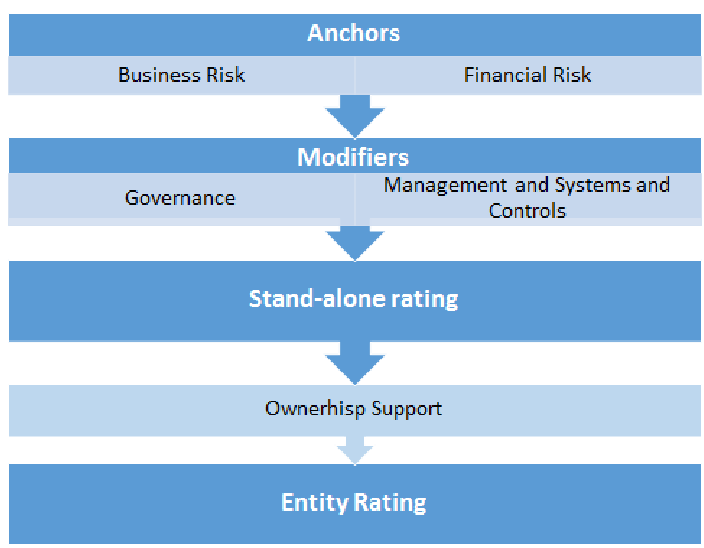
1. SCOPE

- Applicable on Leasing, housing finance companies, investment finance companies, and Modarabas
- SECP – the apex regulator
- Analysis based on qualitative and quantitative data

1.1 Non-banking finance companies (NBFCs) are an important part of the financial system. The operations of most of these NBFCs are not much different from that of the banking companies in the local environment. Traditionally, they used to have their separate space to operate but as the concept of universal banking gained momentum, distinction gets blurred. This implies high competition business environment for NBFCs, thus greater impediments for growth. The key difference between the banks and NBFCs is that the latter cannot offer check-in deposit accounts. NBFCs, as defined in Companies Ordinance 1984, include the companies offering leasing, investment finance services, housing finance, venture capital, discounting, investment advisory, and asset management companies. This methodology mainly covers leasing companies, housing finance companies, and investment finance companies. Modarabas carry similar risk factors as by other NBFCs, thus this methodology equally applies to them. Securities and Exchange Commission of Pakistan (SECP) has been acting as the sector regulator since FY03, when a comprehensive regulatory framework was designed for NBFCs[1]. Modarabas are covered under a separate law[2] issued by SECP.

1.2 The services that an entity can offer are linked with the license it acquires subject to fulfilling regulatory capital requirements. A single entity may acquire multiple licenses, e.g. investment finance, leasing, and housing finance. Thus the company having more than one license can diversify their operations. However, related risks are to be managed accordingly.

1.3 The risk assessment process for NBFCs comprises comprehensive analysis of the particular segment in which the entity operates, profile of the entity, and its relative position in its respective segment. Analyzing the profile of the entity includes comprehensive coverage of both quantitative and qualitative factors. In its assessment, PACRA's quantitative analysis helps to reach an anchor rating. This rating can then be affected by qualitative factors – the modifiers. After standalone rating is finalized, the entity's rating is concluded while incorporating sponsor's assessment of financial strength and expected / agreed level of support.



[1] Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003, and Non-Banking Finance Companies and Notified Entities Regulation, 2008

[2] Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980, and Modaraba Companies and Modaraba Rules, 1981

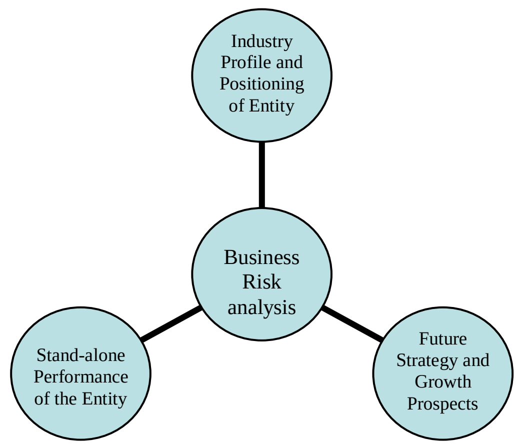
1.4 QUALITATIVE ANALYSIS: Qualitative assessment covers; i) Governance framework, and ii) management quality, and robustness of systems and controls in place to establish a strong governing mechanism on overall operations of the entity. Although these are subjective in nature, PACRA tries to achieve objective results by doing in-depth analysis of these factors through pre-defined parameters for each of these.

