Methodology
Broker Entity Rating

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Summary

PACRA's credit rating is a representation of its opinion on the relative credit risk associated with the entity being rated. PACRA arrives at this opinion by evaluating the entity's business and financial risks, its competitive strengths, along with an assessment of its management quality and the operating environment. Given the inherent volatility in the industry, the assessment of the financial risk profile of a broker also focuses on ascertaining the sustainability of its business operations in stressful times. While several parameters are used, the relative importance of each of these qualitative and quantitative criterion can vary across entities, depending on its potential to change the overall risk profile.

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0. INTRODUCTION

- Scope
- Rating Framework

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, brokers, and regulators. This system ensures smooth flow of funds between savers and borrowers; wherein, brokers 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 Scope: This methodology applies to securities brokers. These are regulated primarily by Securities and Exchange Commission of Pakistan under the Brokers and Agents Registration Rules 2001. SECP issued final Securities Brokers Regulations, June 2016. The firm, to undertake brokerage business, needs to be a TREC holder of an exchange, participant in CDC, a clearing member of NCCPL, and registered with SECP. In the latest regulations, SECP has created a distinction between Trading, Trading and Self Clearing and Trading and Clearing brokers. Separate set of regulations apply to each category including minimum capital, net worth and minimum net capital balance.

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

0.2 Rating Framework: PACRA bases its analysis of brokers on a number of quantitative and qualitative factors, the most significant of which are Profile, Ownership, Governance, Management, Business Risk and Financial Risk. No one factor has an overriding importance or is considered in isolation and all the factors are reviewed in conjunction.

0.2.1 The quantitative factors helps in achieving objectivity in the rating process while the qualitative side helps in establishing the sustainability of the relevant factors in the foreseeable future. Neither all factors can be quantified nor do quantitative values portray the whole story. PACRA, therefore, seeks to employ a best combination of both and would stick to it to ensure comparability on historical as well as synchronic basis.

0.2.2 The basic precepts of this rating methodology is understanding of the business model of the broker (and the inherent risks), the strategy of its management, local macro-economic environment, and developments happening in the industry. The relevant positioning of the broker, established in comparison with relative peers in the industry, is a key consideration under this methodology to reach a final rating for a broker.

0.2.3 While our rating process does not include an audit of a broker's financial statements, it does examine the control environment to establish to which extent they accurately reflect a broker's financial performance and balance sheet integrity. We make adjustments where necessary to make a broker's financial data comparable with those of its peers. In order to carry out adequate analysis of a particular broker, it is helpful to establish a "peer group" of comparable brokers. Short-term and long-term ratings are based on an entity's fundamental credit characteristics, a correlation exists between them (see PACRA's Criteria document "Correlation between Short-term and Long-term Rating Scale").

1. PROFILE

- Background
- Operations

PROFILE

1.1 Background: PACRA reviews the background of the entity to understand its evolution from where it started to where it currently stands. We analyze how and through what means the entity has achieved the desired expansion. PACRA looks at the progress of the entity from its historical past. The progress of the entity helps PACRA in determining the ability of the entity to successfully realize its strategy. The significant factor here for PACRA is to assess whether the entity has achieved the desired expansion through organic growth or acquisitions. Meanwhile, the source of funding for desired growth is also critical.

1.2 Operations: The assessment of operations of an entity depends on the exposure of business segments and the stage the business is in. Understanding of operations help PACRA to identify the types of business risks a broker could face together with its ability to safeguard or defend existing businesses, and gain new business. Here PACRA reviews the diversity, geographic spread of operations, strength and quality of the franchise, licenses, business model, risk management framework, Standard operating procedures, policies and protocols, and product offering. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position.

2. OWNERSHIP

- Ownership Structure
- Stability
- Business Acumen
- Financial Strength

OWNERSHIP

2.1 Ownership Structure: The assessment of ownership begins with an in-depth study of the shareholding mix in order to disentangle structure of the ownership. Key factors that are considered for this purpose, inter-alia include, i) shareholding structure which includes whether the individual 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) part of a group or a standalone entity. All these deliberations are done to identify the man of the last mile. Secondly, analyzing shareholding structure is also important as clarity on ownership generally lacks in a joint venture agreement. Meanwhile, brokers backed by strong institutions and/or foreign broker as strategic investors are expected to have strong financial strength, adequate internal controls and processes and thus are expected to provide higher comfort as compared with other companies which are backed by individual sponsors. PACRA draws comfort from the institutional and/ or foreign ownership as the ability of the broker to raise capital from key sponsor/s, as and when required, is an important credit driver.

