

RATING METHODOLOGY – MUTUAL FUNDS

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in June 2020. While ICRA's fundamental approach to rating mutual fund schemes remains the same, the benchmarks used to arrive at the ratings of the schemes have been revised. This methodology is not applicable for capital protection-oriented schemes and the relevant methodology for such schemes can be accessed from ICRA's website www.icra.in.

Overview

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 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 market risks and hence should not be construed as an indication of the expected returns, prospective performance of the mutual fund scheme, and the ability to redeem investments at the reported net asset value (NAV) or volatility in its past returns, as all these are influenced by market risks.

Our assessment of debt mutual fund schemes is guided by the credit ratings of the individual investments and the relative share of the schemes' allocation towards the investments, besides the maturity schedule of such investments. The relevant data for the above is obtained from the AMC and/or from public sources.

Moreover, ICRA engages in dialogue with the representatives of the AMC, such as the fund manager and/or the product managers, to understand their investment philosophy at the time of the initial assignment of the credit rating, and for periodic monitoring thereafter.

ICRA's mutual fund ratings are not a reflection on 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 whether the AMC or the fund is compliant with the applicable regulatory requirements.

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 of a debt fund scheme is calculated by considering the weighted average of the credit score of the individual investments with the proportion of the market value as the weight. The credit score of an individual investment is computed based on the credit rating associated with each investment in the scheme’s portfolio and 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 credit ratings outstanding from the accredited domestic credit rating agencies.

- For debt securities with 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 credit rating agencies in India, ICRA may consider a different rating based on the assessment by its internal ratings teams. If 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 on the shadow/notional rating of the debt instrument basis the opinion of its internal rating teams.
- While arriving at the credit score, ICRA considers the long-term ratings of the instruments in the portfolio. If the issuer is rated only on the short-term scale by a credit rating agency and ICRA is unable to form a view on the long-term rating, the rating considered is typically the lowest long-term rating as per ICRA’s approach explained in the document titled ‘Mapping of ICRA’s long-term and short-term ratings’, available on ICRA’s website (www.icra.in).

Using the above ratings and the residual maturity for each debt security in the portfolio, ICRA assigns a credit score to a given investment. The default rates for a similar rated paper will be higher for a longer-maturity paper and hence the tenure of the underlying investment can impact the credit score of the portfolio.

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 compared with a benchmark credit score corresponding to the higher of the weighted average maturity of the scheme’s portfolio or the maturity predefined by ICRA for the scheme category. The rating outcome corresponds to the rating level for which the portfolio weighted average credit score is less than the benchmark credit score associated with the rating level. Further, the lowest rating of the investments of the scheme acts as the floor for its rating.

The example below has been provided for the illustration of the approach followed to arrive at the rating outcome.

Rating for corporate bond fund:

	Weighted average maturity of scheme (a)	Predefined maturity for scheme category of short duration fund (b)	Maturity considered (higher of a or b)
Corporate bond fund – Scheme A	6	5	6

The weighted average credit score of Scheme A is 13 (computed as per the weighted average credit score of the underlying portfolio basis their long-term ratings and using the market value of the investment as weights).

The benchmark credit score for the various rating categories and tenor has been provided below:

	Tenor (years)				
	3	4	5	6	7
AAA	6	8	10	12	14
AA+	8	10	14	16	18
AA	10	12	16	18	20
AA-	12	14	18	20	22

Considering the above matrix, a scheme with a weighted average maturity of 6 years and a weighted average credit score of 13 would be eligible for a AA+ rating since it is higher than the credit score of 12, which is applicable for a AAA rating.

For rating schemes on the short-term scale, the mapping is done basis ICRA’s mapping of the long-term-and-short-term rating scales. Hence, for example, the benchmark for an A1+ rated scheme would be mapped to the default rate associated with an A+ rating.

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 of 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. Yet-to-be launched schemes are generally assigned a provisional rating initially. 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. ICRA may choose to assign a final rating to a scheme which is yet to complete three months in instances where the scheme, as defined in its Scheme Information Document, can invest only in government securities or the equivalent.

