Financial Consumer Agency of Canada
Agence de la consommation en matière financière du Canada

Considering an Investment Product Tied to the Stock Market's Performance?

What you should know about index-linked deposits sold in Canada

Protecting Consumers *Informing Canadians*

Canada

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About This Publication

This booklet includes an overview of the disclosure regulations that apply to index-linked deposits sold by banks and trust and loan companies. If you would like more information on this type of investment, contact FCAC or your financial institution.

This document is divided into four sections:

What to Consider — Features of Index-Linked Deposits

- Applies to **consumers** of different financial institutions.

How Index-Linked Deposits Work

- Applies to **consumers** of different financial institutions.

Your Rights under Federal Laws

- Refers to specific consumer protection measures that apply to you if you want to buy an index-linked deposit at a **bank or trust and loan company operating under federal laws**.

Tax Implications of Index-Linked Deposits

- Applies to **consumers** of different financial institutions.

Before you invest in an index-linked deposit, you should fully understand the terms and conditions of this product, as well as the potential benefits and risks involved. By asking questions and shopping around, you will be in a better position to determine if this financial product is right for you.

Always ask questions about anything that you don't fully understand!

What Is an Index-Linked Deposit?

An "index-linked deposit" is a term deposit where any interest payment is based on the change in the value of an underlying point of reference or benchmark. The benchmark can be a market index such as the Standard and Poor's/Toronto Stock Exchange (S&P/TSX) 60, a mutual fund, a stock, or an exchange rate.

For the sake of simplicity, this booklet focuses on an index-linked deposit where the interest is based on the performance of a specific market index (S&P/TSX 60). The "S&P/TSX 60" is often used as a benchmark in the calculation of interest of an index-linked deposit (also called the rate of return).

In recent years, there has been an increase in this type of investment products offered to consumers by financial institutions as an alternative to conservative investments such as guaranteed investment certificates (GICs) or traditional term deposits. An index-linked deposit can also qualify for registered plans or locked-in plans. You can invest in an index-linked deposit as part of your Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF), Registered Education Savings Plan (RESP), Locked-In Retirement Account (LIRA) or Life Income Fund (LIF).

Many types of financial institutions sell index-linked deposits: banks, trust and loan companies, credit unions, caisses populaires and brokerage firms. All banks and some trust and loan companies operate under federal laws. On the other hand, credit unions, caisses populaires and brokerage firms operate under provincial laws.

What to Consider — Features of Index-Linked Deposits

Minimum amount

The minimum amount that you can invest in an index-linked deposit varies by product and issuer, but could be as low as $500.

Term

The term offered is usually between three and five years, but can be longer. Generally, an index-linked deposit cannot be cashed before the end of the term (its maturity date).

Some financial institutions will let you sell your investment before maturity by finding another investor interested in buying your index-linked deposit (this is called selling through a "secondary market"). The transaction takes place at market value. If the specific market index has decreased, you may not recover the full amount of your original investment. However, if the market index has increased, you may be able to make a profit on your investment.

Security

The financial institution guarantees the principal (the amount) invested in an index-linked deposit, but not the amount of interest you will be paid (if there is no minimum rate of return indicated in your contract).

"Opportunity cost"

Some consumers believe that it does not cost them any money when they invest in an index-linked deposit. It is true that the capital invested will be returned to you at the end of the term. However, there is a chance that you will not earn any interest at all with an index-linked deposit, not even the interest you would have earned with a conventional GIC. This is called the "opportunity cost". You will not lose your principal, but you may be giving up what you otherwise would have earned, if you had invested in a different product.

The following example illustrates the opportunity cost. If you invest $10,000 in a three-year index-linked deposit and the market index decreases, you will get your $10,000 back but you will not earn any interest. On the other hand, if you invested your $10,000 in a three-year conventional GIC offering a 4 per cent interest rate that is compounded annually, you would be sure that your investment would be worth $10,000, plus $1,248.64 in interest, for a total value of $11,248.64. "Compound interest" is interest that is calculated not only on your original deposit amount but also on any interest that you have earned with the deposit.

