The Pakistan Credit Rating Agency Limited

Qualitative Rating Considerations Criteria

Methodology

Table of Contents

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, Management. PACRA also looks at 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. At the same time, it 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 historical experience.

Analyst Contacts
Khurrum Amjad
+92-42-3586 9504
khurrum.amjad@pacra.com

The Pakistan Credit Rating Agency Limited
Head Office
FB1 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 35632601

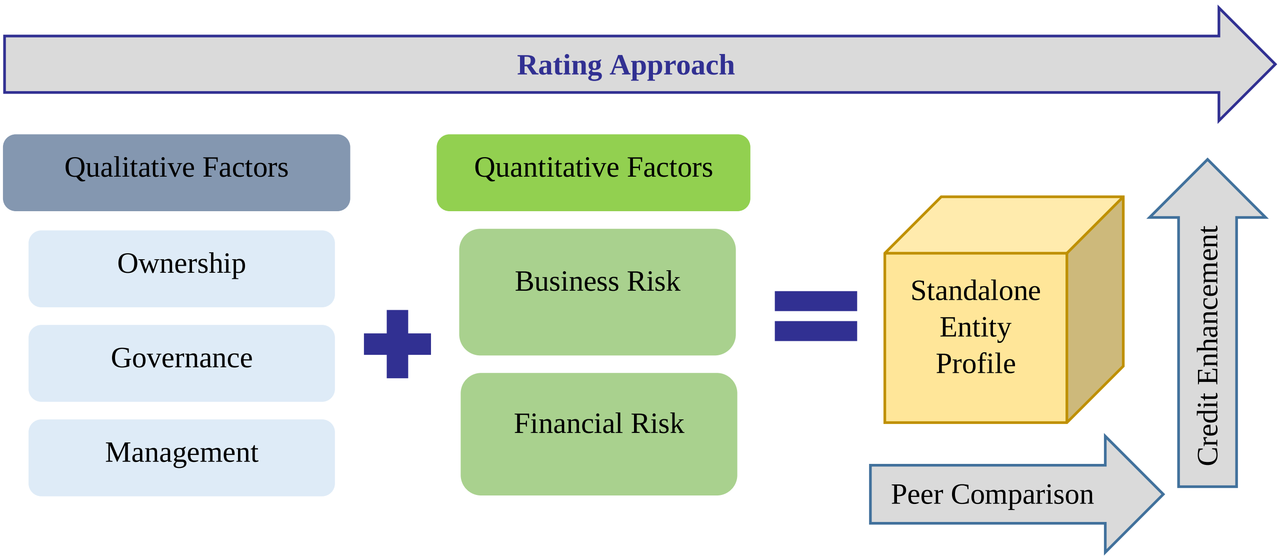
1. Introduction

1.1 Background: 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 it 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, for the purpose of this criteria, 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.

1.2 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.

1.3 The criteria focus 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.

1.4 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.



1.5 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.

1.6 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 & other renowned ethical and quality standards

2. Ownership

2.1 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:

- **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 agreements**: 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.

2.2 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.

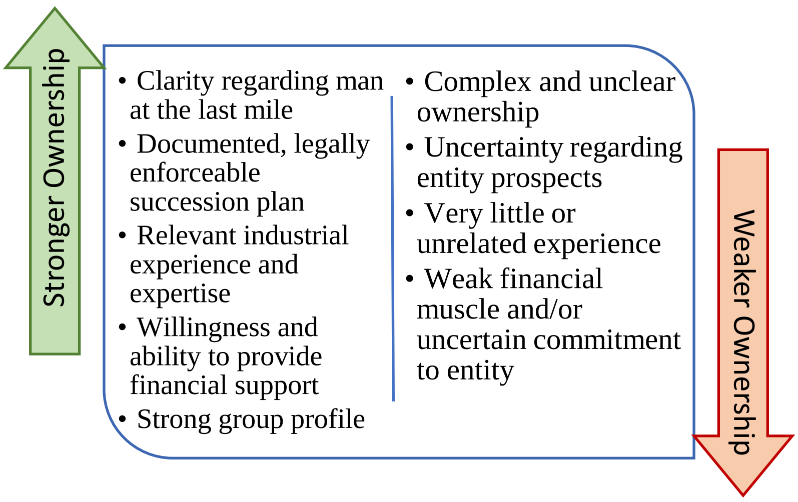
2.3 Business Acumen: PACRA considers owners' business acumen critical for sustainable success of an entity. Business acumen is analyzed through two primary areas: i) industry-specific working knowledge, and ii) strategic thinking capability. Meanwhile, a deep and applicable understanding of the business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

2.4 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.

