The Pakistan Credit Rating Agency

Non-Banking Finance Companies (NBFCs) Rating Criteria

Methodology

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Summary

PACRA's methodology documents lay out the umbrella frameworks guiding its credit ratings. This document provides an overview of PACRA's approach to assigning credit ratings to Non-Banking Finance Companies (NBFCs). PACRA arrives at this opinion by conducting a detailed evaluation of several qualitative and quantitative factors, namely: Profile, Ownership, Governance, Management, Business Risk, and Financial Risk. The relative importance of each of these qualitative and quantitative criteria can vary across sectors depending on their potential to impact the overall risk profile of the NBFC. While standalone credit quality is addressed, PACRA incorporates the relative positioning of an NBFC to arrive at the final credit rating.

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Introduction

Scope

Non-banking finance companies (NBFCs) are an important part of the financial system. The operations of most NBFCs are not that different to those of banking companies in the local environment. Traditionally, NBFCs used to have a separate space to operate. However, as the concept of universal banking gained momentum, the distinction between NBFCs and banks became blurred. This entailed a highly competitive business environment for NBFCs, and thus created greater impediments for growth. The key difference between banks and NBFCs is that NBFCs cannot offer check-in deposit accounts in Pakistan. NBFCs, as defined in Companies Ordinance (1984), and Non-banking Finance Companies and Notified Entities Regulation (2008), include companies that offer either leasing, investment finance (including non-bank microfinance companies), housing finance, venture capital, discounting, investment advisory, or asset management services. This methodology particularly covers leasing companies, housing finance companies, and investment finance companies. Modarabas carry similar risk factors to other NBFCs. Hence this methodology is applicable to them.

PACRA caters to non-bank microfinance companies (NBMFCs), asset management companies (AMCs), and investment advisors (IAs) through their respective methodologies[1]. Securities and Exchange Commission of Pakistan (SECP) has been acting as the sector regulator for NBFCs since FY03 – the year when a comprehensive regulatory framework was designed. Modarabas are covered under a separate law issued by SECP in 2021 titled Modaraba Regulations, 2021. Digital lending NBFCs are also regulated under the non-banking finance companies and notified entities regulations of 2008. These include entities such as EduFi Financial Services, Abhi, and Finja Lending Services, which would also be evaluated and rated in accordance with this methodology.

The services that an NBFC can offer are linked with the license it acquires subject to fulfilling regulatory capital and other requirements. A single NBFC may acquire multiple licenses such as investment finance, leasing, digital lending, and housing finance. An entity with more than one license has greater ability to diversify its operations, however the added related risks must be managed accordingly.

Rating Framework

PACRA bases its analysis of NBFCs on a number of quantitative and qualitative factors. Overall factors are categorized under six key areas: profile, ownership, governance, management, business risk, and financial risk. No single factor has an overriding importance or is considered in isolation. All factors are reviewed in conjunction. Quantitative factors help in achieving objectivity in the rating process while the qualitative side helps in establishing the sustainability of the relevant factors in the foreseeable future. Neither all factors can be quantified, nor do quantitative values portray the whole story. PACRA, therefore, seeks to employ a best combination of both to ensure comparability between ratings over time.

While PACRA's rating process does not include an audit of an NBFC's financial statements, it does examine the control environment to establish extent to which the financial statements accurately reflect an NBFC's financial performance and balance sheet integrity. PACRA makes adjustments where necessary to make an NBFC's financial data

[1] Methodologies: Microfinance Institution Rating , Asset Manager Rating , and Investment Advisory Rating

comparable to those of its peers. In order to carry out adequate analysis of a particular NBFC, it is helpful to establish a "peer group" of comparable NBFCs. Short-term and long- term ratings are based on an NBFC's fundamental credit characteristics, a correlation exists between them (see PACRA's correlation between long-term and short term ratings document[2]).

