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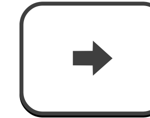

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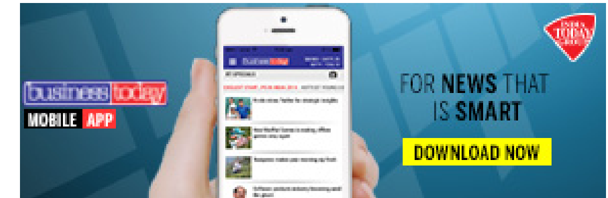

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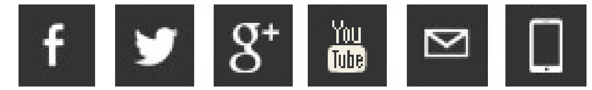

Downgrade Spiral

Mutual funds and private insurers are gradually emerging as big players in corporate bonds. But it is not without credit risk.

By Anand Adhikari Delhi Print Edition: July 3, 2016

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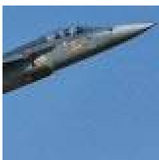

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The numbers tell the story. Four years ago, investment grade corporate paper - bonds available to mutual funds (MFs), insurance companies (insurers), banks, provident and pension funds for investments - was close to two-third of the total issues. This figure has now nosedived to a paltry one-third.

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rating portfolio of rating agencies. This was not the scenario in the boom years of 2004 to 2008 when the high investment

grade paper commanded a lion's share of over 60 per cent. What is worrisome, however, is the pace and quantum of corporate downgrades in the past few years.

These are certainly not normal times for the corporate bond market where the new emerging players, flush with retail money, are MFs and insurers. Currently, MF's exposure to corporate bond market is estimated at around Rs 2,50,054 crore through various debt schemes. Insurers have an exposure of Rs 4,20,349 crore.

Two mishaps have already happened. In August last year, JP Morgan AMC's two schemes came under severe redemption pressure when one of the rating agencies suspended the bonds rating of Amtek Auto. The auto ancillary had a good investment grade rating of AA - (Double A minus) and the two schemes had a substantial exposure - around 5 and 15 per cent - in its bond offering. With the suspension, the two schemes had to mark investments to market, leading to a reduction of their net asset value (NAV) by 1.5 and 3.5 per cent, respectively. It was a huge loss for investors - more so as debt schemes are perceived as safe assets. Similarly, debt schemes of ICICI Prudential and Franklin Templeton took a marginal hit when bonds of Jindal Steel and Power (JSPL) were downgraded by the rating agencies from triple B to double B, early this year. The NAV was impacted only marginally as the exposure of these MFs to JSPL was limited.

Indeed, experts say the downgrades have the potential to take an ugly turn in view of the global headwinds. At the start of

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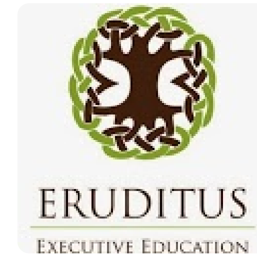
2016, global rating agency S&P warned that the corporate ratings outlook is the worst since the Lehman crisis of 2008. China is already witnessing a spate of downgrades and default of corporate bonds. The largest credit rating agency in India, CRISIL, has recently pegged the aggregate downgraded debt in the domestic market at Rs 3.8 lakh crore. Of this, corporate bonds - mostly subscribed by MFs, insurers and trusts - account for around Rs 45,000 crore. The total outstanding corporate bonds are currently at Rs 17.50 lakh crore. "We don't see the downgrade picture changing anytime soon. We are continuing to see the same pace of downgrades as last year in the first two months of 2016/17," warns Pawan Agrawal, Chief Analytical Officer at CRISIL. Any downgrade has implications for MFs as they have to mark-to-market their investments in their debt schemes. Ultimately, it's a loss for the investors. Similarly, new private sector insurers, while investing in bonds in the HTM (held to maturity) category, have to factor any downgrades by way of impairment in the policyholders' scheme.

"It was equities that bore the brunt of slowdown in the post-2008 period. The focus is now shifting to the bond market," says a debt dealer. India appears to be relatively insulated from the global turmoil but there are risks galore. It explains the rise in the number of downgrades by CRISIL over the past five years - from 492 companies in 2011/12 to 1,171 companies in 2015/16 (see box: The Rising Downgrades). More than half of CRISIL's downgraded debt is in the metal, infrastructure and real estate sectors. Clearly, it points to a poor quality of



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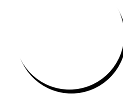

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corporate paper in the market. Indeed, more than three-fourth of CRISIL's rated companies have investment grade rating of BB and below. It's the same story with other rating agencies ICRA and Care Ratings. The financial performance of corporates is not too encouraging. If the global situation worsens further, the domestic corporate bond market will also feel some tremors, impacting the returns to investors in MFs and insurers.