Complex shareholding/ownership structures: *In cases where a broker 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.*

2.2 Stability: In order to analyze the stability of the ownership, a particularly important factor to be taken into account is the succession planning. A very important part of our background analytical work is an attempt to assess whether, and under right of succession, an entity future prospects would be supported, and by whom. A key criteria for PACRA is existence and form of sponsor's agreement. A well-documented sponsor's agreement is considered to bring stability in the long run compared to verbal agreement. A broker's dependence on a single owner, executive or small group of executives can pose increased risks, because the loss of a single person could adversely affect its prospects. Ownership by or reliance on any single individual or group of individuals can also create conflicts of interest and lead to reputational damage by association with such persons, should they become embroiled in adverse publicity from other unrelated activities

2.3 Business Acumen: Here PACRA gauge the Sponsor's business acumen. Having a strong business acumen set has been critical for the sustainable success of the entity. PACRA analyze 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 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 think about and successfully make the right business decisions.

2.4 Financial Strength: Our Framework involves reviewing the sponsor's track record in terms of business growth and support to the business. The sponsor group's prior track-record, commitment to the business along with the financial support extended to the venture in distressful times is also considered. No history of litigations or regulatory fines, would be viewed favorably by PACRA over an aggressive business growth with a track-record of regulatory violations. PACRA critically analyses the willingness and ability of the major shareholder to support the entity to comply with regulatory requirements within required timeframe. Thus ongoing support is considered more likely in these cases. 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 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. The scope for other business of sponsors includes overall profiling of the key sponsor in the context of identifying the resources they have, outside the entity.

Table 1. Information Required on Ownership

- Shareholding pattern
- Details of sponsors' other businesses
- Sponsors' financial information
- Past pattern of sponsor support

3. **GOVERNANCE**

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

GOVERNANCE

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

3.1 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.

3.2 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.

3.3 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.

3.4 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 a Broker'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.*

Table 2. Information Required on Governance

- Profile of BoD members
- Details of committees including TORs
- Minutes of the board meetings
- Information packs for the Board (MIS)
- External auditor detail

4. MANAGEMENT

- Organizational Structure
- Management Team
- Management Effectiveness
- Risk Management Framework

MANAGEMENT

4.0 Good quality management, effective systems and controls, and well-defined strategy are essential ingredients for a successful entity.

4.1 Organization Structure: The assessment of management starts with PACRA conducting an in-depth analysis of organizational structure of the entity. On a standalone basis, PACRA looks into the hierarchal structure, reporting line and coherence of the team. However, PACRA also places the organizational structure in the entity's relative universe for comparison in order to form opinion of optimal structure within the sector in context of its complexity. Number of management committees are established to monitor performance and assure adherence to the policies and procedures. PACRA measures the effectiveness of the entity by forming an opinion on the quality of management committees.

4.2 Management Team: Analysis of management includes evaluating experience profile of key individuals, management's track record to date, in terms of building up sound business mix, maintaining operating efficiency and strengthening the entity's market position. Although judgment about management team is subjective, performance of the entity over time provides a more objective measure. PACRA analyses the quality and credibility of management's strategy, examining plans for internal or external growth. Loss of key personnel, particularly members of senior management, can have potentially adverse effects on overall standing of the entity relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments. Similarly, dependence of the management team on one or more persons is considered risky. In addition, the entity's human resource policies are also reviewed to gauge its emphasis on retaining and recruiting vital staff.

