Credit Rating Industry in Sri Lanka

NELKANI MAYAKADUWA [1], R P C R RAJAPAKSE [2]
[1,2] *University of Sri Jayewardenepura*

Abstract -- An efficient financial system facilitates the optimal allocation of resources towards economic development of a country by allocating resources efficiently. Markets which are a part of the financial system, support efficient allocation of funds, thus development of capital markets play a vital role in economic development of a country. Information asymmetry and lack of information can fear away investors, while a"creditrating" assigned by an independent party can attract investors to markets. The purpose of this study is to identify the current trend of the credit rating industry in Sri Lanka (SL). Data were obtained mainly from interviews and other secondary sources such as annual reports of SEC, and rating reports etc. Quantitative data were analyzed using; ratio analysis and percentage calculations, while qualitative data were analyzed using content analysis. The study revealed that underdeveloped capital markets and low financial literacy hinder the use of credit ratings in SL influencing negatively on investments.

Indexed Terms -- Credit ratings, Credit rating agencies, Sri Lanka

JEL -- D53, E44, G10

I. INTRODUCTION

In British planters commenced the banking industry in Sri Lanka for their trading activities in the early 1880s. Until independence in 1948, there was a liberal economy where there was neither government intervention in international trade nor exchange controls. Subsidiaries of foreign banks dominated the banking sector which mainly met the financial requirements of international trade and the working capital requirements of Sri Lanka's plantation sector. Direct government intervention in the banking industry began after the country gained its independence from Britain in 1948. The first government of independent Sri Lanka emphasized on a self-sufficient economic system and the Banking System was to set priority areas for development. Control of allocation of loan funds, intervening in to setting of interest rates, and introducing strict foreign exchange regulations were common features. The government used banking industry as the main vehicle for mobilizing financial resources for economic development and for providing the most fundamental financial intermediary and payment functions. In 1950, Government of Sri Lanka established the Central Bank of Sri Lanka (CBSL) as their main regulatory body which governs the financial services sector. This inward looking economic policies continued until in 1977, a newly appointed government decided to open up the economy for private investment and to gear the country towards an export led growth. Private sector activities increased gradually and a well-developed banking sector was a necessity to meet their finance needs. However, re-establishment of Stock market in 1985 and the introduction of the bond market in 1995 paved the way to moving into collecting investment needs via these markets. Thus capital market development became a key to economic development. Majority of the people were reluctant to make investments in the stock markets or the debt market, due to lack of knowledge on one side and fear of losing their money on the other. As a result, these markets stay underdeveloped.

'Acredit rating reflects a rating agency's opinion, as of a specific date, of the creditworthiness of a particular company, security, or obligation.' US Securities and Exchange Commission

Thus, Establishment of the credit rating industry was critical to the development of a debt market in Sri Lanka.Identifying this the first credit rating company in Sri Lanka, known as Duff & Phelps Credit Rating Lanka Ltd (DCR Lanka) was established in October 1999. We currently have a total of two CRAs performing their activities as financial intermediaries under the category of 'other financial institutions' in Sri Lankan financial system. This study addresses the niche of the studies done in Sri Lanka and explore information about CR, CRAs, their activities, regulatory framework related to Credit rating industry in SL.

II. LITERATURE

Credit rating can be identified as a valuable input in the decision-making process of regulators, borrowers, investors and many other parties in the financial market thus, attracting the attention of finance researchers. Existing literature can be categorized under several headings.

According to Maththies (2013)"Empirical studies on credit ratings can be roughly divided into three lines of research (Blume et al. (1998)). The first two measure the information content of credit ratingsin different ways. The first line analyses whether credit ratings measure what they claimto measure, i.e. an issuers creditworthiness. More specially, the relationship of ratingsand corporate default is measured (Zhou (2001) and Jorion & Zhang (2007)). The secondline measures the information content of ratings on capital markets. Here, capital marketreactions around rating changes are analyzed to see if ratings contain additional information(for a review see Gonzales et al. (2004)). The third line of research investigates the determinants of credit ratings. Here ratings as independent variables are modeled ona number of financial data (e.g. Ederington (1985)), corporate governance characteristics(Bhojraj & Sengupta (2003)), and macroeconomic factors (e.g. Amato & Furne (2004)).These studies show that ratings can be replicated to a certain degree solely using publicly available data. Further studies in this context analyze the stability of credit ratings with respect to their 'through the cycle' approach (Altman & Rijken (2006)) and the determining factors of rating changes and transition probabilities (e.g. Lando & Skideberg(2002) and Koopman et al. (2008))"

Considerable numbers of researches have been carried out for countries like India, China, and Bangladesh in the Asian region in the field of credit rating. No significant study has been carried out in the case of SL in the field of credit ratings. Thus a gap exists in literature and the authors intend to fill such gap by conducting a study on the Credit rating industry in Sri Lanka. Existing literature makes the basis to carry out studies in different aspects of credit rating in SL. Such as the history of credit rating and profile of credit rating agencies in SL, their activities and the quality of activities they have been carried out, how the capital market in SL reacts to the changes in credit ratings, what is the regulatory framework and its impact on credit ratings, competition and the earnings of CRAs in SL and assess the importance of the role of credit rating for the financial market development of the country etc. While identifying the essential need of research in this area, this research study aims at filling the gap in the exiting literature. However, lack of required data, has limited the scope of this study to cover the following objectives.

III. OBJECTIVES

Main Objective: Identify the CRAs and their role played in the credit rating industry in Sri Lanka
Sub Objectives**:**

1. Understand the importance of credit rating for Sri Lanka
2. Identify the rating activities and evaluate the performance of the credit rating industry in Sri Lanka
3. Effect of regulations on credit rating in Sri Lanka

IV. METHODOLOGY

a) Data:

- Quantitative Data:

Quantitative data from 2011 to 2015 have been collected from the secondary sources; the documents published on websites maintained by the two credit rating agencies, and by the Securities and Exchange Commission of Sri Lanka(SEC), and annual reports of the SEC of Sri Lanka.

- Qualitative Data:

Qualitative data collected from two different sources as from secondary data sources and from in-depth interviews. Websites maintained by credit rating agencies, SEC and from published books, journals, magazine articles and newspaper articles in the form of electronic papers, rating reports published on the websites of credit rating agencies, website of SEC Sri Lanka, as the main regulatory body of credit rating agencies, Colombo Stock Exchange (CSE) and some of the electronic articles, reports published by SEC.

Interviews: An in-depth interview sessionwas carried out with Managing Director of ICRA Lanka Limited. Those data were recorded in a form of an audio data recording.

b) Data Analysis:

A collection of analytical methods has been used for the analysis of data in order to achieve different research objectives. Those techniques will be discussed under each sub sections as follows.

