a company states

- The company's name

- That it is a private company limited by shares

- That the liability of its members is limited

- The amount of share capital it proposes is registered

- The breakdown of the value of the shares

- The number of shares and

- Whether the company adopts supplemental regulations and if so, what those are.

Once incorporated, the constitution can be changed by a special resolution and the company will be required to file an annual return.

5.3.2 Memorandum of Association

The memorandum of association (MOA) is a document which sets out for a designated activity company (DAC) or public limited company (PLC) certain information including:

- The name of the company;
- A statement that the liability of the members is limited;
- The objectives of the company;
- The amount of share capital with which the company proposes to be registered, and the division of such capital into shares of a fixed amount.

5.3.3 Articles of Association

This document sets out the rights of shareholders and the rules for the internal management of a designated activity company (DAC) or public limited company (PLC).

For example, the articles of association will deal with annual general meetings of members, the rights attaching to different classes of shares, transfer of shares, powers and duties of directors, etc.

The articles of association may be altered or added to by means of a *special resolution*, which can only be passed where at least 75% of those who attend the meeting and are entitled to vote, do so in favour of the resolution.

5.3.4 Authorised Share Capital

A company's *authorised share capital is* the number of shares, and the nominal value of shares, which a company can issue to shareholders. This is referred to as the company's *authorised share capital,* that is, the total amount of capital it is authorised to issue to shareholders.

Example

A company may have an authorised share capital of, say, 10m shares at 10c each.

Its total authorised share capital is therefore €1m.

A company's authorised share capital can usually be increased by its shareholders by passing a special resolution at a meeting of the company's shareholders.

5.3.5 Issued Share Capital

A company's *issued share capital* is the nominal value of the shares actually issued by the company to shareholders. The term *nominal value* means the notional or face value of the share.

A company might have an authorised share capital of, say, €1m, comprising of 10,000,000 shares at 10c each, but might only have issued, say, 1,000,000 shares.

Shares may be issued to shareholders at a price above or below the nominal value of the shares.

Example #1

An ordinary share might have a nominal value of €1, but, be issued to shareholders at €1.50 each. In this case the €1.50 paid to the company by the shareholder in return for issuing the share to the investor is dealt with as follows:

- €1 is shown in the company's accounts as the issued share capital;
- The remaining 50c over the nominal value is shown in the company's accounts as a share premium reserve, that is, as part of the capital reserves of the company.

Example #2

An ordinary share might have a nominal value of €1,but be issued to shareholders at €0.40 each. In this case the issued shares are referred to as 'partly paid' as the shareholders have not paid the full nominal value of the shares issued to them. The shareholders holding these shares can be called upon on a wind up of the company to pay up the balance, that is, €0.60 per share in this example, that is, they are liable for the balance of the nominal value of the shares.

5.3.6 Types of Share Issues

Rights Issue

Ordinary shareholders have a statutory right to subscribe to any new ordinary shares issued by a company.

A *rights issue* is where a company seeks to raise additional shareholder capital by giving existing ordinary shareholders the *right* to subscribe for additional shares in the company at a favourable price (that is, below its current market price) for a limited period. The number of shares that they can take up at this price will be dependent on the size of their existing holding.

Example

A company's ordinary share price is currently €10.50 on the stock exchange.

It announces a rights issue where existing shareholders can opt to buy one new share in the company for every four shares they currently have, at a price of €7 per share.

An existing shareholder with 10,000 shares, has therefore the right to buy 2,500 additional shares in the company at €7 each.

Following a rights issue announcement, the market price of the shares can be expected to fall to reflect the additional shares issued and the fresh capital raised by the company.

Using the example above, you would expect the price to fall (all other things being equal) to:

[(10,000 x €10.50) + (2,500 x €7)] / 12,500 = €9.80

This lower price, after announcement of the rights issue, is referred to as the *ex-rights price*.

Bonus Issue

A bonus issue (also known as a *capitalisation issue)* is where ordinary shareholders are given additional free shares in the company, in proportion to their existing shareholding. For example, one new ordinary share for every seven ordinary shares already held.

The effect of a bonus issue is to reduce the share price of the company which is often attractive to a company when its share price is very high and is therefore not as marketable to investors as it should be. While the share price is diluted, the total value of the company remains unchanged.

Scrip Dividend

A *scrip dividend* occurs when a company offers shareholders the option of taking dividends in the form of additional shares in the company based on a predetermined share price, in lieu of taking a cash dividend payment.

While the investor is treated for tax purposes as receiving the dividend in cash, in fact it's automatically reinvested in shares of the company at the then share price.

Example

A company is due to pay out a dividend of €150 to an ordinary shareholder. The company offers ordinary shareholders the alternative option of using this cash amount to buy additional shares in the company at a predetermined share price of say, €14.90.

If the investor has opted for a scrip issue he will get 10 new shares in *lieu* of the dividend.

5.4 Company Accounts

5.4.1 Accounting Principles

The benefits of limited liability provided to investors in ordinary shares bring with them certain additional administrative burdens. These include the requirement for the company to keep proper financial records, to prepare accounts on a regular basis which give a '*true and fair* view' of the state of the company's affairs and to have the accounts audited by a registered auditor.

The audited financial statements must be approved by the members at the AGM.

5.4.2 Balance Sheet

The balance sheet (also known as a Statement of Financial Position) is a snapshot picture of the financial position of a company at a particular moment in time. Specifically, the balance sheet is a table that lists in monetary terms, the resources owned by the company and all claims against those resources at a particular moment in time – the end of the accounting period in question.

In essence, the balance sheet measures the net worth of the company at a particular moment in time.

The resources owned by the business are known as *assets*. An asset is defined as one of two things. It is either:

- Something the company owns. Examples include: cash, land, stock, machinery, intellectual rights, etc.
- Something technically owned by the company but is currently in someone else's possession, that is, something the organisation is owed. For example, if a company sells goods on credit to a person (*debtor*), that person owes the organisation money. The amount owed is an asset of the company.

Claims against resources are known as *liabilities*. A liability is anything that the company owes to another entity and expects to have to make good on at a later date, for example, loans, etc.

The basic balance sheet equation, which will be expanded on below, is given as:

Assets = liabilities

Liabilities can be broken down into two categories:

- *Current liabilities*: liabilities the company will have to pay within one year. Examples include amounts owed to suppliers (creditors) and a bank overdraft.
- *Long-term liabilities*: liabilities the company will have to pay, but not within one year, for example, a long-term bank loan. The capital invested by the owner of the organisation is also considered a long-term liability.

The balance sheet equation now becomes:

Assets = current liabilities + long-term liabilities

Example

Niall Murphy decides to set up a company. He takes €100,000 of his own personal funds and subscribes this amount for shares in his new company, Murphy Enterprises Ltd.

From the company's perspective, its assets have increased by €100,000 (the money sitting in its bank account) but the firm's liabilities have also increased by €100,000 (the capital invested by Niall).

The company's balance sheet looks as follows:

Assets	€
Bank deposits	100,000
Liabilities	
Capital	100,000

Similar to liabilities, assets can be broken down into two categories:

- *Fixed assets*: these are assets that last longer than one year and are not purchased for resale in the ordinary course of the business. They are used by the company itself to help generate sales. Examples include land, buildings, technology equipment, fixtures and fitting etc.

- *Current assets*: these are assets that are either in cash form or are expected to turn into cash within one year. Examples include favourable balances held with banks, debtors and stock (purchased for resale).

Thus, the balance sheet equation can be further expanded to:

Fixed assets + current assets = current liabilities + long-term liabilities

Taking the balance sheet equation above and bringing current liabilities and long-term liabilities across, the equality gives:

Fixed assets + current assets - current liabilities - long-term liabilities = capital

This equation in general terms, represents the structure of the balance sheet.

5.4.3 Profit and Loss Account

The profit and loss account (also known as the Statement of Comprehensive income) calculates *net profit*.

Net profit is equal to:

Gross profit LESS administration, selling and distribution expenses LESS Tax

Before going on to examine the profit and loss account in detail, a distinction must be made between two types of expenditure:

- *Capital expenditure*: this is expenditure on goods that will last for more than one year and are not bought for resale but to be used by the business to help generate sales. Examples include premises, equipment, delivery vans etc.

- *Revenue (current) expenditure*: this is expenditure on goods that will be used up within one year and are not bought for resale. They are incurred in the day-to-day running of the business. Examples include wages, rent, rates, telephone etc.

The profit and loss account is only concerned with *revenue expenditure*.

A typical format for a published profit and loss account for a public limited company is:

Profit and Loss Account for the year ended date	
	€
Turnover	**xxx**
Cost of sales	(xxx)
Gross profit	xxx
Distribution expenses	(xxx)
Administration expenses	(xxx)
Other operating income	Xxx
Operating profit	**xxx**
Interest payable	(xxx)
Investment income	xxx
Profit on ordinary activities before taxation	**xxx**
Taxation on ordinary activities	(xxx)
Profit on ordinary activities after taxation	**xxx**
Extraordinary Items	(xxx)
Profit for the financial year	**xxx**
Dividends paid and proposed	(xxx)
Retained profits for the financial year	xxx

5.4.4 Cash Flow Statements

The *cash flow statement* is a statement showing inflows and outflows of cash over a particular accounting period, analysed by the reason for and purpose of the cash inflow/outflow. It is the third primary statement that makes up a company's financial statements. For the purposes of constructing a cash flow statement *cash* is defined as all cash held in hand, at the bank and other financial institutions (regardless of the currency in which the cash is denominated) and bank overdrafts. Bank overdrafts are regarded as negative cash.

A sample cash flow statement is set out below:

ABC Ltd **Cash Flow Statement for the year to XX XXXXXXX 20XX**		€'000
Net cash inflow from operating activities		2,800
(1) Return on investment and servicing of finance		
Interest received	40	
Interest paid	(180)	
Preference dividend paid	(160)	
Net cash outflow from return on investment and servicing of finance		(300)
(2) Taxation		
Corporation tax paid		(800)
(3) Capital expenditure and financial investments		
Payments to acquire tangible fixed assets	(1,200)	
Proceeds from sale of tangible fixed assets	100	
Net cash outflow from capital expenditure and financial investments		(1,100)
(4) Equity dividends		
Equity dividends paid		(840)
(**5) Management of liquid resources**		
Purchase of treasury bills		N/A
Cash outflow		-240
(6) Financing		
Issue of ordinary shares	600	
Issue of debenture stock	200	
Repayment of loan	(300)	
Net cash inflow from financing		500
Increase in cash during the period		**260**

The cash flow statement lists the cash inflows and outflows of the company and accounts for where these inflows and outflows came from.

Inflow/outflows are categorised into six broad headings. Any cash inflow/outflow will fall under one of these headings:

- *Return on investment and servicing of finance*, deals with cash flows that arise out of:
  - Servicing of financing that is, paying interest on loans or paying preference dividends on the preference shares that provide the financing for the company;
  - Any cash inflows arising out of the investment activities of the firm; and
  - Interest received on favourable bank balances.
- *Taxation*. Here the company records the cash outflow during the accounting period arising from paying the company's tax liability. This figure is not the tax incurred as per the profit and loss appropriation account but the amount of tax that was physically paid to the tax authority during the accounting period in question.
- *Capital expenditure and financial investments*, deals with capital expenditure that is, any cash flow arising from buying or selling fixed assets.
- *Equity dividends*, cash outflows from paying ordinary dividends are recorded.
- Sometimes large companies purchase and/or sell treasury bills (very short-term government deposit securities) usually for investment purposes. Any cash flows from such activities are accounted for under the fifth heading: *management of liquid resources*.
- *Financing*, deals with cash flows arising from movements in the sources of finance of the company. For example, the issue (sale) of new shares will result in a cash inflow for the company whereas the repayment of a loan will result in a cash outflow from the company.

5.4.5 Use of Accounts

Investors use the main published financial statements of companies to help them analyse a company's potential future profitability and ability to provide a return for investors, principally by calculating various ratios or *metrics* (for example, *P/E ratio*, *dividend cover*, *EBITDA*, etc.) that allow investors and analysts to:

- *Detect trends,* for example, a company with a declining cash flow production capability, as measured by the cash flow statement might indicate a deteriorating outlook for the company and a possible need for a rights issue.
- *Compare against peers,* for example, investors and analysts will use ratios etc., to compare, say, AIBs performance with that of BOI, etc.

5.5 Shares

The term *shares* refers to part ownership of a company. A *shareholder* is someone who owns shares in a company which entitles that individual to a share of the profits and losses of that company. A shareholder is technically referred to as a *member* of the company. Shares are also often referred to as *equities*.

For example, if a company has issued 100,000 shares and an individual owns 1,000 shares in that company, then that individual effectively owns 1% of the value of that company.

5.6 Types of Shares - Features

5.6.1 Ordinary Shares

Ordinary shares are the most common type of share issued by companies. The shareholder has no right to any specific level of dividend payment, and on a wind up of the company, is entitled to a share of the surplus after all other prior liabilities and entitlements have been met.

Therefore, ordinary shareholders stand last in the queue for a distribution of profits, but are the owners of the business and are entitled to all profits once prior claims have been met.

A company may have different forms or types of ordinary shares which can differ by:

- Voting rights;
- Dividend rights;
- Repayment rights in the event of the company winding up.

5.6.2 Preference Shares

All companies listed on a stock exchange must have *ordinary shares* in issue. Some companies also have *preference shares* in issue.

Preference shares differ from ordinary shares in two important aspects:

- Preference shares may carry a right to a fixed level of dividend payment *before* ordinary shareholders are paid a dividend, but after corporate bond holders (see Chapter 6) have received their interest. The preference share dividend is usually expressed as a percentage of the nominal value of the share, for example, 5% per annum; and
- In the event of a wind up of the company, the preference shareholders are entitled to repayment of their issued share capital *before* ordinary shareholders get anything, but again usually after other debenture or loan stock holders have been repaid.

Preference shares are not unlike a fixed interest investment. However, like ordinary shares, they do carry a risk that the company could go out of business, and the shares become worthless.

There are many different forms of preference shares which may vary by a number of features, including:

- Priority of repayment in the event of the liquidation of the company; some companies may issue different series of preference shares. Preference shares may rank *pari passu* - that is, all equally - with other preference shares - or in *priority*, that is, first issue having priority over second issue, etc.
- Whether entitlement to the dividend is *cumulative* or not, that is, if cumulative and the company fails to pay a dividend to those preference shareholders in a given year, that dividend entitlement must be carried forward to the next year and must be met together with the subsequent year's dividend entitlement *before* any dividends can be paid to ordinary shareholders.

  Where the preference shares are *noncumulative*, the right to an unpaid preference dividend is lost at the end of that financial year, if not paid.

- Whether the preference shares are *redeemable* or not. If they are redeemable, the value payable is normally the nominal value of the share, which is the price set at the outset. It is not the current market price, which is the price that someone is currently prepared to pay in the market.

  Redeemable preference shares may be issued subject to a wide variety of redemption terms such as:

  - At any time at the company's option; or
  - At a fixed date; or
  - Between two future dates at the company's option.

- Whether the preference shares are *convertible*, that is, the shares carry the right to be exchanged or converted into ordinary shares at some predetermined rate in accordance with the terms of the issue.

  Convertible preference shares can allow an investor to have the best of both worlds, – the investor enjoys the possibility of a guaranteed, fixed income in the short-term plus the option to convert into ordinary shares and reap the benefit of growth of the company in the long-term.

From the investor's viewpoint, all types of preference share carry some disadvantages:

- When compared to debenture securities, that is, fixed interest securities secured on some or all of the company's assets, preference shares offer little or no security.
- When compared to ordinary shares, they offer little or limited prospect for capital growth.

5.6.3 Unquoted Shares

Investors may invest in *unquoted* shares, that is, shares not listed on a recognised stock market, as a direct investment in *private equity*, that is, taking a direct shareholding in a private or public limited company not listed on a stock exchange.

LTD and DAC companies cannot promote their shares to the investing public and usually such shares cannot be transferred to others except with the approval of the shareholders who control the company.

PLCs cannot invite the public to subscribe for shares in the company without issuing a prospectus approved by the Central Bank.

The potential benefits offered by investing directly in shares of a company not listed on a stock exchange is the prospect of potentially higher returns than available from investing in shares of large companies listed on a stock market.

However, investment in shares in private companies carries several risks for investors, as compared with investing in quoted shares:

- *Potential lack of information;* a small shareholder (an investor not involved in the business) in a private company may have little knowledge of day to day trading conditions and results and may only be entitled to a set of company accounts, after the end of the company's financial year.
- *No free market for the shares*: depending on the level of shareholding, other major shareholders may have *pre-exemption* rights to prevent a small shareholder from selling his or her shares to an outside party.

- *Lack of liquidity:* because of no ready market, such shares are highly illiquid and therefore investors may not be able to realise their investment quickly at a time of their choosing, which would be the case with quoted shares.

- *Calls for further capital:* small developing companies frequently are capital hungry and may well come looking to shareholders for fresh capital injections from time to time. This can present a dilemma for existing investors; if they do not put in more capital, their shareholding in the company will be diluted or reduced, but if they do put in more capital, it may be a case of 'good money after bad'.

- *No dividend income*: small companies, because of their frequent need for development capital invariable do not pay out dividends to investors.

- *Dependence on one or more individuals*: small private developing companies frequently are highly dependent on one or more individuals, for example, the individuals who founded the business and who have specific special expertise on which the company depends heavily. The serious illness or death of any of these individuals could cause the failure of the company.

- *High failure rate*: small trading private companies, particularly start-up companies, often have high failure rates.

To counteract some of the risks outlined above, funds which invest in a range or spread of private companies represent a better option for many investors who want exposure to private equity; for every small private start-up company which eventually becomes a Microsoft, there are thousands of others which wind up with a complete loss of capital for investors.

5.7 Benefits of Investing in Shares

The main benefits of investing in shares are: income (received in the form of dividends) and or capital appreciation.

- Potential for capital appreciation, if the share price increases in value. Past experience shows that the share prices of good well-run companies may increase faster than inflation over the long run, but with a high level of volatility in returns from time to time.

- Potential for regular increasing dividend income, from those shares which pay dividends. Past experience shows that good well-run companies may pay dividends which increase faster than inflation over the long-term.

- Tax relief may be available for investment in certain *tax incentivised* shares, such as shares in companies or funds which qualify for the employment and investment incentive (EII) relief.

5.8 Limitations on Investing in Shares

There are a number of limitations on investing in shares:

- The number of regulated entities who can offer direct investment in shares is much smaller than the number of firms who are regulated to offer indirect investment in shares via PRIIPs funds (see Chapter 7).

- Investment firms may impose a minimum investment amount and/or charge a fixed fee which may make investment of a small amount in shares uneconomic.

- A high minimum capital sum may be required to invest in a well-diversified mix of shares, in order to reduce risk.

- Unquoted shares may be very illiquid and may not be sold without the consent of the other shareholders.

- Investors in shares which benefit from tax incentives, such as tax relief on investment in EII company shares, may have to retain those shares for a certain minimum period to retain the full benefit of the tax relief claimed.

5.9 Factors Affecting Quoted Share Prices

Ultimately the price of a quoted share at a particular time on a particular day is determined by the relative supply and demand for that share at that time. If more people wish to buy (that is, demand) than sell (that is, supply), the price will go up; conversely, if sellers exceed buyers, the price will go down.

If you then consider what determines the level of supply and demand for shares, you will discover that the answer to the question as to what factors affect quoted share prices is almost anything! However, we can confine our considerations to three main headings:

- **General investment market factors**, such as the general economic outlook, geopolitical events, investor sentiment, outlook for interest rates and inflation, and the outlook for corporate earnings.

- **Factors affecting a particular sector**; changing patterns of consumer supply and demand can influence the fortunes of a particular sector. For example, a reduced demand for hotel accommodation and air travel caused by a reaction to terrorist events or a volcanic eruption can lead to reduced profit or even loss expectation for companies heavily involved in the hotel and aviation sectors, but not unduly affect the share price of banks, large industrial companies, etc.

- **Factors affecting individual companies**; the fortunes of individual companies can be very volatile. If investors believe a particular company has good future prospects, more investors will want to buy than sell shares in that company, and this may lead to an increase in its share price. But the opposite can happen if investors believe the profit outlook for a particular company is poor.

5.10 Risks of Investing in Shares

Shares are risky investments as there are no guarantees on future dividend income and/or on the price at which the shares may ultimately be sold.

The last 5 years give a useful insight into the impact of volatility over two different time horizons. The following graphs show the performance of the ISEQ Overall Index, over a 1-year and 5 year period to January 2024, which reflects the movement in the market capitalisation of shares listed on the ISEQ over these time periods.

Source: Euronext Live Markets (Date: January 13th 2023 to January 13th 2024)

The graphs also clearly show how for an investor the outcome (fluctuations in value) can significantly differ even if investing in the same index depending on investment period as well as price at entry or exit.

Source: Euronext Live Markets (Date: November 13tht Jan 2019 to 13th Jan 2024)

The risk (volatility) involved in investing in shares can be clearly seen from the graphs shown above, as there were periods when share prices fell sharply, followed by periods of recovery in price, and so on. Stock markets do not move in nice steady lines, unfortunately investing in shares is therefore subject to many risks:

- The risk that stock markets and shares values generally may decline because of general economic conditions or uncertainty over some geopolitical event, for example, terrorist threat, elections, Covid 19 pandemic, Russian invasion of Ukraine, Middle East Invasions, – leading to capital loss. This risk is usually known as the *market risk*, that is, the risk of being invested in the stock market at any time.

- An increase in interest rates has a direct adverse effect on bond values which fall as a result (Bond yields rise with Interest rate rises, and so bond yields going up, sees bond prices go down). This may also lead to a fall in share prices, as rising interest rates may impact consumer spending, subsequently impacting on corporate profitability. This may then see investors become more attracted to investment in bonds and so switch their funds to fixed interest bonds and out of shares. This is referred to as the *interest rate risk*.

- The investor buys or sells shares at the wrong time. As seen in the 12 month graph above, if, an investor who bought the ISEQ in August ‘23 and sold in October ‘23, depending on dates, they could have experienced a greater than 17% loss. This is called *timing risk*.

- The risk that a particular share may fall in value due to some specific factors which impact severely on that company, for example, Boeing the major Aircraft manufacturer suffered a 30% fall in its share price in 2019, following the grounding of its new Boeing 373 Max Jet after two catastrophic accidents in which a total of 346 people died. This is usually referred to as a *stock specific risk*.

- The risk that a particular sector could experience some event or conditions leading to a general fall in prices of all shares in that sector. For example, airlines, following the Covid 19 outbreak in 2020 and the resulting impact on global travel, saw the grounding of planes across the world and the collapse in the Share prices of most global airlines. This is called *sector specific risk*.

- The *currency risk* where a particular company derives a significant proportion of its earnings or profits from a non-eurozone country; for example, Kerry Group plc , which has a significant portion of sales denominated in US dollar terms. In this example, if the dollar falls in value relative to the euro, the euro value of Kerry's US sales and profits will be reduced accordingly.

- The risk that the return achieved may fail to match inflation. This is usually referred to as the *inflation risk*. Over the long-term shares have generally offered the best protection against inflation, but over shorter periods this may not always hold true.

- The risk that the return achieved may fail to match some objective or target return, for example, to accumulate a fund to pay off a loan, etc. This is sometimes referred to as *shortfall risk*.

One way to attempt to reduce the volatility of investing in shares is to diversify across:

- A number of different shares;

- Shares in different business sectors of the market, for example, financials, technology, food, etc.;

- Shares in companies deriving their income and profits from different geographical markets, for example, US, Europe, Japan, UK etc.

As we shall see in Chapter 7 Packaged retail investment & Insurance based products (PRIIPs), like unit funds, unit trusts and UCITS, offer the investor a convenient way to diversify in a manner which would not normally be feasible for the small investor investing directly in shares.

However, even with such diversification, there is still the overall market risk, for example, where the world economy is in recession or some geo-political event causes instability in financial markets worldwide, resulting in share price decline in all major markets and across all sectors.

5.11 Taxation of Returns from Shares

Dividends and capital gains from investment in shares which are personally owned, are liable to tax in the investor's hands and these are described in the following sections.

5.11.1 Dividends

In summary dividends are liable to income tax, Universal Social Charge (USC) and, in certain circumstances, PRSI.

Dividends from Irish resident companies are assessed for income tax under Schedule F, at the investor's marginal tax rate.

Dividends paid by Irish resident companies are normally subject to *dividend withholding tax (DWT)*, which is currently 25%.

The investor is taxed on the sum of the (net dividend received + DWT deducted), with the DWT then being allowed as a credit or deduction from the investor's total income tax liability.

Example #1

Company X pays a dividend of €1,000 to Susan. It must deduct €250 DWT and hence pays Susan €750.

Susan is taxed on €1,000 of gross income, that is, €750 + €250, which, if Susan is a top rate taxpayer, would lead to an income tax liability of €400 (before USC/PRSI; see below).

However, Susan is allowed to offset the €250 DWT deducted against her income tax liability, so that her additional income tax liability on the €750 net dividend received would be €150, assuming that she is a top rate taxpayer.

Of course, in the above example:

- If Susan was a standard rate taxpayer, allowing for her total income including the gross dividend income, she would be entitled to a refund in respect of the dividend, as her marginal overall rate of tax is 20%.

- If Susan were a non-taxpayer, allowing for her total income including the gross dividend income, she would be able to reclaim the DWT deducted and end up with €1,000 total dividend income.

Where an investor opts to receive dividends in the form of shares from an Irish resident company (scrip dividend), instead of cash, DWT is applied to the gross cash amount and the net amount is then used to buy shares for the investor at the predetermined price.

However, the investor is still liable to income tax at their marginal rate on the gross dividend, with allowance for the DWT deducted at source, as if he or she had received the cash dividend payment.

In the case of an individual exercising their option to receive a SCRIP dividend in lieu of cash from the company, they are deemed to have received income, equal to the value of the sum they would have received had they received that distribution in cash.

Example #2

Company X pays a dividend of €1,000 which Susan has chosen to take as shares. It must first deduct €250 DWT and then buys shares worth €750 on Susan's behalf. Susan then receives the new shares to add to her holding.

Susan is taxed on €1,000 of gross income, that is, €750 + €250, which, if Susan is a top rate taxpayer, would lead to an income tax liability of €400 (before USC/PRSI; see below).

However, Susan is allowed to offset the €250 DWT deducted against her income tax liability, so that her additional income tax liability on the €750 net Scripp dividend received would be €150, assuming that she is a top rate taxpayer.

A similar system operates in respect of dividends received on many foreign shares. Currently, however, there is no with-holding tax on UK dividends.

By being treated as *income* for income tax purposes, dividends are:

- Subject to the Universal Social Charge (USC) (see Chapter 11 for more details);
- Subject to PRSI for Class S PRSI payers (self-employed people); for employees and those with occupational pensions taxed under Schedule E, PRSI is payable where their total taxable investment income exceeds €5,000 in a year. Note that no PRSI is payable over age 66. The rate of PRSI is currently 4%.

Example #3

Joe is self-employed and received a net dividend of €750 from an Irish company. Joe is a higher rate taxpayer. He received no other investment income during the year.

Because he is self-employed, he is liable to PRSI irrespective of the amount of total investment income for the year.

Taxation of Joe's dividend

Gross Dividend = €1,000

Income tax (40%) = €400

Less credit for DWT paid = €250 so net Income tax payable = €150

PRSI (4%) = €40

USC (8%) = €80

Balance of Tax payable = €270

5.11.2 Capital Gains or Capital Losses

Any gain, after deduction of allowable expenses, made on the sale of a share is a *chargeable gain* liable to capital gains tax at a rate of 33%. However, the first €1,270 of chargeable gains in a tax year for an individual is tax free. This €1,270 allowance is *not* transferable between spouses/civil partners. See Chapter 11 for more details.

5.12 Assessing Share Values

Obviously, investors in shares hope or expect to get a good investment return, better than deposits. If not, why bother investing in equities?

The return can come from one or both of the following:

- *Dividend income*, if the company pays regular dividends to its ordinary shareholders. In simple terms a dividend payment is the sharing of company profits with shareholders.

  The dividend payment to ordinary shareholders will usually be made in two instalments, an *interim dividend* paid during the company's financial year and a *final dividend* after the end of the company's financial year, when it becomes clear what its final profits for the year were. The interim dividend is usually about 40% of the total dividend, that is, the final dividend is usually about 150% of the level of interim dividend.
  The final dividend payment will be recommended by the directors to an AGM and must be passed by a vote.

  The dividend payments will be influenced by the progress of the relevant company's profits. If the company has a good year, it may increase the dividend pay-out. If it has a bad year, it may cut the dividend payment or maintain it at previous year's level.

A company will not pay out all its profits, as it will have to retain some profits within the company to fund the expansion of the business. Some companies, for example, exploration and technology type companies, may not pay out a dividend for many years, until sustainable profits start to flow. Indeed, companies are not obliged to pay out a dividend at all to ordinary shareholders, and there are many examples where companies have never paid out a dividend to ordinary shareholders.

Well run profitable companies have traditionally been able to increase dividends to ordinary shareholders at a rate in excess of inflation. Investors and advisors should never underestimate the importance of dividends to long term returns from Shares. Quality companies that grow their dividends over time, can provide very strong compounding returns to investors.

- *Capital growth,* if the shares are subsequently sold at a higher price than was paid originally. When companies grow their earnings and profits over time, investors wanting to benefit from that future growth in earnings may drive up the price of the shares through demand. Of course, a loss can arise if the shares fall in value and are sold at a value less than they were acquired at. This can happen for a variety of reasons but predominantly share price falls occur over the longer term if a company's profits fall, or are forecast to fall in the future.

Historically over the long term, research shows that dividend income from the S&P 500 index of US shares accounted for 41% of the total return (if the dividend income is reinvested in the shares), leaving 59% to come from capital growth. (based on S&P 500 returns from 1930 to 2020 source Morningstar)

Therefore, as an investment, ordinary shares in listed companies have three distinctive attributes:

- *They can provide an increasing level of income, growing faster than inflation in some cases.*

- *They are risky investments as in general there is no guaranteed value payable for the shares at any time.*

  The value of the share in a quoted company at any particular time, is what someone else is willing to pay for it at that time in the marketplace. There is therefore a risk of capital loss, as the company could crash and the shareholders could lose all their money, or even if the company didn't crash its share price could fall sharply if it ran into trouble.

- *They are open ended investments*, as in general they do not have a fixed maturity date.

5.12.1 Key Numerical Measures in Assessing Share Value

In assessing the potential value of a particular ordinary share, investors usually look to a number of key numerical measures or *metrics* of the share value:

- Gross dividend yield;

- Dividend cover;

- Earnings per share; (EPS)

- The P/E ratio (PER);

- Net asset value (NAV);

- Market capitalisation;

- Earnings before interest, tax, depreciation and amortisation (EBITDA).

5.12.2 Gross Dividend Yield

This is the gross annual dividend, divided by the current share price.

Example #1

ACE Enterprises Ltd, a quoted company, last declared a gross (that is, before any tax deduction) dividend per ordinary share is 60.4c. Its closing share price today is, say, €8.50.

Its historic gross dividend yield, that is, based on the last actual dividend paid, is therefore:

$$60.4 / 850 = 7.10\%$$

Note that this is the *historic* gross dividend yield based on the dividend paid for the last financial year.

The *prospective* or *forecast* gross dividend yield, on the other hand, is based on the anticipated or forecast dividend in respect of the company's current financial year.

Example #2

Let's say analysts expect ACE Enterprises Ltd final dividend per share in respect of its current financial year to be, say, 68c. Its closing share price today is, say, €8.50.

Its prospective or forecast gross dividend yield is therefore:

$$68 / 850 = 8\%$$

Of course, this *forecast* could be wrong; it is only an estimate prepared by a stockbroker or other analyst. Therefore, forecast yields, etc., are not guaranteed and should not be treated as guaranteed or 'almost' guaranteed. A company's prospects can and do change dramatically over a short period, take Irish bank shares, as an example!

Generally speaking, dividend yield and share value growth prospects tend to be inversely related i.e. a low dividend yield suggests a company with good growth prospects. However, the gross dividend yield on its own is not a reliable measure of a particular share's value as:

- *Companies do not pay out all of their profits in dividends; indeed, many companies pay no dividend;*
- *It may be based on historic data, that is, dividend paid in respect of the last financial year;*
- *It doesn't indicate the financial ability of the company to continue to pay out this level of dividend in the future.*

5.12.3 Dividend Cover

Dividend cover is a measure of the financial ability of a company to continue to pay out the current level of its dividend to ordinary shareholders.

The term *dividend cover* is:

$$\textit{Company's after-tax profits} \,/\, \textit{The total cost of the dividend}$$

Example

A company's dividend cost €1m in respect of a financial year, and the company's after-tax profits for that year were €3m.

Its dividend cover is:

$$\textbf{€3m} \,/\, \textbf{€1m} = 3 \text{ times}$$

Obviously the higher the level of dividend cover, the better, as the company is better able to maintain and increase the dividend compared with a company which has a lower dividend cover which may be forced to reduce or drop its dividend if its profits fall.

Growth stocks would be expected to have a higher level of dividend cover than value stocks, as growth stocks would usually be paying out a much lower proportion of their profits in dividends than value type stocks.

5.12.4 Earnings Per Share (EPS)

The EPS, or *earnings per share*, of an ordinary share is:

$$\textit{Company's after corporation tax profits attributable to shareholders} \,/\, \textit{Number of issued shares}$$

Example

ACE Enterprises Ltd, a quoted company, had in its last financial year pre-tax profits of €6m and after tax profits attributable to ordinary shareholders of €5m. It had 1,903,311 issued ordinary shares.

In calculating the EPS we use net profits. Therefore, Its earnings per share was:

$$€5\text{m} \,/\, 1{,}903{,}311 = €2.627$$

5.12.5 Price / Earnings (P/E) ratio (PER)

The term *P/E ratio*, also sometimes referred to as *PER*, stands for *price earnings ratio*, is a ratio for valuing a company and measures its current share price relative to the companies per-share earnings, and is calculated as:

$$\textit{Current share price} \,/\, \textit{Earnings per share (EPS)}$$

The *P/E ratio* is a different form of numeric assessment of a share's value, which, when combined with the gross dividend yield, offers investors some insight into the market's current view or rating of a share's value and its potential.

Example #1

ACE Enterprises Ltd.'s earnings per share (EPS) for its most recent financial year was €2.627.

Its current share price is €18.16.

Its historic P/E ratio based on its most recent earnings per share, is therefore:

$$\text{Current share price} \Big/ \text{Earnings per share (EPS).}$$

$$€18.16 \Big/ €2.627 = 6.9$$

P/E ratios for individual companies vary greatly and are business sector specific. Therefore, the P/E ratio for any individual company should be compared with its peers trading within the same business sector in order to provide a sense of context, rather than the general market.

Like the dividend yield, the P/E ratio can also be calculated on a *forecast* or *projected* basis, taking account of forecast EPS.

Example #2

An analyst's forecast for ACE Enterprises Ltd.'s EPS for its current financial year is €2.70, say.

Its current share price is €18.16.

Its forecast P/E ratio based on its earnings per share, is therefore:

$$\text{Current share price} \Big/ \text{Earnings per share (EPS).}$$

$$€18.16 \Big/ €2.70 = 6.7$$

If you look on buying a share as buying the right to a flow of future earnings, some but not all of which will be paid out as dividends, then the P/E ratio can be looked on as the number of years it will take to recover your investment made in buying the share.

The P/E ratio is a valuable tool for assessing a given company's prospects:

- A high P/E ratio, relative to the market, may indicate that the markets expect that company's future earnings to grow at a faster rate than the overall market;
- A low P/E ratio, relative to the market, may indicate that the markets expect that company's future earnings to grow at a slower rate than the overall market.

5.12.6 Net Asset Value (NAV)

The *net asset value* of a share is:

$$\textit{Value of company's net assets} \Big/ \textit{Number of shares}$$

It represents the share of the company's assets, less loans and amounts owed, notionally owned by each share.

Example

ACE Enterprises Ltd has total assets currently valued at €10m, debts of €3m and has 25m ordinary shares.

Its net asset value per share would be:

$$(€10m - €3m) / 25,000,000 = 28c \text{ per share.}$$

The NAV represents the estimated value an ordinary share would be entitled to if the company were wound up, all its assets sold and debts repaid and the surplus then distributed among the shareholders, that is, its break-up value.

You might expect that a share price should not ever fall below its NAV, as at that value the company is effectively being valued at its break-up value, and takes no account of its ability and track record to earn profits from these assets.

However:

- A share's accurate NAV is not immediately available to a shareholder, that is, the company would have to be wound up and its surplus distributed to shareholders, in order for shareholders to realise the NAV.
- The market may not be comfortable with the valuation put on the company's assets; the market may feel that certain assets are overvalued on the company's books, for example, goodwill, property assets, etc.
- A share's share price on a particular day reflects the balance of buyers and sellers for that share on that day.

5.12.7 Market Capitalisation

The *market capitalisation* of a particular quoted company is the amount of money it would take at the ordinary share's current share price, to buy up *all* the ordinary shares in the company on that day, and represents the current total value or size of the company as determined by the stock market.

Example #1

ACE Enterprises Ltd.'s share price is €18.16, while the number of its shares issued is currently 536.7m.

Therefore, its market capitalisation currently is:

€18.16 x 536.7m = €9,746m.

That is, if an investor wanted to buy up all of ACE Enterprise's shares on that day he would have needed almost €10bn.

Example #2

Lunar Life Ltd.'s share price is €8.55, while the number of shares issued is currently 276m.

Therefore, its market capitalisation is currently:

€8.55 x 276m = €2,360m.

Therefore, in relative sizes, Lunar Life Ltd could be said to be about 24% of the size of ACE Enterprises Ltd, as measured by their *market capitalisation* on that day.

Some companies may have a large block of shares which are not freely available to buy or sell on the stock market, for example, shares held by the founder of the company (and/or their family), or shares held by employees under various employee share incentive schemes.

In such cases the market capitalisation may be calculated on a *free float* basis, that is, only taking account of the number of shares that are potentially available for purchase today.

Example #3

Lunar Life Ltd.'s share price is €8.55, while the number of shares issued is currently 276m. However, 76m of these shares are held by a large financial services group as a long-term investment.

Therefore, its free float market capitalisation is currently:

€8.55 x 200 = €1,710m.

Companies listed on a stock exchange are sometimes classified by their market capitalisation, often shorted to *cap*. For example, *small cap* and *large cap* companies.

5.12.8 EBITDA

The term *EBITDA* refers to a company's ***E**arnings **B**efore*:

- ***I**nterest* (payable by the company on loan stock, bank borrowings, preference shareholders, etc.);
- ***T**axes* (payable by the company);
- ***D**epreciation* (of fixed assets, etc.); and
- ***A**mortisation* (that is, writing off goodwill in accounts, etc.).

It is sometimes referred to as earnings before nasty bits!

EBITDA can be used to analyse and compare profitability between companies and industries because it eliminates the effects of a company's particular financing and accounting decisions.

Example

A company has, for a financial year, declared net profits of €1,000,000.

However, in arriving at the net profit figure the following were charged in the accounts to arrive at net profit:

Interest:	€100,000
Taxes:	€240,000
Depreciation:	€300,000
Amortisation:	€160,000
	€800,000

Therefore, this company's EBITDA for the financial year in question is:

€1,000,000 + €800,000 = €1,800,000.

5.12.9 Share Prices

Prices, dividend yields, P/E ratios etc., are published regularly in the media and on relevant stock exchange websites.

A share quoted on the stock exchange will usually have two prices at any time:

The *bid price*: That is, the price at which investors are *bidding* to buy the shares.

The *ask/offer price*: That is, the price at which holders of the shares are *asking or offering* to sell their shares.

The bid and ask prices are related to the bid and ask *sizes*, that is, the volume of shares which are available for sale (bid) or which investors are willing to buy (ask) at that price.

A quoted share will have a *closing price,* which is the last bid and ask prices at the close of business on that day.

Of course, the bid and ask prices of a quoted share can move up and down throughout the day, depending on the relative balance of buyers and sellers from time to time.

The difference between the highest and lowest bid and ask prices on a particular day is referred as the *intraday spread*. In volatile trading conditions, the intraday spread for a particular share can be very wide. For example, intraday spreads of 25% were experienced in Irish banks shares on some days during the great financial crash in 2008.

The bid and ask prices of a share should not be confused with the bid and offer prices of a unit linked fund or unit trust. In the case of unit funds and unit trusts, a bid/offer spread amounts simply to an initial charge made on investing in that fund, and does not reflect and is not caused by the difference in bid and ask prices of the fund's underlying investments.

5.13 Buying and Selling Quoted Shares – Changing Ownership

Quoted shares are usually bought and sold through an investment firm, such as a stockbroker. To buy or sell a share, the investor places an *order* with the stockbroker.

5.13.1 Buying

Where a client wants to **BUY** shares, the order will typically specify:

- The name of the company in which the investor wants to buy shares.
- The type of shares the client wants to buy; this will usually be ordinary shares.
- The number of shares the investor wants to buy
- The price limit at which the investor is willing to buy the shares. The investor may specify a *maximum* price he or she is willing to pay for the shares, but would obviously hope to get the shares at a lower price.

  For example, a client might specify a limit of €12.40 or better, where each share is currently trading around, say, €12.60. The term *better* in the case of a buyer refers to *lower* than €12.40.

  Alternatively, the client might not specify a limit price but instruct the firm to buy the shares *at best;* but in this case the stockbroker is obliged to buy the shares at the lowest ask price available in the market at that time.

- The period for which the order is to be valid, that is, if the order is not completed today, because no one is willing to sell the required shares at the specified price, is the order to stay in force until cancelled or should it lapse at the close of business today or continue for a few days.

5.13.2 Selling

Where a client wants to **SELL** shares, the order will typically specify:

- The name of the company in which the investor holds shares.
- The type of shares held, usually ordinary shares.
- The number of shares the investor wants to sell.
- The limit price at which the investor is willing to sell the shares. The investor will usually specify a *minimum* price at which he or she is willing to sell the shares, but would obviously hope to sell the shares at a higher or better price. For example, client might specify €12.80 or better, where each share is currently trading around, say, €12.60.

