VIS

Credit Rating Company Limited

CORPORATE GOVERNANCE RATINGS

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SCOPE OF CRITERIA

VIS has recently reviewed its methodology for Corporate Governance Rating (CGR) to align it with the latest developments in this area. While core aspects of the VIS-CGR methodology remain unchanged, assessment of Environmental, Social and Governance (ESG) aspects have been included in determination of Corporate Governance Ratings of companies across the board. Prior to explaining the VIS methodology a brief background on evolution of corporate governance will be helpful in understanding its importance and the rationale behind VIS methodology.

The term 'corporate governance' covers a broad spectrum of activities of the Board of Directors (BoD) and the management of an organization. The Organization for Economic Co-operation and Development (OECD) has defined corporate governance as:

'…the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders and spells out rules and procedures for making decisions on corporate affairs.'

Till very recently the area of corporate governance was considered the sole jurisdiction of the BoD and the management of the organization in the belief that all the decisions made by them would be in the interest of the organization and hence all the shareholders. However, there is a flaw in this assumption, which results from the 'agency concept'. This concept is a direct outcome of the development of limited liability companies with a large number of shareholders. These shareholders elect some of their own number to the BoD, which is responsible for formulating policies and strategies and monitoring implementation of the same. For reasons of practicality, only a very small fraction of shareholders can actually be on the BoD. The BoD in turn appoints a professional management to run the organization on a day to day basis. This state of affairs means that the actual owners of the company, i.e. the shareholders, actually have very little say in running of an organization on an ongoing basis. Since the basic qualification for membership of the BoD is the shareholding rather than professional expertise, the BoD can become dependent on the management for guidance particularly relating to the more technical aspects of the business.

The realization of this problem emerged in the early 1990s in the United Kingdom following a string of high profile corporate failures including the Bank of Credit and Commerce International (BCCI), Maxwell Communication Corporation, Ferranti International PLC, Colorol Group and Pollypeck International PLC among others. The general feeling was that these failures were generally caused by weak corporate internal systems, inadequate BoD supervision over management and excessive centralization of policy making powers in the hands of a small number of executives. In response to this outcry the Government of the United Kingdom in 1991 appointed the Cadbury Committee, which was headed by leading British industrialist Sir Adrian Cadbury, to '… address the financial aspects of corporate governance.' This was probably the first time that a formal linkage was made between corporate governance and the financial performance of a company.

Two key recommendations of the Cadbury Committee, laid out in 'The Code of Best Practice', were that every BoD should include three independent non-executive directors and that the offices of Chief Executive and Chairman of BoD should not be held by the same person simultaneously. Other recommendations of the Cadbury Committee included disclosure of the remuneration of the chairman and the highest paid director, approval by shareholders of contracts of executive directors which were in excess of three years in length, pay of executive directors be determined by a subcommittee of the BoD comprising primarily of independent directors. Also, the Cadbury Committee recommended another sub-committee of similar composition be constituted to report on the internal control and risk management systems of the company. The reasoning behind these recommendations is obvious. In any organization in which these recommendations were not being implemented, the defining line between supervisors (i.e. the BoD) and the supervised (i.e. the management) becomes blurred, diluting effective corporate governance. It is important to note that the 'The Code of Best Practice' has not been made part of UK corporate law and hence compliance is only voluntary. However, some strength is derived from the fact that the London Stock Exchange requires all listed companies to state whether they are in compliance with the code and if not, provide explanations for the deviations. This quasi-regulatory pressure to enforce the code has borne fruit with a vast majority of listed companies falling in line with the provisions of the code.

Proper reporting of financial statements is as important a part of good corporate governance as proper for BoD structure and its performance. In 1998 the Chairman of the Securities & Exchange Commission of the USA, A. Levitt, stated:

'Qualified committed, independent and tough minded audit committees represent the most reliable guardians of the public interest'.

With Levitt's encouragement, the NASDAQ and NYSE formed the Blue Ribbon Committee (BRC). The mandate of the BRC was to develop a set of recommendations designed to control misstatements in financial reporting through ensuring that audit committees play their due role as financial watchdogs. The BRC's report addressed areas such as audit committee independence, size, number of meetings, financial statement literacy of the committee members and communications with the external auditors. Certain recommendations of the BRC have subsequently been adopted by the regulators in the USA.

