Bond Fund Credit Quality Ratings Criteria

Executive summary

CRISIL assigns credit quality ratings (CQR) to debt mutual fund schemes. The rating on the scheme reflects the likelihood of timely receipt of payments from the investments made by the scheme. The rating scale for bond fund credit quality rating schemes depends upon the contracted maturity of the scheme.

CRISIL’s assessment of a fund’s credit quality is based on bond fund’s overall level of protection against losses associated with credit defaults. CRISIL has a credit quality matrix to assess aggregate credit quality of the portfolio of a fund. The matrix is a set of credit factors derived from CRISIL’s default and transition rates corresponding to each rating category. The fund manager also has to comply with a standard set of warranties. These warranties pertain to minimum quality of assets to be maintained in the fund’s portfolio. Once a rating is assigned, the fund is placed under continuous surveillance. This article also discusses the withdrawal policy for CQR.

Scope

CRISIL’s credit quality ratings serve as a tool to investors for selecting funds with a suitable risk-return criterion and also provide an independent opinion on the credit risk associated with the fund’s portfolio. The rating is not a recommendation to purchase, sell or hold a security and is also not a comment on the market price, yield or suitability for a particular investor.

Rating Scale

Bond fund credit quality ratings range from ‘CRISIL AAAmfs’ to ‘CRISIL C-mfs’ on the long-term scale and ‘CRISIL A1+mfs’ to ‘CRISIL A4mfs’ on the short-term scale. These ratings are based on the credit quality of the portfolio of that particular scheme. The long-term scale is applicable to all open-ended schemes and closed-ended schemes with original contracted maturity of more than one year. The short-term scale is applicable only for closed-ended schemes with original contracted maturity of less than one year.

Bond fund credit quality ratings are based on current information furnished by the fund or obtained from other sources that CRISIL considers reliable. The ratings may be changed, suspended or withdrawn as a result of changes in or unavailability of such information or based on other circumstances. The assigned rating is valid only for that particular scheme. The rating of CRISIL is not an opinion on the Asset Management Company’s (AMC’s) willingness or ability to make timely payments to the investor. The rating is also not an opinion on the stability of the NAV of the Fund, which could vary with market developments.
The rating symbols for both long- and short-term scales are in the following table:

<table>
<thead>
<tr>
<th>Long-Term Scale</th>
<th>Short-Term Scale</th>
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<tbody>
<tr>
<td>CRISIL AAAmfs</td>
<td>CRISIL A1mfs</td>
</tr>
<tr>
<td>CRISIL AAmfs</td>
<td>CRISIL A2mfs</td>
</tr>
<tr>
<td>CRISIL Amfs</td>
<td>CRISIL A3mfs</td>
</tr>
<tr>
<td>CRISIL BBBmfs</td>
<td>CRISIL A4mfs</td>
</tr>
<tr>
<td>CRISIL Bmfs</td>
<td></td>
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<tr>
<td>CRISIL Cmfs</td>
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The ratings from ‘CRISIL AAAmfs’ to ‘CRISIL Cmfs’ may be modified by the addition of a ‘+’ (plus) or ‘−’ (minus) sign to reflect comparative standing within the category. Similarly ratings from ‘CRISIL A1mfs’ to ‘CRISIL A4mfs’ may be modified by the addition of a ‘+’ plus sign to reflect comparative standing within the category.

Methodology

While analysing a bond fund’s credit quality, CRISIL looks into credit quality rating matrix to assess aggregate credit quality of the portfolio of a fund. CRISIL also obtains a list of warranties from the scheme’s fund manager pertaining to minimum quality of assets to be maintained by the fund. These parameters are important inputs to arrive at the final rating and are explained in detail in the section below:

Credit quality rating matrix

CRISIL has developed a credit quality rating matrix to convert the credit rating of the investments made by the scheme into credit factors. The matrix is a set of credit factors derived scientifically from CRISIL’s rating default and transition rates over the past decade.

Each rating, both on the long-term scale (‘CRISIL AAA’, ‘CRISIL AA’ and so on) and short-term scale (‘CRISIL A1’ and ‘CRISIL A2’ and so on) is assigned a credit factor. The credit factor for each rating directly correlates to the default and transition rates of the respective rating. The credit factor increases with the downward movement on the rating scale, indicating the relative increase in the fund portfolio’s default probability.

