METHODOLOGY

MICROFINANCE INSTITUTIONS

An independent rating opinion on relative ability of a Microfinance institution to honor financial obligations

Content

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The Pakistan Credit Rating Agency Limited

www.pacra.com

0. INTRODUCTION

- *Scope*
- *Rating Framework*

A sound financial ecosystem is critical for functioning of any economy. It is defined by interaction of providers of funds - savers, users of funds - borrowers, financial institutions, and regulators. This system ensures smooth flow of funds between savers and borrowers; wherein, financial institutions provide platform for their interaction. Regulatory oversight safeguards the sanctity of this system. Like all systems, financial system has its own set of challenges. The most prominent being "Risk"; the risk that some participant may not be able to meet its commitments. All participants do their best to manage this risk to maximize their return. This is not possible unless we have independent information on this risk. Here comes expertise of rating agencies, providing independent opinion on credit risk. Flow of funds is only possible when the provider of funds has confidence that user of funds will be able to return these in a timely manner and as committed. Ratings help build this confidence. A higher rating means higher likelihood of timely repayment compared to a low rating. Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of a company's performance as well as for peer comparisons.

0.1 Scope: Micro Finance Institutions (MFIs) in many ways are similar to other financial institutions, mainly banks, which primarily operate in lending business. In addition to carrying social objective of meaningful impact on overall society, many MFIs focus on business on self-sustainable basis so as to reduce/eliminate dependence on support i.e. subsidized loans, donations, grants etc. MFIs' primary business is to cater that part of society which is unserved or underserved due to low levels of their income and micro needs, which cannot be satisfied by large financial institutions like commercial banks mainly due to capability as well as business considerations. As amounts involved per borrower are significantly small but the volumes are large, MFIs operate in a different risk framework. This criteria document applies to MFIs, mainly Micro Finance Banks (MFB), which have access to commercial sources of funding, inter alia including, customer deposits, bank borrowings, commercial papers, and Term Finance Certificates.

0.2 Rating Framework: PACRA bases its analysis of financial institutes on a number of quantitative and qualitative factors, the most significant of which are covered below. No one factor has an overriding importance or is considered in isolation and all the factors are reviewed in conjunction.

Micro Finance Institutions Rating Framework

0.2.1 The risk assessment process for MFIs comprises comprehensive analysis of the particular segment in which the entity operates, profile of the entity, and its relative position in its respective segment. Analyzing the profile of the entity includes comprehensive coverage of both quantitative and qualitative factors. In its assessment, PACRA's quantitative analysis helps to reach an anchor rating. This rating can then be affected by qualitative factors – the modifiers. After standalone rating is finalized, the entity's rating is concluded while incorporating sponsor's assessment of financial strength and expected / agreed level of support.

0.2.2 The quantitative factors helps in achieving objectivity in the rating process while the qualitative side helps in establishing the sustainability of the relevant factors in the foreseeable future. Neither all factors can be quantified nor do quantitative values portray the whole story. PACRA, therefore, seeks to employ a best combination of both and would stick to it to ensure comparability on historical as well as synchronic basis.

0.2.3 The basic precepts of this rating methodology is understanding of the business model of the financial institute (and the inherent risks), the strategy of its management, local macro-economic environment, and developments happening in the industry. The relevant positioning of the financial institute, established in comparison with relative peers in the industry, is a key consideration under this methodology to reach a final rating for a financial institute.

0.2.4 While our rating process does not include an audit of a financial institute's financial statements, it does examine the control environment to establish to which extent they accurately reflect a financial institute's financial performance and balance sheet integrity. We make adjustments where necessary to make a financial institute's financial data comparable with those of its peers. In order to carry out adequate analysis of a particular financial institute, it is helpful to establish a "peer group" of comparable financial institutes. Short-term and long-term ratings are based on an entity's fundamental credit characteristics, a correlation exists between them (see PACRA's Criteria document "Correlation between Short-term and Long-term Rating Scale").

1. PROFILE

- *Structure*
- *Background*
- *Operations*

1.1 Structure: PACRA evaluates the legal structure of the entity. Legal status determines the level of expected stability. In cases where the entity is a large financial institute and has a complex business structure, there are unique challenges in evaluating credibility of the entity. PACRA considers the characteristics of the entity as at times entities are run as family concerns despite legally structured as public limited company. Meanwhile, the level of perceived stability gradually increases from a private entity to a listed entity. However, unnecessary complex structures when compared to asset size, scale and peers of the same industry would have an adverse effect on the credit scoring of the entity.

