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# How to Bring Pakistani Credit Rating Agencies at Part with Foreign Credit Agencies

Ali, Imran

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# HOW TO BRING PAKISTANI CREDIT RATING AGENCIES AT PAR WITH FOREIGN RATING AGENCIES

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**CHAPTER 01**

# STATEMENT OF PROBLEM & ITS BACKGROUND


1.1 INTRODUCTION

1.2 STATEMENT OF PROBLEM

1.3 SIGNIFICANCE OF STUDY

1.4 SCOPE AND DELIMITATION

1.5 BASIC ASSUMPTION

1.6 DEFINITIONS

## 1.1 Introduction:

**Credit rating** is a measure of an issuer to meet its commitment to pay all promised interest and principal amounts in full and on time. Borrowers are rated by credit rating agencies according to the borrower's credit-worthiness or risk profile. Credit ratings are expressed as letter grades such as A-, B, or C+. These ratings are based on various factors such as a borrower's payment history, foreclosures, bankruptcies and charge-offs. There is no exact science to rating a borrower's credit, and different lenders may assign different grades to the same borrower.

**Credit rating agency** is a company that rates the ability of a person or company to pay back a loan. The rating of a credit rating agency is important because it determines the interest rate that needed for a loan. This is because interest rates at present are not the same for anyone, but instead are based on risk based pricing, a form of price discrimination.

## ACRAA MEMBERSHIP

ACRAA (the Association of Credit Rating Agencies in Asia) is an association formed by Asian credit rating agencies, and assisted by the Asian Development Bank. ACRAA has been set up to act as a forum for exchange of skills and ideas among rating agencies, and for the promotion of Best Practices and norms of conduct, thereby to aid in the development of Asia's financial markets.

ACRAA has been active in bringing together rating agencies from across Asia for regular interchange of experiences, and has been instrumental in arranging world-class training for persons involved in the rating process in member agencies.

A significant initiative undertaken by the Best Practices Committee of ACRAA was to create the ACRAA Best Practices Checklist. Member Agencies are expected to declare their positions on each of the items in the checklist.

## 1.2 Statement of Problem:

*"How to bring Pakistani credit rating agencies at par with foreign credit rating agencies."*

Credit rating has been recognized as an important fact of transparency in business. Unfortunately in Pakistan this term remains relegated to an obscure and inconsequential slot. Ironically even those supposed to be placed at crucial business positions find themselves inadequately informed when it comes to credit rating.

The success of the developed countries has been hinged on their singular focus towards not only implementing but also sustaining transparency in all their systems.

In this project I have focused that how we can improve the working of our local credit rating agencies so that Pakistani credit rating agencies could compete internationally.

## 1.3 Significance of study:

Rating plays an important role in today's capital markets. They are opinions about risk, not formula. As an investor, one cannot assume that a given letter rating from different agencies indicates the same degree of credit risk. Rating helps investors to compare the relative risks of investing in a bond. In this research, I have analyzed how these different credit rating agencies are rating different to the same company. I have find out the procedure and the content, which are taken for rank an organization. Moreover, what is the difference in local credit rating agencies and foreign credit rating agencies according to procedures and their weight age for the different ratios? And how to bring Pakistani credit rating agencies at par with foreign credit rating agencies.

## 1.4 Scope & Delimitations:

The research is covering these credit rating companies. In Pakistani credit rating companies one is PACRA “Pakistan Credit Rating Agency” and other is JCR-VIS and in foreign credit rating agency which MOODY’S Investors Services. The whole analysis will be on these rating agencies how these are different in their working.

## 1.5 Basic Assumption:

The results, which are calculated, are based on certain assumptions. This analysis is portraying the present situation of these companies.

## 1.6 Definitions:

**Credit rating agency:** Credit rating agency is a company that rates the ability of a person or company to pay back a loan.

**Capital Market**: Market for long-term investment

**Government Bonds:** bonds issued by Government, these bonds are highly secured.

**IPO**: initial public offering the offering of shares directly to public through banks through applications.

**PACRA:** "Pakistan Credit Rating Agency"

**CLA:** "Corporate Law Authority"

**CRA:** "Credit Rating Agency"

**SECP:** "Security and Exchange Commission of Pakistan"

**Rating Watch***:* As and when any significant changes take place, the existing rating is placed on 'Rating Watch'. The rating is then upgraded, downgraded or maintained after assessing the impact of any such change.

