

Behind The News - Structured Notes: Who's at Fault?

Arbitration panels are ruling on complaints from investors that banks' failure to apprise them of the risks caused them to incur heavy losses.

BY PETER CHEN

The bankruptcy of Lehman Brothers in September 2008 triggered the default or early redemption of numerous credit-linked "structured notes"; after the financial tsunami had rendered them worthless or greatly reduced their value. Around the world — Taiwan included — investors in those products suffered heavy losses.

Structured notes are a type of debt instrument whose value is based on an underlying derivative product rather than on fixed rates for periodic payout. The underlying derivative product could be a single asset or a basket of assets such as securities, options, foreign currencies, and commodities, or indices such as the S&P 500. Structured notes are issued by corporations, financial institutions, and government-sponsored entities, typically as bonds or debt notes. The price movements of the derivative asset or index allow investors to hedge the secured notes against the market value to receive larger returns on the investment.

In theory, any investor can engage in these complex investments, but most are deterred by the high transaction costs and volume requirements. Structured products offer an alternative to direct investment by allowing the investor to invest in a wider range of financial products that offer the potential of higher return.

With greater return potential comes greater investment risk, however. "Structured notes involve a high level of sophistication and institutional expertise," explains Norman Yin, director of the Center for Asia Pacific Monetary Studies at National Taiwan Chengchi University. They "should not be sold to unsophisticated investors who do not comprehend their nature and risk."

According to the government's Financial Supervisory Commission (FSC), more than 50,000 Taiwanese invested more than NT\$42 billion (US\$1.25 billion) in structured notes issued by Lehman Brothers alone. The bulk of the holdings — approximately NT\$40 billion (US\$1.21 billion) worth — were by 20 domestic banks.

The collapse of Lehman and other investment houses, and the subsequent devaluation of their structured notes, stirred a strong response from worried individual Taiwanese investors. Many of them resorted to street protests, accusing the banks of misconduct for selling the notes and complaining that the government was siding with the banks. Typically, the protestors asked for repayment of at least 50% of their investment capital and called for the resignation of FSC Chairman Sean Chen.

Over the winter, the FSC took a series of initial actions, requiring banks to 1) take the initiative to contact customers, 2) assist customers in filing claims, and 3) establish phone lines to field questions from the public. Later, the FSC classified disputes involving structured notes into nine categories and issued a set of principles on how banks should handle investor complaints falling into one or more of those categories. The FSC thus placed the burden on the banks to take the initiative to settle complaints filed by investors, especially in cases where the banks had failed to fully disclose the attendant risk, concealed the risks, or otherwise misled investors.

To ensure speedy resolution of disputes, the FSC carried out what it termed "special examinations" of banks that were involved in an especially large number of disputes or that sold a notably large quantity of structured notes. Were such banks to resolve "an unreasonably low percentage" of disputes falling within the nine categories, the FSC indicated that it would reject any application from the bank regarding its other business operations. To expedite the resolution process, the FSC also established a special task force to inspect the banks' dispute-handling procedures.

For demands from disgruntled investors for compensation over NT\$1 million, the complaints are received by the FSC's Banking Bureau. Demands for compensation under NT\$1 million are processed by the Securities and Futures Investors Protection Center if they originated from Lehman products, and by the Bankers Association of the Republic of China for non-Lehman products. After satisfying the initial filing requirements, all complaints are reviewed and ruled upon by an arbitration panel of three members selected from among a pool of scholars, industry experts, and third-party analysts. The Bankers Association's Committee on Banking Consumer Disputes Resolution is responsible for establishing the panels and coordinating the hearings.

According to the China Economic News Service, the rate of compensation is determined by what the panel deems to be the degree of seriousness of error committed by the banks in selling the structured notes. There are five levels of error — "serious," "high," "medium," "low," and "none." An example of serious error would be the forging of signatures on contracts by bank staffers; a low level might be insufficient thoroughness in executing the internal customer policy or the sale of structured notes to unsuitable customers.

Investors who disagree with the arbitration panel's ruling may seek additional remedy through the courts. Banks, however, are bound by the decisions of the panel, though they may settle with investors prior to the hearing or arbitration panel's ruling.

As of June 26, the Bankers Association had received 20,529 complaints, and the arbitration panel had issued rulings on 446 cases. Independently, the banking industry had reached settlement agreements with investors in roughly 5,000 cases out of more than 8,000 requests for compensation.

Of the arbitration rulings, 77% awarded compensation to the investors for their structured-note losses, but the average compensation was only 16% of the original investment amount. The highest level of compensation in any case was under 60% of the original investment.

In a limited number of cases, banks have agreed to purchase structured products back from investors. Standard Chartered, for example, announced that it will buy back from Taiwan investors all structured products that it sold as an agent for the PEM Group, and will press claims against PEM for compensation. PEM was investigated by the U.S. Securities and Exchange Commission and preliminarily found to have engaged in fraudulent conduct.

In an interview with the Taipei Times, Kevin Yeah, head of the Structured Notes Self-Salvation Organization (SNSSO), indicated that the investor group will refuse to recognize any decisions handed down by the Bankers Association until an arbitration committee is set up directly under the auspices of the FSC, with investor representatives able to be present at the proceedings. Further, the organization maintains that the compensation paid by the banks should exceed 50% of the original investment. SNSSO asserts that the banks tricked investors into buying structured notes and then took an average of 20% profit from the proceeds.