Following these two ground breaking efforts, the understanding of the importance of corporate governance has taken an impetus on its own, resulting in acceleration in efforts worldwide to tighten external monitoring of corporate governance. But, as with all new corporate concepts, corporate governance is an evolving field. The Enron disaster, back in 2001, also highlighted the significance of good corporate governance practices in safeguarding interests of the shareholders and other financial stakeholders.

THE PAKISTAN CONTEXT

Corporate governance has been given increasing attention in Pakistan also, with both the Securities & Exchange Commission of Pakistan (SECP) and the State Bank of Pakistan (SBP) showing keen interest in improving the quality of corporate governance in the institutions under their respective jurisdictions. As in the West, this understanding of the importance of corporate governance developed when post-mortems of several failed and sick institutions revealed that the problems faced by them were almost entirely due to poor corporate governance rather than business failures. For example all the high profile bank failures in Pakistan largely occurred due to factors that could have been avoided had strong corporate governance procedures were in place. On the industry side also there has been a realization that the regulators have to adopt means to protect the interests of the minority shareholders and ensure that the Board of Directors plays its due role as the representative of the shareholders in formulation of policies and supervising the performance of management.

The SECP has addressed the Corporate Governance comprehensively and has issued Corporate Governance Framework for designated classes of companies including listed companies, public sector companies, and insurance companies for mandatory compliance. The Corporate Governance Framework is a combination of a cross section of provisions, which cover almost the entire spectrum of issues that need to be addressed to create a proper environment for corporate governance. Besides, corporate governance principles for non-listed companies have been issued for guidance and voluntary compliance, a monitoring mechanism for each ensures compliance.

The State Bank of Pakistan has also implemented a CORPORATE GOVERNANCE REGULATORY FRAMEWORK for the financial institutions regulated by it. This comprehensive framework aims to consolidate the corporate governance instructions, align corporate governance with international and local best practices, laws, rules and regulations. SBP also requires all Banks/DFIs would also follow the code of corporate governance for listed companies issued by the SECP to the extent they are not in conflict with the SBP stipulations.

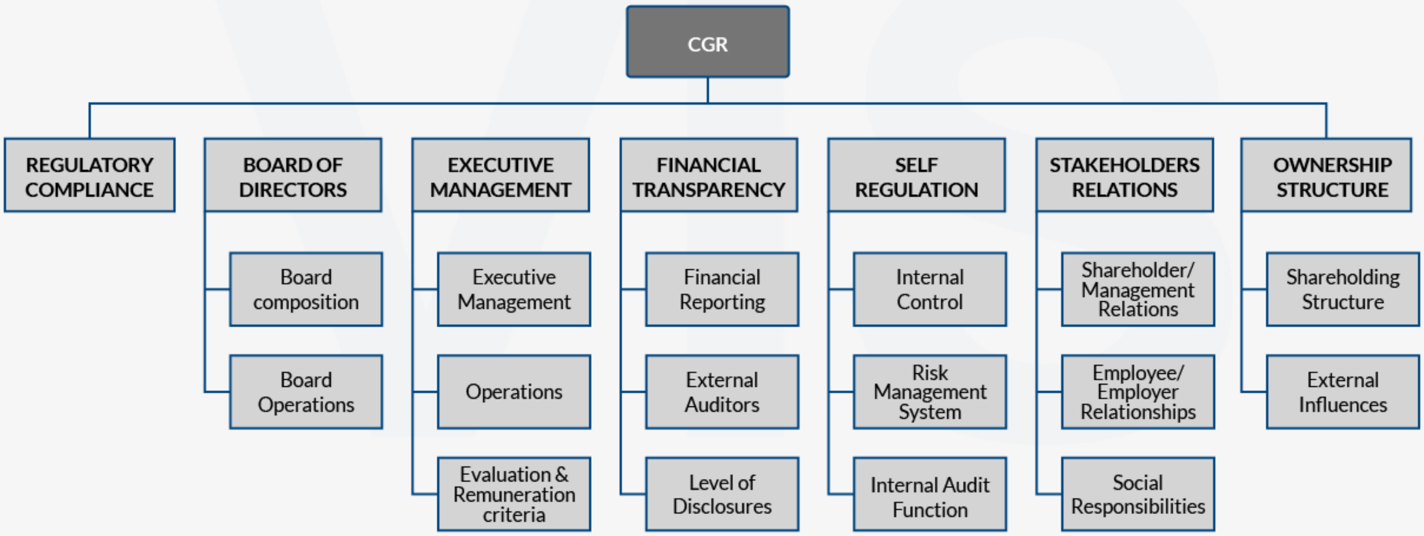
The preparation of such a Framework in a developing economy like Pakistan's is indeed a commendable effort by the Regulators and, if properly implemented, will go a long way in restoring investor confidence in the economy.