**Entity Rating:** business entity (company) rating**.**

**Instrument Rating:** TFC, Equity, COI, Musharika Certificate Rating

# CHAPTER 02

# RESEARCH METHOD & PROCEDURES


**2.1 RESEARCH DESIGN AND METHODS**

**2.2 RESPONDENTS OF THE STUDY**

**2.3 RESEARCH INSTRUMENTS**

**2.4 SOURCES OF DATA**

**2.5 TREATMENT OF DATA**


## 2.1 Research Design & Methods:

Exploratory research is often conducted because a problem has not been clearly defined, or its real scope is yet unclear. It allows the researcher to familiarize him with the problem or concept to be studied, and perhaps generate hypotheses (definition of hypothesis) to be tested. It is the initial research, before more conclusive research (definition of conclusive research) is undertaken. Exploratory research helps determine the best research design, data collection method and selection of subjects, and sometimes it even concludes that the problem does not exist!

I have done an exploratory research in this case. Try to find out the difference in exiting scenario of Pakistan credit rating agencies and foreign credit rating agencies.

The results of exploratory research are not usually useful for decision-making by themselves, but they can provide significant insight into a given situation. Although

the results of qualitative research can give some indication as to the "why", "how" and "when" something occurs, it cannot tell us "how often" or "how many". In other words, the results can neither be generalized; they are not representative of the whole population being studied.

## 2.2 Respondents of the Study:

I have conducted the interviews with employees of the credit rating agencies. Ranks and name of those employees are as under.

### JCR-VIS

Senior Vice President
Safdar Kazi
Safdar@jcrvis.com.pk

### PACRA

Executive Director

Mr. Asadullah Khawaja

## 2.3 Research Instrument:

Research instrument are the formal interviews. And I have also made a questionnaire to focus my research on specific topic. And it have make easy for me to compare responses of the different questions.

## 2.4 Sources of Data:

For this research sources of data are the secondary as well as primary data collection. Secondary and primary sources includes the fallowing

**Secondary Sources:**

- Newspapers

- Magazines
- Internet

**Primary Sources:**

- Interviews
- Questionnaires

## 2.5 Treatment of the Data:

Techniques, which are employed in my research report, are to analyze the process of credit rating agencies and I have also show the weight age of different inputs, which are considered by the different credit rating Agencies.

# CHAPTER 03

# REVIEW OF RELATED LITERATURE AND STUDIES

## 3.1 CREDIT RATING IN PAKISTAN

*By RIZWAN AHMED (Financial Analyst, DCR-VIS)*

## 3.2 SECP STRENGTHENS RULES FOR CREDIT RATING COMPANIES

By Farhan Reza

## 3.3 THE RATING GAME

*By SYED MAHBOOB HUSAIN (Prime Bank)*

## 3.1 *ARTICLE NO 1:*

*PAKISTAN AND GULF ECONOMIST*

*DATED: 1999 VOL: XV111 ISSUE: 19TH*

*By RIZWAN AHMED (Financial Analyst, DCR-VIS)*

# ***Credit Rating in Pakistan***

"*Once credit rating becomes widespread many evils committed by companies would be automatically wiped out*"

Credit rating has been recognized as important fact of transparency in business unfortunately in Pakistan this term remains relegated to an obscure and inconsequential slot, ironically even those supposed to be placed at crucial business positions find themselves inadequately informed when it comes to credit rating.

Credit rating is basically done to assess the ability of the company to pay back its liabilities. There are two main types of credit rating namely the entity rating and the issue rating. The former concerns assessing the ability of the "company" to service its debt while the letter means judging the ability of the company to service "one particular debt issue incident to the company" for example: Term Finance Certificate rating, or any specific Bond rating, etc. in Pakistan where the word defaulter is now no more considered too derogatory due to its being very common, raising debt has become relatively more difficult. Investors have lost the trust in the debt issuers. In such a scenario credit rating should have gained increased attention (rather call it due attention) from the government side but, alas, like many other 'should' also remains a wish with chances of getting turned to reality; yet far from the sight.

## DEVELOPED COUNTRIES

The success of the developed countries has been hinged on their singular focus towards not only implementing but also sustaining transparency in all their systems. Credit rating is no exception and this too has been given its justified importance in these nations. If Pakistani government is truly cognizant of the economic mess, it is places in and is honesty committed to coming out of quickly, and then credit rating should be made mandatory for all debt issuing organizations. To contemplate fully

over the ramifications of credit rating in our economic and financial milieu, let us first briefly explore as to how credit rating is done. First of all the credit rating company would either approach the client for credit rating or the client itself would ask the credit rating firm to rate it. The rating company would then send a detailed questionnaire to the client, which would entail all the qualitative factors pertaining to the entity and its particular sector. Apart from the obvious emphasis on the financials of the firm, such questionnaires also try to capture the vision of management, the human resource aspects, the current sector and company performance, the trend analysis and legal issues, etc.