Required Information

1. Shareholding pattern
2. Succession planning at owners' level
3. Shareholders' financial information/other businesses
4. Financial profile of group (if applicable)
5. Past pattern of financial support provided by the shareholders



3. Governance

Board Structure	Members' Profile	Board Effectiveness	Transparency
Composition of board in terms of size, independence and committees	Relevance and diversity of board members' skills, knowledge and experience	Extent to which board properly discharges its responsibilities	Quality of financial and non-financial disclosures

3.1 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.

3.2 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.

3.3 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

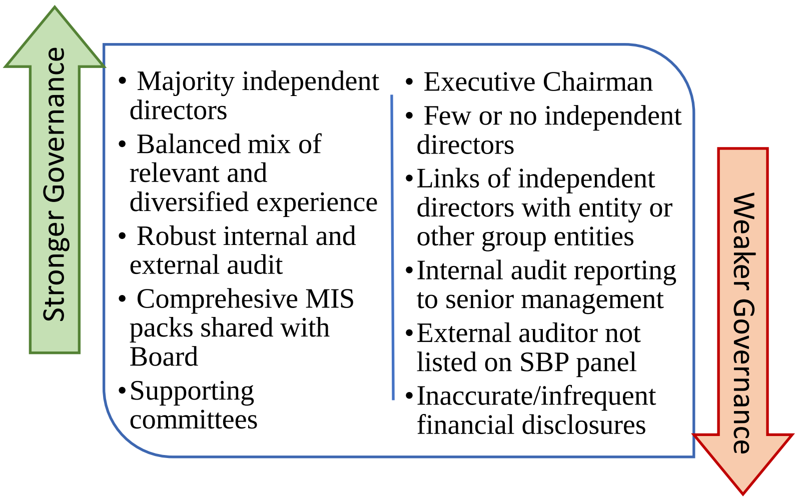
directorships in other companies as an indicator of the time and commitment Board members' may depict in their role as a Board member of the underlying entity.

- **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.

3.4 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.



Information Required

1. Board size and composition
2. Details of Board committees and TORs
3. Board members profile
4. Sample Board information packs
5. Sample minutes of Board meetings
6. Internal & external auditors' details

4. Management

4.1 Organizational Structure: The analysis of management starts with an in-depth analysis of organizational structure of the entity. This is done first on a standalone basis and then in the context of its relative universe to form an opinion on the optimal structure relevant to the complexity of its operations. Some of the underlying considerations include:

- **Organogram:** This includes analysis of hierarchal structure, reporting lines and coherence of team.
- **Staffing**: Occupancy of key positions, adequate staffing in key functions, segregation of duties, clarity in reporting and management of conflicts of interest is important.
- **Management Committees:** Committees can be formed to allow for improved coordination, decision making, performance monitoring, ensuring adherence to organizational policies and procedures or for other more specific purposes. It is preferred that every management committee has documented TORs and all meetings are properly documented in the shape of meeting meetings. The aforementioned meetings should be held at frequencies that comply with regulatory, industry, and entity specific protocols.

