

The Pakistan Credit Rating Agency Limited



Broker Fiduciary Rating

Assessment Framework

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Summary

Broker Fiduciary Rating represents PACRA's opinion on the relative management quality, customer service and sustainability of operations of a broker. PACRA arrives at an opinion after a detailed evaluation of several qualitative and quantitative factors. However, PACRA's approach is more skewed towards the qualitative aspect when assigning Fiduciary Rating to brokers. This document explains our general approach to assigning fiduciary rating to a broker and factors that are likely to affect rating outcomes.

This methodology is applicable to brokers licensed to undertake securities broker activity under the Securities Act, of 2015, and permitted to undertake future's broker activity for futures contracts based on securities and financial instruments as per section 52 of the Futures Market Act, of 2016.

Analyst Contacts

Zohaib Zafar
+92-42-3586 9504
zohaib.zafar@pacra.com

The Pakistan Credit Rating Agency Limited

Head Office

FB1 Awami Complex
Usman Block, New Garden Town
Lahore
Phone +92 42 3586 9504

Karachi Office

PNSC Building, 3rd Floor
M.T. Khan Road, Lalazar, Karachi
Phone +92 21 35632601

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1. Introduction

Scope: Opinion on relative management quality, customer service and sustainability of operations of a broker

1.1 Scope: Securities Brokers (henceforth referred to as ‘brokers’ or ‘brokerage firms’) play a critical role in capital markets by facilitating trades for all categories of investors. The brokerage industry is characterized as very dynamic and volatile due to its direct dependency on the performance of capital markets. PACRA’s Broker Fiduciary Rating aims to facilitate investors in differentiating between brokers on the basis of management quality, customer service and sustainability of operations.

Online-only: SECP introduced the Online-only brokers category in Pakistan. Securities Brokers (Licensing and Operations) Regulations, 2016, covers the regulatory requirements for Online-only brokers in detail. This methodology will also be applicable to Online-only category. For the evaluation of Online-only brokers, all factors that are applicable to other categories will be evaluated for Online-only brokers as well. However, PACRA will also be accounting for regulatory requirements, which are different for Online-only brokers and greater emphasis will be placed on technological platforms, client/investor portals and other related areas.

1.2 Overview: An entity licensed under Securities Brokers (Licensing and Operations) Regulations, 2016, is permitted to provide brokering services (equity, fixed income, and commodity), provide and arrange leverage products (Margin Trading System, Margin Financing, short selling, and Securities Lending and Borrowing) and can also engage in advisory and underwriting. For underwriting, the broker needs to be registered with SECP as an underwriter in compliance with Underwriter Rules, 2015. Brokers who are not engaged in proprietary trading may apply for a license to undertake Investment Advisory Services only for managing discretionary or non-discretionary portfolios for both individual and institutional clients under NBFC Regulations, 2008. Moreover, under the Securities Managers (Licensing and Operations) Regulations, 2024, brokers can now apply for a separate license to carry out portfolio management services for both discretionary and non-discretionary portfolios.

1.3 Regulatory Landscape: Brokers are regulated primarily by the Securities and Exchange Commission of Pakistan (SECP). The regulator has designed a comprehensive set of laws and regulations for brokers. SECP has made it compulsory for brokers licensed in Trading and Self-Clearing to obtain a Broker Fiduciary Rating. The key regulations applicable to the brokers are the Securities Brokers (Licensing and Operations) Regulations, 2016, last updated in March, 2023.

1.4 Rating Scale: BFR has five rating categories from “BFR1” to “BFR5” with BFR1 being the highest. In addition, the scale will be appended with “+” and “++” signs to denote relative status within a category except for “BFR1” and “BFR5”.

2. Rating Framework

Rating Framework: Qualitative and quantitative factors, all factors assessed on

2.1 This rating methodology document delineates factors incorporated in PACRA’s rating opinion to enable investors, market participants and lenders to understand the rating considerations. The envisaged broker rating is based on both qualitative and quantitative factors to reflect the

a standalone *and* relative basis

relative management quality, services provided and sustainability of operations. PACRA uses these key parameters to assess the quality of operations of a broker and the services it offers. Each parameter is assessed individually. These are then aggregated to arrive at the final rating. Each factor has sub-factors and is assigned a weightage to come up with an opinion. These factors include i) Profile, ii) Ownership, iii) Governance, iv) Management and Client Services, v) Internal Controls and Regulatory Compliance, vi) Business Sustainability and, vii) Financial Sustainability.