1.2 Background: PACRA looks at the progress of the entity from its historical past in order to understand the evolution of the entity from where it stood to where it currently stand at. The background of the entity helps PACRA in assessing how and through what means the entity has achieved the desired expansion. However, it also help PACRA in establishing the scope of work in terms of its complexity.

1.3 Operations: The assessment of operations of the entity depends on the type of the industry and the stage the business is in. Here PACRA reviews the diversity, geographic spread of operations, and diversification of major borrowers and lenders. Later, PACRA places the entity within its relative universe to evaluate critical factors that provide competitive advantage. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position.

2. OWNERSHIP

- *Structure*
- *Stability*
- *Business Acumen*
- *Financial Strength*

2.1 Structure: The assessment of ownership begins with an in-depth study of the shareholding mix in order to disentangle structure of the ownership. Key factors that are considered for this purpose, inter-alia include, i) shareholding structure which includes whether the individual own the entity directly or indirectly, ii) foreign or local shareholders, iii) whether the entity is owned by a single group or through a combination of entities and individuals, and iv) part of a group or a standalone entity. All these deliberations are done to identify the man of the last mile.

Complex shareholding/ownership structures: *In cases where an entity has a complex ownership structure, there are unique challenges in evaluating the decision making process, lines of hierarchy and financial obligations and liabilities. In analyzing these entity's the fundamental issue is to explore the underlying reason or motivation for the complexity of the structure.*

Financial Institutions which are owned by private individuals and families: *On the one hand, the concentration of equity ownership might indicate that the majority shareholders have a strong vested interest in creating long-term value and closely monitoring management behavior. On the other hand, a potential concern in such cases is that the owners might rely heavily on extracting funds from the entity as source of income or to fund other business activities, potentially undermining the financial stability of the entity.*

2.2 Stability: In order to analyze the stability of the ownership, a particularly important factor to be taken into account is the succession planning. A very important part of our background analytical work is an attempt to assess whether, and under right of succession, an entity future prospects would be supported, and by whom. This is particularly relevant for support in case of larger sized banks, whose failures could have a contagious effect on the confidence in the overall financial system.

2.3 Business Acumen: Here PACRA gauge the Sponsor's business acumen. Having a strong business acumen set has been critical for the sustainable success of the entity. PACRA analyze the business acumen through two primary areas; i) Industry-specific working knowledge and ii) Strategic thinking capability. Meanwhile, a deep and applicable understanding of the system is critical in order to determine how a business achieves its goals and objectives. The scope includes the assessment and understanding of how the sponsors of the entity think about and successfully make the right business decisions.

2.4 Financial Strength: We analyze the ability and willingness of owners to support the entity in case of need. Particularly in case of small financial institute, where capitalization requirements are yet to meet by the entity, PACRA critically analyses the willingness and ability of the major shareholder to support the entity to comply with regulatory requirements within required timeframe. Thus ongoing support is considered more likely in these cases. However, for large financial institutions, external support from government / regulatory becomes more important. 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, ii) prospective view of key shareholders, incase such need arises, iii) other businesses of sponsors, and iv) the level of commitment of the major shareholder with the entity in providing capital support. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. The scope for other business of sponsors includes overall profiling of the key sponsor in the context of identifying the resources they have, outside the entity.

Information Required

- *Shareholding Pattern*
- *Details of sponsors' other businesses*
- *Sponsor's financial information*
- *Past pattern of sponsor support*

3. GOVERNANCE

- *Board Structure*
- *Members' Profile*
- *Board Effectiveness*
- *Financial Transparency*

3.0 PACRA's assessment of governance involves both systematic analyses of governance data and information, and the more contextual reviews of an entity's governance practices. PACRA considers four main factors while assessing the board structure of an entity: (i) board structure, (ii) members profile, (iii) board effectiveness, and (iv) financial transparency.

