



Complexity Levels: A global first from CRISIL

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Two decades of making markets function better

- Began in 1987 as a credit rating agency
- Rated more than 7,000 debt instruments of Rs.11.8 trillion (about USD 300 billion) issued by more than 4,200 companies
- CRISIL's objectivity and independence are widely recognised
- Introduced several new products, recent examples being:
 - IPO grading
 - Bank loan ratings under new RBI guidelines (Basel II)
 - Ratings of capital protection-oriented funds
 - Fund governance and process quality ratings for mutual funds
- Provides benchmarks for India's markets
 - S&P CNX Nifty and a host of other indices, through a JV with NSE
 - Standard benchmarks for valuing debt held by mutual funds

CRISIL Complexity Levels

Background: Increasing complexity concerns

- Indian Finance Minister Chidambaram
 - “I intend to move forward by taking some more measures to expand the market for corporate bonds. Hence, I propose **to...encourage the development of a market-based system for classifying financial instruments based on their complexity and implicit risks.**”
- US Treasury Secretary Paulson
 - “...Financial innovation has also brought, inevitably, the challenge of complexity. In my judgment, some financial products have become overly complex. **Excessive complexity is the enemy of transparency and market efficiency. Investor sentiment has swung hard to risk aversion, and now markets are punishing not only complex, but non-complex products as well.**”

Background: CRISIL Complexity Levels

- Increasingly complex instruments and products sold in Indian market, some even to retail investors
- Lack of widespread understanding of these products adds potential for large unforeseen losses
- An intuitive and easy-to-use classification will allow investors to gauge the sophistication required to understand such products

A survey across retail and institutional segments reveals that general awareness and understanding of complex financial products is shallow

- Complexity keeps retail investors out of several potential investment avenues
- There is significant variance across institutional investors with regard to their understanding of complex products

CRISIL's past initiatives to improve transparency around complexity

- Proactive efforts to highlight complexity:
 - Started differentiating structured ratings with '(so)' suffix in early 1990s. Global rating agencies and regulators are thinking about it now:
 - From the statement of the US President's Working Group (PWG) on Financial Markets (March 2008):

“The CRAs should reform their ratings processes for structured credit products to ensure integrity and transparency. The PWG welcomes the steps already taken by the CRAs, and **particularly encourages the CRAs to...make changes to the credit rating process that would clearly differentiate ratings for structured products from ratings for corporate and municipal securities**”
 - Introduced rating symbols to highlight non-credit risk such as equity price risk, and foreign exchange risk, in its ratings
- Detailed releases and reports issued with every rating, to alert the market to the dynamics of each rating and the factors driving credit quality

CRISIL Complexity Levels and what they convey

- CRISIL Complexity Levels reflect the ease of understanding and analysing the risk elements in financial products
- Three levels of complexity:
 - **Simple** - Most retail investors can understand the risk elements in a simple instrument and take investment decisions
 - **Complex** - Some level of sophistication is required to understand the risk elements in these instruments
 - **Highly complex** - Only the most sophisticated investors, deploying appropriate tools, can adequately understand the risk elements in these instruments
- A product that is simple is not necessarily less risky
 - For instance, equities can be highly risky, but this risk is widely known and relatively easy to understand

Coverage

- Initial coverage: 77 instrument types
 - 21 simple, 27 complex, 29 highly complex
 - Corporate debt (7 types), Securitised debt (11 types), Hybrids (16 types), Mutual funds (23 types), Derivatives (14 types)
 - Some examples:
 - Plain vanilla debt, balanced mutual funds (Simple)
 - Exchange-traded equity futures (Complex)
 - Equity-linked debentures, OTC cross-currency swaps (Highly Complex)
- The list will expand over time
- We will update the list every six months
- The complexity levels list will be available on the CRISIL website. Every CRISIL rating release and rating report will refer to the complexity of the instrument class being rated.
- Rating Lists will be published by complexity levels

CRISIL Complexity Levels: parameters for classification

- Ease of calculation of payout and returns
 - Determining the payouts for an equity-linked debenture requires considerably more effort than a similar exercise for a plain vanilla bond
- Clarity on timing of cash flows
 - Any uncertainty in cash flow timing will affect returns, and will need to be managed. For instance, prepayments on asset-backed or mortgage-backed securities expose investors to reinvestment risk, adding to the complexity of the investment process
- Number of counterparties involved in the transaction
 - The more the number of counterparties involved, the greater the complexity
- Familiarity of market participants with the instrument
 - An instrument type that has been in the market for some time is relatively easy for market participants to understand

Benefits for the market

- Investors, both retail and institutional
 - Retail investors can make a choice to restrict their investment portfolios to instruments and products that they can understand
 - Institutional investors can set up their investment decision processes in keeping with the complexity of the product being evaluated
- Issuers and financial Intermediaries
 - Deciding the target segment for each product, and directing selling efforts accordingly
 - Helps address the problem of mis-selling
- Regulators
 - Stipulating the maximum complexity levels for investment by a particular class of investors, for example pension funds or insurance companies
 - Addressing issues such as mis-selling

Some simple, complex and highly complex products

<p>Plain vanilla debenture with fixed coupon</p>	<p>Debenture with floating coupon</p>	<p>Debenture with floating coupon and put / call options</p>
<ul style="list-style-type: none"> • Predictable and easy-to-calculate cash flows • Single counterparty • Familiar and widely-used instrument 	<ul style="list-style-type: none"> • Cash flows timing known but quantum variable and needs to be calculated • Single counterparty • Less familiar than fixed coupon debentures 	<ul style="list-style-type: none"> • Cash flows timing uncertain and quantum variable • Single counterparty • Relatively new instrument type, market familiarity limited

Simple

Highly Complex

Some simple, complex and highly complex products

Sector fund	Fund of funds	Constant Proportion Portfolio Insurance
<ul style="list-style-type: none">• Quantum of cash flow uncertain but easy to calculate, risk widely understood• Familiar and widely-used instrument	<ul style="list-style-type: none">• Quantum of cash flow uncertain and not easy to calculate• Indian market not very familiar with the instrument	<ul style="list-style-type: none">• Complex investment mechanism, risks understood by very few people• Indian market not at all familiar with the instrument

Simple

Highly Complex



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