Digital NBFCs: *All digital or traditional NBFCs must obtain an NBFC license by fulfilling the minimum requirements which depend upon the form of the business. Additionally, a digital NBFC is required to disclose the digital nature and the extent of its digital activity upon obtaining its license. PACRA's NBFC methodology is also applicable to digital NBFCs, incorporating additional considerations specific to their digital operations to comprehensively capture the unique risk profile associated with digital business models.*

Profile

Background

PACRA reviews the background of an NBFC to understand its evolution from where it started to where it currently stands. PACRA analyzes how and through what means the NBFC has achieved the desired expansion. PACRA looks at the progress of the NBFC from its historical past, which helps determine the ability of the NBFC to successfully realize its strategy. The significant factor here for PACRA is to assess whether the NBFC has achieved the desired expansion through organic growth or acquisitions. Meanwhile, the source of funding for desired growth is also critical.

Operations

The assessment of operations of an NBFC depends on the scale of business segments and the stage the business is in. Here PACRA reviews the diversity, geographic spread of operations, product offering, asset mix, borrower profile, size of the franchise/portfolio, and track record of operations. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position. Unlike their banking brethren, NBFCs are often subject to less stringent regulations. Despite this, NBFCs typically must comply with various mandatory lending or licensing regulations. Furthermore, in case of digital only NBFC particularly, PACRA evaluates the quality of the application/platform, front-end and back-end applications, customer experience and control mechanisms in place.

Qualitative Factors

Qualitative assessment helps in establishing the sustainability of the credit rating in the foreseeable future. Qualitative considerations here 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; thus, it is essential to incorporate a forward-looking perspective into rating opinions. This section is meant to provide a brief overview of how PACRA generally factors qualitative considerations into its assessment, insofar as they can impact an issuer's ability to meet financial obligations. PACRA's detailed approach undertaken to conduct this analysis is documented in its qualitative rating considerations methodology[3].

[2] Methodology: Correlation between Short-term and Long-term Rating Scale
[3] Methodology: Qualitative Rating Considerations

Incorporating the potential impact of qualitative considerations 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 analyst judgement, supplemented by PACRA's own experience, and the experience of the underlying entity or other entities with similar risks. Three factors underlying PACRA's qualitative analysis at entity level include: ownership, governance, and management (which includes the risk management framework). The scope of analysis for each category is briefly described below.

Qualitative Rating Factors		
Ownership	**Governance**	**Management**
1. Ownership Structure	1. Board's Structure	1. Organizational Structure
2. Stability	2. Member's Profile	2. Management Team
3. Business Acumen	3. Board Effectiveness	3. Management Effectiveness
4. Financial Strength	4. Transparency	4. Risk Management Framework

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. In case of newly established or small financial institutions where capitalization requirements are yet to be met, PACRA critically analyses the willingness and ability of the sponsors to support the institution to comply with the applicable regulatory requirements within required timeframes. In the case of digital lenders, regulatory requirements and owners' experience in the domain is looked at to ascertain their ability to provide strategic guidance for the entity. Any synergies that may exist between owner's other ventures and the digital bank and their eventual impact is also considered.

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. Moreover, for digital lenders, it is vital to evaluate the Board's ability to integrate the required technologies and ensure effective governance.

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 them for efficient decision making, and ensuring adherence to the entity's ethical and quality standards. For digital lenders, the management team's ability to leverage tools for effective service delivery is also pertinent.

Risk Management Framework/Control Environment

This includes an analysis of the NBFC's appetite for risk and the systems in place to manage these risks. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits that have been implemented, the limits setting authority, and the degree to which these procedures are adhered to. PACRA endeavors to assess an NBFC's senior management's understanding of, and involvement in, risk management issues and examine the reporting lines in place. In recent years, there has been a noticeable upgradation in the risk management systems of the NBFC in the face of increasing guidance and supervision from the SECP. For a digital NBFC, PACRA also looks at the cyber security checks and in general adherence with the SECP's digital lending guidelines (Circulars 8,12, and 14).

Quantitative Factors

Business Risk	Financial Risk
1. Industry Dynamics	1. Credit Risk
2. Relative position	2. Market Risk
3. Revenues	3. Liquidity and Funding
4. Cost Structure	4. Capital Structure
5. Sustainability	

Business Risk

Industry Dynamics

The process for anchoring a credit rating of an NBFC builds on PACRA's understanding of the industry dynamics of specific segments that the NBFC is operating in. This understanding, which follows an in-depth research approach, is documented as a sector study. The analysis captures the placement of the local industry in the international context to see the points of identity and distinction. In points of identity, the risks and challenges identified for the international players are re-evaluated for the local players, with a view to see whether the local players have established effective mitigants against those risks and taken due measures to meet the challenges. At the same time, PACRA identifies the risks and challenges specific to the local context of the industry. While conducting the analysis, PACRA takes a view on the industry alone, independent of the market players. This exercise helps to form a view on the industry's significance in the economic environment of the country, the regulatory environment, and the likely support, if needed.

