RATING METHODOLOGY – Capital Protection-Oriented Funds

November 2022

Click to Provide Feedback

This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in October 2020. While the revised version incorporates a few modifications, ICRA's overall approach to rating capital protection-oriented funds remains materially similar.

Overview

Capital protection-oriented funds are close-ended funds and are aimed towards maximising the returns with the objective of protecting the initial investment made by the investor. Accordingly, the approach for rating capital protection-oriented funds considers the structural provisions of such funds, which attempt to protect the capital investment of the investors. Such funds generally invest the majority of their corpus in fixed rate debt instruments whose period of maturity is before the maturity of the fund. Further, a part of the funds' corpus would be invested in other instrument classes to maximise the returns.

As these funds are close-ended, the fund corpus is available to the fund manager for the entire tenure of the fund as the same cannot be redeemed before the scheduled maturity of the fund. As mandated by the Securities and Exchange Board of India (SEBI), the rating symbol for capital protection-oriented funds is suffixed by the letters 'SO' in parenthesis where SO stands for structured obligation. A long-term rating is assigned to a fund with a stated final maturity of more than one year and a short-term rating is assigned to a fund with a stated final maturity of up to one year.

ICRA's ratings for capital protection-oriented funds are a symbolic representation of the credit risk associated with the underlying debt investments and the adequacy of the cash flows (based on coupon and repayment) from the debt investments to repay the principal to the investors while covering the operating expenses for managing the scheme. The ratings do not factor in the market risks and hence should not be construed as an indication of the expected returns or the prospective performance of the mutual fund scheme.

These ratings are not a reflection of the quality of the fund's management or its financial performance, reputation and other business practices including investment strategies, pricing, marketing and distribution activities. Furthermore, the ratings are not a reflection of the adherence of the fund to the regulatory requirements.

Table of Contents:

Overview 1
ICRA's Rating Approach for Capital Protection-oriented Mutual Fund Schemes 2
ICRA's Rating Approach for Other Capital Protection-oriented Mutual Fund Schemes......................................3
Environmental and Social Risks 4
Summing Up 4
Rating Scale and Definitions 5

ANALYST CONTACTS

Karthik Srinivasan
Senior Vice President & Group Head
+91 22 6114 3444
karthiks@icraindia.com

Anil Gupta
Senior Vice President & Co Group Head
+91 124 4545 314
anilg@icraindia.com

Neha Parikh
Vice President
+91 22 6114 3426
neha.parikh@icraindia.com

Niraj Jalan
Assistant Vice President
+91 33 7150 1146
niraj.jalan@icraindia.com

ICRA's Rating Approach for Capital Protection-oriented Mutual Fund Schemes[1]

Capital protection-oriented mutual fund schemes invest a part of the scheme's assets under management (AUM) in debt instruments and money market instruments with the highest investment grade rating as per SEBI guidelines (which would imply a long-term rating of AAA or equivalent). The debt portion is generally sized such that the maturity value of the debt investment is adequate to repay the principal to the investors after factoring in the cash flows on these instruments, a nominal return on the interim cash flows and the operating expenses for managing the scheme. Further, the maturity of the underlying debt instruments is such that it is aligned to be before the maturity of the scheme to minimise/avoid any market risks on maturity/redemption. In case of embedded put options in the debt instruments, the put option date is assumed as the maturity date for such instruments. In case of instruments with a call option, the call option is ignored, and the final maturity is considered, which must be before the maturity of the scheme[2]. The balance portion of the scheme's AUM may be invested in other instruments such as equity and equity-related instruments (including their derivatives) to achieve capital appreciation.

At the time of rating a new scheme, ICRA assesses the proportion of the scheme's proposed investment in AAA-rated debt instruments. For investment in Government securities (G-Secs), the prevailing yield on G-Secs for the proposed tenure is used for projecting interim cash flows. For corporate debt instruments, the prevailing yield on AAA-rated corporate bonds for the proposed tenure of the scheme is taken for projecting interim cash flows. This, with the recurring expenses as stated in the scheme offer document, helps determine the minimum investment required in debt instruments to ensure capital protection at the end of the tenure of the scheme. For a capital protection-oriented scheme, which is proposed to be opened for subscription by investors, or a scheme where the investments are yet to be made, ICRA assigns a provisional rating based on the proposed mix of the share of investment in AAA-rated debt instruments and in equity[3].