- Importance of Credit Rating for Sri Lanka:

How important is credit rating activities for the development of the economy is assessed from the information gathered from in-depth interviews.

- Historical Development of CRAs in Sri Lanka:

Summarizing of data on the existing and recently closed down CRAs in order to identify the similarities and dissimilarities in the rating notches used by the two rating agencies,

c) Rating Activities Carried out in Sri Lanka

- Trend in Credit Rating Activities:

To identify the trend (increasing/ decreasing) in credit rating activities carried out by rating agencies, a line graph is drawn. It plots the annual rating activities for both rating agencies separately and as a total figure for the industry. Using the line graph increasing/decreasing trend in the credit rating activities is identified.

d) Market Share:

Based on the total activities carried out in the credit rating industry, the market share is calculated separately for FRL and ICRAL.

$$\text{Market share of the CRA} = \frac{\text{Total rating activities carried out by CRA}}{\text{Total credit rating activities in the industry}}$$

- Analysis of Credit Rating Activities according to the Type of Issuer/ Issue:

Using pie charts rating activities are being analyzed, according to the type of institution those ratings are assigned (Banks, corporate sector entities, insurance companies, funds and non-bank financial institutions).

- Coverage of Rated Entities in Sri Lanka:

To identify the coverage of credit rating activities in SL, a percentage component bar chart is drawn. It shows, from the total number of institutions in each type (banks, corporate, insurance and non-bank financial institutions), what percentages of institutions have been rated by FRL, ICRAL and mutually by both rating agencies. And it shows what percentages of institutions have been rated neither by FRL nor ICRAL in different sectors.

- Evaluate the Performance of CRAs in the Industry:

Industry performance is analyzed by using three performance indicators; profits, innovations and efficacy as suggested by White (2001).

e) Profit Performance:

To evaluate the profit performances of rating agencies annual 'Net income to total assets' ratios and 'Total revenue to total assets' ratios have been calculated from 2011 to 2015. The analysis, based on calculated ratios is limited by the non-disclosure of free structure and asset structure of both existing rating agencies.

- Innovations and the Efficacy in the Credit Rating Industry:

Data analysis related with innovations and efficacy is being carried out based on the data collected from the interview.

- Effect of Regulations (Mandatory Requirements)on the Credit Rating industry:

The mandatory requirement in the field of Credit rating in SL is identified under two different aspects, as the listing requirements in Colombo Stock Exchange (CSE) and the implications of Basel II accord in the banking sector of SL. Subsequently, the implications of Basel II accord and considerations on the other mandatory requirements of SEC are to be discussed.

V. DISCUSSION

- Importance of Credit Rating for Sri Lanka's Economy:

In the in-depth interview it was revealed that credit rating is vital for the development of the financial market "[Not because of being a middle-income country or nothing else but essentially because of the major role played by CRAs as a financial market intermediary, Credit Rating is very important. Nearly in every country, capital markets are very vital. When

Table 1: Summarized data for the CRAs in Sri Lanka

Name of the CRA	Established in	License from SEC obtained in	Works commenced in	Previously recognized as	Technical Collaboration with
Existing CRAs					
FRL	1999	2000	2000	DCRL	Fitch Ratings Inc., USA
ICRAL	2010	2011	2011	-	ICRA Ltd of India
Not entitled to carry out rating activities					
LRA	2003	2004	2004	RAM Ratings (Lanka) Ltd	RAM Rating Services, Berhad

Notes: FRL = Fitch Ratings Lanka Ltd

ICRAL = ICRA Lanka Ltd

LRA = Lanka Rating Agency Ltd

DCRL = Duff & Phelps Credit Rating Lanka

Source: FRL, ICRAL websites and Papers published on the closed down of LRA

The pioneer of the credit rating in SL is FRL followed by RAM after four years in 2003. The third CRA is ICRAL incorporated in 2010 after 11 years from the establishment of FRL.

Compared to the number of CRAs in other countries in the Asian region, SL has a lower level as by Table 2.

Table 2 : Number of CRAs and GDP Levels of some Asian Countries

Country	Number of CRAs	GDP in 2015 (Millions of US dollars)
China	5	11,007,721
Japan	3	4,123,258
India	6	2,095,398
Korea	4	1,377,873

Indonesia	2	861,934
Thailand	4	395,168
Malaysia	2	296,283
Singapore	4	292,739
Pakistan	2	271,050
Bangladesh	8	195,079
Total	40	
Average	3.63	
Sri Lanka	**2**	**82,316**

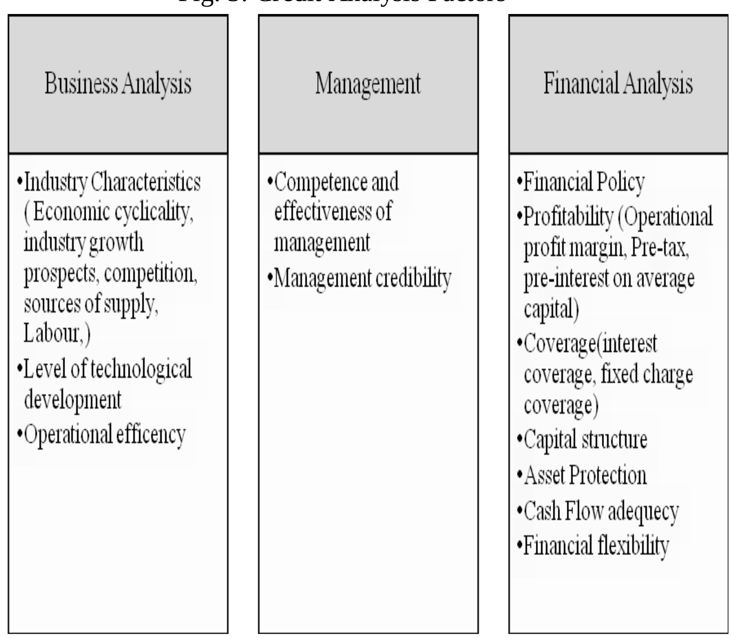
Source: Calculated by authors using information from a collection of websites

SL is smaller in size in terms of Gross Domestic Production (82,316 US $ millions in 2015) compared to other countries in the Asian region like China, Japan, India, Korea, Indonesia, Thailand, Malaysia, Singapore, Pakistan and Bangladesh. Although, there is no standard or benchmark for the number of CRAs, a country should set up,most of the developed countries in the Asian region with higher GDP levels (Japan, China) have got less number of CRAs when compared to the number of CRAs in other developing countries in the region. And as reviewed in the literature countries like Bangladesh, has eight rating companies and they have been struggling with their survival and it has led to an unnecessary competition among them.

