



Stability Rating Criteria Assessment Framework

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Summary

LRA's Stability Rating is assigned to a portfolio of assets (Collective Investment Schemes) rather than an individual security. This methodology applies to various types of fixed-income funds, money market funds, government securities funds, aggressive income funds. Stability Rating provides the investors with an objective measure for the main areas of risk to which the income funds are exposed, that is credit risk, liquidity risk and market risk. Stability Rating provides investors with a useful yardstick in comparing their individual risk-return matrix while making investment decisions.

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1. Introduction

Stability Rating:

Opinion on main areas of risk a Scheme is exposed to – credit, liquidity & market risks

Quantitative and Qualitative factors are considered

1.1 A mutual fund is an effective tool for mobilizing resources from a large number of investors, and in turn, providing them access to a variety of assets. Sri Lanka's Collective Investment Schemes (CIS) has witnessed notable evolution in the overall structure as asset management companies (AMCs) continue to introduce a variety of products in line with the varying risk-return preferences of different investors. No entity shall function as a Managing Company of a CIS without having first obtained a license from Securities and Exchange Commission of Sri Lanka (SEC). Managing Companies are regulation by SEC.

1.2 The asset management business has two distinct elements: the Managing Company, and the Collective Investment Schemes. LRA has developed separate methodologies to capture distinctive components of the industry. LRA's Managing Company Rating is an opinion on the quality of fund management, capability to manage risks inherent in asset management business, ability to generate sound fund performance, and effectiveness of an AMC's systems and processes. LRA offers two products to capture the varied factors of different types of Collective Investment Schemes: Performance Ranking and Stability Rating.

Performance Ranking - Is an Independent Opinion on the Scheme's historical risk adjusted performance in comparison to other Schemes in similar category measured through a quantitative yardstick. Each Managing Company complies their own scheme's performance and the performance of peer schemes. Being an Independent rating agency, LRA ensure that it applies same basis to determine the relative performance of all Schemes.

Stability Rating - This provides investors with an objective measure to the main areas of risk to which income schemes are exposed, that is credit risk, liquidity risk and interest rate risk. Stability rating provides investors with a useful yardstick to compare their individual risk return matrix while making investment decisions.

1.3 Recognizing the rising competition and growth potential in the Schemes, Managing Company's are using varying investment styles and techniques to offer competitive returns. All these developments have necessitated the need for an independent opinion to the risk exposure of these Schemes, which, in turn, has an impact on stability in the Scheme's net asset values.

1.4 LRA's Stability Rating provides investors with an objective measure to gauge the main areas of risk to which Income Schemes are exposed. These are; credit risk, liquidity risk, & market risk. The stability rating provides investors with a useful yardstick for comparing their individual risk-return matrix while making investment decisions.

1.5 There is no requirement of any minimum operational history of the Scheme to be eligible for the rating. Thus, a Scheme proposed to be launched in the near future could also be assigned a stability rating based on the type and extent of risks that emanate through the implementation of the proposed investment policies. However, the absence of a proper track record may lead to some prudence in the rating compared to a Scheme having a sufficiently long operational history. A Scheme is eligible for Preliminary stability ratings as soon as its Trust Deed is finalized and the Key Investor Information Document (KIID) is approved by the Securities and Exchange Commission of Sri Lanka.

Stability Rating Framework:

Sensitivity of NAV to risk factors

1.6 Stability Rating Framework: LRA's Schemes stability rating is an opinion on the relative stability in a Scheme's return. The rating is designed to provide investors with a simple to use indicator for evaluating the sensitivity of a Scheme's NAV to a combination of risks. The rating categories range from "AAA (f)" (Scheme having an exceptionally strong capacity to maintain relative stability in returns and possesses negligible exposure to risks) to "B (f)" (Scheme having a very low capacity to maintain stability in returns and possesses very high exposure to risks). The suffix "(f)" distinguishes Schemes stability ratings from LRA's other ratings.

1.7 The stability rating is based on a detailed quantitative assessment of a Scheme's portfolio and a qualitative assessment of the Managing Company. The rating is current as to the date it is assigned, and any significant changes in the Scheme's portfolio or investment philosophy of the Managing Company may lead to deviation from the assigned rating.

1.8 In forming an opinion on a Scheme's price NAV volatility, LRA will consider a variety of factors aimed at establishing the Scheme's exposure to credit, liquidity, and market risk, and the quality of the Managing Company. These factors are assessed within the broad context of a Scheme's investment objectives and policies to determine how they may affect the Scheme's risk profile and relative price volatility under different market conditions.

