

Fixed Maturity Plans – Are they safe?

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INTRODUCTION: The fire sparked off in the backyard of US due to the current financial debacle has singe the economy and all the developed money is now rushing back home at a speed of sound creating a serious liquidity crisis in India. Suddenly the word ' R' recession got the flavor in US and other parts of the world and is being compared with the Great Depression of 1929-30. Though the Indian government acted swiftly as per their counterparts all around the world through a series of rate cuts and a stimulus economic package, albeit not sufficient enough to boost up the crawling economy as per Indian Inc., the crisis of confidence still lies amongst the players.

With the stock markets down, investors are looking for safer investment avenues that would give them good returns with a high degree of safety. One such avenue that was being strongly promoted by Mutual Fund houses and has been very popular with high net worth investors and corporate is fixed maturity plans (FMPs). As said by the figures, the total FMP contribution as on Sept 2008 was Rs 67,276 crores a whopping 16 per cent of total assets under management of mutual funds accounting to Rs 4,26,669 crores. But the recent crunch in the liquidity which forced RBI to cut the interest rates with few more expected cuts has acted as a dampener for the hot cake ' FMPs' .

WHAT ARE FMPS?

Categorized under the Debt-Specialty, FMPs are close ended funds that invest in debt paper and were first launched in India by Kotak Mutual Fund in 2001. These funds have a pre-defined maturity period that ranges from 15 days to three years. By definition, these funds invest in debt instruments and money market instruments like commercial papers issued by companies and certificates of deposits issued by banks whose maturity coincides with that of the FMP. For instance, a one-year FMP will invest in bonds that will mature in one year. A fund house collects moneys from investors and

uses it to buy one year papers. At maturity, issuers of bonds repay the money with interest to the fund house, which in turn pays investors (minus its charges).

The investment is locked in at a specified rate of return. This way, the investment managers can predict the probable return the scheme will earn when it matures with a high degree of certainty. This also immunises the scheme against interest rate fluctuations during the investment period. Hence, an investor who is invested in a FMP until its maturity is virtually assured of getting the projected returns.

Besides promising indicative returns at the start of the tenure, a factor that makes FMPs attractive is its tax efficiency. Short-term FMPs are subject to dividend distribution tax at the rate of 14.16 per cent, for dividend option. Otherwise, it is treated as short-term capital gains. In FMPs where the tenure is greater than a year, the investor has to pay long-term capital gains at the rate of 11.33 per cent without indexation and 22.66 per cent with indexation. There are double indexation benefits for tenures of over a year.

The chart representing the tax benefit has been inserted here.

Exhibit 1 FMP Tax Benefits			
	Bank Fixed Deposit	FMP	
		With Indexation	Without Indexation
Amount of Investment (Rs.)	10000	10000	10000
Post Expenses Yield (p.a)*	10.50%	10.50%	10.50%
Tenor (in days)	370	370	370
*Final Maturity- Realised Amt	11,064.38	11,064.38	11,064.38
Gain	1,064.38	1,064.38	1,064.38
Indexed Cost	NA	10,616.57	NIL
Indexed Gain/ (Loss)	NA	447.81	1,064.38
Tax Rate	33.66%	22.44%	11.22%
Tax	358.272	100.489	119.424
Post Tax Gain	706.11	963.89	944.96
Long Term Capital Gain/ (Loss)*	NA	-	NA
Post Tax Annualised	6.97%	9.51%	9.32%
Please Note:			
I)Assumption: Cost Inflation Index (CII) for FY 2006-07 and 2007-08 has been taken as			
519 and 551 respectively.			
CII for FY 2006-07			519
CII for FY 2007-08			551

ARE FMPs SAFE?

As a product category, FMPs are very good instruments for parking your short-term surpluses, provided prudent investment choices are made by the fund managers.

However, FMPs carry a higher degree of risk as compared to a fixed deposit or any other debt instruments. FMPs are not the risk-free avenues they are made out to be. This is because they invest in commercial papers issued by companies, which is an unsecured debt. In bad times, some companies, with whom the asset management company places the funds, could default on their commitments. This could put the principal amount at risk. As designed to invest their corpus in a predetermined basket of rated and unrated securities allowing them to protect indicative returns (and risks), many FMPs were decoyed by new opportunities leaped up in long bull markets such as funding the subscription of initial public offerings (IPOs), funding promoters' holding in their listed stocks and funding real estate companies. These investments made through non-banking finance companies, rested on rickety grounds after the stock market indices plummeted more than 50 per cent from their Jan 2008 peak.

Hence, the degree of risk in an FMP is essentially dependant on the ability of the investment manager. A smart manager will choose very high quality instruments where the possibility of default is remote.

CAUSES FOR CURRENT CRISIS IN FMPs

The disclosure norms in all mutual fund schemes in India are stringent enough to protect the investors. However, SEBI has not made mandatory for AMC's to disclose the portfolio and details of underlying securities while selling an FMP. AMC's have taken advantage of this fact.

