

**TAR:SRI 29127**

**ASIAN DEVELOPMENT BANK**

**TECHNICAL ASSISTANCE**

**TO THE**

**DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA**

**FOR ESTABLISHING A**

**CREDIT RATING AGENCY**

**June 1995**

### **CURRENCY EQUIVALENTS**

(as of 6 April 1995)

|               |   |                         |
|---------------|---|-------------------------|
| Currency Unit | — | Sri Lanka Rupees (SLRs) |
| SLRs1.00      | = | \$0.02                  |
| \$1.00        | = | SLRs49.31               |

### **ABBREVIATIONS**

|      |   |                           |
|------|---|---------------------------|
| CBSL | — | Central Bank of Sri Lanka |
| CEO  | — | Chief Executive Officer   |
| CRA  | — | Credit Rating Agency      |

### **NOTE**

In this Report, "\$" refers to US dollars.

## I. INTRODUCTION

1. In November 1994, the Government of Sri Lanka requested Bank technical assistance (TA) for examining the feasibility of establishing a domestic credit rating agency (CRA) and for setting up such an agency should it be found feasible. In response, a Fact-Finding Mission visited Sri Lanka from 3 to 6 April 1995 and reached an understanding with the Government on the objectives, scope, cost estimates and financing plan, implementation arrangements, and terms of reference for consultants for a TA to be conducted in two phases.<sup>1</sup>

## II. BACKGROUND

2. Sri Lankan corporate borrowers have relied principally on the banking system to meet their long-term financial needs. As a result, the capital market (both equity and debt) has been less active than the loan finance market. Following policy reforms pursued by the Government with the support of international agencies including the Bank, the equity market has recorded increased activity in recent years and now dominates the capital market, with market capitalization of SLRs123.8 billion (24.7 percent of gross domestic product at the end of 1993). An orderly growth of the securities market has, however, been constrained by (i) high interest rates on treasury bills, (ii) imposition of withholding tax, and (iii) lack of a market-determined rate for long-term Government securities that can serve as a benchmark for private bonds.<sup>2</sup>

3. The private debt securities market in Sri Lanka is in a nascent state.<sup>3</sup> A few companies listed on the Colombo Stock Exchange have in recent months issued convertible debentures with outstanding value of SLRs5 billion (\$100 million) and commercial paper with estimated outstandings of SLRs8.5 billion (\$170 million). The initial success of these issues has provided the issuing companies access to an additional source of borrowings at attractive interest rates (lower than the prime lending rate of commercial banks). It is expected that a number of companies listed in on the Colombo Stock Exchange will raise debt, which can be rated independently. In addition, there exists the potential for issue of straight bonds and collateralized debts such as mortgage and lease receivables. However, ready market acceptance of such instruments on a regular basis requires independent evaluation of their creditworthiness.

4. In the circumstances, the Government considers that the establishment of a domestic CRA would facilitate the orderly expansion of the capital market, and it has attached high priority to this matter. Furthermore, the Government believes that a well-organized CRA would promote the demand for and supply of high quality debt securities.

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<sup>1</sup> The TA first appeared in *ADB Business Opportunities* in May 1995 (Internet edition).

<sup>2</sup> The last two items were addressed under Loan No. 1302-SRI: Fourth Development Finance Loan Project, for \$75 million, approved on 28 June 1994.

<sup>3</sup> Government securities comprising short-term treasury bills and medium-term rupee securities/loans have been available for some years. The volume of treasury bills issued in 1993 was SLRs158.9 billion (SLRs168.4 billion in 1994), while rupee securities/loans totalled SLRs28.2 billion (SLRs46.9 billion in 1994). A significant portion of these securities were placed with captive institutions controlled/owned by the Government (such as the Employees Provident Fund and the National Savings Bank). The treasury bills are presently auctioned, and the yields are broadly reflective of market trends in interest rates.