Investors have also pointed to the compensation levels in Hong Kong and Singapore as a basis for complaining about the Taiwan arbitration panel's rulings. In Hong Kong, banks bought back Lehman notes at market value, with investors receiving between 30% and 50% in compensation. In Singapore, investors in structured notes have received an average of about 50% in compensation.

Aside from the compensation levels, the regulatory actions taken in Taiwan, Singapore, and Hong Kong have been similar. In Hong Kong, after investigating investor complaints of misconduct in the sale of the notes, the authorities established an independent panel to mediate with the banks. Singapore conducted formal inquiries into allegations of breaches of the law and poor business practices by financial institutions or their representatives. The Central Bank of Singapore banned 10 financial institutions from selling structured notes for between six months and two years after concluding that the institutions were non-compliant in their notices and guidelines in the sale and marketing of notes linked to Lehman Brothers.

The 10 institutions are ABN Amro, DBS Bank, UOB Kay Hian, Malayan Banking Bhd., DMG & Partners Securities, CIMB-GK Securities, Kim Eng Securities, OCBC Securities, Phillip Securities, and Hong Leong Finance. The Monetary Authority of Singapore found that these institutions had omitted risk ratings and warnings in the prospectus and pricing statements, had not properly trained service representatives prior to marketing and selling the structured notes, and had failed to ensure that sales agents had updated and complete information about the products.

In Taiwan, the FSC has taken steps to investigate and examine allegations of bank misconduct. It has also adopted regulations to govern future sales of structured products. Under the new regulations, investors are now categorized based on their professional or personal status and level of investment sophistication, with the level of sales requirements on the banks differing accordingly. In addition, sellers of structured products are now required to provide a 100% guarantee to protect the principal if held to maturity, and are also required to maintain an on-shore presence in Taiwan. A proposed requirement that foreign banks park 70% of the proceeds from the sale of structured notes with Taiwanese trust banks was scrapped after financial institutions argued that the rule would effectively shut down the structured-product market in Taiwan.

The banking industry has been low-key in responding to the dispute-resolution process and new regulations. Most banks contacted for opinions during the preparation of this report declined to comment. Understandably, with the structured-notes issue receiving a high degree of media and political attention, the banks wish to resolve the investor complaints quickly and quietly.

But financial industry members willing to speak out express concern that the new regulations risk overreaching, stagnating the already weak market for structured products in Taiwan. "Compared to other developed nations, Taiwan has a relatively more restrictive environment for financial investment," commented one foreign banker. In particular, he said, the principal guarantee requirement "shrinks the type of investment products that will be available in the retail sector and reduces the ability of investors to diversify the level of risks of their portfolios."

Godwin Chang, Chief Country Officer in Taiwan of Societe Generale, said he welcomes the on-shore presence requirement as it "promotes accountability" among the sellers of structured notes in Taiwan. In addition, he views the classification of investors and corresponding level of risk disclosure requirements as enhancing informed decision-making, which is "good for the investor and good for business."

On the other hand, academic experts such as Professor Yin criticize the regulations as "too little, too late." Yin says the government and industry were warned about the risks of structured products and lack of appropriate regulations as far back as the beginning of the decade, but did little to protect investors. "Part of the problem lies in the lack of expertise regarding structured notes at the investor, institution, and national levels," says Yin. Exacerbating the problem, he says, was the strong promotion of structured notes by local banks and financial managers who earned high commissions on the sales. He suggests that the banks took advantage of the lax regulations to engage in irresponsible, albeit legal, business practices.

Other financial experts share Yin's view that the general lack of expertise about structured notes was the core of the problem. "There is an insufficient level of mastery about the nature and risks of structured notes among the financial industry in Taiwan, let alone the common investors," says Steven Yang, a research division director at the Taiwan Institute of Economic Research (TIER).

Where then should the responsibility lie for the structured notes debacle? Was it mainly the fault of investors who dove into an investment scheme without fully understanding the risks, or of the banks for not sufficiently informing investors about the products before making a sale, or of the government for inadequate regulatory supervision?

From a legal perspective, it can be argued that the investors lack standing to seek compensation for losses resulting from the collapse of the issuers of structured notes. "The legal standard of dispute resolution requires a causal connection between compensation and claim," says Thomas McGowan, a partner in the international law firm of Russin & Vecchi. The causal connection in the structured notes compensation scenario appears weak, he contends, because "the banks that sold the structured products are not responsible for market deterioration or the decisions by the Lehman leadership that led to its fall."

McGowan adds that the "retroactive application of rules to earlier conduct" is troubling. While it is fair and reasonable to have rules on risk disclosure to protect investors, he emphasizes, the decision rests with the investors on whether to take the risks — and therefore it is legally unsound to now demand that banks compensate investors for their losses.

Despite the current controversy, experts interviewed for this article remain relatively optimistic about the long-term outlook for the structured products market in Taiwan. TIER's Steven Yang says that like the rules on other financial instruments, the regulations on structured products will gradually be adjusted to fit changing market conditions. Chang of Societe Generale, commending Taiwan for having "reacted relatively quickly to move along the impact of the structured notes trouble," says he is quite hopeful for Taiwan's financial investment market as regulations are fine-tuned over time.