Methodology Non-Banking Finance Companies (NBFCs) Rating

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Summary

PACRA's Non-Banking Finance Companies (NBFCs) rating is a representation of its opinion on the relative credit risk associated with a NBFC. PACRA arrives at this opinion by conducting, inter-alia, a detailed evaluation of several qualitative and quantitative factors, namely: Profile, Ownership, Governance, Management, Business Risk and Financial Risk. The relative importance of each of these qualitative and quantitative criteria can vary across NBFCs, depending on its potential to change the overall risk profile. While standalone credit quality is addressed, PACRA incorporates the relative positioning of a NBFC to arrive at the final rating.

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0. Introduction

- Qualitative and quantitative factors
- All factors assessed on standalone *and* relative basis

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), NBFCs (intermediaries), and regulators (oversight). This system ensures smooth flow of funds between savers and borrowers; wherein, NBFCs 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 the 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: Non-banking finance companies (NBFCs) are an important part of the financial system. The operations of most NBFCs are not much different from that of banking companies in the local environment. Traditionally, they used to have their separate space to operate but as the concept of universal banking gained momentum, the distinction became blurred. This implied a highly competitive business environment for NBFCs, thus creating greater impediments for growth. The key difference between banks and NBFCs is that the latter cannot offer check-in deposit accounts. NBFCs, as defined in Companies Ordinance 1984 and NBFC& NE Regulation, 2008, include companies offering leasing, investment finance services (including non-bank microfinance companies), housing finance, venture capital, discounting, investment advisory, and asset management companies. This methodology mainly covers leasing companies, housing finance companies, and investment finance companies. Modarabas carry similar risk factors as by other NBFCs, thus this methodology equally applies to them. Meanwhile, non-bank microfinance companies are covered under PACRA's Microfinance Institution Rating methodology while asset management companies are covered under PACRA's Asset Manager Rating methodology. Securities and Exchange Commission of Pakistan (SECP) has been acting as the sector regulator since FY03, when a comprehensive regulatory framework was designed for NBFCs. Modarabas are covered under a separate law issued by SECP in 2021 titled Modaraba Regulations 2021.

0.1.1 The services that a NBFC can offer are linked with the license it acquires subject to fulfilling regulatory capital and other requirements. A single NBFC may acquire multiple licenses such as investment finance, leasing, and housing finance. Thus, an entity with more than one license has greater ability to diversify its operations. However, related risks are to be managed accordingly.

0.2 Rating Framework: PACRA bases its analysis of NBFCs on a number of quantitative and qualitative factors. Overall factors are categorized under six key areas: Profile, Ownership, Governance, Management, Business Risk and Financial Risk. No one factor has an overriding importance or is considered in isolation and all the factors are reviewed in conjunction. Quantitative factors help 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 to ensure comparability between ratings over time.

0.2.1 While our rating process does not include an audit of a NBFC's financial statements, it does examine the control environment to establish to which extent they accurately reflect a NBFC's financial performance and balance sheet integrity. We make adjustments where necessary to make a NBFC's financial data comparable with those of its peers. In order to carry out adequate analysis of a particular NBFC, it is helpful to establish a "peer group" of comparable NBFCs. Short-term and long- term ratings are based on a NBFC'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

- **Background:** Evolution and past strategy
- **Operations:** Key facts including exposure to certain business segments, product slate, geographical location etc.

1.1 Background: PACRA reviews the background of the NBFC to understand its evolution from where it started to where it currently stands. We analyze how and through what means the NBFC has achieved the desired expansion. PACRA looks at the progress of the NBFC from its historical past. The progress of the NBFC helps PACRA in determining the ability of the NBFC to successfully realize its strategy. The significant factor here for PACRA is to assess whether the NBFC has achieved the desired expansion through organic growth or acquisitions. Meanwhile, the source of funding for desired growth is also critical.

1.2 Operations: The assessment of operations of a NBFC depends on the exposure of business segments and the stage the business is in. Here PACRA reviews the diversity, geographic spread of operations, product offering, asset mix, borrower profile, size of the franchise/portfolio and track record of operations. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position. Unlike their banking brethren, NBFCs are often subject to less formal regulations. Even though somewhat less tightly regulated, NBFCs typically must comply with various mandatory lending or licensing statutes.

