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Risky deposits

Dual currency deposits offer high interest rates. But are they worth the risk?

BY KELVIN TAN

Banks promote them as "enhanced" or "premium" deposits that offer annual interest rates of as much as 10%. But look more closely at dual currency deposits (DCDs) and you will find that the high rates of return they offer — compared with Singapore dollar fixed deposit rates of less than 1% — might come at a high price.

Referring to these products as a kind of short-term bank deposit is altogether misleading, say some financial experts. It would be more appropriate to refer to them as a type of financial derivative product. That's because bank customers are being offered significantly higher "interest rates" on their deposits in one currency in return for accepting possible repayment of the principal amount and interest in another currency at a less-than-favourable exchange rate.

For those who haven't been introduced to these products, here's how they work: A bank customer chooses a pair of currencies — a base currency and an alternate currency. A "strike" level of anywhere between 100 and 150 basis points above or below the spot exchange rate between the two currencies, a deposit tenure (as short as a fortnight to as long as a year) and a corresponding rate of interest are agreed with the bank. The customer then places a deposit in the base currency — the minimum deposits usually range from US$10,000 to US$50,000 equivalent, depending on the bank.

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Upon maturity, the customer will receive his principal amount and interest earned in either the base or alternate currency, depending on which is less favourable vis-à-vis the strike level. The bank effectively returns the customer's money to him at the less favourable exchange rate.

So, for example, if the base currency is the Singapore dollar (SGD) and alternate currency is the Australian dollar (AUD), and the strike level is 1.22 SGD/AUD, the depositor would receive his principal and interest in SGD if the spot rate ends at maturity above the strike level. That's because the SGD is weaker than the AUD at that rate compared with the strike level. Conversely, if the spot rate ends below the strike level, the bank would pay the customer the equivalent of his principal and interest in AUD, but converted at the strike level exchange rate. Again, that's because the AUD is weaker than the SGD at that rate compared with the spot rate.

Take a specific example: A bank customer chooses the SGD as base currency and decides to put S$100,000 in a DCD with a one-month tenure at an agreed yearly interest rate of 10%. His alternate currency is the AUD and the agreed exchange rate is fixed at 1.23 SGD/AUD.

Case 1

If the SGD weakens against the AUD just before maturity, say, to a spot SGD/AUD rate of 1.25, the depositor will receive his principal plus interest in SGD, which equates to SGD 100,833 [SGD100,000 + (SGD100,000 x 10% x 1/12)].

Case 2

If the SGD strengthens against the AUD just before maturity, say, to a spot SGD/AUD rate of 1.21, the depositor will receive his principal plus interest in the weaker AUD at a pre-agreed exchange rate of 1.23, which equates to AUD81,978 (SGD100,833 x 1/1.23).

Are DCDs a good deal?

Despite the high interest rates offered by DCDs, the product hasn't impressed many financial experts *The Edge Singapore* spoke to. To begin with, they say the gains are capped to the amount of interest payable and the depositor will not be able to enjoy the benefits of foreign exchange gains. On the flip side, the potential foreign currency losses are unlimited. "The investor should go in with his eyes wide open and know that he can suffer an unlimited capital loss if the alternate currency weakens substantially, where the [currency] depreciation is more than the interest paid to him," warns Dennis Ng Kah Wan, certified financial planner and director of financial consultancy firm Leverage Holdings.

Firth: DCDs are good for those who have needs in two currencies, like expats or those with kids studying overseas

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Byron Murphy, executive director of wealth management firm Global Strategies, is also sceptical about the usefulness of DCDs. "It is true that cash does not generate much of a return on capital but it is not supposed to do so as, after all, it is considered risk-free," he says. By buying a DCD using cash or cash in fixed deposits, consumers are essentially using the risk-free element of one's portfolio for speculation, he adds. "As soon as you take a position in the market, based on a specific direction in a relatively short period of time, you are speculating."

Indeed, DCDs shouldn't be likened to bank deposit products at all as this creates the impression that they are cash or cash-like instruments, some observers say. DCDs are, in fact, substantially riskier instruments compared with ordinary time deposits because the former use financial derivatives such as currency options as yield enhancers. "In essence, we would encourage scepticism [towards products such as DCDs]," says Murphy. "Sometimes it is better to be patient and selectively invest in the right opportunities rather than chase 'safe' returns that are simply not there."

According to financial experts, when you buy into a DCD, you are effectively selling a currency call option to a bank on your base currency. A call option gives the right to the holder at his or her discretion to buy an asset at a specific price on, or at any time until, the expiration date. A seller of the call option is obligated to deliver the asset specified in the contract if the holder of the option chooses to exercise it and buy the asset.

So, when your alternate currency weakens — which also means your base currency has strengthened — the bank exercises its call option to buy your base currency at a cheaper exchange rate to its advantage. And, the currency losses — implicit and explicit — are borne by the depositors. Hence, when you buy a DCD from a bank, you are essentially betting against the bank using currency options. Interestingly, the high interest rates offered by DCDs to compensate depositors for extra currency risks are not paid out from the banks' own coffers but from the proceeds from sales of currency options too. "I think as an individual, it's difficult to research or make bets on currencies against a financial institution with its team of experts in foreign currency trading," Ng points out.

So, who should invest in DCDs?

Despite its shortcomings though, DCDs may be useful to people such as expatriates who have exposure to two currencies. "The products are good for those who have needs in two currencies, like expats or those with kids studying overseas or properties overseas or people who don't mind in which currency they get back their money," says Chris Firth, chief executive officer of online wealth management firm dollarDEX. "You could say these investors are swapping the full potential of forex gains for higher interest rate gains [when putting money in DCDs]," he adds.

Ng offers similar views, saying that people who might find DCDs useful are those who don't mind receiving their money in either the base or alternate currency. An example is a person in Singapore with a son studying in Australia. "This is because he will be indifferent to receiving Autralian dollars even if it weakens or strengthens as he needs to pay his son's tuition fees and other expenses," says Ng.

One thing that all the experts stress is, if you are going to use a DCD or just a plain vanilla foreign currency deposit, it's important to shop around. That's because the interest rates offered by different banks can vary widely.

The Edge Singapore understands that Citibank is currently offering one of the highest interest rates for its DCDs that have SGD as the base currency and AUD as the alternate currency. For a one-month tenure and a strike level fixed at 120 basis points off the current spot SGD/AUD exchange rate, Citibank is currently offering an annual interest rate of 10.13% (as at Aug 16). This is about 1% higher than what many of its peers are offering for the same product.

On the other hand, ABN AMRO Bank is offering the highest rates for ordinary foreign currency time deposits, provided customers open a DCD account with the bank.