Key-man Risk*: Key-man risk occurs when a Broker 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 commonly identified 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 a Broker is dependent on the expertise of such individual(s) and to ensure policies exist for managerial succession to limit the adverse impact of such a person unexpectedly leaving, on the Broker.*

4.3 Management Effectiveness: PACRA conducts a qualitative review of management systems and technology infrastructure to assess management effectiveness. A key measure of management effectiveness is its track record of delivering on past projections and sticking to strategies. One of the key tools available to management to effectively run an organization is the information provided to it. It is critical that information available to management be concise, clear and timely, so it can be interpreted and understood, and the management can respond accordingly. An important part of this analysis is looking at the entity's MIS. PACRA further assesses whether management has developed any critical success factors to evaluate performance of various business segments, and their efficacy. Management meeting minutes are also reviewed, wherever available, to assess the quality of discussion.

MIS: *System generated – real-time based – MIS reports add more efficiency in decision making whether related to operational, financial or strategic issues. PACRA evaluates the quality and frequency of the MIS reports used by the management team to ascertain that decision-making within the entity is information-based.*

4.4 Risk Management Framework: This includes an analysis of the entity's appetite for risks and the systems in place to manage these risks. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits that have been implemented, limits setting authority and the degree to which these procedures are adhered to. PACRA endeavors to assess senior management's understanding of and involvement in risk management issues and examine the reporting lines in place. In recent years, there has been a noticeable upgradation in the risk management systems of the brokers, in the face of increasing guidance and supervision from the SBP and SECP.

Credit risk: *The 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.*

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. For trading activities, our assessment of market risk focuses on the degree of market risk exposure and the means of measuring and managing it. Market risk on its own may not be a rating driver; however, poor market risk management or aggressive market risk-taking without mitigants would likely pressure a broker's ratings.*

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 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 mitigants and limits are considered superior. Herein, PACRA also reviews broker approach towards ALM, brokers funding their proprietary book through raising short term funding is consider highly risky regardless of the positive spread over funding cost.*

Operational Risk: *Operational risk has historically been defined as all other risks other than market, credit and liquidity risk. In the context of Basel II and Basel III, definition of operational risk is: "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events".*

Our analysis of operational risk focuses on a number of issues, including (a) an entity's definition of such risk (b) the quality of its organizational structure (c) operational risk culture (c) the development of its approach to the identification and assessment of key risks (d) data collection efforts; and (e) overall approach to operational risk quantification and management.

Reputation and Other Risks: *Reputation risk may emanate from operational problems or failure in any risk management systems. It may be difficult to evaluate but could adversely affect an institution's rating in cases where it is significant. In addition to reputation risk, any regulatory non-compliance may lead to legal risk with potential ramifications as well.*

Table 3. Information Required on Management

- Latest organogram
- Profile of senior management
- Redundancy pattern
- MIS reports
- Management meeting minutes
- Entity's policies and SOP

5. BUSINESS RISK

- Industry Dynamics
- Relative Position
- Revenue
- Profitability
- Sustainability

BUSINESS RISK

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

5.1.1 PACRA explores the possible risks and opportunities in an entity resulting from social, demographic, regulatory and technological changes. It considers the effects of geographical diversification and trends in industry expansion or consolidation required to maintain a competitive position. The analysis includes the role of the supervisory authority, its supervision of regulated entities, reporting requirements and regulations relating to specific type of brokers and to specific financial products.

Economic Risk: *While analyzing economy, PACRA evaluates economic policies, GDP growth, and performance of important sectors in the economy. An important part of economic analysis is positioning of industry and impact assessment of economic risk factors on the industry.*
Regulatory Environment: *A well-regulated and supervised system is pivotal for credibility and stability of Brokers even when the operating environment is unfavorable. PACRA's evaluation of the regulatory system involves evaluation of criterion related to capital and other countercyclical measures to absorb risk and the extent of regulatory supervision and changes in response to the macro environment and prospective regulatory changes.*

5.2 Relative Position: Relative position reflects the standing of the entity in the related market. The stronger this standing is, the stronger is the entity's ability to sustain pressures on its business volumes and profit margins. This standing takes support from two major factors including a) market share, b) growth trend.