  Alternatively, the client might not specify a particular price but instruct the firm to sell the shares *at best* price available in the market at that time, that is, highest price at which a buyer can be found for the shares at that time.

- The period for which the order is to be valid.

5.13.3 Settlement

Where an individual is selling shares held directly in his or her own name, he or she will have to sign a *CREST transfer form*, to transfer legal ownership to the new owner and deliver the share certificate to the stockbroker by *settlement day*.

In some cases, the CREST transfer form is found as an intrinsic part, on the reverse of the share certificate.

On the Irish stock market settlement is normally on a T + 3 basis, that is, all deals made by investors on a particular day are settled up three working days later.

The term *settlement* refers to the concluding of the transaction, that is:

- Delivering the shares being sold where the individual is selling the shares; and
- Paying the total consideration due, where shares are being purchased.

The system is referred to as *delivery v payment*. As seller, you get paid by the buyer only when you deliver the stock you are selling.

5.13.4 Costs

There are costs involved in buying and selling shares:

- Stamp duty of 1% applies on the transfer of shares listed on the Irish Stock Exchange, payable by the purchaser. Stamp duty of 0.5% applies to the purchases of shares listed on the London Stock Exchange. No stamp duty applies on the purchase of treasury bonds, loan stock listed on the Irish Stock Exchange, or on shares quoted on a US stock market.
- Commissions. This may vary from either a fixed monetary amount to, more typically, a percentage of the value of shares being bought or sold subject possibly to a minimum monetary amount. A maximum rate would be about 1.65%, but stockbrokers may charge lower rates for larger investment amounts, or by orders placed by phone or through online systems.

5.13.5 Contract Note

When a client buys or sells a share, they will receive a *contract note*, which will detail the transaction.

The contract note summarises the details of the transaction:

- Whether the transaction was a BUY or SELL transaction;
- The time and date the shares were purchased/sold for the client;
- The name of the company, and the type of shares bought/ sold;
- The quantity of shares involved in the transaction;
- The price at which the transaction was executed;
- The total value of the transaction, that is, no of shares x price at which transaction was completed;
- Where shares have been purchased, stamp duty of 1% (for Irish registered shares) of the consideration for the purchase of shares;
- Commission for the transaction;
- The total consideration due, that is, total value of the transaction plus stamp duty (if a purchase) plus commission due;
- The date the consideration is due, that is, three days after purchase, which is the standard time for settling up purchases or sales of quoted securities on the Irish Stock Exchange where share transfer is to take place electronically.

5.13.6 Registering Share Ownership

When an individual buys shares, ownership of the shares can be registered in one of three main ways:

- **Share certificates**: in this case the purchaser is registered as the owner of these shares on the relevant company's share register. The individual will receive a physical *share certificate*, evidencing ownership of the shares concerned. This is the traditional way of owning shares.

- **Nominee accounts**: The shares can be registered in the name of the investment firm's *nominee company*, where the shares are held on behalf of the investor, but the legal owner of the shares on the company share register is the nominee company. The investor is still the beneficial owner of the shares, but the legal owner is the stockbroker's nominee company, who acts as a nominee or trustee for the investor.

  This is a convenient way for share ownership to be held electronically.

- **CREST personal accounts**: A CREST personal account is a means of holding share ownership in an electronic format in the CREST settlement system. However, unlike nominee accounts, the investor is still shown on the company's share register as the registered owner of the shares.

  Therefore, under the crest personal account system, the investor is still the legal owner of the shares unlike the nominee account system, where the nominee company is registered as the legal owner of the shares.

  The crest personal account is somewhat of a cross between the share certificate and nominee account methods of share ownership.

5.14 Stock Market Indices

A stock market index is a way of measuring the change in value of shares listed on that exchange. It is calculated from the market capitalisations of companies whose shares are quoted on that exchange.

Market capitalisation for the purposes of calculating the Indices are calculated on a *free float* basis, that is, based only on the shares that are readily available in the market place for sale/purchase and hence excluding *locked up* shares held by long-term investors such as staff, proprietors, governments, etc. The calculation multiplies outstanding shares by the current price of a single share. The components with the higher market cap carry a higher weighting percentage in the index. For example, Apple Inc has a 7% weighting within the S&P 500 Index.

A movement in the market value of a given share included in an Index will cause the Index to change by the proportional amount of that company's free float market capitalisation value as a percentage of the total free float market capitalisation value, that is, a weighted average.

Most stock market indices have two versions, a *price* index, based only on the share price, and a *total return* index, which also allows for the benefit of dividend payments which are assumed to be reinvested in the stock market.

5.14.1 ISEQ Indices

The Irish Stock Exchange produces an official share index, *ISEQ*, which is calculated once per minute during the trading day (08:00 - 17:15). This index measures the movements in the relative market capitalisations of the various companies listed on the exchange.

The ISEQ share index series is comprised of:

- The *All Share Index*, that is, all shares listed on the Irish Stock Exchange;
- The *Financial*, that is, financial shares;
- The *General*, that is, non-financial shares;
- The *Small Cap Index*, that is, stocks with a capitalisation of less than €120m.
- The *20 Index*, that is, an index of the 20 most liquid and largest market capitalisation equities quoted on the Irish Stock Exchange official list.
- The *ISEQ ESM Index*, that is, tracks the performance of the constituents of the Enterprise Securities Market - the ISE market for shares in smaller growth companies.

5.14.2 Other Stock Market Indices

There are similar indices for other stock markets, for example:

- *FTSE 100* (pronounced *Footsie*): **F**inancial **T**imes **S**tock **E**xchange is an index of the top ***100*** stocks by Market Capitalisation quoted on the London Stock Exchange.
- *Standard & Poor's 500 (S&P 500)*: an index of ***500*** stocks quoted on the New York Stock Exchange.
- *The Dow Jones Industrial Average (DJIA)*: an index of the 30 largest industrial type companies quoted on the New York Stock Exchange. (Dow Jones is not weighted by Market Capitalisation)
- *Nasdaq*: the NASDAQ is an electronic exchange in New York where stocks are traded through an automated network. It stands for National Association of Securities Dealers Automated Quotations System. As a general rule of thumb, it is where most technology stocks are traded. The Nasdaq index measures the movement in this market.
- *Dow Jones Euro Stoxx* 50: the Dow Jones Euro STOXX 50 is an index composed of the top 50 stocks in the eurozone.
- *Dax:* an index of shares quoted on the German Stock Exchange.
- *Nikkei 225:* an index of the largest 225 stocks quoted on the Tokyo Stock Exchange.
- *Hang Seng:* an index of shares quoted on the Hong Kong Stock market.

Some of these indices are used in tracker bonds or for indexed investment management.

5.15 MiFID Investment Firm Services

Investment firms authorised under MiFID, may provide two main services:

- The execution of orders to buy or sell securities listed on a stock exchange; and
- The provision of investment services for clients.

This can be in one of two forms:

- **Discretionary management,** where full responsibility for choosing stocks and shares, and whether to buy or sell, has been given by the client to the investment firm without having to revert to the client each time for confirmation to buy or sell a particular share;

- **Advisory**, where the investment firm advises the client about which stocks and shares to buy or sell, but the client makes the decision each time on what securities to buy or sell.

Where an investment firm does not provide any investment service for a client, other than executing a client order to buy or sell a specific security, the firm is said to provide an *execution only* service for that client.

5.16 Derivatives

The term *derivative* refers to a security which derives its value from another security, group of securities or a benchmark for example, from a quoted share and is set between two parties

There are two main types of derivatives related to quoted shares.

5.16.1 Contracts for Difference (CFD)

CFDs are a form of geared investment where the investor does not actually take ownership of an underlying share or shares but rather benefits or loses from *movements* in the price of the share(s).

It is an agreement between two parties to exchange at the close of the contract, the *difference* between the opening price and the closing price of the underlying share, hence the term contract for difference. There is no delivery of physical goods or securities with CFD's.

The investor puts up a deposit, but is committed to the full value of the difference between the deposit and the actual price of the contract. So, it is a highly geared investment.

In reality, CFDs amount to betting (substantially with borrowed funds) on whether a particular share price is going to rise or fall in value, with the possibility of losing more than the bet. Because of the level of gearing involved, CFDs are very high risk/return investments suitable only to high-net-worth investors who can afford to take substantial risks with part of their capital.

An investor in a CFD can adopt either a *short* or *long* position. A *short* position is where the investor is betting on the share price falling from its current level, but a long position is where the investor is betting on the share price rising from its current level.

5.16.2 Covered Warrants

Warrants give the buyer the right, but not the obligation, to buy or sell a particular share at a pre-determined price (the 'strike' or 'exercise' price) on or before a future date. The price paid for this right is called the 'premium' and with covered warrants you cannot lose more than this initial premium paid.

A *call warrant* gives the investor the right, but not the obligation to *buy* the shares at a fixed price at a specified date in the future. An investor would invest in a call warrant if he or she expected the share price to rise from its current value. All things being equal, call warrants increase in price as the value of the share *increases* – the potential upside is unlimited.

A *put warrant* gives the investor the right, but not the obligation to *sell* the shares at a fixed price at a specified date in the future. An investor would invest in a put warrant if he or she expected the share price to fall from its current value. Put warrants will typically increase in price as the value of the underlying share *falls* – the maximum profit is achieved when the share price falls to zero.

A warrant holder has three options with respect to any warrant which he/she holds, that is:

- To sell the warrant before expiration;
- To exercise the warrant at the strike price (if it is profitable to do so, known as being 'in the money'); or
- To allow the warrant to lapse. In this case the investor loses the amount paid for the warrant, but no more than that.

The downside risk for an investor who invests in put and call covered warrants issued on the exchange is limited to the amount paid for the warrant, including commission and charges. This is in contrast to CFDs, where an investor's downside is potentially unlimited.

5.17 Employment and Investment Incentive Scheme (EII)

The Employment and Investment Incentive (EII) scheme provides full income tax relief, at the investor's marginal rate, to investors in new ordinary shares in an unquoted qualifying company, which are typically small to medium sized trading companies, and where the investor is not connected with that company.

The minimum investment period is four years from the date the fund invests in the respective companies and Revenue will clawback income tax relief granted, where the investment is encashed before the four years have ended.

The maximum amount of EII investments which can qualify for income tax relief in any one year is currently €250,000 per investor. The annual limit increases to €500,000 for those investors prepared to invest in EII for seven years or more. A married couple may each invest individually.

Most investors in the EII do so by investing in an EII fund which invests in a mix of different small companies. To qualify for EII tax relief, an EII fund (called a designated investment fund) must be approved by the Revenue Commissioners for this purpose and must meet certain requirements.

The key advantages of EII schemes are the potential for upside growth, coupled with a strong tax incentive.

The key downsides are that the returns are uncertain, and totally depend on the performance of the underlying companies. In addition, exiting at the end of the term may be problematic, as it is an unquoted investment, and a willing buyer has to be found.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] Three mains types of companies, LTD, DAC and PLCs
- [ ] The difference between ordinary and preferences shares, and their rights
- [ ] Memorandum of association and articles of association
- [ ] The main ratios used to assess and compare quoted share values, including in particular dividend yield, earnings per share, PER, and net asset value
- [ ] Factors which can have an influence on quoted share prices, from time to time
- [ ] Buying and selling shares
- [ ] Stock market indices
- [ ] Derivatives; CFDs and covered warrants
- [ ] Taxation of returns from shares
- [ ] Basic accounting principles which apply to the accounts of a typical trading company
- [ ] The main benefits, limitations and risks of investing in shares
- [ ] The main features of EII schemes

Sample Questions

The answers to these questions can be found in your Study Hub.

1. A designated activity company must have:

   (i) a one-page constitution.
   (ii) a Memorandum of Association.
   (iii) Articles of Association.

   A. (i) only.
   B. (i) and (iii) only.
   C. (ii) and (iii) only.
   D. (i), (ii) and (iii).

2. A company's authorised share capital is the:

   A. total nominal value of shares the company can issue to shareholders.
   B. total nominal value of shares the company has actually issued to shareholders.
   C. market capitalisation value of the company.
   D. current net asset value of the company, based on its latest share price.

3. A company has issued four different types of preference shares, classes A, B, C and D. The shares are said to rank *Pari Passu* for repayment on winding up of the company. This means they rank:

   A. equally.
   B. in order of issue, with the older shares ranking ahead of the newer shares.
   C. equally, up to a certain monetary limit, and thereafter they rank in order of date of issue.
   D. equally only for any dividend payment outstanding, otherwise in order of issue.

4. In respect of the ISEQ Overall Index, each quoted stock accounts for a percentage of the total Index, related to its:

   A. market capitalisation.
   B. profitability.
   C. size.
   D. share price.

06

Bonds

In this chapter, the different types of bonds are explained and how they can provide returns (income/capital returns). Some of the terminology used in relation to bonds, such as *running yield*, *gross redemption yield*, and *net redemption yield* are individually explained. The principal factors that affect the returns offered by bonds are examined and the chapter closes with a summary of the main benefits and risks of investing in bonds.

Learning Outcomes – after studying this chapter you should be able to:
understand what a bond is, the different types of bonds, and how a bond provides a return to investors;
explain the following terms relating to a bond and understand how to calculate each one: *running* or *flat yield, gross redemption yield, and net redemption yield;*
understand how returns from bonds are taxed, (including USC and PRSI) in the hands of an investor;
understand the factors which affect returns offered by bonds; and,
understand the benefits, limitations and risks of investing in bonds.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	6	4	6

6.1 What is a Bond?

Bonds are a form of borrowing by the issuer of the bond. The investor buys an IOU provided by the bond issuer. Typical issuers of bonds are governments, public sector bodies and large companies.

Bonds issued by governments are often referred to as *sovereign* bonds while those issued by companies are referred to as *corporate* bonds. Bonds issued by the Irish Government are referred to as treasury bonds.

The bond issuer may undertake to pay a rate of interest (referred to as the *coupon*) on the nominal or face value of the bond and undertakes to repay the nominal or par value of the bond at some specified date in the future, that is, the maturity date.

At any time before the bond matures, the price of the bond is dictated by the markets and could be above or below its nominal value; when the price of a bond stands above its nominal value, for example, price is €110 per €100 nominal value of the bond, the bond is said to stand *above par*, while it is said to stand *below par* if its current price is below its nominal value, for example, €75 per €100 nominal value of the bond.

Bonds vary in terms from months up to 100 years or more, although typically most bonds will have a maturity date of less than 15 years. The term of the bond is commonly referred to as the 'Duration' of the bond.

6.2 Types of Bonds (Treasury Bonds, Corporate Bonds)

6.2.1 Treasury Bonds

A *treasury bond* is a bond issued and guaranteed by the Irish Government which promises to pay:

- A guaranteed annual income (paid yearly in arrears) known as the 'coupon' expressed as a percentage of the nominal value of the bond; and
- A guaranteed capital payment of the nominal value of the bond at a specified maturity date.

Treasury bonds in Ireland are issued by the *National Treasury Management Agency*[8] *(NTMA),* a government agency responsible for all borrowing by the government and for the management of Ireland's national debt.

A selection of the main treasury bonds available for investment is set out below.

Treasury bond title	Coupon date	Maturity date
0% 2031	None	18 Oct 2031
5.4% 2025	13 Mar	13 Mar 2025
1.0% 2026	15 May	15 May 2026
0.2% 2027	15 May	15 May 2027
0.9% 2028	15 May	15 May 2028
2.4% 2030	15 May	15 May 2030
1.35% 2031	18 March	18 March 2031
1.7% 2037	15 May	15 May 2037
2.0% 2045	18 Feb	18 Feb 2045

[8] *NTMA, Government Bonds; Outstanding Bond Report 12th January 2024*

In all these examples an annual interest payment is made, as set out in the title of the bond. In the case where investors wish to receive income from a coupon payable by the treasury bond, the 5.4% 2025 might be an attractive option, however, where investors do not wish to receive an income but do wish to avail of tax free capital growth, the 0.2% 2027 Irish treasury bond might be an attractive option.

In 2023, the benchmark bond issuance average yield was 3.21% with an average maturity of 15.14 years[9] raising €3.5Bn for the state. In 2024, the benchmark bond funding is €3Bn.

The government also issues some *floating rate bonds* whereby the interest payable is not a fixed amount but may be variable, related to some measure of fluctuating market interest rates. As market rates rise, so does the interest payable on the bond, and vice versa.

6.2.2 Corporate Bonds

Corporate bonds may vary in several respects from treasury bonds outlined above:

- Some may not pay interest at all and only promise to pay a capital sum at some stage in the future. Such bonds are called *zero coupon* bonds.

- Some may not have a fixed maturity date at which the capital payment is guaranteed to be paid, either because:

  - The bond is a *perpetual bond*, where the interest is payable in perpetuity and there is no capital repayment; or

  - The bond is a *callable bond*, that is, the issuer has the option to (but is not compelled to) mature the bond and pay the capital repayment on a particular date or dates.

- Some may be secured over some asset or assets of the company, so that in the event of default these bond holders have access to such assets which can be sold and used to repay the bond holders to the extent that the sale proceeds allow. Such bonds are referred to as *debentures* or *secured bonds* or *covered* bonds.

- Some may carry the right of the bond holder to convert the bond into shares in the company on guaranteed terms, at some predetermined date or dates in the future. Such bonds are referred to as *convertible* bonds.

- Some bonds may rank behind others for repayment, in the event of the company winding up. Such bonds are referred to as *subordinated* as their priority for repayment ranks behind that of other *senior* or *unsubordinated* bonds issued by the company.

  For this reason, subordinated bonds issued by a company will tend to offer a higher yield than other similar senior or unsubordinated bonds issued by the same company, because of the higher risk of default on subordinated bonds.

- Corporate bonds tend to have a minimum purchase amount, usually €50,000 nominal.

- Corporate bonds tend to be less liquid, particularly at times of crises, than government bonds. For example, where a company gets into severe financial difficulties it may be very difficult, if not impossible, to find a buyer willing to buy the bond from an existing bond holder at that time. On the other hand, government bonds are highly liquid.

Because of the risks attached to investing in individual corporate bonds, most investors in such bonds do so through PRIIPs which in turns invest in a broad spread of bonds issued by many different companies.

[9] *Irish Treasury bonds issuance results January 2024*

6.3 Features

6.3.1 Return

Income Return

Bonds may provide an income return in several different ways:

- By providing a *fixed level of income*, for example, take the *5.4% Treasury Bond 2025* issued 13th March 2010 by the *National Treasury Management Agency* on behalf of the Irish Government. It guarantees to pay an annual fixed income (gross) on 13th March each year of €5.40 per €100 nominal of stock held, together with a repayment of €100 per €100 nominal of stock held on redemption of the stock on 13th March 2025 (The price[10] for this bond on 23/02/2024 was €102.005)

  In the case of corporate bonds, there may be provision to change the income payable in certain circumstances, for example:

  - If the credit worthiness of the bond is officially downgraded by a credit rating agency, the rate of income payable may increase;

  - If the capital is not repaid by a certain date, the ongoing rate of income payable may increase.

- By providing a *variable or floating level of income*, where the income payable from time to time may be related to some measure or reference of wholesale money market rates, for example, *Euribor* (Euro InterBank Offered Rate) or *LIBOR* (London InterBank Offered Rate), so that as wholesale money market rates increase, so does the income payable by the bond, while if wholesale rates fall, so does the income payable by the bond. Bonds which pay a variable rate of income linked to wholesale interest rates are sometimes referred to as *floating rate notes (FRNs)*.

- By providing *a return linked to inflation*, for example, *inflation linked bonds* issued by a government which guarantee to increase the income payable and the nominal capital value to be repaid in line inflation over the term of the bond, that is, provide a fixed 'real' rate of return.

Capital Return

Bonds may provide a capital return in several different ways, including:

- *A fixed date on which the bond will mature and pay a fixed capital sum*. For example, the 0% Treasury Bond 2031 issued by the *National Treasury Management Agency* on behalf of the Irish Government. This bond is guaranteed to pay €100 per €100 nominal of stock held on redemption of the stock on 18th Oct 2031. On the 23/02/2024, the price of this bond was trading at €81.867 which means the bond is trading 'below par'. Investors buying this bond at prices below par are guaranteeing a small capital gain on the Bond at maturity. (see below running yield to understand why this might happen)

- *A range of dates within which the bond will mature and pay a fixed capital sum*. For example, June 2024/2028. The issuer of the bond can decide to mature it at any date within this period.

- *A date or a range of dates on which the issuer of the bond may opt to pay a fixed capital sum* but *is not obliged to do so*. At the specified date, the issuer of the bond can opt to repay the bond but is not obliged to. Such a bond is said to be *callable* on that date.

[10] *Euronext: https://live.euronext.com/en/markets/dublin/govbonds/list*

If the call date passes without the issuer opting to repay the bond, the bond then is a perpetual bond with no contractual capital repayment date thereafter. In such cases, the terms of the bond may dictate that the income payable after the call date must increase in line with some formula.

- *No fixed maturity date*. Such bonds are referred to as *perpetual bonds*, as the income may be paid in perpetuity.

  Some perpetual bonds may have a *call date*, that is, a date on which the issuer may decide to mature and repay the bond but is not obliged to.

Issuers of callable bonds, that is, bonds where the issuer can on a certain date or dates opt to repay the bond but is not obliged to, are only likely to exercise their call option and repay the bond if they can at that time replace those borrowings with similar borrowings at a lower rate.

If borrowing rates are higher at the call date than the rate at which the bond was issued, the bond issuer is unlikely to opt to repay the bond at the call date as it would cost them more to replace those borrowings.

Some bonds may have *put* dates at which the investor can compel the bond issuer to repay the bond at that date. An investor might exercise such option if interest rates had risen since they invested in the bond, so that they can earn a higher return by reinvesting now, or if they need access to their capital urgently for some purpose.

Covered/Asset Backed Bonds

The income and capital repayments on some capital bonds are backed by the returns earned by a block of assets owned by the company, for example, a bank might issue a bond *covered* by the income and capital returns of a block of mortgage loans it has issued.

6.3.2 Seniority

Where a company issues a number of different bonds, they may vary by their *seniority* for repayment, in the event that the company becomes insolvent and unable to repay all bond holders.

Therefore, *senior* bonds will rank for repayment ahead of *junior* bonds, while the term *subordinated* is used to describe bonds whose right of repayment is subordinated to the rights of other more senior bonds which rank above it for repayment, in the event of the insolvency of the company issuing the bonds.

Therefore, subordinated bonds are riskier than *unsubordinated* bonds, because in the event of the insolvency of the issuer, the chances of subordinated being repaid are lower than for more senior bonds ahead of it in the queue for repayment.

6.4 Returns on Bonds: Calculating Bond Yields

In dealing with bonds, returns are calculated in terms o*f yields,* which include the following:

- Running or flat yield;
- Gross redemption yield;
- Net redemption yield.

6.4.1 Running or Flat Yield

The term *running yield* or *flat yield* refers to the current income yield from the bond, ignoring the capital gain or loss on maturity, expressed as a percentage of its current market value.

Example

5% Bond 2025.

Market value of €100 nominal = €105.50, say.

Flat or Running yield = $^{5}/_{105.50}$ x 100% = 4.74% per annum.

The *running yield* of the bond cannot, however, be looked at in isolation to the level of capital payment, and hence gain or loss, due on maturity of the stock.

In the example above, in addition to the running yield of 4.74% per annum, the investor will make a capital loss at maturity of 5.5% of the nominal value of the bond bought. that is, he or she will only get back €100 for the bond which they would purchase at €105.50 today.

The last few years has seen the unusual scenario of 'negative' bond yields being accepted by investors. In January 2022 the Yield on a 10 year German Government bond was - 0.13% which if purchased and held to maturity guarantees investors a negative return where investors will have effectively 'paid' the German government to mind their money. Germany was not alone in this unusual scenario where through 2021 the bond yields of a number of European countries were negative across a variety of maturity dates.

Why would any investor accept a bond with a negative yield? They may do so in the expectation that the price of the bond will increase in the short term, thus allowing the investor make a capital gain to offset the income loss.

Another reason may be that an investor is willing to pay the price for the extra security of the bond versus other assets, at a time when the investor may expect asset prices generally to fall.

6.4.2 Gross Redemption Yield

The *gross redemption yield* is the annualised return which a bond offers based on its current market price, taking account of both:

- The anticipated income the bond will pay out between now and its anticipated maturity date, that is, *the running or flat yield;* plus
- The anticipated capital gain or loss on maturity, assuming the bond is held to maturity.

This is referred to as the *gross redemption yield*, with:

- *Gross* referring to gross of any tax liability on returns; and
- *Redemption* referring to the yield or return if the bond is held to its redemption at its maturity date.

This exact calculation is based on an actuarial formula but you can work out the gross redemption yield approximately by following the steps below.

There are four steps involved:

Step 1:
Calculate the running yield.

Step 2:
Calculate the percentage of the investment amount that will be gained or lost, on maturity of

the bond. Can be positive or negative, depending on whether the bond is currently standing below or above par.

Step 3:
Divide the percentage in Step 2 by the remaining term of years to maturity of the bond.

Step 4:
Add/subtract the return in Step 3 (could be positive or negative) to the running yield in.

Example

Take an example of a bond with a coupon rate of 5%, a maturity of 1st October 2026 and a current (April 2024) price per €100 nominal of, say, €105.50:

- ***Step 1*:** its flat or running yield is 4.74% (€5/€105.5 x 100%) per annum based on a price of €105.50 per €100 nominal of the stock;
- ***Step 2*:** the investor will also realise a capital loss if he or she holds the bond to maturity on 1st October 2026 as he/she will get only back €100 at maturity for each €105.50 he/she paid to purchase that €100 nominal that is, a loss of [€105.50 - €100.00] = €5.50 or 5.21% of the capital invested in the bond;
- ***Step 3*:** the loss is equivalent to an investment return of -2.08% per annum ($^{-5.21\%}/_{2.5}$, *say*) over the approximate 2.5 year period from April 2024 to maturity in October 2026;
- ***Step 4*:** the gross redemption yield currently offered by this bond is therefore approximately:
  - 4.74% per annum (flat yield);
  - MINUS 2.08% per annum (estimated effect over next 2.5 years of capital loss in 2026) = 2.66% per annum.

6.4.3 Net Redemption Yield

This term refers to the redemption yield, net of taxes, usually calculated at standard rate income tax on the income payments. Gains made on treasury bonds, but not on corporate bonds, are free from capital gains tax.

Example

Take the same example as above, that is, a bond with a coupon rate of 5%, a maturity of 1st October 2026 and a current price per €100 nominal of, say, €105.50:

- ***Step 1*:** its gross flat or running yield is 4.74% per annum based on a price of €105.50 per €100 nominal of the stock; netted down for 20% income tax assumed, this equates to a net running yield of 4.74% x (1 – 20%) = 3.79%;

- ***Step 2*:** the investor will also realise a capital loss if he or she holds the bond to maturity on 1st October 2026, as he will get only back €100 at maturity for each €105.50 he paid to purchase that €100 nominal that is, a loss of [€105.50 - €100.00] = €5.50 or 5.21% of the capital invested in the bond;

- ***Step 3*:** the loss (5.21%) is equivalent to an investment return of – 2.08% per annum ($^{-5.21\%}/_{2.5}$, *say*) over the approx. 2.5 year period from April 2024 to maturity in October 2026;

- ***Step 4*:** the net redemption yield, currently offered by this bond is therefore approximately:
  - 3.79% per annum *(flat yield*);
  - MINUS 2.08% per annum (estimated effect over next 2½ years of capital loss in 2026) = 1.71% per annum.

6.5 Benefits of Investing in Bonds

Bonds can offer investors one or more of the following potential benefits, depending on the features of the bond in question:

- Fixed regular income;
- Some bonds pay gross income not subject to DIRT or other tax deduction;
- Fixed capital repayment;
- A wide choice of terms and issuers, with different risk classifications;
- Generally, less volatile returns than investing in shares.
- May offer tax advantages to higher rate tax payers from Capital Gains on holding Irish Treasury bonds (see Chapter 6.8.3 below).
- May offer tax benefits to non-tax payers, who can earn a gross income return, with no DIRT levied at source.
- Government Bonds offer investors a high level of liquidity as they can be sold easily and rapidly to raise cash if required. (Corporate bonds may be less liquid particularly where credit worthiness of issuer is poor)

6.6 Limitations on Investing in Bonds

There are certain limitations of investing in bonds:

- High minimum investment; some bonds may have a high minimum investment of €50,000 or higher;

- Some bonds are not issued or sold to retail investors; they are only sold to large institutional investors.

6.7 Risks of Investing in Bonds

An individual investor investing in bonds is potentially exposed to a number of risks:

- *The risk of default,* by the issuer. This would cause the bond to fall in value, and possibly become worthless, in certain circumstances. However, in the case of investment in good sovereign debt, this risk is reduced significantly but not eliminated totally.

  The risk is higher for:

  - Subordinated bonds, than for more senior bonds;

  - Unsecured bonds, than for bonds secured on some assets of the issuer.

- *The risk of downgrading of the issuer and/or bond;* for example, a company's or country's bond might be downgraded in its credit rating from say, AA to BBB status, if the company's trading performance or the outlook for the country in question deteriorated sharply. A downgrading could cause the market price of the bond to fall, reflecting the increased return now demanded by the market to invest in this bond, given the now higher perceived default risk.

- The *liquidity risk*, that is, the risk that the investor may not in certain adverse circumstances be able to sell their bond at an acceptable price or even at all. This risk is particularly relevant to corporate bonds.

  The default, downgrading and liquidity risks can be significantly reduced for an individual investor by investing in a PRIIP which invests in a widely diversified range of corporate bonds.

- The *risk that interest rates could rise*, (known as 'interest rate risk') thereby causing a fall in bond prices. The longer the remaining term of the bond, the larger the percentage fall in value if interest rates increase. This is known as 'Duration risk'. The longer a bond's duration, the greater its sensitivity to a change in interest rates. Duration gives us a good measure of the sensitivity of the price of a bond or debt instrument to a change in interest rates. When investing in bonds as part of an overall portfolio, understanding the impact of duration is very important in understanding both the risks and potential rewards (see examples in chapter 6.10 below).

  While investing in short dated bonds can reduce the potential for loss if interest rates increase from their current level, it also reduces the potential for gain if interest rate levels decrease from their current levels.

- The *inflation risk*; where the bond provides a fixed return, rising inflation will decrease the real return offered by the bond.

- The *reinvestment risk*, that is, the risk that interest payments and the capital proceeds (when sold or when the bond matures) may be reinvested at a lower rate of return than provided by the bond. This could happen where interest rates fall from the time the bond was purchased.

- The *currency risk,* where the bond is denominated in a currency other than the euro.

6.7.1 PRIIPs

Most consumers invest in bonds by investing in a PRIIP which invests in a wide spread of bonds issued by different issuers.

This allows for diversification and reduces the risk of default, that is, the risk that the issuer of the bond may default on their payment obligations under the bond, by spreading that risk over a large number of different bond issuers. PRIIPs are covered in detail in Chapter 7.

6.8 Taxation of Returns

6.8.1 Income

The income from bonds is liable to income tax in the hands of an individual investor at his or her marginal rate, but is *not* subject to DIRT, that is, it is paid gross into the hands of an Irish investor.

Bonds may therefore be attractive to individuals who are non-income tax taxpayers, or paying income tax at standard rate, because they offer one of the few ways to earn an income not subject to DIRT.

Non-taxpayers can only reclaim DIRT in certain circumstances if they are over age 65 or permanently incapacitated and not otherwise liable to tax on the income.

For non-taxpayers under age 65 and not permanently incapacitated, bonds represent one of the few ways of earning a gross income return, with no DIRT levied at source.

6.8.2 USC and PRSI

Income received by an individual from a bond is:

- Subject to USC.
- Subject to 4% PRSI for self-employed Class S contributors regardless of amount, and for employees and those receiving occupational pensions who have gross taxable investment income of more than €5,000 in a year. PRSI contribution liability ceases at age 66.

6.8.3 Capital Gains

Any capital gain on maturity or earlier sale of an Irish Government treasury bond is free from capital gains tax in the hands of an individual investor, under current legislation.

The corollary of the capital gains tax exemption for gains made on the maturity or earlier sale of a treasury bond is that losses made in similar circumstances *cannot* be offset against any other chargeable gains the individual may have.

Example

John sells a treasury bond in 2024 and realises a capital loss of €4,000 in the process. Also, during 2024 John made a chargeable gain of €7,000 on the sale of a number of shares.

John cannot offset the loss on the treasury bond against the gain on the sale of his shares, as the treasury bond loss is not offsetable for capital gains tax purposes.

The bond exemption from capital gains tax outlined above only applies to such securities issued by the Irish Government; therefore, the exemption would not apply to, say, UK gilts held by an Irish resident.

Unlike treasury bonds, any capital gain on maturity or earlier sale of other bonds is a chargeable gain for capital gains tax purposes in the hands of an individual investor.

Consequently, a realised loss on such a bond is an allowable loss which can be set against other chargeable gains of the investor.

6.9 Pricing: Clean / Dirty Price

Bonds which pay a fixed coupon, say every year, are akin to a fixed term deposit in that interest is accruing at a fixed rate along the way.

For example, take a bond which pays a coupon of €5 per €100 nominal every year. Six months after the last coupon payment, the bond has accrued 1/2 x €5 of interest.

So, when an investor invests in a bond he or she is buying three separate returns together:

- The right to the capital repayment when the bond matures;
- The right to future accrual of interest from the date of investment; and
- The right to the interest accrued since the last coupon payment, which will be payable to the investor at the next coupon date.

The bond's market price covers the first two items above, with the investor paying an additional amount to purchase the third item, that is, accrued interest.

The market price ignoring the accrued interest is called the *clean price*, while the price including a payment for accrued interest is called the *dirty price*.

6.10 What Factors Affect Returns Offered by Bonds?

As bonds are generally fixed interest securities, the fundamental factors which influences returns offered by bonds at any time are:

- **Anticipated interest rate movements**, at that time, for the remaining term of the bond.

  If interest rates rise then the market value of fixed interest bonds will fall, and vice versa. The longer the term of the bond the greater the percentage rise or fall in value, as the case may be, for a given change in interest rates. Therefore, longer dated bonds display a capacity for greater movement in price, than shorter dated bonds.

  Take, for example, two bonds:

  Bond A: Pays 5% per annum annually in arrears and matures at €100 par value in five years; and

  Bond B: Pays 5% per annum annually in arrears and matures at €100 par value in 20 years.

  Let's assume current five-year interest rates are 2% per annum and 20-year rates are 3% per annum. The question is … if interest rates rise or fall by 1% from current levels, by how much should the price of the two bonds change to reflect the revised interest rates? We can discount the payments in both bonds to represent the market value or price of the bond:

Price of bond

	Bond A	Bond B
Current interest rates	114.14	129.75
Current interest rates +1% per annum	109.16 (- 4%)	113.59 (- 12%)
Current interest rates -1% per annum	119.41 (+ 5%)	149.05 (+ 15%)

We can see from the above that the change in price caused by a 1% shift in interest rates for Bond A, the five-year bond, is much lower than that for Bond B, the 20-year bond. Therefore, Bond B while offering a higher return than Bond A, is a riskier investment as its price will rise or fall more than a shorter-term bond, if interest rates change.

- **Expectations for inflation**; if inflation is expected to rise, investors will demand a higher return to compensate for the higher inflation and hence interest rates may rise and bond price fall accordingly. The opposite may happen if inflation is expected to fall or remain flat.

- The market view of the **credit worthiness** of the issuer of the bond. As indicated already, bonds are debt instruments (that is, IOUs), whereby the issuer of the bond promises to make certain payments to the investor over time.

  There is therefore the risk that the issuer of the bond may default on payments due under the bond.

  Investors may therefore seek a *risk premium* (that is, an additional return over and above normal risk free investment returns over a similar period) in the return offered by some bonds, according to the financial standing/strength of the issuer of the bond. The higher the perceived risk of default, the higher the yield required by investors and hence the lower the price of the bond.

  Rating agencies like Moody's and Standard & Poor's rate bonds issued by governments and commercial companies on a sliding scale as follows:

Grade	Risk	
AAA	Lowest	
AA	Low	
A	Low	
BBB	Medium	
BB, B	High	Junk
CCC, CC, C	Highest	
D	In default	

  Bonds issued by stable governments from strong economic countries will usually be classified as AAA, usually referred to as triple A. Such bonds provided by very strong and stable countries, for example, Germany, would be considered to be the nearest thing you can get to *risk free* investment returns, where risk free is referring only to the risk of default.

  However, the lower down the grading scale you go, the more *risk premium* in terms of higher return the market will seek in terms of returns from such bonds. For example, a bond with an A rating will, all other things being equal, offer a higher return than a bond with a triple A rating, and so on down.

Bonds with a rating of BB downwards to D are sometimes referred to as *junk bonds* or High Yield Bonds. Traditionally these bonds were known as 'junk' but in the last few years reference to '*High Yield*' has become more common. This should not be confused with the term High Yield Equities. High Yield in the context of Shares refers to a high dividend payment which is generally considered a positive. With High Yield Bonds, the reason for the high yield is down to the 'quality' or credit risk of the issuing entity. Although junk (high yield) bonds pay high yields, they also carry higher than average risk of the company defaulting on the bond, and so these need to be viewed in the context of the risk associated with such an investment.

High Yield Bonds also carry a higher level of illiquidity risk, with the investor compensated in part by the payment of a higher return.

The ratings for Irish Government Bonds (as at February 2024) detailed below shows how Rating Agencies can differ in their rating for the same issuer.

Rating Agency	Long-term	Short-term	Outlook / Trend
Standard & Poor's	AA	A-1+	Stable Outlook
Fitch Ratings	AA-	F1+	Positive Outlook
Moody's	Aa3	P-1	Stable Outlook

Source: NTMA: https://www.ntma.ie/business-areas/funding-and-debt-management/investor-relations/credit-ratings (February 2024)

6.11 Buying and Selling Bonds

The procedure for buying and selling bonds is similar to that outlined for buying and selling quoted shares; see Chapter 5.13 for more details.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] What is a bond and what it offers investors
- [ ] Treasury bonds
- [ ] Corporate bonds
- [ ] Taxation of returns
- [ ] Factors that can influence the returns offered by bonds
- [ ] Benefits of investing in bonds
- [ ] Limitations of investing in bonds
- [ ] Risks of investing in bonds

Sample Questions

The answers to these questions can be found in your Study Hub.

1. €100 nominal value of a bond is currently being traded on the market at €125. This bond is said to be:

   A. standing above par.
   B. subordinated to its issue price.
   C. Illiquid.
   D. overpriced.

2. If a bond pays an annual coupon but has no maturity date at which the nominal value of the bond will be repaid, the bond is said to be WHICH type of bond?

   A. Perpetual.
   B. Permanent.
   C. Diluted.
   D. Treasury.

3. If a particular bond issued by a company ranks BEHIND another bond for repayment in the event of the company winding up, the first bond is said to be WHICH type of bond?

   A. Callable.
   B. Perpetual.
   C. Subordinated.
   D. Senior.

4. The price of a bond, excluding accrued interest, is referred to as the:

   A. clean price.
   B. dirty price.
   C. settlement price.
   D. mid-market price.

07

Packaged Retail and Insurance-based Investment Products (PRIIPs)

In this chapter Packaged retail and Insurance-based investment products (PRIIPs) are described, and the different structures compared. Particular attention is paid to developing an understanding of Undertakings for Collective Investment in Transferable Securities (UCITS), alternative investment funds (AIFs) and exchange traded funds (ETFs). The two main investment management styles (active/passive) are discussed and how these can be used in a PRIIP regulated fund based on the particular investment mandate. The key considerations of investing in PRIIPs are outlined with additional commentary on charging structures and tax treatment of returns.

Learning Outcomes – after studying this chapter you should be able to:
understand what a Packaged retail and Insurance-based investment products is, and different structures of such funds;
explain Undertakings for Collective Investment in Transferable Securities (UCITS), alternative investment funds (AIFs) and exchange traded funds (ETFs);
describe different asset allocations and investment management styles of PRIIPs funds;
understand charging structures in PRIIPs;
explain how investment returns from PRIIPs funds are taxed in the hands of an investor; and,
outline the benefits, limitations and risks of investing in PRIIPs funds.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	7	8	13

7.1 What are Packaged Retail and Insurance-based Investment products?

The term Packaged retail and Insurance-based investment product (PRIIP) refers to a range of investment products, subject to fluctuations in market valuations which may or may not be insurance based, and are marketed to **retail** investors. These are also known as collective investment funds and are governed under PRIIPs EU regulation.

In a PRIIP, collectively, a large number of investors pool their money to invest in a diversified range of assets which are managed by a professional investment manager. The PRIIP generally operates on a unitised basis, that is, the value of each investor's holding is measured by the number of *units* or shares he or she owns in the fund. Their unit or share values are based on the *net asset value* of the fund at that time and hence will rise and fall in line with the fluctuating value of the fund's investments.

Some funds undertake to buy back the investor's units at any time at their net asset value; other funds may not provide such an undertaking and hence investors have to sell their shares/units to other investors in the marketplace if they want to encash their investment.

Investments which fall outside the scope of PRIIPs legislation include;

- Individual shares
- Treasury and Corporate Bonds
- Deposits
- Life Assurance Policies which have no exposure to market fluctuations
- Qualified Investor Alternative Investment funds (as these are not marketed to retail investors)

7.1.1 Structures of PRIIPs

PRIIPs investment funds are typically structured in one of three main ways:

- As a life assurance company **unit linked funds**, in which individuals invest in the fund by investing in a unit linked policy issued by that life company. The policy in turn invests in units of the chosen fund(s). **See Chapter 10.1** following for more details.
- As an **investment company**, in which the investor purchases shares in the company; one of the most common forms of investment companies are exchange traded funds (ETFs) which aim to provide the same return as a specified stock market or other index of shares or other securities. S**ee Chapter 7.5** following for more details of ETFs.
- As a **unit trust,** in which the investor purchases units in the unit trust. Assets in a unit trust fund are held by trustees acting on behalf of investors.

7.1.2 Types of Investment Companies/Unit Trusts

There are two types of investment company/unit trust:

1. UCITS – Undertakings for Collective Investments in Transferable Securities

2. AIF – Alternative Investment Funds

7.1.3 Undertakings for Collective Investments in Transferable Securities (UCITS)

The term UCITS stands for **U**ndertakings for **C**ollective **I**nvestment in **T**ransferable Securities. The UCITS system is an EU wide basis of recognition of such funds which meet the requirements of UCITS regulations.