Excerpts from the in-depth interview [“It is very difficult to say that there is a high competitive environment. It is also a good thing in the Credit Rating industry of SL. Both existing CRAs have their ultimate parent companies as main global players in the market of Credit Rating worldwide. Moody’s and Fitch stand always for better quality. So their reputation is very high no much concern on competitive strategies and always consider the quality of ratings. ICRAL does not advertise instead they carry out educational programs for investors and borrowers as well as presentations are made on risk management for financial institutions.”] reveal that there is no such competition in credit rating in Sri-Lanka. The possible reason for having only two rating agencies as revealed by the interview [“No much of the barriers to entry. But in SL the capital market and essentially the capital market is relatively small. And not like in developed countries there is no developed credit rating environment to use more than one rating”] may be the underdeveloped nature of the capital market.

Further, FRL and ICRAL provide similar types of rating services. i.e. banks ratings, corporate entity ratings, non-bank financial institutions ratings, insurance company ratings, ratings of rupee denominated debt instruments, structured obligations, sector specific debt obligations and other services like corporate governance ratings, credit risk rating of debt mutual funds, project finance ratings and rating of claims-paying ability of insurance companies. Both these agencies commonly look into some of the main quantitative and qualitative factors which can be clustered into three major areas as in Figure 3.

Fig. 3: Credit Analysis Factors



Source: Designed by the author using information from ICRAL website and Samarakoon (2000).

The SEC aligns its governance structure with the IOSCO standards, thus the CRAs are guided by the recommendations of IOSCO. In-depth interview revealed that, [“ICRAL uses the issuer-pay business model. It is not that much costly to an issuer to obtain a rating. ICRAL maintains a minimum and maximum fee structure for rating an entity, rate issue of debt. It is not arbitrary and relatively cost is low.”] Sri Lanka’s CRA’s can offer low cost rating services as they adopt an issuer-pay business model.

Table 3 : Different Long Term and Short Term Rating Notches Used by both CRAs in Sri Lanka

	Long Term		Short Term	
Rating Grade	FITCH	ICRA	FITCH	ICRA
Investment Grade				
High credit quality	AAA (lka)	SL]AAA	F1+(lka)	[SL]A+
	AA+(lka), AA (lka), AA- (lka)	[SL]AA+, [SL]AA, [SL]AA-	F1(lka)	[SL]A1
Strong credit quality	A+ (lka), A (lka), A- (lka)	[SL]A+,[SL]A, [SL]A-	F2(lka)	[SL]A2
Satisfactory credit quality	BBB+ (lka), BBB (lka), BBB- (lka)	[SL]BBB+, [SL]BBB, [SL]BBB-	F3(lka)	[SL]A3
Speculative Grade				
Moderately speculative	BB+ (lka), BB (lka), BB- (lka)	[SL]BB+,[SL]BB, [SL]BB-	B(lka)	[SL]A+
Highly speculative	B+ (lka), B (lka), B- (lka)	[SL]B+,[SL]B, [SL]B-	B(lka)	[SL]A4
Substantial risk of default	CCC (lka), CC (lka), C (lka)	[SL]C+,[SL]C, [SL]C-	C(lka)	[SL]A4
Default Grade	DDD (lka), DD (lka), D (lka)	[SL]D	D(lka)	[SL]D

Note: The suffix + or - is used with the rating symbol to indicate the comparative position of the instrument within the group covered by the symbol

Source: Designed by the authors using information from FITCH Ratings Lanka and ICRA Lanka websites

Domestic CRAs represent their credit rating opinions symbolically by using literal and numerical symbols with plus and minus signs. Those rating notches are basically two types as long term and short term (1 year (short-term) or above (long-term)). As exhibited in Table 3, rating notches in the same literal symbol for both rating agencies carry out the same meaning for the quality in long run. Except for default grade in short-term ratings, different literal symbols are used for the same degree of quality.

ICRAL ratings are assigned only for Rupee-denominated debt obligations and not designed to enable any rating comparison among instruments across countries. FRL also has assigned most of their ratings on the National Scale. However, FRL is the only one CRA in SL which assigns ratings on an International Scale, which enables the comparability against other international ratings in the world. Therefore, there is an opportunity for local issuers to structure their debt to get the attention of foreign investors by obtaining and maintaining an investment grade rating notches.

Association of Credit Rating Agencies in Asia (ACRAA) was formed in September 2001 with the membership of China, India, Japan, Korea, Malaysia, Pakistan, Indonesia and Bangladesh in order to bring domestic credit rating agencies in a regional cooperative effort. However, the existing CRAs in SL have not yet obtained the membership of ACRAA. If they can become members of ACRAA, they could interact and exchange ideas, experiences, information, knowledge and skills among the credit rating agencies in Asia. That would enhance their capabilities and their role of providing reliable market information. Further, they could adopt best practices and common standards that ensure high quality and comparability of credit ratings throughout the Asian region. Thus it is advisable to become members in ACRAA like the other countries in the Asian region.

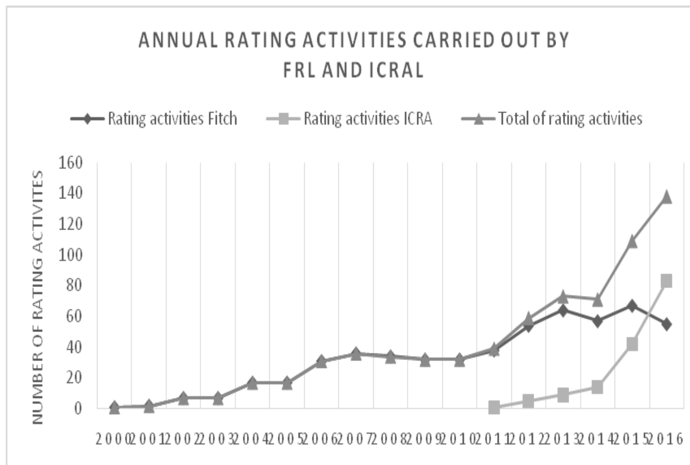
- Rating Activities by CRA's in Sri Lanka:

Excerpts of the in-depth interview revealed the process of credit rating as "Initially, we assign a rating called first time rating. When they have accepted that rating then periodically get their information and keep them under watch. If there is no extraordinary something happens annually we do a full exercise of that rating. If we cannot obtain required information we will withdraw the rating."

To understand clearly the rating activities carried out by FRL and ICRAL, the trend in annual rating activities is assessed, market share calculated, rating activities according to issuer are classified and coverage of rated entities in different sectors in SL are identified.

- Trend in Rating Activities:

Fig. 5: Annual Credit Rating Activities carried out by FRL and ICRAL



Source: Designed by the author using the information of rating activities from the annual rating reports of FRL and ICRAL.

