

A credit rating is an opinion on the creditworthiness of the issuer: Ratings are forward looking as it captures the future outlook of an issuer's ability to service and repay debt in full and on time. It is also a relative ranking of the default risk for a given instrument or issuer, in comparison with all other rated debt instruments.

Ratings have a strong impact on pricing of debt, determining market values of securities and managing risks of investment portfolios. Ratings also facilitate access to innovative and economic forms of capital and make debt instruments more comprehensible to investors. A wider array of financial instruments and securitisation will result in a speedy disintermediation process, where savings will continue to flow directly from investors to ultimate users of funds in an efficient manner.

The role and use of ratings have become institutionalized in almost all developed markets. A well functioning rating system in Sri Lanka will raise investor confidence, improve the market transparency and proactively contribute towards the development of the local debt markets.

DCR Lanka's credit opinions would be unparalleled in terms of quality of service and costs. Continuous monitoring of the ratings and timely communication of changes in credit quality would be cornerstones of DCR Lanka's services to investors.

THE RATING PROCESS

At DCR Lanka, ratings are a relationship-based business. Analysts work closely with issuer's management informing a credit opinion. The rating process is interactive in nature, and provides an opportunity to discuss and agree to the rating.

The process begins when an issuer formally requests a rating and provides necessary preliminary information. A due diligence meeting is held at the companies' facilities to meet the management, and to get a thorough understanding of the issuer's operational, financial and strategic goals.

* Courtesy: Duff & Phelps Credit Rating Lanka Ltd.

Credit Rating: The New Assessment Concept in Financial Market*

The lead analyst will then prepare a detailed credit report and continue to have an ongoing dialogue with the company to resolve any outstanding issues or to obtain additional information.

Once a rating is formulated, it is presented to the Credit Rating Committee to discuss relevant issues and a rating is assigned. The rating committee comprises of the CEO of DCR Lanka, DCR regional heads and industry specialists and is independent of the Board of Directors of DCR Lanka.

The rating is then communicated to the issuer along with the key rating considerations. If the issuer disagrees with the rating, there is an appeal process whereby the issuer is able to provide additional information relevant to the issue. Subsequently, the final rating is announced, and a detailed company credit analysis is made available to the public. A company may keep the rating private.

DCR Lanka will continue to monitor economic, industry and corporate events to ensure that the offered rating is an accurate reflection of the issuer's credit risk at all times. A long-term approach is adopted with regard to revision of any ratings. If a significant change occurs in the underlying fundamental credit strength of the issuer or specific debt issue, then the ratings may be placed under review for possible up or downgrades.

DCR Lanka maintains the strictest standards to ensure complete confidentiality of client data. Press releases and rating changes are initially discussed with the client, prior to public dissemination.

Active investor relations are maintained to ensure that they understand the credit opinions. Analysts will meet with investors regularly to explain their rating rationale of various credits. Investors are

encouraged to contact the analysts regarding specific credit opinions or DCR Lanka's general criteria on the credit ratings.

RATING METHODOLOGY

DCR Lanka seems to understand long-term fundamental credit strengths of a company. At the heart of every rating decision is a qualitative and quantitative assessment of the issuer's ability to generate sufficient cash to meet present and future debt obligations - repayment of principal and interest in full, and on time.

The final rating is based on a broad consideration of factors. Specific weights are not assigned to any one criteria. The analytical framework consists of industry, business and financial analysis and a review of legal documentation.

The focus is on risks that hinder the repayment capacity of a company, and not on its up-side potential for additional profits. Analysts conduct 'stress tests' to determine the company's ability to repay debt under varying industry and/or economic conditions.

The protection is higher, when a company's future cash flows are above its debt obligations, even during adverse industry and/or economic conditions.

Ratings are comparable across different industry groupings and focuses on the same criteria for both short and long-term assessments.

Industry Analysis

DCR Lanka begins each rating analysis with an assessment of the issuer's operating environment. The analysis focuses on the nature and structure of the industry, industry prospects,

patterns of industry cycles, barriers to entry, regulatory restrictions and competitive forces that affect the industry.

Business Analysis

Evaluates corporate strategies, management skills/abilities, motivations and style, strength of support from group companies, market position, competitive strength/weaknesses, business diversification and operating efficiencies.

Financial Analysis

Analysis of capital structure, historical performance and financial forecasts, debt service capacity, liquidity, earnings and accounting quality and financial flexibility. The financial policy with regard to leverage tolerance and dividend payments are also reviewed.