3.1 **Board Structure:** This comprises assessment of board on various criteria including overall size, presence of independent members, association of board members with the entity, overall skill mix and structure of committees of the board. Size of the board may vary as per the scope and complexity of the business operations of the entity. As too small board is not considered good, similarly reaching on a decision in an effective and efficient manner may not be possible in case of a larger board. A healthy composition of board includes the presence of independent / non-executive members having limited relationship with the sponsoring group of the entity. Meanwhile, same individual holding chairman and CEO positions is considered weak governance practice. Thus these should be separate persons. The chairman is expected to have a non-executive role. Compliance of code of corporate governance is also examined. PACRA also examines the independence of management from major shareholders. Lastly, PACRA evaluates number of board committees, their structure, and how these committees are providing support to the BoD. The board with higher total number of members should have higher number of committees in place to achieve efficiency in performing role of the board.

3.2 **Members' Profile:** PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality of overall board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have related experience. Here, director's trainings conducted by the entity are considered good. This is expected to equip the board members in fulfilling their role in an effective manner.

3.3 **Board Effectiveness:** 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. Board members' attendance and participation in meetings is considered a measure to assess the effectiveness. Moreover, PACRA analyses 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. Meanwhile, PACRA also review the number of board meeting held during the year as number of board meetings should be justified with the number of issues/matters arising.

3.4 **Financial Transparency:** Quality of governance framework is assessed by the procedures designed by the board to ensure transparent disclosures of financial information. The board may establish controls to ensure transparency through strengthening the role of audit committee, the quality of internal audit function, and effectiveness of external audit.

Information Required

- *Profile of BoD members*
- *Details of committees including TORs*
- *Minutes of the board meetings*
- *Information packs for the boards (MIS)*
- *Auditor details*

4. MANAGEMENT

- *Organizational Structure*
- *Management Team*
- *MIS*
- *Risk Management framework*
- *Technology Infrastructure*

4.0 Good quality management, effective systems and controls, and well-defined strategy are essential ingredients for a successful entity.

4.1 Organizational Structure: The assessment of management starts with PACRA conducting an in-depth analysis of organizational structure of the entity. On a standalone basis, PACRA looks into the hierarchal structure, reporting line, dependence of the management team on one or more persons, coherence of the team. However, PACRA also places the organizational structure in the entity's relative universe for comparison in order to form opinion of optimal structure within the sector in context of its complexity. Number of management committees are established to monitor performance and assure the adherence to the policies and procedures. PACRA measures the effectiveness of the entity by forming an opinion on the quality of management committees.

4.2 Management Team: Analysis of management includes evaluating experience profile of key individuals, management's track record to date, in terms of building up sound business mix, maintaining operating efficiency and strengthening the entity's market position. Although judgment about management is subjective, performance of entity over time provides a more objective measure. 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. Loss of key personnel, particularly members of senior management, can have potentially adverse effects on overall standing of the entity relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments. In addition, entity's human resource policies are also reviewed to gauge entity's emphasis on retaining and recruiting vital staff and ensuring their redundancy in the structure.

Field Staff: *In case of MFIs, the mid- and low-tier staff is critical in maintaining a strong asset quality as they hold the relationship with the borrower and any misconduct on their part may cost deterioration to the institution's asset quality. Thus their ability to retain good field staff is considered important while assessing human resource management. Moreover, PACRA attempts to understand the client's staffing policies, local language ability of staff dealing with borrower, and their training on social aspects, particularly important to the area of their operations.*

4.3 MIS: One of the key tools available to the management to effectively run an organization is the information provided to it. PACRA closely monitors the type and frequency of information used by the management. The critical aspect is for the information to be concise, clear, and timely so the management can understand and respond accordingly. System generated – real time based – MIS reports add more efficiency in performance monitoring. PACRA evaluates the quality and frequency of the MIS reports used by the department heads. PACRA further assesses whether management has developed any critical success factors (CSF) to evaluate performance of various business segments. The efficacy of these CSF is gauged.

4.4 Risk Management Framework: This includes an analysis of the entity's appetite for risks and the systems in place to manage these risks. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits that have been implemented, limits setting authority and the degree to which these procedures are adhered to. PACRA endeavors to assess senior management's understanding of and involvement in risk management issues and examine the reporting lines in place. In recent years, there has been a noticeable upgradation in the risk management systems of the financial institutes, in the face of increasing guidance and supervision from the SBP and SECP.

Operational Risk: *Operational risk has historically been defined as all other risks other than market, credit and liquidity risk. In the context of Basel II, definition of operational risk is: "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events". This definition includes legal risk but excludes strategic and reputation risk.*

Our analysis of operational risk focuses on a number of issues, including (a) an entity's definition of such risk (b) the quality of its organizational structure (c) operational risk culture (c) the development of its approach to the identification and assessment of key risks (d) data collection efforts; and (e) overall approach to operational risk quantification and management.

