

The Pakistan Credit Rating Agency



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# 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) & 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 & 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.

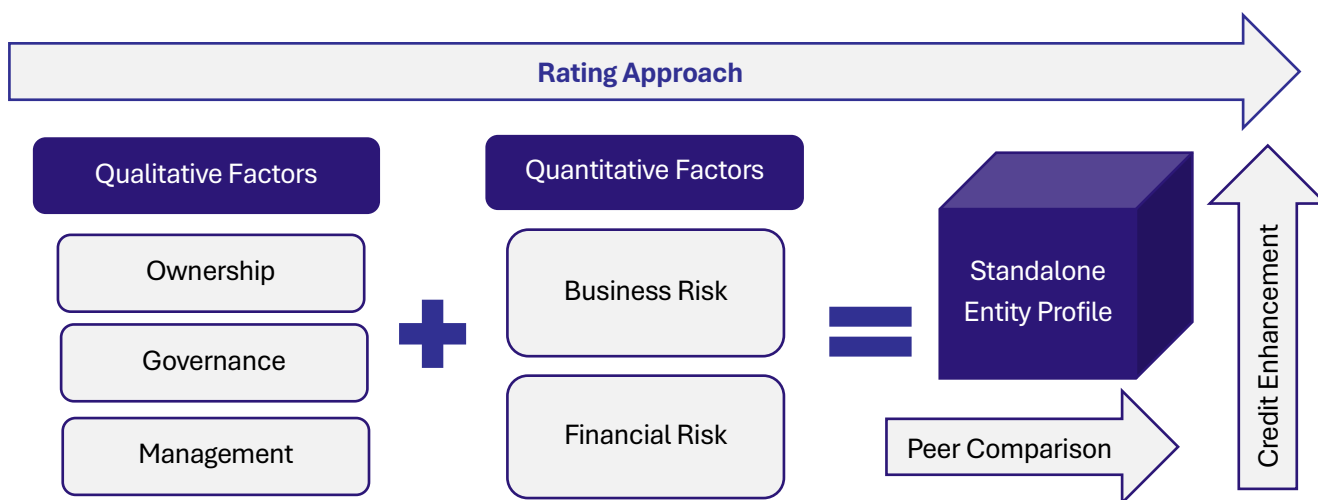
### Rating Framework

PACRA grounds its analysis of MFIs on several factors comprising six key areas: Profile, Ownership, Governance, Management, Business Risk & Financial Risk. The qualitative factors consist of Profile, Ownership, Governance, and Management, while the quantitative factors include Business Risk and Financial Risk. Quantitative factors are often given precedence, given that they are lagging indicators of future performance; neither the qualitative nor the quantitative factors possesses overarching importance in forming the final Credit 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 & 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 in its quest to identify salient features that aided the latter in strategically establishing and growing its presence. For instance, is the MFI operating in a relatively remote location by virtue of donor and government subsidies? Could a more established new MFI enter and increase competition? Is the MFI growing due to the relationships it has managed to establish with its clientele through favorable rates and other supplementary services intended to eventually result in financial independence?

All of these questions aid in discerning the strategic sustainability of the approach adopted by the institution for its expansion. A good strategy is a major differentiator, given that it is designed to approach stakeholders from varying angles as it caters to their demographic and socio-economic needs. Consequently, MFIs are capable of achieving exceptional organic growth, but there remains the possibility that more aggressive players among them could go for acquisitions. PACRA considers the growth achieved by the MFI in relation to the industry and how it was achieved.

### 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 tend to be exposed to greater fixed costs due to their being deposit-taking institutions. As such, accounting for these operational features supplements & 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 & systems, whose synergistic collaboration influences business & 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, & diversity to determine the longevity, competence, & extent of intellectual & financial support this aspect of the institution garners.

NBMFCs, for instance, are usually 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 & dedicated to carrying the institute's mission & 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.

Furthermore, Section 42 NBMFC's member pool does not derive any monetary benefit from the entity's profits. The implication is that there is little self-interest involved in exhausting resources for the sustenance of an entity intended to exist for a social & developmental goal. Hence, financial support from members should be gauged by their ability to obtain external support from the government, regulatory bodies, & international or local donors & lenders as the institute progresses on its path of self-sustained financial viability.

#### Governance

This section evaluates the Board of Directors & their role in establishing a robust oversight & regulatory framework, thereby ensuring appropriate managerial oversight & a fruitful cohesion between shareholder & managerial objectives. Furthermore, the BOD's enforcement of transparent reporting & disclosure standards, coupled with their attempts to remain dedicated to the double bottom line objective of an MFI within the confines of all applicable regulatory requirements, sets a theme for this section's evaluation. Besides, good governance is associated with an increased likelihood of fault determination & risk mitigation concomitant to the establishment of protocols that benefit stakeholders.

#### Management

This section evaluates the risks associated with the management. That includes, but is not limited to, strategy execution, the ability to maintain modernized information systems for operational efficiency & decision-making, & laying the framework for successive expansion without compromising institutional ethics or quality.

### Field Staff

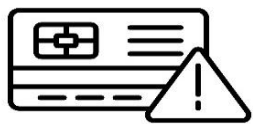
In the context of an MFI, the field staff is crucial for maintaining strong asset quality indicators, thereby acknowledging that they maintain the entity's relationship with the borrower. Building on that, any misconduct on their part may not only deteriorate asset quality but also increase business risk by virtue of a tarnished reputation. This operational aspect becomes even more important as technological penetration improves & other MFIs gain access to geographic localities that they were previously barred from as a result of specificity. Associate this with switching costs on the part of the borrowers or clientele.