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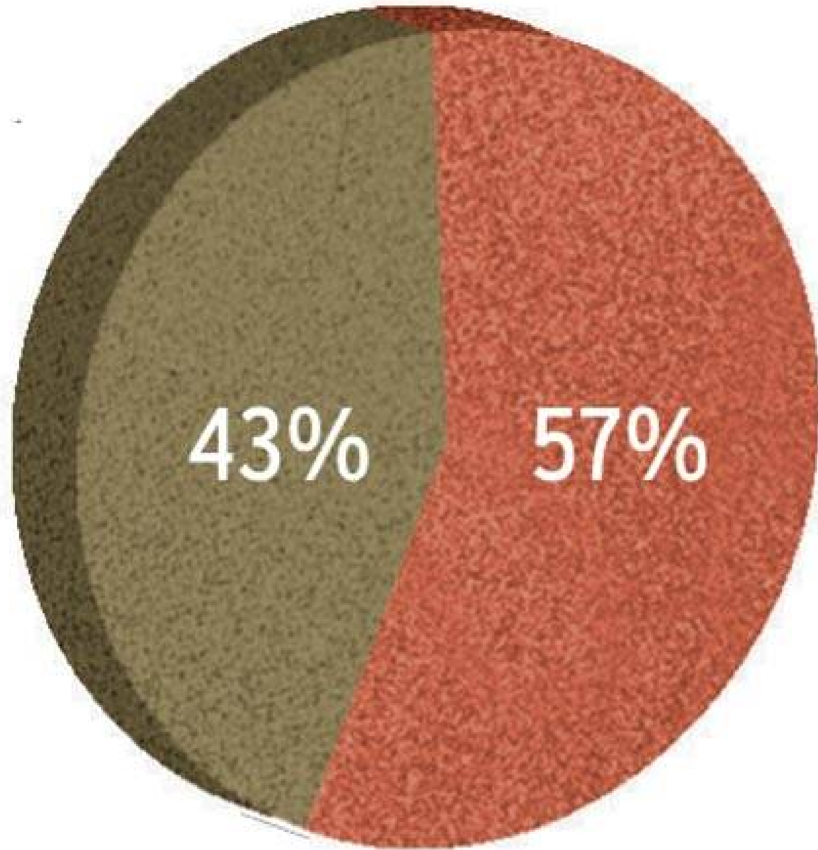

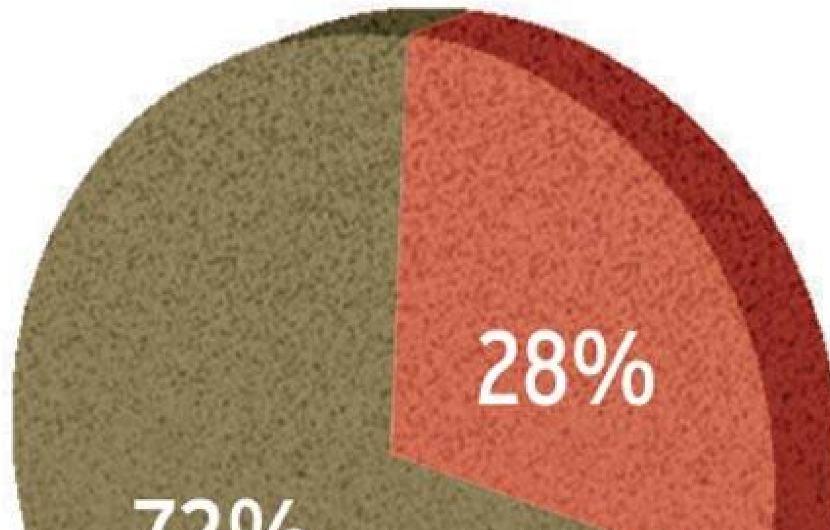

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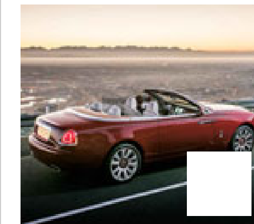

