



## Methodology Broker Management Rating

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### Summary

PACRA's Broker Management Rating aims to facilitate investors to differentiate between brokers on the basis of quality of management and services provided. Brokerage industry is characterized as very dynamic and volatile due to its direct dependency on the performance of capital markets. PACRA's analysis is based on a mix of factors, namely: Ownership, Governance, Management, Business Sustainability and Financial Sustainability. The relative importance of each of these criterion can vary depending on its potential to change the overall profile.

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**0. INTRODUCTION**

- Scope
- Project Grading - Key Factors

**INTRODUCTION**

*A sound financial ecosystem is critical for functioning of any economy. It is defined by interaction of providers of funds - savers, users of funds - borrowers, financial institutions, and regulators. This system ensures smooth flow of funds between savers and borrowers; wherein, financial institutions provide platform for their interaction. Regulatory oversight safeguards the sanctity of this system. Like all systems, financial system has its own set of challenges. The most prominent being “Risk”; the risk that some participant may not be able to meet its commitments. All participants do their best to manage this risk to maximize their return. This is not possible unless we have independent information on this risk. Here comes expertise of rating agencies, providing independent opinion on credit risk. Flow of funds is only possible when the provider of funds has confidence that user of funds will be able to return these in a timely manner and as committed. Ratings help build this confidence. A higher rating means higher likelihood of timely repayment compared to a low rating. Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of a company’s performance as well as for peer comparisons.*

**0.1 Introduction - Broker Management Rating (BMR):** Brokers play a critical role in the 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 Management Rating aims to facilitate investors to differentiate between brokers on the basis of quality of management and services provided.

**0.2 Regulatory Landscape:** Brokers are regulated primarily by the Securities and Exchange Commission of Pakistan. The regulator has designed a comprehensive set of laws and regulations for Brokers. Following are the key regulations applicable to the brokerage segment:

Securities Brokerage	Promulgated / Last Updated
Securities Brokers (Licensing and Operations) Regulations, 2016	Updated February 2020
Research Analyst Regulations, 2015	Updated August 2017
Securities and Future Advisors (Licensing and Operations) Regulations, 2017	Updated February 2020
PSX Rule Book	Updated May 2020
CDC Regulations	Updated November 2019
Securities and Exchange Commission of Pakistan Act, 1997	Updated August 2016
NCCPL Regulations	Updated March 2020
Futures Market Act, 2016	April 2016
Anti-Money Laundering Act, 2010	Updated February 2016
Joint Inspection Regulations, 2015	October 2015

Securities Act, 2015	April 2015
Underwriters Rules, 2015	February 2015
Non-Banking Finance Companies (Establishment and Regulation) Rules	Updated April 2019
Securities and Exchange Ordinance, 1969	Updated 2012
Securities (Leveraged Markets and Pledging) Rules, 2011	February 2011
Commodity Exchange and Futures Contract Rules, 2005	March 2005
Central Depositories Act, 1997	April 1997
Public Offering (Regulated Securities Activities Licensing) Regulations, 2017	Updated February 2020

**0.3** PACRA uses the key parameters listed in the table below to assess the quality of operations of a broker and the services offered by it. Each parameter is assessed individually. These assessments are then aggregated to arrive at the final rating.

## OWNERSHIP

**1.1 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, inter-alia, include: i) shareholding structure which includes whether the individual(s) own the entity directly or indirectly, ii) foreign or local shareholders, iii) whether the entity is owned by a single group or through a combination of entities and individuals, and iv) whether it is part of a group or a standalone entity. All these deliberations are done to identify the man of the last mile. PACRA further considers how an entity is actually run, as, at times, entities are run as family concerns despite being legally structured as companies.

**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 entity's 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 equity ownership 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 extracting funds from the entity as source of income or to fund other business activities, potentially undermining the financial stability of the entity.*

**1.2 Stability:** In order to analyze the stability of ownership, a 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, the entity's prospects

would be supported and by whom. This is particularly relevant in case of family owned businesses and joint ventures, whose failures could have a contagious effect on the sustainability of the entity. A stable ownership with clarity in succession, perhaps major stakes residing with one family or group, is considered positive for ratings. On the contrary, high free float (in case of listed concerns) leads to risk of take over and may anchor lower ratings.

