

## RATING METHODOLOGY FOR MUTUAL FUNDS

July 2025



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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in July 2024. While this revised version incorporates a few changes to provide clarity on some aspects, ICRA's overall approach remains similar.

This methodology is also applicable for rating debt exchange traded funds (ETFs). However, this methodology is not applicable for rating capital protection-oriented schemes and the relevant methodology for rating such schemes can be accessed from ICRA's website [www.icra.in](http://www.icra.in).

### Overview

Mutual fund credit quality ratings, assigned on the mutual fund credit quality rating scale (as defined by the Securities and Exchange Board of India; SEBI), 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 these schemes. The ratings do not indicate the AMC's and/or any of its scheme's willingness and/or ability to make timely redemptions to its investors.

These ratings do not address market risks. Hence, they 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.

ICRA's 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 public sources.

Moreover, ICRA engages with the AMC's representatives, 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. The methodology also encapsulates the review and monitoring of mutual fund credit quality ratings during market dislocation events and the consequent challenges during that period, including but not limited to increased redemption pressure, liquidity challenges, deterioration in the credit quality of the underlying instruments and increased salience of the CDMDf.

ICRA's mutual fund credit quality 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. Further, they are not a reflection of whether the AMC or the fund is compliant with the applicable regulatory requirements.

The rating approach for intraday liquidity facilities and other borrowings availed by the mutual fund schemes of AMCs includes the assessment of the volatility in the assets under management (AUM) across schemes, liquidity management, and the credit quality of open-ended debt mutual fund schemes, among other factors. The rating scale for the intraday liquidity facilities and conventional borrowings of the mutual fund schemes of AMCs is the conventional rating scale and not the mutual fund credit quality rating scale (mfs).

## ICRA's Rating Approach

### A. ICRA's Rating Approach for Mutual Fund Credit Quality Rating

#### 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 the mutual fund scheme based on the credit ratings outstanding from the accredited domestic credit rating agencies.

- For debt instruments with an ICRA rating, the same is considered for the credit risk evaluation.
- For debt instruments without an ICRA rating but with 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 debt instrument.
- For debt instruments with no ratings, ICRA takes a view on the shadow/ notional rating of the debt instrument basis an internal assessment.
- 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 usually 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](http://www.icra.in)).

Using the above ratings and the residual maturity for each debt instrument in the portfolio, ICRA assigns a credit score to a given investment. As the default rates for a similarly rated paper will be higher for a longer-maturity paper, 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 instrument. 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's 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 the fund's rating.

The following example has been provided for the illustration of the approach used 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 years	5 years	6 years

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 the weights).

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

	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 six years and a weighted average credit score of 13 would be eligible for AA+ rating as it is higher than the credit score of 12, which is applicable for 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 for at least the past three months and the rating is assigned on the basis of the credit score of the scheme for each of the past 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 (G-Secs) 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 before the end of the next month, and provides 30 working days from the date of such communication 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, after 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 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 either able to seek full redemption of the amount or sells off the investment. If an investment is fully written down, ICRA continues to consider its gross value 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 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 incremental 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's 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.

### Review and Monitoring during Market Dislocation

In the event of market dislocation, mutual funds may face redemption pressure and/or liquidity challenges, which may lead to a decline in the AUM and/or an increase in the share of lower rated investments, resulting in a breach of the benchmark credit score for the existing rating level. Further, the credit quality of the underlying investments may deteriorate during times of market dislocation. The credit implications of market dislocation may not be fully ascertainable, given the heightened uncertainties during that period. Thus, ICRA may place the mutual fund credit quality ratings on 'Watch', in line with 'ICRA's Policy on Rating Outlook and Rating Watch'. This does not preclude the possibility of a rating downgrade during the period when the rating is placed on 'Watch'.

