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0. INTRODUCTION

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A sound financial ecosystem is critical for functioning of any economy. It is defined by interaction of providers of funds - savers, users of funds - borrowers, financial institutions, and regulators. This system ensures smooth flow of funds between savers and borrowers; wherein, financial institutions provide platform for their interaction. Regulatory oversight safeguards the sanctity of this system. Like all systems, financial system has its own set of challenges. The most prominent being “Risk”; the risk that some participant may not be able to meet its commitments. All participants do their best to manage this risk to maximize their return. This is not possible unless we have independent information on this risk. Here comes expertise of rating agencies, providing independent opinion on credit risk. Flow of funds is only possible when the provider of funds has confidence that user of funds will be able to return these in a timely manner and as committed. Ratings help build this confidence. A higher rating means higher likelihood of timely repayment compared to a low rating. Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of a company’s performance as well as for peer comparisons.

0.1 Introduction - Broker Management Rating (BMR): Brokers play a critical role in the capital markets by facilitating trades for all categories of investors. Brokerage industry is characterized as very dynamic and volatile due to its direct dependency on the performance of capital markets. PACRA’s Broker Management Rating aims to facilitate investors to differentiate between brokers on the basis of quality of management and services provided.

0.2 Regulatory Landscape: Brokers are regulated primarily by the Securities and Exchange Commission of Pakistan. The regulator has designed a comprehensive set of laws and regulations for Brokers. Following are the key regulations applicable to the brokerage segment:

| Securities Brokerage | Promulgated / Last Updated |
|---|----------------------------|
| Securities Brokers (Licensing and Operations) Regulations, 2016 | Updated September 2017 |
| Research Analyst Regulations, 2015 | Updated August 2017 |
| Securities and Future Advisors (Licensing and Operations) Regulations, 2017 | April 2017 |
| PSX Rule Book | Updated April 2017 |
| CDC Regulations | Updated August 2016 |
| Securities and Exchange Commission of Pakistan Act, 1997 | Updated August 2016 |
| NCCPL Regulations | Updated May 2016 |
| Futures Market Act, 2016 | April 2016 |
| Anti-Money Laundering Act, 2010 | Updated February 2016 |
| Joint Inspection Regulations, 2015 | October 2015 |
| Securities Act, 2015 | April 2015 |
| Underwriters Rules, 2015 | February 2015 |
| Non-Banking Finance Companies (Establishment and Regulation) Rules | Updated October 2015 |
| Securities and Exchange Ordinance, 1969 | Updated 2012 |
| Securities (Leveraged Markets and Pledging) Rules, 2011 | February 2011 |
| Commodity Exchange and Futures Contract Rules, 2005 | March 2005 |
| Central Depositories Act, 1997 | April 1997 |

0.3 PACRA uses the key parameters listed in the table below to assess the quality of operations of a broker and the services offered by it. Each parameter is assessed individually. These assessments are then aggregated to arrive at the final rating.

1. OWNERSHIP

- *Structure*
- *Stability*
- *Business Acumen*
- *Financial Strength*



1.1 Structure: The assessment of ownership begins with an in-depth study of the shareholding mix in order to disentangle structure of the ownership. This process includes analyzing the detailed chart. Key factors that are considered for this purpose, inter-alia include, i) shareholding structure which includes whether the individual own the entity directly or indirectly, ii) foreign or local shareholders, iii) whether the entity is owned by a single group or through a combination of entities and individuals, and iv) part of a group or a standalone entity. All these deliberations are done to identify the man of the last mile. Secondly, analyzing shareholding structure is also important as clarity on ownership generally lacks in a joint venture agreement.

***Complex shareholding/ownership structures:** In cases where an entity has a complex ownership structure, there are unique challenges in evaluating the decision making process, lines of hierarchy and financial obligations and liabilities. In analyzing these entity's the fundamental issue is to explore the underlying reason or motivation for the complexity of the structure.*

***Financial Institutions which are owned by private individuals and families:** On the one hand, the concentration of equity ownership might indicate that the majority shareholders have a strong vested interest in creating long-term value and closely monitoring management behavior. On the other hand, a potential concern in such cases is that the owners might rely heavily on extracting funds from the entity as source of income or to fund other business activities, potentially undermining the financial stability of the entity.*

1.2 Stability: In order to analyze the stability of the ownership, a particularly important factor to be taken into account is the succession planning. A very important part of our background analytical work is an attempt to assess whether, and under right of succession, an entity future prospects would be supported, and by whom.