Rating Criteria						
Profile	Ownership	Governance	Management & client services	Internal Controls & Regulatory Compliance	Business Sustainability	Financial Sustainability
1) Background	1) Ownership Structure	1) Board's Structure	1) Organizational Structure	1) Risk Management Framework	1) Operating Environment	1) Credit Risk
2) Operations	2) Stability	2) Member's Profile	2) Management Structure	2) Regulatory Compliance	2) Performance Strategy	2) Market Risk
	3) Business Acumen	3) Board Effectiveness	3) Client Servicing			3) Liquidity Risk
	4) Financial Strength	4) Transparency	4) Complaint Management			4) Capitalization
			5) Extent of Automation			
			6) Continuity of Operations			

3. Profile

Background: Evolution and past strategy

Operations: Review of scope of operations based on license, size and stage of business

3.1 Background: PACRA reviews the background of the broker to understand its evolution from where it started and where it currently stands. We analyze how and through what means the entity has achieved the desired expansion. The significant factor here for PACRA is to assess whether the entity has achieved the desired expansion through organic growth or acquisitions. PACRA looks at the progress of the entity over the years. This helps PACRA determine the entity's ability to successfully execute its strategy and stated plans. Meanwhile, the approach for desired growth is also critical.

3.2 Operations: The assessment of operations of an entity underlines the scope of various business activities undertaken by the broker and what stage the business is in. Understanding operations helps PACRA to identify the types of business risks a broker could face together with its ability to sustain its competitive position and gain new business. Here, PACRA reviews the broker license obtained (Trading and Self Clearing, Trading and Clearing, Trading or Online-only),

the broker's branch network or portal (in the case of an Online-only broker), business model, and product offering. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position.

4. Ownership

Ownership Structure:

Identification of man at the last mile.

Stability: Succession planning at the shareholder level

Business Acumen: Knowledge, skills and experience of key shareholders

Financial Strength: Willingness and ability of key shareholders to provide extraordinary financial support

4.1 Ownership Structure: The assessment of ownership begins by looking at the legal status of the entity. Legal status determines the level of expected stability of an entity. The level of perceived stability gradually increases from a sole proprietor to a listed entity. This is followed by an in-depth study of the shareholding mix in order to disentangle structure of ownership. Key factors that are considered for this purpose include, i) ownership structure, which includes whether individuals own the entity directly or indirectly, ii) foreign or local ownership, iii) is the entity is part of a group or a standalone entity, and iv) whether the entity is owned by a single group or multiple groups through a combination of entities and individuals. All these deliberations are done to identify the man at the last mile. Secondly, analyzing ownership structure is also important as clarity on ownership generally lacks in a joint venture agreement. PACRA draws comfort from the institutional and/ or foreign ownership as the propensity of support (brand name, capital etc.) from key owner/s, as and when required, is an important credit driver.

***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, the fundamental issue is to explore the underlying reason or motivation for the complexity of the structure.*

***Entities which are owned by private individuals and families:** On the one hand, the concentration of shareholding 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 returns from the entity as source of income or to fund other business activities, potentially undermining the financial stability of the entity.*

4.2 Stability: In order to analyze the stability of ownership, a key criterion for PACRA is the existence and form of shareholding agreement among the majority shareholders. In case of multiple owners, a well-documented shareholding agreement is considered to bring stability in the long run compared to verbal understanding. Another particularly important factor to be taken into account is succession planning. A very important part of our background analytical work is an attempt to assess whether, and under the right of succession, an entity's future prospects would be supported, and by whom. Well defined shareholding agreement and succession plan also complement our criteria to identify the man at the last mile. However, an entity's dependence or over-reliance on a single person (owner), especially in terms of decision making, can pose risks.