The Corporate Debt Market Development Fund (CDMDF) was launched in 2023, under SEBI's purview, to act as a backstop facility for the purchase of investment grade corporate debt securities. It was set up to instil confidence among participants in the corporate debt market during times of market stress and to generally enhance secondary market liquidity by creating a permanent institutional framework that can be activated during periods of market dislocation. The fund will act as a 'buyer of last resort' and ease redemption pressure on mutual fund schemes during times of market dislocation. All debt-oriented mutual fund schemes (as specified by SEBI), their AMCs, and the sponsor/investment manager (IM) are required to contribute 0.25%, 0.02%, and 0.02% of their AUM, respectively, to the CDMDF. There are three classes of units allotted by the CDMDF, which are as follows:

1. Class A1 and Class B units allotted to AMCs and Sponsor/IM, respectively (against one-time contribution of 0.02% of AUM of specified debt schemes and sponsor/IM commitment); Class A1 and Class B units are treated at par and referred as Class A1 units only
2. Class A2 units allotted to specified debt schemes (contributing 0.25% of AUM of specified debt schemes)
3. Class A3 units allotted to mutual fund schemes selling debt securities to CDMDF (where 10% of the consideration is in the form of units of CDMDF, called A3 units)

During normal times, the CDMDF will invest in low-duration G-Secs, Treasury bills (T-bills), tri-party repo on G-Secs and guaranteed corporate bond repo with maturity not exceeding seven days. While computing the credit scores of the mutual

<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

fund schemes, a notional rating of AAA is considered for such investments in the units of the CDMDF, given the low credit risk nature of the permissible investments in normal times.

However, in times of market dislocation, the CDMDF may buy other securities (investment grade<sup>3</sup> and listed with residual maturity of up to five years) from the secondary market from participating investors and its portfolio mix might change significantly during such periods. As the portfolio construction cannot be predetermined and will remain volatile during the period of market dislocation, ICRA will assess the credit quality of the CDMDF's investment portfolio by using the aforementioned concept of credit scores to determine the notional rating of the units till the time the entire portfolio from market dislocation is disposed off by the fund. Given the dynamic nature of the CDMDF portfolio during the market dislocation period, ICRA will use a notional rating of A+ (or lower, based on the actual credit score of the scheme) for the A2 units held by the schemes. Further, as losses, if any, are to be borne first by the A3 unitholders vis-à-vis the A1/A2 unitholders, such that the NAV of A1/A2 does not fall below their opening NAV (opening NAV at the time of market dislocation), ICRA will use at least a one notch lower notional rating for the A3 units compared to the A1/A2 units. Moreover, the residual maturity of the A2 units held by the scheme will be the residual tenor of the CDMDF, while that of the A3 units will be considered to be three years, given ICRA's expectation that the fund will be able to liquidate the corporate debt holding acquired during market dislocation within this period.

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<sup>3</sup> CDMDF shall not buy securities in respect of which there is a material possibility of default or adverse credit news or views

## B. ICRA's Rating Approach for Borrowings and Intraday Liquidity Facilities Availed by Mutual Fund Schemes

[The rating approach for these facilities does not aim to assess the credit quality of the borrowings at the AMC level. The credit quality of the borrowings at the AMC level is assessed as per ICRA's corporate credit rating methodology available at [www.icra.in](http://www.icra.in)]

### Rating approach for borrowings availed by the schemes

As equity markets are generally liquid and redemptions are largely met through the sale of the underlying investments of the scheme, the need for borrowings mainly arises in open-ended debt schemes. Further, after the SEBI's circular on liquidity management of open-ended debt schemes and liquid, overnight schemes, these schemes are required to hold 10% and 20%, respectively, of their AUM in liquid assets (G-Secs, T-bills, cash and repo on G-Secs). While these liquid assets are instrumental in managing the day-to-day liquidity requirements arising from redemptions, the need for availing intraday liquidity lines or borrowings may arise to plug the intraday cashflow mismatches or periods of sustained redemptions. The choice between the sale of the underlying investments or the borrowings in such open-ended debt schemes is based on the view of the fund manager/AMC on the expected reversal of investor flow into these schemes, given the various factors driving the seasonality of the inflows and outflows in these schemes.

