Ratings

CRISIL
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CRISIL Ratings criteria for rating capital protection-oriented funds

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Executive summary

Securities and Exchange Board of India (SEBI) defines capital protection-oriented schemes as mutual fund schemes that have been designated as such, and endeavour to protect the capital invested therein through suitable orientation in portfolio structure. As per the current regulations[1] in India, capital protection has to emanate from the scheme's portfolio characteristics; third-party protection is currently not permitted. Capital protection-oriented funds (CPOFs) offer opportunities to risk-averse investors to participate in upswings in the equity markets, while at the same time, being oriented to protect their initial investment.

The structure of CPOFs and the performance of the debt and equity markets are factors that determine the returns on investments in such funds. SEBI regulations require that CPOFs be rated by a credit rating agency, with the ratings indicating the portfolio's ability to protect the capital invested. CRISIL Ratings' rating on CPOFs are, therefore, an opinion on the degree of capital protection offered to investors.

Scope

Globally, CPOFs employ four structures to ensure capital protection on maturity. The structures differ from each other based on the proportion of debt and equity, and trigger mechanisms for portfolio rebalancing to ensure capital protection on maturity. The four structures are:

- Static hedge
- Dynamic hedge
- Constant proportion portfolio insurance (CPPI)
- Dynamic portfolio insurance (DPI)

Under static hedge, a portion of the CPOF is invested in debt securities such that the cash flows realised from the debt portion at maturity will be at least equal to the fund's initially mobilised capital. This ensures that even if the value of the entire equity portion of the CPOF is completely eroded, the initially mobilised capital is protected.

This article[2] explains CRISIL Ratings rating methodology for assessing risks in CPOFs that rely on the static hedge structure for ensuring capital protection. The other three structures are yet to be popular in India, given the greater complexities associated with these structures.

Rating scale

CRISIL Ratings CPOF ratings are an opinion on the degree of capital protection offered to investors. It assesses the credit risk associated with the debt investments of the scheme and the adequacy of the cash flows from these debt investments, net of recurring expenses, in relation to the initially mobilised capital. The rating is not an opinion on the stability of the fund's NAV prior to maturity date. Since there is a structure (static hedge) that is oriented for capital protection, the ratings on CPOFs are assigned on CRISIL Ratings 'structured obligation (SO)' scale. Schemes with an original maturity of more than a year are assigned ratings on the long-term scale, while those with an original maturity of less than a year are assigned ratings on the short-term scale. However, CPOF ratings are not an assurance or guarantee of capital repayment. In addition, if the ratings on the debt investments change during the course of the scheme, the CPOF rating may change, too.

[1] Please refer to the SEBI circular: http://www.sebi.gov.in/legal/circulars/aug-2006/capital-protection-oriented-scheme-and-revision-in-fees_14669.html

[2] This article is being republished following a periodic review. Previous version of this article can be accessed here: https://www.crisil.com/content/dam/crisil/criteria_methodology/funds/archive/Criteria-for-rating-capital-potection-oriented-funds-nov2019.pdf

Methodology

CPOFs are regulated by SEBI, the regulator for mutual funds in India. SEBI defines a capital protection-oriented scheme as “a mutual fund scheme which is designated as such, and which endeavours to protect the capital invested therein through suitable orientation of its portfolio structure.” The regulator stipulates that:

- CPOFs launched be close-ended, and
- AMCs should not repurchase units before the end of the maturity period.

In India, capital protection for a scheme has to be ensured by the scheme’s portfolio characteristics; third -party protection is currently not permitted. In static hedge structures, the debt component of each fund is sized such that the cash flows from the debt investments at the time of redemption of the scheme will be equal to, or greater than, the fund’s initially mobilised capital. While assessing the ability of the debt component in a portfolio to ensure capital protection, CRISIL Ratings takes into account the following:

- Default risk of debt securities
- Reinvestment risk of interim cash flows from debt instruments
- Float risk arising from non-availability of eligible debt securities whose tenors exactly match that of the fund
- Recurring expenses charged to the scheme.

