Are structured products too complex?

Frankly, yes. Nearly all financial products, including most structured products, are complex. They have this in common with many products and services that we use in our everyday lives without giving them a second thought. For instance, ultra-fast smartphones, energy-efficient washing machines, and even train timetable apps. We hardly notice that these are complex, and in any case we would never criticise their complexity because we know that they make our lives easier. Does the same apply to financial products? Yes, at least for structured products. The fact is, greater complexity almost always means lower risk for investors.

Facts

Financial products are complex

Structured products are complex, but so are almost all financial products. For example, there is hardly anything more complex than an endowment life assurance policy. Even building savings contracts, which are very popular in Germany and which people think they understand very well, are actually interest rate swaps combined with interest rate options based on highly complicated mathematics. However, despite their complexity, these investments can make good sense. Investing in structured products is not rocket science; they are much easier to understand than many people assume. Nevertheless, investors must take a little time to familiarise themselves with these types of financial products. The DDV and its member banks provide comprehensive information to anyone interested.

For an introduction to structured products:

[What are certificates actually for?]

Complexity reduces risk

Structured products often consist of two or more components. This is primarily for the protection of the investor. For instance, additional components are needed in order to ensure the full capital protection provided by Uncapped Capital Protection Certificates. This may be complex, but it results in maximum security, as the investor receives at least the nominal value of the invested capital at maturity. The highly leveraged Knock-out Warrants, on the other hand, have a very simple structure but are extremely risky.

For more on the risk associated with structured products:

[Are structured products too risky?]

Complexity and transparency are not mutually exclusive

Many people think that the more complicated a financial product is, the less transparent it becomes. This is not the case, at least for structured products, which are very transparent despite their complexity. Investors know the underlying or underlyings on which their structured product is based, as well as other product features. In addition, investors can tell the current value of their structured products at all times and can sell them on any stock exchange trading day without any problems. They can easily check the Key Information Document to find out what conditions are attached to the returns, as well as the costs and risks associated with the structured product.

More on the transparency of structured products:

[Do structured products lack transparency?]

Complexity is subjective, transparency is objective

Whether a particular financial product is perceived as complex or not is completely subjective. Two investors can view an identical product very differently. If investors are to be protected effectively, financial products should not be assessed by their level of complexity. The decisive factors are how easy to understand and how transparent a product is, and these criteria can be objectively checked. Academic research has identified six criteria for the evaluation of financial products: risk of loss, credit risk, saleability, management costs, return potential, and selling costs. With reliable information on these criteria, preferably in the form of indicators, private investors can assess and compare all financial products quickly and reliably.

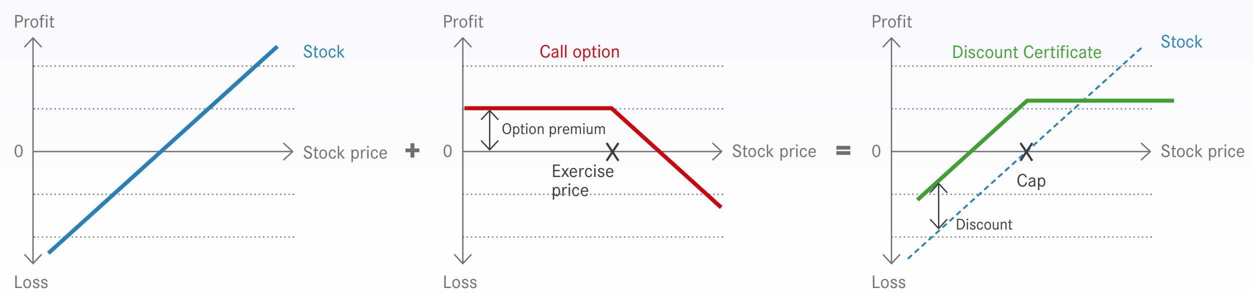
→ Risk reduction: Discount Certificates

Discount Certificates are securities issued by banks and listed on a stock exchange in Germany. The performance of a Discount Certificate always depends on its underlying asset – for instance a stock, or an index such as the DAX. Investors buy the certificates at a more favourable price than the underlying asset, i. e. they get a discount on the cost of a direct investment. If the price of the underlying moves sideways or slightly falls, Discount Certificate investors make a profit. If there is a sharp fall in the price, they make a comparatively smaller loss. Profits from rising prices, on the other hand, are limited by a cap.

The two components of a Discount Certificate with a stock as an underlying

Stock + **Call option** = **Discount Certificate**

The issuer buys a stock. | The issuer sells a call option on this stock. | The private investor buys a Discount Certificate on this stock.



The value of a structured product is always based on its underlying asset, in this case a stock.

The issuer receives an option premium for selling the call option. In exchange, the buyer acquires the right to buy the stock from the issuer at a predetermined exercise price of X.
As long as the price of the stock is below the exercise price, the buyer will not exercise the right to buy.
If the price is at or above X, the buyer will purchase the stock from the issuer at the exercise price.

The option premium and the retained stock dividend enable the issuer to sell the investor a Discount Certificate at a lower price than the underlying stock.
The profit of the Discount Certificate is limited by a cap. The cap is equal to the exercise price of the option, since the issuer must sell the stock at this price.

Orientation guides for investors

Detailed information readily available

Before investing in a structured product, investors should first obtain all the information they need about the products in which they are interested. Detailed information is of course provided by the issuers. In addition, the DDV's website (www.derivateverband.de/ENG/Home) provides general information on investment and leverage products. Information on the creditworthiness of issuers is also important in this context. As is the case with all bearer bonds, investment certificates are exposed to credit risk. The DDV publishes information on its website on the Credit Default Swaps (CDSs) of the most important issuers to help investors assess their creditworthiness.

Since the start of 2018, all potential investors have had to be provided with a Key Information Document prior to purchasing a packaged investment product. In principle, this document applies to structured products and insurance-based investment products, and will also start to apply to investment funds from 2020. The Key Information Document presents the key features and functioning of a financial product on three pages, describes in detail the associated risks and benefits of the product in various scenarios, and also lists the product costs. The Summary Risk Indicator provides a clear presentation of the risks of the investment using seven risk classes. The Key Information Document is also intended to facilitate comparison between different financial products.

Effective investor protection

There is a comprehensive legal framework of German and European regulations for all structured products. These regulations contain the basic civil law provisions for securities as debt instruments as well as comprehensive and detailed requirements for the content of investor information such as in securities prospectuses and Key Information Documents. Furthermore, the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) sets specific guidelines and, where necessary, requirements for market participants. Together with the voluntary undertaking that all members of the DDV have expressly committed themselves to in the Fairness Code, the purchasers of structured products are afforded effective protection.

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