In case of a provisional rating, the rating is finalised on the receipt of regulatory clearance and after the investments are made by the scheme. The portfolio of capital-protection schemes is monitored and analysed on a quarterly basis. If the credit rating of a debt security is downgraded, the debt portfolio of the scheme should be churned and replaced with the highest rated debt instruments within one month. If this is not possible, ICRA would re-evaluate the entire portfolio (equity and debt investments of the scheme) to arrive at a rating which reflects the underlying risk of the debt instruments in the scheme. For this purpose, ICRA would run various scenarios of the payments being received from the debt securities under the scheme after factoring in the probability of default of each debt security (based on the credit rating and tenure of the debt security). In some scenarios, there would be a shortfall in the cash flows from the debt securities compared to the initial capital mobilised after factoring in reinvestment as well as operating expenses.

The number of such scenarios relative to the total number of scenarios simulated gives the default probability for the scheme, which will then be compared with ICRA's internal benchmarks to arrive at the rating outcome. If the asset management company (AMC) corrects its portfolio, post the rating downgrade of the scheme, or the degree of safety improves in any manner subsequent to the downgrade, making the scheme eligible for an upgrade, ICRA may consider an upgrade of the scheme only after a period of at least three months, post the correction of the portfolio.

Capital protection-oriented mutual fund schemes generally adhere to the features as indicated below. Any modifications/changes in the regulatory guidelines shall prevail over the laid-down provisions.

---

[1] SEBI guided capital protection-oriented mutual fund schemes where the debt component of the portfolio has the highest investment grade rating

[2] If the call option is exercised, the scheme could be exposed to reinvestment risk and would be subject to a rating review

[3] Please also refer to the ICRA's Policy on Assigning Provisional Ratings available at www.icra.in

Structural Feature	Description
Debt Security Covenants	
Eligible Securities	G-Secs or debt issued by corporates rated [ICRA]AAA or with an equivalent rating
Maturity Profile of Debt Instruments	• No investment to be made in instruments with a maturity greater than the maturity of the plan • Investments in instruments with the final maturity not exceeding the maturity of the scheme are preferred; however, if an investment is made in an instrument with a maturity beyond the maturity of the scheme, the instrument should have a put option date (before the maturity date of the scheme), which shall be compulsorily exercised by the fund house • In case of instruments with a call option, the call option is ignored, and final maturity is considered, which must be before the maturity of the scheme
Reinvestment Risk	• Investments to be made in fixed income securities only; if any investment is made in floating rate securities, it necessarily has to be swapped into a fixed rate with an [ICRA]AAA (or equivalent)-rated counterparty • The fund shall try to minimise the reinvestment risk as much as possible
Other Requirements	Debt portion of the investments to be generally passively managed except in a few cases where the scheme is either churning to reinvest for a higher yield or churning to liquidate the instruments for which the credit quality has gone below [ICRA]AAA (or equivalent); all churning should be done in line with the provisions in the scheme offer document The scheme would look at investing any interim cash flows, in line with the above-mentioned requirement of AAA rated debt instruments or money market instruments (rated minimum A1+)/deposits in banks rated A1+
Structure Covenants	
Capital Protection	The maturity value of the debt plus the intermediate coupon, after factoring in the reinvestment (benchmarked to savings deposit rate of State Bank of India) and deducting the scheme's expenses, should be greater than the face value of the units subscribed by the investors
Mandatory Liquidation	Full liquidation of the equity portfolio to be completed 3-5 trading sessions prior to the maturity date of the scheme
Dividend Payment	Dividend payout shall be made only out of the surplus in the equity component and no part of the static debt component shall be used to pay dividends

ICRA's Rating Approach for Other Capital Protection-oriented Mutual Fund Schemes

This section outlines the general approach that ICRA would follow in case regulations were to permit capital protection-oriented schemes to invest in debt securities other than those with the highest investment grade rating. In other words, this approach will apply to the capital protection-oriented schemes that could invest a part or the entire AUM of the scheme in debt instruments and money market instruments across the rating spectrum. The balance portion of the scheme's AUM, if any, could be invested in equity and equity-related instruments to achieve capital appreciation. The objective would be to structure the scheme in such a manner that the interim cash flows and the maturity value of the debt investment are adequate to repay the principal to the investors while covering the operating expenses for managing the scheme. Further, the maturity of such debt instruments would be aligned before the maturity of the scheme to ensure timely repayment to the unit holders. In case of embedded put options in the debt instruments, the put option date would be assumed by ICRA as the maturity date for such instruments.

At the time of rating a new scheme, ICRA would analyse the credit profile of the debt securities in which the fund planned to invest. ICRA would also factor in any additional structural features that may be available for providing capital protection to the investors, for example, in the form of the presence of a junior tranche that is subordinated to the senior tranche. This, with the recurring expenses as stated in the scheme offer document, would be used as inputs by ICRA to evaluate the extent of capital protection offered by these funds to the investors. In case the investments are not yet made by the fund, ICRA would assign a provisional rating to such funds and/or the tranche(s) based on the proposed investment mix. The provisional rating would be finalised after the investments are made by the scheme. The portfolio of capital-protection schemes would be monitored and analysed on a quarterly/half-yearly basis, depending on the frequency of the portfolio disclosures being made available.

