RATING METHODOLOGY

BANK RATING

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

Contents

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PAKISTAN CREDIT RATING AGENCY

1. SCOPE

- Applies to local banks
- SBP – the regulator

1.1 This methodology applies to local banking institutions. These institutions are licensed to mobilize deposits and provide credit. These are regulated by the State Bank of Pakistan (SBP) – the central bank. The regulatory framework consists of the laws and regulations designed by SBP.

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

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

1.4 PACRA bases its analysis of banks 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.

Key Rating Factors

Operating Environment	Bank Profile	Risk Management	Financial Profile
Economic risk	Ownership and support	Credit Risk	Earnings and Performance
Industry risk	Governance	Market Risk	Funding and Liquidity
Relative Positioning	Management Quality and Strategy	Operational Risk	Capitalization

2. OPERATING ENVIRONMENT

- Macro-economic Analysis
- Banking Industry
- Relative positioning

2.1 Recognizing the influence of operating environment on an entity's credit worthiness, the rating exercise incorporates a review of the overall economy, the structure of the banking sector in general and existing and potential competition in the market.

2.2 **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 banking industry and impact assessment of economic risk factors on the industry.

2.3 **Industry Risk:** PACRA attempts to measure structure and risks related to the banking industry as a whole. This analysis comprises various factors including regulatory environment and competitive positioning of industry players. 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.

2.4 Relative Positioning: PACRA analyses the diversification of activities undertaken by a bank, in geographical and industrial sector terms. It also examines the diversity of services and products it provides to customers, and its ability to create new products. It takes into account the strength and depth of a bank's franchise as well as its ability to safeguard existing business and gain new business. This analysis helps in establishing the bank's relative position within the banking sector.

3. BANK'S PROFILE

- Structure of ownership and commitment of support
- Governance structure
- Management and its business strategy

3.1 Ownership and support: The ownership of and potential support available to a bank is crucial to our overall rating assessment. We analyze the stability of the shareholding structure of the bank, as well as the ability and willingness of either its owners or the government / regulator to bail out the bank in case of need.

3.1.1 A particularly important factor to be taken into account when rating banks is the presence (or possibly absence) of a lender/rescuer of last resort. A very important part of our background analytical work is an attempt to assess whether, and under what circumstances, a bank 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.

3.1.2 Particularly in case of small banks, where capitalization requirements are yet to meet by the entity, PACRA critically analyses the willingness and ability of the major shareholder to support the bank to comply with regulatory requirements within required timeframe. Thus ongoing support is considered more likely in these cases. However, for large banks, external support from government / regulatory becomes more important.

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

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

3.2 Governance: PACRA is of the view that a bank's governance practices can have a material impact on its credit quality. In governance assessment, PACRA analyses governance data and information systematically, and also performs more contextual, qualitative review of an individual entity's governance practices as per governance model of PACRA. This has divided the analysis of governance structure in four distinct parts, i) board structure, ii) members' profile, iii) board effectiveness, and iv) financial transparency.

3.2.1 The important aspects, which are looked at by PACRA while evaluating the quality of governance structure are mentioned below:

Governance Structure		
Board Structure	1	Size of the board
	2	Positions of Chairman and CEO
	3	Independent directors
	4	Association of directors with the company
	5	Skills mix
	6	Compensation of directors
	7	Sub-committees of board
Members' Profile	1	Directors trainings
	2	Availability / commitments of individuals
	3	Experience of board members
Board Effectiveness	1	No. of board meetings per year
	2	Attendance of board meetings
	3	Quality of board meeting minutes
	4	Robustness of package of board meetings
Financial Transparency	1	Composition of Audit committee
	2	Extent of public disclosures
	3	Internal audit function
	4	External auditor

3.3 Management Quality: An effective management and well-defined strategy are essential ingredients for a successful bank. As part of its assessment of a bank's management, PACRA looks at the organizational structure of the bank, the dependence of the management team on one or more persons, coherence of the team, the independence of management from major shareholders, and management's track record to date, in terms of building up solid business mix, maintaining operating efficiency and strengthening the bank's market position. It also analyzes the quality and credibility of management's strategy, examining plans for future internal or external growth. When evaluating future plans, significant credit is given for delivering on past projections and sticking to strategies. Although judgment of management is subjective, financial performance over time provides a more objective measure.

4. RISK MANAGEMENT

- Risk management function
- Credit risk – both on- and off-balance sheet

4.1 This includes an analysis of the bank'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.

4.2 In recent years, there has been a noticeable upgradation in the risk management

- NPLs and Watchlist – important considerations
- Market risk – analysis of investments book
- Operational risk

systems of the banks, in the face of increasing guidance and supervision from the SBP. Given the implementation of Basel III, efforts for further improvement have already been intensified.