To lure more investors with higher indicative yields and to boast of higher AUMs, some AMC's have resorted to malpractices like allowing mismatches in maturity period (between FMPs and their underlying securities) and have also compromised on the credit quality of securities these FMPs invest in.

Investment Restriction - As per SEBI guidelines, a scheme is allowed to invest up to 15 % of its net assets in debt instruments issued by a single issuer. However, this 15% restriction can be raised to 20% of net assets of the scheme with the prior approval of the Board of Trustees and Board of the AMC. But this restriction does not apply to money market instruments and they can place their entire money in just one instrument of one company.

As in Templeton FHF 15 months, they put 97.7% of its net assets in Reliance Capital and when the distress sale took place due to redemption pressure, their NAV reported in negative return.

Maturity Mismatch – With growing interest of retail and corporate investors in FMPs and the avalanche of funds that followed, a few fund houses started investing in papers whose maturity period was different from that of the FMP. Say, for instance, a three-month FMP invested in one-year paper. (A one-year paper will give one percentage point higher yield than a three-month paper). This is known as maturity mismatch. By doing so, an AMC is taking a call on one, liquidity. At the time of redemption of the three-month FMP or pre-maturity redemption, the mutual fund house could be hard put to find the funds for paying off the investors because the fund has invested in higher-maturity securities. And two, the AMC also courts interest-rate risk. If in the interim, interest rates rise, the value of longer-duration papers would decline. If, under redemption pressures, the fund house is forced to sell off the bond before the maturity, it will incur a loss.

As a general practice in the industry, when there is mismatch in maturity, they use to roll over the money to forthcoming FMPs launched at the redemption date of ending FMP. Rolling over of the money is done on mutual understanding of investment in each other products. Mutual Funds used to invest in companies' papers and in return the companies used to park their money in their schemes. In case the companies needed money desperately as currently due to liquidity crunch, they exited the scheme even at high exit load causing distress selling of portfolio by Fund Managers, giving a hit on NAVs.

Compromise On Credit Quality- To offer higher yields, AMCs also started compromising on the credit quality of the underlying debt paper they invested in. Real estate firms and NBFCs, which are starved for liquidity in the current cash-crunch, offered to pay higher interest rates to AMCs. However, the inability of some of these borrowers to live up to their repayment commitments invited trouble for some AMCs. In fact, real estate companies have offered interest rates as high as 22-24 per cent on debt raised from mutual funds.

In many cases, investors can't even make a sense of the underlying securities. Many are Pass Through Certificates (PTC) which are products out of Securitization and backed by their receivables. Almost all the FMPs put their money in PTCs generally named as *Corporate Loan*

Trust, Loan Receivable Trust, Corporate Debt Trust, Corporate Loan security et al. These are not easy to track and construe and even a single default can cause to a sharp drop in returns.

For example, in Canara Robeco FMP Series 2- 14 Months, the portfolio consists of 37.33 per cent of total assets in PTCs and any further redemption would put them in tizzy mode. Since the announcement of ban on early redemption of FMPs, it must be a relief for them at least for near future if the PTCs would mature in 14 months.

PANICKED INVESTORS

The current financial cataclysm caused a major liquidity crisis and dampened the mood of the investors. When the corporate and HNIs including FIIs started withdrawing money swiftly, *the investment restriction, maturity mismatch and compromise on credit quality* cost some fund houses and showed their NAVs in negative in comparison with par value. In Oct 2008, the RBI introduced a special window of Rs 20,000 crore repo facility for a period till further notice to help these funds bridge the gap between the redemption requests and the actual sale of the underlying assets, the borrowing from the repo markets would increase MF's liability and make NAVs decline more.

Conclusions

No doubt FMPs lost its sheen in the current financial debacle due to liquidity crunch which led to early redemption and to some extent due to weak regulations. But with few regulations, FMPs can work better. The most important, strict portfolio disclosure norms need to be put in place. SEBI should make it mandatory for a fund house to disclose FMP' s tentative portfolio to the investors. Mismatches in maturity between FMPs and their underlying securities should also be checked. Just publishing the name of the companies would not suffice rather AMC's should mention the maturity period of the underlying asset, so that an investor is aware of maturity mismatches, if any. SEBI should also ensure that AMC's invest only in high-quality debt papers that have good credit rating and that too from established rating agencies. Lastly, bifurcated data on investments made by corporate and retail investors should be available.

The recent announcement by SEBI to ban an early redemption and to list all the close-ended schemes on Indian bourses so as to ease the redemption pressure on Fund Manager would definitely be a boon for the once hot cake ' FMPs' . And in the days to come, FMPs would regain its lost ground and provide a good investment vehicle for the retails investors too.
