Debt Instrument Rating Criteria
Methodology

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Summary

LRA’s methodology documents lay out the umbrella framework guiding its credit ratings. This document describes LRA’s approach to rating various types of long-term and short-term debt instruments including, debentures, corporate bonds, corporate debt instruments, Basel III compliant debt instruments, Islamic debt instruments (Sukuk), Green Bonds, and commercial papers. Banking facilities availed by borrowers are also covered in this methodology. A debt instrument rating provides an opinion on the issuing entity’s (hereon referred to as “issuer”) ability to meet the financial obligations pertaining to the debt instrument on a timely basis.

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1. Introduction

1.1 Debt Instrument Market: Sri Lanka has a relatively small debt instrument market. Financing through bank loans is the preferred route for corporates and utilization of capital markets to raise funding through debt instruments like bonds remains low due to unfamiliarity with capital markets in Sri Lanka.

The two main debt Instrument Markets are as follows,

1. Government Securities Market
   - I. Rupee denominated
     - a) Treasury Bills – Short term debt instrument issued with maturities of 91-day, 182-day and 364- day under the Local Treasury Bill Ordinance No 8 of 1923 (as amended)
     - b) Treasury Bonds – Medium to Long-term debt instrument with maturities of 2 year to 30 year issued under the Registered Stock and Securities Ordinance No 7 of 1937 (as amended)
   - II. Foreign currency denominated
     - a) Sri Lanka Development Bonds are debt instruments denominated in US dollars with short term maturities of 3-12 months and with longer term maturities of two years issued by the Government of Sri Lanka in terms of the Foreign Loans Act, No 29 of 1957.
     - b) Sri Lanka International Sovereign Bonds- maturity period of 5 and 10 years and are listed on International Stock Exchanges.

The Public Debt Department (PDD) of the Central Bank of Sri Lanka (CBSL) is in charge of the issuance of government securities and public debt management on behalf of the government treasury. Government Securities are sold by the PDD through multiple price competitive auctions on the primary market. The participants of the primary auction are approved primary dealers.

2. Corporate Debt Securities Market
   - I. Commercial Paper Market (CPs)- Short-term, non-collateralized (unsecured) debt securities issued by private sector companies to raise funds for their own use, by banks and other financial intermediaries. CPs are generally issued by institutions in large denominations and may include bank guarantees.
   - II. Corporate Bond Market - Corporate bonds are medium or long-term securities of private sector companies which obligate the issuer to pay interest and redeem the principal at maturity. Corporate bonds that are not backed by a specific asset are called debentures.
   - III. Corporate Debentures - Debentures are unsecured, medium or long-term, interest-bearing bonds issued by private sector companies, banks and other financial institutions that are backed only by the general credit of the issuer. Debentures are usually issued by larger, well-established institutions. The holders of debentures are considered creditors and are entitled to payment before shareholders in the event of the liquidation of the issuing company
   - IV. Asset Backed Securitization Instruments

The listed corporate debt market in Sri Lanka began in 1997. The primary market for listed corporate debt became active in 2013 as a result of incentives introduced for corporate debt listing by the CSE. One such measure was the enactment of new listing rules for corporate debt in 2013.

3. Unlisted Corporate Debt Instruments - This includes debentures, bonds, commercial papers, and promissory notes issued by both public and private entities that do not trade on the debt board of the CSE.

1.2 Types of Debt Instruments: Debt instruments can be differentiated on the basis of: (i) maturity (over the counter vs on an exchange), (ii) markets in which they are issued (conventional vs. Islamic), (iii) marketability (listed vs. privately-placed), and (iv) structure (secured, unsecured or subordinated). This methodology covers various types of instruments including debentures, bonds, commercial paper, sukuk, Basel III compliant debt instruments, green bonds, and other conventional or Islamic debt instruments.

Green Bonds: LRA's debt instrument rating methodology encompasses coverage of green bonds. Green bonds are a new and rapidly growing investment vehicle in the Sri Lankan market with considerable growth potential. Green bonds are unique financial instruments whose proceeds are exclusively used for 'green' or environmentally sustainable projects (such as renewable energy plants, sustainable waste management, et cetera). As of April 2023, green bonds have been listed and traded on the Columbo Stock Exchange. This methodology focuses solely on the credit rating of green bonds and does not include assessments related to a green bond framework rating or a second party opinion.

Debt instruments	• Conventional or Islamic securities with underlying contractual obligations owed by the issuer to make interest payments and principal repayments to the debt instrument holders (or "lenders/investors") for the life of the debt instrument.