1.5 QUANTITATIVE ANALYSIS: Quantitative assessment comprises; i) business risk (earnings and operational performance), and ii) financial risk. Overall risk management framework of financial institutions is subject to analysis of, i) credit risk, ii) market risk, iii) funding and liquidity, and iv) capital adequacy. The performance of entity is measured against various benchmarks and in comparison to the other industry players.

2. BUSINESS RISK

- Industry performance
- Earnings quality, stability and efficiency

2.1 INDUSTRY PROFILE: As an important part of business risk analysis, PACRA conducts industry study for different segments of NBFCs as per the requirement of the universe under review. The industry review includes industry statistics, relative positioning of various players within the industry, and research and review of historical patterns in key quantitative areas. The entity's performance is thus subject to its relativeness among its peers operating in the industry.



2.2 STAND-ALONE PERFORMANCE: Business risk analysis at the entity level covers an assessment of earning profile of an NBFC, which is dependent on its assets mix and ability to generate non-fund based revenues, mainly fee based income. Fund based income mainly includes, i) interest or profit on advances, loans, ii) interest or profit on fixed income investment or government securities, and iii) dividends or gains (both realized and unrealized) on investments. Non-fund based income may comprise fee, and commission on either off-balance sheet exposures (mainly guarantees), advisory or other services.

2.2.1 As an important factor, PACRA assesses the quality and stability of the earning streams. An adequately diversified revenue stream is considered better as compared to concentrated earning. While evaluating the entity's ability to convert its earnings into profits, efficiency ratios, e.g. 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.

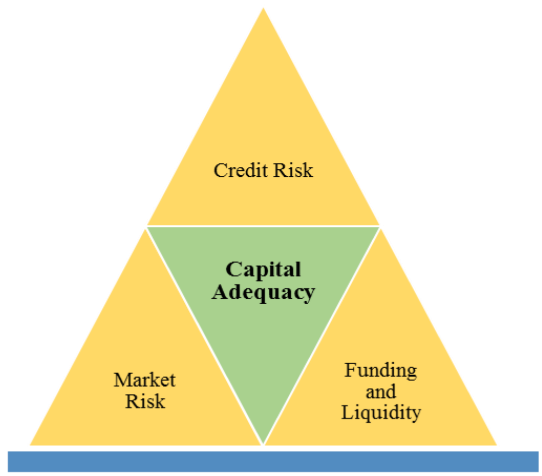
2.2.2 Where necessary in its ratings analysis, PACRA makes adjustments to the entity's reported income statement figures, so that financial performance indicators are comparable across similar entities.

2.3 FUTURE STRATEGY AND GROWTH PROSPECTS: Earnings prospects are monitored, based on budgets and forecast prepared by the NBFC as per the business strategy of the entity. 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.

3. FINANCIAL RISK

- Quality of Risk Management Framework in place
- Credit quality of portfolio
- Market risk
- Funding risk and management of liquidity profile
- Strength of Capital buffer

3.1 RISK MANAGEMENT: This includes an analysis of the entity's appetite for risk and the framework it has in place for managing risk. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits employed, and the degree to which these procedures and limits are adhered to. We assess the senior management's understanding of and involvement in risk management issues, and examine the reporting lines in place. Key risks that can affect the profile of the entity include credit, market, and liquidity risks.



Risk Management Analysis

3.2 CREDIT RISK: Importance of credit risk is significantly more incase of lending institutions including investment finance companies, housing finance companies, leasing companies, and modarabas, because of generally second tier client base of these institutions as compared to commercial banks' borrowers. However, credit risk can arise from both on-balance sheet and off-balance sheet business of the entity. 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 entity. Out of entities covered in this section, generally investment finance companies expose themselves to off-balance sheet risk factors. PACRA analyze both risks in similar manner. However, as quantum of risk taken on balance sheet 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 entity.

3.2.1 The review of credit risk involves assessment of policies and procedures before taking an exposure, post-disbursement monitoring mechanism, criteria for ongoing surveillance, and recovery process.

3.2.2 Credit risk analysis includes review of credit portfolio at all levels. Portfolio is evaluated to calculate market share, to analyze type of counter party e.g. consumer 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 i.e. sector, borrower, and type of product. The level of concentration is considered to have 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.

3.2.3 **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.

3.2.4 Quality of fixed income securities portfolio is measured. In addition to the size of the exposures, business dynamics of the sector of counterparty and security structure of the instrument is considered. Similarly, other exposures are analyzed on the basis of nature, size, and credit worthiness of the counter party.

