

# The Pakistan Credit Rating Agency Limited



## Broker Fiduciary Rating Criteria 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 detailed evaluation of several qualitative and quantitative factors. However, PACRA's approach is more skewed towards qualitative aspect when assigning Fiduciary Rating to a broker. This document explains our general approach to assign 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 Securities Act, 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, 2016.

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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. 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.

**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. Meanwhile, Brokers who are not engaged in proprietary trading may apply for license to undertake Investment Advisory Services only for managing discretionary or non-discretionary portfolios for both individual and institutional clients under NBFC Regulations, 2008.

**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. Following are the key regulations applicable to the brokers:

<i>Securities Broker</i>	<i>Promulgated / Last Updated</i>
<i>NCCPL Regulations</i>	<i>Updated December 2020</i>
<i>Securities Brokers Licensing Regulations, 2016</i>	<i>Updated November 2020</i>
<i>PSX Rule Book</i>	<i>Updated September 2020</i>
<i>Public Offering Regulations, 2017</i>	<i>Updated September 2020</i>
<i>CDC Regulations</i>	<i>Updated November 2019</i>
<i>Non-Banking Finance Companies (Establishment and Regulation) Rules</i>	<i>Updated April 2019</i>
<i>Anti-Money Laundering and Countering Financing of Terrorism Regulations, 2018</i>	<i>Updated January 2019</i>
<i>Securities and Future Advisors Regulations, 2017</i>	<i>Updated February 2018</i>
<i>Research Analyst Regulations, 2015</i>	<i>Updated August 2017</i>
<i>Securities and Exchange Commission of Pakistan Act, 1997</i>	<i>Updated August 2016</i>
<i>Futures Market Act, 2016</i>	<i>April 2016</i>
<i>Joint Inspection Regulations, 2015</i>	<i>October 2015</i>
<i>Securities Act, 2015</i>	<i>April 2015</i>
<i>Underwriters Rules, 2015</i>	<i>February 2015</i>
<i>Securities and Exchange Ordinance, 1969</i>	<i>Updated 2012</i>
<i>Securities (Leveraged Markets and Pledging) Rules, 2011</i>	<i>February 2011</i>
<i>Commodity Exchange and Futures Contract Rules, 2005</i>	<i>May 2005</i>
<i>Central Depositories Act, 1997</i>	<i>April 1997</i>

**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 standalone *and* relative basis

**2.1** This rating methodology document delineates factors incorporated in PACRA’s rating opinion to enable investors, market participants and lenders in understanding the rating considerations. The envisaged broker rating is based on both qualitative and quantitative factors to reflect the 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 offered by it. Each parameter is assessed individually. These are then aggregated to arrive at the final rating. Each factor has sub factors and 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.

Profile	Ownership	Governance	Management & Client Services	Internal Controls & Regulatory Compliance	Business Sustainability	Financial Sustainability
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## 3. Profile

### Background:

Evolution and past strategy

**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 in determining the ability of the entity to successfully execute its strategy and stated plans. Meanwhile, the approach for desired growth is also critical.

### Operations:

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

**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 of operations helps PACRA to identify the types of business risks a broker could face together with its ability to safeguard existing businesses and gain new business. Here, PACRA reviews broker license obtained (Trading and Self Clearing, Trading and Clearing or Trading), broker’s branch network, 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:

**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

Identification of man at the last mile.

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, inter-alia include, i) ownership structure, which includes whether individuals own the entity directly or indirectly, ii) foreign or local ownership, iii) is the entity 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.*

**Stability:**

Succession planning at shareholder level

**4.2 Stability:** In order to analyze the stability of ownership, a key criterion for PACRA is existence and form of shareholding agreement. In case of multiple owners, a well-documented shareholding agreement is considered to bring stability in the long run compared to verbal agreement. 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 right of succession, an entity’s future prospects would be supported, and by whom. Well defined shareholding agreement and succession plan also complements 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.

**Business Acumen:**

Knowledge, skills and experience of key shareholders

**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 financial system is critical in order to determine how a business achieves its goals and objectives. Meanwhile, entities backed by strong institutions and/or foreign institutions as strategic investors are expected to have strong institutional acumen and provide higher comfort. Moreover, the scope includes the assessment and understanding of the owner’s thought process and decision making.

**Financial Strength:**

Willingness and ability of key shareholders to provide extra-

**4.4 Financial Strength:** Our methodology involves reviewing the owner’s track record and support provided to the business in normal circumstance. The owner’s prior trackrecord, commitment to the business along with the financial support extended to the venture in distressful times, is also considered. Thus, ongoing support is considered more likely in these cases. For entities, the most usual source of support is from the shareholders (institutional support), when a corporate parent has

ordinary financial support

a financial sector subsidiary. 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 shareholders, and iv) the level of commitment of the major shareholder. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. The scope for other businesses of owners includes overall profiling of the key owner in the context of identifying financial resources they have, outside the entity.

