The Pakistan Credit Rating Agency

Microfinance Institutions Rating Criteria

Methodology

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Summary

PACRA's methodology documents lay out the framework guiding its Credit Rating Process. This document provides an overview of PACRA's approach to assigning Credit Ratings to Microfinance Banks (MFBs) and Non-Banking Microfinance Companies (NBMFCs).

PACRA's opinion is based on a mix of qualitative and quantitative assessment factors that include Profile, Ownership, Governance, Management, Business Risk and Financial Risk. While standalone credit quality is addressed by PACRA, it incorporates the relative position of a Microfinance Institution to arrive at the final Credit Rating.

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Introduction

Scope

Microfinance Institutions (MFIs) are Financial Institutions (FIs) that serve the bottom of the pyramid with the intention of improving financial inclusivity, eradicating financial illiteracy, and poverty. MFIs fund microentrepreneurial activities, which, in turn, mobilize small industries, thereby contributing to the wealth and socio-economic development of the state. The needs of the underprivileged cannot be catered to by large financial institutions like commercial banks for a myriad of reasons, including the enhanced riskiness of the lending portfolio and the alteration in the required business model for client evaluation. Based on this premise, it is safe to deduce that the amount lent per borrower or client by MFIs is significantly smaller than that of traditional lending institutions, except that the numbers lent and overall turnover are larger. These MFIs operate under a different contextual risk framework. Yet, despite the difference, MFIs try to adopt an efficient operating model so that their dependence on quantifiable support (subsidized loans, donations, grants, et cetera) is diminished or eliminated.

This methodology applies to Microfinance Banks (MFBs) and Non-banking Microfinance Companies (NBMFCs). MFBs and NBMFCs, hereinafter, shall be referred to as MFIs, with no distinction being drawn except where necessary. MFIs intend to maximize their double bottom line concept, with the primary difference being that MFBs have access to customer deposits as a funding type, while NBMFCs generally do not. Furthermore, MFBs fall under the regulatory purview of the State Bank of Pakistan (SBP), whereas NBMFCs are regulated by the Securities and Exchange Commission of Pakistan (SECP). This discrepancy somewhat alters their operational paradigm, despite both being exposed to similar risks.