In other words, in this example, the opportunity cost of investing in an index-linked deposit is $1,248.64. If the index-linked deposit does not earn anything, you are really giving up $1,248.64 that you could otherwise have earned by investing in a GIC. Therefore, when you invest in an index-linked deposit, you are hoping the potential increase in value of the market index to which your deposit is linked will provide you with a greater return than if you had invested in a conventional GIC.

Rate of return

The formula used to determine the rate of return you will receive varies, depending on the type of index-linked deposit, the market index and the financial institution. Some financial institutions base your rate of return on the growth (percentage gain) of the index between the time it is issued and the date the deposit matures. Others use an average of the index, over the term of the index-linked deposit or some shorter time period, to calculate your rate of return. If an average of the index is used to calculate your rate of return, this can potentially provide greater protection against the risk that the market index might decline substantially near the end of your term.

For an index-linked deposit where the interest is based on the performance of a specific market index, your rate of return will depend on any increase in the index to which the deposit is linked.

- **Limit on rate of return**

  You may not receive the full amount of the index growth because your financial institution may place a maximum percentage (cap) or apply a "participation rate" on the gain.

  Maximum percentage rate*:* The maximum percentage rate represents the maximum rate of return you can obtain from your deposit, which is indicated in your contract. Your rate of return for the period of the index-linked deposit cannot exceed this limit. For example, if your cap is set at 30 per cent and your market index increases by 35 per cent between the date of issue and the maturity date, your rate of return will be limited to 30 per cent for the period.

  Participation rate*:* The participation rate represents your portion of the growth in the market index to which your deposit is linked. There is usually no cap with the participation rate. For example, if your participation rate is set at 65 per cent of the market index growth, this means that you would receive $0.65 for each $1.00 of interest produced by the increase in the market index.

If the market index increases by 35 per cent, between the date of issue and the maturity date, your rate of return will be 22.75 per cent (65% x 35%) for the period. In this example, this is less than with the maximum percentage rate in the previous example.

However, if the market index increases by more than 35 per cent, let's say 60 per cent, your rate of return with the participation rate will be 39 per cent (65% x 60%).

The limit type that the financial institution will use to calculate your interest will be stated in your contract. A more detailed illustration of how these two types of limits work is provided in the next section (page 10).

- **Minimum rate of interest**

Some financial institutions may also offer you a minimum rate of return for your index-linked deposit. In this case, the maximum percentage rate or participation rate may be lower because your contract states you will get a minimum return on your investment.

If the index-linked deposit does not have a minimum guaranteed rate of return, your rate of return could be zero per cent. When the return on an index-linked deposit is based on the increase of a specific market index and if the index performs well over the term of the deposit, your investment may earn a return. If the value of the index decreases, you may not earn any interest for the entire period of your deposit and only the principal amount invested will be returned to you. However, the guaranteed principal may be a benefit that other market-linked investments such as mutual funds do not provide.

- **Option to lock in**

  Some financial institutions will allow you to lock in your return at specific times before the end of the index-linked deposit, but you should be aware that your decision to lock-in usually cannot be reversed.

  If, for example, your contract states that you can only earn a maximum rate of return of 30 per cent over three years and you reach that level by the end of the first year, you may want to consider locking in your return, if you are allowed to do so at this time, because your return cannot get any higher.

  On the other hand, if your contract indicates that your participation rate is 65 per cent of the increase in the market index and you decide to lock in what you have earned because you are satisfied with this return, you should remember you might not be able to reverse this decision. When you exercise your lock in option, you are guaranteed to receive the rate of return you have chosen, but you will be giving up any future increases in the market index that you might have been otherwise entitled to.

Deposit insurance

Because your investment is in the form of a deposit, the capital you invest may be eligible for deposit insurance protection in case the financial institution that holds your deposit fails. The Canada Deposit Insurance Corporation (CDIC) insures deposits held in banks and most trust and loan companies. For more information, visit CDIC's Web site at www.cdic.ca or call them toll-free at 1-800-461-2342. Every province also has deposit insurance arrangements for deposits held in deposit-taking institutions not covered by CDIC.