It should now be obvious that the ability to retain good field staff is critical to the evaluation of an MFI's human resource management function. Moreover, PACRA attempts to gauge the MFI's employment policies, the ability of field staff to converse in local languages or dialects, alongside any sensitivity training that they may have undergone.

### Risk Management Framework/Control Environment

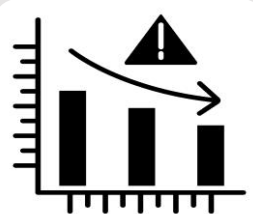
This includes an analysis of the MFI's appetite for risks alongside the systems in place to manage those risks. PACRA examines the independence & effectiveness of the Risk Management function, the procedures involved in risk assessment, including quantification, & any premeditated limits imposed on their asset allocation strategy to curtail undiversifiable risks. It further corroborates the extent to which the designated protocols are adhered to. The Risk Management Function should ideally enhance recovery, and curtail interest rate risk, market risk, & other ailments that could potentially restrict cash flows or require additional funding to mitigate. PACRA, likewise, endeavors to assess the senior management's comprehension of & involvement in the risk management process & any structural reporting lines they may have in place. Recently, there has been a noticeable upgradation in the risk management protocols of MFIs, & it has been brought about by increased guidance and supervision from SBP & SECP.

Despite the introduction of the NBMFC regulatory framework by SECP in 2016, it is safe to suggest that the framework imposed by SBP on MFBs has an edge over the former. For instance, MFBs must pass a pilot program before being granted permission to increase exposure within the Microenterprise segment. Furthermore, their House Financing requirements are more comprehensive than those imposed on NBMFCs. That does not necessarily suggest an absolute disadvantage on part of NBMFCs. NBMFCs are, after all, encouraged to set up subsidiary establishments to supplement their lending operations. Yet, the fact remains that these regulatory differences need to be accounted for, & they are, at PACRA, to retain consistency & comparability between rating opinions between Microfinance Institutional Types.



### 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 disbursement.



### 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 disbursement 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.

## 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 improves & assists risk management protocols. For instance, a unified & organization-wide accessible database on defaulters diminishes the risk that a defaulter reacquires a loan from another branch. Furthermore, information accessed in real-time allows timely interventions & synergizes different functional aspects

of an institution. For instance, HR or the Training & Development Function can more easily access prior training records & take corrective action wherever necessary.

PACRA pays considerable attention to the effectiveness of technological infrastructure in terms of efficiency, being fit for the intended purpose, scalability, & the ability to function as a platform for additional services, including digital financial services. Another complementary aspect of technological evaluation is disaster recovery & business continuity planning. Recall that any ceasing of operations can be devastating for consumer confidence & this applies even more so for the bottom of the pyramid, who are prone to facing immediate liquidity crunches. Consequently, PACRA pays considerable attention to the empirical evidence of such a plan having been tested & the method employed during the testing process. Some methods comprise interruption testing, parallel testing, walkthrough, & checklist testing.

Building on the last point, PACRA evaluates the efforts MFIs put in towards inculcating technology-based solutions. Some MFIs actively work to improve digital accessibility not only by enhancing service offerings, but educating clients in matters of usage & benefits. An exceptional MFI consistently attempts to use technology to decrease operational leverage, reduce specificity, & gain a competitive advantage. Other MFIs, on the opposite spectrum, however, lack standard digital service offerings, consist of ignorant & lazy senior management, & survive by mere virtue of the advantages they enjoy. MFIs of this type may exploit geographical first-mover advantage or some other specificity that aids their financial sustainability. If they offer products digitally, their services comprise poor-quality digital front ends that are neither intuitive nor feature-rich. Microfinance Institutions of this sort do not budge unless pushed by regulatory upheavals or increased business risk.

**Digital Financial Services:** Digital Financial Services constitute an attempt at providing modernized services to clientele in line with those offered by regular commercial Banks. They are offered in the hopes that as the social agenda of MFIs succeeds, the clientele qualifies for a transition towards the traditional banking sector that they would, in this instance, already be privy to.

PACRA, within the confines of the contextual framework, surveys the profitability & prolonged implications of DFS offerings for an entity's operational, business, & credit risk. Due credence is paid to the extent an MFI educates its clientele about digital offerings & the data privacy & protection policies adhered to by an institution.

The following components aid in comprehending precisely what DFS entails.

Type	Elements
Mobile Financial Services (Dedicated Smartphone Application)	View Statements, Transfer Funds, Access Information About Financial Service Subscription, Pay Bills, Obtain Credit, Subscribe to Insurance & Other Products
Mobile Financial Services (Feature Phone)	Statement Summary, Transfer Funds, Access Information About Financial Service Subscription, & Pay Bills



Internet Banking	Enhances Mobile Financial Services through the inclusion of more comprehensive product & service-related transactions.  Examples include subscriptions, inquiries, & digitally processing physical documents.
Digital Outlets & Complements	Debit/Credit Card, ATMs, POS Merchant Transactions, Mobile Wallet (NFC Integration)

## Business Risk

It is necessary to ensure that an MFI is capable of financially sustaining itself. Financial returns are the true culmination of the outcomes of the factors of production, & an entity that fails these quantitative assessment factors shall, likewise, fail to garner support for their enterprising needs. Moreover, MFIs are funded by institutions & individuals with the intent to maximize shareholder & stakeholder value, which is the basis for economic activity. Any failure on the part of the MFI threatens not only the confidence of its clientele but also the ability of a state to use financial institutions as a medium for instigating macroeconomic change.