1.3 **Regulatory Landscape:** Issues of debt instruments are regulated primarily by the Securities and Exchange Commission of Sri Lanka and Colombo Stock Exchange. The regulator has designed a comprehensive set of laws and regulations in this regard.

- ***[CSE] Listing Rules:***
  "Trustee" The Entity should comply with the requirements of the Companies Act and the requirements set out in Rule 2.2.1 (k) (ii), (iii) & (iv) of with regard to the appointment of a Trustee

  "Trust deed" prepared in compliance with Appendix 3B under Listing Rules – Section 3- Contents of Prospectus / Introductory Document

2. Rating Debt Instruments

2.1 A debt instrument rating is an assessment of a specific debt issue of an entity and provides an opinion on the issuing entity's ability to meet the financial obligations pertaining to the debt instrument, on a timely basis. For the purpose of the rating assessment, both the payment of interest and repayment of principal are considered "contractual obligations" by LRA.

2.2 LRA undertakes debt instrument ratings for all kinds of short-term and long-term instruments. For any given debt instrument rating, the entity rating of the issuer is used as a baseline (also called issuer rating). In case the issuer is unrated, LRA first arrives at a baseline rating. The debt instrument rating is then "notched" either higher or lower compared to its corresponding issuer rating.

2.3 **Issuer Profile:** While forming an opinion on an issuer, LRA evaluates the underlying entity as per the specific methodology applicable to it. For instance, for an industrial corporate issuer, Corporate Rating Methodology would apply. Broadly, the rating criteria applied is as follows:

Qualitative Factors for Issuer
Qualitative risk profile is assessed by soliciting information from client and direct interaction with sponsors, management, and/or directors and conducting a visit to plant site and head offices.
Profile: Studying the historical evolution of an entity and the nature, scale and diversity of its operations.
Ownership: Analyzing the legal structure and shareholding mix of an entity to determine the man at the last mile. Determining the skillset of the sponsor and sponsor's willingness and ability to support the entity financially, if needed.
Governance: Studying the structure, quality, effectiveness and transparency of governance practices of an entity.
Management: Studying structure, quality, effectiveness and soundness of management personnel and systems of an entity.
Quantitative Factors for Issuer
Quantitative risk profile is assessed by looking at economic conditions, industry dynamics, and standalone performance of the issuer relative to peers – through financial statements, projections, financial strategy and cash flow analysis. This is very much numbers driven.
Business Risk: Study of the macroeconomic environment within which an entity operates, its current standing and level of competitiveness. Looking at the scale, stability and diversification of revenues, as well as key costs. Analyzing the impact of the aforementioned factors on financial performance and profitability of the entity and how it is likely to behave, going forward.
Financial Risk: Analyzing an entity's financial profile with respect to working capital management, coverages and capitalization with the key objective of understanding the nature, volume and quality of the entity's financial assets and liabilities and how well it is managing them.

2.4 Instrument Rating Considerations: The factors impacting notching of the debt instrument, relative to the issuer profile, are: i) relative seniority of the instrument compared to the issuer's other obligations, and ii) presence of credit enhancement features. An instrument that carries a claim equal or superior to the issuer's other obligations, is viewed positively from a rating perspective, compared to subordinated instruments. Notching impact may be negative, in case of the latter. The extent of negative notching for subordinated instruments (unless government-issued) is typically restricted to minus one notch.

2.5 Credit Enhancements: Presence of certain features may enhance the rating of a particular debt instrument relative to its issuer or its issuer's other debt instruments. Some common examples of credit enhancement features include collateralization, cash collection mechanism and third-party guarantees.

2.5.1 Collateralization: The collateral underlying a debt instrument may influence the extent of notching, provided that the terms of the issue allow for the liquidation of the collateral to making the missed payment/installment **before** an event of default is recognized. In such cases, LRA looks at the following features of the collateral:

- Extent of coverage – the higher the coverage offered by the collateral compared to the debt obligation, the more favorable the notching impact. This is viewed in conjunction with the volatility in collateral value
- Liquidity/marketability – the higher the likelihood of the collateral being monetized in a timely manner with minimal premium, the more favorable the notching impact
- Nature of charge – exclusively held, earmarked collateral (preferably in favor of an independent third party usually the trustee/investment agent) is likely to lead to favorable notching impact

Collateralization over and above the outstanding instrument value, with assets that can be monetized before the due date for debt servicing by the issuer or trustee/investment agent in case the issuer misses a payment/instalment, is considered superior and likely to result in higher notching. Provision of any upfront liquid asset/cash collateral may also warrant higher notching impact.

