



Methodology

Trustee Fiduciary Rating

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Summary

PACRA's Trustee Fiduciary Rating (TFR) is an independent opinion on a trustee's quality of management, sustainability of operations, and adequacy of systems and controls deployed in performing their responsibilities of protecting investor rights and managing entrusted assets. It is important to understand that TFR differs fundamentally from the traditional credit rating, which refers to an entity/issuer's ability to meet its financial obligations. This methodology outlines PACRA's approach to assigning TFR, which is primarily based on assessment of qualitative factors. The factors evaluated include: i) Profile, ii) Ownership & Governance, iii) Management & Systems, iv) Risk Management & Regulatory Compliance, and v) Business & Financial Sustainability. PACRA also considers the relative positioning of the trustee among its peers in the industry to arrive at the final rating.

Analyst Contacts

Zoya Aqib
+92-42-3586 9504
zoya.aqib@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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0. Introduction

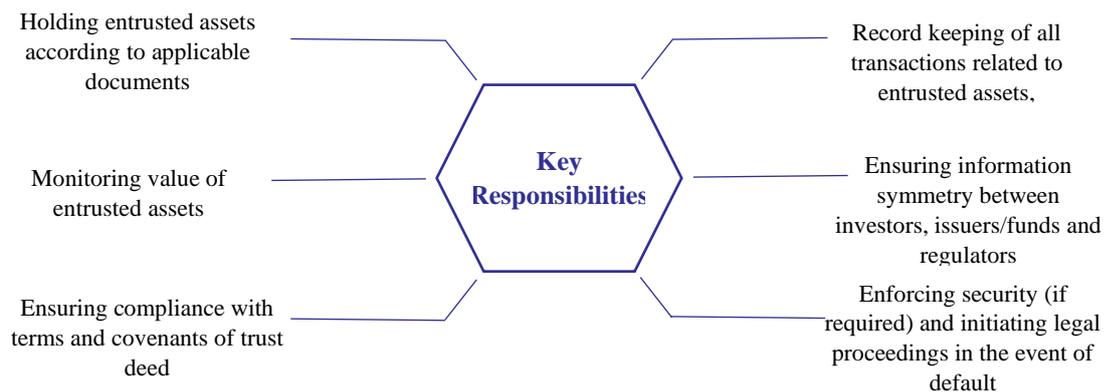
- Trustees responsible for safeguarding rights of investors in variety of transactions
- Regulated under various sets of laws issued by SECP
- Trustee Fiduciary Rating (TFR) – an independent opinion on trustee’s quality of management, sustainability of operations, and adequacy of systems and controls deployed in performing responsibilities of protecting investor rights and managing entrusted assets

0.1 Overview: Trustees play a critical role in capital markets by safeguarding the interests of individual investors in various types of transactions. Trustees are appointed by issuers of securities but undertake the role of an independent third party representing the rights of investors. Thus, establishing credence in the ability of trustees to perform their obligations in protecting investor interests and managing entrusted assets is key towards establishing investor confidence.

0.2 Regulatory Framework: The Securities and Exchange Commission of Pakistan (SECP), the primary regulator of capital markets in the country, has issued various sets of laws and regulations governing the licensing, registration and obligations of trustees in different transactions. Under the regulatory framework, trustees are required to be appointed for a variety of transactions including:

Debt Securities	Funds
<ul style="list-style-type: none"> • Debentures stock • Loan stock • Bonds • Notes • Commercial paper • Term finance certificates • Sukuk 	<ul style="list-style-type: none"> • Collective investment schemes (mutual funds) • Pension funds • Private funds • Real Estate Investment Trusts (REITs) • Exchange traded funds • Private equity and venture capital funds

0.3 Role of Trustees: While the essence of a trustee’s role remains as described above, their roles and responsibilities may vary according the type of transaction, relevant regulatory framework and terms of underlying agreements. The primary document laying out the obligations of a trustee for each transaction is the Trust Deed. The following diagram depicts the key responsibilities of a trustee.