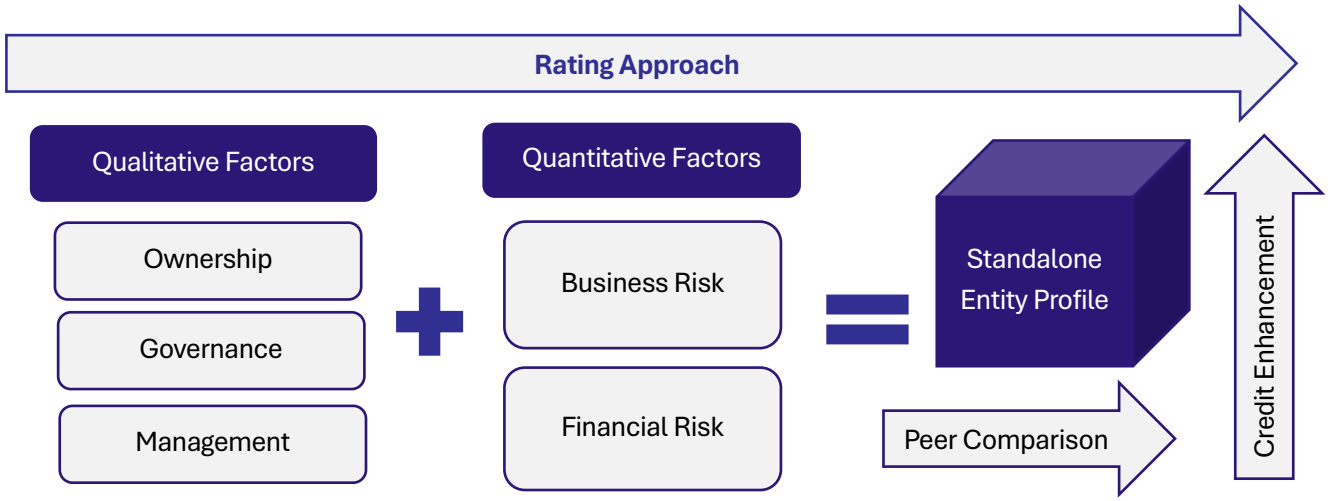
Rating Framework

PACRA grounds its analysis of MFIs on several factors comprising six key areas: Profile, Ownership, Governance, Management, Business Risk and Financial Risk. Quantitative factors (Business risk and Financial risk) are often given precedence, given that they are lagging indicators of future performance. PACRA considers both jointly, and neither the qualitative nor the quantitative factors possesses overarching importance in forming the final rating opinion. These factors are viewed with a holistic perspective to form an appropriate opinion. The quantitative factors objectify the rating process, while the qualitative factors aid in discerning the sustainability of the aforementioned factors and other relevant metrics in the foreseeable future.

The basic precept of this rating methodology is to establish a framework for the evaluation of the business model of an MFI, including its inherent risks, the dedication of its owners or sponsors, the strategy adhered to by its management, and the operational controls imbued in its systems in relation to the macro-economic environment and industry developments. As such, the position attained by an MFI in comparison to its peers is given its due consideration under this methodology before the designation of a Credit Rating.

While the rating process does not entail an audit of an MFI's financial statements, it does examine the control environment that leads to the provision of the aforementioned statements for the purpose of establishing their veracity. That includes independence and effectiveness of the Audit Function. Nevertheless, there may be adjustments to the financial data, as necessary, to ensure adequacy, consistency and comparability across time periods and amongst MFIs. The two types constitute distinguished yet overlapping peer groups. Lastly, short-term and

long-term ratings are based on a set of fundamental credit characteristics exhibited by an MFI. In fact, a correlation exists between the two rating types. (Reference: PACRA's Criteria Document | "Correlation between Short-term and Long-term Rating Scale").



Profile

Background

PACRA evaluates the evolution of an MFI from where it started and where it currently stands. PACRA analyzes how and through what means the MFI has achieved the desired expansion. The significant factor here for PACRA is to assess whether the MFI has achieved the desired expansion through organic growth or acquisitions. Meanwhile, the source of funding for desired growth is also critical. PACRA looks at the sustainability of this strategy, going forward.

Operations

The operational standards and capability of an MFI depend upon the diversity and profile of its clientele, the institution's geographic spread, product offerings, portfolio mix, and technological innovations. PACRA's evaluation of operational sustainability includes all these attributes, leading to overall operational leverage. A reduction in operational leverage can be due to economies of scale, improved technological infrastructure, or a change in business model among peer groups. The former tends to be exposed to greater fixed costs due to them being deposit-taking institutions. As such, accounting for these operational features supplements and strengthens the Credit Rating opinion.

Qualitative Factors

The qualitative assessment establishes the sustainability of the rating in the foreseeable future as well as the feasibility of the strategic direction. Qualitative considerations, in this context, refer to rating factors that do not pertain to an entity's business or financial risk. Instead, they focus more on internal processes, people and systems, whose synergistic collaboration influences business and financial risk. Thus, these factors must be incorporated to embed a forward-looking perspective into the rating opinions.

Ownership

This section evaluates institutional ownership through the lens of expertise, commitment, and diversity to determine the longevity, competence, and extent of intellectual and financial support this aspect of the institution garners.

NBMFCs, in certain instances, are incorporated as public companies limited by guarantee under Section 42 of the Companies Ordinance, 1984 (now Companies Act, 2017). As a result, their structure is distinctive compared to other MFIs, given that their "owners" comprise members rather than shareholders. In this case, PACRA assesses the NBMFC's ability to hone a pool of members who are capable of and dedicated to carrying the institute's mission and services beyond the initial development goals of the early founders. Consequently, an NBMFC's dependence or reliance on a single individual, in terms of decision-making or overarching strategic guidance, can be of dire consequences.

In case of NBMFCs, especially Section 42 companies, the members do not take any monetary benefit from the entity's available funds. Hence, financial support in the form of members backing, will be from other sources, if needed. Here, the ability of key member/s to get external support from government, regulators, and international and local donors/ lenders gains more significance.

Governance

This section evaluates the Board of Directors and their role in establishing a strong oversight and control framework to ensure appropriate management oversight and alignment between shareholder and management objectives. Furthermore, the BOD's establishment of transparent reporting and disclosures, and adherence to applicable regulatory requirements is important. PACRA considers the social mission of the MFI and steps taken at the board level to ensure its sustenance.

