



Making Sense of Structured Notes

About this guide

There are a variety of innovative financial products available for investors these days. Some, like structured notes, have features which are quite different from those of traditional retail products like fixed deposits. This guide highlights key features, risks and important questions to ask before buying a structured note.

What is a structured note?

A structured note is an investment whose return is linked to the performance of one or more reference asset(s) or benchmark(s). Typical reference assets or benchmarks include market indices, equities, interest rates, fixed-income products, foreign exchange rates or any combination of these. It may be the interest amount and/or principal repayment, which are linked to the performance of the underlying instrument.

For example:

Equity-linked notes are linked to equity indices, like the Straits Times Index (STI), or the share price of a company, or even to a basket of shares or a basket of stock indices. For some equity-linked notes, the investor may receive shares instead of cash at the time when the principal is to be repaid.

Similarly, credit-linked notes are investments in which the interest amount and/ or principal repayment are linked to the creditworthiness of an entity or portfolio of entities and/or market value of the debt obligations (e.g. bonds, loans, etc.) of such entity or portfolio of entities.

There are also structured notes with returns linked to two or more reference assets or benchmarks (e.g. the interest amount and/or principal repayment are dependent on both the creditworthiness and the share price of a group of companies).

Besides exposure to credit and equity markets, notes may also be structured such that they are linked to foreign exchange rates, interest rates (e.g. London Interbank Offered Rate (LIBOR)), commodities prices and other asset classes.

What key benefits do structured notes offer?

Structured notes often offer investors potential returns that may be higher than interest rates offered on traditional deposits. They may even offer the potential for capital appreciation. But such returns or capital gains are dependent on the performance of the

underlying reference asset(s) or benchmark(s) which in turn exposes the investor to a greater variety of risks than a traditional deposit would.

[Is a structured note different from a structured deposit?](#)

Yes, investors may potentially lose the whole principal sum when investing in structured notes, whereas investors will definitely receive the principal amount on maturity of the structured deposits (subject to the credit risk of the bank). For more details, please refer to the MoneySENSE guide on structured deposits at http://www.moneysense.gov.sg/publications/guides_publications/Consumer_Portal_Structured_Deposits.html

[Are structured notes suitable for everyone?](#)

Not everyone is suited to invest in structured notes. Do not consider this type of investment if you:

- Want the possibility of returns which are potentially higher than for most traditional products **BUT** are not prepared for variable returns which include the risk of losing all or a substantial part of your original investment amount;
- Do not understand how the payouts in a structured note work. For example, you are unclear about how returns are computed or the factors and scenarios that can affect the returns;
- Do not understand the risks associated with the structured note. For example, the full extent of the credit risks associated with the issuer as well as any other assets referenced in the note;
- Are not prepared to leave your money invested until the maturity date (an early redemption of the structured note may result in the investor receiving much less than his original investment amount);
- Are not prepared for your investment to be redeemed earlier at the issuer's option or for other specified reasons.

Structured notes have a variety of features so it is important that you find out as much as you can about the products on offer and understand the risks involved before you part with your money.

[What are the typical components of a structured note?](#)

Structured notes are typically embedded with derivative instruments such as options or swap contracts. In some structures, the issuer of the structured note enters into a derivative contract with another institution (the counterparty). The performance of the derivative instrument has a direct impact on the returns on the structured note. It provides the link between the note's overall return and the performance of the underlying reference asset or benchmark. In other words, they expose the investor to potential gains and risks from asset classes such as credit, equities and commodities.

While structured notes often offer investors potential returns or interest payments which may be higher than interest rates offered on traditional deposits, it is important to

understand that the enhanced interest payment is to compensate the investor for the higher risks he is exposed to when investing in the structured note. Investors should note that risks arising from the derivative instruments, including the failure of a derivative counterparty to meet its obligations, may be passed on directly to the investor and may result in the total loss of the original investment amount.

In addition, investors in structured notes have full exposure to the issuer of the structured note and must therefore know who the note issuer is, and be comfortable with taking the credit risk of that issuer.

Structured notes can be issued by a financial institution such as a bank or by a special purpose vehicle ("SPV") that has been set up specifically for the purposes of issuing structured notes.

In cases where the structured notes are issued by an SPV, the credit risk faced by the investor will be primarily the assets of such SPV. The investor should therefore evaluate and be comfortable with the assets of the SPV. For example, a structured note issued by an SPV is typically secured by collateral, which may comprise a portfolio of assets that may both enhance the yield to investors as well as expose the investor to additional risks.

Certain events occurring to the collateral may result in a mandatory redemption of the structured notes (e.g. the market value of the collateral falls below a certain level or the issuer of the collateral becomes insolvent). This would result in an early redemption of the notes where the investor receives less than the original investment amount.