0.4 Scope of Rating: Given the crucial role of trustees in preserving the rights of investors, PACRA’s Trustee Fiduciary Rating (TFR) aims to facilitate investors in distinguishing between different trustees on the basis of their quality of management, sustainability of operations, and adequacy of systems and controls deployed in performing their responsibilities of protecting investor rights and managing entrusted assets. The envisaged rating will primarily be based on evaluation of qualitative factors. Meanwhile, some quantitative considerations will also be factored into the analysis insofar as they reflect the trustee’s ability to sustain operations and potentially expand its business. PACRA’s key rating considerations are segregated into the following factors in this methodology: i) Profile, ii) Ownership & Governance, iii) Management & Systems, iv) Risk Management & Regulatory Compliance, and v) Business & Financial

Sustainability. This methodology is not intended to provide an exhaustive list of all considerations reflected in PACRA’s ratings. However, it should enable issuers, investors and other market participants to understand the considerations, which are usually the most important.

0.5 Rating Scale: Trustee Fiduciary Rating scale ranges from TFR1 (reflecting very strong quality of management, systems and controls, and very high likelihood of sustaining operations) to TFR5 (reflecting weak quality of management, systems and controls, and low likelihood of sustaining operations). The scale is appended with “+” and “++” signs to denote relative status within each category except “TFR1” and “TFR5”.

1. Profile

- Scope and complexity of operations
- Licenses held by trustee

1.1 Operations: PACRA initiates its assessment by looking at the scope and complexity of the trustee’s operations. This includes reviewing the licenses held by the trustee. While some may only be functioning as trustees, others may have a more comprehensive set of offerings with licenses to act as custodians, share registrars, intermediaries etc. Further, the regulatory framework laid out by SECP grants eligibility to certain financial institutions, namely scheduled banks and development finance institutions (DFIs), and investment finance companies to act as trustees provided, they meet certain credit rating criteria. Here, the scope of operations is expected to be a lot more expansive and diverse, with trustee function likely to be a small component of overall operations. Even outside of financial institutions, a single trustee may provide services for various investments including debt securities and funds. Thus, it is important for PACRA to develop understanding of the company’s product slate to gauge the nature and scale of operations which would ultimately determine the comprehensiveness of systems and controls to manage and sustain those operations.

2. Ownership & Governance

- Association with financial/non-financial/international group vs. standalone entity
- Willingness and ability of owner to extend support in distressful circumstances
- Role of Board in designing and implementing policies and controls

2.1 Ownership: PACRA looks at the key owners of the trustee. The ownership structure is studied to understand the shareholding mix in terms of: individual vs. institutional owners, foreign vs. local owners, ownership of single group/family vs. multiple institutions/individuals, and whether the trustee is part of a group or is a standalone entity. Compared to standalone entities, PACRA derives greater comfort from institutional, foreign and/or sovereign ownership as ability to provide necessary growth impetus is considered higher. This may be in terms of operational support, brand name, and intellectual capital and expertise, while reputational risk may also be in play. Where available, PACRA reviews the owner’s track record in providing extraordinary support to the trustee in distressful circumstances, particularly in instances where sustainability of operations is threatened. PACRA further considers how an entity is actually run, as, at times, entities are run as owner-driven or family concerns despite being legally structured as companies. Ability of the owners to abide by financial resource requirements prescribed under the regulations is also considered.

2.2 Governance: PACRA analyzes the trustee’s Board of Directors in terms of its size, composition and level of independence. Size of the board may vary as per the scope and complexity of the business operations of the entity while profile of Board members is studied to gauge the depth of related and diversified knowledge and experience. PACRA further reviews the role of the Board and supporting Board committees in developing policies which lay out standardized procedures for key areas of operations including client onboarding, transaction approval and handling, segregation of accounts, conflicts of interest management, record retention, access authorization, and data protection. Involvement of the Board in formulating and implementing policies is considered essential. Meanwhile, existence of a Trustee Oversight Committee (or equivalent forum) for critical and impartial oversight of the trustee’s fiduciary role and soundness of operations is considered important. PACRA reviews the ToRs for such

forum, frequency of meetings and quality of discussions to form a view on how effectively and independently it is discharging its responsibilities.

3. Management & Systems

- Alignment of organogram with entity size, nature of business and requirements
- Relevance and diversity of skills, knowledge and experience of top management
- Quality and frequency of investor communication, instances of negligence or delays in investor reporting, mechanism and efficiency of complaint handling
- Degree of automation of tasks, integration between functions, quality of MIS reports
- Disaster recovery systems and backup plans

3.1 Organizational Structure: PACRA’s analysis of the trustee’s organizational structure focuses on how the entity is organized keeping in view the scope of its operations. Adequacy of staffing in key functions, and management of conflict of interest between functions are two important elements of this analysis. The structure is expected to ensure clear segregation between functions where conflict of interest may arise such as separate reporting lines for operations and marketing/business development divisions.

