Structured Products

What are structured products?

Structured products are issued either publicly or privately. Their redemption value depends on the performance of one or more underlying assets, e.g. shares, interest rates, currencies or commodities. They may have a fixed or unlimited term and consist of one or more components. They may also be admitted to trading on an exchange.

The Swiss Structured Products Association (SSPA) categorises structured products into the following main groups:

- capital protection
- yield enhancement
- participation
- investment products with reference entities

What risks are associated with structured products?

Structured products bear the risk that the issuer may become insolvent (issuer risk). Their value thus depends not only on the performance of the underlying, but also on the creditworthiness of the issuer, guarantor or reference entity. This can change at any time during a structured product's term.

It is also important to consider a structured product's specific risk profile, which can either reduce or increase the risks associated with individual underlyings. Depending on the type of structured product, therefore, investors may aim to profit from rising, stable or falling prices. It is imperative that investors inform themselves precisely about the specific risks attached to a structured product before buying it. This information can be found in the product documentation, the key information document or the prospectus. More detailed information on structured products can be found on the SSPA website at www.svsp-verband.ch.

Voting or participation rights

The buyer of a structured product does not normally acquire voting rights and may not be entitled to dividends on the underlying asset. Participation products are often different in this respect, and include a net dividend after deduction of withholding tax. This net dividend may be wholly or partly retained (reinvested), periodically distributed or incorporated as a discount (a reduction granted on, for example, an issue price) into the issue price.

Special risks

Unlike with collective investment schemes, the issuer of a structured product is liable with their own assets, as is any guarantor to the extent of the guarantee; the underlying assets do not benefit from special protection. Investors must therefore be prepared to accept not just the potential loss due to the change in market value of the underlyings (market risk) but also, in the worst case, loss of their entire investment if the issuer or guarantor becomes insolvent (issuer/guarantor risk). Risk of the issuer or guarantor becoming insolvent.

Capital protection products

Types of capital protection

Some structured products offer capital protection. The level of this protection is fixed by the issuer when the product is issued and indicates the minimum percentage of the nominal value that will be repaid to the investor on expiry.

However, capital protection only applies at the end of the term and may, depending on the product conditions, be less than 100 % of the invested capital. Only financial instruments offering 100 % capital protection guarantee that the investor will receive the full nominal value on expiry.

The accepted standard in the structured products market is that a financial instrument can be described as a capital protection product if it offers at least 90 % protection. If it is lower, the term "minimum repayment" is normally used, and the instrument is classified as a yield enhancement or participation product.

In a capital protection product with participation, the buyer participates in any further rise in the market price of an underlying once it reaches the strike price.

In a barrier capital protection product, the buyer participates in any further rise in the market price of an underlying once it reaches the strike price up to a barrier. If the price rises above the barrier, the value of the product drops back to the capital protection level. The investor receives a coupon (rebate) instead of the participation.

In a capital protection product with coupon, a regular coupon is paid out once the strike price is reached. The level of the coupon depends on the performance of the underlying.

How capital protection products work

Structured products with capital protection normally consist of two elements, such as a fixed-income investment, typically a bond or a money market investment and an option. A fixed-income investment has a specific term and pays interest on specific dates. Examples include bonds and money market investments. This combination allows the investor to participate in the performance of one or more underlyings through the option or participation component, while the capital protection limits the loss risk. The capital protection only covers part of the nominal value, but it defines the minimum repayment the investor receives on expiry, regardless of how the participation component performs.

Capital protection and nominal value

The capital protection is linked to the nominal value rather than the issue price or purchase price. Hence, if the purchase /issue price the investor pays exceeds the nominal value, only the nominal value is capital-protected. The protection of the investor's capital outlay drops accordingly. Conversely, if the purchase / issue price is less than the nominal value, the protection rises accordingly.

The capital protection component can be less than 100 % of the capital invested, depending on the financial instrument. Capital protection does not therefore mean 100 % repayment of the nominal value or capital outlay for all financial instruments. Structured products with capital protection may yield a lower return than a direct investment in the underlying, because the protection comes at a cost.

An investor wishing to sell a structured product with capital protection before it expires may receive less than the value of the capital protection component, as the protection only applies if the product is held until the expiry date.

Participation component

The participation component determines the extent to which an investor can profit from the performance of the underlying(s). In other words, it fixes the level of the potential return over and above the capital protection component. Some structured products with capital protection offer only a limited potential participation (those with a cap); some (those without a cap) offer unlimited potential participation. Others require the market value of the underlying to touch, rise above or fall below a specific barrier before a profit can be made.

The risk on the participation component is the same as that on the corresponding option or combination of options. Depending on the movements in the market value of the underlyings, the participation component may be zero.

Special risks

The maximum loss on a structured product with capital protection is limited to the difference between the purchase price and the capital protection, provided the product is held until expiry. Capital protection offers no protection against issuer risk (risk that issuer will become insolvent). This means that if the debtor of a structured product becomes insolvent, some or all of the capital invested may still be lost.

