Rating Criteria for Capital Protection Oriented Funds

Executive Summary

A Capital Protection-Oriented Funds (CPOFs) are structured to ensure the principal investment is safeguarded while offering potential market-linked returns. The rating methodology for CPOFs focuses on the credit quality of the underlying debt instruments, market risk, liquidity considerations, and the overall fund structure.CPOFs are a type of closed-end hybrid (Equity and Debt) mutual fund designed to prioritize the protection of the initial capital investment in the fund made by the investor while offering potential returns through strategic investments in both debt and equity. The primary objective of such a hybrid fund is to protect investors' capital. In June 2024, the Securities and Exchange Board of India (SEBI) issued regulations for such schemes. The key points covered under these regulations are as follows:

- Asset Management Companies (AMCs) must confirm that the offer documents include the necessary disclosures, that the portfolio structure of the Capital Protection Oriented Scheme is continuously monitored, and that ratings are reviewed on a quarterly basis.
- The Scheme Information Document (SID), Key Information Memorandum (KIM), and advertisements related to the Capital Protection Oriented Scheme must clearly state that the scheme is "oriented towards capital protection" and not "guaranteed returns." It should also be specified that the focus on capital protection comes from the scheme's portfolio structure, and not from any bank guarantees, insurance coverage, or similar protections.
- The proposed portfolio structure outlined in the SID and KIM must be evaluated by a Credit Rating Agency registered with the Board to assess the likelihood of achieving the capital protection objective. The rating should be reviewed on a quarterly basis.
- The Trustees shall continuously monitor the scheme's portfolio structure and provide updates in the Half-Yearly Trustee Reports to the Board. Additionally, the AMC(s) shall include this information in their bimonthly CTR(s) with the Board.
- It must also be ensured that the debt component of the portfolio structure holds the highest investment grade rating.

While different structures are followed globally for ensuring capital protection at maturity, the main structure followed in India is called the Static Hedge, wherein the initially mobilised capital is protected by investing a portion of the fund in debt securities and the remaining in equity. This ensures that the yield on maturity from the mutual fund is at least equal to the initial capital invested, or greater than the initial capital, even if the equity portion is lost. By investing in equities, it also allows investors to benefit from the potential growth of the stock market. However, since the exposure to equities is limited, the downside risk to the overall investment is minimized.

Brickwork Ratings (BWR) assigns ratings to CPOFs that assess the ability of the fund's portfolio structure of meeting the objective of capital protection at the time of maturity. The rating should not be construed as an indication of expected returns, prospective performance of the mutual fund scheme, NAV or volatility in the returns, as it does not factor market risks. BWR assigns CPOF ratings on the Structured Obligation (SO) scale considering the protection offered by the portfolio structure in place. A short-term rating is assigned to a fund having a final maturity of less than one year, and a long-term rating is assigned to a fund having a final maturity of more than one year.

As mentioned earlier, the ratings of CPOFs constitute an important tool for investors, as the ratings for the same are monitored on a quarterly basis and would help investors make an investment decision. BWR's rating criteria are covered in this criteria document.

Scope of the Criteria

BWR assigns ratings to CPOFs, which assess the ability of the fund's portfolio structure of meeting the objective of the protection of capital at the time of maturity, invested by the investor. The rating should not be construed as an indication of expected returns, prospective performance of the mutual fund scheme, Net Asset Value (NAV) or volatility in the returns. BWR's rating methodology, for assigning a rating to CPOFs consists of the investment strategy, prevailing market conditions and track record of the management.

Risk Assessment and Rating Methodology

BWR follows an extensive rating methodology for CPOFs, and ratings are opinions on the degree of certainty with which the portfolio structure ensures the timely payment of at least the face value of the units to unit holders on the maturity of the scheme. BWR analyses the CPOF based on portfolio structure, in terms of how well it is providing capital protection to investors. BWR focuses on the investment strategy of the AMC to determine concentration risk. BWR then looks for the likelihood of a shortfall in the NAV with respect to the face value of the units of the scheme on maturity. A higher rating is assigned to structures that have a lower likelihood of a shortfall in the NAV. BWR also assesses the management quality of the AMC. The following are the risk assessment parameters considered while arriving at the rating. The amount that needs to be invested in the debt component is driven by

- The amount of capital that needs to be protected (typically the amount collected by the fund from its investors adjusted for expenses if deductible)
- Interest rate scenario – In markets with high interest rates, the amount to be invested can be lower as the interest earned would be sufficient to adjust for any losses due to investment in equity.
- Scheme maturity – Considering the volatility of capital markets, schemes that have longer maturity periods can allocate a lesser amount to the debt component and more to equity; shorter maturities will require a higher debt allocation.