PACRA explores the possible risks and opportunities for an NBFC that result from social, demographic, regulatory, and technological changes, including any interplay these factors have among each other. For instance, the recent regulatory changes with regards to digital financial services offered by NBFCs offer opportunities to grow but at the same time, has created tough competition and stricter regulatory compliance. Moreover, it considers the effects of geographical diversification and trends in industry expansion or consolidation required to maintain a competitive position. The analysis includes the role of the supervisory authority, its supervision of regulated entities, reporting requirements, and regulations relating to specific type of institutions and to specific financial products.

Economic Risk: *PACRA analyzes basic economic indicators of the country including size and composition of economy, performance of important sectors, gross domestic product (GDP) growth, inflation, saving & investment trends, and potential demand for credit. An important part of the economic analysis is the positioning of the industry and impact assessment of economic risk factors on the industry.*

Regulatory Environment: *A well-regulated and supervised system is pivotal for credibility and stability of NBFCs even when the operating environment may become unfavorable. PACRA's evaluation of the regulatory system involves evaluation of criterion related to capital and other countercyclical measures to absorb risk and the extent of regulatory supervision and changes in response to the macro environment and prospective regulatory changes.*

Relative Position

Relative position reflects the standing of the NBFC in the related market. The stronger this standing is, the stronger is the NBFC's ability to sustain pressures on its business volumes and profit margins. The standing takes support from three major factors, which include market share, growth trends, and franchise/brand value.

Market Share: *Market share represents the NBFC's penetration in the chosen market. Market share is advantageous as it provides ability to acquire larger business, pricing power, and better expense management. There is a positive correlation between an NBFC's absolute and relative size, and its market position and brand value. The large entities exercise greater power over the pricing, while ensuring commensurate profits. Small entities struggle to obtain business; and with less flexibility in their cost structure, profits remain low. While absolute size is important, it is basically the relative proportion which provides a clear yardstick to analyze the comparative strength of the market players. The more distant a player is from the average on the positive side, the stronger is its ability to reflect the characteristics just mentioned. In a dynamic industry, which is not characterized by concentration, PACRA believes that relative size would better capture the strength of the NBFC's standing in the related market.*

Growth Trend: *While evaluating the size, PACRA looks at the rate of growth. Growth is important as it ensures that the NBFC continues to have the ability to meet the industry's benchmarks. As the industry grows, it uplifts the scale of its operational context. This reflects in the ability of the players to invest in human resource, upgrade the control environment, enhance the product slate, increase the outreach and improve the quality of product/service. To lag the industry's growth trend means to remain short on these avenues, putting pressure on the market position.*

Franchise/Brand Value: *The strength of a franchise determines its capacity to grow while maintaining a reasonable cost-to-income ratio and profitability, thus providing resilience to earnings. PACRA evaluates the franchise strength in terms of scale of operations and market share for various activities, performance and strengths relative to competition, complexity of key segments, diversification across various performance metrics such as branches, advances, liabilities, sources of other income etc., and access to special Government support or privileges - if it exists. A strong franchise is expected to result in a granular asset and liability base. PACRA also considers the brand recognition and life of the NFBC for its franchise strength analysis.*

Revenues

In most NBFCs, interest income is largely skewed towards income from advances, whilst income from investment book varies significantly across NBFCs, mostly making up only a fraction of revenue. An NBFC's core revenues emanate from interest or profit on advances, interest or profit on fixed income investment or government securities, and dividends or gains (both realized and unrealized) on investments. NBFCs vary across asset segments, namely vehicle finance, equipment finance, running finance, mortgage loans, and microfinance. PACRA forms an opinion on product riskiness by evaluating prevailing operating environment, historical and recent trends, granularity, and strength of the loan security. In measuring revenue quality of an NBFC, diversification and stability are very important factors.

An NBFC with a diverse product slate with more than one revenue streams is considered better than an NBFC with a concentrated earning profile.

