



The Pakistan Credit Rating Agency Limited

Capital Protection Rating

An opinion on the prospective relative certainty of capital protection, that is, the timely repayment of the original investment on maturity of the scheme.

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1. INTRODUCTION

- Evolving Nature of Industry
- PACRA's Products
- Capital Protection Rating – A yardstick for measuring certainty of protection of initial investment

1.1 Mutual fund is an effective tool for mobilizing resources from a large pool of investors, and in turn, providing them access to a variety of assets, which might otherwise be difficult. Pakistan's asset management industry, which is still in an initial development phase, has witnessed notable evolution in overall structure during the years. The asset management companies (AMCs) have, intermittently, introduced a variety of products in line with varying risk-return preferences of investors. Equity funds have remained mainstay of the industry for long. However, lately, income funds and its different variants are gaining increasing attention. With the advent of commercial banks in the asset management industry through their subsidiaries, the asset management industry has gained significant momentum. These companies, with established franchise and financial backing of the parent, are helping in expanding the outreach of industry in the retail segment. Their share in the overall growth of the industry has risen sharply, and currently, bank backed AMCs constitute around half of the total assets under management of the industry.

1.2 Recognizing the rising competition and growth potential in this segment, the asset managers, while offering a variety of funds, are using varying investment styles and techniques to achieve competitive returns. All these developments have necessitated the need for an independent opinion as to the risk exposure of these funds, which, in turn, has an impact on future returns.

1.3 The asset management business has two distinct elements – 1) the asset manager, 2) the mutual funds. PACRA has developed different products to capture distinct components of the industry. **Asset Manager Rating** is an opinion on the quality of fund management, capability to manage risks inherent in asset management business and effectiveness of an AMC's systems and processes. PACRA offers three products to capture varied factors of different types of mutual funds. The Performance Ranking (also referred to as **Star Ranking**) is purely a quantitative measure, comparing historical returns of a fund relative to other funds in the same category of classification. The **Fund Stability Rating** provides investors with an objective measure as to the main areas of risk to which the income funds are exposed, that is credit risk, liquidity risk and interest rate risk and is a useful yardstick in comparing their individual risk-return matrix while making investment decisions. The **Capital Protection Rating** is an opinion on the prospective relative certainty of protection of the original investment.

1.4 Since the launch of the first capital protected fund (CPF) in early 2007, there is increasing investor interest in such type of funds. Considering the encouraging response, more asset managers are targeting to tap this avenue for mobilizing funds, going forward. This is due to the unique characteristic of these funds in protecting the investors' initial investment, while at the same time giving them an opportunity to benefit from returns offered by other relatively risky avenues, mainly the stock market. CPFs are attractive for those risk-averse investors who are looking to enhance the yields on the portfolios through some exposure to risky asset classes, and yet seek assurance on the protection of original investment.

1.5 Capital Protection Rating indicates the degree of certainty regarding timely payment of the original investment on maturity of the scheme. Although the rating captures the relative degree of certainty of capital protection, it does not comment

on the relative performance of these schemes in terms of returns offered to investors.

2. PROCESS OVERVIEW

- Protection emanates from structure of the CPF
- Current Opinion on Prospective Certainty of Capital Protection
- Considers a Mix of Qualitative and Quantitative Measures

2.1 STRUCTURE OF CPFs: The protection of original investment at maturity emanates from the structure of CPFs, which can be broadly classified as 1) Static Hedge, 2) Dynamic Hedge, 3) Constant Proportion Portfolio Insurance (CPPI), and 4) Dynamic Portfolio Allocation (DPI). Sometimes, a guaranteed feature could also be embedded in the schemes, either from the asset management company or a third party, which ensures capital protection if the underlying structure fails to ensure that. Such events are more likely in case of complex structures under extreme market conditions.

2.2 THE RATING PROCESS: PACRA’s capital protection rating is a current opinion on the prospective certainty of capital protection. The rating is designed to provide investors with a simple to use indicator for evaluating the certainty of a capital protection scheme to ensure protection of invested capital at the maturity of the scheme. The rating categories range from AAA (cp) (fund having exceptionally strong certainty of capital protection) to BB (cp) (fund having weak capital protection). The (cp) distinguishes the Fund’s capital protection ratings from PACRA’s other ratings.

2.3 There is no requirement of any minimum operational history of the fund to be eligible for the rating. Thus, a fund proposed to be launched in the near future could also be assigned a rating. This would be based on the efficacy of the structure of the scheme in ensuring capital protection, the capacity of the asset manager in terms of quality of human resource, systems and processes to effectively monitor and implement the underlying structure, and the quality of controls and risk management systems employed. The capacity of the asset manager in effectively implementing the structure gains higher importance especially in case of complex structures requiring continuing dynamic asset allocation. Nevertheless, the financial strength of the guarantor is a key factor wherever such an arrangement exists.

2.4 The capital protection rating is based on detailed quantitative and qualitative assessment of a fund’s underlying structure that provides capital protection. The rating is current as to the date it is assigned, and any significant changes in fund’s portfolio, leading to a higher probability of the portfolio value falling below the initially contracted principal value, may lead to deviation from the assigned rating. PACRA will continuously monitor the rated CPFs, usually on quarterly basis, to ensure that the rating remains current and accurate. However, a detailed formal review of a rating will be carried out on annual basis.

