

The truth behind TFCs & their impact on income funds

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Term Finance Certificates, TFCs, are corporate bonds which are issued by listed and non-listed companies to raise business capital. These kind of financial instruments were brought to the scene after Pakistani economy went through a period of liberalization and reforms during the early 1990's. TFC's in terms of their pay off structures are similar to vanilla floating rate bonds, that offer a yield in accordance with a money market and / or risk free benchmark i.e. 6-month Kibor etc. Most of the TFC's are structured with CAP and FLOOR.

CAP is the maximum a bond may yield and FLOOR is the minimum guaranteed rate of return promised by the issuer of the debt instrument. Certain TFC's are also packaged with additional features such as call and put options. This type of floating rate bonds face additional risks and hence their pricing becomes more complicated on day to day basis. Generally TFCs are considered to be less prone to market risk and more culpable in terms of credit risk.

However recent events in context of Pakistani economy have shown that these types of debt instruments are exposed to market risk factors more than vanilla fixed coupon

bonds; that create massive capital losses on the account of price reductions.

The mutual Fund industry in Pakistan faces a similar dilemma, where most of the TFCs held within the fixed income portfolios of funds were considered to be overvalued / priced for a very long time; and have now seen their prices re-adjust in accordance with the SECP directive issued to all AMC's.

However this further necessitates the urgency to introduce and implement a mechanical floating rate bond (with or without embedded options) pricing model for all FMAP - Financial Market Association of Pakistan market makers and investors. This model should price TFCs in accordance with principles of discrete time finance technique that are primarily based upon "CRR - COX, ROSS and RUBENSTEIN" theoretical juxtapositions.

This shall particularly enable income and bond funds to trade and quote long term corporate debt instruments at transparent prices and resultantly strengthen bond market microstructures in our emerging economy.

In such a situation where other funds' values have gone down drastically due to revaluation of TFCs, Faysal Asset Management Limited (FAML) funds have borne a minimal impact.

FAML has yet again proved that its adherence to prudent investment management approach has safeguarded the interests of its investors. Our cautious stance demonstrated effective management of liquidity in our funds.

The money market fund, Faysal Savings Growth Fund contains NO TFC exposure. Faysal Income & Growth fund also has a minute 3.6 per cent TFC exposure only. This resulted in keeping the investments ahead of the curve and yielding higher returns with a risk-averse portfolio.

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