



Qualitative Rating Considerations Criteria Methodology

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Summary

This document provides an overview of how PACRA generally factors qualitative considerations into its rating analysis, insofar as they can impact an issuer's ability to meet financial obligations. This criteria framework applies to credit ratings in all sectors. In certain sectors, there may be some additional or unique considerations, which will be captured accordingly in the relevant sector-specific criteria.

This criteria framework focuses on principal qualitative factors underlying PACRA's analysis: Ownership, Governance, and Management. Additionally, PACRA considers Environmental and Social aspects while evaluating overall Governance framework. Incorporating the potential impact of these factors is essential for developing a forward-looking rating opinion. However, this can be challenging, as qualitative scores are generally inferred or estimated from information that is not standardized and is difficult to quantify. Consequently, some degree of subjectivity and analyst judgement is required, supplemented by PACRA's historical experience.

Analyst Contacts:

Momin Farooque
momin.farooque@pacra.com
+92 42 3586 9504

The Pakistan Credit Rating Agency:

Head Office

FB 1 Awami Complex
Usman Block, New Garden Town
Lahore
Phone: +92 42 3586 9504

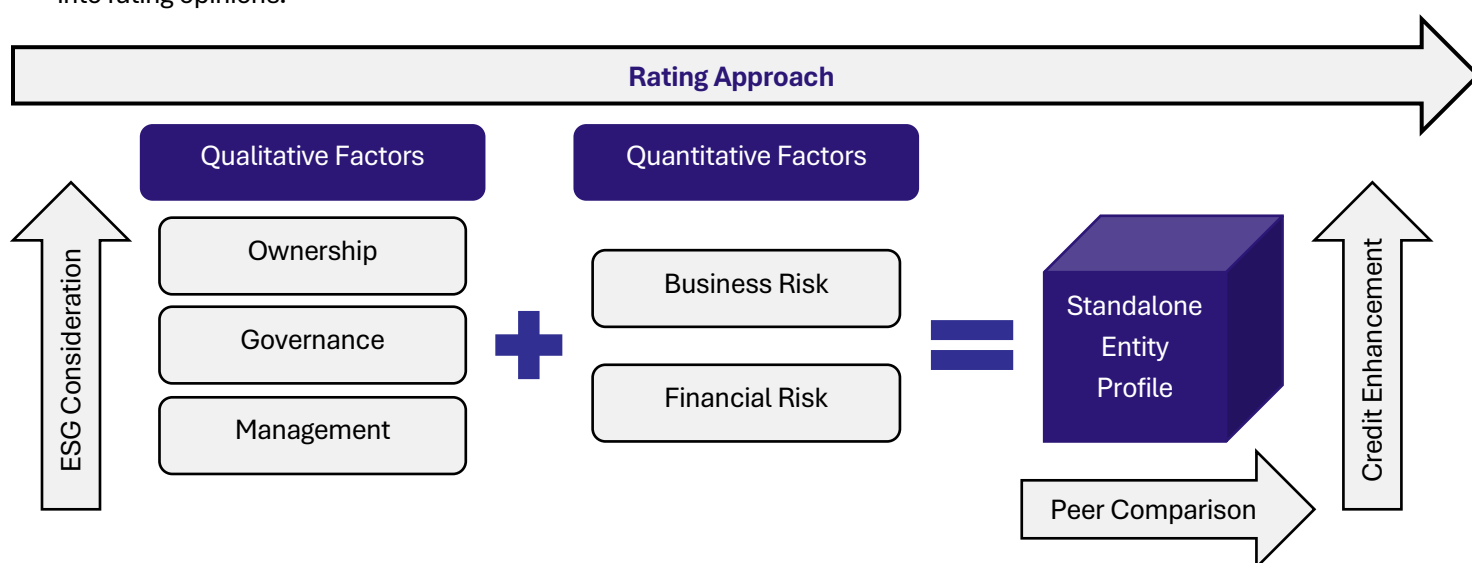
Karachi Office

PNSC Building, 3rd Floor
M.T. Khan Road, Lalazar
Karachi
Phone: +92 21 3563 2601

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Introduction

Credit ratings entail a comprehensive analysis of various quantitative and qualitative factors that can materially impact an entity's ability to honor its financial obligations. The quantitative factors help in achieving objectivity in the rating analysis while the qualitative factors help establish the sustainability of the rating in the foreseeable future. Neither can all factors be quantified, nor do quantitative metrics portray the complete picture. PACRA seeks to employ an optimal combination of both and applies this combination consistently to ensure comparability between ratings over time. This criteria framework is meant to provide an overview of how PACRA generally factors qualitative considerations into its analysis, insofar as they can impact an issuer's ability to meet financial obligations. Qualitative considerations refer to rating factors which do not pertain to an entity's business or financial risk; rather, they focus more on internal processes, people, and systems, and thus are essential to incorporate a forward-looking perspective into rating opinions.