1.3 Business Acumen: Here PACRA gauge the Sponsor's business skills. Having a strong business skill set has been critical for the sustainable success of the entity. PACRA analyze the business acumen through two primary areas; i) Industry-specific working knowledge and ii) Strategic thinking capability. Meanwhile, a deep and applicable understanding of the system is critical in order to determine how a business achieves its goals and objectives. The scope includes the assessment and understanding of how the apex of the entity think about and successfully make the right business decisions.

1.4 Financial Strength: We analyze the ability and willingness of either its owners or the government / regulator to bail out the entity in case of need. Particularly in case of small financial institute, where capitalization requirements are yet to meet by the entity, PACRA critically analyses the willingness and ability of the major shareholder to support the entity to comply with regulatory requirements within required timeframe. Thus ongoing support is considered more likely in these cases. However, for large financial institutions, external support from government / regulatory becomes more important. Here, PACRA gives due importance to, i) the behavior of the major shareholders to provide timely and comprehensive support in times of need in the past, ii) prospective view of key shareholders, incase such need arises, iii) other businesses of sponsors, and iv) the level of commitment of the major shareholder with the entity in providing capital support. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. The scope for other business of sponsors

includes overall profiling of the key sponsor in the context of identifying the resources they have, outside the entity.

2. GOVERNANCE

- *Board Structure*
- *Members' Profile*
- *Board Effectiveness*
- *Financial Transparency*



2.1 Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, association of board members with the entity, overall skill mix and structure of committees of the board. Size of the board may vary as per the scope and complexity of the business operations of the entity. As too small board is not considered good, similarly reaching on a decision in an effective and efficient manner may not be possible in case of a larger board. A healthy composition of board includes the presence of independent / non-executive members having limited relationship with the sponsoring group of the entity. Meanwhile, same individual holding chairman and CEO positions is considered weak governance practice. Thus these should be separate persons. The chairman is expected to have a non-executive role. Assessment of board as a whole Compliance of code of corporate governance is also examined. Here PACRA also examines the independence of management from major shareholders. Lastly, PACRA evaluates number of board committees, their structure, and how these committees are providing support to the BoD. The board with higher total number of members should have higher number of committees in place to achieve efficiency in performing role of the board.

2.2 Members' Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality of overall board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have related experience. Here, director's trainings conducted by the entity are considered good. This is expected to equip the board members in fulfilling their role in an effective manner.

2.3 Board Effectiveness: PACRA considers the role of the board is to work with management in steering the entity to its performance objectives and to provide critical and impartial oversight of management performance. Board members' attendance and participation in meetings is considered a measure to assess the effectiveness. Moreover, PACRA analyses the type and extent of information shared with the board members, and quality of discussions taking place at board and committee level. Effective oversight requires frequent sharing and detailed information than required by statute. Meanwhile, PACRA also review the number of board meeting held during the year as number of board meetings should be justified with the number of issues/matters arising.

2.4 Financial Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial information. The board may establish controls to ensure transparency through strengthening the role of audit committee, the quality of internal audit function, and effectiveness of external audit.

3. MANAGEMENT

- *Management Team*
- *Organizational Structure*
- *Client Servicing*
- *Complaint Management*
- *Extent of Automation / Integration*
- *Continuity of Operations*
- *Risk Management framework*
- *Regulatory Compliance*



3.1 Management Team: Good quality management implies that the broker has effective systems and controls, and well-defined strategy to achieve a desired level of excellence. PACRA assesses the management quality in terms of the experience profile of key individuals and their tenure with the company, dependence of the management team on one or more persons, coherence of the team and management’s past track record. PACRA also analyses the broker’s ability to attract and retain talent, and frequency and quality of the training imparted to the employees. Membership of local and foreign associations also provides comfort and contributes towards the enhancement of management quality.

