Securities Broker Entity Rating Methodology

The Pakistan Credit Rating Agency Limited

An opinion on the credit worthiness of a Securities Broker.

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1. INTRODUCTION

- A large number of brokerage firms
- Few listed firms
- Underwriters to be registered under a new law

1.1 Securities brokers are registered with Securities and Commission of Pakistan under the Brokers and Agents Registration Rules 2001. SECP issued final Securities Brokers Regulations, June 2016. Out of the total 309 brokers as at Dec-16 most of brokers are private limited and only few are listed companies (36). The firm, to undertake brokerage business, needs to be a TREC holder of an exchange, participant in CDC, a clearing member of NCCPL, and registered with SECP. In the latest regulations, SECP has created a distinction between Trading, Trading and Self Clearing and Trading and Clearing brokers. Separate set of regulations apply to each category including minimum capital, net worth and minimum net capital balance.

1.2 A brokerage firm provides services mainly brokering (equity, fixed income, and commodity); deals in listed and unlisted equities; provides and helps provide leverage products (Margin Trading System, Margin Financing, and Securities Lending and Borrowing); few of the brokerage firms are also engaged in advisory and underwriting. For underwriting, the brokerage firm needs to be registered with SECP as underwriter under the Underwriter Rules, 2015.

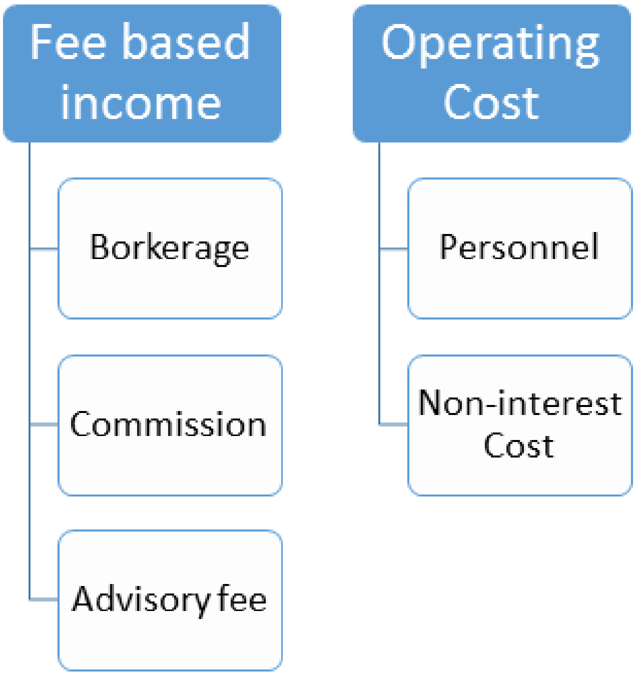
2. BUSINESS RISK

- Core income vs. operating expenses
- Revenue mix to be evaluated

2.1 Industry analysis focuses on the dynamics of the domestic market over the past. The fluctuations and the cyclical movements are analyzed and based on this, future projections are made, especially with reference to the medium term outlook. Key data is interplay of domestic and foreign investors, appetite of these investors and future trends. The trading volumes and their concentration also helps identify the health of the industry. The domestic market dynamics are compared with the regional and global markets. This analysis is done with an objective of identifying the gaps and areas where the domestic market is lagging and what kind of implications it would have on the local market. Industry positioning of significant players is evaluated. At the same time, legal injunctions, current and forthcoming, are reviewed to form a view whether the industry would experience a major shift in the medium term The objective of business risk analysis it to establish the company's ability to sustain – indeed – grow its relative positioning in the industry while ensuring profitable operations.

2.2 The analysis of business risk of a brokerage firm is based on a clear understanding of two lines of business in which the firm may engage itself. One is the fee-based revenue stream and the second is fund based revenue stream. PACRA generally tends to name the first source of revenue as the core business. While the second source of revenue may still be fundamental to the overall profitability of the brokerage firm, it is usually termed non-core to contrast it with the core fee based income. This clarity is helpful in understanding the issues surrounding the sustainability of the brokerage firm, to be rated. The core revenue needs to present a strong case for the continuity of the firm. This is evaluated by comparing the core revenue with the cost of doing business. The cost which is compared against the core revenue qualifies the test of relatedness. Only the cost incurred for the core business is pitched against the core revenue. The diagram explains:

2.3 PACRA considers three types of revenues as core: brokerage, commission and advisory fee. The first type of revenue is most prevalent; the second is relevant for firms which are engaged in underwriting etc. The third is yet to make sizable presence in the domestic market. It is pertinent to analyze each of these revenue streams. 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 the mix of buy and sell brokerage. The alternative revenue streams from underwriting, advisory and financing are analyzed to form a view how significant these are and whether these represent a sustainable revenue stream.



2.4 The related ratios are: fee based income to total income and operating cost to fee based income. The core income/loss explains the firm's strength in its business.

