

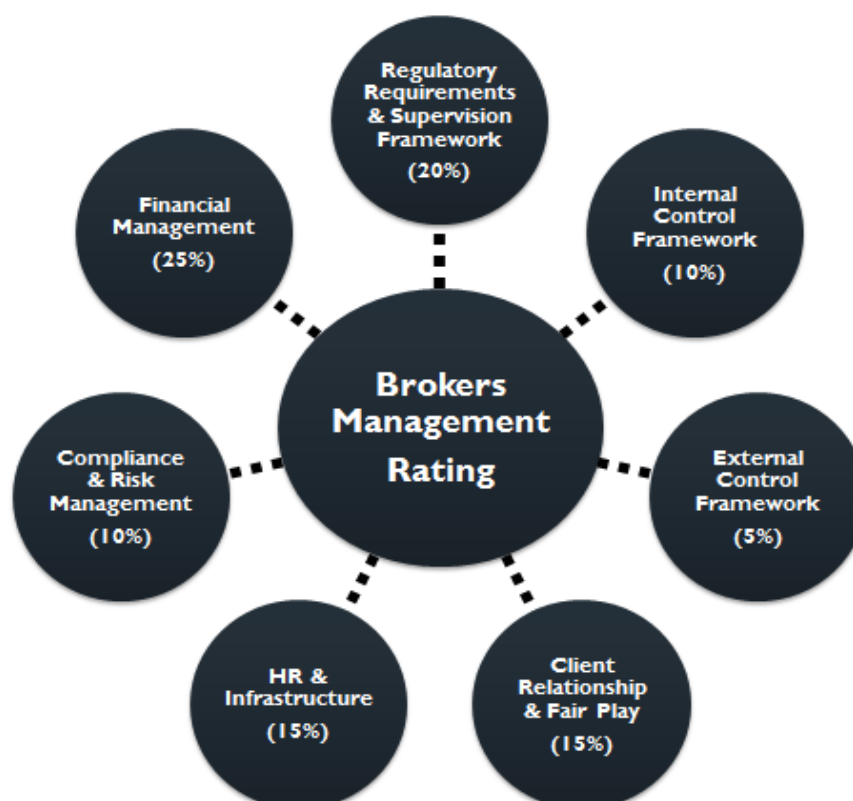
# VIS RATING METHODOLOGY

## Broker Management Ratings

Stock Broker Firms play a critical intermediary role in capital markets for individuals and institutional investors for facilitating the trading of listed securities. The relative financial strength, depth of governance framework and responsiveness of risk and internal control structure along with HR and business infrastructure determine the level of service quality of stock broker firms. Assessment of the fiduciary role of brokers in listed securities trading is very important; aforementioned factors also capture the strength of the same..

VIS Credit Rating Co. Ltd. (VIS) has developed a rating system that evaluates brokerage firms on basis of such practices and the systems instituted to safeguard investor interests.

The methodology for Broker Management Rating (BMR) developed by VIS is unique in the sense that it utilizes a comprehensive and client-friendly interactive web based portal to capture client information and responses which are then assimilated into a rating. The process is supported at the back-end by rating staff who review information online (as filled in portal) and interacts with the client to complete the assignment of respective BMR.



### THE BMR PROCEDURE

All brokerage firms in Pakistan have to be TREC (Trading Right Entitlement Certificates) holders of Pakistan Stock Exchange (PSX). The PSX is regulated by Securities and Exchange Commission of Pakistan (SECP) which has established rules to regulate brokers and listed companies. The SECP and PSX have imposed strict restrictions on trading in order to protect market participants. These rules provide investor protection through minimum capital, exposure limits and margin requirements. Financial audit, system audit, in-depth surveillance by the SECP and PSX as well as the CDC audit is mandatory for brokerage firms; VIS uses the findings of these in its assessment for BMR methodology.

To assess the quality of operations of a brokerage firm, various factors are examined and analyzed. While tables below summarize critical individual factors and related parameters, BMR is not limited to only these.

