

VIS

Credit Rating Company Limited.

FINANCIAL INSTITUTION

Table of Contents

SCOPE OF CRITERIA.....	3
SUMMARY OF CRITERIA CHANGES	3
AN OVERVIEW OF RATINGS FRAMEWORK	3
RATING METHODOLOGY- STANDALONE RATINGS.....	4
A. BUSINESS RISK ASSESSMENT.....	4
B. FINANCIAL RISK ASSESSMENT	6
C. EXTERNAL SUPPORT.....	9
DIGITAL BANKS.....	9
RATING BANK CAPITAL INSTRUMENTS.....	10
KEY RATIOS.....	10
ASSET QUALITY.....	11
PROFITABILITY	11
CAPITALIZATION	11
FUNDING/LIQUIDITY.....	11



SCOPE OF CRITERIA

The criteria titled 'Rating Methodology-Financial Institutions', primarily applies to ratings of entities defined, and regulated as banks, including commercial banks (whether conventional or Islamic), digital banks and other development financial institutions (DFIs), which are regulated by the State Bank of Pakistan excluding microfinance banks. All other non-bank financial companies and microfinance banks are covered under separate criteria document.

SUMMARY OF CRITERIA CHANGES

The Financial Institutions Rating Methodology dated February 2024 has been reviewed, and the fundamental criteria outlined therein remain unchanged.

AN OVERVIEW OF RATINGS FRAMEWORK

VIS rating methodology for financial institutions is composed of three broad analytical frameworks. The assessment begins with an evaluation of the business risk profile of the financial institution, encompassing industry level analysis of operating environment and financial institution review of competitive position, management quality, organization structure as well as operating systems, control procedures and delivery channels.

A financial profile assessment of the financial institution is conducted encapsulating an assessment of asset quality, capitalization, quality of earnings and liquidity profile and lastly followed by an assessment of external support that may be available to the institution. The terms banks and financial institutions have been used interchangeably in the text.



RATING METHODOLOGY- STANDALONE RATINGS

The assessment of standalone risk profile is based on some key factors, qualitative and quantitative, which may further be broken down into sub-factors to comprehensively capture the rating drivers. The quantitative factors have a 50% weight and include analyzing different dimensions including capitalization, asset quality, earning quality & stability and liquid assets carried on balance sheet.

Qualitative factors include an assessment of market access and competitive position which is reflected in market share of the institution, funding profile, depositor concentration, diversity in types of sources for funding and capital market access for raising equity. This dimension has a 30% weight while other qualitative factors include management profile, risk management, technology infrastructure and delivery channels contribute 20% to VIS's overall score. Peer group identification and comparison is an important ingredient of standalone analysis to appropriately stack the performance levels.

A. BUSINESS RISK ASSESSMENT

A. (i) Operating Environment

Operating environment of financial institutions relates to the economic and industry risks to which they are exposed to or may face over the rating horizon.

In the assessment of economic risk, it is important to understand the current and forecasted structure of the economy, flexibility of the economic policy to projected socio-political structure, current and potential economic imbalances, and the major credit risk sectors. In economic risk analysis the banking system's capacity to adjust to national level economic changes on sectoral and individual bank level are also assessed. The degree of economic resilience here mitigates the economic risk particularly for the larger dominating banks whereas it provides enabling environment to trailing mid-tier or smaller banks.

For the industry risk assessment, the depth of coverage of the regulatory environment for banks and its monitoring effectiveness by the regulator is considered. Ratings are also influenced by the ability of the regulators to ascertain the soundness of banks in the system and their capacity and willingness to intervene to prevent institutional failures. The transparency in the system as inculcated by the regulatory framework is also given due weight as well as the efficiency of the overall legal system in case of foreclosure events for customers' security repossession.