<table>
<thead>
<tr>
<th>Rating (Long term)</th>
<th>Credit Factor*</th>
<th>Rating (Short term)</th>
<th>Credit Factor*</th>
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</thead>
<tbody>
<tr>
<td>Government-Securities</td>
<td>0</td>
<td>CRISIL A1</td>
<td>4-19</td>
</tr>
<tr>
<td>CRISIL AAA</td>
<td>4</td>
<td>CRISIL A2</td>
<td>40-62</td>
</tr>
<tr>
<td>CRISIL AA</td>
<td>17-40</td>
<td>CRISIL A3</td>
<td>225-300</td>
</tr>
<tr>
<td>CRISIL A</td>
<td>41-120</td>
<td>CRISIL A4</td>
<td>&gt;301</td>
</tr>
<tr>
<td>CRISIL BBB</td>
<td>121-300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CRISIL BB and below</td>
<td>&gt;301</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*The range in credit factors is on account of modifier level rating. CRISIL may apply ‘+’ (plus) or ‘−’ (minus) signs for ratings from ‘CRISIL AA’ to ‘CRISIL C’. CRISIL may also apply ‘+’ (plus) signs for ratings from ‘CRISIL A1’ to ‘CRISIL A4’. This reflects comparative standing within the category.

By applying the respective credit factor (as mentioned in the above table) to the proportion of securities held in each rating, CRISIL arrives at a fund’s total credit score. The credit score exhibits the fund’s overall default probability and the expected credit quality deterioration in its portfolio. The rating is assigned based on the fund’s total credit score.
List of Warranties

In addition to the above criteria, the scheme’s fund manager has to comply with a standard set of warranties. Since portfolios of these schemes are dynamic in nature, it is important for the fund manager to maintain, at all the times, asset quality consistent with the rating assigned to the scheme. The AMC furnishes a set of warranties to CRISIL. These warranties pertain to the minimum quality of assets to be maintained by the funds and the sharing of information with CRISIL in order to ensure timely rating action.

Warranties furnished by the AMC to CRISIL include the following:

- The AMC shall make its best effort to maintain the credit score applicable for the assigned rating at all times for which the rating is outstanding
- The AMC shall every month submit to CRISIL, portfolio details of investment in securities held by the fund
- The AMC shall also take CRISIL’s view on investment in securities not rated by CRISIL
- CRISIL will take an internal view in case of investments in securities that are not rated by CRISIL. If the fund’s credit score exceeds the credit score stipulated for maintaining the assigned rating, the AMC shall bring back the fund’s credit score within the credit score limit applicable to the assigned rating within a maximum period of 15 calendar days from CRISIL intimating the breach of the warranty
- The assigned rating is valid only for that particular scheme. The rating of CRISIL is not an opinion on the Asset Management Company’s willingness or ability to make timely payments to the investor. The rating is also not an opinion on the stability of the NAV of the Fund, which could vary with market developments

Surveillance process

Once a bond fund rating is published, the rating is placed under continuous surveillance by CRISIL. This means that CRISIL will review the fund’s holdings on a monthly basis and may reevaluate the rating based on new information, whenever such action is warranted. Any change in the rating due to any reason will be communicated to the AMC prior to disseminating it to the public.

If any security in the fund’s portfolio is downgraded, the revised credit factor shall be applicable to the security. In case the revised credit score of the scheme exceeds the credit score applicable to the assigned rating, the AMC shall, within a period of 30 calendar days from the date of downgrade, bring back the credit score within the limit applicable to the assigned rating.

Withdrawal policy

The credit quality rating on mutual fund schemes can be withdrawn if the AMC sends a written request to CRISIL for the same. CRISIL will place the rating on ‘Notice of withdrawal’ for a period of 90 days from the date of request. Subsequent to completion of 90 days, CRISIL will withdraw the rating.
About CRISIL Limited
CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

About CRISIL Ratings
CRISIL Ratings is India's leading rating agency. We pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we have a leadership position. We have rated over 75,000 entities, by far the largest number in India. We are a full-service rating agency. We rate the entire range of debt instruments: bank loans, certificates of deposit, commercial paper, non-convertible debentures, bank hybrid capital instruments, asset-backed securities, mortgage-backed securities, perpetual bonds, and partial guarantees. CRISIL sets the standards in every aspect of the credit rating business. We have instituted several innovations in India including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We pioneered a globally unique and affordable rating service for Small and Medium Enterprises (SMEs). This has significantly expanded the market for ratings and is improving SMEs' access to affordable finance. We have an active outreach programme with issuers, investors and regulators to maintain a high level of transparency regarding our rating criteria and to disseminate our analytical insights and knowledge.

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