भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

CIRCULAR

SEBI/HO/IMD/IMD-II DOF3/P/CIR/2021/573 **June 07, 2021**

All Mutual Funds/

Asset Management Companies (AMCs)/

Trustee Companies/Boards of Trustees of Mutual Funds/

Association of Mutual Funds in India (AMFI)

Sir/ Madam,

Subject: Potential Risk Class Matrix for debt schemes based on Interest Rate Risk and Credit Risk

1. SEBI, vide circulars SEBI/HO/IMD/DF3/CIR/P/2017/114 dated October 6, 2017, SEBI/HO/IMD/DF3/CIR/P/2017/126 dated December 4, 2017 on "Categorization and Rationalization of Mutual Fund Schemes", has specified scheme categorization based on scheme characteristics.

2. Further, SEBI, vide circular SEBI/HO/IMD/DF3/CIR/P/2020/197 dated October 5, 2020 on "Product Labeling in Mutual Funds-Risk-o-Meter", has advised the Mutual Funds to indicate risk taken by the scheme as on the end of the month.

3. The Risk-o-Meter as specified in the abovementioned circular dynamically captures the actual risk in the portfolio taken by the fund manager.

4. For investors to take informed decisions, there is a need to know the following while investing in a mutual fund scheme:
    a. current risk level as indicated by Risk-o-Meter and
    b. maximum risk the fund manager can take in the scheme

5. While the Risk-o-Meter stipulated by SEBI reflects the current risk of the scheme at a given point in time, there is also a need for disclosure of the maximum risk the fund manager can take in the scheme.

6. Based on the recommendation of the Mutual Fund Advisory Committee (MFAC) and discussions held with the mutual fund industry, it has been decided that all debt schemes also be classified in terms of a Potential Risk Class matrix consisting of parameters based on maximum interest rate risk (measured by Macaulay Duration (MD) of the scheme) and maximum credit risk (measured by Credit Risk Value (CRV) of the scheme).

7. While the AMCs will continue to retain the same category of their schemes as per the SEBI circulars SEBI/HO/IMD/DF3/CIR/P/2017/114 dated October 6, 2017, SEBI/HO/IMD/DF3/CIR/P/2017/126 dated December 4, 2017, they have full flexibility to place single/multiple schemes in any cell of the Potential Risk Class matrix (PRC).

8. For the purpose of alignment of the existing schemes with the provisions of this circular, each scheme shall be placed in one of the 9 cells specified at Table 2 below, while retaining their existing scheme category as specified in SEBI circulars on ‘Categorization and Rationalization of Mutual Fund Schemes’. This would not be considered as a change in fundamental attribute.

9. However, subsequently, once a PRC cell selection is done by the scheme, any change in the positioning of the scheme into a cell resulting in a risk (in terms of credit risk or duration risk) which is higher than the maximum risk specified for the chosen PRC cell, shall be considered as a fundamental attribute change of the scheme in terms of regulation 18(15A) of SEBI (Mutual Fund) Regulations, 1996.

10. Further, the Mutual Funds shall inform the unitholders about the abovementioned classification in one of the 9 cells and subsequent changes, if any, through SMS and by providing a link on their website referring to the said change.

11. For new debt schemes, the AMC shall choose the PRC cell at the time of filing of Scheme Information document (SID) with SEBI.

12. Each scheme will continue to comply with the requirements specified in SEBI circulars on categorization of schemes and those specified in this circular.

13. The thresholds for the values of the interest rate risk and the credit risk dimensions would progress in a flexible manner for drawing out the categorization matrix. The thresholds across the matrix would determine the maximum interest rate risk and the maximum credit risk which the scheme would be permitted to take but the scheme would have the flexibility to move downwards on the risk scale. The thresholds along with an illustration of the concept outlined above are given below:

<u>Thresholds</u>

i. Maximum Weighted Average Interest Rate Risk of the scheme (measured in terms of Macaulay Duration):
   1. Class I: MD<= 1 year;
   2. Class II: MD<=3 years;
   3. Class III: Any Macaulay duration

ii. Maximum Weighted Average Credit Risk of the scheme (measured in terms of Credit Risk Value as specified at Table 1 below):
   1. Class A: CRV >=12
   2. Class B: CRV >=10
   3. Class C: CRV <10 [i]

a. The Credit Risk Value of the scheme shall be the weighted average of the credit risk value of each instrument in the portfolio of the scheme, the weights based on their proportion to the AUM. Similarly, Macaulay Duration at the scheme level shall be the weighted average of the Macaulay Duration of each instrument in the portfolio with the weights being based on their proportion to the AUM. The value of the debt instrument to be

[i] Investments by mutual funds are permitted only in investment grade securities in terms of regulation 44(1) read with Schedule VII of SEBI Mutual Fund Regulations, 1996

considered for calculating AUM shall include the accrued interest i.e. dirty price of the instrument.

14. The debt securities of schemes are to be assigned a value for credit risk in the following manner:

TABLE 1	
Instrument	**CREDIT RISK VALUE (CRV)**
G-Sec/ State development loans/ Repo on Government Securities/TREPS / Cash	13
AAA	12
AA+	11
AA	10
AA-	9
A+	8
A	7
A-	6
BBB+	5
BBB	4
BBB-	3
Unrated	2
Below investment grade	1

a. For investment by mutual funds in instruments having short term ratings, the credit risk value shall be based on the lowest long term rating of an instrument of the same issuer as shown above (in order to follow a conservative approach) across credit rating agencies. However, if there is no long term rating of the same issuer, then based on credit rating mapping of CRAs between short term and long term ratings, the most conservative long term rating shall be taken for a given short term rating.

15. For the purpose of nomenclature, the 3 x 3 matrix shall have the following syntax for each matrix cell:

TABLE 2			
Max Credit Risk of scheme→ / **Max Interest Rate Risk of the scheme ↓**	**Class A(CRV >=12)**	**Class B (CRV >=10)**	**Class C (CRV <10)**
Class I: (MD<=1 year)	Relatively Low Interest Rate Risk and Relatively Low Credit Risk	Relatively Low interest rate risk and moderate Credit Risk	Relatively Low interest rate risk and Relatively High Credit Risk
Class II: (MD<=3 years)	Moderate interest rate risk and Relatively Low Credit Risk	Moderate interest rate risk and moderate Credit Risk	Moderate interest rate risk and Relatively High Credit Risk
Class III: Any Macaulay duration	Relatively High interest rate risk and Relatively Low Credit Risk	Relatively High interest rate risk and moderate Credit Risk	Relatively High interest rate risk and Relatively High Credit Risk

16. For example, if an open ended Short Duration Fund wants to invest in securities such that its Weighted Average Macaulay Duration is less than or equal to 3 years and its Weighted Average Credit Risk Value is 10 or more, it would be classified as a scheme with ‘Moderate Interest Rate Risk and Moderate Credit Risk’. The position of the scheme in the matrix shall be displayed by the AMCs as under:

TABLE 3			
Potential Risk Class			
Credit Risk →	**Relatively Low (Class A)**	**Moderate (Class B)**	**Relatively High (Class C)**
Interest Rate Risk↓			
Relatively Low (Class I)			
Moderate (Class II)		B-II	
Relatively High (Class III)			

17. The maximum interest rate risk which the aforesaid scheme can take would be in terms of the Weighted Average Macaulay Duration of the scheme and the same shall be ≤ 3 years. The maximum Weighted Average Credit Risk which the aforesaid scheme can take would have Credit Risk Value of 10 or more. Both the maximum interest rate risk and maximum credit risk would be reflected in the above matrix. By virtue of its placement in this position, the scheme would have the flexibility to take interest rate risk and credit risk below the maximum risk as stated above in Table 2.

18. The type of the scheme shall be modified to include the above cell selection. For the above example, it shall be as under:

An open ended short term debt scheme investing in instruments with Macaulay duration between 1 year and 3 years (please refer to page no.__)#. A moderate interest rate risk and moderate credit risk.

19. For a scheme placing itself in Class I (i.e. MD <=1 year), the maximum residual maturity of each instrument held by the scheme shall be three years. For a scheme placing itself in Class II (i.e. MD <=3 years), the maximum residual maturity of each instrument held by the scheme shall be seven years. A scheme placing itself in Class III can invest in instruments of any maturity. For securities issued by central

government and state governments, the cap for Class I and Class II pertaining to maximum residual maturity of each instrument shall not be applicable.

