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Structured Finance: Complexity, Risk and the Use of Rating

BIS Quarterly Review, June 2005

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Abstract

This article reviews the principal features of structured finance instruments. Key to understanding the risk properties of these products is the evaluation of the risks associated with their contractual structure, in addition to the modelling of the credit risk of the underlying asset pools. It is argued that structured finance ratings, though useful, have intrinsic limitations in fully gauging the risk of these products, even as their complexity creates incentives to rely more heavily on ratings than for other rated securities. Market participants and public authorities need to take account of this in their assessments of structured finance instruments and their markets.

JEL Classification: G100, G200

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