4.3 Credit Risk: PACRA looks at all areas that give rise to credit risk whether arisen from on-balance sheet activities (including loans, fixed-income securities, and interbank deposits and placements) or off-balance sheet transactions (letter of credit, and guarantees etc.).

Credit Risk - Important Ratios
Growth in Advances (%)
Top-20 Performing Private Advances / Total Performing Private Advances (%)
Non - Performing Loans (NPLs) / Gross Advances (%)
Loan Loss Provision / NPLs (%)
Net NPLs / Pure Equity (%)
Watch-list Accounts

4.3.1 We examine the structure of the bank's balance sheet, including the relative proportions of different asset categories. Generally, but not always, the loan book constitutes the most significant portion of a bank's assets and thus a comprehensive review of this is essential (even if it does not account for the bulk of the balance sheet, it is generally where most risk lies). In this context, we ask for a breakdown of lending by type of loan, size, maturity, currency, economic sector and geographical distribution. We also look at concentrations of credit risk, including large exposures (generally top-20 individual and group exposures) and credit risk concentrations in particular industries or sectors.

4.3.2 **Asset Quality:** We analyze those loans considered as "problem" loans, whether they be "sensitive" or "watchlist" (i.e. still performing) loans, non-performing or restructured loans. In assessing the underlying risk of any problem loans, the adequacy of any security and reserve coverage is taken into account. As far as loan loss reserves are concerned, we examine the different types of risk reserves in place (e.g. specific, general, etc.), the bank's overall policy towards provisioning, its historical loan loss experience, and its write-off and recovery policies. Asset quality is assessed using both absolute and relative criteria and, where possible, we compare ratios with those of peer banks.

4.3.3 With reference to the quality of other assets, we analyze the fixed income securities portfolio in terms of the general quality of the securities, their maturity, any undue concentration or particularly large individual exposures and the valuation of these securities. Likewise, an analysis of a bank's interbank deposit and loan book will take into account size, maturity, and concentration of the book as well as the creditworthiness of the counter parties.

4.3.4 Banks' off-balance sheet commitments are important to analyse. Such commitments include guarantees and letters of credit (LCs) as well as derivatives. Similarities exist when analyzing LCs and guarantee exposures. Regarding derivative instruments, PACRA looks at the gross notional and net fair values of a bank's derivative portfolio; it also considers the types of derivative instruments the bank uses and the purpose for which it uses them. As far as credit risk is concerned, it examines the systems used by banks for measuring credit exposure, their valuation policies and the quality of counter parties. Apart from credit risk, derivative instruments also give rise to market, legal and operational risks, which also have to be taken into account, separately.

4.4 Market Risk: Analysis of market risk covers all structural and trading risks across a bank's entire business (including on- and off-balance sheet business). As far as structural risks are concerned, we examine the bank's asset and liability management strategy, and the role of position taking, hedging and accounting in this strategy. We look at the levels of interest rate, foreign exchange and equity risks on and off-balance sheet and how these compare with the limits set for each of these risks.

4.5 On the trading side, we examine the general strategy of the bank in regard to its trading activities (is it a significant position taker or are its trading activities mainly related to client business or hedging transactions?).

4.6 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.

4.6.1 Our analysis of operational risk focuses on a number of issues, including (a) a bank'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.

4.7 Other Risks: As already indicated, a risk often not encapsulated in the above categories is reputation risk, which can be significant for some banks, 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.

5. FINANCIAL PROFILE

- Quality and stability of earnings
- Cost structure
- Funding mix
- Diversification in deposits
- Liquidity profile
- Risk absorption capacity
- Capitalization vis-à-vis regulatory requirement

5.1 Earnings and Performance:

PACRA looks at the historical trend of a bank's performance, the stability and quality of its earnings and its capacity to generate profits. While taking indicators for a bank with those of its peers. Where possible, it also analyses earnings for each of the bank's business lines. In this context, it looks at the trends in:

Earnings and Performance - Important Ratios
Return on Average Equity (%)
Return on Average Assets (%)
Asset Yield (%) & Cost of Funds (%)
Intermediate Efficiency (Spreads) (%)
Cost-to-Total Net Revenue (%)
Cost-to-Total Net Revenue (Net of Capital Gains) (%)
Other Operating Income / Total Net Revenue (%)
Net Non-Earning Assets / Assets Net of Non-Interest Bearing Liabilities (%)

- Net interest revenue, including the evolution of interest spreads in each business line, trends in lending volumes and evolution of funding costs;
- Non-interest income, including more stable revenues in the form of fee and commissions, and inherently more volatile trading revenues;
- Non-interest expenses, breaking down personnel and other expenses, and comparing the expense level not only with total income but also where possible with earning assets, to the number of branches (in the case of retail banking) and to the number of employees;

- Provisioning levels, together with the capacity of the bank's earnings to absorb provisions;
- Exceptional income and expenditure items, as well as developments in taxation incidence.

