

STRUCTURED FINANCE RATING METHODOLOGY



The primary function of PACRA is to evaluate the capacity and willingness of an entity / issuer to honor its financial obligations. Our ratings reflect an independent, professional and impartial assessment of the risks associated with a particular instrument or an entity.

PACRA's comprehensive offerings include instrument and entity credit ratings, insurer financial strength ratings, fund ratings, asset manager ratings and real estate gradings.

PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.

INTRODUCTION

Securitization is a financing tool. It involves creating, combining and recombining categories of assets and securities into new forms. Assets, loans, receivables, etc, from an obligor or a group of obligors are pooled and repackaged, underwritten and sold in the form of asset-backed or other securities. Securitization provides financing for the sellers of the assets. These 'asset-backed securities' (ABS) are collateralized or 'backed' by the pooled assets and are not considered general obligations of the asset sellers. While securitization structures can vary significantly, in general, the investor in an asset-backed security is entitled to receive a pass through of the timely payment of profit and principal on the pooled assets. The investor, therefore, looks to the cash flow from the purchased assets for repayment. A typical securitization involves the creation of a bankruptcy remote special purpose vehicle ('SPV') that issues debt securities.

The securitization process allows the company to separate financial assets from credit, performance and other risks associated with the company itself. As a result, the amount of capital required to finance the pooled assets may be proportionally less than that for the company as a whole, because the company's overall capital costs must take into account all of the collective risks and uncertainties associated with its business operations. In addition, securitization converts illiquid assets that cannot be easily sold to third party investors into liquid, marketable securities.

Securitization is a unique long-term financing tool that requires real commitment on the part of a company, the originator, to develop internal capacity to support the process. There are a number of motivations for securitizing, including:

- Access to longer-term and lower cost financing;
- Access to a new or wider investor base;
- Removal of assets from an originator's balance sheet and transfer of the associated credit risk to investors; and
- Ability to seek financing without increasing on balance sheet debt, which could breach financial covenants for existing debt.

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Rating Methodology

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ASSET CLASSES

A variety of assets, mainly those discussed below, are securitized.

Collateralized debt obligations (“CDOs”)

Pools of commercial loans to corporates or small and medium-sized enterprises (“SMEs”) and pools of corporate bonds.

Asset-backed securities (“ABS”)

Pools of credit card receivables, auto loans or leases, other types of consumer loans, equipment leases or trade receivables.

Mortgage-backed securities (“MBS”)

Pools of residential/commercial mortgages that may consist of a single property or a group of properties financed by a single borrower, or a pool that combines numerous loans from different borrowers secured by diverse properties.

Future flow Securitization

The future cash flows from pools of physical assets such as export receivables, telephone net settlements and airline receivables or flows from financial assets such as credit card voucher processing receivables, trade payments rights or worker remittances.

THE RATING PROCESS

The process starts with the initial contact between the originator or arranger and PACRA. At this point a brief outline of a proposed transaction and its structure and assets, as well as background information on the originator are shared. Based on the information provided, PACRA undertakes a brief financial analysis and industry review.

This includes a basic review of historical performance as well as consideration for future industry trends in the context of a company’s strategy to assess the sustainability of its market position. The purpose of these efforts is to provide a realistic assessment of a company’s ability to securitize the proposed assets as well as early identification of potential challenges, allowing the originator time to address them. In addition, in those cases where a company is the first to securitize an asset class in an industry, it is useful for PACRA to

receive more detailed information regarding the originator’s industry and market, as this may be important later in the rating process. For example, basic profiles of customers and competitors broaden the agency’s understanding of market dynamics. Information on legal and regulatory issues specific to the company and/or industry strengthens the agency’s understanding of the legal environment in which the company operates. In addition, a brief overview of alternate sources of financing in the industry assist in understanding a company’s financing strategy.

If the originator decides to proceed with the securitization, a more detailed review is initiated, which includes the following key components:

COLLATERAL ANALYSIS: The purpose of collateral analysis is to understand the characteristics and behavior of the assets concerned under given stress scenarios. Data on the pool of assets likely to be securitized is provided to the agency, which reviews historical performance in terms of delinquencies, defaults, recoveries and prepayments. The pool is also evaluated in terms of identifying characteristics, such as diversification of obligors, geographical location and asset types, depending on the type of transaction.

ORIGINATOR/SERVICER REVIEW: A critical part of PACRA’s rating process is the originator and servicer review, during which the agency reviews the policies and procedures by which the assets to be securitised are originated and serviced to ensure on-going credit quality. The agency and investors need to understand the background of the originator and the industry in which it operates and will be looking for the company to demonstrate the following:

- An operational track record and stable ownership structure.
- A clear definition of core markets, an understanding of competition and ability to sustain market position.
- Managers with backgrounds and experience that demonstrate an understanding of their business area.
- A rational organisational structure.
- A comprehensive set of human resource and employee training practices.
- A suitable management information system (“MIS”) in key operational areas.