Once the credit rating company receives the requested answers, it thoroughly studies them and later in the light of its findings and observations conducts meeting (called due-diligence) with the company personal (usually the top management). Once the due-diligence is completed the raring company once again gathers, sorts out and analyses the facts. Later, the team working on the project comes out with its credit rating which is in letters form like double A (AA), or like single B plus (B+), etc. the range is from AAA (the best) to DD (defaults) for DCR. This scale varies for each rating company; like for instance S&P might have a different scale and Fitch might have another scale. These ratings reflect the strength of the company to pay back its debt obligations. Once the rating I assigned by the team, an in-house meeting of all the top analysts and CEO of the rating company takes place and the rating is either agreed upon or amended after due discussions. Then the rating company submits its proposed (called preliminary) rating to the client for approval. When the client is convinced of the rating, it is finalized and if the agreement for dissemination has been already made, the credit rating company is free to publicize it in the electronic and/or print media.

That was all about the process. Now comes the real part – its implications. First of all by just undergoing this rigorous process the client unearths its weakness and strengths and hence gets suitably geared towards formulating and implementing a revised strategy in the light of these new facts. Secondly, the credit rating company analysts get to learn something new with each new credit rating. And thirdly, (if the rating is disseminated) while the public gets to know the company standing, the

prospective and current investors can make well-informed investment decisions pertaining to the entity in question.

Usually the good companies are eager to get them rated (just like the craze for getting ISO certification) so that later their good ratings can be effectively used as a marketing tool. On the country lackadaisical companies get scared of credit rating and harbor suspicions regarding them due to the fact that they fear being exposed of their weaknesses in public.

The newly formed SECP (security and Exchange commission of Pakistan) needs to come forward in this regard and give credit rating its deserved position in the Pakistani financial scenario. Let me be explicit in saying that once credit rating becomes widespread many (if not all) evils of which the companies here are quilty of committing intentionally or unintentionally would be automatically wiped out.

## 3.2 *ARTICLE NO 2:*

*Daily Times*

By Farhan Reza

***<u>SECP strengthens rules for credit rating companies</u>***

The Securities and Exchange Commission of Pakistan (SECP) recently amended rules to prohibit the chief executive of a credit rating company to hold a similar position in any other company.

"Investors are now becoming interested in the credit rating of a company," said Faheem Ahmed, chief executive of JCR-VIS Credit Rating Company. "And these amendments will eliminate the conflict of interest factor from the credit rating business.

However, the SECP also said this condition would be relaxed if recommendations were made from the government for state-owned institutions. "This restriction shall not apply to a director of a rating company nominated as a director of an entity by the Federal Government or a Provincial Government or an institution which is directly or indirectly owned or controlled by the Federal Government or a Provincial Government," the SECP order stated.

But, the head of a credit rating company is not permitted to participate in the rating of a company at which he has been appointed from the federal or provisional government. "The director of the rating company shall inform the Commission of such nomination within fifteen days of the receipt of rating mandate from such entity together with an undertaking that he shall not participate in the rating process of that entity," the order stated. The SECP has also directed that every credit rating company submit a report providing sector-wise details of credit ratings provided during the year and fee structure within four months of the close of its accounting year.

The credit rating companies have also been directed not to change their shareholding in the rating company without approval from the SECP. Credit rating companies are also not allowed to change the chairman and chief executive without prior approval of the Commission.

There are two credit rating companies operating in the country: JCR-VIS Credit Rating Company in the private sector and the state-owned Pakistan Credit Rating Agency (PACRA). PACRA started business in 1995 while JCR-VIS set up shop in 1997.

JCR's Ahmed said the business needs to be beefed up with tougher regulation. "The credit rating company should not be allowed to invest in Term Finance Certificates (TFC) the company has rated itself," he said. He also said the credit rating business has flourished with the recent boom in the TFC market.

## 3.3 *ARTICLE NO 3:*

*PAKISTAN AND GULF ECONOMIST*

*DATED: 1993 VOL: X11 ISSUE: 20TH*

*By SYED MAHBOOB HUSAIN (Prime Bank)*

# THE RATING GAME

***"Thoughts on the new credit rating proposals for our capital market"***

The recent announcement by the Corporate Low Authority (CLA) that a Credit Rating System for Corporation will be introduced reflects another step forward to a more responsible and accountable credit environment.

Apparently the scope of such proposed Rating Agencies will include rating the financial stability of the company's sponsors and promoters at the time of the formation of the company, floatation of shares, justification of issuance of right

shares, issuance of shares on premium and monitoring, day to day, performance of the company as a, measure of applying check and balance on the overall operations.

It is understood that the CLA may make it mandatory for a public company to obtain a certificate from CRA before it applies for a public subscription etc.

The first indications are that the government will provide mandated Rate Classification and legislation with a license system. This is not the correct approach. We recommend that a few organizations, no more than 3 or 4 be licensed on the strength of their capabilities. These selected organizations are then asked to workout basis for a Rating Classification using an established quantitative and qualitative standard. The final result will, of course, depends on then agreed objective methodology. This approach ensures a creditable controlled system with impartial reporting.