4.3 Business Acumen: Here, PACRA gauges the owner's understanding of industry dynamics and business skills. Having a strong skill set is considered critical for the sustainable success of the entity through business cycles. PACRA analyzes 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 business is critical in order to determine how an entity achieves its goals and objectives. Entities fully or partially owned by strong local or international institutions

as strategic investors are expected to benefit from strong institutional acumen, providing higher comfort to the rating. Moreover, our assessment incorporates an understanding of the owner's thought process and decision-making. In the case of Online-only brokers, along with regulatory requirements, PACRA also evaluates the owner's experience in the digital and digital financial services domain to ascertain their ability to provide strategic guidance.

4.4 Financial Strength: PACRA's analysis involves reviewing and assessing the owner's willingness and ability to provide financial support to the entity in distressed circumstances. The most common source of support is from the shareholders (institutional support) when a corporate parent has a financial sector subsidiary. A track record of support provided by the owner in terms of equity injection, interest-free loans, letter of guarantee etc., provides comfort here. In the absence of such a track record, PACRA attempts to form a view on likely support by analyzing: the expressed commitment of owners to provide support including letter of comfort, the extent of operational and strategic integration between group companies (that could influence the group's commitment to supporting the entity), and extent of reputational risk. To gauge the ability of the owner to provide support, other businesses of owners are considered to identify their resources, outside of the entity, for financial support, as well as the overall financial profile of the group. However, for large financial institutions, external support from government / regulatory becomes more important.

5. Governance

Board Structure: Composition of the board in terms of size, independence and committees

Members Profile: Relevance and diversity of board members' skills and experience

Board Effectiveness: Extent to which board properly discharges its responsibilities

Transparency: Quality and extent of financial and non-financial information disclosure to stake holders

5.1 Board Structure: This comprises an assessment of board on various criteria including overall size, presence of independent members, association of board members with the entity, overall skill mix and board-level committees. The size of the board may vary as per the scope and complexity of the business operations of the entity. Too small a board (<3 members) may be lacking in terms of diversity and a balanced skill mix, similarly reaching a decision in an effective and efficient manner may not be possible in case of a very large board (>9 members). A healthy composition of the board includes the presence of independent and non-executive members having limited relationship with the key owners of the entity. Meanwhile, the same individual holding chairman and CEO positions is considered weak governance practice. The chairman is expected to have a non-executive role and, ideally, should be independent. The board's compliance with the Code of Corporate Governance and the Securities Brokers Regulations 2016 is considered. Generally, compliance with applicable regulations is considered a bare minimum, while entities that strive to exceed regulatory requirements and align themselves with best industry and international practices are viewed positively. Lastly, PACRA evaluates number of board committees, their structure, TORs, and how these committees are providing support to the board. The board with higher total number of members should have a higher number of committees in place to achieve efficiency in performing the role of the board. Meanwhile, all committees chaired by independent director is considered superior by PACRA. A well-structured board should be supported by three committees at least i.e. Audit Committee, Human Resource & Remuneration Committee and Risk Management Committee as defined in the code of Corporate Governance and in line with best practices.

5.2 Members' Profile: PACRA collects information regarding the profile and experience of each board member. This helps in forming an opinion about the quality and skill set of the overall board. PACRA expects a fair number of Board members to have related experience (brokering, financial advisory, investment management and treasury). However, PACRA equally values diversity in the

background and experience of board members, which can enrich their oversight role. This may entail directorial or managerial experience in financial technology, marketing, financial literacy, cyber security, etc. Regular director trainings conducted by the entity are considered good. This is expected to equip the board members to fulfill their roles in an effective manner.

5.3 Board Effectiveness: PACRA considers that the role of the board is to work with the 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 and is gauged by viewing board meeting minutes. Moreover, PACRA analyses the type and extent of information shared with the board members, and the quality of discussions taking place at the board and committee level. Effective oversight requires frequent sharing and more detailed information than required by statute. Meanwhile, PACRA also reviews the number of board meetings held during the year with reference to the complexity of the entity's operations and compliance with the minimum threshold of corporate governance code applicable to the entity. Number of board meetings should be justified by the number of issues/matters arising.

