

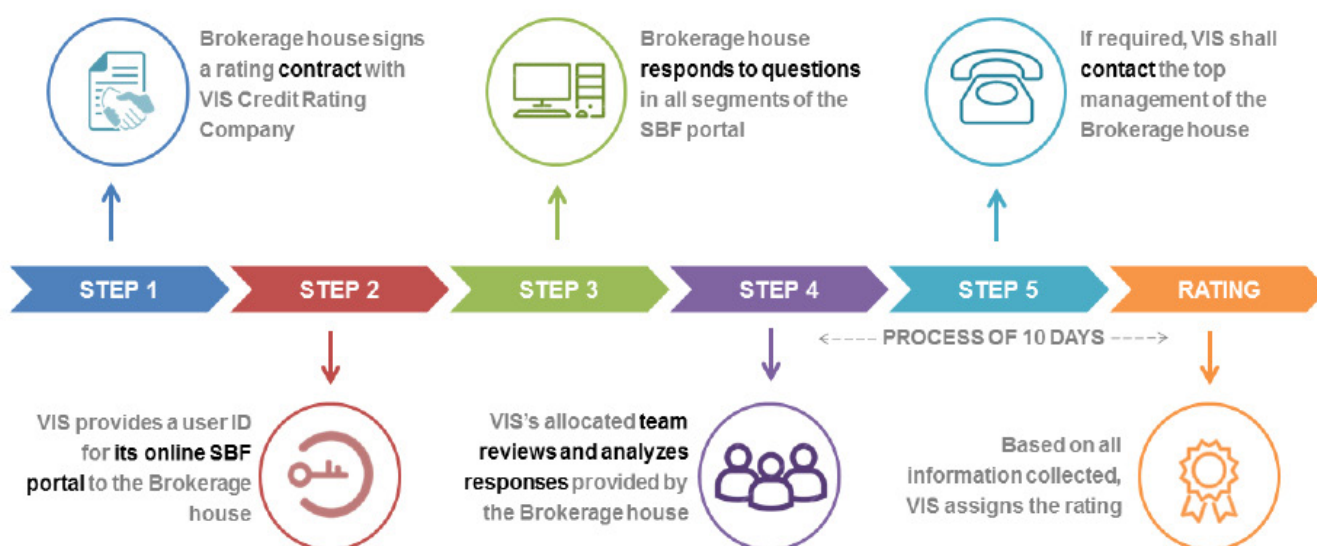
VIS RATING METHODOLOGY

SECURITIES BROKER FIDUCIARY

Securities Broker Firms (SB) play a critical intermediary role in the capital markets for individuals as well as institutional investors by facilitating the trading of listed securities and fixed income debt instruments. Generally, SBs serve the basic function of distributing and trading financial instruments for customers, financing customer positions, and providing advisory and underwriting services. The assessment of the fiduciary role of a SB in the equities and fixed income securities trading process is very important as in this capacity a SB is responsible for managing the client's assets for the benefit of the client, rather than for SB's own profit.

In Securities Broker Fiduciary Rating (SBF), the strength of fiduciary role of the securities brokers is captured through the relative financial strength of the securities broker firm and its sponsors along with depth of internal control and governance framework, which are key rating ingredients. Responsiveness of the risk and internal control structure, quality of HR and soundness of the business infrastructure determine the strength of management and level of service quality of a SB. VIS Credit Rating Co. Ltd. (VIS) has developed a rating system that evaluates brokerage firms on the basis of such practices and the systems instituted to safeguard investor interests are at the forefront.

The methodology for SBF developed by VIS is unique in the sense that it utilizes a comprehensive, client friendly interactive web based portal to capture client information and responses and then assimilates them into a rating. The process is supported at the back-end by rating staff who review the information online and interact with the client to complete the assignment of the respective SB.



THE SBF 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 the Securities and Exchange Commission of Pakistan (SECP) which has established rules to regulate the brokers and listed companies. The SECP and PSX have imposed strict restrictions on securities 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 also utilizes the findings of these in its assessment for this SBF methodology.

To assess the quality of operations of a brokerage firm, various factors are examined and analyzed. While the table below summarizes the individual factors and related parameters considered critical, the SBF is not limited to these factors alone.

1	Ownership and Governance	Sponsors financial strength, depth of corporate structure and implementation of governance principles from risk and regulatory perspective.
2	Business and Financial Stability	Strength of capitalization, core revenue contribution and growth. Prudence in risk limits for business lines and leveraging. Sound asset quality with sustained profitability and robust liquidity. Recognized franchise value in market sphere.
3	Management and Client Services	Well documented and defined business process flow focused on transparency and free of any conflict of interest. Responsive and interactive client management systems managed by professionally competitive personnel.
4	Control Framework and Regulatory Compliance	Robust internal control systems dovetailed with business process flows to ensure timely adherence to internal policy frameworks and regulatory compliances.