2. Ownership

- **Ownership Structure**: Identification of man at the last mile
- **Stability**: Succession planning at shareholder level
- **Business Acumen**: Knowledge, skills and experience of key shareholders
- **Financial Strength**: Willingness and ability of key shareholders to provide extra-ordinary financial support

2.1 Ownership Structure: The assessment of ownership begins by looking at the legal status of the NBFC. The level of perceived stability gradually increases from a sole proprietor to a listed NBFC. This is followed by an in-depth study of the shareholding mix in order to disentangle structure of ownership. Key factors that are considered for this purpose, inter-alia, include: i) shareholding structure which includes whether the individuals own the NBFC directly or indirectly, ii) foreign or local shareholders, iii) whether the NBFC is owned by a single group or through a combination of entities and individuals, and iv) whether it is part of a group or is a standalone NBFC. All these deliberations are done to identify the man at the last mile. PACRA further considers how a NBFC is actually run, as, at times, entities are run as family concerns despite being legally structured as companies. Ownership structure influences the ability of the NBFC to access additional capital or liquidity and can have a bearing on NBFC's ratings. Most NBFCs fall into one of two categories: independent (public or private) or subsidiary of a larger corporate NBFC / financial institute. For independent NBFCs, ownership is often fairly diffused but in case of a subsidiary, control could be more concentrated to one shareholder i.e., the parent company. In such cases, the NBFC's ratings are likely to be closely linked to those of its parent.

Complex shareholding/ownership structures: *In cases where a NBFC 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 NBFCs the fundamental issue is to explore the underlying reason or motivation for the complexity of the structure.*

NBFCs 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*

NBFC as source of income or to fund other business activities, potentially undermining the financial stability of the NBFC.

2.2 Stability: In order to analyze the stability of the ownership, a critical 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, a NBFC's prospects would be supported, and by whom. A stable ownership with clarity in succession, perhaps major shareholding residing with one family or group, is considered positive for ratings. On the contrary, high free float (in case of listed concerns) leads to risk of take over and may anchor lower ratings.

2.3 Business Acumen: PACRA gauges the shareholders' business acumen. Having a strong business acumen is considered critical for sustainable success. PACRA analyzes 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 shareholders of the NBFC think about and successfully make the right business decisions.

2.4 Financial Strength: PACRA analyzes the ability and willingness of the major shareholders to support the NBFC both on a continuing basis, and support in times of crisis. Particularly in case of smaller NBFCs, where capitalization requirements are yet to be met, PACRA critically analyses the likelihood of the major shareholder supporting the NBFC in complying with regulatory requirements within required timeframes. Thus, ongoing support is considered more critical in these cases. However, for large NBFCs, 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 major shareholders, and iv) the level of commitment of the major shareholder with the NBFC in providing capital support. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. The scope for looking at other business includes overall profiling of the key shareholders in the context of identifying the resources they have, outside the NBFC. Here, the standalone rating of the institution can benefit from having majority shareholders with very strong financial strength and commitment to the business. If, in a group structure, the financial strength of the shareholders is deemed to be weaker than that of the NBFC, this may bode negatively for the NBFC's standalone rating given the possibility that the NBFC may at some point of time be bound to extend financial support to its weaker parent.

Information Required on Ownership

- Shareholding pattern
- Details of major shareholders' other businesses
- Shareholders' financial information
- Past pattern of support provided by the shareholders

3. Governance

- **Board Structure**: Composition of the board in terms of size, independence and committees
- **Members' Profile:** Relevance and diversity of board members' skills, knowledge and experience
- **Board Effectiveness**: Extent to which board properly discharges its responsibilities
- **Transparency**: Quality and extent of financial and non-financial information disclosure to stake holders

3.1 Board Structure: This comprises assessment of the board on various criteria including overall size, presence of independent members, duration of board members' association with the NBFC, overall skill mix and structure of board committees. Size of the board may vary as per the scope and complexity of operations. While a very small board is not considered good, similarly, reaching a decision in an effective and efficient manner may not be possible in case of a large board. A healthy composition of board includes the presence of independent/non-executive members having limited relationship with the sponsoring group of the NBFC. Meanwhile, same individual holding chairman and CEO positions is considered weak governance practice. The chairman is expected to have a non-executive role. Compliance with the code of corporate governance is also examined. PACRA also considers independence of governance practices from major shareholders. Lastly, PACRA evaluates number of board committees, their structure, and how these committees provide support to the board. A board with higher number of members should have higher number of committees in place to assist in performing its role.

