The Pakistan Credit Rating Agency Limited

DEBT INSTRUMENTS RATING METHODOLOGY

An independent rating opinion on repayment capacity of the issuer of debt instruments as per agreed terms of the issue

1 THE DEBT INSTRUMENT MARKET

- Small local debt market

1.1 Pakistan has a relatively small debt instrument market. Financing through bank loans is the preferred route for corporates, rather than utilizing the capital markets to raise funding through issuing debt instruments like bonds. Therefore, when instruments are issued, they are plain-vanilla and secured by the assets of the company. Retail investors have only recently been tapped and generally the instruments are the domain of institutional investors – banks, mutual funds, and retirement benefit schemes. Instrument denominations and tenor also remain on the lower side. Given relatively small base and held to maturity stance of most investors, secondary market is yet to evolve in a meaningful platform.

2 SCOPE

- Definition of debt instrument
- Different types of issues

2.1 A debt instrument is a security with an underlying contractual obligation owed by the issuing entity (*also called issuer*) to make interest payments and principal repayments to the debt instrument holders (*also called lenders*) for the life of the debt instrument.

2.2 Key types of debt instruments are term finance certificates (TFCs), commercial papers and sukuk. These debt instruments can be differentiated by: (i) maturity *(money market versus capital market debt instruments*), (ii) type of issuing entities (*government, financial institutions, corporate, etc.*), (iii) types of markets in which these are issued (*conventional versus Islamic*), (iv) accessibility (*listed, privately-place*d), and (v) Security (*secured, unsecured, or subordinated*). Structured debt instruments are dealt with separately under PACRA's methodology "Structured Finance Rating".

3 RATING A DEBT INSTRUMENT

- Principal and interest – contractual obligations
- Notching criteria as per security structure

3.1 PACRA undertakes debt instrument ratings for all kinds of short-term and long-term instruments.

3.2 A debt instrument credit rating is an assessment of a specific debt issue of an entity and provides: (i) an opinion of the issuing entity's ability to meet on a timely basis its principal and interest obligations pertaining to the debt instrument being rated, and (ii) loss-given-default (LGD). For the purpose of the rating assessment, both the payment of interest and repayment of principal are considered "contractual obligations" by PACRA.

3.3 The credit rating incorporates an assessment and subsequent opinion upon the expected loss to be covered in the event of default through the "security structure" underlying the debt instrument.

3.4 A debt instrument rating, hence, is a blend of two factors, likelihood of default and recovery prospects. This enables the debt instrument rating to be notched either "higher" (in case of a secured instrument) or "lower" (in case of a subordinated instrument) as compared to its corresponding issuing entity's rating. An unsecured instrument would have the same credit rating as the entity issuing it.

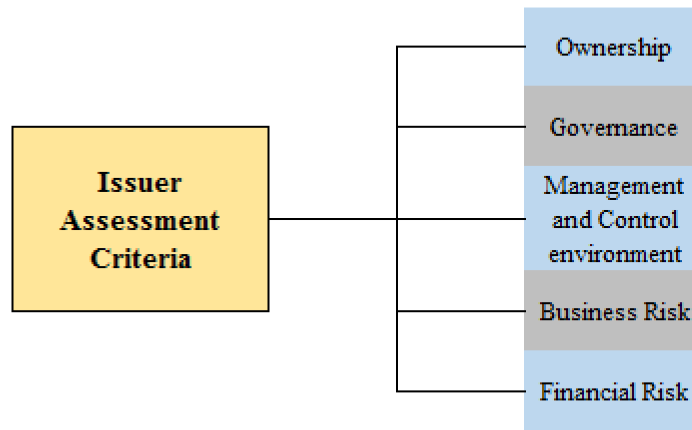
3.5 The weight given to the two factors, default and loss/recovery, blended in the debt instrument rating opinion, varies up and down the credit spectrum, depending on how immediate or distant the likelihood of default. For instance, for an instrument of a very low rated entity, where the likelihood of default is high, considerable weight would be given to the recovery prospects (or lack thereof) in determining the rating of

the instrument. Therefore, as entity approach the high rating level, weight given to the recovery prospects is gradually scaled back and, consequently, the quantum of notching.

4 ISSUER PROFILE

- Shadow entity rating
- Issuer specific methodology applies to assess different issuers

4.1 While forming an opinion on an issuer, PACRA evaluates the underlying entity as per the specific methodology applicable to it. For instance, for an industrial corporate issuer, Corporate Rating Methodology would apply while for an independent power producer, IPP Rating Methodology would be used to arrive at entity rating of the issuer. Broadly rating criteria to assess an issuer covers both qualitative and quantitative factors. These comprise, i) ownership, ii) governance, iii) management and control environment, iv) business risk, and v) financial risk.



4.2 In local environment, banks usually issue unsecured and subordinated debt instruments; though secured instruments can be issued but with specific permission of the regulator. In these cases, PACRA follows its respective entity rating methodology (e.g. Bank Rating Methodology, Microfinance Institutions Rating Methodology, etc.) to arrive at entity rating opinion. This is then notched according to security structure. Meanwhile, PACRA considers lock-in and loss absorbency clauses as mentioned in Basel-III and how these can impact the rights of instrument holders given underlying entity's projections for growth vis-à-vis regulatory capital adequacy requirement over the tenor of the instrument.

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DEBT INSTRUMENT RATING SCALE & DEFINITIONS

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

Long Term Ratings

Rating	Definition
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.

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, the 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/and e) the entity/issuer defaults..

Disclaimer: PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.