CLASS OF BUSINESS TRAINING

SHORT AND LONG TERM DEPOSITS AND STRUCTURED DEPOSITS 2021

Class Five and Six

NKWALI TRAINING CONSULTANTS (PTY) LTD

FP&M Accredited Provider

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Table of Contents

Class of business training legislative requirements 4
Glossary of terms 5
Chapter 1: Introduction to Deposits 10
- 1.0 Introduction 10
- 1.1 Fit and Proper Requirements 11
- 1.3 Legislation Affecting Short, Structured and Long-term Deposits 12
- 1.4 What is a Deposit? 16
- 1.5 Definition of a financial Product 18
- 1.6 Classes of Business 22

Chapter 2: Short Term Deposits 27
- 2.0 Introduction 27
- 2.1 Different types of Deposits 27
- 2.2 Demand deposits 28
- 2.3 Types of accounts that attract bank depositors 29
- 2.4 Interest Rates 30
- 2.5 Factors impacting interest rates 31
- 2.6 Types of interest rates 31
- 2.7 Period of deposit 32
- 2.8 Various profiles of investors 34

Chapter 3: Money Market Instruments 35
- 3.0 Introduction 35
- 3.1 Money market instruments 36
- 3.2 Risks involved in short-term deposits 43
- 3.3 Impact of business cycles and economic factors on deposits 45
- 4.0 Introduction 49
- 4.1 Pricing 49
- 4.2 Fees and charges 51
- 4.3 Commissions 52
- 4.4 Product categories 52
- 4.5 Types of fees and charges 55
- 4.6 Suitability of the type of deposit related product (Whether short, long-term and structured deposits) 60

Chapter 5: Structured Deposits 61
- 5.0 Introduction 61

5.1 Structured deposits 61
5.2 Structured deposits versus fixed deposits 61
5.3 Maximum probable loss under Structured Deposits 64
5.4 Factors to determine whether structured deposits are good for the client 64
5.5 Risks under structured deposits 65
5.6 Fees and charges 66
Chapter 6: Long Term Deposits 68
6.0 Introduction 68
6.1 Similarities between short-term and long-term deposits 69
6.2 Interest earned on long-term deposits 70
6.3 Rollover terms 70
6.4 Mutual Fund 70
6.5 Understanding Mutual Funds 71
6.6 Types of Mutual Funds 73
6.7 Classes of mutual fund shares 77
6.8 Unit trust investments 83
6.9 Annuities 85
6.10 Retirement annuities 89
Bibliography 93

Class of business training legislative requirements

The Financial Sector Conduct Authority (FSCA) **Board Notice 194 of 15 December 2017: Determination of Fit and Proper Requirements** stipulates that a Financial Service Provider (FSP) and a representative must complete the class of business (CoB) training relevant to those financial products for which they are authorised **prior** to rendering any financial service in respect of such products.

A key individual must, likewise, complete the Class of business training in respect of the classes of business for which he/she is approved to act as key individual **prior** to managing the rendering of any such financial services.

The Determination of Fit and Proper requirements define “Class of business training” as training in respect of a specific class of business and which training is provided and assessed by an accredited provider or an education institution.

The Class of Business training applies to the following:

- All FSPs, Key Individuals and Representatives appointed after 1 April 2018.
- FSPs, Key Individuals and Representatives who seek authorisation, approval or appointment for new financial product categories after 1 April 2018.
- Representatives working under supervision as of 1 April 2018 or appointed under supervision after 1 April 2018.
- Certain exemptions apply, depending on the type of business one does, and how it is conducted.

FSPs, KIs and Reps, authorised prior to 1 April 2018 are considered to have completed the Class of Business training in view of their past experience and are therefore exempt from Class of business training, unless they add new products to their licence.

Glossary of terms

Term	Definition
Accredited provider	means a person that is recognised and certified or accredited by a Quality Council as having the capacity or provisional capacity to offer a qualification or part-qualification registered on the NQF at the required standard, or a foreign person that is so recognised and certified or accredited by a foreign authority that is equivalent to a Quality Council.
Automated advise	Means the furnishing of advice through an electronic medium that uses algorithms and technology without the direct involvement of a natural person.
Class of Business	Means the nine classes of business. Class of business training" means the training referred to the nine classes of business and which training is provided and assessed by an accredited provider or an education institution training" means the training referred to in section 29(4) in respect of a class of business and which training is provided and assessed by an accredited provider or an education institution.
Competence	Means having the skills, knowledge and expertise needed for the proper discharge of a person's responsibilities in the performance of his or her functions.
Complain	Means a specific complaint relating to a financial service rendered by a financial services provider or representative to the complainant on or after the date of commencement of the FAIS Act, and in which complaint it is alleged that the provider or representative a) has contravened or failed to comply with the provision of the Act and that as a result thereof the complainant has suffered or is likely to suffer financial prejudice or damage; b) has wilfully or negligently rendered a financial service to the complainant which has caused prejudice or damage to the

	complainant or which is likely to result in such prejudice or damage; or c) has treated the complainant unfairly.
Deposit	When used as a noun, means an amount of money paid by one person to another person subject to an agreement in terms of which: (a) an equal amount or any part thereof will be conditionally or unconditionally repaid, either by the person to whom the money has been so paid or by any other person, with or without a premium, on demand or at specified or unspecified dates or in circumstances agreed to by or on behalf of the person making the payment and the person receiving it; and (b) no interest will be payable on the amount so paid or interest will be payable thereon at specified intervals or otherwise, notwithstanding that such payment is limited to a fixed amount or that a transferable or non-transferable certificate or other instrument providing for the repayment of such amount mutatis mutandis as contemplated in paragraph (a) or for the payment of interest on such amount mutatis mutandis as contemplated in paragraph (b) is issued in respect of such amount, but does not include an amount of money - contract; (ii) paid as security for the performance of a contract or as security in respect of any loss which may result from the non-performance of a contract; (iii) without derogating from the provisions of paragraph (ii), paid as security for the delivery up or return of any movable or immovable property, whether in a particular state of repair or otherwise; (iv) paid by a holding company to its subsidiary, or by a subsidiary to its holding company, or by one subsidiary to another subsidiary of the same holding company; (v) paid by a person who, at the time of such payment -

	(a) is a close relative of the person to whom such money is paid; (b) is a director or executive officer of the person to whom such money is paid; or (c) is a close relative of a director or executive officer of the person to whom such money is paid; (vi) paid by any person to a registered long-term insurer as defined in section 1 of the Long-term Insurance Act, 1998 (Act No. 52 of 1998), as a premium in respect of any kind of policy defined or referred in the Long-term Insurance Act and under which policy that long-term insurer assumes, in return for such premium, such obligation as is described in the Long-term Insurance Act; (vii) paid to a fund registered or provisionally registered under section 4 of the Pension Funds Act, 1956 (Act No. 24 of 1956), as a contribution, contemplated in section 13A of that Act, by or on behalf of a member of that fund; (viii) paid to a benefit fund, as defined in section 1 of the Income Tax Act, 1962 (Act No. 58 of 1962), as a contribution or a subscription by or on behalf of a member of that fund; or (ix) paid by any person to a registered short-term insurer as defined in section 1 of the Short-term Insurance Act, 1998 (Act No. 53 of 1998), as a premium in respect of any kind of policy defined or referred in the Short-term Insurance Act and under which policy that short-term insurer assumes, in return for such premium, such obligation as is described in the Short-term Insurance Act; and "deposit" when used as a verb, or any derivative thereof, has a corresponding meaning (i) paid as an advance, or as part payment, in terms of a contract for the sale, letting and hiring or other provision of movable or immovable property or of services, and which is repayable only in the event of -

	(a) that property or those services not in fact being sold, let and hired or otherwise provided; (b) the fulfilment of a resolute condition forming part of that contract; or (c) the non-fulfilment of a suspensive condition forming part of that.
Execution of sales	Means an intermediary service performed by a person on instruction of a client to buy, sell, deal, invest or disinvest in, replace or vary one or more financial products.
Financial services provider	Any person, other than a representative, who as a regular feature of the business of such a person: • furnishes advice; or • furnishes advice and renders any intermediary service; or • renders an intermediary service.
Fit and Proper	Refers to the experience, qualifications and knowledge of the adviser, personal character qualities such as good standing honesty and integrity as well as the meeting of continuous professional development requirements. Furthermore, the adviser needs to have the competence and operational ability to fulfil the responsibilities imposed by the FAIS Act.
Key individuals	Natural persons responsible for the managing or overseeing of, either alone or together with other people, the activities of a financial services provider and the representative/s.
Long-term deposit	Means a deposit including a foreign currency deposit, with a term exceeding 12 months but excluding a structured deposit.
Money-market instruments	Refers to short-term investment of less than or equivalent to one year which are both denominated in local currency or foreign currency.
Product specific training	Means the training in respect of a particular financial product and which training is assessed, including any amendments to that particular financial product.

Regulatory exam	Means a regulatory examination based on the qualifying criteria the purpose of which is to test a person's knowledge, understanding and application of legislation, including a financial sector law as defined in section 1(1) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017), the Financial Intelligence Centre Act, 2001 (Act No. 38 of 2001), and all measures promulgated in terms of those Acts, directly applicable to an FSP, representative or key individual.
Representative	Any person who renders a financial service for or on behalf of a financial services provider, in terms of conditions of employment or any other mandatory agreement, but excludes a person rendering clerical, technical, administrative, legal or accounting service, which service does not require judgment on the part of that person, or does not lead a client to any specific transaction in respect of a financial product in response to general enquiries.
Short-term deposit	Means a deposit as defined in section 1(1) of the Banks Act, including a foreign currency deposit, with a term not exceeding 12 months but excluding a structured deposit.
Structured deposit	Means a - (a) combination of a short-term deposit or a long-term deposit and another Tier 1 financial product; or (b) a short-term deposit or long-term deposit where the return or value is dependent on the performance of or is derived from the return or value of one or more underlying financial product, asset, rate or index, on a measure of economic value or on a default event.

Chapter 1: Introduction to Deposits

Learning outcomes

By the end of this chapter, you should be able to:

- Explain the relevant legislation governing short-term deposits
- Outline the different classes of business within the financial sector
- Demonstrate understanding of the purpose of the FSR Act
- Describe the key requirements of the FAIS Act and outline its purpose
- Demonstrate an understanding of the fit and proper requirements.

1.0 Introduction

Class of Business training refers to the generic training in respect of the various classes of business for which representatives are accredited to provide a service.

Class of business training becomes a requirement and will be operational on 1 August 2018, and representatives appointed on or after that date, must complete class of business training prior to the rendering on service in those classes of business.

Representatives appointed before 1 April 2018 are exempted from class of business training, but only in respect of products for which they were authorised before 1 April 2018. If they want to be appointed in new product categories, they will have to complete the class of business training in respect of those products. Representatives, who were still acting under supervision on 1 April 2018, are not exempted and must complete class of business training within 12 months commencing from 1 August 2018.

Class of business training must include training on:

- the general and special characteristics of the range of financial products within the class
- the typical fee structures
- charges and other general risks relevant to the products in that class,
- appropriateness of different products or features for different types of clients,
- how economic factors may impact these products
- The effect of applicable legislation such as tax.

Can only be provided by an accredited provider (as defined) or an education institution accredited by Skills Education Training Authorities (SETA) or Quality Council for Trades and Occupations (QCTO).

Product specific training became operational on 1 May 2018, and representatives appointed on or after this date, must complete product specific training prior to rendering financial services in those product categories.

Representatives appointed before 1 April 2018 are exempted from product specific training, but only in respect of, they will have to complete product specific training in respect of those. Products for which they were authorised before 1 April 2018. If they want to be appointed in new product categories, they will have to complete training in respect of those products.

Representatives who are still acting under supervision on 1 April 2018 are not exempted and must complete the product specific training within 3 months from 1 May 2018. Representatives appointed between 1 April and 30 April 2018 must complete product specific training within 3 months from 1 May 2018.

Continuous Professional Development is a requirement for a representative to maintain the required competence to render financial services in the product categories within which they operate.

The CPD requirement became effective from 1 June 2018 and for CPD, for FAIS accreditation purposes to be acceptable it must have been accredited by a Professional Body. It can be provided by any provider as long as a Professional Body has awarded and approved it and indicated the number of CPD credits to it. The Institute of Bankers in SA is a registered Professional Body with specific reference to the banking sector.

A CPD cycle runs for a period of 12 months commencing on 1 June every year and ending on 31 May of the following year. A representative, who renders financial services within a single subclass within a single class of business, must complete 6 CPD hours per cycle. A representative, who renders financial services within more than 1 subclass within a single class of business, must complete 12 CPD hours per cycle. A representative, who renders financial services within multiple classes of business, must complete 18 CPD hours per cycle.

1.1 Fit and Proper Requirements

The new Fit and Proper requirements will form part of the regulatory exam question bank from 1 April 2018. These are:

The fit and proper requirements for each of the categories of FSPs, key individuals and representatives are –

(a) Personal character qualities of honesty and integrity,
(b) Good standing;
(c) Competence,
(d) Continuous professional development,

(e) Operational ability,

(f) Financial soundness.

1.3 Legislation Affecting Short, Structured and Long-term Deposits

1.3.1 The FAIS Act

The FAIS Act (Financial Advisory and Intermediary Services Act) is described as a `market conduct regulation' which sets minimum standards around the manner in which FSPs are required to conduct their business.

FAIS Act purpose:

- Professionalization of the financial services sector
- Protection of consumers.

It became effective in 2002 and was amended through the Financial Services Law General Amendment Act 45 of 2013.

The FAIS Act regulates all financial service providers and intermediaries who give advice or provide intermediary services to clients. It follows a functional approach and not an institutional approach i.e. it regulates certain functions across institutions (insurance companies, brokerages and banks). An institutional approach focuses on specific institutions, like the Banks Act.

The commencement date of the FAIS Act is 15 November 2002, except for the following sections:

- Sections 20 to 31 became operational on 8 March 20031;
- Section 13(1) and Section 7 became operational on 30 September 2004.

The Role-players under the FAIS Act

These are:

- **The Financial Sector Conduct (FSCA)** is the market conduct regulator of financial institutions that provide financial products and financial services. The institutions include banks, insurers, retirement funds and administrators and market infrastructures.
- **Financial Services Providers (FSPs)** are the financial institutions, insurance companies or other entities that need to be authorised or licensed by the FSCA;
- **Key individuals** are employed by the FSPs and are responsible for the management and oversight of the FAIS-related business;

- **Representatives** are employed or mandated by FSPs to provide financial services to clients;
- **Compliance officers** are employed by or contracted by FSPs to assist in ensuring that the FSP complies with all the requirements of the Act; and
- **The Ombud for Financial Services Providers** (FAIS Ombud) resolves disputes between consumers (clients) and financial service providers and their representatives with regard to financial services.
- **The South Africa Reserve Bank**
- **Prudential Authority**
- **Financial Sector Conduct Authority.**

1.3.2 Financial Sector Regulatory Act, 2017 (FSR Act)

The Purpose

FSR ACT – Introduction

The FSR Act was created to establish a system of financial regulation by establishing the

Prudential Authority and the **Financial Sector Conduct Authority.** The powers assigned

to these authorities include:

• Regulating and supervising financial product providers and financial services providers;

• Improving market conduct in order to protect financial customers;

• Providing for co-ordination, co-operation, collaboration and consultation among the Reserve Bank, the Prudential Authority, the Financial Sector Conduct Authority, the National Credit Regulator, the Financial Intelligence Centre and other organs of state in relation to financial stability and the functions of these entities;

• Establishing the Financial System Council of Regulators and the Financial Sector Inter- Ministerial Council;

• Providing for making regulatory instruments, including prudential standards, conduct standards and joint standards;

• Making provision for the licensing of financial institutions;

• Making comprehensive provision for powers to gather information and to conduct supervisory on-site inspections and investigations;

• Making provision in relation to significant owners of financial institutions and the supervision of financial conglomerates in relation to eligible financial institutions that are part of financial conglomerates;

• Providing for powers to enforce financial sector laws, including by the imposition of administrative penalties;

• Providing for the protection and promotion of rights in the financial sector as set out in the Constitution;

• Establishing the Ombud Council and conferring powers on it in relation to Ombud schemes;

• Providing for coverage of financial product and financial service providers by appropriate ombud schemes;

• Establishing the Financial Services Tribunal as an independent tribunal and conferring on it powers to reconsider decisions by financial sector regulators, the Ombud Council and certain market infrastructures;

• Establishing the Financial Sector Information Register and making provision for its operation;

• Providing for information sharing arrangements;

• Creating offences;

• Providing for regulation-making powers of the Minister;

• Amending and repealing certain financial sector laws;

• Making transitional and savings provisions; and

• Providing for matters connected therewith.

1.3.3 FICA -Financial Intelligence Centre Act, 2001 (Act No. 38 OF 2001) and the amendments

FICA came into effect on 1 July 2001 to fight crimes such as money laundering, tax evasion, and other unlawful financial activities. This Act has put South Africa in line with similar legislation in other countries. FICA does not only help curb these illegal activities, but also helps to keep the money of South African citizens safe.

FICA aims to ensure that financial institutions know with whom they are doing business. In terms of FICA, financial institutions are required to preserve the paper trails of all transactions and are obliged to report any possible money laundering to the investigation authorities.

Purpose

to combat money laundering activities and the financing of terrorist and related activities; to impose certain duties on institutions and other persons who might be used for money laundering purposes and the financing of terrorist and related activities;

To provide for customer due diligence measures including with respect to beneficial ownership and persons in prominent positions;

To provide for a risk-based approach to client identification and verification; to provide for the implementation of financial sanctions and to administer measures pursuant to resolutions adopted by the Security Council of the United Nations

1.3.4 The Banking Act, 1990

The Banking Sector is governed by The Banks Act, 1990, and Regulations thereto.

To provide for the regulation and supervision of the business of public companies taking deposits from the public; and to provide for matters connected therewith. The South African Reserve Bank (SARB) is responsible for bank regulation and supervision in South Africa and is our primary regulator. Its purpose is to achieve a sound, efficient banking system in the interest of the depositors of banks and the economy as a whole. The Prudential Authority operates under the administration of the SARB. Whilst at the same the Financial Sector Conduct Authority also regulates the banking sect, hence South African uses a twin regulatory approach.