A UCITS fund can either be an investment company or a unit trust and must always be open ended.

UCITS operate on the principle of risk-spreading. Units/shares in a UCITS fund are, at the request of investors, repurchased or redeemed, directly or indirectly, out of a fund's assets at their net asset value.

The issue price of units or shares of a UCITS must be calculated as:

$$\textbf{[Net Asset Value of fund]} \,/\, \textbf{[Number of units/shares outstanding].}$$

It may then be increased by charges.

Example

A unit trust fund's net asset value on a particular day is €34,550,000 and its number of units outstanding on that day is 18,967,650. The trust makes an initial sales charge of 4% on unit purchases.

The fund may set its unit price on that day as:

$$€34{,}550{,}000 \,/\, 18{,}967{,}650 = €1.82.$$

An investor buying 20,000 units in the fund on that day will therefore pay:

$$20{,}000 \times €1.82 \times 104\% = €37{,}856.$$

Once a collective investment scheme is authorised as a UCITS, in one EU member state and meets the UCITS regulations requirements, it can then be marketed to residents of other EU member states, subject only to meeting local marketing and sales requirements and rules (sometimes referred to as the *common good* requirements). The ability to market and sell a UCITS across EU states is sometimes referred to as *passporting*[11].

Therefore, currently a UCITS set up and approved in Luxembourg, say, can sell to Irish residents subject to notifying the Irish Central Bank and complying with certain requirements of the Irish Central Bank when marketing to Irish residents.

[11] UCITS can be sold in any EEA member state, which is all EU member states plus Norway, Lichtenstein and Iceland. Note that the Channel Islands and the Isle of Man are not part of the EU.

Likewise, a collective investment scheme set up in the State and approved by the Central Bank as a UCITS can be marketed and sold to residents of France and Germany, for example, subject to meeting local regulatory sales and marketing requirements. In fact, the vast majority of UCITS established in Ireland are sold only to investors in other EU member states and are not actively marketed to Irish residents.

All UCITS assets must be held by an independent corporate *trustee*, who is required to ensure that the investment fund is operated in accordance with the trust deed (in the case of a unit trust) or memorandum and articles of association (in the case of an investment company), and in accordance with the requirements of the UCITS regulations. Sometimes this trustee is referred to as a *depository*.

The trustees are liable to the investors for any loss suffered by them as a result of the trustees' unjustifiable failure to perform their obligations under the UCITS regulations.

The trustees must also prepare an annual report which is given to the fund manager and incorporated into the fund manager's annual report to investors.

7.1.4 Alternative Investment Funds (AIFs)

An alternative investment fund (AIF) is type of collective investing where funds are raised from a number of investors with a view to investing them in accordance with a defined investment policy.

AIFs may be established as open-ended, closed-ended or limited liquidity structures and are authorised as one of two categories:

- Retail investor ('RIAIF') authorised to be marketed to retail investors and
- Qualifying investor ('QIAIF') authorised to be marketed to qualifying investors

RIAIFs are subject to less investment and eligible asset restrictions than UCITS but are subject to a regime more restrictive than the QIAIF Regime. RIAIFs do not have the automatic right to market across the EU under the AIFMD marketing passport. Access to individual markets may be granted on a case-by-case basis. RIAIFs must appoint a fully authorised Alternative Investment Fund Manager (AIFM). Non-EU managers or registered AIFMs are prevented from managing RIAIFs.

QIAIFs are not subject to many investment or borrowing restrictions. QIAIFs may be marketed freely to professional investors across the EU and the EEA by an authorised AIFM using the AIFMD marketing passport. The Central Bank's regulatory requirements in relation to QIAIFs are set out in Chapter 2 of the AIF Rulebook.

AIFs are covered in more detail in Chapter 7.3 below.

7.1.5 Advantages of Investing in PRIIPs

Investment funds governed by PRIIPs legislation offer the investor a number of advantages, compared with direct investment in shares, bonds, etc.

- *Reduced risk*, by participating in a much larger diversified pool of assets than could be obtained by direct investment by an individual investor in a smaller number of shares and bonds, that is, *diversification*.
- *Professional investment management,* where the fund is actively managed.

- *Lower dealing costs;* Large funds can buy and sell shares and bonds in bulk much more cheaply than an individual investor buying and selling small amounts. Also, a person may be able to switch to another sub-fund or funds within the range of funds available without being levied with the dealing costs associated with direct investment. This is particularly attractive for an investor who wishes to trade actively.

- *Less administration;* the direct investor will have to collect dividends, make tax returns of investment income and gains, and be involved in a lot of paper work. By investing in a collective fund, the investor avoids all this administration hassle.

- Provides *access to certain asset types* that would not be possible for an individual investing directly; for example, property funds allow small investors to participate in large scale commercial property investments, which would not otherwise be feasible for investors investing directly with their own funds.

7.1.6 Disadvantages of Investing in PRIIPs

There are some potential disadvantages to investing in PRIIP funds as opposed to direct investment by the investor:

- *Charges*:

  - Initial charges may be levied on the sum invested in the fund, for example, a sales charge and/or some funds may impose an exit charge when units are cashed in;

  - Annual fund management charge, including possibly a performance fee, that is, an additional management fee if the fund return exceeds some predetermined benchmark return, such as exceeding cash returns by a specified margin.

- *Lack of control over individual stock selection*. For example, while the investor may be able to pick, say, a UK equity fund, he or she has no control over which individual UK shares the fund invests in.

- *Lack of individual shareholder rights and perks*. A direct investor in a particular share would receive the company's annual report and be entitled to attend the AGM, and speak and vote at that meeting, and may also be entitled to shareholder perks, for example, discounts, etc., for shareholders using the company's goods or services. By investing in a PRIIP, the individual loses the rights and perks of a direct shareholder.

- *Some investors may be disadvantaged from a taxation point of view* by investing in a PRIIP fund, rather than investing directly:

  - Some non-taxpaying investors may be unable to recover exit tax deducted from Irish funds;

  - The tax rate applying to gains made on Irish and EU funds is 41% compared to the capital gains tax rate of 33%;

  - Investors in Irish and EU UCITS funds cannot benefit from the annual €1,270 capital gains tax free exemption, which they could if they invested in capital assets directly;

  - Investors who make a loss on investment in Irish and EU funds, cannot offset this loss against any other chargeable capital gain they might have in that tax year under any other asset; however, an investor who invested directly in shares or in non-EU exchange traded funds can offset a loss on the sale of one share against a gain made on another share or can carry forward losses to future years to be offset against future gains from direct investment in shares.

7.1.7 Limitations on Investing in PRIIPs

There are several limitations on investing in PRIIPs:

- There may be a high minimum investment amount.
- Some funds may only be available to professional investors, such as pension funds and wealth investors, and hence may not be available to consumers.
- To avoid potential exit charges or reduce the impact of initial charges, the investment may need to be maintained for a certain minimum period.
- Restrictions may be placed on switches, into and out, and encashment of certain funds, for example, property funds.
- Potential loss of access to capital in certain funds, where the manager has the power to delay encashment in certain circumstances.
- Investment guarantees, where provided, may only apply if the investment is maintained in full for a certain minimum period, for example, five years. Early partial encashment will usually reduce the level of guarantee provided. Other guarantees may come at the price of lower potential investment returns.

7.1.8 Risks of Investing in PRIIPs

There are several risks which investors may be exposed to when investing in PRIIP funds. These are set out in Chapter 14.2.1.

7.2 PRIIPs Investment Considerations

7.2.1 Fund Choice

PRIIP funds can invest in different investment asset classes and hence there are many different types of funds, such as:

Funds Which Invest in Particular Types of Asset examples would include:

- *Cash/deposit* funds which invest only in deposits or very short-term fixed interest securities;
- *Property funds*, which invest in commercial properties, including retail, industrial or office, with some funds also offering exposure to residential properties;
- *Bond funds*, which invest in government and large company fixed interest securities;
- *Equity funds,* which usually invest only in shares quoted on a recognised stock exchange;
- *Commodity funds,* which invest in various types of commodities, such as gold, food, etc.
- *Alternative funds, which invest in Emerging Market equities and bonds, Infrastructure projects as well as derivative based investments.*

Multi-Asset Funds (MAF's)

Multi-Asset Funds (MAF's) are invested in a mix of asset types such as equities, property, fixed interest securities and deposits. The mix is determined by the investment managers of the fund, and may change over time, as investment conditions change. This type of fund is also sometimes referred to as a managed or mixed fund.

For example, a multi-asset funds might have 50% invested in equities, 25% in bonds, 20% in commercial property and, say, 5% in cash.

Multi Asset funds typically work towards a particular investment mandate and may well be governed to hold both maximum and/or minimum amounts in each asset class. For example, a fund may hold a maximum of 60% in shares and have a minimum of 30% in shares, or in some instances there may be no prescribed minimums (technically could go to zero). By spreading its investment 'eggs' over a number of different 'baskets', the fund will usually display a less volatile return than a fund which invests in one type of asset only, for example, an equity fund.

Funds Which Invest in a Particular Geographical Area and/or a Particular Type of Asset

Examples here would include:

- *Irish equity fund,* which would invest only in shares quoted on the Irish Stock Exchange.
- *Eurozone equity fund,* which would invest in shares from countries who are members of the euro. For example, would not invest in UK equities, but in German, French, Italian, Irish, etc. equities.
- *UK property fund,* which may invest only in UK commercial properties.
- *Technology fund,* which invests in shares of technology companies.

These types of funds are sometimes referred to as *specialist* funds and would be deemed to be higher risk than funds which invest in a broader range of assets.

7.2.2 Investment Management Styles

PRIIP investment funds are managed by professional investment managers and there are two main investment management styles,

Active Management

The investment manager attempts to use their skills to outperform the performance of the benchmark against which the fund performance is to be measured. Any outperformance of that manager relative to the benchmark is referred to as 'Alpha'. For example, an actively managed fund investing in European equities will attempt to outperform a specified index of European equities, such as the Eurostoxx 50. If the index were to increase by 10%, and the manager produces a return of 11%, it is said to have produced 1% 'Alpha' or outperformance. In attempting to outperform the benchmark, certain limits may be placed on the investment manager in relation to risks which can be taken by the fund.

The objective of active investment management is to produce a return in *excess* of the overall market return, so that, for example, if the UK equity market in general increases by 15% during a period, the investment manager of an actively managed UK equity fund would be striving to achieve a return in excess of this. Importantly an active manager can produce this outperformance in either a rising or falling market, so in the above example if the UK equity market was down -15% and the active manager's fund was down -14%, that manager would be deemed to have outperformed the benchmark return.

Passive Management

Many investors believe that the market is 'efficient'. The Efficient Market Hypothesis also known as the 'efficient market theory', states that share prices should reflect all known information all of the time. If this is the case then all shares should trade at fair value on exchanges all of the time, therefore making it impossible for fund managers to consistently outperform the market.

Passive investment management also known as 'index fund management' aims to replicate the returns of a particular market such as the FTSE 100 or S&P 500 Indices. A Passive fund aims to hold each stock in the index, in the same weighting as the index. An example of this might be a stock like Apple, if it has a weighting of 7% of the S&P 500 index, a Passive manager will hold 7% of Apple stock in a Passive investment fund. This is then replicated across all of the stocks within the Index. The aim of the passive manager is to just replicate the return of the index, positive or negative and so the passive manager does not set out to beat the market.

Tracking error: Passive fund managers don't set out to outperform the market, but are expected to produce their returns as close to the market returns as possible. Tracking error measures how well the fund tracks the benchmark over the period of investment. A small tracking error signifies the passive fund will tend to follow its benchmark very closely whereas a large tracking error would suggest the opposite.

Consensus investment management is another form of passive investment management, where both the asset allocation and security selection are determined on a passive basis. The term *consensus* refers to matching the *consensus* investment asset allocations of competing similar funds. Consensus managed funds will therefore mirror the average asset allocation of similar competing funds between equities, bonds, property and cash, and geographical allocation within these asset classes.

A consensus managed fund will not therefore be a top performer, but will not be a bottom performer either, as its performance should mirror the overall average return.

Funds managed on the passive approach frequently have lower fund management charges than actively managed funds, as investment manager costs are lower. Passive funds will also have much lower dealing costs as stocks and shares are generally not being bought and sold continuously to the same extent as would happen in an actively managed fund.

7.2.3 Investment Mandate

Each PRIIP fund will have a particular *investment mandate*, that is:

- The stated particular investment objective of the fund. For example, is the fund objective to produce a certain absolute level of return, or a level of return relative to some benchmark?
- How this objective is to be attained, for example, active or passive investment management, or some combination of both, to be used?
- Are there any particular restrictions or limits placed on investment of the fund, for example, a maximum or minimum percentage invested in equities?

So, while Funds A, B, C and D might all be called *managed or multi-asset* funds, they each may have a very different way of going about their task and hence may produce very different returns and have very different risk profiles.

7.2.4 Guaranteed/Capital Protected Funds

These funds aim to protect the investor's capital, usually at some point in the future, while still offering participation in equity market returns by investing part of the fund in a combination of futures and options and/or retaining the right to switch the fund's investments into short-term fixed interest securities at times of fluctuating equity markets.

The most popular of these funds are so called *protected* or *guaranteed* funds. These often hold a mixture of fixed income securities and equities. The fixed income portion usually provides the guaranteed protection while the equity portion provides the capital growth. The guaranteed portion may also be underwritten by an insurance policy to protect the principal.

Some guaranteed funds can be quite complex in their construct, and the price of the guarantee can be expensive. Advisors should always have a full understanding of both the costs and the potential returns from each particular fund offering.

7.2.5 Income or Growth Funds

PRIIP funds which are investment companies or unit trusts, can be structured either as:

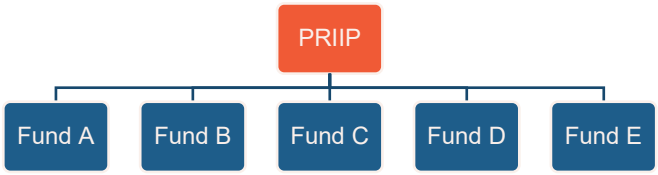
- *Accumulating* or *growth* funds, like life company unit funds, where investment income is retained within the fund to increase the unit/share price and is not distributed separately to investors.

- *Distributing* funds, where the investment income accruing to the fund is paid out or distributed to investors at predetermined intervals, for example, every six months or annually.

  It should be appreciated that distributing funds do not necessarily guarantee that the remaining capital is always secure. The fund assets producing the income may fluctuate in capital value, with equities expected to fluctuate more than bonds.

7.2.6 Fund Structure

A PRIIP may be structured as an *umbrella fund,* that is, the PRIIP has many different *sub-funds* which operate as separate funds under the one legal structure.



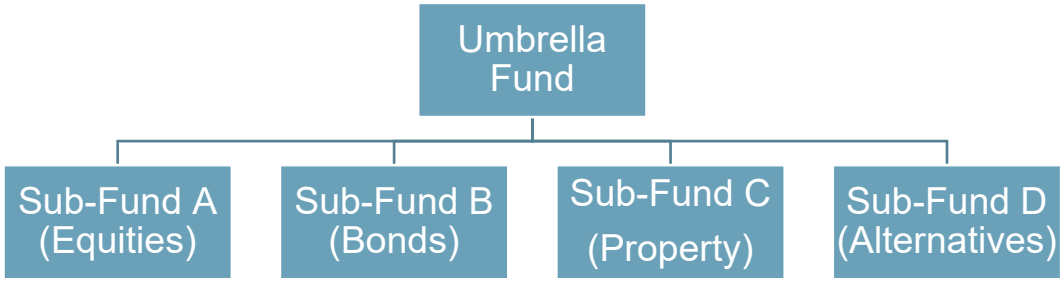
Each sub-fund must comply with the PRIIP regulations, for example, investment restrictions outlined above.

The prospectus (see below) for an umbrella UCITS fund must clearly state the charges, if any, which apply on switching from one sub-fund to another.

Umbrella Funds

A PRIIP (An investment company or unit trust) may consist of just one fund. To switch from this fund to another fund of the same provider would involve the investor encashing their investment in one fund and making a fresh investment in another fund.

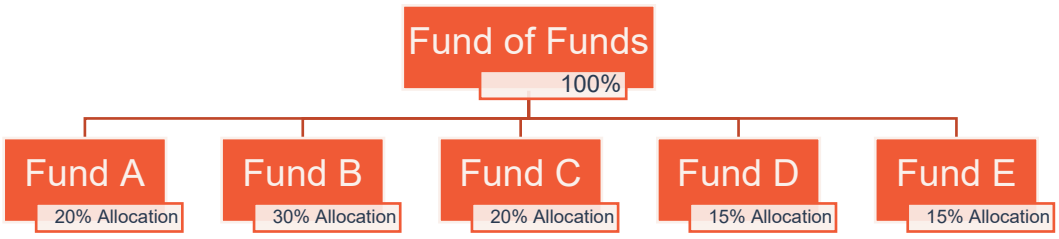
An *umbrella fund*, on the other hand, is split into a number of sub-funds (each with its own separate identifiable group of assets), and the investor can switch from one sub-fund to another, without encashing their investment in the overall product, for example, similar to the way an investor in a life assurance unit linked investment bond can switch from one-unit fund of that life company to another, without being required to encash the policy and without triggering a tax charge.



These sub-funds must be segregated from each other under the terms of the deed or memorandum establishing the unit trust or investment company.

Fund of Funds

A *fund of funds* is an investment fund which invests in other similar investment funds, some of which may be with different providers.



Fund A, B, C, etc., might be invested in similar asset types but managed by different investment managers. The concept behind the *fund of funds* approach in this case is to try to pick the best investment managers from a number of different investment managers. The fund of funds can switch from one fund to another, and hence from one investment manager to another, without triggering any tax charge for the investor.

On the other hand, investing in a fund of funds may involve *layered* charges for the investor, that is, the top line fund may appear to only charge an initial charge of, say, 5% and a fund management charge of 1% per annum. However, the fund of funds may then invest in, say, Fund A which itself has a 2% bid/offer spread and a further fund management charge of 1% per annum. The investor may only see the 5% and 1% per annum charges in the fund of funds in which he or she invests in and think that these are the only charges.

However, where the fund of funds invests in a fund operated by the same fund manager, or by an associated or related company, the manager of the fund in which the investment is being made must waive the preliminary/initial charge which it is entitled to charge, for example, the 2% bid/offer spread in the example above.

7.3 Regulation of PRIIPs

The variety and complexity of PRIIPs products and the size of the market means that consumers need comprehensive information about them. EU Regulation, known as the PRIIPs Regulation introduced in 2018, aims to improve the transparency and comparability of investment products across the EU through key information documents (KIDs).

While there was a derogation for UCITS product providers to produce a Key Information Document, this has now lapsed and from 01.01.2023, all UCITS PRIIPs providers must produce a Key information document.

7.3.1 PRIIPs - Key Information Document

The purpose of the KID which must be offered at the pre-contractual stage is to communicate a summary of the prospectus information in a concise and understandable manner. It must:

- Be a standalone document which is easy to read.
- Be provided to all **retail** consumers before the contract is entered into;
- Be a maximum of 3 A4 pages in length;
- Be updated by the manufacturer at least every 12 months;

- Include information under 9 prescribed headings as follows:

The Purpose of the Document

The purpose of the KID must be clearly displayed and contain the following text:

"This document provides you with key information about this investment product. It is not marketing material. The information is required by law to help you understand the nature, risks, costs, potential gains and losses of this product and to help you compare it with other products".

The PRIIP Manufacturer details

- At the beginning of the document, the name of the PRIIP, the identity and contact details of the PRIIP manufacturer, information about the competent authority of the PRIIP manufacturer and the date of the document;
- Where applicable, a comprehension alert which shall read: 'You are about to purchase a product that is not simple and may be difficult to understand.';

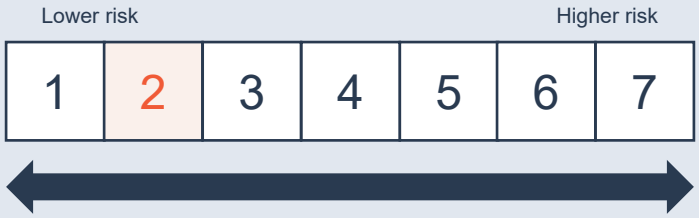
What the product is, its term and the objectives

This includes the main features of the PRIIP including:

- The type of the PRIIP;
- Its objectives and the means for achieving them, in particular whether the objectives are achieved by means of direct or indirect exposure to the underlying investment assets, including a description of the underlying instruments or reference values, including a specification of the markets the PRIIP invests in, including, where applicable, specific environmental or social objectives targeted by the product, as well as how the return is determined;
- A description of the type of retail investor to whom the PRIIP is intended to be marketed, in particular in terms of the ability to bear investment loss and the investment horizon;
- Where the PRIIP offers insurance benefits, details of those insurance benefits, including the circumstances that would trigger them;
- The term of the PRIIP, if known;

What the risks are and what the investor might receive in return

This is presented as a summary risk indicator, supplemented by a narrative explanation of that indicator, its main limitations and a narrative explanation of the risks which are materially relevant to the PRIIP and which are not adequately captured by the summary risk indicator;



It also contains warnings regarding the risk to the investment including;

- The possible maximum loss of invested capital, including, information on:
- Whether the retail investor can lose all invested capital, or
- Whether the retail investor bears the risk of incurring additional financial commitments or obligations, including contingent liabilities in addition to the capital invested in the PRIIP, and
- Where applicable, whether the PRIIP includes capital protection against market risk, and the details of its cover and limitations, in particular with respect to the timing of when it applies;
- Appropriate performance scenarios, and the assumptions made to produce them;
- Where applicable, information on conditions for returns to retail investors or built-in performance caps;
- A statement that the tax legislation of the retail investor's home Member State may have an impact on the actual payout;
- A statement that additional risks such as currency, counterparty and index tracking risks may also apply.

What happens if the PRIIPs manufacturer is unable to pay out

- This includes a brief description of whether the related loss is covered by an investor compensation or guarantee scheme and if so, which scheme it is, the name of the guarantor and which risks are covered by the scheme and which are not;

What the costs are?

The charges in a fund are used to cover the cost of running the fund and will have an impact on the investment return of the fund.

- These include the costs associated with an investment in the PRIIP, comprising both direct and indirect costs to be borne by the retail investor, and includes one-off and recurring costs, presented by means of summary indicators of these costs and, to ensure comparability, total aggregate costs;

- The key information document shall include a clear indication that advisors, distributors or any other person advising on, or selling, the PRIIP will provide information detailing any cost of distribution that is not already included in the costs specified above, so as to enable the retail investor to understand the cumulative effect that these aggregate costs have on the return of the investment;

What the recommended investment term is and can it be encashed early

Under a section titled 'How long should I hold it and can I take money out early', the KID must include

- Where applicable, whether there is a cooling off period or cancellation period for the PRIIP;

- An indication of the recommended and, where applicable, required minimum holding period;

- The ability to make, and the conditions for, any disinvestments before maturity, including all applicable fees and penalties, having regard to the risk and reward profile of the PRIIP and the market evolution it targets;

- Information about the potential consequences of cashing in before the end of the term or recommended holding period, such as the loss of capital protection or additional contingent fees;

How a complaint can be made

under a section titled 'How can I complain?', the KID must contain;

- Information about how and to whom a retail investor can make a complaint about the product or

- The conduct of the PRIIP manufacturer or

- A person advising on, or selling, the product;

Any other relevant information

Under a section titled 'Other relevant information', a brief indication of any additional information documents to be provided to the retail investor at the pre-contractual and/or the post-contractual stage, excluding any marketing material.

7.3.2 Additional Regulatory Requirements for UCITS

Prospectus

A UCITS fund must publish a prospectus, which must be dated and up to date.

The prospectus must contain sufficient information for investors to make an informed judgement of the investment proposed to them and in particular of the risks attached to that investment. The prospectus must also include a clear and easily understandable explanation of the UCITS risk profile.

The prospectus must contain certain specified information and must include:

- Details of the types and main characteristics of the units.
- Procedures and conditions of issue and sale of units.
- Indication of the tax system applicable to the UCITS. Details of whether deductions are made at source from the income and capital gains paid by the UCITS to unit holders.
- Where applicable, indication of stock exchanges or markets where the units of the UCITS are listed or dealt in.
- Description of the UCITS investment objectives (for example, capital growth or income) and investment policy (for example, specialisation in geographical or industrial sectors). The description must also include any limitations on that investment policy, and borrowing powers which may be used in the management of the UCITS.
- A UCITS which tracks an index, that is, passively managed fund, must include a prominent statement to this effect in the prospectus.
- Profile of the typical investor for whom the UCITS is designed.
- The risks applicable to investing in that particular UCITS, such as:
  - The fact that prices of units may fall as well as rise;
  - The desirability of consulting a financial adviser about the contents of the prospectus; and
  - Where relevant, the fact that the difference at any one time between the sale and repurchase price of units in the UCITS means that the investment should be viewed as medium to long-term.

The prospectus must be offered to investors free of charge before investing in the UCITS.

Annual and Half Yearly Reports

A UCITS manager must prepare annual and half yearly reports for investors.

These reports must be sent to the Central Bank and must be:

- Offered free to potential investors, before making the investment; and
- Supplied to investors in the fund free of charge, on request.

The annual report must contain certain specified information.

7.4 Alternative Investment Funds (AIFs)

Investment companies/unit trusts established in the State which are *not* authorised by the Central Bank as UCITS are referred to as alternative investment funds (AIFs). They can be either a unit trust or an investment company.

AIFs are not subject to the various restrictions outlined above for UCITS funds, but are subject to PRIIP Regulations, for **retail** investors, and other restrictions set out in the *AIF Handbook*, issued by the Central Bank which regulates the operation of such funds and other similar foreign funds that market to retail investors in the State.

There are two main types of AIFs:

- **Retail investor AIFs**, which are generally available to all investors;
- **Qualifying investor AIFs**, which are open only to *qualifying investors* with a minimum investment of €100,000.

While many of the restrictions and requirements applying to AIFs (For example: prospectus, production of annual report, etc) are similar to those already outlined for UCITS, the following significant differences also apply:

	UCITS fund	Retail investor AIFs
Investment in assets not dealt with on a regulated market.	Maximum 10% of net assets of fund.	Maximum 20% of net assets of fund.
Investment in securities issued by the same body.	Maximum 10% of net assets of fund.	Maximum 20% of net assets of fund.
Borrowing to invest.	No, except up to 10% of the net fund value for a temporary period.	Allowed, subject to borrowing not exceeding 25% of net asset value of fund at any time.
Investing directly in property.	Not allowed.	Allowed.
Can market to residents of other EU member states when authorised in one state?	Yes.	No.

7.4.1 Qualifying Investor AIFs

A qualifying investor AIF (QIAIF) is an AIF which is marketed only to *qualifying investors* and consequently is *not* subject to some of the investment and borrowing restrictions which apply generally to retail investor AIFs. However, qualifying investor AIFs which are investment companies must still meet the requirement of the Companies Act in relation to the objective of *spreading investment risk*.

The minimum investment in a QIAIF is €100,000 and only investors who meet the definition of a professional client can invest in the fund, that is, *"a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs*".

A professional client automatically includes institutional investors, such as banks, insurance companies, large companies and pension funds. It also can include certain individual investors who can satisfy two of the following three criteria:

- The client has carried out transactions, in significant size, on a relevant market at an average frequency of ten per quarter over the previous four quarters;
- The size of the client's financial instrument portfolio exceeds €500,000;
- The client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

Investors in a QIAIF must certify in writing to the fund manager that they meet the minimum criteria listed above and that they are aware of the risks involved in the proposed investment and of the fact that inherent in such investments is the potential to lose all of the sum invested.

7.4.2 Real Estate Investment Trusts (REITs)

Real Estate Investment Trusts (REIT) are a special type of alternative investment fund (AIF) which invests predominantly in rental investment properties.

In Ireland, the term REIT means a property investment company established in the State which is listed on a stock exchange in an EU member state in which investors hold ordinary or preference shares, and which complies with the following restrictions:

- At least 75% of the fund's income derives from carrying on property rental business;
- At least 75% of the fund's assets relate to its property rental business;
- The fund's property rental business relates to at least three properties, the market value none of which is more than 40% of the total market value of all the rental properties in the fund;
- The fund's debt should not exceed the value of its business assets by more than 50%;
- The fund's annual debt financing costs must be no more than 25% of its annual property income;
- The fund must have diversified share ownership; and
- The fund pays out annually to shareholders by way of a dividend, at least 85% of its annual property income.

7.4.3 Absolute Return Funds

Absolute return funds are sometimes referred to as *target return funds* as they strive to achieve an absolute positive return, and not a relative return (for example, to outperform a stock market index, etc). Many Absolute Return funds aim to achieve a positive absolute return using Cash as a benchmark over a particular timeframe, typically 3 to 5 year rolling periods.

Absolute return funds aim to produce these returns in both rising and falling markets and so can also use complex derivative instruments in order to achieve their returns. With many Absolute return funds 'Cash' would typically be referenced to a 1 or 3 month Euribor rate.

7.4.4 Hedge Funds

Hedge funds are funds which aim to produce returns principally by speculating on differences or anomalies in investment markets (referred to as *arbitraging*), and therefore aim to produce a return not directly linked to overall stock market returns, that is, a hedge fund will aim to achieve a positive return even in falling investment markets. Hedge funds therefore generally hope to achieve a return uncorrelated to market returns.

However, the term *hedge fund* can cover a wide variety of different investment styles and assets.

One particular technique used by some hedge funds is *shorting* shares. Shorting refers to *short selling* that is, selling stock the fund does not actually own at that time in the expectation that the stock price will fall in value and so can be bought back cheaper later and therefore generate a profit for the fund.

Example

Hedge Fund A does not own shares in Grove Oil, a mythical company which we will assume is quoted on the stock exchange.

Grove Oil's current share price is €3. Let's say the fund managers of Hedge Fund A believe the price will fall.

They may sell large amounts of Grove Oil shares at, say, €3, borrowing the amount of Grove Oil shares it has sold, and hope to buy back the shares at a later date at, say, €2.50 per share or lower, and so make a turn on the transaction.

Of course, *shorting* a share, as outlined above, does contain a risk, the risk that the share price may not, in fact, fall in price and might actually increase in price thereby causing a loss for the hedge fund. In the example above, Grove Oil's shares increase in price to €3.30, causing the hedge fund who wants to unwind its position to buy shares at €3.30 to match the shares it sold at €3.00, causing a 10% loss.

Hedge funds can, depending on the nature of the investment approach being taken, be highly speculative and risky funds.

Investors in such funds are typically high-net-worth individuals and/or institutional type investors such as pension funds. The minimum investment in such funds could be €100,000 or €250,000, or even higher in some funds.

7.5 Exchange Traded Funds (ETFs)

7.5.1 What is an Exchange Traded Fund?

An exchange traded fund (ETF) is an open ended PRIIP (usually an investment company or a unit trust) in which investors can buy or sell shares or units in the fund on a stock exchange. It is normally a UCITS where the fund is domiciled in the EU, or a non-UCITS fund, if domiciled outside the EU.

ETFs typically aim to replicate the performance of a specific index of securities (for example, a particular stock market index, but can be any index of securities) and typically incur much lower fees than actively managed funds investing in similar securities. Because there is no active investment management involved, total expense ratios (TERs) or Ongoing Charge Figures (OCF's) of ETFs are as low as 0.2% per annum. This compares with typical TERs of 1.5% ~ 2% per annum for actively managed funds.

The total expense ratio (TER) of a fund is the ratio of the fund's total operating costs to its average net assets. Total operating costs include not just the annual fund management charge, but also performance fees, legal, auditing, trading and custodian fees. It is a more accurate measure of the costs incurred by an investor in a fund, than the fund's annual management charge only.

An ETF provides investors with exposure to a diversified basket of securities making up the relevant Index, through the purchase of one share or unit in the fund.

ETFs were first introduced in the early 1990's in the United States and Canada and since then the number of ETFs traded worldwide and the value of funds invested in ETFs has increased substantially.

There are an increasing number of ETFs covering all the main stock market and other Indices of securities.

7.5.2 Structure of ETF

ETFs are deemed to be a PRIIP and are structured as a unit trust or an investment company, listed on a stock exchange. Most are investment companies, so that an investor buys a share in that company.

There are two main forms of ETFs:

- Those which hold *physical* securities to match the relevant index whose return the ETF is tracking. For example, if an ETF is tracking the EURO STOXX 50 index of European shares, it will hold a portfolio of such shares in the same proportion as the index with a view to replicating the return provided by the index.

- Those which do *not* hold physical securities to match the relevant index but instead hold a different portfolio of securities and enter into a *swap* agreement with a financial institution (or possibly more than one) which undertakes to provide the fund with a return identical to the index which the ETF is following. ETFs of this design are sometimes referred to as *swap* ETFs.

  This financial institution with whom the ETF provider enters into the swap agreement is therefore a *counterparty* to the ETF, and so investors in the ETF are subject to the *counterparty risk,* that is, the risk that the financial institution with which the ETF has entered into the swap agreement will default on its obligation to the ETF and hence in turn the ETF may fail to produce the return produced by the relevant index for an investor in that ETF. However, ETFs which are UCITS have a maximum counterparty risk exposure to a particular credit institution of 10% of the value of its assets.

  Counterparty risk is not a risk that investors in physical ETFs are generally exposed to, as such ETFs hold a portfolio of securities identical (as far as possible) to the make-up of the relevant index. They are therefore not depending on another financial institution to provide the index return. However, investors in physical ETFs may be exposed to a form of counterparty risk to the extent the ETF engages in stock lending, that is, lending some of its securities to hedge funds and others for a short period in return for a fee.

7.6 PRIIP Fund Charges

The charges involved in an investment of a lump sum in a PRIIP fund may be broken down to one or all of the following:

Initial Sales Charge

Some funds may impose an initial specific charge on the purchase of units, for example, a fixed monetary charge or a charge as a percentage of the sum invested. Other funds may impose a sales charge through operating two prices on a day, an offer price at which units are sold to investors, and a lower bid price at which units are encashed on that day.

Fund Management Charge

This is an annual charge taken within the fund *before* the unit/share price is set. A typical *management charge* might be up to 1.5% per annum for an actively managed fund, but significantly lower for passive funds.

Some funds may also provide an additional *performance fee* for the manager, if the fund produces a return over a specified period (for example, one year) in excess of a hurdle or benchmark rate of return over that period. Typically, a performance fee will be 20% of the excess return over the hurdle return.

The hurdle or benchmark rate may be linked to money market interest rates. For example, a fund may have a hurdle rate of, say, 4%. If the fund produces a return over the year of, say, 15%, the performance fee payable out of the fund to the fund manager may be 20% x (15% - 4%), that is, 2.2% of the value of the fund.

Fund Dealing Costs

Every time a fund buys and sells a share or other asset, that is, referred to as *dealing*, costs will be incurred. For example, stamp duty of 1% applies to the purchase of Irish shares, and stockbrokers also charge a commission or fee for handling the purchase or sale of a share.

Stamp duty and legal fees also apply to the purchase of property by PRIIP.

Property Type	€	Rate
Residential	First €1m	1%
Residential	Excess €1m	2%
Non-residential	All	7.5%

There are also costs incurred by the fund in holding and securing the assets which the fund owns. These are usually held by a custodian.

However, these fund costs are deducted within the unit fund before the unit price is set. They are therefore not directly visible to the client and are sometimes referred to as *implicit charges*.

Administration Charges

The fund will incur other charges such as custodian, auditing, and various professional services fees.

Exit Charge

Some funds impose a reduction in the value where units are encashed within an initial period, for example, during the first five years, or at any time.

Trail Commission Deduction

Some funds may provide different remuneration and commission options to introducing intermediaries. Some of these options may involve the intermediary taking an ongoing commission related to the value of the investors holding in the fund in which the client has invested. This type of commission is frequently referred to as a *trail commission*, as it lasts as long as the investment term. A typical trail commission might be 0.5% per annum of the fund, but it could be lower or higher than this in some cases.

Some funds pay this trail commission by way of a regular unit cancellation or deduction from an investor's holding, which would be mandated directly by the client.

Other funds may pay this trail commission from their own margin and do not impose any specific additional charge for the commission.

Total Expense Ratio (TER)

All UCITS funds must publish on a yearly basis the Total Expense Ratio (TER) for the fund. This is intended to help the investor compare the total costs incurred each year by different funds.

The TER includes the management fees and expenses (including any performance fees), administration fees and expenses, Custody fees, Audit fees, distribution (For example; commission) or marketing costs, legal fees, registration and regulatory fees, and remuneration payable to the management company or investment manager (or other party) under any fee-sharing arrangement.

However, the TER does not include some other costs, in particular fund dealing costs. For a fund that is very actively traded, there may be a high level of trading of the underlying assets, and these costs are not captured by the TER.

Ongoing Charge Figures (OCF)

The ongoing charges figure is another way of conveying similar information to the TER and includes operations or remunationary costs borne by the UCITS. These costs may be expressed or calculated in a variety of ways, for example; as a flat fee, a proportion of assets, a charge per transaction, etc.

The following list is indicative but not exhaustive of the types of ongoing charge that, if they are deducted from the assets of a UCITS, shall be taken into account in the amount to be disclosed:

(a) all payments to the following persons, including any person to whom they have delegated any function: - the management company of the UCITS - directors of the UCITS if an investment company - the depositary - the custodian(s) - any investment adviser;

(b) all payments to any person providing outsourced services to any of the above, including: - providers of valuation and fund accounting services - shareholder service providers, such as the transfer agent and broker dealers that are record owners of the UCITS' shares and provide sub-accounting services to the beneficial owners of those shares;

(c) Other operational costs such as registration fees, regulatory fees and similar charges, audit fees, payments to legal and professional advisers and any costs of distribution.

7.7 Taxation of Returns

How returns from investing in PRIIPs are taxed in the hands of an investor, can depend on a number of factors including:

- Where the fund is established;
- The type of fund;
- The type of return received, that is, income or capital.

7.7.1 Irish Based Funds

Irish based unit trusts and life assurance unit linked funds, generally operate on the *gross roll up* basis, that is, investment returns grow or roll up within the fund tax free, but an *exit tax*, currently charged at a rate of 41% on the growth of the investment, is applied by the fund manager from the payment of income distributions to an Irish resident investor and from *chargeable gains* realised by an Irish resident investor on certain *chargeable events*, that is:

- On actual encashment of units;
- On *deemed encashment* of units every eighth anniversary of the investment, when the investment is, for tax purposes, deemed to be encashed and reinvested leading to a deduction of exit tax from any notional gain deemed to be realised on that date.

There are a number of differences between Irish unit linked funds and Irish based unit trusts in relation to what is and what is not a chargeable event giving rise to a possible exit tax charge:

Is it a chargeable event?

	Irish Unit Linked Funds	Irish Unit Trusts
Assignment to a financial institution as security for a loan.	No.	Yes.
On Death.	Yes, but excluding any policy benefit payable only on death.	No, but a chargeable gain may arise on transfer of units/shares to a non-spouse/civil partner of the deceased.

In broad terms, the exit tax rate applying to individual investors in Irish based unit trust and unit linked funds is as follows:

	Unit Trusts	Unit Linked Funds
On income distributions, that is, not an encashment of units/shares.	41%.	Life company unit funds do not distribute investment income separately to investors. Any payment involves encashment of units.
Chargeable gain on encashment of shares/units, actual or deemed (every eighth anniversary).	41%.	41%.
PRSI on returns.	No.	No.
USC on returns.	No.	No.

Irish resident **corporate investors** benefit from a reduced exit tax rate of 25%, if they have completed an appropriate declaration including supplying their tax reference number.

A penal exit tax rate of 60% applies to personal portfolio investment undertakings (PPIUs), which are collective funds where the selection of the assets of the undertaking or fund was or can be influenced directly by the investor.

In broad terms, a chargeable gain is calculated as the monetary gain made on encashment, or deemed encashment, of the units/shares. The following are a series of examples of how Exit tax is applied to UCITS investments.

Example #1

Joe invested €50,000 in a PRIIP in 2018. He encashed the investment for €56,000 in June 2024.

Exit tax of 41% x (€56,000 less €50,000), that is, 41% x €6,000 = €2,460, will be deducted from the encashment and €53,540 paid to Joe.

Example #2

Joe invested €50,000 in a PRIIP in 2016. The investment is worth €61,000 on its eighth anniversary in 2024. As eight years have elapsed, a deemed encashment is assumed.

On its eighth anniversary exit tax of 41% x (€61,000 less €50,000), that is, 41% x €11,000 = €4,510, will be deducted from the investment, hence reducing its value to €56,490.

Note that **switching units/shares** in the following circumstances is *not* a chargeable event for exit tax purposes:

- From one unit linked fund to another within the *same* life policy;
- From one sub-fund to another sub-fund within the *same* umbrella fund structure.

Example #3

Joe invested €50,000 in an equity fund in an umbrella PRIIP in 2018. In June 2024 when its value was €56,000, Joe switched his equity fund units for bond fund units of equivalent value within the same umbrella fund structure.

The switch is not a chargeable event for exit tax purposes and hence no exit tax is deducted on the switch. Exit tax will apply in the normal way when the investment is eventually encashed or the eighth anniversary happens.

Where an investor makes a **partial encashment**, the chargeable gain is calculated based on the proportion of the investment encashed.

Example #4

Joe invested €50,000 in an Irish unit linked fund in 2019, at which time he secured 50,000 units at a €1 unit price in the relevant fund. In June 2024 when the unit price was €1.25 and his investment worth €62,500, he opted to take a partial encashment (before exit tax deduction) of €5,000 to pay for a holiday.

Joe is deemed to be encashing €5,000/€62,500, that is, 8% of his investment and so 8% of the original investment amount is allowed as a deduction in working out the chargeable gain on the partial encashment, that is, the chargeable gain is:

€5,000 – 8% x €50,000 = €1,000

Exit tax of 41% x €1,000 = €410, will be deducted from the partial encashment of €5,000 and €4,590 paid to Joe.

Note that losses on Irish based PRIIPs:

- Cannot be offset against gains on other similar funds unless all the funds are held within the same policy or umbrella investment fund;
- Cannot be offset against chargeable gains for capital gains tax purposes arising from other investments such as shares or property.