3.2 Organization Structure: PACRA’s analysis of the organizational structure focuses on how the company is organized keeping in view the scope of operations, confidentiality and conflict of interest within departments as well as with the clients.

3.3 Client Servicing: The standard practices followed by the broker in servicing clients are evaluated. This helps assess the adequacy of these practices and the quality of services provided to the clients. Nature of value-added services provided (such as research/news updates and investor education programmes), dissemination of trading policies and procedures to clients, order recording and trade confirmation process, periodic reporting to clients and segregation of client money and assets from broker as well as from other clients are among the key parameters that PACRA evaluates.

3.4 Complaints Management: Nature and number of complaints received is an important indicator to measure the quality of services provided and resultant client satisfaction. PACRA also analyses the complaint management system in place and number of complaints received and pending against the brokerage company.

3.5 Extent of Automation / Integration: For the broker to be able to service clients effectively and efficiently, the systems’ backbone needs to be robust. The systems deployed need to be capable of capturing, processing and reporting all transactions of all clients with a zero or near-zero error rate. PACRA's evaluation of the infrastructure framework consists of an assessment of the infrastructure deployed, the extent of automation and integration, type and number of errors encountered, access policies to the computer systems and data, and the quality of reports generated by the MIS.

3.6 Continuity of Operations: PACRA also analyses the adequacy of infrastructure in place, adequacy of connectivity with the exchange, communication network, frequency of connection failure and time taken to restore the connection, database maintained, back up procedures, disaster recovery and business continuity plan, and documentation and monitoring of channels of communication etc. While broker’s existing IT systems may be adequate for current scale of business, PACRA also evaluates the broker’s focus on continuous improvement and ability to scale up its IT systems in line with the business growth.

3.7 Risk Management Framework: PACRA assesses the robustness and reliability of the risk management systems. Evaluating the overall risk management framework enables to determine how various risks are identified, monitored and mitigated across the brokerage house. The efficiency of controls and effectiveness of the internal audit function within a brokerage house is instrumental in mitigating risks arising from operational failures.

3.7.1 Operational Risk and Control Environment: Operational risk is the risk of loss resulting from inadequate or failed internal processes, unauthorized trading, misappropriation of the clients’ money, breach of clients’ confidentiality, fraud in trading or in back office functions and easily accessed computer systems. An analysis of the company’s following policies and procedures and

update frequency helps to determine the viability of the operational control environment against unanticipated errors and failures.

3.8 Regulatory Compliance: Regulatory compliance is very important in the broking industry due to the stringent implementation of rules by the regulators and the possibility of suspension of operations if rules are breached. PACRA assesses the internal control measures adopted to ensure adequate legal and regulatory compliance. An objective assessment of the attitude of management towards legal compliance and the systems set in place to ensure compliance provide assurance that the broker's service continuity will not be affected by the regulator's penal action. Compliance levels are examined in detail, especially with regards to the internal audit, system audit and CDC audit. Correspondence with the SECP, PSX, CDC and NCCPL is evaluated along with any regulatory matters outstanding or actions taken by the regulators. Any litigation pending against the broker is also considered.

4. BUSINESS SUSTAINABILITY

- *Business Risk*
- *Business Profile*
- *Revenue and Profitability Analysis*



4.1 Business Risk: Business risk is the possibility that a broker will have lower than anticipated profits or experience a loss. It impairs a broker's ability to provide its investors and stakeholders with adequate returns. The broker's business strengths and financial soundness are assessed to ascertain the sustainability of its operations.

4.2 Business Profile: PACRA assesses the company's branch network, number of licenses the company holds for carrying out different activities, category under which the company has obtained license (Trading and Self Clearing, Trading and Clearing or Trading), whether it is listed or unlisted, number of clients' CDS account i.e. investor accounts and sub-accounts and market share.

4.3 Revenue and Profitability Analysis: PACRA also analyses the revenue quality. PACRA sees concentration at both product and customer levels. Broking businesses derive strength from diversity of revenue streams; brokers that are not dependent on a few major players, and therefore, have low concentration risk, are better placed. The structure of brokerage fee is evaluated: the mix of value versus scrip revenue, the mix of institutional, HNWs and individuals, the interplay of foreign vs. local clients, the longevity of the relationship, the trend analysis, the average brokerage fee and its relativeness in the industry, and operational profitability. The alternative revenue streams from underwriting and advisory are analyzed to form a view on how significant these are and whether these represent a sustainable revenue stream.