Depending on the terms of the notes, it is also possible that other parties (e.g. the swap counterparty) may have claims on the collateral before the investors in certain circumstances. In the worst case scenario, the market value of the collateral may be less than the costs of unwinding (which may include payments to other parties) and investors may lose their entire investment and may not receive any principal amount on the notes.

How do structured notes work?

Some of the notes pay interest or returns to investors at regular intervals throughout the tenor of the notes. The payouts may be a specified fixed coupon or based on a formula as described in the terms and conditions of the product.

Unless there is an early redemption, the investor will receive at maturity, either repayment of the whole original investment amount or an amount calculated on a formula basis as described in the terms and conditions of the product.

It is quite common for structured notes to provide the issuer with the right to redeem or "call" the notes before the maturity date. When a structured note is "callable" at the issuer's discretion, the notes would normally be redeemed at the full value of the original investment amount. For an investor, such an early redemption by the issuer may result in reinvestment risk and loss if the investor is unable to reinvest the principal received at equally attractive returns.

The structured notes may also be redeemed early in the following circumstances:

- if there is an event of default e.g. if the issuer becomes unable to meet payment obligations under the structured note
- if taxes are imposed on the issuer or on payments arising from the product;
- if an extraordinary or force majeure event occurs (where provided in the product offering documents).
- if the market value of any collateral falls and is insufficient to secure any or all obligations under the structured note.

In these circumstances, investors may receive less than the amount they initially invested.

The conditions affecting the payout of return or interest or principal under the structured notes will be listed in the product offering documents. Investors should ask for a copy of the product offering documents from the financial institution offering them the product and ensure that they understand the information in the documents before deciding whether to invest in the structured note.

What is the maximum amount I can lose?

Generally, most structured notes are not principal-guaranteed. The investor may lose all or a substantial amount of his original investment amount in certain situations, which are described in the product offering documents.

What can cause me to incur losses? Under what situations can I incur losses?

Generally, an investor may lose money if the underlying reference asset or benchmark underperforms, i.e. if the price, value or level of the underlying reference asset or benchmark does not move in the direction and/or by an amount sufficient to produce a return under the structured note.

The following table lists some of the structured notes commonly available and highlights some of the risks unique to each type. The table provides general information and is not meant to be exhaustive.

| Type of Structured Note | Description | Key Risks Involved |
|--------------------------------|--|--|
| Equity -linked | <ul style="list-style-type: none">* Equity-linked notes may be linked to a single stock, or a basket of stocks.* Equity-linked notes may also be linked to an equity index (for example, the S&P 500) or a basket of indices. | <ul style="list-style-type: none">* Returns are dependent on the performance of the underlying stock or basket of stocks, or equity index or basket of indices.* You are exposed to the risk that the level of the underlying asset does not move in the direction and/or by an amount you anticipated.* Where the returns are linked to more than one reference asset (e.g. a basket of stocks), the returns will often not be based on the average of the basket. For example, the formula may be linked to the worst performing stock. In such cases, investors should note that a larger number of reference assets in the basket may actually increase the risk.* The issuer may also cap returns, or may exercise its right to cap returns if the equity instrument performs far beyond expectations. With returns capped, you bear the risk of |

| Type of Structured Note | Description | Key Risks Involved |
|-----------------------------|--|--|
| | | <p>foregoing potentially higher returns from investing directly in the underlying stock or basket of stocks.</p> <p>* Where the structured notes pay you in the form of shares, you may end up buying shares at a price that is higher than their current market price.</p> |
| Interest rate-linked | * Returns for such notes are usually linked to a formula that makes reference to a specific floating interest rate (for example, the Singapore Interbank Offered Rate). | <p>* Your returns may depend on the direction and/or amount by which interest rates move.</p> <p>* You are exposed to the risk that interest rates do not move in the direction or by the amount you anticipated.</p> |
| Credit-linked | *The returns are linked to the occurrence of what is known as a "credit event" (for example, if a specified company becomes insolvent or defaults on its loans) and/or to the credit risk/market value of the underlying collateral. | <p>* Your returns are exposed to the credit risk of specified entities and/or to the credit risk/market value of the underlying collateral, if any. In some cases, you may lose all, or substantially all, of your original investment amount.</p> <p>* You will need to be able to assess the likelihood of a credit event occurring to the specified entities as well as the entities that constitute the underlying collateral.</p> |

In addition, some of the risks that apply generally to structured notes are listed below. Again this is not an exhaustive list.