5.4 Transparency: Quality of the governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of information. The board may establish controls to ensure transparency by strengthening the role of the audit committee, the quality of the internal audit function, and the quality of the external audit. Adherence to the standard accounting practices and transparency in disclosures are critical attributes and the extent of the same are assessed while taking a view on the accounting quality of the broker. In PACRA's view, independence of the internal audit function is of paramount significance. Outsourced internal audit (especially to Big Four audit firms) is considered best practice as third-party audit professionals bring more independence and are less likely to be biased towards existing practices. In-house audit functions are expected to report to the audit committee. Experience and relevant qualifications of the head of the function, adequacy of function staffing and quality of internal audit reports are also assessed. Meanwhile, the quality of external auditors is considered to be reflective of the accuracy and integrity of the entity's financial statements. External auditors among the Big 4 or those listed in the SBP Auditor Panel 'A' category provide greater comfort.

Accounting Quality: PACRA reviews the quality of an entity's accounting policies as reflected in its notes to accounts, auditors' comments and other disclosures that are part of its financial statements. Adherence to accounting standards is assessed, particularly for unlisted concerns.

Quality of disclosures: A well-established information system is required for adequate disclosures. The characteristics of quality information include timeliness, disclosures beyond the minimum regulatory requirements to improve transparency and consistency of such disclosures.

Quality of meeting minutes: PACRA reviews the quality of meeting minutes documented in order to assess the type of discussion that takes place in meetings.

6. Management & Client Services

Organizational Structure:

Alignment of organogram with size and business requirements

Management Team:

Relevance and diversity of skills, knowledge and experience of top management

Client Servicing:

Quality of client reporting, trading facilities, and value-added services, if any

Complaint Management:

Complaint platforms, management guidelines and resolution

Extent of Automation:

Robustness of IT, MIS and level of integration

Continuity of Operations:

Data recovery and disaster management planning

6.1 Organizational Structure: PACRA’s analysis of the organizational structure focuses on how the entity is organized keeping in view the scope of operations, segregation of various functions, client services, compliance with regulations, confidentiality and conflict of interest within departments as well as with the clients. Formation of permanent/standing or special/need-based management committees for improved coordination, decision-making, performance monitoring, ensuring adherence to organizational policies and procedures or more specific purposes is also viewed positively.

6.2 Management Team: Good quality management implies that the broker has effective systems and controls and a well-defined strategy to achieve the desired level of excellence. However, a radical departure in strategy, a shake-up in management, or an untested team can each herald sudden changes that increase the uncertainty about a broker. PACRA assesses the management quality in terms of the experience profile of key individuals, their tenure with the entity, 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 the frequency and quality of the training imparted to the employees. Membership of local and foreign associations provides comfort and contributes towards the enhancement of management quality

Key-person Risk: *Key-man risk occurs when an entity is heavily reliant on an individual, or a limited number of individuals (one or two), who are accepted as the key holder(s) of important intellectual capital, knowledge or relationships. While this type of risk is more common in small to medium-size entities, it can also exist in larger entities and is relatively challenging to benchmark and, hence, mitigate. PACRA attempts to identify the extent to which an entity is dependent on the expertise of such individual(s) and to ensure policies exist for succession/redundancy to limit the adverse impact of such a person unexpectedly leaving the entity.*

6.3 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 programs, online trading, mobile application, sms service etc.), dissemination of trading policies and procedures to clients, order recording and trade confirmation process.

6.4 Complaint 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 broker. Response time, timeline of resolution of complaints and integration of complaints management system with internal control system is critical to PACRA’s assessment.

6.5 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 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, the type and number of errors encountered, access policies to the computer systems and data, and the quality of reports generated by the MIS.

This factor becomes significant in PACRA’s analysis in the case of Online-only brokers since they are interacting with the client digitally instead of physical presence. PACRA looks at the core software deployed, frontend and back-end applications, user interface and channels used by the customers, agreements with vendors or in-house development capabilities, system back-up plans and measures taken for data security by the Online-only brokers. Similarly, risk management mechanisms and controls established are examined.