Scope

These criteria discuss the general principles underpinning PACRA's qualitative analysis for assigning credit ratings in all sectors. The criteria also explain how these qualitative factors are accounted for in instances where they are not explicitly described within a sector-specific criteria. In certain cases, there may be some additional or unique considerations specific to particular sectors. In such cases, those considerations are captured in their relevant sector-specific methodologies.

The methodology primarily focuses on three principal factors underlying PACRA's qualitative analysis at an entity level: Ownership, Governance and Management. The underlying analysis is conducted in light of how these factors may individually, or jointly, impact the entity's ability to meet its financial obligations. Incorporating the potential impact of these factors into the rating opinion can be challenging because it is generally inferred or estimated based on information which may not be standardized and is difficult to quantify. This often requires some degree of subjectivity and judgement on part of the analyst, which is supplemented by PACRA's own experience, as well as the experience of the underlying entity or other entities with similar risks. The analysis is informed by both public and non-public information.

While qualitative considerations form an integral part of PACRA's rating analysis, PACRA completes its analysis after incorporating the relevant quantitative factors. This includes a detailed analysis of financial information, and is supplemented by ratio analysis and financial modelling. To arrive at the final entity rating, PACRA considers the entity's relative position among industry peers, and incorporates the availability of any credit enhancements. These may include third-party guarantees, potential for support from parent companies due to underlying legal, operational or strategic linkages

It is pertinent to note that, in some cases, downside risk posed by qualitative considerations may be considered greater than upside potential. For example, an entity with a track record of delayed or inaccurate financial statements is likely to be penalized for poor governance practices which challenge the quality and integrity of its reporting. Meanwhile, another entity maintaining timely and transparent financial disclosures may not see a comparable credit benefit. Thus, impact of certain rating considerations on the rating opinion is expectedly disproportionate. Furthermore, the relative significance of each factor may vary among entities. While robust system software and control environment may be crucial for a financial institution to avoid operational disruptions, security breaches and regulatory noncompliance, the same is unlikely to be as significant for a mid-sized manufacturing concern.

The criteria are segregated into three sections, each addressing the risks pertaining to each of the three broad categories of qualitative considerations: Ownership, Governance and Management. The scope of analysis for each category is briefly described below:

- **Ownership:** this section provides an overview of the risks pertaining to the structure and stability of the entity's ownership structure, owners' experience and prowess in the entity's industry, and willingness and ability to extend extraordinary financial support in distressful circumstances.
- **Governance:** this section provides an overview of the risks pertaining to the Board of Director's role in establishing a robust oversight and control framework to ensure appropriate management oversight, alignment between shareholder and management objectives, transparency in reporting and disclosures, and adherence to applicable regulatory requirements.
- **Management:** this section provides an overview of the risks pertaining to the management team's proficiency in executing strategy, maintaining strong information systems and utilizing the same for efficient decision making, and ensuring adherence to the entity's and other renowned ethical and quality standards.

Ownership



Ownership Structure

Identification of man at the last mile



Ownership Continuity

Succession planning at owner(s) level



Business Acumen

Knowledge, skills and experience of owner



Financial Strength

Willingness and ability of owner to provide financial support

Ownership Structure

Ownership structure is analyzed to determine i) direct or indirect ownership, ii) foreign or local ownership, iii) ownership by a single group or a combination of entities and individuals, and iv) whether or not the entity happens to be a part of a group rather than being a standalone operation. The primary objective of this analysis is to identify the man at the last mile, which is important for PACRA so that it may better comprehend the decision-making processes involved, the lines of hierarchy and the ultimate stakeholder of financial obligations. This analysis entails the following:

PACRA considers an asset manager's experience in the industry and favorably views asset managers with established track records of several years of navigating through market cycles, developing sound processes, and having well-nurtured expertise to offer asset management services.