Example #5

Joe invested €50,000 in an Irish PRIIP A in 2018. He encashed the investment for €48,000 in June 2024. Also, in 2024 Joe encashed another separate PRIIP B with a different financial institution, which gave rise to a chargeable gain of €6,000.

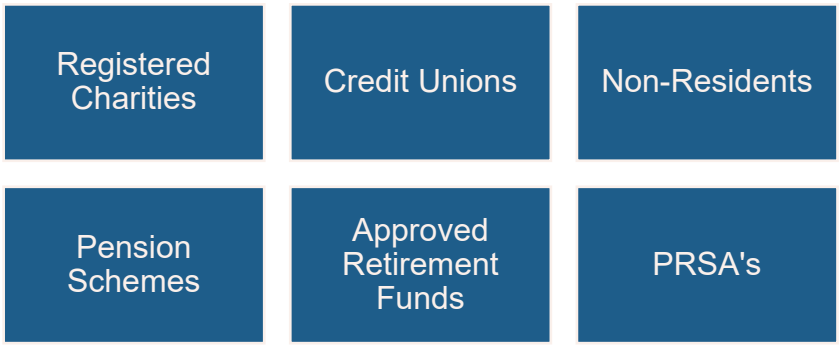
Joe cannot offset the loss on Fund A against the gain on Fund B because they are different investments. Exit tax of 41% x €6,000, that is, 41% x €6,000 = €2,460, will be deducted from the encashment proceeds of Fund B.

Example #6

Joe invested €50,000 in a PRIIP in 2016. He encashed the investment for €42,000 in June 2024. Also, in 2024 Joe sold shares giving rise to a chargeable gain of €5,000.

Joe cannot offset the loss on the PRIIP against the gain on the sale of the shares for capital gains tax purposes.

Certain investors are ***exempt*** from exit tax deduction on chargeable gains arising under an investment in a PRIIP, subject to completing an appropriate Revenue declaration; these include:



Some investors are entitled, in certain circumstances, to **reclaim** from Revenue any exit tax deducted from a chargeable gain on an investment in a PRIIP, these include:

- Individuals who are permanently and totally incapacitated can reclaim the exit tax arising from the investment of compensation awards as a result of personal injury, where the investment returns are the sole or main income of the individual;

- Trusts set up by public subscriptions for the benefit of individuals who are permanently and totally incapacitated can reclaim the exit tax arising from the investment of the trust funds, provided the income from the trust or the investment returns from the investment of the trust funds is the sole or main income of the individual;

- Individuals who received compensation awards for thalidomide children or as a result of Magdalene Laundry claims, can reclaim the exit tax arising from the investment of such awards.

In each case above where the exit tax is reclaimable from the Revenue, the life company or fund MUST deduct the exit tax in the normal manner, but the investor can then reclaim the tax from the Revenue in their tax returns.

Returns from Irish based funds are not subject to USC or PRSI in the hands of an individual investor.

7.7.2 Irish Based Exchange Traded Funds (ETFs)

Because shares in an Irish based ETF are bought and sold on the stock market, exit tax is not deducted from realised chargeable gains or income distributions.

An Irish resident investor must therefore, make a self-assessment tax return of the income and gains, including gains arising under the deemed disposal, and pay income tax at the rate of 41% on all such income and gains.

Gains are worked out in the same way as for Irish based PRIIPs, as outlined above.

Returns are not subject to PRSI or USC.

7.7.3 Irish Real Estate Investment Trusts (REITs)

Returns from REITs established in the State are *not* subject to the exit tax system outlined above for Irish PRIIPs:

- Investment income and gains roll up tax free within the REIT company;

- Dividends are taxable in the hands of an individual investor at marginal rate income tax, and subject to USC and PRSI;

- Any gain made on disposal of shares will be a chargeable gain for capital gains tax (CGT) purposes, potentially liable to CGT applied at a rate of 33% currently, subject to the use of the €1,270 annual CGT exemption and offsetting of any other allowable losses for capital gains tax purposes.

7.7.4 Offshore Exchange Traded Funds

Where an Irish resident investor invests in exchange traded funds (ETFs) established in another country which is a member of the EU/EEA/OECD, the tax treatment is the same as for an Irish Fund, provided it is 'equivalent'. They must be similar in all material respects to an Irish fund.

In all other cases returns are taxed in the same way as any share investment, that is:

- Dividends are subject to income tax at marginal rate, USC and PRSI (where applicable); and

- Gains are liable to capital gains tax at 33%, after allowing for allowable losses and the annual €1,270 exemption.

This is sometimes referred to as *income and capital gain tax* treatment. Currently it appears more beneficial than the normal PRIIP fund tax treatment in three ways:

- Income tax on dividends will be either at nil, 20% or 40% (depending on the Irish taxpayer's income and allowances) whereas a fixed 41% tax charge applies normally;

- Gains realised are currently taxed at a maximum rate of 33%, compared to a fixed 41% for gains normally; and

- Capital Losses made on other assets such as property may be offset against gains realised, whereas losses within a normal ETF cannot be offset against any other gains.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- What is a Packaged Retail and Insurance-based Investment Product? ☐
- Types and structures of PRIIPs ☐
- PRIIPs Regulation ☐
- UCITS ☐
- Alternative investment funds (AIFs) ☐
- Exchange traded funds (ETFs) ☐
- Fund choice and investment management ☐
- Charges ☐
- Taxation of returns ☐
- The benefits of investing in PRIIPs ☐
- The disadvantages of investing in PRIIPs ☐
- The limitations on investing in PRIIPs ☐
- The risks of investing in PRIIPs ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. Investors in an Exchange Traded Fund (EFT) which does not hold physical securities to match the index it is tracking, are consequently exposed to WHICH type of risk?

   A. Counterparty.
   B. Inflation.
   C. Liquidity.
   D. Interest rate.

2. Jack is self-employed and has just encashed, at a profit, an investment he held in an Irish Packaged Retail & Insurance based investment product (PRIIP) Jack's gain on this investment is NOT liable to which of the following:

   (i) Capital Gains Tax.
   (ii) USC
   (iii) PRSI.

   A. (i) only.
   B. (i) and (iii) only.
   C. (ii) and (iii) only.
   D. (i), (ii) and (iii).

3. In their Key Information Document (KID) Packaged Retail and Insurance based investment products (PRIIP) are graded by their risk and reward profile into which number of different categories?

   A. 4
   B. 5
   C. 6
   D. 7

4. A UCITS Key Investor Information document shows which of the following charges?

   (i) Entry.
   (ii) Ongoing.
   (iii) Performance Fee.

   A. (ii) only.
   B. (iii) only.
   C. (i) and (ii) only.
   D. (i), (ii) and (iii).

08

Employee Share Incentives

This short chapter introduces three tax incentive schemes where employees can invest in shares of their employer's company. These schemes are Save as you Earn (SAYE) schemes, Approved Profit Sharing Schemes and Key Employee Engagement Programme, (KEEP),

The nature of the tax treatment is explained.

Learning Outcomes – after studying this chapter you should understand:
the save as you earn (SAYE) scheme for investing by employees in shares of their employer;
the approved profit sharing schemes for employers to provide shares in their company to their employees;
the Key Employee Engagement Programme; and,
how returns from such schemes are taxed in the hands of the employee.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	8	3	5

8.1 Introduction

There are a number of tax incentive schemes whereby employees can invest in shares of their employer's company in certain circumstances. In this textbook we cover the 4 principal schemes:

- Save as you Earn (SAYE) schemes;
- Approved profit sharing schemes;
- Key Employee Engagement Programme;
- Restricted share schemes.

8.2 SAYE Schemes

The term *SAYE* is a short name for *save as you earn*, which in turn is a shortened name for a savings related share option scheme set up by an employer for its employees, under a scheme approved by the Revenue Commissioners.

8.2.1 Features

Such a scheme is composed of two elements:

- A *certified contractual savings scheme (CCSS).*

  A CCSS is a scheme where an employee agrees to save a monthly amount from *after tax income*, of between €12 and €500 per month for a chosen period, typically three or five years Where a five-year-term is chosen, the savings may be left on deposit for a further two years at the end of the five-year-term.

  The end of the target period is called the bonus date. Any interest or bonuses added at that date is tax free and not subject to DIRT. This applies regardless of whether or not the employee uses the CCSS funds to buy shares in the company.

  Monthly contributions to the CCSS must be sufficient to secure, as nearly as possible, repayment of an amount equal to the amount required to pay for as many shares as the individual has the right to acquire under the share option scheme.

- An *approved savings related share option scheme.*

  An approved savings related share option scheme is a scheme set up by an employer under which an employee is given an *option* to purchase shares at a fixed price (which cannot be less than 75% of the market value of the shares at the time of granting the option) at a particular time.

  The option must not be capable of being exercised before the bonus date under the contractual savings scheme. The accumulated savings plus bonuses can then be used by the employee to exercise the option and buy the shares within six months of the end of the chosen savings period.

  The savings amount in the CCSS must be broadly sufficient to buy the anticipated number of shares granted under the option. Only funds from the CCSS can be used to buy shares under the option, other funds cannot be used.

8.2.2 Benefits

- No income tax is charged on the granting or exercise of the option to buy shares, even if the option price is below the value of the shares at the time of exercise of the option.
- The option price of the shares can be set at 75% of the current share price. Therefore, even if there is no growth in the share price over the period, there is still a capital gain to be made.

An example will illustrate how the scheme works.

Example

Mr A works for a large quoted company, ABC Ltd, who have set up a Revenue approved SAYE scheme.

Mr A agrees to save €100 per month under the SAYE scheme for three years, which will be deducted monthly from his after-tax income. The savings will be deposited with a bank which promises a fixed bonus of 2 x monthly contribution, that is, €200, at the end of the three-year period.

Therefore, in return for €100 per month, the bank promises, Mr A, a fixed sum of €100 x 38, that is, €3,800 after three years, under the CCSS.

ABC Ltd also grants Mr A an option to buy 4,750 shares in ABC Ltd, at a price of 80c, after three years. The market price at the time of the option is €1, so the discount to the market value is 20%. Therefore, based on the current price and the option price, the €3,800 maturity value would finance the purchase of 4,750 shares at the option price of 80c on exercise of the option after three years.

The tax position is as follows:

- Mr A has no income tax liability on the granting of the option;
- Mr A earns a tax-free investment return on savings made to the CCSS with the bank.

After three years:

- The CCSS matures and pays Mr A €3,800, tax free.
- The share price of ABC Ltd is, let's assume, €1.90. Mr A could exercise his option to buy 4,750 shares at 80c, at a cost of €3,800. No income tax liability arises on the exercise of the option.

Mr A could decide to immediately sell the resulting 4,750 shares at €1.90 to realise an immediate profit of €9,025 - €3,800 = €5,225.

This gain would be liable to capital gains tax of 33% x €5,225, that is, €1,724 but Mr A may be able to use his €1,270 annual CGT exemption to reduce the tax liability to 33% on €3,955, that is, €1,305. So, Mr A, in this example, has made a gain of €5,225 on which there is a CGT tax liability of just €1,305 and no income tax liability at all. However, there is a liability to PRSI and USC (see below).

If ABC Ltd.'s share price had fallen, Mr A does not have to exercise the option and can retain the €3,800 savings tax free from the CCSS.

SAYE schemes represent a form of each way bet for an employee, if the share price increased over the option price, then the employee can exercise the option and make an immediate capital gain taxable at just 33% maximum or opt to hold onto the shares.

If the share price decreases, the employee still benefits from the tax-free guaranteed investment returns.

8.2.3 Limitations

- Savings level restricted to €12 - €500 per month. The monthly contribution is fixed from the outset and cannot be changed.
- Scheme terms are restricted to three five or seven years. The individual must continue saving for the nominated period to be able to avail of the share options.
- Only employees of participating approved companies can avail of the scheme.
- Must exercise option within six months of end of savings period.
- Participation typically linked to service/salary levels.

8.2.4 Risks

- Employer non-compliance with rules of the scheme.
- The company shares perform poorly so that the opportunity for a capital gain disappears. Of course, the savings amount is still available.
- Option having no value. Depending on the rules of the scheme, it may or may not be possible to exercise options on leaving employment with the company. Although can withdraw their savings including interest earned, tax free.

Taxation (PRSI and Universal Social Charge)

Employees (but not employer) PRSI and the universal social charge are levied on any gain realised on the exercise of the option.

8.3 Approved Profit Sharing Schemes (APSS)

8.3.1 Features

An *approved profit sharing scheme (APSS)* is an arrangement set up by an employer to provide a means of allowing employees to acquire shares in the company, which must be quoted on a recognised stock exchange, so that:

- The amount paid by the company to set up the scheme and acquire the shares for the Scheme is tax deductible for the employer;
- The market value of shares appropriated to an employee under the scheme are free from income tax up to an annual limit of €12,700 per annum.

The scheme must be established under trust, the scheme and trust deed of which must be approved by Revenue.

The employer provides funds to the trustees each year to enable them to purchase the appropriate number of shares on behalf of the employees participating in the scheme.

Although the trustees legally hold the shares, the shares are beneficially allocated to each participating employee or director. The employee or director will receive the dividends from the shares allocated to him or her under the scheme. Such dividends will be liable to income tax at his or her marginal rate.

8.3.2 Benefits

Opportunity for an employee to acquire shares in his/her employer's company in a tax efficient way.

Tax efficiency can be achieved, if, the shares appropriated to the individual under the trust are not disposed of within three years of the shares being appropriated, then no income tax charge applies to the subsequent disposal of such shares by the individual.

If the shares are disposed of by the individual before this three-year period expires, then the individual is charged to income tax on 100% of the *lower* of:

- The market value of the shares at the date of appropriation; and
- The sale proceeds.

So, for example, if the shares had decreased in value since appropriation, and the shares are disposed of by the individual within the three-year period, then the income tax charge would relate to the lower sale proceeds, rather than the higher value originally appropriated to purchase the shares.

When a member of the scheme ceases to be employed due to injury, disability or redundancy, or reaching pensionable age, the shares can be sold immediately, and in such circumstances the income tax charge is related to 50% of the original value of the shares (or the sales proceeds if less).

8.3.3 Limitations

- Qualifying period for employees cannot exceed three years of service.
- Allocation based on length of service / level of basic salary.
- An employee may be allocated shares up to a maximum annual limit of €12,700.
- The value of the appropriation to the employee is tied up for three years. In some instances the employee may have preferred to get immediate access to a cash bonus, albeit fully taxable.

8.3.4 Risks

- The price of the shares may fall. If they fell so significantly to wipe out the tax benefits, then the employee might have been better off taking the benefit in taxable cash bonus instead.
- Retention period: Under the APSS the shares are held in trust for a minimum of two years. After that time, participating employees can dispose of the shares subject to income tax. Alternatively, shares disposed of after three years from the outset will be exempt from income tax, although capital gains tax may apply.

8.3.5 Taxation

The full value of the shares if sold after three years, is free from income tax.

Any dividends received in the meantime on those shares are liable to income tax in the normal way.

PRSI and Universal Social Charge

Employee (but not employer) PRSI and the universal social charge are levied on the initial *market value* of the shares appropriated to the employee under the scheme at the time the shares are appropriated.

Example

John works for a large quoted company, who have set up an approved profit sharing scheme.

Under the scheme, the trustees appropriated shares worth €1,000 to John.

Therefore, the company must impose a PRSI and universal social charge on John related to the market value of the shares appropriated to him, that is, €1,000, at the time of appropriation of the shares.

Capital Gains Tax

The sale of the shares acquired under the scheme is treated as a disposal by the employee for capital gains tax purposes.

Where a potential chargeable gain arises on disposal of shares acquired under such a scheme, the employee may be able to reduce or eliminate the liability by:

- Use of the annual €1,270 CGT exemption, if not already used;
- Spreading the disposal over a number of years to benefit from the annual €1,270 CGT exemption.

8.4 Key Employee Engagement Programme (KEEP)

8.4.1 Features

KEEP – Key Employee Engagement Programme is a share based employee incentive scheme. An employee is granted share options in the company. It is available to certain qualifying small businesses to grant options to certain employees in order to attract/reward/retain them (comparable with larger organisations).

It will allow an employee to participate in a tax efficient way in the growth in value of their organisation and especially if this is a small, young business with growth potential.

While participation in KEEP does not require revenue approval, there are specific conditions that need to be satisfied to obtain the relief, namely: a “qualifying company” carrying out a “qualifying trade” can grant options to “qualifying employees” and these conditions must be satisfied all the way through the period to exercise of the option.

In order to qualify for the KEEP, an option must be:

- Be granted at the market value of the same class of shares at the date of grant;
- Be subject to a written contract of agreement setting out the relevant details;
- Be within the maximum permitted limit in terms of overall awards in the year; in all years of assessment; and annual emoluments;

- Not be exercisable within 12 months from the date of grant;
- Not be exercisable more than 10 years from the date of grant.

8.4.2 Benefits

Helps SME's to attract and retain talent. The scheme allows financial incentives to be given without having to give cash.

8.4.3 Limitations

Value limits apply to granting KEEP options to any one employee, as follows:

- €100,000 in any one year;
- Lifetime limit Max of €300,000;
- Amount of grant cannot be for more than 100% of an employee's total remuneration in any one year;
- The restrictions prohibit many companies from availing of the scheme, for example, financial services companies would not qualify;
- The employee gets a share of the future growth in the company, but does not share in the existing value of the company.
- Liquidity is a significant issue as generally it is not easy to convert shares held in private companies into cash.

8.4.4 Risk

Valuation of the shares and illiquidity of shares will potentially be challenges for the scheme when participants wish to sell.

8.4.5 Taxation

The KEEP scheme allows employees to only be liable to Capital Gains Tax on disposal of the shares[12]. Any tax charge arising will only arise on sale of shares not on the exercise of the option.

This is in contrast to the income tax, USC and employee PRSI which would normally apply on gains arising on the exercise of share options.

[12] *Tax & Duty Manual, Chapter 9, S128F, Revenue.ie*

Example

Katya works for a medium sized enterprise, who granted her an option in April 2020 to acquire 10,000 shares at €1 per share which is the market value of the shares on that date.

In April 2023, the market value of the share increased to €3 per share valuing Katya's option at €30,000 (10,000 x €3). Katya has acquired the shares at the discount of €20,000.

In April 2024, the value of the shares is €4 per share valuing her holding at €40,000 and she decides to sell her shares. Katya pays tax at the marginal rate and has a total income of less than €70,044 per year.

Katya's tax liability is summarised as follows;

10/04/2018: Grant of Option

No Tax Liability

10/04/2023: Exercise of Option

Discount of €20,000. No income tax, PRSI or USC.

10/04/2024: Sale of shares:

Consideration received = €40,000

Consideration paid on Acquisition = €10,000

Chargeable gain = (ignoring annual exemption) = €30,000

CGT at 33% = €9,900

After Tax gain = €20,100

8.5 Restricted Share Schemes

Restricted shares are shares acquired by an employee/director of a company, where there is a "clog" or restriction on the disposal of those shares.

The shares are held in a trust established by the employer for the benefit of the employee for a specified period of at least one year. During this period the employee is restricted from selling the shares. The only exceptions allowing for a disposal during the "clog" period include the death of the employee or on a merger or acquisition of the company such that the employee receives an offer for the shares.

The employee in this case is getting shares that have an existing value. This is in contrast with the KEEP scheme where they get no benefit from the options unless the share price appreciates.

However, a disadvantage is that tax is payable upfront on the deemed value of the grant, albeit the amount chargeable is significantly reduced.

Instead of charging the employee/director income tax (plus PRSI and USC) on the full amount of the difference between the market value of the shares at the date of acquisition and the price (if any) paid by the employee/director, the amount chargeable is reduced by between 10% and 60% depending on the period of restriction. No Employer PRSI is payable.

Period of restriction (years)	% Reduction
1	10%
2	20%
3	30%
4	40%
5	50%
More than 5	60%

Example

Mary works for Tablet Engineering, and is granted 1,000 shares in the company at no cost. Their current market price is €10 per share. Mary is a higher rate taxpayer.

The restricted' or 'clog', period is 6 years.

Value of shares at outset	€10,000
Net of 60% 'clog' discount	€4,000
Tax payable 40% +USC 8% +4% PRSI =	€2,080

In 6 years time Mary can sell the shares. CGT is payable at that stage on the difference between the sale price and the purchase price, the latter deemed to be €4,000.

In addition, for an individual who is a minority shareholder in a private company, it can be argued that a minority discount of up to 70% could apply. This would reduce further the level of income tax payable at the outset.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- SAYE schemes ☐
- Approved profit-sharing schemes ☐
- Key Employee Engagement Programme ☐
- Restricted Share Schemes ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. Under the Key Employee Engagement Programme (KEEP) the amount of grant to any individual employee in any one year cannot be more than which of the following as a percentage of the individual's total remuneration?

   A. 50%
   B. 75%
   C. 100%
   D. 150%

2. Patricia has sold shares she acquired under an Approved Profit-Sharing Scheme at a profit. She is a higher rate taxpayer. How will this gain be taxed?

   A. Exit tax at 41%.
   B. Income tax at 20% (standard rate).
   C. Income tax at 40% (higher rate).
   D. Capital Gains Tax at 33% (after allowing for the annual exemption).

3. An approved profit-sharing scheme must be established under trust and approved by:

   A. the Revenue.
   B. the Central Bank.
   C. company employees.
   D. the stock exchange.

4. Investment returns earned in the Certified Contractual Savings Scheme (CCSS) element of a SAYE scheme are:

   A. taxable, but not liable to DIRT.
   B. liable to DIRT.
   C. income tax free.
   D. tax free, if the funds are used to buy shares.

09

Tracker Bonds & Structured Retail Products

This chapter looks at Tracker Bonds and the two different types, Life Assurance Tracker and Deposit Tracker Bond. The construction of a Tracker bond product is explained and the two component elements are reviewed, the percent guaranteed and the potential bonus payable at maturity.

The prevailing interest rate environment has led to an increase in the development of more complex products known as SRPs -Structured Retail Products.

SRPs are introduced in this chapter and some of their common characteristics, benefits and risks are discussed.

Learning Outcomes – after studying this chapter you should be able to:
understand the structure of deposit and life assurance tracker bonds;
explain how returns from tracker bonds are taxed in the hands of an investor;
outline the benefits, limitations and risks of investing in tracker bonds; and,
understand that there are a wide range of structured retail products (SRP's) available to investors carrying differing levels of risk.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	9	5	7

9.1 Introduction

The Central Bank's Consumer Protection Code defines a tracker bond as follows:

> *"…a deposit or life assurance policy which has either or both of the following features:*
>
> *a. It provides for a minimum payment, at the expiration of a specified period of time, of a specified percentage of the amount of capital invested by the consumer in the product;*
>
> *b. It provides for a potential cash bonus payable after a specified period of time, which is linked to, or determined by, changes over the period of investment in the level of one or more recognized stock market indices, commodity prices, any other recognized financial indices or the price of one or more securities specified at the outset or from time to time.*

This chapter looks at the two different forms of tracker bonds:

- Life assurance;
- Deposit.

9.2 Life Assurance Tracker Bonds

Life assurance companies offer investment bonds, often referred to as tracker bonds, that aim to allow investors to participate in investment market returns with the benefit of a high level of capital guarantee. These types of bonds can also be offered by banks as a form of deposit.

They are fixed term bonds, usually between three to six years.

9.2.1 Features of a Life Assurance Tracker Bond

Typically, such bonds offer two benefits to the investor:

- A guaranteed return of a specified proportion (usually 90% to 100%) of the capital sum invested on maturity of the bond at the end of the fixed term,

AND

- A bonus payable at the end of the fixed term, related to a certain percentage (referred to as the *participation rate)* of the rise, if any, in some specified stock market index or a basket of indices or specific shares. It should be noted that most Tracker bonds offer the bonus return based on Capital growth only of the reference index (e.g. S&P 500) and typically does not include any dividends payable over the term. As outlined in a previous chapter, dividends account for a high percentage of the overall return from Shares in the longer term and so this should be clarified and taken into account when assessing or comparing any such investment offerings.

Sometimes the bonus is limited or capped to a maximum figure. Exit tax at 41% is applied to any bonus payable at maturity over and above the repayment of the capital sum invested (see Chapter 9.5). Of course, if the chosen index or indices or shares do not rise over the period, there may be no bonus payable on maturity.

Example #1

A tracker bond has a term of three years and six months. It offers:

- A capital guarantee of 100% of the capital invested, payable at the end of the 3½-year term; and
- A bonus of 80% of the rise in the S&P 500 —US stock market index over the period, to a maximum bonus of 34%, that is, investor can't get more than a 34% bonus.

At the end of the period let's assume that the rise in the index over the period was 50%.

An investor who invested €100,000 would get back at the end of the 3.5-year term:

- €100,000 capital, that is, the 100% capital guarantee, and
- A bonus of 80% x 50% capped at 34% of €100,000, that is, €34,000 gross, which would be subject to exit tax, currently, at 41%, that is, exit tax of €13,940 to give a net bonus of €20,060.

Therefore, the investor, in this example, gets back a total of €120,060 at the end of the 3.5-year term.

Take the same example, where the index falls over the period.

Example #2

A tracker bond has a term of three years and six months. It offers:

- A capital guarantee of 100% of the capital invested, payable at the end of 3.5-year term; and
- A bonus of 80% of the rise in the S&P 500 —US stock market index over the period, to a maximum bonus of 34%, that is, investor can't get more than a 34% bonus.

At the end of the period let's assume that the index falls over the period by 25%.

An investor who invested €100,000 would get back at the end of the 3.5-year term:

- €100,000 capital, that is, the 100% capital guarantee; and
- No bonus, as the index did not grow in value.

The investor therefore, in this example, gets back a total of €100,000 at the end of the 3.5-year term.

The terms of each tracker bond will vary. There is usually a trade-off between the extent of the capital guarantee given, the investment term, and the maximum potential bonus. Some life companies may offer a range of options regarding these features.

Increasingly, more and more complicated formulae are being used in tracker bonds to determine the bonus payable. Some bonds may headline what may seem to be very attractive participation rates and maximum bonus rates. However, in some case the bonuses are highly conditional; for example, a bonus may be payable if, say, all 30 shares in a specified basket of shares increase in value by at least a specified percentage, and, if even just one share fails to make the threshold growth rate required, no bonus or a substantially reduced bonus is payable.

Traditionally tracker bonds have fixed participation rates, that is, the percentage of the rise in the relevant index or indices payable as a bonus (usually subject to a maximum rise) is fixed at the outset and cannot change.

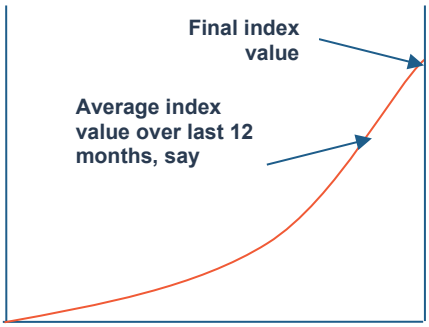
However, some tracker bonds may have a *dynamic* or changing participation rate, which varies over the term of the bond according to some defined formula or basis, for example, changes in interest rates, volatility of the chosen indices, etc.

9.2.2 Averaging of Indices

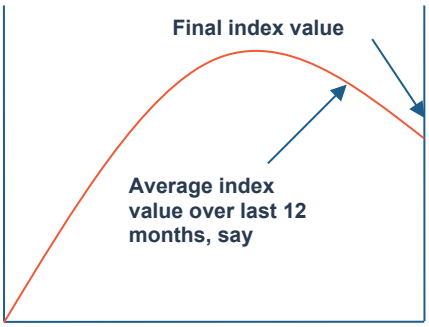
For the purpose of calculating the change in a particular index over the term of the bond, the index value at the end of the term may be averaged over a period, for example, over the last 12 months. So, in other words, on maturity of the bond, the closing index value is not taken, but an average value over the previous, say, 12 months. In limited instances bonds may well also include averaging at the start, where you could have 6 months averaging at the start and 12 months at the end.

This can work out to investor's benefit if the index falls sharply in value just before the bond matures as, in that case, the higher average index value would be used, rather than the lower index value on the day of maturity.

Of course, averaging of the closing index value can also work against the investor. If the index in question is rising sharply coming up to the maturity of the bond, in that case the lower average index value would be used, rather than the higher index value on the day of maturity.



Index rising up to maturity



Index falling up to maturity

Some bonds may have an alternative *lock in* facility whereby the index value to be used to calculate the bonus at maturity is locked in at certain durations or at certain times, so that a subsequent fall in value of the index does not reduce the bonus payable at maturity.

9.2.3 Structure

The investment made by the investor in a tracker bond is split into three components:

- **Step 1 Provision of the Guarantee**: Most of the money is **invested to provide the capital guarantee at maturity of the bond**. This is achieved by determining how much money we need to invest today, at prevailing interest rates, over the period of the investment to provide our capital guarantee. The lower interest rates are, the more money we need to invest to provide the guarantee. When interest rates are very low the term of such Tracker bonds typically needs to get longer, instead of 3.5 years they might go to 5.5 years.

  Alternatively, if the term can't be pushed out longer, the level of capital security may decrease. Instead of putting enough money away to bring us back to 100%, we may just put enough away to bring us back to 90%. In this instance the bond would advertise a 90% level of capital protection.

  While this table shows how much needs to be invested (interest rate 2%) to provide €1,000 at the end of the bond term, it also highlights the challenge for tracker products in a low interest rate environment. In 2021, we found ourselves in a negative interest rate environment and indeed negative bond yield environment, The consequence being that providers struggle to make such investments readily available to investors,

Term (years)	2% per annum
2	961
3	942
4	923
5	905

  The shorter the term and/or the lower the interest rate, then more of the investment amount needs to be invested to secure the capital guarantee, thereby leaving less to provide the bonus.

  Conversely, the longer the term and/or the higher the interest rate, then less of the investment amount needs to be invested to secure the capital guarantee, thereby leaving more to provide the bonus.

  Generally, the life company will secure the guarantee by investing the funds in a fixed rate deposit with a specified bank, who in effect then provide the guarantee to the investor. If the bank fails to repay the full guaranteed amount to the life company, the life company are not liable to make up the difference to the investor. This risk for the investor therefore, is referred to as the *counterparty risk*.

- **Step 2 Purchase an option, also known as a derivative** or **swap** arrangement: with an investment bank, who in return undertake to pay the bonus, if any, to the life company at the end of the bond term. The actual cost of this arrangement will vary from time to time and according to the nature of the bonus, that is, what index or indices it is linked to, the participation rate, the maximum bonus payable, the term of investment, etc. Many investment banks manufacture indices that are specifically for the creation of Structured products such as Tracker Bonds. In some instances, these may well offer investors the growth potential linked to more obscure indices that can be difficult to find detailed information on. Participation rates can often appear very attractive when attached to such indices.

Where a tracker bond offers less than 100% security, the bonus may well be added to the capital secure amount. So, if a bond has 90% capital security, and advertise a very attractive participation rate, you may find that some bonds will add any earned bonus to 90% of the original investment and not 100% of the investment. If this is the case, the return can look significantly less attractive, and you should always clarify this point when comparing offerings in this Tracker bond space.

Most tracker bonds provide that if the provider of this bonus to the life company defaults on payment of the bonus to the life company, then the bonus is not payable to the investor by the life company and hence the investor would not get the bonus. The investor may therefore run a *counterparty risk* in relation to both the capital guarantee and bonus.

- The **balance is taken in charges**, including the 1% stamp duty payable on all new life assurance premiums.

For example, one specific tracker bond marketed in the Irish market showed the following split of a €10,000 investment:

€9,387	That is, 94%, used to secure the promised payment of €10,000 payable at maturity after five years and one month. This is equivalent to a promised return on this part of the investment of 1.27% per annum, before exit tax is deducted.
€291	That is, 2.9%, used to secure the cash bonus payable at maturity through the purchase of a derivative or through some swap arrangement.
€322	That is, 3.2%, taken in charges (in this case excluding the stamp duty, but sometimes this is included in the charge).
€10,000	

So, tracker bonds are essentially fixed interest term investments as, usually, more than 90% of the investment amount earns a fixed return for the term of the bond, with typically less than 5% of the investment amount being used to secure the bonus payable at maturity, linked to stock market returns.

9.2.4 Access to Funds

Tracker bonds are usually described as *illiquid investments*, that is, usually there is no facility for the investor to encash the bond before the maturity date. Therefore, funds are tied up for the term of the bond.

9.2.5 Death

Tracker bonds may provide no death benefit or provide a limited death benefit. The bond terminates on death.

9.3 Deposit Tracker Bonds

A deposit tracker bond is similar in structure to the life assurance tracker bond described above, except that the investment is a fixed term deposit made by the investor with the bank issuing the bond whereby the deposit provides two returns to the investor at the end of the fixed term:

- A guaranteed return of all or a significant proportion of the capital invested; and

- An interest payment, which could be zero, related to the rise in certain stock market indices or basket of shares. Interest in 2024 is subject to DIRT at 33%.

Some deposit tracker bonds may be bundled with a normal fixed rate fixed term deposit of a similar duration, so that, for example, 25% of the investment amount may be placed in a normal fixed rate deposit and the balance in the tracker bond deposit.

Where a deposit tracker bond provides a capital guarantee at maturity of less than 100%, for example, 90%, DIRT is only levied on that part payable at maturity which is in excess of the sum originally invested in the bond by the consumer.

Example

A deposit tracker bond provided a 90% capital guarantee and a bonus related to the movement of a particular stock market index. The bond matures with a bonus of 37%.

The pay-out is therefore 90% capital guarantee plus 37% bonus = 127% of original investment.

DIRT is only levied on the 27% part of the pay-out.

9.4 Benefits of Investing in a Tracker Bond

The main benefit offered by tracker bonds to investors is the opportunity to participate in returns from potentially high risk/high return assets such as equities, with reduced or no risk to capital.

9.5 Limitations on Investing in a Tracker Bond

The limitations on investing in a tracker bond include:

- There may be a minimum investment, for example, €20,000 or upwards.
- The investment does not provide any regular income.
- The investment must be maintained for the full term, in order to obtain the full guarantee and bonus promised.
- Investors do not benefit from dividend returns of the shares or securities to which the bonus is linked; typically, the bonus is linked only to the movement in the capital value of the shares or securities involved, over the term of the bond. (refer to section 5.1.2 for importance of Dividends to long term returns from Shares for investors)
- Limited potential to participate in high risk/return assets as most of the money invested in a tracker bond is actually invested in a short-term fixed interest investment.
- Generally, no or limited access to the investment during the term of the bond therefore the investment may be illiquid

9.6 Risks of Investing in a Tracker Bond

The main risks for a consumer of investing in tracker bonds are:

- The consumer might need access to their funds before the bond matures; the consumer may have no access to their funds at all, or if early encashment is allowed it will incur substantial penalties and lead to a loss for the consumer.
- The consumer may get back less than the amount invested, where the particular bond does not provide a minimum guarantee at maturity of at least 100% of the investment amount.

- The consumer may only get back the guaranteed minimum amount under the bond, that is, that the bonus element payable is nil because the relevant indices or shares does not increase in value sufficiently to give rise to a bonus payment.

- The consumer may be exposed to *counterparty risk* in relation to the capital guarantee and/or bonus payment, where a third party is providing these benefits.

  The consumer's investment may reduce in real value terms if the return provided by the bond at maturity is less than the rate of inflation over the bond term, that is, *inflation risk*; this is particularly likely to happen where the investor gets back only the guaranteed minimum amount under the bond.

9.7 Taxation of Returns

There is a difference in the way returns from life assurance and deposit tracker bonds are taxed in the hands of the consumer.

A summary comparison of the taxation treatment of returns between the two types of tracker bonds, issued by a financial institution established in the State or operating here as a branch, for an *individual* Irish resident investor is:

	Life assurance tracker (domestic)	Deposit tracker (domestic)
1% premium stamp duty charge.	Yes.	No.
Bonus liable to be returned in income tax returns as income.	No.	Yes.
Current tax on bonus (only on excess of pay-out over sum invested).	41% (exit tax).	33% (DIRT).
Can claim **exemption from tax** on bonus?		
Individual or spouse/civil partner over 65 not otherwise liable to income tax on the bonus.	No.	Yes, subject to completion of declaration.
Individual or spouse/civil partner permanently incapacitated and not otherwise liable to income tax on the bonus.	No.	Yes, subject to completion of declaration.
Who can **reclaim tax** deducted on bonus, if not otherwise liable to income tax on bonus?		
Individual or spouse/civil partner over 65 not otherwise liable to income tax on the bonus.	No.	Yes.
Individual or spouse/civil partner permanently incapacitated and not otherwise liable to income tax on the bonus.	No.	Yes.
Investment of personal injury awards.	Yes.	Yes.
Thalidomide awards.	Yes.	Yes.
Bonus liable to USC.	No.	No.

	Life assurance tracker (domestic)	Deposit tracker (domestic)
Bonus liable to PRSI.	No.	Yes (for Class S and for employees with investment income in excess of €5,000 per annum).

The significant difference relates to investors over age 65 or permanently incapacitated. Such investors can potentially get a gross return from a deposit tracker bond, if not otherwise liable to income tax on the bonus, but *not* get a refund of exit tax under a life assurance tracker bond.

9.8 Governance/Regulation: Consumer Protection Code

The Central Bank *Consumer Protection Code* imposes a number of disclosure requirements on providers of tracker bonds to consumers.

9.8.1 Product Brochures/Application Forms

The following information must be included in a prominent position in the product brochure, if any, and on the application form for a tracker bond:

- For tracker bonds which do not promise the 100% return of a consumer's capital on maturity, the following statement:

> *Warning: The value of your investment may go down as well as up. You may get back less than you put in.*

- Where the promised return is known, but is less than the initial 100% invested the following statement:

> *Warning: If you invest in this product, you could lose xx% of the money you invest.*

- If the promised return of capital is only applicable on a specific date, this date and the following statement:

> *Warning: If you cash in your investment before (specify the particular date) you may lose some or all of the money you put in.*

- If there is no access to funds for the term of the bond, the following warning statement:

> *Warning: If you invest in this product you will not have any access to your money for [insert time required before the product matures].*

- The nature, extent and limitations of any guarantee attaching to the product and the name of the ultimate provider of any guarantee.

9.8.2 Key Features Document

Before a consumer signs an application form for a tracker bond, they must be provided with a *Key Features Document* of a format specified in the Code, under the following headings:

- How does the XXX (insert name) tracker bond work?
- Where does my investment go?
- Do I have access to my investment?
- What happens if I die before the bond matures?
- What about tax?

In particular, the following information about the split of the investment must be shown under the heading 'Where does my investment go?'

Your proposed investment of €xx,xxx will be used, at the date of investment, as follows:

€xx,xxx, or xx%, will be used to secure the promised payment of €xx,xxx payable after xx years and yy months. This is equivalent to a promised return on this part of your investment of xx% per annum, before tax is deducted.

€xx,xxx, or xx%, will be used to secure the cash bonus which may be payable after xx years and yy months.

€xx,xxx, or xx%, will be taken in ***charges****. If applicable, intermediary remuneration must be disclosed in this section.*

€xx,xxx Total

If the cash bonus is zero, the guaranteed payment will represent a return of x.x% per annum, on your total investment over the period to the date of the promised payment, before any tax is deducted.

Where relevant, insert an explanation that the consumer's return on his or her investment will be capped/limited. This explanation should clearly set out that the excess of any earnings over the cap/limit will be retained by the product producer and / or a third party."

9.8.3 Illustrations

In relation to illustrations of potential returns from tracker bonds, providers must:

- Show the equivalent compound annual rate (CAR), also known as the AER, of the projected return (see Chapter 12.5);
- Not show 'back testing' results, that is, what the bond would have provided over, say, last six years had it been available six years ago.

9.8.4 On Issue of the Tracker Bond

A life company or bank must provide a consumer who has invested in a tracker bond (or to an intermediary who has sold the tracker bond to the consumer) with a document within five business days of the start of the tracker bond, setting out:

- The name(s) and address(es) of the consumer(s);
- The date of investment;
- The amount of the investment;
- The date or dates on which the minimum payment is payable;
- Disclosure of the make-up of the investment, if the make-up differs from that shown in the Key Features Document;
- The date the investment will mature; and
- If a consumer has the right to cancel the bond within a certain period of time from the sale, that the cooling off period of [insert number] days starts from [insert date: the commencement of the investment date/date of receipt of policy document].

9.8.5 Advertising Tracker Bonds

Where an advertisement for a tracker bond specifies an interest rate relating to a proportion of a tracker bond to be placed on deposit, the advertisement must also clearly state:

- Whether the rate quoted is fixed or variable, and if fixed, for what period and, where relevant, an indication of the rate that will apply thereafter;
- The relevant compound annual rate (CAR)[13], over the full term of the bond, applicable to the proportion of the bond to be placed on deposit; and
- Whether any tax is payable on the interest earned.

Each rate quoted must be of equal font size and prominence.

Where an advertisement for a tracker bond shows a projected return on investment, the advertisement must ensure that the value of the projected return of that bond is expressed and shown as prominently as the equivalent CAR.

9.9 Structured Retail Products

In recent years tracker bonds have become less attractive. Low interest rates have resulted in more and more of the investment having to be set aside to provide the capital guarantee, leaving less and less available to be invested to provide the bonus element.

This has led to the development of more complex products which provide some element of capital protection, but rarely with an absolute capital guarantee.

These are called Structured Retail Products (SRPs).

[13] *Same as the annual equivalent rate (AER).*

Typically, these products offer some element of downside protection. For example, a product that links the performance to an equity index and provided the index does not fall more than 40%, the capital is fully protected. So, in this example the risk is lower than if the individual invested directly in the stock market index, as any market falls from 0% to 40% are eliminated for the investor. However, if the index were to fall by say 50% over the term, the capital protection doesn't apply, and the investment would fall by 50%.

In addition, of course, compared with direct investment in the market index, the upside potential is typically also lower as the total return on the SRP is capped.

Structured products like Tracker Bonds use derivatives to offer investors a combination of potential return with an element of protection. In using derivatives (typically options), structured products are as varied as the options that can be created and offered in the market.

As product manufacturers innovate and continue to create retail product using derivatives there is a broad spectrum and diversity of structured products available. More typically these can be based on for example the performance of an index, a group of indices, a small number of stocks, currencies or a basket of mutual funds.