According to the banking act "the business of a bank" means –

(a) The acceptance of deposits from the general public (including persons in the employ of the person so accepting deposits) as a regular feature of the business in question;

(b) The soliciting of or advertising for deposits;

(c) The utilization of money or of the interest or other income earned on money, accepted by way of deposit as contemplated in paragraph

(i) for the granting by any person, acting as lender in such person's own name or through the medium of a trust or a nominee, of loans to other persons;

(ii) for investment by any person, acting as investor in such person's own name or through the medium of a trust or a nominee; or

(iii) for the financing, wholly or to any material extent, by any person of any other business activity conducted by such person in his or her own name or through the medium of a trust or a nominee;

(d) the obtaining, as a regular feature of the business in question of money through the sale of an asset, to any person other than a bank, subject to an agreement in terms of which the seller undertakes to purchase from the buyer at a future date the asset so sold or any other asset; or

(e) any other activity which the Registrar has, after consultation with the Governor of the Reserve Bank, by notice in the Gazette declared to be the business of a bank,

1.3.5 Mutual Banks Act, 1993 [No. 124 of 1993]

This act provides for the regulation and supervision of the activities of juristic persons doing business as mutual banks; and to provide for matters connected therewith. A mutual bank may, subject to the provisions of this Act and such directives as may from time to time be issued by the Registrar-

(a) accept deposits and grant loans, advances or other credit in the Republic; and

(b) with the written approval of the Registrar accept deposits and grant loans, advances or other credit in any state the territory of which formerly formed part of the Republic.

2) A mutual bank shall not issue negotiable certificates of deposit otherwise than in accordance with such conditions as may be prescribed.

1.3.6 Co-operative Banks Act, 2007

To promote and advance the social and economic welfare of all South Africans by enhancing access to banking services under sustainable conditions; to promote the development of sustainable and responsible co-operative banks; to establish an appropriate regulatory framework and regulatory institutions for co-operative banks that protect members of co-operative banks; to provide for the registration of deposit-taking financial services co-operatives as co-operative banks; to provide for the regulation and supervision of co-operative banks; and to provide for the establishment of co-operative banks supervisors and a development agency for co-operative banks; and to provide for matters connected therewith.

1.3.7 Financial Markets Act, 2012

To provide for the regulation of financial markets; to license and regulate exchanges, central securities depositories, clearing houses and trade repositories; to regulate and control securities trading, clearing and settlement, and the custody and administration of securities; to prohibit insider trading, and to provide for code of conduct inter alia.

1.4 What is a Deposit?

A deposit as defined in Section 1(1) of the Banks Act of 1990 as indicated in the definitions of terms.

When used as a noun, means an amount of money paid by one person to another person subject to an agreement in terms of which -

(a) an equal amount or any part thereof will be conditionally or unconditionally repaid, either by the person to whom the money has been so paid or by any other person, with or without a

premium, on demand or at specified or unspecified dates or in circumstances agreed to by or on behalf of the person making the payment and the person receiving it; and

(b) No interest will be payable on the amount so paid or interest will be payable thereon at specified intervals or otherwise,

notwithstanding that such payment is limited to a fixed amount or that a transferable or non-transferable certificate or other instrument providing for the repayment of such amount mutatis mutandis as contemplated in paragraph (a) or for the payment of interest on such amount mutatis mutandis as contemplated in paragraph (b) is issued in respect of such amount, but does not include an amount of money –

(i) paid as an advance, or as part payment, in terms of a contract for the sale, letting and hiring or other provision of movable or immovable property or of services, and which is repayable only in the event of -

(aa) that property or those services not in fact being sold, let and hired or otherwise provided;

(bb) the fulfilment of a resolute condition forming part of that contract; or

(cc) the non-fulfilment of a suspensive condition forming part of that contract;

(ii) Paid as security for the performance of a contract or as security in respect of any loss which may result from the non-performance of a contract;

(iii) without derogating from the provisions of paragraph (ii), paid as security for the delivery up or return of any movable or immovable property, whether in a particular state of repair or otherwise;

(iv) Paid by a holding company to its subsidiary or by a subsidiary to its holding company or by one subsidiary to another subsidiary of the same holding company;

(v) paid by a person who, at the time of such payment –

(aa) is a close relative of the person to whom such money is paid;

(bb) is a director or executive officer of the person to whom such money is paid; or

(cc) is a close relative of a director or executive officer of the person to whom such money is paid;

(vi) paid by any person to a registered long-term insurer as defined in section 1 of the Long-term Insurance Act, 1998 (Act No. 52 of 1998), as a premium in respect of any kind of policy defined or referred in the Long-term Insurance Act and under which policy that long-term

insurer assumes, in return for such premium, such obligation as is described in the Long-term Insurance Act;

(vii) paid to a fund registered or provisionally registered under section 4 of the Pension Funds Act, 1956 (Act No. 24 of 1956), as a contribution, contemplated in section 13A of that Act, by or on behalf of a member of that fund;

(viii) paid to a benefit fund, as defined in section 1 of the Income Tax Act, 1962 (Act No. 58 of 1962), as a contribution or a subscription by or on behalf of a member of that fund; or

(ix) paid by any person to a registered short-term insurer as defined in section 1 of the Short-term Insurance Act, 1998 (Act No. 53 of 1998), as a premium in respect of any kind of policy defined or referred in the Short-term Insurance Act and under which policy that short-term insurer assumes, in return for such premium, such obligation as is described in the Short-term Insurance Act.

1.5 Definition of a financial Product

Definitions **"Financial product"** means, subject to Subsection (2) -

(a) Securities and instruments, including -

(i) Shares in a company other than a "share block company" as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980);

(ii) Debentures and securitised debt;

(iii) Any money-market instrument;

(iv) any warrant, certificate, and other instrument acknowledging, conferring or creating rights to subscribe to, acquire, dispose of, or convert securities and instruments referred to in subparagraphs (i), (ii) and (iii);

(v) Any "securities" as defined in Section 1 of the Financial Markets Act, 2012 (Act No. 19 of 2012);

(b) A participatory interest in one or more collective investment schemes;

(c) A long-term or a short-term insurance contract or policy, referred to in the Long-term Insurance Act, 1998 (Act No. 52 of 1998), and the Short-term Insurance Act, 1998 (Act No. 53 of 1998), respectively;

(d) A benefit provided by -

(i) A pension fund organisation as defined in Section 1(1) of the Pension Funds Act, 1956 (Act No. 24 of 1956), to the members of the organisation by virtue of membership; or

(ii) A friendly society referred to in the Friendly Societies Act, 1956 (Act No. 25 of 1956), to the members of the society by virtue of membership;

(e) A foreign currency denominated investment instrument, including a foreign currency deposit;

(f) A deposit as defined in Section 1(1) of the Banks Act, 1990 (Act No. 94 of 1990);

(g) a health service benefit provided by a medical scheme as defined in Section 1(1) of the Medical Schemes Act, 1998 (Act No. 131 of 1998);

(h) Any other product similar in nature to any financial product referred to in paragraphs (a) to (g), inclusive, declared by the registrar by notice in the Gazette to be a financial product for the purposes of this Act;

(i) Any combined product containing one or more of the financial products referred to in paragraphs (a) to (h), inclusive;

(j) any financial product issued by any foreign product supplier and marketed in the Republic and which in nature and character is essentially similar or corresponding to a financial product referred to in paragraphs (a) to (i), inclusive;

"**Intermediary service**" means, subject to Subsection (3) (b), any act other than the furnishing of advice, performed by a person for or on behalf of a client or product supplier -

(a) The result of which is that a client may enter into, offers to enter into or enters into any transaction in respect of a financial product with a product supplier; or

(b) With a view to -

(i) buying, selling or otherwise dealing in (whether on a discretionary or non-discretionary basis), managing administering, keeping in safe custody, maintaining or servicing a financial product purchased by a client from a product supplier or in which the client has invested;

(ii) Collecting or accounting for premiums or other moneys payable by the client to a product supplier in respect of a financial product; or

(iii) Receiving, submitting or processing the claims of a client against a product supplier;

The new requirements divide financial products into two Tiers. The reason for this is to distinguish between those financial products which are, in general, simpler and easier to understand (Tier 2) and which may, therefore, have lighter competency standards, and those which are more complex (Tier 1).

Table 1.1

Tier 1 Financial Products	Tier 2 Financial Products
Structures Deposits	Short-term Insurance Personal Lines A1
Short-term Insurance Personal Lines	Long-term Insurance subcategory A
Short-term Insurance Commercial Lines	Long-term Insurance subcategory B1-A
Long-term Insurance subcategory B1	Long-term Insurance subcategory B2-A
Long-term Insurance subcategory B2	Friendly Society Benefits
Long-term Insurance subcategory C	Short-term Deposits
Retail Pension Benefits	Long-Term Deposits
Pension Fund benefits	
Participatory interest in a collective investment scheme	
Participatory interest in a CIS ledge fund	
Forex Investment	
Health Service Benefits	
Shares	
Money market instruments	
Debentures and securitized debt	
Warrants, certificates and other instruments	
Bonds	
Derivative instruments	
Securities and Instruments	

Details of the **6 new product categories (Tier 2)** have been set out in Table 1.1. Five of these product categories are only *new* in the sense that they have been stripped out from existing product categories and have been given their own grouping or name. This means that FSPs who are already licensed for the associated or ‘old’ subcategory and make use of financial

products which now fall into the new product category will have to take the necessary steps to update their license.

Failure to do so means that an FSP will no longer be able to do business in those financial products which now fall under a new product category.

Tier 1 financial products

- Means the financial products listed in column A of Table 1.1;

Tier 2 financial products

- Means the financial products listed in column B of Table 1.1

Table 1.2

New Product Category (Subcategory	**Description**
Long-term insurance subcategory B1-A	Long-term insurance policies referred to in the definition of long-term insurance subcategory B1 which require no or limited underwriting
Long-term insurance subcategory B2-A	Long-term insurance policies referred to in the definition of long-term insurance subcategory B2 where the investment portfolio is managed by the product supplier with no option by the policyholder to request a change or amendment
Short-term insurance personal lines A1	Short-term insurance personal line policies (excluding marine or engineering or guarantee policies, with no or limited underwriting, with a contract term of less than 24 months, which are not subject to the principle of average, and which meet certain conditions relating to policy benefit and exclusions
Structured deposit	Combination of short-term or long-term deposit with another tier 1 financial product, or short-term or long-term deposit where the return value depends on or is derived from the performance of an underlying financial product, index, etc.
Securities and instruments	Securities and instruments that have not already been defined in the determination
Participatory interest in a hedge fund	Participatory interest in a collective investment scheme that is a hedge fund

1.6 Classes of Business

The product classes that an FSP can be licensed for have been divided into **9 broad classes,** each with its own **subclasses.**

For example,

- Short-term Insurance Personal Lines is a class of business with subclasses such as 'Personal Lines: Motor policy, Personal Lines: Accident and health policy', etc.
- Investments are another class with shares, retirement annuities and derivatives being some of the subclasses.

Below is a Table showing all the nine classes.

1.	**Short-term Insurance: Personal Lines**
Subclasses	
1.1	Personal lines: Accident and health policy
1.2	Personal lines: Liability policy
1.4	Personal lines: Miscellaneous policy
1.5	Personal lines: Motor policy
1.6	Personal lines: Property policy
1.7	Personal lines: Transportation policy
1.8	Personal lines: Short-term reinsurance policy
2.	**Short-term Insurance: Commercial Lines**
Subclasses	
2.1	Commercial lines: Accident and health policy
2.2	Commercial lines: Engineering policy
2.3	Commercial lines: Guarantee policy
2.4	Commercial lines: Liability policy
2.5	Commercial lines: Miscellaneous policy
2.6	Commercial lines: Motor policy
2.7	Commercial lines: Property policy
2.8	Commercial lines: Transportation policy
2.9	Commercial lines: Short-term reinsurance policy
3.	**Long-term Insurance**
Subclasses	
3.1	Assistance policy
3.2	Life risk policy
3.3	Life investment, policy
3.4	Fund policy
3.5	Sinking fund policy
3.6	Long-term reinsurance policy
4.	**Pension Fund Benefits**
5.	**Short-term and Long-term Deposits**
6.	**Structured Deposits**

7.	**Investments**
Subclasses	
7.1	Shares
7.2	Money market instruments
7.3	Debentures and securitised debt
7.4	Bonds
7.5	Derivative instruments, warrants, certificates or other instruments
7.6	Securities and Instruments
7.7	Participatory interests in a collective investment scheme
7.8	Participatory interest in a CIS hedge fund
7.9	Retail Pension Benefits
8.	**Forex Investments**
9.	**Health Services Benefits**

Class of Business Training

Class of business training must include training on:

- the general and special characteristics of the range of financial products within the class
- the typical fee structures
- charges and other general risks relevant to the products in that class,
- appropriateness of different products or features for different types of clients,
- how economic factors may impact these products
- The effect of applicable legislation such as tax.

Can only be provided by an accredited provider (as defined) or an education institution accredited by Skills Education Training Authorities (SETA) or Quality Council for Trades and Occupations (QCTO), CHE criteria.

When does the Class of Business Training Requirement Commence?

The provisions which relate to class of business training commenced on 1 August 2018. However, there are a number of transitional arrangements which apply.

Who does Class of Business Training apply to?

As a rule, class of business training generally applies to all FSPs, KIs and Reps. But; there are some entities that are exempted (see Figure 3.3).

FSPs and Reps must complete class of business training ***before*** rendering a financial service in relation to a product and KIs must, ***prior*** to managing or overseeing any financial service, complete class of business training for those classes that they are approved for.

Category I FSPs and KIs and reps authorized, approved, or appointed only for Long-term insurance subcategory A and/or Friendly Society Benefits
Category I reps only appointed for execution of sales for Tier 1 financial products (subject to conditions)
Category I reps only appointed for Tier 2 financial products

Transitional Arrangements for FSPs, KIs and 'Full' Reps

- FSPs, KIs and 'full' Reps (i.e. not under supervision), authorised prior to 1 April 2018 as their experience is recognised and they are considered to have completed the class of business training.
- Any changes made after 1 April 2018, will require compliance with the new requirements.
- One of the conditions of these transitional arrangements is that Category I KIs will have to inform the Registrar of the different classes of business they currently manage and oversee across all FSPs where the KI is appointed.

Transitional arrangements for Reps under Supervision

- A Rep who was working under supervision on 1 April 2018 or who is appointed under supervision between 1 April and 31 July 2018, had 1 year (i.e. until ***31 July 2019***) to meet the class of business training requirements.

What is Product Specific Training?

Product specific training is training about a *particular* financial product, including any amendments or changes to that *particular* financial product. In terms of the definition, this **training must include an assessment.**

A lot of detail is provided about what must be included in product specific training, such as:

- the specific characteristics, terms and features of the product,
- how the product and any underlying features are structured,
- the fee structure, charges and other costs associated with the product and how these will impact on real return or benefits of the product,
- details of guarantees and risks,
- the impact of tax on benefits or real return,
- how abnormal market conditions may impact how the product performs,

- any lock-in periods,
- Identity of the product supplier and providers of any underlying component as well as their good standing and regulatory status, etc.

Product specific training applies to all FSPs, KIs and Reps, except:

- Category II, Category IIA or Category III – FSPs and Reps, provided they comply with all other competency requirements;
- KIs of all Categories of FSPs not giving advice; and
- Those FSPs, KIs and Reps.

Similar to class of business training, FSPs and Reps must complete product specific training ***before*** giving advice and/or providing an intermediary service relevant to the financial product for which they are approved or appointed.

FSPs and Reps (excluding Reps under supervision) who are authorised and appointed before the commencement date of the Board Notice (i.e. 1 April 2018) are ***deemed*** to have completed the product specific training ***only*** for those particular financial products that they were appointed for at that date and they must have given advice or rendered intermediary services in respect of those particular financial products.

However, if there are any changes or amendments to these products, then they must complete product specific training on the amendments or changes. While this gives some relief to those who are already active in the industry, FSPs taking on new entrants as Reps will have to carefully plan for their training needs as this will require provision for additional time and costs.

Chapter 2: Short Term Deposits

Learning outcomes

By the end of this chapter, you should be able to:

- Demonstrate an understanding of short-term deposits and their key characteristics and features
- Explain difference between short-term deposits, structured deposits and long-term deposits
- Explain the difference between savings and investments products.
- Demonstrate the different types of saving accounts
- Outline the types of cheque accounts and their pricing mechanisms
- Explain the different pricing mechanisms used for saving accounts.

2.0 Introduction

This chapter begin by explains the difference between short-term deposits, structured deposits and long-term deposits through use of their definition. It further details the difference between a saving s and an investment. Different types of bank deposit accounts are also discussed.

2.1 Different types of Deposits

a) Short-term deposit
Short-term deposit means a deposit, including a foreign currency deposit, with a term not exceeding 12 months but excluding a structured deposit;

b) Structured deposit
Structured deposit means a combination of a short-term deposit or a long-term deposit and another Tier 1 financial product; or a short-term deposit or long-term deposit where the return or value is dependent on the performance of or is derived from the return or value of one or more underlying financial product, asset, rate or index, on a measure of economic value or on a default event;

c) Long-term Deposit
Long-term deposit means a deposit including a foreign currency deposit, with a term exceeding 12 months but excluding a structured deposit.

2.2 Demand deposits

A demand deposit account is a cheque account, savings account, call account or any other type of account at a banking institution that allows money to be deposited and withdrawn on demand by the accountholder. Depending on the type of account, the bank might charge a service fee, while on other accounts the bank may pay interest on the funds that have been deposited into the account.

2.2.1 Savings and investments

In order to save or invest, clients would need to have some money left over from their income after all expenses have been deducted.

In the banking industry we typically understand the terms savings and investments by relating them to the accounts that are offered. Technically, savings means setting money aside for emergencies or to achieve short-term goals. Typically, savings of this nature would have to be immediately available to the client and banks have products that suit this type of need. Savings accounts provide a safe place to deposit money and these accounts also provide interest earnings, which mean that the money can grow when it is not being used. Therefore, bank accounts such as savings, call, money market transactional accounts and even short-term notice deposit and fixed deposit accounts, could be termed savings accounts.

Investments

Investing means to deposit money for the purpose of making the money grow over time through earning interest. In other words, creating more money over a longer period. Investing usually forms part of a long-term approach and involves larger sums of money than savings as well as attracting higher interest. The main difference in a banking context is that there are various limitations regarding balances and deposit amounts, access restrictions and penalty fees.