How Index-Linked Deposits Work

Mr. Jones wants to buy a $10,000 index-linked deposit, which has the following features:

- Three-year (3) term.
- The return or interest paid is equal to the percentage increase between the value of the S&P/TSX 60 market index **at the end of the period minus the value of the index at the time of purchase**.
- There is no minimum rate of return guaranteed.
- There is no lock in option.
- **Type of limit**

  A) **Maximum Percentage Rate**: The maximum percentage rate is 30 per cent for the three-year term.

  B) **Participation Rate**: The participation rate is 65 per cent for the three-year term.
- The investment cannot be cashed before maturity.
- The value of the S&P/TSX 60 market index, at the time of purchase, is 375.
- The principal of $10,000 is guaranteed by the financial institution and is also insured by CDIC.

Here are four examples of what could happen to Mr. Jones' investment, depending on the value of the index at the end of the term.

Example 1

	End of Year 1	End of Year 2	End of Year 3
January 28, 2003 (Purchase Date)	**January 28, 2004**	**January 28, 2005**	**January 28, 2006 (Maturity Date)**
Starting Index Value=375	Index Value=535	Index Value=550	**Ending Index Value=630**

Difference between Starting and Ending Index Value = (630-375) ÷ 375 = ↑ **68%**

TYPE OF LIMIT

A) Maximum Percentage Rate

Since the maximum return is capped by the contract at 30 per cent, Mr. Jones would **receive an overall rate of return of 30 per cent** even though the index increased by **68 per cent**. This means that Mr. Jones will earn $3,000.00 interest for his three-year investment (the equivalent of an annual compound rate of return[1] of **9.14 per cent per year**).

B) Participation Rate

The growth of the index (68 per cent) is multiplied by the participation rate of 65 per cent. Mr. Jones would **receive an overall rate of return of 44.20 per cent (65% x 68%)**. This means that Mr. Jones will earn $4,420.00 of interest for his three-year investment (the equivalent of an annual compound rate of return[2] of **12.98 per cent per year**).

[1] Note that not all financial institutions provide an annual compound rate of return.
[2] Note that not all financial institutions provide an annual compound rate of return.

Example 2

	End of Year 1	End of Year 2	End of Year 3
January 28, 2003 (Purchase Date)	**January 28, 2004**	**January 28, 2005**	**January 28, 2006 (Maturity Date)**
Starting Index Value=375	Index Value=535	Index Value=550	**Ending Index Value=525**

Difference between Starting and Ending Index Value = (525-375) ÷ 375 = ↑ **40%**

TYPE OF LIMIT

A) Maximum Percentage Rate

Since the maximum return is capped by the contract at 30 per cent, Mr. Jones would **receive an overall rate of return of 30 per cent** even though the index increased by **40 per cent**. This means that Mr. Jones will earn $3,000.00 interest for his three-year investment (the equivalent of an annual compound rate of return[3] of **9.14 per cent per year**).

B) Participation Rate

The growth of the index (40 per cent) is multiplied by the participation rate of 65 per cent. Mr. Jones would **receive an overall rate of return of 26% (65% x 40%)**. This means that Mr. Jones will earn $2,600.00 interest for his three-year investment (the equivalent of an annual compound rate of return[4] of **8.01 per cent per year**).

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[3] Note that not all financial institutions provide an annual compound rate of return.
[4] Note that not all financial institutions provide an annual compound rate of return.

