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Invest

Options and what they mean

Ivan Png
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Last Wednesday night, the Monetary Authority of Singapore announced that two financial institutions had come forward to restructure the Lehman Brothers' Minibonds. Then on Friday, another financial institution came forward, bringing the total number of interested parties to three.

With restructuring, the notes can run to maturity. The institutions would also be giving a cash offer to investors wanting to sell out.

This is welcome news for the 8,000 retail investors who invested $375 million and the various institutions that invested $133 million in the Minibond notes. Investors now have a choice of accepting one of the restructuring offers or a cash exit. The MAS would appoint an independent financial adviser to assist investors on their choice.

The Minibond series of credit-linked notes is just one of the various 'structured products' that financial institutions have sold to Singaporeans. Others include the Merrill Lynch Jubilee Series 3 LinkEarner Notes and the DBS High Notes 5.

Where did all these products come from? As an economist, I would say they are the outcome of supply and demand. On the supply side, banks today are no longer content to take deposits and make loans. They seek fee income - income that does not depend on taking deposits or raising capital.

A major source of such fee income comes from selling investments to retail customers. One is upfront retail commission - why else do you think banks hire so many smart-looking graduates to push these products? The other is possible fees from structuring and supporting the product itself, and possible insurance payments provided by the investments to the bank (on which, more below).

And, on the demand side, the typical Singaporean would like to earn more than the low interest rates that savings or fixed deposits pay.

Structured products offered higher interest rates. But again, as an

economist, I would remind you: 'no risk, no return'. Structured products are far from risk-free, as the holders of the Jubilee Series 3 LinkEarner Notes would tell us. Twenty-eight million dollars worth of these notes were sold in Singapore. On Oct 6, they were declared to be worthless.

So what are the risks? Obviously, these vary from one product to another. Let me illustrate with respect to the Minibond Series 5 notes.

The Lehman bankers who designed this product were not only smart in finance, they were also geniuses in marketing. They gave the name 'Minibond Limited' to the special purpose vehicle that issued the notes.

So the shorthand name for the credit- linked notes issued by Minibond was simply 'Minibond'. But, of course, the notes were not bonds at all.

It took me quite a few hours to piece together an understanding of the structure of these notes from the pricing statement issued by Minibond and an announcement by HSBC Institutional Trust Services (Singapore) Ltd (HTSG), which is the trustee of the notes. I cannot guarantee that my understanding is complete and you may not rely on it as I am not a financial adviser.

Minibond Ltd took money from the noteholders and used it to buy a synthetic collateralised debt obligation (CDO). Subject to two conditions, the synthetic CDO would pay regular but variable interest (what is called a 'floating rate') in US dollars to Minibond. Minibond also arranged with Lehman Brothers, as the 'swap counterparty', to swap this US dollar variable payment into a Singapore dollar fixed payment.

Minibond then passed on this Singapore dollar fixed payment to noteholders, yielding 5.1 per cent interest from 2007 to 2010 and 6.4 per cent interest from 2010 to 2014.

(A swap counterparty is the entity that provides the other side of a swap transaction.)

Now, the two conditions. These explain why the products were properly called 'credit-linked notes'. The first condition was that none of six 'reference entities' - Citigroup, DBS Bank, Goldman Sachs, HSBC, Merrill Lynch and Standard Chartered - would be subject to a 'credit event'. A reference entity is a company for which a credit event would trigger the termination of the notes and a payment to the swap counterparty. An example of a credit event is bankruptcy.

For example, if Merrill Lynch were to declare bankruptcy, the notes would be terminated. In essence, Minibond noteholders were betting that none of the reference entities would be subject to a credit event. This aspect of the Minibond notes was called a 'first to default swap' because it would be triggered by the first of the reference entities to default. In effect, Minibond had provided insurance to Lehman Brothers against any of these reference

entities defaulting.

Note that, in the case of the Minibond notes, Lehman Brothers itself was not one of the reference entities.

The other condition is more difficult to understand. According to the pricing statement, the synthetic CDO was somehow based on a portfolio of 150 securities and the value of the CDO depended on those securities. The noteholders would lose some of their principal if 11 or more of those securities were subject to credit events, and lose all of their principal if 13 or more of those securities were subject to credit events. Essentially, they were betting that fewer than 11 of these securities would be subject to a credit event.

The pricing statement did not disclose the identities of the 150 securities referenced by the synthetic CDO. Subsequently, HTSG revealed that the synthetic CDO was issued by Zircon Finance Ltd. It did not provide any other information about Zircon Finance Ltd.

For the benefit of those who are still reading this essay, I have been told that the noteholders' rights in the synthetic CDO correspond to the mezzanine tranche of a typical CDO. Typically, a CDO is sliced into different risk classes - equity, mezzanine and senior tranches. In the event of any default, the equity tranche loses first, then the mezzanine tranche, and finally, the senior tranche.

In September, as we all know, there was a credit event - but not with any of the six reference entities or, apparently, with the portfolio of 150 securities. Ironically, it was Lehman Brothers itself, the swap counterparty, that collapsed, and so, defaulting on payments to Minibond, and triggering the current controversy.

So what now for the noteholders? They must consider the terms of the three restructuring offers and cash offers, and compare those with the alternative of liquidating the synthetic CDO. Based on the HTSG statement, the restructuring offers would entail a new entity taking over the role of Lehman Brothers as swap counterparty.

By accepting the restructuring offers, noteholders will continue their bet that none of the six reference entities and fewer than 11 of the 150 securities referenced by the synthetic CDO will be subject to a credit event. By taking the cash exit, the noteholders will get a certain amount.

By seeking liquidation, noteholders will get, after paying claims from the liquidator of the Lehman swap counterparty, the remainder of the value of the synthetic CDO, and specifically, the underlying collateral. As of Oct 11, HTSG was in the process of appointing an expert to value the synthetic CDO. So far, it has not provided the expert's report.

Complex? Absolutely.

The writer is Lim Kim San Professor of Business Policy and Professor of Information Systems and Economics at the National University of Singapore.
The opinions expressed here are personal and should not be relied upon as financial advice.

econaa@gmail.com

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