FRL pioneered credit rating activities in Sri Lanka in 2000 to be followed by ICRAL in 2011. Since 2000 to 2016, year-to-year number of rating activities carried out by FRL and ICRAL is presented in a line graph in figure 5. Although fluctuations in the rating activities carried out by FRL and ICRALan increasing trend in the total rating activities can be observed. Initially banks received their ratings followed by financial companies due to the mandatory requirement. Further, the other corporate bodies who wanted to go for public funds to get registered had to get rated. Collectively all these actions resulted in an increasing trend in rating activities carried out in Sri Lanka. There are also some other private companies who got rated. Because of the confidentiality of information, those ratings are not published by both CRAs. But necessarily more corporate entities are getting rated nowadays and it has resulted in an increasing trend in the rating activities in SL.

It is found in Table 4that FRL occupies maximum share, nearly 78% of the credit rating industry, where the rest of 22% is held by ICRAL. Since FRL pioneered the rating activities in SL, they have got a higher reputational advantage than ICRAL (entered to SL rating market in 2011). However, ICRAL has carried out nearly 31% of the total rating activities from 2011 to 2016. But still, FRL leads the credit rating market by providing the high quality credit ratings.

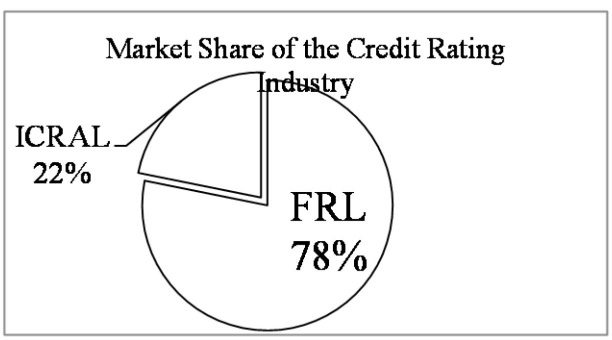
Table 4: Market Share of CRAs in Terms of Rating Activities

Name of CRA	Number of Rating activities		Total	Market share
	2000-2010	2011-2016		
FITCH	216	335 (68.50%)	551	**78.16%**
ICRA	-	154 (31.49%)	154	**21.84%**
Total	216	489 (100%)	705	**100%**

Note: Rating activities carried out by RAM Ratings Lanka has not considered as they are not entitled to carry out rating activities from 2015

Source: Calculated by the author, based on rating reports published by both rating agencies FRL and ICRAL

Figure 6: Market Share Held by FRL and ICRAL



Source: Designed based on Table 4; market share data

- Rating Activities According to the Type of Issuer:

Figure 7 shows the rating activities carried out by FRL and ICRAL according to the type of the issuer. Mainly for banks, non-bank financial institutions (NBFI), insurance companies, funds and corporate entities (Corporate; other than banks, insurance, and NBFIs).

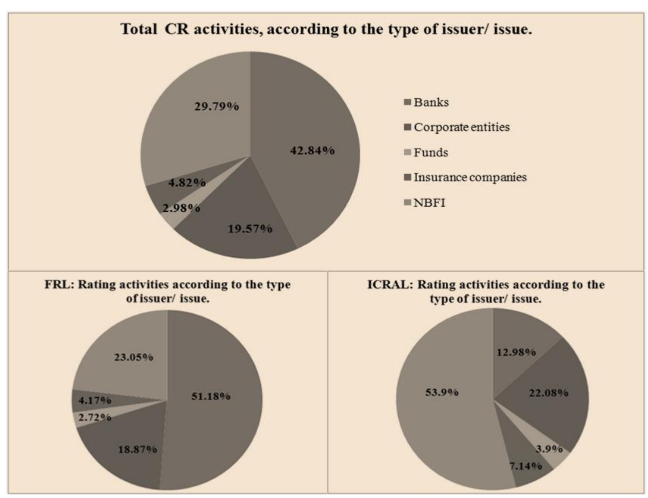


Fig. 7: Rating Activities; According to the Type of Issuer

Source: Designed by the author using issuer wise rating activities from the rating reports of FRL and ICRAL

From the total activities carried out by both CRAs, 42.84% is for banking sector institutions, 29.79% for non-bank financial institutions, about 19.57%for corporate sector entities. Thus, approximately, 73% of rating services are offered to banking and non-banking financial institutions. Lesser number of rating activities has been carried out for insurance companies (4.8%) and fund ratings (2.98%).

FRL is having more than half of their ratings (51.18%) from the banking sector while ICRAL is having their highest proportion of ratings from NBFIs (53.9%). However, ICRAL has more ratings for both corporate and non-bank sector than FRL. Additionally to those ratings some of the rating activities have been carried out under the private domain. They cannot be brought in public domain.

FRL to-date has publicly rated 19 banks, 4 insurance companies, 13 non- bank financial institutions, 13 corporate institutions (listed banks, insurance and NBFIs are not included), on both its national and international rating scales. ICRAL has rated 3 banks, 3 insurance companies, 19 non-bank financial institutions, 14 corporate institutions. Only 5 banks and 1 corporate body have been mutually rated by both rating agencies.

- Coverage of Rating Activities in Different Sectors:

Figure 8 shows what percentage of institutions in different sectors; banks, NBFI, insurance and corporate, have received ratings at least by one of the CRAs in SL.

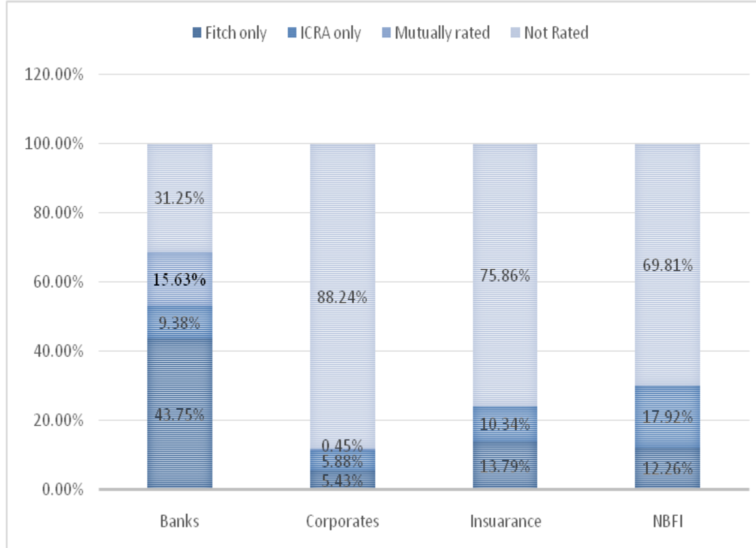


Fig. 8: Coverage of Rated Entities in Different Sectors

Source: Developed by the author using the information of rated entities from the websites of FRL and ICRAL and total number of institutions in different sectors.

