The Pakistan Credit Rating Agency Limited

RATING METHODOLOGY
NON-BANKING FINANCE COMPANIES

[LEASING COMPANIES, HOUSING FINANCE COMPANIES, INVESTMENT FINANCE COMPANIES, AND MODARABAS]

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 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, standalone profile of the entity, and its relative position in its respective segment. Analyzing standalone profile of the entity includes comprehensive coverage of both qualitative and quantitative factors. These are discussed in detail in the following sections.

QUALITATIVE ANALYSIS: Qualitative assessment covers various factors; i) ownership structure, ii) Governance framework, iii) 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, doing in-depth analysis of these factors through pre-defined parameters for each of these. This includes comparison of various entities, normally operating in the same segment.

2. OWNERSHIP

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

2.1 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.

2.2 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

[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

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.

3. GOVERNANCE FRAMEWORK

- Evaluation of overall profile of BoD
- Independence from major shareholder
- Effectiveness of BoD in strategic guidance
- Compliance with regulations – a minimum requirement

3.1 Corporate governance structure of NBFCs is important to qualitative analysis. While analyzing governance framework, among others, four main factors are looked into, i) composition of board, ii) quality, iii) strategic guidance and oversight, and iv) resources.

i) Composition of board: This includes assessment of board as a whole. A healthy composition of board ensures presence of independent members on the board of the NBFC. Moreover, diversification in terms of knowledge background and experience 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) Quality: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality of overall board.

iii) Strategic guidance and Oversight: 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. Another critical function of the board is to strengthen governance of audit function, a key to financial data integrity of the entity.

iv) Resources: PACRA analysis the conduct of board meetings, 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.

4. MANAGEMENT, AND SYSTEMS AND CONTROLS

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

4.1 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, v), and vi) 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 management is subjective, financial performance over time provides a more objective measure.

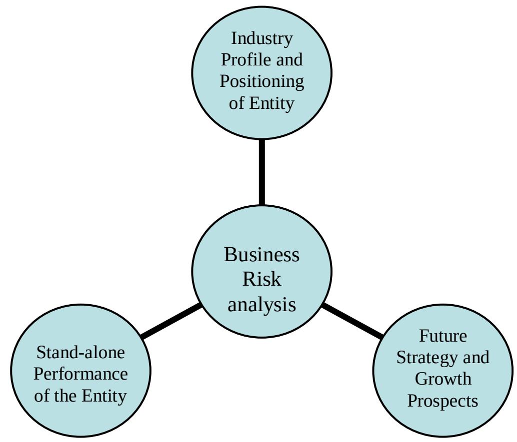
4.2 As part of the rating process, PACRA reviews the management information systems and internal procedures that the management has established to strengthen the control mechanism in the entity. Robustness of control systems is considered a reflection of a good management.

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.

5. BUSINESS RISK

- Industry performance
- Earnings quality, stability and efficiency

5.1 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.



5.2 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.

5.3 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.

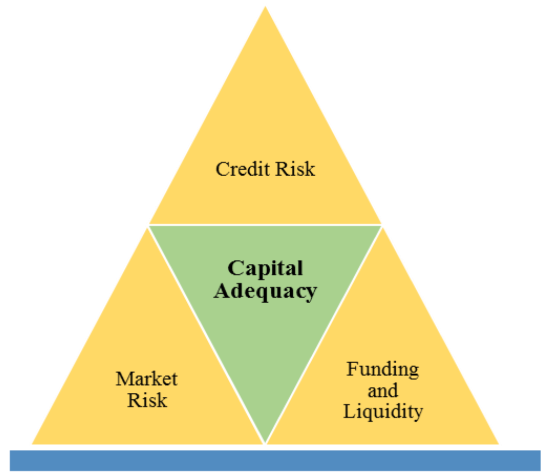
5.4 Where necessary in its ratings analysis, PACRA makes adjustments to the entity's reported income statement figures, so that financial performance indicators are comparable across similar entities.

5.5 Earnings prospects are also monitored, based on budgets and forecast 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.

6. 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

6.1 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

6.2 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.

6.2.1 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.

6.2.2 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.

6.2.3 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.

6.2.4 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.

6.3 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.

6.4 FUNDING AND LIQUIDITY: NBFCs finance their assets through different means of funding including deposits and borrowings from financial institutions. 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.

6.5 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.

6.5.1 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.

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STANDARD RATING SCALES & DEFINITIONS

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.

Long Term Ratings

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 or 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**. "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.

Short Term Ratings

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.

B: The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.

C: An inadequate capacity to ensure timely repayment.

Rating Watch
Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. Rating Watch may carry designation – Positive (rating may be raised, negative (lowered), or developing (direction is unclear). A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled.

Outlook (Stable, Positive, Negative, Developing)
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'.

Suspension
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, a suspended rating should be considered withdrawn.

Withdrawn
A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, or e) the entity/issuer defaults.