The difference between savings and investments

The difference between saving and investment lies in the aim and time period. Savings are meant to be liquid (easy to convert into cash) and the client should have the ability to withdraw this money immediately or within a short notice period. The returns on savings are usually quite small. Investments tend to be less liquid (depending on the type of investment) and usually have a longer time period. Investment accounts offer higher interest rates. In a banking context standard investment accounts are considered low risk, as the capital amount deposited is not at risk compared to other types of investments, such as investing on the stock market or investing in property.

2.3 Types of accounts that attract bank depositors

There are many banking products and services that can be offered to suit the financial needs of the wide range of banking clients. It is important to be aware of the products that are available both in the bank as well as in the marketplace in order to accommodate the different types of needs that clients have.

Cheque account - Cheque accounts are also referred to as transactional accounts. Transactional accounts are a convenient means for business and personal clients to deposit and withdraw money and pay third parties, at the same time providing them with a handy record of transactions made during each month. These accounts are not meant for the purpose of earning interest or for the intention of saving. A cheque account is the ideal account for a client who earns a regular monthly income and makes regular account payments, such as rent or bond, telephone and car repayments. The account provides the client with various transaction methods such as the utilisation of the bank's branch network, a cheque or debit card, an ATM, online banking or telephone and cell phone banking. If the client qualifies, he can also apply for an overdraft facility and chequebook. The client also has the option to receive monthly statements that will help him to keep track of and manage his finances.

Transmission account - Transmission accounts are similar to cheque accounts. A transmission account has lower transactional costs but does not offer access to overdraft or chequebook facilities. It is aimed at clients who need to transact regularly, deposit their wages and make monthly payments, as well as save. Small businesses also can opt for transactional accounts especially where they do not need access to credit or chequebook facilities

Savings accounts – These types of accounts are mainly used for saving. It is simple and easy to manage and suits the needs of people who do not wish to operate a cheque or transmission account. The charges can be fairly high especially on a book-based savings account. Money can be placed in the account or withdrawn at any time. A fairly low interest rate is offered on these accounts and the amount of interest that is earned is dependent on the balance in the account. Savings interest rates are usually tiered which means the higher the balance in the account the higher the rate of interest earned. Savings accounts are designed to allow the client's money to grow. Savings accounts are mostly card based although there are still book-based accounts. Funds can be accessed through the bank's branch network, ATMs, and in certain cases online, telephone or cell phone banking options. The rate of interest varies according to the savings option and the amount of money in the bank account.

Call deposit - This is readily available money that can be accessed on demand. Different call deposits have different restrictions usually pertaining to minimum balances or minimum

transactional amounts. The purpose of call deposits is to earn a higher rate of interest than a savings account. The interest earned will be lower than other fixed interest investment accounts due to the easy accessibility to funds. Individuals or businesses can open a call account.

Money market deposit account - is an account that provides the client with a combination of transacting and investing. This account provides clients with easy access to their funds, simultaneously encouraging clients to invest larger sums, as the higher the balance the higher the rate of interest earned. No notice period is required for withdrawals. This option is suited to individuals, businesses and other organisations. There are restrictions to this type of account such as maintaining a minimum balance of, for example, R20 000.00 – this differs from bank to bank. Interest is calculated daily and capitalised monthly

Notice deposit - An agreed period of notice needs to be given to the bank before money in the account can be accessed. This is usually a 32-day period. The rate available will be higher than the call rate, as funds are tied up for a longer period of time. Notice deposit accounts earn a higher rate of interest but have a number of other restrictions. Besides the agreed notice period, the minimum amount needed to open the account is higher than an ordinary savings account. Interest rates may fluctuate periodically.

Fixed deposit - This type of account offers a fixed interest rate over a fixed period of time (e.g. 12 or 24 months). The money must remain in the account for the specified period of time. This protects the investor from the temptation of drawing the money and is a good form of investing for a long-term goal.

2.4 Interest Rates

Interest is paid to a client by a bank for money held in the form of a deposit in certain savings and investment accounts. The banks usually pay interest monthly, however some products offer the client a choice and interest can be paid monthly, quarterly, half-yearly, annually or on maturity.

There are many product options available to investors and banks have to compete to obtain investors' funds by offering a certain amount of interest in return for their deposits.

Interest is also a fee that is paid to a lender by a borrower for the right to use the money. Interest is paid by clients to the bank when the client avails of an overdraft facility or borrows money in the form of a loan account.

2.5 Factors impacting interest rates

Some of the factors that are likely to have an impact on the level of interest rates are the following:

a) Period or term

The longer the term of the loan, the greater the uncertainty that circumstances may change, therefore, the higher the compensation demanded by the lenders of funds. In the case of investments, the longer the term the higher the demanded rate of return.

b) Ability to repay

The lender needs to be satisfied that there is a good probability that they will get their money back. The higher the risk of default by the user or the lower his/her credit rating, the higher the interest rate asked by the supplier of funds. In the case of investments, the higher the risk, the higher the return demanded.

c) Inflation

The higher the level of inflation the higher the interest rate demanded by investor. Thus to compensate them for the declining value of their funds. Therefore, higher expected inflation will bring about higher interest rates.

The South African Reserve Bank (the Bank) plays an important role in determining the level of short-term interest rates, as these rates are closely related to the rates at which the Bank lends money to private-sector banks

2.6 Types of interest rates

a) Repo rate

The repurchase rate (repo rate) is the interest rate at which commercial banks can borrow money from the Bank. When the repo rate changes, it affects the prime lending rate. The prime lending rate in turn affects the interest rate that commercial banks charge their clients.

The repo rate is one factor that controls the supply of money in South Africa, which in turn has an influence on the following:

- Inflation
- Consumer spending power
- National debt levels
- Business growth.

b) Prime lending rate

When one borrows money from a bank, the interest rate that they will be charged by the bank, is usually specified in terms of the prime interest rate. The prime interest rate or prime lending

rate is a benchmark rate used by commercial banks when issuing variable interest rate loans to clients. The South African prime rate is a few percent higher than the repo rate. Banks can lend money below prime, at prime or above prime rate depending on variables such as the loan risk.

The nominal interest is also known as simple interest. It is the interest rate stated for a specific product calculated on an annual basis and does not take the effect of compounding into account. Typically, a standard fixed deposit would attract a nominal interest rate as it is set for a specified period and interest, therefore, cannot be added to the capital amount until the end of the period.

c) Effective interest rate

The effective interest is the actual interest rate that accrues after taking into account the effects of compounding. Compounding means that interest is added to the capital amount or balance of the account periodically. In other words, interest is earned on interest. Typically, a notice deposit account or ordinary savings account would attract an effective rate of interest.

d) Fixed and variable interest rates

Depending on the product, clients who enter into an agreement with the bank might be given a choice between fixed or variable rates. Banks offer a vast

e) Tiered interest rates

Tiered interest rates refer to a rate of interest scaled according to the amount invested in the account. Typically, the higher the balance in the account, the higher the rate. Savings or investment accounts with longer terms generally pay higher rates than accounts with shorter terms.

This option is beneficial to clients who intend saving continuously and increasing the balance on their account. The more money the client saves the higher the interest rate paid for the money, and if the interest is capitalised the balance will increase even further and the client will earn interest on the interest.

2.7 Period of deposit

When performing a needs analysis with a client it is important to establish the length of time that they are willing to invest. The period of deposit can be defined as the minimum length of time the funds are locked in before a client can access them. In banking terminology this is referred to as the investment period. The various deposits that a bank accepts for savings and investments have specific time periods attached. Usually, the longer money is committed for investment purposes the higher the interest rate paid on this type of investment. By

establishing the client's financial profile one can determine what investment period might best suit his needs. The client can choose from the following options:

- Short-term (less than 12 months) – such as a call account or 32-day notice deposit account
- Medium term (12 months – 5 years) – such as a 12-month fixed deposit or unit trust
- Long-term (5 years and longer) - Unit Trust and other financial products such as retirement annuities

The types of restrictions on interest-bearing products include:

1. Minimum and maximum balance requirements, for example, some money market transaction accounts have to maintain a minimum balance of R20.000. A debit order must also be in place to transfer a minimum amount of R1 000 into this account at a time. If these rules are not adhered to and the account falls below the R20 000 balance the account is closed.

2. Notice periods – Clients can access their funds immediately on a call account but other accounts such as 32-days' notice accounts require prior notice in writing.

3. Interest rate restriction, for example, the interest rate on a 32-day notice account increases after the first 32 days, and again after 64 days, provided that no notice has been input on this account.

4. Age restrictions – the bank provides specifically tailored products to suit the needs of their diverse clients, for example, products for minors, students and senior citizens with specific benefits such as higher interest rates on investment products or special service fees on cheque accounts.

5. Deposit and withdrawal limitations, for example, on a specific product with a fixed maturity date one can make a maximum of two withdrawals of 15% each, of the available balance without any penalties for early redemption.

6. Minimum opening balances ranging from R100 – R50 000

Penalty fees for early redemption of deposit and penalties when no notice has been given. These penalties differ from bank to bank and range from a set fee such as a minimum of R750.00 for early redemption to 1% of the withdrawal amount.

Liquidity

Liquidity relates to how easily funds can be accessed, i.e. how quickly an investment can be converted into cash in the pocket.

The following accounts allow immediate access to funds:

- Savings
- Money market deposit account

The following accounts require notice before funds can be released:

- 32-day, 60-day, 88-days' notice
- Call accounts with 24-hour notice requirements
- Generally, a fixed deposit cannot be accessed prior to maturity; however, the client's request can be processed subject to penalties.

2.8 Various profiles of investors

There are mainly three types of investors; namely:

- Conservative
- Moderate
- Aggressive.

a) Conservative investors

These are investors who want stability and want to protect their investment, low interest rate for low risk suits their profile and they do not mind not increasing the value of the investment dramatically. This type of investor is risk-averse and does not want to take risks with the capital that has been invested.

b) Moderate investors

are long-term investors who want reasonable but relatively stable growth. These investors do not mind some interest rate fluctuation; however, they probably would not invest directly in shares on the stock exchange but rather invest in a unit trust (collective investment scheme).

c) Aggressive investors

are long-term investors who want high capital growth. These investors want a high return and understand that to earn this return there is often a high risk involved.

Chapter 3: Money Market Instruments

Learning outcomes

By the end of this chapter, you should be able to:

- Explain the term money market
- Give examples of money market instruments
- Demonstrate ability to calculate interest amount
- Calculate the Maturity Amount /Future Value of any Money Market instruments.

3.0 Introduction

The money market is defined as that part of the financial market for the issuing, buying and selling of debt instruments with maturities ranging from one day to one year – the most common maturity being three months.

Banks play a significant role in the money market as financial intermediaries and as the medium through which the SARB intervenes in the market for purposes of implementing monetary policy. Owing to their deposit-taking function, banks are large borrowers of funds, as can be seen by the dominant proportion of fixed and floating rate wholesale deposits and negotiable certificates of deposit (NCDs) in relation to other money market funding instruments. The interest rates determined in the markets for NCDs and other deposits, be it in the interbank market or wholesale money market, are used to formulate interest rate benchmark such as the Johannesburg Interbank Agreed Rate (Jibar), South African Benchmark Overnight Rate (Sabor) and the rand overnight deposit rate.

Based on the market value of outstanding debt securities listed on the JSE as at 29 December 2017, about R391.6 billion worth of outstanding debt securities are linked to the Jibar as the reference interest rate. This represents almost all (≈ 99.98%) of the floating rate debt securities listed on the JSE. In particular, the three-month Jibar is used extensively. Furthermore, based on the results of the 2017 funding data collection exercise conducted by the Financial Markets Department of the SARB, the notional value of outstanding derivative and non-derivative contracts that reset against the three-month Jibar exceeded R38.0 trillion and R2.0 trillion respectively as at 31 August 2017.

The SARB fulfils a crucial role in the money market by supplying accommodation to the banking system and, by so doing, influences money-market liquidity and interest rates. The SARB has embarked on a comprehensive review of the monetary policy implementation framework. However, the review of the interest rate benchmarks in the domestic market is a prerequisite for the finalisation of proposals to change the approach to monetary policy. These

proposals will enhance the SARB's influence over interest rates in the market in line with its inflation-targeting monetary policy framework.

An electronic dematerialised money market environment has been established in South Africa. The characteristics of the market include standardised and electronically issued money market securities, same-day settlement (T+0), electronic recording of trades in money market securities, and electronic clearing and settlement of money market trades.

3.1 Money market instruments

Money market instruments are short-term financial instruments such as bankers" acceptances, certificates of deposit.

Money Markets - these provide short-term debt funding and investment opportunities through the issuing of instruments or claims whose tenure is less than one year. As such they are also referred to as the market for short-term securities. The money market can be split into the primary and secondary markets. The primary market refers to the institutional framework where the securities are created and issued (for the first time) while the secondary market is where previously issued securities are bought and sold among investors.

Secondary Market - In the secondary market there are market makers and brokers. Brokers are agents, i.e. act on behalf of other financial market participants in return for a commission. As such, they are not financial intermediaries in the true sense of the term. Market makers are those financial institutions who are always ready and willing to give a two-way quote, i.e. quote buying and selling prices at the same time and also deal in a wide range of volumes in given securities. At this point let us look at the importance of an active secondary market in any security.

i. Assists the primary market to develop this is in the sense that investors are assured that the securities can be sold to other investors should the need arise.
ii. Provides the Basis on which new issues can be priced.
iii. Changing market conditions are quickly assimilated into the price of the existing securities. In this way, it also gives an indication as to how any new issues would be received by the market.
iv. Enables investors to adjust their portfolios in terms of maturity profile, size of portfolio, liquidity and risk return trade-offs.

Money market instruments fall into the following broad categories:

a) JSE Interest rate derivative instruments

An interest rate derivative is a financial instrument with a value that is linked to the movements of an interest rate or rates. These may include futures, options, or swaps contracts. Interest

rate derivatives are often used as hedges by institutional investors, banks, companies, and individuals to protect themselves against changes in market interest rates, but they can also be used to increase or refine the holder's risk profile or to speculate on rate moves.

The JSE has listed a number of interest rate derivatives, namely futures and options on government debt and state-owned company debt, STIRs (Short Term Interest Rate) Futures, namely Jibar Futures and LTIRs (Long Term Interest Rate Futures) namely Swap Futures.

The Interest Rate Derivatives Market offers participants the functionality and facilities to book either on- or off-screen trades. Irrespective of the method of execution, all exchange traded Interest Rate Derivative positions are margined and cleared by JSE Clear clearing house. This reduces counterparty credit risk.

b) Interest-bearing instruments

These are securities that pay interest at a specified rate either at periodic intervals or at maturity. Instruments that are always issued in interest-bearing form include Certificates of Deposit.

c) Discount securities

These are non-interest-bearing money market instruments that are issued at a discount and redeemed at maturity for full face value. They do not pay a cash flow until maturity. The only income received by the investor is the difference between the price paid and the proceeds received at maturity or the sale of the security. Example of discount securities if commercial paper.

3.1.1 Types of the Money Market Instruments

1. Commercial paper
2. Promissory notes
3. Treasury bills
4. NCDs
5. Repurchase Agreements
6. Money Market Derivatives
7. OTC-FRA’s
8. JSE Short-Term Interest Futures
9. Bankers’ acceptances
10. Trade bills.

1. Commercial paper

This is a short term unsecured promissory note issued in the open market as an obligation of the issuing entity. It is an alternative to bank borrowing for large corporations with strong credit

ratings; although lower (credit) rated corporations have issued commercial paper by obtaining credit enhancements or other collateral. However, even those lower rated corporations without enhancements and collateral have also issued what is referred to as high-yield commercial paper. In the developed markets, e.g. USA, the most common maturity range is 30 to 50 days or less. This is mainly because of three reasons. First, Commercial Paper that has maturity exceeding 270 days has to be registered with a relevant authority. Secondly, for issuers to pay off holders of maturing paper they (issuers) generally have to issue new paper and since in the money markets investors are worried about liquidity it follows that the maturity of such paper will be quite short. Thirdly, eligibility concerns have to be considered, i.e. whether a bank would be able to use the paper as eligible collateral if it wanted to borrow from the central bank. For commercial paper to be eligible, its maturity should not exceed 90 days. Eligible paper also trades at lower costs than ineligible paper and as such issuers prefer maturities not exceeding 90 days.

Commercial paper is generally considered to be the riskiest of all money market discount instruments because repayment is (only) guaranteed by the issuing corporate body. The risk faced by the investor is that the borrower will not be able to issue new paper at maturity to repay the loan (maturing paper). As a safeguard, commercial paper is sometimes backed by unused bank credit lines.

2. Promissory Notes

A promissory note is an unconditional promise in writing made by one person to another, signed by the maker, and engaging to pay on demand or at a fixed or determinable future time, a sum certain in money, to a specified person or his order, or to bearer

3. Treasury Bills

These are securities issued by a country's Treasury and are backed by the full faith and credit of that country. This is why such securities are perceived as having no risk of default. Treasury bills are short term debt instruments issued at a discount and in bearer form, i.e. blank, unless otherwise requested. They can be classified into two groups that are distinguishable by the method of issue and the term to maturity. The first group is the weekly tender TB which usually has a term to maturity of 91 days and is issued weekly on a given day. The second is the special tender TB which has any maturity other than 91 days and is issued on any day of the week. In both groups, the primary market for TBs is mainly made up of dealing institutions. As such TBs are held mainly by discount houses and banks (since the TB is the main instrument for central bank accommodation). However, any other institution or individuals can apply for TBs at the weekly tender. Even though some discount houses and banks do create a market

for TBs, the secondary market for this instrument is usually limited due to the fact that the volume in issue is small.

Mathematics of Issuing TBs Bids and offers on TBs are quoted on a bank discount Basis, not on a price Basis. The formula for calculating the yield on a bank discount Basis is as follows:

$y = (360/t)\ (D/F)$

Where y = annualized yield on a bank discount basis expressed as a decimal.

D = Dollar discount from the face value (Face value - current price)

F = Face value of the TB

t= number of days remaining to maturity

Pitfalls of bank- discount- Basis yield

It should however be noted that the quoted yield on a bank discount Basis is not a meaningful measure of the return from holding a TB. This is because of the reasons stated below.

