

Monitoring credit risks, a key imperative for FMPs

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Executive summary

India's increasing interest rates in recent months have significantly enhanced interest in a hitherto neglected investment category among mutual funds -- fixed maturity plans (FMPs). These are investment schemes floated as close-ended mutual funds, and have maturity periods ranging from a month to five years. Taking advantage of the rising interest rate regime, FMPs offer tax-adjusted returns that are higher than those offered by bank fixed deposits (FDs) of comparable maturity. The assets under management in this category have, therefore, grown rapidly in recent months.

FMPs indicate the yields investors can expect at maturity; however, unlike returns from bank FDs and other risk-free investments, FMP yields are not assured. It is, therefore, imperative that investors clearly

understand how FMPs achieve higher yields than FDs, and the risks associated with FMP portfolios; this is a corollary of the classical risk-return paradigm.

This commentary accounts for the FMPs' growing popularity as an investment option. It also explains why investors need to closely monitor the credit risks of portfolios that FMPs invest in. Reliable, third-party evaluations of credit risks, such as those by CRISIL's Credit Quality Ratings (CQRs), can help investors evaluate the credit risks in FMPs.

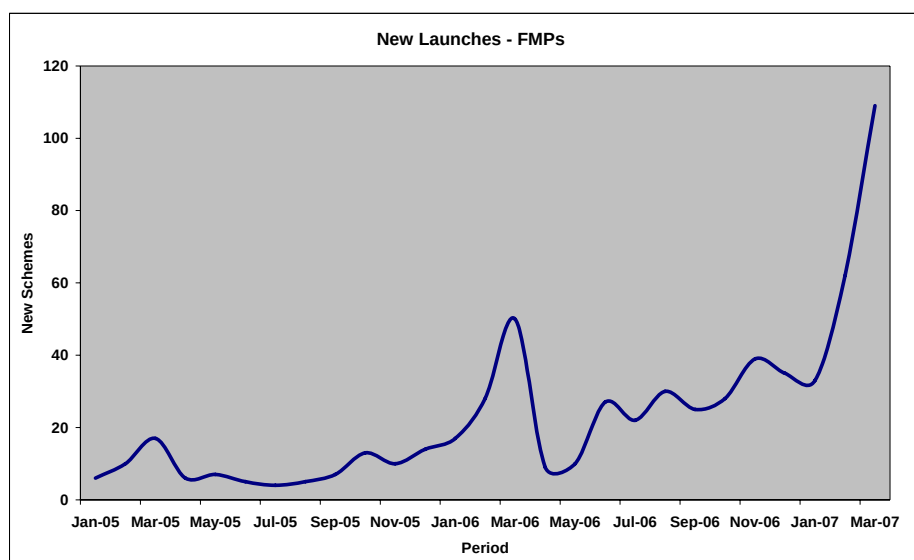
FMPs: why they do what they do

The basic objective of FMPs is to generate steady returns over a fixed-maturity period, thus immunising investors against market fluctuations. FMPs are passively managed fixed-income schemes: the fund manager locks into investments with maturities corresponding to the plan's maturity. This effectively reduces price risks, or the potential to make losses on bonds when interest rates rise, unless there are interim redemptions by investors. Investors are informed of the indicative returns their investments are likely to generate at maturity: the prevalent yield on investments, minus the expense ratio, which varies from 0.25 per cent to 1 per cent of the initial capital mobilised, is the likely return at maturity to the investor. FMPs usually invest in certificates of deposit (CDs), commercial papers (CPs), money market instruments, corporate bonds, and even bank FDs. The plans are predominantly debt-oriented, while some may even have small equity components. In the case of FMPs with equity components, the equity provides an additional boost to returns in the event of a rise in equity markets.

FMPs: an increasingly popular investment option

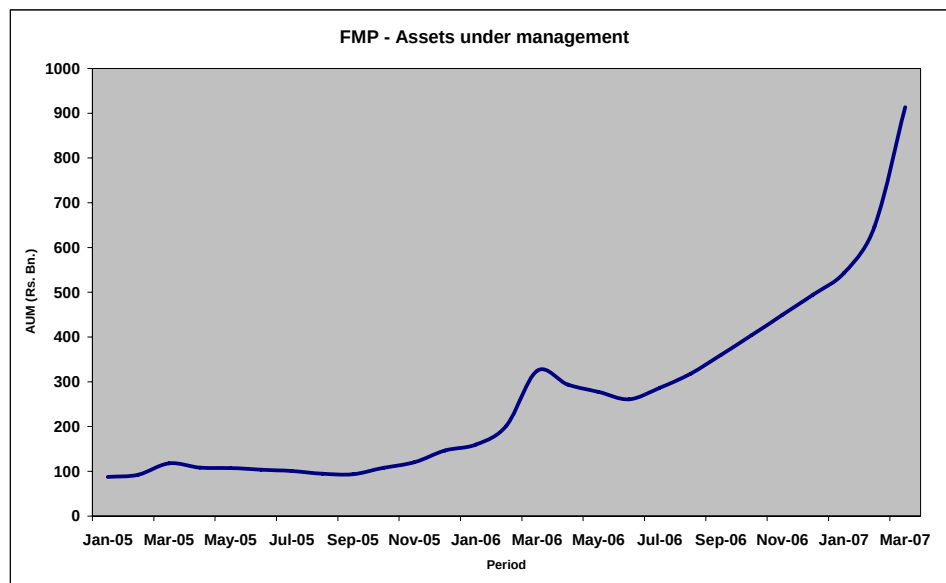
When interest rates first began to increase, there was an increasing allocation by mutual funds in floating rate funds. The trend has now shifted to an increasing participation in FMPs. As Chart 1 indicates, the number of new schemes launched shows a rising trend: around 400 FMPs were launched during the period between April 2006 and March 2007. March 2007 alone accounted for more than 100 new launches. FMPs are now also being launched in series, back-to-back, with each new scheme replacing one that has just matured.