INDIVIDUAL RISK FACTORS AND ASSESSMENT

1. Ownership and Governance

Brokerage firms operate in a highly competitive industry in which trading activities can be greatly impacted by the prevailing economic environment and cycles. VIS rating objective for a securities brokerage firm is to assess likelihood of the company being able to provide professional advisory and transactional services to its clients in a conflict free environment with utmost safe custody of client assets and make timely payment against its obligations. For this purpose, the assessment of the financial strength of the sponsors of the company is undertaken to determine the adequacy of resources with the volume of risk being undertaken. Corporate Governance standards and their evaluation is undertaken to ensure that the organization fairly protects the interest of all stakeholders. To evaluate these governance standards, VIS evaluates the composition of the board, its experience and its level of oversight. Presence of independent directors is considered positively. VIS also places significant emphasis on the governance, procedures, systems and level of controls in place to arrive at a view on the extent to which a securities firm is being able to discharge its fiduciary responsibilities.

A view on the corporate structure is developed also includes the franchise and reputation of the promoters besides just their financial strength.

2. Business and Financial Stability

- **Capitalization, Debt and Liquidity**

PSX has established capital requirements for TREC-holders and have also imposed allowable trade limits in relation to capital which establishes the maximum trading activity that can be undertaken by a SB. This, in addition to the risk arising from other lines of business undertaken by a company, will be evaluated to determine the adequacy of capitalization and the extent of its leveraging. While credit, liquidity, concentration and market risks may be apparent from the company's financial statements, judgment is required on the level of operational risks, litigation and reputational risks involved in the business being undertaken. Composition of funding sources, maturity profile, and diversity is also taken into consideration, while future funding needs and sources are also identified. Analysis of liquidity would include the company's ability to liquidate its investment portfolio in a short span, raise borrowings/avail un-utilized credit lines and cover repayment of liabilities.

- **Profitability**

Both trend analysis and industry comparison is conducted to determine the relative financial performance of the company. Revenue and cost structures are broken down into the separate business/product lines and contribution from different categories of customers. The quality of the company's own investment portfolio, return from proprietary trading, and income from client dealing and any other stable sources of income are taken into consideration. Across time and industry comparison determine how well a SB has been able to manage its risk relative to other players.

Performance measures would include the pre-tax return on funds employed, volatility in revenues, efficiency and any over/under-performance relative to the broader market and the reason for such results. Performance is also evaluated relative to projections and reasons for deviations are explored.

VIS assesses the financial flexibility of any company in managing its costs. The ability of the company to rationalize costs in times of sluggish market conditions and spread fixed costs over a larger volume is critical. Coverage of fixed and variable components of cost on an ongoing basis from core earnings also reflects upon the financial flexibility. Costs per transaction would help indicate the flexibility in pricing available to the company. Larger companies are expected to fare well on the back of economies of scale.

3. Management & Client Services

- **Human Resources**

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.

- **Client Services**

An important factor for broker effectiveness is the well-timed execution of orders. A resilient IT system is, therefore, 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. SBF 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.

With stock brokers being customer oriented service providers, the quality of the same 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.

4. Control Framework & Regulatory Compliance

- **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 the clients and ensuring the confidentiality in their trades. Internal control also oversees that policies and manuals for various operational areas are available and updated at approved frequencies and also that their approvals are obtained from authorized levels in the organization.

VIS also 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.

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.

- **Regulatory Compliance**

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.

VIS reviews the regulatory framework applicable to the securities firms and changes thereto from time to time to arrive at a view on the level of protection afforded to market participants and the risk which may be assumed by a securities firm. In its rating exercise, VIS also reviews the mandatory information submitted to the regulators at periodic intervals.

SBF VALIDITY

The rating assigned to a security 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.

RATING SCALE & DEFINITIONS: SECURITIES BROKER FIDUCIARY RATING**BFR1**

Outstanding fiduciary standards

BFR4++, BFR4+, BFR4

Adequate fiduciary standards

BFR2++, BFR2+, BFR2

Strong fiduciary standards

BFR5++, BFR5+, BFR5

Weak fiduciary standards

BFR3++, BFR3+, BFR3

Good fiduciary standards

Rating Outlooks:

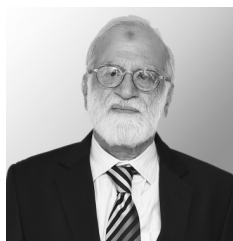
The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details. https://docs.vis.com.pk/docs/criteria_outlook.pdf



Faheem Ahmad

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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.

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.

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