5. FINANCIAL SUSTAINABILITY

- *Credit Risk*
- *Market Risk*
- *Liquidity Risk*
- *Financial Risk*



5.1 Credit Risk: Credit risk emanates from the inability of clients to pay for the securities purchased on their behalf. PACRA analyses the mechanism put in place by the broker to minimize credit risk. This includes procedures related to client acceptance and assessment of credit worthiness of clients, know your customer / client due diligence policy, assignment and adherence to trading limits, margin policies including mechanism of margin calls, reports generated and frequency thereof to

monitor clients' exposures, liquidation of client accounts where necessary and number of days receivables are outstanding.

5.2 Market Risk: Market risk arises primarily from adverse movements in investment values. In certain investments, the interplay of credit risk and market risk aggravates the overall quantum of risk exposure. Management's policy as to the proprietary book play a vital role in the overall assessment of the broker's market risk appetite and its ability to manage conflict of interest. Therefore, it is important to assess the measures used to mitigate market risks. PACRA examines the general strategy with regards to proprietary trading, stability and profitability of sectors and companies invested in, cutoffs for exit from stock market and measurement of risk (Value at Risk – VAR, stress scenarios etc).

5.3 Liquidity Risk: Liquidity risk occurs due to insufficient funds to meet obligations when they fall due. PACRA analyses liquid investments against the company's funding base and the brokerage's ability to raise timely and cost-effective funds from external sources.

5.4 Financial Risk: Given the volatile nature of the equity broking industry, the broker's ability to maintain the related capital regime is analyzed to form a view as to the sustainability of operations. Strong capital levels provide necessary cushion in terms of absorbing any delay in collections from clients and losses during bad capital market.

Broker Management Rating Scale & Definitions

An independent opinion on the quality of management and services provided by the broker

Long Term Ratings

| | |
|---|--|
| BMR 1A | Excellent. Excellent regulatory compliance, control environment, and financial management; governance and risk management frameworks are extremely effective; HR, IT, and customer services are strongly proactive. |
| BMR 1++ BMR 1+ BMR 1 | Strong. Strong regulatory compliance, control environment, and financial management; governance and risk management frameworks are highly effective; HR, IT, and customer services are highly proactive. |
| BMR 2++ BMR 2+ BMR 2 | Sound. Sound regulatory compliance, control environment, and financial management; governance and risk management frameworks are effective; HR, IT, and customer services are proactive. |
| BMR 3++ BMR 3+ BMR 3 | Adequate. Adequate regulatory compliance, control environment, and financial management; governance and risk management frameworks are satisfactory; HR, IT, and customer services are adequate. |
| BMR 4++ BMR 4+ BMR 4 | Inadequate. Inadequate regulatory compliance, control environment, and financial management; governance and risk management frameworks need improvements; HR, IT, and customer services are insufficient. |
| BMR 5 | Weak. Weak regulatory compliance and business practices. |

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. ‘Stable’ outlook means a rating is not likely to change. ‘Positive’ means it may be raised. ‘Negative’ means it may be lowered. Where the trends have conflicting elements, the outlook may be described as ‘Developing’.

Rating Watch Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the rating remains suspended for six months, or/and d) PACRA finds it impractical to surveil the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Disclaimer: The rating is based on information that is obtained from the client and sources we consider to be reliable but its accuracy and completeness are not guaranteed. PACRA shall owe no liability whatsoever to any loss or damage caused by or resulting from any error in such information. Our rating and related analyses are statements of opinions about the relative standing of the company and its affairs as of the date they are expressed. These are not recommendations to buy or subscribe/unsubscribe any services. None of the information in this document may be copied or otherwise reproduced, stored or disseminated in whole or in part in any form or by any means whatsoever by any person without PACRA’s written consent. This disclaimer is in accordance with Section 14(3)(x) of the Credit Rating Companies Regulations, 2016.