3.2 Members' Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the overall quality of the board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have related experience.

3.3 Board Effectiveness: In PACRA's view, the role of the board is to work with management in steering the institution to its performance objectives and to provide critical and impartial oversight of management performance. PACRA analyzes the type and extent of information shared with board members, and quality of discussions taking place at board and committee levels. Effective oversight requires frequent sharing of detailed information covering various aspects of business and market development. Meanwhile, PACRA also reviews the number of board meetings held during the year as these should be justified with the number of issues/matters arising. Board members' attendance and participation in meetings is important, and is gauged by viewing board meeting minutes.

3.4 Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial and other information. This can be achieved through: i) ensuring independence of the audit committee, ii) strengthening the quality of internal audit function, which may be in-house or outsourced, and iii) improving quality of external audit by engaging auditors which are included in the State Bank of Pakistan's panel of auditors and/or have a satisfactory QCR rating.

***Accounting Quality**: PACRA reviews the quality of a NBFC's accounting policies as reflected in its notes to accounts, auditors' comments and other disclosures which are part of its financial statements. Adherence to accounting standards is assessed, particularly for unlisted concerns.*

***Quality of disclosures:** A well-established information system is required for adequate disclosures. The characteristics of quality information includes timeliness, disclosures beyond the minimum regulatory requirements to improve transparency and consistency of such disclosures.*

Information Required on Governance
- Size and composition of board
- Details of board committees including TORs
- Profile of board members
- Information packs used by the board
- Minutes of board meetings
- Internal auditor detail (if outsourced)
- External auditor detail

4. Management

- **Organizational Structure**: Alignment of organogram with entity size, nature of business and requirements
- **Management Team** Relevance and diversity of skills, knowledge and experience of top management
- **Management Effectiveness**: Extent to which top management properly discharges duties and role of technology infrastructure therein
- **Control Environment**: Robustness of systems and processes, especially risk management framework

4.1 Organizational Structure: The assessment of management starts with PACRA conducting an in-depth analysis of organizational structure of the NBFC. On a standalone basis, PACRA looks into the hierarchal structure, reporting line and coherence of the team. However, PACRA also places the organizational structure in the NBFC'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 adherence to the policies and procedures. PACRA measures the effectiveness of the NBFC 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 building up sound business mix, maintaining operating efficiency and strengthening the NBFC's market position. Although judgment about management is subjective, performance of the NBFC over time provides a more objective measure. PACRA analyses the quality and credibility of management's strategy, examining plans for achieving 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 NBFC relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments. Similarly, dependence of the management team on one or more persons is considered risky. In addition, NBFC's human resource policies are also reviewed to gauge its emphasis on retaining and recruiting vital staff.

***Key-man Risk**: Key-man risk occurs when a NBFC is heavily reliant on an individual, or a limited number of individuals, who are accepted as the key holder(s) of important intellectual capital, knowledge or relationships. While this type of risk is more commonly identified in small to medium-sized entities, it can also exist in larger entities and is relatively challenging to benchmark, and hence, mitigate. PACRA attempts to identify the extent to which a NBFC is dependent on the expertise of such individual(s) and to ensure policies exist for managerial succession to limit the adverse impact of such a person unexpectedly leaving, on the NBFC.*

4.3 Management Effectiveness: PACRA conducts a qualitative review of management systems and technology infrastructure to assess management effectiveness. A key measure of management effectiveness is its track record of delivering on past projections and sticking to strategies. One of the key tools available to management to effectively run an organization is the information provided to it. It is critical that information available to management be concise, clear and timely, so it can be interpreted and understood, and the management can respond accordingly. An important part of this analysis is looking at the NBFC's MIS. PACRA further assesses whether management has developed any critical success factors to evaluate performance of various business segments, and their efficacy. Management meeting minutes are also reviewed, wherever available, to assess the quality of discussion.

***MIS**: System generated – real-time based – MIS reports add more efficiency in decision making whether related to operational, financial or strategic issues. PACRA evaluates the quality and frequency of the MIS reports used by the management team to ascertain that decision-making within the NBFC is information-based.*

4.4 Risk Management Framework/Control Environment: This includes an analysis of the NBFC's appetite for risk and 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 NBFC, in the face of increasing guidance and supervision from the SBP and SECP.