This does not mean establishing a monopoly of 3 or 4, as the fees generated by this will not allow an independent operation for any one company. In any case the population of companies requiring such rating will remain small for a number of years. Rather this work will generate marginal income to the CRA thereby ensuring financial independence and ability to resist pressure from clients seeking to improve their ratings.

The final scope of the work of CRA's in Pakistan and statutory obligations that will be attached to their certification still remains to be officially defined. Some discussion is necessary before setting legislation in concrete so as to ensure that the work of CRA is related to their traditional responsibilities and not put in a context, which may compromise the real objective-"assessment of ability to repay obligation."

It is important to keep the work of a Credit Rating Agency within focused defined parameters and leave the rest of statutory reporting work to Accountants, Auditors and lawyers. The CLA may define what emphasis it would place on a Credit Rating of an issuer. Wrong emphasis will tend to stifle corporate financial expansion and remove responsibility from other reporting agencies. Free market policies must be allowed to work as long as the investor is provided with standard and correct financial

statements backed up by relevant certification. High risk, high return securities can only exist if credit is available and CLA permission is not withheld because of a bad credit rating.

Floatation of debt paper and its success or failure should depend on the rating (and by default by the mechanism of a free market economy) rather than the refusal of CLA permission.

However before any recommendations can be put forward a brief review of the work done by Credit Rating Agencies (CRA) in Europe and the United States with references to Standard & Poor's methodology is outlined below.

The basis of a rating is "an assessment of an issuer ability to pay interest and repay capital in a timely manner" the CRA's goal is to perform an accurate assessment of credit quality and the information gathered is used solely for this purpose.

Normally Credit Ratings are assigned at the request of the issuer but subsequent bond issues are also rated. The market practice is to refer to borrowers in terms of their senior debt rating. The rating is assigned to particular debt instruments and not to the issuer.

Thus the rating reflects the specific terms of a debt issue, whether this issue is senior, or subordinated to other debt obligations of the issuer. The rating also specific assets are pledged as collateral for the issue and whether third party guarantees/guarantors are supporting the dept. for commercial paper or medium term rates the rating is assigned to the ongoing offering of debt securities that bear identical characteristics.

What is the operational cycle of getting a Credit Rating? Again using Standard and Poor's methodology there are roughly 5 defined steps that are followed prior to the issuance of a rating.

## THE ANALYTECAL TEAM:

A team of two to four analysts with relevant industry and market expertise is created. The lead analyst acts as the main contact and guide for the duration of this exercise.

Prior to meeting the issuer some information regarding the client is reviewed internally. Such information typically includes 5 year published financial statements, financial projections etc. Non-public information is also reviewed but kept strictly confidential.

## MEETING WITH ISSUER:

The analysts travel to the issuer headquarters for a meeting with senior management. Such meetings last 1 or 2 days and relate to the financial and operational strategies. Industry position, competition and other factors that affect the issuer's credit qualitative assessment are developed that forms the core of the rating decision.

## RATING COMMITTEE:

The findings of the analyst are presented to a Rating Committee for their evaluation. Such a committee consists of senior analysts with expertise in relevant fields including country and industry specialists to ensure that rating are consistent throughout the world.

Once the committee has reached a decision, the issuer is informed of the rating and presented with a full rationale. The issuer may appeal the Rating Committee decision by presenting additional information. In such a case the Rating Committee reconvenes to evaluate the new information before a final rating is assigned. At his point the issuer has the accepted the rating it is released to the general public.

## FOLLOW UP:

The objective is to arrive at a rating that will not change over the course of a normal business cycle. However unforeseeable events can affect the issuer's credit quality. Therefore analysts monitor each issuer on a continual basis and raise or lower ratings to reflect significant changes in credit quality.

A note of caution is necessary here, as the CLA has assigned a role and scope of work to prospective Pakistan CRA, which is beyond what is expected in the West. A rating does not imply financial prosperity; it merely assigns a relative standard reflecting the ability of a borrower to meet his obligations.

We have two examples of countries introducing CR for the financial sector --- Chile and Mexico. It is important for us to review the experience in these two countries when implementing such services in Pakistan.

In Chile the government defined the parameters and drafted legislation. They also "licensed" CR companies, who took, upon the task enthusiastically. With reference to a "free market economy" almost everybody with a personal computer and some knowledge of finance become a CRA. The rating for debt paper was short work for this huge team. They generate additional work when they started rating equities! The resulting chaos is still being sorted out.

Mexico took an approach parallel to the western practice. The result is a for more creditable rating systems and a professional objective reporting.