PACRA sees concentration at product, customer, and geographic levels. In addition, the analysis of target markets to which an NBFC serves forms a part of the assessment. Stability is measured through historical trend analysis of the NBFC's revenues and is considered critical for sustainability of the NBFC. PACRA also assesses the NBFC's ability to generate income from other sources including fees, commission, and advisory, among other services. NBFCs that rely more on generating income from risky business lines like trading activities will typically display more volatile revenue trends.

Diversification: *Diversification is desirable since it enhances an entity's ability to meet present and upcoming challenges. Lack of diversification gives rise to concentration risk, reflecting vulnerability of the NBFC to few elements. At the same time, diversification reduced the risk of disruption in the area of revenue concentration. This does not entail that an entity specializing in a certain product/segment would necessarily be at a disadvantage. The disadvantage would only arise if the institution's business gives rise to concentration risk. At the same time, diversification into riskier segments may not improve resilience and, therefore, may not translate into superior ratings. In assessing diversification, common factors include loan mix, portfolio granularity, sectoral mix, share of domestic and overseas exposure, and borrower profile. Meanwhile, diverse geographical presence bolsters competitive position as it could offset the credit risks arising from unfavorable regional developments.*

Non-Mark-Up Income: *Non-interest income from fees, service charges, commissions, and foreign exchange income may also be an important source of revenue. PACRA views earnings profiles comprised primarily of interest income favorably given the relative stability of this income stream. However, PACRA also assesses the NBFC's ability to complement its interest income with fee income. A large fee income allows greater diversification which can improve NBFC's resilience of earnings and earning profile.*

Cost Structure

Cost structure is analyzed for the amount of flexibility provided when market conditions are less favorable. In this regard, PACRA considers how much of the cost base is variable. PACRA also evaluates the NBFC's performance ratios relative to those of its peers to understand whether costs have been contained while assets and revenue grew. If expense ratios are high, it could be an indicator that the NBFC has a significant fixed cost burden. In this context, key measure that PACRA looks at is the (Non-Mark-Up Expenses/Total Income) ratio. Whereas, non-markup expenses comprise of Personnel expenses, Other non-interest expenses (including legal & professional charges and rent, taxes, insurance, etc.). Performance measures are not assessed in isolation as there may be variations that are caused by business model differences and the importance of ongoing investment in the NBFC's franchise. A low-cost base relative to peers offers the NBFC greater flexibility to deal with competitive pricing pressures.

Performance: *While evaluating the NBFC's ability to convert its earnings into profits, efficiency ratios such as cost-to-total net revenue, are considered. The drag of provisioning expense is incorporated to see the level of pre-tax profitability for the current as well as future periods. Where necessary in its ratings analysis, PACRA makes adjustments to the NBFC's reported income statement figures, so that financial performance indicators are comparable across similar entities. The future profitability of an NBFC is evaluated by analyzing its interest spreads (yields minus cost of funds) and its interest rate risk as both could impact profitability. PACRA analyses NBFC's* *assets and its performance through business cycles. Either higher dependence on one asset segment, or high share of unsecured lending to borrowers with limited credit history is considered risky as any unforeseen changes in business or operating environment could impact the earnings performance.*

Event Risk

Incorporating the risk of unforeseen events into an NBFC's rating opinion is challenging - given their unpredictable nature. These events may be driven externally (e.g., M&As, regulatory changes, litigations, natural disasters, etc.) or internally (e.g., unrelated diversification, or strategic restructuring) and can lead to substantial rating changes. PACRA applies its analytical judgment in assessing the likelihood of such occurrences and their potential impact, insofar as may be possible, and assesses the NBFC's track record, expertise of management team, and level of financial discipline to incorporate the same into its ratings.

Sustainability

Earning prospects are also monitored based on budgets and forecasts prepared by the NBFC. A reality check is performed while analyzing underlying assumption taken by the management as well as management's track record in providing reliable budgets and forecasts. The macroeconomic profile is used to gauge the sustainability, the sovereign's susceptibility to event risk, including political risk, the government's liquidity risk, and the risk of external events such as foreign-exchange shocks, and has a significant bearing on the vulnerabilities of its NBFCs. Additionally, ESG considerations, particularly pertaining to environmental, and social risks, are evaluated to ensure a comprehensive assessment of long-term sustainability.