- A corporate strategy that is ingrained in current corporate practices and forms a basis for future growth.
- A track record of financial strength and a clear strategy for meeting financing needs.
- An understandable and realistic motivation for securitization.

These issues form the basis of the analysis of a company's ability to act as originator and servicer in a transaction. PACRA and investors also consider the availability of a back-up servicer, which is frequently a similar company in the same industry. This function is important to the securitization process as it provides a degree of protection for investors in a situation where an originator is no longer able to service a transaction.

LEGAL STRUCTURE AND DOCUMENTATION REVIEW:

The purpose of this review is to assess the credit and legal implications of the transaction structure. As part of this review, issues considered include transferability of assets; bankruptcy remoteness of SPV; taxation issues including transfer tax, stamp duty and withholding tax; regulatory issues and set-off risk. When rating a securitization transaction, particularly in an industry with no previous securitization transactions or examples in the proposed asset class, an understanding of the legal environment is vital. PACRA has found that the legal ability to transfer assets and attached security to a third party can often be constraints to securitization. Most securitizations rely on a "true sale" of assets where ownership cannot be challenged in the event of the originator's bankruptcy.

PACRA typically seeks legal counsel early in the rating process to assess legal issues impacting the feasibility of a transaction.

CASH FLOW ANALYSIS & FINANCIAL STRUCTURE:

Collateral cash flow analysis considers the financial structure and determines credit enhancement. PACRA develops a base-case portfolio performance expectation, which represents the anticipated performance of a portfolio under a non-stressed economic scenario. This base case is run through stress scenarios at each desired rating category. For the purposes of credit enhancement, the agency also considers liquidity issues; payment priority; commingling, negative carry, profit rate, and reinvestment risks; and amortization issues.

CHALLENGES TO RATING SECURITIZATION TRANSACTIONS

It would be difficult to stress too strongly the importance of reliable and standardized data in the rating process. The availability of data is typically the major impediment in the rating process. This is because the data required for the on-going management of an asset pool is frequently different to that evaluated in the standard entity/instrument rating process. Securitization may call for data in formats not previously captured by a company's systems. Recreating historical data for existing assets using new parameters is time-consuming and can be a major cause of delay. However, companies that bring their information systems in line with the data requirements of such transactions find that the process can be completed efficiently.

PACRA looks for a set of data that provides an understanding of an underlying pool of assets. The dataset varies depending on the asset class to be securitized, but generally provides information on characteristics of the asset pool, and underlying collateral. The agency often analyses the data in ways that are new for a company. For many types of assets, the most easily securitizable portfolio consists of a homogeneous pool, ideally with a diversified obligor and collateral base that generates a stable and predictable cash flow. Homogeneous pools are groups of receivables that are similar both in contractual terms and profit rates and in terms of prepayments, delinquencies, defaults and recoveries. PACRA reviews obligor concentrations in a portfolio. The outstanding exposure to each obligor is compared against a pool's total outstanding obligations, with special attention placed on those representing sizable contribution in a portfolio. The credit quality of those obligors is reviewed and the impact of their default analyzed in terms of the ability of the remaining portfolio to meet the obligations to the investors. In some securitizations, concentrations in the underlying collateral also are examined.

PACRA also requests data to better understand an asset pool's historical performance, including delinquencies, defaults, recoveries and prepayments. All companies monitor the performance of their outstanding credits, focusing on delinquencies and defaults. However, PACRA believes a securitization is impacted by the performance of a portfolio more directly than a company would be when the assets remain on its balance sheet.

For example, within a bank, repayments received on a loan portfolio are generally used to cover floating, short-term liquidity needs, funding additional loans or paying short-term liabilities. Liquidity managers typically have access to a range of cash inflows and are therefore able to cover liquidity needs even if expected loan payments are not received. In contrast, when this same loan pool is securitized, the cash flows from the loans are the only monies available to meet fixed repayment obligations. Delinquencies and defaults increase the cost of securitization to originators, as credit enhancement and liquidity facilities are put into place to cover potential cash shortfalls when expected payments from the assets are not received. For this reason, clearly understood trends in delinquencies and loss exposures are important to managing the securitization.

PACRA views a portfolio from the standpoint of its ability to make timely payments to investors. To assess credit enhancement appropriately, PACRA should be able to accurately project what percentage of cash flows from a pool of assets may not be available due to extended nonpayment to meet repayment obligations to investors. PACRA attempts to quantify the magnitude of ultimate losses in a portfolio caused by defaults. The agency needs to estimate, based on historical data, how long it takes for a company to recover funds from defaulted assets, which it uses to model the level and timing of cash flows a transaction can realistically expect to receive from defaulted assets to meet its obligations to investors. Finally, some securitization transactions are impacted by the potential that obligors make prepayments, repaying their obligations ahead of schedule. The analysis incorporates an understanding of which customers are most likely to prepay and for what reasons.

PERFORMANCE ANALYTICS

Once a transaction has been closed, PACRA continues to play a role in the securitization throughout the life of the transaction. The agency's dedicated Performance Analytics team provides a valuable tool for investors by monitoring and reporting on the performance of the rated securities.