Management

This section evaluates the risks associated with the management. This includes, but is not limited to, strategy execution, the ability to maintain strong information systems for operational efficiency, decision making, and laying the framework for successive expansion while ensuring adherence to the MFI's ethical and quality standards.

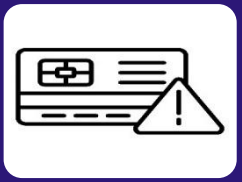
i. Field Staff

In case of MFIs, the field staff is crucial for maintaining strong asset quality indicators, as they hold the relationship with the borrower. Any misconduct on their part may not only deteriorate asset quality, but also create reputational risk for the MFI. This operational aspect becomes even more important as MFIs compete in similar geographies. Thus, the ability to retain good field staff is critical while assessing human resource management. Moreover, PACRA attempts to understand the MFI's staffing and employment policies, the ability of field staff to conversing in local languages and dealing with borrowers, and their training on social aspects, particularly important to the area of their operations.

ii. Risk Management Framework/Control Environment

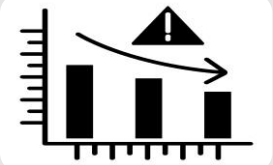
This includes an analysis of the MFI's appetite for risks alongside the systems in place to manage these risks. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits that have been implemented, limits setting authority and the degree to which these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

Regulatory framework has historically been stronger for MFB with comparatively strict regulatory and Capital Adequacy requirements in place. Similarly, non-banking microfinance regulatory framework was introduced by the SECP in 2016 to facilitate and strengthen the sector. In addition, regulators support small entities in microfinance business in funds mobilization by issuing microfinance credit guarantee schemes (MCGF) and other such facilities.



Credit Risk

- Credit risk, which refers to the risk of default of the borrowers, can be measured using asset quality indicators and concentration metrics.
- Asset Quality Indicators can function as early warning signals for a shortfall in liquidity or inadequacy of funding.
- Credit risk management is further assessed by evaluating operational protocols that lead to the approval of the loan & its disbursal.



Market and Interest Rate Risk

- Asset and Liability Management Strategy is reviewed.
- Board and management policy limits, typically expressed as earnings at risk, are 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 pressurize an institution's ratings.

Operational Risk

- The risk of loss resulting from inadequate or failed internal processes, people and systems or external events.
- The MFI's evaluation of a borrower's repayment capacity.
- The relevance & feature set of its Management Information System such that it aids decision-making & provides real-time updates across the value chain
- The existence of policies & procedures intended to codify protocols & assess their adherence to them. This includes a customer complaint, risk management, & disaster recovery policy.
- The ability to retain critical staff & ensure an effective disbursal of the workload.

Reputational and Other Risks

- May emanate from operational problems or failure in any of the MFI's Risk Management systems.
- A bad reputation may result in a failure to meet institutional social imperatives and a reduction in deposit base.
- Any regulatory non-compliance could lead to potential legal ramifications.

iii. Technological Infrastructure

Technological progress to enhance service standards and delivery processes is crucial for a progressive MFI's strategy. It aids in ensuring the scalability of financial services to remote and far-flung areas, thereby increasing outreach. Furthermore, technology assists and strengthens risk management protocols.

PACRA evaluates the efforts of MFIs to inculcate technology-based solutions to remain competitive and enhance risk controls. Similarly, impact of these technological initiatives on operational efficiency and market reach is assessed in relative terms.

Digital Financial Services: With recent influx of digital financial services providers, PACRA evaluates the effectiveness of these for MFIs. Similarly, considering the 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.

Type of Digital Finance Service	Elements
Mobile Financial Services (Dedicated Smartphone Application)	View Statements, Transfer Funds, Access Information About Financial Service Subscription, Pay Bills, Obtain Credit, Subscribe to Insurance and Other Products
Mobile Financial Services (Feature Phone)	Statement Summary, Transfer Funds, Access Information About Financial Service Subscription, and Pay Bills
Internet Banking	Enhances Mobile Financial Services through the inclusion of more comprehensive product and service-related transactions. Examples include subscriptions, inquiries, and digitally processing physical documents.
Digital Outlets and Complements	Debit/Credit Card, ATMs, POS Merchant Transactions, Mobile Wallet (NFC Integration)

Business Risk

Industry Dynamics

The process for anchoring the credit rating of an MFI encompasses PACRA's understanding of the industry dynamics. This understanding, following an in-depth research approach is documented and published as a sector study. The analysis incorporates macro-economic indicators that can impact the sector and also 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 mitigants 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.

