

Dual Currency Deposits – Do You Know You Have Become The Insurer?

By Eng Tiang Chuan

Avoided like the plague during the financial crisis, structured products are reviving like green shoots after a long awaited rain. Dual Currency Deposits in particular, have been really popular. Depositors may not have understood the risks involved.



Structured products earned a bad name after the Minibond saga in 2008. Many investors were badly burnt during the worst financial crisis in living memory. Not all structured products are bad. However, a big number of investors did not understand the risks involved and were shocked to see their investments turn into waste paper during the crisis.

While some structured products are easily identifiable, others have been mistaken for having the low risk nature of plain vanilla deposits. Dual Currency Deposits (DCD) are highly popular yet greatly misunderstood. Numerous investors were shocked when told that their deposits had suffered huge losses along with the many other investments when they thought that deposits were supposed to be low risk. Many depositors went ahead with the deposits without realizing they have actually entered into a derivative contract.

A well-encountered sales pitch for DCD would typically emphasize the higher interest potential compared to a normal deposit. Attention on the scenario of currency con-

version is diverted away to the possible uses of the new currency, for example, using it for a holiday, paying for children’s education or for business. Not explained are the risks involved in this type of structured product.

By entering into the Dual Currency Deposit, the depositor has actually sold a Put-Option to the bank. There are different variations of the structure available. Before explaining how one type of DCD structure works, let’s take a look at the terms used in the structured products:

- **Put-Option** – A right, but not the obligation, to sell an underlying asset at a pre-agreed price at a pre-determined date.
- **Put-Option Seller** – The party that has sold the Put-Option. Has the obligation to buy the underlying asset at the pre-agreed price and date.
- **Put-Option Buyer** – The party who has bought the Put-Option.
- **Option Premium** – The price of the option.
- **Strike Price** – The pre-agreed price. In a DCD, the strike price is called the Strike Rate

or Conversion Rate which is the pre-agreed exchanged rate.

Put-option buyers generally have a bearish view or wish to protect their holdings. To protect the position, a put-option is bought and the option premium paid to the put-option seller. The put-option allows the option buyer to sell the asset at a pre-determined price (strike price) if the asset price drops as anticipated. The put-option seller, having collected the option premium, thus has the obligation to buy the asset from the option buyer at the pre-determined price.

In a DCD, the bank is the option buyer and the depositor is the option seller. The bank will typically sell the put-option bought from the depositor in the secondary options market or use it for internal hedging. If the option is sold in the secondary market, part of the option premium collected from the open market is passed to the put-option seller in the form of the higher interest. The bank takes the rest of the premium as earnings. If the option is used for internal hedg-

ing, the bank is able to buy the put-option cheaper than what is available in the market.

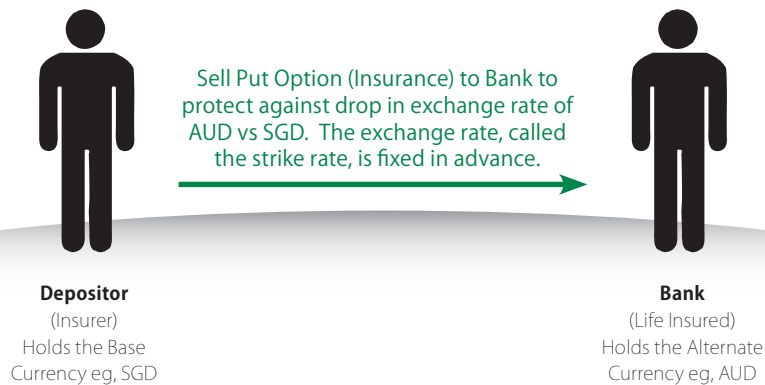
A simpler way of looking at the arrangement is through an insurance perspective. The put-option seller is the insurer. The put-option buyer is the insurance buyer looking for insurance protection (to protect his investment position). The insurance buyer (put-option buyer) pays an insurance premium (option premium) to the insurance company (put-option seller) for the insur-

ance contract (put-option).

