

# Credit-linked note

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A **credit linked note** (CLN) is a form of funded credit derivative. It is structured as a security with an embedded credit default swap allowing the issuer to transfer a specific credit risk to credit investors. The issuer is not obligated to repay the debt if a specified event occurs. This eliminates a third-party insurance provider.

It is issued by a special purpose company or trust, designed to offer investors par value at maturity unless the referenced entity defaults. In the case of default, the investors receive a recovery rate.

The trust will also have entered into a default swap with a dealer. In case of default, the trust will pay the dealer par minus the recovery rate, in exchange for an annual fee which is passed on to the investors in the form of a higher yield on their note.

The purpose of the arrangement is to pass the risk of specific default onto investors willing to bear that risk in return for the higher yield it makes available. The CLNs themselves are typically backed by very highly-rated collateral, such as U.S. Treasury securities.

The Italian dairy products giant, Parmalat, notoriously dressed up its books by creating a credit-linked note for itself, betting on its own credit worthiness.

In Hong Kong and Singapore, credit-linked notes have been marketed as "**minibonds**" and sold to individual investors. After Lehman Brothers, the major issuer of minibond in Hong Kong and Singapore, filed for bankruptcy in September 2008, many retail investors of minibonds claim that banks and brokers mis-sold minibonds as low-risk products. Many banks accepted minibonds as collateral for loans and credit facilities.<sup>[1]</sup>

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## Example

A bank lends money to a company, XYZ, and at the time of loan issues credit-linked notes bought by investors. The interest rate on the notes is determined by the credit risk of the company XYZ. The funds the bank raises by issuing notes to investors are invested in bonds with low probability of default. If company XYZ is solvent, the bank is obligated to pay the notes in full. If company XYZ goes bankrupt, the note-holders/investors become the creditor of the company XYZ and receive the company XYZ loan. The bank in turn gets compensated by the returns on less-risky bond investments funded by issuing credit linked notes.