PACRA explores the possible risks and opportunities for MFIs 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 regulators, their supervision of regulated entities, reporting requirements and regulations relating to specific type of institutions and to specific financial products. For instance, regulators in Pakistan have started emphasizing Environmental, Social and Governance (ESG) related requirements and disclosures for entities. This will have an impact on disclosure and reporting requirements for all MFIs that come under their ambit.

Economic Risk

An economic overview, which includes sectoral contribution to the economy, the performance of sectors relevant to MFIs, the nuances of the gross domestic product (GDP), inflationary pressures, and other trends in savings and investments is analyzed for any notable implications. The basic premise is to identify any trends that will hamper the repayment ability of MFIs' borrowers given their socioeconomic status. Similarly, rising interest rates or other factors can increase cost of funds for MFIs, impacting spreads and efficiency.

Regulatory Environment

A well-regulated environment is pivotal for the credibility and stability of MFIs even when the operating environment is unfavorable. PACRA's evaluation of the regulatory system includes review of capital and other countercyclical measures implemented to absorb risk and the extent of regulatory supervision and changes in response to the macro environment. Key areas such as Portfolio-at-Risk (PAR), Non-Performing Loans (NPL) recognition, provisioning, capital adequacy, liquidity, benchmark lending rate and expansion and their impact on MFIs are reviewed.

IFRS 9: As part of the regulatory framework, MFBs have adopted IFRS 9. This shift entails that the financial institutions would adopt and report under the new expected credit loss model (ECL) method and enhances transparency in the classification of financial assets (loans, investments, etc.) and certain other disclosures. PACRA incorporates these implemented changes in its evaluation of financial institutions.

Relative Position

Relative position reflects the standing of the MFI against its peers. This accounts for, among other factors, market share, growth trend, performance, and franchise/brand value created by an MFI. The stronger the standing of a MFI, stronger is its ability to sustain pressures on its business volumes, profit margins and funding.

i. Market Share

Market share represents the MFI's penetration in the chosen market. There generally is a positive correlation between, market penetration and brand value. Key factors that are evaluated to assess the market share of a financial institution include its share in the sector's total advances, total deposits and franchise presence. Market share in terms of deposits, is only applicable to MFBs. 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. In a dynamic industry, which is

not characterized by concentration, PACRA believes that relative size would better capture the strength of the MFI's standing.

ii. Growth Trend

While evaluating the growth of a MFI, PACRA looks at various trends and factors contributing to these trends. They are evaluated for metrics like revenue, gross loan portfolio, deposit base, geographical presence etc. Growth is important as it ensures that the MFI continues to have the ability to meet the industry benchmarks. As the industry grows, it uplifts the scale of its operational context, which may be reflected by an increase in the number of advances or deposits, allow the financial institution to grow geographically, and diversify its loan portfolio. To lag the industry's growth trend means to remain short on these avenues, putting pressure on the market position and overall profile of the MFI. PACRA monitors higher than-industry growth to understand the quality of the incremental business. High growth correlated with declining portfolio quality is perceived negatively.

iii. 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, funding, sources of other income etc. and access to any Government support or privileges relative to other MFIs. A strong franchise is expected to result in a granular asset and liability base. PACRA also considers the brand recognition and life of institution for its franchise strength analysis.

Revenues

In measuring revenue quality of a MFI, diversification and stability are very important factors. An MFI with a diverse product slate, with more than one revenue stream, is considered better than an MFI with a concentrated earning profile. Composition of revenue from core business activities – advances – is considered critical. PACRA sees concentration at product, customer and geographic levels. Stability is measured through historical trend analysis of the MFI's revenues.

i. Diversification

Diversification is desirable since it enhances the MFI's ability to meet challenges, both present and upcoming. Lack of diversification gives rise to concentration risk, reflecting vulnerability of the MFI to few elements. PACRA uses a number of approaches to gauge concentration risk. These include, sectoral concentration, geographic concentration, asset base and funding concentration. In this regard, contribution of top 20 advances in total loan portfolio and top 20 depositors in deposits is looked at. Similarly, reliance on single source of funding or a single donor, is considered risky.