(i) it is Based on a face value investment as opposed to the actual dollar amount invested

(ii) the yield is annualized on the basis of a 360-day year as opposed to a 365-day year, which makes it difficult to compare the yield of say, a money market discount instrument like a TB to that of capital market coupon paying instruments like Treasury Notes or bonds, which pay interest on the Basis of a 365-day year. It is even difficult to compare such a discount yield to coupon paying money market instruments which also quote Based on a 360-day year.

In a bid to make the quoted discount yield comparable to that of a coupon paying instrument, two other yield measures are used. These are the Bond Equivalent Yield and the CD Equivalent Yield (or money market equivalent yield). The former seeks to make the TB yield comparable to that of Treasury notes and bonds while the latter seeks to make it comparable to the yields on interest bearing money market instruments that pay interest on a 360-day year Basis. This is done by considering the price, P of the Treasury Bill as opposed to its face value

The Bond Equivalent Yield (Be) This is applicable for instruments maturing in less than 6 months.

$BeY = [(365)\ (y)] / [360 – (y)\ (t)]$

The CD Equivalent Yield (CDeY)

$CDeY = [360(y)] / [360 – (yt)]$

The Issuing Mathematics of TBs – submitting tenders They are issued on a tender Basis and the Reserve Bank would normally specify the face value and how those who want to tender

should submit their (tender) bid prices. This could be in multiples of R1 000 or any other suitable figure.

Calculating the TB price (actual/365 basis)

Price = R100 – (yt/365), where y is expressed in absolute terms

Or

Price = F [1 – (yt/365)], where y is expressed as a decimal

4. Certificate of Deposit (CD)

This is a certificate issued by a bank to a depositor (investor) as acknowledgement that a given amount of money has been deposited at the issuing bank. On maturity, the holder of the CD will present it to the issuing bank which will issue a cheque for the face value plus accrued interest, also known as the Maturity Value. The certificate will typically contain the following information.

- name of issuing bank - issue date - maturity date
- amount of the deposit
- maturity value
- rate of interest per annum.

Certificates of Deposit can either be **negotiable** or **non-negotiable.** If the CD is non-negotiable, it means the (initial) depositor must wait until the maturity date of the CD before they can get back the funds, otherwise an early withdrawal penalty would be levied should they want their money back earlier. On the other hand, a negotiable CD allows the initial depositor or any other subsequent owner of the CD to sell it in the open (or secondary) market before maturity date. The importance of negotiable CDs is that they help banks to increase the amount of funds raised in the money market and also motivate competition among banks.

The primary market for NCDs includes Banks, Discount houses, Mines, Building Societies, Insurance companies, Pension funds, Private companies, Local authorities & Individuals. Banks raise or borrow funds for their daily business activities by issuing CDs, which can either be negotiable or non-negotiable.

Non-negotiable CDs are typically issued for small deposits which are usually made by individuals, in bearer form & sometimes in the name of the original depositor.

Types of CDs for developed economies like the US, CDs can be classified into four types: 1) Domestic CDs i.e. CDs issued by domestic banks 2) Euro (dollar) CDs i.e. those denominated in US dollars but issued out of the US. 3) Yankee CDs i.e. those denominated in US dollars

but issued by a foreign bank with a branch in the US. 4) Thrift CDs, i.e. issued by savings banks and savings/loan associations.

Yields on CDs

These are based on three factors. These are:

(i) The credit rating of the issuer
(ii) The term to maturity
(iii) Market conditions.

Since banks issue CDs as a strategy to manage the liability side of their Balance sheets, the supply of CDs will depend on the demand for bank loans. It is also important to note that the different types of CDs mentioned above have different yields, for example Euro CDs offer a higher yield than Domestic CDs and this can be attributed to three reasons: -

1) Reserve requirements – Issues of domestic CDs are subject to local central bank regulations on reserves while those on Euro CDs are not. This tends to raise the cost of funds for the issuers of domestic CDs as they cannot invest all the proceeds received from issuing a CD i.e. the portion kept as a reserve does not give a return although it has a cost. As a result of the fact that it will earn less on funds raised by selling domestic CDs, the domestic issuing bank will pay less on its domestic CDs than a Euro CD.

2) Insurance – Issuers of domestic CDs (usually) have to pay insurance (deposit insurance schemes to safeguard the interests of depositors) which also raises the cost of funds and lowers the return.

3) Sovereign risk – Euro CDs are obligations of an entity operating under the jurisdiction of a foreign country. This exposes the holders of such CDs to sovereign risk – the risk that the holders" claim may not be enforced by the foreign jurisdiction. Thus there is a need for the issuers of Euro CDs to compensate the holders for this risk and this is done by paying a sovereign risk premium, leading to the higher yield.

The Attraction of NCDs -available across the full short term maturity and quality spectrum -tenure can be tailor made to the needs of investors -offer the same security as a term deposit with the issuing bank -fully negotiable before maturity

The Secondary Market for NCDs -this is created by institutions that are ready to quote firm buying and selling rates for immediate settlement and in reasonable volume. Such institutions should maintain an adequate portfolio of NCDs for the purpose of trading. Participants in this market include banks, discount houses, mining houses and building societies

Mathematic of Dealing in NCDs that have interest payable at maturity are traded (or negotiated) on a yield Basis. To determine the investment of the purchaser, or the proceeds to the seller the following formula is used Class exercise/example

5. Repurchase Agreements

Repurchase agreements (also commonly referred to as repo agreements) are short-term secured loans frequently obtained by dealers (borrowers) to fund their securities portfolios, and by institutional investors (lenders) such as money market funds and securities lending firms, as sources of collateralised investment.

A repurchase agreement (repo) is a form of short-term borrowing for dealers in government securities. In the case of a repo, a dealer sells government securities to investors, usually on an overnight basis, and buys them back the following day at a slightly higher price

6. Money Market Derivatives

Participants in the money markets use a variety of derivative instruments for the purposes of trading and hedging. These are primarily interest-rate derivatives. The market in short-term interest-rate derivatives is large and liquid, and the instruments involved are used by both financial institutions and corporates. In this chapter we review the two main contracts used in money markets trading, the short-term interest rate future and the forward rate agreement. Money market derivatives are priced on the basis of the forward rate, and are flexible instruments for hedging against or speculating on forward interest rates. The FRA and the exchange-traded interest-rate future both date from around the same time, and although initially developed to hedge forward interest-rate exposure, they now have a variety of uses. In this chapter the instruments are introduced and analysed, and there is a review of their main uses. We also consider a more recent addition to the money markets, the overnight-interest rate swap, known as the overnight-index swap or OIS swap. This is sometimes called a basis swap, but this term should be used really for swaps whose legs have different bases such as different currencies to them.

7. OTC-FRA's

This is an over-the-counter (OTC) derivative instrument that trades as part of the money markets.

8. JSE Short Term Interest Futures

IBAR Futures (STIR) are Short-Term Interest Rate Futures Contracts. The underlying instrument is the three-month Johannesburg Interbank Agreed Rate (JIBAR) rate. The JIBAR is used as the barometer of Short-Term interest rate movements in South African financial markets.

9. The Bankers' Acceptance (BA)

It is a bill of exchange drawn on and accepted by a bank as a potential or contingent liability. By accepting, the bank accepts the ultimate responsibility to (re)pay (a loan to) its holder. It can be viewed as a vehicle created to facilitate commercial trade transactions. It was created primarily to evade technical or practical problems that arose due to the physical distance between buyers and sellers. Other reasons were as a result of the need to add value to the quality of bills of exchange and also provide alternative short-term credit for industry, trade and commerce.

The problem of distance was solved in the sense that instead of sellers drawing bills on buyers (usually located in distant places); both sellers and buyers in need of short term credit would simply draw bills of exchange on their local bank branches who would undertake to pay at maturity. This also served to reduce4 the credit risk associated with selling goods on credit terms.

The major issuers of BAs are usually merchant banks although commercial and other banks can create these instruments. The normal practice is for created BAs to be discounted with discount houses and dealing banks that will then create a market by quoting two-way market rates continuously at any given time.

10. Trade bills

A trade bill is a negotiable instrument issued by a trader for payment on a future date and becomes accepted when signed by acceptor or debtor. A bill of exchange drawn on and accepted (trade acceptance) by a trader in payment for goods.

3.2 Risks involved in short-term deposits

- **Credit risks**

  Credit risk is the possibility of a loss resulting from a borrower's failure to repay a loan or meet contractual obligations. Traditionally, it refers to the risk that a lender may not receive the owed principal and interest, which results in an interruption of cash flows and increased costs for collection. Therefore, in the case the depositor who is the lender to the bank may fail to receive the principal amount deposited plus the interest amount earned over the period. Hence, Credit risk is the risk of loss that may occur from the failure of any party to abide by the terms and conditions of any financial contract, principally, the failure to hour request by the depositor to withdrawal the amount as previously agreed.

  Default risk is the risk that a financial loss will be incurred if a counterparty to a (derivatives) transaction does not fulfil its financial obligations in a timely manner. It is

therefore a function of the following: the value of the position exposed to default (the credit or credit risk exposure); the proportion of this value that would be recovered in the event of a default; and the probability of default. Credit risk is also used loosely to mean the probability of default, regardless of the value that stands to be lost.

- **Concentration risk**

  Concentration risk is a banking term describing the level of risk in a bank's portfolio arising from concentration to a single counterparty, sector or country. The risk arises from the observation that more concentrated portfolios are less diverse and therefore the returns on the underlying assets are more correlated.

- **Liquidity risks**

  Liquidity risk is the risk that a company or bank may be unable to meet short-term financial demands. This usually occurs due to the inability to convert a security or hard asset to cash without a loss of capital and/or income in the process.

  Liquidity is the ability of a company or an individual to pay its debts by selling off its assets or securities without suffering tremendous losses. Basically, it describes how quickly an asset can be converted into cash. Liquidity risk refers to how a bank's inability to meet its obligations (whether real or perceived) threatens its financial position or existence. If the bank fails to pay depositor, they will be loos of confident and suddenly every depositor demands their money. The bank will then fail.

- **Inflation risk**

  Inflationary risk is the risk that inflation will undermine an investment's returns through a decline in purchasing power. Bond payments are most at inflationary risk because their pay-outs are generally based on fixed interest rates and an increase in inflation diminishes their purchasing power. Inflation risk, also referred to as purchasing power risk, is the risk that inflation will undermine the real value of cash flows made from an investment.

- **Tax risk**

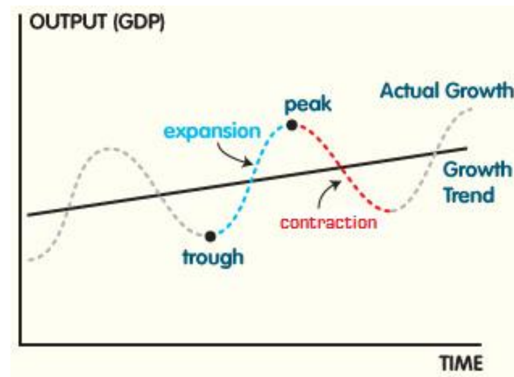
  These are all sources of risks that create an unexpected outcome from a tax position. Therefore, in line with short-term deposits the interest income may be taxable depending on the client s age. From a company perspective tax risk is the risk that companies may be paying or accounting for an incorrect amount of tax (including both income and indirect taxes), or that the tax positions a company adopts are out of step with the tax risk appetite that the directors have authorised or believe is prudent

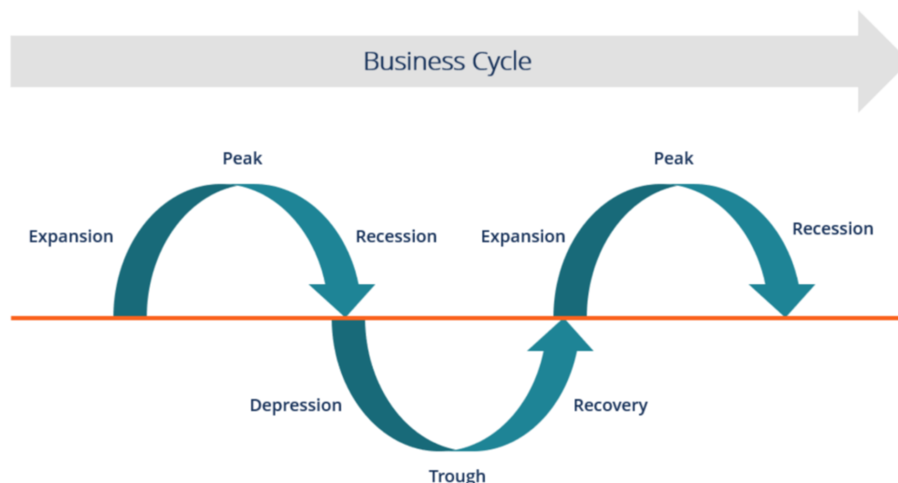
- **Default risk**

Default risk is the risk that a lender takes on in the chance that a borrower will be unable to make the required payments on their debt obligation. Lenders and investors are exposed to default risk in virtually all forms of credit extensions. In this case the depositor being the lender, they are taking risk that the borrower (the bank) might fail to honour its obligations and withdrawals.

3.3 Impact of business cycles and economic factors on deposits

The term "business cycle" (or economic cycle or boom-bust cycle) refers to economy-wide fluctuations in production, trade, and general economic activity. From a conceptual perspective, the business cycle is the upward and downward movements of levels of GDP (gross domestic product) and refers to the period of expansions and contractions in the level of economic activities (business fluctuations) around a long-term growth trend.





Business Cycle Phases

Business cycles are identified as having four distinct phases: expansion, peak, contraction, and trough.

An **expansion** is characterized by increasing employment, economic growth, and upward pressure on prices. A **peak** is the highest point of the business cycle, when the economy is producing at maximum allowable output, employment is at or above full employment, and inflationary pressures on prices are evident. During this period short-term and long-term deposits are likely to grow as business expands and the same time business while be growing through borrowing for expansion. Following a peak, the economy typically enters into a correction which is characterized by a **contraction** where growth slows, employment declines (unemployment increases), and pricing pressures subside. During contraction deposits are likely to be dampens as investors utilities funds. This implies that money growth rate is likely to be dampened as businesses are not growing. There is high unemployment. The slowing ceases at the **trough** and at this point the economy has hit a bottom from which the next phase of expansion and contraction will emerge.

1 Expansion

The first stage in the business cycle is expansion. In this stage, there is an increase in positive economic indicators such as employment, income, output, wages, profits, demand, and supply of goods and services. Debtors are generally paying their debts on time, the velocity of the money supply is high, and investment is high. This process continues as long as economic conditions are favourable for expansion.

2 Peak

The economy then reaches a saturation point, or peak, which is the second stage of the business cycle. The maximum limit of growth is attained. The economic indicators do not grow further and are at their highest. Prices are at their peak. This stage marks the reversal point in the trend of economic growth. Consumers tend to restructure their budgets at this point.

3 Recession

The recession is the stage that follows the peak phase. The demand for goods and services starts declining rapidly and steadily in this phase. Producers do not notice the decrease in demand instantly and go on producing, which creates a situation of excess supply in the market. Prices tend to fall. All positive economic indicators such as income, output, wages, etc., consequently start to fall.

4 Depression

There is a commensurate rise in unemployment. The growth in the economy continues to decline, and as this falls below the steady growth line, the stage is called depression.

5 Trough

In the depression stage, the economy's growth rate becomes negative. There is further decline until the prices of factors, as well as the demand and supply of goods and services, reach their lowest point. The economy eventually reaches the trough. It is the negative saturation point for an economy. There is extensive depletion of national income and expenditure.

6 Recovery

After this stage, the economy comes to the stage of recovery. In this phase, there is a turnaround from the trough and the economy starts recovering from the negative growth rate. Demand starts to pick up due to the lowest prices and, consequently, supply starts reacting, too. The economy develops a positive attitude towards investment and employment and production starts increasing.

Employment begins to rise and, due to accumulated cash balances with the bankers, lending also shows positive signals. In this phase, depreciated capital is replaced by producers, leading to new investments in the production process.

Recovery continues until the economy returns to steady growth levels. It completes one full business cycle of boom and contraction. The extreme points are the peak and the trough.

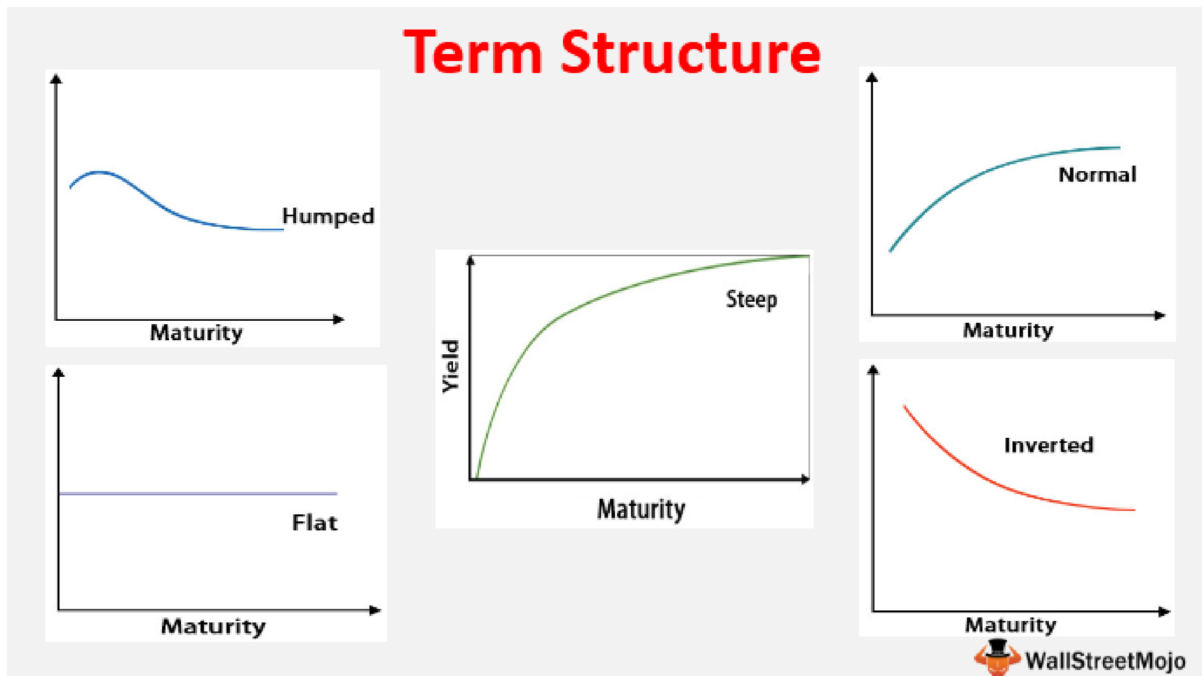
The relationship between short-term deposits and long-term deposits

If the rates are higher on the short-term, it is likely that investor will investor in the short-term and not on the long-term. The opposite is true if interest rates are higher on the long-term, investor will not invest in the short-term.