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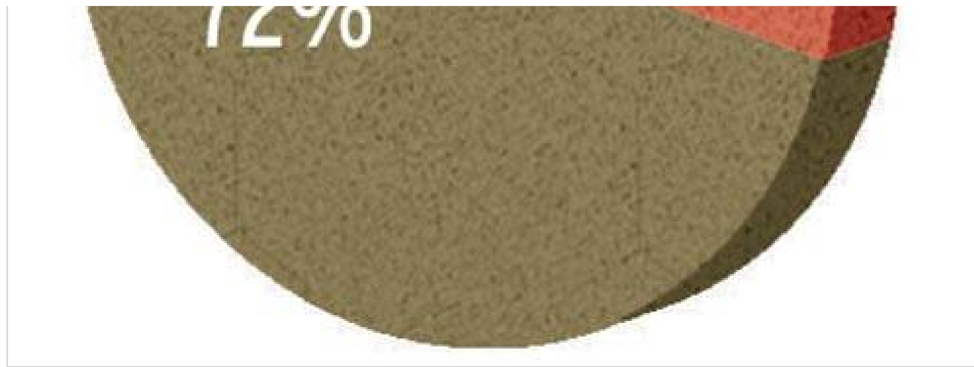

CRISIL does not expect a sharp improvement in credit quality in the near future. Rajesh Mokashi, Deputy MD at Care Ratings, is more optimistic. "Some downgrades have already happened in the past two years. Some more may happen going forward. However, upgrades have exceeded downgrades last year and there are also instances of restructuring of weak entities, which in turn could improve their ratings," says Mokashi.

Credit Risk

Over the past decade, the MFs have emerged as a big subscriber of corporate bonds in their income funds. In fact, the share of corporate bonds is close to 30 per cent in the total AUM of MFs. Unlike pension and provident funds and insurers, there is no limit on investment by MFs in the corporate bond market. But this also exposes the mutual funds to another risk apart from downgrades. The composition of corporate bonds in the MF's books is highly skewed towards NBFCs. "There is a concentration risk. The bond market portfolio is very, very skewed towards the financial sector," says an analyst at a rating agency. According to CRISIL data, the

financial services sector including housing finance companies and banks have a share of 64 per cent in the new issuances, while the private sector (non financial companies) has a share of just 29 per cent.

	2011/12	2012/13	2013/14	2014/15	2015/16
Number of Upgrades	562	670	921	1,518	**1,521**
Number of Downgrades	492	1,073	1,165	902	**1,177**
Outstanding ratings at the end of the period	8,849	11,527	13,038	13,691	**14,252**

There are other risks as well. Initially, the MF's exposure was restricted to highest rated AAA bonds but that is changing now. "In the past three years, fund houses have launched products that are investing in lower investment grade papers," admitted Milind Barve, Managing Director at HDFC Mutual Fund, at a bond seminar recently. HDFC Mutual Fund is one of the largest fund houses in the country. Currently, investment in G-sec, where bulk of the debt money goes, offers a yield of 7.98 per cent. The state development loans (SDLs) offers 8.17 per cent and a triple A rated paper offers 8.25 per cent. Since lower graded corporate bond paper offer higher yield than the 8.25 per cent, the schemes manage to offer higher returns.

What is more dangerous is the MFs high dependence on credit rating agencies. There are some well established MF's that rely on their own research to make a final decision rather than merely go by credit ratings."We use credit rating agency as a qualitative element and super-impose other information like corporate governance, management style, related party

transactions etc," says Lakshmi Iyer, CIO, Debt & Head of product at Kotak MF.

Lakshmi Iyer, CIO, Debt & Head of product, Kotak MF (Photo: Rachit Goswami)

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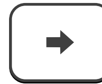

> "We use credit rating agency as a qualitative element and super impose other information like corporate governance, management style, related party transactions etc"

But good quality paper is in short supply, thereby forcing the MFs to go for lower rated paper. Currently, there are only 5 per cent of the issues rated as AAA. (See Box: Deteriorating Investment Quality). An HDFC Securities report has noted that they have not seen any drastic trimming of MF's exposure to 'AA and below' after the Amtek Auto fiasco. "Interestingly, we see an increase in the allocation to such bonds. It shows the confidence of the AMC on their credit research and choosing the papers of the right companies. However, another credit downgrade emergence of JSPL may caution the fund industry to be careful on investing in such bonds," cautioned the report released in April.

In addition, the MFs have also been investing in unrated bonds, which are yield kickers. The risk to MFs also emanate from such unrated investments. "High yield in itself implies the risk is high," says Agrawal. The current cap for unrated papers is very liberal, at 25 per cent with 10 per cent in a single issuer.