6.6 Continuity of Operations: PACRA also analyses the adequacy of infrastructure in place along with strong connectivity with the exchange. The communication network and available channels, frequency of connection failure and time taken to restore the connection, database maintenance are also looked at. Similarly, disaster recovery and business continuity plan and system to provide strong backup are considered. While the broker’s existing IT systems may be adequate for the 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. Rapid growth may introduce other challenges, such as operational strains and back-office staff or system strains. This is carefully analyzed to form an opinion.

7. Internal Controls & Regulatory Compliance

Risk Management Framework: Quality of policies and systems surrounding credit, liquidity and market risk management

Regulatory Compliance: Strength of internal control policies and procedures incl. internal audit, system audit and CDC audit

7.1 Risk Management Framework: PACRA assesses the robustness of the overall risk management framework to determine how various risks are identified, monitored and mitigated across the brokerage firm. PACRA’s assessment of risk controls considers the breadth and sophistication of the risk management framework relative to the risk profile of the entity and the types of MIS reports generated. The efficacy of the framework is assessed by reviewing the risk management committee’s involvement in reviewing risk appetite, policies and controls put in place. The efficiency of controls and effectiveness of the internal audit function within a brokerage firm is instrumental in mitigating risks arising from operational failures. The risk analysis includes an assessment of overall risk control framework, integration with the front office, risk monitoring and measurement, compliance and whether the entity’s incentive structure discourages excess risk-taking and promotes an alignment of interests with clients’ objectives. From the rating perspective, it is of prime importance for a brokerage firm to maintain a separate risk management team, independent of the business acquisition. Meanwhile, standardized, system-driven, policy-based risk management procedures are considered precursors of strong risk management function. Moreover, it is of utmost importance that the broker ensures complete segregation between its core operations and portfolio management function. PACRA closely looks into policies to mitigate the conflict of interest especially if the broker is involved in providing investment advisory and portfolio management services. The overall aim is to evaluate the adequacy of the broker’s risk management function on the following parameters: credit, market, liquidity and operational risks.

7.1.1 Credit Risk Management: 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, knowing 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.

7.1.2 Market Risk Management: 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 plays 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. Moreover, PACRA assesses mechanism of margin trading system. The margin management system should be able to calculate margin calls, handle margin disputes, and provide daily reporting on initial and variation in margin.

7.1.3 Liquidity Risk Management: Liquidity risk occurs due to insufficient funds to meet obligations when they fall due. PACRA analyses liquid investments against the entity’s funding base and the broker’s ability to raise timely and cost-effective funds from external sources. Funding and liquidity are relevant because inadequacies in these two areas often lead to broker failures as a result of asset/liability mismatches or asset illiquidity. Brokers with a well-defined policy approved by the board and considers maintaining adequate liquidity with identified risk mitigation and limits are considered superior. Herein, PACRA also reviews broker’s approach towards brokers funding their proprietary book. Proprietary investments through raising short-term funding is considered risky regardless of the positive spread over funding cost.

7.1.4 Operational Risk Management: Operational risk is the risk of loss resulting from inadequate or failed internal processes, systems issues and outages. This could potentially lead to a loss of franchise value, unauthorized trading, misappropriation of the client’s money, breach of clients’ confidentiality, fraud in trading or in back-office functions and easily accessed computer systems. For Online-only brokers, the protection of client data and cyber security becomes even more critical. An analysis of the entity’s policies and procedures and update frequency helps to determine the viability of the operational control environment against unanticipated errors and failures

7.2 Regulatory Compliance: Regulatory compliance is crucial in the brokerage 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 legal and regulatory compliance. An objective assessment of the attitude of management towards legal compliance, systems set in place to ensure compliance and independence of the compliance function provide assurance that the broker’s service continuity will not be affected due to potential regulatory breaches. 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. For the Online-only brokers category, all these factors are assessed along with their specific regulatory requirements.