Market Share: *Market size represents the entity's penetration in the chosen market. Size is advantageous as it provides ability to acquire larger business, pricing power and better expense management. There is a positive correlation between an entity's absolute and relative size and its market position and brand value. The large entities exercise greater power over the pricing, while ensuring commensurate profits. Small entities struggle to obtain business; and with less flexibility in the cost structure, their profits remain low. While absolute size is important, it is basically the relative proportion which provides a clear yardstick to analyze the comparative strength of the market players. The more distant a player is from the average on the positive side, the stronger is its ability to reflect the characteristics just mentioned. In a dynamic industry, which is not characterized by concentration, PACRA believes that relative size would better capture the strength of the entity's standing in the related market.*

Growth Trend: *While evaluating the size, PACRA looks at the rate of growth. Growth is important as it ensures that the entity continues to have the ability to meet the industry's benchmarks. As the industry grows, it uplifts the scale of its operational context. This reflects in the ability of the players to invest in human resource, upgrade the control environment, enhance the product slate, increase the outreach and improve the quality of product/service. To lag the industry's growth trend means to remain short on these avenues, putting pressure on the market position.*

5.3 Revenues: In measuring earning's quality of an entity, diversification and stability are very important factors. Broker with a diverse product slate with more than one revenue streams is considered better than a broker with a concentrated earning profile. PACRA sees concentration at both product and customer levels. The analysis of business risk of a broker is based on a clear understanding of two lines of business in which the firm may engage itself. One is the fee-based revenue stream and the second is fund based revenue stream. PACRA generally tends to name the first source of revenue as the core business. While the second source of revenue may still be fundamental to the overall profitability of the broker, it is usually termed non-core to contrast it with the core fee based income. This clarity is helpful in understanding the issues surrounding the sustainability of the broker, to be rated. The core revenue needs to present a strong case for the continuity of the firm. This is evaluated by comparing the core revenue with the cost of doing business. The cost which is compared against the core revenue qualifies the test of relatedness. Only the cost incurred for the core business is pitched against the core revenue.

5.3.1 PACRA considers three types of revenues as core: brokerage, commission and advisory fee. The first type of revenue is most prevalent; the second is relevant for firms which are engaged in underwriting etc. The third is yet to make sizable presence in the domestic market. It is pertinent to analyze each of these revenue streams. The structure of brokerage fee is evaluated: the mix of value versus scrip revenue, the mix of institutional, HNWs and individuals, the interplay of foreign vs. local clients, the longevity of the relationship, the trend analysis, the average brokerage fee and its relativeness in the industry, and the mix of buy and sell brokerage. The alternative revenue streams from underwriting, advisory and financing are analyzed to form a view how significant these are and whether these represent a sustainable revenue stream.

Segments
Products
Customers
Geography

5.3.2 Diversification: Diversification is a holistic perspective. It encompasses many aspects which govern the business model of the entity. Multiple array of product provider against mono-line product provider is perceived to have less business risk. Diversification is utmost desirable. The rationale for this is that diversification enhances the ability to meet challenges, both present and upcoming. The lack of diversification gives rise to concentration risk, reflecting vulnerability of the broker. Concentration is considered a major negative because it limits the entity's ability to ensure sustainability in its business let alone expand it. At the same time, it enhances the risk of disruption in the operations if the area of concentration goes wrong. This does not entail that a broker specializing in a certain product/segment would be put at a disadvantage. The disadvantage would only arise, if the company's business gives rise to concentration risk.

5.4 Cost Structure: Cost structure is analyzed for the amount of flexibility provided when market conditions are less favorable. In this regard, PACRA considers how much of the cost base is variable. PACRA also evaluates the entity's performance ratios relative to those of its peers to understand whether costs have been contained while growing assets and revenue. If expense ratios are high, it could be an indicator that the FI has a significant fixed cost burden. In this context, key measure that PACRA looks at are the (Cost as a percentage of Fee Income and Cost as a percentage of Total Operating Income). Non-mark-up expenses are also compared where possible with earning assets and to the number of employees. Performance measures are not assessed in isolation as there may be variations that are caused by business model differences and the importance of ongoing investment in the FI's franchise. A low-cost base relative to peers offers the broker greater flexibility to deal with competitive pricing pressures

Margins: *PACRA looks at the historical trend of a broker's performance, the stability and quality of its earnings and its capacity to generate profits. While taking indicators for a broker with those of its peers. Where possible, it also analyses earnings for each of the broker's business lines. In this context, it looks at the trends in;*