A. (ii) Market Access & Competitive Position

Market position of a bank is mainly determined in terms of the deposits mobilized by the bank in comparison to total deposits mobilized by the overall banking industry. Banks having a sizeable market share benefit from economies of scale and may also have greater pricing power. Moreover, banks after having achieved a certain market share, gain systemic importance in the domestic context. Market share has a sizeable weight within VIS's overall score for market access and for higher rating bands it may become a differentiating factor. For a 'AAA' rated bank, market share is expected to be around 8~10% or higher.

Total market-based funding of the bank in relation to total liabilities and assets are tracked by VIS in order to monitor reliance of the bank to credit sensitive counterparties. Market base funding is considered less stable by VIS as compared to funds raised through deposits.

Within deposits mobilized by a bank, analysis would focus on types (core vs. non-core deposits and retail vs. corporate deposits) and composition of deposits. The granularity level in deposits measured through concentration profile in CASA (current account/saving account) along with the accumulation level in top twenty to top hundred depositors would provide an insight into the stability of liquidity at the bank. A higher market share in deposits with granularity and significant CASA would be considered a strength to the risk profile and would generally be accompanied with a larger, geographically diversified branch network.

A. (iii) Management Quality

The stability of the management as indicated through succession plans and employee turnover ratios affect the continuity of the management's long-term plans, and instability in management will discount the assessment of the strategy. Qualification and experience of senior management and across different management remains a rating consideration.

The control procedures implemented at the bank and the future of the entity as envisioned by the top management is a significant rating factor. The trickle down of the top management's vision and the clarity of the strategy identified, are factored into the ratings. Control measures undertaken by the management including contingency plans and the degree of centralization are separately analyzed. Factors such as effectiveness of credit appraisal and monitoring procedures are also given due weight.

A. (iv) Operating Systems

Information systems in place are assessed for their adequacy as an integral element of internal controls in terms of their ability to generate and transfer data and ensure its timely availability to management for decision making. From an IT perspective, it is important to assess the ease of flow of information between functions, diverse report generating capability and the service efficiency of the internal and external sources in maintenance and development of the IT system. The IT security policies and disaster recovery plans are critical for system reliability and sustenance and would grow in importance as more branchless platforms are inducted into the banking field. The capacity of the existing or planned IT platform to develop or assimilate such technology-based products is assuming greater importance, going ahead. By the same token, the effectiveness of internal audits, their frequency and their usage by the management is also counted towards the strength of systems and procedures. Risk management function is assessed for its ability to track overall risk profile of the assets & liabilities of a commercial bank. Risk assessment of credit, market and interest rate risk in the portfolio and the asset/liability maturity mismatch is also taken into account. The dovetailing of Risk Management, Compliance, AML and KYC and other control functions with the updated IT platform is considered important.

Assessment of the extent of ESG integration has become pivotal for a Financial Institutions sustainable growth. Firstly, environmental considerations encompass the bank's/DFI's role in financing projects that are environmentally friendly or have potential adverse environmental impacts. Financial Institutions that finance green initiatives may be viewed more favorably, while those supporting industries with heavy environmental footprints might face reputational risks and the borrowers should be subject to higher scrutiny during the credit underwriting process to address climate transition credit risks.

On the social front, financial institutions lending practices need to be evaluated to ensure they do not inadvertently support practices that harm social welfare and equity. Lastly, from a governance perspective, strong corporate governance mechanisms, including transparency in operations, ethical lending practices, and robust internal controls, can elevate institutions credibility and trustworthiness.

A. (v) Delivery Channels

The delivery channels of financial institutions are dependent upon its business strategy and model. Delivery channels also have to be aligned with the type of asset and/or liability business which the commercial bank plans to push through a particular channel. To assess the suitability of the delivery channel, the trends in growth of the branches are compared to growth of deposits and further analyzed to changes in granularity and CASA composition internally and to the total borrowings. The existing and planned transformation of the delivery channels onto a digital platform is also factored into analysis.