## Industry Dynamics

An element that significantly impacts overall institutional business risk is the outlook, or, to rephrase, the expansionary capacity of the industry in general. The premise behind the evaluation of Industry Dynamics is that if the totality of an industry finds itself with ample growth opportunities, then that would be reflective of opportunities an entity could potentially capitalize on. Consequently, whenever the inverse is true, it would be indicative of an absence of a replicable path to sustainability, in which case, the strategic capabilities of the entity end up becoming relatively more pertinent.

PACRA's evaluation of this sub-factor is influenced by an internally prepared research journal, referred to as a sector study. The sector study for MFIs spans the range in terms of the overall macroeconomic environment & its impact on institutional clientele, the operational risks encompassing entities irrespective of their size, regulatory changes & their implications, governmental support to the industry & infrastructural development relevant to their geographic scope of operations. These subjects are supplemented by an evaluation of strategic & innovative maneuvers occurring internationally, which are then contextualized to the local context, to present an overarching view of the industry. The view accounts for any prudent decisions certain institutes may have opted for to safeguard their competitive position.

Moreover, PACRA explores the risks, strengths, weaknesses, opportunities, & threats to MFIs within the framework of social, demographic, psychographic, regulatory, environmental, & technological changes. It considers the effects of geographical diversification & any trends, if applicable, in industrial expansion or consolidation for the purpose of maintaining a sustainable financial position. For instance, environmental disasters could be cataclysmic for MFIs heavily concentrated in agricultural loans. If that were to apply to the industry in general, then significant flooding, as is common in the local context, diminishes the benefits of geographical diversification in conformance with the fact that agricultural fields across the country have potentially been damaged. Similarly, given that 90% of liability funding for MFBs originates through deposits & the fact that the number of depositors has grown exponentially over a short period, it is quite apparent that deposit-taking institutions have an edge over NBMFCs as far as their value proposition



is concerned. The implication is that NBMFCs are forced to operate in more obscure environments & provide far more personable services. This dampens their expansionary capacity, including their ability to break even, which may result in a business case for consolidation. Such subtleties have to be accounted for while forming a credit rating opinion.

### Economic Risk

An economic overview, which includes industrial contribution to the economy, the performance of sectors relevant to MFIs, the nuances of the gross domestic product (GDP), inflationary pressures, & other trends in savings & investments, is analyzed for any notable implications. The point being that periods of economic distress result in the survival of those that operate at the minima of the marginal cost (MC) curve, which indicates that their average variable cost is low & necessarily so, is their average total cost. The basic problem with the borrowers of MFIs is that, given their socio-economic status & environment, they have not reached the minimum or point of inflection in the MC curve. As such, a dip in demand concomitant to the supply curve shifting towards the left threatens their already fragile productive capacity, causing them to drift towards financial turmoil. That is precisely why economic risks are a continuous & tantamount threat to the bottom of the pyramid, & this threat's disruptive potential spills over into the institutions serving them.

### Regulatory Environment

A well-regulated environment is pivotal for the provision of a common ground that Microfinance Institutions can utilize to assess their culpability & defense against a variety of risks. The implication is that MFIs lacking the resources or ability to quantify appropriate funding & liquidity requirements retain & benefit from the option of outsourcing this nuance to the regulator. For instance, the ideal extent to which MFIs can benefit from the forced sale value of an asset when provisioning for their portfolio at risk is dictated by a regulator. That is superior to MFIs being left to their own devices, in which case, they will have to bear the additional operational burden of calculating or proving recoverability before provisioning. In fact, they could be negligent & assume absolute recoverability only to report losses later down the road, further enhancing their credit risk. PACRA pays close attention to the vigilance of different regulators, in this context, the State Bank of Pakistan (SBP) & Securities & Exchange Commission of Pakistan (SECP). This is built upon by gauging the extent of compliance with regulatory injunctions. Naturally, certain regulatory injunctions can be unreflective of credit risk, case in point, regulatory reliefs provided as a result of disasters in regards to the recognition of substandard instruments. PACRA's due diligence is extensive enough to account for such implications, thereby ensuring that its credit rating opinion is not sullied by misrepresentation.

### IFRS 9

As part of the regulatory framework, Pakistan is transitioning to IFRS 9 reporting for financial institutions. SBP has issued detailed guidelines and a timeframe for financial institutions to adopt the new reporting standards. This shift entails that the financial institutions would adopt and report under the new expected credit loss model (ECL) method. This shift is expected to enhance transparency in the classification of financial assets (loans, investments, etc.) and certain other disclosures by financial institutions. PACRA will incorporate these changes in its evaluation of financial institutions once they are implemented.

### Relative Position

This sub-factor benchmarks an MFI against its peers. It serves to demarcate institutions based on their size & the natural advantages brought about as a result of scale & market penetration. Institutions with a larger market share tend to operate in a myriad of areas, thereby minimizing geographic & specificity-associated risks. They have greater top-of-mind awareness & recognition, which causes most clients & potential clients to remain inclined towards them. That caters to an enhanced disseminative capacity. Besides, larger concerns are far more likely to attain operational efficiency as well as sustain austerity.

### Market Share

This section refers to market penetration, & there generally happens to be a positive correlation between market penetration & brand value. Its assessment includes the Gross Loan Portfolio's size of an MFI relative to the industry, coupled with a measure for Deposits' Market Share that applies solely to MFBs. Recall that this methodology accounts for both banking & non-banking Microfinance Institutions. Naturally, entities that do well in both metrics have an edge in terms of diversity across revenue streams & funding, accounting for both asset & liability classes. So, what other benefit does Market Share entail? Given that the overwhelming majority of the market is controlled by MFBs, it may be prudent to understand the implications of considerable Deposits' Market Share.