- **Legal Status:** Legal status determines the level of expected stability of an entity. The level of perceived stability gradually increases from a sole proprietorship to a listed entity.
- **Shareholding Agreement:** Existence of shareholding agreements is a key consideration, particularly in case of family-owned businesses. PACRA also considers how an entity is actually run, as, at times, entities are run as family concerns despite being legally structured as companies.
- **Complexity:** PACRA recognizes that ownership structures can become increasingly complex as an entity grows in size and/or expands its operations. The aim here is to understand the underlying reason or motivation for the complexity in the structure.
- **Concentration:** Concentration of ownership in entities owned by private individuals and families may indicate that the owners have a vested interest in creating long-term value & closely monitoring performance. However, the owners might also rely heavily on extracting funds from the entity, as income, or perhaps as a mode of financing for other business activities. This, could potentially undermine the financial stability of an entity.

Ownership Succession

A very important part of our background analytical work is an attempt to assess whether, under right of succession, the entity's prospects would be supported and by whom. Hence, succession planning is a critical aspect of ownership analysis.

- **Documentation:** PACRA values formal documentation in this regard, such as transparent agreements and actionable succession plans, outlining mutually acceptable terms between owners to remove room for ambiguity and conflict. This is particularly relevant in case of family-owned businesses and joint ventures where fall out among owners can have serious implications for the survival of the entity.
- **Stability:** A stable ownership with clarity in succession, and perhaps major shareholding residing with one family or group, is considered positive for ratings. On the contrary, high free float (in case of listed concerns) leads to risk of take over and may anchor lower ratings. PACRA also assesses whether a track record of frequent changes in majority ownership exists, to form a view on stability in ownership.

Business Acumen

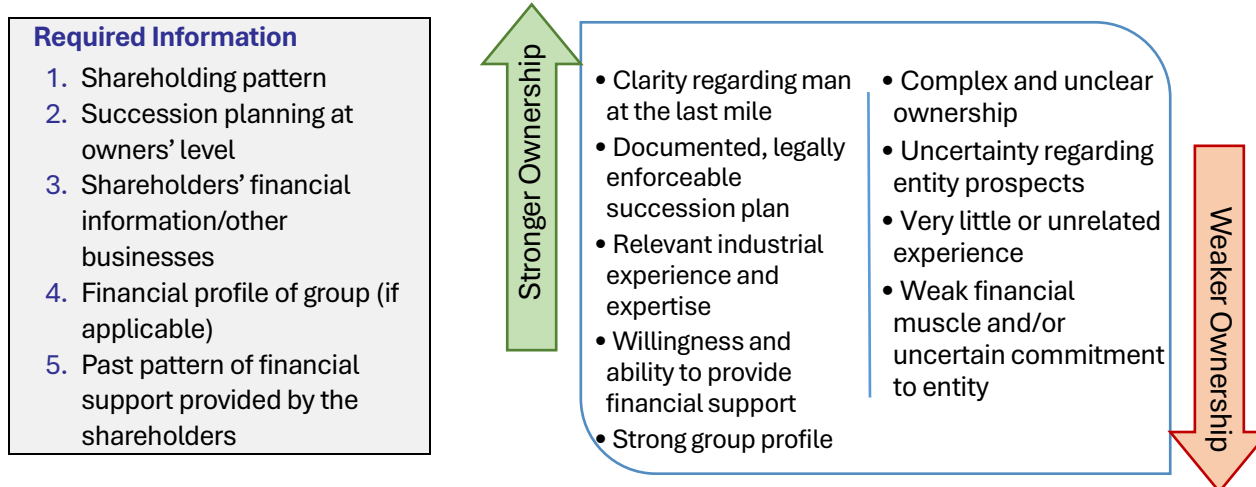
PACRA considers owners' business acumen critical for sustainable success of an entity. Business acumen is analyzed through two primary areas: i) industry-specific working knowledge, and ii) strategic thinking capability. Meanwhile, a

deep and applicable understanding of the business is critical in order to determine how a business achieves its goals and objectives. The scope includes an analysis and understanding of how the sponsors of the entity deliberate over and successfully make the right business decisions.