Regarding the banking sector of SL, more than half of banks have been rated (68.75%). Only 31.25% of licensed commercial and specialized banks have not yet been rated. Most of the banking sector ratings are assigned by FRL. The least rated sector in SL is the corporate sector entities (other than Banks, Insurance and NBFIs listed in CSE). From 221 companies listed in Colombo Stock Exchange as at 30th September 2016, only 11.76% of corporate entities have receivedratings. The insurance sector is the second least rated sector in SL. Approximately, 76% of insurance companies have not been rated to date. Most of the companies in the insurancesector are rated by FRL. In NBFI sector, only 30.18% of institutions have been rated. ICRAL has assigned the majority of NBFI ratings (17.96%).

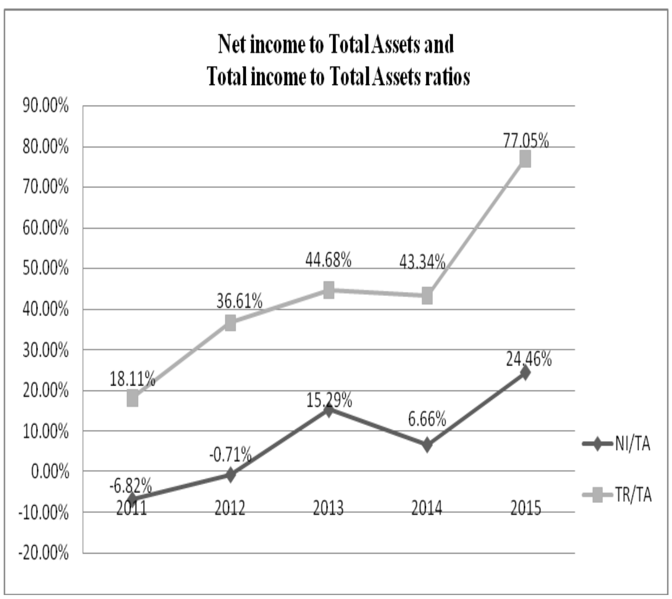
The higher percentages of non -rated entities reveal that most of the institutions in these different sectors have not yet identified the importance of the credit rating. Most of the entities are getting rated, as they want ratings to mobilize funds from the public. But the advisable way is to get the ratings, a long time before a public issue. It leads to maintain a consistent rating and greater confidence in the minds of investors.

In SL, Capital market is still underdeveloped and consequently, there is less use of Credit rating among Sri Lankans. Ratings have been used in SL mainly due to its mandatory requirement in listing and for the financial institutions who take deposits from the public. But in developed countries, people use at least two minimum ratings, before a decision is being made on an investment opportunity. It creates the objectivity of the use of Credit rating. If both agencies have the same opinion, go for that investment and if not, revise the idea and reconsider the investment decision. According to figure 5, 15.63% of the banks and 0.45% of corporate entities have obtained ratings from both FRL and ICRAL. Nevertheless, only two CRAs are operating in SL and only one rating is considered before making an investment. This is mainly due to the lack/ low level of financial literacy among people in SL. They are not awareof the value addition of credit ratings to many users in the financial market.

- Industry Performance of CRAs:

Performance of the credit rating industry is analyzed by using three performance indicators. i.e. Analysis of profit, innovations, andefficacy. Profits in the Credit Rating Industry.

Fig. 9: Annual NI/TA and TR/TA ratios of CRAs in SL



Source: Developed by the author using the information from annual reports of SEC

The most used performance indicator in any industry is profit. In the credit rating industry of SL, the NI/TA and TR/TA ratios have been increasing continuously, except for the year 2014. In 2014 NI/TA has declined by nearly 56%. Though there is no considerable change in both total revenue and total assets levels, the net income could have reduced due to the increasing expenses of CRAs. Administrative expense component is the highest expense component in a CRA’s comprehensive income statement as more expenses are incurred in conducting different analysis. With the data obtained in a collective way of CRAs in the market, the reason for the changes in ratios cannot be identified appropriately. For over the 16 years since the commencement of rating activities, there is an increasing trend is observed for SL. Discontinuation of rating activities by LRA in July 2015, it has not substantially affected the profits in the industry.

- Innovations:

The second performance indicator is the innovations in the credit rating industry. There is no absolute standard for the judgment of innovations in the credit rating industry (White 2001). There is no considerable amount of innovations has been arisen in this industry for SL, as the rating market, as well as the capital market, is still underdeveloped. Thus, for a better performance in the innovations, capital market should be further developed asit will stimulate financial innovations like structured financial instruments in the financial market of SL.

Currently, the debt market is nearly nonexistent. Even the large institutions depend on bank borrowings or use their own retained earnings. As reviewed in the literature, the role of credit rating is well played in a developed bond market scenario. Countries like United States (US), United Kingdom (UK), Japan, Germany and China have got a well-developed bond market mechanism and the role of the CRAs is vital in those markets. If the Sri Lankan bond market expects to be grown with innovative financial products, there would have a better chance for a developed credit rating industry. Enforcement of rating requirement and developing the settlement and clearing system, will help increase the bond market activities.

- Efficacy:

The third performance indicator is the efficacy in the credit rating industry is defined as the amount of extra information provided to the capital market by the assigned ratings (White 2001). Additional information about default probabilities is provided to the market indirectly by ICRA and FRL. In-depth interviews revealed that: in the ongoing process of assigning a credit rating, a large amount of information is collected in public domain,and they come out with a final rating, that reflects all that information related to the credit-worthiness of the borrower. Banks or any other institution does not carry out that much of analysis like a CRA does, as CRAs have got a specialized work-force in analyzing data and a final rating includes a wide variety of information on the probability of default.

This enables investors in Sri Lankan capital market to take informed investment decisions based on their risk-return preferences and select appropriate investment opportunities from a large range of options available. Inherent problems like information asymmetry and adverse selection problem in the Sri Lankan financial market can be answered through a better rating service provided by FRL and ICRAL. It reflects the efficacy in the Credit rating industry in SL.

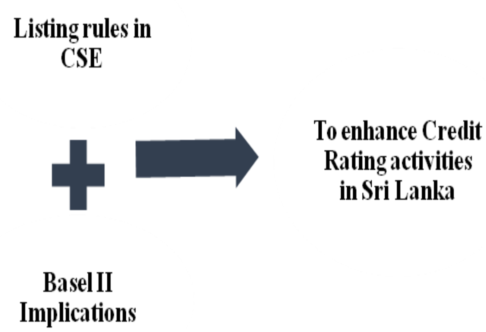
The accuracy of the ratings can be identified by using the default rates. Higher rated borrowers/ issues are less frequent in default than the lower rated borrowers/ issues. Though ICRAL believes that it is ideally to calculate default rates, rates are not yet being calculated and suppose to calculate it in the future. The access to default probabilities in FRL is limited.