1.9 The foremost factor is credit risk, having the highest weight in the rating matrix. This is followed by market risk and liquidity risk. These three factors collectively have 90% of the weight. This means that the Scheme's stability rating would be directly governed by its policies on credit, market, and liquidity risks.

2. Credit Risk

Overall Risk

Assessment: Credit risk, concentration risk, & weighted average maturity (WAM)

Market Segment:

Exposure towards certain market segments

Weighted Average Credit Quality:

Weighted Average ratings of individual securities in portfolio

2.1 Overall Risk Assessment: The assessment of a Scheme's credit risk aims at forming an opinion on the Scheme's overall exposure to this risk. The opinion is based on review of various factors, including the Scheme's investment policies regarding credit risk exposure towards various market segments, individual and cumulative credit quality of the investment portfolio, and the diversification of assets across investment types and issuers, and weighted average maturity.

2.2 Market Segment: The Scheme's exposure to market segments is analyzed to estimate the risk inherent in the investment portfolio. LRA believes that one market segment, despite belonging to the same operating environment, could have distinct independent characteristics from others due to the specific attributes of the players therein. High rated Schemes will have predominant exposure to low-risk segments (government securities) and low proportion towards high-risk avenues (Commercial Papers & Debentures, Fixed Deposits).

2.3 Weighted Average Credit Quality: Rating of the securities and the counterparties, where available, will be used to form an objective opinion as to credit quality. For securities or investment segments, where ratings are not available, LRA will form its own opinion as to the credit risk involved. Moreover, whenever there is a difference of opinion with reference to the assigned rating, the view of LRA shall prevail. The overall opinion as to the credit quality of the underlying portfolio will be based on the weighted average rating of individual securities in the portfolio. Meanwhile, higher ratings on issuers and obligations within the Scheme's holdings will generally imply that the probability of default and transition to lower ratings is less-frequent compared to lower-rated issuers and obligations. Herein, both the individual rating and the weighted average rating would be the yardstick to follow. LRA

believes that an individual scrip is critically proportionate to its bearing on the cumulative credit quality of the portfolio. Table 1 elaborates LRA's view as to the computation of weighted average credit quality of the Scheme.

Scoring Band		Govt. Securities/AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
9.0	10.0	=>75%	=<25%														
8.0	9.0	=>50%		=<25%													
7.5	8.0	=>25%			=<25%												
7.0	7.5					=<25%											
6.0	7.0						=<25%										
5.5	6.0							=<25%									
5.0	5.5								=<25%								
4.0	5.0									=<25%							
3.5	4.0										=<25%						
3.0	3.5											=<25%					
2.5	3.0												=<25%				
2.0	2.5													=<25%			
1.5	2.0														=<25%		
0.5	1.5															=<25%	
0.0	0.5																=<25%

The remaining portfolio allocation should be in higher rating categories, subject to the minimum specified in government securities.

Note: Actual asset allocation may vary over time as the assigned weights are indicative.

2.4 The table shows that a portfolio with a minimum exposure of 75% to government securities or AAA rated investment avenues would have the maximum score for weighted average credit quality. Similarly, a minimum exposure of 50% to government securities or AAA rated investment avenues, while having 50% distributed across AA+ or AA investments or instruments subject to a maximum of 25% in the lowest mentioned rating category would carry a score from the second-highest scoring band.

2.5 Portfolio credit quality is a primary rating factor for Scheme stability ratings. Failure to maintain credit quality scores within required benchmarks can become a limiting factor for stability ratings. In such cases, LRA allows a curing period to the Scheme to bring its credit quality score within the benchmarks required to maintain the rating. If the Scheme fails to correct this within the requisite timeframe, it may be downgraded.

2.6 Non-Performing Assets: The asset composition of the portfolio will be reviewed in terms of non-performing/under-restructuring assets with respect to the Scheme size. The presence of non-performing assets will have a diluting impact on the overall credit quality of the underlying portfolio. The size of a Scheme is critical when assessing the degree of variability in the NAV in the event of a default or non-performance of an instrument. Generally, an equal sized default/non-performing instrument in portfolio will have greater effect on a smaller Scheme's NAV than its larger peer. However, the ability of Scheme's performing assets to counterbalance current and future losses, ensuring stability of returns, will also be examined.