B. FINANCIAL RISK ASSESSMENT

VIS, over time has developed benchmarks for key quantitative areas including capitalization, asset quality, liquidity, and profitability. Compliance/violation of no single benchmark is a guarantee for a rating associated with the benchmark.

While sustainable earnings (profits before all extraordinary items, provisions, and taxes) and risk profile of the institution are given due coverage in the analysis, VIS is of the opinion that the bank's franchise value and the ability of the management to enhance and capitalize on this value, determines its financial strength over the long term. Therefore, it is entirely possible for commercial banks with weaker financial ratios to have higher ratings based on management quality, support factors and franchise; ratings are consequently not entirely driven by the financial silhouette of an institution.

B. (i) Capitalization

Strength of capitalization of a bank is reflected in its unimpaired capital base compared to its risk weighted assets. Generally known as Capital Adequacy Ratio (CAR), it is denominated in percentage terms. CAR is one of the most important tools of risk assessment of a bank and is hence regulated through mandatory minimum limits. CAR at regulatory prescribed minimum is considered adequate and able to withstand normal business losses. CAR at levels higher than the regulatory limit are able to absorb greater than normal business losses and such banks are expected to survive longer periods of economic downturns or business adversities. A lower than prescribed CAR, weakens bank's ability to absorb losses and it may become exposed to regulatory reviews. CAR in its standalone position, provides a fair assessment of the bank's ability to absorb losses, dovetailing it with earning potential, gives a clearer picture of a bank's loss or risk absorption capacity over a time horizon. CAR is also reviewed along with asset quality of the bank; higher the risk of losses from performing portfolio, more the capital would be required to maintain capitalization levels. Besides CAR, equity in relation to total assets is also tracked in order to have an un-weighted view of capitalization indicators. The continued adequacy of capital as reflected in the growth in equity in relation to the growth in assets is of critical significance to ratings as a reflection of risk.

Absolute size of equity base and cushion over regulatory minimum capital requirement (MCR) is also considered important. Equity size is critical as banks may at times be compelled to take the loss from non-performing loans all at once, rather than being able to spread the loss over years by way of provisions. As such, capital base serves as the buffer against sudden deterioration in asset quality or acute dips in earnings in any particular year.

With the introduction of Basel-III, VIS places more emphasis on quality of capital carried on the bank's balance sheet. In this regard, greater consideration is given to core capital which has a higher ability to absorb losses. Resultantly, items such as intangibles and goodwill are also excluded from calculation of core capital. Moreover, deferred tax asset whose reliability depends on future earnings, will also be adjusted to assess the impact on capitalization indicators.

Capital requirements have also become more stringent with the introduction of Basel III. VIS will continue to track bank's ability to comply with current and future regulatory requirements in the backdrop of future growth plans of individual banks. In line with Basel-III requirements, State Bank of Pakistan (SBP) also has enhanced total CAR requirements (including capital conservation buffer - CCB) to 12.5%, which was relaxed to 11.5% during COVID, while tier-1 capital requirement is at 10%. SBP has also designated certain banks as Domestic Systemically Important Banks (D-SIBs). These Banks have to comply with additional CET-1 capital buffer as has been defined by SBP. VIS has defined benchmarks for Tier-1 and overall CAR for different rating bands. Banks in the investment grade rating must be compliant with Tier-1 and overall CAR while the highest rated banks are expected to have a cushion of around 3% over Tier-1 and overall CAR regulatory requirements. For D-SIBs, the cushion (as required by VIS) is over and above the CCB and D-SIB buffer that is required by the Bank to comply with regulatory requirement.

B. (ii) Asset Quality

Key asset risk considerations include rapid loan growth, impairment in current loan portfolio, and provisioning & collateral coverage along with risk from concentration of asset profile (counterparty, sector and geographic concentration). Rapid loan growth when accompanied with lower underwriting standards may result in asset quality pressures for banks which are more visible in economic downturns. Growth is also monitored within various financing segments in order to track whether growth has been manifested in high-risk segments which are also a potential source of credit risk. The individual bank's loan portfolio spread in its Obligors Risk Rating format is also considered.