Failure, on the part of an MFB, to benefit from the potential to raise deposits inadvertently raises their cost of capital & prevents them from optimizing the nuances pertinent to their industry. Those nuances include the higher operating expenses faced by MFBs by virtue of their business model, the optimization of which shall aid a deposit-taking institution in increasing its Minimum Lending Rate Margin. Besides, a greater deposit market share indicates both brand recognition & trust. It also incentivizes depositors to fulfill their borrowing needs from the institution in question. Control over a client's deposits enables an institution to provide a subsidized interest rate to that client, & could potentially ensure greater recovery rates.

### Growth Trend

PACRA further tends to closely analyze the growth and decline trends for a variety of elements. They are evaluated for metrics like revenue, the gross loan portfolio, deposit base, & the portfolio at risk. The trend for each element adds analytical insight, but the purpose of its evaluation is to gauge the likelihood that an organization can sustain the aforementioned advantage brought about by virtue of its presence. Furthermore, this particular assessment aids institutions that are relatively new to the industry & happen to exhibit exceptional growth. The absence of this assessment in their context implies that the rating opinion would not account for their potential. Besides, growth is somewhat indicative of the fulfillment of an MFI's social mission, provided that it occurs organically. Nevertheless, PACRA is cautious about growth rates greater than that of the overall industry itself, including whatever impact they have on other metrics like sector or geographic concentration. Similarly, considerable growth in the Gross Loan Portfolio must not entail a considerable, equal or even greater deterioration in asset quality. Furthermore, in times of distress, when the loan portfolio shrinks, the portfolio at risk should shrink even more so to relieve the entity of any additional stresses on its bottom line through provisioning.

### Brand Value

PACRA also considers efforts by MFIs to capitalize on any social goodwill generated by virtue of their being developmental institutions. This goodwill or brand value is generated via socially responsible acts & honoring the rights of clientele as individuals. Yet, brand value also comprises the operational efficiency & sustainability of an entity. It encompasses the quality of its credit appraisal process, the competence of its loan officers, the quality & diversity of its assets & any other supplementary services offered by an institute to reduce its business risk. A loan portfolio diversified into a variety of segments via multiple products that happen to be both financially sustainable & great contributors towards the institutional developmental objectives is an inherent strength benefiting all stakeholders, including potential stakeholders. Potential stakeholders include donor & government agencies willing to provide support in a monetary & intellectual capacity, the presence of which shall inevitably prolong the life of an institution.

### Revenues

The stability of an MFI's revenue stream is crucial to the reduction of business risk, as is the degree to which the incoming revenues are larger than expenses, because that helps determine the leeway institutes possess for fluctuation in their expense variables. This approach may be contrasted against the difference between the required rate of return & the internal rate of return. It is through the revenue stream that an MFI shall generate profits that account for its financial expenses, the amortization of its borrowings, allocations to working capital, reallocation of its asset classes, dividends for shareholders, & surplus for retention. As such, any neglect of this element within business risk shall egregiously deteriorate the quality of the credit rating opinion.

PACRA assesses revenue quality through the lens of stability, margins, concentration, & non-core supplements. Stability is accounted for via variation & trends. A distinct metric for the computation of margin within PACRA is the Minimum Lending Rate Margin, which shall be elaborated in the subsequent sections. Concentration is gauged through the lens of sectors, geography, & dependency on a handful of borrowers. Non-core supplementary income is any additional revenue that an MFI earns through the provision of products & services that aid its lending business, case in point: vocational training. Refer to the "Risk Management Framework/Control Environment" section for additional insight. In essence, the idea is that diversification constitutes a strength because it reduces the likelihood of unmitigable events distressing an institution.

### Concentration

A lack of diversification is undesirable since it renders an MFI vulnerable to a handful of income streams, the stability of which is up for grabs, given the severe developmental constraints in the areas inhabited by the bottom of the pyramid. As such, PACRA uses several approaches to gauge concentration risk. The first metric employed is Sector Concentration. A sector pertains to or may be defined by the nature, purpose, or reason for the origination of a financial transaction. Therefore, a sector could be demarcated by the borrowing needs, products relevant to it, fulfilled within a contextual framework. That framework could be, for instance, the fraction of the microcredit portfolio utilized for agricultural purposes. Sector Concentration rewards an institution by noting that entities serving a variety of sectors diversify their revenue streams, such that they are less likely to be egregiously impacted by sudden calamities. Whereas, entities bound to particularized sectors run the risk of increased defaults & non-performance due to unforeseen circumstances despite potential geographic, product, & borrower diversification. Excessive reliance on

any particular sector type implies that an institute is not diversifying enough to strengthen its brand presence in other segments.

The second metric for gauging concentration risk is Geographic Concentration, & it complements Sector Concentration by noting that a degree of concentration risk exists within districts despite the possibility of a diverse array of products serving that particular district. An excellent & relevant example would be a lockdown in a certain district, detrimentally impacting economic activity. The definition of what constitutes a district is a legal one, & noting that, this component superbly gauges geographical market presence & effectively accounts for the localization risk inherent in smaller NBMFCs. However, this does not entail a favorable tilt towards larger MFIs. That is because larger institutes have the propensity to ignore certain districts despite their presence within them by concentrating their efforts in regions deemed more profitable. The top 20 advances' ratio is an additional supplement to PACRA's analysis & it is grounded in the premise that MFIs should avoid giving out exceptionally large loans to a handful of borrowers. There are regulatory injunctions to this effect. For instance, as per SBP's AC&MFD Circular No. 02 of 2022, MFBs shall not exceed a 40% threshold for Microenterprise loans. As such, PACRA's assessment of these risks is in line with regulatory requirements. This does not imply that PACRA by default considers all microenterprise loans one & the same. Instead, it gives due credence to the fact that there is considerable diversification within this class of loans, except that PACRA is not negligent of any violation by an MFB of the State Bank's injunctions.