Business Risk – Key Ratios	
Revenues	•Advances Yield (%) •Deposits/Borrowings Cost (%) •Core Spread (%) •Net Mark Up Income/Total Income (%)
Earnings	•Return on Average Equity (%) •Return on Average Assets (%) •Non-Mark Up Expenses/Total Income (%) •Personnel Expense/Total Income (%)
Relative Position	•Number of branches •Total Advances/Sector's Total Advances (%)

Information Required on Business Risk

- Financial statements of the NBFC for the last three years and latest four quarters Profile of senior management
- Current capacity utilization of the plant and its trend for next three years
- Breakup of the geographic sales
- Marketing and distribution network
- Market share (%) along with marketing strategy
- Top 20 performing advances

Financial Risk

Credit Risk

Importance of credit risk is significantly more in case of lending institutions including investment finance companies, housing finance companies, leasing companies, and modarabas, because of the generally second tier client base of these institutions (as compared to commercial banks' borrowers). Credit risk can arise from both on- and off-balance sheet business of the NBFC. On-balance sheet credit risk can materialize from loans, investment in fixed-income securities, and inter-bank deposits. Off-balance sheet credit risk includes non-performance of the counter party on the guarantees issued by the NBFC. Out of entities covered in this section, generally investment finance companies expose themselves to off-balance sheet risk factors. PACRA analyzes both risks in similar manner, however, as the quantum of risk taken on from on-balance sheet business is higher, particular emphasis is placed on it. Moreover, investments in fixed income securities of private corporates are considered part of the overall financing portfolio for the purpose of credit risk analysis. This is because of their nature, which is very much similar to the financing operations of NBFC.

Credit risk analysis includes review of credit portfolio at all levels. The portfolio is evaluated to calculate market share, analyze type of counter party (consumer, SME, or corporate etc.), and product mix in terms of secured and unsecured. Meanwhile, concentration level is given high importance. Concentration is assessed at all levels including sectoral exposure, borrowers, and type of products. The level of concentration is considered to have a positive correlation with the degree of risk, i.e., the higher the concentration, more risk the portfolio carries. Thus, high level of diversification can shield NBFCs from the impact of downturn in any single segment. Moreover, diversification into riskier segments does not necessarily provide any help to improve the risk profile of the portfolio; it may negatively impact the ratings.

Asset Quality: *Assessing quality of assets is an important pillar of credit risk. The portfolio is analyzed with respect to size of the exposure, mainly top 20 exposures, and sectoral division. In addition, watch-list accounts and sectors that are still performing, and non-performing accounts are reviewed to analyze the current asset quality as well as future impact of any expected delinquencies on the overall quality of the portfolio. Post delinquency, the level of reserves maintained for provisioning requirements is considered important. Meanwhile, asset quality is assessed using both absolute and relative criteria, and where applicable, ratios are compared with the peers. Quality of fixed income securities portfolio is measured. In addition to the size of the exposures, the business dynamics of the sector relating to the counterparty and security structure of the instrument is given due credence. Similarly, other exposures are analyzed on the basis of nature, size, and credit worthiness of the counterparty.*

PACRA also observes the quality of the collateral available against the NBFC's financing facilities. Here the point of emphasis is to bifurcate between clean lending portfolio and collateralized portfolio. PACRA also ascertains the *quality of collateral in terms of type of charge, marketability and recoverability prospects, while keeping in view applicable regulations.*

Market Risk

Many of the NBFC's, in addition to regulatory investments (applicable to deposit taking entities), maintain their own investment portfolio. This may comprise investments in fixed income securities, government papers, and direct exposure to equity markets. PACRA evaluates market risk with particular emphasis on the trading book of the NBFC. While potential losses lying on the balance sheet that are yet to materialize stand as a risk of drag on performance of the NBFC, any available unrealized gain on investments held for sale is considered as a cushion to unforeseen losses that may arise due to price movements.

Liquidity and Funding

NBFCs are classified into two main segments for funding and liquidity assessment, which include NBFCs that finance their assets through either deposits or borrowings from NBFCs, or a combination of both, and NBFCs that meet their requirement either from internal sources (equity) and/or from shareholder loans.