Credit quality of the portfolio – In cases where the debt portfolio is of a higher credit quality that is AAA, the probability of loss is lower. On the other hand, a reduction in the credit quality may necessitate portfolio adjustments.

The surplus amount post debt investments are usually invested in equity markets. Returns generated from equity allow for maximising returns earned from investments. Thus, the static hedge considers debt and equity components that can be invested into different asset classes to ensure capital protection. Surplus investments in equities, including futures and options, allow investors to benefit from potential equity appreciation. However, if equity markets decline, the portfolio is designed to protect investors from capital loss at maturity.

Thus, in assessing the ability of the fund's structure in meeting the objective of capital protection, BWR assesses the following:

- Strength of the fund's portfolio structure based on
- Credit risk of the underlying portfolio (default risk, as well as transition risk): It refers to the potential risk that the issuers of the debt securities held within the portfolio may default on their obligations, such as failing to pay interest or principal. Since capital protection funds aim to preserve investors' principal while generating moderate returns, managing credit risk is critical. Key factors related to credit risk in a capital protection-oriented fund include Debt Component Quality, Tenor Matching and Portfolio Diversification.Debt Component Quality**:** The rating of underlying debt securities is a primary factor, ensuring investment-grade quality to preserve capital.
- Tenor Matching**:** The maturity of fixed-income securities should align with the investment horizon to avoid reinvestment risk.
- Portfolio Diversification**:** Exposure across multiple high-quality issuers reduces default risk.

To prevent default, SEBI restricts CPOFs in investing in securities with minimum rating of AAA', thereby causing AMCs to invest in GSec. Warranties from the AMC to maintain credit quality for the same, reinvestment and Float risk are also obtained.

Reinvestment risk: It involves the potential for returns or interest income generated by the fund's investments to be reinvested at a lower rate of return or yield than the original investment. This can impact the overall performance of the fund, particularly if interest rates decrease over time.

Float risk: It is the potential risk associated with changes in the interest rate or the floating rate of the securities held within the portfolio. These securities may have variable or floating interest rates that adjust periodically based on market conditions, which can affect the income generated by the fund. Float risk arising from non-availability of eligible debt securities whose tenors exactly match that of the fund.

Recurring expenses charged to the scheme: Recurring expenses charged to the scheme, such as management fees or operational costs, can affect the fund's overall returns and should be considered when evaluating its performance and risk.

Market-Linked Exposure: The proportion of investment in equity or other non-fixed-income assets is evaluated to ensure that market volatility does not compromise capital protection.

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- Analysis of the fund manager's investment strategy to determine how concentration risk is managed, sector-specific investments and so on
- Representations and warranties provided by the AMC to BWR equivalent securities.

Investment Policies and Processes

BWR considers the equity and debt investment policies, price volatility management and processes that are in place at the AMC/investment strategies for the schemes. Internal documentation as well as detailed discussions allow BWR to understand how aligned the investment process is with regard to the stated investment objective of the capital protection scheme.

Liquidity Risk

This risk pertains to difficulty in ensuring liquidity of the investments. It means the difficulty of selling or buying an investment. Some debt instruments may face a wider gap between the bid and ask price. Similarly, some stocks are traded with very thin margins and may face high impact costs at the time of

selling. Hence, this risk becomes critical and is factored in the rating. The evaluation of the rating takes into account the following factors:

a) **Debt Instrument Liquidity:** The ability to sell fixed-income securities without impacting the fund's stability is crucial.

b) **Redemption Restrictions:** CPOFs typically have a lock-in period to ensure capital preservation; Credit Rating Agencies (CRAs) assess whether such restrictions align with investor protection.

Investment Strategy of Fund Manager

There are two ways in which a portfolio can be managed, passively or actively. If a portfolio is passively managed, it is based on an established index, and the portfolio structure is decided keeping in mind the underlying index. In the case of an actively managed portfolio, the fund manager plays an important role in selecting the components of the portfolio. In doing so, the fund manager must comply with the reporting standards as per SEBI, and other regulatory authorities. Moreover, fund managers have the responsibility of protecting investors' wealth, which they do by employing various risk management techniques to evaluate investments, taking steps to ensure a diversification in the portfolio, and so on. BWR assesses the strategies of fund managers based on how well their funds perform and whether their portfolio can generate returns higher than the interest rate and inflation rate. A fund manager with an established track record of successful portfolio management and ability to gauge various market risks is seen positively by BWR.

