Options and what they mean

Minibonds

Singaporeans who pumped millions into Minibonds at a recent gathering called by an activist to consider their plight and discuss their options.

PHOTO: REUTERS

Minibonds

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 offered are of risk-free, as the notes of the Jubilee Series 3 Linklerner 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 Minibonds 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 worth 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, a number of institutions and Singapore-based (like HSBC) 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 advisor.

Minibond Ltd took money from the noteholders and used it to buy a synthetic collateralized debt obligation (CDO). Subject to two conditions, the synthetic CDO would pay regular but variable interest (what is called "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 2011 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 the reference entities would have to pay any interest. The reference entity is a company for which a credit event would trigger the termination of the notes and 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 "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.

But, in the case of the Minibond note, 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 this portfolio depended on those securities. The noteholders would lose some of their principal if those securities were subject to 11 or more credit events, and lose all of their principal if those securities were subject to 13 or more 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 Citigroup Finance Ltd. It did not provide any other information about Citigroup Finance Ltd.

For the benefit of those who are still reading this, 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 -- not only a default of one 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.

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