Rating Criteria for Capital Protection Oriented Funds

Executive Summary

Capital Protection Oriented Funds (CPOFs) are mutual fund schemes comprising a mix of debt and equity, geared towards maximising returns and protecting the initial capital investment in the fund made by the investor. The primary objective of such a hybrid fund is to protect investors' capital in the case of an economic downturn. In August 2006, the Securities and Exchange Board of India (SEBI) issued regulations for such schemes. The key points covered under these regulations are as follows:

- The AMC launching these funds cannot provide a guarantee for capital protection. However, they can endeavour and focus on the protection of invested capital in a volatile market scenario.
- No third-party credit enhancement may be provided for such a fund in the nature of a guarantee/insurance/liquidity facility and so on.
- Capital protection funds are exempt from the mandatory requirement of listing on a stock exchange.
- AMCs cannot repurchase units under the scheme before the maturity period.
- The units of the scheme are required to be rated by a SEBI-registered credit rating agency from the viewpoint of the ability of its portfolio structure to attain the protection of the capital invested therein. Ratings would be reviewed on a quarterly basis.

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, even if the equity portion is lost.

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 note.

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, 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. 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, 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.

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)
    - Reinvestment risk
    - Float risk - To arrive at the portfolio's ability to generate the required returns for capital protection
- 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

Portfolio Structure Assessment

In assessing the ability of the fund's structure, strategy, portfolio reshuffle frequency in meeting the objective of capital protection, BWR assesses the strength of the fund's portfolio structure based on the following factors:

Credit Risk

A CPOF is exposed to credit risk due to the possibility of a default in payment. Such a default results in a risk of the downgrade of the risk securities. To mitigate credit risks, SEBI guidelines call for CPOFs to refrain from investing in debt securities having a credit rating of below "AAA", AAA being the highest degree of safety. The rating can be downgraded if the investment strategy stipulates a minimum credit quality for the debt component, and this will lower the credit quality of the portfolio.

Reinvestment Risk

Reinvestment risk arises when the AMC is unable to generate cash flows received from the debt securities at the same yield prevalent as originally invested. It is lower yield on investment after reinvesting these cash flows as compared to the yield on the initial investments. In such a case, the portfolio faces a reinvestment risk; the yield on reinvesting such cash flows is expected to be lower than the yield on the original investment. A safety net needs to be in place for such a reinvestment risk at the time of the assessment of the debt instrument's ability to provide capital protection at the time of maturity.

Float Risk

If funds are not deployed in a timely manner, it may lead to a lower investment and hence, a lower yield than projected. It is imperative for the fund manager to build a cushion for float risks, at the start and maturity of the fund, as well as during rebalancing, while computing the maximum permissible investment in equities.

Market Risk

Market risk pertains to market factors such as equity prices, interest rates, exchange rates and inflation. This particular risk can affect the portfolio if the maturity of the debt instrument does not line up with maturity of the scheme due to the non-availability of instruments.

Macro-Economic indicators:

- Interest rate, GDP growth and inflation and other economic indicators are assessed to see the impact on the portfolio.
- Prevailing regulatory environment and conditions for the MF industry, which may constrain or impact the returns.

Portfolio diversification

Maturity of investment in instruments should match the final maturity of the funds or scheme. The fixed income component of the scheme shall be invested in G-Sec (Government Securities) and/or securities rated BWR AAA or its equivalent. However, if fixed income debt is downgraded during the tenor of the scheme, AMC should ensure the credit quality of portfolio, to ensure its investment in BWR AAA or its 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.

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, 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:

- 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.
- Portfolio details of investments in securities held by the fund shall be submitted to BWR every month.
- Churn in debt securities in the portfolio shall be minimised to the extent possible.
- 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
- 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 close-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 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 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 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 a 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 www.brickworkratings.com/download/Criteria-CapitalProtectionOrientedFunds.pdf

About Brickwork Ratings: Brickwork Ratings (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by Reserve Bank of India [RBI], offers credit ratings of Bank Loan, Non-convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage-backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. BWR has rated over 11,400 medium and large corporates and financial institutions' instruments. BWR has also rated NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations. BWR has Canara Bank, a leading public sector bank, as one of the promoters and strategic partner. BWR has its corporate office in Bengaluru and a country-wide presence with its offices in Ahmedabad, Chandigarh, Chennai, Hyderabad, Kolkata, Mumbai and New Delhi along with representatives in 150+ locations.