8. Business Sustainability

Operating Environment: Extent to which industry dynamics, regulatory regime and

8.1 Operating Environment: Business risk is the possibility that a broker will have lower than anticipated profits or experience a loss. It impairs the broker’s ability to provide its investors and

unforeseen events can impact a broker's business

Performance:

Volume, stability and diversification in revenue base, control over costs, profitability

Strategy:

Management's long-term plans and projections, and their viability

stakeholders with adequate returns and could hamper its operations. The broker's business strengths and financial soundness are assessed to ascertain the sustainability of its operations.

8.1.1 Industry Risk: While analyzing the brokerage industry, PACRA evaluates GDP growth, performance of important sectors in the economy, capital markets performance, trading volumes, and regulatory environment. An important part of industry analysis is the positioning of the industry and impact assessment of economic risk factors on the brokerage industry

8.1.2 Susceptibility to Event Risk: Susceptibility to sudden, extreme events that could severely impact the brokerage industry is an important indicator due to its volatile nature. Event risks could be triggered due to geopolitical, economic, social, and or financial sector risks and impact capital markets. We believe that such events could have significant negative implications for the business risk of brokerage industry if markets underperform for a relatively long period.

8.1.3 Regulatory Regime: Regulator's role in the form of new regulations, market development, and support provided through various actions can have a significant impact on the brokerage industry. The impact can be viewed as positive or negative for the sector depending on how an entity has positioned itself via the robustness of its operations and controls. Herein cost of compliance for the industry is an important aspect as it can affect industry structure and level of competitiveness through consolidation. At the same time, development of capital markets could broaden the scope and prospects of new products and investors through innovation, an important criterion for future performance.

8.1.4 Relative Position: Relative position reflects the standing of the entity in the brokerage industry. The stronger this standing is, the greater is the entity's ability to sustain pressure on its business volumes and profit margins. This standing takes support from two major factors: i) market share and brand equity, and ii) growth trend.

8.2 Performance: PACRA also analyses the revenue quality. PACRA sees concentration at both product and customer levels. Brokerage business derives strength from diversity of revenue streams and diversity in client base. Brokers that are not dependent on a few major clients, and therefore have low concentration risk, are better placed. The structure of brokerage fees is also evaluated. The mix of value versus scrip revenue, institutional, HNWs and individual client mix, the interplay of foreign vs. local clients is reviewed. The longevity and retention of clients and average brokerage fees and its relativeness in the industry is also analyzed to determine operational profitability. The alternative revenue streams from underwriting, advisory and portfolio management services are analyzed to form a view on how significant these are and whether they represent a sustainable revenue stream. The overall profitability and its sustainability are important as it determines the broker's ability to sustain its operations and act as a first line of defense against other sources of risk or loss.

8.2.1 PACRA considers three types of revenues as core: brokerage fee, 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 a sizable presence in the domestic market but few brokerage firms have established themselves well in this arena. It is pertinent to analyze each of these revenue streams to form a view on their significance and sustainability

8.2.2 The performance of the proprietary book and the broker's reliance on capital gains is analyzed. Brokers that are highly reliant on proprietary trading profits are considered volatile as

operational profitability through core activities (brokerage fee, underwriting, and advisory) is considered superior by PACRA.

8.2.3 A positive adjustment could be made to a broker's earnings and profitability score where earnings have proved to be stable through a cycle or where recent performance suggests a sustainable improvement compared to the broker's historical average. Conversely, high earnings volatility or a recent structural weakening of performance could lead to a negative adjustment.

8.3 Strategy: PACRA evaluates the strategy of the management and the viability of its plans for future growth. Earnings prospects are monitored, based on budgets and forecasts prepared by the management. The underlying assumptions are reviewed along with the management's track record in providing reliable budgets and forecasts.

9. Financial Sustainability

Credit Risk: Inability of clients to settle trades

Market Risk: Controls in place to manage adverse movement in security prices

Liquidity Risk: Ability to service short-term obligations

Capitalization: Equity cushion to absorb losses and remain compliant with regulatory requirements

9.1 Credit Risk: Credit risk emanates from the inability of clients to pay for the securities purchased on their behalf. Here PACRA analyses the quantitative aspect of credit risk. Trade receivables, quantum of provisions and write-offs of bad debts are also analyzed. The overall exposure limits, both at client and script levels, for client and proprietary book are analyzed against the firm's capital. Herein, PACRA reviews Net Capital Balance Report and Financial statements of the entity to ascertain its criteria.