Environmental and Social Risks

While capital protection-oriented mutual fund schemes do not face material physical climate risks, they are exposed to environmental risks indirectly through their portfolio of assets. If the entities or businesses, to which capital protection-oriented mutual fund schemes have an exposure, face business disruption because of physical climate adversities or if such businesses face climate transition risks because of technological, regulatory, or customer behaviour changes, the same could translate into credit risks for the schemes. However, the risk can be mitigated via adequate portfolio diversification. Further, the scheme's investment exposure is typically over a short-to-medium-term period that could allow it to adapt and take incremental exposure only to businesses with relatively lower environmental risks. Likewise, the exposure of these schemes to social risks depends on the nature of the sectors and/or entities in the portfolio and the relative concentration of investments.

Summing Up

ICRA’s capital protection-oriented fund ratings are a symbolic representation of the extent of capital protection offered by these funds to the investors while covering the operating expenses for managing the scheme. ICRA’s methodology for assigning these ratings involves assessing the investment mix of the debt and non-debt instruments, the credit quality of the debt instruments and the prevailing yields. Further, ICRA would assess the presence of structural features such as tranches of different seniority to provide capital protection to the senior investors, if applicable.

Rating Scale and Definitions

ICRA's Long-term Capital Protection-oriented Fund Rating Scale – This scale applies to capital protection-oriented funds with an original maturity of more than one year.

[ICRA]AAA(SO) Instruments with this rating are considered to have the highest degree of safety regarding the timely servicing of financial obligations. Such instruments carry lowest credit risk.

[ICRA]AA(SO) Instruments with this rating are considered to have a high degree of safety regarding the timely servicing of financial obligations. Such instruments carry very low credit risk.

[ICRA]A(SO) Instruments with this rating are considered to have an adequate degree of safety regarding the timely servicing of financial obligations. Such instruments carry low credit risk.

[ICRA]BBB(SO) Instruments with this rating are considered to have a moderate degree of safety regarding the timely servicing of financial obligations. Such instruments carry moderate credit risk.

[ICRA]BB(SO) Instruments with this rating are considered to have a moderate risk of default regarding the timely servicing of financial obligations.

[ICRA]B(SO) Instruments with this rating are considered to have a high risk of default regarding the timely servicing of financial obligations.

[ICRA]C(SO) Instruments with this rating are considered to have a very high likelihood of default regarding the timely payment of financial obligations.

[ICRA]D(SO) Instruments with this rating are in default or are expected to be in default soon.

Note: *For the rating categories [ICRA]AA(SO) through to [ICRA]C(SO), the modifiers + (plus) or – (minus) may be appended to the rating symbols to indicate their relative position within the rating categories concerned. Thus, the rating of [ICRA]AA+(SO) is one notch higher than [ICRA]AA(SO), while [ICRA]AA-(SO) is one notch lower than [ICRA]AA(SO).*

ICRA's Short-term Capital Protection-oriented Fund Rating Scale – This scale applies to capital protection-oriented funds with an original maturity of up to one year.

[ICRA]A1(SO) Instruments with this rating are considered to have a very strong degree of safety regarding the timely payment of financial obligations. Such instruments carry lowest credit risk.

[ICRA]A2(SO) Instruments with this rating are considered to have a strong degree of safety regarding the timely payment of financial obligations. Such instruments carry low credit risk.

[ICRA]A3(SO) Instruments with this rating are considered to have a moderate degree of safety regarding the timely payment of financial obligations. Such instruments carry higher credit risk compared to instruments rated in the two higher categories.

[ICRA]A4(SO) Instruments with this rating are considered to have a minimal degree of safety regarding the timely payment of financial obligations. Such instruments carry a very high credit risk and are susceptible to default.

[ICRA]D(SO) Instruments with this rating are in default or expected to be in default on maturity.

Note: *For the short-term ratings [ICRA]A1(SO) through to [ICRA]A4(SO), the modifier + (plus) may be appended to the rating symbols to indicate their relative position within the rating level concerned. Thus, the rating of [ICRA]A1+(SO) is one notch higher than [ICRA]A1(SO) and so on.*

Contact us for any feedback or comments at: methodologies@icraindia.com

RELATIONSHIP CONTACT

L Shivakumar
+91 22 6114 3406
shivakumar@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
+91 124 4545 860
communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in and www.icraresearch.in

ICRA Limited

Registered Office

B-710, Statesman House, 148 Barakhamba Road, New Delhi-110001
Tel: +91 11 23357940-45

Branches