Credit Risk: *A key attribute of a well-run institution is that it establishes clear parameters around risk appetite and expected returns (profit) for risks being taken. Asset quality indicators are a primary tool to assess the level of risk being taken. The level and volatility of asset quality indicators is viewed in the context of returns achieved and the adequacy of risk management to determine how the risk return equation may evolve in different phases of the business cycle. Indications of poor asset quality or credit risk management will typically lead to lower ratings, whereas strong asset quality and credit quality are positively factored into a rating decision. 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.*

Market Risk: *PACRA's analysis of market risk incorporates structural risks (such as interest-rate risk management) and/or trading risks when present. The vast majority of institutions are subject to structural interest-rate risks due to the shorter nature of their liabilities compared with the duration of their assets. Many institutions are also exposed to structural foreign exchange risk. PACRA reviews the asset and liability management strategy to assess the risk appetite of the institution. Board and management policy limits are typically expressed as earnings at risk limits. These are usually evaluated along with reports from management systems. Market risk on its own may not be a rating driver; however, poor market risk management or aggressive market risk-taking without mitigants would likely pressure an institution's ratings.*

Operational Risk: *In this context operational risk is defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events"[1]. Our analysis of operational risk focuses on a number of issues, including (a) NBFC's definition of such risk (b) the quality of its organizational structure (c) operational risk culture (c) approach to the identification and assessment of key risks (d) data collection efforts; and (e) overall approach to operational risk quantification and management. Extent of technological integration is considered crucial in mitigation of operational risks such as fraud, cyber risk, loss of data and technological disruptions in critical processes. High degree of automation in day-to-day operations is considered favorable to operational risk management.*

Reputation and Other Risks: *Reputation risk may emanate from operational problems or failure in any risk management systems. It may be difficult to evaluate but could adversely affect an institution's rating in cases where it is significant. In addition to reputation risk, any regulatory non-compliance may lead to potential legal ramifications as well.*

Information Required on Management

- Latest organogram
- Details of management committees
- Profile of senior management
- Redundancy pattern
- MIS reports
- Minutes of management committees' meetings
- NBFC's policies and SOPs

[1] BIS: Basel Framework, Chapter OPE - Calculation of RWA for operational risk

5. Business Risk

- **Industry Dynamics**: Systematic risks and opportunities in the operating environment
- **Relative Position**: Current standing among peers
- **Revenues**: Quantum, stability and diversification of inflows from core and non-core operations
- **Cost Structure**: Key costs and associated risks and likely impact on profitability
- **Sustainability**: Soundness and viability of long-term strategy

5.1 Industry Dynamics: The process for anchoring credit rating of a NBFC builds on PACRA's understanding of the industry dynamics of specific segments that NBFC is operating in. 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 regulatory environment and likely support, if needed.

5.1.1 PACRA explores the possible risks and opportunities in a NBFC 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 institutions and to specific financial products.

Economic Risk: *PACRA analyzes basic economic indicators of the country including size and composition of economy, performance of important sectors, gross domestic product (GDP) growth, inflation, saving and investment trends and potential credit demand. An important part of economic analysis is positioning of industry and impact assessment of economic risk factors on the industry.*

Regulatory Environment: *A well-regulated and supervised system is pivotal for credibility and stability of NBFCs even when the operating environment may become unfavorable. PACRA's evaluation of the regulatory system involves evaluation of criterion related to capital and other countercyclical measures to absorb risk and the extent of regulatory supervision and changes in response to the macro environment and prospective regulatory changes.*

5.2 Relative Position: Relative position reflects the standing of the NBFC in the related market. The stronger this standing is, the stronger is the NBFC's ability to sustain pressures on its business volumes and profit margins. This standing takes support from three major factors including: i) market share, ii) growth trend, and iii) franchise/brand value.

