ICRA LANKA - MUTUAL FUND
CREDIT RISK RATING METHODOLOGY

OVERVIEW

Our goal in credit risk rating of debt mutual funds is to provide investors with a simple-to-use measure of credit risk. The credit risk ratings incorporate ICRA Lanka's assessment of a debt fund's published investment objectives and policies, its management characteristics, and the creditworthiness of its investment portfolio. Consistent with our general approach to other credit ratings, our assessment of debt funds incorporates both qualitative and quantitative factors. ICRA Lanka's analytical process focuses on portfolio credit quality referenced to the maturity structure as well as, management characteristics, operating procedures and controls, and regulatory compliance.

ICRA LANKA'S RATING APPROACH

ICRA Lanka's analysts obtain and rely on relevant data from public and non-public sources. While this data may vary according to the type and nature of the debt fund, the following information is typically used in the rating process:

- Prospectus and related documents
- Debt fund portfolio data, including periodic investor reports and public filings
- Industry surveys, studies, and special reports
- Internal documents describing the AMC's structure, investment philosophy, decision making process, and performance track record

In addition, ICRA Lanka encourages a continuous dialogue with the AMC's management. ICRA's analysts would normally meet with the company representatives for a discussion of the relevant factors in connection with the assignment of an initial credit risk rating, and on a periodic basis thereafter.

MANAGEMENT CHARACTERISTICS

ICRA Lanka seeks to form an opinion and understand the factors that are likely to have an influence on the portfolio management function and related debt fund support activities. This is necessarily a qualitative assessment, which takes into consideration the financial standing of the firm, its ownership structure, reputation and general business practices, including: product, pricing, marketing and distribution activities. In addition, the firm's organizational structure and composition of the AMC's board of trustees or directors are also examined.

The professional skills and track record of the debt fund manager are useful factors in assessing the likelihood of achieving the debt fund's investment objective and adherence to stated policies. These may also provide indications about how the debt fund might respond to future opportunities or stress situations under different market conditions. This assessment provides an initial guide in the evaluation of a debt fund's overall credit quality. ICRA Lanka will also seek to understand the debt fund's investment practices and procedures, including the use of repurchase agreements, securities lending, and derivative transactions, if any.

OPERATIONAL PROCEDURES AND CONTROLS

Sound operational procedures and controls are important to the long-term success of a debt fund. The information we obtain regarding a debt fund's custodian, administrator, and shareholder servicing agent provides insight into various operational functions and compliance practices.

REGULATORY COMPLIANCE

Proper practices in the areas of compliance and disclosure play a key role in the successful management of a debt fund. A good compliance program will tend to minimize the risks factors typically associated with poor compliance or non-compliance, including loss of investor confidence or damage to a debt fund's reputation. Thus, ICRA Lanka attempts to review a debt fund's compliance practices and procedures along with its adherence to relevant Indian rules and regulation. Compliance reviews may include the monitoring of regulatory disclosures, public pronouncements and past and pending litigation.

PORTFOLIO CREDIT QUALITY

As a measure of the credit quality of a debt fund's assets, ICRA Lanka uses the concept of "credit scores". These scores are based on ICRA Lanka's estimates of credit risk associated with each exposure of the portfolio taking into account its maturity. To quantify the credit risk scores, ICRA Lanka uses its database of historical default rates for various rating categories for various maturity buckets.

PORTFOLIO MATURITY

ICRA Lanka reviews the portfolio's maturity strategy based on the type of debt fund rated and the fund's stated guidelines. ICRA Lanka considers the structure and composition of a debt fund's portfolio within the context of its liquidity requirements, the size of the debt fund and historical cash flow patterns. This evaluation typically includes a review of policies on weighted average maturity and maturity distribution.

PORTFOLIO CREDIT EVALUATION

At the outset, ICRA Lanka analyses the credit quality of the investment portfolio of a MF portfolio based on the outstanding ratings. For debt securities, which carry an ICRA Lanka rating the same is considered for the credit risk evaluation. For debt securities which do not carry ICRA Lanka ratings, but have outstanding ratings from other recognised rating agencies in the country, ICRA Lanka generally would consider a similar view but may consider a different rating based on its own judgement. For debt securities, which do not carry any ratings, ICRA Lanka takes an implicit view of the credit risk.

Using the above ratings and the residual maturity (principal only – ICRA Lanka does not consider interest rate resets as maturity), for each of the debt security in the portfolio, ICRA Lanka assigns a credit score. This credit score is derived from the ICRA Lanka's database of historical experience of credit risk for various rating categories and maturity buckets. The portfolio credit score is calculated by considering the weighted average credit risk of the portfolio and is compared against benchmark for various rating categories and ratings are assigned accordingly.

THE ICRA LANKA'S CREDIT MATRIX

ICRA Lanka's Credit Matrix provides debt fund managers with investment decision flexibility. The Credit Matrix is a tool used by ICRA Lanka for analysing the investment portfolio of the debt mutual fund schemes by measuring the portfolio's aggregate credit quality, by reviewing the credit quality of each underlying debt security. The portfolio's weighted average credit quality is then measured against appropriate benchmark credit score. Separate benchmark credit scores are used for liquid and bond funds. The short-term debt funds are with weighted average portfolio maturities of upto one year and are typically liquid/cash funds. The long-term debt funds are with weighted average maturity of more than one year and are typically bond funds. ICRA Lanka benchmarks the short-term debt funds including liquid/cash funds against a 12-month benchmark credit score, whereas the long-term debt funds are benchmarked against the long term benchmark credit score. ICRA Lanka generally assigns short-term MF credit risk ratings to short-term/liquid fund but gives an option to these funds to seek a long-term MF credit risk rating. Similarly ICRA Lanka generally assigns long term MF credit risk ratings to bond funds but gives an option to those funds with a weighted average maturity of less than 12 months to seek a short-term MF credit risk ratings.

ONGOING REVIEW AND MONITORING

Once a debt fund is rated and the rating is accepted, ICRA Lanka reviews relevant fund information on an ongoing basis to support its published rating opinions. To this end, ICRA Lanka relies on a flow of information obtained from the AMC and/or from publicly available sources. ICRA Lanka would carry out the rating surveillance of the mutual fund ratings on a monthly basis, which would be evaluating the portfolio credit scores. If the portfolio credit score meets the benchmark of the assigned rating during the review, the rating is retained. In an event that the benchmark credit score is breached, ICRA Lanka gives a month's time to the debt fund manager to bring the portfolio credit score within the benchmark credit score. If the debt fund manager is able to reduce the portfolio credit score within the benchmark credit score, the rating is retained. If the portfolio still continues to breach the benchmark credit score, the rating is revised to reflect the change in credit quality.