9.2 Market Risk: Here PACRA reviews investment book against the risk associated with each asset class. Brokers that do not hold securities on their balance sheets generally have only limited exposure to market risk. However, their revenue is heavily exposed to the volume of transactions in the market. Brokers that maintain their own proprietary investment book may comprise investments in fixed-income securities, government papers, and direct exposure to equity markets. PACRA evaluates market risk with particular emphasis on the trading book, mainly equities, of the broker. Higher exposure in government securities adds stability due to lower credit risk but at the same time exposes the broker to higher interest rate risk. Here duration is a key parameter. While potential loss lying on the balance sheet that is yet to materialize stands as a risk of drag on performance of the broker, any available unrealized gain on investments held for sale is considered as a cushion to unforeseen losses that may arise due to price movements.

9.3 Liquidity Risk: Liquidity risk occurs due to insufficient funds to meet obligations when they fall due. PACRA analyses the liquidity profile of the broker. Here, compliance with regulatory liquidity and reserve requirements are considered as a minimum baseline. Furthermore, PACRA analyses short-term vs long-term mix; the maturity profile of liabilities is seen in conjunction with related asset base to analyze liquidity profile. PACRA believes higher asset turnover as compared to liabilities is good for liquidity management. The broker's compliance with regulatory reserve requirements is a minimum. PACRA also contrasts Adjusted Liquid Capital Balance to Liquid Capital Balance to determine the liquidity position of the broker. Furthermore, in the case of a proprietary investment book, the quantum of investments and their nature is analyzed. This also includes the broker's ability to raise timely and cost-effective funds from external sources including unutilized banking lines. Funding and liquidity are relevant because inadequacies in these two areas often lead to broker failures as a result of asset/liability mismatches or asset illiquidity.

9.4 Capitalization: Given defined regulatory requirements, the broker's ability to maintain the related capital requirements level is critical. PACRA evaluates the broker's capitalization as a cushion to absorb unreserved losses. These include the impact of foreseeable future business losses, if any, and expected level of provisioning on bad debts and nonperforming investments. Strong capital levels provide a necessary cushion in terms of absorbing any delay in collections from clients and losses during unfavorable market conditions. A small (in absolute terms) capital base can leave an institution more vulnerable to unforeseen events, especially where there are risk concentrations. This may result in a downward adjustment of a broker's capitalization and leverage score. A large (in absolute terms) capital base along with strong capitalization ratios could be positive for the assessment. Leverage and capital adequacy measures are relevant because they determine a broker's ability to handle higher trading volumes (depending on category of license) and absorb unexpected losses. Meanwhile, Net Capital Balance (NCB) reflects the overall capitalization of the entity and would normally coincide with its size and trading activities. PACRA also evaluates the capital formation rate of a broker from internal sources. Meanwhile, the dividend payout policy is considered important as it may have a significant bearing on the potential capital formation rate.

Broker Fiduciary Rating Scale & Definitions

An independent opinion on a broker's quality of management and client services and sustainability of operations

Scale	Definition
BFR 1	Very Strong. Very Strong quality of management and client services and a very high likelihood of sustaining operations.
BFR 2++ BFR 2+ BFR 2	Strong. Strong quality of management and client services and a high likelihood of sustaining operations.
BFR 3++ BFR 3+ BFR 3	Good. Good quality of management and client services and an above average likelihood of sustaining operations.
BFR 4++ BFR 4+ BFR 4	Adequate. Adequate quality of management and client services and an average likelihood of sustaining operations.
BFR 5	Weak. Weak quality of management and client services and a weak likelihood of sustaining operations.

<p>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'.</p>	<p>Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. 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 rating outlook of the respective opinion.</p>	<p>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.</p>	<p>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.</p>	<p>Harmonization A change in rating due to revision in applicable methodology or underlying scale.</p>
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Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

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