In the majority of cases, longer-term deposits have higher interest rates than shorter ones. This is because banks want to hold deposits for an extended period of time, so they are more likely to offer a more lucrative interest rate to attract business. Plus, term deposit interest rates are expressed on a *per annum basis,* meaning a six-month term deposit interest rate is actually half that.

The relation between short-term and long deposits can be best explained by the term structure of interest rates. The relationship between short-term rates (or its dynamics) and long-term rates is also an important aspect of the monetary transmission mechanism. The classic expectations hypothesis about the term structure of interest rates remains an important and commonly used result in macro-economic and monetary policy. (Guidolin and Thornton (2008), Fedderke and Pillay (2010).) Generally, put, it states that long-term rates are a weighted average of expected (or forecast of) short-term rates, under a zero or constant risk premium. The expectations hypothesis is intuitively appealing, and easy to implement. The

diagram below shows the term structure of interest rates.



Term structure of interest rates is the relationship between interest rates or bond yields and different terms or maturities. When graphed, the term structure of interest rates is known as a yield curve, and it plays a crucial role in identifying the current state of an economy. Expectations theory attempts to predict what short-term interest rates will be in the future based on current long-term interest rates. The theory suggests that an investor earns the same amount of interest by investing in two consecutive one-year bond investments versus investing in one two-year bond today.

Factors to consider when investing in short-term deposits

- Liquidity of the investment
- Safety of the investment
- Credit rating of the bank
- Interest rates
- Amount of money available for invest
- When the money will be required to be used in the future
- Tenure
- Investment instruments available
- Liquidity of the money market
- The interbank rate
- Tax rates.

Chapter 4: Pricing, Commissions and Fees

Learning outcomes

By the end of this chapter, you should be able to:

- Explain bank deposits found in retail banking and discuss their typical fee structures.
- Explain the pricing, fees and commission of various deposit related products.
- Identify types of pricing used by financial institution for various accounts.
- Explain various types of fees charged by the financial services providers.

4.0 Introduction

This chapter seek explain different type of bank deposits found in the retail banking which are mostly short- term deposits. Long-term deposits are most issued by treasury department but of late some retail commercial banks have been offering saving bond hence these shall be discussed at the end of the chapters. It further explains what types of fees, charges and commissions levied by the banks. Bank deposits consist of money placed into banking institutions for safekeeping. These deposits are made to deposit accounts such as savings accounts, checking accounts and money market accounts. The account holder has the right to withdraw deposited funds, as set forth in the terms and conditions governing the account agreement.

When a client enters into an agreement with the bank in respect of products and services, the client must be informed of what charges and fees will be levied on the various transactions that are usually performed on that account. There are also additional fees that could be levied on the account depending on the type of product that the client has chosen.

4.1 Pricing

Pricing can be defined as the valuation of something in terms of its price. The price is the value (perceived or actual) of a product, expressed as an amount of money and charged for a specific product or service.

a) Price

The price would be the whole amount that one pays for a product. The price charged for a product could be defined as the fees and charges levied for each transaction utilised over a specified period (usually a month). The total of all fees and charges calculated for a particular month are then levied automatically by debiting the client's account. These debits are

processed at the same time every month and certain products allow clients to choose the date on which the total fee will be levied.

b) Retail banks and pricing

Retail banks use a form of **value-based pricing**, which means that the price of the product or service is based on the value it creates for the client. In other words, the higher the demand for the product, the higher the price of the product. Retail banks take a number of factors into account when working out the price of the product – the value-based approach only forms part of the costing structure. The other factors that are considered are client behaviour (what products are clients using currently), the economic climate, market research, especially regarding how much people are prepared to pay for a particular product (what they consider to be a fair price) and competitor pricing. Each bank generally ensures that their pricing is in line with their competitors. There is a trend in South Africa that when banking product prices increase, they tend to increase across banks and vice versa.

Products and services have to be appropriately priced to attract clients. An organisation such as a bank can position themselves for a specific target market if they price their products and services appropriately.

c) Pricing and market segments

The market segments are ascertained through research and the transactional behaviour pattern of various income groups are studied in order to be able to capture the correct target audience. This is done by providing them with products and services that can match their specific needs at a price that the target market would deem appropriate.

Pricing is used either to attract a specific market segment or to encourage the use of a specific product. On the other hand, pricing can be used to discourage a market segment or product use. For example, if a retail bank decides to focus on a specific target market such as a high-income niche group to gain market share in this segment, the range and price will be geared at matching the needs of this specific group. However, the bank runs the risk of losing market share if they do not have appropriately priced products for other segments such as the mass market.

If the bank wants to attract the middle and mass market in order to ensure sustainable profit and grow their market share from this specific market segment, they would need to ensure that the pricing is appropriate for these segments.

When a bank wants to discourage the use of a specific product the price of this product could also be increased, for example, banks would prefer to minimise the number of clients that perform over-the-counter transactions, in order to be able to focus banking on a service-

oriented business, opposed to a purely transactional-based operation. An example of this would be the higher pricing of book-based savings accounts. This is a labour-intensive form of dealing with clients and is not a very profitable product. This type of pricing is intended to discourage all those clients who are able to make use of the more modern card-based savings accounts and minimise the number of clients that require over-the-counter banking facilities. This pricing strategy could have a negative impact on certain low-income earners, especially the illiterate client who is unable to operate electronic mechanisms.

d) Pricing options

Banks offer various pricing options such as standard options that relate to a specific product, or flexible options that can be tailored to suit the needs of their client base. Banks have a variety of products in each product category, so even though the pricing may be standard for a specific product, there are a wide range of products available with unique pricing options that could suit the client's needs

Example:

A cheque account could have some of the following options:

- Fixed service fee for a set number of transactions
- Pay fees per transaction utilised (each transaction will have its own price attached depending on the type of transaction)
- Minimum balance option – maintain a minimum credit balance at all times and qualify for free banking.

4.2 Fees and charges

In the banking industry pricing generally relates to the structure of prices relating to the various products, i.e. the various fees charged for transactions and utilisation of an account product or service. A fee can be defined as a monetary payment charged for services, for example, a management fee for overdraft facilities. It is, therefore, the price one pays as remuneration for services. Fees can also be defined as charges or payments for services relating to account transactions in the financial industry.

Banks price their transactions by applying various pricing formulas. Depending on the bank and their specific procedures, transactions can be charged/levied on the following basis:

a) Flat (fixed) fee

This is a fixed amount charged per transaction. This means that the fee charged stays the same regardless of the amount of the transaction. Some banks charge a flat fee for a package or bundle of transactions, e.g. R70.00 is a once-off fee paid for 35 transactions, regardless of

the value or type of transactions. Other banks use a tiered flat fee structure, e.g. the first eight transactions are charged at a flat fee and thereafter a higher flat fee is levied for the next set (bundle) of transactions.

b) Ad valorem fee

An ad valorem fee can be defined as a fee that increases as the value of the transaction increases.

The formula for the ad valorem fee structure generally consists of three parts:

- A minimum fee
- A value-related fee (represents the fee calculated on the value in units of R100 or part thereof)
- A maximum amount that can be levied.

c) Banded fee

This fee structure is not used by all banks. A banded fee is similar to a tiered rate option; the higher the value of the transaction the higher the fee. The banded fee works in a similar way to the ad valorem fee but is simpler to calculate.

4.3 Commissions

Commission is a fee charged by an agent or broker, i.e. an intermediary, for facilitating a transaction. The term financial intermediary includes banks, investment companies, insurance companies, etc. Intermediaries assist in the transfer of savings from individuals with excess money to those that need capital for investments. In practice, an intermediary service can be defined as the facilitation of a financial transaction, where the service is not regarded as providing recommendation or giving advice regarding financial products, for example, the processing of claims or collecting of premiums.

Commission is compensation received by a broker or insurance agent paid by the insurance company and is a percentage of the insurance premium, or a percentage of a portion of the insurance premium

4.4 Product categories

The categories of deposit accounts discussed below are discussed broadly. Banks offer various product types within these categories, such as a standard cheque account aimed at entry level cheque account users opposed to a more exclusive cheque account aimed at attracting high net worth clients.

Various pricing options are available and the pricing of a product will depend on the option that the client has chosen.

a) Cheque and transmission or transactional accounts

Transactional accounts have various pricing options that a client can choose. These accounts do not attract credit interest. A cheque account, also called a demand deposit account, is a basic current account. Consumers deposit money and the deposited money can be withdrawn as the account holder desires on demand. These accounts often allow the account holder to withdraw funds using bank cards, checks or over-the-counter withdrawal slips. In some cases, banks charge monthly fees for current accounts, but they may waive the fee if the account holder meets other requirements such as setting up direct deposit or making a certain number of monthly transfers to a savings account. The pricing option are available for cheque or transactional accounts.

1. Pay-as-you use option

This option means that the client only pays for the transactions made on the account. The transaction fees applicable to the account type will be levied from the account on a monthly basis. In some instances, depending on the product, the fees are levied immediately which means the account is debited as soon as the transaction has been processed.

2. Fixed monthly fee option:

A monthly fee is levied for a specific number of transactions (not all transaction fees are included in the monthly fee option, for example, once-off or specialised fees such as special clearance or overdrawn account fees). If the limit of the number of transactions chosen by the client is exceeded, the client is charged per transaction.

3. Monthly balance maintained:

If a client maintains a specified balance in the account, for example, R10 000.00 for a full calendar month, certain service fees will not apply.

b) Money market deposit or transactional accounts

The general price of these accounts relates to the transactional fees that could be considerably higher than a basic cheque account, given that the account attracts interest on credit balances, as well as providing the same transactional ability as a cheque account. The transactions are usually charged on an ad valorem basis which means that some transactions are charged a base fee plus a percentage of the transaction value up to a maximum amount, while others are charged a base fee only. Depending on the bank some transactions will be “free” or included as part of the product package.

c) Savings account

Savings accounts offer account holders interest on their deposits. However, in some cases, account holders may incur a monthly fee if they do not maintain a set balance or a certain number of deposits. Although savings accounts are not linked to paper checks or cards like current accounts, their funds are relatively easy for account holders to access.

In contrast, a money market account offers slightly higher interest rates than a savings account, but account holders face more limitations on the number of checks or transfers they can make from money market accounts.

There are various savings account options available to choose from, ranging from a standard savings plan to a contractual savings plan. The pricing depends on the type of savings account selected. Transactional fees applicable to this type of account are cash withdrawal and cash deposit fees as well as ATM withdrawal and deposit fees. Some banks charge a monthly fee for this type of account. There are also savings accounts that have a transactional functionality, i.e. they are similar to transmission accounts but attract interest on credit balances. Transaction fees on this type of account will be charged on an ad valorem basis.

d) Call accounts

Financial institutions refer to these accounts as interest-bearing checking accounts, Checking Plus or Advantage Accounts. These accounts combine the features of checking and savings accounts, allowing consumers to easily access their money but also earn interest on their deposits.

Call accounts do not attract specific pricing options. In some cases, an ad valorem fee might be charged on deposits, withdrawals, transfers and statements. Fees for special clearances could also be levied on this account as well as any additional requests for backdated statements. There are no penalty fees on a basic call account because the funds can be accessed immediately. Most banks do not charge for the basic transactions on these types of accounts. The interest earned on this type of account will be lower than that of a notice deposit or fixed deposit. The pricing structure of an account includes the interest rate paid on the account and the bank can price interest rates in such a manner that it includes basic transactional costs.

e) Notice deposit accounts

These accounts do not attract a specific pricing option and there is no monthly fee payable. Special fees such as a request for special clearance or backdated statements could attract a fee. Cash deposits could also attract an applicable cash deposit fee. Penalty fees are payable

on these types of accounts and the pricing differs from a flat fee to a percentage of the withdrawal amount.

f) Fixed deposit accounts

These accounts do not attract a specific pricing option and there is no monthly fee payable. Penalty fees are payable on these types of accounts and the pricing differs from a flat fee to a percentage of the withdrawal amount.

The Code of Banking Practice states that it is the duty of banks to provide details on the following:

- Charges for basic banking services
- Charges for all products and services as requested by the client
- Charges and fees that are negotiable
- Charges and fees that are in addition to the basic charges and fees advertise
- Interest rates and calculations.

Clients are informed of the fees and charges that will be levied for various transactions that are usually carried out on the specific product that they have chosen. Fees and charges can be levied at regular intervals, e.g. each month. Fees and charges could also be levied at the time a transaction takes place.

Transactional accounts such as transmission, cheque accounts and money market accounts attract regular fees such as ATM transaction fees or monthly administration fees. These accounts can also attract ad hoc fees, i.e. fees that are not a regular feature of the account, for example, unpaid debit order fees where there were insufficient funds in the account or special clearance fees where a special clearance was requested on a cheque deposit.

Call, notice and fixed deposits generally do not attract regular fees. A penalty fee would be applicable to a notice or fixed deposit account, should the client wish to withdraw part or all of the funds prior to the expiry of the notice period or maturity of the fixed deposit. These fees vary from bank to bank.

4.5 Types of fees and charges

There are numerous types of transactions that can take place on bank accounts. Banks charge a fee for most transactions and services. These fees include VAT.

There are many types of fees that banks charge for the various product types, including the following:

a) Over-the-counter fees

These are charges for transactions made in the branch such as when the client deposits cash or makes a withdrawal at the teller's counter. It is cheaper to avail of electronic type banking and banks encourage clients to use this mechanism. The more labour intensive a service, the higher the cost, i.e. the more clients that come into a bank to perform basic transactions, the more staff members have to be employed and the higher the cost of the overall business operations. Certain over-the-counter enquiries such as balance requests could also attract a fee.

b) Administration fees

These fees are also known as monthly service fees and the pricing for each product will differ. This charge is a fee levied over and above any transactional fees on the account and is a once-off monthly payment. A service fee is usually charged based on the nature of the product and the corresponding service provided.   Debit order fees

This is a charge to the client for the processing of a debit order to the client's account and the pricing of these fees vary from bank to bank.

c) ATM transaction fees

Fees are charged for withdrawals, deposits, balance enquiries and mini statements as well as account payments and transfers. The price and fees for transactions always relate to the type of pricing option chosen and the account product. ATM fees are charged at a higher rate when using another bank's ATM.

d) Card fees

Clients can be charged an annual card fee depending on the product as well as replacement card fee when the card has been lost or stolen. (These fees can be negotiated and in some cases the charge can be waived.)

e) Statement fees

Many banks charge clients for mailing regular statements to them on a monthly basis, depending on the product type. If the client makes use of electronic receipt of statements, for example, via email, then there is no charge. Fees are also charged for the request of additional statements. (Note: when a customer has a complaint and a statement has to be drawn to resolve the complaint there is no charge.)

f) Stop payment fees

If the customer requests to stop a debit order or a cheque, a fee is charged for the cost of processing the request.

g) Special clearance

A special clearance is often requested by a client when a cheque deposit is made into his account that he requires express clearance on. Cheques generally have a clearance period of seven days depending on bank policy and process. The charge is the cost involved for performing a process that will speed up the clearance time on this specific cheque. The time that a special clearance takes depends on which bank the cheque originates from and the process involved clearing the cheque.

h) Unpaid fees

A fee is charged for a cheque or debit order that has to be returned because the client has insufficient funds in the account to cover the amount.

4.5.1 Retail Savings Bond

The Fixed Rate Retail Savings Bond series consists of bonds with 2-year, 3-year, and 5-year terms. Fixed Rate Retail Savings Bonds earn a market-related fixed interest rate, which is priced off the current government bond yield curve and is payable on the interest payment dates until maturity. Different interest rates apply to each of the maturities in the series. Investors in these bonds may choose not to receive their interest payments on the payment dates, but rather to reinvest the payments. Such reinvested payments then form part of the capital balance and attract interest at the same rate as the capital amount. Investors must indicate the relevant option on their application form. Note: This option may only be exercised on the date of application, or prior to the first interest payment date, and may not be exercised or changed after such date again.

Investors in Fixed Rate Retail Savings Bonds who are 60 years and older can elect, on application, to receive their interest payments on a monthly basis. Please note that the monthly interest will only start to pay on the last day of the month following the investment date. Accrued interest will be included in the first interest payment. However, under this option, interest payments may only be paid into the designated bank account and may not be reinvested. This option is known as the Pensioners Bond.

Interest due on each of the Fixed Rate Retail Savings Bonds is paid into the designated bank account semi-annually on the interest payment dates, being the 31st of March and the 30th of September each year.

Investors in Fixed Rate Retail Savings Bonds may elect not to receive their interest payments on the interest payment dates, but rather to reinvest the interest payments. Such reinvested interest payments then form part of the capital balance and attract interest at the same interest rate as the capital amount. An investor is required to indicate the relevant option on the

application form. Please note that this option may only be exercised on the date of application, or on any date prior to the first interest payment date and may not be changed thereafter.

In addition, investors in Fixed Rate Retail Savings Bonds who are 60 years and older are entitled, on application, to elect to receive their interest payments on a monthly basis. Please note that the monthly interest will only start to pay on the last day of the month following the investments date. Accrued interest will be included. However, under this option, interest payments may only be paid into the designated bank account and may not be reinvested. This option is known as the Pensioners Bond.

a) Restart option

The restart investment option enables a Fixed Rate RSA Retail Savings Bond investor to earn the best interest rate over the life of their investments. An investor will be allowed to restart their Fixed Rate RSA Retail Savings Bond at a new prevailing interest rate, after twelve months. The restart option also allows an investor to change their investment period. For example, an investor in a 5-year Fixed Rate RSA Retail Savings Bond can choose twelve months after they have invested, to restart their 5-year bond at the prevailing interest rate in the month they restart. Or the investor can choose to restart their investment as a 2 year or 3-year bond, at the prevailing rate of the month they restart in.

