

Rating Methodology Fund Credit Quality

[In supersession of “CARE’s Fund Credit Quality Rating Criteria” issued in [September 2018](#)]

Introduction

Debt mutual funds have gained considerable prominence in India. A large variety of debt mutual fund schemes with different investment styles and objectives are now available in the Indian market. Fund managers today have a variety of options to construct their portfolios from plain vanilla bonds to more complex derivatives. In this context, CARE Ratings introduced the Fund Credit Quality Ratings aimed at enhancing the understanding of fund credit risk for the investors.

CARE Ratings’ fund Credit Quality Ratings (CQR) is an opinion on the overall credit quality of specific debt mutual fund schemes. The ratings capture the fund’s overall exposure to default risk based on the credit quality of individual securities in the portfolio. The CQR is aimed at providing an independent opinion on fund’s credit quality and act as a tool for investors to evaluate credit risk of such fund schemes.

What fund ratings are not?

CARE Ratings’ Fund CQR are not a recommendation to purchase, sell, or hold a security/fund. They neither comment on the current market price, suitability for a particular investor nor on the prospective performance of the fund with respect to appreciation, volatility of net asset value (NAV), or yield of the fund. The ratings do not address the fund’s ability to meet the payment obligations to the investors.

Rating Methodology

CARE Ratings’ Fund CQR is based on evaluation of the fund’s investment strategy and portfolio credit risk. It involves evaluation of credit quality of individual securities, diversification of portfolio, management quality and operational policies. CARE Ratings uses the concept of credit scores assigned to individual securities, as per credit scoring matrix developed by it.

CARE Ratings’ Credit Scoring Matrix

In the credit scoring matrix, a credit score is computed based on the credit rating and residual maturity of individual securities. Such credit scores are arrived at using CARE Ratings’ historical data on defaults adjusted for data limitations. The credit score is lower for higher ratings and

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vice versa. The portfolio credit score is arrived at by using the weighted average (using proportion of the exposure in the scheme) credit score for each security in the scheme. The portfolio credit score reflects the credit quality rating of the fund. For assigning a rating (and subsequently to maintain the rating at a given level), the fund credit score has to be within the benchmark fund score of the rating category. CARE Ratings has derived separate credit scoring matrix for its long-term and short-term rating scales.

Credit Quality of Individual Securities

The credit quality of individual securities in the scheme is assessed by using CARE assigned ratings wherever such ratings are outstanding. In case of securities not rated by CARE, the lowest rating assigned by other credit rating agencies (CRA) is used as a guide. Subsequently, if CARE has additional information which it feels has not been factored in the other CRA rating, it will form its internal view on the rating and may deviate from the other CRA rating. In case of unrated securities CARE forms an internal view on the rating by considering publicly available information about the issuer.

Further, in case of securities where ratings are under ‘credit watch with negative implications’ or have a ‘negative’ outlook, CARE will stress the portfolio score by considering appropriately notched down rating for such securities.

Concentration Factor

CARE factors in concentration risk and adjusts the portfolio credit score if the single largest exposure exceeds 10% of the fund’s NAV. While there are no sectoral concentration caps defined, but CARE may introduce an adjustment factor if it feels that the concentration to a stressed sector has increased vis-à-vis the past.

Qualitative factors

Qualitative factors also play an important role in arriving at the final rating. The qualitative factors examined are:

Management Quality

CARE Ratings assesses the asset management company (AMC) in terms of organization set up, qualifications and experience of senior management team. The AMC’s track record in fund

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management is also examined. CARE Ratings also examines the credentials of AMC sponsors and the board of trustees.

Operations & Risk Management Systems

CARE Ratings studies the MIS (management information systems) and risk management systems of an AMC. An understanding of the portfolio monitoring process and other important operational processes is gained through interaction with the AMC. The accounting systems, disclosure levels and the regulatory compliance record of the AMC as well as systems to ensure such compliance are also studied. The quality of trading and back office systems, control systems for segregation of trading and back office operations is also studied.