In conclusion the Credit Rating system will help us and the overseas investors to look favorably at our developing Capital Market. Some clarification as to the scope of responsibility and area of work is required and legislation if any should be discussed publicly before finalization.

# CHAPTER 04:

# PRESENTATION ANALYSIS

**CREDIT RATING:**

**SOURCES OF FINANCING**

**TYPES OF RATING**

**RATING SEQUENCE**

**RATING METHODOLOGY**

**BOND RATING CRITERIA**

**STANDARD RATING SCALES AND DEFINITIONS BEING USED**

- **PACRA**
- **JCR-VIS**

# CREDIT RATING:

Credit rating these days has assumed much importance for those who want to raise financing resources from the market with the objective of providing money for short term, medium term and sometimes even long term needs. Poor corporate governance, low rate of return and some times zero rate of return on the shares of listed companies has almost driven away the general public from stock market. More and more companies are now opting for Term Finance Certificate (TFCs). According to state Banks Annual (2001) and first quarter (2002) reports as many as 17 “TFCs” were issued between July to September 2001. One 4th November, 2001 PARCO (Pak Arab Refinery Limited) floated its first public issue of TFCs amounting to Rs. 2.5 billion. This is the biggest “AAA” rated TFC issued to date in Pakistan.

In order to appreciate and understand the concept of “Credit Rating: easily and logically this presentation has been conveniently divided into 7 segments with appropriate heading which are described below:

## 1. SOURCES OF FINANCING:

Sources of financing for any business entity are “Equity and Debt”. Equity can be defined as interest of the share-holders in the assets of a company; it is the resources or capital \made available by the owners of an organization. “Debt” is the loan taken by an entity of finance its fixed (Long term) and current (Short term) and sometimes medium term assets.

Debt instruments (Investment Vehicles) are Bonds, Certificate of investments. Term Finance Certificates (TFCs), Guaranteed Debt, senior debt, sub-ordinated debt, etc. each of these debt instruments has risk element which every prudent and wise investor tries to minimize keeping in view the rate of return available on “Investment Vehicles” (Debt Instrument). “Risk” and “Return” are synergetic ally related to each other. Generally high risk investments (Debt instrument) carry high rate of profit or return whereas investments having lower risk profile earn moderate or low rate or return.

## 2. DEFFINATION

"Rating" is an interactive process relaying primarily on gathering information from the issuer of debt instrument and supplementing it with strategic information obtained from outside independent sources. The rating process covers analysis of both the quantitative and qualitative aspects including operations, finance, management and strategy. Rule 8 of "Credit Rating Companies Rules 1995" issued under section 33 of the Securities and Exchange Ordinance 1969 defines " Credit Rating" as formal evaluation of credit history of the company and capability of repaying its obligation. From this definition it can conspicuously be observed that the scope of "Credit rating" has been put in a capsule although it has got a wider definition and application.

Credit Rating conveys risk level of any "debt security" or "Entity" and covers financial and business risk associated with any "debt security" or "Entity". It helps an investor in making investment decision and he knows the level of risk and reward associated with investment vehicle.

## 3. TYPES

Credit rating can focus either on entity including a country or specific debt instrument or individual each of which is explained as under:

### i. Entity Rating

Entity rating signifies the level of investment risk and capacity of an entity or country to meet its debt obligations. The risk level is indicated by long and short term ratings. Generally international credit rating agencies like "Standard and Poor" and "Moody's Services Inc." issue country reports containing information on credit rating status of country which indicates the level of investment risk, a potential or existing investor may have to face on its investment. Credit rating is prepared on the basis of information gathered on core economic performance indicator and may be revised on quarterly or six monthly or even on yearly basis.

Specific benefits of "entity rating" are that:

- It severs as a reliable credit risk indicator for banks/NBFIs and potential investors.
- It assists depositors to select a financial institution based on return offered and the risk profile as measured by credit rating.
- It assists management flexibility in determining and choosing the rate of return on debt instrument to be issued in future.

### ii. Instrument Rating

It covers all non-equity instruments, like bonds, certificate of investment, Musharika Certificates including TFCs (long and short term), convertible debentures, redeemable certificates (capital). By indicating the risk profile of the debt instrument, the assigned rating would help the \issuer in deciding the terms and conditions of issue of instruments while on the other hand in guiding the potential investor in investment decision.

### iii. Individual Rating

Initial assignment of risk profile of the issuer (entity) could be referred to as "generic" or "individual" rating. This rating is then used to generate the standard long and short term rating.

## 4. RATING SEQUENCE

Rating sequence consists of the following steps which must be followed in order to advise the client on rating status. A lot of analysis and paper work together with discussions both in-house and with the client has to be gone through before completion of rating sequence.

**i. Collection of Public Information**

Easily available information, statistics and data from various sources are collected on the client and relevant industry.