5. To further develop the capital market, in particular, the market for debt securities, it is necessary to instill investor confidence<sup>1</sup> through independent analysis and assessment of the creditworthiness of the debt instruments offered to the public. In the process, an evaluation of the issuers also becomes necessary. At the same time, professional assessment by an independent expert agency (such as a CRA) gives corporate borrowers increased access to long-term funds at reasonable cost. Thus, the existence of an independent and reliable CRA would contribute to debt securitization, enhance investor confidence, and encourage creditworthy issuers to access the debt market at reasonable cost. This is likely to enhance the profitability of corporate borrowers and consequently to increase investments, engendering economic growth.

6. The examination of the feasibility and the actual establishment of a CRA are specialized and complex tasks that require a high level of expertise and sophistication. They also require the involvement of internationally recognized experts to support the credibility of the proposed undertaking. This expertise is currently not available in Sri Lanka. Provision of Bank TA to develop this expertise/specialized skill is considered appropriate. The Bank has previously provided assistance for the establishment of CRAs in India,<sup>2</sup> Malaysia,<sup>3</sup> and Thailand<sup>4</sup> (all these resulted in subsequent formation of CRAs — Bank equity participation — which are performing satisfactorily). The Bank is thus in a suitable position to respond positively to the Government's request.

### III. THE TECHNICAL ASSISTANCE

#### A. Objectives

7. The principal objectives of the TA are to examine the feasibility and financial viability of the establishment of a CRA in Sri Lanka (Phase I); and, pending positive results from the study under Phase I, to provide detailed advisory services to set up a CRA, train the staff, and prepare credit analysis manuals and operating guidelines (Phase II).

#### B. Scope

8. Phase I will involve identifying potential shareholders and assessing the demand for rating services. The first phase will also address issues such as ownership and corporate structure, capitalization, scope of operations, range of fees to be levied, staff requirements, and human resource development. This study will also incorporate financial projections, training and information technology requirements, office equipment, and a detailed time schedule for the establishment of a CRA.

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<sup>1</sup> Investor confidence has been tested in recent years through closure of a number of finance companies and the collapse of a foreign commercial bank.

<sup>2</sup> Investment No. 7016-01, equity investment of \$450,000 in the Credit Rating Information Service of India (under a line of equity to the Industrial Credit and Investment Corporation of India), approved on 29 October 1987.

<sup>3</sup> TA No. 1184-MAL: Establishment of a Rating Agency, for \$100,000, approved on 27 July 1989.

<sup>4</sup> TA No. 1251-THA: Establishment of a Credit Rating Agency, for \$186,000, approved on 21 December 1989.

9. Subject to positive findings and a decision on the part of potential shareholders to set up a CRA, Phase II will provide detailed advisory services to help in the establishment of a CRA, preparation of operating guidelines and manuals covering the principal activities, and administration. This phase of the TA will also provide assistance in training the staff of the CRA in Sri Lanka and overseas.

### **C. Cost Estimates and Financing Plan**

10. The total cost of the TA is estimated at \$277,000 equivalent of which \$253,000 will be in foreign exchange and the remaining \$24,000 equivalent in local currency cost (Appendix 1 provides the detailed cost estimates).

11. The estimated cost of Phase I (including contingencies) is \$97,000 equivalent, comprising \$87,000 in foreign currency and \$10,000 equivalent in local currency. Phase II is estimated to cost \$180,000 equivalent (inclusive of contingencies), of which \$166,000 will be in foreign currency and the remaining \$14,000 equivalent in local currency. The Bank will finance the entire foreign exchange costs and \$8,000 equivalent in local currency costs, for a total of \$261,000 as a grant. The Government will finance the remaining \$16,000 equivalent to cover the cost of office space, secretarial assistance, support services, and local transportation.