9.9.1 Common Features

- Fixed term to maturity (or specified early redemption event)
- Capital protection (ranging from zero to 100%)
- Returns are capped
- Underlying financial instrument (certificate, deposit, warrant or notes)
- Derivative (typically an option).

9.9.2 Benefits

- Structured products can enable access by retail investors to a range of different and non-standard investments.
- Where applicable MiFID ii now requires that the best and worst case outcomes are outlined which assists investors in understanding the risk of a complex product.
- MiFID ii also requires full transparency of fees and charges, which aids product comparability which was historically opaque.
- Structured products can form part of an investor's portfolio where it acts appropriately (aligned to investor risk appetite and time horizon) as a complement to more traditional assets held (diversification).

9.9.3 Risks

- The level of protection to capital is based on the terms of the guarantee provided and this needs to be evaluated and understood. Partial or soft guarantees are sometimes described which can be (conditional) based on the achievement of certain hurdle events.
- The credit quality of the provider of the Guarantee will vary and is a key consideration (Counterparty risk)
- Prevailing market conditions can impact the value of the option. (Market risk)
- Some structured products can be sector/region focused (e.g. financial stocks, oil stocks, German index) creating a concentration risk.

- While access to funds may be allowed, mid -term liquidity may be based on finding a willing purchaser.
- Usually, investors must hold to a specified maturity date. (Liquidity risk)
- Inflation over the investment term can erode value in real terms (Inflation risk)

9.9.4 Challenges

- Complexity in understanding the product (difficult for inexperienced investors)
- Closed end investment, no ability to stay invested beyond the maturity date.
- Guarantees to capital need to be fully assessed and the best and worst case scenarios understood.
- Difficulty in evaluating a future position (e.g. level of an index/ stock price) at a specified time in the future.

9.9.5 Taxation

As structured products are significantly varied in how they offer the potential of return, they are also varied in terms of their underlying construction. Tax treatment varies based on their specific underlying make up. Their specific tax treatment needs to be clarified and understood in each instance prior to investment. As tax treatment may differ, the tax rate charged will also differ and this has a bearing on the net return for the investor.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- Life assurance tracker bonds ☐
- Deposit tracker bonds ☐
- Taxation of returns ☐
- Benefits, limitations and risks of investing in tracker bonds ☐
- Introduction to Structured Retail Products (SRP's) and their common characteristics ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. Siobhan, age 72, invested € 40,000 in a life assurance tracker bond in 2018 and it matured in February 2024 at € 45,000, before tax. What amount did Siobhan get into her hands from the life company?

   A. €40,500
   B. €42,950
   C. €43,350
   D. €44,000

2. Investing in a tracker bond was suitable for Jack, but NOT for Jill. This was because:

   A. Jack had €50,000 to invest while Jill had €30,000.
   B. only Jack was a standard rate taxpayer.
   C. only Jill, required a regular income from her investment.
   D. Jill paid income tax at the standard rate.

3. A deposit Tracker Bond is which type of deposit?

   A. Fixed term.
   B. Notice.
   C. Demand.
   D. Tiered.

4. Counterparty risk in relation to a life assurance Tracker Bond is the risk that:

   A. the tax which will be applied to the maturity proceeds will be higher than the applicable rate today.
   B. a third party may default on its obligations to the life company, causing a loss for the investor.
   C. inflation will erode the real value of the return provided by the bond.
   D. the investor may die before the bond matures, causing a loss for the investor's dependants.

10

Unit Linked Policies

Unit Linked Policies are a form of PRIIP (or Collective Investment Fund) which are covered in detail in Chapter 7. With a unit linked policy, an investor buys a life assurance policy from a life company, which then invests in units of a chosen fund or funds. Many of the features and benefits are the same as discussed in Chapter 7, and this Chapter focuses on the main differences.

Unit linked savings plans and unit linked investment bonds are examined separately. The structure, charges, benefits and limitations are examined for each of these investment types. Taxation of returns is looked at and examples provided with calculations for a number of different scenarios.

Learning Outcomes – after studying this chapter you should be able to:
discuss the structure, charges, benefits, limitations and risks of unit linked savings plans and unit linked investment bonds;
outline how returns from unit linked policies are taxed in the hands of a consumer;
know the details of premium stamp duty;
understand how policies are legally structured; and,
be familiar with revenue reporting requirements for life companies.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	10	9	14

10.1 Unit Linked Savings Plans

A unit linked savings plan is designed to accumulate a capital sum over a period, from regular monthly savings called *premiums or contributions*.

The policy holder may encash the plan at any time for its then encashment cash value less any early encashment charges applicable, to provide a capital sum to meet some financial need; however, a minimum savings term of 10 years is usually recommended.

Unit linked savings plans are therefore generally not suitable for very short-term savings needs.

10.1.1 Features

Unit Allocation

As each regular premium is paid into the plan, it notionally purchases units in one or more of the life company's unit funds at the unit price then ruling. Units can be encashed at the unit price at the date of encashment. Take, for example, this possible pattern of unit purchases where the policy holder is saving €100 per month:

Month	(1) Premium paid	(2) Unit price	(3) = (1) / (2) Units bought	(4) Unit balance	(5) = (4) x (2) Encashment value of plan
1	€100.00	€1.00	100.00	100.00	€100.00
2	€100.00	€1.03	97.09	197.09	€203.00
3	€100.00	€1.01	99.01	296.10	€299.06
4	€100.00	€0.98	102.04	398.14	€390.16
5	€100.00	€1.15	86.96	485.09	€557.85

This table illustrates two important aspects of how unit linked savings plans work:

- The fixed monthly premium secures a fluctuating number of units; as the unit price increases, fewer units are allocated to the plan, but when unit prices fall more units are allocated to the plan.

- As the number of units allocated to the plan increases, so does the encashment value of the plan. This is how a capital sum is gradually built up over time from small regular savings.

Savings Term

Most unit linked savings plans on the market do *not* have a fixed *savings term*, that is, a pre-defined term of years at end of which the policy automatically matures and the encashment value is paid out.

Rather, most unit linked plans are *open ended*, that is, the policy holder can pay into the policy for as long as he or she wants to, and encash the policy, in full or partially, at any time.

Being open ended with no fixed savings term, the saver can stop and restart his or her savings at any time.

However, because of the charges deducted from the plan and the fact that the plan is linked to unit funds which can fluctuate in value in line with investment markets, the normal recommended *minimum* savings term of a unit linked savings plan is usually 10 years. This is so because earlier encashment runs the risk of the saver getting back less than they saved. The earlier a plan is encashed the higher this risk becomes; likewise, the longer the plan is held, the lower this risk becomes.

Life assurance savings plans are therefore not suitable for very short-term savings, for example, where the saver may need the funds in one or two years to buy a new car or go on a holiday.

Encashment Value

The encashment value at any time of a unit linked savings plan is usually calculated as:

Number of units x unit price

Some plans may apply an early encashment charge, where units are encashed within some initial period of the plan, for example, within the first five years.

As unit values of most unit funds are not guaranteed and can fall as well as rise, the encashment value of a typical unit linked savings plan is not guaranteed and will fluctuate in value as the unit price rises or falls.

Some older unit linked savings plans may secure units at the ruling *offer price* and encash units at the ruling *bid price*, with the percentage difference between these two prices on any day being a *bid/offer spread,* in effect a charge for investing in the units.

In such cases the encashment value of the plan on any day is:

Number of units x unit bid price

Life Cover

As a unit linked savings plan issued by a life assurance company is a life assurance policy, it must provide some death benefit, that is, a benefit payable on death.

The level of life assurance cover, if any, on a unit linked savings plan will be much lower than on a unit linked protection policy. Indeed, some unit linked savings plans may pay back only the encashment value of the plan on death, that is, the value the saver could have received anyway by surrendering the policy on the day before he or she died, or the encashment valued increased by a very small amount for example, 100.1% of the encashment value.

The life assurance cover on older unit linked savings plan may be defined as the *greater* of:

- A specified monetary level of cover, if any; and
- The encashment value of the plan at the date of death.

Example #1

Mr Smith takes out a unit linked savings plan at a monthly premium of €100. The plan provides a specified level of life cover of 120 x monthly premiums, that is, €12,000.

If he dies when the encashment value of the plan is €3,000, then €12,000, that is, the greater of the specified level of cover and the encashment value at the date of death, is payable as a death benefit.

Example #2

Mr Smith takes out a unit linked savings plan at a monthly premium of €100. The plan provides a specified level of life cover of 120 x monthly premiums, that is, €12,000.

If he dies when the encashment value of the plan is €13,000, then €13,000, that is, the greater of the specified level of cover and the encashment value at the date of death, is payable as a death benefit.

Most unit linked savings plans are now marketed with no specified level of life cover; in other words, on death, the encashment value is payable as a death benefit, subject possibly to a minimum pay out of some low monetary amount, say, €500.

Unit linked savings plans that carry significant levels of life cover may make a charge for that cover, by encashing units from the plan each month, and so the cost of providing the cover eats into the accumulating value of the plan. The higher the level of life cover attaching to a unit linked savings plan, the higher the deductions become and hence the lower the savings return becomes.

For this reason, it is generally not a good idea to mix savings and a high level of protection in the one unit linked policy, even if the policy allows such a mix.

If a high level of protection cover is required by a client, in addition to a long-term savings need, it is better to take out two separate policies, that is:

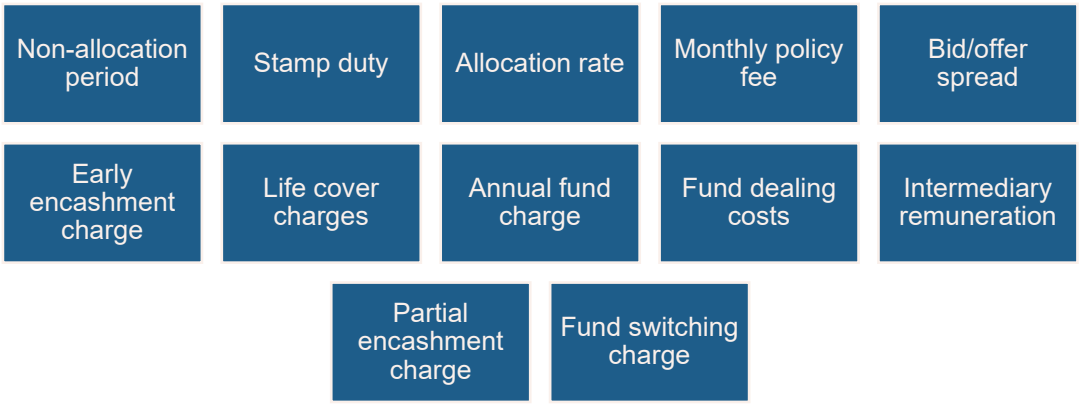
- A protection policy for a high level of cover; and
- A savings plan, with a low or no specified level of life cover.

Charges

Life companies incur various expenses in setting up and operating a life assurance savings plan.

Some of the expenses may be incurred at the start of the plan, for example, initial commission paid to an introducing intermediary, while others are incurred more evenly over the life of the policy for example, customer servicing expenses and renewal commissions.

To meet these expenses, and to provide a profit margin, the life company will make various charges against the unit linked savings plan, which may include some or all of the following:



Non-Allocation Period

An initial period during which the premium paid to the plan is *not* allocated to buy units but is retained by the life company, for example, a plan might have a *non-allocation period* of, say, the first six months of the plan.

During this period, the plan has no encashment value, as it has no units allocated to the plan.

This type of charge is referred to as a *front-end* or *initial charge*, that is, a charge that is made at the *front* or *initial* period of the plan.

Insurance Premium Stamp Duty

Premiums received by a life company are subject to a 1% premium stamp duty. Life companies will therefore usually reduce the premium received by this amount *prior* to allocating the premiums to buy units.

Allocation Rate

The percentage of the premium used to secure units at the ruling unit price, after a deduction of 1% for the insurance premium stamp duty.

Where the allocation rate is less than 100%, the reduction below 100% represents a charge. Where the allocation rate is more than 100%, the extra allocation represents a reduction or rebating of charges as in this case more money is being used to secured units than is paid in by the saver.

Frequently the *allocation rate* will vary by the size of the monthly premium, for example:

Monthly premium	Allocation rate
< €100 per month	95%
€100 - €150 per month	98%
€150 + per month	102%

So, in the case of a monthly savings amount of, say, €50 per month, 95% of premium after deducting the 1% levy, that is, €49.50 is used in this example to secure units; the other 5% is retained by the life company as a charge.

In some cases, the allocation rate may be reduced for the first year or so of the plan, and increased after that, for example:

Monthly premium	Allocation rate	
	Year 1	Year 2 +
< €100 per month	75%	95%
€100 - €150 per month	80%	98%
€150 + per month	90%	102%

Some plans may vary the allocation rate by the savings term of the plan, with lower initial allocation rates applying to plans with shorter savings terms.

Monthly Policy Fee

A life company may deduct the first, say, €3 from each monthly premium, *before* purchasing units, or may alternatively use the full premium to secure units but encash units each month to the value of the policy fee.

The policy fee obviously has a proportionately greater impact on a lower premium than on a higher premium. So, for example, a €3 per month policy fee amounts to 10% of a €30 per month premium, but just 5% of a €60 per month premium or 2% of a €150 per month premium.

Most life companies retain the right to increase the policy fee on a regular basis, for example, in line with inflation, so that if inflation was, say, 3% per annum, a €3 per month policy fee, in the second year might become €3 x 1.03 = €3.09 per month, and €3.09 x 1.03 in the third year, and so on. This is usually referred to as an *indexed policy fee,* as it is indexed in line with inflation. Where the premium is fixed, an indexed policy fee will absorb an increasing proportion of the premium over time, and hence reduce the amount invested.

Bid/Offer Spread

For some older plans, units are bought at the ruling offer price and encashed at the ruling bid price. The offer price may typically be 5% more than the bid price, the difference representing a sales charge or mark-up which is referred to as the *bid/offer spread*.

Example

Offer price: 100c Bid price: 95c

A saver who purchases a unit at 100c could only cash it in immediately at 95c, so that effectively the saver has lost 5% immediately.

Not all life companies operate a 5% bid/offer spread. Some operate a lower, say, 3% spread and some indeed do not have a bid/offer spread at all, that is, have the same unit price on a day for buying and selling units. However, plans which have no bid/offer spread may levy an *early encashment charge* where units are encashed early.

Early Encashment Charge

Some plans which have no bid/offer spread may alternatively have an early encashment charge if units are encashed within an initial period, say within the first five years.

For example, a plan might have no bid/offer spread but would levy a charge or penalty on units encashed as follows:

Within years 1 to 3	5%
In year 4	3%
In year 5	1%
Years 6 +	Nil

So, for example, if a saver had accumulated 1,203 units, with a current unit price of €1.23, and now wanted to encash the plan in its third year, the encashment value of this plan at that stage would be:

1,203 x €1.23 x 95% = €1,405.70

However, if the saver had accumulated 2,567 units, with a current unit price of €2.34, and wanted to encash the plan in its 10th year, the encashment value of this plan at that stage would be:

2,567 x €2.34 = €6,006.78

Charges for Life Cover

Where the plan offers a significant monetary level of life cover, units may be encashed each month to pay for the cost of the life cover, based on the difference between the level of cover and the then encashment value of the plan.

For example, a savings plan provides a fixed amount of life cover of €20,000 and its encashment value this month is, say, €4,500. The charge for life cover for this month will be based on [€20,000 - €4,500], that is, €15,500 of life cover.

As units are encashed to pay for the life cover provided, the encashment of units for this purpose might not be looked on as a *charge*. However, it does reduce the value of the plan.

Annual Fund Charge

This is an annual charge taken within the life company's unit fund *before* the unit price is set. A typical *fund charge* would be 1% ~ 1.5% per annum, but some charges are higher or lower than this depending on the fund in question.

Example

Fund A earns an investment return over the year of 6%.

The fund charge on that fund is 1% per annum. This charge will be taken evenly over the year, before the unit price is set.

Therefore, the *unit growth* over that year (that is, the rate of increase in the unit price) is 5%, as the 1% fund charge is taken out before the unit prices are set.

The term *investment return* is often used to describe a unit fund's investment return *before* the deduction of the annual fund charge, while the term *unit growth* refers to the growth in unit values, that is, *after* the deduction of the annual fund charge from the fund.

So, in the example above:

- The fund's *investment return* over the year is 6%; but
- The fund's *unit growth* over the year is 5%.

Although the annual fund charge is often presented to clients as the charge made by the life company purely for the investment management of the fund, in reality, it is a general charge made by the life company and not just to meet the cost of managing the fund's investments. The actual cost of managing the unit fund might be as low as 0.1% ~ 0.5% per annum.

Most life companies retain the right to increase the annual fund charge in the future; so, in the above example, the life company could decide after a number of years to increase the annual fund charge from 1% per annum to 1.25% per annum.

Some plans may provide for a reduction in the fund charge in certain circumstances. For example:

- If the regular premium exceeds a certain level;
- If the encashment value of the plan exceeds a certain value;
- If a once off contribution, of a specified minimum amount, is added to the plan either initially or during some initial period of the plan.

Fund Dealing Costs

Every time a unit fund buys and sells a share or other asset, *dealing* costs will be incurred. For example, stamp duty of 1% applies to the purchase of Irish shares, and stockbrokers also charge a commission or fee for handling the purchase or sale of a share. Stamp duty and legal fees also apply to the purchase of property. There are also costs incurred by the fund in holding and securing the assets which the fund owns, for example, custodian fees, auditing fees, etc.

However, these fund costs are deducted within the unit fund *before* the unit price is set. They are therefore not visible to the client and are sometimes referred to as *implicit charges* as they are not defined.

Intermediary Remuneration Options

Where unit linked savings plans are sold through *regulated intermediaries*, a life company may offer a choice of remuneration scales to the intermediary; the charges to be made to the plan will usually be directly affected by the level of remuneration chosen.

Partial Encashment Charge

Some unit linked savings plans may impose a small monetary charge for processing a partial encashment, that is, where the saver encashes some of his or her units, but not them all. For example, a charge of €25 might be deducted from the partial encashment charge.

Fund Switching Charge

Some unit linked savings plans may impose a charge where the saver opts to switch units from one unit fund to another. For example, a charge of €25 might be deducted from the value of units being switched from one fund to another.

Investing: Unit Fund Choice

Investors can usually opt to invest their premiums in a mix of different unit funds, for example, 50% in a managed fund and 50% in a particular equity fund.

Investors can change their unit fund choice later on, if they wish. *Switching* refers to exchanging units of one unit fund for units of equivalent value in another unit fund. (this assumes a choice of different funds available in the contract and the switch of units is within the same policy)

Example #1

A policy holder has accumulated 1,452.23 units in a managed fund, which has a current bid price of €2.45. The policy holder is concerned about volatility in equity markets and decides to switch his managed fund holding to the more secure cash fund, which has a current bid price of €1.45.

The switch would usually be done on a *bid to bid* basis so that:

- 1,452.23 units in managed fund has a current value of 1,452.23 x €2.45 = €3,557.96;
- €3,557.96 would secure €3,557.96/€1.45, that is, 2,453.77 units in the cash fund.

So immediately after the switch, the encashment cash value of the policy is exactly as before the switch, so that in this example no charge has been made for the switch.

The life company may have the right to defer an instruction to switch *out* of a property fund, for up to six months or possibly longer depending on the individual contract terms and conditions. This time may be needed by the life company to sell properties to raise the liquid funds required to meet the switch instruction.

An alternative form of fund switching allows the saver to redirect future premiums only to buy units in a different unit fund, while retaining units of the current unit fund.

Example #2

A policy holder has accumulated 1,452.23 units in a managed fund, which has a current bid price of €2.45. The policy holder is concerned about volatility in equity markets and instructs the life company to use future premiums to buy units in a cash fund, while retaining the 1,452.23 units accumulated in the managed fund.

Therefore, going forward, the saver's plan will hold units in both the managed fund and the cash fund.

Partial Encashment

Most unit linked savings plans allow savers to take a *partial encashment,* by encashing some but not all units held by the plan. The saver may then continue paying premiums and keep the plan going.

Example

John has accumulated 3,460.20 units in a unit linked savings plan; the current unit price is €2.33. John needs €1,000 now; so, he instructs the life company to encash units to the value of €1,000.

The life company would encash €1,000/2.33 = 429.18 units from the plan and so the plan would then have [3,460.20 – 429.18], that is, 3,031.02 units going forward.

(The above example ignores the impact of exit tax on encashment; see Chapter 10.7 re exit tax on encashment.)

Projected Breakeven Point

A unit linked savings plan will have a projected *breakeven point*, that is, a duration at which the projected value of the plan first exceeds the total premiums paid to date.

Take, for example, a unit linked savings plan A with this charging structure and a monthly premium of €150:

- 99% allocation, that is, 100% less 1% premium stamp duty;
- No bid/offer spread;
- Policy fee €3 per month taken from the monthly premium before allocation to units;
- Early encashment charge: 5% in years one, two, and three; 3% in year four; 1% in year five, and nil thereafter;
- Annual fund charge: 1.25% per annum.

Let's assume an investment return of 5% per annum, so that the unit fund is assumed to grow at 3.75% per annum.

Month	Prem	Unit price	Units secured	Total units	Total Units Value	Total prems paid	Encash value (before exit tax)
1	€150	€1.000	145.50	145.50	€145.95	150	€138.65
2	€150	€1.003	145.05	290.55	€292.34	300	€277.72
3	€150	€1.006	144.61	435.16	€439.19	450	€417.23
4	€150	€1.009	144.16	579.33	€586.48	600	€557.16
5	€150	€1.012	143.72	723.06	€734.23	750	€697.52
10	€150	€1.027	141.54	1435.12	€1479.80	1500	€1405.81
15	€150	€1.043	139.38	2135.35	€2236.88	2250	€2147.40
19	€150	€1.056	137.68	2689.65	€2850.95	2850	€2736.92
20	€150	€1.059	137.26	2826.92	€3005.65	3000	€2885.43
30	€150	€1.092	133.12	4176.70	€4579.01	4500	€4441.64
37	€150	€1.116	130.29	5097.23	€5709.41	5550	€5595.22

In this example and based on unit fund return assumption of 3.75% after the annual management charge, the projected breakeven point happens in month 19, that is, in month 19 the projected value of the plan *first* exceeds the total premiums paid to date. Encashment of the plan before this date would therefore result in a projected loss.

However, when the encashment value which includes the encashment penalty, is taken into account, the projected breakeven point is pushed out to month 37.

10.1.2 Benefits of Unit Linked Savings Plans

The main benefits of a unit linked savings plan are:

- A facility to accumulate a capital lump sum from regular income savings over a long period;
- Flexible savings term;
- Savings can be invested in a wide range of professionally managed investment funds, which accumulate tax free subject to exit tax being deducted from any gain paid out to the saver;
- By investing a fixed amount on a regular monthly basis, the saver is less exposed to the *timing risk* of investment that is, investing at just the wrong time before the markets crash, as the investment is spread out over a long period;
- The saver can usually reduce, suspend, recommence or terminate his or her savings at any time;
- Addition of optional life cover, in some cases.

10.1.3 Limitations of Unit Linked Savings Plans

The main limitations associated with unit linked savings plans are:

- Unit linked savings plans are not suited to short-term savings needs;
- Non-taxpayers cannot reclaim any exit tax deducted from an encashment value;
- Restrictions may be placed on switches out of a property fund (can usually be delayed by life company in certain circumstances for up to six months or longer if fund is short of cash) or switches into a with profit fund;
- Some plans have a minimum savings amount, for example, €75 per month etc.

In order to commit to a regular savings plan, a consumer needs to have sufficient regular surplus income after normal living costs and, preferably, major protection needs have been met.

The amount of surplus income which the client expects to have regularly available for savings will usually be identified from the fact-find and should be confirmed with the client.

10.1.4 Risks of Unit Linked Savings Plans

The main risks associated with unit linked savings plans are:

- The saver could get back less than the amount saved; this can arise through a combination of investment risk and plan charges;

- The saver could get back less than the anticipated or targeted amount shown to the saver at the outset if the unit fund or funds to which the plan is linked produces a lower investment return than anticipated or assumed at the outset;
- The plan may produce a return less than inflation, and so the plan value fails to keep pace with inflation;
- The exit tax rate applying to gains realised when the plan matures (or on each eighth anniversary) may be higher than anticipated at the time the plan was taken out.

10.2 Unit Linked Bonds

A *unit linked bond* is a single premium life assurance policy, where a once off premium is invested to secure units in one or more unit funds operated by the life assurance company. It is set up as a whole of life policy, that is it is open ended with no fixed term.

The minimum initial investment is usually €20,000, but can be higher or lower for some funds.

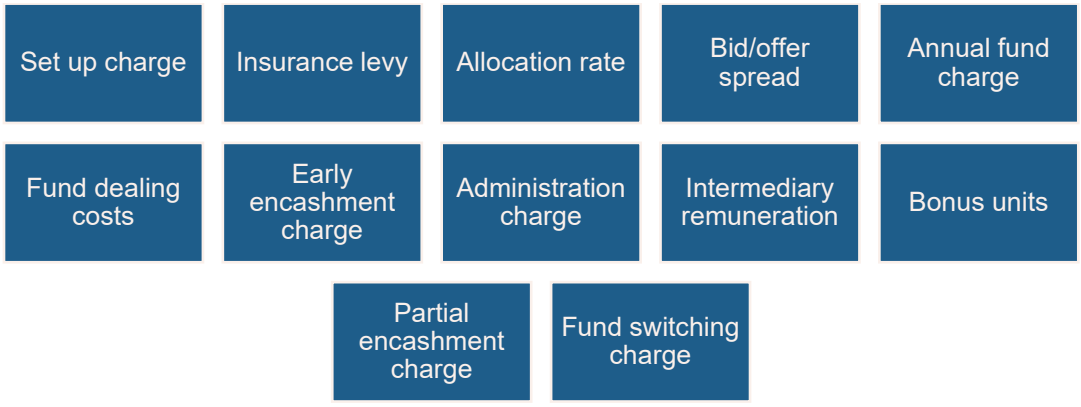
10.2.1 Features

Investment Term

Unit linked bonds are *whole of life* policies and therefore do not have any fixed investment term. However, due to the impact of charges and the fluctuating value of unit fund prices, it is normally recommended that clients should be prepared to leave their funds invested in a unit linked bond for at least five to seven years.

Charges

Unit linked bonds carry charges similar in nature to those already outlined for unit linked savings plans:



Initial Monetary Set Up Charge

Some bonds may impose an initial monetary set up charge, for example, €500, which would be taken from the initial investment amount *before* the investment is used to secure units.

Insurance Premium Stamp Duty

Premiums received by a life company are subject to a 1% premium stamp duty. Life companies will therefore reduce the premium received by this amount prior to allocation to buy units.

Allocation Rate

The allocation rate is the percentage of the investment which is used to purchase units at the ruling unit price. An allocation rate above 100% represents a reduction or rebate in the initial charges levied on the investment amount. Frequently this *allocation rate* will vary by the size of the investment, for example:

Investment	Allocation rate
< €100,000	100%
€101k - €299k	101%
€300k +	102%

Bid/Offer Spread

Units are bought at the ruling offer price and encashed at the ruling bid price, the difference representing a charge or mark-up which is referred to as the *bid/offer spread*. An easy way to remember these terms can be to think about the 'offer' price as the price the company will offer to sell you units in a fund, while the 'bid' price is how much the company will buy or 'bid' for your units back from you. This difference can be anything up to 5% or more depending on the contract.

Increasingly, unit linked bonds on the market do not contain a bid/offer spread but use an early encashment charge, as outlined below.

Annual Fund Charge

This is an annual charge taken within the life company's unit fund *before* the unit price is set. A typical annual charge would be 0.75% ~ 1.5% per annum, but some charges will be higher or lower than this, depending on what the fund invests in and how it is managed.

Some bonds may undertake to reduce the fund charge by a specified amount, after the bond has been in force for a specified period, for example, after five years.

For example, a bond may have a fund charge of 1.5% per annum, reducing after five years to 1.3% per annum, say.

Fund Dealing Costs

The costs of buying, selling and safeguarding the fund's assets. These costs are deducted from the fund value, before setting the unit price.

Early Encashment Charge

Some unit linked bonds impose a reduction in the encashment value where units are encashed within an initial period, for example, during the first five years. This is sometimes used in lieu of a bid/offer spread.

This charge frequently scales down over this period.

Example

A bond imposes an initial early encashment charge as follows:

Units encashed in year	Charge
1	5%
2	4%
3	3%
4	2%
5	1%

So, for example, if an investor has 2,300 units in a unit fund and the investor decides to encash the units in year three of the bond, when the unit price is €1.87, the encashment value of the bond at that time would be:

2,300 x €1.87 x 97% = €4,172

Administration Unit Cancellation

Some bonds may provide for an annual charge, say 1% per annum, to be paid by *unit cancellation,* that is, 1% of the total number of units then attaching to the bond are encashed by the life company each year, and the value retained by the life company.

Therefore, in this example, the client's unit holding would reduce by 1% per annum.

Example

A client invests in a life assurance unit linked bond and 10,000 units in a unit fund are initially allocated to the bond. The bond provides for an annual administration charge of 1% per annum, to be met by unit deduction at the end of each year. The client's unit holding would reduce as follows:

Year	Number of units at start of year	Admin charge units deducted	Number of units end of year
1	10,000	100	9,900
2	9,900	99	9,801
3	9,801	98	9,703
4	9,703	97	9,606
5	9,606	96	9,510
6	9,510	95	9,415

The 1% charge is applied to the reducing balance of units each year. If the client surrendered units during the year in order to take a partial encashment, the charge would be applied to the balance of units remaining *after* the partial encashment.

Intermediary Remuneration

Where the unit linked bond provides *initial commission* to intermediaries, the allocation rate is usually reduced by the level of initial commission taken by the intermediary.

Example

Client wishes to invest €50,000 in a unit linked bond. The standard allocation rate for this amount is, say, 102.5%.

If the intermediary opts to take 2% initial commission, the allocation rate will be 102.5% less 2% = 100.5%.

Some life companies are willing to pay trail or fund based commission to intermediaries on unit linked bonds, as a percentage of the encashment value of the bond. Fund based commission is recovered by way of a corresponding regular unit cancellation by the life company or increase in the annual fund charge.

Bonus Units

Bonus units are units that may be added back to the bond at some stage in the future, in certain circumstances. They act as an incentive for the investor to maintain their investment for a set period of years.

Example

A bond promises to add a bonus of 1% of the then unit holding after one year and another 1% of the then unit holding after five years.

Bonus units can be looked on as a way of rebating or refunding part of the annual fund charge for investments which stay a certain minimum period with the life company. Any encashment of units before the bonus date loses out on this bonus.

For example, a 1% bonus added after five years is equivalent to a reduction in the fund charge already charged of 0.2% per annum.

Bonus units added in this way are also sometimes referred to as a *loyalty bonus*, that is, the extra units are added to investors who are 'loyal' and leave their funds invested for a prolonged period.

Partial Encashment Charge

Some bonds may impose a monetary charge for processing a partial encashment, that is, where the investor encashes some of his or her units, but not them all.

Fund Switching Charge

Some unit linked bonds may impose a charge where the saver opts to switch units from one unit fund to another, usually as a percentage of the value of units switched subject to a minimum and/or maximum monetary charge.

Death Benefit

Unit linked bonds frequently provide a death benefit slightly higher than the encashment value of the bond, for example, 101% of value of units on death. Some companies may offer a minimum death benefit as the greater of the value of the investment at death or the value of the original investment less any encashments. Death benefit in this instance typically would not be open ended but may apply to a maximum period such as the first 5 years of the policy, and would apply to the second death on a joint investment policy.

Some bonds do not impose the early encashment charge on death.

Example

Joe invests €50,000 in a unit linked bond with Acme Life Co. The bond has an early encashment charge of 6% in year one reducing each year to 1% in year 6. The death benefit is 101% of the value of units at the date of death.

Joe dies during the fourth year of the bond, when the bond has 19,104 units. At the time of death, the unit price is €3.20. The normal encashment value of the bond at that time would be:

19,104 x €3.20 x 97% = €59,298 (before tax is deducted).

As a death benefit, the benefit payable would be:

19,104 x €3.20 x 101% = €61,744 (before tax is deducted).

Joint life unit linked bonds are usually arranged on a joint *life last survivor basis*, that is, no death benefit is payable on the first to die; rather ownership of the bond passes automatically to the survivor. The death benefit is only payable when both have died.

Investing: Unit Fund Choice

There will usually be a wide range of unit funds offered to the investor in a unit linked bond.

Life companies will usually group their unit fund choice into groups dictated by the likely volatility of unit price, as between low, medium and high risk.

For example, a life company might group their unit funds offered to investors into Seven different categories, with one being the lowest risk and seven the highest risk. For example, funds might be categorised as follows:

1	2	3	4	5	6	7
Cash	Cash/bond	Cautiously managed	Balanced managed	Adventurous managed	Specialist equity	Options/ Geared

A key part of the investment advisory service to consumers is to recommend funds or funds appropriate to the level of risk that consumer is willing and able to accept.

While the vast majority of unit funds do not provide any guarantee on the unit price and hence the value of units can fall, some *managed* type funds may provide an element of guarantee to the investor, for example:

- If the bond is held for, say, five years, there may be a guarantee that the encashment value of the bond on the fifth anniversary will not be less than the original investment amount.
- There may be a guarantee that the unit price cannot fall, if held for a certain period.

  There may be a guarantee that the unit price at which units are encashed will not be less than some specified percentage of the highest unit price achieved during the investment period.

However, these guarantees come at a price to the investor:

- The annual fund charge will usually be higher (typically, +1% per annum) than a similar fund without such guarantees.

- The life company will retain the right to vary the asset mix of the funds so that, for example, if investment markets are falling the life company will increase the proportion of the fund invested in more secure assets like bonds and deposits.

  So, for example, the fund might start off invested, say, 75% in equities and 25% in secure assets such as bonds and cash. If equity values fall, the proportion of the fund in equities falls. This is then compounded if the life company further reduces the percentage of the fund invested in equities and increase the percentage invested in secure assets. The life company does this to ensure it can deliver on any guarantee that has been promised. This however is at the expense of the fund return potential. As markets recover, the life company is likely to retain the high proportion in secure assets, so the investor loses out on the recovery.

  The result is that there is a risk that the fund can become substantially or fully *cash locked*, that is, because of fluctuating investment markets the fund can become substantially or fully invested in lower return secure assets and remain that way. Therefore, the guarantee provided can often come at the expense of potential returns.

With Profit System

Some older policies may use a different investment return system called With Profit.

The With Profit system is designed to smooth out the ups and downs of investment markets over time to give the bond holder a 'smoothed' investment return, while also providing some element of a guarantee.

With Profit policies may offer investors bonus payments, either on a particular anniversary such as the 5th or 10th anniversary or at maturity of the policy. When it's a maturity bonus this is known as a terminal bonus. These bonuses are additional to annual declared profits which may be added to the policy.

On withdrawal, the company may adjust the value of the plan if the value of the underlying assets is less than the declared value of the plan including all bonuses. This adjustment is known as a Market Value Reduction (MVR). It is designed to protect investors who are not taking their money out. Some With Profit policies offer guaranteed withdrawal dates during which an MVR cannot be applied, such as a 10th anniversary or at a maturity date.

When dealing with existing With Profit policies advisors should carry out careful research before recommending any changes, withdrawals or encashments as depending on the policy conditions, such changes may invalidate terminal bonuses or nil MVR periods.

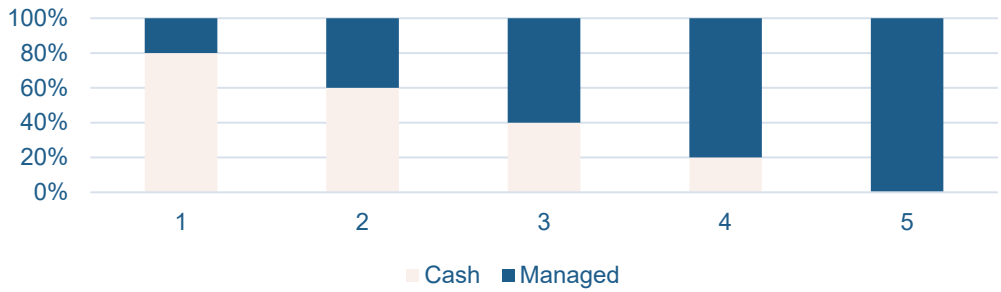
Drip-Feeding

Some unit linked bonds offer an option to initially invest the investment amount into a secure cash fund and then drip-feed the investment into the chosen fund or funds, for example, a managed fund, over a period of months during the first year of investment.

Example

Mary invests €50,000 in a unit linked bond. Her chosen fund is the life company's managed fund. She opts for the drip-feeding option over five months, and hence her bond will be invested as follows, over the first five months:

Month	In cash fund	In managed fund
1	80%	20%
2	60%	40%
3	40%	60%
4	20%	80%
5	Nil	100%



The drip-feeding facility is designed to protect the investor from the *timing risk* involved in making a large investment based on the unit prices of an unguaranteed fund ruling on the day of investment.

Drip-feeding therefore aims to protect the consumer from potentially investing all of his or her investment at a high point in investment markets; however, the downside is that it may also prevent the consumer from investing all of his or her investment at a low point in the investment markets and hence reduce future growth.

Drip-feeding is therefore not a guaranteed benefit to the investor; in falling markets it can protect the consumer, but in rising markets it can reduce the return to the investor as the full investment does not benefit from rising markets.

Partial Encashment

Most unit linked bonds offer the investor the option to take a *partial encashment*, that is, surrender of *part* of their unit holding.

Any early encashment charges would only then be applied to the unit holding actually encashed. The bond then continues on as normal with the remaining balance of units.

Life companies will usually impose a minimum partial encashment amount, for example, €500, and subject to a minimum remaining value of the bond of, say, €5,000.

Regular Encashment Facility

Normal partial encashment are encashments taken at the initiative of the policy holder.

Some unit linked bonds offer a facility for the investor to opt to take regular, for example, monthly or quarterly, partial encashments, which are made *automatically* by the life company and the payments sent automatically to the investor's bank account or by cheque to him or her.

This facility is referred to as regular encashments or an automatic income facility.

Different regular encashment options are sometimes offered to the policy holder:

- A specified percentage of the then unit holding, for example, the investor can specify a rate of 5% per annum of the unit holding. This percentage of units would then be encashed each year and the proceeds sent to the investor, less exit tax if appropriate.

- A specified monetary amount, *before* exit tax, for example, €500 every six months or, say, 5% per annum of the initial investment, *before* exit tax, would be funded by automatic encashment of units. The exit tax, if applicable, would be deducted and the net payment sent to the investor.

- A specified monetary amount, *after* exit tax, for example, €500 every six months or, say, 5% per annum of the initial investment, *after* exit tax, every six months would be funded by automatic encashment of units of sufficient value so that, after exit tax, the specified monetary amount would be payable to the investor.

Frequently the life company may impose a maximum rate of withdrawal, for example, 8% per annum, so that investors do not risk run down their investment too quickly.

However, there are two important points to be remembered about this facility:

- Despite sometimes being called automatic *income* payments, the payments are not in fact *income* from the unit fund's investments but rather a partial encashment of the client's total unit holding. This is important in their treatment for tax.

The value of the bond will therefore fall immediately after each partial encashment. The client is therefore eating into his or her investment, unless the unit growth on the remaining unit holding at least matches the rate at which units are being encashed.

- The payments are not *income* for income tax purposes in the hands of the investor, but a partial encashment of the individual's life assurance policy. *Exit tax* may be deductible from any gain realised on a partial encashment. Once this tax is deducted, the investor has no further tax liability on returns.

It is important that investors realise the risks involved in taking regular partial encashments; that such encashments are eating into the value of their investment and that, unless the remaining unit values grow at a faster rate than encashments are being taken, the remaining value of the bond will decrease and could eventually run out.

The term automatic *income* is therefore misleading, as the client could infer from the *income* reference that all he or she is taking from the bond is the *income* accruing to the fund and that his or her capital invested is still intact. This is not the case.

In extreme cases, there is a danger that the cash value of the bond could run out completely, due to a combination of too high a rate of drawdown and too low an investment return achieved.

Fund Switching

As outlined earlier for unit linked savings plans, unit linked bonds also offer investors the opportunity to switch units from one unit fund to another, based on equivalent values.

Example

John has a unit linked investment bond which currently holds 10,345 units in the life company's managed fund. The current unit price of the managed fund is €2.456.

Because of investment volatility, he has decided to switch his managed fund units to the cash fund. The current unit price of the cash fund is €1.268. The life company does not impose a charge for the switch.

Following the switch, the number of units his bond will hold in the cash fund is:

$$10{,}345 \times €2.456 / €1.268 = 20{,}037 \text{ units.}$$

Immediately after the switch the cash value of his bond will be exactly the same as it was just before the switch:

Cash value before switch: 10,345 x €2.456 = €25,407.

Cash value after switch: 20,037 x €1.268 = €25,407.

Rebalancing

Some unit linked bonds offer the option of an automatic *rebalancing* facility. This facility is designed to ensure that where an investor opts initially to invest in a mix of different unit funds, the percentage split of their bond value between these funds is automatically maintained at the initial percentage chosen at the outset, by the life company automatically encashing units.

Without rebalancing, the percentage of the bond value invested in the different funds would move away from the initial choice, over time, due to differing fund performance.

Example

John invests €50,000 in a unit linked bond, and opts to invest this sum as follows:

- 50% in an equity fund;
- 25% in a bond fund; and
- 25% in a cash fund.

If, over the first year, the equity fund unit price increased by 20%, the bond fund by 7% and the cash fund by 2%, the value of John's bond at end of the first year would be:

- €25,000 x 1.20 = €30,000 in the equity fund;
- €12,500 x 1.07 = €13,375 in the bond fund; and
- €12,500 x 1.02 = €12,750 in the cash fund.

The total value of the bond at the end of the first year is €56,125.

So, at the end of the first year, the value of John's bond at that stage would now be split as follows:

- €30,000/€56,125 = 53.45% in the equity fund;
- €13,375/€56,125 = 23.83% in the bond fund; and
- €12,750/€56,125 = 22.71% in the cash fund.