### Regulatory Requirements and Supervision Framework

- Level of regulatory compliances and strength of corporate governance structure
- Promoters' quality franchise value
- Quality and independence of Board

### Internal Control Framework

- Extent of and compliance with internal control policies & procedural framework
- Depth of conflict of interest policies
- KYC and client confidentiality
- Firewalls between customer and proprietary accounts
- Regulatory compliance

### External Control Framework

- Book keeping and disclosure Standards
- Quality of external auditors
- Transparency and fidelity in handling of customer assets

### Client Relationship and Fair Play

- Fair play and transparency in customer dealing
- Timely client portfolio position reporting
- Value added Services
- Product offering
- Quality of research
- Effective customer support service

### HR & Infrastructure Framework

- Quality and stability of top management
- Organizational structure compatible with strategic direction
- Robustness and sophistication of IT systems
- Adequacy and scalability of MIS
- Strength of back office operations

### Compliance and Risk Management

- Policies monitoring for Exposure and Credit Risk mitigation
- Assessment of Fiduciary relationship
- Strength of monitoring of internal and external compliance benchmarks

### Financial Management

- Market Position
- Earning Strength and Stability
- Capital Adequacy and Leverage
- Asset Quality
- Liquidity management

## **INDIVIDUAL RISK FACTORS AND ASSESSMENT**

### **1. Regulatory Requirements and Supervision Framework**

Brokerage firms operate in a highly competitive industry in which trading activities can be greatly impacted by prevailing economic environment and cycles. The index volume and value can also be greatly affected by event risk, particularly resulting from regulatory and political developments. Such factors can lead to greater volatility in earnings and profitability relative to other industries. The regulatory framework for broker firms, besides being a statutory requirement also is important for providing investor protection and curbing risk factors; strict adherence to the same is considered essential. In addition to the local regulations, international guidelines and regulations on conflict of interest and code of ethics will also be referred to on a continuous basis while conducting these assignments. A view on the corporate structure is developed which includes the franchise and reputation of the promoters along with their financial strength. The quality and independence of the Board is also evaluated to ensure the protection of the company's stakeholders.

Recently, SECP has approved few amendments to broker regulations. Amended regulations categorize securities brokers with enhanced measures for investor protection through safe custody of their assets, improved governance standards, transparency and risk management. Impact of these developments in regulations and the impact of the same on brokerage industry will be an important part of the rating evaluation.

### **2. Internal Control framework**

The important features of internal control framework at a brokerage house encompass the areas of conflict of interest in self and client trades. It is also responsible for KYC of clients and ensuring confidentiality in their trades. Internal control also oversees that policies and manuals for various operational areas are available and updated at approved time frequencies and also that their approvals are obtained from authorized levels in the organization. Strict accountability and fair practices are all assessed under the internal control framework laid out by the firm.

### **3. External Control Framework**

The quality and depth of book keeping standards in a brokerage house are reflective of the transparency in handling its own business and that of the client. Quality of disclosure standards and meeting the regulatory requirements is important from the financial stakeholder's perspective. The clear demarcation of client assets in the book of accounts and the frequency reporting of client assets to the client confirmations thereof are transparency indicators in a brokerage firm. External control framework draws strength from the level of QCR assigned to the external auditors by the ICAP as also their classification in the SBP category of Auditors. The finding of external regulatory inspections such as those by PSX, CDC & NPCCL are also important.

### **4. Client Relationship and Fair Play**

With stock brokers being customer oriented service providers, the level of service provided can be a distinguishing factor. The standard practices in customer facilitation are evaluated; range of product offering, quality of research, transparency of information shared and timeliness of execution of transactions, along with cost effectiveness are key areas of assessment. The mechanism in place for redressal of customer complaints and the quality and frequency of reporting to clients regarding their portfolio status and value along with trade alerts through multiple channels are also important considerations. The level of integration of these channels with the IT system will have a bearing on the assessment. Institutional investors may be viewed more favorably as compared to individual investors. The quality and coverage of research available to the client is another assessment factor.