2.5.2 Cash Collection Mechanism: Debt instruments may be secured by a cash collection mechanism, whereby cash flows generated by the issuer are used to fund a debt service reserve, typically monitored by the trustee/investment agent. These cash flows may or may not emanate from earmarked assets (also referred to as "escrow mechanism"). In determining the impact of the cash collection mechanism on the credit rating of the instrument (if any), key factors to assess include:

- Cash source – greater comfort would be derived if the source of the cash is identified/earmarked
- Extent of coverage – a cash collection mechanism covering both principal and markup, and the longer the period of debt servicing covered by the cash collection mechanism, the higher the notching impact
- Replenishment mechanism – timely restoration of the reserve once it is utilized to make a payment and source of replenishment, is important. LRA looks at the cushion in No. of days between the date of replenishment and payment date

2.5.3 Third Party Guarantees: The debt instruments that carry third party guarantee to make good the amount obligated to the lenders by the issuer may provide additional support to its rating. In determining the impact of a guarantee on the credit rating of the instrument (if any), key factors to assess include:

- Invocation of the guarantee – a pre-default guarantee invocation mechanism must be in place; LRA does not consider post-default guarantees to be a credit enhancement from rating perspective
- Legal clauses – strong legal clauses pertaining to enforceability, irrevocability and unconditionality are expected
- Financial profile of the guarantor (or its credit rating, where available) having incorporated the burden of the guarantee into its debt profile – if the guarantors' financial profile/credit rating is weaker than that of the issuer, it is unlikely to result in notching benefit.
- Extent of coverage – a guarantee which does not cover all obligations of the instrument (partial guarantee), for its entire duration, is likely to result in limited notching benefit

Overall, the strongest form of guarantee is considered where the guarantee covers all obligations of an instrument for its entire tenure, with strong legal clauses and a well-defined invocation mechanism. In such cases, given that the financial profile/credit rating of the guarantor is stronger than that of the issuer, notching impact may constitute multiple positive notches and may also result in equalization of instrument rating with the credit rating of the guarantor.

2.5.4 Between the various types of credit enhancements, third party guarantees are generally likely to result in the highest positive notching impact. This is because other forms of credit enhancement, including collateralization and cash collection mechanism cannot fully be isolated from the issuer and remain vulnerable to changes in issuer's operational viability and credit profile. Explicit third-party guarantees, meanwhile, provide supplementary support completely delinked from the issuer.

3. Rating Sukuk

3.1 Shariah Compliant Debt Securities means Debt Securities of an Entity such as Sukuk, which are certified as Shariah permissible for investment by a minimum of three (3) Shariah Scholars, based on the Entity's compliance with the Rules and Principles of Shariah. Shariah Scholar is a person who certifies Islamic financial products as being compliant with Rules and Principles of Shariah in the capacity of a Supplementary Service Provider in accordance with Section 169 of the SEC Act and complies with the "Guidelines applicable to a Shariah Scholar" issued by the SEC which are published on the SEC website.

A Sukuk is a financial instrument similar to conventional debt securities and is linked to an underlying asset (normally tangible). From the perspective of the investors, holding of a Sukuk represents a partial ownership in the relevant asset. Sukuk exist because in Islamic Finance the charging or receiving of interest is prohibited; under Shariah, an investor should realize no profit or gain merely for the employment of money. A Sukuk may take any mode of financing – Ijarah, Murabaha, Salem, Wakala and Mudaraba.

4. Rating Banking Facilities

4.1 LRA's approach to rating banking facilities availed by borrowers is aligned with its debt instrument rating approach outlined in detail in Section I. For long-term and short-term banking facilities, the assessment of the issuer's credit profile acts as the baseline rating. Facility rating considerations are then taken into account for notching. As elaborated in Section I, these include seniority of claim and credit enhancements including collateralization and guarantees.

4.2 LRA considers the latest facility documentation to govern its analysis. If a borrower has requested restructuring or rescheduling of a facility, it must be formally approved by the bank for LRA to consider the revised repayment schedule in its analysis. Until such request is fulfilled, a borrower is expected to continue to meet interest payment and principal repayment obligations on time in accordance with the original schedule. Failure to do so is considered a default on the rated facilities. This is in line with LRA's approach to default recognition covered in greater detail in LRA's Recognition of Default Criteria.

5. Rating Basel III Compliant Debt Instruments

5.1 Basel III Compliant Debt Securities are issued by Commercial banks and Specialized banks licensed by the Central Bank of Sri Lanka in compliance with Direction No 01 of 2016, of the Central Bank of Sri Lanka dated 29th December 2016. Only the "Qualified Investors" (as defined under Section 8 of ATS rules) is permitted to trade on Basel III Compliant Debt Securities.

