



Complexity Level of Financial Instruments

Introduction

Rating agencies have been assessing a wide range of financing instruments with varied characteristics and intricacies. During the last few years, the Indian capital market has witnessed a scenario of newer and innovative financial instruments/ issues being floated by the issuers. These instruments include structured bonds, asset/ mortgage-backed securities, convertible/ non-convertible debentures, etc.

In the context of the intricacies involved in the innovative instruments, the investors may not fully understand the implications arising out of the complexity involved in such instruments. In order to inform the investor about the complexity of such instruments, Acuite has categorised such instruments into three levels: Simple, Complex, and Highly Complex. Acuite's categorisation of the instruments across the three categories is based on factors like variability of the returns to the investors, ease of understanding and computation of the returns, uncertainty in cash flow patterns and their timings, number of counterparties, and general understanding of the instrument by the market.

It has to be understood that complexity is different from credit risk, and even an instrument categorised as 'Simple' can carry high levels of risk.

Simple Instruments

These instruments carry a high degree of certainty regarding their risk-return relationships and are reasonably well understood by investors and other market players.

Complex Instruments

These instruments typically have variable risk-return profiles, and the understanding of these instruments among market participants is lower vis-à-vis Simple instruments. These are mainly instruments with variable returns over time. The number of counterparties for such instruments can be more than one.

Highly Complex Instruments

These instruments are the highest in terms of complexity, and the understanding of their risk profile is usually more difficult than 'Complex instruments'. The cash flow, return, and maturity characteristics are variable in nature and often involve a large number of counterparties.

Classification of Instruments based on their Complexity

Corporate and Bank - Debt			
	Simple	Complex	Highly Complex
Bank Facilities	All	-	-
Fixed Deposits	Fixed Rate of Interest	-	-

Commercial Paper	Fixed Rate of Interest	-	-
Corporate Bonds and Non-Convertible Debentures	Fixed Coupon Rate	Fixed Coupon with Put/ Call Option	-
		Floating Rate Linked to Certain Benchmark Rate (With or Without Put/ Call Option)	
Convertible Debentures	-	Compulsorily or Optionally Convertible	-

Structured Instruments			
	Simple	Complex	Highly Complex
Structured Bonds/ NCDs	-	Backed by a Guarantee of the Govt/ Group Company	Partially-Guaranteed Bonds/ NCDs
Asset-Based Securities (ABS)	-	Fixed Rates	Floating Rates
		Backed by Specified Escrow of Cash Flows or Fixed Deposit	Linked to Certain Benchmark Rates Covered Bonds
Mortgage-Based Securities (MBS)	-	-	MBS With Reset of Rates
Pass Through Certificates (PTC)	-	-	Instruments Backed by ABS/ MBS
Collateralised Debt Obligations (CDO)	-	Single Asset	Multiple Asset

Bonds Structures for Pool Financing	-	-	Bonds Structured for Pool Financing
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Hybrid Instruments			
	Simple	Complex	Highly Complex
Lower Tier 2 Bonds	Fixed Coupon	Fixed Coupon with Features (Say a Put/ Call Option)	Floating Rate with Features (Say Put/ Call Option, Floors/ Caps)
		Floating Rate (Yield Linked to Benchmark)	
Hybrid Debt Instruments	-	Basel III Compliant Subordinated Debt Instruments	Innovative Perpetual Debt
			Upper Tier 2 Bonds
			Basel III Compliant Tier 1 Instruments
Other Hybrid Instruments	-	Separate Trading of Registered Interest and Principal Securities (STRIPS)	Security Receipts (Issued by Asset Reconstruction Companies)
			Principal Protected Market-Linked Debentures
			Equity-Linked Debentures
			Commodity-Linked Debentures

Equity & Preference Shares			
	Simple	Complex	Highly Complex
Equity Shares	Exchange-Traded Equity Shares	-	-
Preference Shares	-	Plain Vanilla	Perpetual Non-Cumulative Preference Shares (PNCPS)
		Cumulative Convertible Preference Shares	

Mutual Funds			
	Simple	Complex	Highly Complex
Debt Funds	Gilt Funds	Floating Rate Funds	-
		Monthly Income Plans	
	Liquid Funds		
	Debt Funds		
	Fixed Maturity Plans		
	Interval Funds		
Structured Mutual Funds	-		Capital Protected Fund-Leveraged

		Capital Protected Fund-Static Hedge	CPPI (Constant Proportion Portfolio Insurance)
		Arbitrage Funds	
			DPI (Dynamic Portfolio Insurance)
Mutual Funds- Equity and Others	Plain Equity Funds	Derivative Funds	Art Funds
		Fund Of Funds	
	Sector-Based Funds	International Funds	
		Special Situation Funds	
	Balanced Funds		
	Gold Funds		
	Exchange-Traded Funds		
	Index-Linked Mutual Funds		

Derivatives			
	Simple	Complex	Highly Complex
Equity Derivatives	-	Buying Index/ Stock Options (Long Position)	Selling Index/ Stock Options (Short Position)
		Index/ Stock/ Currency Futures (Buying and Selling)	

Commodity Derivatives	-	Commodity Futures	-
Foreign Exchange Derivatives	-	Simple Single Currency Forward Rate Agreement Without Any Features (Cap, Collar, Knock In, Knock Out, etc.)	Forward Rate Agreement with Customised Features
			Cross-Currency Forward Rate Agreements
			Currency Options
			Currency Swaps
Interest Rate Derivatives	-	-	Interest Rate Swaps
			Cross-Currency Interest Rate Swaps
Credit Derivatives	-	Credit Default Swaps-Protection Buying-Single Asset	Credit Default Swaps-Protection Selling-Single Asset
			Credit Default Swaps-Multi Asset (Both Buying and Selling)

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