2.5 In forming an opinion on a fund’s relative certainty to provide capital protection, PACRA will consider a variety of factors aimed at establishing the quality of the fund management, and the fund’s exposure to credit, liquidity and market risks. These factors are assessed within the broad context of a fund’s underlying structure, investment objectives and policies to determine how they may affect the fund’s capital protection features under different market conditions.

3. CREDIT RISK

- Credit quality of underlying asset classes
- Review of credit risk management processes

3.1 Capital Protected Funds are subject to default risk and downgrade risk, owing to the nature of the asset classes the fund invests in. Investors assume full credit risk of the underlying asset classes, the underlying institution with which funds are placed to ensure capital protection, as well as the credit risk of the institution that guarantees capital protection at maturity, if applicable. Therefore, for capital protected funds involving relatively less complex portfolio structures, it is unlikely that the rating of such CPFs exceeds the credit rating of the underlying asset class that provides capital protection for the fund. The credit risk in CPFs may be minimized by investing in asset classes with high credit quality.

3.2 The review of credit risk management process in place at the asset management company is an important element in overall assessment of the credit risk of the fund. This involves review of the in-house credit and research analysis, security evaluation process, and ongoing surveillance procedures. The investment proposals and minutes of the Investment Committee meetings will also be reviewed to examine the depth and quality of analysis, and consistency of approach to understand the manager's credit risk tolerance.

4. MARKET RISK

- Gap Risk
- Interest Rate Risk
- Reinvestment Risk
- Float Risk
- Liquidity Risk
- Transaction Costs
- Prepayment Risk

4.1 The key factors to be considered while analyzing the CPF's market risk exposure are gap risk, interest rate risk, reinvestment risk, float risk, liquidity risk, transaction costs and prepayment risk. Given the difference in investment philosophy of various CPF structures, the relative degree of emphasis on these factors may vary for different types of CPFs. Nevertheless, these risks will be more pronounced for CPF schemes embodying dynamic asset allocation and CPPI methodologies than for static allocation schemes.

4.1.1 Gap Risk: Gap risk is typical of CPPI and other dynamic asset allocation schemes, and occurs when the portfolio value falls below the floor value. Capital protection fails when a gap event occurs. This necessitates that the option to switch the entire portfolio to risk free assets (thereby protecting the principal) always exists with the fund manager as long as the gap event does not occur. The risk can be mitigated by determining the maximum permissible equity portfolio (e.g. by restricting the multiplier for a CPPI based CPF) based on stress tests on the past performance of equities.

4.1.2 Interest Rate Risk: Interest rates may vary over time, causing the value of debt securities to fluctuate and contribute towards portfolio losses. A rise in interest rates during the investment term, for instance, may result in reduced return in terms of opportunity cost. On the contrary, in a declining interest rate scenario, investing in fixed income instruments with a predetermined rate may provide steady cash flows to ensure capital protection at maturity. This risk may be mitigated by considering a cushion for unanticipated interest rate shifts.

4.1.3 Reinvestment Risk: Another corollary of interest rate risk is reinvestment risk i.e. the risk that cash flows from interest-bearing debt instruments may be reinvested at a lower yield than that of the original investment. In a CPPI-based structure, a cushion for reinvestment risk may be built in the computation of the maximum permissible investment in equity (e.g. by raising the floor value).

4.1.4 Float Risk: The structure may have a lower yield than projected in case there is a delay in deployment of funds, or if the debt instruments do not have the

same maturity profile as the CPF scheme. The fund manager needs to build a cushion for float risks, at the launch and maturity of the fund as well as during rebalancing, while deciding the investment portfolio mix.

4.1.5 Liquidity / Prepayment Risk: Liquidity concerns can be important in case of large redemption pressure. It is due to the impact cost of selling investments in distress to generate liquidity. An analysis of unit-holder concentration may signify the extent of redemptions in the fund. The risk, to some extent, may be mitigated by keeping credit lines available to meet untimely redemptions. A queue system in case of excessive redemptions may also help in managing this risk. An exit load may be imposed to discourage early redemptions, and, in case these redemptions occur, the exit load would compensate for the impact cost. In case heavy redemption is unavoidable, the fund may invoke its arrangements with the guarantor (if applicable) to ensure that capital protection for the remaining investors is intact. A clause stipulating core investors to hold their investment for a minimum lock-in period necessary to ensure capital protection, along-with imposition of a back-end load in case of early redemption, may mitigate this risk.

4.1.6 Transaction Costs: In case of dynamic allocation and CPPI schemes, frequently rebalancing the portfolio at every rebalancing date may cause increased transaction costs. However, since this would be reflected periodically in the portfolio value, its impact would automatically be factored in subsequent rebalancing.

RATING SYMBOLS & DEFINITIONS

AAA (cp) Exceptionally strong certainty of capital protection.

AA (cp) Very strong certainty of capital protection.

A (cp) Strong certainty of protection.

BBB (cp) Adequate certainty of capital protection.

BB (cp) Weak capital protection.

Note: *A plus (+) or minus (-) sign may be appended to a rating to denote relative status within major rating categories except for AAA (cp) and BB (cp).*

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