**1.3 Business Acumen:** PACRA gauges the sponsors’ business acumen. Having a strong business acumen set has been critical for sustainable success. PACRA analyzes business acumen through two primary areas: i) industry-specific working knowledge, and ii) strategic thinking capability. Meanwhile, a deep and applicable understanding of the system is critical in order to determine how a business achieves its goals and objectives. The scope includes the assessment and understanding of how the sponsors of the entity deliberate over and successfully make the right business decisions.

**1.4 Financial Strength:** PACRA analyzes the ability and willingness of the major shareholders to support the entity both on a continuing basis, and support in times of crisis. Here, PACRA gives due importance to: i) behavior of the major shareholders to provide timely and comprehensive support in times of need in the past, ii) prospective view of key shareholders, in case such need arises, iii) other businesses of sponsors, and iv) the level of commitment of the major shareholder with the entity in providing capital support. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. Support, in this context, refers strictly to financial support, rather than operational support. The scope for looking at other business of sponsors includes overall profiling of the key sponsors in the context of identifying the resources they have, outside the entity. If, in a group structure, the financial strength of the sponsor is deemed to be weaker than that of the entity, this may bode negatively for the entity’s standalone rating given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent.

## 2. GOVERNANCE

- Board Structure
- Members' Profile
- Board Effectiveness
- Transparency

### GOVERNANCE

**2.1 Board Structure:** This comprises assessment of board on various criteria including overall size, presence of independent members, and duration of board members’ association with the entity, overall skill mix and structure of board committees. Size of the board may vary as per the scope and complexity of the operations of the entity. While a very small board is not considered good, similarly, reaching a decision in an effective and efficient manner may not be possible in case of a large board. A healthy composition of board includes the presence of independent/non-executive members having limited relationship with the sponsoring group 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. Compliance with the code of corporate governance is also examined. PACRA also examines the independence of governance from major shareholders. Lastly, PACRA evaluates number of board committees, their structure, and how these committees provide support to the board. A board with higher number of members should have higher number of committees in place to assist in performing its role.

**2.2 Member’s Profile:** PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about overall quality of the board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have related experience.

**2.3 Board Effectiveness:** In PACRA’s view, the role of the board is to work with management in steering the entity to its performance objectives and to provide critical and impartial oversight of management performance. PACRA analyzes the type and extent of information shared

with board members, and quality of discussions taking place at board and committee levels. Effective oversight requires frequent sharing of detailed information covering various aspects of business and market development. Meanwhile, PACRA also reviews the number of board meetings held during the year as these 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.

**2.4 Financial Transparency:** Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial and other information. This can be achieved through: i) ensuring independence of the audit committee, ii) strengthening the quality of internal audit function, which may be in-house or outsourced, and iii) improving quality of external audit by engaging auditors which are included in the State Bank of Pakistan’s panel of auditors and/or have a satisfactory QCR rating.

***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.*

### 3. MANAGEMENT

- Management Team
- Organizational Structure
- Client Servicing
- Complaint Management
- Extent of Automation / Integration
- Continuity of Operations
- Risk Management framework
- Regulatory Compliance

### MANAGEMENT

**3.1 Management Team:** Good quality management implies that the broker has effective systems and controls, and well-defined strategy to achieve a desired level of excellence. PACRA assesses the management quality in terms of the experience profile of key individuals and their tenure with the company, 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 also 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, 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, on the entity.*

**3.2 Organization Structure:** PACRA’s analysis of the organizational structure focuses on how the company is organized keeping in view the scope of operations, confidentiality and conflict of interest within departments as well as with the clients.

**3.3 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 programmes), 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.

**3.4 Complaints 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 brokerage company.

**3.5 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 all 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.

**3.6 Continuity of Operations:** PACRA also analyses the adequacy of infrastructure in place, adequacy of connectivity with the exchange, communication network, frequency of connection failure and time taken to restore the connection, database maintained, back up procedures, disaster recovery and business continuity plan, and documentation and monitoring of channels of communication etc. 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.

**3.7 Risk Management Framework:** PACRA assesses the robustness and reliability of the risk management systems. Evaluating the overall risk management framework enables to determine how various risks are identified, monitored and mitigated across the brokerage house. The efficiency of controls and effectiveness of the internal audit function within a brokerage house is instrumental in mitigating risks arising from operational failures.

**3.7.1 Operational Risk and Control Environment:** Operational risk is the risk of loss resulting from inadequate or failed internal processes, 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 company's following policies and procedures and update frequency helps to determine the viability of the operational control environment against unanticipated errors and failures.