ii. Minimum Lending Rate Margin (MLRM)

PACRA uses this measure to ascertain an institution's ability to cover its operating and financial expenses by optimally pricing its loan portfolio in terms of interest charged. The MLRM is the minimum rate that an MFI needs to sustain its operations through its core lending operations.

iii. Non-markup Income

For most MFIs, interest income from the loan portfolio and investments makes up much of the revenue base. However, non-interest income from fees, service charges, and commissions also represents an important and growing source of revenue. PACRA views earnings profile that complements interest income favorably given the relative stability of this income stream. PACRA also assesses the MFI's ability to complement its interest income with fee income. A large fee income allows greater diversification, which can improve MFI's resilience of earnings and earning profile.

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 MFI'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 MFI has a significant fixed cost burden. In this context, key measure that PACRA looks at is the (Non-Mark-Up Expenses/Total Income) ratio. Non-mark-up expenses are also compared where possible with earning assets, to the number of branches and to the number of employees. 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 MFI's franchise. A low-cost base relative to peers offers the MFI greater flexibility to deal with competitive pricing pressures. PACRA also considers provisioning levels, together with the capacity of the MFI's earnings to absorb provisions.

i. Margins

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 funding remains weak. Thus, in addition to risk profile, their cost structure is high. These institutions serve a large client base with small loan size. This results in higher operational costs, including staff costs, for MFIs. Therefore, MFIs charge fairly high price to their customers. Although their interest margins seem higher as compared to other Fis, once loaded with business acquisition and servicing cost, their pre provision profit margins are comparable to other FIs.

Sustainability

PACRA evaluates management strategy, its viability, and key performance indicators developed to assess the identified milestones. Earnings prospects are monitored based on budgets and forecasts prepared by the management. PACRA pays particular attention to underlying assumptions taken by the management as well as management's track record in providing reliable budgets and forecasts. Adjustments are made where necessary for comparable results or reality check. In addition, measures taken by the MFI to cultivate long-term relationships with existing clients along with efforts to enhance coverage of vulnerable communities to expand outreach are important indicators of sustainability.

Event Risk

Incorporating the risk of unforeseen events into an MFI's rating opinion is challenging. These events may be external (M&As, regulatory changes, litigations or a natural disaster) or may be internally driven (unrelated diversification or strategic restructuring) and can lead to substantial rating changes. PACRA's due diligence process uses analytical reasoning in assessing the likelihood of such occurrences as well as their potential impact. Measures adhered to by the MFI for guarding itself against this risk are part and parcel of the evaluation. For instance, if an MFI operates in an

area prone to earthquakes, PACRA shall be particularly concerned about whether or not their data storage and application hosting servers happen to be geographically dispersed.

Information Required on Business Risk

- Type of License
- Target Market
- Outreach, Market Share, Details pertaining to Operations within Particular Districts
- Key Figures; Agents, Deposit Attributes (amount, volume, and number), Number of Transactions, and Portfolio Concentration Statistics
- Industry and Entity Information, including additional data as may be necessary about the loan portfolio, depositors, and number of borrowers.
- Top 20 Advances and Deposits
- Branchless Banking Operations
- Two-year projections accompanied by the details of any underlying Assumptions
- Future Strategic Details and Relevant KPIs

Business Risk – Key Ratios

Revenues	•Product/Sector Concentration (%) •Geographic Concentration (%) •Portfolio Yield (%) •Minimum Lending Rate Margin (%) •Non-Mark Up Income/Total Income (%)
Cost Structure | Earnings	•Operational Self-sufficiency (%) •Return on Equity (%) •Cost per Borrower •Return on Assets (%) •Non-Mark Up Expenses/Total Income (%) •Compensation Expense/Total Income (%)
Relative Position	•Deposits' Market Share (%) •Gross Loan Portfolio Market Share (%) •Number of Branches •Profit After Tax / Microfinance Industry's Profit After Tax (%)

Financial Risk

PACRA's financial risk assessment is a quantitative measure and comprises four sub-factors: i) Credit Risk; ii) Market Risk; iii) Liquidity and Funding; and iv) Capital Structure.

Credit Risk

Credit risk is significant for any lending institution. As MFIs cater to small borrowers, this entails different approach towards credit risk assessment. These 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.