- Mandatory Requirement of Credit Ratings in SL:

The CBSL and IFC introduced and promoted CRAs in SL, in order to channel savings to different investment opportunities and thereby achieve a higher economic growth and a higher standard of living. In order to achieve this objective, investors should have the ability to ascertain the credibility of the borrowers. The mandatory requirement of credit rating makes the required information available in the market. It helps to decide on appropriate investment opportunities by assessing risk and return of those investments. Therefore, the mandatory requirement of the use of credit rating reduces the information asymmetry in SL by providing information on the rated issuer/ issue.

This mandatory requirement comes from two different aspects as exhibited in figure 10.

Fig. 10: Two Different Mandatory Requirements of CR in SL



Source: Designed by the author based on the information related to the mandatory requirement of credit rating in SL.

- Table 5 : Listing Requirements of CSE

Section	Requirement related with Credit Rating
Section 1: Listing of shares and debentures	Eligibility to be listed *If the applicant is a Government Entity or a Public*

• Listing Debt	*Corporation*; • should provide unconditional and irrevocable guarantee from the Government of Sri Lanka or a bank licensed by the Central Bank of Sri Lanka and having a minimum of a "A" rating from a rating agency registered with the SEC or an international multilateral or bilateral or other agency acceptable to the Exchange for the repayment of the capital and interest • Or • the Debt Security to be listed shall have an Investment • Grade rating obtained from a rating agency registered with the SEC. • • *If the applicant is a Company;* • It has to obtain a mandatory rating for the Debt security to be listed • and • that rating shall have a minimum of one notch above the Investment Grade, obtained from a rating agency registered with the SEC. • • Mandatory publication of a revision to the rating • An issuer shall publish any revision to the credit rating assigned to the Debt Securities during the tenure of the Debt Securities listed on the Exchange. • *Special:* • If a Public Listed Company wishes to change the rating agency during the tenure of the Debt securities, such entity shall be mandatorily required to obtain a rating from the original credit rating agency at the point of exit. Such rating obtained from the original rating agency shall be immediately published by the company.

	•
• Section 3: Contents of prospectus/ introductory document • Debt	• Contents of prospectus of a listed entity • *Offer at glance:* With relevant other documents also should submit details of the rating attached to the Debt Securities to be listed. • Contents of an introductory document • Should submit details of the rating including the basis for assigning the rating and an interpretation of the risk profile. • Minimum content of a trust deed • Where the Guarantor is a bank (as mentioned in section 2); have to provide a confirmation that the Guarantor is maintaining the rating obtained at the time of issuing the debentures. •
• Section 7: Continuing Listing requirements • Debt	• Contents of annual reports • Any changes in credit rating (for the Entity or any other instrument issued by the Entity), they must include in their annual reports with the other relevant information. • • Revision in ratings assigned to debt securities • A Listed Entity shall maintain, at all times, a rating for its Debt Securities listed on the Exchange. • If there is any change in the rating agency and/or any revision of the rating assigned to the Debt Securities listed on the Exchange, they shall immediately disclose to the Exchange.

- Source: Designed by the author using the information from Colombo Stock Exchange (CSE); listing rules.

According to the listing rules in Table 5, there is a mandatory requirement for the listing of debt securities. A minimum investment grade is the hurdle rating for firms which expect to issue debentures. These companies get a tax break to list their debt, but in order to list they should have obtained a minimum of investment grade. And once a debt security gets listed, the issuers continuously have to maintain that rating and make public aware on any rating changes over the tenure of that debt security. The SEC has decided to mandate the addition of information on the rated securities in the prospectus in order to reduce the information asymmetries.

- Basel II Implications:

The aim of introducing Basel II in SL was to ensure that local banks, as well as the foreign banks, would adopt a well-defined credit risk management system. Basel I accord did not sufficiently relate the credit risk with capital requirement. The capital requirement for a client with AAA rating was same as for a CCC rated one. Therefore, the consideration on credit ratings was not mandatory. But in Basel II accord, the capital requirement for a client with AAA rating is lower than for a CCC rated one. The capital requirement depends on the credit rating of the borrower and it made credit rating of borrower's mandatory.

Among the recommended three levels of rating systems in Basel II, CBSL adopted a standardized approach in January 2008. Accordingly, banks were advised to apply the standardized approach for credit risk. Under this approach, credit risk is measured, based on ratings given by the External Credit Assessment Institutions (ECAI's). Both FRL and ICRAL play a major role in implementing Basel II, as they provide the external ratings for banks, regardless of whether they have an internal rating system or not. The CBSL has made guidelines for the licensed banks to grant facilities for the issue of commercial papers, only which have been assigned an investment grade rating by one of the existing rating agency. Therefore, it is clear that credit ratings play an important role in Sri Lankan financial market. Other than above two mandatory requirements, SEC is considering to introduce a mandatory rating for stock broking firms in SL. The SEC wants to enable the investors to select a stock broker after ascertaining their credibility. It is believed that the ratings for stock brokers in SL will improve investor confidence and protect investor interest.

This mandatory rating platform has enforced the use of Credit Rating in SL. Most of the people in SL question as to why they should take ratings, due to the poor level of financial literacy. Thus SL, ratings have been widely used because of its mandatory requirement. However, this enforcement of rating requirement helps improve the attractiveness of the bond market while minimizing the default risk. It also reduces the high dependability on the bank financing and improves the efficiency, transparency and investor confidence in Sri Lankan bond market.

One of the best ways to promote the use of credit rating is, to increase the awareness about credit rating and improvement of knowledge about credit rating and its importance for the development of financial/capital market in SL. Still the majority of savers in SL invest in high-pressure savings accounts believing those as safe investments. They have got a poor knowledge in risk return trade-offs. To increase the financial literacy of market participants, FRL and ICRAL have conducted numerous programs. They expect to educate people not only about credit ratings but also about the risk and returns of capital market investments. Increased awareness would reduce the uncertainty in investment opportunities and encourage bond market growth, greater capital market efficiency and liquidity.

VI. SUMMARY, CONCLUSIONS AND IMPLICATIONS

This study was performed with the intention of identifying the current situation of the credit rating industry in SL with special focus on CRAs in SL, industry performance, rating activities carried out in the industry and the mandatory requirement of Credit Rating in SL. To achieve this broader purpose, the researcher has gone through the annual reports of SEC, rating reports published by both CRAs, primary data collected from an interview and different other secondary sources of data from 2000 to 2016.Different data analysis techniques have been used for the analysis on collected data.