Example 3

	End of Year 1	End of Year 2	End of Year 3
January 28, 2003 (Purchase Date)	**January 28, 2004**	**January 28, 2005**	**January 28, 2006 (Maturity Date)**
Starting Index Value=375	Index Value=535	Index Value=550	**Ending Index Value=405**

Difference between Starting and Ending Index Value = (405-375) ÷ 375 = ↑ **8%**

TYPE OF LIMIT

A) Maximum Percentage Rate

In this scenario, the growth of the index (8 per cent) is lower than the capped 30 per cent stated in Mr. Jones contract. Mr. Jones would then **receive an overall rate of return of 8 per cent, which is equal to the growth (8%) of the market index**. This means that Mr. Jones will earn $800.00 interest for his three-year investment (the equivalent of an annual compound rate of return[5] of **2.60 per cent per year**).

B) Participation Rate

The growth of the index (8 per cent) is multiplied by the participation rate of 65 per cent. Mr. Jones would **receive an overall rate of return of 5.2 per cent (65% x 8%)**. This means that Mr. Jones will earn $520.00 interest for his three-year investment (the equivalent of an annual compound rate of return[6] of **1.70 per cent per year**).

[5] Note that not all financial institutions provide an annual compound rate of return.
[6] Note that not all financial institutions provide an annual compound rate of return.

Example 4

	End of Year 1	End of Year 2	End of Year 3
January 28, 2003 (Purchase Date)	**January 28, 2004**	**January 28, 2005**	**January 28, 2006 (Maturity Date)**
Starting Index Value=375	Index Value=535	Index Value=550	**Ending Index Value=335**

Difference between Starting and Ending Index Value = (335-375) ÷ 375= ↓ **10.67%**

A) Maximum Percentage Rate and B) Participation Rate

Since the index decreased in value (-10.67 per cent), Mr. Jones would only receive the principal amount ($10,000) that was invested. The **overall rate of return would be 0 per cent for the entire three-year period**, meaning that Mr. Jones will earn $0.00 interest for his three-year investment.

Using the lock-in option (if available in your contract)

In the preceding examples 3 and 4, it would have been useful for Mr. Jones to have the lock-in option. At the end of Year 1, the index value was at 535 but decreased in the third year to end at 405 (Example 3) and 335 (Example 4).

If Mr. Jones' index-linked deposit offered a lock-in option and he was able to exercise it at end of Year 1, he could have locked in his gains at the end of Year 1. Here is what his overall rate of return would have been.

Example 3

Difference between Starting and Ending Index Value at end of Year 1 =
(535-375) ÷ 375 = ↑ **42.67%**

TYPE OF LIMIT

A) Maximum Percentage Rate

Since the maximum return is capped by the contract at 30 per cent, Mr. Jones would have **received an overall rate of return of 30 per cent instead of 8 per cent**. This means that Mr. Jones would have earned $3,000.00 interest instead of $800.00 for his three-year investment (the equivalent of an annual compound rate of return[7] of **9.14 per cent per year instead of 2.60 per cent per year**).

B) Participation Rate

The growth of the index (42.67 per cent) is multiplied by the participation rate of 65 per cent. Mr. Jones would have received an **overall rate of return of 27.74 per cent (65% x 42.67%) instead of 5.2 per cent**. This means that Mr. Jones would have earned $2,774.00 interest instead of $520.00 for his three-year investment (the equivalent of an annual compound rate of return[8] of **8.50 per cent per year instead of 1.70 per cent per year)**.

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[7] Note that not all financial institutions provide an annual compound rate of return.
[8] Note that not all financial institutions provide an annual compound rate of return.

Example 4

Difference between Starting and Ending Index Value at end of Year 1 =
(535-375) ÷ 375 = ↑ **42.67%**

TYPE OF LIMIT

A) Maximum Percentage Rate

Since the maximum return is capped by the contract at 30 per cent, Mr. Jones would have **received an overall rate of return of 30 per cent instead of 0 per cent**. This means that Mr. Jones would have earned $3,000.00 interest instead of $0.00 for his three-year investment (the equivalent of an annual compound rate of return[9] of **9.14 per cent per year instead of 0 per cent per year**).

B) Participation Rate

The growth of the index (42.67 per cent) is multiplied by the participation rate of 65 per cent. Mr. Jones would have received **an overall rate of return of 27.74 per cent (65% x 42.67%) instead of 0 per cent**. This means that Mr. Jones would have earned $2,774.00 interest instead of $0.00 for his three-year investment (the equivalent of an annual compound rate of return[10] of **8.50 per cent per year instead of 0 per cent per year**).