## 5. Governance

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

**5.1 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 board level committees. Size of the board may vary as per the scope and complexity of the business operations of the entity. Too small a board (2-3 members) is not considered good, similarly reaching a decision in an effective and efficient manner may not be possible in case of a larger (9 or more members) board. A healthy composition of board includes the presence of independent / non-executive members having limited relationship with the key owners of the entity. Meanwhile, 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 to the code of Corporate Governance is also examined. 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 higher number of committees in place to achieve efficiency in performing 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.

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

**5.2 Members' Profile:** PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality and skill set 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.

**Board Effectiveness:**  
Extent to which board properly discharges its responsibilities

**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. 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 reviews the number of board meetings held during the year with reference to the complexity of entity's operations and compliance to the minimum threshold of corporate governance code applicable to the entity. Number of board meetings should be justified with the number of issues/matters arising. Board members' attendance and participation in meetings is important and is gauged by viewing board meeting minutes.

**Transparency:**

Quality and extent of financial and non-financial information disclosure to stakeholders

**5.4 Transparency:** Quality of 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 through strengthening the role of audit committee, the quality of internal audit function, and quality of 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. Specifically, PACRA considered audit function outsourced to big four audit firms superior compared to establishing an in-house function. PACRA applies same criteria when assessing the quality of external auditor, here QCR rated firms which are included in the State Bank of Pakistan’s panel of auditors and/or have a satisfactory QCR rating, especially big four audit firms provide more 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 which 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 includes timeliness, disclosures beyond the minimum regulatory requirements to improve transparency and consistency of such disclosures*

## 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

**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.

**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 increases 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 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-man 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-sized 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.*

**Client Servicing:**

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

**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, app, sms service etc.), 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.

**Complaint Management:**

Complaint platforms, management guidelines and resolution

**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.

**Extent of Automation:**

Robustness of IT, MIS and level of integration

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

**Continuity of Operations:**

Data recovery and disaster management planning

**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 back up are considered. 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. Rapid growth may introduce other challenges, such as operational strains and back-office staff or system strain. 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

**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 risk management framework relative to the risk profile of the entity and types of MIS reports generated. The efficacy of the framework is accessed 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 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 precursor of strong risk management function. PACRA evaluates the adequacy of broker's risk management function on the following parameters such as 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, 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.

**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 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 of 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 consider 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 clients' money, breach of clients' confidentiality, fraud in trading or in back office functions and easily accessed computer systems. 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

**Regulatory Compliance:**

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

along with any regulatory matters outstanding or actions taken by the regulators. Any litigation pending against the broker is also considered.

## 8. Business Sustainability

### Operating Environment:

Extent to which industry dynamics, regulatory regime and unforeseen events can impact a broker's business

**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 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 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 positioning of 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 business risk of brokerage industry if markets under perform 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 entity has positioned itself via 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.

### Performance:

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

**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 fee 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 fee and its relativeness in the industry is also analyzed to determine operational profitability. The alternative revenue streams from underwriting and advisory 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 is 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 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.

**Strategy:**

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

**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

**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.

**Credit Risk:**

Inability of clients to settle trades

**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. Broker's 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 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.

**Market Risk:**

Controls in place to manage adverse movement in security prices

**9.3 Liquidity Risk:** Liquidity risk occurs due to insufficient funds to meet obligations when they fall due. PACRA analyses liquidity profile of the broker. Here, compliance with regulatory liquidity and reserve requirements are considered as 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

**Liquidity Risk:**

Ability to service short-term obligations

liabilities is good for liquidity management. The broker's compliance to regulatory reserve requirements is a minimum. PACRA also contrasts Adjusted Liquid Capital Balance to Liquid Capital Balance to determine liquidity position of the broker. Furthermore, in case of 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 and sustaining this level is critical. PACRA evaluates broker's capitalization as a cushion to absorb unreserved losses. These include impact of foreseeable future business losses, if any, and expected level of provisioning on bad debts and nonperforming investments. Strong capital levels provide 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 capital formation rate of a broker from internal sources. Meanwhile, dividend payout policy is considered important as it may have a significant bearing on potential capital formation rate.

**Capitalization:**

Equity cushion to absorb losses and remain compliant with regulatory requirements

### Broker Fiduciary Rating Scale & Definitions

An independent opinion on the quality of management and client services and sustainability of operations

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

<p><b>Outlook (Stable, Positive, Negative, Developing)</b> 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><b>Rating Watch</b> 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><b>Suspension</b> 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><b>Withdrawn</b> 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><b>Harmonization</b> 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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