Market Share: *Market size represents the NBFC'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 a NBFC'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 NBFC'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 NBFC 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.*

Franchise / Brand Value: *The strength of a franchise determines its capacity to grow while maintaining a reasonable cost to income ratio and profitability, thus providing resilience to earnings. PACRA evaluates the franchise strength in terms of scale of operations and market share for various activities, performance and strengths relative to competition, complexity of key segments, diversification across various performance metrics like branches, advances, liabilities, sources of other income etc. and access to special Government support or privileges, if it exists. A strong franchise is expected to result in a granular asset and liability base. PACRA also considers the brand recognition and life of the NFBC for its franchise strength analysis.*

5.3 Revenues: In most NBFCs, interest income is largely skewed towards income from advances whilst income from investment book varies significantly across NBFCs, mostly making up only a fraction of revenue. These are the primary source of revenue and include: i) interest or profit on advances, ii) interest or profit on fixed income investment or government securities, and iii) dividends or gains (both realized and unrealized) on investments. NBFCs vary across asset segments, namely vehicle finance, equipment finance, running finance, mortgage loans and microfinance. PACRA forms an opinion on product riskiness by evaluating prevailing operating environment, historical and recent trends, granularity and strength of the loan security. In measuring revenue quality of a NBFC, diversification and stability are very important factors. A NBFC with a diverse product slate with more than one revenue streams is considered better than a NBFC with a concentrated earning profile. PACRA sees concentration at product, customer and geographic levels. In addition, the analysis of target markets to which a NBFC serves forms a part of the assessment. Stability is measured through historical trend analysis of the NBFC's revenues and is considered critical for sustainability of the NBFC. An NBFC's core revenues emanate from: PACRA also assesses the NBFC's ability to generate income from other sources including fee, commission and advisory or other services. NBFCs that relies more on generating income from risky business lines like trading activities, will typically display more volatile revenue trends.

5.3.1 Diversification: Diversification is desirable since it enhances the entity's ability to meet challenges, both present and upcoming. Lack of diversification gives rise to concentration risk, reflecting vulnerability of the NBFC to few elements. At the same time, it enhances the risk of disruption in if the area of concentration goes wrong. This does not entail that an entity specializing in a certain product/segment would necessarily be at a disadvantage. The disadvantage would only arise if the institution's business gives rise to concentration risk. At the same time, diversification into riskier segments may not improve resilience and, therefore, may not translate into superior ratings. In assessing diversification, common factors include loan mix, portfolio granularity, sectoral mix, share of domestic and overseas exposure and borrower profile. Meanwhile, diverse geographical presence bolsters competitive position as it could offset the credit risks arising from unfavorable regional developments.

5.3.2 Non-Mark-Up Income: Non-interest income from fees, service charges, commissions and foreign exchange income may also be an important source of revenue. PACRA views earnings profiles comprised primarily of interest income favorably given the relative stability of this income stream. However, PACRA also assesses the NBFC's ability to complement its interest income with fee income. A large fee income allows greater diversification which can improve NBFC's resilience of earnings and earning profile.

5.4 Cost Structure: Cost structure is analyzed for the amount of flexibility provided when market conditions are less favorable. In this regard, PACRA considers how much of the cost base is variable. PACRA also evaluates the NBFC's performance ratios relative to those of its peers to understand whether costs have been contained while growing assets and revenue. If expense ratios are high, it could be an indicator that the NBFC has a significant fixed cost burden. In this context, key measure that PACRA looks at is the (Non-Mark-Up Expenses / Total Income) ratio. Whereas, Non- Markup expenses comprise of i) Personnel expenses, ii) Other Non-Interest expenses (including Legal & Professional Charges and Rent, Taxes, Insurance etc.). Performance measures are not assessed in isolation as there may be variations that are caused by business model differences and the importance of ongoing investment in the NBFC's franchise. A low-cost base relative to peers offers the NBFC greater flexibility to deal with competitive pricing pressures.

Performance: *While evaluating the NBFC's ability to convert its earnings into profits, efficiency ratios like cost-to-total net revenue, are considered. 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 ratings analysis, PACRA makes adjustments to the NBFC's reported income statement figures, so that financial performance indicators are comparable across similar entities. The future profitability of a NBFC is evaluated by analyzing its interest spreads (yields minus cost of funds) and its interest rate risk as both could impact profitability. PACRA analyses NBFC's assets and its performance through business cycles. Either higher dependence on one asset segment or high share of unsecured lending to borrowers with limited credit history is considered risky as any unforeseen changes in business or operating environment could impact the earnings performance.*

5.5 Sustainability: Earning prospects are also monitored, based on budgets and forecast prepared by the NBFC. 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. Since Macro profile is used to gauge sustainability, the sovereign's susceptibility to event risk, including political risk, the government's liquidity risk and the risk of external events, such as foreign-exchange shocks, has a significant bearing on the vulnerabilities of its NBFCs.