Chart 1: FMPs – New Launches



The total assets under management by the FMPs have also increased by over 7 times in the two years ended March 2007 (*see Chart 2*).

Chart 2: FMPs – Assets under management



FMPs vs FDs

FMPs are the mutual fund industry's equivalent of FDs, with a caveat: the maturity amounts of FDs are assured returns unless the bank issuing the FD is in financial distress, while the returns on FMPs are only indicative. However, FMPs are more tax efficient than FDs are. A comparison of a one-year FMP (dividend option) and an FD of a similar tenure, for individuals, indicates that the post-tax returns are higher for FMPs than for FDs. This is because dividends are tax free for the investor, though the mutual fund pays a dividend distribution tax of 14.16 per cent (inclusive of surcharge and cess). In contrast, the interest gained on FDs is added to the main income and taxed as per the applicable income tax rate. For an individual with an income of over Rs.1 million, for instance, the tax on interest on FDs is 34 per cent (inclusive of surcharge and cess). Though the latest budget has narrowed the arbitrage between the money market or liquid funds and bank FDs, by raising the dividend distribution tax to 25 per cent, it remains unchanged for FMPs, at 12.5 per cent (both values exclude surcharge and cess).

FMPs with growth options and tenors of more than a year can avail of the benefits of long-term capital gains, where the tax rate is at 10 per cent (without indexation benefits) or 20 per cent (with indexation benefits). Investors can also avail of double indexation benefits by investing in an FMP in, say, March 2007 (financial year 2006-07), and redeeming the same in April 2008 (2008-09). In such cases, the incidence of tax is further reduced.

FMPs vs other debt funds

The principal difference between the regular debt funds and FMPs is in the risk profile. Other debt funds are typically exposed to three types of risk: risks relating to interest rate, liquidity and credit. Interest rate risks arise when the fund constantly buys and sells bonds, thus exposing itself to interest rate fluctuations, which manifest themselves as the marked-to-market action on portfolio value. Liquidity risks arise owing to the huge redemption pressures that result when the fund sells its holdings at short notice, and at times, even at unfavourable prices. Credit risks occur when risks of default on securities lead to valuation losses.

FMPs, on the other hand, face only credit risks, by virtue of being close-ended. Interest rate risks are ruled out because the fund manager holds most investments to maturity, thereby obtaining fixed rates of return. Liquidity risks are also minimised because funds are close-ended; the events for redemption of securities in FMPs are likely to be lower than that for other debt funds. Although there is a measure of liquidity risk involved in interim redemptions, this is minimised because most investors park their funds in FMPs with a view to holding them to maturity.

Another advantage FMPs have over other debt funds is in low transaction costs. Transaction costs remain negligible for FMPs; this is because securities are held to maturity, with the result that the portfolio is subject to a lesser degree of churn.

FMPs: the risks

The single greatest risk factor that FMPs face relates to the credit quality of their portfolios. The indicative yields declared by FMPs have increased over time. One of the ways FMPs increase their yields is by investing in credits that are not in the highest safety category. As one moves down the rating scale, the yield on instruments picks up; this is the reward that investors get for being willing to take on higher credit risk. The investors' willingness to move down the rating scale is a heartening development, and bodes well for the deepening of the corporate bonds market. However, it is imperative that investors know how much credit risk they will take on by moving down the rating spectrum.

It is also pertinent to note that FMPs are not capital protection-oriented funds. The maturity amounts of FMPs are only 'indicative,' and not 'protected' or 'oriented towards protection.' Investors could suffer losses on invested capital at maturity in the event of default in even one security. Investors, therefore, need to ensure that the FMP does not take on credit risk that is inconsistent with their risk profile.

CRISIL CQRs: a tool for investors

Credit risks in FMP investments constitute the investors' biggest risk. Investors will do well to understand the credit risks involved by closely monitoring the FMPs' portfolios. Reliable, third-party evaluations of credit risk will help them do so.

CRISIL's CQRs provide an independent opinion on the overall credit risks associated with securities in a fund's portfolio. CQRs address the credit risks associated with bond funds; a 'AAAF' rating, for instance, denotes that CRISIL has judged the fund's portfolio to offer very strong protection against credit default. Of the 41 CQRs assigned by CRISIL till March 31, 2007, not even one has been downgraded, or moved into default grade. This indicates how robust CRISIL's monitoring process is; it also supports CRISIL's belief that its CQRs are a reliable third-party evaluation of the default risks of bond fund portfolios.

Conclusion

FMPs provide investors with opportunities to register returns that are higher than those available with risk-free investments. However, investors need to be aware of the credit quality of the portfolio at all times, and of the fact that high returns are possible only when there is no default in the underlying securities. In other words, credit risk monitoring is a key imperative for FMPs. Credit risks can be mitigated if the investor ensures that the credit quality of the portfolio is maintained at all times.

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