### **5. HR and Infrastructure**

Success of any organization is largely based on continuity of its business strategy as well as the depth and stability of its management team. The stability and experience of the top management in capital markets and their past performance through business cycles is valuable as well. Remuneration practices for key staff, particularly for client managers and those who are managing firm's own portfolio, represent another area that could provide insights into possible conflict of interest concerns. Succession planning, training, attracting and retaining quality

resource is also important.

VIS places emphasis on the level of controls in place to fulfill the fiduciary responsibility of the broker in keeping the clients' positions and cash balances ring fenced from own and other clients' positions and cash balances from being captured in legal claims in case of default of broker. Strong approval systems for execution of trades are viewed as a positive while prudent steps taken by brokers beyond the rules and regulations are also noted.

In the brokering industry, accurate and timely information is of paramount importance to the investor which is why well-timed execution of orders is an important factor for broker effectiveness. A resilient IT system is the hallmark to fulfill trade orders in a timely manner and primarily dependent on the processes, practices and systems in place to ensure minimal risk to the investor as well as the intermediary. System audit plays a significant role in providing third party opinion on the strength and limitations of the support infrastructure in place.

The development of an operational business infrastructure which supports defined policies and procedures as well as displays scalability for expansion is viewed favorably. A poor infrastructure is likely to compromise on customer service and overall risk management. VIS evaluates the integrity and strength of the Information Technology (IT) systems in place which ensures smooth running of operations on a day to day basis. Disaster Recovery Plans should also be in place in order to safeguard investor's interest and assure continuity of business. BMR places emphasis on the versatility of the IT system in timely identifying and blocking the individual and total exposure limits along with sending early warning signals for limit breaches.

### 6. Compliance and Risk Management

Broad parameters of risk factors include price, credit/counter party risk and operational risk. Market risk becomes important if brokers carry out proprietary trading. Controls are also needed to prevent an intermixing of incentives to manage the firm's own book vis-à-vis client trades.

VIS reviews the risk management guidelines, which have been developed by the company and the extent of any deviation from these guidelines. These would, as a minimum, include guidance regarding the total level of exposure taken on clients in aggregate in relation to the brokers' own assets, maximum exposure taken on any client and their assessment procedure being followed, quality of collateral, time allowed to offload stock purchased on behalf of client and margin cover maintained. Strong internal controls to mitigate operational risks which include errors in trading and investment, fraud and embezzlement should also be in place. Risk management needs to be a continuous process in the firm and the tools utilized need to be robust enough to adapt to the changing needs of the company and its environment. VIS positively views a level of stringency which is over and above the regulatory requirements.

VIS looks at the institutionalization of the risk management function with the perspective of independence and the quality of expertise and resources employed within the institution.

The effective compliance function monitors the adherence to internal control guidelines and regularly reports the deviations therein to management; these are assessed from the frequency and quality of compliance reporting. The extent of regulatory concerns expressed or adjudicated by the regulator are among the strong indicators of the strength of compliance function. The strength of compliance function is also assessed through observations in the inspection reports of regulators and the timeliness of filing of mandatory returns.

### 7. Financial Management

Both trend line and industry comparison is conducted to determine the relative financial standing of the firm. Revenue and cost streams are broken down into separate business/product lines and contribution from different customer categories. A diversified revenue stream as well as customer granularity adds to the financial strength of the firm. The quality of the firm's own portfolio earnings and income from client dealings are taken into consideration. An important comparison here is the percentage of brokerage earned to the gross value of the shares traded. Generally, revenue from brokerage, fee and commission are considered as core income of the company which should be able to cover the key operating expenses.

Efficient and prudent utilization of leverage is also a key driving factor in BMR determination. VIS also assesses the financial flexibility of the firm which includes the ability to rationalize costs in times of sluggish market conditions.

Larger companies would be able to fare better in developing economies of scale.

The stock markets have established a capital requirement for their TREC-holders and have also imposed allowable trading limits in relation to their capital. Whereas this sets the minimum requirement of capitalization, a view is developed for the adequacy of the same relative to the level of risk assumed by the company's business lines. Composition of funding lines, maturity, diversity and cost are also taken into consideration while future funding needs are identified. Analysis of liquidity would include firm's ability to liquidate investment portfolio in a short span, raise borrowings or un-utilized lines and cover repayment of liabilities.

