Chapter 2 Lehman Brothers-related Minibonds and structured financial products sold in Hong Kong

2.1 This chapter describes the impact of the collapse of LBHI and its group of companies (collectively referred to as LB) on retail investors in Hong Kong holding outstanding LB structured products.

The collapse of LB

2.2 The collapse of LB in September 2008 dealt a severe blow to the economic development and financial stability worldwide. The ensuing financial tsunami has often been described as a "once-in-a-century" crisis. In the first three quarters of 2008, some form of rescue or bail-out action had been taken out by the US government and other Wall Street institutions in respect of certain troubled financial institutions such as Bear Stearns and American International Group. However, such has not been the case for LB.

2.3 Founded in 1850, LBHI was the fourth largest investment bank in US. In June and July 2008, the credit ratings of LBHI were lowered by major credit-rating agencies. On 15 September 2008, LBHI filed for bankruptcy protection under Chapter 11 of US Bankruptcy Code. This also triggered insolvency proceedings against LB subsidiaries in other jurisdictions. Here in Hong Kong, eight LB companies were put into liquidation, including Lehman Brothers Asia Limited (LBAL) which was the arranger for a number of LB structured products sold in Hong Kong, including Minibonds.

Local investors' exposure to LB structured products

2.4 The Subcommittee has noted from the HKMA Review Report that local banks' direct exposure to LB was insignificant. The aftermath was mainly manifested in terms of individual investors' exposure to the credit risk of LB through their purchase of LB structured products distributed by banks and securities brokers[1]. According to the information in the HKMA Review Report, over HK$20.23 billion worth of outstanding LB structured products had been sold to more than 43 700 investors[2] in Hong Kong through retail banks. The banks which distributed LB structured products are at **Appendix 2(a)**. The major categories of LB structured products that remained outstanding at the collapse of LB and the number of affected investors are in **Appendix 2(b)**.

2.5 It is noted that among the LB structured products affected by the failure of LB, the Minibonds issued by Pacific International Finance Limited (PIFL), the credit-linked notes issued by Constellation Investment Limited and a wide range of other LB structured products distributed through private placement accounted for a significant number of affected investors and investment amount. For example, some HK$11.2 billion in value of Minibonds had been sold to over 33 000 investors. About HK$6.2 billion worth of various LB structured products distributed by way of private placement were held by customers in 6 130 bank accounts[3]. The major distributing banks of these products are at **Appendix 2(c)**.

[1] According to the information published by SFC, the following brokers also distributed LB-related structured financial products to their customers: Core Pacific-Yamaichi International (H.K.) Limited, Grand Cathay Securities (Hong Kong) Limited, Karl Thomson Investment Consultants Limited, KGI Asia Limited and Sun Hung Kai Investment Services Limited.

[2] Please see footnote 1 of Chapter 1.

[3] Please see footnote 1 of Chapter 1.

Minibonds

2.6 Minibonds was the name for over 30 series of credit-linked notes issued by PIFL[4] under its Secured Continuously Offered Note Programme and arranged by LBAL for distribution in Hong Kong. PIFL issued Minibonds Series 1 to 36[5] from 2002 to 2008. Sun Hung Kai Investment Services Limited (SHKIS) was the co-ordinating distributor for Minibonds in Hong Kong. Minibonds were distributed by 16 retail banks[6] and several securities brokers including SHKIS.

2.7 Minibonds were unrated structured debt instruments linked to the credit of a basket of six to eight reference entities, mostly well-known listed corporations. The proceeds from the sale of Minibonds would be used by the issuer to purchase collateral which would be held by a trustee for the benefit of the note-holders subject to the terms of the relevant notes. Such collateral must meet certain criteria as specified in the relevant prospectus, e.g. AAA-rated. At the time of subscription for the Minibonds, the particulars of the collateral were not known to the investors. The collateral held by a trustee was segregated for each series. For the earlier series (up to Series 9), the collateral comprised debt obligations of Lehman Brothers Treasury Co. B.V. (LBTC) while the collateral for later series (from Series 10 onwards) were AAA-rated collateralized debt obligations (CDO)[7]. For most series, the issuer also entered into swap arrangements with a swap counterparty, which was also

[4] PIFL was a special purpose vehicle set up for the sole purpose of issuing the series of credit-linked notes known as Minibonds.

[5] Series 4, 13, 14 and 24 were not offered for various reasons. At the time when LBHI filed for bankruptcy, Series 1, 2 and 3 had matured and Series 8 had been the subject of an early call by the issuer.

[6] Except CHKL, DBSHK and SCBHK, the remaining 16 banks listed in Appendix 2(a) distributed Minibonds.

[7] CDOs are a type of structured asset-backed security whose value and payments are derived from a portfolio of fixed–income underlying assets. CDOs are assigned different risk classes, or tranches, whereby "senior" tranches are considered the safest securities. Interest and principal payments are made in order of seniority, so that junior tranches offer higher coupon payments (and interest rates) or lower prices to compensate for additional default risk.

an LB entity, whose obligations were in turn guaranteed by LBHI. The swap arrangements included interest rate and/or currency swaps.