While seasonal factors, such as quarter end and tax payment dates, are some of the drivers of the flows of open-ended debt schemes, the volatility of these flows could be higher for schemes with similar types of investors, especially large ones, like corporate treasuries or banks. These investors may, as a class, have a concurrent need to undertake redemptions or deployment. Accordingly, such open-ended debt schemes with significant investor concentration could exhibit high volatility in the AUM, with consecutive days of large outflows, thereby necessitating not only the sale of the underlying investments but also borrowings to meet the redemption requirements against the outflows. This could be temporary and may reverse in the near term. Among open-ended debt schemes, ICRA notes that schemes with lower portfolio duration, viz. liquid funds, money market funds, ultra-short duration funds, low duration funds and overnight funds, exhibit the highest volatility in AUM, which could sustain for a few consecutive days. This could lead to a considerable dip in the AUM, necessitating the borrowing across these schemes to meet redemptions. Nonetheless, borrowing requirements could also arise for other open-ended debt schemes, depending on the extent of outflows.

The sanction letter for such borrowings typically specify the debt schemes which can avail these borrowings. Accordingly, the credit quality of the underlying investments in these specified open-ended debt schemes, where these borrowings are allowed to be used, becomes the anchor for arriving at the rating for such bank borrowings. However, there may be instances where the sanction letter does not specify the schemes where these borrowings can be availed and instead permits all open-ended debt schemes of an AMC to avail the borrowing facility. In such cases, the credit quality of the underlying investments of certain open-ended debt schemes, which exhibit high volatility in their AUM and where these borrowings will be potentially used, becomes the anchor rating for arriving at the rating for such bank borrowings. To assess this, ICRA uses the approach of 'portfolio credit quality' (as highlighted earlier in this document) as a proxy for the credit risk and debt-servicing ability of these schemes. The lowest 'portfolio credit quality' among the schemes concerned will typically be the key rating driver for such borrowings, besides a few additional factors like the scheme's track record, its approach to liquidity management and track record of its borrowings.

### Rating approach for intraday liquidity facilities availed by the schemes

The AMCs typically pay out the redemption requests across schemes early in the morning, for which they rely on intraday liquidity lines from banks to meet the redemptions across the schemes at the AMC level. These lines are unsecured and are required to be repaid by day end to the bank. The usage of these lines is seen to be relatively higher for schemes with high volatility in the AUM. The redemptions across the equity schemes is managed through the sale of assets on the previous day (i.e. on the day of the redemption request) and the liquidity so generated is deployed in TREPS, a day before the redemption payout day. Subsequently, the repayment of the intraday line used to meet the redemption of the equity schemes is met through the TREPS balances of the equity schemes available towards the end of the day.

For open-ended debt schemes, intraday liquidity management is a combination of the fresh inflows expected in the scheme, maturity of underlying investments in the scheme, the liquidity of the underlying investments (sale) and the ability of the schemes to raise funds by pledging securities (largely TREPS of G-Secs/T-bills). As fresh inflows are difficult to predict, the ability of such open-ended debt schemes to repay these intraday liquidity lines becomes a function of the saleability (which is largely a function of the credit quality of the underlying investments) or ability to raise overnight funds through TREPS or other borrowings as highlighted in the previous section.

While these intraday liquidity lines can be used across all the mutual fund schemes of the AMCs, the analysis of saleability or ability to raise overnight funds is largely focused on open-ended debt schemes with high volatility in the AUM. As mentioned earlier, certain open-ended debt schemes witness high volatility in their AUM and the same approach of 'portfolio credit quality' is used as a proxy for the credit risk and saleability of the underlying investments in these schemes. Further, the extent of borrowing that is already availed may constrain the ability of the schemes to borrow afresh, implying a higher reliance on the sale of investments to repay the intraday liquidity line at day end. Hence, the volatility, credit quality, and track record of borrowing (quantum and frequency) of certain open-ended debt schemes will tend to be the key driver of their ability to repay the intraday lines by day end. As overnight debt schemes largely have assets deployed on overnight TREPS, their ability to repay the intraday facilities in a timely manner is unlikely to be a challenge, regardless of the volatility in the AUM.

Overall, ICRA's approach for rating the intraday facilities availed by mutual fund schemes involves an assessment of the following factors:

1. **Volatility in the AUM**
2. **Credit quality of the underlying investments in the identified open-ended debt schemes**
3. **Scheme's track record, its approach to liquidity management and its borrowings**

Further, the conventional rating scale will be used for rating the borrowing facilities and the intraday liquidity facilities, not the mutual fund credit quality (mfs) rating scale.