### Minimum Lending Rate Margin (MLRM)

This is a measure of an institute's ability to cover all of its fundamental expenses not via the entirety of its operating income, but instead only the proportion earned on its loan portfolio. Ergo, it is a metric accounting for institutional sustainability through the lens of nothing more than the core business function of lending. It comprises a bunch of fractions in an arithmetic expression that use an equivalent base to standardize themselves, which in this case is the Gross Loan Portfolio. The fractions refer to additional metrics such as portfolio yield, operating, financial, & impairment expenses. Portfolio yield measures the earnings on the GLP, whereas operating, financial, & impairment/provisioning expenses collectively constitute fundamental costs for an MFI to sustain itself. The expenses constitute the bare minimum that an entity shall need to earn to sustain its core operations. Hence, the term, minimum lending rate, & the difference between the yield & the latter is called the Minimum Lending Rate Margin.

There are instances in which an institution could thrive despite negative margins, such as when an MFI has diversified into a plethora of non-lending products & services. Then they would be able to lend at the lower spectrum of the interest rate associated with a risk profile. However, it may just be that they are constrained in their ability to generate appropriate yields due to the presence of larger competitors, whereas others might be stymied by slow growth in their contribution margin per borrower. In any case, it should be blatantly obvious as to why PACRA's assessment must discern whether or not an MFI can sustain itself through its fundamentals, & identify relevant reasons for divergence from this obvious expectation.

### Miscellaneous Aspects of Revenue

For most MFIs, interest income from the loan portfolio & investments makes up most of their revenue base. However, non-interest income from fees, service charges, commissions, & any other value-added services also represents an important & growing source of revenue. PACRA views an earnings profile that complements interest income favorably, given that it stabilizes fluctuations with an entity's earnings. Besides, it is crucial to comprehend that MFIs, as alluded

to earlier, are not just in the business of lending. Any developmental institute facilitating long-term change has to provide supplementary services that facilitate the risk-taking activities of its clientele. To this effect, PACRA analyzes a host of different components, including Non-Mark-Up Income.

### Cost Structure

This structural aspect of an institute is studied to discern any operational leeway or advantage afforded to an institution by virtue of its technological or operational infrastructure, especially when the industry, as a whole, is strained. The goal of this assessment, firstly, is to judge whether or not the institute generates enough gross margins, & secondly, to inspect the coverage afforded by the margins against fixed costs or operational expenses, including the necessary impairment provisions. Entities that operate efficiently, in the sense that their average cost has been minimized, gain a competitive advantage because the threat of competitors or the bargaining power of customers & suppliers of credit is comparatively diminished.

The implication is that such institutions can generate enough financial profit to maintain their cash flows such that their debt repayment capacity is not entirely dependent upon liquid reserves. With that in mind, there are a handful of metrics studied to ensure that the cost structure is not exorbitantly disadvantageous to increased leverage. Those metrics include Operational Self Sufficiency, Return on Equity, & the Cost per Borrower. This list, though, is not exhaustive & other elements factored into the evaluation include a contrast between the overall income & non-markup expenses concomitant to forays, determining the proportion of the earning asset base. PACRA is acquainted with the differences in the cost structure arising from the operational model of an MFI; as such, a relatively poorer cost structure does not write off an institution altogether.

### Operational Self Sufficiency (OSS)

OSS contrasts the totality of operating income against operational expenses, thereby judging the ability of an institute to survive based on its operational fundamentals. This is different from the aforementioned MLRM, which gauges an institute's ability to thrive off of its lending portfolio. By observing OSS, it is easier to cognize whether or not the totality of an MFI's offerings, including supplementary services, is sufficiently advantageous to permit its sustainability as a going concern. OSS remaining stable while an institute's bottom line deteriorates is indicative of a problem in something other than the core fundamentals, which, if rectified, could easily get an MFI to thrive. Naturally, PACRA is cautious about the cause, if any, causing a contrast between OSS & the net income/profits after tax.

### Cost per Borrower (CPB)

The metric discerns operational efficiency in relation to the borrowers. High costs distributed amongst a larger number of borrowers are not as disconcerting as high costs amongst a lower number of borrowers. Adding to that, institutions with a lower CPB find themselves in an excellent position to customize their offerings in accordance with the borrower profile. Besides, CPB is not distorted by the size of the gross loan portfolio; it does not judge based on the standalone operating expenses, & rewards institutions for their efficiency if the costs per borrower are low despite not having a large number of borrowers. Other measures, such as Gross Loan Portfolio Market Share, intended to gauge relative position, could be distorted by the mere virtue of overall portfolio currency denomination. Cost per Borrower, on the other hand, complements & diminishes the limitations of other aspects of the evaluation process, quite effectively.