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

3.4 **FUNDING AND LIQUIDITY:** NBFCs are classified into two main segments for funding and liquidity assessment, i) NBFCs that finance their assets through either deposits or borrowings from financial institutions or a combination of both, and ii) NBFCs that meet their requirement either from internal sources (equity) and / or from sponsor loans.

3.4.1 In case of first kind of NBFCs, PACRA analyses funding mix, i) short-term vs long-term; the maturity profile of liabilities is seen in tandem with related asset base to analyze liquidity profile, ii) fixed rate vs floating rate; this has direct implications on business margins in case of mismatch with assets, and iii) retail vs institutional; retail deposits are considered sticky as compared to institutional deposit. While 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.

3.4.2 In other scenario, where the assets are financed from equity, sufficiency of free capital available to the entity is assessed as discussed in Capital Adequacy section. While in case of sponsor loan, the terms of loan, its repayment flexibility, and the entity's plan to meet the repayment terms are analyzed.

3.5 **CAPITAL ADEQUACY:** 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. Where necessary in such cases, PACRA requires comfort from major shareholders of the entity as to ability and willingness to provide support, if the need arises.

3.5.1 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 entity. As ratings are not point-in-time, PACRA also sees 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 considers compliance with regulatory requirements important for an NBFC.

4. GOVERNANCE FRAMEWORK

- Evaluation of overall structure and profile of BoD
- Existence of independent board members
- Effectiveness of BoD in strategic guidance
- Compliance with regulations – a minimum requirement

4.1 Corporate governance structure of NBFCs is important to qualitative analysis. While analyzing governance framework, among others, four main factors are looked into, i) board structure, ii) members' profile, iii) board effectiveness, and iv) financial transparency.

i) Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, overall skill mix and structure of committees of the board. Size of the board may vary as per the scope and complexity of the business operations of the entity. Diversification in terms of knowledge background and experience of board is considered positive. However, a fair number of board members should have financial sector experience. Compliance of code of corporate governance is also examined.

ii) Members' Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality of overall board.

iii) Board Effectiveness: PACRA considers the role of the board is to work with management in steering the entity to its performance objectives and to provide critical and impartial oversight of management performance. Board members' attendance and participation in meetings is considered a measure to assess the effectiveness. Moreover, PACRA analyses the type and extent of information shared with the board members, and quality of discussions taking place at board and committee level. Effective oversight requires frequent sharing and detailed information than required by statue.

iv) Financial Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial information. The board may establish controls to ensure transparency through strengthening the role of audit committee, the quality of internal audit function, and effectiveness of external audit.

5. MANAGEMENT, AND SYSTEMS AND CONTROLS

- Organizational Structure
- Experience profile of top management
- Effectiveness of MIS reporting

5.1 Good quality management, effective systems and controls, and well-defined strategy are essential ingredients for a successful entity. As part of its assessment of management, PACRA looks at, i) organizational structure, ii) experience profile of key individuals, iii) existence of any single man risk, iv) coherence of the team, and v) management's track record to date, in terms of building up sound business mix, maintaining operating efficiency and strengthening the entity's market position. PACRA analyses the quality and credibility of management's strategy, examining plans for internal or external growth. When evaluating future plans, significant credit is given for delivering on past projections and sticking to strategies. Although judgment about

- Technology infrastructure

management is subjective, financial performance over time provides a more objective measure.

5.2 As part of the rating process, PACRA reviews the management information systems and internal procedures that the management has established to strengthen the control mechanism in the entity. Robustness of control systems is considered a reflection of a good management.

6. OWNERSHIP

- Financial strength of major shareholders
- Reliance of entity on major shareholder in raising capital
- Willingness to support

6.1 The ownership of and potential support available to an NBFC is crucial to PACRA's overall rating assessment. This factor becomes more important for small size NBFCs or NBFCs that are facing operational losses, where entity is majorly reliant on key shareholders to meet capital requirements.

6.2 PACRA analyzes the ability and willingness of the major shareholders to support the entity both on a continuing basis, and support in times of crisis. Key factors that are considered for this purpose, inter-alia include, shareholding structure, financial strength of major shareholders, operational synergies with the major shareholders' other businesses, and the level of commitment of the major shareholder with the entity in providing capital support. Here, PACRA gives due importance to, i) the behavior of the major shareholders to provide timely and comprehensive support in times of need in the past, and ii) prospective view of key shareholders, incase such need arises. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support.