Yield enhancement products

How yield enhancement products work

Structured products with yield enhancement normally consist of two elements, such as a fixed-income investment (see above) and an option – normally on equities or currencies. This combination allows the investor to participate in the performance of one or more underlyings up to a cap, through the option component. However, with yield enhancement products the minimum repayment is either absent or conditional, and they normally bet on underlyings trending sideways or slightly upwards. The interest paid or discount on the issue price offers the investor a higher return than on a direct investment if the price of the underlying remains essentially unchanged. On the other hand, the investor will not benefit from the full potential return of the underlying.

If the price of the underlying rises, the investor will receive the interest and nominal value paid out on expiry. There may also be provision for a discount on the issue price. If the market value of the underlying rises sharply, a direct investment may achieve a higher return. Conversely if it falls sharply, the investor receives a cash settlement or delivery of the underlying on expiry, and so will also participate in the negative performance of the underlying. However, the loss incurred is reduced by the interest payment received during the term of the product, unless a discount was granted on the issue price.

Many yield enhancement products are based on more than one underlying and provide for the investor to participate in the negative performance of the worst-performing underlying on expiry, if the underlying touches, rises above or falls below a predetermined barrier during the term.

Yield enhancement with barrier and cap: As long as the barrier is never touched, the maximum repayment (cap) or the nominal value plus a coupon is repaid. If the barrier is touched, the product is converted into a pure cap product.

Yield enhancement with cap: Once the strike price is reached, the maximum amount (cap) is repaid. Up to that level, the risk of loss compared with the underlying is reduced by the payment of a coupon or grant of a discount.

Special risks

EIf the performance of the underlying is unfavourable, the financial instrument can trade some way below the issue price during its term even if the barrier has not yet been touched, exceeded or undershot. The level of interest is directly linked to the level of the barrier, the number of underlyings and the term of the yield enhancement product. The nearer the barrier is to the market price of the underlying on the day of issue, the higher the interest the investor will normally receive. However, this also entails the risk of the barrier being reached.

In the worst case, the entire capital invested in a yield enhancement product may be lost.

Participation products

How participation products work

Structured products with participation enable the investor to participate in the performance of one or more underlyings. Often they have neither a profit ceiling nor capital protection. However, they may offer a conditional minimum repayment, in which case the risk is smaller than with a direct investment provided the market value of the underlying does not reach a specific barrier (termed the "knock-out").

If it touches, rises above or falls below the barrier, the minimum repayment is forfeited. The repayment is then dependent on the performance of one or more underlyings.

Classical participation: The investor participates 1:1 in the performance of the underlying.

Participation with barrier: The investor participates in the performance of the underlying with minimum repayment until the barrier is reached, at which point the product is converted into a classical participation product.

Participation with outperformance: The investor participates 1:1 in the performance of the underlying until the strike price is reached. Thereafter, they participate disproportionately in the positive or negative performance of the underlying.

Special risks
Some financial instruments with participation are based on more than one underlying and provide for the investor to receive the security with the worst (or sometimes best) performance on expiry. The underlying is delivered or a cash settlement is paid if the underlying touches, rises above or falls below a predefined barrier during the term of the financial instrument. The financial instrument can trade some way below the issue price during its term even if the barrier has not yet been touched, exceeded or undershot. Moreover, the level of participation is directly related to the level of the barrier. An investor who has accepted a higher level of risk when choosing the barrier will participate with a larger amount.
In the worst case, the entire capital invested in a structured product with participation can be lost.

Investment products with a reference entity
How reference entity certificates work
Investment products with a reference entity are referred to as reference entity certificates. Normally they are variants on a conventional capital protection, yield enhancement or participation product with the basic structure extended to include an additional reference (corporate or government) bond. Repayment depends in particular on the non-occurrence of a credit event involving the reference entity, as defined in the relevant product description. In the absence of such an event, reference entity certificates work in the same way as comparable capital protection, yield enhancement or participation products. Owing to the additional risk, these products offer better conditions, such as higher coupons.
If a relevant credit event occurs, the financial instrument may fall due and be repaid before expiry. The repayment amount is related to the credit event, and may be zero.

Special risks
The risk of a reference entity certificate depends not just on the normal risks of comparable capital protection, yield enhancement or participation products and the issuer risk, but also on the creditworthiness of the reference entity. In the worst case, the entire capital invested can be lost.

Special risks of credit-linked notes (CLNs)
Credit-linked notes (CLNs) are bonds whose repayment and interest payment depend on the performance of a specific underlying or reference portfolio – such as a loan or bond. Particular attention should be paid to the creditworthiness of the debtor to which the CLN is linked, as a credit event may render it worthless.
There is an issuer risk (risk of the issuer of the financial instrument becoming insolvent), i.e. a credit risk of the issuing bank, just as with other structured products. There is also a leverage effect on fluctuations in the underlying and the creditworthiness of the issuer during the term. The secondary market for CLNs has limited liquidity, which may make it impossible for the investor to sell the CLN before the end of the term.

DISCLAIMER

This information sheet contains an extract from the brochure “Risks Involved in Trading Financial Instruments” published by the Swiss Bankers Association (SBA), the complete version of which can be consulted at www.swissbanking.org or on the Bank’s website (www.corner.ch).

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