**ii. Analysis of Audited Financial Statements**

Generally audited financial statements, over a period of three to five years, are collected from the client including the latest. The

financial statements are analyzed in-depth and core financial ratios are worked out which are analyzed to know the financial strength or otherwise of the client. Past financial statements analyzed also helps in forecasting the future financial performance.

iii. **Preparation of Agenda**

On the basis of information and data collected and analysis of financial statement an agenda is prepared for discussion with the client (issuer).

iv. **Questionnaire**

Along with the agenda a questionnaire on strategic and vital information is issued to the client before the meeting and the client is asked to complete it for discussion in the meeting.

v. **Meeting with the Issuer (Client)**

After this a meeting is held with the client in which detailed and threadbare discussion is held on all the dimensions.

vi. **Preparation of Draft Report**

Based on the discussion in the meeting with the issuer (Client) a draft report is prepared and sent to the issuer for review and factual accuracy.

vii. **Rating committee**

The rating company has a "rating committee" which reviews the amended report along with the issuer's (client) comments. Each member of the rating committee puts his own remarks on the amended reports. After this the rating committee assigns a rating which is advised to the client.

## 5. RATING METHODOLOGY

The methods to be adopted before assignment of the rating status are vast and varied. In general the following factors are to be considered while forming opinion on rating status.

i. **Industry Risk**

This risk is measured by the strength of the industry within the economy and relative to economic trends.

**ii. Market Position**

It covers the company's market share of its major activities or operations and the historical protection of its position and projected ability for the future. It also covers the company's historical operating margins and its ability to maintain or improve them.

**iii. Ownership and Support**

It includes ownership structure, size and status of ownership, potential for support from owner and other tangible benefits.

**iv. Management Evaluation**

It looks into the record to date in operation, financial area, corporate goals, control environment and system and experience.

**v. Accounting Quality**

This area includes overall review of accounting policies employed and consistency in their application.

**vi. Earnings**

The key variables indicating the basic long term earning power of the company is looked into. Additionally, consistency and trend of core earnings, earning mix and capacity for internal growth are also covered.

**vii. Cash Flow**

Relationship of each flow to leverage (ratio of equity to debt) and ability too internally meet all business cash needs is evaluated. The volatility of cash flow over time and the impact of seasonality on cash flow is also evaluated.

**viii. Capital and Debt Structure**

The historical and projected gearing or leverage levels are analyzed. Sensitivity analysis is carried out by varying critical assumptions for determining the cushion available for meeting

future obligations in the case of adverse changes in business conditions.

**ix. Funding and Flexibility**

This covers an evaluation of the company's financing needs, plans and alternative and its flexibility to achieve its financing programs under stress without impairing credit worthiness.

**x. Corporate Strategy**

The corporate strategy of the company is analyzed and sensitivity analysis is done to determine the impact of change in the external environment.

**xi. Regulatory Environment**

This includes the role and functions of the supervisory or regulatory authorities, degree of state control and the requirement of public reporting under the relevant corporate laws.

**xii. "SWOT" Analysis**

Sometimes "SWOT" analysis is also carried out for the organization (Client), In this analysis the organization is analyzed in the area of its "Strengths", "Weaknesses", "Opportunities" and "Threats".

**xiii.** Additionally the following areas are also relevant for a financial institution:

- Quality of financial assets
- Stability of earnings
- Sources and cost of funds
- Capital adequacy and liquidity
- Planning and market environment
- Contingent and prospective liabilities

## Bond Rating Criteria:

Bond ratings are based on both qualitative and quantitative factors, some of which are listed below:

## Quantitative factors:

| | AAA | AA | A | BBB | BB | B | CCC |
|---|---|---|---|---|---|---|---|
| Times interest earned (EBIT/interest) | 12.9 | 9.2 | 7.2 | 4.1 | 2.5 | 1.2 | (0.9) |
| EBITDA interest coverage (EBITDA/interest) | 18.7 | 14.0 | 10.0 | 6.3 | 3.9 | 2.3 | 0.2 |
| Net cash flow / Total debt | 89.7% | 67.0% | 49.5% | 32.2% | 20.1% | 10.5% | 7.4% |
| Free cash flow / Total debt | 40.5% | 21.6% | 17.4% | 6.3% | 1.0% | (4.0)% | (25.4)% |
| Return on capital | 30.6% | 25.1% | 19.6% | 15.4% | 12.6% | 9.2% | (8.8)% |
| Operating income/ Sales | 30.9% | 25.2% | 17.9% | 15.8% | 14.4% | 11.2% | 5.0% |
| Long term debt / Total capital | 21.4% | 29.3% | 33.3% | 40.8% | 55.3% | 8.8% | 71.5% |
| Total debt / Total capital | 31.8% | 37.0% | 39.2% | 46.4% | 58.5% | 71.4% | 79.4% |

Bond Rating Criteria: Three year (1996-1998) financial ratios for different bond rating classifications.