The credit rating industry in SL is still in an undeveloped stage. The existing rating agencies, FRL and ICRAL have their technical collaboration with international rating agencies Fitch and Moody's investor service. They carry out their operations aligning with IOSCO standards. Though FRL and ICRAL are performing in the Asian region, they have not yet obtained the membership of ACRAA. It is advisable to become members in ACRAA like the other regional countries; China, India, Japan, Korea, Malaysia, Pakistan, Indonesia and Bangladesh. Further when comparing the number of CRAs in SL with the other countries in the Asian region, SL has only two which is well below the average. But with relatively lower GDP level and underdeveloped capital market, those two agencies have succeeded in satisfying the existing need of Credit rating in SL. It is hard to mention that there is high competition between ICRAL and FRL asCRAs has always been focusing on the quality of ratings. Therefore, the credibility on the information they have been providing is high. Moreover, the issuers are not allowed to bargain for favorable ratings.

Rating services provided by FRL and ICRAL include banks ratings, corporate entity ratings, non-bank financial institutions ratings, insurance company ratings etc. No innovations have been arisen in this industry other than the existing traditional ratings, as the rating market as well as the capital market is still underdeveloped. The capital market development is a key factor to stimulate the issues of new structured instruments to create alternative sources of funds, thus motivating financial innovations.

In the process of assigning a credit rating, both rating agencies commonly look into quantitative and qualitative factors which come under the business analysis, management and financial analysis. When they come out with a rating, it reflects all that information related to the credit-worthiness of the borrower. Thus, the final rating includes a wide variety of information on the probability of default. This enables investors in Sri Lankan capital market to take informed investment decisions based on their risk-return preferences. The inherent problems like information asymmetry and the adverse selection problem can be answered through a better rating service provided by FRL and ICRAL.

Both FRL and ICRAL follow the same basic process of assigning a credit rating. But FRL involves a complex and lengthy process in their committee and appealing procedures. The long term rating notches with same literal symbol reflects the same degree of quality. But for the short run they have different literal symbols. FRL is the only CRA, which assigns on an international rating scale that creates an opportunity for local issuers to structure their debt to get the attention of foreign investors by obtaining and maintaining an investment grade rating notches.

The findings show that there is an increasing trend in the total rating activities carried out by existing rating agencies. As a result of that, profit performance in the rating industry is increasing. An average of 7.77% net income to total asset ratio has been appeared for the five-year period from 2011 to 2015. Though the LRA did discontinue their rating activities in July 2015, it has not considerably affected the profit performance in the industry.

The findings show that FRL occupies maximum share nearly 78% of the credit rating industry, where the rest of 22% is held by ICRAL. Since FRL pioneered the rating activities in SL, they have got a higher reputational advantage than ICRAL (which entered to the rating market in 2011). From the total activities carried out by both CRAs, 42.84% is for the banking sector institutions, 29.79% for non-bank financial institutions, 19.57% for corporate sector entities. Nearly, 73% of rating services are offered to banking and non-banking financial institutions in SL. FRL is having more than half of their ratings (51.18%) from the banking sector while ICRAL is having their highest proportion of ratings from NBFIs (53.9%). However, ICRAL has more ratings for both corporate and non-bank sector than FRL. In the banking sector, more than half of banks have been rated (68.75%) and only 31.25% has not yet been rated. The least rated sector in SL is the corporate sector entities (other than Banks, Insurance and NBFIs listed in CSE; only 11.76% has got rated. The insurance sector is the second lowest rated sector in SL. Approximately, 76% of insurance companies are not rated to date. In non-bank financial sector, only 30.18% of institutions have been rated. The higher percentages of non-rated entities reveal that most of the institutions in these different sectors have not yet identified the importance of the credit rating. Most of the entities are getting rated, as they want ratings to mobilize funds from the public, nevertheless the prudent way is to get the ratings, long time before a public issue. It leads to maintain a consistent rating and greater confidence in the minds of investors.

Ratings are used in SL, mainly because of its mandatory requirement in listing and for the financial institutions which take deposits from the public. Corporate entities which are registered under Companies Act, No. 7 of 2007 and listed in CSE to issue their debt securities, have been rated as a result of this mandatory requirement. On the other hand, the CBSL adopted the standardized approach of Basel II accord in January 2008 and it made credit rating of bank borrowers mandatory. Other than above two mandatory requirements, SEC is considering, introducing a mandatory rating for stock broking firms in SL. This mandatory rating platform has enforced the use of Credit Rating in SL. As the in-depth interview revealed most of the people in SL question as to why they should take ratings, this is because of very low level of financial literacy. Thus in SL, ratings are being used as a result of the mandatory requirement. However, this enforcement of rating requirement helps improve the attractiveness of the bond market while minimizing the default risk. It also reduces the high dependability on the bank financing and improves the efficiency, transparency and investor confidence in the Sri Lankan bond market.

REFERENCES

[1] Abeysuriya, R 2001, Role of international credit rating agencies in the context of capital market development, viewed 8 August 016, file:///C:/Users/D/Desktop/reference/ref%20list/Research%20articles/Role%20of%20International%20Credit%20Rating%20Agencies.pdf.

[2] Ahn, M, Bonsall, S & Buskirk, VA 2014, Asymmetric disclosure to credit rating agencies, viewed 2 September 2016, https://www.mccombs.utexas.edu/~/media/Files/MSB/Departments/Accounting/Brownbag%20papers/VanBuskirkUTWorkshop9122014.pdf.

[3] Benmelech, E and Dlugosz, J 2010, 'The credit rating crisis', NBER Macroeconomics Annual, vol. 24, viewed 5 August 2016, http://www.nber.org/chapters/c11794.pdf.

[4] Bian, J 2015, 'Regulating the Chinese credit rating agencies: progress and challenges', Journal of Money Laundering Control, Vol. 18, no. 1, viewed 27 October 2016, http://dx.doi.org/10.1108/JMLC-07-2014-0022.

[5] Ekins, EM & Calabria, MA 2012, Regulation, market structure and role of the credit rating agencies, viewed 27 September 2016, https://object.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf.

[6] Estrella, A 2000, Credit ratings and complementary sources of credit quality information, viewed 22 September 2016, http://www.bis.org/publ/bcbs_wp3.pdf.

[7] Fernández, JL & Vila, RS 2015, The credit rating agencies, institutional strengths and methodological weaknesses: The banks' ratings case, viewed 2 September 2016, http://ddd.uab.cat/pub/trerecpro/2015/hdl_2072_254108/TFM_jlozano_rsanchez.pdf.

[8] Galil, K 2003, The quality of corporate credit rating: an empirical investigation, viewed 27 October 2016, http://www.mathematik.uniulm.de/carfi/vortraege/downloads/Credit_Ratings.pdf.