5.1.2 Where necessary in its ratings analysis, PACRA makes adjustments to a bank's reported income statement figures, so that financial performance indicators are as comparable as possible from one bank to another.

5.1.3 Earnings prospects are also closely examined, based on budgets and forecasts given to us by a bank, as well as any medium-term plan it may have. External factors which may influence future earnings trends are taken into account, as well as management's track record in providing reliable budgets and forecasts.

5.2 Liquidity and Funding:

Liquidity and Funding - Important Ratios
Liquid Assets / Deposits and Borrowings (%)
Advances / Deposits (%)
Finances / Deposits and Borrowings (%)
Investments / Deposits (%)
Government Securities / Total Assets (%)
Retail Deposits / Total Deposits (%)
Top-20 Deposits / Total Customer Deposits (%)

5.2.1 Main areas to analyze in this section are the structure and diversification of a bank's funding base (in particular the proportion of retail and wholesale funding), including any marked concentration of deposits (mainly in terms of top-20 deposits) or borrowing, significant trends in funding sources and in the bank's liquidity. The main risk for a bank's funding is not being able to renew or replace maturing liabilities, either at all or at a reasonable cost. A well-diversified and stable funding base and a good spread of suppliers within each source type can limit this risk. It is thus important to analyze the composition of a bank's deposit base and other sources of borrowing by size, maturity, geographical source and currency.

5.2.2 As far as liquidity is concerned, we analyze both the bank's internal sources of liquidity (marketable securities, maturing loans, etc.) and external sources (such as access to money markets, stand-by lines from other banks and rediscount facilities at the central bank). Against a possible liquidity crunch, most banks hold a portfolio of marketable securities and other assets, which can be sold quickly for cash in case of need. It is, however, important to assess how marketable a bank's marketable securities portfolio really is, and whether such securities would be sufficiently liquid in the case of a crisis. Finally, banks should have a clear contingency plan, in case they run into difficulties, specifying who is responsible for the management of liquidity in a crisis, what action is to be taken and at what point, and what arrangements exist with "last resort" lenders.

5.3 Capitalization:

Capitalization - Important Ratios
Equity / Total Assets (%)
Free Capital / Adjusted Assets (%)
Tier-I Capital / Risk Weighted Assets (RWA) (%)
Contribution and structure of Tier - II
Regulatory Capital Adequacy Ratio (%)

5.3.1 A bank's equity capital provides a cushion to absorb unreserved losses and thereby allows it to continue as a going concern, thus staving off insolvency, or, if insolvency does become inevitable, to some finite degree absorbing losses which would otherwise have to be borne by creditors. Both the absolute size of a bank's equity capital and its capital adequacy (i.e. the size of its capital in relation to its risks) are thus fundamental considerations when analyzing its creditworthiness.

5.3.2 Besides regulatory capital requirements, PACRA has its own standard quantitative measures of capitalization, which it applies to banks across the board, the principal one being pure common equity as a percentage of total assets.

5.3.3 While the evolution of a bank's capitalization is an important part of our analysis, we also examine closely the quality of capital: what percentage of the capital base is pure common equity and how much is in the form of subordinated debt, perpetual debt, and other forms of quasi-equity (such as revaluation reserves, unrealized gains, underprovided non-performing loans and overvalued assets). Management's policies with regard to minimum capital ratio objectives, share buyback programmes and dividend payouts are also taken into account, as are the bank's ability to raise new capital and its internal capital generation record.

5.3.4 It is also important to analyze the level of "free capital" a bank has. If the entirety of its capital base is, for instance, tied up in long-term participations or fixed assets, it will not have any "free" (i.e. immediately available) capital with which to absorb unreserved losses.

5.3.5 PACRA additionally looks at the trends in a bank's regulatory capital ratios, both in absolute terms and in relation to those of its main peers. Moreover, PACRA analyses capital formation rate of a bank to form a view on the bank's ability to strengthen its capitalization. This is determined on the basis of net retained profits of the banks after deducting the impact of dividend.

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