November, 2021

VIS
RATING
METHODOLOGY

RATING THE ISSUE

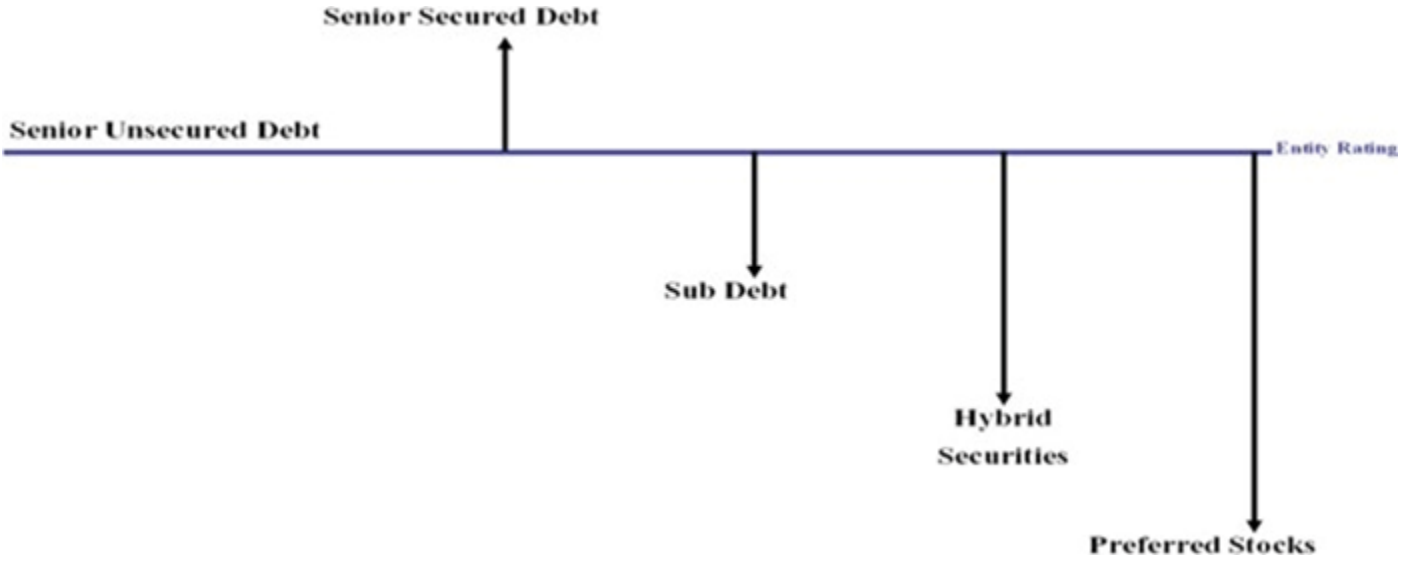
Credit ratings provide an opinion on a company's ability and willingness to meet its obligations on time. VIS Credit Rating Company Limited assigns credit ratings to both issuers and issues. These issuers may include corporations, financial institutions or sub-sovereigns. The issuer ratings take into account the business and financial risk profile of the entity as a whole. The specific factors that need to be taken into account in case of issuer rating depend on the type of issuer. In case of a corporate issuer, one of the most important factor that may need to be considered is the strength of debt service coverage , whereas in case of a financial institution, the liquidity profile and portfolio quality may be amongst the most critical factor.

The issue specific rating takes into account the relative priority of claim of a particular class of debt vis-à-vis the other outstanding obligations of that particular entity. This means that issue specific rating takes into account both the probability of default on an entity level basis and the recovery prospects associated with a particular debt issue. As a general rule, the set of creditors that will be settled first in a bankruptcy scenario will be assigned the highest ratings, whereas the equity holders have residual claim on a company's assets. This essentially means that VIS will first arrive at the issuer rating, (actual or shadow) which is also the rating applicable to senior unsecured creditors (in case of deposit taking financial institutions it will signify repayment ability of the institution to deposit holders) and then the ratings of individual debt issues may be determined based on their specific features.

Broadly speaking, the following factors must be considered before arriving at issue specific rating:

- Debt specific factors, including security and relevant legal structure;
- Relative seniority of the debt issue vis-à-vis other outstanding debt obligations of the issuing entity;
- Credit enhancement, if any.

NOTCHING GUIDELINES



The above chart summarizes the notching guidelines practiced by VIS, in terms of where a particular debt issue will be placed in relation to the entity rating. Generally as the ratings move into higher bands, the reliance on collateral support progressively becomes lower. The importance of timeliness increases for investment grade ratings whereas the potential for ultimate recovery becomes important for lower grade ratings which have higher probability of default.

