VIS

Credit Rating Company Limited

NON-BANK FINANCIAL COMPANIES

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SCOPE OF CRITERIA

The scope of the methodology applies to leasing companies, Investment Banks, Modarabas, Asset Management & Investment Advisory Services, Housing Finance Services and Discounting Services, whether operating on conventional or digital platform, which VIS will collectively refer to as Non-bank Financial Companies (NBFCs) for the purpose of this methodology.

SUMMARY OF CRITERIA CHANGES

The Non-Banking Finance Companies and notified Entities Regulations, 2008 (NBFCR); have been amended upto May 17, 2023. The amended regulations beside including the 'Infrastructure Finance Company (IFC)' under the ambit of NBFCs as also expanded the scope of NBFCs to Data processing, Digital Fund Management, Digital Lending and Digital Trustee. Functions of each of these and the regulatory requirement on them are detailed in the sections related to these new business of NBFC in the amended regulations.

Maintaining its alignment with the International Best Practices, VIS has written an independent and comprehensive methodology for review and assessment of ESG framework in a wide variety of Institutions. The Methodology is termed as " ESG RATING METHODOLOGY" and is available at our website on the following link, https://docs.vis.com.pk/docs/ESGRatingMethodology.pdf

The comments and assessment on ESG are presented in the report in a concise manner providing VIS assessment of the status of achievements and risks in Environmental, Social and Governance areas applicable to the rated entity.

The significance of the status of achievements and risks in the Environment, Social and Governance segments is captured in the overall rating determination.

A large portion of country's financial assets continue to be managed by Commercial Banks while NBFCs contribution has consistently remained low. The sector continues to face challenges such as limited resource-mobilization, non-availability of credit lines from financial institutions, limited ability for deposit-taking and no regulatory support in case of financial distress, as the Securities & Exchange Commission of Pakistan (SECP) is not 'the lender of last resort'. As per regulations, NBFCs are classified from their business perspective into lending NFBCs (whether deposit taking or non deposit taking), fund management NBFCs and advisory NBFCs. They are also classified into conventional and digital from their mode of operation. The regulations specify different minimum equity requirements for various NBFCs, link deposit raising ability of an NBFC to its equity & credit rating and also impose limit on aggregate liabilities of a non-deposit taking NBFC.

Key requirements in this regard are as follows:

FORM OF BUSINESS	MINIMUM EQUITY REQUIREMENT
New deposit taking NBFCs for obtaining license of Investment Finance Services or Leasing or Discounting or Housing Finance Services	Rs. 1,000 million
Existing NBFCs with valid deposit taking permission having Investment Finance Services license	Rs. 750 million
Existing NBFCs with valid deposit taking permission having Leasing license	Rs. 500 million
Non-deposit taking NBFCs for Investment Finance Services license	Rs. 100 million Rs. 40 million for Digital Lending
Non-Bank Microfinance Company for Investment Finance Services License *	Rs. 50 million Rs. 20 million for Digital Lending
Non-deposit taking NBFCs for Leasing or Discounting or Housing Finance Services license	Rs. 50 million for each form of business Rs. 20 million for Digital Lending
Asset Management Services	Rs. 200 million Rs. 50 million for Digital Asset Management Services
Investment Advisory Services	Rs. 30 million Rs. 10 million for Digital Asset Management Services

Note:
*The Non-Bank Micro Finance Companies which do not have share capital shall maintain minimum "Fund and Reserves" (being the excess of assets over liabilities excluding surplus on revaluation of assets and investments) equal to the amount of minimum equity requirement as prescribed in the above table.

Credit Rating	Total Deposits from all sources including deposits from individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions and section 42 companies.	Deposits from individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions and section 42 companies.
AA- and above	5 times of Equity	4 times of Equity
A- to A+	3 times of Equity	2 times of Equity
BBB to BBB+	2 times of Equity	Nil

The regulatory environment in Pakistan has strengthened over time with increased comprehensiveness in prudential regulations, and improved standards of corporate governance. External factors that tend to impact credit ratings include the effectiveness of the regulatory environment and external monitoring tends to have a positive impact on the protection available to creditors.