The option can only be exercised once the investment has been active for twelve months. The restart terms and conditions:

- The investment must be a Fixed Rate RSA Retail Savings Bond and be active for a period of twelve months or longer.
- The restart option is only valid for the Fixed Rate RSA Retail Savings Bond and not the Inflation Linked RSA Retail Savings Bond.
- The investor agrees that this is not a withdrawal of their investment(s) from the RSA Retail Savings Bonds. The prevailing Terms and Conditions of Issue and the Terms and Conditions of Purchase of the RSA Retail Savings Bonds shall apply.
- No merging of investments shall be permitted, i.e., if an investor has three active investments, they cannot opt to have all three restarted into a single RSA Retail Savings Bond investment.
- No penalty or charges shall be incurred by the investor for applying for the restart option. This initiative is intended to encourage investors to invest for longer and enjoy the peace of mind of earning the best returns at all times.

b) Withdraw from Savings Bonds

An investor may make a withdrawal of his/her capital balance after 12 months from the settlement date, by submitting an application to the National Treasury on the prescribed application form. Copies of the prescribed application form can be obtained from the National Treasury or can be downloaded from the RSA Retail Savings Bonds website at www.rsaretailbonds.gov.za. Should one wish to withdraw a portion of the capital amount invested, the capital balance must not be less than R1 000.00 (one thousand Rand) after the withdrawal. Investors will have to decide whether to withdraw the entire capital balance or not to effect the early withdrawal.

Interest on the withdrawal amount since the previous interest payment date will be calculated and paid on the withdrawal date. However, a penalty is imposed on the withdrawal amount. The penalty is equal to approximately one interest payment on the early withdrawal amount and will be deducted from the withdrawal amount before being repaid to an investor. Where an investor has elected to reinvest their interest, the penalty on partial withdrawals will be deducted from the capitalised interest.

Payment of the withdrawal amount, less the penalty, shall be made into the designated bank account within 20 business days of the date of receipt of the application. No cheques will be issued by the National Treasury for any reason whatsoever, and investors may not instruct the National Treasury to credit any third-party account.

Investors may be allowed to withdraw a portion of (provided that the capital balance does not fall below R1 000.00), or the entire investment, within the first 12 months of the settlement date, only on the grounds of extraordinary changes in personal circumstances. In such an event, investors must submit a formal application to the National Treasury, setting out the particulars of such extraordinary changes in circumstances that compel the investor to effect such withdrawal. The National Treasury reserves the right, within its sole and absolute discretion, to grant or refuse the request. Should the request be granted, the penalty for withdrawal prior to the expiry of 12 months from the settlement date shall be a total forfeiture of all interest received on such withdrawal, which amount shall be set-off against that portion of the amount being withdrawal.

c) Taxation of Interest Earned on Savings Bonds

The provisions of the Income Tax Act, 1962 (Act 58 of 1962) regarding interest apply to all interest earned on RSA Retail Savings Bonds. As a general rule, investors treat interest received as ordinary revenue for purposes of income tax. Depending on the personal circumstances and age group of an investor, investors may be entitled to the tax exemption of a portion of or all of the interest.

D) Charges on Savings Bonds

Usually, they are no fees and charges levies except penalties levied in the event of early withdrawal or termination.

4.6 Suitability of the type of deposit related product (Whether short, long-term and structured deposits)

The suitability of the type of deposit related product depends on several factors. The financial representative may need to consider the following factors when assisting the client:

- Age of the investor/ depositor
- Income (Level of income, consistency, reliability and source)
- Risks of associated with the deposit related product
- Investment or savings objectives
- Liquidity of the deposit
- Early withdrawal penalties
- Inflation
- Tenure of investment or Period of the deposit
- Interest rates
- Nature of the financial institution and credit profile
- Charges, fees, commission and penalties involved.
- The type of the investor (Depositor) – Conservative, Aggressive and Medium risk appetite.
- Taxation
- Nature of the economy (Fiscal and money policies in place).

Chapter 5: Structured Deposits

Learning outcomes

By the end of this chapter, you should be able to:

- Describe and explain what structured deposits are
- Identify types of pricing used by financial institution for various accounts
- Explain various types of fees charged by the financial services providers for structured deposits.

5.0 Introduction

This chapter explains what structured deposits are and differentiates them from fixed deposits. It details the types of fees, charges and levies on structured deposits and how different pricing option are utilised by financial institutions. Risks involved with utilizing structured deposits are also discussed. The chapter also looks at the factors to consider when deciding whether structured deposits are suitable for the client. These are very important factors that financial service representatives must consider before they recommend them to the client.

5.1 Structured deposits

A structured deposit combines a deposit with an investment product. The return on a structured deposit depends on the performance of an underlying financial asset, product or benchmark. These may include market indices, shares, interest rates, bonds or other fixed-income securities, foreign exchange rates, or a combination of these. Structured deposits may be suitable for investors who want exposure to assets or markets that are not easily accessible to retail investors.

Typical returns:

The return is calculated according to a formula set out in the structured deposit's terms and conditions. It also depends in the underlying asset or investment.

5.2 Structured deposits versus fixed deposits

A structured deposit is different from a fixed deposit. Structured deposits may provide the potential for higher returns compared to fixed deposits, but they come with more risks, including the possibility that the returns received are lower than expected.

At maturity, the client will receive the principal amount of the structured deposit. But just like traditional deposits, the return of the principal and any returns is subject to the credit risk of

the bank holding the deposit. If the deposit is withdrawn early, the client may not get back 100% of the money invested.

In the case of fixed deposits, the returns and maturity periods are fixed. Structured deposits, on the other hand, have variable returns, and in some cases, variable maturities as well.

	Structured deposits	**Fixed deposits**
Minimum deposit	A higher minimum investment amount may be required (usually R50,000).	Minimum amount for a fixed deposit can be less at R10,000.
Maturity period	Varies from 2 weeks to 10 years.	Varies from 1 month to 3 years.
Principal	Principal (or capital) will be repaid in full at maturity or if bank redeems (or "calls") deposit before maturity.	Principal (or capital) will be repaid in full at maturity.
Returns	• Potentially higher returns compared with fixed deposits. There is exposure to more risks. Returns depend on performance of underlying asset or index. • Returns received may further depend on: i) "cap" rate on underlying asset or index; and/or ii) participation rate.	• Returns are usually lower. • Funds are normally placed in money markets for a short period of time (for example, overnight).
Early redemption / callable by issuer (variable maturity)	Structured deposit may allow the bank to redeem (or "call") the deposit early. This	No early redemption by bank.

	means the maximum returns are capped.	
Covered by the Deposit Insurance Scheme?	No	Yes
Guaranteed payments	• Some structured deposits provide higher guaranteed early payments compared to traditional fixed deposits. Such payments are usually only for the first few months or years; payments in later years may be variable. • Ask about the effective rate of return for the structured deposit being considered.	• Interest is guaranteed and fixed throughout term of fixed deposit (provided there is no early withdrawal).
Guaranteed payments	• Some structured deposits provide higher guaranteed early payments compared to traditional fixed deposits. Such payments are usually only for the first few months or years; payments in later years may be variable.	• Interest is guaranteed and fixed throughout term of fixed deposit (provided there is no early withdrawal).

	• Ask about the effective rate of return for the structured deposit being considered.	

5.3 Maximum probable loss under Structured Deposits

The client may lose some or all of their return depending on how the return is structured and whether the underlying financial asset, product or benchmark underperforms.

The principal amount that the client invests is also subject to the credit risk of the bank the structured deposit is held with. Further, if the client withdraws the deposit early, they may not receive 100% of the principal invested.

5.4 Factors to determine whether structured deposits are good for the client

Not everyone should invest in structured deposits. Before the client invest, check whether they:

- Want potentially higher returns but are also prepared for variable returns
- Understand how returns are calculated and are clear about the factors and scenarios that can affect returns
- Understand the risks associated with the structured deposit. Structured deposits use derivatives to hedge risks and to improve performance. Investors should be aware of the risks associated with the use of derivatives, including the risk that the provider or counterparty of the derivative defaults.
- Are prepared to leave their money tied up for the periods required. If they need to convert their investments to cash in the short-term to meet specific needs every now and then, a structured deposit may not be suitable for them.

Types of Structure Deposits

Equity-linked	May be linked to return of a single share, basket of shares, equity index (e.g., the S&P 500) or a basket of indices.
Bond-linked	May be linked to return of a single bond (e.g., Singapore Government Securities), basket of bonds, bond index, or a basket of bond indices.

Interest rate-linked	May be linked to a specified floating interest rate (e.g., the Singapore Interbank Offer Rate or The Prime rate in South Africa or Johannesburg Interbank Offer Rate etc.). Returns may be directly linked to the specified interest rate, i.e. if the specified interest rate rises, the returns will rise and if the interest rate falls, the returns fall. But some returns are inversely related, i.e. when the specified interest rate falls, better returns are obtained and if the interest rate rises, the return falls. Such products are usually called "inverse floaters" or "reverse floaters". Payments may also rise or "step up" on fixed dates if deposit is not redeemed by issuer.
Credit-linked	May be linked to credit quality of a specified entity or entities. If there is a "credit event" (e.g., if specified entity becomes insolvent or defaults on its loans), there may be no returns for investor.

5.5 Risks under structured deposits

Common risks associated with structured deposits include the following:

Withdrawal before maturity date	They may be substantial losses to client's principal if they choose to end the investment early. They should also bear in mind that structured deposits may be subject to periodic valuation, which may not be on a daily basis. This means that they may not be able to withdraw the deposit amount immediately. Client should check and understand the terms and conditions for early withdrawal of the deposit with their bank.
Credit risk	If the bank defaults, the client could lose all of their investment.
Reinvestment risk	If the structured deposit is callable, the client may risk having to reinvest the money at less attractive rates.

Reinvestment risk	If the structured deposit is callable, the client may risk having to reinvest the money at less attractive rates.
No deposit insurance	Structured deposits are not usually insured under the Deposit Insurance Scheme . In South Africa, the reserve bank is still in the process of formulating the deposit insurance scheme.

5.6 Fees and charges

The banks differ in the pricing, charges and fees. If the clients make an early withdrawal, the client may have to forgo some of their returns as there could be transaction or unwinding costs. The financial advisory representative must be authorised to give advice. The representative must disclose all the product features, risks, fees and charges including provisions of early termination.

When choosing whether to use structured deposits, the client should ensure that

- Investing in the structured deposit is in line with their own investment objectives
- They understand the factors that will impact their returns; are familiar with the underlying financial asset, product or benchmark and they are comfortable with the exposure and the market view they are taking
- They understand all the risks and are comfortable that they match their own risk profile
- They are comfortable with the credit risk of the bank they are placing their money with. Find out about alternative investment products and compare their risk-return profile and features with the structured product introduced.
- They ask whether the addition of this product to their investment portfolio will expose them to more risks than they are comfortable with.

Structured deposits are products, which combine features of a term deposit (100% protection of capital applies during to the entire duration of the product depending on the terms and conditions) and investments on financial markets (a chance to have gains higher than standard interest rate on deposits). They exploit the opportunities on many markets and they are an excellent tool for portfolio diversification: The interest rate depends on value of underlying instrument identified in Structured Deposit, terms and conditions in the contract with the bank depending on whether it’s currency, commodities, shares, market

indices Therefore, one size doesn't fit all with structured deposits, they should be tailored made to the client's needs.

Chapter 6: Long Term Deposits

Learning outcomes

By the end of this chapter, you should be able to:

- Recap on the differences between short-term and long-term deposits
- Outline the various products that fall under long-term deposits
- Demonstrated an understanding of unit trusts and mutual funds
- Discuss conventional annuities as well as retirement annuities.

6.0 Introduction

Unlike short-term deposits which allows an investor to invest their money for a short period of time to get a quick (but most likely smaller) return, longer-term deposits will lock funds away for a longer term from one year up to 10 years.

Long-term deposits are an appealing savings plan and a common rival to high-interest savings accounts. There is no hard or fast rule when deciding which way one should invest their money.

The benefits:

- Term deposits are fixed-term investments, so once the term is locked, one cannot withdraw any funds, which is a great savings tool
- Long-term deposits are usually less volatile than other types of investments
- As a general rule, the longer one invests money, the higher the interest rate
- Some high-interest savings accounts require the investor to deposit a minimum amount each month in order to earn interest. This is not the case for term-deposits so they can be easier to manage.

A recap from Chapter 2:

A **short-term deposit** generally means one that lasts anywhere from 1 to 12 months. Usually, the investment terms on offer go up by months at a time, meaning that the client might be able to choose 2 months, 3 months, 4 months and so on.

A **long-term deposit**, on the other hand, can last up to 10- 20 years. Long-term deposits tend to increase in yearly jumps, so the client   lock their money in for 2 years, 3 years, and 4 years and so on.

The key differences of short-term and long-term deposits are summarised in a table below:

Short-term deposit	**Long-term deposit**
Generally, offers lower interest rates	Tends to come with higher interest rates attached
Good for short-term goals, so if the client needs to do savings to buy a new car in three months, or for a holiday in 6, this may suit them.	Good for long-term savings plans. Maybe the client is saving up a deposit for own home in five years' time, o may they are just setting up a savings strategy that will carry them through to retirement. Either way, a long-term deposit could be just what they need.
Usually pays interest at maturity.	Payment frequencies are more varied. The client can choose to have their interest paid at maturity, annually, six-monthly or monthly.
Shorter terms offer a little more flexibility, in the sense that when they end, the client will have the opportunity to deposit extra funds, spend the money or choose a more competitive term deposit offer before investing for another term.	The funds are locked in for years, which can be a good way to ride out changes in the market and maintain a steady savings strategy - as long as the client snag a good term deposit deal initially!

6.1 Similarities between short-term and long-term deposits

Although there are key differences between long- and short-term deposits, there are also some features that are the same. These are things that are pretty universal to all term deposit include:

- **A fixed interest rate.** As a low risk investment option, the term deposit will always come with a fixed interest rate, which locks the client in for a short or long investment term.
- **Early withdrawal fees.** If the client needs to take money out of a term deposit before it reaches maturity, they will pay penalty fees, and the interest rate will likely be reduced. This applies to long and short-terms, but the client may find it easier to avoid early withdrawals by choosing short-terms and then reinvesting if it turns out they do not need the cash.

- **Minimum balance.** Many term deposit offers come with a minimum balance requirement, depending on the banks minimum bank balance requirements.

6.2 Interest earned on long-term deposits

Generally speaking, a longer investment term will mean more interest simply because it gives client pile more time to earn, plus it will often come with a higher interest rate attached. But there are some other things, that can have an effect on the earning potential, including:

- **Deposit balance** - generally speaking, the more money client put into term deposit, the more interest they will earn. A large deposit locked away for a shorter term might ultimately earn more interest than a small deposit with a longer investment term.
- **Interest payment frequency** – If the client is paid monthly, they will a get a slightly lower interest rate to offset the effect of compound interest as compared when paid annually.

6.3 Rollover terms

It is important for the client to keep an eye on the term deposit, long or short, to make sure that do not accidentally end up with another investment term that they did not bargain for.

This is called a rollover term - if the client forgets to tell the bank what to do with their money when the term deposit matures, the money can roll over and be invested for a new term. This term often comes with a rock bottom interest rate and will be the same length as the original investment. To get out of it before that time is up, the client will have to pay an early withdrawal penalty fee. Therefore, the client must have a plan for what they are going to do with their money when term deposit matures.

6.4 Mutual Fund

A mutual fund is a type of financial vehicle made up of a pool of money collected from many investors to invest in securities like stocks, bonds, money market instruments, and other assets. Mutual funds are operated by professional money managers, who allocate the fund's assets and attempt to produce capital gains or income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.

Mutual funds give small or individual investors access to professionally managed portfolios of equities, bonds, and other securities. Each shareholder, therefore, participates proportionally in the gains or losses of the fund. Mutual funds invest in a vast number of securities, and performance is usually tracked as the change in the total market cap of the fund—derived by the aggregating performance of the underlying investments.

Key takeaways:

- A mutual fund is a type of investment vehicle consisting of a
- Portfolio of stocks, bonds, or other securities.
- Mutual funds give small or individual investors access to diversified, professionally managed portfolios at a low price.
- Mutual funds are divided into several kinds of categories, representing the kinds of securities they invest in, their investment objectives, and the type of returns they seek.
- Mutual funds charge annual fees (called expense ratios) and, in some cases, commissions, which can affect their overall returns.
- The overwhelming majority of money in employer-sponsored retirement plans goes into mutual funds.

6.5 Understanding Mutual Funds

Mutual funds pool money from the investing public and use that money to buy other securities, usually stocks and bonds. The value of the mutual fund company depends on the performance of the securities it decides to buy. So, when one buys a unit or share of a mutual fund, they are buying the performance of its portfolio or, more precisely, a part of the portfolio's value. Investing in a share of a mutual fund is different from investing in shares of stock. Unlike stock, mutual fund shares do not give its holders any voting rights. A share of a mutual fund represents investments in many different stocks (or other securities) instead of just one holding.

That's why the price of a mutual fund share is referred to as the net asset value (NAV) per share, sometimes expressed as NAVPS. A fund's NAV is derived by dividing the total value of the securities in the portfolio by the total amount of shares outstanding. Outstanding shares are those held by all shareholders, institutional investors, and company officers or insiders. Mutual fund shares can typically be purchased or redeemed as needed at the fund's current NAV which, unlike a stock price does not fluctuate during market hours, but it is settled at the end of each trading day.

The average mutual fund holds hundreds of different securities, which mean mutual fund shareholders, gain important diversification at a low price. Consider an investor who buys only Google stock before the company has a bad quarter. He stands to lose a great deal of value because all of his dollars are tied to one company. On the other hand, a different investor may buy shares of a mutual fund that happens to own some Google stock. When Google has a

bad quarter, she loses significantly less because Google is just a small part of the fund's portfolio.

Mechanics of Mutual Funds

A mutual fund is both an investment and an actual company. This dual nature may seem strange, but it is no different from how a share of AAPL is a representation of Apple Inc. When an investor buys Apple stock, he is buying partial ownership of the company and its assets. Similarly, a mutual fund investor is buying partial ownership of the mutual fund company and its assets. The difference is that Apple is in the business of making innovative devices and tablets, while a mutual fund company is in the business of making investments.

Investors typically earn a return from a mutual fund in three ways:

1. Income is earned from dividends on stocks and interest on bonds held in the fund's portfolio. A fund pays out nearly all of the income it receives over the year to fund owners in the form of a distribution. Funds often give investors a choice either to receive a check for distributions or to reinvest the earnings and get more shares.
2. If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
3. If fund holdings increase in price but are not sold by the fund manager, the fund's shares increase in price. One can then sell their mutual fund shares for a profit in the market.

