VIS

Credit Rating Company Limited.

RATING THE ISSUE RATING METHODOLOGY

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SCOPE OF CRITERIA

The criteria ‘Rating Methodology- Rating the Issue’ focuses on specific debt or hybrid issues issued by corporates and financial institutions, Microfinance banks and Non-bank Financial Company (NBFC). Issue rating can either be long-term or short-term. Short-term ratings are generally assigned to those obligations with maturities of less than 365 days, including Commercial Paper. Short-term ratings may also be issued to indicate the creditworthiness of an obligor with respect to put features on long-term obligations

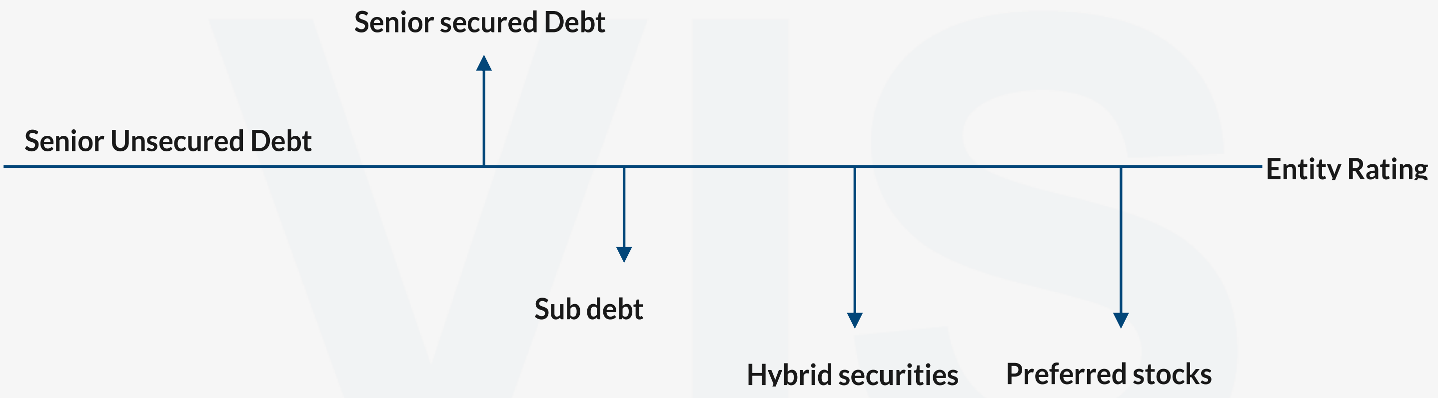
SUMMARY OF CRITERIA CHANGES

This methodology is based on the same fundamental criteria as outlined in ‘Rating the Issue’ dated November 2021 with no major change in the rating framework. The main change to the criteria is in the rating of capital instruments issued by banks under Basel III framework. VIS has outlined a separate rating scale (https://docs.vis.com.pk/docs/VISRatingScales.pdf) for Basel III instruments to encompass the peculiar features of the instruments and distinguish them from the conventional scale.

AN OVERVIEW OF RATINGS FRAMEWORK

VIS criteria for rating the issue refers to the capacity and willingness of the obligor to meet its financial commitments on time, in accordance with the terms of the obligation. Issue credit ratings, in addition to expressing default risk, also takes into account recovery prospects associated with a particular debt issue including the protection factors and relative position of the obligation in the event of bankruptcy. 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 shall be considered before arriving atissue 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 forlower grade ratings, whichhave higher probability ofdefault.

In terms of rating,this implies thatthere may be greater differentiation between let's say the entity andsubordinated debt ratings of a non-investment grade issuer vis-à-vis an investment grade issuer, while the soundness of security and credit enhancementfeatures inadebtissuewouldinfluenceits relativepositiontoentity rating.Moreover,theremay 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 impactthe 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, ifthe diversity of a company is likely to dissipate in the foreseeable future,for example,through a contemplated asset sale, no benefitin analysis is provided to such companies.