A. CROSS-SECTOR COMPARABILITY

Assigned ratings are considered to be comparable across sectors. Our assessment endeavors to position each company that VIS rates, vis-à-vis any other company in the rated universe, thereby maximizing the utility of ratings for the common investor by providing a single yardstick for assessing the credit-worthiness of any institution. While assessing the ratings, sector related risks are taken into account in addition to firm-specific risks. Therefore changes in economic indicators along with those in the financial sector in general, are factored into ratings of any financial institution. Furthermore, the underlying concept and the basic principles of arriving at a rating for any NBFC remain largely similar to that used for any other sector.

B. ANALYTICAL FRAMEWORK

VIS's rating methodology for NBFCs is composed of three broad analytical frameworks. The assessment begins with system-wide external factors that may impact risk profile of NBFCs followed by standalone operating profile in addition to an assessment of external support that may be available to the institution.

Analytical Framework for Assessing NBFCs

OPERATING ENVIRONMENT

An assessment of operating environment of NBFCs incorporates economic and industry risks to which NBFCs are exposed to or may face over the rating horizon. In the assessment of economic risk it is important to understand the current and forecasted state of the economy, flexibility of the economic policy to projected socio-political structure, current and potential economic imbalances and the major credit risk sectors. In economic risk analysis, the NBFC's capacity to adjust to national level economic changes is also assessed.

For the industry risk assessment, the depth of coverage of the regulatory environment for NBFCs and its monitoring effectiveness by the regulator is taken into account. Ratings are also influenced by the ability of the regulators to ascertain the soundness of NBFC in the system and their capacity and willingness to intervene to prevent institutional failures. The transparency in the system as inculcated by the regulatory framework is also given due weight as well as the efficiency of the overall legal system in case of foreclosure events for customers' security repossession.

ASSESSMENT OF STANDALONE OPERATING PROFILE

Assessment of standalone operating profile looks into both qualitative and quantitative factors which are discussed in detail below:

A. QUALITATIVE FACTORS

A. (i) Corporate Governance

To the extent that poor governance jeopardizes the interest of creditors, its impact is factored into credit ratings. The objective of our assessment of corporate governance is to ensure that the organization is structured to allow for an effective internal control environment to develop, and minimize the possibility of the misuse of power by dispersing it optimally within the organization. Among other variables are the various features of the board of directors. In the context of the board's structure, VIS focuses on the role played by the board, the quality of its vision, the blend of its professionals and their relevance to the business, and the efficacy of its committees. Other key areas are the strength of the supervisory functions including internal and external audit. The degree of sophistication in risk management systems being employed is also a paramount consideration in our evaluation. Eventually good governance and sound risk management protects the value of a company's resources and optimizes their utilization, allowing the entity to honor its commitments to all its stakeholders including the creditors.

A. (ii) Management

Experience profile of senior management team and ability of the organization to continue operations without signifi- cant disruption in case of loss of key personnel is assessed while reviewing the senior management profile. Presence and evidence of strategic planning process, consistency of strategy along with availability of resources and strong policy & procedural framework are also positive from a ratings perspective.

A. (iii) Resilience and Market Power

The size of an entity, though not the only indicator of an issuer's strength, correlates strongly with market position. Given a comparable performance track record, larger entities will tend to be rated higher. While evaluating an organi- zation on attributes like asset quality or access to financial resources, the benefit of diversification, which is generally greater in larger entities, is to be taken into account.

There are tangible reasons behind the effect of size being visible in ratings. Firstly, it generally affords an organization more market power in all facets, i.e. ability to attract the best quality people, attracting financial resources, access to better infrastructure and of course pricing power. If however, these strengths are somehow absent in a large organization or are present in smaller ones, ratings will be mindful of such instances, although such cases are exceptions rather than a norm.