Quality of loans & advances portfolio is assessed through measurement of credit risk, concentration risk and interest rate risk present in the portfolio. Judgment for credit risk is arrived at by examining the risk classification of the impaired portfolio under prudential regulations adjusted for specific exposures identified by internal or external auditors. For restructured exposures, VIS continues to consider them as risky exposures unless a material payment has been made to reduce the outstanding principal and the borrower has the capacity to make upcoming payments as per the restructuring terms. The classification of non-performing loans & advances portfolio under the categories stipulated by the prudential regulations reveals the risk spectrum of the portfolio. The absolute quantum of nonperforming loans as well as their ratio to the total advances and to the unimpaired equity is important from the earning potential and business extension prospects of the bank. Asset risk arising from current performing exposures is also monitored in order to gauge future provisioning requirements. The extent of provision coverage on overall non-performing portfolio is important to assess the extent of uncovered exposure being carried on the books. VIS adjusts specific provisioning against non-performing portfolio as required by the prudential regulations issued by SBP to assess net infection ratio. Regulatory requirement also requires banks to charge general provision against consumer finance portfolio. Moreover, the adoption of IFRS 9 requires the Banks to record an allowance (general provision) against expected credit loss on stage 1 and stage 2 exposures also. Loan loss coverage is generally assessed without taking into account general provisioning against financial assets. However, when general provisions & collateral coverage are sizable in relation to the credit portfolio, viewed in the perspective of relative quality of exposures, VIS positively adjusts the bank's asset risk score. VIS has defined benchmarks of net infection for various rating bands with banks in the 'AAA' rated category expected to have net infection of around 2% or less.

The quality of credit portfolio is also dependent on the counterparty and sectoral risk in the portfolio. A sizeable and granular lending portfolio in terms of number of relationships may result in lower asset quality pressures as compared to a lending portfolio which features concentration and may result in quality strain in case of impairment in large financings. The credit concentration is assessed by looking at top credit exposures - both funded and unfunded - separately and combined as a proportion of total on balance sheet and off-balance sheet exposures. Concentration in single or few

sectors may lead to abnormal credit and earning loss in situations where these sectors may come under economic or business cycle stress.

The distribution level of the loans & advances portfolio between variable and fixed return terms would indicate the interest rate risk on the portfolio.

B. (iii) Quality and Earning Stability

The level of basic earnings and its sustainability is the focal point in assessing profitability as an entity's integral strength. Basic earnings of an institution exclude the effect of one-time gains, provisions and taxation. Profitability determines an institution's ability to build reserves and be able to provide for unrealized losses, without affecting the bank's existing capital base. The sustained earning potential of an institution is a key determinant of franchise value and effective management and allows a bank to continually invest in new products and technology. Sizable growth in earnings level in a particular year will not contribute towards the ratings, if achieved through sources believed to be volatile.

Business position and earning potential is a function of the concentration or diversification in the business services offered, the franchise value enjoyed by the bank and the distribution of its earning streams. The variety of funded and non-funded services available to the customers of the bank and the efficacy of their delivery leads to the development of franchise value which when done effectively over a period of time becomes intertwined in supporting each other. It is to be noted here that while franchise value takes a considerable time to accumulate, its loss may occur much faster with fewer lapses. Majority of bank's earning emanate from loans & advances and investments (fixed income and market based) followed by trade related activities and one-off gains. Among these, the income from loans & advances constitutes the most stable and bulk of earning in normal times followed by investment and trade related income.

A review period and time series analysis of net interest margin to total revenue as well as fee and commissions to total revenue individually and for peer group would indicate the relative risk position of a bank in its own timeline and among its peer group. The trend and contribution of one-off gains/losses to total revenue would reveal the business strategy and stability of income stream of a bank.

