



Rating Criteria for Debt Mutual Funds Scheme

Executive Summary

The debt mutual fund schemes of fund houses cater to a select set of investors - corporate investors (looking to manage their liquidity/treasury), financial institutions (treasury/liquidity management) and retail investors who have a lower risk appetite.

As such, these funds invest in debt markets via listed/unlisted debt securities, the maturities of which could vary with the investment strategy and policy of the fund house. The rating assigned by Brickwork Ratings (BWR) for such schemes reflects the credit quality of the scheme considering the underlying portfolio and investment policies and processes.

Brickwork Ratings assigns ratings to Debt Mutual Fund Schemes on the long- and short-term rating scale. The rating is followed by an 'mfs' suffix to indicate that the ratings have been assigned to Debt Mutual Fund Schemes. It should be noted that a rating assigned to a Mutual Fund is not indicative of the probability of default of the fund, but of the credit quality of the fund and the scheme's willingness and/or ability to make timely redemption to its investors considering the underlying portfolio, overall Assets Under Management (AUM), fund manager, their investment strategies, management and sponsorship of the fund/ Asset Management Company (AMC). At no time should the rating assigned by BWR be construed as advice to buy, sell or hold the instrument or an indication of the expected returns as the ratings do not address market risks associated with the scheme.

Fund ratings assigned by BWR are for both long- and short-term funds. However, Capital Protection Oriented Funds are very similar to Collateralised Debt Obligations involving a pool of corporate debt exposures, and hence an 'SO' rating symbol will be used. The ratings would be on the regular rating scale for debt instruments and not on the mutual fund rating scale.

Scope of the Criteria

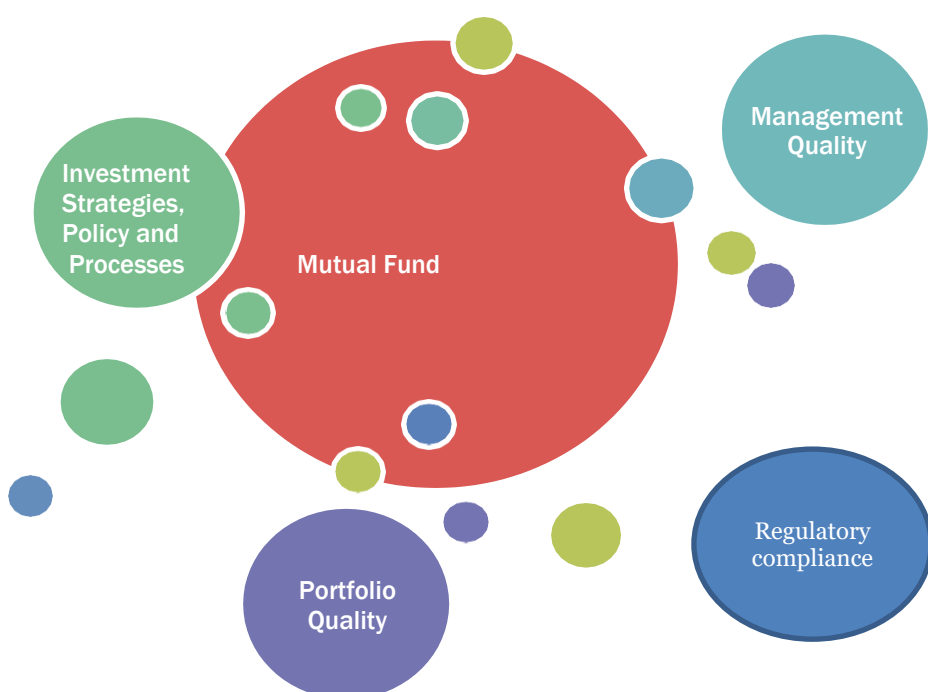
The document provides details of the qualitative and quantitative parameters considered by BWR to arrive at the rating of a Debt Mutual Fund Scheme. These parameters range from the assessment of the track record and expertise of sponsors, investment policies and processes, portfolio quality, effectiveness of AMC, and regulatory compliance, to the ability to identify the right investments, their investment strategies and measuring risks involved in each investment.

Risk Assessment and Rating Criteria for Rating Debt Mutual Funds scheme

Brickwork Ratings (BWR) does an assessment of the following four main parameters in the rating of debt mutual fund schemes:

- a) Management Quality at the AMC/ Trustee company level and quality of investment team
- b) Investment Strategies, Policies and Processes
- c) Regulatory compliance
- d) Portfolio Risk/ Credit Quality of the portfolio

The criteria are captured in the figure shown below:



Approach & Methodology

1. Management Quality

BWR assesses the quality of the management teams at two levels:

- a. Management quality at the AMC:** This reflects the overall experience and track record of the Board of Directors, governance standards of the AMC, reputation and the experience of the fund house in managing such schemes. The management quality of the AMC will also reflect in its investment strategies, pricing, marketing and distribution activities, policies and processes.
- b. Quality of the investment team:** This reflects the overall experience and track record of the investment team managing the fund, especially fund manager. In cases where the team may be inexperienced in such schemes, their overall experience, as well as the experience at the top management at the AMC, will be considered while analysing this criterion.