If a mutual fund is construed as a virtual company, its CEO is the fund manager, sometimes called its investment adviser. The fund manager is hired by a board of directors and is legally obligated to work in the best interest of mutual fund shareholders. Most fund managers are also owners of the fund. There are very few other employees in a mutual fund company. The investment adviser or fund manager may employ some analysts to help pick investments or perform market research. A fund accountant is kept on staff to calculate the fund's NAV, the daily value of the portfolio that determines if share prices go up or down. Mutual funds need to have a compliance officer or two, and probably an attorney, to keep up with government regulations.

Most mutual funds are part of a much larger investment company; the biggest have hundreds of separate mutual funds. Some of these fund companies are names familiar to the general public, such as Fidelity Investments, The Vanguard Group, T. Rowe Price, and Oppenheimer Funds.

6.6 Types of Mutual Funds

Mutual funds are divided into several kinds of categories, representing the kinds of securities they have targeted for their portfolios and the type of returns they seek. There is a fund for nearly every type of investor or investment approach. Other common types of mutual funds include money market funds, sector funds, alternative funds, smart-beta funds, target-date funds, and even funds-of-funds, or mutual funds that buy shares of other mutual funds.

a) Equity Funds

The largest category is that of equity or stock funds. As the name implies, this sort of fund invests principally in stocks. Within this group are various subcategories. Some equity funds are named for the size of the companies they invest in small-, mid-, or large-cap. Others are named by their investment approach: aggressive growth, income-oriented, value, and others. Equity funds are also categorized by whether they invest in domestic (U.S.) stocks or foreign equities. There are so many different types of equity funds because there are many different types of equities. A great way to understand the universe of equity funds is to use a style box, an example of which is below.

The idea here is to classify funds based on both the size of the companies invested in (their market caps) and the growth prospects of the invested stocks. The term value fund refers to a style of investing that looks for high-quality, low-growth companies that are out of favour with the market. These companies are characterized by low price-to-earnings (P/E) ratios, low price-to-book (P/B) ratios, and high dividend yields. Conversely, spectrums are growth funds, which look to companies that have had (and are expected to have) strong growth in earnings, sales, and cash flows. These companies typically have high P/E ratios and do not pay dividends. A compromise between strict value and growth investment is a "blend," which simply refers to companies that are neither value nor growth stocks and are classified as being somewhere in the middle.

The other dimension of the style box has to do with the size of the companies that a mutual fund invests in. Large-cap companies have high market capitalizations, with values over R50 billion. Market cap is derived by multiplying the share price by the number of shares outstanding. Large-cap stocks are typically blue chip firms that are often recognizable by name. Small-cap stocks refer to those stocks with a market cap ranging from R2 billion to R20 billion. These smaller companies tend to be newer, riskier investments. Mid-cap stocks fill in the gap between small- and large-cap.

A mutual fund may blend its strategy between investment style and company size. For example, a large-cap value fund would look to large-cap companies that are in strong financial shape but have recently seen their share prices fall and would be placed in the upper left

quadrant of the style box (large and value). The opposite of this would be a fund that invests in start-up technology companies with excellent growth prospects: small-cap growth. Such a mutual fund would reside in the bottom right quadrant (small and growth).

b) Fixed-Income Funds

Another big group is the fixed income category. A fixed-income mutual fund focuses on investments that pay a set rate of return, such as government bonds, corporate bonds, or other debt instruments. The idea is that the fund portfolio generates interest income, which it then passes on to the shareholders.

Sometimes referred to as bond funds, these funds are often actively managed and seek to buy relatively undervalued bonds in order to sell them at a profit. These mutual funds are likely to pay higher returns than certificates of deposit and money market investments, but bond funds are not without risk. Because there are many different types of bonds, bond funds can vary dramatically depending on where they invest. For example, a fund specializing in high-yield junk bonds is much riskier than a fund that invests in government securities. Furthermore, nearly all bond funds are subject to interest rate risk, which means that if rates go up, the value of the fund goes down.

c) Index Funds

Another group, which has become extremely popular in the last few years, falls under the moniker "index funds." Their investment strategy is based on the belief that it is very hard, and often expensive, to try to beat the market consistently. So, the index fund manager buys stocks that correspond with a major market index such as the S&P 500 or the Dow Jones Industrial Average (DJIA). This strategy requires less research from analysts and advisors, so there are fewer expenses to eat up returns before they are passed on to shareholders. These funds are often designed with cost-sensitive investors in mind.

d) Balanced Funds

Balanced funds invest in a hybrid of asset classes, whether stocks, bonds, money market instruments, or alternative investments. The objective is to reduce the risk of exposure across asset classes. This kind of fund is also known as an asset allocation fund. There are two variations of such funds designed to cater to the investors' objectives.

Some funds are defined with a specific allocation strategy that is fixed, so the investor can have a predictable exposure to various asset classes. Other funds follow a strategy for dynamic allocation percentages to meet various investor objectives. This may include responding to market conditions, business cycle changes, or the changing phases of the investor's own life.

While the objectives are similar to those of a balanced fund, dynamic allocation funds do not have to hold a specified percentage of any asset class. The portfolio manager is therefore given freedom to switch the ratio of asset classes as needed to maintain the integrity of the fund's stated strategy.

e) Money Market Funds

The money market consists of safe (risk-free), short-term debt instruments, mostly government Treasury bills. This is a safe place to park one's money. A saver will not get substantial returns, but they will not have to worry about losing their principal. A typical return is a little more than the amount one would earn in a regular cheque or savings account and a little less than the average certificate of deposit (CD). While money market funds invest in ultra-safe assets, during the 2008 financial crisis, some money market funds did experience losses after the share price of these funds, typically pegged at R10, fell below that level and broke the buck.

f) Income Funds

Income funds are named for their purpose: to provide current income on a steady basis. These funds invest primarily in government and high-quality corporate debt, holding these bonds until maturity in order to provide interest streams. While fund holdings may appreciate in value, the primary objective of these funds is to provide steady cash flow to investors. As such, the audience for these funds consists of conservative investors and retirees. Because they produce regular income, tax-conscious investors may want to avoid these funds.

g) International/Global Funds

An international fund (or foreign fund) invests only in assets located outside the home country. Global funds, meanwhile, can invest anywhere around the world, including within the home country. It is tough to classify these funds as either riskier or safer than domestic investments, but they have tended to be more volatile and have unique country and political risks. On the flip side, they can, as part of a well-balanced portfolio, actually reduce risk by increasing diversification, since the returns in foreign countries may be uncorrelated with returns at home. Although the world's economies are becoming more interrelated, it is still likely that another economy somewhere is outperforming the economy of the home country.

h) Specialty Funds

This classification of mutual funds is more of an all-encompassing category that consists of funds that have proved to be popular but do not necessarily belong to the more rigid categories we have described so far. These types of mutual funds forgo broad diversification to concentrate on a certain segment of the economy or a targeted strategy. Sector funds are targeted strategy funds aimed at specific sectors of the economy, such as financial,

technology, health, and so on. Sector funds can, therefore, be extremely volatile since the stocks in a given sector tend to be highly correlated with each other. There is a greater possibility for large gains, but a sector may also collapse (for example, the financial sector in 2008 and 2009).

Regional funds make it easier to focus on a specific geographic area of the world. This can mean focusing on a broader region (say Latin America) or an individual country (for example, only Brazil). An advantage of these funds is that they make it easier to buy stock in foreign countries, which can otherwise be difficult and expensive. Just like for sector funds, one have to accept the high risk of loss, which occurs if the region goes into a bad recession.

Socially responsible funds (or ethical funds) invest only in companies that meet the criteria of certain guidelines or beliefs. For example, some socially-responsible funds do not invest in "sin" industries such as tobacco, alcoholic beverages, weapons, or nuclear power. The idea is to get competitive performance while still maintaining a healthy conscience. Other such funds invest primarily in green technology, such as solar and wind power or recycling.

i) Exchange Traded Funds (ETFs)

A twist on the mutual fund is the exchange traded fund (ETF). These ever more popular investment vehicles pool investments and employ strategies consistent with mutual funds, but they are structured as investment trusts that are traded on stock exchanges and have the added benefits of the features of stocks. For example, ETFs can be bought and sold at any point throughout the trading day. ETFs can also be sold short or purchased on margin. ETFs also typically carry lower fees than the equivalent mutual fund. Many ETFs also benefit from active options markets, where investors can hedge or leverage their positions. ETFs also enjoy tax advantages from mutual funds. The popularity of ETFs speaks to their versatility and convenience.

j) Mutual Fund Fees

A mutual fund will classify expenses into either annual operating fees or shareholder fees. Annual fund operating fees are an annual percentage of the funds under management, usually ranging from 1–3%. Annual operating fees are collectively known as the expense ratio. A fund's expense ratio is the summation of the advisory or management fee and its administrative costs.

Shareholder fees, which come in the form of sales charges, commissions, and redemption fees, are paid directly by investors when purchasing or selling the funds. Sales charges or commissions are known as "the load" of a mutual fund. When a mutual fund has a front-end load, fees are assessed when shares are purchased. For a back-end load, mutual fund fees are assessed when an investor sells his shares.

Sometimes, however, an investment company offers a no-load mutual fund, which does not carry any commission or sales charge. These funds are distributed directly by an investment company, rather than through a secondary party.

Some funds also charge fees and penalties for early withdrawals or selling the holding before a specific time has elapsed. Also, the rise of exchange-traded funds, which have much lower fees thanks to their passive management structure, have been giving mutual funds considerable competition for investors' dollars. Articles from financial media outlets regarding how fund expense ratios and loads can eat into rates of return have also stirred negative feelings about mutual funds.

6.7 Classes of mutual fund shares

Mutual fund shares come in several classes. Their differences reflect the number and size of fees associated with them. Mutual fund classes indicate the type and number of fees charged for the shares in a fund.

Mutual funds fall into one of four main asset classes:

a) Equity Funds

An equity fund is a fund that invests primarily in stocks. The objective of an equity fund is generally to seek long-term capital appreciation. These types of funds may focus on certain sectors of the market or may have a specific investment style, such as investing in value or growth stocks.

b) Fixed Income Funds

A fixed income fund is a fund that invests primarily in bonds or other debt securities. Fixed income funds generally pay a return on a fixed schedule, though the amount of the payments can vary. Investors may consider this type of fund for their potential for income generation and capital preservation.

c) Multi-Asset Funds

There is more to diversification than just combining bonds and stocks. A multi-asset fund offers exposure to a broad number of asset classes, often offering a level of diversification typically associated with institutional investing. Multi-asset funds may invest in several traditional equity and fixed income strategies, index-tracking funds, financial derivatives as well as alternative investments. This diversity allows portfolio managers to potentially balance risk with reward and deliver steady, long-term returns for investors, particularly in volatile markets.

d) Alternative Funds

Potentially attractive for investors seeking to reduce volatility and improve returns in their portfolios, alternative funds invest in a variety of strategies and asset classes, looking to

provide risk and return profiles that have lower correlations to traditional asset classes (such as equities, fixed income, and cash).

Currently, most individual investors purchase mutual funds with shares through a broker. This purchase includes a front-end load of up to 5% or more, plus management fees and on-going fees for distributions, also known as 12b-1 fees. To top it off, loads on shares vary quite a bit, which can create a conflict of interest. Financial advisors selling these products may encourage clients to buy higher-load offerings to bring in bigger commissions for them. With front-end funds, the investor pays these expenses as they buy into the fund.

To remedy these problems and meet fiduciary-rule standards, investment companies have started designating new share classes, including "level load" C shares, which generally do not have a front-end load but carry a 1% 12b-1 annual distribution fee.

Funds that charge management and other fees when an investor sells their holdings are classified as Class B shares.

Mutual fund companies can have seven or more classes of shares for a particular fund. However, there are three main types of mutual fund classes: A, B, and C.[1] They are also known as A-shares, B-shares, and C-shares:

Class A Shares	Class B Shares	Class C shares are a type of level-load fund, which charges an annual fee. This class works well for individuals who will be redeeming shares in the short-term.
A-shares charge an upfront sales fee, or front-end load, that is taken off the initial investment	The B-shares are classified by their back-end or contingent deferred sales charge. This fee is paid when one sells shares a specified period of years after the original purchase. These shares are typically good for investors with little investment cash and a long investment horizon	

e) A New Class of Fund Shares

The newest share class, developed in 2016, consists of clean shares. Clean shares do not have front-end sales loads or annual 12b-1 fees for fund services. American Funds, Janus, and MFS are all fund companies currently offering clean shares.

By standardizing fees and loads, the new classes enhance transparency for mutual fund investors and, of course, save them money. For example, an investor who rolls R100,000 into an individual retirement account (IRA) with a clean-share fund could earn nearly R18, 000 more over a 30-year period as compared to an average A-share fund, according to an April 2017 Morningstar report co-written by Aron Szapiro, Morningstar director of policy research, and Paul Ellenbogen, head of global regulatory solutions.[2]

6.7.1 Advantages of Mutual Funds

There are a variety of reasons that mutual funds have been the retail investor's vehicle of choice for decades. The overwhelming majority of money in employer-sponsored retirement plans goes into mutual funds. Multiple mergers have equated to mutual funds over time.

a) Diversification

Diversification, or the mixing of investments and assets within a portfolio to reduce risk, is one of the advantages of investing in mutual funds. Experts advocate diversification as a way of enhancing a portfolio's returns, while reducing its risk. Buying individual company stocks and offsetting them with industrial sector stocks, for example, offers some diversification. However, a truly diversified portfolio has securities with different capitalizations and industries and bonds with varying maturities and issuers. Buying a mutual fund can achieve diversification cheaper and faster than by buying individual securities. Large mutual funds typically own hundreds of different stocks in many different industries. It would not be practical for an investor to build this kind of a portfolio with a small amount of money.

b) Easy access

Trading on the major stock exchanges, mutual funds can be bought and sold with relative ease, making them highly liquid investments. Also, when it comes to certain types of assets, like foreign equities or exotic commodities, mutual funds are often the most feasible way—in fact, sometimes the only way—for individual investors to participate.

c) Economies of scale

Mutual funds also provide economies of scale. Buying one spares the investor of the numerous commission charges needed to create a diversified portfolio. Buying only one security at a time leads to large transaction fees, which will eat up a good chunk of the investment. Also, the R1, 000 to R2, 000 an individual investor might be able to afford is usually not enough to buy a round lot of the stock, but it will purchase many mutual fund shares. The smaller denominations of mutual funds allow investors to take advantage of dollar cost averaging.

Because a mutual fund buys and sells large amounts of securities at a time, its transaction costs are lower than what an individual would pay for securities transactions. Moreover, a

mutual fund, since it pools money from many smaller investors, can invest in certain assets or take larger positions than a smaller investor could. For example, the fund may have access to IPO placements or certain structured products only available to institutional investors.

d) Professional management

A primary advantage of mutual funds does not have to pick stocks and manage investments. Instead, a professional investment manager takes care of all of this using careful research and skilful trading. Investors purchase funds because they often do not have the time or the expertise to manage their own portfolios, or they do not have access to the same kind of information that a professional fund has. A mutual fund is a relatively inexpensive way for a small investor to get a full-time manager to make and monitor investments. Most private, non-institutional money managers deal only with high-net-worth individuals—people with at least six figures to invest. However, mutual funds, as noted above, require much lower investment minimums. So, these funds provide a low-cost way for individual investors to experience and hopefully benefit from professional money management.

e) Variety and freedom of choice

Investors have the freedom to research and select from managers with a variety of styles and management goals. For instance, a fund manager may focus on value investing, growth investing, developed markets, emerging markets, income, or macroeconomic investing, among many other styles. One manager may also oversee funds that employ several different styles. This variety allows investors to gain exposure to not only stocks and bonds but also commodities, foreign assets, and real estate through specialized mutual funds. Some mutual funds are even structured to profit from a falling market (known as bear funds). Mutual funds provide opportunities for foreign and domestic investment that may not otherwise be directly accessible to ordinary investors.

f) Transparency

Mutual funds are subject to industry regulation that ensures accountability and fairness to investors.

Pros

- Liquidity
- Diversification
- Minimal investment requirements
- Professional management
- Variety of offerings.

Cons

- High fees, commissions, and other expenses

- Large cash presence in portfolios
- No FDIC coverage
- Difficulty in comparing funds
- Lack of transparency in holdings.

6.7.2 Disadvantages of Mutual Funds

Liquidity, diversification, and professional management all make mutual funds attractive options for younger, novice, and other individual investors who do not want to actively manage their money. However, no asset is perfect, and mutual funds have drawbacks too.

a) Fluctuating Returns

Like many other investments without a guaranteed return, there is always the possibility that the value of a mutual fund will depreciate. Equity mutual funds experience price fluctuations, along with the stocks that make up the fund. The Federal Deposit Insurance Corporation (FDIC) does not back up mutual fund investments, and there is no guarantee of performance with any fund. Of course, almost every investment carries risk. It is especially important for investors in money market funds to know that, unlike their bank counterparts, these will not be insured by the FDIC.

b) Cash Drag

Mutual funds pool money from thousands of investors, so every day people are putting money into the fund as well as withdrawing it. To maintain the capacity to accommodate withdrawals, funds typically have to keep a large portion of their portfolios in cash. Having ample cash is excellent for liquidity, but money that is sitting around as cash and not working is not very advantageous. Mutual funds require a significant amount of their portfolios to be held in cash in order to satisfy share redemptions each day. To maintain liquidity and the capacity to accommodate withdrawals, funds typically have to keep a larger portion of their portfolio as cash than a typical investor might. Because cash earns no return, it is often referred to as a "cash drag."

c) High Costs

Mutual funds provide investors with professional management, but it comes at a cost—those expense ratios mentioned earlier. These fees reduce the fund's overall pay-out, and they are assessed to mutual fund investors regardless of the performance of the fund. In years when the fund does not make money, these fees only magnify losses. Creating, distributing, and running a mutual fund is an expensive undertaking. Everything from the portfolio manager's salary to the investors' quarterly statements cost money. Those expenses are passed on to the investors. Since fees vary widely from fund to fund, failing to pay attention to the fees can have negative long-term consequences. Actively managed funds incur transaction costs that

accumulate over each year. Remember, every dollar spent on fees is a dollar that is not invested to grow over time.

d) "Diworsification" and Dilution

"Diworsification" - a play on words - is an investment or portfolio strategy that implies too much complexity can lead to worse results. Many mutual fund investors tend to overcomplicate matters. That is, they acquire too many funds that are highly related and, as a result, do not get the risk-reducing benefits of diversification. These investors may have made their portfolio more exposed. At the other extreme, just because one owns mutual funds does not mean they are automatically diversified. For example, a fund that invests only in a particular industry sector or region is still relatively risky.