ICRA will monitor the above ratings by reviewing the credit quality of the portfolio based on the monthly portfolio disclosures published by the schemes.

## Summing Up

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ICRA's mutual fund credit quality 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.

ICRA's rating for intraday liquidity facilities and conventional borrowings by mutual funds is driven by their ability to meet its debt repayments on an intraday as well as ongoing basis. This, in turn, is a function of the volatility in the AUM, the credit quality of the underlying investments of the open-ended debt schemes for which such lines are frequently used, apart from the AMC's liquidity management philosophy.

## ICRA Mutual Fund Ratings: Scale and Definitions

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To view the rating scale and the definitions applicable for mutual fund credit quality ratings, please refer to ICRA's website ([link](#)).

To view the rating scale and the definitions applicable for the borrowing facilities and the intraday liquidity facilities by mutual funds, please refer to the long-term and short-term rating scales at ICRA's website ([link](#)).

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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](http://www.icra.in) and [www.icresearch.in](http://www.icresearch.in)

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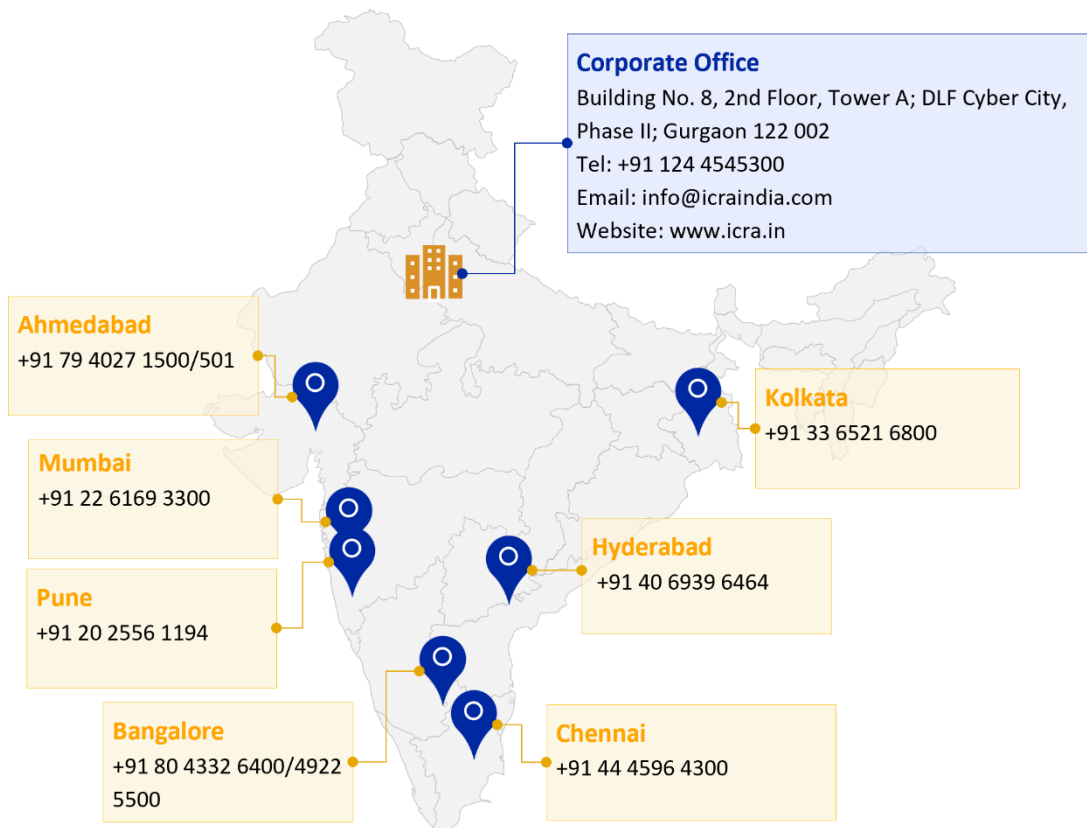
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