Event Risk: *Incorporating the risk of unforeseen events into a NBFC's rating opinion is challenging, given their unpredictable nature. These events may be external (e.g., M&As, regulatory changes, litigations or natural disasters) or may be internally driven (e.g., unrelated diversification or strategic restructuring) and can lead to substantial rating changes. PACRA applies its analytical judgment in assessing the likelihood of such occurrences and potential impact, insofar as may be possible, and assesses the NBFC's track record, expertise of management team and level of financial discipline to incorporate the same into its ratings.*

Business Risk -Key Ratios:

Revenue:

- Advances Yield (%)
- Deposits Costs (%)
- Core Spread (%)
- Non-Mark Up Income / Total Income (%)

Earnings:

- Return on Average Equity (%)
- Return on Average Assets (%)
- Non-Mark Up Expenses / Total Income (%)
- Personnel Expense / Total Income (%)

Information Required on Business Risk:
- Financial statements of the NBFC for the last three years and latest four quarters Profile of senior management
- Current capacity utilization of the plant and its trend for next three years
- Breakup of the geographic sales
- Marketing and distribution network
- Market share (%) along with marketing strategy
- Top five suppliers along with respective contribution
- Top ten largest customers, separately for each business segment, along with contribution

6. Financial Risk

- **Credit Risk**: Quality and concentration of exposures, both on and off-balance sheet
- **Market Risk**: Composition of investment portfolio and related risks
- **Liquidity and Funding**: Adequacy of access to internal and external sources for meeting financial needs
- **Capital Structure**: Equity cushion to absorb losses

6.1 Credit Risk: Importance of credit risk is significantly more in case of lending institutions including investment finance companies, housing finance companies, leasing companies, and modarabas, because of generally second tier client base of these institutions as compared to commercial banks' borrowers. Credit risk can arise from both on-balance sheet and off- balance sheet business of the NBFC. On balance sheet credit risk can materialize from loans, investment in fixed-income securities, and inter-bank deposits. Off-balance sheet credit risk includes non-performance of the counter party on the guarantees issued by the NBFC. Out of entities covered in this section, generally investment finance companies expose themselves to off-balance sheet risk factors. PACRA analyze both risks in similar manner. However, as quantum of risk taken on balance sheet is higher, particular emphasis is placed on it. Moreover, investments in fixed income securities of private corporates are considered part of the overall financing portfolio for the purpose of credit risk analysis. This is because of their nature, which is very much similar to the financing operations of NBFC.

6.1.1 Credit risk analysis includes review of credit portfolio at all levels. Portfolio is evaluated to calculate market share, analyze type of counter party (consumer, SME or corporate etc.), and product mix in terms of secured and unsecured. Meanwhile, concentration level is given high importance. Concentration is assessed at all levels including sectoral exposure, borrowers, and type of products. The level of concentration is considered to have positive correlation with the degree of risk, i.e., the higher the concentration, more risk the portfolio carries. Thus, high level of diversification can shield NBFCs from the impact of downturn in any single segment. Moreover, diversification into riskier segments does not necessarily provide any help to improve the risk profile of the portfolio; it may negatively impact the ratings.

6.1.2 Asset Quality: Assessing quality of assets is an important pillar of credit risk. The portfolio is analyzed with respect to size of the exposure, mainly top 20 exposures, and sectoral division. In addition, watch-list accounts and sectors that are still performing, and non-performing accounts are reviewed to analyze the current asset quality as well as future impact of any expected delinquencies on the overall quality of the portfolio. Post-delinquency, the level of reserves maintained for provisioning requirements is considered important. Meanwhile, asset quality is assessed using both absolute and relative criteria, and where applicable, ratios are compared with the peers.

6.1.3 Quality of fixed income securities portfolio is measured. In addition to the size of the exposures, business dynamics of the sector of counterparty and security structure of the instrument is considered. Similarly, other exposures are analyzed on the basis of nature, size, and credit worthiness of the counter party.