Moreover, 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 portfolio. Analysis of product mix in terms of secured and unsecured lending is conducted. 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.

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. PACRA analyzes True Infection Ratio and other metrics to assess lending portfolio quality. Regarding provisioning criteria, PACRA takes comfort from stringent regulatory requirements. Recently, MFBs have adopted IFRS 9, in line with SBP guidelines. Asset quality is now considered based on Stage I, Stage II and Stage III loans. Pre- and 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 MFIs. 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.

Market Risk

MFIs generally exhibit limited exposure to market risk as they invest primarily in government securities or place funds with FIs (mainly banks) to meet regulatory liquidity, cash reserve requirements and other day-to-day needs. Moreover, MFIs are only allowed to invest in limited sectors. This curtails overall exposure of MFIs to market risk.

Liquidity and Funding

MFBs finance their assets mainly through deposits – micro savings as well as corporate deposits – in addition to other funding sources and funding lines, where available. The proportion of different funding sources (deposits, borrowings, debt instruments etc.) utilized by the MFB is analyzed. Meanwhile, funding sources for NBMFCs typically comprise borrowings, grants and donations. PACRA analyzes funding mix and concentration levels therein. For MFBs, the mix of deposits in terms of retail vs. institutional and current vs. savings/fixed term deposits is considered. A large, granular pool of micro savers is considered stable in comparison to large institutional deposits.

PACRA analyses the maturity profile of liabilities in tandem with related asset base to analyze liquidity profile of an MFI. PACRA believes higher asset turnover as compared to liabilities is good for liquidity management, given strong recovery mechanisms are in place. The MFI's compliance to regulatory reserve requirements is a minimum. The presence of Asset Liability Committee is essential to ensure effective monitoring of liquidity mismatches. Liquid assets are looked at in terms of coverage against demand deposits and Top 20 depositors among other ratios.

Capital Structure

Compliance with minimum capital requirement is key to obtain and sustain the license. For MFBs, PACRA considers SBP's minimum capital and capital adequacy requirements, including applicable implementation deadlines; for NBMFCs, it considers SECP's minimum equity and leverage requirements. 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 MFIs, especially for investment grade rating categories. However, additional capital cushion is required for higher rating categories.

Credit Risk Enhancement

MFIs providing third-party commitments, such as guarantees on behalf of others, enhance their credit risk. This is prudently factored into the credit rating opinion, while accounting for the amount guaranteed, likelihood of guarantor liability, and the duration for which such guarantees remain applicable.

Financial Risk – Key Ratios	
Credit Risk	•Risk Coverage Ratio (%) •True Infection Ratio (%) •Non-Performing Advances/Gross Advances (%) •Non-Performing Finances/Gross Finances (%) •Top 20 Advances/Advances (%) •Exposure per Borrower
Market Risk	•Government Securities/Investment (%) •Non-Performing Debt Instruments / (Debt Instruments + Non-Performing Debt Instruments) (%) •(Investment + Debt Instruments)/Total Assets (%)
Liquidity and Funding	•Liquid Assets/(Deposits & Short-term Borrowings) (%) •Demand Deposit Coverage Ratio •Liquid Assets / Top 20 Depositors •Institutional Depositors / Deposits (%)
Capitalization	•Capital Adequacy Ratio (%) •Uncovered Capital Ratio (Net NPL / Equity) (%) •Capital Formation Rate (%)

Information Required on Financial Risk

- Outstanding exposures amount along with segment-wise/product-wise details of the classified advances portfolio
- Industry-wise concentration and exposure
- Party-wise detail of classified advances portfolio (Top 20)
- Industry loan portfolio
- Total available money market lending and borrowing lines, along with average rates and repayment schedules
- Details of the 50 largest depositors along with their maturity profile and profit rates (MFBs)
- Industry information for deposit portfolio (MFBs)
- Committed donor funds and avenues of funds (NBMFCs)
- SBP returns filed, including i) Reserve Ratio Requirements, and ii) Capital Adequacy Statement (MFBs)
- Spread calculations
- Projected funds inflows vs projected liabilities

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.

Scale	Long-Term Rating
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.

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

Rating Modifiers | Rating Actions

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 surveil 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. Rating actions may include "maintain", "upgrade", or "downgrade".

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 Company

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