Other Risks: *As already indicated, a risk often not encapsulated in the above categories is reputation risk, which can be significant for some entities, particularly those active in private banking. A good name and brand image are often an important differentiator of long-term performance in an industry which is becoming increasingly commoditized.*

4.5 Technology Infrastructure: With the growth of technology-based opportunities to enhance service standards and delivery processes, technology has to be an important part of any forward-thinking MFI's strategy. The advent of technology in microfinance sector is needed to not only scale up the access to finance but also attempt to ensure provision of financial services to the remotest and far-flung areas, hence increasing the outreach. PACRA evaluates the efforts of MFIs to not only constantly examine options for technology-based solutions, but also subject them all too rigorous cost/benefit and risk analysis. Digitalization of banking procedures is very critical for the future growth of MFIs.

Branchless Banking: *With recent growth in branchless banking (BB) segment by microfinance banks (MFBs), PACRA evaluates BB operations in detail. In addition to surveilling its profitability, PACRA gives importance to, i) Agent networks, ii) Regulatory reporting, and iii) related Systems and controls. Besides adding diversity to the revenue stream, it has been observed that BB operations can generate low-cost deposits; thus further strengthening the profitability.*

Information Required

- *Latest Organogram*
- *Profile of senior management*
- *Redundancy pattern*
- *MIS reports*
- *Management meeting minutes*
- *Entity's policies and SOP*

5. BUSINESS RISK

- *Industry Dynamics*
- *Relative Position*
- *Revenue*
- *Profitability*
- *Sustainability*

5.1 Industry Dynamics: The process for anchoring credit rating of an entity builds on PACRA's understanding of the industry dynamics. This understanding, following an in-depth research approach, is documented as a sector study. The analysis captures the placement of the local industry in the international context to see the points of identity and distinction. In points of identity, the risks and challenges identified for the international players are re-evaluated for the local players, with a view to see whether the local players have established effective mitigant's against those risks and taken due measures to meet the challenges. At the same time, we identify the risks and challenges specific to the local context of the industry. While conducting the analysis, PACRA takes a view on the industry alone, independent of the market players. This exercise helps PACRA to form a view on industry's significance in the economic environment of the country, its attractiveness to entrepreneurs, barriers to entry, and the power of suppliers and customers.

5.1.1 PACRA explores the possible risks and opportunities in an entity resulting from social, demographic, regulatory and technological changes. It considers the effects of geographical diversification and trends in industry expansion or consolidation required to maintain a competitive position. The analysis includes the role of the supervisory authority, its supervision of regulated entities, reporting requirements and regulations relating to specific type of financial institutions and to specific financial products.

5.1.2 PACRA determines an entity's rating within the context of its industry fundamentals. Segments that are in decline, highly competitive, capital intensive, cyclical or volatile are inherently riskier than stable with oligopolistic structures, high barriers to entry, national rather than international competition and predictable demand levels. Major industry developments are considered in relation to their likely effect on future performance. The inherent riskiness and/or cyclicality of an industry may result in an absolute ceiling for ratings within that industry. Therefore, an entity in such an industry is unlikely to receive the highest rating possible ('AAA') despite having a conservative financial profile, while not all entities in low-risk segments can expect high ratings. Instead, many credit issues are weighed in conjunction with the risk characteristics of the industry to arrive at an accurate evaluation of credit quality.

5.1.3 Economic Risk: While analyzing economy, PACRA evaluates economic policies, GDP growth, performance of important sectors in the economy and potential credit demand. An important part of economic analysis is positioning of industry and impact assessment of economic risk factors on the industry.

5.2 Relative Position: Relative position reflects the standing of the entity in the related market. The stronger this standing is, the stronger is the entity's ability to sustain pressures on its business volumes and profit margins. This standing takes support from two major factors including a) market share, b) growth trend.