The split of John's bond value between the three funds has therefore drifted away from his initial choice (50%/25%/25%), due to differing fund performance.

In the example above, the rebalancing feature would periodically *automatically* switch some units from the equity fund to the bond and cash funds at the end of year one, so that after such switch the then value of John's bond would revert to his initial 50%/25%/25% split.

The benefit to the investor of using rebalancing is that the risk profile of the investment, in terms of asset allocation, is maintained at the initial level chosen and doesn't drift over time to a higher or lower risk profile, due to differing fund performance.

So, a medium risk investment could, over time, silently turn into a high-risk investment. Of course, the opposite could also happen; without rebalancing a medium risk investment could, over time, silently turn into a low-risk investment.

Rebalancing may be offered on a monthly or quarterly or annual basis.

10.2.2 Property Fund Restrictions

Life companies frequently impose certain restrictions on investing in property unit funds:

- Some funds may be closed to new investments, from time to time; During 2020 many Property funds in the Irish market closed to new investors due to the Covid-19 pandemic. During periods of crisis (war, economic recession, pandemic) Property valuers may find it difficult to apply reliable valuations to commercial, retail, industrial or indeed residential Properties. In these instances what is known as a 'Material Valuation uncertainty clause' may prevail within a Property fund contract meaning that the company is unable to stand over the valuations, which underpin the unit prices. In such instances Property funds may close until such time as this uncertainty clause is lifted.

- The life company may retain a right to delay encashment from or switches out of the fund by up to six months, typically, or even longer, where the fund is experiencing net cash outflows and therefore needs to sell properties to meet the cash demands of investors cashing in their investments. Outside of liquidity issues, the Material uncertainty clause may also create a situation where a Property fund has to close to withdrawals due to uncertainty over values being applied to unit prices. During 2020 we saw almost every unit linked Property fund in the Irish market impose a 6 month withdrawal notice for investors in the fund, some due to liquidity, some due to the Valuation uncertainty.

10.3 Benefits of Unit Linked Bonds

Unit linked bonds offer the investor a number of advantages, compared with direct investment in shares, bonds, etc.:

- *Reduced risk*, by participating in a much larger diversified pool of assets than could be obtained by direct investment by an individual investor in a smaller number of shares and bonds, that is, *diversification*.

- *Professional investment management*, where the fund is actively managed.

- *Lower dealing costs.* Large funds can buy and sell shares and bonds in bulk much more cheaply than an individual investor buying and selling small amounts. Also, a person may be able to switch to another fund or funds, within the range of funds available in the policy, without being levied with the dealing costs associated with direct investment. This is particularly attractive for an investor who wishes to trade actively.

- *Less administration;* the direct investor will have to collect dividends, make tax returns of investment income and gains, and be involved in a lot of paperwork. By investing in an Irish based collective fund, the investor avoids all this administration hassle.

- Provides *access to certain asset types* that would not be possible for an individual investing directly; for example, property funds allow small investors to participate in large scale commercial property investments, which would not otherwise be feasible for investors investing directly with their own funds.

10.4 Disadvantages of Unit Linked Bonds

However, there are some potential disadvantages to investing in a unit linked bond as opposed to direct investment:

- *Charges*;
- *Lack of control over individual stock selection*;
- *Lack of individual shareholder rights and perks*;
- *Some investors may be disadvantaged from a taxation point of view* by investing in a *unit linked bond*, rather than investing directly:
  - Some non-taxpaying investors may be unable to recover exit tax deducted;
  - The exit tax rate at 41% is currently higher than the capital gains tax rate of 33%;
  - Investors cannot benefit from the annual €1,270 capital gains tax free exemption, which they could if they invested directly;
  - Investors who make a loss on investment on a unit linked bond investment, cannot offset this loss against any other chargeable gain they might have in that tax year under any other asset; however, an investor who invested directly can offset a loss on the sale of one asset against a gain he or she may make on another asset or can carry forward losses to future years to be offset against future gains from direct investment.

10.5 Limitations of Unit Linked Bonds

Unit linked bonds may be subject to certain limitations or restrictions (similar to PRIIP Funds – see Chapter 7.5):

- A minimum investment of €20,000 typically. Partial encashment may be subject to a certain minimum remaining value in the bond.
- To avoid potential exit charges, the investment may need to be maintained for a certain minimum period.
- Restrictions may be placed on switches, into and out, and encashment of certain funds, for example, property funds.
- Potential loss of access to capital in certain funds, where the manager has the power to delay encashments in certain circumstances.
- Any investment guarantees may only apply if the investment is maintained in full for a certain minimum period, for example, five years. Early partial encashments will usually reduce the level of guarantee provided. Other guarantees may come at the price of lower potential investment returns.

10.6 Risks of Unit Linked Bonds

The main investment risks associated with unit linked bonds are covered in detail in Chapter 14.2.1

10.7 Taxation of Returns

All life savings and investment policies, which are not pension policies, taken out on or after 1st January 2001 with life companies established in the State or operating in the State as a branch, are taxed on what is called the *gross roll up (GRU)* system, that is, investment returns accrue or roll up tax free, but an *exit tax* is deducted by the life company from any investment gain paid out to a policy holder, that is, when funds are exiting the policy.

The main details of how exit tax works on Irish PRIIPs funds was set out earlier in Chapter 7.7. A similar approach applies to Irish unit linked funds.

Example #1: Savings Plan – Full Encashment – Gain

Mary takes out a unit linked savings plan at a monthly amount of €100. After five years, when she has paid in €6,000 in premiums she encashes the policy for €6,760.

The gain is calculated as (€6,760 - €6,000) = €760.

The life company will currently deduct exit tax at 41% on this gain, that is, will deduct €311.60 in tax from the plan, and so will pay out €6,760 – 41% x €760 = €6,448.40 to her.

Example #2: Unit Linked Bond – Full Encashment – Gain

Mary invests €10,000 in a unit linked bond.

Five years later she fully encashes the bond for €15,000. She has not previously made any partial encashment.

So, the gain, liable to exit tax of 41%, is = €15,000 - €10,000 = €5,000.

Exit tax deducted by life company currently = 41% x €5,000 = €2,050.

Paid out = €15,000 - €2,050 = €12,950.

Note that any benefit payable *only* on death under a unit linked policy is *not* treated as a chargeable gain and hence is not subject to exit tax on death pay-out.

In the example below, the pay-out is on death. The gain is calculated as if the bond has been encashed the day *before* death.

Example #3: Unit Linked Bond – Death – Gain

Mary invests €10,000 in a unit linked bond.

Six years later she dies when the cash value of the bond is €15,000. The death benefit is 101% x cash value of bond.

For exit tax purposes, the bond is treated as having been encashed just before death.

So, the gain, liable to exit tax of 41% (currently), is €15,000 - €10,000 = €5,000.

Exit tax deducted by life company = 41% x €5,000 = €2,050.

Paid out to estate = €15,000 x 101% - €2,050 = €13,100.

The extra benefit payable only on death, that is, 1% x bond value, is not subject to exit tax.

In the case of a partial encashment, that is, where an investor encashes some but not all of their unit holding, the gain is calculated allowing a proportion of the original investment to be offset against the encashment for exit tax purposes; the proportion being:

$$\textbf{[Partial encashment} \,/\, \textbf{Value of bond before encashment]}$$

Example #4: Unit Linked Bond – Partial Encashment – Gain

Mary invests €10,000 in a unit linked bond.

Six years later when the bond is worth €15,000, she takes a partial encashment of €2,500. She has not previously made any partial encashment.

In working out the gain on the partial encashment, only part of the original investment is allowed as a deduction, the part being calculated as:

$$\left(\text{Partial encashment value} \,/\, \text{Value of bond before partial encashment}\right):$$

The taxable gain on this partial encashment is therefore calculated as:

$$= €2{,}500 – [€10{,}000 \text{ x } (€2{,}500 \,/\, €15{,}000)] = €2{,}500 - €1{,}667 = €833$$

Exit tax currently of 41% x €833 is deducted, that is, €341.50, from the partial encashment and so €2,500 - €341.50 = €2,158.50 is paid out to Mary as a partial encashment.

Where a policy is in force eight years, a *deemed encashment* is applied to the policy on the eighth anniversary and any gain deemed to arise is subject to exit tax, with the exit tax then being withdrawn from the policy.

Example #5: Deemed Encashment After Eight Years

Mary invests €10,000 in a unit linked bond.

She does not take any encashment from the policy.

On the policy's eighth anniversary its cash value at that stage is €18,000, say.

The policy is *deemed* to be *encashed* and so the gain, liable to exit tax currently of 41% = €18,000 - €10,000 = €8,000.

The life company will therefore deduct €8,000 x 41%, that is, €3,280 from the bond just after the eighth anniversary and pay it over to Revenue.

Returns from Irish unit linked funds are not subject to PRSI or USC.

10.8 Premium Stamp Duty

Life companies are required to pay a stamp duty to the Government of 1% of all premiums received on most existing and new policies. The 1% duty (sometimes also referred to as a *levy*) applies to all savings, investment, and protection policy premiums.

Although the duty is levied on the life company, and not directly on the policy holder, life companies seek to recover the cost of the duty from unit linked savings policies and investment bonds by reducing the premium received by 1% before allocating the premium to buy units.

10.9 Policy Ownership

Most unit linked policies are arranged in one of two ways:

- *Own life*, that is, the life assured and policy holder are the same person. On death, the death benefit under the policy is payable to the deceased's estate.

- *Joint life,* that is, the policy is arranged on two lives assured, who are also the joint proposers. Most joint name unit linked bonds are arranged in this way.

  The joint life policy is arranged on a *joint life last survivor* basis, that is, on the first of the joint names to die, the death benefit is not payable but full ownership of the policy passes to the survivor, who then owns the bond fully in their own name.

  On the death of the survivor, the death benefit is then payable to his or her estate.

10.10 Reporting Benefit Payments to Revenue

Life assurance companies are required to make an annual electronic return to the Revenue Commissioners of certain benefit payments made to unit linked policy holders during the year.

The annual return must include the following details of each benefit payment subject to these reporting obligations:

- The payee's name and address;

- The individual's PPSN;

- If the payee is a charity, the charity's CHY Revenue reference number;

- If the payee is a company, the company's name, registered address and tax reference number;
- The policy number or reference;
- The total amount of benefit paid during the year on that policy;
- In the case where there is more than one policy holder, for example, a joint life policy, each policy holder is returned separately in respect of their share of the benefit payment;
- An indication that the life company knows the payee is the beneficial owner of the payment(s) being returned, if that is the case.

The benefit payment to be returned does *not* include any payment made *solely* by reason of death or disability.

A life assurance company is required to seek the tax reference number (for example, PPSN for individuals) for new policies effected on or after 1st January 2013 and the prospective policy holder is required to provide that tax reference number.

If the prospective policy holder refuses to provide their tax reference number or a document verifying their tax reference number, the life company can still proceed with the policy but must include on their return to Revenue of benefit payments under such policy a marker to indicate that the tax reference number of the policy holder in question was not provided or verified, as the case may be.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- Unit linked savings plans ☐
- Unit linked bonds ☐
- Taxation of returns ☐
- Premium stamp duty ☐
- Policy ownership ☐
- Reporting benefit payments to Revenue ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. A prospective unit linked bond investor refuses to provide their tax reference number on the life company application form. In order to proceed with the policy, the life company MUST:

   A. obtain a disclaimer signed by the applicant.
   B. request in writing that the tax reference number is submitted within 14 working days.
   C. ensure that the tax reference number is provided in the following year's return of benefits payments to the Revenue.
   D. include in its return of benefits payments to the Revenue that the tax reference number was not provided for this investor.

2. When a unit linked policy is 8 years in force a deemed encashment is applied. This means:

   A. exit tax on the value of the policy is calculated and paid over to the Revenue.
   B. exit tax on the gain on the policy is calculated and paid over to the Revenue.
   C. exit tax on the value of the policy is calculated and accrued within the policy.
   D. exit tax on the gain on the policy is calculated and accrued within the policy.

3. Paul has a unit linked investment bond which currently holds 10,200 units in the life company's managed fund. The current price of the fund is € 2.50. He has decided to switch 50% of his units to the cash fund, which has a current price of € 1.50. There is no charge for the switch. How many cash fund units does Paul hold after the switch?

   A. 5,100
   B. 8,500
   C. 13,600
   D. 17,000

4. The difference between the Offer and Bid prices of a unit linked fund (the Bid/Offer Spread), is due to:

   A. tax.
   B. a distribution of profits to policyholders.
   C. a sales charge.
   D. a charge for life cover.

11

Taxation

This chapter looks at the income and USC tax liabilities of an individual and shows a sample personal income tax calculation. Capital gains tax (CGT) is also examined: when it arises, how it is calculated and when the liability must be paid. Corporation tax and partnerships tax treatment are briefly looked at.

Learning Outcomes – after studying this chapter you should be able to understand:
income tax and USC: and how an individual's tax liability is calculated;
capital gains tax: Understand how an individual's capital gains tax liability on sale of an investment is calculated and when the tax must be paid; and,
the taxation of companies and partnerships in relation to investment returns.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	11	3	5

11.1 Income Tax

11.1.1 The Tax Year

Income earned or received by an individual in any calendar year is taxable in the Irish state and the degree to which the taxation is applied depends on the individual's residency and domicile status. The Irish tax year runs from the 1st of January to December 31st .

11.1.2 Residency and Domicile

An individual is regarded as being resident in Ireland for a tax year if he or she is present in the state:

- For a total of 183 days or more, at any one time or on several occasions in the year of assessment. For the purposes of counting, an individual is deemed to be in the state for the full or part of any one day.
- At any one time in the year of assessment and the preceding year for a period which in total amounts to 280 days or more.
- However, he / she will not be regarded as resident for any tax year in which they spend a period in the whole, amounting to 30 days or less in the state and no account shall be taken of such a period for the purpose of the 280 day test.
- An individual is ordinary resident in the state if he / she has been resident for each of the three tax years preceding that year.
- An individual will not be ordinary resident for a tax year until such time as three consecutive tax years of non-residence have passed.

A domicile is a complex legal concept which is based on case law and generally applies to where a person is a national and where they choose to spend their lives. However, this is not always the case. The concept of Domicile requires that:

- No person can be without a domicile,
- No person can have more than one domicile,
- An existing domicile continues to exist until proven otherwise,

An individual is born with a domicile known as a domicile of origin which is usually (though not always) aligned with the domicile of their father.

The implications of residence, ordinary residence and domicile on Taxation in Ireland are important concepts which govern how taxation in Ireland is applied to individuals on a bespoke basis.

11.1.3 The Self-Assessment System

Payment of tax in Ireland is achieved using either

- The PAYE system (where the Employer deducts the Tax at source) or
- The self-assessment system where the onus is on the individual to Pay and File a tax return.

Within the PAYE system, an employee who has no other income other than their salary has no other return filing or tax payment obligations since all their tax is deducted at source.

However, income can be earned outside of the PAYE system and tax on this income must be paid using the self-assessment system. This may include income received from trading, investments, rental etc.,

In this case the “Chargeable Person” must file a tax return and pay their tax liability using the “Pay and File” system.

The common date for Paying and filing a tax return for a chargeable person is October 31st each year if completing the return by paper or mid-November if using the Revenue online System (ROS). The pay and file system allows for the:

- Payment of preliminary income tax due for the current tax year
- Payment of the balance of the income tax due for the previous year
- Filing a tax return for the previous year and
- Filing a calculation of a tax liability.

Where there is a failure to pay tax due on income received, an interest payment of 0.0219% per day will be charged by revenue.

11.2 Income Tax Schedules

For income tax purposes, income is classified under a number of different headings or *schedules*.

Schedule D, in turn, is divided into a number of different *cases*:

Schedule	Type of income
Schedule E	• Salary and wages arising from an employment; • Benefits in kind provided by an employer for an employee; • Pensions and annuities. • Normally, Schedule E income is subject to PAYE, PRSI and USC deduction at source.
Schedule D – Case I&II	• Income from a self-employed trade or profession.
Schedule D – Case III	• Dividends, rents and interest from foreign investments.
Schedule D – Case IV	• Deposit interest subject to DIRT, and other miscellaneous types of income.
Schedule D – Case V	• Rental income from an Irish property.
Schedule F	• Dividends from an Irish resident company.

Schedule E and Schedule D, Case I and II (above) relate to *earned income*, while the other Schedules relate to *unearned income*.

11.2.1 Tax Rates

Income tax is levied for the 2024 tax year on taxable income as follows:

Taxable income up to *standard rate band*	20%
Excess at *higher rate*	40%

Each taxpayer has a *standard rate tax band*, that is, a level of taxable income subject to standard rate tax, and personal tax credits to be offset against their income tax liability. Any income above this level is taxed at the top or *higher rate*.

Dividends paid by an Irish resident company are subject to withholding tax at 25% rate, before payment to individual investors.

The level of standard rate band varies by the marital status of the taxpayer and whether one or both spouses are working.

A *tax credit* is a credit or deduction against an individual's income tax liability.

The tax bands and main tax credits in 2024 are:

	Standard rate tax band 2024	Personal tax credit 2024
Single/widowed	€42,000	€1,875
Married/civil partners, one income	€51,000	€3,550
Married/civil partners, two incomes	€51,000 + increase max €33,000*	€3,550
One parent family	€46,000	€1,750 (additional)
Age tax credit (65 and over)		€245 (€490 for a married/civil partners)
Employee		€1,875 (max)
Earned income (self-employed)		€1875 (max)

**The increase is the lower of €33,000 and the amount of income of the spouse / civil partner with the lower income. The increase is not transferable between spouses / civil partners.*

11.2.2 Universal Social Charge (USC)

A universal social charge (USC) is payable on an individual's income from all sources, that is, on income ***before*** deduction of any tax reliefs, covenants etc.

The standard rate of USC payable in 2024 is as follows:

Total income subject to USC	USC rate
The first €12,012	0.5%
Income from €12,012.01 to €25,490	2.0%
Income from €25,490.01 to €69,774	4.0%*
Balance over €70,044	8.0%

There is a surcharge of 3% (total rate 11%) on individuals who have non-PAYE income that exceeds €100,000 in a year, regardless of age.

In the case of a married couple/civil partners, the USC rates and thresholds apply to each person individually. So, for example, if both are earning less than €70,044, the 8% rate will not apply, despite the fact that their combined income may be over €70,044.

All individuals are liable to pay the Universal Social Charge if their gross income exceeds the threshold of €13,000 p.a.

*Reduced USC rates, of 0.5% on the first €12,012 and 2% on the balance, apply to:

- Those aged 70 or over with total income less than €60,000; and
- Those aged under 70 with total income less than €60,000 and who hold a medical card.

The following types of income are exempt from USC:

- State pensions, benefits, and similar payments;
- Deposit interest on which DIRT has already been paid;
- Dividends paid by credit unions to their members;
- Returns from PRIIP investments;
- The tax-free part of ex-gratia redundancy payments paid by employers.

Where income is taxed under the PAYE system, the USC is applied to the gross income, *before* deduction of pension contributions, reliefs, tax credits, etc.

11.2.3 Income Tax Calculation Example

The general outline of how income tax is charged is as follows. The example is assumed to refer to a married couple with *one* earned income, and both are under age 65:

	Example
Total gross income from all sources, earnings, taxable investment income, etc.	Schedule E: €95,000 Schedule F: €5,000 (gross dividends from an Irish resident company) **Total: €100,000**
LESS	
Reliefs, such as personal pension plan contributions, permanent health insurance premiums.	- €3,000 (gross personal pension plan contribution)
Taxable income	**€97,000**
Standard rate tax band	€51,000 (assume married couple, one income) at 20% = €10,200
Balance taxable at 40%	€46,000 at 40% = €18,400
Total tax	**€28,600**
LESS	
Tax credits:	Married tax credit: € 3,750 PAYE tax credit: € 1,875 Dividend withholding tax on Irish dividends: € 1,250 Medical expenses (€2,000 at 20%) € 400 Total credits: **€7,275**
PLUS	
Total income tax liability for 2023	**€28,600 - €7,275 = €21,325**
PLUS USC First €12,012 at 0.5% Next €13,478 at 2% Next €44,284 at 4.5% Balance of €30,225 at 8%	 € 60 € 269 € 1992 € 2,418 **€ 4,679**
Total income tax and USC liability for 2024 (in addition to €1,250 already paid in DWT)	**€26,004**

11.2.4 Income Exemption Limit

A very important relief for income tax is the *income exemption relief*, which exempts individuals aged 65 and over totally from income tax (but not from the USC) where their total income from all sources, that is, *before* reliefs and tax credits, in the 2024 tax year does not exceed €18,000, or €36,000 for a married couple where at least one of them is age 65 or over. Individuals in receipt of the State pension only would therefore not be liable to income tax on it:

Married couple/Civil partners (age 65 and over)	2024
Income exemption limit	€36,000
State pension (contributory)[14] (individual + adult dependant over age 66)	€27,441 per annum
State pension (contributory)[14] (both spouses qualifying for pension in own right)	€28,939 per annum

11.3 Capital Gains Tax

Capital gains tax (CGT) is one of the capital taxes and is payable on profits realised on the sale or disposal of certain assets, such as shares, bonds, property or Irish REITs (see Chapter 7.7.3).

Capital gains tax applies at a current rate of 33% on chargeable gains made by an individual in a year, over and above an annual exemption limit of €1,270 of chargeable gains.

A chargeable gain on the disposal of an asset is arrived at by:

[Consideration received for disposal, less disposal costs] LESS [purchase price of assets, plus acquisition costs (adjusted for indexation relief, if appropriate)] = chargeable gain

Example

Paul buys 1,000 shares in a company at €15 per share in 2016. He pays stamp duty of 1% and commission of 1.5% on the acquisition of the shares.

He subsequently sells the shares in 2024 at €20 per share. The commission paid on the sale was 1.5%.

Calculate Paul's chargeable gain.

Consideration received less disposal costs =

(1000 x €20) – [0.015 x (1000 x €20)] = €19,700.

Purchase price plus acquisition costs =

(1000 x €15) + [(0.01 + 0.015) x (1000 x €15)] = €15,375.

Chargeable gain for CGT purposes = €19,700 – €15,375 = €4,325.

Indexation relief is the indexing of the cost of acquiring an asset in line with inflation from the time the cost was incurred to the time the asset is sold; the rationale being that you should only pay capital gains tax on a gain over and above inflation, that is, on a *real* gain. However, indexation relief only applies to the disposal or sale of assets which were originally acquired on or before 31st December 2002.

In general, losses arising on disposal of shares and any other types of assets, for example, property, etc., can be offset firstly against chargeable gains arising in the same tax year, any unrelieved losses can be carried forward and offset against any chargeable gains arising in future tax years.

[14] State pension (contributory) becomes payable from age 66, at the earliest. Annualised rate is weekly rate x 52.18.

The term *bed and breakfasting* refers to a practice of:

- Selling shares which stand at a gain and reacquiring the shares shortly afterwards, in order to crystallise a gain against which the investor can offset other allowable losses he/she may have in the same tax year, and/or to use the €1,270 annual CGT exemption. The dealing costs need to be offset against the tax saving to see if the transaction is worthwhile.

  Crystallising the gain also has the benefit of establishing a higher base cost for CGT purposes for future disposal of the shares.

- Selling shares which stand at a loss and reacquiring the shares shortly afterwards, with the purpose of realising a loss which can be offset against other chargeable gains arising in the same tax year.

  A minimum 30-day period must elapse between the sale of the shares and their reacquisition if the loss is to be allowable in the tax year of sale of the shares.

11.3.1 First in First Out

Where an investor buys shares in the same company at different times, when he or she comes to sell some of these shares, for capital gains tax purposes, it is important to determine which shares are being sold? The *first in first out* (FIFO) principle applies, whereby shares which are bought first are the ones deemed to be sold first.

Example

John buys shares in a company in three lots as follows:

January 2005: 1,000 shares at €2.00 each.

March 2006: 1,500 shares at €2.75 each.

March 2007: 2,000 shares at €3.75 each.

If John sells 1,500 shares in January 2024 at €4.00 each, the question arises as to which shares are being sold, in order to work out the capital gains tax liability.

In the example above, the 1,500 shares being sold in January 2024 would be deemed to be:

- 1,000 shares bought in January 2005 at €2.00 each; and
- 500 shares bought in March 2006 at €2.75 each.

The gain would be calculated accordingly:

1,500 x €4.00 less [(€1,000 x €2.00) + (500 x €2.75)] = €2,625.

11.3.2 Losses

Realised losses on some investments can be offset again chargeable gains liable to capital gains tax, before arriving at an investor's chargeable gains liable to CGT for a tax year. Losses carried forward from previous years can be offset against chargeable gains liable to capital gains tax in the current year. Losses can be transferred between spouses.

Note that realised losses on Irish and EU based PRIIPs, including unit linked policies and tracker bonds, *cannot* be offset against chargeable gains liable to capital gains tax purposes and *vice versa*, as these investments are exempt from CGT (see below). This is because these UCITS investments are taxable under the gross roll up scheme.

Example

Georgina sells shares in 2024 realising a large gain for capital gains tax purposes. In 2024, she also encashed a unit linked investment bond at a loss.

Georgina cannot offset the loss on the unit linked bond against the gain on the sale of the shares because they are treated for Tax differently.

11.3.3 Annual Allowance

Individuals, but not companies, are entitled to an annual capital gains tax exemption of €1,270 of chargeable gains in any tax year. If the annual exemption is not used by an individual in a particular year, it *cannot* be carried forward.

An individual is *not* entitled to transfer any part of the unused €1,270 annual allowance to their spouse/civil partner.

11.3.4 Exemptions

Capital gains tax is *not* payable on any gain arising to an individual investor from the sale or encashment of:

- Treasury bonds;
- Irish unit linked savings and unit linked bonds; gains are already subject to Exit tax before encashment value is paid out;
- EU based PRIIPs.
- Irish tracker bonds; gains are subject to exit tax (life assurance type) or DIRT (deposit type) before encashment value is paid out;
- Deposits; interest may be subject to DIRT or to income tax;
- The investor's main or sole residence;
- Property (land & buildings) bought between 6th December 2011 and 31st December 2014…and held for at least 4 years… on the gain made in the first 7 years of ownership.

11.3.5 Payment of Capital Gains Tax

Any capital gains tax liability arising in respect of a tax year must be paid by the chargeable person, direct to the Revenue Commissioners. The tax due date is dependent on when the gain was made, as follows:

When disposal of asset giving rise to gain occurs	CGT must be paid by
On or before 30th November in a tax year.	15th December in that same tax year.
1st December to 31st December in a tax year.	31st January in the following tax year.

So, for example, capital gains tax in respect of any chargeable gains made:

- In the period 1st January to 30th November 2024 must be paid by 15th December 2024
- In the period 1st December to 31st December 2024 must be paid by 31st January 2025.

11.3.6 Reliefs from CGT

There are a number of important reliefs from Capital Gains Tax available to business owners and entrepreneurs when the time comes to sell their businesses. These reliefs are dependent on fulfilling extensive criteria of ownership and level of participation in the business and include:

- Retirement Relief which can provide an absolute exemption from CGT on the disposal of certain qualifying assets by individuals who are aged between 55 and 66 years or more on the date of disposal. Retirement relief is a misnomer, as the business owner having disposed of the business assets, does not actually have to cease working in the business and the extent to which it is applied depends on who the sale is made to.
- Revised Entrepreneurial Relief provides for a reduced rate of CGT of 10% on the chargeable gain up to a lifetime limit of €1m assuming that certain conditions are met in full.

11.4 The Gross Roll Up Regime

Finance Act 2000 introduced the Gross Rollup taxation regime for investment undertakings (Also covered in 7.7). The general thrust of the regime is that there is no annual tax on income or capital gains arising to a fund. However, a fund has responsibility to deduct exit tax in respect of payments made to certain unit holders in that fund.

Where exit tax is deducted by a fund the deduction represents a final liability to Irish tax for unit holders who are individuals. For companies, see how they are treated in Chapter 11.5 below.

11.4.1 When must the investment undertaking deduct Exit tax?

In general, Exit tax must be deducted on the occurrence of a chargeable event. Such chargeable events happen:

- On the making of a regular payment by a fund to a unit holder.
- On the making of any other payment by a fund to a unit holder (e.g. on redemption of units), including where a payment is made on the death of a unit holder;

- On the transfer by a unit holder of his or her entitlement to units in a fund, including where a payment is made on the death of a unit holder;
- On the appropriation or cancellation of units by a fund to discharge tax payable on a gain arising from a transfer of units by a unit holder;
- On the ending of an 8-year period from inception, and each subsequent 8-year period beginning when the previous one ends; commonly known as a "Deemed Disposal.

Example

Peter invested €20,000 in an Investment bond with a Life Company. On the 7th anniversary, Peter sold all the units and encashed the investment. The value at the date of encashment was €28,142.

Exit tax at 41% was deducted, totalling €3,338, leaving a net amount payable of €24,804.

11.5 Corporation Tax

Companies pay corporation tax at 12.5% on their trading profits and 25% on investment income and realised gains.

Unrealised capital gains are gains that may be recorded on a company's balance sheet, where the investment has grown in value, but has not yet been sold and the gain realised.

Where a company realises a gain on a PRIIP from which Exit tax at 25% has been deducted, then the company is not liable to corporation tax on the return.

11.6 Partnerships Tax Treatment

Partners in a partnership are fully liable for the debts of the partnership, *pro rata* to their partnership share.

They are subject to income tax and capital gains tax on their respective share of the partnership taxable income and realised gains, that is, the partnership is looked through to the partners for income tax and capital gains tax purposes.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- Income tax ☐
- Capital gains tax ☐
- The Gross Roll Up Regime ☐
- Corporation tax ☐
- Partnerships tax treatment ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. What exit tax rate applies to gains realised by a company investment in an Irish Packaged Retail and Insurance Based-Investment Product (PRIIP)?

   A. 12.5%
   B. 25%
   C. 33%
   D. 41%

2. Miriam will NOT have a potential capital gains tax liability on disposal of which one of the following investments?

   A. A treasury bond issued by the Irish Government.
   B. A property located in a foreign jurisdiction.
   C. A bond issued by a company.
   D. Gold.

3. Mark and Joanne are married to each other and are in their late 60s. They are exempt from income tax in 2024 if their total income does NOT exceed:

   A. €13,000
   B. €18,000
   C. €25,000
   D. €36,000

4. Jordon pays income tax under Schedule D Case I. This confirms that he:

   A. receives dividend income.
   B. is engaged in a self-employed trade.
   C. receives rental income.
   D. is 66 or over.

12

Financial Maths

This chapter explains and builds an understanding of *the time value of money*. Both future value and present value (over a range of time periods) are examined, and examples shown. The impact of inflation and deflation on investment returns is explored and their importance in relation to financial planning. Measurements of return: IRR, AER and CAR are discussed as well as the impact of charges on investment return which can be measured by calculating reduction in yield (RIY).

Learning Outcomes – after studying this chapter you should be able to:
understanding the *time value of money*;
calculating the rate of inflation or deflation over a particular period of time;
accumulating and discounting a capital sum over a particular period of time;
measurements of returns: *internal rate of return, AER* and *CAR*; and,
reduction in yield (RIY) measurement of the impact of charges in an investment product.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	12	3	5

12.1 Understanding the 'Time Value of Money'

When advising a consumer in relation to personal financial planning, accumulating funds for the future is a constant theme, for example:

- Accumulating savings to grow into a capital sum in the future;
- Investing a lump sum to grow and be drawn on, in the future.

It is important to understand that the value of a €1 changes over time:

- A €1 invested today will accumulate with interest over a period to an amount greater than €1;
- A €1 in, say, 20 years, will be worth less, that is, in terms of the goods and service it can buy called the *present value*, than a €1 today.

It is therefore important to understand, what is called, the *time value of money.*

12.2 Inflation and Deflation

Inflation is the rate of increase in the price of an average basket of goods and services used by the average consumer, over a period of time. The most frequently quoted rate of inflation is the annual *inflation rate,* that is, the increase in the price of goods and services over the last 12 months.

However, it is possible for the price of goods and services to fall, in which case the rate of decline in the price of goods and services over a period is referred to as *deflation*.

Although we can sometimes talk about inflation in relation to one item for example, house prices, or a small group of items, the term is usually used to describe the general increase in prices of those goods and services which make up the *Consumer Price Index - All Items* (CPI).

Every month, the *Central Statistics Office (CSO)* issues a statistical release which publishes the most recent CPI value. This can be obtained from www.cso.ie. The index values (using a base of 100 at November 1996) over the last 20 years are:

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2003	123.6	124.8	125.8	126.1	126.0	126.0	125.1	125.9	126.1	126.0	126.0	126.5
2004	125.9	126.9	127.4	127.9	128.1	128.8	128.5	129.2	129.3	129.4	129.7	129.8
2005	128.8	129.8	130.1	130.8	131.1	131.6	131.5	132.1	133.2	133.3	133.0	133.0
2006	132.6	134.0	134.6	135.7	136.3	136.7	137.1	138.0	138.5	138.5	139.0	139.5
2007	139.3	140.5	141.5	142.6	143.1	143.5	143.9	144.5	145.0	145.2	145.9	146.1
2008	145.3	147.2	148.6	148.8	149.8	150.6	150.2	150.9	151.2	150.9	149.6	147.7
2009	145.3	144.7	144.7	143.6	142.9	142.5	141.4	141.9	141.4	141.1	141.0	140.3
2010	139.5	140.1	140.2	140.6	141.3	141.2	141.2	142.2	142.0	142.1	141.9	142.2
2011	141.9	143.1	144.4	145.0	145.1	145.0	144.9	145.2	145.6	146.1	146.1	145.7
2012	144.9	146.2	147.7	147.7	147.7	147.5	147.3	148.1	147.9	147.9	147.3	147.4
2013	146.7	147.8	148.5	148.5	148.3	148.4	148.3	148.4	148.2	148.0	147.7	147.7
2014	146.9	147.8	148.7	148.8	148.8	149.0	148.7	149.0	148.7	148.2	147.9	147.3
2015	146.1	147.0	147.9	147.8	148.4	148.8	148.4	149.0	148.4	147.9	147.5	147.4
2016	146.2	146.8	147.4	147.7	148.5	149.5	149.1	148.8	148.2	147.6	147.5	147.4
2017	146.7	147.6	148.5	149.1	148.7	148.8	148.9	149.5	148.6	148.4	148.2	148.0
2018	147.0	148.2	148.7	148.5	149.4	149.5	150.0	150.4	150.0	149.7	149.1	149.0
2019	148.1	149.2	150.3	150.9	150.8	151.1	150.8	151.5	151.2	150.9	150.6	150.9

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2020	150.0	150.8	151.4	150.8	150.0	150.6	150.2	150.0	149.5	148.6	149.0	149.4
2021	149.7	150.2	151.4	152.4	152.6	152.9	153.4	154.4	155.0	156.1	157.0	157.8
2022	157.1	158.5	161.6	163.1	164.5	166.7	167.4	167.7	167.7	170.4	171.0	170.7
2023	169.3	172	173.9	174.8	175.4	176.9	177.2	178.3	178.6	179.1	177.7	178.5

To calculate the inflation or deflation rate over a particular period, the following formula is used:

$$\left(\frac{CPI^{\text{End period}}}{CPI^{\text{Start period}}} - 1\right) \times 100\%$$

If the answer is positive, it's *inflation*. If the answer is negative, it's *deflation*.

So, for example, over the period January 2005 to January 2006:

$$\left(\frac{132.6}{128.8} - 1\right) \times 100\% = +2.95\%$$

So, the rate of *inflation* over this period was 2.95%.

Over the period March 2009 to March 2010:

$$\left(\frac{140.2}{144.7} - 1\right) \times 100\% = -3.1\%$$

So, over the period March 2009 to March 2010 there has been *deflation* of 3.1%, that is, the average price of goods and services measured by the CPI (All Items) *fell* by 3.1% over this period.

If you review & consider the numbers for the 4-year period, January 2013 to January 2017 it gives an interesting snapshot of the Irish economy for that time slot. Inflation was zero for the period while more recently for 2022 (as measured from December 2021 to December 2022) inflation was 8.2%.

12.2.1 Allowing for Inflation

So far, we have looked at inflation from a historic perspective. In the more immediate past we have had deflation, rather than inflation.

However, inflation is more likely to occur over the longer term, than deflation, as inflation is usually a sign of healthy economic growth. Deflation, on the other hand, is typically a sign of temporary economic recession, when demand for goods and services in the economy falls.

If we were to assume that inflation would average 2% per annum over the next 20 years, this table highlights the purchasing power of money over the term:

2% per annum inflation assumed

After	Projected purchasing power in the future of €1,000 of 2024 money	Sum needed in the future to provide the same purchasing power as €1,000 did in 2024
5 years	€906	€1,104
10 years	€820	€1,219
15 years	€743	€1,346
20 years	€673	€1,486

Most people would consider 2% per annum to be a low inflation rate.

Yet the impact of this modest inflation rate on the future purchasing power of €1,000 is striking ... after 15 years the same €1,000 will only buy 74% of the goods and services as it would today. Just to keep pace with inflation, the €1,000 would need to have grown to €1,346.

If we were to assume a 5% rate, the figures are even more striking:

5% per annum inflation assumed

After	Projected purchasing power in the future of €1,000 of 2024 money	Sum needed in the future to provide the same purchasing power as €1,000 did in 2024
5 years	€784	€1,276
10 years	€614	€1,628
15 years	€481	€2,079
20 years	€377	€2,653

As far as providing financial advice to clients is concerned, the above figures make it clear that it is prudent to allow for some level of future inflation in financial planning.

Inflation has a significant effect on savers and investors. Most savers and investors will want, as a minimum objective, to at least maintain the real (that is, after allowing for inflation) value of their accumulated capital, as otherwise its real value, in terms of purchasing power, will be declining.

However, investors ideally want to beat inflation, not just match it. In effect investors want to obtain a real investment return, that is, a return over and above the ongoing inflation rate. Therefore, if inflation over the year was, say, 1%, investors would need to obtain a return of 3% over that year, if they wanted to achieve a real return on their savings and investments of 2% over the year.

12.3 Compound Interest

12.3.1 Overview

It is obvious after having looked at the impact of inflation that a €1, in terms of its purchasing power, will not retain the same purchasing power as a €1 in 10 years.

Therefore, in considering the value of money we have to consider the impact of compound interest, in **two** different ways:

- *Accumulating*; and
- *Discounting*.

These are two sides of the same *compound interest* coin.

12.3.2 Accumulating

When we refer to a 3% per annum interest rate, for example, we mean that €1,000 invested will earn €30 interest paid at the end of the year. Interest is like rent paid for the use of money. So, after one year, we would expect €1,000 to have grown to €1,030. The €30 interest is added to the capital to become €1,030 capital.

If this sum is then left for a further year, at a 3% interest rate, then at the end of the second year 3% interest is added to the €1,030 capital to give interest for that year of €30.90, and a new capital balance of €1,060.90. The extra €0.90 is the *interest on the interest*. This is the effect of compound interest.

So, the formula for accumulating €1,000 at an interest rate of 3% per annum, is:

Accumulated value at 3% per annum of €1,000 invested for N years

= €1,000 x (1.03)^(N).

Some calculators have a $y^{\wedge x}$ button, which you can use to work out this calculation.

Example

If €1,000 is invested at 6% per annum over 10 years, what will it have accumulated to at the end of the 10 years?

The answer is = €1,000 x (1.06) ^ (10) = €1,790.80.

This table shows the accumulated value of €1,000 at five yearly intervals.

After	Accumulated value of €1,000…		
	…at 2% per annum	…at 3% per annum	…at 5% per annum
5 years	€1,104	€1,159	€1,276
10 years	€1,219	€1,344	€1,629
15 years	€1,346	€1,558	€2,079
20 years	€1,486	€1,806	€2,653
25 years	€1,641	€2,094	€3,386

12.3.3 Discounting

Discounting is a way of expressing the value of a sum of money payable in the future, in terms of its value today, that is, its present value. It is the inverse or opposite of accumulation.

Present Value

Therefore, the formula for calculating the *present value*, at say 3% per annum, of €1,000 payable after N years is:

Present value at 3% per annum of €1,000 payable after N years

= €1,000 / (1.03)^(N).

The following is a series of examples of how discounting works.

Example #1

Which would you choose if offered:

1. €10,000 in five years; or
2. €20,000 in 10 years.

Which is the more valuable in terms of today's money, that is, what is the present value of the two sums today?

Let's say we assume a 5% per annum interest rate.

Present value of €10,000 in 5 years = €10,000/(1.05)^(5) = €10,000/1.276 = **€7,836**.

Present value of €20,000 in 10 years = €20,000/(1.05)^(10) = €20,000/1.629 = **€12,277**.

So, assuming a 5% interest rate, €20,000 in 10 years is more valuable than €10,000 in five years.

Sometimes we want to approach things from the other way... that is, what amount needs to be invested now to accumulate a particular lump sum at a certain time in the future.

Example #2

What lump sum needs to be invested today at, say, 5% per annum, to accumulate to €50,000 in 20 years?

Lump sum = €50,000/((1.05) ^ (20)) = €50,000/2.653 = €18,844.5.

So, assuming 5% per annum interest, €18,844.5 would need to be invested today to accumulate to €50,000 in 20 years.

This table shows the *present value* of €1,000 payable at certain durations**,** that is, these factors are simply the inverse of the equivalent accumulating factors:

€1,000	Present value today…		
payable after	…at 2% per annum	…at 3% per annum	…at 5% per annum
5 years	€906	€863	€784
10 years	€820	€744	€614
15 years	€743	€642	€481
20 years	€673	€554	€377
25 years	€610	€478	€295

Tables showing the accumulation and discounting factors at different rates and at yearly durations from one year to 25 years are shown at the end of this chapter.

12.3.4 The Internal Rate of Return (IRR)

The *internal rate of return* or *IRR* is the term used to describe the interest rate at which the present value of one series of payments is equal to the present value of another set of payments, that is, the rate at which the net present value of the two series of payments is zero.

Example #1

Consider two series of payments:

Series 1: €100,000 now;

Series 2: €10,000 per annum for 15 years.

The internal rate of return or IRR is the rate of interest at which the present value of Series 2 payments is = €100,000.

