Ratings Methodology - Fund Credit Quality

[Issued in February 2023]

Overview

CARE Ratings' fund Credit Quality Rating (CQR) is an opinion on the overall credit quality of a debt mutual fund scheme. The rating captures the fund's overall exposure to the default risk based on the credit quality of individual securities in the portfolio. The CQR is aimed at providing an independent opinion on the fund's weighted average credit quality and acts as a tool for the investors to evaluate credit risk of such fund schemes.

What fund ratings are not?

- CARE Ratings' Fund CQR is not a recommendation to purchase, sell, or hold a security/fund. They comment neither 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.
- The ratings are not an opinion on the fund management practices (including fund structure, expense ratios & marketing activities), financial performance as well as management quality of an AMC and hence do not comment upon the business practices.
- The ratings are also not indicative of compliance & reputation risks, liquidity, market and sectoral risks.

Rating Methodology

CARE Ratings' Fund CQR is based on evaluation of the fund's stated investment strategy and portfolio credit risk. It involves evaluation of credit quality of individual securities as well as diversification of portfolio. CARE Ratings Limited (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 security. Exceptions include instruments with put options, whereby earlier of residual maturity or put option date is considered. Such credit score assigned to each security is arrived at using CARE Ratings' historical data on defaults, updated at regular intervals, adjusted for data limitations. The credit score is lower for higher ratings and 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 and is a summation of credit score of each security in 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.

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

To assign a rating, CARE Ratings would typically analyse the latest 3 months' portfolio to arrive at the credit score based on the credit score of the scheme for each of these 3 months. For schemes that are yet to be launched, CARE Ratings discusses the proposed investment-mix in terms of the credit quality that the fund manager intends to maintain. Once the schemes are launched for regular investments, a detailed review of the investment portfolio shall be carried out.

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 Ratings, the lowest rating assigned by other credit rating agencies (CRAs) is used as a guide. Subsequently, if CARE Ratings 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 Ratings forms an internal view on the rating by considering publicly available information about the issuer.

Furthermore, in case of securities where ratings are under 'Rating watch with Negative Implications' or have a 'negative' outlook, CARE Ratings will stress the portfolio score by considering appropriately notched down rating for such securities.

Concentration factor

The regulatory guidelines limit investments in debt instruments issued by a single issuer at 10% of fund's NAV for AAA rated securities, 8% in respect of AA rated securities and 6% in respect of A and below rated securities. CARE Ratings shall factor in concentration risks in line with the SEBI-defined thresholds for debt mutual fund schemes. In case of any breach in exposure limit, the score of a notched down rating shall be considered and a higher credit score may be applicable for the exposure over and above SEBI-defined thresholds.

Ongoing Review, Monitoring & Surveillance

CARE Ratings reviews the rating of mutual fund scheme on an on-going basis to support its published rating opinions. As such, portfolio of the fund is reviewed on monthly basis. 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 Ratings 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 Ratings would construe sale of downgraded securities from the scheme as an act of portfolio realignment. A write-off of downgraded/defaulted exposures will not be considered as realignment, and CARE Ratings will assign the downgraded rating on the entire par value of such exposures in the latest portfolio while calculating the overall credit score. CARE Ratings will continue to do this for a period of at least six months from the date of complete write-down of such investment or till full redemption/sale of such securities, whichever is earlier. 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. However, post any downgrade of the rating of the scheme, CARE Ratings would monitor the scheme's portfolio for at least three months before revising the rating upwards based on the revised portfolio.

[For previous version please refer 'Rating Methodology – Fund Credit Quality' issued in January 2021**]**

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India. The wholly-owned subsidiaries of CARE Ratings are (I) CARE Advisory, Research & Training Ltd, which offers customised advisory services, credible business research and analytical services (II) CARE Risk Solutions Private Ltd, which provides risk management solutions.