2.5 Fund based income is an additional buffer. This may emanate from financing activities, fixed income avenues and generally proprietary book. The depth and diversity of this income stream is analyzed with an objective to form a view whether this is one-off or recurrent. PACRA takes comfort from demonstrated stream of recurrent non-fee based income. Funding to the clients may result in crystallization of credit risk; hence bad debts are analyzed and pitched against financing book. The aging analysis also becomes relevant, though its impact is fully catered in the financial risk analysis of the broker.

3. FINANCIAL RISK

- Receivables a source of credit risk
- Leveraged products
- Liquidity coverage

3.1 Financial risk of a brokerage firm emanates from the type of transactions that the firm executes. A brokerage firm may engage in a) leveraged products, b) receivable financing, c) ready futures, and d) proprietary investments. These transactions may (or may not) be backed by borrowings: short term usually and long term rarely. In addition to the borrowing, the firm may utilize clients' funds (normally reported under advances from and/or payables to clients). The higher the reliance on borrowings and payables, the higher the quantum of risk the brokerage firm is carrying. It is therefore fundamentally important to classify the firm's finances and funding avenues with marked clarity. This would capture the amount of risk that the firm is carrying on the balance sheet at a first glance. From here, a case may be built for an in-depth analysis of each risk.

3.2 **Credit Risk:** Credit risk results from the credit offered to the clients. The highest level of risk exists in case of receivables, primarily related to the securities purchased on behalf of the clients. This is a type of clean credit though the firm is carrying respective clients' scrips in the sub-account. For these scrips, the market risk is most critical. In the event of downfall of the market, the value of these scrips may stumble suddenly, inducing the client to withdraw from their commitment to settle the receivable. The mechanism put in place by the broker to limit its loss ensuing from the credit risk is assessed. Herein the most important is the system of margin calls, how timely and effective it is.

3.2.1 Credit risk also results from the leverage products as well. These products are governed by the oversight of National Clearing Company of Pakistan Limited. Currently, Margin Trading System and Margin Financing are mostly availed in the domestic market. The design and structure of MTS make it less risky, so is true for MF to some extent. Nevertheless, the counterparty credit risk is borne by the financier as the ultimate analysis of the products dictate.

3.2.2 Ready futures transactions entail purchase of securities from the current market and sale of the same in the future. This type of transactions has inherent risk mitigants against credit risk since the securities would be handed over only in case of payment settlement. Nevertheless, the market risk would become relevant in case of client's denial to make the payment in future to take up the securities.

3.3 **Market Risk:** The assessment of market risk is premised on an understanding that not all types of investments are equally exposed to market risk. Alternatively, while investments are mostly exposed to market risk, the impact of this risk, should it materialize, would be different from one type of investment to the other type of investment. In certain investments, the interplay of credit risk and market risk aggravates the overall quantum of risk exposure. Bonds are exposed to interest rate risk; in so far as these are exposed to credit risk, their valuations are much vulnerable. Hence, bonds with low credit rating should secure less score. Management's policy as to prop book including equities play a vital role in the overall assessment of company's market risk appetite and its ability to manage conflict of interest.

3.4 **Liquidity Risk:** Liquidity risk is evaluated to identify balance sheet cushions against committed liabilities. Liquidity risk has a very straightforward computation. Liquid investments are compared against the company's funding base.

3.5 **Capital and Funding:** The broker's ability to maintain the related capital regime is analyzed to form a view as to the sustainability of operations. The funding lines and their utilization is assessed to evaluate fall back avenues. Net Capital Balance (NCB) must reflect the overall health of the company and would normally coincide with its size and rating.

4. QUALITATIVE ASSESSMENT

- Evaluation of overall structure and profile of board
- Existence of independent board members
- Effectiveness of BoD in strategic guidance
- Compliance with regulations – a minimum requirement

4.1 Governance: PACRA's assessment of governance involves both systematic analyses of governance data and information, and the more contextual reviews of the firm's governance practices. PACRA considers four main factors while assessing the board structure of a broker: (i) board structure, (ii) members profile, (iii) board effectiveness, and (iv) financial transparency.

(i) Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, 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. Diversification in terms of knowledge background and experience of board is considered positive. However, a fair number of board members should have financial sector experience. Compliance of code of corporate governance is also examined.

(ii) 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.

(iii) 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 statue.

(iv) 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.

4.2 Management: PACRA's assessment of management focuses on company strategy, risk tolerance and funding policies of the management. Company goals are evaluated to determine if management has an aggressive style dedicated to rapid growth that maximizes near-term earnings or a conservative style geared toward optimizing cash flow over the long term. A policy of growth through acquisition is not necessarily a negative factor. The historical mode of financing acquisitions and internal expansion provides insight into management's risk tolerance. Although a judgment on the quality of management is subjective, financial performance over time provides a more objective measure. PACRA assesses management's track record in terms of its ability to create a healthy business mix, maintain operating efficiency and strengthen market position. PACRA also gives management significant credit for delivering on past projections or maintaining previously articulated strategies when evaluating future growth plans and related financial projections. The focus is to establish whether the company has a team or group of individuals. Team is defined by its cohesive vision and its ability to steer the company collectively. A high turnover is definitely a negative indication.