2.7 Concentration Risk: The concentration risk in the portfolio is established by analyzing the diversification across investment types and issuers. Well-managed Schemes will have clearly articulated and documented policies and procedures to ensure compliance with its stated portfolio diversification objective. Scheme portfolios are subject to additional risk when they are highly concentrated in a specific industry. For example, concentration in securities of a specific industry may expose a Scheme to industry risks that could deviate significantly from general market trends. High

Non-Performing Assets:

Percentage of non-performing securities to total Scheme value

Concentration Risk:

Segment & security-wise concentration

rated Schemes would have a diversified portfolio, minimizing exposure to any single issuer, sector, security, or market segment.

Weighted Average Maturity: Sensitivity of portfolio with time horizon

2.8 Weighted Average Maturity: The weighted average maturity of the investment portfolio is analyzed to capture the time horizon over which the portfolio is exposed to risk. Portfolios having a longer WAM are more vulnerable to credit risk (default and transition to lower rating) in comparison to portfolios with a shorter WAM. Table 2 is considered to gauge a Scheme's ability to maintain the threshold.

Table 2	
Score	WAM
9 to 10	45 Days
8 to 9	60 Days
7 to 8	90 Days
6 to 7	180 Days
4 to 6	2 Years
1 to 2	4 Years
0 to 1	Above 4 Years

Information Required on Credit Risk:

- Publicly available information of the Scheme
- Information about the credit quality of Financial Instruments in the Scheme
- Allocation of AUM within AAA to AA+ Financial Instruments
- Details of any non-performing instruments
- Maturity of investments executed by the Scheme

3. Market Risk

3.1 The more complex part of evaluating a Scheme's stability involves determining the Scheme's sensitivity to the changing market conditions. LRA assesses market risk in the nexus of variables affecting the market value of the underlying portfolio. Market value can fluctuate due to a number of variables largely including interest rate, liquidity, and operating environment. Another key factor affecting the stability of returns is the volatility in prices of debentures, conceiving the absence of a well-established bond market. However, given the difference in investment philosophy and operating characteristics of income and money market Schemes, the relative degree of emphasis on identified factors may vary for different categories of Schemes.

Interest Rate Risk: Sensitivity of fund to interest rate movements

3.2 Interest Rate Risk: Movement in interest rates is the principal determinant of a Scheme's price and these represent one of the most important factors contributing to a Scheme's risk profile. The interest rate risk measures the Scheme's sensitivity to shifts in the yield curve. Duration is a useful tool for quantifying a Scheme's exposure to interest rate risk. It is defined as the rate of change of Scheme's NAV with respect to change in interest rates. In general, the longer the duration, the more susceptible the Scheme is to interest rate movements. As the majority of the corporate bonds issued in the country are based on floating interest rates, the LRA considers the terms of repricing while evaluating interest rate risk. The result of the threshold mentioned in Table 3 is considered to gauge the Scheme's ability to maintain market value and avoid disruption in returns.

Table 3	
Score	WAM
9 to 10	45 Days
8 to 9	60 Days
7 to 8	90 Days
6 to 7	180 Days
4 to 6	2 Years
1 to 2	4 Years
0 to 1	Above 4 Years

Information Required on Market Risk:

- Publicly available information on the NAV
- Liquidity position of the Scheme
- Sensitivity of the Scheme to interest rates movements

4. Liquidity Risk

Redemption:

Liquidity and monetizing risk associated with redemption

4.1 The liquidity of a Scheme's portfolio is critical for maintaining a stable NAV. The liquidity of a security refers to the speed at which that security can be sold for approximately the price at which the Scheme has it valued. Securities which are less liquid are subject to greater price variability and can significantly impact the NAVs at times of major redemptions. More liquid investments present lower risk, as these are more amenable to accurate pricing on a daily basis and support the Scheme's ability to correctly measure NAV. While analyzing the liquidity of an investment portfolio, LRA considers the types of investments in the portfolio, the maturity structure, and secondary market liquidity.

4.2 Redemption: The counterpart to managing the liquidity of investments is the necessity to accurately monitor and anticipate subscription/redemption activity. Unexpected large redemptions have a direct influence on the Scheme's market risk exposure, as they could lead to liquidation of investments at below their fair value to meet redemption requests. Redemption volatility also adds to the complexity in managing a Scheme, as the uncertainty created by the instant liquidity requirements can make it difficult to employ a consistent investment strategy. Therefore, LRA carefully reviews the characteristics of each Scheme's unit holder's base, including the proportion of top investors in total net assets of the Scheme. LRA also examines the effectiveness of the management's policies and procedures for tracking and anticipating major redemption activity.