6.2 Market Risk: Many of the NBFC's, in addition to regulatory investments (applicable to deposit taking entities), maintain their own investment portfolio. This may comprise investments in fixed income securities, government papers, and direct exposure to equity markets. PACRA evaluates market risk with particular emphasis on trading book of the NBFC. While potential loss lying on the balance sheet that is yet to materialize stands as a risk of drag on performance of the NBFC, any available unrealized gain on investments held for sale is considered as a cushion to unforeseen losses that may arise due to price movements.

6.3 Liquidity and Funding: NBFCs are classified into two main segments for funding and liquidity assessment, i) NBFCs that finance their assets through either deposits or borrowings from NBFCs or a combination of both, and ii) NBFCs that meet their requirement either from internal sources (equity) and / or from shareholder loans.

6.3.1 In case of first kind of NBFCs, PACRA analysis includes identifying any marked concentration in deposit base and/or borrowings, as well as identifying significant trends in funding sources. Composition of the deposit base is analyzed in terms of: i) Tenor and pricing of deposits – the maturity profile of liabilities is seen in tandem with related asset base to analyze liquidity profile, ii) fixed rate vs floating rate – this has direct implications on business margins in case of mismatch with assets, and iii) retail vs institutional – retail deposits are considered sticky as compared to institutional deposit. While concentration level in funding base is analyzed, due importance is given to liquidity management. PACRA believes higher asset turnover as compared to liabilities is good for liquidity management.

6.3.2 In the second case, where the assets are financed from equity, sufficiency of free capital available to the NBFC is assessed as discussed in Capital Adequacy section. While in case of shareholder loans, the terms of the loan, repayment flexibility, and the NBFC's plan to meet the repayment terms are analyzed.

6.4 Capital Structure: PACRA evaluates an NBFC's 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 and nonperforming investments.

6.4.1 While analyzing capital, PACRA excludes the amount that is tied up in fixed assets and, where applicable, any strategic investments from available capital to assess the adequacy and sufficiency of equity of the NBFC. PACRA also assesses the ability of the company to generate capital from internal sources. Meanwhile, dividend payout policy is considered important to evaluate as it may have a significant bearing on potential capital formation rate. Additionally, PACRA gives dues consideration to compliance with regulatory requirements.

Credit Enhancement: *The NBFC 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.*

Financial Risk – Key Ratios

Credit Risk:

- Top 20 Performing Advances / Total Finances (%)
- Non-Performing Advances / Gross Advances (%)
- Non-Performing Advances / Equity (%)
- Gross Finances / Funding (%)

Market Risk:

- Government Securities / Investments (%)
- Investments / Equity (%)
- (Investments + Debt Instruments) / Total Assets (%)

Liquidity and Funding:

- Liquid Assets / Funding (%)

- Advances / Deposits (%)
- Top 20 Deposits / Deposits (%)
- Short Term Funding / Funding (%)

Capital Structure:

- Equity / Total Assets (%)
- Total Debt / Equity (%)
- Capital Formation Rate (%)

Information Required on Financial Risk:

- Top 20 performing private group exposure
- Statement of credit exposure by type of security
- Latest internal risk ratings of Facilities obligators
- Party wise detail of classified loan portfolio
- Latest statement of marginal/watchlist accounts
- Details of funding lines and repayment pattern

Credit Rating

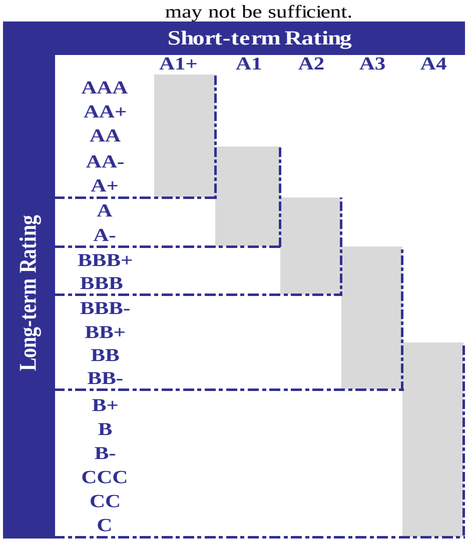
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating

Scale	Definition
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
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



The correlation shown is indicative and, in certain cases, may not hold.

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 some material identifiable event with indeterminable rating implications. 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 rating 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) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) 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.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

a) Broker Entity Rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) Independent Power Producer Rating
g) Microfinance Institution Rating
h) Non-Banking Finance Companies Rating