Which credit products are suited to the masses?

By Oliver Chen & Anand Shrinivasan for The Straits Times

For many investors in Singapore, the current financial crisis has been magnified by its impact on the structured credit products that were issued by several financial institutions in Singapore during the past few years. While only a few of these investment products have suffered forced redemptions at a fraction of their face value, all the products in the category have gained attention.

Some of the products that have been in the news include High Notes, Pinnacle Notes, Jubilee Notes and Minibonds. They fall in the general category of what are referred to as "first to default credit-linked notes".

What exactly does that mean? Let's start from the simplest possible instrument - a bond. Bond issuers pay an interest rate, or coupon that depends on two factors: the likelihood of bankruptcy and the recovery that is expected if bankruptcy does occur. Issuers that are more risky will have to pay a higher interest rate to induce people to invest in their bonds.

Credit-linked notes are similar to bonds in that the note issuers are lending the face value to the note issuer in return for regular interest payments and the return of the face value of the note at maturity. As with a bond, a note with a higher likelihood of default will have a lower expected recovery in the event of default and will need to offer a higher interest rate. However, there is an important difference in the nature of the risks assumed by investors in bonds and those in credit-linked notes.

A first to default credit-linked note will reference several different firms. If any of those referenced firms experiences a credit event, including bankruptcy, the note is synthetically structured so that it will have a forced redemption where the proceeds paid on redemption will depend on the recovery rate of the bond of the defaulting referenced firm. If the value of the bond was 10 per cent of face value on the date of bankruptcy, typically the investor would lose 90 per cent of their investment.

For an investor in a first to default note, the relevant probability of default is the probability that any one of the referenced firms will default before the maturity of the note. Unlike a typical portfolio where having a larger number of issuers will lower the impact of a given issuer’s default on the investor’s return, having a greater number of issuers in a first to default credit-linked note increases the likelihood of default.

Take the example of High Notes 5, a first to default note where Lehman’s bankruptcy has rendered the investment worthless. In contrast, a diversified bond portfolio that had invested in Lehman and the same firms as in High Notes 5 would not be greatly impacted by Lehman’s bankruptcy, if the portfolio had 10 per cent of the money invested in Lehman and the recovery rate of Lehman bonds was 10 per cent of face value, the loss to the portfolio would be around 9 per cent, one tenth of the loss as compared to a credit-linked note investor.

Some structured products, whose risks are very difficult to understand, may never be suitable for retail investors. Having a regulatory framework that mandates clear and transparent disclosure of risks would prevent a recurrence of what we are witnessing.

With several of the note issuers, their pricing was further complicated by the fact that the money borrowed from the note investors was in turn used to purchase underlying securities consisting of other credit-linked notes. Such credit-linked notes are even more complicated than first to default notes, and so there are still other risks to consider.

In the note issues that we have examined, the firms that are referenced for the first to default structure are clearly stated in adversarial default before the maturity of the note. A general description of the structure of the notes and the risks of the underlying securities was found only in much more detailed reading. These products would indeed be difficult for the average investor to understand.

Even pricing the first to default structured note would require assessing the probabilities of default and the possible recovery rates for each of the reference entities. Taking into account changes in value of the underlying securities would further complicate matters.

So why were these complicated products issued? On one side, investors were looking for larger coupons relative to the 2 per cent available on a typical certificate of deposit. And in the low interest rate environment which prevailed before mid-2007, risks needed to be magnified in order to obtain attractive coupons.

These notes were issued in part so financial institutions could obtain insurance against the first default in the referenced firms. For example, although Lehman did not issue the minibonds, they obtained insurance against default of the referenced firms because Lehman was the swap counterpart and would obtain a payment if that first default occurs. The payment would come from the principal of the note investors. The note investors were in fact providing insurance in this structure.

One could argue that retail investors invest in equity-based unit trusts all the time, which, as we have seen in recent days, can have downside risks comparable to the credit-linked note. Does the unit trust investor look into the prospects of each company the unit trust invests in?

But that is not a valid comparison. An investor in a unit trust is told the policy and investment style of the unit trust. These give a clear understanding of the risks involved. Also, the impact of any one firm on the value of the unit trust will be small, unlike in first to default notes where the value is critically dependent on each of the referenced firms.

A key consideration in deciding whether such structured products should be marketed to retail investors should be whether the risks involved can be readily understood. Some structured products, whose risks are very difficult to understand, may never be suitable for retail investors. Having a regulatory framework that mandates clear and transparent disclosure of risks would prevent a recurrence of what we are witnessing, while at the same time allowing the market for structured products to develop in a sustainable manner.

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