Disclaimer: It must be clearly understood that a Rating opinion is based on various factors/aspects which includes application of certain Rating criteria. The particular criteria applied depends on a number of factors, inter alia, sector/Industry, historical performance, cyclical trends, prevailing economic condition, group support etc. Rating opinions factor many assumptions and the application of any particular criteria or a set of criteria may be full or partial depending upon peculiarity of each case. Application of any Rating criteria should not therefore be considered as rendering finality or completeness to a Rating assessment. A reference to criteria needs to be perceived in broad terms, only as an aid to a rating decision.

Brickwork Ratings India Pvt. Ltd. (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by the Reserve Bank of India [RBI], offers credit ratings of Bank Loan facilities, Non-convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage-backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. [hereafter referred to as "Instruments"]. BWR also rates NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations.

BWR wishes to inform all persons who may come across Rating Rationales and Rating Reports provided by BWR that the ratings assigned by BWR are based on information obtained from the issuer of the instrument and other reliable sources, which in BWR's best judgement are considered reliable. The Rating Rationale / Rating Report & other rating communications are intended for the jurisdiction of India only. The reports should not be the sole or primary basis for any investment decision within the meaning of any law or regulation (including the laws and regulations applicable in Europe and also the USA).

BWR also wishes to inform that access or use of the said documents does not create a client relationship between the user and BWR.

The ratings assigned by BWR are only an expression of BWR's opinion on the entity / instrument and should not in any manner be construed as being a recommendation to either, purchase, hold or sell the instrument.

BWR also wishes to abundantly clarify that these ratings are not to be considered as an investment advice in any jurisdiction nor are they to be used as a basis for or as an alternative to independent financial advice and judgement obtained from the user's financial advisors. BWR shall not be liable to any losses incurred by the users of these Rating Rationales, Rating Reports or its contents. BWR reserves the right to vary, modify, suspend or withdraw the ratings at any time without assigning reasons for the same.

BWR's ratings reflect BWR's opinion on the day the ratings are published and are not reflective of factual circumstances that may have arisen on a later date. BWR is not obliged to update its opinion based on any public notification, in any form or format although BWR may disseminate its opinion and analysis when deemed fit.

Neither BWR nor its affiliates, third party providers, as well as the directors, officers, shareholders, employees or agents (collectively, "**BWR Party**") guarantee the accuracy, completeness or adequacy of the Ratings, and no BWR Party shall have any liability for any errors, omissions, or interruptions therein, regardless of the cause, or for the results obtained from the use of any part of the Rating Rationales or Rating Reports. Each BWR Party disclaims all express or implied warranties, including, but not limited to, any warranties of merchantability, suitability or fitness for a particular purpose or use. In no event shall any BWR Party be liable to any one for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of any part of the Rating Rationales and/or Rating Reports even if advised of the possibility of such damages. However, BWR or its associates may have other commercial transactions with the company/entity. BWR and its affiliates do not act as a fiduciary.

BWR keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of the respective activity. As a result, certain business units of BWR may have information that is not available to other BWR business units. BWR has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

BWR clarifies that it may have been paid a fee by the issuers or underwriters of the instruments, facilities, securities etc., or from obligors. BWR's public ratings and analysis are made available on its web site, www.brickworkratings.com. More detailed information may be provided for a fee. BWR's rating criteria are also generally made available without charge on BWR's website.

This disclaimer forms an integral part of the Ratings Rationales / Rating Reports or other press releases, advisories, communications issued by BWR and circulation of the ratings without this disclaimer is prohibited.

BWR is bound by the Code of Conduct for Credit Rating Agencies issued by the Securities and Exchange Board of India and is governed by the applicable regulations issued by the Securities and Exchange Board of India as amended from time to time.