3.2 Management Team: PACRA assesses the trustee’s management team through the relevant experience of key individuals, their tenure with the entity, dependence on one or few key persons and coherence within the management team. Fitness and propriety of key individuals as per the applicable regulations is ensured. PACRA also considers development of human resources in terms of the company’s ability to attract talent, train and retain its employees. Meanwhile, management’s track record in delivering on projections and sticking to strategies is also assessed. These factors are important as a radical departure in strategy, shake-up in management, or an untested team can each herald sudden changes that may threaten the quality and sustainability of operations.

3.3 Investor Relations: To maintain good relationships and repute with investors, it is essential that a trustee uphold the quality of its services, investor reporting and communication. PACRA would assess the quality of the trustee’s services by looking at:

- Timeliness and accuracy of reporting to investors. Higher frequency of reporting is expected to provide greater comfort to investors due to availability of adequate resources to guide decision making, and is viewed positively
- Past instances of delayed reporting and negligence or delay in identifying and reporting covenant breaches would be considered negatively
- Establishment of convenient mechanism for investors to lodge queries and grievances, preferably digitally. PACRA looks at the nature, number and frequency of complaints received as a measure of the quality of services provided and resultant client satisfaction. The processes in place to record and time taken to address and resolve queries and complaints along with integration of complaint management system with internal control systems is a key part of PACRA’s assessment

3.4 Extent of Automation: PACRA gives due credit to trustees who have robust and secure technology systems in place for automation of operations, digitalization of documentation and integration between functions. Functions which may be automated include monitoring the value of underlying assets, timely payments to investors, compliance with key covenants, and record keeping. To make these key processes flexible and reliable, the technological backbone needs to be robust. The systems deployed need to be capable of capturing, processing and reporting of all transactions and 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, information sharing between functions, type and number of errors encountered, and the quality of reports generated by MIS. PACRA also studies the trustee’s plans and capacity to improve and upscale its systems in line with its business growth objectives to ensure prevention of operational strains in the future.

3.5 Continuity of Operations: PACRA also analyses the adequacy of infrastructure in place along with strong connectivity to form an opinion on the networks and available channels for external communication and data safekeeping. Frequent connection failure, delayed restoration

in connectivity, and irregular infrastructural maintenance can pose a threat to the safety of critical information. PACRA also analyzes disaster recovery and business continuity plans and procedures in place to ensure data is backed up and secure in the event of an operational, technological or natural disaster.

4. Risk Management & Regulatory Compliance

- Existence of risk management systems, mechanisms and policies governing key processes and functions
- Conflict of interest management
- Extent of regulatory compliance

4.1 Ability to Perform Duties: The ability of a trustee to perform its obligations under the applicable regulatory framework and according to the terms of the Trust Deed are a critical part of PACRA’s analysis. Establishment of effective mechanisms to ensure fulfilment of regulatory and legal obligations, and ensuring implementation and adherence to such mechanisms is reflective of strong ability of a trustee to perform its obligations. PACRA is cognizant that the intricacies of such procedures are well-defined within the individual Trust Deed of each transaction. However, it is expected that overall protocols for execution, approvals and timely communication with investors and regulator are in place. Some salient features under PACRA’s assessment include:

4.1.1 For debt securities trustees, mechanisms to ensure:

- Payment of profit to debt securities holders and redemption of the debt security as per the redemption schedule
- Identification of any event of delay or default in payment of profit and redemption of principal amount to the debt securities holders
- Compliance with all the covenants of the Trust Deed
- Sufficiency of quantum of security for secured debt securities to ascertain whether it is sufficient to discharge the claims of debt securities holders as and when due
- Protocols relating to the course of action in the event that the security becomes enforceable or in case the security becomes impaired

4.1.2 For trustees of funds, mechanisms to ensure:

- Sale, purchase, issue, transfer, repurchase, redemption and cancellation of units or certificates are in accordance with Constitutive Documents
- Adherence to investment and borrowing limitations set out in the Regulations and Constitutive Documents
- Methodology and procedures for calculating the valuation and pricing of units