In other words, it is possible to have poor returns due to too much diversification. Because mutual funds can have small holdings in many different companies, high returns from a few investments often do not make much difference on the overall return. Dilution is also the result of a successful fund growing too big. When new money pours into funds that have had strong track records, the manager often has trouble finding suitable investments for all the new capital to be put to good use.

One thing that can lead to diworsification is the fact that a fund's purpose or makeup is not always clear. Fund advertisements can guide investors down the wrong path. The Securities and Exchange Commission (SEC) requires that funds have at least 80% of assets in the particular type of investment implied in their names. How the remaining assets are invested is up to the fund manager.[3]However, the different categories that qualify for the required 80% of the assets may be vague and wide-ranging. A fund can, therefore, manipulate prospective investors via its title. A fund that focuses narrowly on Congolese stocks, for example, could be sold with a far-ranging title like "International High-Tech Fund."

e) Active Fund Management

Many investors debate whether or not the professionals are any better than them at picking stocks. Management is by no means infallible, and even if the fund loses money, the manager still gets paid. Actively managed funds incur higher fees, but increasingly passive index funds have gained popularity. These funds track an index such as the S&P 500 and are much less costly to hold. Actively managed funds over several time periods have failed to outperform their benchmark indices, especially after accounting for taxes and fees.

f) Lack of Liquidity

A mutual fund allows an investor to request that their shares be converted into cash at any time; however, unlike stock that trades throughout the day, many mutual fund redemptions take place only at the end of each trading day.

g) Taxes

When a fund manager sells a security, a capital-gains tax is triggered. Investors who are concerned about the impact of taxes need to keep those concerns in mind when investing in mutual funds. Taxes can be mitigated by investing in tax-sensitive funds or by holding non-tax sensitive mutual funds in a tax-deferred account, such as a 401(k) or IRA.

6.7.3 Evaluating Funds

Researching and comparing funds can be difficult. Unlike stocks, mutual funds do not offer investors the opportunity to juxtapose the price to earnings (P/E) ratio, sales growth, earnings per share (EPS), or other important data. A mutual fund's net asset value can offer some basis for comparison, but given the diversity of portfolios, comparing the proverbial apples to apples can be difficult, even among funds with similar names or stated objectives. Only index funds tracking the same markets tend to be genuinely comparable.

6.8 Unit trust investments

Unit Trusts, or collective investments, are popular investments in which investors' funds are pooled and managed by professional managers.

Investing in shares has traditionally yielded good returns, offering investors the opportunity to build real wealth. But the large amounts of money required to buy shares are often out of reach of smaller investors. Pooling everyone's funds in a collective investment enables fund managers to build a portfolio of securities or shares and to then offer cost-effective access to financial markets.

There are two main sources of income for Unit Trust funds: interest from interest-bearing investments, such as money-market instruments and bonds, and dividends from shares.

There are around 1 500 locally managed Unit Trust funds available to investors in South Africa. Even if an investor has not specifically invested in a Unit Trust, it is likely that their retirement annuity and other investments are invested in Unit Trusts to earn the highest return.

6.8.1 The Advantages of a unit trust investment

a) Well regulated

Unit Trusts are strictly regulated by the Financial Sector Conduct Authority (FSCA), the ASISA, and each collective investment scheme manager's trustee or custodian. Investors enjoy wholly transparent fees, charges and investment performances.

b) Low investment risk

A Unit Trust spreads money across many investments; reducing the chances of suddenly losing large amounts of money should the markets change. For example, if one of the

companies in which one has invested suffers a severe setback, only a small percentage of an investment will be affected as it is spread across multiple companies.

c) Easy to know investment status

It is easy to monitor the performance of Unit Trusts. One can access their statement online or receive regular updates from a fund manager. They can also track the performance of their Unit Trust fund on a daily basis on investment websites or via the press.

d) Start with a small investment

One does not need a large amount to start investing. On average monthly debit orders usually start at around R500. By investing a little more every month, one can start to grow their investment steadily. The reason Unit Trust funds exist is to make it easy for anyone to invest in any part of the economy they choose to and to benefit from professional fund management.

6.8.2 The cons of a unit trust investment

a) Spoilt for choice

Investors looking into Unit Trusts will find a multitude of options available in the South African market, making it difficult to choose. If one are not conversant with investments or Unit Trusts, it is worth making use of a registered financial advisor to assist them.

b) No guarantees

Unit Trust funds are invested across a range of different investments, over various geographical regions, providing different risk with various financial institutions. There is no guaranteed return or a guarantee that one will not lose money. However, with an investment term over at least a five-year period, a return is generally achievable and probable, with the correct investment strategy.

6.8.3 Mechanics of unit trust investments

Investors earn interest and/or dividends from Unit Trusts, depending on the type of fund they have invested in.

Interest is what is earned on the money by lending it. Dividends are a share of profits that an investor gets as a part owner of a company when they purchase its stock. It is a portion of the company’s earnings. Unit Trust fund managers may declare these earnings monthly, quarterly or every six months.

When interest and/or dividends are earned, the default option is for them to be automatically reinvested, increasing the number of units owned by an investor. Alternatively, they could opt to have dividends paid out to them instead of being reinvested, but this will have an impact on future growth.

6.8.4 Fees charged

There are fees that an investor needs to be aware of when investing in unit trusts. These fees will be deducted as a percentage of the investment. There are two distinct types of fees:

1. Upfront fees

These fees are deducted on the first day of the new investment. This is a once-off fee, which usually ranges as follows:

- Unit Trust management company initial fee: ranges from: 0.25% – 2.00%
- Financial advisor initial fee: ranges from: 1.00% – 3.00%

VAT is levied on top of this fee.

2. On-going fees

On-going annual fees are deducted over the lifetime of the investment. This is shown as a percentage, which will be deducted monthly over 12 months. On-going fees usually range as follows:

- Unit Trust management company fee: ranges from 0.50% – 1.75% p.a.
- Financial advisor fee: ranges from 0.50% – 1.25% p.a.
- Unit Trust platform admin fee: ranges from 0.25% – 0.95% p.a.

6.8.5 Taxation of unit trusts

Unit Trusts are subject to two types of taxes:

1. Tax income earned in the form of interest and dividends
At the end of the tax year, an investment company will issue an ITB3 certificate, a certificate produced annually for every account that has received credit interest. It states how much interest was earned during the tax year. If an account earns interest above the prescribed threshold, it must be declared on an annual tax return.

2. Capital Gains Tax
If one sells a unit trust, or if they switch from one unit trust to another, they will be disposing of assets and are subject to Capital Gains Tax.

6.9 Annuities

An annuity is a contract between an investor and an insurance company in which they make a lump-sum payment or series of payments and, in return, receive regular disbursements, beginning either immediately or at some point in the future.

In short:

- Annuities are insurance contracts that promise to pay a regular income either immediately or in the future.
- One can buy an annuity with a lump sum or a series of payments.
- The income received from an annuity is taxed at regular income tax rates, not capital gains rates, which are usually lower.

6.9.1 How an Annuity works

The goal of annuity is to provide a steady stream of income, typically during retirement. Funds accrue on a tax-deferred basis, and like 401(k) contributions, can only be withdrawn without penalty after age 59½.[1]

Many aspects of an annuity can be tailored to the specific needs of the buyer. In addition to choosing between a lump-sum payment and a series of payments to the insurer, one can choose when they want to annuitise their contributions - that is, start receiving payments. An annuity that begins paying out immediately is referred to as an immediate annuity, while one that starts at a predetermined date in the future is called a deferred annuity.

The duration of the disbursements can also vary. One can choose to receive payments for a specific period of time, such as 25 years, or for the rest of their life. Of course, securing a lifetime of payments can lower the amount of each check, but it helps ensure that one do not outlive their assets, which is one of the main selling points of annuities.

6.9.2 Special Considerations

An important feature to consider with any annuity is its tax treatment. While the balance grows tax-free, the disbursements received are subject to income tax. By contrast, mutual funds that are held for over a year are taxed at the long-term capital gains rate, which is generally lower.

6.9.3 Types of Annuities

There are different types of annuities. Annuities come in three main varieties: fixed, variable, and indexed. Each type has its own level of risk and pay out potential. Fixed annuities pay out a guaranteed amount. The downside of this predictability is a relatively modest annual return, generally slightly higher than a Certificate of Deposit from a bank.

Variable annuities provide an opportunity for a potentially higher return, accompanied by greater risk. In this case, pick from a menu of mutual funds that go into a personal "sub-account." Here, payments in retirement are based on the performance of investments in a sub-account.

Indexed annuities fall somewhere in between when it comes to risk and potential reward. An investor receives a guaranteed minimum pay out, although a portion of their return is tied to

the performance of a market index, such as the S&P 500.Variable and indexed annuities are often criticised for their complexity and high fees compared with other kinds of investments.

Despite their potential for greater earnings, variable and indexed annuities are often criticized for their fees and their relative complexity. For example, many annuitants have to pay steep surrender charges if they need to withdraw their money within the first few years of the contract.

Annuities make the most sense for pre-retirees and retirees who want to minimize worry about bear markets in retirement. Retirees know they will have a specific stream of income no matter how markets perform. Annuities, in short, represent certainty in an uncertain world.

There are five major categories of annuities, namely:

- Fixed annuities,
- Variable annuities,
- Fixed-indexed annuities,
- Immediate annuities and,
- Deferred annuities.

The best annuity for any investor depends on several variables, including their risk orientation, income goals, and when they want to begin receiving annuity income.

a) Fixed annuities

These are fixed interest investments issued by insurance companies. They pay guaranteed rates of interest, typically higher than bank CDs, and one can defer income or draw income immediately. These are popular among retirees and pre-retirees who want a no-cost, modest and guaranteed fixed investment.

b) Variable annuities

These allow investors to choose from a basket of subaccounts (mutual funds). Account value is determined by the performance of the subaccounts, and a rider can be purchased to lock in a guaranteed income stream regardless of market performance — a key hedge if subaccounts perform poorly. These are popular among retirees and pre-retirees who want a shot at capital appreciation in tandem with guaranteed lifetime income.

c) Fixed-indexed annuities

These are essentially fixed annuities with a variable rate of interest that is added to the contract value if an underlying market index, such as the S& P 500, is positive. They typically offer a guaranteed minimum income benefit, and the chance of principal upside pegged to a market-based index. A drawback is that upside potential is limited by a so-called participation rate, caps or a spread — all methods in which a return in a rising stock market is trimmed.

Consequently, buyers of these annuities never keep pace with a robust market. These appeal to retirees and pre-retirees who want to conservatively participate in potential market appreciation without fuss and with downside principal protection.

d) Immediate annuities

These are basically a mirror image of a life insurance policy. Instead of paying regular premiums to an insurer that makes a lump-sum payment upon death, the investor gives the insurer a lump sum in return for regular income payments until death, or for a specified period of time, typically starting one to 12 months after receipt of the investment. Payments are typically higher than other annuities because they include principal, as well as interest, and so also offer favourable tax treatment. These are popular among retirees and pre-retirees who need a higher-than-average stream of income and are comfortable sacrificing principal in exchange for higher lifelong income.

e) Deferred annuities

These delay payments until a future date (greater than one year). They enable people to increase their income stream later in life for less money because the insurance company is not on the hook as long when income payments are deferred. These appeal to people who want guaranteed income in the future, not now, or who want to create a ladder of income over different periods later in life. For example, they may want to work in retirement but know that eventually they will stop working and, at that point, and not before, will need guaranteed income from an annuity.

Annuity Type	**Advantages**	**Disadvantages**	**Fees**
Fixed Annuity	Simple and straight forward	Pay-less	None
Variable Annuity	Offers maximum stock market exposure	May lose principal	Highest
Fixed Indexed Annuity	Market Exposure with no risk	Participation rates, etc., diminish potential for gain	Mid-level
Immediate Annuity	Pay highest	Must sacrifice principal	None

Deferred Annuity	Cheaper and enable timing of payments.	Must sacrifice about how long one will wait for income.	Mid-level

6.10 Retirement annuities

A retirement annuity (RA) is a retirement fund in terms of the Pension Funds Act. It is a tax effective investment vehicle designed for individual investors (as opposed to employees who contribute to a workplace retirement fund). A retirement annuity is ideal for people who

- are self-employed;
- do not have access to a work-place pension or provident fund through their employer;
- want to supplement their pension or provident fund savings
- earn significant amounts of non-*pensionable income* (e.g. interest and rental income).

Pensionable income is the income used by an employer to calculate contributions to the company pension or provident fund. This will likely include an employee's full basic salary but may exclude discretionary payments such as bonuses/ incentives. It will also exclude any non-work-related income, such as interest or rental income.

Tax benefits: Since 1 March 2016, RAs qualify for the same tax incentives as pension and provident funds. One may deduct contributions to an RA fund up to 27.5% of taxable income or gross remuneration (whichever is the higher) for tax. The 27.5% limit applies to the aggregate of contributions to all funds (pension, provident and RA). The overall tax-deductible limit is R350,000 per annum. Contributions over the annual rand limits may be rolled over to future years but will be subject to the limits applicable in those years.

The client can join as many RAs as they wish, but the tax relief is determined in aggregate, not in respect of each individual fund. The employer may contribute to an RA fund on an employee's behalf. They can deduct unlimited contributions but those contributions will be taxed as a fringe benefit.

Access: The client can only retire from a RA from age 55 onwards (the one exception is early retirement due to ill-health). They can however withdraw before age 55, either on emigration, if they have gone through the formal financial emigration process with SARB and SARS, or if the paid-up RA value is less than R7,000. Withdrawals are subject to withdrawal lump sum tax (see table below).

The client can also make their RA 'paid-up'. This means the client no longer pay monthly contributions; however, they will stay invested until they retire (from age 55 onward).

At retirement, the client may take up to one third as a cash lump sum (subject to retirement lump sum tax (see table below); at least two-thirds must go towards a compulsory annuity. Compulsory annuitisation applies to fund balances above R247,500. If one owns multiple RAs in one RA fund, then the annuitisation requirement considers the aggregate value of the RAs. If one has multiple RAs in different RA funds, then the annuitisation requirement is applied to each RA individually.

There is no maximum age at which the client needs to stop contributing to an RA, or at which the client needs to access their RA.

On *death*, client's benefit will be allocated by the Fund Trustees according to the rules set out in the Pension Funds Act. The Trustees must ensure that all the clients' financial dependents are considered. If the client does not leave any financial dependents, the Trustees will allocate the benefit according to a client's beneficiary nomination form. If they do not have any financial dependents and the client failed to complete this form, the money will fall into client's estate and will be distributed according to client's will. Any lump sum payment on client's death will be taxed as a retirement benefit as though it had been received by client prior to their passing.

Fig 1: Retirement and withdrawal lump sum tax tables

At Retirement	Tax Rate	Withdrawal	Tax Rate
R0 - R 500,000	0%	R0 - R25,500	0%
R500 000 - R700 000	18%	R25 001 - R660 000	18%
R700 001 - R1 050 00	27%	R660 000 - R990 000	27%
+R1 050 000	36%	+R990 000	36

Source: SARS

Transfers: The client can transfer their RA tax free from one RA provider to another but they cannot transfer their RA to another type of retirement fund. The *cost or penalty* for transferring or making the RA paid-up depends on the service provider.

Types of RAs: There are two broad types of RAs. The traditional policy-based RA is underwritten by the big life assurance companies whereas the "new generation" unit-trust based RA are offered by the asset management industry.

Policy-based RAs are inflexible. The client enters into a long-term contract and incur obligations for decades into the future, specifying how much they must save and for how long. Breaking these terms accelerates the recovery of upfront costs (mainly commissions) loaded against the policy. These then appears as the notorious variation or early termination charges everyone complains about. They are capped at a maximum of 30% of a RA (if the policy was bought before 2006) or 15% (if the policy was bought after 2006).

If the client is considering transferring RA to another service provider, be aware that surrender penalties are costs that will be charged irrespective of whether the transfer is done or not. Traditional RAs are usually sold through a broker. Even if the client come direct, they may be "allocated" a financial adviser. Their commission depends on the terms client agreed to; the higher the client's contribution, the higher the escalation rate, the fund fees and the investment term, the bigger the broker's commission. This incentive may tempt intermediaries to maximise their commission rather than client's return. The recovery of this cost can reduce the investment return by between 0,5% and 0,75% pa. This may not seem like a lot, but over a 30-year savings period, it will cut the final pay-out by up to 15%.

These issues are not with a *new generation RA*. The clients are not locked in. In addition, the client can cancel or lower contributions at any time. They can take an indefinite contribution holiday. As fees are recovered on an as-and-when basis only, there is no charge for unrecovered costs. The client can also avoid brokers with a new generation RA and invest directly with the asset manager.

Costs are an important consideration with any investment. Traditional RAs have a reputation for being very expensive, costing as much as 3% pa, after taking into account investment management, platform, and broker and administration fees. The 10X Retirement Annuity is a new generation RA. An investor is not required to use a broker (they can deal with 10X directly) and is charged only one investment management fee, at a maximum of 0.90% pa (excl. VAT) of the capital. The fee drops for amounts above R1m.

6.10.1 Benefits of Retirement Annuities

The client gets tax benefits

Contributions to a retirement annuity are tax deductible and the returns that the client earns while invested are tax free.

Client needs a small amount each month

Client decide how much to invest – at least R500 a month or a single lump sum of R20 000 if they do not want to make a monthly investment. They can make changes whenever an investor need to, no transaction fees and no penalties.

The investment is safeguarded

The restrictions in a retirement annuity aim to ensure that client's money is kept for their retirement and that it is protected from potential creditors.

6.10.2 Reasons why retirement annuity may not be suitable for certain clients

- Prescribed legal investment limits restrict how much they can invest in the types of investments that are considered higher risk, for example equities and offshore investments.
- The investor can only access their money after the age of 55, except in certain circumstances, like emigration.
- When one retires, they can only withdraw up to one-third of their investment as cash. The rest must be transferred to a product that can provide them with retirement income.

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Board Notice 64 of 20019

Board Notice 194 of 2017