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 earlier, if required, which involves an evaluation of the rating corresponding to the portfolio credit score in relation to the existing rating outstanding. If the portfolio credit score meets the benchmark score for the existing rating, the rating is retained. If the portfolio credit score has a negative breach from the benchmark credit score for the existing 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 maintaining the existing 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 a rating upgrade only if the credit score is maintained consistently 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 value¹ of the investment for computing the credit score for a period until the scheme is either able to seek a full redemption of the amount

¹ Market value of the instrument before the multi-notch downgrade

or sells off the investment. If 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 was 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 additional change in the rating of the instrument downgraded earlier. Such events can also lead to a downgrade in the mutual fund's rating.

The credit score of the fund can also deteriorate when some of the investments, which were previously written down, are upgraded, but to a relatively 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 pocketing², 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 residual maturity, 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.

² 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

ICRA Mutual Fund Ratings: Scale and Definitions

ICRA's Long-term Debt Mutual Fund Rating Scale – This scale 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.

[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.

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in and www.icraresearch.in

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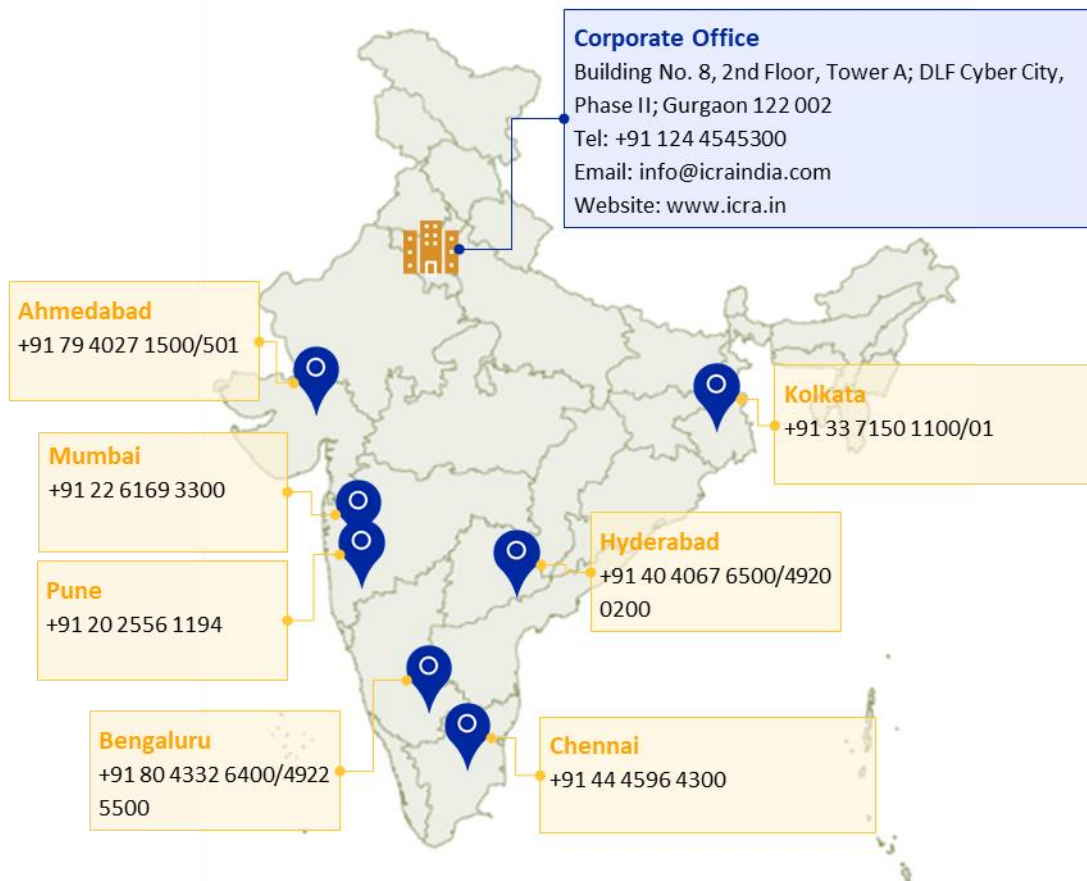
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