The difference between the capital mobilised and minimum debt component may be invested in equities, including futures and options; investors can, therefore, benefit from any appreciation in the equity portfolio value. At the same time, if equity markets decline, the portfolio structure is expected to protect investors from loss of capital on maturity.

Consider the illustration presented in Table 1, depicting the various scenarios for an initial investment of Rs 100, of which Rs 90 is invested in debt securities while the remainder is invested in equities. On maturity, the debt securities are assumed to provide an outflow of Rs 100 equal to the initial investment.

Table 1: Static hedge structure - returns under different scenarios

Investment mix	Initial investment (Rs crore)	Cash flows on scheme maturity (Rs crore) – different scenarios			
		ROE* @ 10%	ROE @ 0%	ROE @ -50%	ROE @ -100%
Debt	90	100	100	100	100
Equity	10	11	10	5	0
Total	**100**	**111**	**110**	**105**	**100**
ROE = Return on equity investments					

Determining the initial debt component

CRISIL Ratings analyses the indicative minimum debt the scheme has to invest in to ensure capital protection on maturity of the scheme. The debt levels vary depending on the yield expected on the debt securities. The following risks are considered during the rating analysis:

1.1.1 **Credit risk:** A CPOF’s investment in debt securities is exposed to default risk on the securities in the portfolio—that is, the risk of payments on these securities not being made. Currently, SEBI regulations restrict CPOFs from investing in debt instruments rated lower than 'AAA', which indicates highest degree of safety. Therefore, AMCs invest in fixed-income securities of highest credit quality (or Government of India securities), thus ensuring that the credit risk of the debt securities is commensurate with a ‘AAA (SO)’ rating for the scheme.

CRISIL Ratings also obtains warranties from the AMC pertaining to the credit quality of the debt investments during the tenor of the rated scheme. As per the warranties, the AMC undertakes that:

- The fixed-income component of the scheme shall be invested only in Government of India securities (G- Secs) and/or other fixed-income instruments rated CRISIL AAA or its equivalent.

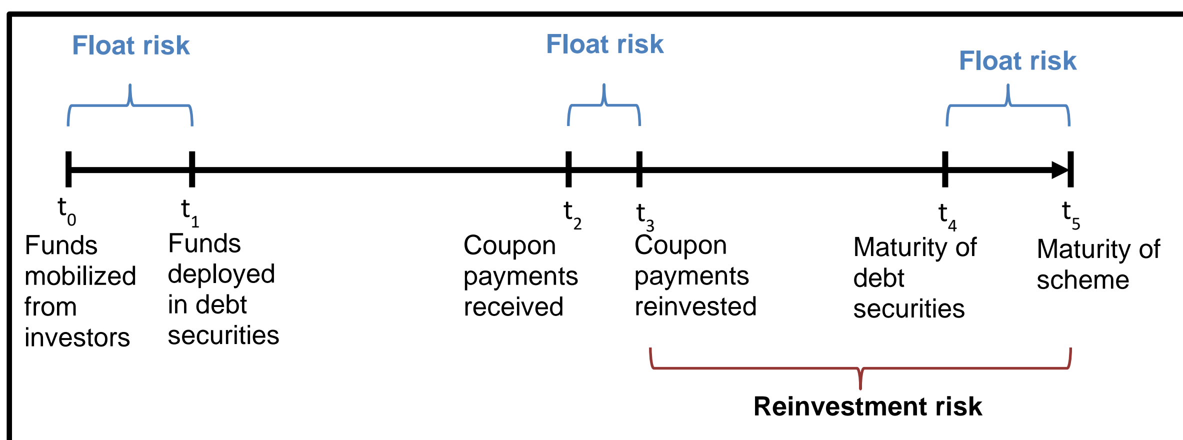
- The credit quality of the fixed-income portfolio shall be consistent with the credit score applicable for instruments rated 'CRISIL AAA' or its equivalent in accordance with CRISIL Ratings credit quality rating methodology at all points in time (refer to the article, 'Bond Fund Credit Quality Rating Criteria,' available at www.crisil.com). The AMC shall seek CRISIL Ratings view on a continuous basis on instruments not rated by CRISIL Ratings.