Please note that there may be transaction or unwinding costs associated with early or mandatory redemption which could adversely impact the amount you receive.

| Key risk | What this means | What happens then | Redemption amount |
|----------------------------------|---|--|---|
| Credit risk of the issuer | The issuer's default on a payment due would constitute an event of default. | This triggers an early (or mandatory) redemption of the notes. | Investors may lose all or a substantial part of their original investment amount. |

| Key risk | What this means | What happens then | Redemption amount |
|--|--|--|---|
| | | | |
| Derivative counterparty defaults | <p>Derivative counterparty becomes unable to make payments due under the derivative transaction (which may be a swap or option), e.g. if it is insolvent or becomes bankrupt.</p> <p>If the derivative counterparty defaults, the issuer will not receive any payments under the derivative transaction and may not be able to meet its payment obligations under the notes.</p> | This triggers an early (or mandatory) redemption of the notes. | Investors may lose all or a substantial part of their original investment amount. |
| Certain events adversely affecting the value or performance of the collateral | <p>The assets constituting the collateral may suffer a loss in market value thereby leading to a loss in the market value of the collateral as a whole.</p> <p>The issuer of the collateral (e.g. bonds) becomes insolvent or defaults on any of its payment obligations.</p> | This triggers an early (or mandatory) redemption of the notes. | Investors may lose all or a substantial part of their original investment amount. |

A further risk to consider when investing in any product is liquidity. As an investor, you need to consider whether you might need access to the money you invested before the maturity date. You would also need to know who to approach should you wish to sell the structured note or get a quotation on the value of the structured note. Any sale of the structured note ahead of maturity may result in partial loss of your return and/or principal.

Key Questions To Ask Your Adviser Before You Invest In A Structured Product

The following questions were first developed by the Securities Investors Association (Singapore) (SIAS) and published on 17 December 2008 and are set out below with minor changes.

Are you familiar with my financial needs and objectives?

Financial institutions are equipped with fact finding tools to help you understand your financial health and investment needs. It is important for you to go through this financial health check with your financial institution before embarking on any investment product discussions. Be honest in your disclosure of your financial information. If there is insufficient or inaccurate information, you may be recommended products that are not suitable.

Do you know my risk profile?

Financial institutions are also equipped with suitability analysis tools to help identify your risk profile (or preference). This - together with the fact finding process - should be conducted by the financial institution before introducing products to you. You must insist on this process.

How risky is the structured product?

Remember, the higher the returns, the higher the risks. Do not take on more risk than you can tolerate. Find out what the worst case scenario is. For example, can you lose all or a significant part of your capital? Ask for details of the various risk factors that may affect your returns or put your principal at risk.

You should also ask:

- who the counter parties are, if any, and what counterparty risks are involved;
- what is the likelihood of default by the issuer.

What are the expected returns on the structured product?

You should be familiar with the conditions attached to the payment of returns especially for structured products. One way to assess how attractive the returns are is to compare the returns with interest rates currently offered by fixed deposits. Ask yourself if the higher returns justify the risk you are taking. If you receive attractive information on past returns, ask your adviser if these returns are realistic given current scenarios. Also ask about potential returns when the product underperforms expectations.

How does this product fit my investment needs?

Once the financial institution's sales staff has taken time to understand your investment needs, risk profile, budget and explained to you the different products shortlisted, he should be able to explain to you how the products fit your investment needs and your risk profile. The conversation should not be just about how good the structured products are but also how well they fit your needs.

Also ask the sales staff whether there are alternative investment products with similar risk-return profile as that of the structured product introduced to you.

How does this product fit into my investment portfolio?

Always ensure that your investment portfolio is well diversified and not unnecessarily skewed by any investments.

What fees would the financial institution and its sales staff earn on the product?

This can help you assess whether the financial institution and its sales staff would be in a position of conflict where they may be motivated to promote one product over another.

How often will you update me on the product after the investments?

Ensure that you receive product updates and valuations from your financial institutions regularly, regardless of financial or economic conditions. This will allow you to make adjustments to your portfolio through the investment period. Get a commitment from the financial institution to provide such "after investment" service.

How can I exit this structured product and what should I expect when exiting?

Knowing how and when the structured product can be liquidated as well as the cost attached to the liquidation will help you plan your cash flow and balance sheet.

When you invest in structured products, your money will be tied up for a period of time and early withdrawal may result in loss of part of your return and/or principal. Make sure that you have sufficient savings set aside before investing in structured products.

Can I go back and consider the structured product you have introduced?

Make sure you read and understand the documents relating to the product before you make any investment decision. Note that you may be asked to indicate that you have read and understood the material in the transaction documents. Do not invest in a product if you do not understand it or are not comfortable with the risks and if you need to seek advice, you should do so before investing.

In any case, investment opportunities abound and you should not rush into any investment without due and proper consideration.

MoneySENsIBLE TIPS

Structured products have risky elements and many features that are more complex than traditional deposits. Remember that:

- Higher returns mean that higher risk is involved. In the worst case scenario, you could lose all of your investment.

- The interest payments may not be guaranteed. Find out what factors would affect them.
- Your money will be tied up for a set period of time. Redeeming your investment before maturity may not be possible, or would come with substantial cost. Make sure you will be able to keep your money invested for the duration.

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