Representations and Warranties by the AMC

The AMC provides certain representations and warranties or covenants to BWR that the fund manager must adhere to. These include the extent to which investments in non-debt instruments will be capped, the quality of the portfolio that will be invested in, maximum tenure of investments and sharing of information with BWR during the tenure of the scheme. Adherence to these warranties plays an important role in the rating actions taken by BWR for such funds. The warranties furnished by the AMC may include the following:

a) An initial investment mix of equity and fixed-income securities shall be maintained such that the maturity value of the fixed-income or debt portfolio, at the time of scheme's redemption, net of all expenses, shall exceed or equal the face value of units issued. Further, BWR assesses the basis of the debt portion to be defined at the initial investment level so that the capital is protected.

b) Portfolio details of investments in securities held by the fund shall be submitted to BWR every month.

c) Churn in debt securities in the portfolio shall be minimised to the extent possible.

d) The aggregate residual value of the following shall never exceed the maximum permissible value of the non-debt portion:

   - The outstanding position in the cash-market segment
   - The premium paid or payable on option contracts
   - The notional value of exposures in the future segment

e) Options shall not be written or sold during the tenor of the instrument

Surveillance of Ratings Assigned

CPOF ratings assigned are subject to continuous surveillance by BWR. Fund holdings are monitored on a quarterly and/or periodic basis and in some cases may require to be re-evaluated, based on new information. Any change in the rating assigned will be communicated by BWR in the public domain.

SEBI Regulation:

- Orientation towards the protection of capital should originate from the portfolio structure and not from any bank guarantee, insurance cover, and so on.
- Close-ended and no re-purchase - All CPOFs should be closed-ended, and the AMC is not allowed to repurchase any unit of the scheme before maturity. This implies that there is no exit route available to investors unless the scheme is listed on an exchange.
- Debt component of the portfolio structure should be of the highest investment grade rating.
- Rating - SEBI regulations state that "the proposed portfolio structure indicated in the offer document and key information memorandum must be rated by a SEBI-registered credit rating agency from the viewpoint of assessing the degree of certainty for achieving the objective of capital protection."
- Rating should be reviewed on a quarterly basis.

CPOF Rating Scale

The CPOF Ratings are an opinion on the degree of safety of capital protection offered to investors. A suffix of SO (denoting Structured Obligation) is included to indicate the protection provided by the portfolio structure, as the structure originated for capital protection is static hedge in nature. CPOF ratings may be assigned on the long-term scale when the original maturity of the scheme is greater than one year and on the short-term scale when the original maturity of the scheme is less than or equal to one year.

Long-term Capital Protection Oriented Fund Scheme Ratings - Schemes that have an original maturity exceeding one year

BWR AAA (SO)	Schemes with this rating are considered to have the highest degree of safety regarding the timely receipt of payments from the investments that they have made.
BWR AA (SO)	Schemes with this rating are considered to have a high degree of safety regarding the timely receipt of payments from the investments that they have made.
BWR A (SO)	Schemes with this rating are considered to have an adequate degree of safety regarding the timely receipt of payments from the investments that they have made.
BWR BBB (SO)	Schemes with this rating are considered to have a moderate degree of safety regarding the timely receipt of payments from the investments that they have made.
BWR BB (SO)	Schemes with this rating are considered to have moderate risk of default regarding the timely receipt of payments from the investments that they have made.

BWR B (SO)	Schemes with this rating are considered to have a high risk of default regarding the timely receipt of payments from the investments that they have made.
BWR C (SO)	Schemes with this rating are considered to have a very high risk of default regarding the timely receipt of payments from the investments that they have made.
BWR D (SO)	Schemes with this rating are in default or are expected to be in default soon.

Modifier {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories BWR AA (SO) to BWR C (SO). The modifiers reflect comparative standing within the category.

Short-term Capital Protection Oriented Fund Scheme Ratings - Schemes have an original maturity of/up to one year.

BWR A1 (SO)	Schemes with this rating are considered to have a very strong degree of safety regarding the timely receipt of payments from the investments that they have made.
BWR A2 (SO)	Schemes with this rating are considered to have a strong degree of safety regarding the timely receipt of payments from the investments that they have made.
BWR A3 (SO)	Schemes with this rating are considered to have a moderate degree of safety regarding the timely receipt of payments from the investments that they have made.
BWR A4 (SO)	Schemes with this rating are considered to have a minimal degree of safety regarding the timely receipt of payments from the investments that they have made.
BWR D (SO)	Schemes with this rating are in default or are expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories BWR A1 (SO) to BWR A4 (SO). The modifier reflects comparative standing within the category.

Conclusion

BWR assesses the risk associated with the debt component of CPOF through analysing the risks associated with the portfolio structure, capabilities of fund managers and effectiveness of the management of the Asset Management Company. The ratings assigned are an indicator of the degree of safety of capital protection offered by an AMC through such funds to investors.

The previous version of this document can be found in

https://www.brickworkratings.com/download/Criteria-CapitalProtectionOrientedFundsUpdated-Sep2021.pdf

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