Financial Strength

PACRA analyzes the ability and willingness of major shareholders to support an entity in times of financial crisis. The standalone rating of an entity benefits from possessing a majority of shareholders endowed with exemplary financial muscle and overall commitment to the business. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. Support, in this context, refers strictly to financial support, rather than operational support. Here, PACRA looks at:

- Track record of timely and comprehensive support by the owner in times of need
- Prospective view of key shareholders, in case such need arises
- Other businesses of major shareholders to identify their resources outside the entity from where financial support could be derived
- Extent of integration between group companies and reputational risk, which could influence the group's commitment to supporting the entity
- Financial profile of parent group – If financial strength of the owners is deemed to be weaker than that of the entity itself, the entity may at some point be bound to extend financial support to its weaker parent, causing a drag on its own financial resources.
- Legal, business, operational and strategic linkages with owners which can influence the owners' willingness to support the entity (PACRA's approach towards this is covered comprehensively in its Parent and Subsidiary Rating Linkage Criteria).



Governance



Board Structure

Composition of board in terms of size, independence and committees



Member's Profile

Relevance and diversity of board members' skills, knowledge and experience



Board Effectiveness

Extent to which board properly discharges its responsibilities



Transparency

Quality of financial and non-financial disclosures

Board Structure

This comprises an analysis of the board based on various criteria including overall size, presence of independent members, ratio of independent directors, duration of board members' association with the entity, overall skill-mix and structure of board committees.

- **Board Size:** Size of the board may vary as per the scope and complexity of the operations of the entity. While a very small board is not considered good in terms of diversity and skill set optimization, similarly, reaching a decision in an effective and efficient manner may not be possible in case of a very large board.
- **Composition:** A healthy composition of board members includes a mix of executive and non-executive members and independent members having limited relationship with the sponsoring group of the entity. Meanwhile, the same individual holding chairman and CEO positions is considered weak governance practice. The chairman is expected to have a non-executive or independent role. PACRA also considers independence of governance practices from major shareholders.
- **Regulatory Compliance:** Compliance with regulatory requirements is applicable across this framework. Adherence to SECP's code of corporate governance is considered. Generally, compliance with applicable regulations is considered a bare minimum, while entities which strive to exceed regulatory requirements and align themselves with best industry and international practices are viewed positively.
- **Board Committees:** Committees in place to support the Board are evaluated in terms of their number, composition and reporting lines. A board with a higher number of members should have a higher number of committees in place to assist in the performance of its role. Meanwhile, having documented TORs for each committee, ensuring a high & regulatorily compliant frequency of committee meetings, and decent documentation of meeting minutes is, likewise, viewed positively.

Members' Profile

PACRA collects information regarding the profile and experience of each board member. This helps in forming an opinion about the overall quality of the board. A fair number of board members are expected to have relevant experience. However, diversity in terms of knowledge, background, experience and perspective is also viewed positively. Certain board committees may require specialized expertise, such as audit committees. Likewise, a greater proportion of Board members who have received directorship trainings is viewed positively.

Board Effectiveness

In PACRA's view, the role of the board is to work with the management in steering the entity to its performance objectives and to provide critical and impartial oversight towards management performance and the internal control environment. Major governance breaches can cause severe loss of confidence among investors and result in reputational and financial risk, including lack of accessibility to fresh funding and increased cost of financing. Thus, effectiveness of the Board is analyzed through:

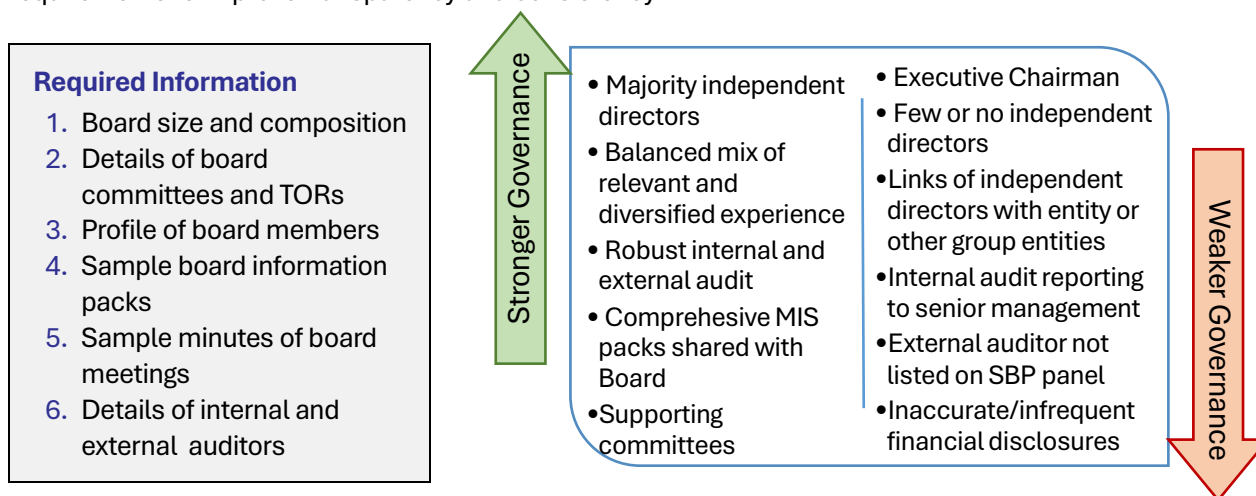
- **Information Sharing:** PACRA analyzes the type and extent of information shared with board members, and quality of discussions taking place at board and committee levels. Effective oversight requires frequent sharing of detailed information covering various aspects of business and market development.
- **Participation:** Number of board meetings held is expected to be commensurate to issues/matters arising. Board members' attendance and balanced participation in meetings is important, and is gauged by viewing board meeting minutes. PACRA also views how many directors hold directorships in other companies as an indicator of the time and commitment Board members' may depict in their role as a Board member of the underlying entity.
- **Oversight:** PACRA expects the Board to exhibit a healthy level of oversight and intervention without micromanagement. For this, it is essential that there be a clear distinction between management and Board members which is not always found, particularly in smaller companies. The Board's active role in monitoring of the company's defined goals and designing robust controls and policies is important rather than only acting as an approving authority.