- *Where necessary in its ratings analysis, PACRA makes adjustments to a broker's reported income statement figures, so that financial performance indicators are as comparable as possible from one broker to another.*
- *The related ratios are: fee based income to total income and operating cost to fee based income. The core income/loss explains the firm's strength in its business.*
- *Fund based income is an additional buffer. This may emanate from financing activities, fixed income avenues and generally proprietary book. The depth and diversity of this income stream is analyzed with an objective to form a view whether this is one-off or recurrent. PACRA takes comfort from demonstrated stream of recurrent non-fee based income. Funding to the clients may result in crystallization of credit risk; hence bad debts are analyzed and pitched against financing book. The aging analysis also becomes relevant, though its impact is fully catered in the financial risk analysis of the broker.*

5.5 Sustainability: PACRA evaluates the strategy of the management and the viability of designed path to reach to the goal. Earnings prospects are monitored, based on budgets and forecast prepared by the management. A reality check is performed while analyzing underlying assumption taken by the management as well as management's track record in providing reliable budgets and forecasts.

Event Risk*: Incorporating the risk of unforeseen events into an entity's rating opinion is challenging, given their unpredictable nature. These events may be external (e.g. M&As, regulatory changes or a natural disaster) or may be internally driven (e.g. unrelated diversification or strategic restructuring) and can lead to substantial rating changes. PACRA applies its analytical* *judgment in assessing the likelihood of such occurrences, insofar as may be possible, and assesses the entity's track record, expertise of management team and level of financial discipline to incorporate the same into its ratings.*

Table 4. Information Required on Business Risk

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

6. FINANCIAL RISK

- Credit Risk
- Market Risk
- Liquidity Risk
- Capitalization

FINANCIAL RISK

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

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

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

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

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

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

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

Credit Enhancement: *The entity that carry third party commitment to make good an amount obligated to the lenders may provide additional support to its financial risk profile. In this case, in determining the impact on rating, key factors to assess are the financial profile of the third party and the extent of coverage – quantum and duration – it provides.*

Table 5. Information Required on Financial Risk

- Top 10 trade receivables and top 10 trade payables.
- Top 10 accounts classified under doubtful receivables
- Details of exposure limits for the brokerage operations and measures taken by the management to ensure implementation of these limits
- Details of instances of margin calls during recent one year
- Authority limits of treasury head and other top management as well as policy regarding total investment limit in said securities as percentage of equity
- Details of latest approved funding limits along with outstanding amount
- Internally approved list of eligible securities for margin financing (if any).
- Calculation of net capital balance under Rule 2 (D) of the SECP Rules, 1971
- Aging analysis of receivables
- Statutory reports filed with PSX and SECP

Credit Rating

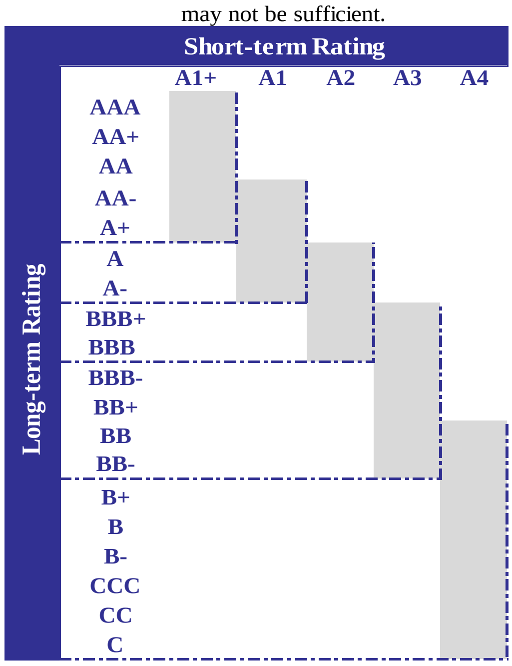
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

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

Short-term Rating

Scale	Definition
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of 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.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) 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 surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

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.

Note. This scale is applicable to the following methodology(s):

Entities

a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments

a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating