



## ICRA Rating Feature

### Methodology for Rating Mutual Fund Schemes

This rating methodology updates and supersedes ICRA's earlier methodology note on this subject, published in January 2018.

#### What do the ratings of mutual fund schemes reflect?

Mutual fund ratings incorporate ICRA's assessment of the creditworthiness of a debt mutual fund scheme's investment portfolio. These ratings are a symbolic representation of the credit risk in the underlying investments or the degree of safety regarding the timely receipt of payments from the investments that have been made by the mutual fund schemes. The ratings do not indicate the asset management company's (AMC) and/or any of its scheme's willingness and/or ability to make timely redemptions to its investors. The ratings do not address the market risks and hence should not be construed as an indication of the expected returns, the prospective performance of the mutual fund scheme, and the ability to redeem the investments at the reported net asset value (NAV) or the volatility in its past returns as all these are influenced by market risks.

ICRA's assessment of debt mutual fund schemes is guided by the credit ratings of the individual investments, the relative share of the investments in the overall assets under management (AUM) of the scheme and the maturity schedule of such investments. The relevant data for the above is obtained from the AMC and/or public sources. In addition, ICRA engages in continuous dialogue with the representatives of the AMC such as the fund manager and/or product manager to understand their investment decisions and outlook during the initial credit risk rating and for periodic monitoring thereafter.

ICRA's mutual fund ratings are not a reflection of the quality of the management of the AMC or its financial performance, reputation and other business practices including investment strategies, pricing, marketing and distribution activities. Furthermore, the ratings are not a reflection of the adherence of the AMC or the fund to the regulatory requirements. These mutual fund ratings are suffixed by the 'mfs' symbol.

#### ICRA's Rating Approach

##### Portfolio Credit Quality

As a measure of the credit quality of a debt fund's investments, ICRA uses the concept of credit scores. The credit score is calculated by considering the weighted average credit risk of the portfolio with the market value as the weight. These scores are based on ICRA's estimates of the credit risk associated with each investment in the scheme's portfolio considering its maturity. To quantify the credit score, ICRA uses its database of historical default rates for various rating categories across different maturity buckets.

At the outset, ICRA analyses the credit quality of the investment portfolio of a mutual fund scheme based on the ratings outstanding.

- ❖ For debt securities, which carry an ICRA rating, the same is considered for the credit risk evaluation.
- ❖ For debt securities, which do not carry an ICRA rating but have ratings outstanding from other rating agencies in India, ICRA may consider a different rating based on its own judgement. In case ICRA is unable to form a view, it would consider the lowest public rating on the security.
- ❖ For debt securities which do not carry any ratings, ICRA takes a view based on the shadow/notional rating of the debt instrument.

Using the above ratings and the residual maturity for each debt security in the portfolio, ICRA assigns a credit score. In case of embedded put options in the debt instruments, the put option date is assumed as the maturity date for such instruments. For two similarly rated papers, the default rate would be higher for the paper that has a longer maturity and hence the tenure of the underlying investment can impact the credit score of the portfolio. At each rating category, the default rates have been assumed to be the same for 3 years and beyond.

## **ICRA's Credit Matrix**

The credit matrix is a tool used by ICRA for analysing the investment portfolio of the debt mutual fund schemes by assessing the portfolio's aggregate credit quality while reviewing the credit quality of each underlying debt security. The portfolio's weighted average credit quality is then measured against the appropriate benchmark credit score in the credit matrix.

Separate benchmark credit scores are used for short-term and long-term funds. Short-term funds include overnight funds, liquid funds, ultra-short duration funds, low duration funds and money market funds and any other funds with similar names. Long-term funds include schemes such as short duration funds, medium duration funds, long duration funds and any other funds with similar names.

Hence, the short-term debt funds are those with weighted average portfolio maturities of up to one year, whereas the long-term debt funds are those with a weighted average maturity of more than one year. ICRA benchmarks the short-term debt funds against a 12-month benchmark credit score while the long-term debt funds are benchmarked against the long-term benchmark credit score.

ICRA generally assigns short-term mutual fund ratings to short-term funds and long-term mutual fund credit risk ratings to long-term debt funds. While arriving at the credit score, ICRA considers the long-term ratings of the instruments in the portfolio. The mapping of the long-term and short-term rating scale does not hold for mutual fund ratings.

To assign a rating, the portfolio of the scheme is analysed at least for the last three months and the rating is assigned on the basis of the credit score for the scheme for each of the last three months. For schemes that are yet to be launched, ICRA discusses the proposed investment mix in terms of the credit quality that the fund manager intends to maintain. Schemes, which are yet to be launched, are initially assigned a provisional rating. Later, on the opening of the schemes for regular investments, the investment portfolio and its credit score are benchmarked against the credit matrix to finalise the rating.

## **Ongoing Review and Monitoring**

Once a mutual fund scheme is rated and the rating is accepted, ICRA reviews the underlying investment portfolios for the credit scores on an ongoing basis. To this end, ICRA relies on the information provided by the AMC and/or publicly available sources. ICRA reviews the mutual fund ratings on a monthly basis or as and when required, which involves the evaluation of the portfolio credit score. If the portfolio credit score meets the benchmark of the existing rating, the rating is retained. If the portfolio credit score breaches the benchmark credit matrix score for the current rating, ICRA communicates the same to the fund manager/product manager or other officials of the concerned AMC and may provide a month's time to bring the portfolio credit score within the benchmark credit score for the current rating level. If the investment composition of the fund is realigned to bring the portfolio credit score within the benchmark credit score, the rating is retained.

However, if the portfolio continues to breach the benchmark credit score for the existing rating level, the rating is revised to reflect the change in the portfolio's credit quality. In case of sharp breaches of the benchmark credit score (for instance due to a multi-notch downgrade in the underlying investment) and/or if ICRA believes that the breach may not get rectified within a month of the ongoing review, the rating is generally corrected immediately without giving a month's time for rebalancing the portfolio. If the AMC corrects its portfolio post the rating downgrade of the scheme or the credit score improves in any manner subsequent to the downgrade, making the scheme eligible for an upgrade, ICRA may consider an upgrade of the scheme only if the scheme consistently maintains the credit score for a period of at least three months.

In case an investment by the scheme is partly written-down by the AMC, ICRA continues to consider the gross value<sup>1</sup> of the investment for computing the credit score for a period until the scheme is able to seek a full redemption of the amount or sells-off the investment. In case an investment is fully written-down, ICRA continues to consider the gross value of the investment for computing the credit score for a period that is earlier of the passage of at least six months from the date when such investment is fully written-down or until the scheme is able to seek a full redemption of the amount or sells-off the investment.

ICRA has also observed that in the event of the rating downgrade of any instrument in the portfolio, large investors (corporates or institutions) typically redeem their investments, whereby such redemptions are generally met by the fund through the sale of better rated investments. In such a scenario, the share of the downgraded instrument increases in the portfolio, leading to further deterioration in the credit score even though there is no further change in the rating of the instrument downgraded earlier. Such events can also lead to changes in mutual fund ratings.

The credit score of the fund can also deteriorate when some of the investments, which were previously written down, are upgraded, but to a lower rating category and are hence written back by the AMC. In such cases, the credit score is determined after excluding such investments and the fund manager is provided with a six-month time frame to divest such investments to align the portfolio with the rating category. If such investments remain a part of the portfolio even after six months, the credit score and the fund rating are determined after including such investments in the portfolio.

In case of side pocketing<sup>2</sup>, for computing the credit score, ICRA continues to consider the gross value of the investment which has been side pocketed for a cooling period of at least six months from the date of side pocketing.

## Summing Up

ICRA's mutual fund ratings are a symbolic representation of the degree of safety regarding the timely receipt of payments from the investments made by the mutual fund schemes being rated. This opinion is arrived at by computing the weighted average credit score based on the credit rating of the individual investments and their tenure, which is then mapped to the appropriate benchmark credit score in ICRA's credit matrix that is developed on the basis of historical default rates for different rating categories across various tenures of rated instruments.

---

<sup>1</sup> Market value of the instrument before the multi-notch downgrade

<sup>2</sup> Side pocketing is a mechanism introduced by SEBI in December 2018 to separate distressed, illiquid and hard-to-value assets from other more liquid assets in a portfolio.

## Annexure

### ICRA Mutual Fund Ratings: Scale and Definitions

ICRA's Long-Term Debt Mutual Fund Rating Scale - This scale largely applies to debt funds with a weighted average maturity of more than one year.

**[ICRA]AAAmfs** - Schemes with this rating are considered to have the highest degree of safety regarding the timely receipt of payments from the investments made by them.

**[ICRA]AAmfs** - Schemes with this rating are considered to have a high degree of safety regarding the timely receipt of payments from the investments made by them.

**[ICRA]Amfs** - Schemes with this rating are considered to have an adequate degree of safety regarding the timely receipt of payments from the investments made by them.

**[ICRA]BBBmfs** - Schemes with this rating are considered to have a moderate degree of safety regarding the timely receipt of payments from the investments made by them.

**[ICRA]BBmfs** - Schemes with this rating are considered to have a moderate risk of default regarding the timely receipt of payments from the investments made by them.

**[ICRA]Bmfs** - Schemes with this rating are considered to have a high risk of default regarding the timely receipt of payments from the investments made by them.

**[ICRA]Cmfs** - Schemes with this rating are considered to have a very high risk of default regarding the timely receipt of payments from the investments made by them.

**Note:** Modifiers {'+' (plus) / '-' (minus)} can be used with the rating symbols for the categories [ICRA]AAmfs to [ICRA]Cmfs. The modifiers reflect the comparative standing within the category.

ICRA's Short-Term Debt Mutual Fund Rating Scale - This scale applies to debt funds with a weighted average maturity up to one year. Such funds would generally include liquid funds and cash funds. The benchmark maturity for this scale is 12 months.

**[ICRA]A1mfs** - Schemes with this rating are considered to have a very strong degree of safety regarding the timely receipt of payments from the investments made by them.

**[ICRA]A2mfs** - Schemes with this rating are considered to have a strong degree of safety regarding the timely receipt of payments from the investments made by them.

**[ICRA]A3mfs** - Schemes with this rating are considered to have a moderate degree of safety regarding the timely receipt of payments from the investments made by them.

**[ICRA]A4mfs** - Schemes with this rating are considered to have a minimal degree of safety regarding the timely receipt of payments from the investments made by them.

**Note:** Modifiers {'+' (plus)} can be used with the rating symbols for the categories [ICRA]A1mfs to [ICRA]A4mfs. The modifier reflects the comparative standing within the category.

Contact us for any feedback or comments at: [methodologies@icraindia.com](mailto:methodologies@icraindia.com)

## ANALYST CONTACTS

**Karthik Srinivasan**

+91 22 61143444

karthiks@icraindia.com

**Neha Parikh**

+91 22 61143426

neha.parikh@icraindia.com

**Niraj Jalan**

+91 33 71501146

niraj.jalan@icraindia.com



## ICRA Limited

**CORPORATE OFFICE**Building No. 8, 2<sup>nd</sup> Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002

Tel: +91 124 4545300; Fax: +91 124 405042

Email: [info@icraindia.com](mailto:info@icraindia.com), Website: [www.icra.in](http://www.icra.in)**REGISTERED OFFICE**1105, Kailash Building, 11<sup>th</sup> Floor; 26 Kasturba Gandhi Marg; New Delhi 110001

Tel: +91 11 23357940-50; Fax: +91 11 2335794

---

Branches: **Mumbai:** Tel.: + (91 22) 61693300 **Chennai:** Tel + (91 44) 4596 4300 **Kolkata:** Tel + (91 33) 7150 1100/01 **Bengaluru:** Tel + (91 80) 4332 6400/ 4922 **Ahmedabad:** Tel + (91 79) 4027 1500/01 **Hyderabad:** Tel + (91 40) 4920 0200/ 4067 6500 **Pune:** Tel + (91 20) 2556 0194/ 6606 9999

---

© Copyright, 2020 ICRA Limited. All Rights Reserved.

Contents may be used freely with due acknowledgement to ICRA.

All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable. Although reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies, while publishing or otherwise disseminating other reports may have presented data, analyses and/or opinions that may be inconsistent with the data, analyses and/or opinions presented in this publication. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.