The **IRR** can be found, in the above example, by a series of trial and error:

Present value of Series 2 payments at 5% per annum: €103,797.

Present value of Series 2 payments at 6% per annum: €97,123.

So, we know the answer, that is, the discount rate at which the present value of Series 2 payments = €100,000, is somewhere between 5% and 6% per annum.

Financial Calculators or Spreadsheet packages, like *Excel*, usually contain inbuilt functions which can calculate the IRR for two series of payments. Using the IRR function in Excel, the IRR of the two series of payments above is 5.56% per annum.

In other words, if you paid out €100,000 now in return for €10,000 per annum payable at the end of each of the next 15 years, you would get an investment return of 5.56% per annum, that is, the rate at which the present value of each of the series of payments is equal and the net present value is zero.

The IRR is a valuable metric for assessing the viability of an investment while taking into account the time value of money. Take the example below where an investment of €100,000 is made and a series of payments increasing in value, are received over the following five years.

Example #2

	2024	2025	2026	2027	2028	2029
Initial Investment	(€100,000)					
Cashflow		€25,000	€30,000	€35,000	€40,000	€45,000

Consider two series of payments:

Series 1: An investment of €100,000 in 2024;

Series 2: Receipt of incrementally increasing payments for the next 5 years.

The internal rate of return or IRR is the rate of interest at which the present value of Series 2 payments is = €100,000. In this case, the IRR is 19.71% per year for the series of future payments.

In making investment decisions, the IRR must be compared to a standard, say the cost of capital. If the IRR is greater than or equal to the cost of capital, an investor might accept the payment series as good investment. The goal is that the investor is making the best use of available cash and future cashflows.

12.4 Reduction in Yield (RIY)

12.4.1 What is the RIY?

The term *reduction in yield* or RIY is the term used to describe a means of expressing the impact of all projected charges in a savings or investment product over a period of time, in terms of a reduction in the yield or return that would otherwise have been provided if the policy carried no charges at all. The charges might include (but are not limited to) set up charges, exit penalties, ongoing charges, advisor charges, provider charges and fund charges and are apportioned over the investment term.

Example

Take a unit linked investment bond.

If we assumed an investment return before charges of, say, 6% per annum, then if the bond had a reduction in yield of, say, 1.5% per annum, the projected return, net of all charges, provided by the bond is 4.5% per annum, in this example.

Disclosure notices for savings, investment and pension policies must show the projected reduction in yield.

12.4.2 Comparing RIYs

All other things being equal, a particular product, out of a group of similar competing products, with the lowest *RIY* over a specified period is likely to have the lowest charges of those competing products over that period.

RIYs can be particularly useful in comparing competing savings and investment products.

However, it shouldn't always be taken as a certainty of lowest charges for the following reasons:

- Some products may have an ability to increase charges in the future; for example, a fund management charge may be 1% per annum today, but a life company may be able to increase that charge in the future. Therefore, a projected RIY calculated assuming a 1% per annum fund management charge continues unchanged for the specified period, may be invalidated later by an increase in the level of the fund management charge.

- A projected RIY calculation relates to a particular period of time, for example, the anticipated savings term of savings plans. A different projected RIY may apply at shorter durations, so that, depending on the nature and incidence of the charging structure used, in the example below Plan A might be more expensive over a shorter term.

Projected RIY of two competing savings plans

	Plan A	Plan B
Over 10 years	2.4% per annum	2.0% per annum
Over 20 years	2.0% per annum	1.9% per annum
Over 25 years to retirement	1.6% per annum	1.8% per annum

In the above example, comparing RIYs over the term would suggest that Plan A has lower projected charges than Plan B.

However, if the plan were to be drawn on earlier than expected, Plan B would have lower charges than Plan A over the same period.

The above example of projected RIYs might be explained by Plan A having a *front-end charge* design, but Plan B having a *spread charge design*.

12.5 AER

The term AER refers to the ***a**nnual **e**quivalent **r**ate*. It is used as a means of expressing the return quoted on a deposit account in terms of the equivalent annual rate of interest payable at the end of the year and takes into account the number of periods of compounding. See Chapter 7 for more details on the calculation of AER and its use to compare deposit rates.

The Central Bank Consumer Protection Code requires that any advertisement for a savings or deposit account must show the AER along with the relevant interest rate quoted for any particular term, and that both rates must be given equal prominence.

In the past, the term ***c**ompound **a**nnual **r**ate* (CAR) has been used to describe this annual equivalent rate and indeed you may see the term EAR (equivalent annual rate) used in advertisements.

However, a clarification document issued by the Central Bank in relation to the Consumer Protection Code states that:

> *"…for clarity and comparative purposes for consumers the use of acronyms for interest rates in advertisements for savings and investment products should be consistent. It is the view of the Central Bank that the appropriate term to describe this rate is AER. The term CAR is only used in the Consumer Protection Code in relation to Tracker Bonds."*

Future value of €1,000 invested now at end of year x, at the rates shown

After (years)	1% per annum	2% per annum	3% per annum	5% per annum
1	€1,010	€1,020	€1,030	€1,050
2	€1,020	€1,040	€1,061	€1,103
3	€1,030	€1,061	€1,093	€1,158
4	€1,041	€1,082	€1,126	€1,216
5	€1,051	€1,104	€1,159	€1,276
6	€1,062	€1,126	€1,194	€1,340
7	€1,072	€1,149	€1,230	€1,407
8	€1,083	€1,172	€1,267	€1,477
9	€1,094	€1,195	€1,305	€1,551
10	€1,105	€1,219	€1,344	€1,629
11	€1,116	€1,243	€1,384	€1,710
12	€1,127	€1,268	€1,426	€1,796
13	€1,138	€1,294	€1,469	€1,886
14	€1,149	€1,319	€1,513	€1,980
15	€1,161	€1,346	€1,558	€2,079
16	€1,173	€1,373	€1,605	€2,183
17	€1,184	€1,400	€1,653	€2,292
18	€1,196	€1,428	€1,702	€2,407
19	€1,208	€1,457	€1,754	€2,527
20	€1,220	€1,486	€1,806	€2,653
21	€1,232	€1,516	€1,860	€2,786
22	€1,245	€1,546	€1,916	€2,925
23	€1,257	€1,577	€1,974	€3,072
24	€1,270	€1,608	€2,033	€3,225
25	€1,282	€1,641	€2,094	€3,386

Present value of €1,000 payable at end of year x, at the rates shown

Payable in (years)	1% per annum	2% per annum	3% per annum	5% per annum
1	€990	€980	€971	€952
2	€980	€961	€943	€907
3	€971	€942	€915	€864
4	€961	€924	€888	€823
5	€951	€906	€863	€784
6	€942	€888	€837	€746
7	€933	€871	€813	€711
8	€923	€853	€789	€677
9	€914	€837	€766	€645
10	€905	€820	€744	€614
11	€896	€804	€722	€585
12	€887	€788	€701	€557
13	€879	€773	€681	€530
14	€870	€758	€661	€505
15	€861	€743	€642	€481
16	€853	€728	€623	€458
17	€844	€714	€605	€436
18	€836	€700	€587	€416
19	€828	€686	€570	€396
20	€820	€673	€554	€377
21	€811	€660	€538	€359
22	€803	€647	€522	€342
23	€795	€634	€507	€326
24	€788	€622	€492	€310
25	€780	€610	€478	€295

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] The time value of money
- [ ] The impact inflation can have on a client's financial needs over time
- [ ] How to calculate the rate of *inflation* over a specified period, using a supplied table of *Consumer Price Index* values
- [ ] How to calculate the rate of *deflation* over a specified period, using a supplied table of *Consumer Price Index* values
- [ ] How to calculate a sum *discounted* over a specified period at a specified rate of interest, using supplied discounting tables
- [ ] How to calculate a sum *accumulated* over a specified period at a specified rate of interest, using supplied accumulation tables
- [ ] What each of the following terms is, and how they can be used*; internal rate of return, reduction in yield,* and *AER*

Sample Questions

The answers to these questions can be found in your Study Hub.

1. The compound annual return of a deposit is also referred to as the:

   A. AER.
   B. RIY.
   C. IRR.
   D. RIC.

2. What sum must Emily invest now for seven years to accumulate a fund of € 20,000 after seven years, assuming she earns an investment return of 3% per annum over that period, using the supplied factors?

   A. €12,060
   B. €14,220
   C. €16,260
   D. €18,480

3. If inflation runs at 5% per annum over the next 15 years, what will be the purchasing power of €1,200 in 15 years' time in terms of the equivalent purchasing power of €1,200 today, using the supplied factors?

   A. €481
   B. €577
   C. €743
   D. €844

4. If the Consumer Price Index one year ago was 142.5 and today it is 148.4, what has been the rate of inflation over the last 12 months?

   A. 3.5%
   B. 3.9%
   C. 4.1%
   D. 5.9%

13

Consumer Protection Code Promotional Obligations

This chapter introduces the main obligations and restrictions on product producers and intermediaries (under the CPC) when advertising savings and investment products.

Learning Outcomes – after studying this chapter you should be able to:
understand the Consumer Protection Code *obligations* on product producers and intermediaries when advertising savings and investment products; and,
know the Consumer Protection Code *restrictions* on product producers and intermediaries when advertising savings and investment products.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	13	3	5

13.1 Advertising

The Central Bank's *Consumer Protection Code* imposes a number of obligations on all financial services providers in relation to *advertisements* for investment products which are subject to the Code. The code was published in 2012 and is currently undergoing a review process. As part of this process, the Central Bank has issued a consultation paper requesting stakeholder comments and feedback and a revised code is due to be published in early 2025 with implementation scheduled for between 2025 and 2026.

The term *advertisement* is very wide and includes:

> *"…any commercial communication in respect of a regulated entity, which is addressed to the consumer public or a section of it, the purpose being to advertise a regulated activity or a regulated entity excluding name plaques, sponsorship material and a prospectus drawn up in accordance with the Prospectus Directive (2003/71/EC)."*

So, the term would include brochures and flyers for savings and investment products, as well as websites promoting investment products. However, it excludes plaques and sponsorship material.

Advertising of any kind is a key source of information for consumers. It is therefore important that regulated entities produce advertising that is 'clear, fair, accurate and not misleading' as this is one of the over-arching principles of the advertising requirements of the Consumer Protection Code 2012 ("the Code"). The advertising material used by a regulated entity needs to match what its products and services deliver and enable consumers to feel confident about the choices they make. Headline claims and offers in advertising materials must be balanced with information on areas such as risks, fees and charges, to enable the consumer to make a fully informed choice.

CBI guidance Oct 2013 on the Advertising Requirements of the Consumer Protection Code 2012

13.1.1 Inclusion of Warning Statements

A number of different warning statements must be placed on all advertisements for investment products:

- Where the advertised investment product can fluctuate in price or value, the advertisement must contain the following warning statement:

  Warning: The value of your investment may go down as well as up.

- Where an investment product is described as being likely to yield income or as being suitable for a consumer particularly seeking income, and where the income from such product can fluctuate, the advertisement must contain the following warning statement:

  Warning: The income you get from this investment may go down as well as up.

- An advertisement for a product where the consumer may not get back 100% of the initial capital invested must contain the following warning statement:

  Warning: If you invest in this product you may lose some or all of the money you invest.

- An advertisement for a product where the promised return of capital is only applicable on a specific date, must contain the following warning statement:

  Warning: If you cash in your investment before [specify the particular date] you may lose some or all of the money you invest.

- An advertisement for a product where there is no access to funds for the term of the product must contain the following warning statement:

  Warning: If you invest in this product you will not have any access to your money for [insert time required before the product matures].

- An advertisement which contains information on past performance must contain the following warning statement:

  Warning: Past performance is not a reliable guide to future performance.

- Where an advertised investment product is denominated or priced in a foreign currency, or where the value of an advertised product may be directly affected by changes in foreign exchange rates, the advertisement must contain the following warning statement:

  Warning: This product may be affected by changes in currency exchange rates.

Central Bank guidance on this requirement states:

"…they should be consistent with the content in the advertisement. Where there are stipulations on benefits or returns, these must be explained to ensure that the advertisement is clear, fair and accurate and that the consumer is not misled.

For example, should an investment product only yield a promised return of capital on a particular date, the warning should clearly inform the consumer that an early encashment could result in the consumer losing some or all of their capital investment."

13.1.2 Key Information

The Code requires that:

- Key information, in relation to the advertised product or service, is prominent and is not obscured or disguised in any way by the content, design or format of the advertisement; and

- Small print or footnotes are only used to supplement or elaborate on the key information in the main body of the advertisement and must be of sufficient size and prominence to be clearly legible.

Key information is defined in the Code as “any information which is likely to influence a consumer’s actions with regard to a product or service.”

The Central Bank has provided guidance as to what might constitute key information in relation to a savings or investment product:

- A clear description of the actual product (for example, lump sum versus regular savings);

- Rate/rate type (for example, fixed, variable);

- The term;

- Whether withdrawals are permitted and whether penalties apply;

- New business restrictions;

- Minimum/maximum opening balance;

- Minimum/maximum deposit amounts (including if lumps sums can be lodged);

- Frequency of deposits;

- Applicability of capital guarantees;

- Applicability of State guarantees;

- Net interest rates;

- Expiration (what happens).

13.1.3 Providing Information on Past Performance

Where information is being provided about the past performance of an advertised product, this information must:

- Be based on a product similar to that being advertised;

- Not be selected to exaggerate the success or disguise the lack of success of the advertised product;

- State the source of the information;

- Be based on actual performance;

- State clearly the period chosen, which must be related to the term of the product being advertised;

- Include the most recent period;
- Indicate, where they arise, details of transaction costs, interest and taxation that have been taken into account; and
- State, where applicable, the basis upon which performance is quoted.

13.1.4 Providing Information on Simulated Performance

Simulated performance involves indicating what an investment product which is now available would have produced if it had been available in the past. For example, advertising for a tracker bond currently for sale might show what the bond would have produced had someone invested in it, say, five years ago.

Where information is given in an advertisement about the simulated performance of an advertised investment product, this information must:

- Be based on a simulated performance that is relevant to the performance of the advertised product or service or of the regulated entity;
- Not be selected to exaggerate the success or disguise the lack of success of the advertised product or service or of the regulated entity;
- State the source; and
- Indicate whether, and to what extent, transaction costs, interest and taxation have been taken into account.

An advertisement which contains illustrations or information on simulated performance must also contain the following warning statement:

> *Warning: These figures are estimates only. They are not a reliable guide to the future performance of this investment.*

13.1.5 Use of the Term Guaranteed

An advertisement must not describe an investment product as *guaranteed* or partially guaranteed unless:

- There is a legally enforceable agreement with a third party who undertakes to meet, to whatever extent is stated in the advertisement, the consumer's claim under the guarantee;
- The regulated entity has made, and can demonstrate that it has made, an assessment of the value of the guarantee;
- It clearly states the level, nature and extent of limitations of the guarantee and the name of the guarantor; and
- Where it is the case, the advertisement must state that the guarantee is from a connected party of the regulated entity.

Note that a life company, for example, can not advertise a tracker bond as being guaranteed unless the guarantee is provided by a third party, for example, where part of the investment amount is placed on deposit with a bank. If the life company is providing the guarantee itself, it cannot describe the product as being guaranteed.

13.1.6 Reference to Taxation

Where an advertisement contains a reference to the impact of taxation, it must:

- State the assumed rate of taxation;
- State, where applicable, that the tax reliefs are those currently applying, and state that the value of the tax reliefs referred to in the advertisement apply directly to the consumer, if appropriate;
- State, where applicable, that the matters referred to are only relevant to a particular class or classes of consumer with particular tax liabilities, identifying the class or classes of consumer and the type of liabilities concerned;
- State who has the responsibility for obtaining the tax benefits advertised;
- Not describe the advertised product as being free from any liability to income tax unless equal prominence is given to a statement, where applicable, that the income is payable from a product from which tax has already been paid; and
- Not describe the advertised product or service as being free from any liability to capital taxation unless equal prominence is given to a statement, where applicable, that the value of the advertised product is linked to a product which is liable to capital taxation.

13.1.7 Return Unknown in Advance

Where the return on an investment product is not set or calculated until a particular date in the future, for example the maturity date of the investment, this must be clearly stated in an advertisement for such a product.

An example would be a tracker bond, where the return cannot be determined until the bond matures.

13.1.8 Regular Encashment

Where an advertised product offers the facility of a planned withdrawal from capital as an income equivalent, the effect of such a withdrawal on the investment must be clearly explained in the advertisement, for example, that unless the remaining capital grows at a rate at least equal to the rate of regular withdrawals, the investor's capital will be reduced and could eventually be exhausted all together.

13.1.9 Not Readily Realisable

An advertisement for an investment product which is not readily realisable, must state that it may be difficult for consumers to sell or exit the product and/or obtain reliable information about its value or extent of the risks to which it is exposed.

13.1.10 Early Encashment

An advertisement for an investment product that cannot be encashed prior to maturity, or which incurs an early redemption charge if encashed prior to maturity, must clearly states that this is the case.

13.1.11 Products Subject to Front-End Charges

An advertisement for a product subject to *front-end* charge must state that:

- Deductions for charges and expenses are not made uniformly throughout the life of the product, but are loaded onto the early period;
- If the consumer withdraws from the product in the early period, the practice of front-end loading of charges will impact on the amount of money which the consumer receives; and
- If applicable, that a consumer may not get back the full amount they invested.

13.2 Obligations on Product Producers

The Consumer Protection Code imposes a number of obligations on product producers in relation to investment products. Product producers are financial institutions who *"produces, manufactures or packages a product of a financial or investment nature"*, for example, life assurance companies, banks and investment firms.

13.2.1 Launching New Investment Products

When a product producer designs and launches a new investment product to be sold to consumers, the product producer must provide the following details to any intermediary who is promoting and selling that product to consumers:

- The key characteristics and features of the product;
- The target market of consumers for the product;
- The nature and extent of the risks inherent in the product; and
- The level, nature, extent and limitations of any guarantee attaching to the product and the name of the guarantor.

The term *target market* is defined in the Code as: *"the profile of the group of consumers at which the regulated entity aims a particular investment product"*, that is, the profile of consumers for whom the product may be suitable.

Within the first year of launching a new investment product which is sold to consumers, and at least annually thereafter, a product producer must update the product information above and provide that updated information to any intermediary who is promoting and selling that product to consumers.

13.2.2 Intermediaries

When selling an investment product to consumers through an intermediary channel, a product producer must provide information to the intermediary about the investment product that is clear, accurate, up to date and not misleading, and includes the information outlined in the previous section.

The product producer must provide an ongoing facility to the intermediary to ask questions and obtain information on an investment product. The product producer must:

- Provide this facility to the intermediary for the duration of the period in which that product is offered for sale by the product producer; and
- Inform the intermediary of his or her right to that ongoing facility.

13.2.3 Packaged Retail & Insurance Based Products (PRIIPs)

Packaged retail and insurance-based investment products (PRIIPs) cover the range of investment products marketed to retail investors which are subject to an investment risk. Their scope includes insurance linked investment products and UCITS, as well as other more complex products.

The variety and complexity of the products and the size of the market means that consumers need comprehensive information about them. The main requirement is the production of a Key Information Document (KID) to be supplied to consumers at pre contract stage. This is covered in Chapter 7.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- CPC advertising restrictions ☐
- CPC obligations on product producers ☐
- The CPC Requirements for Financial Advisors selling packaged investment products ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. When a product producer markets an investment product through intermediaries, it must, under the Consumer Protection Code, provide intermediaries with a facility to ask questions and obtain information on the product:

   A. only before the product is launched.
   B. only before the intermediary first sells the product to a consumer.
   C. throughout the period in which the producer offers that product for sale.
   D. for the first year only, after launch of the product.

2. For a life company to describe its Tracker Bond as 'guaranteed', the MINIMUM requirement under the Consumer Protection Code is that the:

   A. life company must have a credit rating of at least AA.
   B. bond must have a term of at least three years.
   C. guarantee must be provided by a third party.
   D. life company must be established in the State.

3. When providing information on simulated performance on an investment product:

   A. the information must exclude transaction costs that may have been incurred.
   B. the source of the information must be stated.
   C. the information must be accompanied by a warning saying that ‘these figures are a reliable guide to
   future performance’.
   D. the minimum period that must be used is ten years.

4. Under the Central Bank’s Consumer Protection Code in relation to ‘advertisements’ for an investment product, which of the following is NOT included?

   A. A commercial communication by a regulated body.
   B. Sponsorship material.
   C. A flyer for an investment product.
   D. A website promoting an investment product.

14

Comparing Investment Products

There are a range of potential risks to be considered and evaluated when choosing a savings or investment product. In this chapter investment risk (the risk of volatility of investment returns) is reviewed under a number of headings and how these are interrelated.

Learning Outcomes – after studying this chapter you should be able to:
outline the main factors to consider when comparing savings and investment products: investment risk, charges, returns, taxation and access; and,
have an understanding the different types of investment risk.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	14	3	5

14.1 Investment Options

As we have seen, there are a number of different savings and investment products available to meet the needs of consumers:

- Deposits;
- State savings;
- Shares;
- Bonds;
- Packaged Retail Insurance based and Investment Products (PRIIPs);
- Unit linked savings plans provided by life companies;
- Tracker bonds, provided by life companies and banks.

Sometimes more than one product type can meet a consumer's needs, and within one product type there may be different products available from different providers.

Therefore, an essential part of providing financial advice to consumers is to:

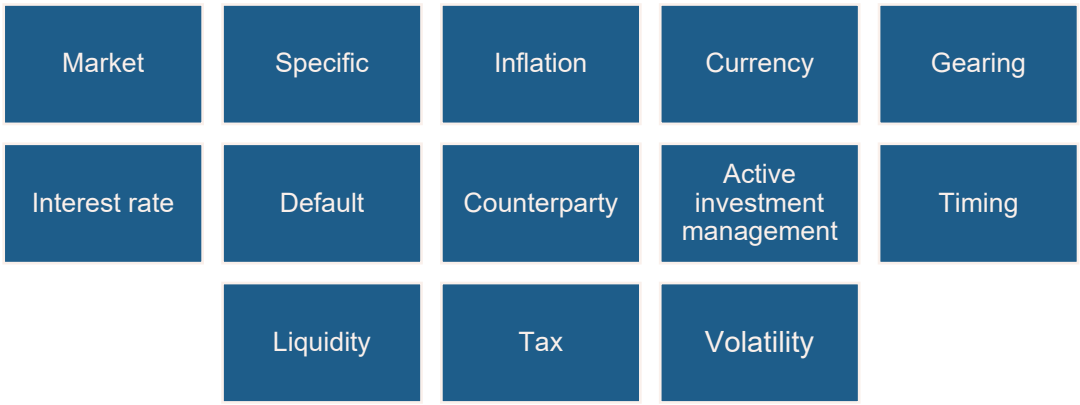
- Compare one generic type of product with another generic product type; for example, investing in shares directly as compared to investing in a PRIIP; and
- Compare similar product types from different providers, for example, unit linked investment bonds from different life assurance companies.

14.2 Basis for Comparison

14.2.1 Investment Risk

In Chapter 3 we discussed the volatility of investment returns, which is a key measure of investment risk.

However, there are different causes or components of investment risk that may be involved in investment products. Some of these risks are interrelated.



Market Risk

This refers to the general risk of being invested in a particular investment market at any time, such as stocks and shares, and property.

An investment in stocks and shares (whether direct or indirectly through a collective investment scheme fund) can fall in value due to a general slide in the value of stock markets generally, for example, during the recent Covid-19 pandemic. Sometimes this is referred to as systemic investment risk. It is the risk of being invested in the market.

One method of attempting to reduce market risk is through diversification between the main asset classes, for example, with a portfolio of equities, bonds, property and alternatives such as commodities, in the hope or expectation that their returns will not be highly correlated with each other. This is the basic premise behind 'Multi Asset Funds' offered from the various life companies today.

Specific Risk

This is the risk that events could happen which will adversely affect the value of a specific investment or a whole category of such investments.

An example would include Volkswagen's share price falling sharply in 2015, following the discovery that they had falsified nitrogen oxide emissions from their cars.

Specific risk can be reduced through diversification across a large number of different stocks and shares, including diversification across different industries, size of companies, and geographical areas, so that all eggs are not put in the one investment basket. PRIIPs, including unit linked funds, can provide this diversification to investors.

Inflation Risk

Inflation risk is the risk that the investment will not produce a *real* investment return, that is, a return that at least matches inflation over the investment term. If investment returns do not match inflation the spending power of your money reduces, and so the real value of your investment falls.

Therefore, some financial products which appear to have no or low risk of capital loss, for example, deposits, State savings, tracker bonds, etc., usually have an *inflation risk*, that is, the risk of the value of the investment depreciating in real terms.

The traditional way to protect an investment portfolio from the long-term effects of inflation has been to invest in real assets, that is, in equities and property, which have traditionally provided '*real*' returns over and above inflation for long-term investors.

In order to reduce inflation risk, clients may have to embrace some element of market risk. There is a balance to be achieved between managing these two risks and this balance can be better understood by defining the investment objective.

Currency Risk

Investing either directly or indirectly in assets denominated in a different currency from the euro involves an additional *currency risk*, that is, the risk that the currency in which the asset is denominated will fall in value against the euro.

For example, if the US stock market provided a return of 5% over a year, but the US dollar depreciated in value by 8% against the euro over the same year, a euro investor in the US stock market would have achieved a -3% return in euro terms over that year, even though the US stock market provided a return of 5% over that year.

Some investment products or funds may 'hedge' part or all of the currency risk away, so that in the above example the euro investor in the US stock market fund would have achieved a return of 5% over the year (less the cost of the currency hedging in the fund).

Of course, currency movements can work the other way and turn a 'local' loss into a gain; for example, if the US stock market provided a return of -5% over a year, but the US dollar appreciated in value by 12% against the euro over the same year, a euro investor in the US stock market would have achieved a + 7% return in euro terms over that year, even though the US stock market declined by 5% in dollar terms.

Currency can have a significant impact on the return of assets over time, and both investors and advisors should always be aware of where currency exposures may expose their investments to risks that they may not be aware of. There is no real right or wrong on whether currency risk should be hedged, but understanding the difference when considering investment risk is important.

Gearing Risk

Some investments funds may contain leverage or be 'Geared' that is, the investment fund has borrowed funds to invest. This can enhance the potential returns from an investment, which in good times can be very attractive, but when it goes wrong, Gearing has the ability to create significant losses for clients. Understanding the benefits, and more importantly the risks associated with Geared investments is vital.

For example, consider a property investment fund set up to invest in one specific property; the fund gears up on a factor of 3:1, that is, it borrows three times the amount invested in the fund and hence buys a property for four times the amount investors have invested in the fund (75/25).

This table shows the fall in the value of an investor's capital in a fund, at different gearing levels and for different falls in the underlying fund asset value:

Fall in asset value	Gearing level			
	None	1:1	2:1	3:1
5%	5%	10%	15%	20%
10%	10%	20%	30%	40%
15%	15%	30%	45%	60%
20%	20%	40%	60%	80%
25%	25%	50%	75%	100%

So, for example, an investor would suffer a 60% fall in the value of their investment in a fund with 3:1 gearing, if the value of the underlying asset fell by just 15%; an investor in a similar fund with 2:1 gearing would have suffered a 45% fall in the value of their investment, while an investor in a similar fund with no gearing would have suffered a 15% fall in the value of their investment.

In the above example we can see that effectively an investor with 3:1 gearing would see the entire value of their investment wiped out with a 25% fall in the value of the asset. There are additional risks to consider with gearing in that often if the clients original capital falls to zero (or a threshold that may not even be as low as zero) they may not be given the opportunity for the fund to rise in value again as loans may be called in by the lending institution. When this happens, the asset must be sold and the investor effectively loses their entire investment.

Interest Rate Risk

Interest rate risk is the risk that a future change in interest rates may adversely affect the level of income produced by an investment and/or its capital value.

A general rise in interest rates will likely result in a fall in the market value of certain investments, such as bonds. In general, longer dated bonds are likely to fall proportionately more in value than shorter dated bonds, if interest rates rise because they are more sensitive to interest rate changes.

Therefore, while longer dated bonds will generally offer higher returns than shorter dated bonds, the investor in longer dated bonds is taking an increased interest rate risk, as well as an increased inflation risk. (remember from Chapter 6 – 'Duration risk' the sensitivity of the price of bonds to a change in interest rates). 2022 saw a significant reduction in the capital value of most bond funds as interest rates started to rise from negative or near zero rates, globally.

A significant sustained rise in interest rates is also likely to result in a fall in property values and Shares prices as Interest rate rises take spending power out of the economy, which in turn may see company profits fall due to the higher cost of credit.

Default Risk

There is a risk that the financial institution which owes money to the investor, for example, a life company in the case of a unit linked investment bond, a bank which has accepted a deposit from an investor, or a government or company which has issued a bond to investors, could get into financial difficulties and become unable to meet its financial obligations in full to the investor, under the investment in question. This risk for the investor is referred to as the *default* or *credit risk*.

Default in bonds can be technical, such as the non-payment of a coupon payment, or an extension to the maturity of a bond. Any of these can be considered a form of default and would have an impact on the asset itself, or it could create a 'market risk' event, such as a country defaulting on a bond may see the prices of other bonds fall as a contagion effect across that asset class.

In some cases, there may be partial or full protection for the investor against this risk, for example, the deposit guarantee scheme covers deposits up to €100,000 per investor.

Counterparty Risk

In some investment products, some part or parts of the promised return may be dependent on a third party providing that return to the financial institution providing the investment product in question.

For example, a life company provides a tracker bond which guarantees a return of capital after five years.

The life company invests the client funds with a bank who undertake to repay the capital sum to the life company when the bond matures. But if the bank defaults on its promise to the life company, the life company in turn will default on its promise to repay the capital to the investor.

In such a circumstance, the investor is subject to the risk that the relevant counterparty, that is, the bank, may default on its payment to the life company, who will then in turn default on its payment to the investor.

It is therefore important for investors to determine who is ultimately providing the guarantee or other promised benefits under a structured investment product like a tracker bond, to determine if the investor is subject to a counterparty risk.

Active Investment Management Risk

Some investment funds are actively managed by a professional investment manager, with a view to obtaining a return in excess of market returns.

There is a risk that the manager of such a fund will get some investment decisions wrong and hence produce a return lower than the market return.

Passively managed funds eliminate this active investment management risk, but offer no prospect of outperforming the market.

Timing Risk

Some investments in risky assets may involve a significant timing risk, that is, the risk that the investor invests at the top of the market, just before the market falls in value, or encashes at the very bottom of the market just before asset values start to recover. For example, an investor who invested in Equities in February 2020, or someone who switched out of equities and into cash in March 2020.

World Stock Market Index

Global Equity performance above is one example that shows across a time period of c.3 years how timing can impact return.

One way to reduce investment timing risk is to drip-feed the investment into the relevant assets over a period, for example, investing a lump sum in 12 monthly instalments rather than all at once. This is commonly referred to as ‘cost averaging’ or ‘Euro cost averaging’. Whilst this strategy can help to avoid getting your timing wrong, we should remember that if the market continues to rise strongly over the period in which your client is phasing into the market, such a strategy can create a lower return than if they had invested all together at the first instalment. This shows that timing can be an issue for investors in both a rising and falling investment market.

The longer the period which risky assets are held for, the lower timing risk becomes. Timing risk is high where investors invest in risky volatility assets with a short-term horizon.

Lack of Liquidity

Some investments, for example, in property funds, unlisted shares and fixed term deposits, may be difficult, or impossible, to realise if funds are required urgently.

For example, some unit linked property funds may impose a six-month delay in executing unit encashment/switching instructions if the fund is experiencing a strong outflow of investors. Investors in unit linked, open ended Property funds should always be aware of the risks association with illiquidity. Whilst volatility is a measure many use to assess the risk associated with investing in Property funds, if the fund provides exposure to directly held properties, then Illiquidity typically poses a greater risk than volatility for investors.

Using Standard deviation (volatility) to measure such risk is not advisable as Standard Deviation cannot provide any measure of such illiquidity risk.

Other investments, such as unlisted shares in private equity, may have no or very limited available purchasers at certain times, and so the value of such investments may be nil or close to it, at certain times, for example, during a stock market crash.

Tax Risk

The tax treatment to be applied to returns in the future may turn out to be worse than expected at the time of investment. For example, the exit tax rate increased from 23% in 2008 to 41% by January 2014. Similarly, the CGT rate over the same period increased from 20% to 33%.

14.2.2 Return

Investment Products differ in their returns by whether return will come in income and/or capital form, and whether any part of the return is fixed or guaranteed. Where there is a guarantee, it may be dependent on certain factors or conditions being satisfied over the term of the investment, that is, the guarantee may be conditional on other factors and circumstances.

Also, where a guarantee is provided, it should be clarified who is providing the guarantee and the credit worthiness or quality of that guarantee.

The potential for return has also to be considered; in general, the potential for return is directly linked to risk, in that low risk assets and investments are likely over the longer term to produce lower returns than high risk assets, and vice versa.

The potential for return will be heavily influenced by the asset allocation of the product or fund in question, that is, what is it really investing in?

14.2.3 Investment Term

Some products may have a fixed investment term and/or may provide certain benefits or guarantees at certain fixed points in time. Other products are open ended with no fixed investment term.

Investment term is closely related to access; see following.

14.2.4 Access to Funds

A key issue for many investors may be the ability to get access to part or all of their investment, if required.

There is a risk with some investments that the investor, in certain circumstances, may not be able to sell part or all his or her investment at all, or sell it at its then fair value and turn it into cash when needed. An example includes investing in a tracker bond which provides no access to funds during the term of the bond.

In some cases, potential penalties may apply on part or total encashment in certain circumstances. (another form of illiquidity risk mentioned in 14.2.1.11). It is therefore important that investors maintain sufficient liquidity in their investment portfolios to meet expected and potentially unexpected demands for funds, often accompanied by an interruption of earning income.

14.2.5 Taxation of Returns

Different types of investment product may vary in relation to how the return will be taxed, and the extent (if any) to which the investor may be exempt from tax on returns or may be able to reclaim tax deducted from returns.

The main taxes on investments are Capital Gains Tax (33%), Exit Tax (41%) and Corporation tax (25%). It is important for advisors to understand what tax applies to an individual investment and who is required to make the tax return. There may also be differences in whether returns are subject to USC and/or PRSI, in individual circumstances.

In some cases, there may be broader tax benefits attached to the investment, such as income tax relief on investment in Employment & Investment Incentive Schemes (EIIs).

14.2.6 Charges

Some product may have *explicit* charges, that is, they are taken from the investment, while others may be implicit, that is, the return provided/promised is after an allowance has been made for the provider's charges.

An example of an *explicit* charge might be a PRIIP which imposes a 3% initial charge on investments, that is, 97% of the investment amount is invested to secure units/shares in the fund.

Charges may take many forms:

- Initial charges;
- Recurring charges;
- Early encashment/exit charges.

Charges may vary by the size of the investment, and/or by the length of time the investment is held, and are likely to differ between providers and products.

An example of an *implicit* charge might be the terms of a tracker bond which promise to provide a capital guarantee and a bonus; these returns are after the tracker bond provider's charges and deductions.

14.3 Comparing Investment Products – Suitability

Investment decisions must be progressed based on a full appreciation of the financial circumstances of the investor and based on suitability. Understanding the level of an investor's capacity to invest and their willingness to invest are critical. An investors risk tolerance and their capacity for risk can be different. It is the role of the Financial Advisor to understand the investment objective and to be able to balance the investment objective with the level of risk of the investment.

Examples:

i. A Depositor holding significant surplus funds, has capacity to invest but may have no risk tolerance for loss and is therefore unwilling to invest.

ii. An investor may overstate their risk appetite / risk tolerance perhaps seeking returns in the short term but may not have the capacity to suffer the possible losses.

iii. A 25 year old starting contributions to their retirement fund may choose to invest conservatively to "avoid" capital loss.

These examples highlight the requirement to understand the range of investment products across the risk spectrum and their features in order that they can be appropriately matched to the customer and their needs and objectives.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- Investment risk comparison factors ☐
- Other investment comparison factors ☐

Sample Questions

The answers to these questions can be found in your Study Hub.

1. A life company deducts 3% from each investment made in their unit linked bond. This type of charge is called:

   A. an implicit charge.
   B. a spread charge.
   C. an early encashment charge.
   D. an explicit charge.

2. Default risk is MAINLY applicable to which type of security?

   A. Equities.
   B. Bonds.
   C. Futures.
   D. Property.

3. An investor is said to have achieved a real investment return:

   A. when the return has at least matched inflation over the investment term.
   B. when the return is positive but below inflation over the investment term.
   C. when the value has appreciated over the investment term.
   D. when the return is guaranteed.

5. The risk that some event could happen to adversely affect the value of one particular investment is called which type of risk?

   A. Inflation.
   B. Specific.
   C. Market.
   D. Currency.

15

Providing Investment Advice

This chapter discusses the five stages of the personal financial advisory process. It covers the statutory requirements under the Consumer Protection Code and MiFID regulatory requirements, including knowing the consumer and suitability.

When taking the steps of the financial planning process, relevant information is gathered (including attitude to risk and capacity for loss) and this is then evaluated to develop a recommendation. The final step in the process is to schedule ongoing reviews to ensure that the advice continues to meet the client's then current and anticipated financial needs and objectives.

Learning Outcomes – after studying this chapter you should be able to:
understand the main generic types of savings and investment needs a consumer may have at different life stages;
know the five stages of the personal financial advisory process;
understand the main Consumer Protection Code and MiFID regulatory requirements applying to the provision of investment advice to consumers, including *knowing the consumer* and *suitability*;
assess a consumer's attitude to and capacity for investment risk;
make an investment recommendation;
know the requirements for *execution only* transactions;
understand the provision of information about investment products;
appreciate the value of client reviews.

Chapter weightings	Number of questions which may appear		
In the exam, questions are taken from each chapter based on the following approximate chart:	Chapter	Minimum	Maximum
	15	7	11

15.1 Personal Financial Needs

Most consumers will have, from time to time, various personal *financial needs*, that is, a need to take some action to safeguard or enhance their own financial well-being and/or that of their dependants and attain some particular financial plan or objective.

Generic personal financial needs divide into five main groups, according to the nature of the need:

Savings

A need to accumulate from regular surplus income, over a period of time, a capital lump sum to be used to meet some anticipated financial expenditure or demand in the future, and/or to build up a general *rainy day* fund available to meet expenditures arising from unpredictable or unforeseen events.

Examples of anticipated financial expenditures and demands include:

- Saving up for a holiday or to buy a new car;
- Saving to accumulate a deposit to buy a home;
- Saving to accumulate a fund to repay a loan in one lump sum at some point in the future;
- Saving to accumulate funds to send children to university.

Examples of unpredictable expenditures or unforeseen events for which a rainy day fund might be needed include:

- Sudden Illness;
- Redundancy;
- Home repairs.

Investment

A need to invest a lump sum, not required for a period of time, to earn an investment return to match or outperform the rate of inflation, or to simply protect the capital.

Examples include:

- A client who inherits money;
- A client who retires and receives a lump sum retirement benefit;
- A client who is made redundant and receives a lump sum termination payment;
- A client who has accumulated capital over the years from savings and other investments.

Protection

A need to provide financially for certain unpredictable events, such as ill health or death, which will cause the interruption or total cessation of earned income for the client and/or their dependants.

Examples include:

- A client who takes out a mortgage and needs to take out a life assurance policy to ensure that the mortgage is paid off in full on death before the end of the mortgage term.

- A self-employed client who needs to take out ill health cover to provide a replacement income should he or she be unable to work for a prolonged period due to sickness or disability.

Retirement Funding

A need to accumulate funds to provide a replacement income in retirement, when the client will no longer be working.

Examples include:

- A client who is working in a job that has no pension scheme and needs to save for retirement;

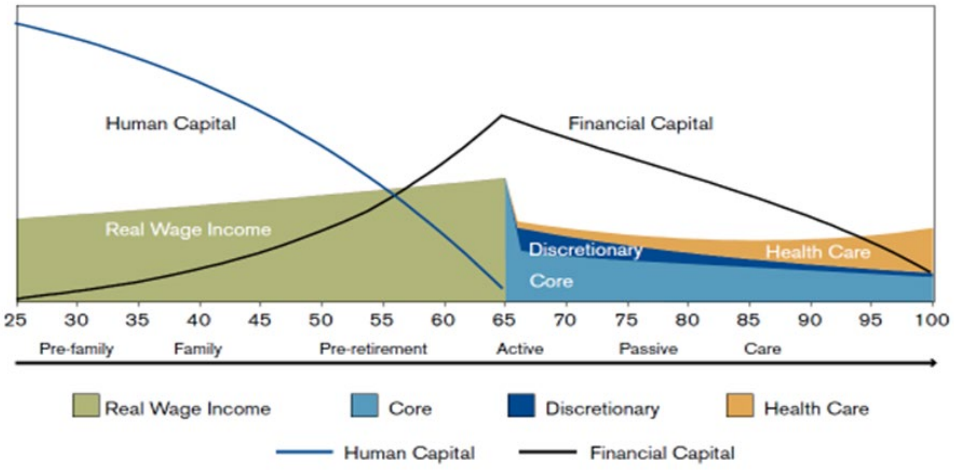
- A self-employed client who has no employer and needs to build up a pension fund by retirement.

Mortgages

- A need to borrow a capital sum to fund the purchase of a property to be used as the individual's private residence.