This is not to imply that agile and small organizations lose their competitive edge over time. While they may continue to be successful as business models, market power will inevitably be accounted for as one of the variables in the risk equation. Particularly, in growing economies, as the business environment becomes increasingly competitive and mergers and acquisition related activity also increases as its natural outcome, economies of scale generally assume greater significance.

A. (iv) ESG Status & Digital Platform

The ESG policies of the NBFC are reviewed, where applicable. In NBFC operating on a digital platform the strength of its digital platform is also reviewed.

B. QUANTITATIVE FACTORS

B. (i) Capitalization and Leverage: Building blocks for the future

Capital is viewed by VIS as a cushion available to an entity against unforeseen losses. It is the foremost indicator of the degree of protection that an organization provides to its creditors against future losses and its sufficiency is to be assessed in relation to risks being carried by the company. Credit risk, market risk and operational risks being the primary sources of risk, are assessed to determine whether the entity is appropriately capitalized. NBFCs may also diversify their operations into money and capital market operations and the presence of market risk in addition to potential for loan and lease losses is quantified in relation to equity. Hidden reserves if any are also to be accounted for.

Leverage, or the amount of debt in relation to the capital base, is a crucial factor in assigning ratings. VIS believes that in a growing economy and in dynamic organizations, capitalization levels generally move towards optimization and higher than average capitalization levels are ultimately leveraged to obtain higher value for shareholders.

Nevertheless, organizations may be less or more risk averse and higher levels of capital, both in absolute and relative terms are viewed favorably in ratings. Therefore, understanding the propensity of both owners and management to take risk is part of our judgment process. Prudential regulations allow leverage up to 5 times of equity (for AA rated de- posit taking NBFCs); this level indicates a steeper risk profile by VIS benchmarks. Cushion over Capital Adequacy Ratio requirement (mentioned in NBFC regulations) is also an important rating factor.

We also focus on an NBFC's ability to grow its capital base through retention of earnings, as this is the most reliable source for stable growth. This brings into focus the dividend payout policy as even strong profitability can be diluted through heavy cash payouts. A substantial capital base enables the management to make circumspect decisions regarding growth and funding alternatives.

B. (ii) Funding & Liquidity:

In case of NBFCs, the degree of leverage has to be considered in the context of the nature of liabilities, which are time-based primarily in contrast to demand liabilities as in case of commercial banks. Therefore, liquidity indicators required to qualify for higher ratings are often lower for NBFCs as compared to commercial banks. More specifically, we evaluate the degree to which it has been able to match its assets and liabilities, and whether short-term and long-term debt corresponds with the maturity and interest rate profile of the financing and investment portfolios. Liquidity available to meet its short-term obligations is judged through the assessment of all near-term claims against short-term sources of cash. VIS considers the quality, diversity and stability of the sources of cash. The generation and prudent management of these cash flows is a key factor in our assessment.

Access to funding is another important rating consideration. NBFCs largely rely on secondary sources of funding such as institutional borrowings, although a number of them have also accessed public funds through the issuance of Certificates of Investments (COIs) or other forms of debt instruments. Consequently, the ability to access the short, medium, and long-term markets at competitive rates is critical to their ongoing viability. The diversification and stability of funding sources in turn determines liquidity requirements for an institution. Ideally, an NBFC's funding strategy should include a variety of funding sources.

VIS evaluates an entity's flexibility to deal with market events and capacity to fund new business. We place high value on its access to debt markets and the portion of assets that can be liquidated without any significant impairment to value.

B. (iii) Asset Quality: Managing the Portfolio

Appraising the asset quality is a key factor in the rating process. Fundamental to this process is analyzing the asset mix. NBFCs are increasingly diversifying their scope of operations into a variety of avenues as afforded under the NBFC rules, in addition to the traditional financing portfolios. While this translates into diversification of revenue stream, it also exposes NBFCs to a variety of risks including market risk in addition to interest rate risk and credit risk. Increased treasury and capital market operations warrant an in-depth analysis of the mechanisms used to adjust to the changing environmental dynamics and maintenance of the liquidity position.

