



The Pakistan Credit Rating Agency Limited

PRESS RELEASE

Rating Action

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Analyst

Waqas Munir
(+92-42-586 9504)
waqas@pacra.com

Samiya Mukhtar
(+92-42-586 9504)
samiya@pacra.com

PACRA SEES PRESSURE MOUNTING ON THE BROKERAGE INDUSTRY

Equity markets in Pakistan, after witnessing a buoyant period since 2002 have lately come under severe pressure. The country's deteriorating economic profile emanating from various broad socio-economic risks has impacted investors' sentiments and magnified the intensity of the downfall. These factors, mainly independent in nature, include the widening fiscal and trade imbalances, rising inflation, weakening Pak Rupee and worsening law and order situation. Meanwhile, turmoil in the global markets and the flight of foreign portfolio investment has further exacerbated the situation. While, in the past, the markets have recovered from sharp dips, this time the scale of the downturn appears more pervasive and substantial. Although various proposals are being considered to support the market, given the pressure on the overall economy, the possibility of any material support in the near future appears less likely.

The basic business model of a brokerage company involves revenue generation from brokerage fees through facilitating trades for their clients. To boost trading volumes, brokerage houses also provide margin financing facility to their customers, either on their own account or through external sources. Meanwhile, some brokers also manage proprietary equity portfolio. These business lines generate multiple risks including credit, market and operational risk. The risk assumed is usually a function of margin requirement against open positions, credit evaluation process of the customers, and level of proprietary trading vis-à-vis broker's own financial strength.

The equity brokerage industry has a high correlation with performance of the bourses. The recent meltdown in the equity market has eroded trading volumes. Further, many market players actively maintained proprietary investments, value of which has significantly declined. Under the current scenario, profitability prospects of the brokerage industry are expected to remain under pressure.

In view of further erosion expected in the market value of securities, brokerage houses with inadequate margin arrangements against clients' exposure in CFS financing or other open positions are likely to suffer losses in the form of write-offs of receivables. The risk is magnified for those entities which have financed their positions through short-term bank lines. The banks, in the current scenario, have restricted lending to the brokerage industry. Consequently, a few of the brokerage houses are finding it difficult to honor their commitments relating to deposit of margin shortfall towards the clearinghouse. Meanwhile, industry players with substantial proprietary books would have to book revaluation losses. Nonetheless, brokerage houses with robust risk management



systems, sound capital structure and good management teams having the ability to rationalize cost structure in the current scenario, and availability of group support are expected to withstand this difficult operating environment. At the same time, the companies that have restricted their operations only to brokerage services with limited lending exposure and/or investment activities are likely to fare well.

PACRA considers the need for tighter regulatory requirements engendering development of sound risk management systems and control procedures in the industry and further refining of the minimum capital requirements compared to the risk undertaken. Segregation of brokerage services, lending, and investment businesses would be an important step towards avoidance of undue concentration of risk.

PACRA, as a part of its ongoing surveillance process, is monitoring all developments very closely, and may take a client specific rating action wherever deemed appropriate. We would like to emphasize that for any concern about the financial strength of a rated entity in the country, it is appropriate to consult the respective rating agency before drawing any conclusion. This does not necessarily exclude independent analysis or objective reservations about the rating opinion. Nevertheless, discussion with the respective rating agency would only help in developing a more informed view about the company.

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