

Structured Products - Booking

There is a huge variety of structured products, but most of them have in common that the repayment of the investment is not necessarily done in cash, but with the delivery of securities. We could take as an example the Multiple Barrier Reverse Convertible whose attractiveness cannot be denied. The interests paid are quite higher than those of a regular bond and the repayment is done to 100% with a fairly large probability. However, if the repayment is done as a delivery of securities, the realized loss can be massive, as shown in the following example.

Regarding the securities' accounting, one basic rule is to be remembered: the repayment must be booked at the market value of the received securities. This principle is illustrated in the following example.

Example

Let's see the example of the multiple barrier reverse convertible "10 ¼ % Equity Yield Notes Credit Suisse". This asset has various securities as underlyings. A rule will determine if the repayment will be done in cash (100%) or with the delivery of securities (which ones and which quantity). The basic rule is that the repayment is done in the form of delivery of securities if at least one of the underlyings reaches a lower price than a predefined "barrier".

We bought for CHF 100'000 of this reverse convertible on the 25th of January 2007 with a price of 100%, which we have booked normally, resulting in a book value of CHF 100'000.

On January 25th we receive the interest payment of CHF 10'250. The repayment is done in a cash part for the amount of CHF 674.35 and the delivery of 1'160 "Credit Suisse Group CHF 0.04" stocks. On that date the stock had a price of CHF 56.55.

Booking

On January 25th we first book the interests of CHF 10'250, then the repayment in cash of CHF 674.35. This second transaction will reduce the book value of our position to CHF 99'325.65. We also received as a repayment 1'160 "Credit Suisse" stocks for a market value of CHF 65'598 (= 1'160 x 56.55). We want to book the repayment with this amount, resulting in a realized loss of CHF 33'727.65! Here are the steps to follow:

- We book the delivery of the 1'160 "Credit Suisse" stocks with the price of CHF 56.55, with a final settlement of CHF 65'598.
- We book the repayment of the reverse convertible for the amount of CHF 65'598, corresponding to the market value of the received stocks. This transaction results in a realized loss of CHF 33'727.65 on the account for "realized losses on structured products".

Performance

This way of booking the repayment of the multiple barrier reverse convertible leads us to a performance of -23.48%, perfectly reflecting the relatively low value of the repayment. If the received stocks were to be resold immediately to the market price, the performance of the stocks would be of zero, as it logically should be.

Mistakes to avoid

The repayment of the reverse convertible should under no circumstances be booked to 100% and the delivery of the "Credit Suisse" stocks with the amount of CHF 100'000. There would then be no realized loss on the reverse convertible, it would rather be booked as a loss on Swiss stocks by a reevaluation or the sale of the "Credit Suisse" stocks, which doesn't correspond to the reality at all. By booking the reverse convertible this way, a performance of +10.25% would be generated and if the stocks were to be resold immediately to the market price, they would have a performance of -34.40%!

The performance of the derivative products would therefore be massively overestimated and the one of the stocks underestimated, which could result in false investment decisions.