

# How do banks make money on structured products?

Needless to say, banks want to make money from selling structured products. But how do they earn it exactly, and how much do they earn? What services do investors pay for, and how much do they cost? To find out, a closer look has to be taken at the individual price components of a product. This will show that those under the impression that issuers are concealing high costs in structured products, raking in profits at the expense of the investor, are mistaken.

## Facts

Structured products are securities, structured and issued by banks. Issuing a structured product is different from selling one. Often the bank issues the structured product and also distributes it, but there are also distribution partners, independent from the banks, that advise investors on structured products and earn money on sales. For this reason, a distinction needs to be made between the issuer and the distributor when looking at profits. It is important for retail investors to know how much they are paying the issuer for the structuring of the structured product. On top of the structuring costs, there are the distribution costs and fees incurred in the buying or selling of a structured product.

## ... what a bank earns on the production of a structured product

### Expected issuer margin

Regardless of where and how an investor buys a structured product, the price always includes what is known as the expected issuer margin. It is important to note that this margin is not the same as the issuer's net profit. The expected issuer margin includes the expected profit, but it also covers all the issuer's operational costs. These include, for example, personnel costs, exchange listing fees and/or trading system expenses.

Incidentally, the reason it is called the 'expected' issuer margin is that, due to unforeseeable market developments, the amount is not certain at the time of the sale and is only based on estimates. This is just the same as in other areas of business: an airline selling tickets today for flights next summer does not know either the future price of aviation fuel or what the terms of the next wage agreement will be. Nevertheless, based on certain assumptions, it charges a price for a ticket that takes into account the expected costs and profits.

For a long time, there was no reliable information on the margins of structured product issuers. In December 2017, the Academic Advisory Board of the DDV conducted a wide-ranging study on the subject. The study determined an average expected issuer margin for structured products of 0.3 percent per annum – much lower than widely assumed. This is in spite of the fact that the margin includes all the operational costs of the issuer.

Capital Protection Products with Coupon	0.09 % p. a.
Uncapped Capital Protection Certificates	0.26 % p. a.
Reverse Convertibles	0.50 % p. a.
Express Certificates	0.26 % p. a.
Credit-Linked Notes	0.16 % p. a.
Discount Certificates	0.42 % p. a.
Bonus Certificates	0.76 % p. a.
Tracker Certificates	0.12 % p. a.
Outperformance Certificates	0.15 % p. a.
Capped Outperformance Certificates	0.30 % p. a.
Others	0.49 % p. a.
<b>Total</b>	<b>0.30 % p. a.</b>

Source: 2017 study by the DDV Academic Advisory Board "Total costs and cost components of investment in structured products"



The reason for this is obvious: more than 20 issuers offer structured products on the German market. This means issuers face tough competition for individual retail investors.

To the Academic Advisory Board study:

[Total costs and cost components of investment in structured products](#)

### Cost transparency for structured product investors

With every financial product, the expected return is undoubtedly one of the chief buying criteria. However, by displaying the costs, issuers can offer investors an additional guide. Issuers of structured products inform investors about the costs of the products in the respective Key Information Documents or product information sheets. In accordance with the regulatory provisions, these product costs include the entry charges, the ongoing charges, and the exit charges. They also contain the operational costs incurred by the issuer for structuring (e. g. costs of drawing up the securities prospectuses, costs of admission of the structured products to listing), market making (i. e. costs of continuous pricing on the exchange and over the counter) and settlement of the respective structured product. The costs also include the expected profit for the issuer.

### ... what a bank earns from the sale of a structured product

There are many ways for an investor to buy a structured product, and each involves different costs. A retail investor can buy a structured product through an investment adviser in a bank, or as a self-directed investor - without investment advice - from an online broker. In both cases, the investor buys the structured product either by means of direct over-the-counter trading or on a securities exchange. The extent to which the bank earns anything on further services over and above the issuer margin depends on whether it has an internal distribution or branch network.

### Sales commission

Sales commission only has to be paid by investors who buy the structured product as advised investors through a distribution partner or through the issuer's internal branch network, if it has one. In this case, investors normally buy the structured product after receiving advice. The sales commission paid by the investor covers this advisory service. The investor must be told how much will be charged in sales commission.

### Front-end load fee during the subscription period

A front-end load fee can only be charged for structured products acquired within the subscription period, as with investment funds. This fee varies from issuer to issuer and depends on the category of the structured product. The front-end load fee has to be disclosed to the investor.

## ... the costs incurred in trading on the secondary market

### Bid-ask spread

Retail investors wishing to buy a structured product after the subscription period or to sell it before maturity, either on an exchange or directly over the counter, can find out the value of the structured product at any time during exchange trading hours. Every second, the Stuttgart and Frankfurt exchanges publish and update the buy and sell prices of all structured products listed on the exchanges. The issuers also continuously quote bid and ask prices at which trading is possible in over-the-counter trading. The bid price is always equal to the selling price and the ask price is equivalent to the buying price of a structured product. As a rule, the ask prices are higher than the bid prices, as they are with equities or exchange-traded funds (ETFs). As a hypothetical example, if an investor were to buy and sell a structured product simultaneously, they would make a loss equal to the difference between the bid and ask prices. This difference is termed the bid-ask spread. This is a kind of fee charged by the issuer for its hedging costs and the infrastructure costs for facilitating continuous trading of structured products. In general, these spreads are very small. Some products, such as Tracker Certificates, are even traded without a bid-ask spread.

### Exchange fees, transaction costs and securities account charges

All investors, whether advised or self-directed, need a securities account with a bank or an online broker for every financial instrument they buy. This means they incur securities account charges in addition to transaction costs for buying and selling any type of security. If a retail investor or an adviser acting on behalf of a client acquires the structured product on an exchange rather than directly through over-the-counter trading, an exchange fee is also usually incurred. Investors can find out from the bank or online broker at any time whether securities account charges, transaction costs or exchange fees are payable, as well as how high they are.