Moreover, LRA considers the extent to which the Scheme is invested in liquid avenues as a percentage of net assets; notably short-term government securities along with any other sources of potential liquidity. The liquidity of the Scheme is gauged with reference to its underlying character, as depicted in the KIID. A Scheme styled as a high liquid Scheme would have an investor base with different characteristic as against a Scheme where the objective is to earn high returns.

Information Required on Liquidity Risk:

- Details of planed and previous redemptions
- Details of Unit holders along with their holdings
- Internal control polices

5. Historical Returns' Volatility

Coefficient of variation of returns

5.1 For Schemes having an operational history of six-months or more, the variability in returns is gauged on standardized basis through the coefficient of variation for each Scheme in a category. The coefficient of variation is calculated by dividing standard deviation of Scheme's monthly returns by average monthly return (SD of Monthly Returns/Average Monthly Return).

6. Management Review

Management

Review: Asset manager rating, experience, skill set, track record

6.1 The ability of a Scheme to meet its investment objectives and adhere to stated policies ultimately depends on the management's experience and the quality of support systems. Therefore, an assessment of the Person making investment decisions on behalf of Unit Holder's qualification and experience, and the Managing Company's capabilities and track record are an integral part to the Scheme rating process. The assessment of management quality may also provide a basis for how the Scheme might respond to future opportunities or stress situations under different market conditions.

6.2 Management scoring is directly derived from the Managing Company rating of the Scheme. During the evaluation process, LRA reviews the policies and procedures developed by the management to meet its investment objectives and assesses the efficacy of the investment management process, the supporting organizational structure, internal controls, risk management, and reporting systems. A detailed description of the key factors that contribute to an assessment of the Scheme management qualities is reflected in our methodology for rating Managing Company.

6.3 To determine the Scheme's level of risk tolerance, confirm the degree of harmony within a Scheme's stated objectives and the Person making Investment decision on behalf of Unit Holder's investment philosophy in future courses of action, discussions with the Person making Investment decisions on behalf of Unit Holders regarding the prospective asset mix and investment strategy will be vital during the rating process. The framework deployed to ensure compliance with regulatory requirements and its actual effectiveness would likewise be an important consideration.

Information Required on Management Review:

- List of staff along with their experiences & qualifications
- Management and investment policies
- Investment Prospects and harmony against the stated objectives are discussed in the management meeting

Opinion on the relative stability in a Scheme's return, the rating provides an objective measure as to the main areas of risk to which fixed-income Schemes are exposed, that is credit risk, liquidity risk and interest rate risk.

Scale	Definition
AAA (f)	Exceptionally Strong: An exceptionally strong capacity to maintain relative stability returns and possesses negligible exposure to risks.
AA+ (f)	Very Strong: A very strong capacity to maintain relative stability in returns and possess low exposure to risks. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions.
AA (f)	
AA- (f)	
A+ (f)	Strong: A Scheme with stable performance generally in line with its peers with strong capacity to respond to future opportunities or stress situations.
A (f)	
A- (f)	
BBB+ (f)	Adequate: An adequate capacity to maintain relative stability in returns and possess high exposure to risks. This capacity may be impacted adversely by changes in circumstances or in economic conditions.
BBB (f)	
BBB- (f)	
BB+ (f)	Inadequate: A low capacity to maintain stability in returns and possesses very high exposure to risks.
BB (f)	
BB- (f)	
B (f)	Weak: A very low capacity to maintain stability in returns and possesses very high exposure to risks.

The Scheme stability rating scale of AAA to B is appended by the letter (f) to denote Scheme ratings and to differentiate it from the nomenclature used for issue and issuer

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate terms in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. "stable" outlook means a rating is not likely to change.	Rating Watch Alert to the possibility of a rating change subsequent to or in anticipation of some material identifiable event with indeterminate rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future. but	Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.	Withdrawn A rating is withdrawn on a) termination of rating mandate. B) cessation of underlying entity. C) the debt instrument is redeemed. D) the rating remains suspended for six months. E) the entity / issuer defaults. Or / and f) LRA finds it impractical to surveil the opinion due to lack of requisite information	Harmonization A change in rating due to revision in applicable methodology or underlying scale.
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“positive” means it may be raised. “Negative” means it may be lowered. Where the trends have conflicting elements, the outlook may be described as “developing”	may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.			
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