Market Share: *Market size represents the entity's penetration in the chosen market. Size is advantageous as it provides ability to acquire larger business, pricing power and better expense management. There is a positive correlation between an entity's absolute and relative size and its market position and brand value. The large entities exercise greater power over the pricing, while ensuring commensurate profits. Small entities struggle to obtain business; and with less flexibility in the cost structure, their profits remain low. While absolute size is important, it is basically the relative proportion which provides a clear yardstick to analyze the comparative strength of the market players. The more distant a player is from the average on the positive side, the stronger is its ability to reflect the characteristics just mentioned. In a dynamic industry, which is not characterized by concentration, PACRA believes that relative size would better capture the strength of the entity's standing in the related market.*

Growth Trend: *While evaluating the size, PACRA looks at the rate of growth. Growth is important as it ensures that the entity continues to have the ability to meet the industry's benchmarks. As the industry grows, it uplifts the scale of its operational context. This reflects in the ability of the players to invest in human resource, upgrade the control environment, enhance the product slate, increase the outreach and improve the quality of product/service. To lag the industry's growth trend means to remain short on these avenues, putting pressure on the market position.*

5.3 Revenues: In measuring earning's quality of an entity, diversification and stability are very important factors. An entity with a diverse product slate with more than one revenue streams is considered better than an entity with a concentrated earning profile. PACRA sees concentration at both product and customer levels. In addition, the analysis of target markets to which an entity serve s forms a part of the assessment. Stability is measured through historical trend analysis of the entity's revenues.

Segments
Products
Customers
Geography

5.3.1 Diversification: Diversification is a holistic perspective. It encompasses many aspects which govern the business model of the entity. Multiple array of product provider against mono-line product provider is perceived to have less business risk. Diversification is utmost desirable. The rationale for this is that diversification enhances the ability to meet challenges, both present and upcoming. The lack of diversification gives rise to concentration risk, reflecting vulnerability of the entity to few elements. Concentration is considered a major negative because it limits the entity's ability to ensure sustainability in its business let alone expand it. At the same time, it enhances the risk of disruption in the operations if the area of concentration goes wrong. This does not entail that a company specializing in a certain product/segment would be put at a disadvantage. The disadvantage would only arise, if the company's business gives rise to concentration risk.

5.4 Profitability: MFIs carry high credit risk on their balance sheet due to the nature of their operations. Moreover, due to certain limitations, inter-alia including, small size, and limited outreach, their ability to mobilize low cost deposits remains weak. Thus in addition to risk profile, their cost structure is high. These institutions serve a large pool of client base with small loan size. This results in high operational including staff costs for MFIs. Therefore, MFIs charge fairly high price to their customers. Although their interest margins seem high as compared to other FIs; once loaded with business acquisition and servicing cost, their pre-provision profit margins are comparable to other FIs.

PACRA evaluates an entity's ability to convert its earnings into profits as well as efficiency ratios, e.g. operational self-sufficiency. Moreover, the quality and stability of the earning streams are assessed. An adequately diversified product slate is considered good as compared to concentration in a single loan product. In case MFI can generate revenue from some business other than lending, it is seen positively. But its contribution towards bottom-line is measured to incorporate its impact on overall performance. In addition, the drag of provisioning expense is incorporated to see the level of pre-tax profitability for the current as well as future periods.

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

5.5 Sustainability: PACRA evaluates the strategy of the management and the viability of designed path to reach to the goal. Earnings prospects are monitored, based on budgets and forecast prepared by the management. 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.

Information Required

- *Industry information for Loan portfolio, depositors, number of borrowers*
- *Projection of two years, with details of underlying assumptions*
- *Type of License*
- *Branchless Banking operations, outreach, market share, target market, strategy for future, key figures (agents, deposits in amount and volume, number of transactions)*

6. FINANCIAL RISK

- *Credit Risk*
- *Market Risk*
- *Funding*
- *Liquidity*
- *Capitalization*

6.1 Credit Risk: Importance of credit risk is significant to any lending institution. As MFI's type of customers is different i.e. micro-borrowers, it entails different approach towards credit risk assessment. Micro-borrowers tend to have little or no documentation. Moreover, the tenor of loans is usually short, one year or less. Thus an MFI's risk evaluation systems should be able to appraise the ability of such borrowers to repay on time. The relationship of MFI's loan staff with the borrower himself or with the people around him is critical to assess the means of the borrower for repayment of loans.

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. Credit risk analysis includes review of credit portfolio at all levels. Portfolio is evaluated with respect to its size to establish market share. PACRA evaluates the size of loan per borrower to get an understanding of the risk profile of the book. Analysis of product mix in terms of secured and unsecured is done. Collateralized loan book is considered superior as compared to non-collateralized portfolio. Loans having staggered repayment structure are considered better vis-à-vis loans with bullet payment at maturity.