### **BMR SCALE & VALIDITY**

VIS BMR Scale extends from BMR1A to BMR5. BMR1A may be assigned to institutions with strong operational platform and having diversified international reach (or foreign presence) on account of being market leaders in terms of adopting global corporate governance best practices. BMR 5 is assigned to institutions with weak regulatory compliance levels and financial management. The details of BMR Scale and definitions of each grade are provided on the next page. The grade assigned to a brokerage firm will be valid till such time as withdrawn and is reviewed generally on an annual basis. VIS may at any time deem necessary to change the rating assigned to the firm depending on changes to corporate practices affecting the governance profile of the institution

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**RATING SCALE & DEFINITIONS: BROKER MANAGEMENT RATING**
**BMR1A**

Excellent regulatory compliance, control environment, and financial management; governance and risk management frameworks are extremely effective; HR, IT, and customer services are strongly proactive.

**BMR3++, BMR3+, BMR3**

Adequate regulatory compliance, control environment, and financial management; governance and risk management frameworks are satisfactory; HR, IT, and customer services are adequate.

**BMR1++, BMR1+, BMR1**

Strong regulatory compliance, control environment, and financial management; governance and risk management frameworks are highly effective; HR, IT, and customer services are highly proactive.

**BMR4++, BMR4+, BMR4**

Inadequate regulatory compliance, control environment, and financial management; governance and risk management frameworks need improvements; HR, IT, and customer services are insufficient.

**BMR2++, BMR2+, BMR2**

Sound regulatory compliance, control environment, and financial management; governance and risk management frameworks are effective; HR, IT, and customer services are proactive.

**BMR5**

Weak regulatory compliance and business practices

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**Rating Outlooks:**

The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details. [www.vis.com.pk/images/criteria\\_outlook.pdf](http://www.vis.com.pk/images/criteria_outlook.pdf)



### **Faheem Ahmad**

*President & CEO, VIS Credit Rating Company Limited  
Founder, VIS Group  
Chairman, Association of Credit Rating Agencies in Asia*

Mr. Ahmad possesses 30+ years experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters Degrees in Engineering and Business Administration from USA.



### **Javed A. Callea**

*Advisor*

Mr. Callea is a professional in the financial sector with over 35 years of experience mostly in the financial institutions with certain exposure to service and infrastructure sectors in Pakistan. He has held the position of Chief Executive of a leasing company for 10 years. His core areas of expertise cover leasing, development financing, project management, investment & merchant banking, strategic investment management and real estate. Major financial institutions he worked for include Pakistan Industrial Credit and Investment Corporation, State Life Insurance Corporation, Bankers Equity, Crescent Leasing Corporation and Saudi Pak Ind. & Agri. Inv. Company. He has also served as Member Finance of Water & Power Development Authority of Pakistan and as member of the Inquiry committee on stock exchange crises in 2000 commissioned by the SECP. He earned his MBA degree from the Institute of Business Administration in 1974.



### **Muhammad Tabish**

*Assistant Manager*

Mr. Muhammad Tabish has been associated with VIS since July 2017. During the course of his career, he has been involved with rating assignments in a broad range of sectors including industrial corporates, banking, asset management, brokerage and insurance. He covered eight sector and an economy update in a period of three years. Mr. Tabish holds an undergraduate degree in Accounting & Finance from Institute of Business Administration (IBA) Karachi. He is currently pursuing MBA from IBA.

Jahangir Kothari Parade (Lady LLOYD Pier)

Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose generosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

*Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.*

*Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.*



Jahangir Kothari Parade

## National Excellence, International Reach

VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, VIS is positioned to aim for an international mark. In this regard, the global experience of our principal, Japan Credit Rating Agency, Ltd. has been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors.

The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, VIS continues its endeavor to remain an emblem of trust.

# VIS Credit Rating Company Limited

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