### Return on Equity (ROE)

This is a universal metric for the acceptability of returns, & it is a leveraged metric that measures the returns provided to shareholders by incorporating all of the costs incurred by an institution, including financial costs. This also accounts for any discrepancy caused by virtue of an entity's shareholding structure. For instance, the dividends payable to preferred stockholders for the period are not available to ordinary shareholders. The idea behind it is to judge whether or not the returns of an MFI are sufficient, in the sense that they function as a reward against the risk undertaken by virtue of the enterprising activity. Furthermore, given that ROE is not limited to operational, financial, or impairment expenses, the leeway afforded by the totality of the cost structure ends up getting assessed in this analysis. A question that may arise is what purpose does this metric serve for a Section 42 NBMFC. A non-profit institute may not be in the business of providing returns to shareholders, but that does not vindicate it of the obligation to yield similar results, especially if it desires to alleviate the sponsors of the burden of continuous support.

### Sustainability

PACRA evaluates management strategy, its viability, the involvement of the Board of Directors & the Key Performance Indicators developed to assess the goals & objectives of that strategy. That shall include any budgets & forecasts ratified by the management. PACRA is particularly intrigued by the assumptions underlying a particular strategic path, including its logical & deductive coherence. Strategic plans, as they may be, are benchmarked against rivals, and trends within the Microfinance Industry, wherever applicable, & are contrasted against the management's track record for reliability & the ability to achieve prior strategic goals. Additionally, any measures to enhance communal outreach by an MFI, such that it leads to the cultivation of long-term relationships with existing clients or results in the acquisition of new ones, are viewed favorably. Such social measures include establishing new grievance expression mechanisms, overhauling data privacy & protection policies such that they result in fewer chances of exploitation, conducting seminars to help the bottom of the pyramid better comprehend microfinance products, etc.

### 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) & 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 & 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 & application hosting servers happen to be geographically dispersed.

**Table 1. Information Business Risk**

- Type of License
- Target Market
- Outreach, Market Share, Details pertaining to Operations within Particular Districts
- Key Figures; Agents, Deposit Attributes (amount, volume, & number), Number of Transactions, & Portfolio Concentration Statistics
- Industry & Entity Information, including additional data as may be necessary about the loan portfolio, depositors, & number of borrowers.



- Top 20 Advances & Deposits
- Branchless Banking Operations
- Two-year projections accompanied by the details of any underlying Assumptions
- Future Strategic Details & 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

Financial Risk is comprised of four different sub-factors: Credit Risk, Market Risk, Liquidity & Funding, & Capital Adequacy. Credit Risk assesses asset quality, the reliability of the entity's lending portfolio. An unreliable portfolio threatens the stability of the enterprise, given that both the principal & its associated interest would otherwise have to be paid from earnings & reserves. Market Risk assesses the approach employed to conserve liquid assets regarding time value & the tradeoffs, if any, of it. The tradeoffs include the presence of residual risk within the investment portfolio, whose earnings are meant to supplement the lending portfolio. Liquidity & Funding checks the institute's ability to pay off certain liabilities either on demand or if required to do so. In essence, it elucidates the extent of coverage the entity's liquid holdings can provide in the event of austerity or the ordinary course of business. Capitalization verifies whether or not an institution is sufficiently funded to sustain potential losses from its equity funding. This serves the purpose of ensuring that creditors need not worry excessively about recovering chunks of their principal.

### Credit Risk

The risk that an institute's borrowers fail to meet their obligations. PACRA evaluates this risk by assessing asset quality, which is more or less the key to judging the stability of a financial institution. Failures to recover the lending portfolio



imply that the MFI has to make up for the shortfall via remnant returns, its investment portfolio, or its loss-absorbing equity. That entails exhausting any liquid reserves to simply remain operational, which is effectively disastrous from the perspective of lenders to an MFI. To be more precise, the credit risk associated with an MFI's borrowers is correlated to its own credit risk as an institution.

The institutional rating assessment involves carefully screening the credit risk assessment protocols employed by an MFI against its own borrowers, & that is inclusive of the capabilities of its Management Information System. Recall that its borrowers happen to be the impoverished, & they tend to have little or no documentation. So, any risk assessment must ideally encompass information about the borrower's income, details of other borrowings, including those through usurers, assets capable of collateralization, familial information, communal perception, etc. Furthermore, given that this assessment is intrinsically tied to the capabilities of its loan officers, the MFI's ability to train & retain them is included as part of the scope of the evaluation. Lastly, the post-disbursement monitoring mechanism & the collateral realization & recovery process must be attuned to the risk characteristics of the industry.

Asset quality is accounted for by a handful of metrics, including but not limited to the True Infection Ratio, the Risk Coverage Ratio, Top 20 Advances as a percentage of Advances, Exposure per Borrower, & the percentage of the portfolio collateralized. Portfolio aspects such as those consisting of a staggered repayment structure contrasted against those with bullet payment are given due credence.

### True Infection Ratio (TIR)

The True Infection Ratio encompasses two components: the Portfolio-at-Risk (PAR) & Write Offs. PAR pertains to the portion of the portfolio that has been overdue for at least 30 days, depending upon the loan type & the regulatory guidelines applicable. Generally speaking, given the fact that microcredit loans tend to be lent out for a shorter duration, a delay in payment for 30 days should be deemed concerning. Renegotiated & restructured loans, due to potential delinquency, may be deemed part of portfolio-at-risk. Moving on to the second component, loans are written off because it is pertinent that their odds of recovery have fallen below a particular threshold. Given that, write-offs include loans that have been directly expensed in the P&L as well as those written off against provisions.