In terms of ratings, this implies that there may be greater differentiation between let's say the entity and subordinated debt ratings of a non-investment grade issuer vis-à-vis an investment grade issuer, while the soundness of security and credit enhancement features in a debt issue would influence its relative position to entity rating. Moreover, there may be no need to create any differentiation at all between the entity and subordinated debt rating of 'AAA' rated issuer. Preference shares however carry greater credit risk as compared to debt instruments because of their two features: the dividend is at the discretion of the issuer and in the event of bankruptcy, the preference represents a deeply subordinated claim. Accordingly, preference shares are notched below subordinated debt even if the entity is in the 'AAA' category unlike sub-ordinated debt notching as stated above.

The extent of notching of subordinated/unsecured debt also depends on the quantum of secured or preferred debt carried by a company in relation to the total pool of assets that may be offered as collateral. If a company does not have sufficient assets remaining after satisfying the obligations of secured/preferred creditors, then this could put the subordinated/unsecured debt holders at a disadvantage and may warrant a larger rating differential than may otherwise be warranted.

The quality of security plays an important role in the extent of notching up of secured debt, including its current valuation, nature of charge, probability of obsolescence and the level of enforceability of securities as incorporated in the legal documentation.

Quality of collateral may range from highly liquid and readily marketable securities to specialized assets, with the ratings advantage being minimal or absent in case of latter on account of two major reasons. Firstly, in case of specialized assets, which do not have salability or utility outside of the business of the entity, such as those that may be carried by a telecom operator or a refinery, VIS may not necessarily consider any differentiation between the entity and secured debt ratings. Secondly, the time involved in recovery may also impact the degree of notching of a secured debt instrument.

In a parent-subsidiary relationship, particularly in case of a single operating subsidiary and non-operating holding company structure where both are taken into default simultaneously, even the contractually subordinated debt of the subsidiary would have a higher claim than the senior creditors of the parent entity. This is because the parent's creditors would have a residual claim on the subsidiary's assets after all the liabilities of the subsidiary have been settled. This structural subordination may put the parent's creditors at a material disadvantage. However, certain mitigating factors exist that can limit the degree of notching, or eliminate it altogether. Upstream guarantees can position the claims of a parent on a pari passu basis with the guaranteeing subsidiary, which results in a convergence of ratings. However, certain requirements such as unconditionally and irrevocability of upstream guarantees are essential for such a convergence to take place. If the parent company is directly in possession of any assets, the degree of subordination will be diluted. Moreover, ratings may also be distinct in case of parent companies that have diverse investments, since multiple income streams may provide a cushion for creditors. However, if the diversity of a company is likely to dissipate in the foreseeable future, for example, through a contemplated asset sale, no benefit in analysis is provided to such companies.

FACTORING IN CREDIT ENHANCEMENTS

Credit enhancement is any form of risk reduction technique that provides protection, in the form of financial support, to cover losses under stressed scenarios or that protects a particular set of creditors from the risks faced by the entity as a whole either fully or to some extent. Two commonly used credit enhancements:

- Third party guarantees
- Cash collection mechanism

In case of the former, the extent of enhancement is a function of the strength of guarantor, amount of guarantee vis-à vis amount of debt and the timeliness of the guarantee. Moreover, a corporate guarantee carries less weight vis-à-vis a guarantee issued by a financial institution/government. If a particular security is fully secured by a third party, then the counterparty risk will be replaced by the guaranteeing entity given that the guarantee ensures timely payment on call. For instance, a debt instrument issued by an entity rated 'BBB' and fully guaranteed by an entity rated 'A' would be assigned rating of 'A', assuming that the guaranteeing entity is rated by VIS. If VIS does not have an outstanding opinion on the guaranteeing entity, then a shadow rating may be done, and the debt instrument would be rated accordingly. Notching up is also possible though establishing a strong structure which gives significant additional enhancement to the debt recovery prospects. This could be achieved through credit enhancement features such as creation of a reserve or sinking fund, dedicated liquidity support for debt servicing obligations or presence of a share

conversion reserve or sinking fund, dedicated liquidity support for debt servicing obligations or presence of a share conversion mechanism whereby shares of a company are pledged and are transferred to the debt holders accounts prior to due date in case cash flows from operations are insufficient for debt servicing.

Cash collection mechanism which can also be referred to as on-balance sheet securitization, can sometimes also result in a particular debt instrument being rated distinctly from what may be indicated by the issuer rating and notching guidelines discussed above. When captured, one specific revenue stream of the entity, backing a particular liability may result in a better credit quality vis-à-vis the entity rating. The entrapment of revenue in designated accounts however has to be viewed in context of the likely cash requirements for normal business operations. VIS recognizes that cash entrapment mechanism cannot compensate for an issuer's ability to pay if overall entity level debt servicing capacity is considered constrained in general, since an entity that stops making payments on a particular class of debt, may stop payments on all types of debts; this may also be triggered by cross-default covenants in loan documents. If however, there is sufficient legal ring fencing, which would ensure that payments on a particular class of debt will continue even if the entity defaults on one or other liabilities, then the necessary credit enhancement may be built into the ratings of the debt instrument backed by specific cash flows.