CORPORATE GOVERNANCE RATINGS (CGRS)

Corporate governance comprises the framework of rules, relationships, systems and processes within and by which fiduciary authority is exercised and controlled in institutions. Ratings of corporate governance provide a third party opinion on the corporate governance practices of an institution. Corporate governance ratings require a comprehensive knowledge of all relevant legal and regulatory issues as well as an in depth study of the corporate governance practices of individual institutions and matching these against global 'best practices'. Credit rating agencies are uniquely placed to carry out this function, as the assessment of management is by far the most important qualitative aspect examined while assigning a credit rating. These agencies also have good understanding of the regulatory framework existing in the environment in which the entity being rated operates and the various kind of risks the financial stakeholders are exposed to. Consequently, they are in an ideal position to determine whether the corporate governance practices of an institution are in consonance with the best interests of its financial stakeholders.

VIS believes that in the long run, companies will only be able to access long-term capital if their potential stakeholders are convinced that their interests will be looked after by the management. Investor confidence in corporate governance practices can be enhanced through the use of a third-party opinion.

While carrying out CGRs, VIS aims to determine to what extent the corporate governance practices put in place by management help in achieving the ultimate goals of transparency, accountability and fair play. The following are the key areas VIS examines while assigning a CGR:



Incorporating ESG factors, the VIS Corporate Governance Ratings also reflect how entity's exposure to and management of environmental, social, and governance (ESG) risk factors may affect its long-term sustainability and long-term competitiveness. In addition to evaluation of a company on key Environmental and Social risk factors, VIS ESG Ratings for Corporate Governance take into consideration company's management measures relative to their aggregate ESG risks and opportunities. Management measures are generally evaluated through companies' governance structures, policies and targets, quantitative performance metrics, and relevant controversies. Detailed "ESG CORPORATE GOVERNANCE RATING METHODOLOGY", is available at our website on the following link, https://docs.vis.com.pk/docs/ESGRatingMethodology.pdf

RATING SCALE & DEFINITIONS

Rating Scale and Definitions may be accessed at (https://docs.vis.com.pk/docs/VISRatingScales.pdf).

Faheem Ahmad

President & CEO, VIS Credit Rating Company Limited
Founder, VIS Group Chairman,
Vice-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 - Member

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.

Syed Asif Ali

Executive Director - Ratings

Mr. Ali is a professional banker having more than thirty years of experience mainly in risk management, project finance, project management and credit management. He has worked in leadership positions in local as well as international financial institutions and commercial banks. He obtained his B.S degree in Mechanical Engineering from NED University of Engineering and Technology, Karachi. He also holds Masters Degrees in Business Administration from the Institute of Business Administration, Karachi and Management from USA.

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 genrosity 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.

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 internation al mark. In this regard, the global experience of our international affiliates and partners have 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 i nvestors. 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 endeavour to remain an emblem of trust.

INTERNATIONAL

Affiliates

Islamic International Rating Agency – **Bahrain –** iira.com
Credit Rating Information & Services Ltd. – **Bangladesh –** crislbd.com

Collaborations

Japan Credit Rating Agency, Ltd. - **Japan**
China Chengxin International Credit Rating Company Limited - **China**

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