5.2 **Basel III Instrument Rating Considerations:** As in case of other instrument ratings, LRA first arrives at the entity rating of the issuer, in this case, using the Financial Institution Rating Methodology. In case the issuer is unrated, LRA first arrives at a baseline rating. LRA then evaluates the risks associated with the instrument in line with its unique and respective criteria as per Central Bank of Sri Lanka guidelines, the structure of the instrument and its intended purpose when forming a view on the rating.

5.2.1 **Priority Order:** LRA takes into account the priority and level of subordination of the instrument and incorporates the same into its rating opinion.

5.2.2 **Non-performance Risk Assessment:** Non-performance risk is the risk that the issuer will not be able to meet the contractual obligations, and hence other related clauses would kick in. LRA opines non-performance as the prime risk because non-performance on the contractual obligations essentially means that "priority order" would not be triggered. LRA believes that the futuristic performance of the issuer, and the bank's management and planning play a crucial role in performance risk, and hence, sustainability of the risk profile of the instrument. Hence, apart from assessing the credit profile of the issuing commercial bank/specialized bank, LRA considers:

- **i.** Future profitability of the commercial bank/specialized bank, providing internal capital and cushion to the risk absorption capacity of the commercial bank/specialized bank.
- **ii.** Cushion that a bank maintains in its CET-I (including capital conservation buffer) on a sustainable basis over the regulatory requirement prescribed by Central Bank of Sri Lanka.
- **iii.** Management plan to maintain and adhere to the cushion in its CET-I ratio.

Meanwhile, LRA also takes into account entity's projections for growth vis-à-vis regulatory capital adequacy:

- **i.** Capital Adequacy Ratio (CAR) of the bank

ii. Composition of the CAR including the CET-I, ADT-I and Tier 2
iii. The rate of consumption of the CAR along with future forecasts.

5.3 The following table outlines the typical notching impact for Tier 1 and Tier 2 instruments. In certain cases, LRA's ratings may differ from the notching guidance specified in the table. This is possible in cases where "non-performance" is deemed to be essentially non-existent, especially in case of "AAA" (Triple A) rated financial institutions. Such high-rated commercial banks/specialized banks typically have a history of strong equity base and steady profitability. Thereby, the risk of non-performance decreases inversely proportionate to their rating at the higher end of the spectrum, reducing the riskiness of their instruments. Thus, in these cases, LRA is not strict on priority. Meanwhile, such comfort may also be available whereby LRA is able to establish that some form of credit enhancement would avert "non-performance". Conversely, in case of lower rated financial institutions, with greater pressure on equity base and related ratios, instruments may be rated more than 2 notches below the issuer rating due to the greater non-performance risk.

Instrument Type	Likely Notching Impact
ADT-I	0, -1, -2
Tier 2	0, -1

5.4 As per CBSL, an AT1 (Additional Tier 1) Capital Instruments under Basel III also known as perpetual instruments are perpetual, unsecured, and designed to absorb losses to qualify as part of the bank's capital base. They are designed to absorb losses, either by converting into equity or by converting into equity or by being written down, when the bank's capital falls below a certain level. The issuer has the discretion to determine the timing and amount of coupon or dividend payments. These payments are typically made from bank's current year earnings. Such discretion means that banks can choose to suspend or defer payments if needed, particularly during financial stress or when regulatory requirements necessitate it. Due to these risks and lower priority order, AT1 instruments are rated lower than Tier 2 instruments. Invocation of conversion clause due to any regulatory requirement, or any other trigger is considered a credit event by LRA resulting in rating action.

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5.5 Tier 2 capital for banks/specialized banks includes instruments like subordinated debt, regulated by the Central Bank of Sri Lanka. These instruments have a Point of Non-ViabiityPONV) provision to ensure stability and a "lock-in" clause preventing interest or principal payments if they would lead to a breach of the bank's Minimum Capital Requirements (MCR) or Capital Adequacy Ratio (CAR). If this clause is triggered , rating agencies , such as LRA may downgrade the instrument and the bank's credit rating, potentially impacting investor confidence and financial stability.

6. Additional Considerations for Short-term Instruments

6.1 **Additional Considerations:** LRA's approach to rating short-term debt instruments is similar to that used for long-term debt instruments. However, two factors are given more emphasis when rating short-term debt instruments, namely: i) short-term liquidity position, and ii) financial flexibility of issuer.

6.1.1 **Short-term Liquidity Position**: When assessing liquidity, LRA focuses mainly on the cash flow and working capital management of the entity to assess repayment ability. In addition to this, availability of unencumbered liquid investments and/or other liquid current assets ensures a cushion for urgent cash in stressed times. Meanwhile, in case of rollover instruments, a longer-term view is incorporated into the rating opinion.