As far as the financing portfolios are concerned, cash recoveries against these are critical to the timely servicing of debt obligations. Since improvement or deterioration in the portfolio can lead to significant changes in the financial strength of the company, VIS seeks to conduct a comprehensive analysis of asset quality. In this regard, level of infection and the effectiveness of the management policies regarding recoveries and risk assessment procedures are assessed.

The size of the portfolio on both an absolute and relative basis is another consideration. There is less risk associated with a portfolio that is diversified in terms of geography, customer base, and type of product. Management's philoso- phy regarding concentration is reviewed, along with its growth plans. Weaker companies are more sensitive to changes in the environment and the nature and intensity of changes in market conditions has a substantial impact on their financial strength and ratings.

B. (iv) Profitability: The key to financial Strength

Improvement in profitability in a single year generally does not add significantly to risk protection available to creditors. However, sustained profitability over a number of years leads to a strong institution. The quality of earnings is given as much importance as its level, with emphasis on the continuity and predictability of revenues. Our analysis segregates recurring earnings, which are expected to provide a better picture of a company's future earning potential, from non- core earnings.

Earnings reflect the efficacy of the management's strategy and capacity of an institution to generate capital internally. The level of basic earnings (excluding provisions, taxes and any other non-recurring items) determines the institution's capacity to create reserves for potential losses.

EXTERNAL SUPPORT

An NBFC's ability to honor its financial commitments is also affected by the degree of external support. Ownership pattern and track record of the promoters/group companies is reviewed. Likelihood of support from strong promoters in times of need generally tends to be high. Creditworthiness of financially weak NBFCs may be enhanced, if backed by a strong third party. By the same token, the financial viability of associated concerns is also taken into account and translated into any strength/ stress that may impact the risk profile of the entity being rated. The sponsors support extended by way of equity injection is ranked higher than interest free redeemable capital/loan.

RATING SCALE & DEFINITIONS

Rating scale and Definitions may be accessed at (https://docs.vis.com.pk/docs/VISRatingScales.pdf)

Faheem Ahmad
President & CEO, VIS Credit Rating Company Limited
Founder, VIS Group Chairman,
Vice-Chairman, Association of Credit Rating Agencies in Asia

Mr. Ahmad possesses 30+ years experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters Degrees in Engineering and Business Administration from USA.

Javed A. Callea - Member
Advisor

Mr. Callea is a professional in the financial sector with over 35 years of experience mostly in the financial institutions with certain exposure to service and infrastructure sectors in Pakistan. He has held the position of Chief Executive of a leasing company for 10 years. His core areas of expertise cover leasing, development financing, project management, investment & merchant banking, strategic investment management and real estate. Major financial institutions he worked for include Pakistan Industrial Credit and Investment Corporation, State Life Insurance Corporation, Bankers Equity, Crescent Leasing Corporation and Saudi Pak Ind. & Agri. Inv. Company. He has also served as Member Finance of Water & Power Development Authority of Pakistan and as member of the Inquiry committee on stock exchange crises in 2000 commissioned by the SECP. He earned his MBA degree from the Institute of Business Administration in 1974.

Jahangir Kothari Parade (Lady LLoyd Pier) Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose genrosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.

VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, VIS is positioned to aim for an international mark. In this regard, the global experience of our international affiliates and partners have been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors. The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, VIS continues its endeavour to remain an emblem of trust.

INTERNATIONAL

Affiliates

Islamic International Rating Agency – **Bahrain –** iira.com
Credit Rating Information & Services Ltd. – **Bangladesh –** crislbd.com

Collaborations

Japan Credit Rating Agency, Ltd. - **Japan**
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