Ability of a bank to absorb provisioning expenses, over a business cycle, from profitability of that year reflects positively on asset quality of the bank. In any given year during a business cycle (10 years or a period of one economic downturn), if provisioning charges do not exceed half of net profits of the year over a business cycle, then bank's earnings (before provisioning and taxes) are expected to have the capacity to absorb future provisioning charges. This has generally been the case for large banks which absorbed the impact of higher provisioning charges during economic slowdown from profitability of the year. VIS has defined benchmarks for pre-tax economic ROAA (excluding non-recurring income) for various rating bands. Average provisions will be used for the purpose of calculating economic ROAA to account for volatility in provisioning charges during a particular year. Banks rated in the investment grade are expected to have a positive pre-tax economic ROAA.

B. (iv) Liquidity

Liquid assets carried on balance sheet provide cushion to the bank for meeting liabilities which may arise unexpectedly. VIS has defined benchmarks for liquid assets in relation to deposit & borrowings and only account for high quality liquid assets in its calculation. VIS also places emphasis on Basel III Liquidity Coverage Ratio and the buffer a Bank has over the 100% regulatory requirement. Non-performing/weak credit quality assets as well as encumbered assets are not incorporated in this calculation. Liquid assets to short term liabilities and liquid assets to total borrowings are other common ratios for determination of liquidity profile on standalone and for peer group comparison. For smaller banks,

minimum liquidity for qualifying to higher rating bands is relatively higher than that for larger banks, due to a lower risk appetite of smaller banks.

Assessment of liquidity risk is undertaken to determine the extent a bank would be able to withstand adverse market and economic conditions without resorting to significant support from the central bank. It is important here to study the maturity mismatches between assets and liabilities on the maturity bucket timeline. VIS will also monitor funding gaps through Net Stability Funding Ratio introduced by Basel III. A ratio over 100% is indicative of the bank being able to meet its liabilities as its assets mature. The stress testing undertaken by risk management serves as a useful tool in liquidity management if done with pragmatic assumptions. The extension of stress testing to contingent liabilities and their size also has a direct bearing on the liquidity profile of the bank.

C. EXTERNAL SUPPORT

The external support to a commercial bank may be available from its existing major shareholder(s), the government, or an identified incoming major shareholder.

A commercial bank's ability to honor its financial commitments is also affected by the degree of external support. Creditworthiness of financially weak commercial banks may be enhanced, if backed by a strong third party. The strength of sponsors, shareholders, group, sovereign or even the peers, is a positive influence on the ratings. By the same token, the financial viability of associated concerns is also considered and translated into any strength/stress that may impact the risk profile of the entity being rated.

Support mechanisms are counted towards credit enhancements provided a viable mechanism is in place and is crucial in the rating analysis, highlighting the fact that it is not the eventual repayment capacity that the ratings drive to establish rather the timeliness of that repayment, which is to be benchmarked.

Third party support is at its most effective in the form of sovereign support. Though the presence of either explicit or an implicit support from the sovereign prevents economy-wide repercussions of a failed bank and may result in a higher credit rating, strong predictability of state support often hinders the development of the local banking system.

DIGITAL BANKS

Digital bank is defined as a bank that offers all kinds of financial products and services primarily through digital platforms or electronic channels instead of physical branches. As such, it relies heavily on technology infrastructure, including mobile apps, online platforms, and digital payment systems, to deliver banking services. Assessing a digital bank involves evaluating the robustness, scalability, and security of its digital infrastructure. In addition, interoperability is also important while assessing digital banks technology platform. The ease with which systems can seamlessly interact with other internal and 3rd party platforms will remain important as it provides cross-selling opportunities as well as enhances customer experience. Effectiveness of banks customer support channels will also be part of the assessment. The robustness of the online technical support from the Enterprise Resource Planning (ERP) provider is of vital significance in the functioning of the Digital Bank as also the acumen and specialized experience of the Human Resource base.