## Qualitative factors:

1. Various ratios, including the debt ratio, the times interest earned ratio, and the EBITDA coverage ratio. The better the ratios, the higher the rating.
2. Mortgage Provisions: Is the bond secured by a mortgage? If it is, and if the property has a high value in relation to the amount of bonded debt, the bond's rating is enhanced.
3. Subordination provisions: Is the bond subordinated to other debt? If so, it will be rated at least one notch below the rating it would have if it were not subordinated. Conversely, a bond with other debt subordinated to it will have a somewhat higher rating.

4. Guarantee Provisions: Some bonds are guaranteed by other firms. If a weak company's debt is guaranteed by a strong company (usually the weak company's parent), the bond will be given the strong company's rating.
5. Sinking fund: Does the bond have a sinking fund to ensure systematic repayment? This feature is a plus factor to the rating agencies.
6. Maturity: Other things the same a bond with a shorter maturity will be judged less risky than a longer term bond, and this will be reflected in the ratings.
7. Stability: Are the issuer's sales and earnings stable?
8. Regulation: Is the issuer regulated, and could an adverse regulatory climate cause the company's economic position to decline? Regulation is especially important for utilities and telephone companies.
9. Antitrust: Are any antitrust actions pending against the firm that could erode its position?
10. Overseas operations: What percentage of the firm's sales, assets, and profits are from overseas operations, and what is the political climate in the host countries?
11. Environmental factors: Is the firm likely to face heavy expenditures for pollution control equipment?
12. Product liability: Are the firm's products safe? The tobacco companies today are under pressure, and so are their bond ratings.
13. Pension liabilities: Does the firm have unfunded pension liabilities that could pose a future problem?
14. Labor unrest: Are there potential labor problems on the horizon that could weaken the firm's position? As this is written, a number of airlines face this problem, and it has caused their ratings to be lowered.
15. Accounting policies: If a firm uses relatively conservative accounting policies, its reported earning will be of "higher quality" than if it uses less conservative procedures. Thus, conservative accounting policies are a plus factor in bond ratings.

# STANDARD RATING SCALES AND DEFINITIONS BEING USED BY PAKISTAN CREDIT RATING AGENCY (PACRA)

## LONG TERM RATINGS

**AAA** – HIGHEST CREDIT QUALITY:
'AAA' ratings denote the lowest expectation of credit risk. They are assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.

**AA** – VERY HIGH CREDIT QUALITY:
'AA' ratings denote a very low expectation of credit risk. The capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.

**A** – HIGH CREDIT QUALITY:
'A' ratings denote a low expectation of credit risk. This capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.

BBB – GOOD CREDIT QUALITY:
'BBB' ratings indicate that there is 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. This is the lowest investment grade category.

**BB** – SPECULATIVE:
'BB' ratings indicate that there is a possibility of credit risk developing, particularly as a result of adverse economic change over time; however, business or financial

alternatives may be available to allow financial commitments to be met. Securities rated in this category are not investment grade.

B – HIGH SPECULATIVE:
'B' ratings indicate that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.

**CCC, CC, C** – HIGH DEFAULT RISK:
Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. A 'CC' rating indicates that default of some kind appears probable. 'C' ratings signal imminent default.

## SHORT TERM RATINGS

**A1+** : Obligations supported by the highest capacity for timely repayment.

**A1** : Obligations supported by a strong capacity for timely repayment.

**A2** : Obligations supported by a satisfactory capacity for timely repayment, although such capacity may be susceptible to adverse changes in business, economic, or financial conditions.

**A3** : Obligations supported by an adequate capacity for timely repayment. Such capacity is more susceptible to adverse changes in business, economic, or financial condition than for obligations in higher categories.

**B** : Obligations for which the capacity for timely repayment is susceptible to adverse changes in business, economic, or financial conditions.

**C** : Obligations for which there is an inadequate capacity to ensure timely repayment.

**D** : Obligations which have a high risk of default or which are currently in default.

A plus (+) or minus (-) may be appended to a rating to denote relative status within major rating categories. Such suffixes are not added to 'AAA' long-term rating category, to categories below 'CCC', or to short-term ratings.

# STANDARD RATING SCALES AND DEFINITIONS BEING USED BY JCR-VIS CREDIT RATING COMPANY

## MEDIUM TO LONG TERM

**AAA** : Highest Credit quality. The risk factors are negligible being only slightly more than for risk-free Government of Pakistan debt.

**AA+, AA, AA-** : High credit quality. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

**A+, A, A-** : Good credit quality. Protection factors are adequate. Risk factors may vary with the possible changes in the economy.