Indenture Provisions

Review of legal obligations of the issuer to repay debt and the priority of claim of the debt holder in the event of bankruptcy of the issuer.

RATING SCALES

DCR Lanka will rate local institutions from a domestic currency perspective. Accordingly, sovereign risk would not apply and all organizations will be benchmarked off an implied Sri Lankan Government rating of AAA.

BENEFITS OF CREDIT RATING Issuers

- .. Clarifies the level of risk and allows issuers to borrow more economically and efficiently.
- .. Provides increased flexibility and diversity of funding sources to issuers in the larger public debt market.
- .. Alleviates the need to provide guarantees or collateral to raise finance for business growth.
- .. Manages investor perception of credit risk over time, and maximizes access to the markets.
- .. Diversifies the risks of borrowing from only one source, thus eliminating related constraints

Long - Term Debt Rating Scale for Sri Lanka

Rating	Definition
SL AAA	Highest credit quality. The risk factors are negligible, being only slightly more than for risk-free Sri Lankan Government debt (Treasury Bonds)
SL AA+ SL AA SL AA-	Very high credit quality. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.
SL A+ SL A SL A-	Protection factors are average but adequate. However, risk factors are more variable and greater in periods of economic stress.
SL BBB+ SL BBB SL BBB-	Below average protection factors but still considered sufficient for prudent investment. Considerable variability in risk during economic cycles.
SL BB+ SL BB SL BB-	Below investment grade but deemed likely to meet obligations when due. Present or prospective financial protection factors fluctuate according to industry conditions or company fortunes. Overall quality may move up or down frequently within this category.
SL B+ SL B SL B-	Below investment grade and possessing risk that obligations will not be met when due. Financial protection factors will fluctuate widely according to economic cycles, industry conditions and/or company fortunes. Potential exists for frequent changes in the rating within this category or into a higher or lower rating grade.
SL CCC	Well below investment grade securities. Considerable uncertainty exists as to timely payment of principal, interest or preferred dividends. Protection factors are narrow and risk can be substantial with unfavourable economic/industry conditions, and/or with unfavourable company developments.
SL DDD	Defaulted debt obligations, issue failed to meet scheduled principal and/or interest payments

- .. such as collateral, single borrower limits, mortgage requirements etc.
- .. Increases market standing and corporate credibility
- .. Facilitates securing better credit terms from suppliers and soliciting orders from customers.
- .. Helps management to focus attention on competitive issues, potential threats and down side risks of the business.

Investors

- .. Provides a simple criterion to determine whether or not a debt security meets the investors' guidelines of acceptable credit risk
- .. Maximizes the returns of institutional investors by reducing the costs of credit assessment and facilitating investment selection based on risk-adjusted returns, maturity structures, particular investment needs, etc.
- .. Provides an essential indicator of how much return (risk premium) investors should receive to compensate for higher risks.

- .. Assesses the market value of debt securities held in investment portfolios and indicates the liquidity of the securities in the secondary market.
- .. Facilitates professional fund managers to actively manage the risk of their fixed income portfolios to meet clients risk tolerance levels.
- .. Increase market transparency and efficiency by reducing uncertainty, thus ensuring that prices of securities adjust quickly to changes in the market place.
- .. Reduce information costs to investors by providing direct access to rating analysts, regular mailings and on-line services to ensure investors are fully aware of ratings, industry and company research publications.

RATINGS AFFECT PRICING

(Premium over US Treasury Bill rate)

The following graph shows the impact of credit ratings on bond yields in the US Markets.

For example, "AA+" rated bonds would attract an interest rate of T bill plus 80 basis points while "B-" rated bonds would attract approximately T bills 560 basis points.

ACCURACY OF RATINGS

(US cumulative mortality losses by original rating 1970-1998)

The following graph shows a high correlation between credit ratings and default rates. A high credit rating has low or no default rates. A high credit rating has low or no default risks.

For example, during the period 1970 to 1998 only 2% of issues that were originally rated as AAA defaulted

where as 52.9% of issues that were originally rated as B defaulted.

Services of Credit Rating:

The following debt instruments issued by corporate, banks, governments, projects etc could be brought under this:

- Commercial Paper
- Bonds/Debenture
- Securitized Paper
- Structured Debt Securities
- Mortgage Back Securities
- Fixed Deposits
- Insurance Claim Paying

Abilities

- Certificates of Deposit
- Preference Stock
- Project Finances
- Collateralized Loan/Bond

Obligations

- Municipalities
- Sovereigns ■