Transparency

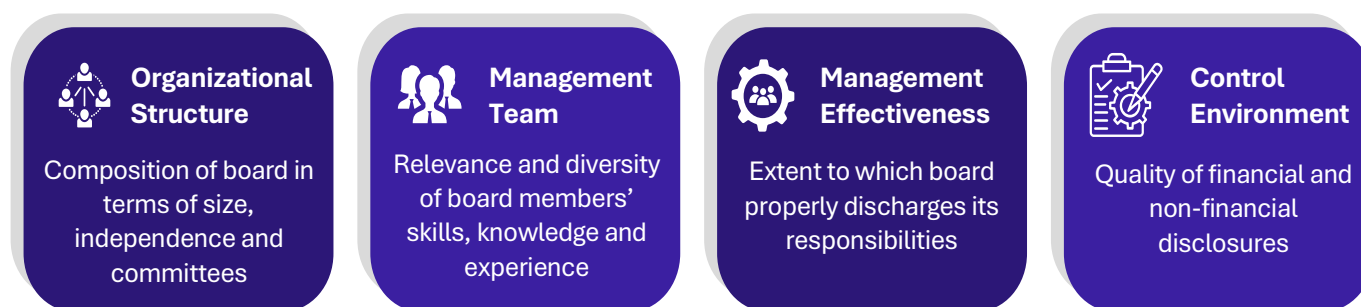
Quality of governance framework is also assessed through the controls designed by the board to ensure transparent monitoring and disclosures of financial and other relevant information. PACRA looks at:

- **Internal Audit:** PACRA assesses whether an internal audit function has been established, and whether it is in-house or outsourced. In PACRA's view, independence of the internal audit function is of paramount significance. From independence perspective, outsourced internal audit is considered best practice as third-party audit professionals are not beholden to the entity management for compensation and are less likely to evidence bias or influence. However, PACRA recognizes that there are certain restrictions surrounding outsourcing this function, particularly in case of certain financial institutions. Furthermore, limited communication with entity management and lack of ground-level knowledge of its operations (especially in specialized sectors), can compromise the effectiveness of the function. In-house audit functions are expected to report to the audit committee. Experience, relevant qualifications, & independence of the head of the function coupled with the adequacy of the function's staffing and the quality of internal audit reports are also assessed as part of this framework.
- **External Audit:** PACRA considers the quality of the external auditor to be reflective of the accuracy and integrity of the entity's financial statements. PACRA examines whether external auditor is listed on the State Bank of Pakistan's panel of auditors and/or has a satisfactory QCR rating.

- **Quality of Disclosures:** Disclosures pertaining to financial statements, off-balance sheet items, related party transactions and other information relevant to shareholders, are assessed. Quality of financial reporting is gauged through adherence to accounting standards, comprehensiveness of notes to accounts and auditors' comments. High quality disclosures should be timely, comprehensive, and go beyond minimum regulatory requirements to improve transparency and consistency.