**BBB+, BBB, BBB-** : Adequate credit quality. Protection factors are reasonable and sufficient. Risk factors arte considered variable if changes occur in the economy.

**BB+, BB, BB-** : Obligation deemed likely to be met when due. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

**B+, B, B-** : Obligations deemed less likely to be met when due. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

**CCC** : Considerable uncertainty exists towards obligations when due. Protection factors are scarce and risk may be substantial.

**CC** : A high default risk.

**C** : A very high default risk.

**D** : Defaulted obligations.

## SHORT-TERM

**A-1+** : Highest certainty of timely payment short-term liquidity, including internal operating factors and / or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

**A-1** : High certainty of payment. Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

**A-2** : Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Although ongoing funding needs may enlarge total financing requirements, access to capital markets is good. Risk factors are small.

**A-3** : Satisfactory liquidity and other protection factors qualify issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

**B** : Speculative investment characteristics. Liquidity may not be sufficient to ensure timely payment of obligations.

**C** : Capacity for timely payment of obligations is doubtful

**D :** Defaulted obligations.

A plus (+) or minus (-) is added to the rating symbols from 'AAA' to 'B' to indicate relative standing within each of those rating categories.

# CHAPTER 05:

# SUMMARY OF FINDINGS, CONCLUSION & RECOMMENDATIONS.

**5.1 FINDINGS**

**5.2 CONCLUSION**

**5.3 RECOMENDATIONS**

## 5.1 FINDINGS

- Credit rating has been recognized as important fact of transparency in business.
- Credit rating is done to assess the ability of the company to pay back its liabilities.
- There are two main types of credit rating namely the entity rating and the issue rating.
- The success of the developed countries has been hinged on their singular focus towards not only implementing but sustaining transparency in all their systems.
- Scale varies for each rating company, like for instance S&P might have a different scale and Fitch might have another scale.
- Good ratings can be effectively used as a marketing tool.
- The criticism on Credit rating agencies are biased in some way towards the profit of banks and at the expense of the customer. This may or not be intentional. For example, an individual is usually not given a high credit rating initially, but usually must "prove himself" by using credit, many times unnecessarily (incurring expense), in order to build up a credit history.
- Large corporate rating agencies like Standard & Poor are criticized for having too familiar relationships with company management, possibly opening them to undue influence. These agencies meet frequently in person with the management of many companies, and advise on actions the company should take to maintain a certain rating.

## 5.2 CONCLUSION

- ❖ There will be evolution of a primary and secondary market for long term debt securities for which the government has already initiated a number of steps for putting in place a legal and financial framework.
- ❖ Capital market will now be able to move ahead.
- ❖ Sponsors having good track record will now be able to mobilize public debt at a reasonable and competitive cost.
- ❖ Potential investors can now expect a better (even higher) return on their securities (Capital) as compared to return on "bank deposits". Further they will now have the option of instant liquidity by sale in the stock market.
- ❖ Potential investors will now be in a better position to judge the risk profile in the light of the assigned ratings.
- ❖ Experts are of the opinion that the huge pool of funds (estimated to be Rs. 70 to 80 billion) locked up in various deposit schemes could be diverted into the securities market.
- ❖ There is likely to be financial restructuring in major industrial and financial organizations e.g. high cost leasing may be replaced by term financing and working capital requirement may also be financed through issue of commercial papers.

## 5.3 RECOMMENDATION

- The companies should expand R & D expenditure which will result in better designing, and lowering cost, and in assessment of the actual need of the customers.
- Proper training schemes for skilled, semi-skilled and management personnel of the industry need to be designed and implemented.
- For proper handling of the international markets, the industry needs to develop efficient liaison with the customers in the foreign markets. This can be effective
- Companies should establish international marketing budgets for their international marketing activities.
- Participation in international exhibitions will enable company to see world trends in the different industries and conceive ideas. This will also facilitate entry into joint venture with companies abroad.
- Company should hire the foreign experienced person in their company to compete in foreign market.
- Measures should be taken by national and international organization to increase co-operation between the developed and other economies in training and other means of disseminating the management and marketing techniques required for producing the effective techniques.
- The concerned government organizations should create and enforces quality control measures for specific procedures and rules to be followed.
- Sub regional and regional trade and industrial associations should be created.
- Companies should emphasize to do work for credit rating of Islamic banks and organizations are operating in Islamic world. This will enhance the business of local companies to international level. This will have advantage over the others credit rating companies like S&P and Moody's.
- The members of rating committee are also the directors of the other companies or have some relationship with particular field (the underlying organization) would effect the decision related to rating assigned.

- There is the need of one or two more credit rating agencies in order to create an environment of competition which may also upgrade the quality of service delivered.