6.1.2 Financial Flexibility: Financial flexibility allows an entity the latitude to meet its debt service obligations and manage stress without eroding credit quality. While one aspect of financial flexibility is an entity's capital structure (thoroughly assessed during long-term rating assignment), alternative sources include support available from sponsor (in the form of a line of credit, or otherwise) and commercial credit lines available to the entity.

6.2 Linkage between Short-term and Long-term: When assessing an issuer's liquidity profile, some temporary features may appear to skew the short-term rating for an issuer due to cyclicality or seasonality within a given industry or sector. Thus, LRA focuses on the sustainable liquidity profile of an issuer and cushion available in period of low liquidity. Herein, long-term credit quality plays a key role, thus creating a linkage between short-term and long-term ratings. This is due to two main reasons. Firstly, an entity with higher long-term credit quality has a stronger ability to refinance, and/or gain access to other sources of funding. Secondly, many short-term instruments tend to get rolled over and, therefore, call for a longer-term rating view. Thus, long-term ratings cannot be disregarded when assigning short-term ratings.

7. Role of Trustee

7.1 Trustees in the debt instruments should comply with the requirements rule 2.2.1 (k) (ii), (iii), (iv) and (v) of the CSE Listing Rules. They should act for the benefit of and interest of the Debenture Holders on the terms and conditions contained in the said Trust Deed. The responsibilities include i) overseeing payments to investors, ii) ensuring arrangement and maintenance of security / collateral throughout the tenure of the issue, iii) ensuring information symmetry between the issuer and investors, iv) ensuring compliance with the terms and covenants of the trust deed/issuance agreement, and v) initiating legal proceedings in the event of default, among other responsibilities. When looking at the Trustee, LRA evaluates; i) independence, and ii) terms/covenants of the trust deed/issuance agreement.

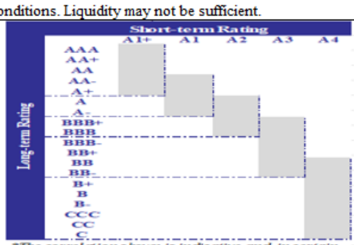
8. Surveillance

8.1 Once a debt instrument is issued, LRA undertakes a formal review once in every twelve months. Surveillance frequency may be higher depending on payment terms, frequency of payments and other unique characteristics of a particular issue. LRA also establishes relationship with the trustee and/or issuer of the debt instrument to remain updated on all information pertaining to the rating of the instrument.

Credit rating reflects forward looking opinion on credit worthiness of underlying entity or instrument. More specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

	Long-term Rating
Scale	Definition
AAA	Highest credit quality: Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.
AA+ AA AA-	Very high credit quality: Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitements. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	High credit quality: Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may , nevertheless, be vulnerable to change in cirucmstances or in economic conditions.
BBB+ BBB BBB-	Good credit quality: Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate , but adverse changes in cicumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	Moderate risk: Possiblity of credit risk developing. There is a possibility of credit risk developing particularty as a result of adverse economic or business changes over time: however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	High Credit Risk: A limited margin of safety remains against credit risk. Financail commitments are currently being met, however, capacity for continued payment is contigent upon a sustained, favourable business and economic environment.
CCC CC C	Very high credit risk : Substantial credit risk "CCC" Default is a real possiblity. Capacity for meeting financial commitments is solely reliant upon sustained, favourable business or economic developments. "CC" Rating cindicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default

Short-term Rating
Definition
A1+ The highest capacity for timely repayment
A1 A strong capacity for timely repayment
A2 A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic or financial conditions.
A3 An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business , economic or financial.
A4 The capacity for timely repayment is more susceptible to adverse changes in business, economic or financial conditions. Liquidity may not be sufficient.



*The correlation shown is indicative and, in certain cases, may not hold.

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 fundamentatl business/financial conditions. It is not necessarily a precursor to a rating change."stable" outlook meansa a rating is not likely to change."positive" means it may be raised."Negative" means it may be lowered. Where the trends have conflicting elements , the outlook may be descibed as "developing"

Rating Watch Alert to the possibility of a rating change subsequent to or in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future. but may continue if underlying circumstances are not setted. Rating watch may accompany rating outlook of the respective opinion.

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 methodolgoy or underlying scale.

comprehensive surveillance of rating opinion is carried out atleast once every 12 months. Howver, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note: This scale is applicable to the following metholdogy (s):

a) Stockbroker entity rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) MicroFinance Institution Rating
g) Non-banking Finance Companies Rating