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[9] Note that not all financial institutions provide an annual compound rate of return.
[10] Note that not all financial institutions provide an annual compound rate of return.

Your Rights under Federal Laws

This section contains specific consumer protection measures that apply to you if you want to buy an index-linked deposit at a bank or trust and loan company that operates under federal laws or from one of its agents (who are authorized to sell their financial products). Because consumer protection measures apply to banks and trust and loan companies operating under federal laws, the information in this section does not necessarily apply to all financial institutions.

If you wish to buy an index-linked deposit at a credit union, caisse populaire or brokerage firm that is regulated at the provincial or territorial level, similar laws may apply. Contact your provincial or territorial government to find out about its consumer protection laws.

Except for sales over the telephone, banks, trust and loan companies that operate under federal laws or any agent selling their products, **must** provide you, **in writing**, with specific information related to the questions below **before or at the time** you invest in an index-linked deposit.

To make this section easier to read, we refer to a bank or a trust and loan company simply as a "bank".

When the sale is made over the telephone, the bank must send you a written disclosure statement, explaining your investment. For more details on buying index-linked deposits by telephone see the section "Thinking of buying an index-linked deposit by telephone?" on page 20.

Before you invest, what questions should you ask?

Interest calculation

- How is interest on my index-linked deposit calculated? We have provided examples of common methods used to calculate interest on pages 10-16. Banks may also use other methods to calculate the interest. These include "averages of the index over the period" and the "quarterly method". Therefore, before you invest, it is important for you to fully understand the method the bank uses to determine the interest you will be paid.

- What is the market index that will determine my rate of return (for example the S&P/TSX 60)?

- What are the characteristics of the market index? For example, what types of stocks are included in the index (for instance, the S&P/TSX 60 is an index that is made up of 60 stocks of large Canadian companies). How volatile is the index (how rapidly does its value increase and decrease)? If the market index is very volatile, there will be more or larger increases and decreases throughout your investment period. If there is a big decrease near the end of your term, your investment may earn a low rate of return, or no return at all.

- In what circumstances would I receive no interest? If there is no increase in the market index that my deposit is linked to, does this mean that I will not receive any interest for the entire period?

- What is the maximum limit on the rate of return that I will earn? How does this limit affect my rate of return?

- Is there a minimum amount of interest that I will be paid? If **YES**, how will this affect the limit on my rate of return?

- How often will I be paid interest, and what options do I have concerning interest payments? For example, if there is no guaranteed minimum rate of return, you may have to wait for the end of the term to receive any interest. On the other hand, if there is a guaranteed minimum rate of return, you may be able to choose when you receive the interest you have earned (every three months, twice a year or once a year).

- Does my index-linked deposit contract allow the bank to make changes in the way it calculates interest? If **YES**, the bank **must** send you a notice **in writing**, clearly explaining any change, if it is significant, prior to making the change. If it is not possible for the bank to notify you before the change is made, it must do so as soon as possible afterward. Therefore, it is important for you to read your contract carefully.

- Are there other circumstances that might affect the interest I will be paid?

Access to funds

- Can the money be withdrawn before the end of my contract? If **YES**, what are my rights concerning withdrawing funds?

- What is the term and maturity date of my index-linked deposit?

Security

- Can the bank confirm that the initial amount (the "principal") that I invest in an index- linked deposit is guaranteed to be paid to me at the end of the term?

Thinking of buying an index-linked deposit by telephone?

Before you buy an index-linked deposit by telephone you should ask the same questions as outlined previously and take note of what is said. In addition, you should ask your bank the following questions:

- What are my rights under the contract if I want to cancel my purchase? (After you receive the disclosure statement, explaining your investment, some banks give you 48 hours from the earlier of actual or deemed receipt to cancel your purchase. If the disclosure documents are sent to you by mail, you are deemed to have received them on the 5th day after they were mailed out and the 48-hour period runs from that date. These banks are: Bank of Montreal, CIBC, Laurentian Bank, National Bank, Royal Bank, Scotiabank and TD Canada Trust).