20. With regards to existing holding of perpetual bonds by debt schemes as on the date of this circular, (including debt instruments with special features viz. subordination to equity which absorbs losses before equity capital and /or convertible to equity upon trigger of a pre-specified event for loss absorption, for instance Additional Tier I bonds issued under Basel III framework), it has been decided that AMCs shall:

    a. reckon such bonds as having residual maturity as outlined in SEBI circulars SEBI/HO/IMD/DF4/CIR/P/2021/034 dated March 22, 2021 and SEBI/HO/IMD/DF4/CIR/P/2021/032 dated March 10, 2021

    b. grand-father existing investments in such instruments with the following provision:

        i. calculation of Macaulay Duration of the scheme to follow the guidelines in terms of SEBI circulars SEBI/HO/IMD/DF4/CIR/P/2021/034 dated March 22, 2021 and SEBI/HO/IMD/DF4/CIR/P/2021/032 dated March 10, 2021.

        ii. if the scheme places itself in Class I or II, and the MD exceeds the stipulated level, then it would be treated as a passive breach and a suitable period may be permitted for regularizing the passive breach. Until regularization, the scheme cannot make any investments that would effectively increase the MD of the portfolio. Calculation of MD for this purpose shall be post exclusion of such instruments having special features. To clarify, if a scheme AUM is INR 100 crores, of which INR 10 crores is in such instruments with special features, the base for calculation of MD for the purpose of PRC will be INR 90 crores. The scheme will continue to maintain the threshold of the cell in which it is positioned on INR 90 crores in line with Class I &/or Class II categorization in line with this circular.

21. AMCs shall update their SIDs to reflect the fact that placement of the scheme in one of the cells of PRC matrix does not reflect the scheme holdings pertaining to the aforementioned perpetual bonds with respect to the MD and maturity thresholds specified above, till the time such bonds are held by the scheme, for pre-existing holding of aforementioned perpetual bonds by debt schemes as on the date of this circular.

22. Fresh investments in perpetual bonds (including Additional Tier 1 bonds) can only be made in schemes that are in Class III.

23. For the debt instruments with call / put options, the deemed maturity will be in terms of SEBI Circular No. MFD/CIR/8/92/2000 dated September 18, 2000 and SEBI Circular No. SEBI/HO/IMD/DF4/CIR/P/2019/102 dated September 24, 2019. For instruments with interest rate reset dates, the interest rate reset date shall not be treated as deemed maturity.

24. The dynamic aspect of the risk of each scheme would be separately reflected in the Risk-o-Meter of the scheme, which would be published on a monthly basis.

25. Mutual Funds shall publish the aforesaid matrix in their scheme wise Annual Reports and Abridged Summary.

26. For existing schemes, Mutual Funds shall rebalance their scheme portfolios in line with the applicable cell of the above mentioned matrix by December 1, 2021.

Disclosure of the matrix

27. The aforesaid matrix along with the mark for the cell in which the of scheme resides shall be disclosed on:
    a. front page of initial offering application form, Scheme Information Documents (SID) and Key Information Memorandum (KIM).
    b. common application form – along with the information about the scheme.

    the PRC matrix with appropriate mark with respect to (a) & (b) above shall be placed in proximity to the caption of the scheme and shall be prominently visible and in bold.

c. Scheme advertisements – placed in manner by the Mutual Fund and its distributors so as to be prominently visible to investors.

Applicability of the circular

28. This circular shall come into force with effect from December 1, 2021, for all the existing debt schemes and all the debt schemes to be launched on or thereafter. However, mutual funds may at their discretion, choose to adopt the provisions of this circular before the effective date.

29. This circular is issued in exercise of the powers conferred under Section 11 (1) of the Securities and Exchange Board of India Act 1992, read with the provision of Regulation 77 of SEBI (Mutual Funds) Regulation, 1996 to protect the interests of investors in securities and to promote the development of, and to regulate the securities market.

Yours faithfully,

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