In case of the first kind of NBFCs, PACRA's analysis includes identifying any marked concentration in deposit base and/or borrowings, as well as identifying significant trends in funding sources. Composition of the deposit base is analyzed in terms of tenor and pricing of deposits – the maturity profile of liabilities is seen in tandem with related asset base to analyze liquidity profile, fixed rate vs floating rate – this has direct implications on business margins in case of mismatch with assets, and retail vs institutional – retail deposits are considered sticky as compared to institutional deposit. While the concentration level in funding base is analyzed, due importance is given to liquidity management. PACRA believes higher asset turnover as compared to liabilities is good for liquidity management.

In the second case, where the assets are financed from equity, sufficiency of free capital available to the NBFC is assessed as discussed in Capital Adequacy section. While in case of shareholder loans, the terms of the loan, repayment flexibility, and the NBFC's plan to meet the repayment terms are analyzed.

Capital Structure

PACRA evaluates an NBFC's capitalization as a cushion to absorb unreserved losses. These include impact of foreseeable future business losses, if any, and expected level of provisioning on bad loans and non-performing investments.

While analyzing capital, PACRA excludes the amount that is tied up in fixed assets and, where applicable, any strategic investments from available capital to assess the adequacy and sufficiency of equity of the NBFC. PACRA also assesses the ability of the company to generate capital from internal sources. Meanwhile, dividend payout policy is considered important to evaluate as it may have a significant bearing on potential capital formation rate. Additionally, PACRA gives dues consideration to compliance with regulatory requirements.

Credit Enhancement: *The NBFC that carries a third-party commitment to make good on an amount obligated to the lenders may provide additional support to its financial risk profile. In this case of determining the impact on a rating, key factors to assess are the financial profile of the third party and the extent of coverage – quantum and duration – it provides.*

Information Required on Financial Risk

- Top 20 performing private group exposure
- Statement of credit exposure by type of security
- Latest internal risk ratings of Facilities obligators
- Party wise detail of classified loan portfolio
- Latest statement of marginal/watchlist accounts
- Details of funding lines and repayment pattern

Financial Risk – Key Ratios

Credit Risk	•Top 20 Advances / Total Finances (%) •Non-Performing Advances / Gross Advances (%) •Non-Performing Advances / Equity (%) •Gross Finances / Funding (%)
Market Risk	•Government Securities / Investments (%) •Investments / Equity (%) •(Investments + Debt Instruments) / Total Assets (%)
Liquidity and Funding	•Liquid Assets / Funding (%) •Advances / Deposits (%) •Top 20 Deposits / Deposits (%) •Short Term Funding / Funding (%)
Capitalization	•Equity / Total Assets (%) •Total Debt / Equity (%)

Key Risks

Credit Risk

- Asset quality Indicators: Primary tool to assess the level of risk being taken.
- These indicators are viewed in the context of returns achieved
- Credit risk management is assessed to determine how the risk return equation evolve in different phases of financial instituions business cycle.

Market Risk

- Asset and liabilities management strategy is reviewed.
- Board and management policy limits, typically expressed as earnings at risk, are evaluated along with reports from management systems.
- Market risk on its own may not be a rating driver. However, poor market risk management or aggressive market risk-taking without mitigants would likely pressurize an institution's ratings.

Operational Risk

- Operational Risk analysis include,
- Financial institution's definition of such risk,
- The quality of its organizational structure,
- Operational risk culture,
- Approach to the identification and assessment of key risks
- Data collection efforts, and
- Overall approach to operational risk quantification and management.

Reputational and other Risks

- May emanate from operational problems or failure in any risk management systems
- Results in withdrawl of deposits in case of strain on reputation.
- Difficult to evaluate but could adversely affect an institution's rating in cases where it is significant.
- Any regulatory non-compliance may lead to potential legal ramifications as well.

Credit Rating

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

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

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

Rating Modifiers | Rating Actions

Outlook (Stable, Positive, Negative, Developing)	Rating Watch	Suspension	Withdrawn	Harmonization
Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business / financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.	Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.	It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.	A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveil the opinion due to lack of requisite information.	A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening. Rating actions may include "maintain", "upgrade", or "downgrade".

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

a) Broker Entity Rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) Independent Power Producer Rating
g) Microfinance Institution Rating
h) Non-Banking Finance Company