2.8 Note-holders would receive from the issuer periodic payments of interest and at maturity, the repayment of principal if no credit event or early redemption event had occurred during the tenor of the notes. Credit events normally included situations where an entity in the basket of reference entities became insolvent or unable to meet its specified obligations. Early redemption would occur where the swap arrangements were early terminated and in such event the collateral would be sold to effect early redemption payment. The interest payable varied from series to series but was generally above the HIBOR/LIBOR prevailing at the time of issue. This was made possible by means of a credit default swap (CDS)[8]. In effect, the holders of Minibonds were insuring the issuer against the likelihood of a credit event happening to the reference entities, in return for payment of coupon by the issuer.

2.9 In order to meet its obligations to note-holders, the issuer would have to rely on receiving from the swap counterparty money or securities due under the terms of the collaterals. Since the swap counterparty was an LB entity and the swap guarantor was LBHI, the insolvency of LB meant that the issuer would not receive what was due to it under the swap agreements and would in turn default in respect of its obligations to the note-holders.

2.10 The insolvency of LBHI constituted a termination event under the swap arrangements entitling the issuer to terminate the swaps and triggering early redemption of the Minibonds. In the event of an early

[8] A CDS is a swap designed to transfer the credit exposure between parties. As to the CDS arrangements of Minibonds, the issuer will pay to the swap counterparty a sum equal to the interest receivable by the issuer in respect of the collateral. The swap counterparty will pay the issuer an amount equal to the interest due on the Minibonds which the issuer uses to pay to the note-holders. Upon the occurrence of a credit event to a reference entity, the issuer will deliver the collateral to the swap counterparty and the swap counterparty will then pay the issuer an amount equal to the market value of debt obligations of the reference entity in respect of which the credit event was occurred.

redemption of the Minibonds, the recourse of the note-holders would be limited to the proceeds of realization of the collateral (net of costs and expenses) which could be less than the principal amount invested.

LB-related Constellation Notes

2.11 LB-CLNs were a series of credit-linked notes issued by Constellation Investment Limited under its Limited Recourse Secured Note Programme and arranged by DBS Bank Limited, in which LBHI was one of the reference entities. The failure of LBHI constituted a credit event under which each of the relevant series of LB-CLNs had to be redeemed at its credit event redemption amount. This was calculated by reference to, among others, the price of a specified reference obligation of the reference entity that had suffered the credit event. Considering the results of the Lehman Credit-Swap Auction in October 2008, which indicated a value in the region of eight to 10 cents on the dollar for LBHI debt, the value of any such reference obligations would likely be substantially less than the principal amount of the LB-CLNs.

LB structured products distributed through private placement

2.12 In addition to the above products which were distributed through "offers to the public", a variety of other LB structured products with an aggregate nominal value of HK$6.2 billion were distributed by banks through "private placement" to over 6 000 customers. The Subcommittee has examined the termsheets of some of these products which were more widely sold to investors[9]. Most of them were non-principal protected ELNs issued by LBTC under its Euro Medium

[9] For example, the Lehman Brothers 1 Year USD Daily Accrual Coupon Auto-call Note with Daily Knock-In – Series 10 linked to PetroChina (0857.HK) and China Life Insurance (2628.HK) distributed by CHKL, the Lehman Brothers 1-Year HKD All Weather Coupon Daily Callable ELN – Series 17 (390+1800) distributed by SCBHK, and LB 2-Year HKD Index Bonus Fixed Coupon PPN – Private Placement (LMP0017) – Mini PPN distributed by DSB.

Term Note (EMTN) Programme, and guaranteed by LBHI. They were unrated structured notes with a tenor usually not exceeding two years. Unlike Minibonds, these LB-ELNs were not secured by any distributable collateral.

2.13 The Subcommittee notes that the return on these notes was linked to the performance of a basket of exchange-traded shares. The interests payable usually consisted of a "fixed" interest for the first month of the tenor and a "variable" interest for the remaining months calculated with reference to the prices of the shares in the basket. It is not uncommon that a fixed interest exceeding 30% per annum was payable for the first month, while a relatively lower rate of variable interest was payable in subsequent months depending on the prices of the shares in the basket. Under specified circumstances, including the occurrence of a "Knock-In" Event[10], the note-holder would end up receiving the physical shares of the worst performing stock in the basket upon maturity of the LB-ELN, in addition to the coupon already received. The note-holder would incur a loss of the principal amount if the market price of the worst performing stock fell significantly.

2.14 It should be noted that the repayment of principal upon early redemption of the LB-ELN, or the delivery of the worst performing shares or the repayment of principal at maturity to the investors, was provided by the issuer/guarantor and therefore subject to their credit risk. In other words, investors had taken on the risk of the issuer/guarantor's failure to fulfil their obligations under the LB-ELN in question. In the event of insolvency of the issuer/guarantor, any amounts owed under the notes would become unsecured claims that would be paid, if at all, only after all secured claims had been settled in the amount allowed by the US bankruptcy law. In the circumstances, note-holders of such products would not be able to recover much of their investments upon the

[10] A "Knock-In" Event is deemed to have occurred if any one share in the reference basket closes at or below its lower barrier price (knock-in price) on any scheduled trading day from the issue date to the final valuation date.

insolvency of the issuer or guarantor. At the time of preparing this report, LBTC was in insolvency proceedings in the Netherlands[11]. LBHI, which had filed for bankruptcy protection in US in 2008, announced on 6 March 2012 that it had emerged from bankruptcy and would commence distributions to creditors on 17 April 2012[12].