### **D. Implementation Arrangements**

12. It is expected that the TA will require a total of seven person-months of consultancy: three person-months for Phase I and four person-months for Phase II. Under the first phase, one CRA specialist, with experience in the operation of a CRA, will require about three months for the preparation of a feasibility study. The second phase of the TA will require about four months of expert services in the following areas: (i) one CRA expert to act as an advisor to the chief executive officer (CEO) of the CRA; and (ii) one training specialist to prepare the operating manuals and train CRA staff in credit analysis and operations. In view of the specialized nature of the expert services needed for this TA, it is necessary to select consultants from a reputable CRA with relevant experience and technical qualifications. Consultants will be selected sequentially for Phases I and II by the Bank in consultation with the Government in accordance with the Bank's *Guidelines on Use of Consultants*. The detailed terms of reference for the consultants are presented in Appendix 2.

13. The Central Bank of Sri Lanka (CBSL) will be the Executing Agency for the TA and will provide the necessary local support services, office facilities, and local transportation. CBSL will designate a senior officer as the coordinator for the TA. With CBSL's pool of knowledge in financial sector/capital markets and its commitment to the development of this important sector, its active participation will contribute to the successful establishment of a CRA.

14. It is expected that the consultant for Phase I of the TA could be fielded by the third quarter of 1995, and a feasibility report could be prepared by the end of 1995. Depending on the conclusions of the feasibility study, the work for the establishment of the CRA (Phase II) could commence around the beginning of 1996 and be completed by the third quarter of 1996. The closing date of the TA should be 31 December 1996.

15. The principal consultants will be required to submit to the Bank and to the

Executing Agency an inception report two weeks after commencement of their assignments. The advisor to the CEO of the CRA, to be employed for one person-month, will be required to submit a final report upon completion of the assignment. A final report on each phase of the TA, incorporating the comments of the Bank and the Executing Agency, should be submitted within three weeks after completion of the assignments. The CBSL should also submit monthly reports to the Bank on the progress under each phase of the TA.

#### **IV. RECOMMENDATION**

16. The President, acting under the authority delegated to him by the Board, has approved the provision of technical assistance, on a grant basis, to the Government of the Democratic Socialist Republic of Sri Lanka in an amount not exceeding \$261,000 for the purpose of establishing a credit rating agency in Sri Lanka, and hereby reports his action to the Board.

**COST ESTIMATES**  
(in \$)

| I. Phase I                     |  | <u>Foreign Currency</u> | <u>Local Currency</u> | <u>Total</u> |
|--------------------------------|--|-------------------------|-----------------------|--------------|
| A. <u>Bank Financing</u>       |  |                         |                       |              |
| 1.                             | Consultants  | 78,500                  | —                     | 78,500       |
| 2.                             | Documentation<br>(reports including translation)   | —                       | 2,500                 | 2,500        |
| 3.                             | Contingency<br>(including contract negotiations)   | 8,500                   | 500                   | 9,000        |
| B. <u>Government Financing</u> |  |                         |                       |              |
|                                | Support services including office<br>space, secretarial assistance, and<br>local transport | —                       | 7,000                 | 7,000        |
| Subtotal - Phase I             |  | 87,000                  | 10,000                | 97,000       |
| II. PHASE II                   |  |                         |                       |              |
| A. <u>Bank Financing</u>       |  |                         |                       |              |
| 1.                             | Consultants  | 118,000                 | —                     | 118,000      |
| 2.                             | Overseas Training  | 33,000                  | —                     | 33,000       |
| 3.                             | Documentation<br>(reports including translation)   |                         | 4,500                 | 4,500        |
| 4.                             | Contingency (including<br>contract negotiations)   | 15,000                  | 500                   | 15,500       |
| B. <u>Government Financing</u> |  |                         |                       |              |
|                                | Support services including office<br>space, secretarial assistance, and<br>local transport | —                       | 9,000                 | 9,000        |
| Subtotal - Phase II            |  | 166,000                 | 14,000                | 180,000      |
| GRAND TOTAL (Phases I and II)  |  | 253,000                 | 24,000                | 277,000      |

**NOTE:** Any amount not utilized in Phase I will be allocated to the contingency budget of Phase II

## **TERMS OF REFERENCE**

### **A. Implementation Arrangements**

1. The technical assistance envisages the utilization of the services of three consultants:

#### Phase I

- one credit rating agency (CRA) specialist, with practical experience in the operations and management of a CRA, for preparation of the feasibility study, for about three months.