- When does the bank start to calculate the interest on my index-linked deposit?

Tax Implications of Index-Linked Deposits

For income tax purposes[11], any amount that you will earn with an index-linked deposit will be considered as interest.

- **If you buy an index-linked deposit inside a Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF), Registered Education Savings Plan (RESP), Locked-In Retirement Account (LIRA) or Life Income Fund (LIF):**

  The amount of interest can grow tax-deferred (this means that it will not be taxed in the year that you earned or received the interest) until the funds are withdrawn from the registered or locked-in plan.

- **If you buy an index-linked deposit outside a Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF), Registered Education Savings Plan (RESP), Locked-In Retirement Account (LIRA) or Life Income Fund (LIF):**

  The amount of interest will normally be taxed at your regular income tax rate.

  However, you should be particularly aware of the potential impact of the interest you may receive when you invest in an index-linked deposit outside a registered plan or locked-in plan. Your return on the index-linked deposit will not be known until the maturity date unless the return is locked in (if the deposit has a lock-in option). Unlike conventional term deposits where the annual interest is taxed each year, the interest on your index-linked deposit is taxed only in the year when the return is known. If you invested $40,000 in a deposit linked to a specific market index for five years, which provided you with a 50 per cent rate of return, you would have $20,000 of taxable income to report for the year it matured.

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[11] Assumes that the individual is a resident of Canada during the term and at maturity.

You cannot apply any of the interest income to the previous years, since the amount of interest was not known or earned — unlike bonds or conventional GICs, where you have to declare the interest income each year as it is earned.

Therefore, the interest based on the performance of an index is treated as income and is fully taxable in the year when the interest rate is known. However, if the index-linked deposit provides a minimum rate of return, that minimum amount of interest is taxable annually as it is earned, even though it is received at maturity.

Your tax rate may also increase to the next level, because of the additional income you receive in the year the index-linked deposit matured or when you have exercised your lock-in option (where the interest is known). This means that more of the index-linked deposit interest may go to taxes than would be the case if it was spread out over the period of the investment.

It is also important to consider how any additional amount earned in a particular year would affect such things as old-age security (the amount of benefit you receive may be reduced if your total income, including interest, exceeds a certain level), GST rebates and guaranteed income supplements.

NOTE: Since tax consequences will depend on your personal circumstances, you should consult a tax advisor for further details.

Who We Are

We are the **Financial Consumer Agency of Canada (FCAC).**

The **Government of Canada** set up the Agency to protect your rights as consumers and give you information about the financial products and services you use.

Information

Through our Consumer Contact Centre and publications, we provide user-friendly information to inform you of your rights and help you shop around for the financial products and services that meet your needs.

When we provide information, we do not favour any product or service. We give you facts that will help you choose the one that is best for you.

Protection

We also make sure that financial institutions that are regulated by the federal government, such as banks and trust and loan companies, respect the laws of Canada that protect consumers. We monitor if they follow their own voluntary codes of conduct and respect their public commitments to you. You can obtain more information on the financial institutions we regulate and the laws that apply to them by contacting us.

How to Contact Us

If you think that a bank or trust and loan company has not respected federal consumer protection laws related to index-linked deposits, please contact us:

Financial Consumer Agency of Canada
427 Laurier Avenue West
Enterprise Building, 6th Floor
Ottawa, ON K1R 1B9

Telephone (toll-free): 1-866-461-3222

Fax (toll-free): 1-888-814-461-2224

E-mail for information: info@fcac-acfc.gc.ca
E-mail for publications: pub@fcac-acfc.gc.ca

Web site: www.fcac-acfc.gc.ca

All of our information and services are available to you free of charge.

Protecting Consumers
Informing Canadians

Protéger les consommateurs
Informer les Canadiens