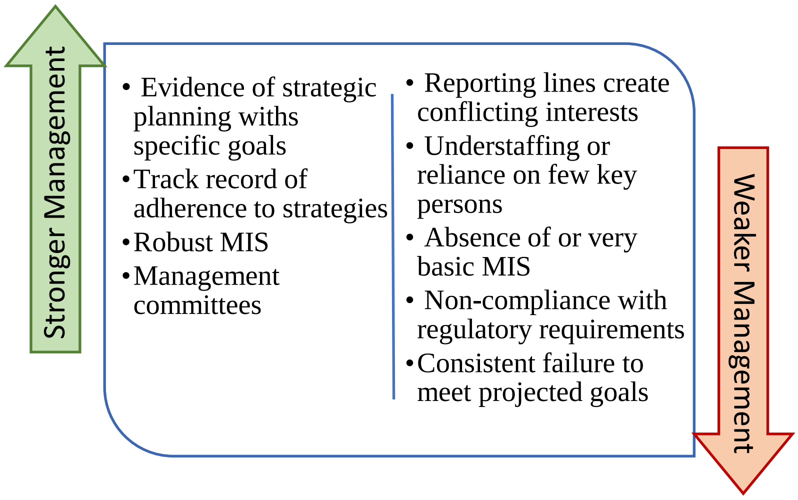
4.2 Management Team: Analysis of management includes evaluating the experience and educational profile of key individuals, management's track record to date in building up sound business mix, maintaining operational efficiency and strengthening the entity's market position. Over time, the performance of the entity can objectively reflect the management team's ability to develop and implement financial and operational strategies.

- **Turnover:** Frequent turnover and/or loss of key personnel, particularly members of senior management, can have adverse effects. HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments while human resource policies are also reviewed to gauge emphasis on recruiting and retaining vital staff.
- **Key-person Risk**: Key-person risk occurs when an entity is heavily reliant on an individual, or a limited number of individuals, who are accepted as the key holder(s) of important intellectual capital, knowledge or relationships. While this type of risk is more common in small to medium-sized entities, it can also exist in larger entities and is relatively challenging to benchmark and, hence, mitigate. PACRA attempts to identify the extent to which an entity is dependent on the expertise of such individual(s) and ensures that policies pertaining to succession/redundancy exist in order to limit the adverse impact of such people leaving unexpectedly.

4.3 Management Effectiveness: PACRA conducts an evidence-based analysis of the management's ability to create an adequate business mix, sustain operational efficiency and strengthen the entity's market position. This analysis is conducted relative to competitors and management's own projections. PACRA further assesses whether management has developed any critical success factors to evaluate performance of various business segments and their efficacy.

- **MIS**: One of the key tools available to the management is the information it is provided. PACRA conducts a qualitative review of information systems and technological infrastructure. The entity's MIS is assessed in terms of its quality, maintenance status, frequency of updation, and comprehensiveness of generated reports. System generated, real-time MIS reports improve the efficiency of decision making irrespective of it pertaining to operational, financial, or strategic issues. It is critical that MIS output be concise, complete and timely, to enable efficient decision making.

4.4 Control Environment: PACRA assesses the mechanisms in place to ensure compliance with relevant regulatory requirements. A robust control environment ensures that the entity is driven by processes instead of being dependent upon individuals. Therefore, evaluation of the quality of policies and procedures, and invariable adherence to these, remains pivotal in the analysis of control environment. PACRA also assesses the integration of the entity's operations into technology. Built-in controls should demonstrate that conflict of interest is avoided. In the wake of recent emerging issues related to data privacy, PACRA considers the controls implemented and the efforts made to maintain and improve data storage and cyber security systems. This can be particularly important for financial institutions where loss of data or data breaches can lead to significant operational, reputational and even legal implications. These concerns are covered in greater detail in the relevant sector-specific methodologies.



Information Required
1. Latest organogram
2. Profile of senior management
3. Details of management committees and TORs
4. Redundancy pattern
5. MIS reports
6. Sample minutes of committees' meetings

5. Environmental, Social & Governance (ESG) Considerations

5.1 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[1]. 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.

5.2 ESG awareness in South Asia is lagging compared to Europe and North America[2]. 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.

5.3 ESG disclosures are at a nascent stage in Pakistan as sustainability reporting is not mandated under the current regulatory regime. As in all cases, PACRA would use the best information available to it to make its decision. 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.

[1] Reuters, Bloomberg
[2] PWC [Environmental, social and governance (ESG) in Asia Asset and Wealth Management]

6. Conclusion

6.1 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.

6.2 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.

6.3 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.