4.3 Control Environment: Another testimonial of the strong oversight and effective management is the control environment. PACRA considers that a good company should be driven by processes instead of being dependent upon individuals. Therefore, evaluation of the quality of policies and procedures and invariable adherence to those policies and procedures remain pivotal in the assessment of the control environment. Segregation of duties and occupancy of the all positions would provide comfort as to the minimization of operational risk. With the passage of time, the importance of information technology infrastructure has increased tremendously. The companies that take advantage of advanced I.T. solutions deliver comparatively better on many fronts. This helps in internal MIS design and quality of service to the customers. The customer satisfaction is core to the analysis. PACRA, therefore, assesses the quality of the I.T. infrastructure and the breadth and depth of activities performed by this division. Herein, analysis of the integration of the company's operations into technology would be pivotal. Built-in controls should demonstrate that conflict of interest is avoided. One significant advantage of technology is the timely, precise and accurate MIS. The analysis of MIS being generated by the technology and its use by the department heads and the top management would underpin the comparative advantage (or disadvantage) that the company would have on a relative scale. The strength of the control environment reflects in immaculate fulfillment of all compliance requirement and regulatory requirements laid down by SECP.

5. SPONSORS' SUPPORT

- Ongoing support vs. extraordinary support
- Willingness to support

5.1 PACRA classifies sponsors' support into two types: a) ongoing support b) extraordinary support. The ongoing support may come in multiple forms, for instance, technology, branding, and marketing. The ongoing support, being the continuing feature, would provide comfort in any of the relevant sections described above.

5.2 The extraordinary support denotes the support provided in unusual circumstances and may take the form of: i) liquidity injections during crisis, ii) subordinated loans to ease cash flow pressure, iii) recapitalizations to improve capital structure, iv) arrangement of a solvency rescue package through other market participants.

5.3 PACRA analyses the ability and willingness of the major shareholders to support the entity both on a continuing basis, and support in times of crisis. Key factors that are considered for this purpose, inter-alia include, shareholding structure, financial strength of major shareholders, operational synergies with the major shareholders' other businesses, and the level of commitment of the major shareholder with the entity in providing capital support. 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, and ii) prospective view of key shareholders, incase such need arises. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support.

INFORMATION REQUIREMENT FOR BROKER ENTITY RATINGS

The following section illustrates the general set of information requirement for the rating process. Depending on the historical performance, operational characteristics, and investment policies and strategies, some additional information may also be sought.

A. BUSINESS RISK

- Market Share
- Branch network
- List and contribution to brokerage income of top 10 brokerage clients, separately for local and foreign clients, pertaining to individuals and corporates.
- Contribution to brokerage revenue alongwith the number of trading accounts from each of the above category.
- Break-up of brokerage sales in terms of number of shares handled on stock and commodity exchange on monthly basis.
- Client wise (i.e. individuals, corporate, foreign) transaction rate charged.
- Financial projections.

B. FINANCIAL RISK

- Top 10 trade receivables and top 10 trade payables.
- Top 10 accounts classified under doubtful receivables.
- Details of exposure limits for the brokerage operations and measures taken by the management to ensure implementation of these limits including: a) Per client exposure, b) Single script exposure, c) Sector exposure, d) Loss limits.
- Details of instances of margin calls during recent one year.
- Authority limits of treasury head and other top management as well as policy regarding total investment limit in said securities as percentage of equity of the company for
  i. Money market instruments
  ii. Fixed income instruments (including income funds and TFCs)
  iii. Equities. Also provide the latest guidelines and limits for running proprietary trading book.
- Details of latest approved funding limits along with outstanding amount.
- Internally approved list of eligible securities for margin financing (if any).
- Calculation of net capital balance under Rule 2 (D) of the SECP Rules, 1971.
- Statutory reports filed with PSX and SECP
- Aging analysis of receivables

C. GOVERNANCE

- Profile of the Board of Directors.
- Minutes of the BoD meetings.

D. MANAGEMENT

- Latest organogram of the company.
- Profile of key management personnel as per pre-determined format.
- Minutes of the management committee meetings.

E. CONTROL ENVIRONMENT

- Brief write-up on core operating software.
- Copy of the management letter by external auditors.

F. SPONSORS

- Shareholding pattern of the company
- Brief write-up on history of the sponsoring group/s
- Other business ventures of the sponsoring group/s and their shareholding therein.
- Financial statements of the these business ventures

CREDIT RATING
SCALE & DEFINITIONS

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.
AA+ **AA** **AA-**	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ **A** **A-**	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ **BBB** **BBB-**	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ **BB** **BB-**	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ **B** **B-**	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC **CC** **C**	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short Term Ratings

A1+: The highest capacity for timely repayment.

A1:. A strong capacity for timely repayment.

A2: A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.

A3: An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.

B: The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.

C: An inadequate capacity to ensure timely repayment.

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 settled. Rating Watch may accompany Outlook of the respective opinion.

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 debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information

Disclaimer: PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.