Entities that monitor such asset quality metrics in real time are allowed to ramp up recollection measures in accordance with the delay. Note that this metric is impacted by the frequency of loan payments. For instance, weekly repayments being in arrears for 30 days is a greater cause for concern than the monthly ones. Furthermore, TIR is not impacted by entities excessively writing off loans to improve their Portfolio-at-Risk, considering that it includes both as part of its result. It is notable that PACRA even segregates TIR into its constituents: the Portfolio-at-Risk Ratio & the Write-Offs Ratio to discern any individual peculiarities that end up getting lost in the merger.

### Risk Coverage Ratio (RCR)

This metric is meant to check for adequate provisioning against substandard or doubtful debt. PACRA takes comfort from the regulatory general & specific provisioning requirements in accordance with the regulatory framework applicable to the MFI. However, the analysis cannot be devoid of credence being paid to certain fundamental realities. For instance, general provisioning requirements for NBMFCs happen to be 0.5% of the net outstanding portfolio, whereas they are 1.0% for MFBs, net of specific provisions.

Similarly, housing loans, provided by MFBs, may be written off 3 years after having been classified as being at loss, whereas NBMFCs remain obliged to follow their standard conventions. That results in a discrepancy, which would result in significant provisioning requirements had NBMFCs participated as frequently as MFBs in the house financing scheme, assuming that a portion of the debt turned out to be substandard. An MFB, in this situation, is not obliged to recognize additional provisioning requirements except without a delay, as per SBP. Besides, an MFB shall, in this context, have a greater time period to recover the property mortgaged over to them, irrespective of the odds of recovery. Furthermore, unless acted upon prudently, certain loans shall remain classified as at-risk within an MFB's balance sheet for a longer duration of time, which would inadvertently sully the True Infection Ratio. How may all of these peculiarities be accounted for at once? PACRA, for prudential purposes, deems an RCR of at least one as being optimal so that such peculiarities may be accounted for & that there is excess provisioning against substandard debt irrespective of the duration of its non-performance.

### Market Risk

This risk may be defined as one arising as a result of fluctuations in the returns or values underlying financial & equity securities. Unsystematic Risk would not technically constitute market risk, but given that institutions may not have sufficiently diversified, residual traces of it shall remain in the risk as accounted for by this sub-factor. The primary reason why MFIs invest is to meet their cash & liquidity requirements such that their cash-in-hand ceases to devalue. However, there is another reason behind it, & that is to supplement their excessively risky returns from the Microcredit Loan Portfolio. In essence, the goal is to be able to meet revenue shortfalls, which may arise as a result of economic instability & credit risk. A problem that arises, in this context, is that economic risk is intrinsically tied to overall market performance & the microcredit loan portfolio's credit risk.

PACRA negatively perceives an institute's investment portfolio, particularly for an MFI, if it tilts toward lower returns per unit of risk involved. With this in mind, it is notable that MFIs generally tilt towards investments in government securities, & that is a safe bet given that smaller NBMFCs may not necessarily have the resources or capacity to delve into investment management. However, there is no substantial drawback in an MFI investing in Mutual or Fixed Income Funds so long as the risk appetite of the institution is not imprudent.

### Liquidity & Funding

The importance of adequate liquidity cannot be downplayed for MFBs or NBMFCs, but assuming that such a shortfall were to occur, the implications for an MFB would be somewhat more egregious. That is because a general principle that applies to banking institutions is that any of them could default if a chunk of depositors were to withdraw simultaneously. Colloquially & in financial terminology, the described situation is referred to as a run on a bank. Resultantly, given that MFBs serve the bottom of the pyramid, it is of dire significance that their confidence in the banking system be retained. Neither must their savings, as minuscule as they may be, be threatened due to the mismanagement of the credit risk on the institute's lending portfolio. In this context, PACRA differentiates its evaluation of Liquidity & Funding for MFBs & NBMFCs.

For MFBs, PACRA pays attention to the deposit mix, a proportional comparison between demand, savings, & fixed or term deposits, for instance. Of course, any assessment must be wary of the fact that in some instances, the terms & conditions applicable to savings accounts render them equal to demand accounts. Furthermore, MFBs exhibiting

greater reliance on larger deposits per depositor are considered relatively riskier than those whose deposit base is extensively diversified.

In the case of NBMFCs, it should be noted that despite their inability to raise deposits, their funding sources are not too restrictive either. They are allowed to finance themselves through debt, grants, & donations. Grants & donations may be used to finance fixed assets, & grants themselves, depending upon the rationale for their issuance, can be utilized by NBMFCs to offset their expenses. Regarding credit risk, however, it is the ability to pay back debt that needs to be accounted for, even if it originates from donor organizations at lower interest rates. So, the liquid assets of an NBMFC should ideally permit them to make up for any shortcomings in their earnings concerning the burn rate & provide a degree of coverage for interest & principal payments. PACRA also considers an NBMFC's debt servicing capability if the benefits of donor financing were extinguished from the cost of funding.

Due credence is paid to structural liquidity for MFIs in general, just as institutional compliance with the regulatory liquidity & reserve requirements is monitored. Lastly, a degree of preference is given to institutions with a greater loan portfolio turnover.

### **Liquid Assets as a Percentage of Deposits & Short-term Borrowings (LAPDSB)**

In the event of austerity, it is prudent for an entity to have enough liquid reserves to be able to compensate its creditors, especially those that are owed within the span of a year. A healthy ratio of liquid assets, as aforementioned, ensures that entities can effectively manage their burn rate plus make up for any shortcomings in their ability to repay principal amounts. MFIs do not expect to suffer a severe setback in the ordinary course of business, but certain catastrophes tend to prove more detrimental for smaller, less resourceful entities, case in point: pandemics. Besides, liquid assets themselves are accounted for by this ratio & PACRA is appreciative of MFIs that generate complementary income via their investments.