GLOSSARY OF IMPORTANT TERMS

Asset-Backed Securities (ABS)

Securities, typically bonds or notes, backed by pools of assets providing a reliable flow of cash, such as auto loans, equipment leases or consumer loans.

Base Case

Expected performance under a non-stressed economic scenario.

Commingling Risk

The risk that cash belonging to an entity issuing notes is not held separately from that belonging to the servicer.

Credit Enhancement

Structural mechanisms cushioning investors from losses on the underlying assets, including over-collateralization, excess profit, reserve accounts and subordinated or junior classes of securities.

Default

In terms of the securitisation process, a default is the time at which the cash flow from a delinquent asset is no longer considered available to meet payment obligations to investors.

Delinquency

The failure on the part of a borrower to make a payment against a debt obligation by the specified payment date.

Homogeneous Pool

Groups of assets with similar contractual terms.

Negative Carry

The situation in which the profit earned on the securitised assets is less than that owed to the investors.

Obligor

The borrower or trade customer whose debt or receivable is being securitised.

Originator

A company that generates a pool of assets, such as loans, mortgages, leases or trade receivables to be securitised.

Performance Analytics

The on-going monitoring of the performance of a securitisation transaction by a rating agency.

Prepayment

When a customer repays its obligations before the scheduled date

Rating

A rating is an opinion on the ability of a security issuance to meet its financial commitments (for example, payment of profit and fees and repayment of principal) on a timely or ultimate basis. It is not a recommendation to buy, sell or hold a security.

Seasoning

The time lapsed between an asset's origination or disbursement date, indicating the number of payments that a borrower has made against the obligation. For example, a 12-month loan to a business is disbursed on January 1. On May 1 of the same year, the loan would have four months' seasoning.

Securitization

The process by which securities are issued, backed by the predicted cash flows from specific assets.

Servicer

The company that manages the collection of payments on the securitized assets, which it distributes according to the specific issue documentation.

Special Purpose Vehicle (SPV)

An entity specifically created for the purposes of securitization, whose obligations should be limited to the issuance of securities and the acquisition of assets. It is structured to be legally independent from the originator of the assets to be purchased and usually bankruptcy remote.

Static Pool

A group of assets which have a common defining characteristic (for example, a period of origination or period of default) against which performance can be measured.

Stress Testing

The process of evaluating the ability of a pool of assets under differing negative performance scenarios to generate sufficient cash flows to meet obligations to investors in terms of principal and profit payments. Stress testing is used to determine credit enhancement levels.

Stress Scenario

Economic and business circumstances under which the key performance indicators of the portfolio are significantly altered.

Vintage

A static pool relating to a particular period of time (month, quarter or year of origination) or the particular period of time (month, quarter or year).

STANDARD RATING SCALE & DEFINITIONS

| LONG TERM RATINGS | SHORT TERM RATINGS |
|--|--|
| <p>AAA: Highest credit quality. ‘AAA’ ratings denote the lowest expectation of credit risk. They are assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.</p> <p>AA: Very high credit quality. ‘AA’ ratings denote a very low expectation of credit risk. They indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.</p> <p>A: High credit quality. ‘A’ ratings denote a low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.</p> <p>BBB: Good credit quality. ‘BBB’ ratings indicate that there is currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. This is the lowest investment-grade category.</p> <p>BB: Speculative. ‘BB’ ratings indicate that there is a possibility of credit risk developing, particularly as a result of adverse economic change over time; however, business or financial alternatives may be available to allow financial commitments to be met. Securities rated in this category are not investment grade.</p> <p>B: Highly speculative. ‘B’ ratings indicate that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favourable business and economic environment.</p> <p>CCC, CC, C: High default risk. Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favourable business or economic developments. A ‘CC’ rating indicates that default of some kind appears probable. ‘C’ ratings signal imminent default.</p> | <p>A1+: Obligations supported by the highest capacity for timely repayment.</p> <p>A1: Obligations supported by a strong capacity for timely repayment.</p> <p>A2: Obligations supported by a satisfactory capacity for timely repayment, although such capacity may be susceptible to adverse changes in business, economic, or financial conditions.</p> <p>A3: Obligations supported by an adequate capacity for timely repayment. Such capacity is more susceptible to adverse changes in business, economic, or financial conditions than for obligations in higher categories.</p> <p>B: Obligations for which the capacity for timely repayment is susceptible to adverse changes in business, economic, or financial conditions.</p> <p>C: Obligations for which there is an inadequate capacity to ensure timely repayment.</p> <p>D: Obligations which have a high risk of default or which are currently in default.</p> |

Notes:

1. PACRA's ratings are an assessment of the credit standing of entities in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors.
2. A plus (+) or minus (-) may be appended to a rating to denote relative status within major rating categories. Such suffixes are not added to the ‘AAA’ long-term rating category, to categories below ‘CCC’, or to short-term ratings.
3. PACRA's rating is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.