Management



Organizational Structure

PACRA's analysis of the organizational structure focuses on how the AMC is organized while keeping in view the scope of its operations and the diversity of its product base. PACRA believes that departments should be structured in an AMC while keeping in view the segregation of duties and the importance of the functions to be performed. In this respect, functional separation of the front office from the middle and/or back offices is considered important. Furthermore, it is key for PACRA that the risk management function of the AMC is separate and independent.

Management Team

PACRA's evaluation of human resources is based on an objective criterion that focuses on the background of management and staff both individually and collectively. Assessment is based on the years of relevant work experience, prior track record, and tenure with the AMC. Similarly, for digital AMC's management team is evaluated and more attention is paid to their experience in digital services. Each functional area is covered, including portfolio management, risk management, investment research, sales and distribution, marketing, internal audit, and

compliance. Loss of key personnel, particularly members of senior management and senior portfolio managers, can have potentially adverse effects on the performance of funds under management and the overall standing of the AMC relative to peers. Hence, human resource turnover is reviewed to determine the stability of critical staff, with a particular focus on key departments. In addition, the AMC's human resource policies are also reviewed to gauge its emphasis on retaining and recruiting vital staff members, and ensuring their redundancy in the structure. It is important for AMCs to ensure adequate knowledge and training of staff/employees when dealing with clients, potential clients, or managing client portfolios and assets.

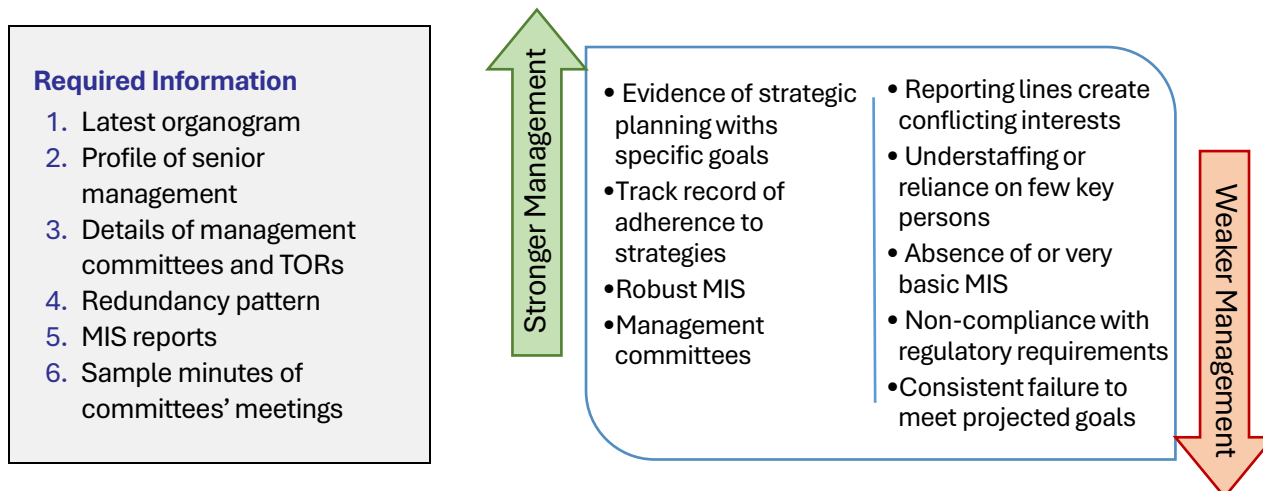
Management Effectiveness

Optimum portfolio management requires adequate technological resources, provided by the parent AMC, an affiliate, and/or an external third party (e.g., vendors). The most critical IT resources are portfolio management and order management systems. Various features of the portfolio management system are explored including its robustness, coverage of instruments, time delay before transactions are entered, timeliness and accuracy of portfolio pricing, and ability to monitor value-added indicators and order simulation. PACRA assesses the quality and reliability of the order management process in terms of systems and procedures to ensure the security, timeliness, and fair handling of multiple transactions. Electronic ordering and order confirmation also add value and security, notably when trading is a risk. The integration of custodians and fund administrators within the systems is also cautioned. PACRA places high value on management information systems (MIS) - system-generated MIS reports are considered superior. Another key measure of management effectiveness is the management's track record of delivering on past projections and sticking to strategies.