6.1.1 Asset Quality: Assessing asset quality is an important pillar of credit risk. In this regard, an MFI's overdue, restructured, and written off loans are taken into account to see the overall performance of the portfolio. Regarding provisioning criteria, PACRA takes comfort from stringent regulatory requirements. Post-delinquency, the level of reserves maintained for provisioning requirements is considered important.

MFIs' asset quality remains exposed to risk of undocumented earning streams vis-a vis the amount of loans obtained by the borrowers from different financial institutions. Thus assessment of over-indebtedness remains a challenging task. Nevertheless, structuring of in-house evaluation *framework and availability of micro finance exclusive credit information reports lend help to MFIs in this regard.*

6.2 Market Risk: Microfinance institutions in normal circumstances only invest in government securities to meet regulatory statutory liquidity and cash reserve requirements. Moreover, regarding equity investments, microfinance institutions are only allowed investment in limited sectors. This limits overall exposure of MFIs to market risk.

6.3 Funding: MFIs finance their assets mainly through deposits – micro savings as well as corporate deposits, in addition to other funding sources, where available. PACRA analyzes funding mix (short-term vs long-term, and retail vs institutional etc.) as well as concentration levels in funding base. A large pool of micro savers is considered stable in comparison to large institutional deposits. Due importance is given to management's strategy to keep risks related to funding at manageable level.

6.4 Liquidity: Another most important risk is liquidity management. PACRA analyses short-term vs long-term mix; the maturity profile of liabilities is seen in tandem with related asset base to analyze liquidity profile. PACRA believes higher asset turnover as compared to liabilities is good for liquidity management. The bank's compliance to regulatory reserve requirements is a minimum. The presence of Asset Liability Committee is essential to ensure effective monitoring of liquidity mismatches.

6.5 Capitalization: Compliance with minimum capital requirement is key to obtain license. For MFBs, the requirement for capital increases with the operational scale i.e. district, provincial, or national. Like in case of other financial institutions, PACRA considers MFIs 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.

While analyzing capitalization, PACRA sees higher capital adequacy ratio positively. As ratings are not point-in-time, PACRA sees the ability of the institution to generate capital from internal sources. In case of MFBs, 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 MFBs.

Credit Enhancement: *The entity that carry third party commitment to make good an amount obligated to the lenders may provide additional support to its financial risk profile. In this case, in determining the impact on rating, key factors to assess are the financial profile of the third party and the extent of coverage – quantum and duration – it provides.*

Information Required

- *Total available money market lending and borrowing lines along with the average rates*
- *SBP returns filed including i) Reserve Ratio Requirements', and ii) Capital Adequacy Statement*
- *Details of 50 largest depositors along with their maturity profile and profit rates*
- *Spread Calculations*
- *Industry information for Deposit portfolio*
- *Outstanding exposures amount along with segment wise/product-wise details of the classified advances portfolio*
- *Industry-wise concentration of exposures of entity*
- *Party wise detail of classified advances portfolio (Top 20)*
- *Industry loan portfolio*

Rating Scale | MFI

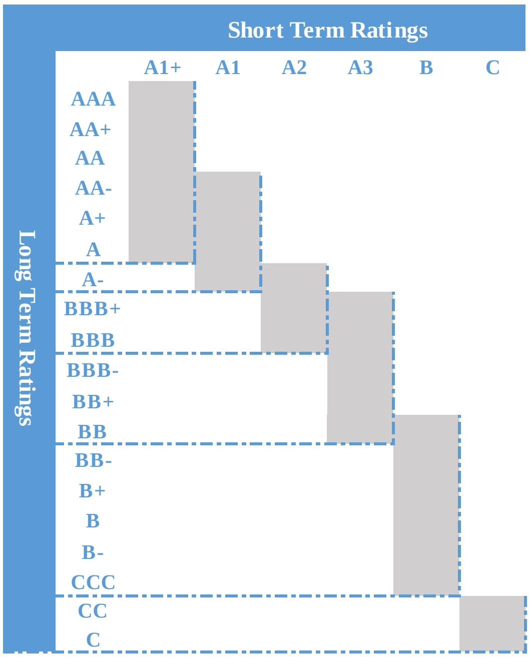
2019

Credit Rating Scale & 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 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.



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'.

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. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

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, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.