Complexity of Rated Instruments

Introduction

ACER Credit Rating Private Limited (ACER), a SEBI-registered credit rating agency, is committed to providing independent and transparent opinions on issuer and credit ratings. ACER's credit insights aim to empower investors, lenders, and businesses with opinions on ratings. It enables external stakeholders with informed decisions and fosters confidence in India's financial markets. With a clear vision to support India's economic growth story, ACER upholds the highest ethical and analytical standards, combining deep domain expertise, advanced analytics, and rigorous processes to ensure every rating is objective and insightful.

The Company reserves the right to amend this policy from time to time in accordance with regulations, circulars, and directives issued by the Securities and Exchange Board of India. This rating criteria will be reviewed annually.

This disclosure outlines ACER Credit Rating Private Limited (ACER) framework for classifying financial instruments on the basis of their complexity, credit risk, and key characteristics, including rate of return and redemption terms. The purpose of this framework is to ensure transparency, consistency, and clarity for investors, regulators, and other stakeholders regarding the nature, risk profile, and expected performance of financial instruments held or issued by the company.

The classification differentiates instruments into Simple, Complex, and Highly Complex categories, reflecting variations in structural features, cashflow predictability, embedded options, and associated risk levels. By linking instrument complexity with credit risk assessment, monitoring practices, and disclosure standards, ACER aims to strengthen risk governance, facilitate informed decision-making, and enhance market confidence.

Furthermore, this disclosure highlights the benefits of categorisation for all stakeholders, ensuring that investors, issuers, and market intermediaries have a clear understanding of the features, expected returns, and inherent risks of financial instruments, thereby supporting effective risk management and transparent market practices.

Simple Financial Instruments

Simple financial instruments are basic financial products with clearly defined terms and predictable cash flows, where the repayment method is simplified, such as periodic instalments, bullet repayment, etc., and the rate of return is fixed or benchmark-linked. These instruments have no embedded derivatives, complex triggers, or structured payoffs and are well-understood and widely used by market participants. The primary risks associated are credit risk, interest rate risk, liquidity risk, and market risk are easily identifiable and measurable.

Complex Financial Instruments

Complex financial instruments are financial products with features or structures that make cashflows non-linear, variable, or contingent on multiple factors. These instruments may include embedded derivatives, optionality, leverage, or structured payoffs, making valuation, risk assessment, and monitoring

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more involved than simple instruments. The repayment methods and returns are often conditional or linked to market indices, benchmarks, or specific events, rather than fixed. Complex instruments carry higher levels of credit risk, market risk, liquidity risk, and model/ valuation risk, requiring advanced analytical techniques to assess.

Highly Complex Financial Instruments

Highly complex financial instruments are sophisticated financial products with multiple interdependent components, embedded derivatives, exotic triggers, or structured payoff mechanisms, often involving leverage, contingent rights, etc. Cash flows and returns are highly non-linear, contingent on multiple market or credit variables, and may require advanced modelling for accurate assessment.

Significance of Instrument Classification for External Stakeholders

Categorising financial instruments based on their complexity provides clear advantages to all market participants. For investors, it facilitates better understanding of risk-return profiles, informed decision-making, and efficient portfolio allocation, ensuring exposures are aligned with risk appetite and regulatory limits. For issuers, it enables transparent communication of product features, appropriate pricing, and improved investor confidence, thereby supporting market acceptance and trust. For market intermediaries, including banks, brokers, etc., categorisation of instruments supports accurate risk assessment, monitoring, reporting, and advisory services, allowing them to structure, recommend, and manage instruments appropriately based on their complexity and risk.

Relationship Between Instrument Complexity and Credit Risk

The complexity of a financial instrument is closely linked to the challenge of assessing its credit risk. Instruments with simple structures, predictable cash flows, and fixed or benchmark-linked returns allow for straightforward evaluation of repayment capacity and potential loss, with risks that are transparent, measurable, and can be monitored.

Instruments with embedded derivatives, contingent payoffs, optionality, or leverage introduce non-linear exposures and uncertainty, thereby increasing the difficulty of quantifying credit risk. Higher complexity also amplifies market, liquidity, operational, and model risks, requiring advanced analysis, scenario assessment, and continuous monitoring. Understanding this relationship enables the organisation to allocate resources effectively, set appropriate risk limits, and implement risk mitigation measures, ensuring exposures remain aligned with the company's risk appetite and governance standards. Further, some complex instruments like securitisation structure have different rating notation as per SEBI regulations which are addressed through our disclosure on Rating Symbols.

The complexity of an instrument may influence its credit risk profile; however, the extent and direction of this relationship depend on the specific structural characteristics and nature of the instrument.

Categorization of Financial Instruments by Complexity Level into complex and highly complex instruments.

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Complex Instruments (Illustrative examples)

Instrument	Key Structural Features
Subordinated Debt	Lower repayment priority; principal loss risk increases in insolvency; fixed tenor but structurally higher loss severity
Convertible Debentures	Fixed coupon; option/mandatory conversion into equity; principal may convert instead of being repaid
Optionally Convertible Preference Shares (OCPS)	Dividend payout; conversion discretion; principal variability upon conversion
Callable Bonds	Issuer has right to redeem early; tenor variability due to call option
Perpetual / AT1 Bonds	No fixed maturity; coupon discretion; principal write-down or conversion upon regulatory trigger
Structured / Market-Linked NCDs	Returns linked to benchmark/index; payout variability due to embedded derivative
Pass Through Certificates (PTCs)	Backed by asset pool; tenor and payouts depend on pool cash flows; principal impacted by pool losses
Mortgage-Backed Securities (MBS)	Prepayment risk; pool performance driven payouts; principal exposed to borrower defaults
Revenue Bonds (Project Finance)	Repayment dependent on project cash flows; tenor linked to project life; principal exposed to project failure
Credit Linked Notes (CLNs)	Returns linked to credit event of reference entity; principal reduced upon credit trigger

Highly Complex Instruments (Illustrative examples)

Instrument	Key Structural Features

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Collateralized Debt Obligations (CDOs)	Multi-tranche structure; waterfall loss allocation; principal write-down based on tranche hierarchy
Synthetic CDOs	Exposure via credit derivatives; no direct asset ownership; highly model-dependent loss allocation
Contingent Convertible Bonds (CoCos)	Automatic conversion or write-down upon capital trigger; perpetual structure
Structured Multi-Tranche Obligations	Sequential/pro-rata payment waterfall; tranche-specific risk and tenor variability
Hybrid Mezzanine Instruments	Combination of debt, equity, and warrants; principal recovery highly contingent
Leveraged Buyout (LBO) Structures	Multi-layered debt; PIK toggles; high structural subordination
Credit Default Swaps (CDS)	Derivative-based credit risk transfer; payout triggered by credit event
Exotic Structured Notes (Barrier/Path Dependent)	Non-linear payoff; payout and principal dependent on market path
Deep Subordinated Perpetual Instruments	No maturity; full loss absorption capability; discretionary payouts
Distressed / Recovery-Based Instruments	Valuation and repayment dependent on recovery outcomes

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