Ongoing Review, Monitoring/Surveillance & Withdrawal of Rating

CARE Ratings reviews the rated mutual fund scheme on an on-going basis to support its published rating opinions. As such, monthly portfolio of the fund is obtained. In addition, detailed annual review of the fund is also undertaken. The fund has to maintain the fund credit score within the benchmark fund score associated with a given rating level. If in any particular month, the fund credit score breaches the benchmark, CARE Ratings generally provides a curing period of one month to the AMC to correct the situation and realign the score. If the fund credit score is not corrected within the curing period, CARE Ratings would consider revising the rating. Further, if CARE believes that the fund score is unlikely to be realigned in the one month time frame, it may directly act on the ratings without providing any curing period.

CARE would treat sale of downgraded securities from the scheme as a means to realign portfolio exposures. A write-off of downgraded/defaulted exposures will not be considered as realignment and CARE will assign the downgraded rating on the entire par value of such exposures in the latest portfolio while calculating the overall credit score. Further, in case of defaulted exposures, CARE will continue to assign lowest rating to the par value of the exposure, even if the fund manages to sell the security. This is done so as to reflect the deterioration in the credit quality of the fund even though the fund's NAV would adjust upon such default. Post the downgrade of the scheme, CARE will reassess the ratings based on the revised portfolio.

Withdrawal of CQR

CARE Ratings would withdraw the ratings of open ended mutual fund schemes (being perpetual in nature and having no specified maturity) after placing them on 'Notice of Withdrawal' for 30

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days and upon receipt of request for withdrawal from the Asset Management Company (AMC). CARE will review the rating during the notice period and may revise the rating based on updated portfolio composition and ratings.

Rating Symbols and Definition

Symbols	Rating Definition
CARE AAAmfs	Schemes with this rating are considered to have the highest degree of safety regarding timely receipt of payments from the investments that they have made.
CARE AAmfs	Schemes with this rating are considered to have the high degree of safety regarding timely receipt of payments from the investments that they have made.
CARE Amfs	Schemes with this rating are considered to have the adequate degree of safety regarding timely receipt of payments from the investments that they have made.
CARE BBBmfs	Schemes with this rating are considered to have the moderate degree of safety regarding timely receipt of payments from the investments that they have made.
CARE BBmfs	Schemes with this rating are considered to have moderate risk of default regarding timely receipt of payments from the investments that they have made.
CARE Bmfs	Schemes with this rating are considered to have high risk of default regarding timely receipt of payments from the investments that they have made.
CARE Cmfs	Schemes with this rating are considered to have very high risk of default regarding timely receipt of payments from the investments that they have made.

Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories CARE AAmfs to CARE Cmfs. The modifiers reflect the comparative standing within the category.

CARE Ratings will generally assign long-term credit quality rating to a fund; however, upon specific requests from AMCs, the fund can also be rated on the short-term scale subject to the fund meeting the following criteria.

- All of the fund’s holdings should have a residual maturity of less than one year
- The fund’s mandate is to invest predominantly in short-term debt securities

The short-term rating scale for fund credit quality rating is as below.

Symbols	Rating Definition
CARE A1mfs	Schemes with this rating are considered to have very strong degree of safety regarding timely receipt of payments from the investments that they have made.
CARE A2mfs	Schemes with this rating are considered to have strong degree of safety regarding timely receipt of payments from the investments that they have made.
CARE A3mfs	Schemes with this rating are considered to have moderate degree of safety regarding timely receipt of payments from the investments that they have made.
CARE A4mfs	Schemes with this rating are considered to have minimal degree of safety regarding timely receipt of payments from the investments that they have made.

Modifier {"+" (plus)} can be used with the rating symbols for the categories CARE A1mfs to CARE A4mfs. The modifier reflects the comparative standing within the category.

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Disclaimer

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