When the option structure is applied to the DCD, the depositor becomes the insurance company who sells the insurance policy to the bank who is the life insured. In exchange, the bank pays an insurance premium for the protection. The insured event is the drop in exchange rate versus the base currency. When nothing happens, the depositor will pocket the insurance premium and pay out nothing. This is the best

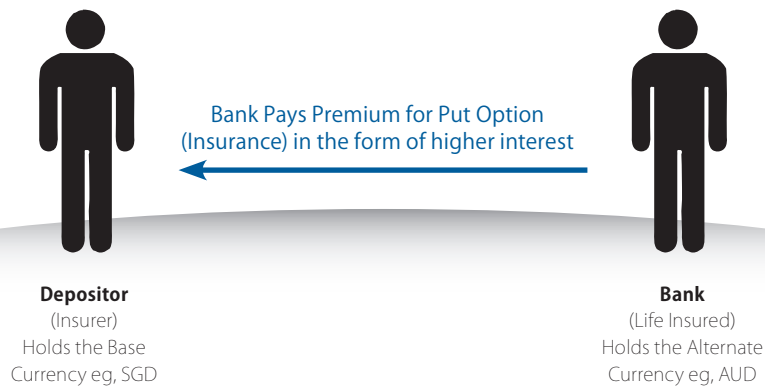
case scenario. However, if the insured event occurs, ie, the exchange rate of the alternate currency drops versus the base currency, the depositor has to pay the life insured the base currency (which is the stronger currency) and take the alternate currency (which is now the weaker currency). The exchange rate is the strike rate which is pre-determined. The following figures illustrate how the DCD works.

At The Start of Dual Currency Deposit



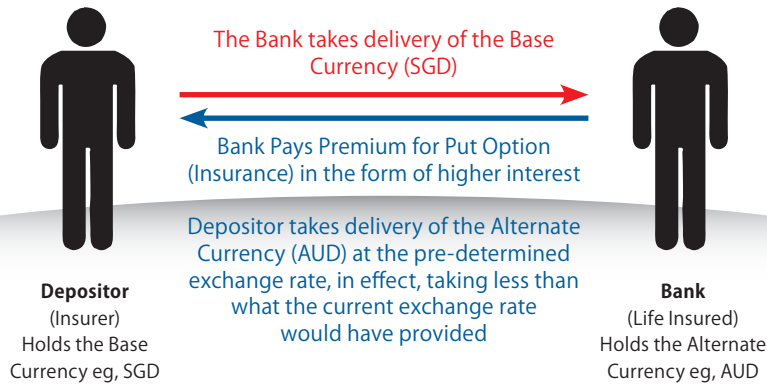
At Maturity of Dual Currency Deposit

Exchange Rate of AUD/SGD is **Above** Strike Rate
ie, AUD strengthen against SGD



At Maturity of Dual Currency Deposit

Exchange Rate of AUD/SGD is **Below** Strike Rate
 ie, AUD weaken against SGD



As many DCD depositors found out, currencies such as the Australian dollar dropped as much as 30% against the Singapore dollar during the crisis. Many depositors were converted to the weaker currency at easily 20% to 30% higher exchange rate, thus suffering big losses even after the higher interest rate.

There are a few points that DCD depositors have to take note:

- The depositor always receives the weaker currency (beyond the strike rate). Should the Alternate Currency (eg, AUD) appreciate against the Base Currency (eg, SGD), the depositor still holds on to weaker currency (SGD). In the event the Alternate Currency depreciates against the Base Currency beyond the strike rate, the depositor is left with the weaker Alternate Currency (eg, AUD).
- The exchange rate used for converting to the Alternate Currency is not the spot (current) exchange rate. The conversion takes place at a disadvantageous rate which was decided in advance. Depositors could suffer huge losses being forced to convert at the higher rate strike rate. In other words, the depositor can convert currencies at the current exchange rate which is much lower.
- With a DCD, the depositor effectively becomes an Insurer. Insurance works on the basis of risk pooling and law of large numbers

where risks are spread out. For the DCD Depositor, there is no risk pooling. He bears all the risks. A single big currency movement against him could cause huge damage.

- An equity investor is compensated with the upside by taking on the risk of downside movement. In fact, theoretically, there is unlimited upside (share price goes up and up) and limited downside (share price goes to zero). In the case of a DCD, for a limited upside (higher interest), the depositor takes on a much higher downside risks (huge currency movement). The depositor effectively becomes the Insurer for the currency fluctuations.
- When promoting the DCD, the relationship manager would typically emphasize the uses for the currency should there be a conversion. Is there really a need for the currency or is the 'need' just a marketing gimmick?
- Deposits are low risk savings. If the depositor needs or wants a low risk product, a DCD is definitely not for them.

Despite the lessons from the Lehman Minibond fiasco, Dual Currency Deposits are still aggressively peddled to depositors. Carrying an inappropriate name with the word 'Deposit', non-discerning depositors could again be making the same mistakes that

the Minibond holders made. Do not assume that there will be another round of compensations. Don't become an Insurer if you are not ready to be one. ■

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