

## Ratings Criteria for Bond Fund Credit Quality

CRISIL assigns credit quality ratings to fixed income mutual funds. These ratings reflect the level of protection that a fund's portfolio provides against losses from credit defaults.

Typically, debt investors have a lower risk appetite than equity investors and look for both protection of their principal and for fixed returns. Consequently, the credit quality of a debt fund's investments is a critical input for determining the quality of its portfolio's returns. In this regard, CRISIL's bond fund 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.

Bond fund credit quality ratings are based on an analysis of the fund's investment philosophy, its management, investment strategies, operational policies and internal controls. Credit quality incorporates the credit risk of securities and the counter-party risk involved in transactions such as repurchase agreements, derivatives and the like. A fund's credit quality rating is based on an assessment of the protection its portfolio provides against the losses from default risk. The higher the default risk of a fund's portfolio, the lower the rating of the fund.

### ■ CRISIL's credit quality rating matrix

CRISIL has developed a Credit Quality Matrix to evaluate a bond fund's overall level of protection against losses associated with credit default. The matrix is essentially a set of credit factors derived scientifically from CRISIL's rating default and transition rates over the past ten years.

Each rating sub-category ('AAA', 'AA+' and so on) is assigned a credit factor. The credit factor for each rating sub-category is directly correlated to the default and transition rates of the respective category. The credit factor increases with the downward movement on the rating scale indicating the relative increase in the fund portfolio's default probability. By applying the respective credit factor to the proportion of securities held in each rating category, a fund's total credit score is derived. The credit score will exhibit 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. To retain the rating, the fund needs to maintain the applicable credit score at all times.

### ■ Qualitative factors

In addition to the above criteria, CRISIL evaluates the following qualitative factors while assigning a bond fund credit quality rating:

### **Management evaluation**

CRISIL believes that the quality of a fund's management is critical to its overall performance. Factors like the management's track record in the fund management business and the quality of its key personnel are studied.

### **Investment strategy**

CRISIL also studies the fund's internal credit analysis and security evaluation, asset selection and credit surveillance procedures. In addition, the fund's regulatory compliance and track record are also examined.

### **Systems and counter-parties**

The fund's systems and procedures for executing investment decisions, back office systems, reconciliation with custodians and registrars, calculation of net asset value, tracking of interest payments, empanelment of brokers and dealings with counter-parties are also factored into the rating.

### **Surveillance**

Once a bond fund rating is published, the fund is placed under continuous surveillance by CRISIL. This means that CRISIL will review the fund's holdings, its regulatory aspects and corporate actions on a monthly basis and may reevaluate the rating based on new information, whenever such action is warranted. In addition, each rated fund is subject to a formal review at least once a year. Any change in the rating due to any reason will be communicated to the fund prior to disseminating it to the public.

### **Rating Definition**

Bond fund credit quality ratings, which range from 'AAAf' to 'C-f', are based on the creditworthiness of a fund's overall portfolio. The ratings are broadly classified into two categories: secure and vulnerable. Ratings from 'AAAf' to 'BBB-f' are classified as 'secure' ratings, indicating the relative safety of the fund's portfolio against credit defaults. Ratings from 'BB+f' to 'C-f' are

classified as vulnerable ratings, indicating the portfolio's relative vulnerability to losses from credit defaults.

A credit quality rating is not a recommendation to purchase, sell or hold a security in as much as it is not a comment on the market price, yield or suitability for a particular investor. The 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 rating symbols and definitions are as follows:

#### **Secure Ratings**

- AAAf The fund's portfolio holdings provide very strong protection against losses from credit defaults
- AAf The fund's portfolio holdings provide strong protection against losses from credit defaults
- Af The fund's portfolio holdings provide adequate protection against losses from credit defaults
- BBBf The fund's portfolio holdings provide moderate protection against losses from credit defaults

#### **Vulnerable Ratings**

- BBf The fund's portfolio holdings provide uncertain protection against losses from credit defaults
- Bf The fund's portfolio holdings exhibit vulnerability to losses from credit defaults
- Cf The fund's portfolio holdings make it extremely vulnerable to losses from credit defaults

The ratings from 'AAf' to 'Cf' may be modified by the addition of a plus (+) or minus (-) sign to show the relative standing within the major rating categories.