If, however, a fixed-income security is downgraded during the tenor of the scheme, the AMC shall ensure the credit quality of the fixed-income portfolio remains equivalent to 'CRISIL AAAmfs,' in line with its credit quality rating methodology. If not, CRISIL Ratings shall analyse the protection available from the debt and equity holdings of the scheme at that time.

1.1.2 **Reinvestment risk:** Reinvestment risk on a portfolio arises when the AMC is unable to deploy cash flows received from the debt securities at the same yield prevalent at the time of the initial investment. The scheme could face reinvestment risks on interim interest cash flows, if the yield on reinvesting these cash flows is lower than the yield on the initial investments. For instance, if the debt security has an annual coupon payment of 8%, it may not be possible to invest the coupons at an yield of 8%, resulting in a shortfall in the final value of the debt portfolio. Therefore, a cushion for reinvestment risk needs to be built in while assessing the ability of the debt component to ensure capital protection on maturity. CRISIL Ratings does this by assuming that the interim cash flows are reinvested at very low interest rates, benchmarked to savings rate.

1.1.3 **Float risk:** The structure may have a lower yield than projected if there are delays in funds deployed, or if the debt instruments are not co-terminus with the scheme's maturity. Hence, a cushion needs to be built in for float risk, at the start and maturity of the fund as well as during rebalancing (as indicated in Figure 1). While analysing the debt component in the initial investment mix, CRISIL Ratings assumes that the scheme's funds will remain undeployed in debt securities for a period of around 2 months, during which the funds may earn very low rates of interest benchmarked to the savings rate. If the float period of a scheme is higher than what was envisaged, CRISIL Ratings will evaluate other factors such as the extent of capital allocated to debt, the yield on investments/reinvestments to determine the extent of capital protection

Figure 1: Depiction of reinvestment risk and float risk



Warranties

The AMC managing the scheme has to comply with the standard set of warranties furnished to CRISIL Ratings. The warranties pertain primarily to the investment mix to be maintained to ensure capital protection on maturity, minimum quality of assets maintained by the funds, maximum tenor of investments in the portfolio, and the sharing of documents with CRISIL Ratings to facilitate timely rating action.

The warranties furnished by the AMC shall include those delineated under credit quality (refer to Section 3.1.1), in addition to the following:

- An initial investment mix of equity and fixed-income securities shall be maintained such that the maturity value of the fixed-income portfolio, at the time of scheme's redemption, net of all expenses, shall exceed or equal the face value of units issued.
- Portfolio details of investments in securities held by the fund shall be submitted to CRISIL Ratings 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:
  1. The outstanding position in cash-market segment;
  2. The premium paid or payable on option contracts; and
  3. The notional value of exposures in the future segment
- Options shall not be written or sold during the tenor of the instrument

Surveillance process for CRISIL Ratings

Once a CPOF is rated, CRISIL Ratings places the fund under continuous surveillance. This means that CRISIL Ratings will review the fund's holdings on a periodic basis and may re-evaluate the rating based on new information, whenever such action is warranted. Based on information obtained from the AMCs, it analyses the credit quality of the debt securities. Further, CRISIL Ratings also evaluates the possibility of cash flows from the debt securities (including cash flows from reinvestment of interim coupons) on the scheme's maturity falling below the initial capital mobilised. CRISIL Ratings will publish any change in rating, along with a rationale for the rating action.

Conclusion

CRISIL Ratings CPOF ratings are an opinion on the degree of capital protection offered to investors. It assesses the credit risk associated with the debt investments of the scheme and the adequacy of the cash flows from these debt investments, net of recurring expenses, in relation to the initially mobilised capital.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 1,10,000 MSMEs have been rated by us.

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