Digital banks often rely on alternative revenue streams such as subscription fees, transaction fees, and partnerships with Fintech companies, in addition to traditional banking activities like lending and deposit-taking. Assessment involves evaluating the sustainability and diversification of the bank's revenue model. Moreover, evaluating banks strategy with

respect to asset origination opportunities as well as customer acquisition and retention to attain sufficient scale to achieve profitability will be important.

Digital banks typically have leaner operations compared to traditional banks, with fewer physical branches and a greater reliance on automation. Rating assessment involves examining their cost efficiency, agility in adapting to technological changes, and ability to scale operations rapidly. While both digital and commercial banks face similar risks such as credit risk, market risk, and operational risk, the nature and magnitude of these risks may differ. Digital banks may face additional risks related to cybersecurity, data privacy, and technology failures. Assessing a digital bank involves evaluating the effectiveness of its risk management framework in addressing these specific risks.

RATING BANK CAPITAL INSTRUMENTS

Bank Capital Instruments is included in Instrument Rating Methodology which can be accessed at <https://docs.vis.com.pk/Methodologies-2025/IRM-Apr-25.pdf>



KEY RATIOS

ASSET QUALITY

- Gross Infection: Non-performing loans (NPL)/gross advances
- Net Infection: NPL – provision for NPL / net advances
- Provisioning Coverage: Provisions / NPLs

PROFITABILITY

- Return on Markup bearing assets: Interest income on assets / Average markup bearing assets (based on 5 point).
- Average Cost of Deposits: Deposit financial expenses / Average deposits (based on 5 point).
- Average cost of borrowing: Financial expenses / Average borrowings (based on 5 point).
- Spreads: Return on Markup bearing Assets - Average cost of borrowing.
- Net Markup Margin: Net Finance Income / Markup Bearing Earning Assets.
- Core Earnings: Net Interest Income + Fee Commission Income + Income from Forex + Dividend Income – Admin Expenses.
- Efficiency: Admin Expenses / Net Interest Income + Fee Commission Income + Income from Forex + Dividend Income
- Basic ROAA: Core Earnings / Average Total Assets.
- Basic ROAE: Core Earnings / Average Net Worth
- Overheads: Admin Exp / Avg. Total Assets.
- Pre-tax Economic ROAA: (Core Earning – Average Provisions) / Average Assets

CAPITALIZATION

- Total Equity to Total Assets: Net Worth / Total Assets.
- Tier 1 Capital Adequacy Ratio (CAR): Tier 1 Capital / Risk Weighted Assets.
- Capital Adequacy Ratio (CAR): Tier 1 Capital + Eligible Tier 2 capital / Risk Weighted Assets.
- Net NPLs in relations to Tier 1 Equity: (Gross NPLs – Specific Provisions)/(Capital + General Provisions).

FUNDING/LIQUIDITY

- Advances to Deposit Ratio: Total loans / Total deposits (Adjusted for Export Refinance Scheme).
- Liquid Assets to Deposits & Borrowings: High Quality Liquid Assets/ Total Borrowings and Deposits.
- Average Liquidity Coverage Ratio: Average High Quality Liquid Assets/Average Net Cash Outflow.
- Net Stability Funding Ratio: Total Available Stable Funding/Total Required Stable Funding.



Jahangir Kothari Parade (Lady Lloyd Pier) Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose generosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.

VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, VIS is positioned to aim for an international mark. In this regard, the global experience of our international affiliates and partners have been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors. The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, VIS continues its endeavour to remain an emblem of trust.

INTERNATIONAL

Affiliates

Islamic International Rating Agency – **Bahrain** – iira.com
 Credit Rating Information & Services Ltd. – **Bangladesh** – crislbd.com

Collaborations

Japan Credit Rating Agency, Ltd. - **Japan**
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