In distressed restructuring whereby lenders have diminished financial returns relative to the original obligation and the restructuring has the effect of allowing the obligor to avoid a bankruptcy or payment default may generally warrant one to several notch downgrade or assignment of 'D' rating. Default is generally recognized after the expiry of grace period. However, if investors have entered into a restructuring agreement, rating may be suspended or assigned a Rating Watch status till provision of complete details of the restructuring have been made available.

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-àvis amount of debt and the timeliness of the guarantee. Moreover, a corporate guarantee carries less weight vis-à-visa guarantee issued by a financial institution/government. If a particular security is fully secured by a third party, then the counterparty riskwill be replaced by the guaranteeing entity given thatthe 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' wouldbe 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 supportfor 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 howeverhas to be viewed in context of the likely cash requirements for normal business operations. VIS recognizes that cash collection 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 builtinto the ratings of the debt instrument backed by specific cash flows.

RATING BANKCAPITAL INSTRUMENTS

VIS uses a separate rating scale for hybrid Tier-1 and Tier-2 capital instruments issued by Banks (https://docs.vis.com.pk/docs/VISRatingScales.pdf), under Basel III guidelines as implemented by SBP. The rating scale captures the peculiar characteristics of the hybrid instruments in relation to their conversion / write-down feature.

The issue specific rating takes into account the relative priority of claim of a hybrid capital classes, having lower priority claim on a company's assets, assigned correspondingly lower ratings. This essentially means that VIS will first arrive at the issuer rating, which is also the ratingapplicable to senior unsecured creditors or in other terms the depositors and then the ratings of individual debtissues may be determined based on their specific features and priority of claims under bankruptcy.

VIS's approach to rating Basel III Tier-2 instrument is to lower one 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 difference on between the entity and Tier-2 instrument rating in case of 'AAA' rated issuer.

This gap may widen up to several notches if financial performance of the entity and CAR continues to weaken to capture the incremental non-performance risk. For subordinated debt to be Tier-2 eligible instrument under the Basel III regime, SBP issued guidelines in 2013 which ranks Basel III compliant Tier-2 instruments 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 these features:

- A lock-in-clause which restricts principal and interest payment.
- Loss absorbency clause through either a conversion into common stock or write-down feature at the point of nonviability (PONV). As per local regulations, PONV is determined by the regulator.

Basel III Tier 1 instrument issued must be perpetual, non-cumulative and must permanently be available to absorb losses. Additional features for Basel III 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.

In case of Basel III compliant Tier-1 instrument, rating may be two to three notches below the issuer's entity given their low priority in settlement of claims, non-performance risk and recovery prospects. This gap may widen up to several notches if financial performance of the entity and CAR continues to weaken to capture the incremental non-performance risk.

Basel III Tier-1 instrument needs to include a conversion option at a pre-specified trigger event i.e., if CET-1 ratio falls to or below 6.625%. VIS believes that the chance of a banking institution reaching PONV will be rare in the domestic context given the regulatory oversight and financial importance in the economy of banks in the country. However, if VIS observes continuous weakening in CAR, issuer ratings may be downgraded to lower 'A' band for medium sized banks and lowered to low 'BBB' band for small sized bank. For large banks, including D-SIBs, ratings fall may generally be gradual given extraordinary historic regulatory support due to systemic risk. In event of lock-in clause being invoked by the regulator or partial conversion / write-down, the ratings shall move to 'B' band. On complete conversion/write-down, ratings shall be withdrawn.

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 will be done on hybrid scale (https://docs.vis.com.pk/docs/VISRatingScales.pdf) and are notched from entity ratings in accordance with the notching criteria laid down for banks capital instruments. For instruments issued for liquidity purposes, rating 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 places emphasis on cushion on balance sheet to meet obligations as they become due.

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.

Sara Ahmed

Director - Rating

Sara Ahmed possesses 17+ years of experience in financial risk assessment and credit structuring. She has worked in Corporate Banking & Risk Management functions locally as well as internationally. Sara has been involved in the entity ratings of numerous corporate organizations as well as financial institutions besides being part of the Methodology and Criteria Development team. She holds a Master's degree in Business Administration from the Institute of Business Administration, Karachi (2001).

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

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Islamic International Rating Agency – **Bahrain –** iira.com
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Collaborations

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

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