2.15 The Subcommittee was aware that some principal-protected LB-related notes were linked to the performance of market indices such as the Hang Seng Index and the Nikkei 225 Stock Average Index. Similar to the non-principal protected ELNs, they were issued by LBTC under the EMTN Programme and guaranteed by LBHI. Investors had likewise assumed the risk of the default of the issuer/guarantor in respect of their obligations. It is noted that the description of "principal protection" mainly specifies the need for note-holders to hold the notes until maturity to benefit from full repayment of principal.

Other LB structured products

2.16 The Subcommittee has noted that in addition to the major types of products described above, the collapse of LBHI also resulted in the default of LB in respect of its obligations in respect of certain series of Pyxis Notes and ProFund Notes. It also constituted a credit event leading to the early termination of certain outstanding series of Retail-Aimed Callable Investment Notes and Octave Notes with LBHI as one of the reference entities.

[11] Information about the progress of the insolvency proceedings is published by the Bankruptcy Trustees of LBTC through public reports that are available on the website at http://www.lehmanbrotherstreasury.com.

[12] The LBHI's announcement dated 6 March 2012 is available on the website at http://www.lehman.com.

Offering documentation of LB structured products

2.17 The relevant prospectuses of Minibonds and other LB structured products expressly stated that these products were not suitable for all investors. For example, the issue prospectus of Minibonds Series 35 and LB-CLNs Series 34 stated respectively that the products were "not suitable for everyone" and "not suitable for inexperienced investors". They were suitable for investors who were looking for fixed rate quarterly interest income, as well as confident that none of the reference entities would be affected by a credit event, and who were willing to accept the risk that the notes were not principal protected, and that the credit event redemption amount or early redemption amount received by them could be significantly less than the principal amount of the notes. It was also stipulated in the terms and conditions of most LB-ELNs offered by way of private placement that investors should ensure that they had the knowledge, experience and expertise in financial and business matters necessary to enable them to understand and evaluate the risks associated with the products. Investors were also asked to consider carefully whether the products were suitable for themselves in the light of their experience, objectives, financial position and other relevant circumstances. The Subcommittee notes, for example, that according to the terms and conditions of a two-year LB-ELN distributed by RBS[13], the product was "not suitable for inexperienced purchasers". It is stated in the Base Prospectus of the EMTN Programme that "prospective investors should read the entire Base Prospectus" which comprises over 200 pages in English. Apparently, LB structured products including Minibonds were suitable for the more sophisticated investors with experience and knowledge in structured financial products, and who were able to tolerate the various risks associated with the products.

[13] Lehman Brothers 2-Year USD HK Basket (0857.HK+0883.HK+3328.HK) Daily Accrual Callable Equity Linked Note with Daily Knock-In Put

Observations

2.18 The Subcommittee is aware that structured financial products generally refer to products which, in addition to the credit or default risk of the issuer (or guarantor, where applicable), contain an exposure to an underlying asset, opportunity or risk that is usually unrelated to the issuer or the guarantor. In effect, a person investing in structured financial products is relying on a pre-determined formula or occurrence of events described in the prospectus to be paid the return promised. The LB structured products described in the foregoing paragraphs are but some examples of structured financial products, which were offered to tens of thousands of retail investors in Hong Kong from about 2003 to 2008.

2.19 Taking the example of Minibonds and its product structure which had evolved over time, there is no doubt that retail investors needed to understand quite a number of matters, notably the collateral securing the product, special financial arrangements involving CDOs and synthetic CDOs, swap arrangements and CDS etc. The risk implications of various LB entities taking up the roles of arranger, swap counterparty and swap guarantor in the structure of the product and the consequences of any default in their respective obligations might also not be readily comprehensible. Some other LB structured products, though not involving any underlying collateral, were linked to the performance of various underlying assets. For example, the ELNs issued by LBTC and distributed by banks through private placement were linked to a basket of listed stocks. The investors would need to understand that the payout to them was to be determined with reference to certain price levels (e.g. strike price, call price, lower barrier price etc.) of the shares linked to the notes. The Subcommittee considers that retail investors who were not conversant with financial market products could hardly understand without investment advice the structure of Minibonds and other LB structured products and their related risks.

2.20 Although the relevant offer documents of the LB structured products expressly stated that they are not suitable for everyone and are only appropriate for the more experienced and knowledgeable investors, the Subcommittee has noted with concern that more than 43 000 investors in Hong Kong had invested over HK$20 billion in such products and incurred heavy losses as a result of the collapse of LB. The Subcommittee is also concerned that a large number of these investors, who had purchased the LB structured products through banks, alleged that they did not have the requisite experience with or knowledge of the products they had purchased, contrary to what was specified in the prospectuses and other offer documents.