RATING BANK CAPITAL INSTRUMENTS

The issue specific rating takes into account the relative priority of claim of a particular class of debt vis-à-vis the other outstanding obligations of that particular entity. This means that issue specific ratings take into account both the probability of default at an entity level along with the recovery prospects associated with a particular debt issue. As a general rule, the set of creditors that will be settled first in a bankruptcy scenario will be assigned the highest ratings, whereas the equity holders have residual claim on a company's assets. This essentially means that VIS will first arrive at the issuer rating, which is also the rating applicable to senior unsecured creditors and then the ratings of individual debt issues may be determined based on their specific features.

As per SBP issued guidelines issued in 2013 under Basel-3 regime, subordinated debt to be Tier-2 eligible instrument should rank below all other liabilities of the bank including depositors, however, senior to instruments eligible for inclusion in Tier-1 instruments. Moreover, a Tier-2 eligible instrument should also have the following features:

- A lock-in-clause which restricts principal and interest installments in case the payment may result in shortfall of MCR or CAR or increase any existing shortfall.
- Loss absorbency clause through either a conversion into common stock or write-down feature at the point of non- viability (PONV). As per local regulations, PONV is determined by the regulator.

While the regulatory framework may not consider a missed coupon payment as a default; as per the credit rating methodology employed by VIS, any such missed payments will trigger one to several notch downgrade. Upon occurrence of PONV event as defined by SBP's Basel III guidelines, rating would deemed to have been withdrawn.

As per SBP instructions, all instruments issued after January 1, 2013 have to be compliant with Basel 3 criteria (including the loss absorbency clause requirements) to qualify as regulatory capital.

Basel 3 Tier 1 instrument issued must be perpetual, non-cumulative preference shares and must permanently be available to absorb losses. Additional features for Basel 3 Tier 1 instruments include full discretion to the issuer over the amount and timing of dividend/coupon payment i.e. failure to pay should not constitute event of default. Moreover, dividend coupon should only be paid from earnings of the year. Also, Basel 3 Tier 1 instrument needs to include a con- version option at a pre-specified trigger event.

VIS's approach to rating Basel 3 Tier 2 instrument is to lower up to two notches from an issuer's entity rating based on its priority below unsecured creditors. However, there may be no need to create any differentiation between the entity and Tier 2 instrument rating in case of 'AAA' rated issuer.

In case of Basel 3 compliant Tier-1 instrument, rating may be one to three notches below the issuer's entity given their low priority in settlement of claims, non-performance risk and recovery prospects.

For entities rated in the lower investment grade bands, notching differential for instrument ratings may be greater while for entities rated in the higher investment grade bands, particularly with very strong risk profile, differential in instrument ratings may tend to narrow with entity ratings.

RATING DEBT INSTRUMENTS BY MICROFINANCE BANKS

Capital instruments issued by Microfinance Banks (MFBs) are unsecured, subordinated as to payments of principal and profit to all other indebtedness of MFBs including deposits and have lock-in clause as well as loss absorbency as required under Basel III criteria for regulatory capital. For such capital instruments, ratings are notched from entity ratings down due to priority and presence of lock in and loss absorbency clauses. For instruments issued for liquidity purposes, ratings of debt instruments may be equated with entity ratings in case of structured security mechanism (partial cash coverage and creation of debt payment account) and charge on present and future assets of the MFB. VIS here will place emphasis on cushion on balance sheet to meet obligations as they become due.

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

Medium to Long-Term

AAA

Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-

High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-

Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-

Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if chang es occur in the economy.

B+, B, B-

Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

CCC

Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC

A high default risk

C

A very high default risk

D

Defaulted obligations

Short-Term

A-1+

Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1

High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2

Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3

Satisfactory liquidity and other protection factors qualify entities /issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B

Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C

Capacity for timely payment of obligations is doubtful.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details.www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

Faheem Ahmad

President & CEO, VIS Credit Rating Company Limited

Founder, VIS Group

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.

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

Jahangir Kothari Parade

National Excellence, International Reach

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 endeavor to remain an emblem of trust.

VIS Credit Rating Company Limited

International Affiliates

Islamic International Rating Agency - **Bahrain**
Credit Rating Information & Services Ltd. - **Bangladesh**
Borhan Credit Rating Company Ltd. - **Iran**

International Collaborations

Japan Credit Rating Agency, Ltd. - **Japan**
China Chengxin International Credit Rating Company Limited - **China**

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