4.2 Control Environment: Establishment of robust control systems and policies is indicative of a strong control environment which is crucial for a trustee to maintain quality, integrity and transparency in its operations. PACRA favorably views system-driven and/or physical segregation between functions to restrict flow of confidential information. PACRA would also assess the trustee’s management of segregated accounts (such as debt redemption or debt servicing reserves) for distributions to investors on behalf of issuers. Here, the trustee’s ability to establish controls to prevent comingling of funds is of utmost importance to avoid payment interruption to investors. The trustee is also obligated to reporting actual or potential breaches of its own to investors and the regulator. In this regard, establishment of whistle-blowing mechanisms and encouraging speak-up culture are considered valuable in maintaining institutional integrity through timely identification of maladministration and fraudulent practices.

4.2.1 Managing Conflicts of Interest: PACRA evaluates whether the trustee plays other key roles in the underlying investments which may give rise to conflicts of interest. Some aspects of conflicting interests are curtailed through regulatory provisions, for example:

- limits on investment in the debt instrument/funds for which they are trustees
- restrictions pertaining to ownership

- restrictions on certain roles of trustee (e.g., debt securities trustees may not be underwriters to the debt instrument)

A trustee which itself is not invested in the transaction for which it is appointed would be viewed favorably due to implied impartiality in its oversight and decision making. However, trustees often play multiple roles in transactions which increases susceptibility to conflicts of interest between their various roles. This can be particularly be the case for financial institution trustees in which they or their associated companies which take up a variety of roles in an issuance of a debt security, for example banker, consultant, underwriter and arranger to an issue. Furthermore, PACRA considers that being trustee to multiple transactions of a single entity may also diminish the oversight role over the medium term to prevent loss in business.

4.3 Regulatory Compliance: Regulatory compliance is crucial for trustees due to the sensitive nature of their fiduciary role and possibility of suspension of operations by the SECP upon material negligence or breaches. 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 in place to ensure compliance and independence of the compliance function provide assurance that the trustee’s service continuity will not be affected due to potential regulatory breaches. Meanwhile, past instances of breaching obligations or legal/regulatory action against the trustee (past or ongoing) in the form of penalties, restrictions on activities, refusal on renewal of registration or temporary suspension of license can be expected to suppress the rating.

5. Business & Financial Sustainability

- Relative position among peers in terms of volume of business and earnings
- Financial ability to sustain and expand operations, repay obligations, and meet unexpected outflows

5.1 Market Position & Performance: PACRA considers the relative position of the trustee among peers to form a view on its ability to sustain pressure on its volume of business and earnings. A trustee’s market position is driven by its tenure of operations, experience of participating in transactions of varying complexity, track record of fulfilling roles and responsibilities and market reputation. Ultimately, a trustee with a superior market position can be expected to exhibit greater volume and stability in earnings, thus enhancing its ability to sustain and expand its operations alongside upgrading its technological infrastructure and control systems to maintain quality of services.

5.2 Adequacy of Financial Resources: Fulfilment of minimum applicable regulatory equity requirements at all times is considered. While trustees do not require significant cash outlay in the normal course of operations, it is important that they maintain sufficient financial resources to support technological upgradation and human resource spending. Ability to meet unexpected outflows including regulatory penalties and potential losses caused by commingling of funds is also a consideration. While borrowing is an uncommon feature, where applicable, PACRA would evaluate ability to make timely and full repayments by looking at the trustee’s credit rating. Meanwhile, existence of adequate insurance arrangements to mitigate risks such as professional indemnity, employee negligence or fraud and data theft would provide comfort to the rating.

Trustee Fiduciary Rating

An independent opinion on the quality of management, sustainability of operations, and adequacy of systems and controls deployed by a trustee to perform its responsibilities of protecting investor rights and managing entrusted assets

Scale	Definition
TFR 1	Very Strong. Very strong quality of management, systems and controls, and very high likelihood of sustaining operations
TFR 2++ TFR 2+ TFR 2	Strong. Strong quality of management, systems and controls, and high likelihood of sustaining operations
TFR 3++ TFR 3+ TFR 3	Good. Good quality of management, systems and controls, and above average likelihood of sustaining operations
TFR 4++ TFR 4+ TFR 4	Adequate. Adequate quality of management, systems and controls, and average likelihood of sustaining operations
TFR 5	Weak. Weak quality of management, systems and controls, and low 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) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) 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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