Rajesh Mokashi, Deputy MD, CARE Ratings (Photo: Rachit Goswami)

> "There has to be a minimum issue size for debt mutual fund schemes in order to mitigate risk. A bad exposure to a small scheme has the potential to impact the yield of the entire scheme significantly. I believe there is a strong case for minimum scheme size of Rs 4,000 crore for debt schemes"

Similarly, private sector insurance companies are also amassing huge AUMs, and a part of the funds is now getting invested in the corporate bond market. They have been allowed to invest up to 15 per cent in AA-rated corporate bonds with another 15 per cent cap in housing and infrastructure sector. While a bulk of the investments goes into G-sec, corporate bonds find a place as they offer higher yields. Currently, around 8-10 per cent of the insurance money is parked in corporate bonds, but this share is expected to rise substantially. Globally, the insurance companies are one of the biggest players in the corporate bond market. The insurers, too, faces similar risk as MFs with the only exception being they hold the bonds under

'held to maturity' portfolio. While there is no provision for mark-to-market losses, they have to factor in the impairment in value. "Different companies follow different impairment policies. There could be a big risk to insurers if the impairment is not valued properly," says a market dealer.

Limited Choices

The big challenge for MFs and insurers is to mitigate the risk in lowly rated bonds. In fact, there are no avenues to sell the investment as there is no secondary market for bonds. "The liquidity risk is far bigger," admits Iyer of Kotak MF. The only exit option is to do a bilateral deal in a distress manner. Banks and insurance companies including LIC hold corporate bonds under the held to maturity category and don't trade, one of the reasons for the poor liquidity. "There is also no retail participation in the secondary market," says a dealer. Globally, apart from a well developed secondary market, there is also a credit default market, which is like an insurance against a possible default in a corporate bond. A likely default in the paper worries investors. "Investors like MFs or insurance need a protection against credit or a credit default insurance, which is something yet to develop in India," says Pawan Agrawal, Chief Analytical Officer at CRISIL. The credit default swap (CDS) market, which provides a protection against default, is completely non- existent in India.

There is also a need for credit enhancement mechanism through a bond guarantee fund or

The Regulatory Action

SEBI is waking up to protect investors in mutual funds

Investment limit in bonds of a company lowered from
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Sector exposure limit lowered from
30% to 25%

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5%
investment limit. The earlier figure was
10%

some sort of financial support from other institutions. These are currently not in place. The RBI has recently allowed foreign portfolio investors (FPI) to invest in a default paper, but there is hardly any interest because of the challenges in recovery. In fact, the global markets have enough avenues to exit, but the Indian market is still in its infancy jeopardising the interest of investors and policyholders.

The Safeguards

After the Amtek issue, the regulators, the Securities and Exchange Board of India (Sebi) and Insurance Regulatory Development Authority (IRDA) have stepped up their vigil. (See Box: Sebi's exposure limits). There is, however, need to do more. "There has to be a minimum size of say Rs 4,000 crore for debt mutual fund schemes in order to mitigate risk. A bad exposure in a small scheme has all the potential of impacting the yield of the entire scheme significantly," suggests Mokashi of Care. There is also need for more disclosure norms to protect the interest of MFs and insurers. For example, companies today release only the profit and loss statement on quarterly basis. "There has to be a mandatory requirement for all the companies with bond issuance to also issuer quarterly data of balance sheet," says Mokashi.

The regulators often wake up when a mishap takes place in the market. It's time for policy makers to build enough safeguards

as more and more retail money pours into MFs and insurance companies.

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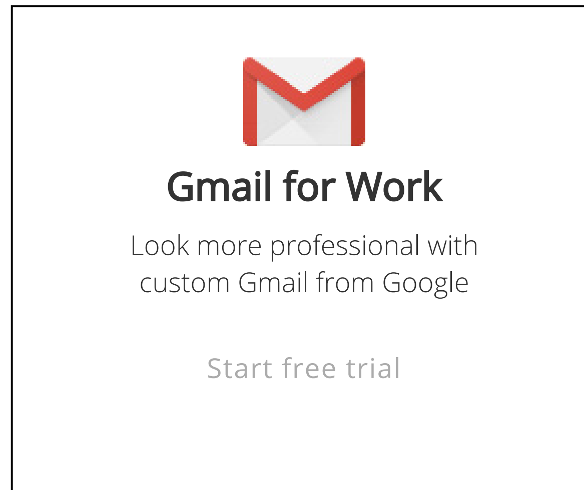

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