BWR will also consider the experience of other key personnel in the organisation while assessing the overall management quality. Governance standards at the AMC will be evaluated considering the disclosures made and adherence to regulatory requirements, as well as policies, investment strategies and processes in place.

2. Investment Strategies, Policies and Processes

BWR considers the investment policies and processes in place at the AMC/ investment strategies for the schemes. Internal documentation, as well as detailed discussions, allow BWR to understand how aligned the investment process is with regard to the stated investment objective of the scheme. The following parameters are considered for the same:

- a. **Investment Policies** – Such as rating requirements for the credit evaluation, due diligence requirements, investment strategies, documentation maintained for investments and regulatory guidelines followed
- b. **Organisational Structure** – Role of the front and back offices, presence of a mid-office, fund management team, reporting lines and structures that allow for management of conflicts of interest
- c. **Operational Policies and Procedures** – Usually analysed with the investment policy and processes and organisational structure
- d. **Risk Management Policies and Systems** in place, as well as monitored by internal and external audits

3. Portfolio Quality

The quality of the portfolio managed in the scheme is studied at a consolidated level.

- **Credit Quality:** The credit quality of the underlying portfolio mix is understood asset-wise. Thus, each instrument invested in is considered to determine the credit rating.
 - a. Where the instrument invested in by the Fund has an outstanding BWR rating, the rating is considered as is during the portfolio assessment.
 - b. Where the instrument invested in by the Fund has outstanding ratings assigned by other rating agencies (lowest ratings if rated by more than one CRA), BWR may use the rating as is or may adjust for the same based on its analysis.
 - c. For the unrated portion of the portfolio, BWR may assess the credit quality separately for each unrated instrument.
 - d. Cash and cash equivalents are treated at the highest rated category, allowing for counterparty credit risk of the bank in which the same is maintained.
 - e. Treasury bills and Central Government securities would be treated as having highest credit quality. Separate benchmark credit scores are used for investment in each of the rating categories and short-term and long-term funds.

- **Credit Score:** The overall credit score of the portfolio is then calculated based on the weighted average credit quality of the investments. BWR will also subject the portfolio to certain stress tests on the credit quality to consider portfolio performance in the case of movements of the instruments from one rating to the other.
- **Diversification:** Diversification refers to both sector-wise, as well as asset-class-wise. The more the number of instruments (determined by the counterparties rather than just the number) are, the better is the diversification in the portfolio. Concentration risk is determined as per regulatory guidelines, which limits investment issued by a single issuer as a percentage of the portfolio (at present, it is 10% in each rating category, except government bonds/securities, as per SEBI guidelines and can go up to 12% with the approval of the board of trustees). In case the exposure limits are breached, the credit score will be analysed factoring the same. BWR also analyses top investors of the fund and factors into the diversification of investor base for the fund.
- **Liquidity:** Liquidity management plays an important role in ascertaining the quality of the portfolio. Redemption patterns are understood to ensure that the cash and cash equivalents, as well as the credit facilities availed from banks, will allow for adequate liquidity.

4. Regulatory Compliance

BWR also considers the processes in place at the fund house to ensure compliance with regulatory guidelines and requirements. Compliance allows for reducing risk due to a loss from regulatory proceedings in the case of a change in regulatory guidelines, as well as reputational loss. Adherence to compliance, on-going and past regulatory discussions, as well as any pending/past litigation, are discussed with the AMC in detail.

Periodic Review of the Portfolio:

BWR reviews and monitors ratings assigned on an on-going basis. In cases where there is a change in the portfolio, the credit quality is evaluated and discussed with the investment team at the AMC. In case of changes in the management, strategies, policies and processes, among others, the AMC is required to share the portfolio details on a monthly basis, credit quality of the portfolio as per initial investment strategies, and any major developments that would have a bearing on the ratings, if any. BWR will consider the effect of the same on the rating assigned and may revise the assigned ratings. The Rating Symbols and Definitions for Long-Term / Short-Term Debt Mutual Fund Schemes would be as per SEBI Circulars and Guidelines issued from time to time.

Withdrawal Policy:

Mutual fund schemes (closed-ended or open-ended), Alternative Investment Funds (AIFs, closed-ended or open-ended) and capital protection-oriented schemes come under pooled investment schemes and the ratings for the same can be withdrawn as per BWR rating withdrawal policy on pooled investment schemes.

Conclusion

BWR analyses each parameter after measuring the impact of the aforementioned risks and attributes, along with the credentials of the AMC's management and investment portfolio, to arrive at the overall credit assessment of the Debt MF scheme. The emphasis is laid on the AMC's investment strategies portfolio credit quality, along with the maturity profile of the investments made by the investors in the scheme, and investment policies and process. While the methodology comprises a comprehensive analysis of various risks associated with the regulatory aspects, investment risk, portfolio risk and operational risk, the final rating is assigned based on the overall credit quality of the fund considering the underlying portfolio of investment, the management and sponsorship of the fund.

The previous version of this document can be found in
www.brickworkratings.com/download/Criteria-MutualFunds.pdf

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