15.1.1 Life Cycle

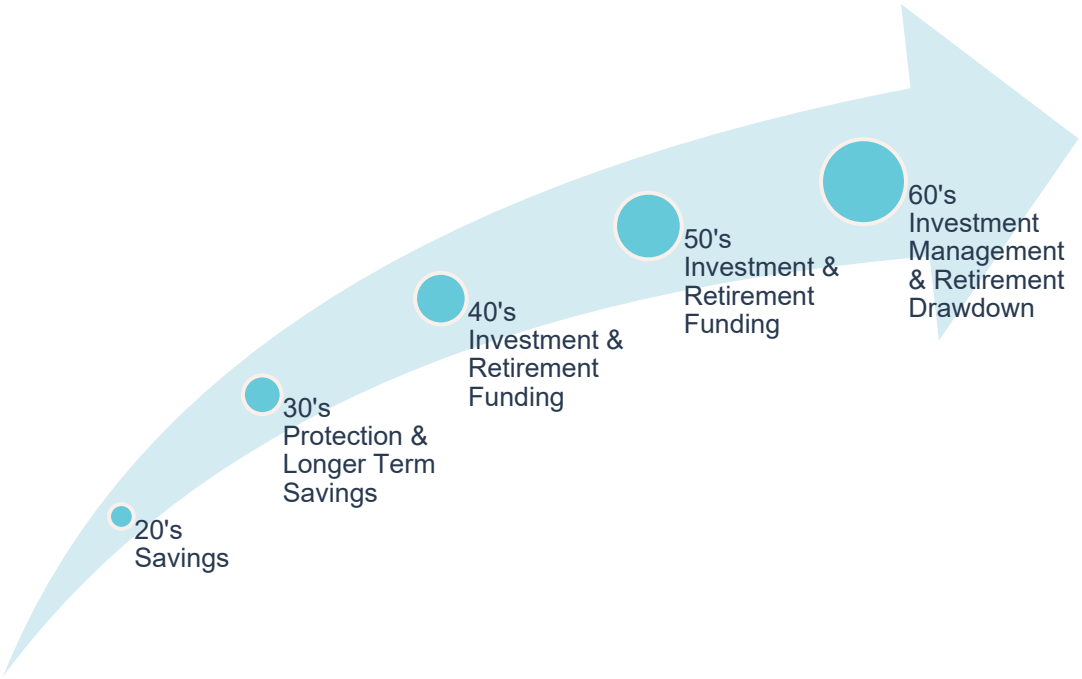
To understand a person's changing Financial needs, it is important to appreciate the concepts of Human and Financial Capital and how these change over their lifespan. Human Capital in this context is a person's ability to earn income over their working life. In their early years, this is high, and it gradually decreases as they approach their normal retirement age. As they earn income over their working life, it is important to use some of their income earned to create financial Capital, from which they can withdraw when their working life is over.



The diagram[15] above also illustrates a person's main income which covers their lifestyle expenses, and which is funded by their Real Wage Income and their later life spending requirements which is funded from their Financial Capital, built up during their working life.

[15] *A holistic framework for Financial planning, Milliman Research Report, July 2009*

As can be seen in the above diagram, personal financial needs generally change and vary by age. This is a general generic *timeline* of typical changing financial needs:



It's not suggested that every client fits neatly into this pattern; they don't. Every client's financial needs will be individual and different. You will have clients who don't fit neatly in the progression above. For example, a Lotto winner in their 20s with €5m to invest!

Nevertheless, there is generally a change in a client's financial needs over their lifetime as financial and personal circumstances, financial plans and objectives change over time.

So, a savings need generally applies at younger ages (for example, a need to accumulate a deposit to buy a first home) and then possibly change to a borrowing need to buy a home, and then protection needs when a couple have young dependants, to an investment and income need at older ages, after mortgages and loans have been paid off. Obviously, there are periods when the different types of generic financial needs overlap.

15.2 The Financial Planning Advisory Process

There are five stages to the financial planning advisory process:

1. **Determine the consumer's current personal and financial circumstances,** principally their current income and expenses, financial assets and liabilities, details of dependants, their investment knowledge and experience, and attitude to and capacity for investment risk. This step is sometimes called *fact-finding* or *knowing the consumer.*

2. **Identify, quantify and prioritise, in conjunction and in agreement with the consumer, their financial needs and objectives**. The agreed objectives should be quantified financially.

3. **Devise a strategy to meet the consumer's financial needs and objectives,** taking account of the consumer's available financial resources, attitude to and capacity for investment risk, investment time horizon, the nature of their financial needs and objectives, and the proper use of suitable financial products;

4. **Make suitable recommendations to the consumer on a strategy to best meet their financial needs and objectives**, setting out, in the case of each recommendation:

- The reason for a particular recommendation, should be aligned with, how it is likely to help your client achieve their financial needs and objectives; and

- Why that recommendation, in terms of a recommended financial product or service, is suitable to the consumer at that time.

This step is referred to as *suitability* and is usually qualified with a Statement of Suitability.

5. **Regularly monitor and review the consumer's circumstances**, to determine:

- Any change in their financial circumstances, needs and objectives, or personal circumstances;

- Any change in the tax or regulatory legislation which may impact on the consumer's current strategy or on his or her need or objectives;

- The extent to which the consumer's financial strategy and financial products are meeting their current financial needs and objectives; and

- The changes, if any, required in the consumer's current financial strategy in order to best meet their revised financial needs and objectives.

The financial planning process, if implemented properly with the benefit of professional competent advice, is likely to benefit the consumer in a number of different ways:

- It helps consumers identify and prioritise their financial needs and objectives; without the benefit of professional advice, many consumers 'drift' from a personal financial planning point of view, with no clear focus on their objectives in life and their associated financial needs and objectives.

- It helps to achieve certain financial needs and objectives which they might otherwise, in the absence of professional financial planning advice, fail to achieve or fail to achieve to the same extent.

- It helps the consumer to take a holistic or overall view of their financial circumstances and that of their dependants, rather than the uncoordinated piecemeal approach adopted by many consumers acting without the benefit of professional advice.

- It helps the consumer to make best use of their financial resources by only buying and investing in financial products and services suitable to their particular circumstances. In particular, clients will be advised to invest in products that are appropriate to their attitude to investment risk.

- Through regular reviews, the consumer's changing financial needs and objectives are identified and appropriate changes recommended to the consumer to stay on track in terms of meeting their financial needs and objectives.

15.3 Regulation

There are different statutory based regulatory provisions which impact the delivery of **investment advice** to consumers which provide a degree of protection to the consumer, and these include:

- The Consumer Protection Code (CPC 2012); which provides consumers with protection against the information asymmetry between intermediaries and the layperson regarding financial products (including investments) . The CPC (2012) and its addendums provide a set of conduct of business rules by which the intermediary must abide when transacting financial service products. The Central Bank of Ireland is currently undertaking a review of the CPC 2012 with a view to its update in 2025 to bring it in line with the rapidly evolving financial services industry.

- The Minimum Competency Code (2017); requires that individuals providing advice to consumers on retail financial products (including investment products), are appropriately qualified, experienced and competent to provide that service. The Central Bank of Ireland has recently published an addendum to the MCC (2017) which provides for amending competencies relating to sustainability for all financial products (including investments) which will come into effect on the 1st January 2025.

- The Markets in Financial Instruments Directive (MiFID) Regulations; provide for firms which offer investment advice on and arrange investments for consumers in a wider range of investments than allowed for by intermediaries who are authorised under the investment intermediaries Act 1995. These might include shares and bonds not listed on a stock exchange, Contracts for Difference and Options swaps and other derivatives.

These topics are covered in more detail in the QFA Regulation Textbook.

15.4 Investment Needs and Objectives

15.4.1 Identification

Following the "knowing the consumer" process, a consumer may have a number of identified financial needs and objectives which may be met (partially or fully) by the use of available financial resources.

15.4.2 Determine the Term

Each financial need and objective will have an estimated term or duration, at which the need or objective will or may arise, for example, the cost of children's third level education will arise when the consumer's oldest child reaches 18, or so and the requirement for retirement income may arise at 65 years. These should be quantified where possible.

15.4.3 Quantification

Having identified certain financial needs and objectives, the next step is to:

- Determine whether the consumer has an adequate level of emergency liquid funds, to meet unexpected medical expenses, unexpected redundancy, etc. (See below regarding emergency fund).

- Quantify the amount of capital that is likely to be needed to meet identified financial needs and objectives, where such needs and objectives are capable of being quantified.

- Allowance will need to be made for inflation in estimating the capital required.

- Quantify the level of capital growth required to provide a real growth in value, where that is a financial objective.

- Quantify the level of income, where income is required from the investment of a lump sum. Is it required that this income increases with inflation? What is the minimum and maximum investment term?

- What is the maximum investment term for which the consumer can tie up their investment or investments? This is also related to the likely term of the relevant financial need or objective.

However, in some cases the financial need or objective may be incapable of precise quantification in terms of capital required without further discussion with the consumer, for example, a consumer's financial objective is identified as *having a comfortable* retirement. Further questioning of the consumer is required to more accurately quantify this objective: for example, *"*What *exactly do you mean by 'comfortable' retirement? What level of additional income do you require, on top of your anticipated pension and other income in retirement?"*

15.4.4 Savings and Investment Needs

A consumer may therefore have an *investment need which might be*:

- To invest capital to meet some particular financial need or objective the consumer has. This will have been identified and quantified from the knowing the consumer process;

- To invest surplus capital or income, not immediately required by the consumer for any specific purpose, to accumulate a capital sum or as long term savings.

The investment need will usually crystallise into investing to generate:

- Capital growth;

- Income; or
- A mix of income and capital growth.

Some investment needs may be immediate, for example, to take maximum income from Investments, while others may be longer term.

The *investment need* may therefore be:

- A requirement to invest capital to achieve a particular level of capital growth, to meet a quantifiable established financial need or objective at a predetermined time in the future, for example a certain level of retirement fund.
- An immediate need to take income from invested capital to top up current income. A particular level of additional income may be required, or the maximum income may be required.
- A longer term need to take income from invested capital to top up income in the future, for example, the consumer wants to invest his capital to be able to afford to take early retirement.
- A requirement to invest capital or income, which is not required for any particular immediate purpose or objective, to achieve capital growth.

15.4.5 Emergency Fund

A priority savings and investment need for all consumers who depend substantially on earned income to live on, is the accumulation and maintenance of a readily accessible *emergency fund*, that is, a fund that is readily available at short notice without financial penalty to meet unexpected expenditure, for example, sudden illness, redundancy, etc.

It is normally recommended that an emergency fund be at least three to six times the consumer's monthly net earned income, that is, after tax, where the consumer has regular earned income.

Example

A consumer's net income, after tax, before mortgage and other outlays is €2,700 per month.

The consumer would normally be advised to maintain an emergency fund of at least 3 x €2,700 = €8,100.

An emergency fund is normally maintained in an investment product which offers total capital security and is readily available within, say, less than seven days without financial penalty.

Even if an individual has substantial assets, there is still a need to have a portion of those assets in liquid form to meet regular expenses, upcoming purchases and/or emergency spending.

Certain types of investments are *not* suitable as a vehicle for a consumer's emergency funds, for example:

- An investment that may not be readily accessible if required suddenly, for example, a tracker bond investment is generally not accessible during the term of the bond or a term or notice deposit where funds cannot be accessed within, say, seven days, and/or

- An investment which if accessed before a certain period, could involve a significant financial penalty or capital loss for the consumer. For example, encashing a unit linked fund investment shortly after investment or when unit prices are significantly below the level at which the investment was made, or loss of interest where a notice/term deposit is accessed early.

15.5 Suitability

The Central Bank *Consumer Protection Code* requires financial advisers to assess the suitability of any investment recommendation provided to consumers.

The financial adviser must when assessing the suitability of an investment product or advice for a consumer, consider and document whether, on the basis of the information gathered about the consumer:

- The product to be recommended meets that consumer's financial needs and objectives;
- The consumer:
  - Is likely to be able to meet the financial commitment associated with the product on an ongoing basis; that is, can afford the product costs;
  - Is financially able to bear any risks attaching to the product;
- Whether the investment product is consistent with the consumer's attitude to risk.

MiFID Regulations require MiFID investment firms when providing investment advice to a consumer to ensure that any investment recommendation to the consumer is *suitable* for that consumer, that is, the firm must reasonably believe that:

- The consumer has the necessary knowledge and experience to understand the risks involved in the recommended investment product or advice;
- The consumer is able to financially bear the investment risks (including actual losses or loss of access to funds) in the context of the investment objective/strategy of the consumer and the type of consumer; and
- The recommendation meets the financial objectives of the consumer. Financial objectives are clarified in the MiFID Regulations as: *"information on the length of time for which the consumer wishes to hold the investment, the consumer's preferences regarding risk taking, the consumer's risk profile and the purposes of the investment".*

In MiFID Regulations, this is referred to as *suitability*.

Therefore, a key part of the adviser's role following the identification and quantification of the consumer's financial needs and objectives, is in correctly matching various investment products to the client to achieve the best fit.

A key part of the matching process is to first determine the client's *attitude to investment risk* so that appropriate investment products can be matched to the client's circumstances.

15.6 Assessing a Consumer's Attitude to and Capacity for Investment Risk

A consumer's attitude to investment risk might be accessed through considering a combination of factors:

- The consumer's age;
- The consumer's current investment portfolio;
- The consumer's past investment experience;
- Asking the consumer to risk rate themselves;
- Asking the consumer a series of risk aligned questions;
- The consumer's financial capacity to accept capital loss;
- The objective and term of the investment;
- Other financial needs and objectives of the consumer.

15.6.1 Consumer's Age

In general, the older a consumer becomes the more averse to the risk of capital loss they become. This probably happens due to a combination of factors:

- In general, consumers become more conservative as they get older and psychologically become less willing to deal with uncertainties and change. It is not a co-incidence that many older retired people have substantial parts of their portfolios in deposits and other guaranteed products.
- The older a consumer becomes, in general, the less financially able a consumer may be to make up a financial loss, as their future income earning capacity (Human Capital) is much shorter and reducing, compared to a younger person.
- For example, a consumer who has already retired and is on a relatively small pension may not be financially able to rebuild a capital loss, but a young investor in their early 30s with a good earnings profile may be able, financially, to recover from a capital loss by saving from future earnings.
- The older a consumer becomes, the shorter the investment time span available.

15.6.2 Current Investment Portfolio

A consumer's current investment portfolio will sometimes give a good indication of their attitude to investment risk, particularly for an older consumer.

For example, does the consumer hold a high proportion of his or her existing investments in deposit based products, or is there a high percentage invested in unguaranteed risky investment products?

A high proportion in deposits, however, will not necessarily indicate that the consumer is totally risk averse, since the consumer may previously have regarded deposits as an easy option requiring no special knowledge, that is, investor inertia, or may be currently invested in deposits as a safe haven during a period of volatile investment markets.

Equally, if the consumer has shares in his portfolio, this may not necessarily reflect his personal attitude to risk as these investments may have been inherited, or for example, acquired under a work-related SAYE scheme or share option scheme, or the shares may possibly have been acquired on demutualisation of a life company or building society. It is, therefore, vital to review & clarify how the current investments came about and the consumer's attitude to his current investments.

15.6.3 Past Investment Experience

A consumer's past experience of saving and investing will also help to build up a picture of the consumer's attitude to risk.

Example

Mary has most of her investments in deposits.

However, on further investigation it transpires that she had invested directly in stocks and shares in the past, but switched to deposits as she was not happy with the level of volatility involved, having got stung by investing in Irish bank shares.

During the *knowing the consumer* process a consumer might be asked to confirm which of a range of investments the consumer has *ever* invested in at any stage in the past.

A consumer's investment experience will obviously be heavily influenced by their age. Younger consumers may not simply have had an opportunity so far to invest in some of these investment types.

A consumer's investment experience may indicate the degree of the consumer's understanding of the fundamental relationship between investment risk and return, that is, that high return investments will tend to carry a higher level of risk than lower return investments. Some degree of risk must be taken to receive better returns than deposits.

15.6.4 Asking the Consumer to Risk Rate Themselves

Many fact-finds at some stage ask consumers to risk rate themselves in some manner. For example:

- A consumer may be asked to describe their attitude to investment risk as being either no, low, medium or high risk. But of course, these descriptions can mean different things to different people.

- A consumer may be asked to rate their attitude to risk on some scale, for example, one to seven, with one being lowest risk and seven, say, being highest or maximum risk.

- Alternatively, more detailed questions might be asked of the consumer, where examples of products that would fit each category or risk are given.

There are obvious weaknesses in asking a consumer to rate themselves as low, medium or high risk, or on a range from one (no risk) to seven (high risk), as such terms are entirely subjective if not accompanied by some quantification and illustration to the consumer of the risk applicable to each term. The terms on their own do not indicate to the consumer the possible range of investment losses that might be incurred, and the products attributed to each risk category may not be a perfect risk match.

For example, if a consumer opts for low (as opposed to 'no') risk and invests in a product which loses 15% of their capital over two years, is this type of return a valid low risk experience? The consumer may think not, but the financial institution providing the investment product may consider that this is a valid low risk return over such a period.

So, there can be different perceptions between the investor and the financial institution over the scale of investment volatility implicit in such terms as low, medium and high risks.

In this regard, the Assistant Director General of the Central Bank, Mr Bernard Sheridan, said:

> *"We strongly encouraged firms to look at how they classify investment risk profiles to ensure that the customers attitude to risk corresponds with their individual circumstances and that customers are guided toward a suitable risk category of product.*
>
> *Firms should be careful that terms for investment risk are well understood and are not subject to misinterpretation. In particular firms should be careful about the designation 'low risk' as some customers may interpret this to mean 'no risk'."*

15.6.5 Asking the Consumer a Series of Questions (Risk Profiling)

This is sometimes referred to as *risk profiling*. The consumer may be asked (possibly through a software package) a series of questions, which are designed to determine the consumer's risk tolerance, that is, what level of investment volatility is the consumer likely to be willing to accept.

An example of one such question might be:

> *The thought of losing my money on an investment makes me nervous.*

The investor might then be asked to pick *one* answer from a range:

- *Disagree strongly;*
- *Disagree;*
- *Neither agree or disagree;*
- *Agree or agree strongly.*

Based on the consumer's answers to a series of questions, the software will then score the consumer and place them in one of a range of risk categories, for example, cautious, balanced, adventurous, or one to seven, etc. Each level corresponds to a particular range of investment volatility.

Such software may then recommend an investment portfolio, made up of a number of underlying funds, which has an expected investment volatility range similar to that scored by the investor through his or her answers to the questions posed.

15.6.6 Consumer's Financial Capacity for Investment Loss

One of the Consumer Protection Code requirements in relation to investment advice suitability is that the consumer should be *financially able to bear any risks attaching to the recommended product.*

It is therefore important to determine what level of capital loss would have a serious negative impact on the consumer's standard of living, in order to determine whether the consumer is financially able to bear the potential risks attached to the investment product recommended.

15.6.7 Purpose and Term of the Investment

The level of investment risk a consumer is prepared and financially able to take with a particular investment is closely linked to the purpose and term of the consumer's financial objective for which purpose the investment is being considered.

For example, a *low* or no capacity for capital loss may be appropriate to a proposed investment which:

- Is to be part of the consumer's emergency funds; or
- Will be required for a specific purpose and for a specific amount, within a short period, for example, a specific level of capital required to repay a loan in, say, three years.

Other financial objectives may be less definable in relation to the amount and timing of investment returns, and hence a higher level of investment risk may be considered by the consumer.

15.6.8 The Investment Portfolio Approach

Any attempt to categorise a consumer into a *one size fits all* risk categorisation for all or his or her investments, will usually be inappropriate as most consumers will have a portfolio of different financial needs and objectives and so may require a portfolio approach to investment and associated risk.

Example

A consumer may describe themselves as low risk but may still be willing to take a risk with, say, up to 15% of their investment portfolio, as they can afford some level of capital loss or they have envisaged a long investment term.

A consumer who describes themselves as *medium risk* (most consumers do!) may be saying that they would prefer the majority of their investments to be in a medium risk category but want a certain percentage of their investments to be in low/no risk products (for example, emergency fund) and may be able to tolerate a small percentage in higher risk assets.

15.6.9 Fund Risk Profiling

Care should be taken in matching particular investment funds to a particular investment risk category, for example, medium or level four risk, etc.

The particular fund name is not important in itself; the key issues are:

- The underlying asset allocation of the fund in question, as between the main asset classes, that is, equities, property, bonds, and cash; and
- The fund's investment mandate or objectives. Has the fund any published investment mandate, for example, maximum percentage which can be invested in equities?

In some cases, the provider of the fund in question may place the fund on a risk scale, for example, from one to five, or one to seven, etc.

However, in other cases, the fund provider may not categorise the fund in terms of its risk profile. Fund names like 'growth' and 'adventurous growth' etc., may not, on their own, adequately convey the risk profile of the fund in question.

The Financial Services Ombudsman commented on this issue in his annual report for 2008, in relation to the investment bond sales practices of one company:

> *"I was also severely critical of the terminology used by the Company to classify risk, categories which included '100% Growth' and '100% Active Growth', which I found carried connotations only of the positive, without any real sense of an alert to the risk involved that negative growth could result in significant loss in value."*

15.7 Making an Investment Recommendation

15.7.1 Developing a Recommendation

The final step is the process to develop and present an investment recommendation to the consumer. A recommendation may consist of one or more of:

- *Advice only*.

  The end result is not always that the consumer should invest funds in a new investment product.

  There may be many cases where a consumer's investment portfolio adequately meets their current investment needs and objectives in a manner consistent with their attitude to and capacity for investment risk, or only a minor amendment or tweaking of their portfolio is required.

- *Advice to invest funds in one or more investment products* where the consumer's investment needs and objectives are not being met in a manner consistent with their determined attitude to and capacity for investment risk.

- *Advice to terminate or encash some existing investment product or products held by the consumer.*

  However, this course of action should only be recommended where the existing investment product or products clearly no longer meets any identified financial need or objective of the consumer or the investment product is not consistent with the consumer's attitude to and capacity for investment risk, relative to a particular financial need or objective related to that investment.

15.7.2 Consumer Protection Code Suitability Requirement

Most Suitable Product

Under the Consumer Protection Code an adviser must ensure that any investment product offered to a consumer is *suitable* to that consumer, having regard to the facts disclosed by the consumer and other relevant facts about that consumer of which the adviser is aware.

The following additional requirements also apply:

- Where an adviser offers a selection of investment product options to the consumer, the product options contained in the selection must represent the *most suitable* from the range available to the adviser; and

- Where an adviser recommends a specific investment product to a consumer, the recommended product must be the *most suitable* product for that consumer.

The requirements in relation to *suitable* investment products can be summarised as follows:

- Only investment products suitable for the consumer's needs can be considered by the adviser;
- All investment products which are suitable for the consumer's needs, and which the adviser can offer advice on, must be considered by the adviser. This includes the consumers sustainability preferences and
- From the range of suitable investment products, the adviser can advise on, the adviser must recommend the most suitable product for the consumer.

Example

ACME Financial Advisers Ltd, who are investment intermediaries, are dealing with Mr Brown in relation to a lump sum investment. During the fact-finding phase, ACME established that Mr Brown requires a minimum money back guarantee at maturity and the maximum term he can invest for is five years, as he requires access to the funds in five years.

The Code requires ACME to:

- Only offer lump sum investment products to Mr Brown which contain a minimum money back guarantee at maturity and have a maximum investment term of five years, as only products which meet these criteria are suitable for Mr Brown's identified financial need;
- To consider all such suitable products which ACME can advise on; given ACME's regulatory status, they can only consider products from financial institutions with whom they have written agency appointments.

Let's assume that they have agency appointments with financial institutions, A, B, C, D and E, and that financial institutions A, C and E offer lump sum investment bonds with a capital guarantee at maturity and a maximum five years investment term.

ACME must therefore:

- Consider the most suitable investment products from these three financial institutions (A, C and E) and can't limit itself to one particular financial institution, say A in this example; and
- Recommend from the three suitable products, that is, from financial institutions A, C and E, the most suitable product of the three for Mr Brown.

Reason Why Statement

The Consumer Protection Code requires that before providing or arranging an investment product, an adviser must prepare a *written* statement setting out:

- The reasons *why* an investment product offered to a consumer is considered to be *suitable* to that consumer; or
- The reasons *why* the investment product options contained in a selection of investment product options offered to a consumer are considered to be the *most suitable* to that consumer; or
- The reasons *why* a recommended investment product is considered to be the *most suitable* product for that consumer.

This statement is usually referred to as a *reason why* statement, as it sets out the reasons why a particular investment is suitable.

The reasons set out in the reason why statement must reflect the information gathered under the knowing the consumer requirement, to assist the consumer in understanding *how* the investment product recommended meets, where relevant, the consumer's:

- Financial needs and objectives;
- Personal circumstances; and
- Financial situation.

The written statement must also include an outline of the following, where relevant:

- How the risk profile of the investment product is aligned with the consumer's attitude to investment risk; and
- How the nature, extent and limitations of any guarantee attached to the investment product is aligned with the consumer's attitude to investment risk.

The adviser must sign the reason why statement and provide a copy of the statement on paper or on another durable medium, dated on the day on which it is completed, to the consumer *prior* to providing or arranging an investment product for the consumer, and retain a copy.

The following statement must be included at the start of the reason why statement:

Important Notice – Statement of Suitability

This is an important document which sets out the reasons why the product(s) or service(s) offered or recommended is/are considered suitable, or the most suitable, for your particular needs, objectives and circumstances.

Where an adviser has provided an oral explanation to the consumer of the investment product(s) offered or recommended, the adviser must include a record of such explanation in or with the reason why statement.

15.7.3 MiFID Suitability Requirement

A MiFID investment firm providing investment advice to a client is required to ensure that any investment recommended to the client is *suitable* for that client.

To this end, the MIFID Regulations require the investment firm to assess the suitability of an investment recommendation by determining whether the recommendation reasonably satisfies the following requirements:

- Does it meet the investment objectives of the client?
- Is the client able financially to bear any related investment risks consistent with the client's investment objectives?
- Has the client the necessary experience and knowledge to understand the risks involved in the recommended transaction?
- A suitability report must be provided to a retail client when that client has been provided with investment advice, regardless of whether or not the advice is followed by a transaction.

The MiFID conduct of business rules do not specifically require an investment firm to provide a reason why statement where it is providing investment advice. However, in most cases under MiFID, firms are required to show that any investment advice given is suitable for the client. The firm will need to record details as to the reason why this is the case. Therefore, firms will normally note details of the reason for a particular recommendation on the client file and may well include this in a letter to the client.

MiFID conduct of business rules do require that certain information be provided to client before an investment service is provided, including:

- Details of the nature and risk associated with the financial instruments for which the firm may provide services to the client, taking account of the client's categorisation for example, as a retail or professional client.
- A summary of the firm's policy in relation to conflicts of interest, and, where appropriate details of any conflicts of interest that arise.
- Information on the firm's *best execution* policy.

15.8 Execution Only

In some cases, the consumer may approach the adviser and ask the adviser to arrange an investment in a specific investment, without the adviser providing any investment advice to the consumer in relation to such a transaction. This is sometimes referred to as *execution only* as the adviser is being asked to simply *execute* a particular investment transaction for the consumer, with no advice provided.

15.8.1 Consumer Protection Code

The Code provisions on knowing the consumer and suitability do **not** apply where:

A. The consumer has specified both the investment product and the product producer by name and has not received any assistance from the adviser in the choice of that investment product and/or product producer.

   In this case, the adviser must warn the consumer, on paper or on another durable medium, that he or she does not have the information necessary to determine the suitability of that product for the consumer.

   OR

B. The adviser has established that the consumer is seeking a deposit account and has alerted the consumer to any restrictions on the account.

15.8.2 MiFID

Where a MiFID investment firm is *not* providing investment advice or portfolio management to a client, but is simply executing an order from them to buy or sell shares, bonds, Contracts for difference (CFDs), or PRIIPs such as exchange traded funds and UCITS, the firm is not required to comply with the MiFID *suitability* requirement but is required to comply with the MiFID ***appropriateness*** requirement, that is:

- The firm must ask the client about their knowledge and experience in the investment field relative to product requested by the client and must take that information into account in assessing whether the product requested is appropriate for that client.
- A firm may conclude that the product requested is appropriate for the client where it reasonably determines that the client understands the risks involved in the investment.

- If the firm considers on the basis of the information received about the client's investment knowledge and experience, that the requested product is not appropriate to that client, then the firm must warn the client appropriately but can still carry out the transaction for the client.

- In this regard, MiFID specifically clarifies that "*investment firms should undertake a suitability assessment not only in relation to when recommendations to buy a financial instrument are made, but for all decisions, including whether or not to buy, hold or sell an investment*".

Where the client refuses to provide the requested information about their investment knowledge and experience or the client provides insufficient information, the firm must warn the client that by not providing the information the firm will not be able to determine whether the product requested is *appropriate* for the client but can still carry out the transaction for the client.

The appropriateness requirement above in relation to execution only transactions does NOT apply where all of the following conditions are met:

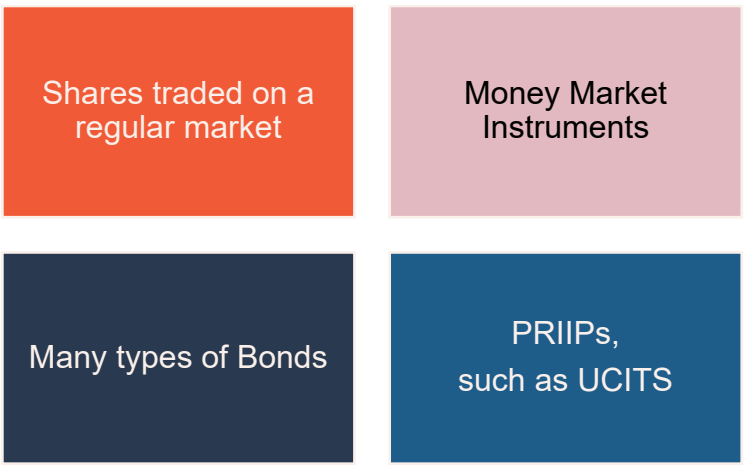
- The product requested is a *non-complex* product;

- It is provided at the initiative of the client;

- The client has been clearly informed that the firm is not required to assess suitability; and

- The firm complies with the MiFID conflicts of interest requirements.

Examples of MiFID *non-complex* products include:



Examples of MiFID products that are considered to be complex products, and hence the appropriateness requirement still applies on execution only transactions, include:

15.9 Provision of Information about the Investment Product

The Consumer Protection Code requires that prior to offering, recommending, arranging or providing an investment product (other than a tracker bond), an adviser must provide a consumer with information (in a standalone document) on the following, where relevant:

- Capital security;
- The risk that some or all of the investment may be lost;
- Leverage and its effects;
- Any limitations on the sale or disposal of the product;
- Restrictions on access to funds invested;
- Restrictions on the redemption of the product;
- The impact, including the cost, of exiting the product early;
- The minimum recommended investment period;
- The risk that the estimated or anticipated return on the investment product will not be achieved;
- The potential effects of volatility in price, fluctuation in interest rates, and/or movements in exchange rates on the value of the investment; and
- The level, nature, extent and limitations of any guarantee and the name of the guarantor.

This information will usually be supplied by the relevant product producer to the adviser either as:

- A key features type document; or
- In the life assurance disclosure notice, where the investment product is a life assurance policy subject to the life disclosure regulations.

15.10 Client Reviews

The process of identifying and satisfying client financial needs does not stop once the initial recommendations have been implemented. Clients will continue to need financial advice on their changing personal circumstances and on the ongoing suitability of the initial savings and investment products recommended.

Therefore, regular reviews of both the client's position and the products recommended will be essential in order to check if the portfolio of financial products held by the client at that time continues to meet their current and anticipated financial needs and objectives, as far as is possible.

The normal procedure is to have a planned review, in order to detect and allow for any changes in:

- The client's personal circumstances, for example, earnings, dependants, etc.;
- External developments which might effect the investment strategy;
- Product requirements;
- Investment market conditions.

15.10.1 Personal Circumstances

Changes to the client's personal circumstances since the original fact-find was completed and the recommendations implemented will almost always create a need for review.

The Central Bank *Consumer Protection Code* specifies that:

> *"A regulated entity must gather and maintain a record of details of any material changes to a consumer's circumstances prior to offering, recommending, arranging or providing a subsequent product or service to the consumer. Where there is no material change, this must be noted on a consumer's records…"*

Therefore, at any review with a client it is important to seek to gather and record sufficient information to detect any material changes in the client's circumstances.

15.10.2 External Developments

External developments may also make it appropriate to review both the client's financial position and existing products. The following are examples to consider.

Tax Changes

Changes in taxation may affect a client's financial position and/or the appropriateness of financial products already held. For example, a change in income tax or exit tax rates may create a need for a client review of existing savings and investment products.

Market Changes

Changes in the investment markets, for example, a steep fall in investment markets may mean that a review of the client's existing investment and saving products would be appropriate and, in some instances, quite urgent. A client may panic when he or she reads of '*tumbling stock markets' and reads headlines such as '€3bn wiped off stock market today!'.* They may need reassurance and possibly a review of their investment portfolio, although 'panic' recommendations should not normally be made.

As a further example, falling interest rates may mean the client faces an income shortfall, if he or she had been depending on deposit interest income, which could seriously affect his or her financial position.

Product Developments

New types of financial products may come to the market, which may suit some clients better than products and options previously available. An example may be the new Irish REITs.

15.10.3 Product Requirements

An important factor in determining when a client's position should be reviewed will be the original product recommendation or recommendations made.

Savings Plans

A savings plan may need to be reviewed:

- To ensure that the chosen fund or funds is still appropriate to the client's needs and current risk profile; a switch to a different type of fund may be appropriate in some circumstances.

- To check if the projected value of the plan is still on target to meet some stated financial objective or plan; for example, a plan taken out to meet third level education costs will need to be reviewed regularly to see if it's on track to fund the estimated costs.

- As a plan nears the end of its fixed term, where it has a fixed savings term. There may be a need to reinvest the emerging proceeds.

Investment Products

A client's investment portfolio needs to be reviewed regularly:

- To ensure that the chosen fund or funds is still appropriate to the client's needs and current risk profile; a switch to a different type of fund may be appropriate in some circumstances. Rebalancing the asset allocation of the portfolio may be required in some circumstances, for example, as a client gets older their attitude to and capacity for investment risk reduces.

- To review the performance of the portfolio/funds against the client's stated objectives and investment mandate for the fund/portfolio. A change of investment manager(s) may be warranted if there is a systematic failure to meet stated objectives and investment mandates, for example, a fund which indicated that its objective was to be in the top quartile, but which has consistently been in the lower third and fourth quartiles over the last three years.

- When a product reaches the end of its fixed term. For example, after a tracker bond matures. The proceeds may become available for reinvestment.

- Where a client is depending on regular income/withdrawals from a product or products. For example, a client taking so called *automatic income* payments from a unit linked bond. The likely future sustainability of ongoing payments should be reviewed regularly in the light of changing investment markets.

- To ensure that a client is making maximum use of various tax reliefs and allowances. For example, utilising the annual €1,270 capital gains tax exemption where a client holds equities directly or offsetting previously documented capital losses against future capital gains.

15.10.4 Investment Market Conditions

Periods of volatility and uncertainty in investment markets can cause some clients sleepless nights; a review of their portfolio against their needs and objectives and attitude to risk, may be required. However, the adviser should be careful not to recommend substantial knee jerk changes in a client's portfolio at such times; markets can bounce back quickly.

During any portfolio review, the aim should always be to adjust the risk profile of the client's investment portfolio to that level of risk the client is *then* prepared to accept until the next review period.

Remember you will be establishing the customer's attitude to and capacity for risk at the outset during the process of getting to know the customer, that is, fact-finding.

Risk can never be eliminated; however, the following list of points should be looked at to ensure that risk has been controlled as far as possible:

- Ensure diversification between the main asset classes, appropriate to the client's current risk profile;
- Avoid over concentration of investment in specific financial institutions, securities, industries, or geographical areas;
- Ensure that the portfolio gives adequate protection against inflation, in so far as possible;
- Ensure adequate liquidity in the portfolio, so that longer term investments may not need to be drawn on, if the client needs funds for an immediate purpose;
- Be aware of the potential risks involved in investments which contain underlying gearing. Gearing increases potential returns, but also potential losses.

Review

Now consider the main teaching points, which were introduced in this chapter. They are listed below. Tick each one as you go through them.

- [ ] Personal financial needs
- [ ] The financial planning advisory process
- [ ] Investment needs and objectives
- [ ] Suitability
- [ ] Assessing a consumer's attitude to and capacity for investment risk
- [ ] Making an investment recommendation
- [ ] Execution only
- [ ] Provision of information about the investment product
- [ ] Client reviews

Sample Questions

The answers to these questions can be found in your Study Hub.

1. In MiFID regulations, the definition of a non-complex product includes:

   (i) shares listed on a regulated stock exchange.
   (ii) UCITS funds.
   (iii) derivatives.

   A. (iii) only.
   B. (i) and (ii) only.
   C. (ii) and (iii) only.
   D. (i), (ii) and (iii).

2. What is the FOURTH step in the financial planning advisory process?

   A. Identifying financial needs.
   B. Factfinding.
   C. Devising a strategy to meet the consumer's needs.
   D. Make suitable recommendation.

3. The Reason Why statement required by the Central Bank's Consumer Protection Code must be provided to a client:

   A. prior to the provision of any investment advice to the client.
   B. prior to providing or arranging an investment product for the client.
   C. at the same time as the client signs an investment product application form.
   D. before the expiration of the cooling off period applicable to a recommended product.

4. The process of matching various financial products to a client to achieve the best fit is known as:

   A. factfinding.
   B. fitness.
   C. reasoning.
   D. suitability.

How well do you know your textbook?

Chapter 1

- Explain three functions of the financial services system.
- List three participants of the financial services system.
- What is the function of the Capital Markets?
- What is the difference between a primary and a secondary capital market?
- What is Market Manipulation?

Chapter 2

- If a government decides to increase income tax rates, which type of policy decision is this, monetary or fiscal?
- List three different possible causes of unemployment?
- What is Inflation?
- How can inflation be controlled?

Chapter 3

- What are the main investment asset classes?
- What are the two main ways in which investment volatility can be reduced?
- What is diversification?
- What is asset correlation?
- Outline the benefits of long-term investments.
- What is sustainable investing?
- What obligations do Financial Advisors have in relation to establishing sustainable preferences?

Chapter 4

- How best to compare rates advertised for deposit products?
- What types of investors may be liable to pay PRSI on their deposit interest?
- What are the most important issues with investing in deposits over the long-term?

Chapter 5

- What is a share's P/E ratio and how is it calculated?
- How are dividends received by an investor from an Irish resident company taxed in his or her hands?
- What are the main factors which could cause the price of a particular quoted share to fall on a particular day?
- What are Derivatives and Explain Contracts for Difference and Covered Warrants?

Chapter 6

- What is a treasury bond?
- How is the running yield of a bond calculated?
- How is the Gross Redemption Yield Calculated?
- How is interest received from a treasury bond taxed in the hands of an individual Irish investor?
- What are the main risks of investing in bonds?

Chapter 7

- If a PRIIP fund's prices are calculated on a net asset value basis, what does this mean?
- List three benefits of investing in a PRIIP.
- List three potential disadvantages of investing in a PRIIP.
- Is a UCITS fund allowed to borrow to invest?
- How are UCITS funds, Irish REIT's and Offshore Exchange Traded Funds taxed for gains and income?

Chapter 8

- Briefly describe the four types of Employee Share Incentives.
- What is the maximum value of shares which an employee can be provided with annually under an approved profit-sharing scheme?

Chapter 9

- What types of consumers would be better off investing in a deposit tracker bond than in a life assurance tracker bond, and why?
- Outline how a Life Assurance tracker bond is constructed?
- What are the risks and benefits of investing in a Tracker bond?

Chapter 10

- What is the projected breakeven point in a unit linked savings plan?
- What risk does drip-feeding a lump sum from a cash fund to a managed fund in a unit linked bond, attempt to protect the investor from?
- What tax is applied to Life investment policies and how is the tax calculated on a partial encashment.

Chapter 11

- Summarise the Tax schedules.
- What types of income are exempt from universal social charge?
- If a consumer sells shares in July 2023 giving rise to chargeable gain for capital gains tax purposes, by what date must he or she pay capital gains tax to the Revenue Commissioners?
- What are the deadline dates for filing Income tax and CGT returns?

Chapter 12

- If the CPI one year ago was 116.4 and today its 121.3, what was the inflation rate over the last year?
- If an investor invests €30,000 now at 2% per annum, what will its accumulated value be in 17 years?
- If an investor expects a fund of €30,000 to emerge from a savings plan in 10 years, what is the present value of this benefit, using a discount rate of 3% per annum?

Chapter 13

- In what circumstances can a life company describe its tracker bond as being guaranteed?
- A life assurance company launches a new unit linked bond, which will be promoted and sold to consumers through intermediaries. What information must the life company provide to intermediaries about the bond?

Chapter 14

- What type of collective funds might be subject to gearing risk?
- List FOUR different factors by which you might compare two different PRIIPs in terms of potential suitability for an investor.
- Highlight the main investment risks to a 40 year old couple who wish to invest €25,000 into a suitable instrument as an education fund for their children who are aged 10 and 6 years.
- What investment risks should be highlighted to a 65 year old retiree who wishes to invest €50,000 in a geared property fund.

Chapter 15

- Outline the Financial Advisory process expanding the reason for each section.
- List two investments which are not suitable for a consumer's emergency funds?
- In what circumstances do the provisions of the Consumer Protection Code on suitability not apply?
- What considerations should be given to a 35 year old couple wishing to start an education fund for their two children aged 3 and 5 years?

Are you ready for your exam?

01

Do you understand the exam format?

Familiarise yourself with the structure and requirements of the exam. Understand how many questions you'll need to answer, the time limit, and any specific instructions or scoring methods.

02

Have you covered the full course material?

Have you read and understood the full textbook? Have you used the additional supplementary study resources available in your online Study Hub (pre-recorded videos, microlearning webinars, exam preparation masterclass recording)?

03

Have you created a revision plan?

Develop a study plan that outlines your exam preparation strategy. Break down your study sessions into manageable chunks and allocate time for each topic or chapter. Ensure you have sufficient time to review all the relevant material before the exam.

04

Practice sample questions

Use the sample questions related to each chapter. This will help you become familiar with the types of questions typically asked and allow you to practise applying your knowledge. Time yourself during these practice sessions to get used to working within the exam time constraints.

05

Have you used the "Take a Test" facility?

Test yourself by answering practice questions without referring to your study materials under exam conditions. This will help reinforce your knowledge and identify any remaining gaps you need to address.

06

Have you familiarised yourself with the Online User Guide and Exam Regulations, which can be found in your Study Hub?

This will help you become familiar with the online exam environment and the rules that need to be followed.

07

Have you checked your computer set up and broadband speed and stability in preparation for your online exam?

Please consult the Online Exam User Guide for further information regarding system requirements. This will help ensure your exam runs smoothly.

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