#### Phase II

- one CRA specialist to act as advisor to the chief executive officer of the CRA in the establishment of a CRA and in determining its policies (one month).
- one CRA training specialist to prepare manuals and to train the staff in the use of the manuals, as well as in the operations of a CRA (three months).

2. The Executing Agency for the TA will be the Central Bank of Sri Lanka (CBSL), which will provide the consultants with all necessary support services, office facilities, and local transportation. CBSL will designate one senior official as the coordinator for the TA, provide logistic support needed for its implementation, and send monthly progress reports to the Bank.

### **B. Detailed Terms of Reference**

#### A. CRA Specialist (Phase I)

3. The consultant will prepare a detailed feasibility study including financial projections for the establishment of a CRA. The study should focus on the following areas:

- (i) **Ownership Structure:** Identify potential shareholders and recommend the proportion of shares to be owned by the public and by private sector organizations. The ownership structure should be diffused, with no individual shareholders or sectors holding a significant interest, to ensure that the CRA will have the necessary independence to announce objective ratings.
- (ii) **Capitalization:** Recommend the size and structure of capital for the CRA, bearing in mind that initial capital and subsequent infusions should provide it with financial autonomy and not compromise its independence and objectivity.
- (iii) **Instruments to be Rated:** Identify the possible range of instruments that may be rated. Also evaluate the potential for rating of the following instruments: (a)



corporate bonds; (b) commercial paper; (c) certificates of deposit; (d) preference shares; and (e) obligations of insurance companies, deposit takers, and leasing companies. In assessing the market for rating services, attention should be paid to (a) data on rateable instruments in Sri Lanka over the past five years, and projections of the likely volume of such instruments over the period 1996-2005, with a clear statement of assumptions used; (b) measures to be taken by the Government or professional bodies to develop the market for rating services including a review of a relevant laws and regulations; recommend necessary legal reforms where relevant; and (c) the type and extent of public information campaigns that could be undertaken by the CRA for both investors and corporate borrowers to enhance the demand for rating services.

- (iv) **Investment Restriction:** Review the investment policies of major local institutional investors and identify legal or other restrictions placed on eligible investments. Recommend specific amendments (where relevant) to statutes to encourage the flow of investments and quality-rated debt securities issued by private issuers.
- (v) **Rating Categories:** Recommend rating categories and gradation within each category.
- (vi) **Fees:** Review the criteria/formulas to be used in determining the rating fees and suggest a realistic scale of fees to be charged by the CRA.
- (vii) **Projections:** Prepare financial projections for the decade 1996-2005 for the CRA showing profit/loss statement, balance sheet, and cash flow statement. Specify the assumptions and rationale for each major item of projection. These projections should determine the financial viability of the CRA.
- (viii) **Organizational Structure:** Prepare an appropriate organizational structure of the CRA with estimates of number, timing, and expertise of the personnel to be hired.
- (ix) **Training:** Identify the pre-establishment and continuing training requirements of CRA staff in key areas such as a credit analysis, corporate finance techniques, and rating agency operation.
- (x) **Operations:** Recommend operational policies and procedures for (a) operational methods such as rating formulation, watch-listing criteria, and composition and qualification of the "Rating Committee"; (b) avoidance of conflict of interest and of inadequacy of information from issuers who are averse to further disclosure; (c) type of information storage and use of information technology; and (d) requirements of office space, equipment, data processing, storage, and retrieval.
- (xi) **Accounting/Auditing Standards:** Review the accounting and auditing standards used in Sri Lanka and determine their adequacy for credit analysis. Recommend, if necessary, enhancements to the standards.