Control Environment

An analysis of the overall Compliance and Internal Control framework (including Internal Audit procedures) of the AMC helps in identifying the procedures, control centers, and reporting lines in order to manage conflicts of interest, meet fiduciary responsibilities, and verify the accuracy of financial and accounting information prepared for unit-holders and other stakeholders. This analysis would assess the strength of the overall compliance and control environment beyond regulatory requirements. Positive factors for AMC rating include having well-documented and comprehensive internal policies overseeing: investment, risk management, segregation of duties, the information barriers between various functions of the internal audit, safeguarding (cybersecurity) of the flow of sensitive information within the company (by establishing necessary firewalls) along with having a structured internal control program. The compliance function is evaluated on an enterprise-wide basis. More value would be given to the independence of the compliance function and its integration into the overall systems of the AMC.

In the case of digital AMC, the reliability of digital infrastructure is critical. Therefore, for digital AMCs, PACRA pays more attention to core software deployed, frontend and back-end applications, vendor details for software services, user interface and channels used by the customers, in-house development capabilities, system back-up and business continuity plan and measures taken for data security. Similarly, risk management mechanisms and controls established are examined.



Environmental, Social, and Governance (ESG) Considerations

Global focus on Environmental, Social and Governance (“ESG”) considerations is increasing rapidly, with over one-third of global assets under management now invested in ESG assets. This section outlines how PACRA incorporates ESG concerns into its credit risk analysis. Since Governance has been discussed in detail in Section 2 above, this section primarily addresses PACRA’s analysis of Environmental (E) and Social (S) risks which can materially impact an entity’s credit profile.

ESG awareness in South Asia is lagging compared to Europe and North America. In Pakistan, ESG concerns are not yet at the forefront of consideration between investors and lender. However, PACRA expects this to change, going forward, if benefits start materializing in the form of avoiding regulatory penalties, attracting foreign investment and foreign borrowing, enhancing competitiveness, and building long-term sustainable relations with ever more aware consumers and other stakeholders. Businesses with global operations and those looking to access global capital markets are expected to be impacted earlier even as ESG becomes mainstream in the local context.

ESG disclosures are at a nascent stage in Pakistan. However, the SECP has initiated regulatory tightening in regards to ESG practices, with significant amendments in the Corporate Code of Governance emphasizing on the promotion of, ESG and diversity, equity, and inclusion (DE&I) practices, along with mandating some practices as well. Moreover, the SECP has mandated the adoption of IFRS Sustainability Disclosure Standards among the larger listed companies starting July 2025, and shall extend this mandate onto smaller listed companies and select unlisted public interest companies in subsequent years. That said, as in all cases, PACRA would use the best information available to it to make its decision and thus, when available, would make use of published sustainability reports of companies. PACRA will assess the impact of E&S factors on the credit risk profiles of entities based on the materiality of these considerations in each case, and factor it into the rating opinion accordingly. While evaluating the E&S risks, PACRA will focus on immediate or near-term risks and assess whether the entity has a plan in place to mitigate them.

Conclusion

PACRA endeavors to incorporate all aspects of strategic, financial and operational risks which can impact an entity’s ability to meet financial obligations. To this end, the qualitative considerations discussed in this document are a crucial element of rating opinion formation. Their potential to impact an entity’s capacity to honor its financial obligations can

become a limiting factor, particularly in higher rating categories. This may be if, in PACRA's opinion, the people, processes and systems running the entity allow or encourage excessive risk taking, inadequate controls or misinformed decision making.

Some weaknesses/challenges on the qualitative side may become more obvious upon occurrence of certain events such as the sudden departure of a director or auditor, a qualified audit report, regulatory action, or sudden change in majority ownership. However, PACRA recognizes that interaction of owners, directors and management with the entity is largely hidden from view. This is precisely why site visits and management meetings are key components of PACRA's rating process. The underlying objective is to meet the people behind the scenes to discuss their vision, strategy and long-term business and financial outlook. It also allows PACRA to develop a ground level understanding of entity operations and incorporate important non-public information into the rating analysis. This becomes an important step in reaching forward-looking rating opinions.

While scarce availability of standardized data is one obstacle when factoring in qualitative rating considerations, what can make the process more challenging is the uncertainty surrounding the timing and magnitude of the impact of such risks. In this regard, PACRA recognizes and appreciates the need for analyst judgement in its analysis to avoid overreliance on formula-based or quantitative metrics risks which can make the analytical process artificially mechanistic. PACRA places great value on enhancing transparency and consistency in its rating criteria and methodologies and will continue to share insights on its analytical and monitoring standards in the best interests of all market participants.