[9] Gonzalez, F, Haas, F, Johannes, R, Persson, M, Toledo, L, Violi, R, Wieland, M & Zins, C 2004, 'Market dynamics associated with credit ratings: a literature review', ECB Occasional Paper, no. 16, viewed 29 September 2016, https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp16.pdf?c0bf8dc9a602887114123c58b87d5698Haan, JD & Amtenbrink, F 2011, Credit rating agencies, viewed 2 September 2016, https://www.dnb.nl/en/binaries/Working%20Paper%20278_tcm47-246556.pdf.

[10] Hamilton, DT & Cantor, R 2004, 'Rating transition and default rates conditioned on outlooks', Journal of Fixed Income, vol. 14, no. 2, viewed 27 October 2016,

http://www.cfapubs.org/doi/pdf/10.2469/dig.v35.n2.1660.

[11] International Organisation of Securities Comission (IOSCO) 2003, Report on the activities of credit rating agencies, viewed 22 September 2016, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf.

[12] Jeon, DS & Lovo, S 2013, 'Credit rating industry: A helicopter tour of stylized facts and recent theories', International Journal of Industrial Organization, vol. 31, no. 5, viewed 2 September 2016, http://www.tse-fr.eu/sites/default/files/medias/doc/wp/io/wp_tse_376.pdf.

[13] Kashyap, AK & Kovrijnykh, N 2014, 'Who Should Pay for Credit Ratings and How?', Review of Financial Studies, vol. 29, no. 2, viewed 5 August 2016, http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.434.1561&rep=rep1&type=pdf.

[14] Kisgen, DJ 2004, Credit ratings and capital structure, viewed 22 September 2016, http://depts.washington.edu/cfoforum/CreditRating.doc.

[15] Langohr, HM & Langoh, PT 2008, The rating agencies and their credit ratings: what they are, how they work and why they are relevant, viewed 25 September 2016, file:///C:/Users/D/Desktop/9780470714355_leseprobe_01.pdf

[16] Malik, K 2014, Is competition the right answer? A case of credit rating agencies, viewed 19 September 2016,

[17] http://www.lse.ac.uk/IPA/images/Documents/PublicSphere/2014/4-Malik-Competit.pdf.

[18] Matthies, AB 2013, Empirical Research on Corporate Credit-Ratings: A Literature Review, viewed 28 September 2016,

[19] http://sfb649.wiwi.hu-berlin.de/papers/pdf/SFB649DP2013-003.pdf.

[20] Mazumder, BC 2015, 'Credit rating companies and their activities in Bangladesh: An evaluation', Colombo Business Journal, vol. 6, no. 2, viewed 21 September 2016, http://mgmt.cmb.ac.lk/cbj/wp-content/uploads/2016/03/3.-Credit-rating-companies-in-BDesh.pdf.

[21] Nabar, YKS 2003, 'Why do stock prices react to bond rating downgrades' , Managerial Finance, Vol. 29, no. 11, viewed 27 October 2016, http://dx.doi.org/10.1108/03074350310768599.

[22] National Institute of Securities Markets (NISM) 2009, Assessment of long term performance of credit rating agencies in India, viewed 15 September 2016, http://www.sebi.gov.in/cms/sebi_data/attachdocs/1288587929503.pdf.

[23] Organisation for Economic Co-operation and Development (OECD) 2010, Competition and credit rating agencies, viewed 21 September 2016, https://www.oecd.org/competition/sectors/46825342.pdf.

[24] Ranwela, L n.d., Credit risk management in banks- A best practice approach, viewed 16 September 2016,

[25] http://www.apbsrilanka.org/articales/17an/artical-17a-lani_ranwela.html.

[26] Ryan, J 2012, The negative impact of credit rating agencies and proposals for better regulation, viewed 2 September 2016, https://www.swpberlin.org/fileadmin/contents/products/arbeitspapiere/The_Negative_Impactof_Credit_Rating_Agencies_KS.pdf.

[27] Sakalasooriya, I 2015, 'SEC mulls mandatory rating for brokerages', Daily Mirror, 25 June, viewed 15 September 2016, http://www.dailymirror.lk/77481/sec-mulls-mandatory-rating-for-brokerages.

[28] Samarakoon, LP 2000, Sri lankan corporate bond market, UK Graphics, Nugegoda.

[29] Securities and Exchange Commission of Sri Lanka (SEC) 2016, FAQ on Credit Rating, viewed 12 October 2016,

[30] http://www.sec.gov.lk/wp-content/uploads/FAQ-on-Credit-Rating-pi.pdf

[31] Sivanesan, V 2004, ‘New Basel capital accord and credit ratings’, The Island, 25 July, viewed 15 September 2016, http://www.island.lk/2004/07/25/busine08.html.

[32] Subbiah, P 2014, RAM announces sale of RAM Ratings (Lanka) Ltd., 15 September 2016, https://www.ram.com.my/press_Release_View.aspx?ddlid=8ae146fc-cfd7-4860-b372-1813d4f69c83&catid=8ae146fc-cfd7-4860-b372-1813d4f69c83&returnURL=&id=cd53a98d-d470-4882-b051-b23f87181b21.

[33] Sy, ANR 2009, The systemic regulation of credit rating agencies and rated markets, viewed 2 September 2016, https://www.imf.org/external/pubs/ft/wp/2009/wp09129.pdf.

[34] Weerakkody, C 2011, ‘ICRA Lanka to grade IPOs’ , Daily FT, 29 July, viewed 15 September 2016,http://www.ft.lk/article/41181/ICRA-Lanka-to-grade-IPOs.

[35] White, LJ 2001, The credit rating industry: An industrial organization analysis, viewed 18 September 2016, http://archive.nyu.edu/bitstream/2451/26205/2/1-2.pdf.

[36] White, LJ 2009, A brief history of credit rating agencies: How financial regulation entrenched this industry's role in the subprime mortgage debacle of 2007–2008, viewed 20 September 2016,https://www.mercatus.org/system/files/59_CRA_history_%28web%29.pdf.

[37] White, LJ 2010, 'Markets: The credit rating agencies', The Journal of Economic Perspectives, vol. 24, no. 2, viewed 20 September 2016, http://mng.ibu.edu.ba/assets/userfiles/mng/coursematerials/reading%20Credit%20Rating%20Agencies.pdf.

[38] White, LJ 2013, ‘Credit rating agencies: An overview’, Annual Review of Financial Economics, vol. 5, no. 1, viewed 2 September 2016, http://webdocs.stern.nyu.edu/old_web/economics/docs/workingpapers/2013/White_CRAsARFE_Jun2013.pdf.