**3.8 Regulatory Compliance:** Regulatory compliance is very important in the broking 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 adequate legal and regulatory compliance. An objective assessment of the attitude of management towards legal compliance and the systems set in place to ensure compliance provide assurance that the broker's service continuity will not be affected by the regulator's penal action. 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.

#### 4. BUSINESS SUSTAINABILITY

- Business Risk
- Business Profile
- Revenue and Profitability Analysis

#### BUSINESS SUSTAINABILITY

**4.1 Business Risk:** Business risk is the possibility that a broker will have lower than anticipated profits or experience a loss. It impairs a broker’s ability to provide its investors and stakeholders with adequate returns. The broker’s business strengths and financial soundness are assessed to ascertain the sustainability of its operations.

**4.2 Business Profile:** PACRA assesses the company’s branch network, number of licenses the company holds for carrying out different activities, category under which the company has obtained license (Trading and Self Clearing, Trading and Clearing or Trading), whether it is listed or unlisted, number of clients’ CDS account i.e. investor accounts and sub-accounts and market share.

**4.3 Revenue and Profitability Analysis:** PACRA also analyses the revenue quality. PACRA sees concentration at both product and customer levels. Broking businesses derive strength from diversity of revenue streams; brokers that are not dependent on a few major players, and therefore, have low concentration risk, are better placed. The structure of brokerage fee is evaluated: the mix of value versus scrip revenue, the mix of institutional, HNWs and individuals, the interplay of foreign vs. local clients, the longevity of the relationship, the trend analysis, the average brokerage fee and its relativeness in the industry, and operational profitability. The alternative revenue streams from underwriting and advisory are analyzed to form a view on how significant these are and whether these represent a sustainable revenue stream.

#### 5. FINANCIAL SUSTAINABILITY

- Credit Risk
- Market Risk
- Liquidity Risk
- Financial Risk

#### FINANCIAL SUSTAINABILITY

**5.1 Credit Risk:** 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, liquidation of client accounts where necessary and number of days receivables are outstanding.

**5.2 Market Risk:** 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 play 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. PACRA examines the general strategy with regards to proprietary trading, stability and profitability of sectors and companies invested in, cutoffs for exit from stock market and measurement of risk (Value at Risk – VAR, stress scenarios etc).

**5.3 Liquidity Risk:** Liquidity risk occurs due to insufficient funds to meet obligations when they fall due. PACRA analyses liquid investments against the company’s funding base and the brokerage’s ability to raise timely and cost-effective funds from external sources.

**5.4 Financial Risk:** Given the volatile nature of the equity broking industry, the broker’s ability to maintain the related capital regime is analyzed to form a view as to the sustainability of operations. Strong capital levels provide necessary cushion in terms of absorbing any delay in collections from clients and losses during bad capital market.

## Broker Management Rating

An independent opinion on the quality of management and services provided by the broker

Scale	Definition
<b>BMR 1A</b>	<b>Excellent.</b> Excellent regulatory compliance, control environment, and financial management; governance and risk management frameworks are extremely effective; HR, IT, and customer services are strongly proactive.
<b>BMR 1++</b> <b>BMR 1+</b> <b>BMR 1</b>	<b>Strong.</b> Strong regulatory compliance, control environment, and financial management; governance and risk management frameworks are highly effective; HR, IT, and customer services are highly proactive.
<b>BMR 2++</b> <b>BMR 2+</b> <b>BMR 2</b>	<b>Sound.</b> Sound regulatory compliance, control environment, and financial management; governance and risk management frameworks are effective; HR, IT, and customer services are proactive.
<b>BMR 3++</b> <b>BMR 3+</b> <b>BMR 3</b>	<b>Adequate.</b> Adequate regulatory compliance, control environment, and financial management; governance and risk management frameworks are satisfactory; HR, IT, and customer services are adequate.
<b>BMR 4++</b> <b>BMR 4+</b> <b>BMR 4</b>	<b>Inadequate.</b> Inadequate regulatory compliance, control environment, and financial management; governance and risk management frameworks need improvements; HR, IT, and customer services are insufficient.
<b>BMR 5</b>	<b>Weak.</b> Weak regulatory compliance and business practices.

<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’.	<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.	<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.	<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.	<b>Harmonization</b> A change in rating due to revision in applicable methodology or underlying scale.
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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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