### **MFB | Demand Deposit Coverage Ratio (DDCR)**

This ratio is quite traditional & relevant to any analysis that studies the financial statements of banking institutions for reasons explained in the introduction to Liquidity & Funding. The rationale behind this metric could be questioned, given the nature of the previous one (LAPDSB). However, there is a difference between them; the previous metric estimates the overall buffer that has the propensity to be availed, whereas this is particularized to demand deposits. It also has the propensity to lessen the intensity of the alarm sounded by the previous ratio.

### **MFB | Liquid Assets / Top 20 Depositors**

This component evaluates another aspect of risk carried by an MFB, which is that a major source of its funding is not subject to significant withdrawal constraints. Demand deposits could be withdrawn at any moment, but the same holds for other deposit types. Term deposits, for instance, often carry a penalty on early withdrawal, but a depositor could be completely lackadaisical about it in the event of urgency. Besides this, this component, as blatant as it is, aids PACRA in assessing deposit concentration & institutional reliance on a set of larger depositors.

### MFB | Funding Diversification

As per the funding options available to MFBs, PACRA inspects the proportion of funding from different sources availed by the MFB. A delicate balance between deposit & debt financing is considerably favorable, except that this metric is not evaluated in isolation.

### Capital Structure

Microfinance Institutions are bound to equity financing requirements as per the regulator whose domain they fall under, & that can be expanded upon for MFBs through the incorporation of their regional scope. While the credit rating opinion accounts for these requirements, simply meeting the regulatory requirement does not suffice for PACRA's purpose. Instead, due credence is paid to additional equity or funding reserves, particularly, loss-absorbing Tier I Equity, which shall be explained as part of the methodology. What is most striking is that PACRA equates the capitalization requirements for MFBs & NBMFCs through the calculation of the Capital Adequacy Ratio in the case of the latter. Note that MFBs are regulatorily obliged to publish CAR, which has been set at 15%. PACRA, however, applies the same benchmark to NBMFCs & justifies it by considering that NBMFCs are, by & large, exposed to the same risky asset classes. In fact, both MFI types cater to the same audience with overlapping microcredit product types. One primary difference is that NBMFCs operate in comparably more remote geographic domains, except that that is not a reprieve to the riskiness of their asset portfolio.

Besides the emphasis on CAR, the Uncovered Capital Ratio is accounted for to inculcate an estimate for the maximum potential losses that an MFI's equity or funding base is likely to encounter. The retention rate is evaluated through the lens of the dividend payout policy encompassing both preferred & common equity holders. So, to summarize, the essence of studying the capital structure of an MFI is to ensure that they have sufficient loss-absorbing equity to make up for any losses as may be encountered in the ordinary course of business or in instances of socio-economic distress. The ability to generate internal capital for growth is accounted for in the strategic plans provided by the management for holism.

### Capital Adequacy Ratio (CAR)

The most widely recognized ratio in the financial industry for evaluating the sufficiency of equity funding of a financial institution. CAR is calculated by summing Tier I & Tier II Equity & dividing the result by the Risk-Weighted Assets of an institution. Tier I Capital comprises paid-up capital, premium, general reserves, unappropriated profits, etc. However, it needs to be adjusted for intangibles, deferred tax assets, significant investments, & shortfalls in provisions. The resultant amount is an entity's core or Tier I Capital. Tier II or Supplementary Capital comprises freely available provisions, revaluation reserves, & subordinated debt, which is generally considered to be somewhat akin to equity. The summation of Tier I & Tier II capital results in the equity or funding base capable of providing cover to risky assets, in part, because the likelihood of a catastrophe eradicating the entirety of the asset base, subject to coverage, is relatively minuscule. The denominator for CAR, the Risk Weighted Assets, is a collection of assets adjusted for the proportion that requires coverage in accordance with their risk profile. The microcredit loan portfolio of an MFI, for instance, shall require a 100% inclusion given the credit risk associated with it.

CAR essentially assists in inferring, based on the variation in the overall value of risky assets coupled with potential losses on account of that variation, as to whether or not the existing capitalization suffices to both absorb losses &

leave behind sufficient funding to keep an institution solvent for a particular duration. Entities that experience complications, insofar as their ability to raise Tier I & Tier II Capital is concerned, can improve their capitalization metric by moving to lower risk-weighted asset classes.

### Uncovered Capital Ratio (UCR)

A simple, yet informative ratio that encapsulates the risk arising from a deduction in future earnings as a result of insufficient provisioning. If the provisions are sufficient, then the existing buffer will not adversely impact equity or unappropriated profit/(loss). However, if the provisions are insufficient, the implication is that the entity may end up requiring additional write-offs in successive periods.

### 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, & 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 (%)

### Table 2. Information 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+	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.
AA	
AA-	
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.
A	
A-	
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.
BBB	
BBB-	
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.
BB	
BB-	
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.
B	
B-	
CCC	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.
CC	
C	
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

<b>Outlook (Stable, Positive, Negative, Developing)</b> 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'.	<b>Rating Watch</b> 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.	<b>Suspension</b> 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.	<b>Withdrawn</b> 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.	<b>Harmonization</b> A change in rating due to revision in applicable methodology or underlying scale.
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**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         | e) Holding Company Rating            |
| b) Corporate Rating             | f) Independent Power Producer Rating |
| c) Debt Instrument Rating       | g) Microfinance Institution Rating   |
| d) Financial Institution Rating | h) Non-Banking Finance Company       |

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